mp banki

# Consolidated Financial Statements
# 31 December 2013

MP banki hf. • Ármúli 13a • 108 Reykjavík • Iceland • Reg. no. 540502-2930

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# Endorsement and Statement
## by the Board of Directors and the CEO

The Consolidated Financial Statements of MP banki hf. for the year 2013 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, and additional Icelandic disclosure requirements. The Consolidated Financial Statements comprise MP banki hf. and its subsidiaries.

According to the Consolidated Income Statement, loss in 2013 amounted to ISK 477 million. According to the Consolidated Statement of Financial Position, the Group's equity at the end of the year 2013 amounted to ISK 5,037 million. As at 31 December 2013, the Group's total assets amounted to ISK 60,509 million. The Capital Adequacy Ratio (Tier 1) of the Group was 14.2% but the minimum requirement by law is 8.0%.

The Bank's issued share capital amounted to ISK 5,854 million as at 31 December 2013 (2012: ISK 5,554 million). At year-end the Bank held treasury shares with a nominal value of ISK 4 million (2012: ISK 4 million). The Bank's share capital was increased by nominal value of ISK 300 million in 2013.

The Bank had 49 shareholders at year-end (2012: 49), none of which held more than 10% of shares in the Bank (2012: 1). Further information about the shareholders of the Bank is provided in note 67.

The Bank's Board of Directors propose that no dividend will be paid in the year 2013 on 2012 operations.

**Revised growth plan**

Since new shareholders joined the Bank in 2011 its operations have been fast growing. The emphasis has been on both internal and external growth. In the year 2012 the loan portfolio grew by over 100% in one year and total assets increased by ISK 19 billion. The Bank ventured into Asset Finance and there was internal growth in other operations such as Trading, Asset Management and Corporate Finance.

In the beginning of 2013 the Bank started out with a continued growth plan based on further strengthening of the share capital base. Later in the year it became evident that the share capital increase would not materialize. The original plans for balance sheet growth have therefore been revised and the Bank has already implemented several measures to adjust the cost base, balance sheet and scope of operations to the revised plans.

In October 2013 the Bank announced organizational changes which included consolidation of all lending activities under one Banking division. The Bank closed its branch at Borgartún 26 and sold its minority share in GAM Management. As part of the revised plan the Bank also initiated sale of its Asset Finance business (Lykill) which was later concluded in March 2014, see in note 68.

Despite currently reduced capacity for balance sheet growth the Bank has ample resources for further growth of its asset management businesses and continued leadership in investment banking.

At year end 2013 the Bank's capital and liquidity ratios are strong. The quality of the loan portfolio is very high with default rates at lowest levels so far. The foundations are strong for building a quality bank with a carefully structured balance sheet and clear focus on the Bank’s core competencies in asset management, capital markets and specialized banking.

**Corporate Governance**

The Board of Directors emphasizes good corporate governance and following accepted guidelines on corporate governance. The Board has laid down comprehensive rules in which the authority of the Board is defined and its scope of work in conjunction with the CEO. They cover e.g. order at meetings, competence of Board members to participate in individual decisions, confidentiality and information disclosure between the CEO and the Board. Majority of Board members are independent of the Bank and there are no executive directors on the Board.

The Board determines compensation for the CEO. The Board of Directors has delegated certain tasks to two subcommittees, the Remuneration Committee and the Audit Committee. Each committee has three members appointed by the Board, the majority of which is independent of the Bank.

# Endorsement and Statement
## by the Board of Directors and the CEO

**Statement by the Board of Directors and the CEO**

To the best of our knowledge the Consolidated Financial Statements of MP banki hf. for the year 2013 comply with International Financial Reporting Standards as adopted by the EU, and give a true and fair view of the Group's assets, liabilities and financial position as at 31 December 2013 and the financial performance of the Group and changes of cash flows for the year 2013.

Further, in our opinion the Consolidated Financial Statements and the Endorsement of the Board of Directors and the CEO gives a fair view of the development and performance of the Group's operations and its position and describes the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO of the Bank have today discussed the Consolidated Financial Statements for the year 2013, and confirm them by the means of their signatures.

Reykjavík, 27 March 2014.

Board of Directors

CEO

# Independent Auditor's Report

**To the Board of Directors and Shareholders of MP banki hf.**

We have audited the accompanying consolidated financial statements of MP Bank hf., which comprise the consolidated statement of financial position as at 31 December 2013, and the consolidated statements of comprehensive income, changes in equity and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

**Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards as adopted by the EU, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 2013, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

**Report on the Board of Directors report**

Pursuant to the legal requirement under Article 104, Paragraph 2 of the Icelandic Financial Statement Act No. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the financial statements includes the information required by the Financial Statement Act if not disclosed elsewhere in the Financial Statements.

Reykjavík, 27 March 2014.

KPMG ehf.

Sigurður Jónsson

Hrafnhildur Helgadóttir

MP banki hf. Amounts are in ISK thousands

# Consolidated Income Statement
## For the year 2013

| | Notes | 2013 | 2012 |
|---|---|---|---|
| Interest income | | 3,644,118 | 3,495,332 |
| Interest expense | | (2,160,603) | (1,779,213) |
| **Net interest income** | 3 | 1,483,515 | 1,716,119 |
| Fee and commission income | 4 | 1,847,843 | 1,505,321 |
| Fee and commission expense | | (93,342) | (110,263) |
| **Net fee and commission income** | | 1,754,501 | 1,395,058 |
| Net financial income | 5-6 | 275,383 | 637,035 |
| Share in profit of associates, net of income tax | 22 | (3,715) | 217,482 |
| Other operating income | | 94,871 | 28,873 |
| **Other operating income** | | 366,538 | 883,390 |
| **Net operating income** | | 3,604,554 | 3,994,567 |
| Administrative expenses | 7-10 | (3,648,863) | (3,128,166) |
| Impairment of loans and receivables | 19 | 46,834 | (670,962) |
| Impairment of intangible assets | 23-24 | (771,930) | 0 |
| Profit (loss) from assets held for sale | 28, 96 | 9,927 | (10,989) |
| **(Loss) profit before taxes** | | (759,478) | 184,451 |
| Income tax | 11 | 302,948 | 148,413 |
| Special tax on financial institutions | 12 | (20,413) | (81,516) |
| **(Loss) profit for the year** | | (476,943) | 251,348 |

| | Notes | 2013 | 2012 |
|---|---|---|---|
| Attributable to the shareholders of MP banki hf. | | (486,220) | 255,500 |
| Attributable to non-controlling interest | 21 | 9,276 | (4,153) |
| **(Loss) profit for the year** | | (476,943) | 251,348 |

*The notes on pages 9 to 53 are an integral part of these Consolidated Financial Statements.*

MP banki hf. Amounts are in ISK thousands

# Consolidated Statement of Comprehensive Income
## For the year 2013

| | Notes | 2013 | 2012 |
|---|---|---|---|
| **(Loss) profit for the year** | | (476,943) | 251,348 |
| | | | |
| Fair value changes of securities classified as available for sale | | (24,742) | (121,707) |
| Exchange difference on translation of foreign operations | | 10,709 | 2,549 |
| **Other comprehensive income, net of tax** | | (14,032) | (119,158) |
| | | | |
| **Total comprehensive (loss) income for the year** | | (490,975) | 132,189 |

| | Notes | 2013 | 2012 |
|---|---|---|---|
| Attributable to the shareholders of MP Bank hf. | | (500,252) | 136,342 |
| Attributable to non-controlling interest | | 9,276 | (4,153) |
| **Total comprehensive (loss) income for the year** | | (490,975) | 132,189 |

*The notes on pages 9 to 53 are an integral part of these Consolidated Financial Statements.*

MP banki hf. Amounts are in ISK thousands

# Consolidated Statement of Financial Position
## As at 31 December 2013

| Assets | Notes | 2013 | 2012 |
|---|---|---|---|
| Cash and cash equivalents | 14 | 17,795,993 | 20,405,530 |
| Receivables from Central Bank of Iceland | | 4,510,503 | 3,287,741 |
| Fixed income securities | 15 | 4,284,835 | 5,105,066 |
| Shares and other variable income securities | 16 | 953,747 | 1,243,133 |
| Securities used for hedging | 17 | 2,853,272 | 6,807,792 |
| Loans to customers | 18-19 | 27,242,120 | 27,789,290 |
| Derivatives | 20 | 504,341 | 312,795 |
| Investment in associates | 22 | 309,021 | 560,825 |
| Intangible assets | 23-24 | 305,028 | 1,103,829 |
| Property and equipment | 25 | 99,465 | 738,099 |
| Deferred tax asset | 26 | 613,777 | 292,288 |
| Other assets | 27 | 731,371 | 646,485 |
| Assets classified as held for sale | 28 | 305,390 | 1,100,000 |
| **Total assets** | | 60,508,862 | 69,392,873 |

| Liabilities | Notes | 2013 | 2012 |
|---|---|---|---|
| Deposits | 29 | 35,229,708 | 42,402,442 |
| Deposits from credit institutions | 30 | 2,346,121 | 3,515,054 |
| Borrowings | 31 | 8,327,416 | 6,575,208 |
| Short positions used for trading | 32 | 4,492,682 | 5,961,847 |
| Short positions used for hedging | 33 | 3,174,046 | 2,024,604 |
| Derivatives | 20 | 184,109 | 221,518 |
| Current tax liabilities | 26 | 20,045 | 3,180 |
| Deferred tax liabilities | 26 | 334 | 180 |
| Other liabilities | 34 | 1,697,634 | 2,644,220 |
| Liabilities associated with assets classified as held for sale | 28 | 0 | 795,000 |
| **Total liabilities** | | 55,472,095 | 64,143,251 |

| Equity | Notes | 2013 | 2012 |
|---|---|---|---|
| Share capital | 35 | 5,850,000 | 5,550,000 |
| Share premium | | 8,088 | 7,500 |
| Option reserve | 64 | 2,388 | 518 |
| Other reserves | | 28,261 | 41,890 |
| Accumulated deficit | | (857,244) | (346,283) |
| **Total equity attributable to the shareholders of MP banki hf.** | | 5,031,493 | 5,253,625 |
| Non-controlling interest | | 5,274 | (4,003) |
| **Total equity** | | 5,036,767 | 5,249,622 |
| **Total liabilities and equity** | | 60,508,862 | 69,392,873 |

*The notes on pages 9 to 53 are an integral part of these Consolidated Financial Statements.*

MP banki hf. Amounts are in ISK thousands

# Consolidated Statement of Changes in Equity

## For the year 2013

| 1 January 2013 to 31 December 2013 | Notes | Share capital | Share premium | Option reserve | Other reserves | Accumulated deficit | Total shareholders' equity | Non-controlling interest | Total equity |
|---|---|---|---|---|---|---|---|---|---|
| Equity as at 1 January 2013 | | 5,550,000 | 7,500 | 518 | 41,890 | (346,283) | 5,253,625 | (4,003) | 5,249,622 |
| Total comprehensive loss for the year | | | | | 10,709 | (510,961) | (500,252) | 9,276 | (490,975) |
| New share capital sold | 35 | 300,000 | | | | | 300,000 | | 300,000 |
| Treasury shares acquired | 35 | (25,000) | 1,250 | | | | (23,750) | | (23,750) |
| Equity instrument related to ALFA verðbréf hf. acquisition converted to equity | 35 | 25,000 | (662) | | (24,338) | | 0 | | 0 |
| Share-based payment transactions | 64 | | | 1,870 | | | 1,870 | | 1,870 |
| **Equity as at 31 December 2013** | | 5,850,000 | 8,088 | 2,388 | 28,261 | (857,244) | 5,031,493 | 5,274 | 5,036,767 |

| 1 January 2012 to 31 December 2012 | Notes | Share capital | Share premium | Option reserve | Other reserves | Accumulated deficit | Total shareholders' equity | Non-controlling interest | Total equity |
|---|---|---|---|---|---|---|---|---|---|
| Equity as at 1 January 2012 | | 5,550,000 | 7,500 | | (8,478) | (480,076) | 5,068,945 | 9 | 5,068,954 |
| Total comprehensive income for the year | | | | | 2,549 | 133,793 | 136,342 | (4,153) | 132,189 |
| Acquisition of non-controlling interest | | | | | | | 0 | 141 | 141 |
| Equity instrument related to ALFA verðbréf hf. acquisition | | | | | 47,819 | | 47,819 | | 47,819 |
| Share-based payment transactions | 64 | | | 518 | | | 518 | | 518 |
| **Equity as at 31 December 2012** | | 5,550,000 | 7,500 | 518 | 41,890 | (346,283) | 5,253,625 | (4,003) | 5,249,622 |

*The notes on pages 9 to 53 are an integral part of these Consolidated Financial Statements.*

MP banki hf. Amounts are in ISK thousands

# Consolidated Statement of Cash Flows
## For the year 2013

| Cash flows from operating activities | Notes | 2013 | 2012 |
|---|---|---|---|
| (Loss) profit for the year | | (476,943) | 251,348 |
| Adjustments for: | | | |
| Indexation and exchange rate difference | | (67,018) | 231,607 |
| Share in profit of associates, net of income tax | 22 | 3,715 | (217,482) |
| Depreciation and amortisation | 23-25 | 124,253 | 119,125 |
| Net interest income | 3 | (1,483,515) | (1,716,119) |
| Impairment of loans and receivables | 19 | (46,834) | 670,962 |
| Impairment of intangible assets | 23-24 | 771,930 | 0 |
| Income tax | 11 | (302,948) | (148,413) |
| Special tax on financial institutions | 12 | 20,413 | 81,516 |
| Other adjustments | | (57,713) | 23,431 |
| | | (1,514,660) | (704,026) |
| Changes in: | | | |
| Receivables from Central Bank of Iceland | | (1,222,761) | (3,287,741) |
| Securities | | 4,924,738 | 9,390,886 |
| Loans to customers | | 521,013 | (14,989,996) |
| Derivatives - assets | | (191,545) | (113,224) |
| Other financial assets | | (24,742) | (121,707) |
| Deposits | | (6,645,275) | 7,283,641 |
| Deposits from credit institutions | | (1,168,933) | 3,515,054 |
| Short positions | | (319,723) | 1,873,259 |
| Derivatives - liabilities | | (37,409) | 120,020 |
| Other financial liabilities | | (24,338) | 47,819 |
| Other assets and liabilities | | (968,711) | 454,630 |
| | | (6,672,346) | 3,468,615 |
| Interest received | | 3,376,608 | 2,901,668 |
| Interest paid | | (1,877,308) | (1,393,062) |
| Income tax paid | | (3,180) | (31,093) |
| Special tax on financial institutions paid | | (81,516) | (57,930) |
| **Net cash (to) from operating activities** | | (5,257,742) | 4,888,198 |

| Cash flows from investing activities | | | |
|---|---|---|---|
| Disposal of shares in associates | 22 | 348,614 | 42,607 |
| Acquisition of intangible assets | 23 | (28,874) | (32,229) |
| Acquisition of property and equipment | 25 | (57,526) | (504,680) |
| Proceeds from the sale of property and equipment | 25 | 575,249 | 34,167 |
| Proceeds from the sale (acquisition) of assets classified as held for sale | 28, 96 | 129,129 | (305,000) |
| **Net cash from (to) investing activities** | | 966,592 | (765,135) |

| Cash flows from financing activities | | | |
|---|---|---|---|
| Proceeds from borrowings | | 95,245,252 | 24,911,000 |
| Repayment of borrowings | | (93,500,594) | (20,386,947) |
| Proceeds from issue of new share capital | | 300,000 | 0 |
| **Net cash from financing activities** | | 2,044,658 | 4,524,053 |

| | | | |
|---|---|---|---|
| Cash and cash equivalents at the beginning of the year | 14 | 20,405,530 | 11,648,011 |
| Net (decrease) increase in cash and cash equivalents | | (2,246,492) | 8,647,116 |
| Effects of exchange rate fluctuations on cash and cash equivalents held | | (363,046) | 110,403 |
| **Cash and cash equivalents at the end of the year** | 14 | 17,795,993 | 20,405,530 |

*The notes on pages 9 to 53 are an integral part of these Consolidated Financial Statements.*

# Notes to the Consolidated Financial Statements

## General information

**1. Reporting entity**

MP banki hf. (the Bank) is a limited liability company incorporated and domiciled in Iceland, with registered offices at Ármúli 13a, Reykjavík. The Consolidated Financial Statements for the year ended 31 December 2013 comprise MP banki hf. and its subsidiaries (together referred to as the Group). The Group is primarily involved in investment, corporate and retail banking, and in providing asset management services.

The Consolidated Financial Statements were approved and authorised for issue by the Board of Directors and CEO on 27 March 2014.

**2. Basis of preparation**

a. Statement of compliance
The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union.

b. Basis of measurement
The Consolidated Financial Statements have been prepared using the historical cost basis except for financial instruments at fair value through profit or loss, available for sale financial assets, non-current assets classified as held for sale and short positions, which are measured at fair value. A breakdown of the accounting classification of financial assets and financial liabilities is provided in note 56.

c. Functional and presentation currency
The Consolidated Financial Statements are prepared in Icelandic Krona (ISK), which is the Bank's functional currency. All financial information has been rounded to the nearest thousand, unless otherwise stated.

d. Going concern
The Bank's management has assessed the Group's ability to continue as a going concern and it is satisfied that the Group has the resources to continue its operations.

e. Estimates and judgements
The preparation of financial statements in accordance with IFRSs requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

The estimates and underlying assumptions are based on historical result and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying amounts of assets and liabilities that are not readily apparent from other sources.

The estimates and underlying assumptions are reviewed on an on going basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period and future periods if the revision affects both current and future periods.

Information about areas of estimation uncertainty and critical judgements made by management in applying accounting policies that can have a significant effect on the amounts recognised in the Consolidated Financial Statements is provided in note 104.

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

## Income statement

### 3. Net interest income

Interest income is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Cash and cash equivalents | 665,377 | 988,318 |
| Derivatives | 258,233 | 165,695 |
| Loans to customers | 2,601,451 | 1,803,778 |
| Other interest income | 119,056 | 537,541 |
| **Total** | 3,644,118 | 3,495,332 |

Interest expense is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Deposits | 1,388,328 | 1,452,621 |
| Borrowings | 481,807 | 282,279 |
| Other interest expense | 290,468 | 44,313 |
| **Total** | 2,160,603 | 1,779,213 |

Other interest income includes interest income from securities classified as available for sale.

### 4. Fee and commission income

Fee and commission income is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Banking | 413,916 | 391,914 |
| Capital Markets | 455,093 | 458,049 |
| Asset Management | 600,157 | 361,943 |
| Other | 378,677 | 293,415 |
| **Total** | 1,847,843 | 1,505,321 |

### 5. Net financial income

Net financial income is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Fixed income | 255,309 | 423,409 |
| Equities | 103,480 | (7,572) |
| Foreign currency exchange difference | (76,187) | 68,168 |
| Fair value changes | (7,219) | 153,030 |
| **Total** | 275,383 | 637,035 |

### 6. Foreign currency exchange difference

Foreign currency exchange difference is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| (Loss) gain on financial instruments at fair value through profit and loss | (70,486) | 27,486 |
| (Loss) gain on other financial instruments | (5,701) | 40,683 |
| **Total** | (76,187) | 68,168 |
| | | |
| Change in the ISK trade index during the year | -9.7% | +7.1% |

Note 53 provides information about the development of foreign exchange rates against the Icelandic krona.

# Notes to the Consolidated Financial Statements

## 7. Administrative expenses

Administrative expenses are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Salaries and related expenses | 2,051,622 | 1,668,078 |
| Other operating expenses | 1,372,598 | 1,230,621 |
| Depositors' and Investors' Guarantee Fund contributions | 100,283 | 110,342 |
| Depreciation and amortisation | 124,359 | 119,125 |
| **Total** | 3,648,863 | 3,128,166 |

## 8. Salaries and related expenses

Salaries and related expenses are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Salaries | 1,578,369 | 1,195,574 |
| Performance based payments excluding share-based payments | 3,451 | 100,897 |
| Share-based payment expenses | 1,870 | 518 |
| Pension fund contributions | 198,117 | 163,538 |
| Tax on financial activity | 110,654 | 72,848 |
| Other salary related expenses | 159,162 | 134,703 |
| **Total** | 2,051,622 | 1,668,078 |

| | 2013 | 2012 |
|---|---|---|
| Average number of full time employees during the year | 129 | 117 |
| Total number of full time employees at year-end | 117 | 125 |

According to Act No. 165/2011, passed in 2011, banks and other financial institutions providing VAT exempt services, must pay a tax based on salary payments, called tax on financial activity. The current tax rate is 6.75% (2012: 5.45%).

## 9. Employment terms of the board of directors and management

Salaries paid to the Board of Directors, the CEO and Managing Directors of the Bank for their work for companies within the Group, and their shareholding in the Bank, are specified as follows:

| | Salaries and benefits | Number of shares | 2013 Options | Salaries and benefits | Number of shares | 2012 Options |
|---|---|---|---|---|---|---|
| Sigurður Atli Jónsson, CEO | 47,813 | 37,500 | 25,000 | 43,043 | 25,000 | 25,000 |
| Þorsteinn Pálsson, Chairman of the Board | 6,600 | 0 | 0 | 6,600 | 0 | 0 |
| Skúli Mogensen, Deputy Chairman of the Board | 3,338 | 580,300 | 0 | 3,440 | 960,600 | 0 |
| Hanna Katrín Friðriksson, Board member | 4,422 | 0 | 0 | 3,300 | 0 | 0 |
| Mario Espinosa, Board member | 3,440 | 0 | 0 | 3,000 | 0 | 0 |
| Inga Björg Hjaltadóttir, Board member | 3,312 | 0 | 0 | 2,500 | 0 | 0 |
| Vilmundur Jósefsson, alternative Board member | 3,318 | 20,000 | 0 | 3,300 | 20,000 | 0 |
| Michael Crossley Wright, former alternate Board member | 1,740 | 0 | 0 | 2,600 | 0 | 0 |
| Managing Directors (2013: 7, 2012: 7) | 182,011 | 0 | 112,000 | 194,628 | 0 | 120,000 |
| **Total** | 255,994 | 637,800 | 137,000 | 262,411 | 1,005,600 | 145,000 |

Figures for shares and share options are in thousands and include shares held by companies owned by or under the control of the respective parties as at 31 December 2013 and 31 December 2012.

The Bank has defined one Managing Director as Key Employee, as defined in Act No. 161/2002 on Financial Undertakings. Furthermore the Bank has approved and published internal rules covering the qualification requirements, evaluation process and conduct of Key Employees, in accordance with requirements set forth by the Icelandic Financial Supervisory Authority.

The Bank has adopted a remuneration policy at the proposal of the Remuneration Committee. The policy covers three remuneration components, base pay, performance based incentive scheme and other benefits, including pension fund contributions. Further information about the remuneration policy is provided in notes 62-64.

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**10. Auditor's fees**

Remuneration to the Group's auditors is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Audit of annual accounts | 30,768 | 23,075 |
| Review of interim accounts | 7,126 | 6,979 |
| Other audit related services | 5,754 | 5,339 |
| **Total** | 43,649 | 35,392 |
| | | |
| Thereof to the auditors of the Bank | 41,823 | 32,083 |

**11. Income tax**

Income tax recognized in the income statement is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Current income tax | (20,045) | 3,180 |
| Deferred tax income | 322,993 | 145,233 |
| **Total** | 302,948 | 148,413 |

Reconciliation of effective tax rate:

| | | 2013 | | 2012 |
|---|---|---|---|---|
| (Loss) profit before income tax | | (779,891) | | 102,935 |
| Income tax using the domestic corporation tax rate | 20.0% | 155,978 | 20.0% | (20,587) |
| Effect of tax rates in foreign jurisdictions | (1.2%) | (9,527) | 5.1% | (5,253) |
| Non-deductible expenses | (10.1%) | (79,090) | 17.2% | (17,725) |
| Non-taxable income | 21.3% | 165,816 | (130.6%) | 134,446 |
| Recognition of previously unrecognised tax losses | 9.6% | 74,506 | 0.0% | 0 |
| Other changes | (0.6%) | (4,735) | (55.9%) | 57,532 |
| **Effective income tax** | 38.8% | 302,948 | (144.2%) | 148,413 |

**12. Special tax on financial institutions**

According to Act No. 155/2010 on Special Tax on Financial Institutions, certain types of financial institutions, including banks, must pay annually a tax based on the carrying amount of their liabilities as determined for tax purposes in excess of ISK 50 billion. The tax rate is set at 0.376% (2012: 0.1285%) for taxes payable in 2014 and beyond. This tax is not a deductible expense for income tax purposes.

| | 2013 | 2012 |
|---|---|---|
| Special tax on financial institutions | 20,413 | 81,516 |

**13. Quarterly statements (unaudited)**

| | Q4 2013 | Q3 2013 | Q2 2013 | Q1 2013 | Q4 2012 |
|---|---|---|---|---|---|
| Net interest income | 208,891 | 395,676 | 406,374 | 472,573 | 412,708 |
| Net fee and commission income | 545,009 | 346,892 | 442,966 | 419,635 | 412,335 |
| Net financial income | 17,695 | 85,331 | 29,173 | 143,184 | 159,203 |
| Share in profit of associates, net of income tax | (34,602) | 17,244 | 0 | 13,643 | 0 |
| Other operating income | 8,545 | 12,897 | 17,119 | 56,309 | 21,867 |
| Net operating income | 745,537 | 858,040 | 895,632 | 1,105,344 | 1,006,113 |
| Administrative expenses | (1,059,053) | (784,786) | (911,180) | (893,844) | (889,563) |
| Impairment of loans and receivables | (174,858) | 37,040 | (36,714) | 221,366 | (390,817) |
| Impairment of intangible assets | (771,930) | 0 | 0 | 0 | 0 |
| Profit (loss) from assets held for sale | 0 | 0 | 9,927 | 0 | (10,989) |
| **(Loss) profit before taxes** | (1,260,305) | 110,294 | (42,334) | 432,867 | (285,256) |
| Income tax | 196,094 | 24,438 | 31,573 | 50,843 | 180,431 |
| Special tax on financial institutions | (2,797) | (4,889) | 5,482 | (18,209) | (16,208) |
| **(Loss) profit for the quarter** | (1,067,008) | 129,843 | (5,279) | 465,501 | (121,033) |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

## Statement of Financial Position

### 14. Cash and cash equivalents

Cash and cash equivalents are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Cash | 71,056 | 106,824 |
| Balances with banks | 8,084,945 | 9,313,187 |
| Certificates of deposits issued by the Central Bank of Iceland | 7,517,655 | 10,869,548 |
| Treasury bills | 2,122,337 | 115,972 |
| **Total** | 17,795,993 | 20,405,530 |

The comparative amounts include ISK 116.0 million in treasury bills which were classified as fixed income securities in 2012.

### 15. Fixed income securities

Fixed income securities are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Government bonds and bonds with government guarantees | 2,919,271 | 3,131,968 |
| Listed bonds | 1,168,028 | 1,775,643 |
| Unlisted bonds | 197,537 | 197,455 |
| **Total** | 4,284,835 | 5,105,066 |

Treasury bills valued at ISK 116.0 million at year-end 2012 are now included in cash and cash equivalents.

### 16. Shares and other variable income securities

Shares and other variable income securities are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Listed shares | 400,662 | 349,076 |
| Listed unit shares | 221 | 199 |
| Unlisted shares | 182,379 | 129,836 |
| Unlisted unit shares | 370,485 | 764,022 |
| **Total** | 953,747 | 1,243,133 |

### 17. Securities used for hedging

Securities used for hedging are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Government bonds and bonds with government guarantees | 0 | 2,614,941 |
| Listed bonds | 54,241 | 784,324 |
| Listed shares | 2,799,031 | 3,408,527 |
| **Total** | 2,853,272 | 6,807,792 |

### 18. Loans to customers

Loans to customers are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Loans to customers, gross amount | 27,747,012 | 28,619,840 |
| Specific allowance for impairment losses | (294,306) | (661,360) |
| Collective allowance for impairment losses | (210,587) | (169,190) |
| **Total** | 27,242,120 | 27,789,290 |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**19. Allowance for impairment losses**

Change in allowance for impairment losses is specified as follows:

a. Loans to customers

| **2013** | **Specific** | **Collective** | **Total** |
|---|---|---|---|
| Balance as at 1 January 2013 | 661,360 | 169,190 | 830,550 |
| Charge to the income statement for the year | (91,862) | 41,397 | (50,465) |
| Write-offs | (275,193) | 0 | (275,193) |
| **Balance as at 31 December 2013** | 294,306 | 210,587 | 504,893 |

| **2012** | **Specific** | **Collective** | **Total** |
|---|---|---|---|
| Balance as at 1 January 2012 | 157,401 | 57,796 | 215,197 |
| Charge to the income statement for the year | 557,591 | 111,394 | 668,985 |
| Write-offs | (53,631) | 0 | (53,631) |
| **Balance as at 31 December 2012** | 661,360 | 169,190 | 830,550 |

b. Other assets

| **2013** | **Specific** | **Collective** | **Total** |
|---|---|---|---|
| Balance as at 1 January 2013 | 23,251 | 6,977 | 30,228 |
| Charge to the income statement for the year | 0 | 3,631 | 3,631 |
| **Balance as at 31 December 2013** | 23,251 | 10,608 | 33,859 |

| **2012** | **Specific** | **Collective** | **Total** |
|---|---|---|---|
| Balance as at 1 January 2012 | 23,251 | 5,000 | 28,251 |
| Charge to the income statement for the year | 0 | 1,977 | 1,977 |
| **Balance as at 31 December 2012** | 23,251 | 6,977 | 30,228 |

**20. Derivatives**

Derivatives are specified as follows:

| | | | **2013** | | | **2012** |
|---|---|---|---|---|---|---|
| | **Notional** | **Assets** | **Liabilities** | **Notional** | **Assets** | **Liabilities** |
| Interest rate derivatives | 2,500,000 | 216,918 | | 2,500,000 | 120,635 | |
| Currency forwards | 454,052 | 20,620 | | 231,977 | | 6,344 |
| Bond and equity total return swaps | 6,823,240 | 265,884 | 174,019 | 11,133,697 | 192,160 | 215,173 |
| Equity options | 228,387 | 919 | 10,089 | | | |
| | 10,005,679 | 504,341 | 184,109 | 13,865,674 | 312,795 | 221,518 |

**21. Group entities**

The Group held 10 subsidiaries at year-end (2012: 12), all of which are included in the Consolidated Financial Statements. They are specified as follows:

| | **Domicile** | **Share 2013** | **Share 2012** |
|---|---|---|---|
| Axia Asset Management UAB | Lithuania | 100% | 100% |
| FÍ Fasteignafélag GP ehf. | Iceland | 70% | 70% |
| Heildun UAB | Lithuania | 100% | 100% |
| Horn Florida Ltd. | UK | 100% | 100% |
| Júpíter rekstrarfélag hf. | Iceland | 100% | 100% |
| LV31 ehf. | Iceland | 100% | 100% |
| Lykillán ehf. | Iceland | 100% | 100% |
| M-Investments ehf. | Iceland | 100% | 100% |
| M8 ehf. | Iceland | - | 100% |
| Mánatún GP ehf. | Iceland | 100% | 100% |
| Mánatún slhf. | Iceland | - | 100% |
| MP Pension Funds Baltic UAB | Lithuania | 100% | 100% |

Mánatún slhf. was a wholly owned subsidiary of Mánatún GP ehf., a subsidiary of the Bank, at year-end 2012. The Bank reduced its share in Mánatún slhf. in 2013 and in Q2 2013 the remaining interest was reclassified as an associate. In Q3 2013 the Bank reduced its share in Mánatún slhf. below 20% and the company is no longer classified as an associate.

The Bank sold its share in M8 ehf. in November 2013. The sale had a minor effect on the income statement and statement of financial position.

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

## 22. Investment in associates

a. Associated companies at the end of the period:

| | Domicile | Share 2013 | Share 2012 |
|---|---|---|---|
| GAM Management hf. | Iceland | - | 27% |
| Londonderry Associates LLC | USA | 38% | 38% |
| Teris | Iceland | 50% | 50% |

The Bank sold its share in GAM Management hf. in December 2013. The sale had an immaterial effect on the income statement and statement of financial position.

Teris has sold all material assets and operations to Reiknistofa Bankanna hf., and is in the process of winding down its operations. This process is expected to be completed in 2014.

b. Changes in investments in associates are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Balance at the beginning of the year | 560,825 | 405,272 |
| Acquisition of shares in associates | 0 | 534 |
| Disposal of shares in associates | (332,518) | (65,913) |
| Reclassification | 88,552 | 0 |
| Share in profit of associates, net of income tax | (3,715) | 217,482 |
| Translation difference | (4,122) | 3,449 |
| **Total** | 309,021 | 560,825 |

## 23. Intangible assets

Intangible assets are specified as follows:

| **2013** | **Software** | **Goodwill** | **Other** | **Total** |
|---|---|---|---|---|
| Balance as at 1 January 2013 | 179,975 | 599,930 | 323,924 | 1,103,829 |
| Acquisitions | 28,874 | 0 | 0 | 28,874 |
| Impairment losses | 0 | (599,930) | (172,000) | (771,930) |
| Amortisation | (37,330) | 0 | (18,415) | (55,745) |
| Translation difference | (0) | 0 | 0 | (0) |
| **Balance as at 31 December 2013** | 171,519 | 0 | 133,509 | 305,028 |

| **2012** | **Software** | **Goodwill** | **Other** | **Total** |
|---|---|---|---|---|
| Balance as at 1 January 2012 | 181,588 | 599,930 | 342,339 | 1,123,857 |
| Acquisitions | 32,229 | 0 | 0 | 32,229 |
| Amortisation | (33,843) | 0 | (18,415) | (52,258) |
| Translation difference | 1 | 0 | 0 | 1 |
| **Balance as at 31 December 2012** | 179,975 | 599,930 | 323,924 | 1,103,829 |

## 24. Impairment testing

Assets with indefinite useful life, such as goodwill, are not amortised but are subject to annual impairment testing as described in note 92. The assets were acquired in business combinations in 2011. Purchase price allocation was completed in Q4 2011 at which time the fair value of the assets was determined. Impairment testing was performed in 2012 and again in 2013.

a. Assets with indefinite useful life

| | 2013 | 2012 |
|---|---|---|
| Goodwill | 599,930 | 599,930 |
| Other intangible assets | 172,000 | 172,000 |
| **Total** | 771,930 | 771,930 |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**24. Impairment testing cont.**

b. Allocation of assets to cash-generating units

As described in note 60, the Bank has changed its internal reporting structure starting from 1 January 2014. This change is the result of a structural change and renewed focus on core competencies which was announced in Q3 2013. The Bank has subsequently amended its definition of cash-generating units and the allocation of assets to cash-generating units.

Allocation of assets to cash-generating units is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Asset Management | 475,312 | 186,821 |
| Banking | 296,619 | - |
| Investment Banking | - | 55,540 |
| Retail Banking | - | 268,849 |
| Other Operations | - | 260,720 |
| **Total** | 771,930 | 771,930 |

c. Methodology and key assumptions

The recoverable amount of cash-generating units was based on their value in use. Value in use was determined by discounting the future cash flows generated from the continuing use of the units. Cash flows were projected based on a 3 year financial plan and extrapolated for determining the residual value using a constant long-term nominal growth rate.

| | 2013 | 2012 |
|---|---|---|
| Discount rate | 13.3% | 13.8% |
| Long-term nominal growth rate | 3.0% | 3.0% |

d. Results of impairment testing

As a result of this analysis, full impairment of intangible assets with indefinite useful life was recognised for all cash-generating units of the Bank.

**25. Property and equipment**

Property and equipment is specified as follows:

| **2013** | Real estate | Other | Total |
|---|---|---|---|
| Balance as at 1 January 2013 | 613,923 | 124,176 | 738,099 |
| Additions | 33,000 | 24,526 | 57,526 |
| Disposals | (525,078) | (6,684) | (531,762) |
| Reclassified to assets classified as held for sale | (94,456) | 0 | (94,456) |
| Depreciation | (26,159) | (42,349) | (68,508) |
| Translation difference | (1,230) | (205) | (1,434) |
| **Balance as at 31 December 2013** | 0 | 99,465 | 99,465 |
| Gross carrying amount | 0 | 196,484 | 196,484 |
| Accumulated depreciation | 0 | (97,019) | (97,019) |
| **Balance as at 31 December 2013** | 0 | 99,465 | 99,465 |

| **2012** | Real estate | Other | Total |
|---|---|---|---|
| Balance as at 1 January 2012 | 199,553 | 129,047 | 328,599 |
| Additions | 460,400 | 44,281 | 504,681 |
| Disposals | (31,153) | (15,600) | (46,753) |
| Depreciation | (20,674) | (33,607) | (54,281) |
| Translation difference | 5,797 | 56 | 5,853 |
| **Balance as at 31 December 2012** | 613,923 | 124,176 | 738,099 |
| Gross carrying amount | 695,681 | 183,089 | 878,770 |
| Accumulated depreciation | (81,758) | (58,913) | (140,671) |
| **Balance as at 31 December 2012** | 613,923 | 124,176 | 738,099 |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

## 26. Deferred tax assets/liabilities

Change in deferred tax is specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Balance at the beginning of the year | 292,108 | 107,569 |
| Calculated income tax | 302,948 | 148,413 |
| Current income tax payable | 20,045 | (3,180) |
| Income tax recognized in other comprehensive income and equity | 6,185 | 30,427 |
| Other changes | (7,843) | 8,880 |
| **Net** | 613,443 | 292,108 |

The Group's deferred tax assets (liabilities) are attributable to the following items:

| | 2013 | 2012 |
|---|---|---|
| Property and equipment | 4,250 | 23,079 |
| Intangible assets | (10,947) | (7,725) |
| Assets and liabilities denominated in foreign currencies | (456) | (8,203) |
| Other items | 2,607 | 2,372 |
| Tax losses carried forward | 617,989 | 282,585 |
| **Total** | 613,443 | 292,108 |

Tax losses carried forward start to expire in 2019.

## 27. Other assets

Other assets are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Accounts receivable and prepayments | 731,371 | 646,485 |
| **Total** | 731,371 | 646,485 |

## 28. Assets classified as held for sale

The Group has classified certain properties as held for sale. The designation, which resulted in a reclassification of some real estate as disclosed in note 25, did not affect the income statement. The Group intends to dispose of these assets in 2014, and they are included in Other operations for segment reporting purposes as disclosed in note 60.

## 29. Deposits

Deposits are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Demand deposits | 26,480,832 | 36,212,486 |
| Time deposits | 8,748,877 | 6,189,956 |
| **Total** | 35,229,708 | 42,402,442 |

## 30. Deposits from credit institutions

The Bank provides foreign exchange payment and settlement services for several savings banks according to an agreement signed in 2012. Liabilities related to these services were previously included in other liabilities.

## 31. Borrowings

Borrowings are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Repo transactions and overnight borrowings from the Central Bank of Iceland | 0 | 147,682 |
| Money market deposits | 8,327,416 | 6,427,526 |
| **Total** | 8,327,416 | 6,575,208 |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**32. Short positions used for trading**

Short positions used for trading are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Government bonds and bonds with government guarantees | 4,431,398 | 5,947,104 |
| Listed bonds | 0 | 14,435 |
| Listed shares | 57,594 | 300 |
| Unlisted shares | 6 | 7 |
| Unlisted unit shares | 3,683 | 0 |
| **Total** | 4,492,682 | 5,961,847 |

**33. Short positions used for hedging**

Short positions used for hedging are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Government bonds and bonds with government guarantees | 3,174,046 | 2,024,604 |
| **Total** | 3,174,046 | 2,024,604 |

**34. Other liabilities**

Other liabilities are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Unsettled securities transactions | 336,538 | 1,220,677 |
| Accounts payable | 329,913 | 138,765 |
| Taxes, other than income tax | 20,515 | 81,837 |
| Withholding taxes | 335,579 | 462,549 |
| Other liabilities | 675,089 | 740,391 |
| **Total** | 1,697,634 | 2,644,220 |

**35. Equity**

a. Share capital

The nominal value of shares issued by the Bank is ISK 1 per share. The holders of shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

| | 2013 | 2012 |
|---|---|---|
| Share capital according to the Bank's Articles of Association | 5,854,000 | 5,554,000 |
| Nominal amount of treasury shares | 4,000 | 4,000 |

b. Capital management

A capital plan is prepared on an annual basis and approved by the Board, with the objective of maintaining both the optimal amount of capital and the mix between the different components of capital. The Bank’s policy is to hold capital in a range of different forms and from diverse sources.

The Icelandic Financial Supervisory Authority supervises the Bank on a consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the Bank as a whole. The Bank's regulatory capital calculations for credit risk and market risk are based on the standardised approach and the capital calculations for operational risk are based on the basic indicator approach.

c. Share capital increase authorizations

At the Bank's Annual General Meeting in April 2012 the Board of Directors was authorized to increase share capital by up to 275 million shares in stages to fulfil obligations rising from the Bank's share-based incentive scheme. The scheme is further discussed in notes 62-64.

d. Share capital increase

The Bank issued 300 million new shares during the year. The issue price was ISK 1.0 per share and the entire issue was bought by existing shareholders.

e. Acquisition of treasury shares

The Bank purchased 25 million treasury shares during the year to fulfil requirements arising from an acquisition in 2011.

Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**36. Capital adequacy ratio (CAD)**

Equity at the end of the year was ISK 5,037 million (2012: 5,250 million), equivalent to 8.3% (2012: 7.6%) of total assets according to the statement of financial position. The capital adequacy ratio of the Group, calculated in accordance with Article 84 of Act No. 161/2002 on Financial Undertakings, was 14.2% (2012: 10.8%). The minimum according to the Act is 8.0%. The ratio is calculated as follows:

| **Tier 1 capital** | **2013** | **2012** |
|---|---|---|
| Total equity | 5,036,767 | 5,249,622 |
| Goodwill and intangibles | (305,028) | (1,103,829) |
| Shares in financial institutions | (2,595) | (178,017) |
| Subordinated fixed income securities | (61,851) | (96,156) |
| Deferred tax asset | (613,777) | (292,288) |
| **Total** | 4,053,515 | 3,579,332 |

| **Capital requirements** | **2013** | **2012** |
|---|---|---|
| Credit risk | 1,703,380 | 1,993,050 |
| Market risk | 110,200 | 220,044 |
| Operational risk | 471,455 | 436,841 |
| **Total** | 2,285,035 | 2,649,934 |

| | | |
|---|---|---|
| Surplus capital | 1,768,480 | 929,398 |
| Capital adequacy ratio (CAD) | 14.2% | 10.8% |

# Notes to the Consolidated Financial Statements

## Risk management

**37. Risk management framework**

a. Board of Directors

The Bank's Board of Directors has overall responsibility for the establishment and oversight of the Group's risk management framework and risk appetite setting. Risk management policies are reviewed regularly to reflect changes in market conditions and the Group's activities. The Group, through training and management standards and procedures, aims to develop a disciplined and constructive control environment in which all employees understand their roles and obligations.

b. Board of Directors sub-committees

The Bank's Board of Directors has established two sub-committees, Remuneration Committee and Audit committee. The Audit Committee oversees how management monitors compliance with the Group's risk management policies and procedures. The Audit Committee is assisted in its oversight role by Internal Audit.

c. CEO

The CEO is responsible for the effective implementation through the corporate governance structure and committees. The CEO has established three committees, which are responsible for developing and monitoring risk management policies in their specified areas.

d. Committees

The Bank operates three committees that are involved in risk management: an Asset and Liability Committee (ALCO), a Credit Committee and a Quality and Security Committee.

The ALCO Committee meets regularly and each department reports on its operations and positions activity since the previous meeting. The committee addresses matters regarding the Bank's risk management, financing, capital management and proprietary trading.

The Credit Committee addresses matters regarding the Bank's loan activities. The committee is responsible for the approval of individual loans as well as deciding on credit limits for individual clients in derivative trades, and is the primary forum for the discussion of loan activity policy.

The Quality and Security Committee is responsible for supervision and implementation of the Bank‘s security and quality policies. The security policy mainly addresses data security and operational security in IT systems, physical security for the personnel and proper access controls and monitoring in the Bank‘s premises. The quality work is aimed at upholding proper quality in work processes, IT systems and services to support performance and profitability, lower operational risk and increase the customer experience.

e. Risk management

The purpose of the Bank's risk management unit is to identify, quantify, control and report on the risks that the Group is exposed to in its daily activities. The unit also participates in drafting the overall risk policy and has representatives on the ALCO committee, Credit committee and the Quality and Security committee. The unit’s main activities include monitoring and managing credit risk, market risk, liquidity risk and operational risk. The Board of Directors sets the rules and guidelines regarding the Group's risk policy and the obligations of risk management and credit control. The division reports regularly on the Group’s positions and exposure to risk to the Board of Directors, the CEO and to the ALCO

f. Compliance Officer

The Compliance unit ensures that the Group adheres to its rules on securities trading and insider trading and operation comply with the Act on Securities Transactions, the Act on Actions to Combat Money Laundering and Terrorist Financing and other relevant legislation and regulations.

g. Internal audit

Internal audit has the role to give objective opinion on the Group's operations and advisory that aims to increase its value, and to strengthen risk management and internal control. The tasks of internal audit and main emphasis are to estimate whether processes and systems are in place, and whether they are relevant and efficient. Internal auditor is recruited by the board and is located accordingly in the hierarchy. It's operations cover all units of operations, including subsidiaries.

**38. Hedging**

A part of the Group’s portfolio consists of securities held as a hedge against derivatives positions of customers. The Group hedges currency exposure between the Group's loan portfolio and debts to the extent possible, but does not apply hedge accounting.

# Notes to the Consolidated Financial Statements

**39. Credit risk - overview**

a. Definition

One of the Group’s primary sources of risk is counterparty credit risk. Credit risk is defined as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

b. Management

The risk management unit is responsible for managing and reporting on credit risk. The Group uses a variety of tools and processes to manage credit risk, including collaterals, hedges and loan portfolio management.

c. Credit approval process

The originating department prepares a proposal for each loan or credit line which is presented to the credit committee for approval. The proposal consists of a basic description of the client, the purpose of the loan, a simple credit assessment and arguments for or against granting the loan. The committee decides whether there is need for further credit assessment and on what terms the loan may be granted.

A more thorough credit assessment may be conducted if considered appropriate and can include an assessment of a borrower’s fundamental credit strength as well as the value of any collateral. To assess the borrower’s capacity to meet his or her obligations the committee can request stress test analysis of the borrower’s cash flow or call for third party assessments.

d. Collateral

Securing loans with collateral is a traditional method to reduce credit risk. The Group uses different methods to reduce credit risk by obtaining collateral from customers where appropriate. Such collateral gives the Group right to the collateralised assets for current and future obligations incurred by the customer.

The Group places emphasis on ensuring that loans are secured with collateral that can be marked to market, and that asset coverage exceeds 100%. The Group applies appropriate haircuts on all collateral in listed securities in order to ensure proper risk mitigation. For all collateral in listed securities, the Group maintains the right to liquidate collateral in case its market value falls below a predefined limit.

To a very large extent the Group’s loan portfolio consists of senior loans, most of which are highly collateralised.

e. Credit rating, control and provisioning

The risk management unit is responsible for credit rating and reviewing the loan portfolio. In case of any significant delay of payments or defaults the unit carefully analyses the underlying assets and loan documents and organizes the process of collection.

The Group monitors the value of collateral by listed securities on a real time basis, and takes prompt action when necessary.

Provisioning for loan impairments is estimated on the basis of models assessing a portfolio as a whole based on the seniority of the loans, the degree of collateralisation and the Group's history of defaulted loans. Risk management suggest a provisioning percentage for the portfolio, based on the loss assessment. Risk management reassess impairments in the event of collateral decay, delayed payments or other early warning signs. Provisions require approval by the CEO and the credit committee.

f. Loan portfolio management

To ensure an effective diversification of the loan portfolio the board has set a limit framework defining maximum exposure as a ratio of the Group’s equity and/or the total size of the loan portfolio. These limits include limitation on joint exposure to associated clients, exposure to individual and associated industries, single regions and countries etc. It is the responsibility of risk management to monitor that these limits are not being violated and to report discrepancies to the credit committee.

g. Derivatives

The Group offers derivative contracts in the form of swap contracts on listed, highly liquid securities. On the day when the contract is entered into, the Group purchases the underlying security and hedges its exposure to price changes. Collateral is in the form of cash or listed, highly liquid securities. The risk management sets rules about the level of collateralisation and monitors the compliance to these rules. Contracts are closed if required levels of collateralisation are not met.

h. Securities used for hedging

The Group hedges itself for market risk of derivative contracts by purchasing the underlying securities at the commencement of the contract. Since the contracts require delivery of the underlying securities to the customer on the settlement day, the credit risk towards the issuer is immaterial.

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

## 40. Maximum exposure to credit risk

The maximum exposure to credit risk of on-balance sheet and off-balance sheet financial instruments, before taking into account any collateral held or other credit enhancements, is specified as follows:

| | Public entities | Financial institutions | Corporate customers | Individuals | Other | 2013 |
|---|---|---|---|---|---|---|
| Cash and cash equivalents | 13,610,163 | 4,185,830 | | | | 17,795,993 |
| Receivables from Central Bank of Iceland | 4,510,503 | | | | | 4,510,503 |
| Fixed income securities | 3,183,738 | 716,713 | 384,384 | | | 4,284,835 |
| Securities used for hedging | | 54,241 | | | | 54,241 |
| Loans to customers | 156,493 | 1,776,846 | 16,737,896 | 8,558,863 | 12,021 | 27,242,120 |
| Derivatives | | 282,480 | 209,517 | 12,344 | | 504,341 |
| Other assets | 10,524 | 24,311 | 375,015 | 319,110 | 2,410 | 731,371 |
| | 21,471,421 | 7,040,421 | 17,706,812 | 8,890,318 | 14,431 | 55,123,403 |
| Loan commitments | 962 | 4,105 | 2,074,286 | 1,110,465 | 44,239 | 3,234,058 |
| Financial guarantee contracts | | | 517,932 | 23,922 | 600 | 542,453 |
| **Total** | 21,472,383 | 7,044,526 | 20,299,030 | 10,024,705 | 59,270 | 58,899,914 |

| | Public entities | Financial institutions | Corporate customers | Individuals | Other | 2012 |
|---|---|---|---|---|---|---|
| Cash and cash equivalents | 16,237,235 | 4,168,295 | | | | 20,405,530 |
| Receivables from Central Bank of Iceland | 3,287,741 | | | | | 3,287,741 |
| Fixed income securities | 3,289,361 | 852,426 | 963,280 | | | 5,105,066 |
| Securities used for hedging | | 3,399,265 | | | | 3,399,265 |
| Loans to customers | 4,399 | 131,411 | 20,413,882 | 7,215,763 | 23,835 | 27,789,290 |
| Derivatives | | 189,164 | 112,906 | 2,940 | 7,786 | 312,795 |
| Other assets | 49,554 | 177,654 | 197,246 | 217,468 | 4,562 | 646,485 |
| | 22,868,290 | 8,918,214 | 21,687,314 | 7,436,171 | 36,183 | 60,946,172 |
| Loan commitments | 587 | 80,077 | 2,033,392 | 1,136,431 | 69,009 | 3,319,497 |
| Financial guarantee contracts | | | 1,302,420 | 15,093 | 1,110 | 1,318,623 |
| **Total** | 22,868,878 | 8,998,291 | 25,023,126 | 8,587,695 | 106,302 | 65,584,292 |

## 41. Credit quality of financial assets

a. Breakdown

| 2013 | Neither past due nor individually impaired | Past due but not individually impaired | Individually impaired | Total | Less specific impairment allowance | Less collective impairment allowance | Carrying amount |
|---|---|---|---|---|---|---|---|
| Cash and cash equivalents | 17,795,993 | | | 17,795,993 | | | 17,795,993 |
| Receivables from Central Bank of Iceland | 4,510,503 | | | 4,510,503 | | | 4,510,503 |
| Fixed income securities | 4,284,835 | | | 4,284,835 | | | 4,284,835 |
| Securities used for hedging | 54,241 | | | 54,241 | | | 54,241 |
| Loans to customers | 24,228,954 | 3,124,583 | 393,476 | 27,747,012 | (294,306) | (210,587) | 27,242,120 |
| Derivatives | 504,341 | | | 504,341 | | | 504,341 |
| Other assets | 736,848 | | 28,381 | 765,229 | (23,251) | (10,608) | 731,371 |
| **Total** | 52,404,851 | 3,124,583 | 421,857 | 55,951,291 | (317,557) | (221,194) | 55,412,540 |

| 2012 | Neither past due nor individually impaired | Past due but not individually impaired | Individually impaired | Total | Less specific impairment allowance | Less collective impairment allowance | Carrying amount |
|---|---|---|---|---|---|---|---|
| Cash and cash equivalents | 20,405,530 | | | 20,405,530 | | | 20,405,530 |
| Receivables from Central Bank of Iceland | 3,287,741 | | | 3,287,741 | | | 3,287,741 |
| Fixed income securities | 5,105,066 | | | 5,105,066 | | | 5,105,066 |
| Securities used for hedging | 3,399,265 | | | 3,399,265 | | | 3,399,265 |
| Loans to customers | 23,432,028 | 4,377,923 | 809,889 | 28,619,840 | (661,360) | (169,190) | 27,789,290 |
| Derivatives | 312,795 | | | 312,795 | | | 312,795 |
| Other assets | 647,134 | | 29,578 | 676,713 | (23,251) | (6,977) | 646,485 |
| **Total** | 57,263,939 | 4,377,923 | 839,468 | 62,481,330 | (684,611) | (176,167) | 61,620,552 |

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# Notes to the Consolidated Financial Statements

**41. Credit quality of financial assets cont.**

b. Past due but not individually impaired

Past due but not impaired financial assets are those assets where contractual payments are 1 or more days past due but the Group believes that impairment is not appropriate on the basis of the level of security or future cash flows of the borrower. Past due loans are reported as the total claim value and not only those payments that are past due.

| | **2013** | **2012** |
|---|---|---|
| Past due 1-30 days | 1,858,208 | 2,080,336 |
| Past due 31-60 days | 772,756 | 173,059 |
| Past due 61-90 days | 211,380 | 1,347,803 |
| Past due more than 90 days | 282,239 | 776,725 |
| **Total** | 3,124,583 | 4,377,923 |

c. Individually impaired

Individually impaired financial assets are those assets where there is objective evidence of impairment, the asset has been individually assessed and comparison of the carrying amount and the present value of the expected cash flow from the asset reveals a need for impairment. All individually impaired assets are considered non-performing.

| **2013** | **Past due 1-30 days** | **Past due 31-60 days** | **Past due 60-90 days** | **Past due over 90 days** | **Claim value** |
|---|---|---|---|---|---|
| Services | | | | 14,594 | 14,594 |
| Individuals | | 1,422 | 686 | 120,425 | 122,533 |
| Holding companies | 19,666 | 464 | 95 | 1,855 | 22,081 |
| Retail | | | | 10,317 | 10,317 |
| Other | | | 1,559 | 250,773 | 252,332 |
| **Total** | 19,666 | 1,886 | 2,340 | 397,964 | 421,857 |

| **2012** | **Past due 1-30 days** | **Past due 31-60 days** | **Past due 60-90 days** | **Past due over 90 days** | **Claim value** |
|---|---|---|---|---|---|
| Services | 8,440 | | | 409 | 8,849 |
| Individuals | | | 877 | 206,258 | 207,135 |
| Holding companies | | | | 417,305 | 417,305 |
| Retail | | 7,801 | | 12,790 | 20,592 |
| Other | | | | 185,588 | 185,588 |
| **Total** | 8,440 | 7,801 | 877 | 822,349 | 839,468 |

**42. Breakdown of loans**

a. By segments

The breakdown of the loan portfolio by industries is specified as follows:

| **2013** | **Claim value** | **Impairment allowance** | **Carrying amount** | **%** |
|---|---|---|---|---|
| Services | 8,747,861 | (101,165) | 8,646,696 | 31.7% |
| Individuals | 8,183,623 | (139,995) | 8,043,628 | 29.5% |
| Holding companies | 3,173,116 | (23,805) | 3,149,312 | 11.6% |
| Retail | 2,852,387 | (45,351) | 2,807,036 | 10.3% |
| Other | 4,790,025 | (194,577) | 4,595,448 | 16.9% |
| **Total** | 27,747,012 | (504,893) | 27,242,120 | 100.0% |

| **2012** | **Claim value** | **Impairment allowance** | **Carrying amount** | **%** |
|---|---|---|---|---|
| Services | 10,075,217 | (85,778) | 9,989,440 | 35.9% |
| Individuals | 6,636,570 | (49,456) | 6,587,114 | 23.7% |
| Holding companies | 4,190,828 | (526,837) | 3,663,992 | 13.2% |
| Retail | 3,585,068 | (39,986) | 3,545,082 | 12.8% |
| Other | 4,132,157 | (128,495) | 4,003,663 | 14.4% |
| **Total** | 28,619,840 | (830,550) | 27,789,290 | 100.0% |

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# Notes to the Consolidated Financial Statements

**42. Breakdown of loans cont.**

b. By seniority

The following definitions are used when ranking its loan portfolio by seniority:

- Senior I loans are loans which have first priority claims on the borrower's assets, are secured with collateral which can be marked to market and have asset coverage exceeding 100%
- Senior II loans have sufficient coverage and liquid collateral, but the collateral can in some cases not be marked to market, e.g. unlisted shares
- Junior loans have second lien claims on the borrower's assets or lower levels of collateral coverage
- Mezzanine loans are loans which are unsecured and subordinated to all of the borrower's liabilities

The breakdown of loans by categories is as follows:

| | Senior I | Senior II | Junior | Mezzanine | 2013 |
|---|---|---|---|---|---|
| Neither past due nor individually impaired | 8,575,784 | 11,185,373 | 2,276,808 | 2,004,268 | 24,042,232 |
| Past due but not individually impaired | 792,015 | 1,091,016 | 784,035 | 433,651 | 3,100,718 |
| Individually impaired | | 25,233 | 4,557 | 69,380 | 99,170 |
| **Total** | 9,367,799 | 12,301,622 | 3,065,399 | 2,507,299 | 27,242,120 |

| | Senior I | Senior II | Junior | Mezzanine | 2012 |
|---|---|---|---|---|---|
| Neither past due nor individually impaired | 6,382,527 | 11,389,751 | 3,093,760 | 2,421,953 | 23,287,991 |
| Past due but not individually impaired | 1,839,799 | 1,340,372 | 665,936 | 506,663 | 4,352,770 |
| Individually impaired | | 1,955 | | 146,574 | 148,529 |
| **Total** | 8,222,326 | 12,732,078 | 3,759,696 | 3,075,190 | 27,789,290 |

**43. Collateral types**

Collateral held by the Group against loans to customers is specified as follows:

| | Deposits | Fixed income securities | Variable income securities | Real estate | Other fixed assets | Other | 2013 |
|---|---|---|---|---|---|---|---|
| Public entities | | 151,192 | | | 2,140 | | 153,332 |
| Financial institutions | 54 | 1,577,681 | | | | | 1,577,735 |
| Corporate customers | 397,118 | 519,112 | 1,718,758 | 8,636,933 | 1,982,214 | 2,577,223 | 15,831,358 |
| Individuals | 11,937 | 19,262 | 43,712 | 3,853,277 | 2,625,773 | 94,162 | 6,648,122 |
| Other | | | | | 2,701 | | 2,701 |
| **Total** | 409,109 | 2,267,247 | 1,762,470 | 12,490,210 | 4,612,827 | 2,671,385 | 24,213,248 |

Amounts have been adjusted to exclude collateral in excess of claim value, i.e. overcollateralization. Other collateral includes financial claims, inventories and receivables.

Comparative information for the year 2012 is not available.

**44. Loan-to-value**

a. General

The loan-to-value ratio (LTV) is the ratio of the gross amount of the loan to the value of the collateral, if any. The general creditworthiness of a customer is viewed as the most reliable indicator of credit quality of a loan. Therefore, no routinely update of the valuation of collateral held against all loan is done. Valuation of a collateral is updated, however, if changes in the creditworthiness of a customer cause the loan to be monitored more closely.

b. Breakdown

The breakdown of loans to customers by LTV is specified as follows:

| | 2013 | % |
|---|---|---|
| Less than 50% | 5,403,697 | 19.8% |
| 51-70% | 8,653,589 | 31.8% |
| 71-90% | 6,119,251 | 22.5% |
| 91-100% | 3,123,000 | 11.5% |
| More than 100% | 3,942,583 | 14.5% |
| **Total** | 27,242,120 | 100.0% |

Comparative information for the year 2012 is not available.

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# Notes to the Consolidated Financial Statements

**45. Foreclosed assets**

The Group's policy is to sell foreclosed assets as soon as possible. The Group did not hold or take possession of collateral held as security in 2013 or 2012.

**46. Large exposures**

In accordance with the Financial Supervisory Authority's regulation no. 625/2013 on financial institutions' large exposures, total exposure towards a customer is classified as a large exposure if it exceeds 10% of the Bank's capital base (see note 35). According to the regulation a single exposure, net of risk adjusted mitigation, cannot exceed 25% of the capital base.

The rules on large exposures incurred by financial undertakings were amended in June 2013. In October 2013, the Financial Supervisory Authority provided guidance on some of the changes in the rules. As a result, nostro deposits with foreign and domestic banks are no longer excluded from large exposures.

| | | 2013 | | 2012 |
|---|---|---|---|---|
| **Large exposures net of collateralised assets** | **Number** | **Amount** | **Number** | **Amount** |
| 10-20% of capital base | 9 | 5,340,921 | 6 | 2,805,348 |
| 20-25% of capital base | 2 | 1,941,754 | 1 | 789,711 |
| Exceeding 25% of capital base | 0 | 0 | 0 | 0 |
| **Total** | 11 | 7,282,675 | 7 | 3,595,059 |
| Thereof nostro accounts with foreign banks with S&P rating of A- or higher | 3 | 2,681,805 | | |

**47. Liquidity risk**

a. Definition

Liquidity risk is the risk that the Group will encounter difficulty in meeting contractual payment obligations associated with its financial liabilities that are settled by delivering cash or another financial asset. This risk mainly arises from mismatches in the timing of cash flows. The Group has internal rules that require certain matching of the maturities of assets and liabilities. Furthermore, to ensure the sufficiency of funds, the Group has lines of credit, overdraft facilities and highly liquid securities such as treasury bills and treasury bonds.

b. Management

Liquidity is managed by treasury and monitored by risk management. Liquidity position is reported to the ALCO committee. The Group is subject to the Central Bank's of Iceland requirements about minimum coverage ratio between cash flows of assets and liabilities. The Group was in compliance with external liquidity requirements throughout years 2013 and 2012.

c. Maturity analysis of financial assets and liabilities

The following table shows a maturity analysis of financial assets and liabilities, for both on-balance sheet and off-balance sheet items. The analysis is based on contractual maturities and amounts presented are undiscounted cash flows, including both principal and interest cash flows. If an amount receivable or payable is not fixed, e.g. for inflation indexed assets and liabilities, the maturity analysis is based on estimates that refer to current conditions.

When the timing of a cash flow is not fixed, e.g. for demand deposits, the analysis assumes the earliest possible payment of amounts due and the latest possible payment of amounts receivable, which is the worst case scenario from the Group's perspective.

The analysis only takes into account the contractual maturity of financial assets and liabilities and does not account for measures the Group could take to improve its liquidity, e.g. the sale of listed securities. The Group also holds market securities with a carrying amount of ISK 1.8 billion at the reporting date, which can be converted to cash through repurchase agreements within two days.

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# Notes to the Consolidated Financial Statements

**47. Liquidity risk cont.**

**2013**

| **Financial assets** | **On demand** | **up to 3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **No stated maturity** | **Total** | **Carrying amount** |
|---|---|---|---|---|---|---|---|---|
| Cash and cash equivalents | 8,156,001 | 8,999,063 | 640,929 | | | | 17,795,993 | 17,795,993 |
| Receivables from Central Bank of Iceland | | 4,510,503 | | | | | 4,510,503 | 4,510,503 |
| Fixed income securities | | 1,097,000 | 985,625 | 1,230,196 | 2,320,895 | 14,468 | 5,648,183 | 4,284,835 |
| Shares and other variable income securities | | | | | | 953,747 | 953,747 | 953,747 |
| Securities used for hedging | | 2,853,297 | | | | | 2,853,297 | 2,853,272 |
| Loans to customers | 1,555,011 | 6,882,759 | 5,221,822 | 8,812,266 | 5,671,189 | | 28,143,046 | 27,242,120 |
| Other assets | | 630,819 | 32,010 | | | 68,541 | 731,371 | 731,371 |
| Financial assets excluding derivatives | 9,711,012 | 24,973,439 | 6,880,386 | 10,042,462 | 7,992,083 | 1,036,756 | 60,636,139 | 58,371,840 |
| Derivatives | 442 | 309,543 | 187,895 | 29,023 | | | 526,903 | 504,341 |
| **Total** | 9,711,454 | 25,282,983 | 7,068,281 | 10,071,484 | 7,992,083 | 1,036,756 | 61,163,042 | 58,876,181 |

| **Financial liabilities** | **On demand** | **up to 3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **No stated maturity** | **Total** | **Carrying amount** |
|---|---|---|---|---|---|---|---|---|
| Deposits | 26,474,219 | 3,946,844 | 1,759,947 | 3,153,336 | 364,003 | | 35,698,349 | 35,229,708 |
| Deposits from credit institutions | 2,346,121 | | | | | | 2,346,121 | 2,346,121 |
| Borrowings | | 8,631,262 | | | | | 8,631,262 | 8,327,416 |
| Short positions used for trading | | 2,103,763 | 156,060 | 1,338,447 | 2,674,820 | | 6,273,089 | 4,492,682 |
| Short positions used for hedging | | 3,175,178 | | | | | 3,175,178 | 3,174,046 |
| Other liabilities | 401,986 | 1,092,108 | 149,815 | 53,725 | | | 1,697,634 | 1,697,634 |
| Loan commitments | 1,573 | 1,139,976 | 1,300,167 | 759,560 | 32,782 | | 3,234,058 | |
| Financial guarantee contracts | | 48,263 | 249,611 | 211,407 | 33,172 | | 542,453 | |
| Financial liabilities excluding derivatives | 29,223,899 | 20,137,394 | 3,615,600 | 5,516,475 | 3,104,778 | 0 | 61,598,145 | 55,267,607 |
| Derivatives | 1,724 | 197,124 | | | | | 198,848 | 184,109 |
| **Total** | 29,225,623 | 20,334,518 | 3,615,600 | 5,516,475 | 3,104,778 | 0 | 61,796,994 | 55,451,716 |

| | **On demand** | **up to 3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **No stated maturity** | **Total** | **Carrying amount** |
|---|---|---|---|---|---|---|---|---|
| Financial assets | 9,711,454 | 25,282,983 | 7,068,281 | 10,071,484 | 7,992,083 | 1,036,756 | 61,163,042 | 58,876,181 |
| Financial liabilities | (29,225,623) | (20,334,518) | (3,615,600) | (5,516,475) | (3,104,778) | | (61,796,994) | (55,451,716) |
| **Net financial assets (liabilities)** | (19,514,169) | 4,948,465 | 3,452,681 | 4,555,009 | 4,887,305 | 1,036,756 | (633,952) | 3,424,465 |

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# Notes to the Consolidated Financial Statements

**47. Liquidity risk cont.**

**2012**

| **Financial assets** | **On demand** | **up to 3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **No stated maturity** | **Total** | **Carrying amount** |
|---|---|---|---|---|---|---|---|---|
| Cash and cash equivalents | 9,420,011 | 10,869,548 | 115,977 | | | | 20,405,536 | 20,405,530 |
| Receivables from Central Bank of Iceland | | 3,287,741 | | | | | 3,287,741 | 3,287,741 |
| Fixed income securities | | 494,151 | 498,937 | 2,099,529 | 3,534,932 | 22,613 | 6,650,163 | 5,105,066 |
| Shares and other variable income securities | | | | | | 1,243,133 | 1,243,133 | 1,243,133 |
| Securities used for hedging | | 6,808,787 | | | | | 6,808,787 | 6,807,792 |
| Loans to customers | 1,969,576 | 7,077,369 | 4,883,810 | 9,510,614 | 5,287,601 | | 28,728,971 | 27,789,290 |
| Other assets | | 422,249 | 60,746 | | | 163,489 | 646,485 | 646,485 |
| Financial assets excluding derivatives | 11,389,586 | 28,959,845 | 5,559,471 | 11,610,143 | 8,822,534 | 1,429,236 | 67,770,815 | 65,285,037 |
| Derivatives | 82 | 201,688 | | 120,582 | | | 322,352 | 312,795 |
| **Total** | 11,389,669 | 29,161,533 | 5,559,471 | 11,730,725 | 8,822,534 | 1,429,236 | 68,093,167 | 65,597,833 |

| **Financial liabilities** | **On demand** | **up to 3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **No stated maturity** | **Total** | **Carrying amount** |
|---|---|---|---|---|---|---|---|---|
| Deposits | 34,776,210 | 3,741,574 | 1,379,021 | 2,903,295 | 121,724 | | 42,921,824 | 42,402,442 |
| Deposits from credit institutions | 3,515,054 | | | | | | 3,515,054 | 3,515,054 |
| Borrowings | | 6,793,825 | | | | | 6,793,825 | 6,575,208 |
| Short positions used for trading | | 25,087 | 4,358,612 | 1,395,558 | 706,754 | | 6,486,011 | 5,961,847 |
| Short positions used for hedging | | 2,025,127 | | | | | 2,025,127 | 2,024,604 |
| Other liabilities | 368,616 | 2,052,247 | 120,078 | 91,801 | | 11,477 | 2,644,220 | 2,644,220 |
| Loan commitments | 1,250 | 891,170 | 1,483,495 | 930,060 | 13,522 | | 3,319,497 | |
| Financial guarantee contracts | | 858,495 | 305,515 | 128,441 | 26,172 | | 1,318,623 | |
| Financial liabilities excluding derivatives | 38,661,130 | 16,387,525 | 7,646,721 | 5,449,155 | 868,173 | 11,477 | 69,024,180 | 63,123,374 |
| Derivatives | 3,276 | 230,427 | | | 0 | | 233,703 | 221,518 |
| **Total** | 38,664,406 | 16,617,952 | 7,646,721 | 5,449,155 | 868,173 | 11,477 | 69,257,883 | 63,344,891 |

| | **On demand** | **up to 3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **No stated maturity** | **Total** | **Carrying amount** |
|---|---|---|---|---|---|---|---|---|
| Financial assets | 11,389,669 | 29,161,533 | 5,559,471 | 11,730,725 | 8,822,534 | 1,429,236 | 68,093,167 | 65,597,833 |
| Financial liabilities | (38,664,406) | (16,617,952) | (7,646,721) | (5,449,155) | (868,173) | (11,477) | (69,257,883) | (63,344,891) |
| **Net financial assets (liabilities)** | (27,274,737) | 12,543,581 | (2,087,250) | 6,281,571 | 7,954,361 | 1,417,758 | (1,164,716) | 2,252,941 |

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# Notes to the Consolidated Financial Statements

**48. Market risk**

a. Definition

Market risk constitutes risk due to changes in the market prices of financial instruments and comprises interest rate risk, currency risk and other price risk.

b. Management

The Group has a strict policy on controlling market risk and to keep the exposure within set limits. The risk management unit monitors market risk limits on a daily basis and reports regularly to the ALCO committee and to the CEO.

**49. Interest rate risk**

a. Definition

The Group's exposure to interest rate risk is twofold. On one hand, the Group has a proprietary portfolio of bonds, where market rates affect prices and any fluctuations are recognised in the income statement. On the other hand, the Group has mismatch in assets and liabilities with fixed interest terms. These include loans and swap contracts for securities on the asset side and borrowings and deposits on the liability side. This mismatch does not create an immediate effect on the income statement but nevertheless affects the Group's economic value.

Proprietary positions which are subject to interest rate risk fall under the scope of the Group's market risk management.

b. Management

The Group takes measures to minimise interest rate risk by matching the interest rate profile and duration of assets with the Group’s liabilities as well as using derivative and non-derivative financial instruments to manage effectively the risk of an adverse impact on the Group’s earnings.

**50. Interest rate risk associated with trading portfolios**

a. Breakdown

The breakdown of financial assets and liabilities in trading portfolios by the earlier of interest repricing time or maturity is specified as follows:

| | **up to 1 month** | **1-3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **2013** |
|---|---|---|---|---|---|---|
| Fixed income securities ........................................................... | 50 | | 1,654,298 | 1,408,501 | 1,221,987 | 4,284,835 |
| Short positions - fixed income securities ................................ | | (1,931,140) | | (874,544) | (1,625,715) | (4,431,398) |
| **Net imbalance** | 50 | (1,931,140) | 1,654,298 | 533,957 | (403,728) | (146,563) |

| | **up to 1 month** | **1-3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **2012** |
|---|---|---|---|---|---|---|
| Fixed income securities ........................................................... | 50 | | 1,406,695 | 1,495,238 | 2,203,083 | 5,105,066 |
| Short positions - fixed income securities ................................ | | | (4,228,026) | (1,192,044) | (541,469) | (5,961,540) |
| **Net imbalance** | 50 | 0 | (2,821,331) | 303,194 | 1,661,614 | (856,474) |

b. Sensitivity analysis

The Group performs monthly sensitivity analysis on financial assets and liabilities in trading portfolios that are subject to interest rate risk. The sensitivity analysis assumes a shift in the yield curves for all currencies. A parallel shift in yield curves would have the following impact on the Group's pre-tax profit and equity, assuming all other risk factors remain constant:

| | **Shift in** | | **2013** | | **2012** |
|---|---|---|---|---|---|
| **Currency** | **basis points** | **Downward** | **Upward** | **Downward** | **Upward** |
| Indexed ............................................................................................ | 50 | 15,465 | (15,465) | 63,086 | (63,086) |
| Non-indexed .................................................................................... | 100 | (21,001) | 21,001 | (12,698) | 12,698 |
| **Total** | | (5,536) | 5,536 | 50,387 | (50,387) |

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# Notes to the Consolidated Financial Statements

**51. Interest rate risk associated with non-trading portfolios**

a. Breakdown

The breakdown of financial assets and liabilities in non-trading portfolios by the earlier of interest repricing time or maturity is specified as

**2013**

| **Financial assets** | **up to 1 month** | **1-3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **Total** |
|---|---|---|---|---|---|---|
| Cash and cash equivalents | 16,141,453 | 547,014 | 1,107,526 | | | 17,795,993 |
| Receivables from Central Bank of Iceland | 4,510,503 | | | | | 4,510,503 |
| Loans to customers | 16,104,568 | 8,072,589 | 1,054,369 | 1,728,509 | 282,085 | 27,242,120 |
| Financial assets excluding derivatives | 36,756,524 | 8,619,602 | 2,161,895 | 1,728,509 | 282,085 | 49,548,615 |
| Effect of derivatives held for risk management | 3,500,595 | 248,521 | | 2,746,970 | | 6,496,087 |
| **Total** | 40,257,119 | 8,868,124 | 2,161,895 | 4,475,480 | 282,085 | 56,044,702 |

| **Financial liabilities** | **up to 1 month** | **1-3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **Total** |
|---|---|---|---|---|---|---|
| Deposits | 34,945,172 | 23,939 | 144,954 | 115,643 | | 35,229,708 |
| Deposits from credit institutions | 2,346,121 | | | | | 2,346,121 |
| Borrowings | 4,685,067 | 3,642,349 | | | | 8,327,416 |
| Financial liabilities excluding derivatives | 41,976,360 | 3,666,288 | 144,954 | 115,643 | 0 | 45,903,245 |
| Effect of derivatives held for risk management | 6,263,282 | 239,698 | | | | 6,502,980 |
| **Total** | 48,239,642 | 3,905,986 | 144,954 | 115,643 | 0 | 52,406,226 |
| **Total interest repricing gap** | (7,982,523) | 4,962,138 | 2,016,940 | 4,359,836 | 282,085 | 3,638,476 |

**2012**

| **Financial assets** | **up to 1 month** | **1-3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **Total** |
|---|---|---|---|---|---|---|
| Cash and cash equivalents | 20,289,559 | | 115,972 | | | 20,405,530 |
| Receivables from Central Bank of Iceland | 3,287,741 | | | | | 3,287,741 |
| Loans to customers | 16,126,129 | 5,504,179 | 1,263,472 | 3,553,899 | 1,341,611 | 27,789,290 |
| Financial assets excluding derivatives | 39,703,429 | 5,504,179 | 1,379,444 | 3,553,899 | 1,341,611 | 51,482,562 |
| Derivatives | 8,128,859 | 57,168 | | 2,650,065 | | 10,836,091 |
| **Total** | 47,832,287 | 5,561,346 | 1,379,444 | 6,203,964 | 1,341,611 | 62,318,653 |

| **Financial liabilities** | **up to 1 month** | **1-3 months** | **3-12 months** | **1-5 years** | **Over 5 years** | **Total** |
|---|---|---|---|---|---|---|
| Deposits | 42,402,442 | | | | | 42,402,442 |
| Deposits from credit institutions | 3,515,054 | | | | | 3,515,054 |
| Borrowings | 3,357,286 | 3,217,922 | | | | 6,575,208 |
| Financial liabilities excluding derivatives | 49,274,782 | 3,217,922 | 0 | 0 | 0 | 52,492,704 |
| Derivatives | 5,918,395 | 58,682 | | | 0 | 5,977,076 |
| **Total** | 55,193,177 | 3,276,603 | 0 | 0 | 0 | 58,469,780 |
| **Total interest repricing gap** | (7,360,889) | 2,284,743 | 1,379,444 | 6,203,964 | 1,341,611 | 3,848,873 |

b. Sensitivity analysis

The Group performs monthly sensitivity analysis on financial assets and liabilities in non-trading portfolios subject to interest rate risk. The sensitivity analysis assumes a shift in the yield curves for all currencies. A parallel shift in yield curves would have the following impact on the Group's pre-tax profit and equity, assuming all other risk factors remain constant:

| | **Shift in** | | **2013** | | **2012** |
|---|---|---|---|---|---|
| **Currency** | **basis points** | **Downward** | **Upward** | **Downward** | **Upward** |
| ISK, indexed | 50 | 35,625 | (35,625) | 86,850 | (86,850) |
| ISK, non-indexed | 100 | 37,133 | (37,133) | 40,610 | (40,610) |
| Other currencies | 20 | 1,209 | (1,209) | 224 | (224) |
| **Total** | | 73,967 | (73,967) | 127,684 | (127,684) |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**52. Exposure towards changes in the CPI**

a. Definition

Exposure towards changes in CPI is the risk that fluctuations in the Icelandic Consumer Price Index (CPI) will affect the balance and cash flow of indexed financial instruments.

The Group is exposed to Icelandic inflation since CPI indexed liabilities exceed CPI indexed assets. All indexed assets and liabilities are valued according to the CPI measure at any given time and changes in CPI are recognised in the income statement as interest.

b. Management

The Group controls its indexation risk through derivatives contracts and sales and purchases of indexed bonds, mostly government bonds, and thus keeps its inflationary position within the limits set by the ALCO committee.

c. Balance of CPI linked assets and liabilities

The net balance of CPI linked assets and liabilities is specified as follows:

| | **2013** | **2012** |
|---|---|---|
| Assets | 8,897,489 | 10,063,006 |
| Liabilities | (6,170,250) | (5,834,415) |
| **Total** | 2,727,239 | 4,228,591 |

**53. Currency risk**

a. Definition

Currency risk arises when financial instruments are not denominated in the functional currency of the respective Group entity and can affect both the Group's income statement and statement of financial position. A part of the Group's financial assets and liabilities is denominated in foreign currencies.

b. Management

Currency positions are monitored by risk management and reported to the ALCO committee. Any mismatch between assets and liabilities in each currency is monitored closely and managed within limits.

The Group is subject to limits set by the Central Bank of Iceland regarding the maximum open currency position. At 31 December 2013 and 31 December 2012 the Group's position in foreign currencies was within those limits.

c. Exchange rates

The following exchange rates have been used by the Group in the preparation of these financial statements:

| | **Closing 2013** | **Average 2013** | **Closing 2012** | **Average 2012** |
|---|---|---|---|---|
| EUR/ISK | 158.5 | 162.4 | 169.8 | 160.6 |
| USD/ISK | 115.0 | 122.3 | 128.7 | 125.0 |
| ISK trade index | 198.1 | 206.5 | 219.4 | 209.1 |

Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**53. Currency risk cont.**

d. Breakdown of financial assets and financial liabilities denominated in foreign currencies, by currency

**2013**

| **Financial assets** | **EUR** | **USD** | **Other currencies** | **Total** |
|---|---|---|---|---|
| Cash and cash equivalents | 1,075,562 | 723,636 | 1,329,127 | 3,128,324 |
| Fixed income securities | 1,109,257 | 919,053 | 108,495 | 2,136,805 |
| Shares and other variable income securities | 847 | 78,272 | 78,768 | 157,886 |
| Securities used for hedging | 67,152 | 95,533 | 0 | 162,685 |
| Loans to customers | 690,747 | 214,015 | 49,722 | 954,484 |
| Other assets | | 67,596 | 290,717 | 358,313 |
| Financial assets excluding derivatives | 2,943,565 | 2,098,104 | 1,856,828 | 6,898,497 |
| Derivatives | 62,375 | 2,475 | | 64,850 |
| **Total** | 3,005,940 | 2,100,579 | 1,856,828 | 6,963,347 |

| **Financial liabilities** | **EUR** | **USD** | **Other currencies** | **Total** |
|---|---|---|---|---|
| Deposits | 2,803,783 | 1,682,091 | 1,398,415 | 5,884,290 |
| Short positions used for trading | | 185 | 48 | 233 |
| Financial liabilities excluding derivatives | 2,803,783 | 1,682,276 | 1,398,463 | 5,884,522 |
| Derivatives | 47,550 | 334,047 | 51,834 | 433,432 |
| **Total** | 2,851,333 | 2,016,323 | 1,450,298 | 6,317,954 |

| **Net currency position** | **EUR** | **USD** | **Other currencies** | **Total** |
|---|---|---|---|---|
| Financial assets | 3,005,940 | 2,100,579 | 1,856,828 | 6,963,347 |
| Financial liabilities | (2,851,333) | (2,016,323) | (1,450,298) | (6,317,954) |
| Net off-balance sheet position | (34,078) | (83,136) | (50,033) | (167,247) |
| **Total** | 120,530 | 1,120 | 356,496 | 478,146 |

**2012**

| **Financial assets** | **EUR** | **USD** | **Other currencies** | **Total** |
|---|---|---|---|---|
| Cash and cash equivalents | 2,446,953 | 464,712 | 793,139 | 3,704,804 |
| Fixed income securities | | | 138,590 | 138,590 |
| Shares and other variable income securities | 840 | 88,141 | 42,765 | 131,745 |
| Securities used for hedging | 91,315 | 1,604 | 905 | 93,824 |
| Loans to customers | 1,044,610 | 288,119 | 82,945 | 1,415,673 |
| Other assets | | 73,786 | 252,775 | 326,561 |
| Financial assets excluding derivatives | 3,583,718 | 916,361 | 1,311,119 | 5,811,198 |
| Derivatives | 43,038 | 7,320 | 1,199 | 51,557 |
| **Total** | 3,626,756 | 923,681 | 1,312,318 | 5,862,755 |

| **Financial liabilities** | **EUR** | **USD** | **Other currencies** | **Total** |
|---|---|---|---|---|
| Deposits | 3,552,260 | 1,172,418 | 687,957 | 5,412,635 |
| Short positions used for trading | | 246 | 61 | 307 |
| Financial liabilities excluding derivatives | 3,552,260 | 1,172,664 | 688,018 | 5,412,942 |
| Derivatives | 133,293 | | 105,028 | 238,321 |
| **Total** | 3,685,553 | 1,172,664 | 793,047 | 5,651,263 |

| **Net currency position** | **EUR** | **USD** | **Other currencies** | **Total** |
|---|---|---|---|---|
| Financial assets | 3,626,756 | 923,681 | 1,312,318 | 5,862,755 |
| Financial liabilities | (3,685,553) | (1,172,664) | (793,047) | (5,651,263) |
| Net off-balance sheet position | (256,816) | (59,408) | (98,488) | (414,711) |
| **Total** | (315,613) | (308,391) | 420,784 | (203,219) |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**53. Currency risk cont.**

e. Sensitivity to currency risk

Given the net currency position, a 10% change in the value of the ISK would, with other things constant, result in the following changes to the Group's pre-tax profit.

| | | 2013 | | 2012 |
|---|---|---|---|---|
| **Assets and liabilities denominated in foreign currencies** | **-10%** | **+10%** | **-10%** | **+10%** |
| EUR | 12,053 | (12,053) | (31,561) | 31,561 |
| USD | 112 | (112) | (30,839) | 30,839 |
| Other currencies | 35,650 | (35,650) | 42,078 | (42,078) |
| **Total** | 47,815 | (47,815) | (20,322) | 20,322 |

The effect on equity would be the same, net of income tax.

**54. Other price risk**

Other price risk arises from changes in the market prices of equity securities in the Group's portfolio. The Group invests primarily in equity securities listed on regulated markets, but has also invested in unlisted equities. A breakdown of shares and other variable income securities is provided in note 16. The Group's risk is the general risk involved in investing in equity securities. Efforts are made to reduce this risk through active risk management.

| | | | 2013 | | | 2012 |
|---|---|---|---|---|---|---|
| | | | **Carrying** | | | **Carrying** |
| | **Average** | **Max** | **amount** | **Average** | **Max** | **amount** |
| Listed shares | 278,700 | 524,633 | 400,662 | 113,807 | 393,951 | 349,076 |
| Listed unit shares | 208 | 231 | 221 | 173 | 199 | 199 |
| Unlisted shares | 244,189 | 587,835 | 182,379 | 167,794 | 176,569 | 129,836 |
| Unlisted unit shares | 892,923 | 1,314,089 | 370,485 | 829,388 | 888,372 | 764,022 |
| **Total** | | | 953,747 | | | 1,243,133 |

The Group is also exposed to changes in the market prices of equity options as specified in note 20 and equities included in short positions used for trading as specified in note 32.

**55. Operational risk**

a. Definition

Operational risk is the risk of financial losses resulting from the failure or inadequacy of internal processes or systems, from employee error or from external events. Operational risk includes legal risk, but excludes reputational risks. It is therefore inherent in all areas of business activities.

b. Management

Operational risk can be reduced through staff training, process re-design and enhancement of the control environment. The risk management unit monitors operational risk by tracking loss events, quality deficiencies, potential risk indicators and other early-warning signals. The unit takes an active role in internal control and quality management.

Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

## Financial assets and liabilities

**56. Accounting classification of financial assets and liabilities**

The accounting classification of financial assets and liabilities is specified as follows:

| **2013**<br>**Financial assets** | **Held for trading** | **Designated at fair value** | **Available for sale** | **Loans and receivables** | **Other at amortised cost** | **Total carrying amount** |
|---|---|---|---|---|---|---|
| Cash and cash equivalents | | | | 17,795,993 | | 17,795,993 |
| Receivables from Central Bank of Iceland | | | | 4,510,503 | | 4,510,503 |
| Fixed income securities | 2,416,145 | 197,537 | 1,671,154 | | | 4,284,835 |
| Shares and other variable income securities | 692,893 | 260,854 | | | | 953,747 |
| Securities used for hedging | | 2,853,272 | | | | 2,853,272 |
| Loans to customers | | | | 27,242,120 | | 27,242,120 |
| Derivatives | 504,341 | | | | | 504,341 |
| Other assets | | | | 731,371 | | 731,371 |
| **Total** | 3,613,378 | 3,311,663 | 1,671,154 | 50,279,986 | 0 | 58,876,181 |

| **Financial liabilities** | **Held for trading** | **Designated at fair value** | **Available for sale** | **Loans and receivables** | **Other at amortised cost** | **Total carrying amount** |
|---|---|---|---|---|---|---|
| Deposits | | | | | 35,229,708 | 35,229,708 |
| Deposits from credit institutions | | | | | 2,346,121 | 2,346,121 |
| Borrowings | | | | | 8,327,416 | 8,327,416 |
| Short positions used for trading | 4,492,682 | | | | | 4,492,682 |
| Short positions used for hedging | 3,174,046 | | | | | 3,174,046 |
| Derivatives | 184,109 | | | | | 184,109 |
| Other liabilities | | | | | 1,697,634 | 1,697,634 |
| **Total** | 7,850,836 | 0 | 0 | 0 | 47,600,880 | 55,451,716 |

| **2012**<br>**Financial assets** | **Held for trading** | **Designated at fair value** | **Available for sale** | **Loans and receivables** | **Other at amortised cost** | **Total carrying amount** |
|---|---|---|---|---|---|---|
| Cash and cash equivalents | | | | 20,405,530 | | 20,405,530 |
| Receivables from Central Bank of Iceland | | | | 3,287,741 | | 3,287,741 |
| Fixed income securities | 3,071,839 | 197,455 | 1,835,772 | | | 5,105,066 |
| Shares and other variable income securities | 1,026,128 | 217,005 | | | | 1,243,133 |
| Securities used for hedging | | 6,807,792 | | | | 6,807,792 |
| Loans to customers | | | | 27,789,290 | | 27,789,290 |
| Derivatives | 312,795 | | | | | 312,795 |
| Other assets | | | | 646,485 | | 646,485 |
| **Total** | 4,410,763 | 7,222,251 | 1,835,772 | 52,129,046 | 0 | 65,597,833 |

| **Financial liabilities** | **Held for trading** | **Designated at fair value** | **Available for sale** | **Loans and receivables** | **Other at amortised cost** | **Total carrying amount** |
|---|---|---|---|---|---|---|
| Deposits | | | | | 42,402,442 | 42,402,442 |
| Deposits from credit institutions | | | | | 3,515,054 | 3,515,054 |
| Borrowings | | | | | 6,575,208 | 6,575,208 |
| Short positions used for trading | 5,961,847 | | | | | 5,961,847 |
| Short positions used for hedging | 2,024,604 | | | | | 2,024,604 |
| Derivatives | 221,518 | | | | | 221,518 |
| Other liabilities | | | | | 2,644,220 | 2,644,220 |
| **Total** | 8,207,968 | 0 | 0 | 0 | 55,136,923 | 63,344,891 |

# Notes to the Consolidated Financial Statements

**57. Financial assets and liabilities measured at fair value**

a. Fair value hierarchy

The fair value of financial assets and liabilities that are traded in active markets are based on quoted market prices. For other financial instruments the Bank determines fair value using various valuation techniques. IFRS 13 specifies a fair value hierarchy based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources whereas unobservable inputs reflect the Bank's market assumptions. These two types of inputs result in the following fair value hierarchy:

- Level 1
  Inputs are quoted market prices (unadjusted) in active markets for identical instruments.
- Level 2
  Inputs are not quoted market prices but are observable either directly, i.e. as prices, or indirectly, i.e. derived from prices. This category includes financial instruments valued using quoted prices in active markets for similar instruments, quoted prices for similar or identical instruments in markets that are considered less than active and other instruments which are valued using techniques which rely primarily on inputs that are directly or indirectly observable from market data.
- Level 3
  Inputs are not observable or unobservable inputs have a significant effect on the valuation. This category includes instruments that are valued based on quoted prices for similar instruments for which significant unobservable adjustments are required to reflect the differences between the instruments.

b. Valuation process

The Bank's ALCO committee is responsible for fair value measurements of financial assets and liabilities classified as level 2 or level 3 instruments. The valuation is carried out by personnel from Risk and Treasury and is revised at least quarterly, or when there are indications of significant changes in the underlying inputs.

c. Valuation techniques

The Group uses widely recognized valuation techniques, including net present value and discounted cash flow models, comparison with similar instruments for which market observable prices exist, Black-Scholes and other valuation models.

Valuation techniques include recent arm's length transactions between knowledgeable, willing parties, if available, reference to the current fair value of other instruments that are substantially the same, the discounted cash flow analysis and option pricing models. Valuation techniques incorporate all factors that market participants would consider in setting a price and are consistent with accepted methodologies for pricing financial instruments. Periodically, the Group calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument, without modification or repackaging, or based on any available observable market data.

For more complex instruments, the Group uses proprietary models, which usually are developed from recognised valuation models. Some or all of the inputs into these models may not be market observable, and are derived from market prices or rates or are estimated based on assumptions. When entering into a transaction, the financial instrument is recognised initially at the transaction price, which is the best indicator of fair value, although the value obtained from the valuation model may differ from the transaction price. This initial difference, usually an increase in fair value, indicated by valuation techniques is recognised in income depending upon the individual facts and circumstances of each transaction and no later than when the market data becomes observable.

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the statement of financial position.

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**57. Financial assets and liabilities measured at fair value cont.**

d. Fair value hierarchy classification

The fair value of financial assets and liabilities measured at fair value in the statement of financial position is classified into fair value hierarchy as follows:

**2013**

| **Financial assets** | **Level 1** | **Level 2** | **Level 3** | **Carrying amount** |
|---|---|---|---|---|
| Held for trading | | | | |
| Fixed income securities | 2,416,145 | | | 2,416,145 |
| Shares and other variable income securities | 692,893 | | | 692,893 |
| Derivatives | | 504,341 | | 504,341 |
| Designated at fair value | | | | |
| Fixed income securities | | | 197,537 | 197,537 |
| Shares and other variable income securities | | 3,260 | 257,594 | 260,854 |
| Securities used for hedging | 2,853,272 | | | 2,853,272 |
| Available for sale | | | | |
| Fixed income securities | 1,671,154 | | | 1,671,154 |
| **Total** | 7,633,463 | 507,600 | 455,131 | 8,596,195 |

| **Financial liabilities** | **Level 1** | **Level 2** | **Level 3** | **Carrying amount** |
|---|---|---|---|---|
| Held for trading | | | | |
| Short positions used for trading | 4,492,675 | 6 | | 4,492,682 |
| Derivatives | | 184,109 | | 184,109 |
| Short positions used for hedging | 3,174,046 | | | 3,174,046 |
| **Total** | 7,666,721 | 184,115 | 0 | 7,850,836 |

**2012**

| **Financial assets** | **Level 1** | **Level 2** | **Level 3** | **Carrying amount** |
|---|---|---|---|---|
| Held for trading | | | | |
| Fixed income securities | 3,071,839 | | | 3,071,839 |
| Shares and other variable income securities | 1,023,655 | 2,473 | | 1,026,128 |
| Derivatives | | 312,795 | | 312,795 |
| Designated at fair value | | | | |
| Fixed income securities | | | 197,455 | 197,455 |
| Shares and other variable income securities | | | 217,005 | 217,005 |
| Securities used for hedging | 6,807,792 | | | 6,807,792 |
| Available for sale | | | | |
| Fixed income securities | 1,835,772 | | | 1,835,772 |
| **Total** | 12,739,059 | 315,268 | 414,459 | 13,468,786 |

| **Financial liabilities** | **Level 1** | **Level 2** | **Level 3** | **Carrying amount** |
|---|---|---|---|---|
| Held for trading | | | | |
| Short positions used for trading | 5,961,839 | 7 | | 5,961,847 |
| Short positions used for hedging | 2,024,604 | | | 2,024,604 |
| Derivatives | | 221,518 | | 221,518 |
| **Total** | 7,986,443 | 221,525 | 0 | 8,207,968 |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**57. Financial assets and liabilities measured at fair value cont.**

e. Reconciliation of changes in Level 3 fair value measurements

| 2013 | Fixed income securities | Shares and other var. income securities | Total |
|---|---|---|---|
| Balance as at 1 January 2013 | 197,455 | 217,005 | 414,459 |
| Total gains and losses in profit or loss | 39,867 | (16,765) | 23,102 |
| Purchases | 61,851 | 1,665 | 63,516 |
| Settlements and sales | (101,635) | (27,500) | (129,135) |
| Transfers into Level 3 | | 83,190 | 83,190 |
| **Balance as at 31 December 2013** | 197,537 | 257,594 | 455,131 |

| 2012 | Fixed income securities | Shares and other var. income securities | Total |
|---|---|---|---|
| Balance as at 1 January 2012 | 203,144 | 224,447 | 427,591 |
| Total gains and losses in profit or loss | 5,760 | (9,641) | (3,881) |
| Purchases | 50 | 2,199 | 2,249 |
| Settlements and sales | (11,500) | | (11,500) |
| **Balance as at 31 December 2012** | 197,455 | 217,005 | 414,459 |

f. Change in unrealised gains or losses related to assets held at year-end

| 2013 | Fixed income securities | Shares and other var. income securities | Total |
|---|---|---|---|
| Net financial income | | | |
| Fixed income | 39,870 | | 39,870 |
| Equities | | (2,801) | (2,801) |
| Foreign currency exchange difference | | (9,217) | (9,217) |
| **Total** | 39,870 | (12,018) | 27,852 |

| 2012 | Fixed income securities | Shares and other var. income securities | Total |
|---|---|---|---|
| Net financial income | | | |
| Equities | | (11,697) | (11,697) |
| Foreign currency exchange difference | | 206 | 206 |
| **Total** | 0 | (11,492) | (11,492) |

g. Unobservable inputs in fair value measurements

The fixed income securities classified as level 3 are unlisted and not traded in active markets. Their fair value is estimated based on the financial position of the issuer and expected recovery. Given the nature of the valuation method, a range of unobservable inputs is not available.

The shares and other variable income securities classified as level 3 are unlisted and not traded in active markets. Their fair value is estimated based on analysis of financial position and performance, valuations provided by third parties and recent transactions. Given the nature of the valuation method, a range of unobservable inputs is not available.

h. The effect of unobservable inputs in Level 3 fair value measurements

The Group believes its estimates represent appropriate approximations of fair value and that the use of different valuation methodologies and reasonable changes in assumptions or unobservable inputs would not significantly change the estimates.

A 10% change in the estimates would have the following effect on profit before taxes:

| | +10% | -10% |
|---|---|---|
| Fixed income securities | 19,754 | (19,754) |
| Shares and other variable income securities | 25,759 | (25,759) |
| **Total** | 45,513 | (45,513) |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**58. Financial assets and liabilities not measured at fair value**

Financial assets and liabilities not measured at fair value have either a short time to maturity or settlement, variable interest rates or other attributes which result in the carrying amount being a reasonable approximation of their fair value.

a. Fair value hierarchy classification

The carrying amount of financial assets and liabilities not measured at fair value in the statement of financial position is classified into a fair value hierarchy as follows:

**2013**

| **Financial assets** | **Level 1** | **Level 2** | **Level 3** | **Fair value** |
|---|---|---|---|---|
| Cash and cash equivalents | | 17,795,993 | | 17,795,993 |
| Receivables from Central Bank of Iceland | | 4,510,503 | | 4,510,503 |
| Loans to customers | | 26,848,644 | 393,476 | 27,242,120 |
| Other assets | | 702,990 | 28,381 | 731,371 |
| **Total** | 0 | 49,858,129 | 421,857 | 50,279,986 |

| **Financial liabilities** | **Level 1** | **Level 2** | **Level 3** | **Fair value** |
|---|---|---|---|---|
| Deposits | | 35,229,708 | | 35,229,708 |
| Deposits from credit institutions | | 2,346,121 | | 2,346,121 |
| Borrowings | | 8,327,416 | | 8,327,416 |
| Other liabilities | | 1,697,634 | | 1,697,634 |
| **Total** | 0 | 47,600,880 | 0 | 47,600,880 |

**2012**

| **Financial assets** | **Level 1** | **Level 2** | **Level 3** | **Fair value** |
|---|---|---|---|---|
| Cash and cash equivalents | | 20,405,530 | | 20,405,530 |
| Receivables from Central Bank of Iceland | | 3,287,741 | | 3,287,741 |
| Loans to customers | | 26,979,401 | 809,889 | 27,789,290 |
| Other assets | | 616,906 | 29,578 | 646,485 |
| **Total** | 0 | 51,289,579 | 839,468 | 52,129,046 |

| **Financial liabilities** | **Level 1** | **Level 2** | **Level 3** | **Fair value** |
|---|---|---|---|---|
| Deposits | | 42,402,442 | | 42,402,442 |
| Deposits from credit institutions | | 3,515,054 | | 3,515,054 |
| Borrowings | | 6,575,208 | | 6,575,208 |
| Other liabilities | | 2,644,220 | | 2,644,220 |
| **Total** | 0 | 55,136,923 | 0 | 55,136,923 |

b. Determination of fair value

Cash and cash equivalents includes several components as detailed in note 14. Cash equivalent assets are either balances available on-demand or on very short notice, or other assets easly converted to cash. The carrying amount of these assets is therefore a reasonable approximation of their fair value.

Receivables from Central Bank of Iceland represent short-term claims on the Central Bank of Iceland resulting from reverse repurchase agreements. Due to the nature and short duration of these receivables the carrying amount is a reasonable approximation of their fair value.

Loans to customers are substantially all either short-term or have variable interest rates and the Group considers their carrying amount to be a reasonable estimate of their fair value.

Other assets consist primarily of short-term receivables and prepayments and their fair value is considered to be the same as carrying value.

Deposits, Deposits from credit institutions and borrowings are typically either short-term or have variable interest rates and their carrying amount is considered a reasonable approximation of their fair value.

Other liabilities consist primarily of accounts payables, withholding taxes and other short-term payables, and their fair value is considered to be the same as their carrying value.

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

## Segment information

**59. Geographical information**

Net operating income is based on the customer's country of domicile and assets are based on the geographical location of the assets.

| Net operating income | 2013 | 2012 |
|---|---|---|
| Iceland | 3,539,553 | 3,795,220 |
| Other regions | 8,935 | 75,362 |
| Eliminations | 56,066 | 123,985 |
| **Total** | 3,604,554 | 3,994,567 |

| Total assets | 2013 | 2012 |
|---|---|---|
| Iceland | 60,689,382 | 70,971,872 |
| Other regions | 425,115 | 474,157 |
| Eliminations | (605,636) | (2,053,156) |
| **Total** | 60,508,862 | 69,392,873 |

**60. Business segments**

Segment reporting is based on the same principles and structure as internal reporting to senior management and the board of directors. Segment performance is evaluated on earnings before tax.

Assets and liabilities which support revenue generation are allocated to business segments. All equity is allocated to Treasury. The segments pay and receive interest from Treasury to reflect the allocation of capital and funding costs, with inter segment pricing being determined on an arm's length basis. Administrative expenses of support functions are allocated to business segments based on the underlying cost drivers.

a. Reportable segments
The Group defines four reportable segments.

- **Asset Management** provides asset management, private banking and advisory services to its clients, who consist primarily of institutional investors and high net worth individuals.
- **Investment Banking** is divided into Corporate Finance, Capital Markets, Credit, Proprietary Trading and Treasury and serves institutional and private investors and corporate clients. Services provided to external customers include advisory services for mergers and acquisitions, refinancing and restructuring projects, securities and foreign exchange brokerage, specialized lending and market making activities.
- **Retail Banking** provides selected banking services, such as savings, payment cards and lending, with a special focus on small and medium sized enterprises and professionals.
- **Asset Financing** provides equipment financing to individuals and corporate clients.

Other divisions, subsidiaries and certain legacy assets form a fifth reportable segment, **Other Operations**.

b. Business segment balance sheet

| 2013 | Asset Management | Investment Banking | Retail Banking | Other Operations | Elimination entries | Total |
|---|---|---|---|---|---|---|
| Segment assets 31.12.2013 | 1,446 | 61,744,934 | 48,660,920 | 6,145,367 | (56,043,805) | 60,508,862 |
| Segment liabilities 31.12.2013 | 1,446 | 56,708,167 | 48,660,920 | 6,145,367 | (56,043,805) | 55,472,095 |
| Segment equity 31.12.2013 | 0 | 5,036,767 | 0 | 0 | 0 | 5,036,767 |

| 2012 | Asset Management | Investment Banking | Retail Banking | Other Operations | Elimination entries | Total |
|---|---|---|---|---|---|---|
| Segment assets 31.12.2012 | 0 | 71,288,957 | 56,131,633 | 5,062,212 | (63,089,929) | 69,392,873 |
| Segment liabilities 31.12.2012 | 0 | 66,039,334 | 56,131,633 | 5,062,212 | (63,089,929) | 64,143,251 |
| Segment equity 31.12.2012 | 0 | 5,249,622 | 0 | 0 | 0 | 5,249,622 |

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

**60. Business segments cont.**

c. Business segments results

| 2013 | Asset Management | Investment Banking | Retail Banking | Other Operations | Elimination entries | Total |
|---|---|---|---|---|---|---|
| Net interest income | (43) | 1,169,667 | (39,873) | 353,763 | (0) | 1,483,515 |
| Net fee and commission income | 356,310 | 797,261 | 246,128 | 383,522 | (28,720) | 1,754,501 |
| Net financial income | (27) | 251,983 | 1,192 | 22,234 | 0 | 275,383 |
| Share in profit of associates, net of income tax | 0 | 0 | 0 | 4,572 | (8,287) | (3,715) |
| Other operating income | 2 | 1,813 | 26 | 93,029 | 0 | 94,871 |
| Net operating income from external customers | 356,242 | 2,220,725 | 207,474 | 857,120 | (37,007) | 3,604,554 |
| Net operating income from internal customers | 7,412 | (647,493) | 896,765 | (256,684) | 0 | 0 |
| Net operating income | 363,654 | 1,573,232 | 1,104,239 | 600,436 | (37,007) | 3,604,554 |
| Administrative expenses | (272,576) | (1,283,734) | (1,208,546) | (874,474) | (9,533) | (3,648,863) |
| Impairment of loans and receivables | 0 | (92,178) | (98,514) | 237,527 | 0 | 46,834 |
| Impairment of intangible assets | 0 | 0 | 0 | (771,930) | 0 | (771,930) |
| Profit (loss) from assets held for sale | 0 | 0 | 9,927 | 0 | 0 | 9,927 |
| **(Loss) profit before taxes** | 91,078 | 197,320 | (192,894) | (808,442) | (46,540) | (759,478) |

| 2012 | Asset Management | Investment Banking | Retail Banking | Other Operations | Elimination entries | Total |
|---|---|---|---|---|---|---|
| Net interest income | (76,349) | 1,872,620 | (209,106) | 128,954 | 0 | 1,716,119 |
| Net fee and commission income | 195,741 | 747,399 | 258,782 | 212,068 | (18,932) | 1,395,058 |
| Net financial income | 113 | 478,735 | 14,851 | 172,585 | (29,250) | 637,035 |
| Share in profit of associates, net of income tax | 0 | 0 | 0 | 74,565 | 142,917 | 217,482 |
| Other operating income | 0 | 1,605 | 12 | 27,256 | 0 | 28,873 |
| Net operating income from external customers | 119,505 | 3,100,360 | 64,539 | 615,428 | 94,735 | 3,994,567 |
| Net operating income from internal customers | 109,703 | (984,690) | 987,717 | (112,730) | 0 | 0 |
| Net operating income | 229,208 | 2,115,670 | 1,052,256 | 502,698 | 94,735 | 3,994,567 |
| Administrative expenses | (248,179) | (1,222,031) | (1,076,000) | (598,190) | 16,233 | (3,128,166) |
| Impairment of loans and receivables | 0 | (38,216) | (104,059) | (528,687) | 0 | (670,962) |
| Profit (loss) from assets held for sale | 0 | 0 | 0 | (10,989) | 0 | (10,989) |
| **(Loss) profit before taxes** | (18,970) | 855,423 | (127,802) | (635,167) | 110,968 | 184,451 |

d. Changes in reportable segments

In October 2013 the Bank announced organizational changes and a renewed focus on core competencies. To support these changes the Bank has changed its definition of reportable segments. The new definition has been used in the preparation of the operating budget for 2014-2016 and has been used in internal reporting to senior management and the board of directors starting from January 2014.

The following operating segments will be in use started from 2014:

- **Asset Management** manages assets on behalf of its clients, who consist primarily of institutional investors and high net worth individuals, and offers a variety of products and services to meet their diverse needs.
- **Banking** provides selected banking services with a special focus on SME's and professionals and also provides Treasury services to the Bank.
- **Markets** provides securities and FX brokerage, specialized lending and market making activities and M&A advisory services to clients, which include institutional investors, corporates and high net worth individuals.
- **Asset Financing** provides equipment financing to individuals and corporate clients.

Other divisions and certain legacy assets form a fifth reportable segment, **Other Operations**.

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

## Other information

**61. Related parties**

a. Definition of related parties

The Group has a related party relationship with the board members of the Bank, the CEO of the Bank and key employees (together referred to as management), associates as disclosed in note 22, shareholders with significant influence over the Bank (defined as holding 10% or greater of the shares in the Bank as disclosed in note 67), close family members of individuals identified as related parties and entities where related parties are determined to hold significant influence.

b. Arm's length

Transactions with related parties are carried out at arm's length and subject to an annual review by the Bank's internal auditors.

c. Effects on statement of financial position

| 2013 | Loans & receivables | Deposits & payables |
|---|---|---|
| Management and board members | 10,784 | 188,940 |
| Associates | 2,307 | 314,172 |
| Shareholders | 0 | 0 |
| **Total** | 13,091 | 503,112 |

| 2012 | Loans & receivables | Deposits & payables |
|---|---|---|
| Management and board members | 62,902 | 36,331 |
| Associates | 80,582 | 39,160 |
| Shareholders | 25,200 | 380,915 |
| **Total** | 168,685 | 456,405 |

d. Off-balance sheet obligations

As at 31 December 2013 and 31 December 2012 there were no off-balance sheet obligations with related parties.

e. Effects on income statement

| 2013 | Interest income | Interest expense | Impairment expense | Fees received | Fees paid |
|---|---|---|---|---|---|
| Management and board members | 1,942 | 13,934 | 0 | 2,633 | 30,426 |
| Associates | 7,376 | 6,246 | 0 | 299 | 5,649 |
| Shareholders | 0 | 0 | (8,440) | 0 | 0 |
| **Total** | 9,318 | 20,180 | (8,440) | 2,932 | 36,075 |

| 2012 | Interest income | Interest expense | Impairment expense | Fees received | Fees paid |
|---|---|---|---|---|---|
| Management and board members | 4,554 | 1,806 | 0 | 5 | 6,718 |
| Associates | 6,343 | 1,951 | 0 | 624 | 74,031 |
| Shareholders | 675 | 4,643 | 8,440 | 26,520 | 73,425 |
| **Total** | 11,572 | 8,401 | 8,440 | 27,149 | 154,175 |

Further information about salaries and benefits paid to the Board of Directors, the CEO and Managing Directors is provided in note 9.

MP banki hf. Amounts are in ISK thousands

# Notes to the Consolidated Financial Statements

## 62. Remuneration policy

The Board of Directors has adopted a remuneration policy at the proposal of the Remuneration Committee. The policy was approved by the Bank's Annual General Meeting in April 2012.

The remuneration policy conforms to Article 57 of Act No. 161/2002 on Financial Undertakings, Act No. 2/1995 on Public Limited Companies and the Icelandic FSA's directive No. 700/2011 on Incentive Schemes. The policy covers three remuneration components, base pay, performance based incentive scheme and other benefits, including pension fund contributions. A more detailed description of the policy can be found on the Bank's website, www.mp.is.

## 63. Incentive scheme

The Board of Directors has approved a performance based incentive scheme at the proposal of the Remuneration Committee. The scheme forms a part of the remuneration policy adopted by the Bank.

a. Description
The incentive scheme conforms to the Icelandic FSA's directive No. 700/2011 on Incentive Schemes. Payments according to the scheme are based on key performance indicators (KPIs) that reflect the goals of the Bank, the division and the employee. The basis for performance based pay reflects sound risk management and does not induce excessive risk taking. Performance based pay to individual employees does not exceed 25% of their annual base salary, and payment of 40-60% of the performance based pay is deferred for three years. Performance based pay can be in the form of cash payments or share options. Share based payments are discussed in note 64.

b. Performance based payments

| | 2013 | | 2012 | |
|---|---|---|---|---|
| | **Cash** | **Options** | **Cash** | **Options** |
| Non-deferred | 1,951 | 0 | 28,935 | 0 |
| Deferred | 1,500 | 2,126 | 71,962 | 13,628 |
| **Total** | 3,451 | 2,126 | 100,897 | 13,628 |

c. On-balance sheet deferred performance based payments

| | **2013** | **2012** |
|---|---|---|
| Deferred cash payments | 40,585 | 71,962 |
| **Total** | 40,585 | 71,962 |

## 64. Share-based payments

The remuneration policy approved by the Board of Directors of the Bank includes a share-based incentive scheme. At the Bank's Annual General Meeting in April 2012 the Board of Directors was authorized to increase the share capital of the Bank by up to 275 million shares in stages to fulfil any obligations arising from the scheme.

a. Description
In 2012 the Bank established a share based incentive scheme that grants key personnel options to purchase shares in the Bank at a fixed price. The options are equity-settled, have a term of five years and will vest in three tranches with vesting dates 36, 48 and 60 months from the grant date. The grant is subject to the participant's continued employment by the company, and various other conditions satisfying the requirements of the Icelandic FSA. A more detailed description of the scheme can be found on the Bank's website, www.mp.is.

As at 31 December 2013, the Bank had enrolled 13 employees in the share-based incentive scheme, with a total number of options granted equalling 212 million shares in the bank. No options had vested as at 31 December 2013.

b. Grant date fair value
The grant date fair value of the options granted through the scheme was as follows:

| | **2013** | **2012** |
|---|---|---|
| Grant date fair value (ISK per share) | 0.08-0.17 | 0.01-0.13 |

The grant date fair value of the options is calculated using the Black-Scholes method for European style options pricing. The following inputs were used in the valuation of the options:

| | **2013** | **2012** |
|---|---|---|
| Exercise price (ISK per share) | 1.15 | 1.15 |
| Risk free interest rate | 5.5%-6.0% | 6.0%-6.7% |
| Expected volatility | 1.0%-1.1% | 2.7% |
| Option life (years) | 3-5 | 3-5 |

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# Notes to the Consolidated Financial Statements

## 65. Operating lease commitments

The Group leases under operating leases office premises for its operations in Reykjavik, London and Vilnius. The typical lease period is 3-5 years with a renewal option. In some leases the rent is based on the Icelandic Consumer Price Index and changes accordingly. Future non-cancellable minimum operating lease payments are specified as follows:

| | 2013 | 2012 |
|---|---|---|
| Up to 1 year | 70,678 | 81,422 |
| 1-5 years | 77,519 | 144,361 |
| **Total** | 148,197 | 225,783 |

## 66. Pledged assets

The Group has pledged assets, in the ordinary course of banking business, to the Central Bank of Iceland in the amount of ISK 3.0 billion as at 31 December 2013 (2012: 3.0 billion) to secure settlement in the Icelandic clearing systems. Further pledges have been placed in the ordinary course of banking business for netting and set-off arrangements in the total amount of ISK 14.2 billion as at 31 December 2013 (2012: 9.5 billion).

## 67. Shareholders of the Bank

Ownership in the Bank is specified as follows:

| Shareholder | Country | 2013 % | 2012 % | Beneficial owners if not shareholder |
|---|---|---|---|---|
| Manastur Holding B.V. | Netherlands | 9.99% | 9.54% | Joseph Lewis (100%) |
| Títan B ehf. | Iceland | 9.91% | 17.30% | Skúli Mogensen (100%) |
| Lífeyrissjóður verslunarmanna | Iceland | 9.74% | 9.72% | |
| Linley Limited | UK | 9.54% | 9.54% | The Rowland Purpose Trust 2001 |
| Mízar ehf | Iceland | 9.40% | 9.00% | Guðmundur Steinar Jónsson (100%) |
| Fagfjárfestasjóðurinn Norðurljós | Iceland | 8.20% | 0.00% | Júpíter rekstrarfélag hf., as managing company |
| Tryggingamiðstöðin hf. | Iceland | 5.12% | 5.40% | |
| Drómi hf. | Iceland | 4.36% | 4.59% | Sparisjóður Reykjavíkur og nágrennis hf. (99%) |
| Klakki ehf. | Iceland | 4.27% | 4.50% | Arion banki hf. (32%), Kaupþing hf. (19%) |
| MP Canada Iceland Ventures Inc. | Canada | 3.42% | 3.60% | Robert Reich (100%) |
| Alkor ehf | Iceland | 2.76% | 2.25% | Berglind Björk Jónsdóttir (100%) |
| ET sjón ehf | Iceland | 2.56% | 2.70% | Eiríkur Ingvar Þorgeirsson (100%) |
| Arkur ehf. | Iceland | 2.56% | 2.70% | Steinunn Jónsdóttir (100%) |
| P 126 ehf. | Iceland | 1.71% | 1.80% | Charamino Holdings Limited (100%) |
| Stekkur fjárfestingarfélag ehf | Iceland | 1.71% | 1.80% | Kristinn Aðalsteinsson (100%) |
| Others, each less than 1% | | 14.68% | 15.47% | 2013: 34, 2012: 35 |
| | | 99.93% | 99.93% | |
| Treasury shares | | 0.07% | 0.07% | |
| **Issued share capital** | | 100.00% | 100.00% | |

The information presented is based on publicly available information and the Bank is in some cases unable to verify its accuracy.

## 68. Events after the reporting date

The Bank has entered into agreement for the sale of its equipment financing business, which operates under the brand name Lykill. The sale is expected to be completed in Q2 and will not have a significant impact on the Bank's income statement.

# Notes to the Consolidated Financial Statements

## Significant accounting policies

**69. Basis of consolidation**

The accounting policies set out below have been applied consistently to all periods presented in these Consolidated Financial Statements, and have been applied consistently by Group entities.

a. Subsidiaries

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Group holds more than 50% of the voting power of the subsidiary. In assessing control, potential voting rights that are presently exercisable or convertible, if any, are taken into account. The financial statements of subsidiaries are included in the financial statements of the Group from the date that control commences until the date that control ceases.

The Group uses the acquisition method to account for the acquisition of subsidiaries. The cost of an acquisition is measured as the fair value, at the date of exchange, of the assets given, liabilities incurred or assumed and equity instruments issued. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest.

The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recognised as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised immediately in the income statement.

b. Non-controlling interest

Non-controlling interest represent the portion of profit or loss and equity not owned, directly or indirectly, by the Bank. Non-controlling interest is presented separately in the income statement and is included in equity in the statement of financial position, separately from equity attributable to owners of the Bank.

The Group chooses on an acquisition-by-acquisition basis whether to measure non-controlling interest in an acquiree at fair value or according to the proportion of non-controlling interests in the acquiree's net assets. Changes in the Bank's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions. In such circumstances the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interest is adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the Bank.

c. Fiduciary services

The Group provides custody services, fund management and discretionary and advisory investment management services which require the Group to make decisions on the handling, acquisition or disposal of financial instruments on behalf of its clients.

The financial statements of managed funds and investment portfolios managed by the Group on behalf of customers are not included in the financial statements, as they do not constitute assets or liabilities of the Group.

d. Transactions eliminated on consolidation

Intra-bank balances, income and expenses, and unrealised gains and losses arising from intra-bank transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with associates are eliminated against the investment to the extent of the Group's interest in the associate. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

**70. Foreign currency**

a. Foreign currency transactions

Transactions in foreign currencies are translated into the functional currency of the respective Group's entity using the exchange rate at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated to the functional currency using the exchange rate at the reporting date. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated using the exchange rate at the date the fair value was determined.

b. Foreign operations

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into the functional currency at spot exchange rate current at the reporting date. The income and expenses of foreign operations are translated into the functional currency at the spot exchange rates at the dates of the transactions.

# Notes to the Consolidated Financial Statements

**71. Recognition and derecognition of financial assets and liabilities**

a. Recognition

Loans to customers and deposits are recognised on the date that they are originated. All other financial assets and liabilities are initially recognised on the trade date, which is the date when the Group becomes a party to the contractual provisions of the instrument.

b. Derecognition

A financial asset is derecognised when the contractual rights to the cash flows from the asset expire, or when the Group enters into a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Group is recognised as a separate asset or liability.

Financial liabilities are derecognised when the obligation of the Group is discharged, cancelled or expires.

**72. Offsetting**

Financial assets and liabilities are offset, and the net amount reported in the statement of financial position, when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis for gains and losses arising from a group of similar transactions, such as in the Group's trading activity, or other circumstances permitted by International Financial Reporting Standards.

**73. Amortised cost measurement of financial assets and liabilities**

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

**74. Financial guarantees**

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.

Financial guarantee liabilities are initially recognised at their fair value, and initial fair value is amortised over the life of the financial guarantee. The guarantee liability is subsequently carried at the higher of this amortised amount and the present value of any expected payment, when a payment under the guarantee has become probable. Financial guarantees are included within other liabilities.

**75. Financial instruments - accounting classification**

Upon initial recognition, financial assets and liabilities are classified into one of the categories below. This classification determines amongst other things initial measurement, subsequent accounting and handling of interest revenue and expenses. International Financial Reporting Standards restrict the reclassification of financial instruments after initial recognition.

a. Held for trading

A financial instrument is classified as held for trading if it is purchased or incurred with the intention to resell and repurchase within a short period of time, or if it is a part of a group of defined financial instruments managed on a portfolio basis and historical data shows recent pattern of short-term profit taking or it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Financial assets held for trading include fixed income securities, shares and other variable income securities and derivatives. Financial liabilities held for trading include derivatives and short positions, i.e. commitments to deliver financial assets that the Bank has borrowed and sold to a third party.

Financial instruments held for trading are initially recognised at fair value, with transactions costs recognised in profit or loss. They are subsequently measured at fair value in the statement of financial position. Interest income and expense from derivatives is recognised in net interest income but all other interest income and expense, and all changes in fair value, are recognised as financial income.

b. Designated at fair value

A financial instrument is designated at fair value through profit and loss when it is a part of a portfolio of financial instruments that are managed on the basis of fair value and information provided to management is based on fair value.

Financial assets designated at fair value include fixed income securities, shares and other variable income securities and securities used for hedging.

Financial instruments designated at fair value are initially recognised at fair value, with transactions costs recognised in profit or loss. They are subsequently measured at fair value in the statement of financial position. Interest income and expense, and all changes in fair value, are recognised as financial income.

# Notes to the Consolidated Financial Statements

**75. Financial instruments - accounting classification cont.**

c. Available for sale

Non-derivative assets with fixed or determinable payments and fixed maturity that the Group has the positive intent and ability to hold indefinitely, but not necessarily to maturity, are classified as available for sale.

Financial assets classified as available for sale consist of fixed income securities.

Financial instruments classified as available for sale are initially recognised at fair value. They are subsequently measured at fair value in the statement of financial position, with interest income recognised in net interest income using the effective interest method. The difference between fair value and amortised cost is recognised in comprehensive income until the financial instrument is sold or reaches maturity, whereupon the cumulative gains or losses previously recognised in other comprehensive income are reclassified to financial income.

d. Loans and receivables

Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market are classified as loans and receivables.

Financial assets classified as loans and receivables include cash and cash equivalents, loans to customers and receivables.

Financial assets classified as loans and receivables are initially recognised at fair value, which is typically equal to cost, i.e. cash advanced plus any transaction costs. They are subsequently measured at amortised cost using the effective interest method. Accrued interest, in the case of interest bearing assets, is included in the carrying amount. Interest income is recognised in net interest income.

e. Other at amortised cost

Non-derivative financial liabilities with fixed or determinable payments that are not quoted in an active market are classified as other at amortised cost.

Financial liabilities classified as other at amortised cost include deposits, borrowings and payables.

Financial liabilities classified as other at amortised cost are initially recognised at fair value, which is typically equal to cost, i.e. cash advanced less any transaction costs. They are subsequently measured at amortised cost using the effective interest method. Accrued interest, in the case of interest bearing liabilities is included in the carrying amount. Interest expense is recognised in net interest income.

**76. Determination of fair value**

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. For all other financial instruments fair value is determined by using valuation techniques, see in notes 57 - 58.

**77. Impairment**

a. General principle

The carrying amount of the Group's non-financial assets and financial assets not at fair value through profit and loss is reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. An impairment is recognised in the income statement whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount.

b. Reversal of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is recognised as reduction of cost in the income statement. An impairment loss recognised for goodwill is not reversed in a subsequent period.

c. Calculation of recoverable amount

The recoverable amount of the Group's investments in financial assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate.

The recoverable amount of other assets is the greater of their fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

# Notes to the Consolidated Financial Statements

**78. Impairment of loans**

a. Indications of impairment

Objective evidence of impairment includes information about one or more of the following:

- Indications of significant financial difficulties of the borrower, including financial restructuring and refinancing concessions that a lender would not otherwise consider
- A breach of contract, such as a default on instalments or on interest or principal payments
- An observable decrease in the estimated future cash flows from a group of loans due to adverse changes in the economic conditions of a sector or region in which the borrower operates, even if the decrease cannot yet be identified with the individual financial assets in the group
- The disappearance of an active market for an asset held as collateral

Impairment losses expected as a result of events taking place after the reporting date, no matter how likely, are not recognised.

b. Calculation of impairment losses

Impairment loss is calculated by comparing the carrying amount of individual loans with the present value of their expected future cash flows, discounted at their original effective interest rate. In the case of loans at variable interest rates, the discount rate used is their current effective interest rate.

c. Individually assessed loans

Impairment losses on individually assessed loans are determined by an evaluation of the exposures on a case-by-case basis. This procedure is applied to all loans that are considered individually significant. In making the assessment, the following factors are considered:

- The Group's aggregate exposure towards the customer
- The amount and timing of expected receipts and recoveries
- The likely recovery upon liquidation or bankruptcy
- Complexity and uncertainty related to ranking of creditor claims and legal standing
- The realisable value of securities or other credit mitigants and the likelihood of successful repossession
- The likely deduction of any costs involved in recovery of amounts outstanding

d. Collectively assessed loans

Impairment losses on collectively assessed loans are determined by an evaluation of the exposures on a group of loans with similar risk characteristics. This procedure is applied to all loans that are not considered individually significant, or have been individually assessed but showed no indications of impairment. This loss covers loans that are impaired at the reporting date but which will not be individually identified as such until some time in the future.

The collective impairment loss is determined after taking into account the following:

- Historical loss experience in portfolios of similar risk characteristics, for example, by industry sector, loan grade or product
- The estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan
- Management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience

Estimates of changes in future cash flows for groups of assets are consistent with changes in observable data from period to period, for example changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to minimise any differences between loss estimates and actual losses.

e. Loan write-offs

The carrying amount of impaired loans is reduced through the use of an allowance account. Loans are written off, partially or in full, when there is no realistic prospect of recovery.

**79. Interest income and expense**

Interest income and expense are recognised in the income statement using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash flows to the carrying amount of the financial asset or liability, over the expected life of the financial instrument. Estimated future cash flows take into account all contractual terms of the financial instruments but not future credit losses.

Interest income and expense presented in the income statement includes interest on:

- financial assets classified as loans and receivables
- financial assets classified as available for sale
- financial liabilities carried at amortised cost
- derivatives

Further information about the accounting classification of financial assets and liabilities is provided in notes 56 and 75.

# Notes to the Consolidated Financial Statements

**80. Fee and commission income and expense**

The Group earns income from providing various services to its customers. This includes fees for managing assets on behalf of customers, commissions received for equity and bond transactions and fees and commissions for various other financial services.

Fee and commission income and expense comprises the following:
- Fee and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate
- Other fee and commission income is recognised in the income statement as the services are provided
- Fee and commission expense relates mainly to transaction fees, which are expensed as the services are received

**81. Net financial income**

Net financial income comprises the following:
- Realised and unrealised gains or losses from price changes of fixed income securities carried at fair value
- Realised and unrealised gains or losses from price changes of variable income securities
- Interest income from fixed income securities carried at fair value through profit or loss
- Dividends, excluding dividends from associates
- Fair value changes in derivatives
- Foreign exchange difference

**82. Dividend income**

Dividend income is recognised when the right to receive income is established. Usually this is the ex-dividend date for equity securities. Dividends, other than those from associates, are presented as a component of net financial income.

**83. Administrative expenses**

Administrative expenses comprise expenses other than interest expenses, fee and commission expenses and expenses related to fair value changes. A breakdown of administrative expenses is provided in note 7.

**84. Employee benefits**

a. Short-term employee benefits
Short-term employee benefits obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

b. Defined contribution plans
Obligations for contributions to defined contribution plans are expensed in profit or loss as the related service is provided. The Group has no further obligations once those contributions have been paid.

c. Shared-based payments
The grant date fair value of equity settled share-based payment awards granted to employees is recognised as an employee expense, with a corresponding increase in equity, over the period that the employees become unconditionally entitled to the awards. The amount recognised as an expense is adjusted to reflect the number of awards for which the related service and non-market performance conditions are expected to be met, such that the amount ultimately recognised as an expense is based on the number of awards that meet the related service and non-market performance conditions at the vesting date.

# Notes to the Consolidated Financial Statements

**85. Income tax**

Income tax comprises current and deferred tax. Income tax is recognised in the income statement, except to the extent that it relates to items recognised directly in other comprehensive income or equity, in which case it is recognised there.

Current tax liabilities include the estimated tax payable next year on current year's profit according to the tax rates prevailing at reporting date, in addition to corrections on tax from previous years.

The deferred income tax asset and/or liability has been calculated and recognised in the statement of financial position. The calculation is based on the difference between assets and liabilities as presented in the tax return on one hand, and in the consolidated financial statements on the other, taking into consideration tax losses carried forward. This difference is due to the fact that the tax assessment is based on premises that differ from those governing the financial statements, mostly due to temporary differences arising from the recognition of revenue and expense in the tax returns and in the financial statements.

Deferred tax assets and tax liabilities are offset in the statement of financial position when there is a legal right to settle on a net basis and they are levied by the same taxing authority on the same entity or on different entities subject to joint taxation.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

**86. Cash and cash equivalents**

Cash and cash equivalents include notes and coins on hand, unrestricted balances held with central banks and highly liquid financial assets with original maturities of three months or less from the acquisition date that are subject to and insignificant risk of changes in their fair value, and are used by the Group in the management of its short-term commitments.

Cash and cash equivalents are carried at amortised cost in the statement of financial position.

**87. Fixed income securities**

Fixed income securities are initially measured at fair value and subsequently accounted for depending on their classification as discussed in note 75.

**88. Shares and other variable income securities**

Shares and other variable income securities consist of equity investments and unit shares in mutual funds. Shares and other variable income securities are initially measured at fair value and subsequently accounted for depending on their classification as discussed in note 75.

**89. Securities used for hedging**

Securities used for hedging consist of non-derivative financial assets that are used to hedge the Group's risk exposure arising from derivative contracts with customers. Securities used for hedging are designated at fair value as discussed in note 75.

**90. Loans to customers**

Loans are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and include loans provided by the Group to its customers, participation in loans from other lenders and purchased loans that are not quoted in an active market and which the Group has no intention of selling immediately or in the near future.

Loans are initially recognised at fair value, which is the cash advanced, plus any transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and advances. The carrying amount of impaired loans is reduced through the use of an allowance account.

When the Group purchases a financial asset and simultaneously enters into an agreement to resell the asset, or a substantially similar asset, at a fixed price at a future date (“reverse repo” or “stock borrowing”), the arrangement is accounted for as a loan and the underlying asset is not recognised in the Group’s statement of financial position.

# Notes to the Consolidated Financial Statements

**91. Derivatives**

A derivative is a financial instrument or another contract that falls under the scope of IAS 39 and has the following three characteristics:

- Its value changes due to changes in an underlying variable, such as bond price, share price, security or price index (including CPI), foreign currency exchange rate or interest rate
- The contract requires no initial investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- Settlement takes place at a future date

The Group uses derivatives for trading purposes and to hedge its exposure to market price risk, foreign exchange risk and inflation and interest risk arising from operating, financing and investing activities. The Group does not apply hedge accounting.

Derivative assets and liabilities are initially recognised and subsequently measured at fair value in the statement of financial position. Derivatives with positive fair values are classified as financial assets and derivatives with negative fair values as financial liabilities. Revenue from derivatives is split into interest income and net income from financial instruments at fair value and presented in the corresponding line items in the income statement.

**92. Intangible assets**

a. Asset categories
The Group groups intangible assets into three categories:

- Software
  Software comprise acquired software licences and external costs associated with the development of bespoke applications.
- Goodwill
  Goodwill arises in business combinations. It is recognised as of the acquisition date and measured as the aggregate of (a) the fair value of the consideration transferred, (b) the recognised amount of any non-controlling interest in the acquiree, and (c) the fair value of any previously held equity interest in the acquiree, less the net recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed, all measured as at the acquisition date. The consideration transferred includes the fair value of assets transferred, liabilities incurred and equity interests issued by the Group. In addition, consideration transferred includes the fair value of any contingent consideration. Following initial recognition, goodwill is recognised at cost less any accumulated impairment losses.
- Other intangible assets
  Other intangible assets comprise licences and acquired trademarks used in the operation of the Group.

b. Initial recognition
Intangible assets are initially recognised at cost.

c. Subsequent measurement
The Group uses the cost model for measurement after recognition and intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. Intangible assets are reviewed for indications of impairment or changes in estimated future economic benefits at each reporting date. If such indications exist, the assets are analysed to assess whether their carrying amount is fully recoverable. An impairment loss is recognised in accordance with the accounting policy for non-financial assets described in note 78.

d. Amortisation
Intangible assets with finite useful life are amortised using the straight-line method over their estimated useful economic life, with the amortisation recognised in the income statement. The estimated useful life of intangible assets is as follows:

| | |
|---|---|
| Software | 5-10 years |
| Other intangible assets with finite useful life | 10 years |

**93. Investments in associates**

Associates are those entities in which the Group has significant influence, but not control, over the financial and operating policies. Significant influence generally exists when the Group holds between 20% and 50% of the voting power, including potential voting rights, if any. Investments in associates are initially recognised at cost.

The Group's share of the total recognised gains and losses of associates is included in the financial statements of the Group on an equity accounted basis, from the date the significant influence commences until the date it ceases.

If the Group's share of loss exceeds its interest in an associate, the Group's carrying amount is reduced to zero and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

# Notes to the Consolidated Financial Statements

**94. Property and equipment**

a. Asset categories
The Group groups intangible assets into two categories:

- Real estate
  Real estate comprise office buildings.
- Other property and equipment
  Other property and equipment comprise automobiles, furniture and fixtures, computers and other office equipment.

b. Initial recognition
Property and equipment is initially recognised at cost, which includes direct expenses related to the purchase.

c. Subsequent measurement
The Group uses the cost model for the measurement after recognition and property and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses. Property and equipment is reviewed for indications of impairment or changes in estimated future economic benefits at each reporting date. If such indications exist, the assets are analysed to assess whether their carrying amount is fully recoverable. An impairment loss is recognized in accordance with the accounting policy for non-financial assets described in note 78.

d. Subsequent cost
The Group recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred if it is probable that the future economic benefits embodied with the item will flow to the Group and the cost of the item can be measured reliably. The decision, if subsequent costs are added to the acquisition cost of property and equipment, is based on whether an identified component, or part of such component, has been replaced or not, or if the nature of the subsequent cost means a contribution of a new component. All other costs are expensed in the income statement when incurred.

e. Depreciation
Depreciation is recognised in the income statement on a straight-line basis over the estimated useful lives of each component of an item of property and equipment. The estimated useful lives are as follows:

| | |
|---|---|
| Real estate | 15-50 years |
| Other property and equipment | 3-5 years |

Where parts of an item of property and equipment have different useful lives, those components are accounted for separately.

**95. Other assets**

Other assets are measured at amortised cost.

**96. Assets classified as held for sale**

Non-current assets that are expected to be recovered primarily through sale rather than through continuing use, are classified as held for sale. Immediately before classification as held for sale, the assets are remeasured in accordance with the Group's accounting policies. Thereafter the assets are measured at the lower of their carrying amount and fair value less cost to sell. Impairment losses on initial classification as held for sale and subsequent gains or losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

**97. Deposits**

Deposits consist of time deposits and demand deposits. Money market deposits are included in borrowings. Deposits are recognised at amortised cost, including accrued interest.

**98. Borrowings**

Borrowings are initially recognised at fair value less attributable transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in their carrying amount.

When the Group sells a financial asset and simultaneously enters into an agreement to repurchase the asset, or a substantially similar asset, at a fixed price at a future date (“repo” or “stock lending”), the arrangement is accounted for as a borrowing and the underlying asset continues to be recognised in the Group’s statement of financial position.

# Notes to the Consolidated Financial Statements

**99. Short positions used for trading**

Short positions are carried at fair value with all fair value changes recognised in the income statement under net financial income.

**100. Short positions used for hedging**

Short positions used for hedging consist of non-derivative financial liabilities that are used to hedge the Group's risk exposure arising from derivative contracts with customers.

**101. Other liabilities**

Other liabilities are measured at amortised cost.

**102. Share capital**

a. Treasury shares
Acquired own shares and other equity instruments (treasury shares) are deducted from equity. No gain or loss is recognised in income statement on the purchase, sale, issue or cancellation of treasury shares. Consideration paid or received is recognised directly in equity. Incremental transaction costs of treasury share transactions are accounted for as a deduction from equity, net of any related income tax benefit.

b. Share premium
Share premium represents excess of payment above nominal value (ISK 1 per share) that shareholders have paid for shares sold by the Group.

c. Dividends on share capital
Dividends on share capital are deducted from equity in the period in which they are approved by the Group's shareholders meetings.

**103. New standards and interpretations**

A number of new standards, amendments to standards and interpretations were not yet effective for the year ended 31 December 2013 and have not been applied in the preparation of these financial statements. Early adoption of new standards and amendments is not planned and the effects of adoption are not known.

a. New standards, amendments and interpretations which became effective for the financial year starting 1 January 2013
Several new standards and interpretations relevant to the Group became effective during the financial year, the most significant of which is IFRS 13 Fair Value Measurement. The adoption of these standards and amendments did not have a material effect on the statement of financial position or the income statement, but has resulted in new or amended disclosures provided in the notes.

b. New standards, amendments and interpretations which become effective for the financial year starting 1 January 2014
Several new standards and interpretations relevant to the Group will become effective during the next financial year, the most significant of which is are IFRS 10 Consolidate Financial Statements and IFRS 12 Disclosure of Interests in Other Entities. The adoption of these standards and amendments is not expected to have a material effect on the statement of financial position or the income statement, but may resultin new or amended disclosures provided in the notes.

**104. Use of estimates and judgements**

In the process of applying the Group's accounting policies, management makes use of judgements and estimates which are based on various assumptions. These judgements and estimates can affect the reported amounts of assets and liabilities, income and expense.

Assumptions and estimates are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances, and are reviewed on an on-going basis. The estimates form the basis for judgements about the carrying value of assets and liabilities that are not readily available from other sources and actual results may differ. Judgement may also be required in circumstances not involving estimates, e.g. when determining the substance of a particular transaction, contract or relationship.

The areas where the use of judgements and estimates has the most significant effect on the amounts recognised in the statement of financial position or the income statement are disclosed in this note.

a. Fair value of financial instruments
The fair value of financial instruments that are not quoted in active markets is determined using valuation techniques which are reviewed regularly as discussed in note 57.

b. Impairment of financial assets
As outlined in notes 77-78, the use of estimates and judgement is an important component of the calculation of impairment losses. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience. Unforeseen events could, however, result in further impairment losses which would have a material effect on the income statement and statement of financial position.

# Notes to the Consolidated Financial Statements

**104. Use of estimates and judgements cont.**

c. Impairment of intangible assets

Intangible assets with indefinite lifetime are subjected to impairment testing at least annually as discussed in note 24. Impairment testing requires the use of estimates and judgement which may significantly alter the outcome. Sensitivity analysis is used to determine the potential effect on the results.

d. Deferred tax asset

Judgement is required to determine the extent to which deferred tax assets are recognised in the statement of financial position, based on the likely timing and level of future taxable profits.