Íslandsbanki hf.

CONSOLIDATED UNAUDITED INTERIM FINANCIAL STATEMENTS 1Q18

1Q18 financial highlights

- Profit after tax was ISK 2.1bn (1Q17: ISK 3.0bn) generating a 4.8% return on equity (1Q17: 7.0%).
- Earnings from regular operations were ISK 2.9bn (1Q17: ISK 3.5bn) and return on equity from regular operations normalised for 15% CET1 was 8.2% (1Q17: 10.6%).
- Net interest income amounted to ISK 7.7bn (1Q17: ISK 7.4bn), an increase of 4.6%. Net interest margin was 2.9% (1Q17: 2.9%).
- Net fee and commission income was ISK 2.8bn (1Q17: ISK 3.3bn), down by 15% from the same time last year mostly due to lower activity levels from fee-generating subsidiaries.
- Administrative costs excluding one-off costs totalled ISK 6.8bn, a 7.3% rise between years but when adjusted for inflation, the increase was 2.9%. This is mainly a result of lower capitalisation of IT consultant work, increased IT investment and increases in negotiated salary agreements.
- Loans to customers grew by 2.8% (ISK 21bn) to a total of ISK 776bn at the end of the quarter. Total new lending amounted to ISK 42bn which was split across various lending divisions while deposits from customers grew by 1.4% (ISK 8.2bn) to ISK 575bn at the end of the quarter.
- The Bank´s liquidity and capital position continues to be strong and exceed all internal and external requirements.

Key figures and ratios

		1Q18	4Q17	3Q17	2Q17	1Q17
PROFITABILITY	ROE 15% CET1 (regular operations)[1]	**8.2%**	10.8%	8.1%	11.8%	10.6%
	ROE (after tax)	**4.8%**	7.0%	4.7%	11.3%	7.0%
	Net interest margin (of total assets)	**2.9%**	2.8%	2.8%	3.0%	2.9%
	Cost to income ratio[2]	**69.8%**	69.2%	62.7%	58.3%	60.1%
	After tax profit, ISK m	**2,097**	3,112	2,073	4,997	3,044
	Earnings from regular operations, ISK m[3]	**2,881**	3,670	2,812	3,860	3,506
		31.3.2018	31.12.2017	30.9.2017	30.6.2017	31.3.2017
CAPITAL	Total equity, ISK m	**166,337**	181,045	177,819	175,928	170,765
	Tier 1 capital ratio	**20.3%**	22.6%	22.5%	23.3%	22.8%
	Total capital ratio	**21.4%**	24.1%	22.7%	23.5%	23.1%
	Leverage ratio	**14.3%**	16.2%	15.3%	15.7%	15.5%
BALANCE SHEET	Total assets, ISK m	**1,088,308**	1,035,822	1,077,623	1,047,221	1,028,808
	Risk exposure amount, ISK m	**795,923**	775,492	767,536	736,310	730,120
	Loans to customers, ISK m	**776,149**	755,175	741,380	721,820	703,447
	Total deposits, ISK m	**588,759**	578,218	599,606	581,769	578,739
	Total deposit / loan ratio	**71.5%**	74.0%	76.9%	78.0%	78.4%

1Q18 operational highlights

- In January, the Bank issued an innovative EUR 300m 6NC5 fixed rate senior unsecured bond at a spread of 75 basis points over 5-year mid swaps. This issue, the longest-dated and most tightly-priced benchmark bond from an Icelandic financial institution since 2008, is a significant achievement for the Bank.
- In February, IS Funds, Íslandsbanki´s subsidiary, launched a development company, 105 Miðborg, which plans to build nearly 42,000 m2 of above-ground housing at Íslandsbanki´s old HQ location, Kirkjusandur.
- ISK 13bn dividend payment was approved at the Bank´s Annual General Meeting in March. From 2013 the Bank has paid ISK 73bn in dividend to its shareholders.
- New mortgage loans were 5% higher than during same period last year.
- About 4,500 overdraft applications approved for over ISK 1.2bn via new automated online service.
- The Bank announced its open banking strategy in order to develop new digital services for its customers.

1. Return from regular operations on normalised CET1 of 15%, adjusted for risk free interest on excess capital. From January 2018 the definition of regular operations has been revised to include profit from discontinued operations as the Bank has successfully divested all non-core business related assets.
2. Calculated as (Administrative expenses + Contribution to the Depositors´ and Investors´ Guarantee Fund – One off items) / (Total operating income – one off items)
3. Earnings from regular operations is defined as earnings excluding one-off items e.g. bank tax, one-off costs due to headquarters and the impairment of goodwill.

Birna Einarsdóttir, Chief Executive Officer at Íslandsbanki

Íslandsbanki started the year with continued strong lending growth of 2.8%, a deposit increase of 1.4% and a 5.1% increase in its balance sheet to ISK 1,088bn from year-end 2017. There was good growth in new mortgages which grew by 5% compared to first quarter last year. Fees and commissions were in line with expectations for the parent company whilst the group as a whole saw fees decline by 15%, from the same time last year, mostly due to lower activity levels from two of our fee-generating subsidiaries.

On the expense side, our administrative costs are still too high as the real change from first quarter last year was 2.9% and can be mostly explained by work related to our new core deposit and payment system and negotiated salary increases. Upon the completion of the core system later this year, and building on our recently revised organisational structure, last year´s completed move to our new HQs, continued streamlining and the most efficient branch network in Iceland, we are confident that we will soon be on the path to cost reduction.

Our international and domestic funding operations have done well recently. We issued two successful senior callable bonds in foreign public markets, a EUR 300m 6-year issue at 75 basis points (bp) over 5-year mid-swaps, and a SEK 1bn 4-year deal at 80 bp over 3-month STIBOR. The callable feature in both transactions is designed to improve funding efficiency in the years ahead, and demonstrates our willingness to embrace useful innovation. The Bank also continued to lead in the domestic market, and issued ISK 9.5bn of covered bonds during the quarter.

Most of our interactions with customers today are through digital channels and as part of our vision of being number 1 for service, we used our online platforms, the Íslandsbanki, Kass and Kreditkort apps, to launch several new digital solutions in the first quarter. In addition, we just announced a new initiative as a response to the EU's new payment directive (PSD2), where we are opening up the Bank for cooperation with certified third-party providers. With this, Íslandsbanki is taking an important step towards modernising its banking services, by reflecting customer digital preference and rapid market development.

INCOME STATEMENT

ISK m	1Q18	1Q17	Δ	4Q17	Δ	2017
Net interest income	**7,740**	7,397	343	7,338	402	29,999
Net fee and commission income	**2,778**	3,270	(492)	3,632	(854)	13,750
Net financial income	**(283)**	12	(295)	260	(543)	(715)
Net foreign exchange gain	**(10)**	201	(211)	81	(91)	527
Other operating income	**13**	160	(147)	122	(109)	628
Total operating income	**10,238**	11,040	(802)	11,433	(1,195)	44,189
Salaries and related expenses	**(3,926)**	(3,659)	(267)	(4,297)	371	(15,233)
Other operating expenses	**(2,924)**	(2,759)	(165)	(3,358)	434	(11,735)
Administrative expenses	**(6,850)**	(6,418)	(432)	(7,655)	805	(26,968)
Depositors'and Investors' Guarantee Fund	**(292)**	(253)	(39)	(288)	(4)	(1,083)
Bank Tax	**(785)**	(720)	(65)	(614)	(171)	(2,892)
Total operating expenses	**(7,927)**	(7,391)	(536)	(8,557)	630	(30,943)
Profit before net impairment on financial assets	**2,311**	3,649	(1,338)	2,876	(565)	13,246
Net impairment on financial assets	**88**	240	(152)	969	(881)	1,556
Profit before tax	**2,399**	3,889	(1,490)	3,845	(1,446)	14,802
Income tax expense	**(1,015)**	(1,130)	115	(816)	(199)	(4,151)
Profit for the period from continuing operations	**1,384**	2,759	(1,375)	3,029	(1,645)	10,651
Profit from discontinued ops. net of income tax	**713**	285	428	83	630	2,575
Net profit	**2,097**	3,044	(947)	3,112	(1,015)	13,226

Net interest income prominent in 1Q18

Total income amounted to ISK 10.2bn in 1Q18, a decline of 7% between years mainly due to lower net fee and commission income and negative net financial income.

Net interest income totalled ISK 7.7bn, an increase of 4.6% from the previous year. The net interest margin was 2.9%, at comparable levels to 1Q17. The net interest margin is expected to be slightly below 3.0% in the near to medium term.

Net fee and commission income amounted to ISK 2.8bn, compared to ISK 3.3bn in 1Q17. Overall net fee income showed a 15% decline year on year, principally due to lower activity levels from two of the Bank´s fee generating subsidiaries.

Core income (net interest income and net fee and commission income) contributed fully to the Bank´s total operating income during the quarter. The Bank remains focused on strong core earnings and stable long-term income.

The Bank recorded a net financial expense of ISK 283m in 1Q18, compared to a gain of ISK 12m in 1Q17. The loss derives largely from losses in mark-to-market of derivative hedges and losses on equity trading. The Bank also realised a net foreign exchange loss of ISK 10m in 1Q18, compared with profit of ISK 201m in 1Q17.

Other operating income totalled ISK 13m in 1Q18, as opposed to ISK 160m in 1Q17. This includes gains on real estate sales, rental income, service-level agreement fees, and a share in the profit or loss of associates.

Cost combating continues

The Bank continues to implement the new organisational structure outlined in 2017, adopt new international regulatory frameworks such as IFRS 9 and invest in new IT systems such as the Sopra Banking Platform, which will replace the Bank's core deposit and payment systems. These items contributed to the increased administrative expenses by ISK 0.4bn year-on-year or 7.3%. When adjusted for inflation, the increase is 2.9%

The salary cost increases in 1Q18 were largely due to the conclusion of the capitalisation of IT contractor expenditure but also due to the introduction of negotiated salary agreements, which along with related expenses, led to a 7% year-on-year increase (ISK 3.9bn) in salary and related costs for 1Q18. The average number of full-time equivalent positions (FTE) was 852 for the parent company (905 in 1Q17) and 1,036 (1,075 in 1Q17) for the group.

The cost-to-income (C/I) ratio in the first quarter was 69.8%, compared with 60.1% in 1Q17, which is above the Bank's long-term target of 55%. The C/I ratio excludes the bank tax and other one-off cost items.

The after-tax profit from discontinued operations was ISK 0.7bn in 1Q18, compared with ISK 0.3 in 1Q17. The profit derives from the sale of the Bank's assets and income from foreclosed assets.

Net impairment on financial assets

Net impairment on financial assets generated a gain of ISK 88m in 1Q18, compared to ISK 240m gain in 1Q17. Net loan impairments remain positive due to a favourable economic environment.

Taxes and levies continue to affect profitability

The tax on the profit for the period amounted to ISK 1.0bn, compared to ISK 1.1bn in 1Q17. The effective tax rate was 42.2%, compared to 29.1% in 1Q17, when there was a larger amount of non-taxable income. The bank tax accounted for ISK 0.8bn in 1Q18, compared with ISK 0.7bn in 1Q17. The bank tax increased significantly in 2013 as a temporary measure, but the government has recently announced that it intends to gradually decrease the tax from 0.376% to 0.145% during the 2018-2023 period. In addition, the Bank is subject to the special financial tax of 6% on taxable profits in excess of ISK 1bn and makes contributions to the Debtors' and Investors' Guarantee Fund, the Financial Supervisory Authority, and the Office of the Debtors' Ombudsman. Total taxes and levies amounted to ISK 2.4bn in 1Q18, at comparable level to previous year. The contribution to the Depositors' and Investors' Guarantee Fund, was at ISK 0.3bn, marginally higher than previous year.

Profit for the period

Profit after tax was ISK 2.1bn in 1Q18 (1Q17: ISK 3.0bn) and return on equity (after tax) was 4.8% in 1Q18 (1Q17: 7.0%). Earnings from regular operations were ISK 2.9bn, (1Q17: ISK 3.5bn). Return on equity from regular operations normalised for 15% CET1 was 8.2% in 1Q18, compared to 11.8% in 1Q17. Regular earnings decreased by ISK 0.6bn between years, mainly due to underperformance from two of the Bank´s fee generating subsidiaries.

BALANCE SHEET

Assets – continued strong loan growth and bigger balance sheet

The balance sheet grew by 4.9% from year-end 2017, to ISK 1,088bn. Loans to customers grew 2.8%, or ISK 21bn. Demand for new credit stemmed primarily from corporations and to a lesser extent from individuals. Mortgage loans rose by ISK 4.2bn from year-end 2017. New lending amounted to ISK 42.3bn, as opposed to ISK 46.3bn in the previous year, a decrease of 8.6%. Outstanding loans to the tourism industry in Iceland are 13%, unchanged from year-end 2017.

Loans are generally well covered by stable collateral, majority in residential and commercial real estate while the second most important collateral type is fishing vessels. The weighted average loan-to-value (LTV) ratio for the residential mortgage portfolio was 63.2% at March 2018 compared to 63.3% at year-end 2017. The Bank's asset encumbrance ratio was 15.8% at March 2018 compared to 15.2% at year-end 2017.

Liquidity levels remained very strong during the quarter, benefitting among others from reduced concentration in the deposit base. Three items – cash and balances with the Central Bank, bonds and debt instruments, and loans to credit institutions – amount to about ISK 273bn, some ISK 248bn of which are liquid assets.

ISK m	**31.3.2018**	31.12.2017	Δ
Cash and balances with CB	**177,029**	189,045	(12,016)
Bonds and debt instruments	**49,140**	27,090	22,050
Shares and equity instruments	**10,208**	10,177	31
Derivatives	**4,673**	2,896	1,777
Loans to credit institutions	**47,220**	26,617	20,603
Loans to customers	**776,149**	755,175	20,974
Investment in associates	**672**	704	(32)
Property and equipment	**7,025**	7,128	(103)
Intangible assets	**4,412**	4,231	181
Other assets	**10,732**	9,993	739
Non-current assets held for sale	**1,048**	2,766	(1,718)
Total assets	**1,088,308**	1,035,822	52,486

Liabilities – diversified funding strategy

Total liabilities amount to ISK 922bn, an increase of 7.9% from year-end 2017. The Bank maintained strong liquidity levels into 2018, and all regulatory and internal metrics were well above the set limits. At March 2018, the Bank's liquidity coverage ratio (LCR) was 158% for the group. The net stable funding ratio (NFSR) in foreign currency was 140% and the total NFSR was 116% for the group. Throughout 2018, the Bank aims to continue to steer its liquidity ratios with the aim of reducing liquidity cost further while keeping the ratios comfortably above minimum requirements.

Total deposits increased by 1.4% from year-end 2017, to ISK 588.8bn. Deposits are still the Bank's main source of funding, and concentration levels are monitored closely. The increase was due mainly to a rise in pension fund positions. The ratio of customer deposits to customer loans lowered to 74.1% at March 2018, compared to 75.1% at the end of 2017. The deposit-to-loan ratio is 71.5% but is expected to decrease gradually in the future and the Bank´s target is to maintain it over 60%.

ISK m	31.3.2018	31.12.2017	Δ
Deposits from CB and credit inst.	**13,563**	11,189	2,374
Deposits from customers	**575,196**	567,029	8,167
Derivatives and short positions	**8,104**	5,492	2,612
Debt issued and other borrowings	**269,255**	217,748	51,507
Subordinated loans	**8,838**	9,505	(667)
Tax liabilities	**7,908**	7,787	121
Other liabilities	**39,028**	35,947	3,081
Non-current liabilities held for sale	**79**	80	(1)
Total liabilities	**921,971**	854,777	67,194
Total equity	**166,337**	181,045	(14,708)
Total liabilities and equity	**1,088,308**	1,035,822	52,486

The Bank's debt issuance continued in the first quarter of 2018, primarily through its Global Medium-Term Note (GMTN) and covered bond programmes, with an eye to mitigate risk through diversification of funding. Apart from deposits, the main domestic funding vehicles were covered bonds and short-term unsecured bonds. Market access for covered bonds remains solid, with issuance of ISK 9.5bn in the first quarter, reinforcing the Bank's position as Iceland's largest covered bond issuer.

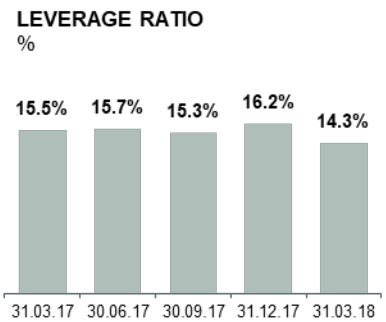
In January 2018, Íslandsbanki issued a EUR 300m 6NC5 1.125% fixed rate senior unsecured bond, at a spread of 75 basis points over 5-year mid-swaps. The issue was more than four times oversubscribed, with total demand for the transaction amounting to EUR 1,255m from 121 investors. The bonds were sold to a diversified spectrum of investors, including in the UK, continental Europe, Scandinavia and Asia and was listed on the Irish Stock Exchange on 19 January 2018. This issue, the longest-dated and most tightly-priced benchmark bond from an Icelandic financial institution since 2008, was a significant achievement for the Bank. In January 2018 the Bank issued three private placements, each SEK 100m, under its GMTN Programme.

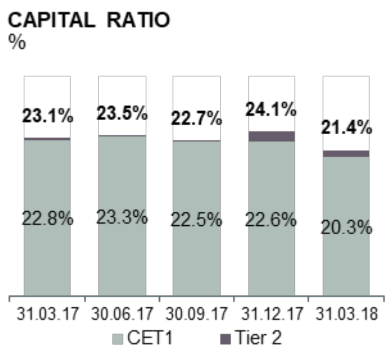
Equity

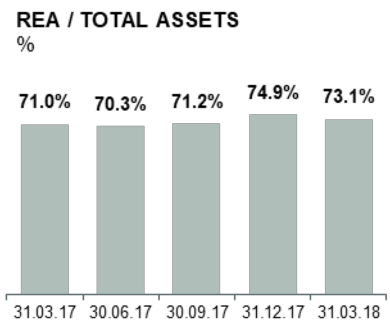
Total equity amounted to ISK 166.3bn at March 2018, compared to ISK 181.0bn at the end of 2017. Of that total, ISK 2.4bn is attributable to non-controlling interests. The nominal value of the Bank's authorised share capital was ISK 10bn at the end of the quarter, and total share capital amounted to ISK 65bn.

At the end of March, the Bank's total capital ratio was 21.4%, compared to 24.1% at year-end 2017, marginally above its target range of 20.3-21.3%. The Bank's Tier 1 ratio was 20.3% at March 2018, compared to 22.6% at year-end 2017. The Icelandic Financial Supervisory Authority (FME) sets the minimum requirement for total capital at 19.8%.

The Bank has introduced a new long-term capital target, which is based on its internal capital adequacy assessment (ICAAP) and the supervisory review and evaluation process (SREP). The target assumes that the Bank will maintain a capital management buffer of 0.5%-1.5% in excess of the SREP results to ensure that short-term fluctuations do not bring the ratio below the regulatory minimum. The capital target supports the Bank's business strategy and takes into account changes or uncertainties in the operating environment. It can change over time, reflecting changes in the Bank's risk profile, business strategy, and external environment. Based on last year's SREP results, this translates to a long-term target total capital ratio of 20.3-21.3%. It is worth noting that the Financial Stability Board has recommended that FME increases the countercyclical capital buffer from 1.25% to 1.75%, which would be effective one year after FME's announcement.







Íslandsbanki uses the standardised method to calculate its risk exposure amount (REA), which amounted to ISK 795.9bn at March 2018, or 73.1% of total assets, an increase of 2.6% from year end 2017. The quarter-end leverage ratio was 14.3%, compared to 16.2% at year-end 2017, indicating low leverage.

Dividend

Íslandsbanki´s dividend pay-out ratio target is 40-50% of after tax profits. Due to its strong capital position, a higher dividend payment of ISK 13bn was approved during its March Annual General Meeting (AGM), bringing the Bank´s total dividend payments to ISK 76bn since 2013. The AGM also approved that the Board may convene a special shareholder meeting later in the year where a proposal regarding payment of dividends of profit for the previous fiscal years could be suggested.

Ratings

Íslandsbanki is the only bank in Iceland with credit ratings from two international rating agencies, Fitch Ratings and Standard & Poor's Global Ratings (S&P).

Fitch Ratings upgraded the Bank to BBB/F3 in January 2017, with a stable outlook, and affirmed the ratings in December 2017.

In June 2017 S&P upgraded Iceland's sovereign rating to A in recognition of its continued progress towards capital account liberalisation and its declining debt levels.

In October 2017, S&P upgraded Íslandsbanki's credit ratings to BBB+/A-2 with a stable outlook.

INVESTOR RELATIONS

Investor call in English

Today, 9 May, the Bank will host an investor call in English to present the financial results at 13:00, Icelandic time. The call will start with a short macro update on the Icelandic economy, followed by a review of the financial results and Q&A.

Please register by replying to: ir@islandsbanki.is. Dial-in details and presentation will be sent out prior to the call.

Additional investor material

All presentation material will subsequently be available and archived on the Bank´s investor relations website where other material is also available: https://www.islandsbanki.is/english/investor-relations/

Financial calendar

Íslandsbanki plans to publish its interim and annual financial statements according to the below financial calendar:

- Q2 2018 results - 2 August 2018
- Q3 2018 results - 8 November 2018
- Q4 2018 and year-end results - 14 February 2019

Please note that the dates are subject to change.

Financial calendar and silent periods

Information on Íslandsbanki's financial calendar and silent periods can be found on the IR website