

ANNUAL REPORT 2003

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Key Figures

	Icebank			The savings banks		
	2003 ISK '000	2002 ISK '000	Change %	2003 ISK '000	2002 ISK '000	Change %
Net interest income	541,198	491,594	10.1%	6,363,940	7,086,703	(10.2%)
Net operating income.....	1,017,679	985,967	3.2%	12,689,521	10,936,059	16.0%
Other operating expenses.....	-589,063	-625,196	(5.8%)	-7,056,040	-7,108,716	(0.7%)
Provision for losses.....	-222,340	-205,000	8.5%	-2,651,738	-2,228,194	19.0%
Profit before taxes.....	206,276	155,771	32.4%	2,981,743	1,599,149	86.5%
Net earnings	163,130	125,328	30.2%	2,569,013	2,064,056	24.5%
Total assets	37,576,569	44,244,026	(15.1%)	180,673,523	184,423,496	(2.0%)
Equity	2,429,811	2,266,681	7.2%	21,842,427	18,925,966	15.4%
Stockholders' guarantees	604,465	604,465	0.0%			
Net interest revenue /						
Average total assets.....	1.4%	1.1%		3.5%	4.3%	
Net operating revenue /						
Average total assets.....	2.5%	2.2%		7.0%	6.7%	
Other operating expenses /						
Net operating income	57.9%	63.4%		55.6%	65.0%	
Provision for losses on loans /						
Net operating income	21.8%	20.8%		20.9%	20.4%	
Net profit for the year /						
Net operating income.....	16.0%	12.7%		20.2%	18.9%	
Return on equity before taxes	8.8%	7.1%		14.6%	8.8%	
Return on equity after taxes	7.0%	5.7%		12.6%	11.4%	
Capital ratio (CAD)	14.3%	15.7%		17.2%	13.9%	

ACTIVITIES IN 2003 AND PROSPECTS FOR 2004

Activities in 2003, Overview and Key Figures

- Net interest income up by 10% from 2002, a new record level
- Net interest margin 1.4%, up from 1.0% in 2002 and 0.8% in 2001
- Total income excluding irregular items up by 21% from 2002
- Operating expenses down by 6% from the preceding year
- Provision for losses up by ISK 17 million or 8% from 2002
- Net profit for the year ISK 163 million, up by 30% from 2002
- Cost-income ratio 58%, down from 63% in the preceding year
- Total assets ISK 37.6 billion, down from 44.2 billion at year-end 2002
- Capital adequacy ratio 14.3%, down from 15.7% at year-end 2002
- Return on equity after taxes 7.0%, up from 5.7% in 2002

Prospects for 2004

The year 2004 will be a testing time for Icebank. The success of the savings banks has led to a large inflow of deposits which the banks, in turn, have placed with Icebank. Their share in total deposits in the

Icelandic banking market has been stable, around one quarter of the market. In addition, there is strong competition among all the banks for domestic lending, especially to corporate customers, which has put pressure on margins and made it more difficult for Icebank to identify acceptable lending projects. The Icelandic economy is growing at a healthy rate and it is expected that credit demand at Icebank will gradually increase as the year progresses. The net profit of the Bank in 2004 is projected to be ISK 150–175 million.

The corporate form and viability of the network of savings banks in Iceland have been under threat since the summer of 2002. At that time, Búnaðarbanki Íslands (now merged into Kaupthing Bank) and a group of individuals attempted a hostile takeover of Reykjavík Savings Bank (SPRON). The Financial Supervisory Authority (FSA) did not grant its approval of this. In late December 2003, the Board of Directors of SPRON and Kaupthing Bank signed an agreement whereby Kaupthing Bank would acquire SPRON but continue to operate it as an independent company (i.e. a limited liability savings bank) within the KB Group. This move was highly controversial, both because it tested certain

Establishment and role

Icebank (Sparisjóðabanki Íslands hf.) was established in October 1986 by the savings banks in Iceland. It is still wholly owned by the 24 savings banks in the country. The Bank has a commercial banking licence. However, there is a significant difference between the Bank's operations and those of the other commercial banks in Iceland, as it primarily provides services to the savings banks themselves and their customers and only conducts limited operations directly with other parties. Such operations are concentrated in areas where the savings banks themselves are unable to provide services, either because of their small size or limited areas of expertise and capabilities.

aspects of the banking legislation and because of subsequent effects on other large savings banks and the savings banks system as a whole. For this reason, Parliament decided to step in and amend certain provisions of the Act on Financial Undertakings. As a result of the amendment the plans to convert SPRON into a limited liability company were shelved and the agreement with Kaupthing Bank subsequently set aside. It now seems unlikely that a savings bank will be acquired by a commercial bank, although a merger of two or more savings banks remains possible.

Operating performance in 2003

Icebank's performance continued to improve in 2003 despite strong competition in the domestic market. Net interest income reached its highest level ever and the interest margin rose for the third consecutive year, to 1.38%, up from 1.0% in 2002 and 0.85% in 2001. This happened despite the 15% decline in the balance sheet of the Bank from year-end 2002 (ISK 44.2 billion) to year-end 2003 (ISK 37.6 billion) and despite a 20% increase in deposits by savings banks at the Bank from 2002 (ISK 10.4 billion) to 2003 (ISK 12.4 billion). Furthermore, total lending to savings banks declined by ISK 2.3 billion from year-end 2002 and year-end 2003. Hence, the net-position of savings banks vis-à-vis the Bank improved by ISK 4.3 billion over the year, putting significant pressure on the Bank's net-interest

margin. However, the Bank managed to increase its direct lending to corporate customers by 20%, from ISK 9.2 billion at year-end 2002 to ISK 11 billion at year-end 2003. It is important for the Bank to continue this trend, as loans to corporate customers carry higher margins than loans to savings banks.

The operations of the Bank in 2003 reflect a threefold strategy formulated in 2002. First, a large effort has been invested in strengthening and streamlining the Bank's operations. This has resulted in improved quality and increased efficiency. The number of staff declined in 2002 for the first time in the Bank's history and there was a further decline in the average number of staff in 2003, from 59 in 2002 to 54 in 2003. The total wage bill shrank by 2% between 2002 and 2003 despite a 3% general wage increase at the beginning of 2003. Second, the Bank's direct holdings in individual companies within or closely related to the savings banks' group have been systematically reduced. As a result the Bank reduced its interest in the life insurance company Alþjóða líftryggingarfélagið from 12.1% to 0.1% in 2002 and in the leasing company SP-Fjármögnun from 27.9% to 0.1% in 2002. Furthermore, the Bank sold most of its holdings in Kaupthing Bank in 2002. Finally, the Bank has increased its focus on direct lending to larger corporate customers, most often in cooperation with savings banks but also on its own although not in competition with savings banks.

Primary functions

Icebank serves five primary functions for the Icelandic savings banks:

- It acts as their clearing bank and as a treasury department for most of them.
- It handles all their foreign exchange operations.
- It participates in their lending operations, especially when the size and scope of the lending would otherwise be beyond their individual capacity.
- It raises funds in the domestic and international financial markets for re-lending to individual savings banks as they require.
- It provides expertise to the savings banks and their customers.

The banking market in Iceland changed dramatically in 2003. The government completed the privatisation of Búnaðarbanki Íslands and Landsbanki Íslands in early 2003. In May, Búnaðarbanki and Kaupthing Bank merged into Kaupthing Bank, the largest bank in Iceland. The savings banks represent the fourth player in the market for traditional banking services.

The accommodating monetary policy pursued by the Central Bank of Iceland, which included a reduction in the reserve requirement, led to a strong liquidity position of all the banks. This, together with a slower pick-up in economic activity in 2003 than expected, has led to fierce competition between the banks, especially for corporate customers, and declining margins in that segment of the market. The lending by savings banks and Icebank to corporate customers has been under strong pressure, but this situation should gradually change as the economy heats up.

The year 2003 was favourable to Icebank in many other respects. Net income from commissions rose by 49% from 2002 showing a healthy demand for the Bank's services. The Bank will strive to increase this activity further in 2004. Developments in domestic and foreign securities markets in 2003 were favourable to the Bank, leading to a net income

of ISK 183 million, as compared to ISK 77 million in 2002. However, it must be borne in mind that the Bank is not an investment bank and the main emphasis has been and will be on various services to the savings banks and traditional lending activities.

Corporate lending and provisions

As stated above, Icebank's lending to corporate customers grew in 2003 by 20%, from ISK 9.2 billion at year-end 2002 to ISK 11 billion at year-end 2003. This was achieved mostly through participation in syndicated loans with other Icelandic banks, both domestically and abroad. The Bank believes there is further room for growth of this activity, especially in projects abroad. It is one of the main objectives of the Bank in 2004 to increase the share of lending to corporate customers and thereby continue to improve its operations.

Provisions for losses increased from ISK 205 million in 2002 to ISK 222 million in 2003, as compared to ISK 220 million in 2001. This unexpected reversal is mostly due to difficulties of four customers within the fisheries sector (ISK 145 million), which have had to deal with the continued appreciation of the exchange rate of the Icelandic króna. Difficulties of a customer within the agricultural sector led to a

The savings banks' co-operation

The savings banks in Iceland co-operate closely on information technology, product development, marketing, and training, in addition to their close financial co-operation:

- The Savings Banks' Association is a trade association, which attends to relationships with authorities and the European and International savings banks' associations, handles joint marketing, product development and training.
- The Savings Banks' Data Centre provides joint IT-services.
- Icebank is a service bank for the savings banks.
- The savings banks own 49% of the leasing company SP-Fjármögnun with Landsbanki Íslands.
- The savings banks own 42% of the life insurance company, Alþjóða líftryggingarfélagið.
- The savings banks have large stakes in VISA Iceland, MasterCard-Kreditkort, the Icelandic Banks' Data Centre, the Iceland Stock Exchange and the Icelandic Securities Depository.

loan-loss provision of ISK 38 million. In total, these five customers account for ISK 183 million of the total provisions in 2003.

International activities

One of the main objectives of Icebank is to provide the savings banks and their customers with comprehensive services in their international activities. In order to successfully carry out these services, the Bank maintains account relationships with banks in all the western European countries, USA, Canada and Japan and has business relations with banks in many countries on the other continents as well.

All international payments to and from the country pertaining to the savings banks' customers are channelled through Icebank and the SWIFT Bic of the Bank is the common address for all the member savings banks. The Bank is also the centre for the savings banks in respect of all their trade finance activities and responsible for the execution and financing of import and export documentary credits and collections in relation to their customers.

Both turnover and transaction volume in these activities continued to increase over the preceding year, as they have in every consecutive year since 1990, when Icebank started providing international services to the savings banks as permitted by law only some four years earlier.

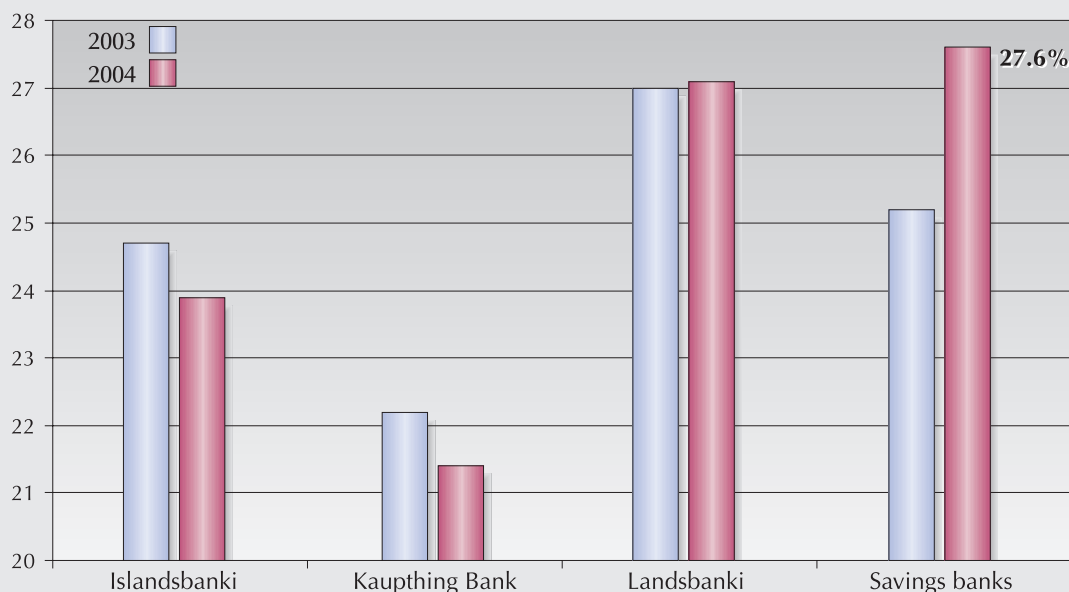
The overall market share of the savings banks has also been growing steadily all these years and has reached some 23% in terms of deposits, 16% in terms of lending and 11% in terms of international transactions.

The volume of currency trading grew by some 24% and transactions related to import/export activities continued its proportionate growth, turnover grew by 15% and transactions by 7% respectively. There is an increasing demand for the customised services offered by Icebank to export companies, particularly in respect of fish export. The service consists of tailored packages of credit insurance and receivables financing combined with traditional trade finance services.

As a result of the high liquidity and fierce competition in the Icelandic banking market,

Where do you bank?

(Poll by Gallup among a random sample of individuals aged 16–75)



Icebank started to explore opportunities in the European loan market during the year and has begun, albeit on a modest scale, to participate in lending in collaboration with close partners in the banking sector.

A medium-term syndicated credit facility was successfully launched under the lead of Bayerische Landesbank. The initial launching was for 30 million, but in fact 50 million were actually raised. The main purpose of the credit facility was to refinance two previous facilities expiring in June and December respectively in the total amount of 43 million. A similar transaction is being prepared for the year 2004, this time also to refinance two existing facilities in the total amount of 54 million.

Equity and shareholders' guarantees

Icebank's equity amounted to ISK 2,430 million at year-end 2003, slightly up from ISK 2,267 million at year-end 2002.

At year-end 2003, the capital adequacy ratio came to 14.3%, as compared to 15.7% at year-end 2002 and 11.5% at year-end 2001. It is the stated policy

of the Board of Directors to maintain a capital adequacy ratio between 11% and 13% and a Tier 1 ratio of 8% or more. The latter ratio now stands at 9.8%, as compared to 11.2% at year-end 2002 and 6.5% at year-end 2001.

In addition to their shares in Icebank, all the savings banks have issued guarantees to the Bank equal to the amount of their shareholdings at any time. The guarantees extend to the commitments of the Bank to foreign financial institutions. At year-end 2003 these guarantees amounted to ISK 604.5 million, effectively bringing the Bank's equity to ISK 3,037 million vis-à-vis foreign financial institutions.

Economic environment

The year 2003 was characterized by a moderate economic growth of 2.5%, mainly as the result of strong growth in private consumption (6% vs. 0.6% decline in 2002) and investment in the public and private sectors (10.5% vs. 14.8% decline in 2002). The unemployment rate continued to increase (3.25% vs. 2.5% in 2002) despite the healthy economic growth. A relatively weak performance of the export sector and increasing imports led to a

Economic indicators 2000–2004

	2000	2001	2002	2003	Forecast 2004
Economic growth (<i>year on year, %</i>)	5.5	3.6	-0.6	2.5	3.0
Inflation (<i>year on year, %</i>)	5.0	6.8	4.8	2.0	2.5
Current account balance (<i>% of GDP</i>)	-10.3	-4.3	-0.1	-4.2	-5.2
Gross fixed capital formation (<i>% of GDP</i>)	24.1	22.3	18.8	20.0	20.8
Financial balance, general gov. (<i>% of GDP</i>)	2.5	0.2	-1.0	-1.1	0.3
Unemployment (<i>% of labour force</i>)	1.3	1.4	2.5	3.2	3.0
3-month REIBOR (<i>year-end, %</i>)	12.0	12.5	6.2	5.1	-
25-year housing bonds (<i>real yield, year-end, %</i>)	6.3	5.9	5.2	5.0	-
Credit growth in banking sector					
Households (<i>within year, %</i>)	27.5	9.5	8.0	-1.1	-
Corporate sector (<i>within year, %</i>)	58.6	15.7	3.2	23.1	-
Growth of deposits in banking sector	11.5	15.1	16.1	23.5	-
Exchange rate index (<i>year-end</i>)	120.8	141.8	124.9	123.4	-



widening of the current account deficit (-4.25% of GDP vs. -0.1% in 2002). A rising inflow of foreign capital into investment projects in the power intensive sector and the domestic bond market, led to a steady appreciation of the exchange rate of the Icelandic króna. Its trade-weighted index stood at 124.9 at year-end 2002 and at 123.5 at year-end 2003.

The year 2003 also saw a shake-up in the ownership of many of Iceland's best known public companies and a delisting of a number of companies from the Iceland Stock Exchange. The equities market did exceptionally well, with the most important index, the ICEX-15, rising by 56% in 2003, outperforming most if not all equities markets in the industrialized countries.

As the economy cooled down in 2002 and in the early months of 2003, the inflation rate subsided gradually. The year-on-year change in the consumer price index (CPI) came to only 2% in 2003, down from 4.8% in 2002. As imbalances in the economy disappeared, the Central Bank gradually lowered its policy rate from 10.1% in 2002 to its current rate of

5.3%. However, the Central Bank has now reversed its outlook and an increase is expected in the first half of 2004. The reasons are prospects of healthy economic growth over the next few years resulting from huge investments in the aluminium sector and associated power production plants. These investments, combined with good prospects for many of Iceland's outward looking companies have led to a growing optimism and the reappearance of imbalances in the economy.

All in all, it is expected that the Icelandic economy will fare well in the years ahead. Economic growth in 2004 and 2005 is projected at 3% and 3.5% respectively, fuelled in large part by investment expenditure and to a lesser extent private consumption. The unemployment rate is expected to decline gradually to 2.75% in 2005, down from its current rate of 3.25%. The inflation rate is expected to pick up gradually to 2.5% in 2004 and 2.75% in 2005. However, these projections are very much dependent on the outcome of the upcoming round of wage negotiations by all the major labour unions in early 2004.

ENDORSEMENT AND SIGNATURES OF THE BOARD OF DIRECTORS AND THE MANAGING DIRECTOR

The Annual Accounts of Icebank hf. have been prepared in accordance with the Annual Accounts Act and the Regulation on the Preparation of Annual Accounts for Credit Institutions. The accounting principles applied in preparing the Bank's Annual Accounts are consistent with those used for the previous year.

According to the Profit and Loss Account, the net profit for the year amounted to ISK 163 million and is transferred to retained earnings. According to the Balance Sheet, the equity amounted to ISK 2,430 million at year-end. The equity ratio, calculated according to a provision in the Act on Financial Undertakings, is 14.3%. According to the Act the ratio may not be lower than 8.0%. The Board of Directors does not propose payment of dividend for the year 2003. Allocation of profit and changes in equity are further explained in the notes to the Annual Accounts.

During the year 2003 the average number of employees of the Bank was 54. Salaries amounted to ISK 233 million.

The share capital at year-end 2003 was ISK 604 million. The Bank is authorized to issue a non-taxable stock dividend amounting to ISK 449 million, which means that share capital could be multiplied by a factor of 1.74. At year-end shareholders were 25, of which the following four owned more than 10%:

Sparisjóður Reykjavíkur og nágrennis	24.7%
Sparisjóður Hafnarfjarðar	14.8%
Sparisjóður vélstjóra	14.1%
Sparisjóðurinn í Keflavík	11.7%

The Board of Directors and the Managing Director of Icebank hf. hereby confirm the Bank's Annual Accounts for the year 2003 by their signatures.

Reykjavík, 17 February, 2004.

Board of Directors,
Geirmundur Kristinsson
Friðrik Friðriksson, Guðmundur Hauksson
Hallgrímur Jónsson, Þór Gunnarsson

Managing Director,
Finnur Sveinbjörnsson



AUDITORS' REPORT

To the Board of Directors and shareholders of Icebank hf.

We have audited the accompanying Balance Sheet of Icebank hf. as of 31 December, 2003, and the related Profit and Loss Account and Statement of Cash Flows for the year then ended. These Annual Accounts are the responsibility of the Company's management. Our responsibility is to express an opinion on these Annual Accounts based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Annual Accounts are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Annual Accounts. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Annual Accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Annual Accounts give a true and fair view of the financial position of Icebank hf. as of 31 December, 2003, and the results of its operation and its cash flows for the year then ended, in accordance with the law and generally accepted accounting principles in Iceland.

Reykjavík, 17 February, 2004.

KPMG Endurskodun hf,
State Authorised Public Accountants

Sigurður Jónsson

Profit and Loss Account for the Year 2003

	Notes	2003	2002
Financial income:			
Interest from credit institutions		1,079,909	1,726,465
Interest on loans		379,878	596,150
Interest on bonds		503,311	745,385
	4	1,963,098	<u>3,068,000</u>
Financial expenses:			
Interest to credit institutions		831,202	1,786,440
Interest on deposits		73,996	43,381
Interest on borrowings		415,387	653,620
Interest on subordinated loans		98,733	89,298
Other interest expenses		2,582	3,667
	4	1,421,900	<u>2,576,406</u>
		Net interest income	541,198
			491,594
Other operating income:			
Dividends from shares and other holdings	6,31-32	17,473	59,016
Income from commissions	5,17	224,503	149,335
Commission expenses		(48,718)	(31,673)
Value adjustment of other financial operations	18	273,368	163,211
Other operating income	19	9,855	154,484
		476,481	<u>494,373</u>
		Net operating income	1,017,679
			985,967
Other operating expenses:			
Salaries and salary-related expenses	20-22	284,193	289,548
Other administrative expenses		246,544	270,398
Depreciation of fixed assets	12,33	58,326	65,250
		589,063	<u>625,196</u>
Provision for losses	29	(222,340)	<u>(205,000)</u>
		Profit before taxes	206,276
			155,771
Calculated income tax	13,40	(43,146)	<u>(30,443)</u>
Net profit for the year	43	163,130	<u><u>125,328</u></u>

Amounts are in ISK thousands.

Balance Sheet

Assets

	Notes	2003	2002
Cash and demand deposits with the Central Bank ...		<u>1,849,469</u>	<u>70,021</u>
Treasury bills		<u>477,940</u>	<u>1,666,953</u>
Amounts due from credit institutions:			
Required deposits with the Central Bank		<u>1,576,794</u>	4,158,228
Commercial banks		<u>1,658,280</u>	3,246,641
Savings banks		<u>10,010,764</u>	12,351,473
Other credit institutions		<u>619,610</u>	<u>1,842,363</u>
	24-26	<u>13,865,448</u>	<u>21,598,705</u>
Loans:			
Loans to customers	24-26	<u>10,952,611</u>	9,160,444
Mortgages foreclosed	27	<u>20,181</u>	<u>25,181</u>
	8-10	<u>10,972,792</u>	<u>9,185,625</u>
Bonds and shares in other companies:			
Bonds and other fixed-income securities	30	<u>7,993,529</u>	9,605,478
Shares in other companies and other variable-yield securities	31	<u>1,913,207</u>	1,262,858
Shares in associated companies	32	<u>20,461</u>	<u>299,706</u>
	11	<u>9,927,197</u>	<u>11,168,042</u>
Other assets:			
Fixed assets	12,33	<u>439,812</u>	497,776
Other assets		<u>34,002</u>	45,018
Prepaid expenses and accrued income		<u>9,909</u>	<u>11,886</u>
		<u>483,723</u>	<u>554,680</u>
Total assets		<u><u>37,576,569</u></u>	<u><u>44,244,026</u></u>

Amounts are in ISK thousands.

31 December, 2003

Liabilities and equity

	Notes	2003	2002
Amounts due to credit institutions:			
Central Bank		8,762	6,388,488
Commercial banks		14,976,165	15,964,230
Savings banks		12,425,226	10,387,271
Other credit institutions		379,919	489,834
	37	27,790,072	<u>33,229,823</u>
Customer accounts, on demand		1,304,631	<u>1,735,597</u>
Borrowings	38	4,707,105	<u>5,731,663</u>
Other liabilities:			
Sundry liabilities	39	39,580	49,891
Accrued expenses and deferred income		41,627	34,243
		81,207	<u>84,134</u>
Provision for liabilities:			
Provision for deferred income-tax liability	13,40	172,779	<u>134,099</u>
Subordinated loans	14,41	1,090,964	<u>1,062,029</u>
Equity:			
Share capital and shareholders' guarantees		1,208,930	1,208,930
Shareholders' guarantees		(604,465)	(604,465)
Share capital		604,465	604,465
Statutory reserve		248,078	248,078
Retained earnings		1,577,268	1,414,138
Total equity	42-46	2,429,811	<u>2,266,681</u>
Total liabilities and equity		37,576,569	<u>44,244,026</u>
Off-Balance Sheet Items:			
Obligations on behalf of customers	47		
Other obligations	48		

Amounts are in ISK thousands.

Statement of Cash Flows for the Year 2003

	Notes	2003	2002
Cash flows from operations:			
Net profit for the year		163,130	125,328
Difference between net profit and cash from operations:			
Indexation and exchange rate difference		(421,293)	(560,756)
Net profit of associated companies		(15,851)	(39,702)
Provision for losses	29	222,340	205,000
Other items		45,526	(106,663)
Changes in assets and liabilities		60,303	108,553
Net cash used in operating activities		54,155	(268,240)
Cash flows from investing activities:			
Time deposits with the Central Bank, changes		2,581,434	456,687
Other credit institutions, changes		4,852,373	11,346,130
Loans to customers, changes		(1,412,040)	1,835,389
Trading bonds, changes		1,611,949	(1,695,168)
Variable-yield securities, changes		(536,988)	1,072,954
Shares in other companies, sold		329,254	202,290
Investment in shares in other companies		(4,784)	(106,566)
Investment in fixed assets		(1,419)	(13,624)
Sold assets		1,200	0
Other assets, changes		11,016	14,134
Net cash used in investing activities		7,431,995	13,112,226
Cash flows from financing activities:			
Amounts owed to credit institutions, changes		(5,463,800)	(11,055,307)
Deposits, changes		(469,881)	(940,692)
Borrowings, changes		(951,723)	454,934
Other liabilities		(10,311)	1,798
Net cash provided by financing activities		(6,895,715)	(11,539,267)
Increase (decrease) in cash		590,435	1,304,719
Cash and cash equivalents at the beginning of the year		1,736,974	432,255
Cash and cash equivalents at the end of the year	15	2,327,409	1,736,974

Amounts are in ISK thousands.

Notes to the Annual Accounts

Summary of accounting principles

Basis of preparation

1. The Annual Accounts have been prepared in accordance with the Annual Accounts Act and the Rules on the financial statements of credit institutions. They are based on cost accounting and are prepared according to the same accounting principles as for the previous year. The Annual Accounts are prepared in Icelandic currency and amounts are presented in thousands of Icelandic krónur.
2. Associated companies are companies where the Bank. has significant influence over the financial and operational policies but not a controlling interest. The Annual Accounts include the Bank's share in the performance of associated companies during the time that the influence exists. Where the Bank's share in a loss is higher than the book-value of an associated company the book-value is recorded as zero and further entries of loss are ceased unless the Bank has granted guarantees or financing to the associated company.

Foreign currency

3. Assets and liabilities in foreign currencies are converted into Icelandic currency at the year-end 2003 exchange rate. Operating revenue and expenses in foreign currencies are converted at the exchange rate of the date of transaction.

Interest income and interest expenses

4. Interest income and interest expenses are entered into the Profit and Loss Account as they accrue based on actual interest rate. Interest income is calculated on amounts due from other financial institutions, loans and trading securities. Interest expenses are calculated on amounts owed to financial institutions, deposits, borrowings and subordinated loans. If loans have been in default for more than three months interest income is no longer calculated.

Revenue and expenses equalling interest, such as up-front fees, are included among interest income and expensed as they accrue.

Commissions

5. The Bank provides various services to its customers and derives income from such services. Commissions include income from consulting to companies and other customers. Commissions are entered into the Bank's Profit and Loss Account when they are derived.

Income from shares and other holdings

6. The Bank's share in the profit or loss of associated companies is included in income from shares and other holdings, along with dividends on shares. Dividends from trading shares are included among value adjustment of other financial operations in the Profit and Loss Account.

Earnings per share

7. Earnings per share is the ratio between profit and weighted average of share capital during the year and shows the profit per ISK 1 of share capital. The profit for the year amounted to ISK 163 million and the weighted average of the nominal value of share capital was ISK 604 million.

Loans

8. Loans are capitalised with accrued interest, indexation and exchange rate difference at year-end. Indexed loans are entered based on indices effective at the beginning of 2004 and loans in foreign currencies based on the exchange rates of the relevant currencies at year-end 2003.
9. The provision for losses on the loan portfolio is made to meet the risk attached to lending operations. The loss provision is based on estimation and does not represent a final write-off. In addition to the required contribution, certain risk factors are evaluated to determine the total contribution for this purpose. First, there are specific provisions to adjust for obligations of creditors who have received a poor risk evaluation, and second, there is a general provision to meet the general risk of lending operations. Interest on doubtful loans is not entered as income. The provision has been deducted from the appropriate Balance Sheet items, less the provision for issued, guarantees which are posted among sundry liabilities in the Balance Sheet.
10. The Bank has redeemed assets on foreclosed mortgages. Foreclosed mortgages are entered at estimated market prices in the Bank's Annual Accounts.

Market securities and holdings

11. The Bank's securities are partly presented as trading securities and partly as investment securities. Investment securities are those which by a formal decision are expected to be held for more than one year, whereas other securities are categorised as trading securities.

Investment shares are capitalized at the cost price or estimated market price, whichever is lower. Listed trading securities are capitalized at year-end market value. Unlisted trading bonds are valued according to the required rate of return at the time of purchase, whereas unlisted trading shares are valued at the cost price or estimated market price, whichever is lower.

Property and equipment

12. Property and equipment are capitalized at cost price less depreciation. Depreciation is calculated as a fixed annual percentage based on the estimated useful life of the property and equipment until a scrap value is reached. Estimated useful life is specified as follows:

Real estate	50 years
Fixtures	5 years
Office equipment	4-5 years
Vehicles	6 years

Deferred income-tax liability

13. The deferred income-tax liability has been calculated and entered in the Balance Sheet. The calculation is based on the difference between Balance Sheet items as presented in the tax return, on the one hand, and in the Annual Accounts, on the other hand, taking into account carry-forward tax loss. This difference is due to the fact that tax assessments are based on rules which differ from those governing the Annual Accounts, mostly temporary difference because expenses are entered earlier in the tax turn than in the Annual Accounts.

Subordinated loans

14. The Bank has borrowed funds by issuing indexed bonds in Icelandic currency on subordinate terms. The bonds have the characteristics of equity in being subordinate to other liabilities of the Bank. In the calculation of the capital ratio, the bonds are included with equity, as shown in note 45. The subordinate loans mature in 10 years. The loans are entered as liabilities with accrued interest and indexation at year-end. Indexed loans are posted using indices effective as of 1 January 2003.

Cash and cash equivalents

15. Cash and cash equivalents in the Statement of Cash Flows consist of cash and demand deposits with the Central Bank, Treasury bills eligible for repurchase agreement with the Central Bank and demand deposits with credit institutions.

Derivatives

16. Derivatives are financial instruments, the contracted or notional amounts of which are not included in the Bank's Balance Sheet, either because rights and obligations arise out of one and the same contract, the contracts perform after the Balance Sheet date or because the notional amounts serve merely as variables for calculating purposes. The notional amounts of derivatives do not necessarily give any indication of the size of the cash flows and the market and credit risk attached to derivatives transactions. Examples of derivatives are forward exchange contracts, options, swaps, futures and forward rate agreements. The underlying value may involve interest rate, currency, commodity, bond or equity products.

The Bank's derivatives transactions are conducted as trading activity, entered at their market value, and as a hedge against the Bank's own interest rate and currency exposure due to securities issue and other borrowings. Hedge contracts are entered in the same manner as the hedged item. The Bank's derivatives are mainly intended to reduce the price, exchange and interest rate risk assumed by the Bank or its customers. Derivatives performance is entered in the Profit and Loss Account and in the Balance Sheet. Net assets are capitalised among amounts due from credit institutions and other assets, whereas net obligations are entered among sundry liabilities and amounts owed to credit institutions.

The market risk attached to derivatives is created by changes in the price of the factors on which the contracts are based, such as interest rate changes, or exchange rate changes in currency and listed securities. Risk attached to borrowings reflects the loss incurred by the Bank if the counter party in a derivative contract could not fulfil its part of the contract.

Forward rate agreements and futures relating to currency, securities and interest rate are entered in the Bank's Annual Accounts at their year-end market value.

Other operating income

	2003	2002
17. Commissions are itemised as follows:		
Commissions on guarantees	72,754	54,647
Other commissions	<u>151,749</u>	<u>94,688</u>
Total	<u>224,503</u>	<u>149,335</u>

18. Value adjustment of other financial operations is itemised as follows:

Trading bonds	(147,957)	106,806
Trading shares	330,646	(29,474)
Foreign exchange assets and liabilities	<u>90,679</u>	<u>85,879</u>
Total	<u>273,368</u>	<u>163,211</u>

19. Other operating income is itemised as follows:

Proceeds from the sale of shares	0	142,688
Other income	<u>9,855</u>	<u>11,796</u>
Total	<u>9,855</u>	<u>154,484</u>

Personnel

	2003	2002
20. The Bank's total number of employees is as follows:		

Average number of employees during the year, measured in full-time equivalent positions	54	59
Full-time equivalent positions at year-end	54	53

21. Salaries and salary-related expenses are itemised as follows:

Total salaries	232,570	242,804
Salary-related expenses	<u>51,623</u>	<u>46,744</u>
Total	<u>284,193</u>	<u>289,548</u>

Amounts are in ISK thousands.

2003

22. Executive employment terms:

Chairman of the Board	1,530
Other members of the Board (4)	3,060
Managing Director	18,648
Total	23,238

23. Fee to the Bank's auditors is specified as follows:

Audit of the Annual Accounts	3,260
Interim Accounts review	1,049
Other services	790
Total	5,099

Loans to customers and amounts due to credit institutions

24. Loans to customers itemised by types of loans:

	2003		2002	
	Credit institutions	Loans to customers	Credit institutions	Loans to customers
Required deposits with the Central Bank	1,576,794	0	4,158,228	0
Overdrafts	98,843	38,737	366,237	153,309
Production and operations credit	438,711	243,045	776,434	186,825
Bills of exchange	1,360,647	571,780	2,716,903	595,050
Bonds	2,721,884	2,158,045	2,592,181	1,425,081
Foreign loans	7,093,121	7,925,604	9,327,299	6,800,179
Deposits, currency linked	266,726	0	921,719	0
Inter-bank loans	262,315	0	700,469	0
Subordinated loans	46,407	15,400	39,235	0
Total	13,865,448	10,952,611	21,598,705	9,160,444

25. Loans to customers itemised by sector:

	2003	2002
Municipalities	2.8%	1.1%
Business enterprises:		
Agriculture	1.5%	0.5%
Fishing industry	38.0%	46.1%
Services	35.6%	38.7%
Other	22.1%	13.6%
Total	100.0%	100.0%

Amounts are in ISK thousands.

26. Amounts due from credit institutions and loans to customers itemised by maturity:

	2003		2002	
	Credit institutions	Loans to customers	Credit institutions	Loans to customers
Required deposits with the Central Bank	1,576,794	0	4,158,228	0
On demand	0	99,255	0	101,645
Up to 3 months	3,934,774	3,983,169	8,042,192	2,912,874
Over 3 months and up to 1 year	2,441,552	1,543,339	2,697,297	1,316,615
Over 1 year and up to 5 years	5,192,659	4,217,993	5,787,347	3,563,801
Over 5 years	719,669	1,108,855	913,641	1,265,509
Total	13,865,448	10,952,611	21,598,705	9,160,444

27. The Bank has redeemed assets on foreclosed mortgages. They are itemised as follows:

	2003	2002
Real estate	20,181	25,181
Total	20,181	25,181

28. Non-performing loans are itemised as follows:

Loans with a specific provision for losses	681,640	386,233
Specific provision for losses	(288,052)	(158,951)
Other non-performing loans	242,739	67,329
Total	636,327	294,611

29. A provision for losses on the loan portfolio has been deducted from the appropriate Balance Sheet items. However, the provision for guarantees issued is posted among sundry liabilities, amounting to ISK 30 million. The changes in the provision are itemised as follows:

	Provision for losses 2003			2002
	Specific	General	Total	Total
Balance at the beginning of the year	158,951	198,100	357,051	627,100
Provision for losses over the year	212,340	10,000	222,340	205,000
Actual losses during the year	(83,239)		(83,239)	(475,049)
Balance at year-end	288,052	208,100	496,152	357,051
Provision for losses			3.5%	3.6%

Amounts are in ISK thousands.

Bonds and shares in other companies

30. Bonds and other fixed-income securities are itemised as follows:

	Market value	Book value
Trading bonds:		
Listed on the Iceland Stock Exchange	4,336,437	4,336,437
Other listed bonds	661,720	661,720
		4,998,157
Investment bonds:		
Listed on the Iceland Stock Exchange	1,073,718	1,075,871
Other listed bonds	1,730,525	1,717,915
Bonds, unlisted		201,586
		2,995,372
Bonds and other fixed-income securities at year-end 2003		7,993,529
Bonds issued by public bodies		5,366,658
Bonds issued by others		2,626,871
		7,993,529

Of the above amounts, ISK 1,468 million will be paid within one year.

31. Shares and other variable-yield securities are itemised as follows:

	Market value	Book value
Trading shares:		
Shares listed on the Iceland Stock Exchange	402,385	402,385
Other listed shares	151,626	151,626
Unlisted shares		1,229,569
Total		1,783,580

Amounts are in ISK thousands.

Investment securities and primary capital:	Ownership	Dividend/ interest	Nominal value	Book value
Sparisjóður Ólafsfjarðar	12.3%		25,000	30,386
Sparisjóður Hornafjarðar og nágrennis	7.7%		3,439	3,439
Eignarhaldsfélagið Verðbréfafing hf., Reykjavík	0.7%	108	292	379
Smárahúsið ehf., Kópavogur	5.0%		125	145
Klettháls ehf., Reykjavík	16.7%		100	119
Greiðslumiðlun hf., Reykjavík	0.1%	135	449	3,204
Median hf., Reykjavík	3.6%		1,150	8,049
Intrum Island hf., Reykjavík	0.9%	232	6	2,969
Salka-Fiskmiðlun hf., Dalvík	13.6%	1,147	2,294	74,000
Ljósavík hf., Þorlákshöfn	7.0%		900	1,500
SP-Fjármögnun hf., Reykjavík	0.1%		460	2,688
Alþjóða líftryggingarfélagið hf., Reykjavík	0.1%		19	571
Other				2,178
Total		1,622		129,627
Shares and other variable-yield securities, total				1,913,207

32. Shares in associated companies are itemised as follows:

	Ownership Holdings	Profit share	Nominal value	Book value
Reiknistofa bankanna, Reykjavík	0.5%	685	7,538	7,538
Scandinavian Holding S.A., Luxembourg	14.0%	13,276	0	0
Tölvumiðstöð sparisjóðanna, Kópavogur	5.0%	1,890	12,923	12,923
Associated companies, total		15,851		20,461

Amounts are in ISK thousands.

Other assets

33. Fixed assets are itemised as follows:

	Real estate	Fixtures, equipment and vehicles	Total
Total value 1.1.2003	426,878	268,304	695,182
Additions during the year	0	1,419	1,419
Sales and disposals during the year	0	(8,500)	(8,500)
Total value 31.12.2003	426,878	261,223	688,101
Previously depreciated	66,042	131,364	197,406
Depreciation during the year	8,817	49,509	58,326
Sales and disposals during the year	0	(7,443)	(7,443)
Total depreciation 31.12.2003	74,859	173,430	248,289
Book value 31.12.2003	352,019	87,793	439,812
Annual depreciation ratio	2–4%	15–25%	

At year-end 2003, the official value of buildings was ISK 219 million and ISK 28 million for land, or a total of ISK 247 million. The fire-insurance value of the buildings, fixtures and equipment amounted to ISK 446 million at year-end 2003.

Amounts due from associated companies

34. Amounts due from associated companies are itemised as follows:

	2003
Deposits	90,600
Total	90,600

Assets and liabilities, index-linked or in foreign currencies

35. The total of indexed assets amounted to ISK 6,549 million at year-end, while indexed liabilities amounted to ISK 4,088 million at the same time. Included in assets and liabilities are forward contracts, see note no. 47.

36. The total amount of assets in foreign currencies amounted to ISK 27,526 million at year-end, and the total amount of liabilities amounted to ISK 27,394 million at the same time. Included in assets and liabilities are forward contracts, see note no. 47.

Amounts are in ISK thousands.

Liabilities to credit institutions

	2003	2002
37. Amounts owed to credit institutions mature as follows:		
Up to 3 months	13,555,909	17,901,715
Over 3 months and up to 1 year	1,956,077	3,895,526
Over 1 year and up to 5 years	12,278,086	11,432,582
Total	27,790,072	33,229,823

Borrowings

	2003	2002
38. The Bank's borrowings are itemised as follows:		
Bonds issued	3,613,957	4,482,352
Borrowings from credit institutions	1,093,148	1,249,311
Total	4,707,105	5,731,663

The Bank's borrowings mature as follows:

Up to 3 months	1,641,965	2,451,871
Over 3 months and up to 1 year	0	195,924
Over 1 year and up to 5 years	1,093,148	1,249,311
Over 5 years	1,971,992	1,834,557
Total	4,707,105	5,731,663

39. Sundry liabilities are itemised as follows:

Provision for losses on guarantees	30,000	30,000
Other liabilities	7,613	19,891
Total	37,613	49,891

Deferred income-tax liability

	2003	2002
40. Changes in the Bank's deferred income-tax liability are itemised as follows:		
Provision for deferred income-tax liability at the beginning of 2003	134,099	103,656
Calculated income tax for 2003	38,680	30,443
Income tax payable in 2004 on 2003 activities	0	0
Provision for deferred income-tax liability at the end of 2003	172,779	134,099

Amounts are in ISK thousands.

The deferred income-tax liability is itemised as follows:	2003	2002
Shares in other companies	284,044	258,545
Property and equipment	12,389	11,612
Carry-forward taxable loss	(123,654)	(136,058)
Provision for deferred income-tax liability at the end of 2003	172,779	134,099

Subordinated loans

41. The Bank has borrowed funds by issuing bonds on subordinate terms. The bonds have the characteristics of equity in being subordinated to other liabilities of the Bank. In the calculation of capital ratio, the bonds are included with equity, as shown in note 45. The subordinated loans have an interest rate of 7.0% and will be repaid fully with indexation in 2011. As of 26 September, 2005, the Bank may redeem the bond by submitting a notice to such effect.

Equity

42. According to the Bank's Articles of Association, total capital stock amounts to ISK 609 million. At year-end, shares with a nominal value of ISK 5 million were unsold. One share carries one vote and each share is one ISK

43. Changes in equity are itemised as follows:	Capital stock	Statutory reserve	Retained earnings	Total
Equity 1.1.2003	604,465	248,078	1,414,138	2,266,681
Net profit			163,130	163,130
Equity 31.12.2003	604,465	248,078	1,577,268	2,429,811

44. Statutory reserve is itemised as follows:

Share premium account	174,965
Statutory reserve	73,113
Total	248,078

45. Equity at year-end amounts to ISK 2,430 million, which corresponds to 6,5% of total assets. The Bank's capital ratio, calculated according to Article 84 of the Act on Financial Undertakings, is 14,3%. According to the Act, this ratio may not be below 8.0%. The ratio is calculated as follows:

	Book value	Weighted value	
		2003	2002
Risk base:			
Assets recorded in the Annual Accounts	37,576,569	21,401,526	18,705,402
Assets subtracted from equity		(60,318)	(171,286)
Guarantees and other items not included in the Balance Sheet		2,780,431	1,622,363
Risk base, total		24,121,639	20,156,479
Capital:			
Tier I capital:			
Recorded equity		2,429,811	2,266,681
Tier II capital:			
Subordinated loans		1,090,964	1,062,029
Investment in credit institutions		(60,318)	(171,286)
Total equity		3,460,457	3,157,424
Capital ratio		14.3%	15.7%

46. At year-end, the shareholders of the Bank had provided guarantees to the benefit of the Bank equal to the share capital holding of the respective shareholders at any given time. These guarantees apply to the obligations of the Bank against foreign financial institutions. The Board of Directors of the Bank is at any time authorised to make cash calls on shareholders under these guarantees at the discretion of the Board to be able to meet the above obligations.

At year-end 2003, these guarantees amounted to ISK 604 million.

Amounts are in ISK thousands.

Off-Balance Sheet items

47. The Bank has granted its customers guarantees and documentary credits. Furthermore, it has entered into forward contracts and currency and interest rate contracts with its customers. These obligations and contracts are itemised as follows:

	2003	2002
Guarantees and documentary credits	4,052,456	2,372,811
Unused overdrafts	33,300	57,302
Forward contracts:		
Assets in ISK	2,808,453	1,024,725
Assets in foreign currencies	5,214,934	5,628,747
Liabilities in ISK	875,139	3,012,641
Liabilities in foreign currencies	7,147,002	3,641,178
Currency and interest rate swaps:		
Assets in foreign currencies	2,621,283	493,232
Liabilities in ISK	102,963	156,507
Liabilities in foreign currencies	2,483,687	344,761

The contracts are made to reduce currency and interest risk for the Bank and its customers. The Bank's risk relating to the contracts is a result of possible currency fluctuations or changes in interest rates. At year-end, the risk is valued at ISK 88 million in the calculation of capital ratio according to applicable rules.

48. According to the Act on the Deposit Insurance Fund for Owners of Saving Deposits and Investors, the total assets of the Fund must correspond to a minimum of 1.0% of the average insured deposits in Commercial Banks and Savings Banks for the previous year. As total assets of the Fund do not fulfill these requirements, the Bank's liability according to the Act amounts to ISK 2 million. The liability is not entered in the Annual

	2003 ISK '000	2002 ISK '000	2001 ISK '000	2000 ISK '000	1999 ISK '000
Profit and loss account					
Financial income	1,963,098	3,068,000	4,024,526	3,300,590	2,205,518
Financial expenses.....	1,421,900	-2,576,406	-3,603,578	-3,033,155	-1,874,849
Net interest income	541,198	491,594	420,948	267,435	330,669
Other operating income	476,481	494,373	285,182	427,627	479,095
Net operating income	1,017,679	985,967	706,130	695,062	809,764
Other operating expenses	589,063	-625,196	-535,438	-456,962	-370,084
Provision for losses	-222,340	-205,000	-220,000	-101,500	-121,134
Profit before taxes	206,276	155,771	-49,308	136,600	318,546
Income and net worth tax.....	-43,146	-30,443	64,361	-33,510	-111,671
Net earnings	163,130	125,328	15,053	103,090	206,875
Assets					
Cash and treasury bills.....	2,327,409	1,736,974	432,255	1,176,750	2,117,751
Loans to credit institutions and customers ..	24,838,240	30,784,330	42,627,197	34,895,580	31,114,715
Securities and shareholding	9,927,197	11,168,042	10,586,698	8,573,190	7,169,615
Other assets	483,723	554,680	662,881	523,538	277,168
Total assets	37,576,569	44,244,026	54,309,031	45,169,058	40,679,249
Liabilities and capital					
Deposits	29,094,703	34,965,420	46,862,289	35,442,096	33,269,896
Borrowings	4,707,105	5,731,663	4,026,729	6,957,888	5,268,035
Other liabilities	81,207	84,134	103,632	110,867	204,790
Provision for liabilities	172,779	134,099	133,869	183,335	134,340
Subordinated loans	1,090,964	1,062,029	1,041,159	500,233	0
Total liabilities	35,146,758	41,977,345	52,167,678	43,194,419	38,877,061
Capital	2,429,811	2,266,681	2,141,353	1,974,639	1,802,188
Total liabilities and capital	37,576,569	44,244,026	54,309,031	45,169,058	40,679,249
Off-balance sheet items					
Letters of credit and guarantees.....	4,052,456	2,372,811	952,724	1,349,182	765,563

Amounts are in ISK thousands.

	2003 ISK '000	2002 ISK '000	2001 ISK '000	2000 ISK '000	1999 ISK '000
Profit and loss account					
Financial income	15,070,317	17,913,221	20,537,490	14,528,881	11,336,941
Financial expenses	-8,706,377	-10,826,518	-14,442,923	-9,745,420	-6,937,126
Net interest income	6,363,940	7,086,703	6,094,567	4,783,461	4,399,815
Other operating income	6,325,581	3,849,356	2,693,076	6,481,290	3,350,635
Net operating income	12,689,521	10,936,059	8,787,643	11,264,751	7,750,450
Other operating expenses	-7,056,040	-7,108,716	-6,210,295	-5,531,622	-4,760,176
Provision for losses	-2,651,738	-2,228,194	-2,620,375	-1,457,372	-1,302,221
Profit before taxes	2,981,743	1,599,149	-43,027	4,275,757	1,688,053
Income and net worth tax	-412,730	464,907	759,147	-1,136,035	-502,575
Net earnings	2,569,013	2,064,056	716,120	3,139,722	1,185,478
Assets					
Cash and treasury bills	1,288,247	1,180,429	1,043,586	1,630,309	1,486,712
Loans to credit institutions and customers ..	143,730,261	145,148,622	130,266,835	112,645,069	95,286,339
Securities and shareholding	31,584,498	32,287,868	26,979,009	22,126,410	16,395,181
Other assets	4,070,517	5,806,577	3,682,559	5,129,101	3,261,736
Total assets	180,673,523	184,423,496	161,971,989	141,530,889	116,429,968
Liabilities and capital					
Deposits	116,524,315	118,959,743	105,068,300	69,331,542	60,741,344
Borrowings	32,032,722	36,380,626	29,415,555	27,277,125	21,275,156
Other liabilities	2,095,222	2,071,577	2,049,141	26,238,109	21,326,564
Provision for liabilities	3,081,772	2,853,363	2,970,299	3,451,970	2,435,744
Subordinated loans	5,097,065	5,232,221	5,076,967	500,233	0
Total liabilities	158,831,096	165,497,530	144,580,262	126,798,979	105,778,808
Capital	21,842,427	18,925,966	17,391,727	14,731,910	10,651,160
Total liabilities and capital	180,673,523	184,423,496	161,971,989	141,530,889	116,429,968
Off-balance sheet items					
Letters of credit and guarantees	3,140,672	4,670,969	8,203,990	7,113,082	4,685,963

Amounts are in ISK thousands.

