



Linda Jónsdóttir, Chairman of the Board
Jón Guðni Ómarsson, CEO
Íslandsbanki hf.
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Reykjavík, 14 February 2025

Expression of interest for a proposed merger of Íslandsbanki hf. and Arion Bank hf.

- A merged bank could provide even better services with lower costs, invest more in development and innovation, and provide more support for a stronger financial system and the Icelandic economy.
- Direct savings for Icelandic consumers expected to exceed ISK 50bn over the next ten years, substantially contributing to the government's ongoing efficiency initiative. Indirect savings also anticipated to be significant.
- Shareholders of Íslandsbanki, including the Icelandic state will receive a 5% premium when exchange ratios are set, and more valuable shares in a larger entity.
- We believe that the efficiencies of the merger meet the three cumulative conditions from European Commission's Merger Guidelines, namely being beneficial to consumers, efficiencies are merger-specific, and verifiable.

Dear Linda and Jón,

As you are well aware, the Icelandic banking system is governed by an extensive European regulatory framework and rules applicable specifically to Iceland. This framework is perceived as encumbering for large international banks, but even more so for Icelandic banks which are small by international standards. It is therefore evident that our customers and the society bear a relatively higher burden with regard to costs of financial services than in our neighbouring countries.

We believe there is considerable opportunity for rationalization in our banking sector and that the sector can serve its customers more effectively in terms of costs and time. It is unheard of elsewhere that a nation as small as Iceland has three systematically important banks that almost exclusively service the domestic market. And as you know, there are substantial operational challenges that come with being a systematically important bank in a small economy. Operating a financial system in such a way can impact opportunities to expand, innovate and compete in an effective manner.

We therefore present to you our interest to merge Arion Bank hf. ("Arion") and Íslandsbanki hf. ("Íslandsbanki"), creating a strong combined bank with greater efficiency. The potential merger offers significant benefits, with considerable synergies that will directly benefit consumers. Arion is committed to working closely with the Icelandic Competition Authority to ensure that at least ISK 5 billion in annual savings are passed on to consumers in the form of lower costs. These figures do not account for expected additional efficiencies within the broader financial system beyond the merged entity.

This merger would represent a unique opportunity to restructure our country's banking system, for it to become more efficient by spreading the regulatory burden over a larger asset base and offering synergies in innovation costs that would enhance consumer-focus and capability of meeting the demands of the modern economy. This would strengthen the foundations of two systematically important banks in Iceland to provide better services at lower costs, support economic growth, reduce systemic risk and make the Icelandic financial system more competitive. A simpler system, with only two systemic banks, could further provide opportunities for savings with regulatory agencies for the benefit of the Icelandic nation.

Arion is willing to offer a 5% premium over Íslandsbanki's market value when estimating the possible exchange ratios between the banks in a merged entity. The Icelandic state, along with other shareholders, would therefore receive a higher price for its share in Íslandsbanki and acquire a share



in a merged bank which is larger and more efficient. A larger bank is also more likely to attract interest from international investors.

In addition, the public in Iceland would, e.g. with indirect ownership through pension funds, own a significant share in the merged bank and would through that also benefit from the merger.

It is assumed that consideration in the transaction would be in the form of shares. Exchange ratios would be determined based on the average share price over the last 30 days and adjusted for changes in the banks' capital, including any dividend distributions and share buybacks. Furthermore, the pricing would be subject to adjustments in the event of any material changes in the banks' financial position.

We hold Íslandsbanki hf. in the highest regard and respect its track record and reputation. It is clear to us that Arion and Íslandsbanki have a very strong strategic, cultural, and operational alignment and combining the strengths of the companies would expectedly generate substantial benefits for our customers, employees, shareholders, and the Icelandic nation.

With reference to the above, we are pleased to formally submit our expression of interest to initiate a collaborative exploration of these value-creation opportunities. Our objective is to enhance efficiency and translate these gains into tangible benefits for shareholders and consumers, including lower prices and improved services.

1. BENEFIT AND RATIONALE

Arion has recently initiated a structured dialogue on the costs of financial products in Iceland, including the so-called "Iceland premium." As part of this effort, we have presented a set of potential actions for the new government to consider, aimed at supporting long-term cost reductions for Icelandic consumers.

A part of the Iceland premium that was not directly included in this list relates to the fixed costs in the banking system and the lack of economies of scale when operating three systematically important banks in an economy of under 400,000 inhabitants.

The current structure of the Icelandic banking sector is to an extent a legacy of the position of Iceland's financial system before the financial crisis of 2008, where these three banks built up significant international operations, and necessary infrastructure, which is not the case today.

The three banks are among the smallest systemically important banks globally which involves significant costs for Iceland, both in higher operating costs for the banks and the need for significant regulatory oversight.

The operating expenses of these banks are significant in comparison to the scale of the Icelandic economy. In total, these three banks have operating expenses totalling ISK 90bn annually. This represents over 2.1% of GDP and over ISK 400,000 for each employed citizen of Iceland per year.

Pressure on these costs is expected to increase in the near term with incoming legislation and regulation, e.g. pertaining to AML, ESG/taxonomy, investor protection, fraud protection, data protection, cyber security, AI and reporting obligations.

There is also indirect cost in that the banks need to fund themselves abroad but are small and pay a premium partly due to their size. Icelandic banks for example face higher wholesale funding costs compared to similarly rated banks abroad, this forms part of the Iceland premium.

Additionally, there has been relatively little interest in the banks' shares abroad, partly because of their size. This negatively impacts overall investor knowledge of the Icelandic banking sector and thus indirectly feeds into funding costs and overall funding availability.

This has also resulted in limited interest from international investors in the Icelandic state's sell-down of its holding in Íslandsbanki, for an example.

There is also systemic risk for three small banks in building the infrastructure required for systemically important banks with small economies of scale and limited investment capacity.

This presents a significant challenge in implementing regulations and oversight. While the Icelandic banks have to date fairly successfully managed this, it continues to come at a significant cost and with the limited scale will continue to be challenging going forward.

It is important to strengthen the foundations of the systematically important banks in Iceland to support economic growth and reduce systemic risk by creating stronger entities.

This is a trend we generally observe in banking sectors abroad, including in neighbouring countries. Bank merger dialog has increased recently, often justified by the same arguments, that with growing



regulatory frameworks, economies of scale have become extremely important to support economic growth and deliver the best prices to consumers.

These perspectives are further reinforced by research, including the report by Mario Draghi on the future of European competitiveness, which underscores the critical role of economies of scale in strengthening competitive positioning, driving development, and maximizing value creation.

Additionally, it is worth noting that many banks advocating for increased economies of scale are significantly larger than Icelandic banks. Despite the substantial difference in size, they operate under the same regulatory frameworks, sometimes even simpler ones, as Icelandic banks are also subject to specific Icelandic regulations.

Stronger Icelandic banks would furthermore be in a better position to compete should foreign banks with higher efficiency decide to increase their presence in the Icelandic market, ensuring the stability of the system.

The merger also supports the ability to ensure that the Icelandic financial system, and therefore the Icelandic economy, can play a role in future Arctic development, such as in Greenland, which will be more difficult with the current small-scale units.

The timing is right. The restructuring of Iceland's financial system after the 2008 financial crisis has been successful, and Icelandic banks today are built on solid foundations by most comparative standards. Following the system's reconstruction, there are now opportunities for efficiency gains and value creation to support continued economic growth and Iceland's future competitiveness.

Competition in key markets is strong and growing as new mavericks are strengthening. Arion, along with leading economics consultancy Copenhagen Economics, has conducted a thorough assessment of the competitiveness within the main markets in the Icelandic financial sector. The findings suggest a healthy competitive market in an international context, supported by numerous factors:

- a) Consumer mobility is among the highest in Europe and barriers to entry are low in most markets. Furthermore, conditions for competition have become more favourable over the past decade as digitalization and regulatory changes have promoted lower barriers to entry and higher consumer mobility. The findings suggest increasing competitive pressure from both domestic entrants and international foreign financial institutions in recent years towards Icelandic banks. This is evidenced by new players, particularly within the Retail Banking markets, being able to capture market share in a short period of time.
- b) New companies on the financial market are numerous and they have achieved notable growth in a relatively short period with low costs and have ambitious growth plans. These challengers operate within certain submarkets and do not have to comply with the same strict regulation as the larger banks. In addition, there is competition from larger players, such as the pension funds for mortgage lending, international banks for corporate lending and international asset managers for pension savings and general asset management services.
- c) Regulations on the financial markets, plus technological advances, will continue to cultivate and strengthen the competition environment.

Research further supports the argument that the proposed merger will lead to efficiency gains to the benefit of consumers. Smaller banks require economies of scale to operate efficiently. The regulatory, capital and liquidity requirements place a relatively higher burden on small banks compared to larger ones. Evidently the three large banks do not have the equivalent economies of scale to simultaneously comply with a higher regulatory burden and innovate, expand and compete in an increasingly international banking sector.

We believe the efficiencies of the merger meet the three cumulative conditions from European Commission's Merger Guidelines. The consumer benefits are substantial, quantifiable and could not be achieved through alternative means.

2. CONDITIONS

We expect that additional conditions will be discussed and negotiated between the parties as potential discussions progress. However, we expect that our discussions and any potential merger would be subject to at least the following conditions:

- a) Any conditions imposed by the Competition Authorities in relation to the merger shall not be unduly burdensome, create excessive uncertainty or result in loss or significant risk for Arion's shareholders.
- b) The merger is approved by the Financial Supervisory Authority of the Central Bank of Iceland.
- c) The merger is approved by the requisite majority of votes at shareholders' meetings of both parties.



3. EXCHANGE OF INFORMATION

We expect that additional provisions on the exchange of information will be discussed and negotiated between the parties as potential discussions progress. However, we expect that the parties would agree to establish a “clean team”, consisting of a limited number of designated individuals, who would be responsible for reviewing, analysing, and discussing confidential information provided by each party in relation to the potential merger. The clean team members would be independent of the parties' respective deal negotiation teams and should not be involved in any direct discussions or negotiations related to the potential transaction. However, in light of the fact that both parties are well-established and publicly listed entities, we would expect that a full-scale due diligence review of the parties would neither be suggested nor required.

4. NOTIFICATION TO THE REGULATORY AUTHORITIES

We expect that the commencement of discussions between the parties would be notified to the Icelandic Competition Authority and to the Financial Supervisory Authority the Central Bank of Iceland, along with any subsequent developments, in accordance with relevant laws, regulations and customary practices. Following such notifications, the parties would cooperate fully with the relevant authorities and provide any additional information or documentation as required to ensure compliance with applicable laws and regulations. Both parties would agree to work in good faith to address any concerns or requirements raised by the authorities in a timely and efficient manner.

5. DISCLOSURE

Arion, as a listed company, discloses the contents of this letter to the market simultaneously with its delivery to you. Arion expects that further developments of our potential discussions will be disclosed to the market in accordance with the applicable laws and regulations.

6. FEES AND EXPENSES

Each party shall be responsible for its own costs and expenses incurred in connection with the potential discussions related to the proposed merger, including but not limited to legal, financial, and advisory fees, and no party shall be liable for any costs or expenses incurred by the other party.

We hope this expression of interest, which is sent to you with the consent and endorsement of Arion's Board of Directors, provides you with compelling arguments for the opportunities in a merger of Íslandsbanki and Arion. In our view, this merger would be beneficial to all our stakeholders, but not the least for the Icelandic nation.

We kindly request that you notify the undersigned no later than within fourteen (14) days from the date of this letter whether the board of Íslandsbanki hf. is willing to engage in discussions with Arion pertaining to a potential merger of the two banks. Should you require any further information or wish to clarify any aspects of this letter or other matters pertaining thereto, please do not hesitate to contact us at your earliest convenience. Furthermore, should you require additional time to provide a response, you are welcome to request an extension of the timeframe suggested above and we will be happy to accommodate as possible.

Sincerely,

Benedikt Gíslason
CEO of Arion Bank hf.

Paul Horner
Chairman of the Board of Directors of Arion Bank hf.