Municipality Credit Iceland

Financial statements
Annual Report 2010

Index

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Municipality Credit Iceland Plc.
Identity number 580407-1100
Borgartun 30, Post-box 8100, 128 Reykjavik

Report of the Board of Directors and the Managing Director

Lending and borrowings

Disbursed long term loans during the year 2010 amounted to ISK 6,378 million compared to ISK 8,410 million for the year 2009.

Municipality Credit Iceland (MCI) has never suffered a loan loss since it commenced operations in 1967 and does not make provisions for estimated loan losses in its books. MCI takes pledge in the municipalities revenues as collateral for loans and guarantees. MCI applied its pledge once during the year 2010, which resulted in the borrower in question settling its arrears. At year end there was no loan in arrears.

Loans financed with share capital are CPI-linked and can be prepaid. The interests are variable but remained at 4.25% throughout the year 2010. Borrowed money is re-lent with a 0.05% margin in order to cover part of operating costs. In the past MCI has never taken more than minimum currency and interest rate risk in its operation. With the collapse of the Icelandic banks in 2008 some currency hedges that MCI had with local banks closed. As a consequence, MCI has an open currency position of ISK 635 million at the end of the year as compared to ISK 2,648 million at year end 2009.

Bonds amounting to ISK 8,562 million were issued during the period to fund lending. The bonds are listed on the Iceland Stock Exchange.

Operating results and financial position

The profit for the year amounted to ISK 1,248 million, as compared to ISK 1,656 million the previous year and was in line with expectations. The decrease in profits between years can mainly be explained by lower interest rate and decrease in inflation, though offset by a net foreign exchange gain.

Total assets at year end amounted to ISK 73,735 million, as compared to ISK 70,524 million the previous year. Total outstanding loans amounted to ISK 62,381 at the end of the year compared to 65.048 the year before. The reduction is mainly explained by strengthening of the ISK and by the fact that loan repayments were greater than granted loans during the year. Equity amounted to ISK 14,178 million as compared to ISK 12,930 million at year-end 2009 which is an increase of 9.7% during the year.

The CAD ratio, according to Basel II, was 78% at year end 2010.

MCI is owned by the 76 municipalities in Iceland. Reykjavik city holds 17,5% share and is the only shareholder with a total share above 10%.

The board of MCI as well as the Managing Director assess MCI as operational and this financial statement is put forward on that basis.

Statement by the Board of Directors and the Managing Director

MCI has reveiwed the ruling by the Supreme court on June16th, in which Icelandic loans linked to foreign currency were ruled illegal. Following a consultation with its lawyers, it is MCI´s opinion, that MCI´s loans in foreign currency are in general in compliance with provisions of the Act on Interest and Indexation no. 38/2001.

The financial statements for the year ended 31 December 2010 have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU and additional Icelandic disclosure requirements in Act No. 3/2006. According to our best knowledge it is our opinion that the financial statements give a true and fair view of the financial performance of MCI for the financial year 2010, its assets, liabilities and financial position for the year 2010.

Further, in our opinion the financial statements gives a fair view of the development and performance of MCI´s operations and its position and describes the principal risks and uncertainties faced by the company.

The Board of Directors of Municipality Credit Iceland and the Managing Director hereby confirm the financial statements for the year 2010 with their signatures.

Reykjavik, 8 March 2011

Magnus B Jonsson
Chairman

Svanfridur Inga Jonasdottir

Kristinn Jonasson

Ellidi Vignisson

Thorbjorg Helga Vigfusdottir

Ottar Gudjonsson
Managing Director

Independent Auditor's Report

To the Board of Directors and Shareholders of Municipality Credit Iceland Plc.

We have audited the accompanying financial statements of Municipality Credit Iceland Plc., which comprise the statement of financial position as at December 31, 2010, the statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising 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 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 judgment, 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 accompanying financial statements give a true and fair view of the financial position of MCI as of 31 December 2010, and of its financial performance and its 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 106, Paragraph 1, Item 5 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.

Reykjavik, 8 March 2011

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Income Statement

		Year ended 31 December	
	Notes	2010	2009
Interest income		4.113.311.637	6.687.510.948
Interest expense		(3.016.954.039)	(4.861.170.954)
Net interest income	5	1.096.357.598	1.826.339.994
Net (loss) gains on financial assets held for trading	6	(26.124.431)	75.977.451
Net loss on financial assets designated at FV through P&L	7	(216.494)	(67.624.095)
Net foreign exchange gain (loss)	8	321.433.656	(46.182.181)
Other operating income (expenses)		295.092.731	(37.828.825)
Net operating income		1.391.450.329	1.788.511.169
Salaries and related expenses	9	45.384.427	43.162.579
Pension cost	9	10.079.375	704.313
Cost of bond issuance	10	27.854.291	31.652.994
FSA's annual fee and monitoring fee		12.753.773	3.563.000
Other operating expenses	10	46.105.222	52.024.890
Depreciation	16	1.195.628	1.195.628
Operating expenses		143.372.716	132.303.404
Profit for the year and comprehensive income		1.248.077.613	1.656.207.765
Earnings per share			
Basic and diluted earnings per share	11	0,25	0,33

Balance Sheet

	Notes	At 31 December 2010	2009
Assets			
Cash and balances within the Central bank	12	8.969.736.222	5.358.120.732
Amounts due from credit institutions	13	2.331.565.093	40.510.645
Loans	14	62.381.281.528	65.047.779.527
Short term loans		0	8.256.250
Financial assets held for trading - Derivatives		0	13.325.970
Financial assets designated at fair value through profit or loss	15	329.079	1.443.357
Property, plant and equipment	16	51.411.980	52.607.607
Other assets		941.987	2.077.771
Total assets		73.735.265.889	70.524.121.859
Liabilities			
Debt securities in issue	17	39.806.886.488	34.794.336.531
Other borrowed funds	18	18.160.976.640	21.983.633.294
Short term borrowings	19	1.532.327.435	0
Financial liabilities held for trading - Derivatives		0	13.325.970
Liability to municipalities	20	0	750.000.000
Other liabilities	21	3.298.722	4.576.997
Pension obligations	22	54.105.946	48.656.022
Total liabilities		59.557.595.231	57.594.528.814
Equity			
Share capital		5.000.000.000	5.000.000.000
Reserves		1.250.000.000	1.250.000.000
Retained earnings		7.927.670.658	6.679.593.045
Total equity	23	14.177.670.658	12.929.593.045
Total equity and liabilities		73.735.265.889	70.524.121.859

Statement of Changes in Equity

	Share capital	Reserves	Retained earnings	Total
Changes in equity 2009				
Equity at 1.1.2009	5.000.000.000	1.250.000.000	5.023.385.280	11.273.385.280
Profit for the year			1.656.207.765	1.656.207.765
Equity as at 31.12.2009	5.000.000.000	1.250.000.000	6.679.593.045	12.929.593.045
Changes in equity 2010				
Equity at 1.1.2010	5.000.000.000	1.250.000.000	6.679.593.045	12.929.593.045
Profit for the year			1.248.077.613	1.248.077.613
Equity as at 31.12.2010	5.000.000.000	1.250.000.000	7.927.670.658	14.177.670.658

Statement of Cash Flows

	Notes	Year ended 31 December 2010	2009
Cash flows from operating activities			
Profit for the year		1.248.077.613	1.656.207.765
Items not affecting cash:			
Depreciation	16	1.195.628	1.195.628
Financial assets designated at FV - write offs		0	112.895.696
Indexation and exchange rate difference		(368.116.030)	(562.091.913)
Pension obligations, changes	23	5.449.924	(4.733.609)
Financial assets designated at FV through P&L		463.571	(75.977.451)
Short term loans provided to customers		7.500.000	1.407.500.000
Short term loans, borrowings		1.531.598.233	0
Other assets, (increase) decrease		1.135.784	(1.558.699)
Other liabilities, (decrease) increase		(1.278.275)	(717.268)
Net cash from operating activities		2.426.026.448	2.532.720.149
Cash flows from investing activities			
Amounts due from credit institutions, changes		0	243.041.442
Loans provided to customers		(6.377.887.899)	(8.409.214.426)
Loan collection from customer		8.009.895.988	6.744.192.845
Financial assets designated at FV through P&L, changes		650.707	3.672.193
		1.632.658.796	(1.418.307.946)
Cash flows from financing activities			
Borrowings		9.929.398.540	8.191.683.755
Borrowings repaid by MCI		(7.335.413.845)	(6.314.370.675)
Charge due to derivatives		0	(22.651.827)
Payment to municipalities	20	(750.000.000)	(750.000.000)
		1.843.984.695	1.104.661.253
Net increase in cash and cash equivalents		5.902.669.939	2.219.073.456
Cash and cash equivalents at the beginning of year		5.398.631.376	3.179.557.921
Cash and cash equivalents at end of year		11.301.301.315	5.398.631.376
Interest and similar income received		2.642.802.440	3.203.809.348
Interest paid		(1.873.876.730)	(2.084.780.023)

1. General information

Municipality Credit Iceland Plc. (MCI) is a statutory limited liability company owned by the Icelandic municipalities. MCI is a financial institution, and operates pursuant to Act No. 161/2002 on Financial undertakings; cf. The Companies Act No. 2/1995 and is supervised by the Icelandic Financial Supervisor. MCI´s main function is to secure favorable funding to the municipalities and related organisations and enterprises. In order for MCI to be able to fund projects on behalf of the municipalities they have to be of general economic interest.

MCI is incorporated and domiciled in Iceland. The address of its registered office is as follows: Borgartún 30, Reykjavík.

MCI has issued bonds which are listed at the OMX Nordic Exchange and MCI has market maker agreements in place for some of them.

The Financial statements were approved for issue by the Board of Directors of Municipality Credit Iceland on 8 March 2011.

2. Summary of significant accounting policies

The principal accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to all years, unless otherwise stated.

2.0 Basis of preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU).

The financial statements are prepared on the historical cost basis, except for derivatives and short-term securities which are measured at fair value.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the company's accounting policies. See further explanation in Note 3.

Changes in accounting standards and interpretations that have not been implemented

MCI has implemented all international accounting standards, changes and interpretations that EU has confirmed as of year end 2010 and apply to MCI´s operations. MCI has not implemented the standards, changes and interpretations which come to effect after year end 2010, but which are voluntary to adopt earlier. The effects on MCI´s financial statements are considered to be inconsiderable.

2.3 International currency translation

(a) Functional and presentation currency

The Financial statements is presented in the Icelandic krona (ISK) which is MCI´s functional and presentational currency.

(b) Transactions and balances

International currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. International currency exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in international currencies are recognised in the income statement.

2.4 Segment reporting

Due to the nature of the MCI´s business its operation has not been split into different segments.

2.5 Interest income and expense

Interest income and expense for all interest-bearing financial instruments, except for those classified at fair value through profit or loss, are recognised within the income statement using the effective interest method.

The effective interest rate method is a method of calculating the amortised cost of a financial asset or a financial liability and allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, MCI estimates cash flows considering all contractual terms of the financial instrument but does not consider future credit losses. The calculation includes all fees and payments paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

2.6 Derivatives

Derivatives are initially recognised at fair value on the date which a derivative contract is entered into and are subsequently remeasured at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, and valuation techniques, including discounted cash flow models and options pricing models, as appropriate.

The best method to measure the fair value of a derivative is to use quoted market prices except when the price of the derivative is based on a price of a similar transactions with similar financial instruments in a comparable market. The fair value can also be found from valuation techniques.

Certain derivatives are embedded in other financial instruments, and are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with the changes in fair value recognised in the income statement.

2.7 Financial assets

MCI classifies its financial assets in the following categories: Financial assets held for trading, financial assets designated at fair value through profit or loss and loans and receivables. The classifications are determined at initial recognition.

(a) Financial assets held for trading

Financial assets held for trading are financial assets acquired principally for the purpose to sell immediately or in the short term. Derivatives are also categorised as held for trading unless they are designated as hedging instruments.

(b) Financial assets designated at fair value through profit or loss

Financial assets are designated at fair value through profit or loss when:

- Financial assets are managed and evaluated on a fair value basis in accordance with the fund's risk management or investment strategy.

- Financial assets, such as debt securities, containing one or more embedded derivatives can significantly modify the cash flows.

Financial assets designated at fair value through profit or loss are initially recognised and subsequently measured at fair value in the balance sheet with fair value changes being recognised in the income statement. After initial recognition as financial asset designated at fair value through profit or loss a resclassification is not possible.

2.7 Financial assets cont.

(c) Loans and receivables

Loans and receivables are financial instruments with fixed or determinable payments which are not quoted in an active market. Loans and receivables are recognised when cash is advanced to borrowers and the fund does not intend to sell immediately or in the near term.

Loans and receivables are recognised at amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and receivables in the balance sheet.

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet 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.

Borrowings are recognised initially at fair value net of transaction costs incurred. Borrowings are subsequently stated at amortised cost using the effective interest method.

Cash and cash equivalents in the statement of cash flows consist of cash, non-restricted balances with central banks and amounts due from credit institutions.

2.8 Impairment on loans and receivables

At the end of each financial period, the fund estimates whether there is objective evidence of a financial asset or group of financial assets being impaired.

According to MCI´s Articles of Association, the principal objective of MCI is to secure favorable funding for the Icelandic municipalities, their organisations and enterprises for projects which are of general public interest. The condition for the extension of credit to municipality-owned enterprises and institutions is that such enterprises and institutions must be wholly owned by municipalities or jointly owned by municipalities and the State Treasury, with both acting as guarantors to the company for the loans.

According to paragraph 3 of article 73 of Act No. 45/1998 (Local Government Act), municipalities may put up their revenues as security for loans they receive from MCI and for guarantees they grant. The Minister of Social Affairs may make further provisions in regulations, regarding MCI’s security in municipal revenues (Act No. 123/2006). MCI's objective is to demand such lines as security for the loans.

MCI has not had any impairment losses on loans since its inception in 1967 and therefore does not have an impairment allowance account.

2.9 Property, plant and equipment

Property, plant and equipment is stated at historical cost less depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or are recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the company and the cost of the item can be measured reliably. All other repairs and maintenance are charged to other operating expenses during the financial period in which they are incurred.

Depreciation is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives, as follows:

Property .... 50 years

The assets residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. The recoverable amount is the higher of the asset's fair value less costs to sell and value in use.

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in other operating expenses in the income statement.

2.10 Post-employment obligations

MCI and other jointly administrated institutions are subject to pension fund obligations related to their employees, that have and do participate in the B-department of the State Employees' Pension Fund. MCI's obligation is calculated at the end of the year and recorded as debt in the balance sheet in accordance with Actuary´s calculations. Those calculations are the same as for the B-department of the State Employees´ Pension Fund, with a 2,0% interest rate and same expected lifetime as for 2004-2008. The benchmark of 65 years is used in order to calculate the post-employment liability.

2.11 Share capital

In December, 2006 the Icelandic Parliament, Althingi, approved a new Act No. 150/2006 on the incorporation of Municipality Credit Iceland as a statutory limited liability company. On the initial shareholders´ meeting of the fund it was decided that the capital was to be ISK 5,000 million. The shareholders of MCI are all 76 municipalities, which are defined in Act No. 150/2006.

2.12 Comparatives

Where necessary, comparative figures have been adjusted to conform with changes in presentation in the current year.

2.13 Taxes

According to Act No. 90/2003 on Income tax, MCI is exempted from paying income tax.

According to Act No. 94/1996 on Capital tax, MCI is exempted from paying capital tax.

According to Act No. 161/2002 on Capital tax, MCI is exempted from stamp duty.

3. Critical accounting estimates and judgements

Assets and liabilities are based on management´s judgement and are valued with respect to upcoming financial year. Such estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under given circumstances.

There is a substantial risk of causing material change to the carrying amounts of assets and liabilities within the next financial year. Determination of fair value changes is an example of that. The determination of the fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. These valuation techniques are validated and periodically reviewed by qualified personnel.

4. Financial risk management

4.1. General

Through MCI's activities it is exposed to a variety of financial risks and those activities involve the analysis, evaluation, acceptance and management to some degree of risk or combination of risks. Effective risk management includes analysis of main risk factors, risk measurement, processes to limit risk and continous supervision. MCI´s aim is therefore to identify MCI´s main risk factors, implement processes to monitor them, access them regularly, maintain supervision and rules in order to keep the risk factors within predefined risk limits.

The Board of Directors determines MCI's risk management policy and is responsible for it´s uphold. The Managing Director is responsible to the Board of Directors and proposes new policies and if appropriate, risk limits and is responsible for the monitoring of the major risk factors.

MCI has been granted an exemption from operating an internal auditing department in accordance with guidelines from the Financial Services Authority nr. 4/2003. The guidelines spell out how an internal audit shall be conducted and that the main role of an internal audit is to oversee the operations to ensure that rules are being followed in accordance with the boards decisions. MCI´s board contracts the annual internal audit of the fund in accordance with the Financial Services Authority´s rules.

MCI is an intermediary for the Icelandic municipalities and their organisations and enterprises to the domestic and foreign financial markets. The main objective is to secure funding on favourable terms. Credit risk is the greatest single risk faced by the company, however liquidity risk, counterparty risk and operational risk are also important to the fund. Market risk is kept at it´s minimum even though it is present in terms of interest and currency risk.

4.2. Risk policy

Exposure to *credit risk* arises from MCI´s loans to Icelandic municipalities and the State Treasury. MCI solely grants loans to municipalities, their organisations and enterprises. The condition for the provision of credit to municipality-owned enterprises and organisations is that such enterprises and organisations must be wholly owned by municipalities or jointly owned by municipalities and the State Treasury, with both acting as guarantors to the Company for respective loans.

According to the Local Government Act No. 45/1998, municipalities may pledge their revenues as security for loans granted by MCI and for guarantees it provides, but for no other loans or guarantees. When granting loans it is the policy of MCI that such security should be provided for by the municipality in question. Income derived from the State Treasury and Ministry of Social Affairs serves as secure collateral for MCI.

Liquidity risk is the risk that MCI will encounter difficulty in meeting contractual payment obligations associated with its financial liabilities. MCI formulates liquidity management policies regarding its liquidity position and funding, to maintain the flexibility needed. The principal rule is to finish the funding process of a loan before granting a loan commitment. Part of the equity resources is managed short term to ensure a constant access to liquid capital and to maintain

Counterparty risk arises in financial assets and derivatives. Counterparty risk excluding the credit risk is limited to the State Treasury and entities with guarantees from the State Treasury as well as domestic financial institutions which have a license from the Financial Services Authority, to a maximum of 25% of their equity. Risk related to a foreign financial institution shall be approved by the board.

Regarding *operational risk,* MCI aims to have written and clear policies for all major business processes and standardise it´s loan agreements. It has also been a policy to outsource administrative services in order to minimise risk by distributing operations. MCI focuses as well on integrating the information systems in order to increase the electronic information transfers. As the operation of MCI can be characterised as relatively simple with the clients both being homogeneous and limited, the operational risk is limited. There are a total of 830 loan agreements between MCI and 61 municipalities and 31 municipality-owned enterprises.

Regarding *interest risk*, it is the policy of MCI to keep a balance between the interest bearing assets and liabilities as well as fixed and variable interest rates. Loans normally have the same maturity, payment schedule, interest rate, date of interest payments and date of terms re-evaluation as funding. The interest rates on the CPI linked loans which are funded with equity and have variable interest rates can be changed by MCI.

MCI is not permitted to invest in shares, raw materials or financial instruments linked to its price index.

The policy of MCI is to eliminate *currency risk* by minimizing the mismatch between financial assets and financial liabilities denominated in foreign currencies. The mismatch shall never exceed 4% of equity for each international currency and total net currency gap shall not exceed 6%.

4.3. Credit Risk

The exposure in credit risk arises from MCI´s loans to the municipalities. The maximum exposure is the book value of the loans recognised in the balance sheet.

4.3.1 Lending process

When loan applications are reviewed, the borrower has to fulfill all of the legal requirements for receiving a loan as well as the project being of general economic interest. A thorough valuation on the financial position and development of the borrowers and their guarantors is performed. All loan applications are introduced to the board of directors, either for their approval or as an introduction in line with MCI´s credit rules which are summarized on MCI´s web site.

4.3.2 Loan portfolio

The exposure to credit risk is limited to the Icelandic municipalities. The municipalities have been reliable borrowers and there has not been a loan loss since MCI commenced operations in 1967. MCI does not make provisions for loan losses in its books. For loans and guarantees MCI has a pledge in the municipalities' revenues. MCI did not have any loans in arrears at the end of year 2010.

The municipalities are now a total of 76, their number has decreased over the last years which has led to a stronger financial position towards MCI. At year-end MCI had loans outstanding to 61 municipalities. The Local Government Act is a solid legal frame for the municipalities to operate under. The Icelandic municipalities can technically not become bankrupt as it is stated in the Local Government Act that the State secures the financial solvency of a municipality.

At year end MCI had no customer defined as a large exposure. Large exposures are defined as exposures that exceed 10% of MCI´s equity. Ten of the largest borrowers hold 54% of the total loans. According to MCI´s internal limits, no single exposure may exceed 25% of MCI´s equity.

4.3.3 Impairments

MCI has strict requirements regarding granting loans to the municipalities and has therefore never suffered a loan loss since MCI commenced operations in 1967. An evaluation on the loan portfolio has never led to write offs and accordingly MCI does not make provisions for future estimated loan losses in its books. In addition to that the fund has good security as the municipalities are allowed to put their revenues as security for loans they receive from MCI and for guarantees they grant according to paragraph 3 of article 73 of Act No. 45/1998 (Local Government Act).

4.3.4 Maximum Credit Risk

The following table shows MCI´s maximum Credit Risk at year end 2010 and 2009. Assets as they appear in the Balance Sheet are net assets.

	Maximum Credit exposure	
	31.12.2010	**31.12.2009**
Credit Risk position due to balance sheet assets in ISK million:		
Loans to municipalities and their companies	62.381	65.048
Financial assets held for trading - Derivatives	0	13
Bonds	0	1
Amounts due from credit institutions	2.332	41
Other assets	1	2
Total credit risk	64.714	65.105

4.3.5 Credit risk management

The managing director is responsible for MCI´s credit risk monitoring. Exposure to credit risk is regularly reviewed and managed through an analysis and evaluation of loans and defaults. The Fund applied its pledge once during the year 2010, which resulted in the borrower in question settling its arrears.

4.4 Liquidity Risk

MCI monitors maturities on the financial instruments in order to secure that it can pay all liabilities on due dates. MCI always has to have enough liquidity to be able to meet predictable and unpredictable obligations.

The following tables present the future cash flow for financial instruments. Accrued interests, discounts and lending fee is not included.

Financial instruments at 31.12.2010 in ISK million:

	0 to 1 months	1 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Total
Financial assets						
Cash and deposits	11.301					11.301
Loans	12	1.709	6.720	19.622	33.567	61.630
	11.313	1.709	6.720	19.622	33.567	72.931
Financial liabilities						
Short term liabilities	1.532					1.532
Borrowed funds and bonds issued	18	4.124	5.132	18.232	31.783	59.289
Total financial liabilities	1.550	4.124	5.132	18.232	31.783	60.821
Net, assets - liabilities	9.763	(2.415)	1.588	1.390	1.784	12.110

Financial instruments at 31.12.2009 in ISK million:

	0 to 1 months	1 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Total
Financial assets						
Liquid assets	5.399					5.399
Short term lending	8					8
Financial assets, securities	1					1
Loans	48	2.321	5.546	22.551	33.897	64.364
Total financial assets	5.456	2.321	5.546	22.551	33.897	69.772
Financial liabilities						
Borrowed funds and bonds issued	64	4.142	3.018	22.245	28.765	58.235
Liability to municipalities			750			750
Total financial liabilities	64	4.142	3.768	22.245	28.765	58.985
Net, assets - liabilities	5.392	(1.821)	1.778	306	5.132	10.787

4.4 Liquidity Risk cont.

Financial instruments - Repayment profile split by currency in ISK million 31.12.2010.

	CPI linked ISK	ISK	EUR	USD	JPY	Other currencies	Total
Financial assets							
Year 2011	4.632	9.184	5.104	781	26	15	19.742
Year 2012	4.212	0	855	118	26	15	5.226
Year 2013	3.953	0	855	118	26	15	4.967
Year 2014	3.751	0	855	118	26	15	4.765
Year 2015	3.650	0	855	118	26	15	4.664
Over 5 years	27.017	0	5.326	779	151	293	33.567
Total financial assets	47.215	9.184	13.850	2.032	281	369	72.931
Financial liabilities							
Year 2010	3.729	1.532	4.773	772			10.806
Year 2011	3.781	0	2.427	236			6.444
Year 2012	2.747	0	1.039	98			3.884
Year 2013	2.786	0	1.039	98			3.923
Year 2014	2.844	0	1.039	98			3.981
Over 5 years	26.240	0	5.127	416			31.783
Total financial liabilities	42.127	1.532	15.444	1.718	0	0	60.821

Financial instruments - Repayment profile split by currency in ISK million 31.12.2009.

	CPI linked ISK	ISK	EUR	USD	JPY	Other currencies	Total
Financial assets							
Year 2010	5.165	6.488	1.268	362	25	15	13.323
Year 2011	4.181	200	3.259	850	25	15	8.531
Year 2012	3.753	0	1.000	128	25	1511%	4.922
Year 2013	3.488	0	1.000	128	25	15	4.656
Year 2014	3.274	0	1.000	128	25	15	4.442
Over 5 years	25.212	0	7.229	972	167	317	33.897
Total financial assets	45.074	6.688	14.756	2.568	294	361	69.772
Financial liabilities							
Year 2010	3.448	1.090	3.087	350			7.975
Year 2011	3.249	0	5.440	838			9.527
Year 2012	3.286	0	2.554	256			6.096
Year 2013	2.263	0	931	106			3.299
Year 2014	2.286	0	931	106			3.323
Over 5 years	22.705	0	5.502	558			28.765
Total financial liabilities	37.236	1.090	18.444	2.215	0	0	58.985

4.5 Interest rate risk

MCI monitors interest sensitivity of all interest bearing loans and funding with relation to their duration. Part of the loans are funded with MCI´s equity which explains why financial assets are greater than financial liabilities in the chart below.

The table below shows the interest bearing loans and funding categorised by interest periods. Amounts with variable interest rates are categorised by the maturity of the interest, accrued interest, discounts and lending fees are not included.

Financial assets and liabilities, classified by interest repricing time, in ISK million as at 31.12.2010.

	0-1 years	1-5 years	5-10 years	Over 10 y.	Total
Financial assets					
ISK	9.184				9.184
ISK - CPI linked	7.502	2.476	4.915	32.322	47.215
EUR	13.850				13.850
USD	2.032				2.032
JPY	281				281
CHF	192				192
SEK	71				71
CAD	62				62
GBP	44				44
Total financial assets	33.218	2.476	4.915	32.322	72.931
Financial liabilities					
ISK	1.532				1.532
ISK - CPI linked	0	2.228	4.337	35.562	42.127
EUR	15.444				15.444
USD	1.718				1.718
Total financial liabilities	18.694	2.228	4.337	35.562	60.821

Financial assets and liabilities, classified by interest repricing time, in ISK million as at 31.12.2009.

	0-1 years	1-5 years	5-10 years	Over 10 y.	Total
Financial assets					
ISK	6.688				6.688
ISK - CPI linked	9.853	465	5.227	29.528	45.074
EUR	14.756				14.756
USD	2.568				2.568
JPY	294				294
CHF	198				198
SEK	75				75
CAD	67				67
GBP	52				52
Total financial assets	34.552	465	5.227	29.528	69.772
Financial liabilities					
ISK	1.090				1.090
ISK - CPI linked	235	3.249	3.885	29.867	37.236
EUR	18.444				18.444
USD	2.215				2.215
Total financial liabilities	21.984	3.249	3.885	29.867	58.985

Interest sensitivity

Interest sensitivity analysis with the assumption of average lifetime shows that 1 percentage interest increase would increase net interest revenue by ISK 186 million or 1,31% of MCI´s equity.

CPI link effects	**31.12.2010**	**31.12.2009**
CPI linked assets	47.215	45.074
CPI linked liabilities	42.127	37.236
Net CPI linked position	5.088	7.838

4.6 Currency Risk

The policy of MCI, as illustrated in Note 4.2, is to have a balance between the assets and liabilities denominated in international currency. Due to Glitnir bank hf. going into receivership in November 2008, MCI´s outstanding derivatives contracts with Glitnir bank defaulted which affected MCI´s currency hedging. The table below shows MCI´s currency positions, accrued interest, discounts and lending fees are not included.

Financial assets and liabilities in ISK million as at 31.12.2010

	EUR	**USD**	**JPY**	**Other currency**	**Total**
Financial assets					
Cash and deposits	2.317				2.317
Loans	11.533	2.032	281	369	14.215
Total financial assets	13.850	2.032	281	369	16.532
Financial liabilities					
Borrowed funds	15.444	1.718			17.162
Total financial liabilities	15.444	1.718	0	0	17.162
Net, assets-liabilities	(1.594)	314	281	369	(630)

Financial assets and liabilities in ISK million as at 31.12.2009

	EUR	**USD**	**JPY**	**Other currency**	**Total**
Financial assets					
Cash and deposits					0
Loans	14.756	2.568	294	392	18.010
Total financial assets	14.756	2.568	294	392	18.010
Financial liabilities					
Borrowed funds	18.444	2.214			20.659
	18.444	2.214	0	0	20.659
Total financial liabilities					
Net, assets-liabilities	(3.688)	354	294	392	(2.649)

5. Net Interest Income

	1.1.-31.12.2010	1.1.-31.12.2009
Interest income and indexation		
Loans	3.716.704.933	6.276.428.975
Cash and short term funds	396.606.704	397.193.890
Securities	0	13.888.083
	4.113.311.637	6.687.510.948

Interest expense and indexation		
Debt securities in issue and other borrowed funds	3.016.954.039	4.861.170.954
	3.016.954.039	4.861.170.954

6. Net (loss) gain on financial instruments held for trading

	1.1.-31.12.2010	1.1.-31.12.2009
Fair value adjustments	(26.124.431)	75.977.451

7. Net gain on financial instruments designated at fair value through profit or loss

	1.1.-31.12.2010	1.1.-31.12.2009
Bonds	0	41.846.626
Impairment of bonds issued by SPRON	0	(112.895.696)
Money market securities	(216.494)	3.424.975
	(216.494)	(67.624.095)

8. Net foreign exchange gains

	1.1.-31.12.2010	1.1.-31.12.2009
Loans	(2.273.811.212)	980.630.913
Borrowings	2.582.984.090	(982.078.595)
Amounts due from credit institutions	12.260.778	(44.734.499)
	321.433.656	(46.182.181)

9. Salaries and related expenses

At the end of 2009 there were three employees working for MCI. MCI has entered into a service agreement with the Icelandic Association of Local Authorities regarding the purchase of administrative services and such expense is recorded under the other operational expenses item.

Salaries and related expenses are specified as follows:	1.1.-31.12.2010	1.1.-31.12.2009
Salaries	40.840.842	39.896.080
Pension obligations	10.079.375	3.266.499
Related expenses	4.543.585	704.313
	55.463.802	43.866.892

9. Salaries and related expenses (cont.)

Salaries and other fees to the Board of Directors and the Managing Director are specified as follows:

	1.1.-31.12.2010	1.1.-31.12.2009
Ottar Gudjonsson, managing director	16.775.028	15.999.423
Thorsteinn Thorsteinsson, former managing director	0	1.520.588
Board of Directors:		
Magnus B. Jonsson, chairman	998.952	915.702
Kristinn Jonasson	665.964	610.464
Svanfridur Inga Jonasdottir	665.964	610.464
Thorbjorg Helga Vigfusdottir	665.964	499.470
Jonmundur Gudmarsson	554.970	610.464
Ellidi Vignisson	166.491	0
Anna Skuladottir	0	160.941
Pall Dagbjartsson	0	49.947
	3.718.305	3.457.452

10. Other operating expenses

Bond issuing costs	**1.1.-31.12.2010**	**1.1.-31.12.2009**
Market makers	21.000.002	24.000.000
Bond issuance fees	2.430.954	6.016.731
Annual fees related to bond issuance	4.423.335	1.636.263
	27.854.291	31.652.994
Other operating expenses		
Contract with the Icelandic Association of Local Authorities	13.971.756	15.192.996
Computer and software	11.381.183	10.087.606
Auditor´s fees	6.953.227	13.462.657
Housing expenses	4.177.408	5.158.292
Professional fees	2.677.500	3.066.300
Travelling expenses	1.811.548	2.116.080
Office equipment	1.706.559	850.125
Reception	987.931	676.695
Other operating expenses	2.438.110	1.414.139
	46.105.222	52.024.890

11. Earnings per share

Earnings per share is specified as follows:	**1.1.-31.12.2010**	**1.1.-31.12.2009**
Profit attributable to equity holders of the company	1.248.077.613	1.656.207.765
Weighted average number of ordinary shares in issue	5.000.000.000	5.000.000.000
Earnings per share	0,25	0,33

12. Cash and balances with the Central bank

	31.12.2010	**31.12.2009**
Non mandatory deposits with the Central bank	4.464.438.722	5.358.120.732
Deposit certificates with the Central bank	4.505.297.500	
	8.969.736.222	5.358.120.732

Cash and balances within the Central bank as well as amounts due from credit institutions constitute cash and cash equivalents at year end as stated in the Cash Flow, amounting to 11,301 million.

13. Amounts due from credit institutions

	31.12.2010	**31.12.2009**
Bank accounts	2.331.565.093	40.510.645

14. Loans and receivables

Loans and receivables are specified as follows:	**31.12.2010**	**31.12.2009**
International currency loans	14.226.690.016	18.045.240.989
CPI linked loans	47.954.492.623	45.721.329.137
Other loans	200.098.889	1.289.465.651
	62.381.281.528	65.056.035.777

15. Financial assets designated at fair value

	31.12.2010	**31.12.2009**
Money market loans	329.079	1.443.357

MCI had outstanding derivatives constracts with Glitnir bank hf. which went into receivership in November 2008. As a consequence no payments were exchanged after that date between MCI and Glitnir bank hf. in relation to the before mentioned contracts. MCI´s net claim on Glitnir bank amounted to ISK 1,472 million at year end 2008. Due to uncertainty of payments regarding the contracts, the claim was written down to 0 in MCI´s annual statement for 2008 and is still 0. In November 2009 a claim of ISK 5,631 million was lodged against Glitnir bank recievership, as of today the recievership has acknowledged recieving the claim but nothing further than that.

MCI took provision against a bond, issued by SPRON, of the amount of 112.9 million in 2009. A claim of 144 million was lodged against SPRON´s Winding-Up Board on January 21st 2010. According to SPRON´s claim list, dated on the 10th of March 2010, a confirmed claim was 134.7 million.

16. Property, plant and equipment

At year end 2009

Opening net book amount	53.803.235
Depreciation during the year	(1.195.628)
Closing net book amount	52.607.607

Closing net book amount is specified as:

Historical cost	59.781.371
Accumulated depreciation	(7.173.764)
Closing net book amount	52.607.607

At year end 2010

Opening net book amount	52.607.607
Depreciation during the year	(1.195.628)
Closing net book amount	51.411.979

Closing net book amount is specified as:

Historical cost	59.781.371
Accumulated depreciation	(8.369.392)
Closing net book amount	51.411.979

17. Debt securities in issue

	Average Interest rate*		Total	Total
	2010	**2009**	**31.12.2010**	**31.12.2009**
Unlisted securities, due 2013	5,00%	5,00%	50.926.054	66.133.173
LSS '03, notes due 2018	5,17%	5,17%	809.035.157	893.101.066
LSS '04, notes due 2019	4,08%	4,08%	1.620.139.768	1.753.142.565
LSS '05 3A+B, notes due 2010	-	-	0	548.947.533
LSS '05-1, notes due 2012	4,16%	4,16%	2.228.232.268	3.247.558.219
LSS '05-2, notes due 2022	4,30%	4,30%	6.363.828.325	6.699.966.476
LSS '05-4, notes due 2020	4,11%	4,11%	989.021.511	1.040.558.152
LSS 150224, notes due 2024	5,33%	5,53%	20.658.622.274	14.617.122.050
LSS '08 1, notes due 2034	5,25%	5,44%	7.087.081.131	5.927.807.297
			39.806.886.488	34.794.336.531

* Average interest rate is calculated in accordance with the effective interest rate method.

18. Other borrowings

	Average Interest rate* 2010	Average Interest rate* 2009	Total 31.12.2010	Total 31.12.2009
EUR loans (Euribor + margin)	0,24%	0,27%	15.476.923.812	18.479.246.679
USD loans (LIBOR + margin)	0,13%	0,13%	1.720.480.247	2.219.689.966
ISK loans (CPI linked)	6,09%	5,76%	963.572.581	1.284.696.649
			18.160.976.640	21.983.633.294
New borrowings in 2010 thereof:				
EUR 15m, due 2020 (Libor + margin)	0,41%	-	2.316.884.188	0

19. Short term borrowings

			31.12.2010	31.12.2009
ISK loan, non-CPI linked	3,00%	-	1.532.327.435	0

20. Liability to municipalities

In accordance with temporary provision no. I of Act No. 150/2006 on the incorporation of Municipality Credit Iceland as a statutory limited liability company, the annual general meeting of MCI for 2006 decided to reduce the equity of MCI by ISK 3 billion as MCI continues to comply with the conditions of statutory law regarding the equity ratio of financial undertakings, notwithstanding the reduction, and retains sufficient cash to meet its obligations. This reduction of ISK 3 billion has been paid to the municipalities as owners during the years 2007-2010. The fourth and last payment was paid out to the municipalities on July 1st 2010.

21. Other liabilities

	31.12.2010	31.12.2009
Creditors	1.285.917	2.731.057
Salaries related expenses	2.012.805	1.845.940
	3.298.722	4.576.997

22. Post-employment obligations

MCI and other jointly administrated institutions are subject to pension fund obligations related to their employees, that have and do participate in the B-department of the State Employees' Pension Fund. The calculations of an actuary has been calculated for the pension fund obligations and recorded as debt in the balance sheet based on a 2,0% interest rate. The benchmark of 65 years is used when it comes to calculating the post-employment obligations.

Post-employment obligations are specified as:	31.12.2010	31.12.2009
Pension liability as at 1.1.	48.656.022	53.389.631
Paid during the year	(329.785)	(1.518.583)
Increase (decrease) during the year	5.779.709	(3.215.026)
	54.105.946	48.656.022

23. Equity

Balance 01.01	12.929.593.045
Net profit for the year	1.248.077.613
	14.177.670.658

At the end of the year the total share capital was ISK 5.000 million. One vote is entitled to each nominal ISK.

Total equity at year end is ISK 14.178 million or 19% of the balance sheet. The capital adequacy ratio (CAD) which was calculated according to Basel II was 67% at year end 2009. At year end 2010 the CAD ratio, based on Basel II, was 78%. Under Icelandic law the minimum requirement is 8%.

The capital adequacy ratio is determined as follows:

	Book value	Weighted value
Risk base:		**31.12.2010**
Assets recorded in the financial statements	73.735.265.889	13.689.661.566
Market risk		1.589.670.000
Operational risk		2.819.398.062
Risk base total	73.735.265.889	18.098.729.628
Capital:		
Recorded equity	14.177.670.658	14.177.670.658
Capital total	14.177.670.658	14.177.670.658
Capital adequacy ratio		78%

24. Related party disclosures

The fund has widened it´s definition for related parties in line with SFA´s interpretation. Related parties are now defined as municipalities and companies, owned by them, which are related to members and reserve members of MCI´s board of directors as well as municipalities and related companies who are among the 10 largest shareholders of MCI. This definition is based on IAS 24. Information regarding related parties are as follows (in ISK thousand):

	31.12.2010	31.12.2009
Balance at the beginning of year	38.747.669.270	36.450.281.671
New loans to related parties	3.538.000.000	5.112.230.131
Loan payments to related parties	(5.409.060.389)	(5.413.571.976)
Other changes	(1.019.338.665)	2.598.729.444
Balance at year end	35.857.270.216	38.747.669.270

No provisions have been recognised in respect of loans given to related parties.

Transactions with related parties are all in the normal course of MCI´s activities.

26. Loans

The table below shows the outstanding loans for each municipality borrower, excluding lending fees, amounting to a total of ISK 57.025 million. In addition to that the fund has granted loans to companies held 100% by the municipalities totalling ISK 5.429 million.

Municipality	Habit. 31.12.10	Amount	Municipality	Habit. 31.12.10	Amount
Hafnarfjarðarkaupstaður	26.100	7.045	Sveitarfélagið Garður	1.500	381
Kópavogsbær	30.800	5.920	Djúpavogshreppur	450	368
Sveitarfélagið Árborg	7.800	4.058	Rangárþing eystra	1.700	352
Fjarðabyggð	4.600	3.658	Sv.fél. Hornafjörður	2.100	349
Akureyrarkaupstaður	17.800	3.194	Húnaþing vestra	1.100	317
Fljótsdalshérað	3.400	2.229	Fjallabyggð	2.000	299
Reykjanesbær	14.000	2.223	Þingeyjarsveit	940	257
Sv.fél. Skagafjörður	4.100	1.911	Sveitarfélagið Ölfus	1.900	242
Ísafjarðarbær	3.800	1.887	Hrunamannahreppur	800	209
Akraneskaupstaður	6.600	1.863	Langanesbyggð	500	206
Sveitarfélagið Álftanes	2.500	1.737	Eyjafjarðarsveit	1.000	203
Garðabær	10.900	1.513	Dalabyggð	680	187
Borgarbyggð	3.500	1.493	Skaftárhreppur	450	182
Sandgerðisbær	1.700	1.458	Mýrdalshreppur	470	164
Grindavíkurbær	2.800	1.419	Grímsnes- ogGrafningshr.	400	150
Mosfellsbær	8.600	1.252	Breiðdalshreppur	200	137
Reykjavíkurborg	118.900	996	Hörgársveit	600	136
Norðurþing	2.900	905	Seltjarnarneskaupstaður	4.300	120
Hveragerðisbær	2.300	898	Húnavatnshreppur	420	78
Stykkishólmsbær	1.100	829	Reykhólahreppur	280	72
Grundarfjarðarbær	900	732	Tálknafjarðarhreppur	310	56
Snæfellsbær	1.700	711	Grýtubakkahreppur	330	36
Seyðisfjarðarkaupst.	670	584	Flóahreppur	590	32
Dalvíkurbyggð	2.000	569	Skeiða- og Gnúpverjahr.	500	31
Vesturbyggð	890	557	Súðavíkurhreppur	190	25
Rangárþing ytra	1.500	549	Kaldrananeshreppur	110	19
Blönduósbær	900	537	Strandabyggð	500	13
Bláskógabyggð	940	457	Sv.fél. Skagaströnd	530	9
Sveitarfélagið Vogar	1.200	419	Borgarfjarðarhreppur	140	3
Bolungarvíkurkaupstaður	890	407	Hvalfjarðarsveit	620	2
Vopnafjarðarhreppur	670	382			