Risk and capital management at the Länsförsäkringar Bank Group

PILLAR III OF THE BASEL II REGULATORY FRAMEWORK

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Introduction

The new capital adequacy rules, Basel II, were introduced in February 2007. Accordingly, Länsförsäkringar applies the Internal Ratings-based Approach (IRB Approach), in accordance with the permit from the Swedish Financial Supervisory Authority. The aim of the new rules is to achieve enhanced transparency and risk management, and thereby greater stability in the financial system. The advanced risk classification method provides the greatest opportunity to strategically and operationally manage credit risks and is used for all retail exposures. The Standardized Approach is currently applied to agriculture and other exposures to calculate the capital requirement for credit risk. The changes in capital requirements will emerge gradually since the transition rules involve a three-year adaptation period.

Länsförsäkringar Bank Group

Länsförsäkringar Bank AB (publ) is part of the Länsförsäkringar AB Group, with Länsförsäkringar AB as the Parent Company, which is owned by 24 independent and customer-owned regional insurance companies and 14 local insurance companies.

The regional insurance companies offer customers products via their three core businesses: Banking, Non-life insurance and Life assurance. Länsförsäkringar Bank is 100%-owned by Länsförsäkringar AB (publ) (556549-7020).

The Banking Group comprises the Parent Company Länsförsäkringar Bank AB (publ) (516401-9878) and the wholly owned subsidiaries Länsförsäkringar Hypotek AB (publ) (556244-1781), Wasa Kredit AB (556311-9204) and Länsförsäkringar Fondförvaltning AB (publ) (556364-2783).

Operations

Länsförsäkringar offers private individuals and farmers payment services, savings and lending products. It also carries out lending activities through Wasa Kredit in the form of leasing and hire purchase agreements.

Länsförsäkringar Bank works through 24 independent regional insurance companies who are responsible for providing service, distribution and sales of the bank's products. The bank's customers can receive financial advice and services from any of the regional insurance companies' more than 100 branches that conduct banking operations. The bank branches are located at, or adjacent to, the regional insurance branches. The number of customers totaled 665,000 at year-end 2007.

Risks and risk management

The Board of Directors is ultimately responsible for the Banking Group's operations and, as a result, for protecting the Group's affairs and creating risk awareness in the Group. The Board accomplishes these objectives by annually establishing a central risk strategy and a risk policy document that ensure a sound and well-balanced process for risk-taking and risk management. A sound and well-balanced process should be characterized by deliberate focus on changes in the operations and their surroundings.

The Board is also responsible for establishing all of the methods, models, systems and processes that form the internal measurement, control and reporting of identified risks. Through the Compliance and Internal Audit functions, the Board is also responsible for ensuring that the requirement compliance and management of risks are satisfactory.

The President is responsible for the administration in accordance with the risk strategies and risk policies established by the Board. This means that the President is responsible for ensuring that the methods, models, systems and processes that form the internal measurement, control and reporting of identified risks work in the manner intended and decided by the Board.

The President is the Chairman of an Asset Liability Committee (ALCO), formed on January 1, 2008, whose main task is to follow up on the Banking Group's capital and financial matters. These issues were previously handled by the Finance Committee.

Risk Control reports to the President. Risk Control is an independent unit and has an independent position in relation to the corporates operations that it has been assigned to monitor and control. Risk Control is responsible to the Board of Directors for ensuring that risk policies are complied with and risk limits are monitored and that non-compliance is reported to Board. Risk Control's responsibility for managing risks includes indentifying, measuring, following up on, controlling and reporting risks.

The Banking Group is exposed to several risks:

- Credit risk
- Financial risk
- Operational risk
- Business risk

Refer to Länsförsäkringar Bank's Annual Report for 2007 for a description of the various risk categories.

Capital base and capital requirements

The Board of Directors has determined that the capital target for the Banking Group is 10.5%, subject to a variation of 0.5%, for total capital adequacy and 8.5% for core capital (Tier 1), subject to a variation of 0.5%.

The Board has also stipulated that the capital adequacy and Tier 1 capital ratio must not represent an adverse factor for the Banking Group's rating and that capital adequacy and the Tier 1 capital ratio shall match the capital adequacy and Tier 1 capital ratio of equivalent players in the capital market. Internal calculations show that the Banking Group is well capitalized in relation to its total risks.

Capital base	Basel II	According to older regulations (Basel I)	
SEK 000s	**Dec. 31, 2007**	**Dec. 31,2007**	**Dec. 31, 2006**
Tier 1, gross	4,113,732	4,113,732	3,461,725
Less intangible assets, etc.	–246,805	–246,805	–143,619
Less deferred tax assets	–5,077	–5,077	–172
Less IRB deficit	–103,771		
Tier 1, net	3,758,079	3,861,850	3,317,934
Supplementary capital	860,000	860,000	760,000
Expanded capital base	–	–	–
Deduction supplementary capital	–103,771	–	–
Total capital	**4,514,309**	**4,721,850**	**4,077,934**
Risk-weighted assets excluding transition rules	**26,189,263**	**47,423,148**	**38,513,995**
Risk-weighted assets including transition rules	**42,457,738**	**47,423,148**	**38,513,995**

Capital requirement

SEK 000s	**Dec. 31, 2007**
Credit risk in accordance with IRB Approach	
Retail exposures	
Exposures secured by real estate	829,633
Other retail exposures	524,226
Non credit obligation assets	1,648
Total capital requirement for credit risk	**1,355,507**

SEK 000s	**Dec. 31, 2007**
Credit risk in accordance with Standardized Approach	
Exposures to institutions	152,214
Exposures to corporates	342,849
Retail exposures	21,470
Exposures secured on residential property	97,600
Past due items	2,259
High-risk items	–
Other items	22,924
Total capital requirement for credit risk	**639,316**

SEK 000s	**Dec. 31, 2007**
Operational risks in accordance with the Standardized Approach	
Capital requirement for operational risks	**100,318**

Total capital requirement for credit risk	Basel II	According to older regulations (Basel I)	
SEK 000s	**Dec. 31, 2007**	**Dec. 31, 2007**	**Dec. 31, 2006**
Capital requirements for credit risk in accordance with Standardized Approach/older regulations	639,316	3,793,852	3,081,120
Capital requirement for credit risk in accordance with IRB Approach	1,355,507		
Capital requirement for operational risks	100,318		
Capital requirement	**2,095,141**		
Adjustment according to transition rules	1,301,478		
Total capital requirement	**3,396,619**	**3,793,852**	**3,081,120**
Tier 1 ratio, % before adjustment according to transition rules	14.35%	8.14%	8.61%
Capital adequacy ratio, % before adjustment according to transition rules	17.24%	9.96%	10.59%
Capital base in relation to capital requirement excluding transition rules	2.15	1.24	1.32
Tier 1 ratio, % after adjustment according to transition rules	8.85%		
Capital adequacy ratio, % after adjustment according to transition rules	10.63%		
Capital base in relation to capital requirement including transition rules	1.33		

Credit risk

Implementation plan for the IRB Approach

In December 2006, Länsförsäkringar Bank received permission from the Swedish Financial Supervisory Authority to apply the IRB Approach in computing the capital requirement for credit risks for its retail exposures, which accounts for most of the credit portfolio, and since February 2007 the IRB Approach has been applied to these exposures. Permanent exemptions have been granted for exposure to central and local governments and banks. For other components of the credit portfolio, internal models will be implemented during the period up to January 1, 2012. This complies with the implementation plan approved by Swedish Financial Supervisory Authority.

Risk classification system

The risk classification system is a core component of the credit process and consists of methods, models, processes, controls and IT systems to support and further develop the quantification of credit risks. Specifically, the risk classification system is used in conjunction with:

- The credit process
- Monitoring and reporting
- Calculation of capital requirement
- Capital allocation

Some of the core concepts in the risk classification system are described below.

Probability of Default (PD) is the likelihood that a counterparty will default within 12 months. A counterparty is viewed as defaulting if a payment is more than 60 days overdue or if there is reason to expect that the counterparty cannot meet his undertakings to the bank. Following the calculation of PD, all counterparties in IRB are ranked and categorized according to the bank's PD scales. For Länsförsäkringar Bank and Hypotek, the PD scale comprises seven risk classes for non-defaulted counterparties and one risk category for defaulted counterparties. For Wasa Kredit, the PD scale comprises five risk classes for non-defaulted counterparties and one risk category for defaulted counterparties. For each risk class, a PD is calculated based on the average long-term default frequency. This PD has a safety margin incorporated to ensure that risk is not underestimated. Finally, the PD is adjusted to reflect the average default frequency over a number of business cycles.

Länsförsäkringar Bank and Hypotek

Dec. 31, 2007 SEK 000s

PD-class	PD	EAD
A	0.16%	16,308,928
B	0.27%	24,174,901
C	0.86%	7,688,783
D	2.53%	2,560,461
E	5.63%	1,022,888
F	11.01%	407,393
G	32.91%	421,469
Default	100.00%	118,935
Total		**52,703,758**

Wasa Kredit

Dec. 31, 2007, SEK 000s

PD-class	PD	EAD
A	0.22%	2,709,256
B	0.77%	2,164,617
C	1.70%	1,916,473
D	4.34%	923,877
E	18.67%	906,585
Default	100.00%	40,093
Total		**8,660,901**

In developing models for PD calculations, the information most relevant for each type of counterparty has been taken into account. Thus, PD classification can be done either by means of an individual expert assessment or via methods based on statistical analysis (credit scoring). The models take into account internal as well as external information.

Loss Given Default (LGD) is the anticipated share of exposure that will be lost in the event of default. Internal estimates of LGD are calculated for the exposures for which the bank applies the IRB Approach. These estimates are based on internal information on loss portions, loan-to-value and products. The estimate has a safety margin incorporated to ensure that the risk is not underestimated. Finally, the estimate is adjusted to reflect the expected loss portion in a recession.

Exposure at Default (EAD) is the exposure amount that the counterparty is expected to utilize in the event of default. In the case of on-balance sheet undertakings, EAD is defined as the capital liability plus accrued and past due unpaid interest payments and charges. For off-balance sheet undertakings, EAD is calculated by multiplying the counterparty's unutilized amount by a conversion factor (CF). In the case of exposures for which the bank applies the IRB Approach, internal estimates of conversion factors are calculated. These estimates are calculated on the basis of internal information regarding degree of realization, degree of utilization and products. The estimate incorporates a safety margin to ensure that risk is not underestimated. Finally, the estimates are adjusted to reflect CFs in a recession.

Expected Loss percentage (EL, %) is the probability of default multiplied by LGD. The anticipated loss amount is gained by multiplying EAD by the percentage EL.

The risk-weight (RW) is calculated using functions supplied by the Swedish Financial Supervisory Authority. The bank's internal estimates of risk parameters serve as input data for these functions. Risk-weighted assets (RWA) are calculated by multiplying EAD by the risk-weight. The capital requirement is 8% of risk-weighted assets.

Expected Loss Amounts in relation to outcome

The presentation below shows the PD and LGD data to be used in capital adequacy reports, meaning those that include safety margins and adjustments for economic conditions.

The exposure-weighted PD for all non-defaulted exposures encompassed by IRB at December 31, 2006 was 1.39%, distributed in the form of 0.99% for credits secured by real estate properties and 2.73% for other retail exposures. The percentage of these exposures defaulting in 2007 was 0.60%, distributed in the form of 0.37% for credits secured by real estate properties and 1.39% for other retail exposures.

The exposure-weighted LGD for all non defaulted exposures encompassed by IRB at December 31, 2006 was 32.9%, distributed in the form of 24.9% for credits secured by real estate properties and 59.4% for other retail exposures. The actual loss level for the exposures defaulting in 2007 was 21.6%, distributed in the form of 12.7% for credits secured by real estate properties and 51.2% for other retail exposures. Since the average recovery period was only six months, the loss portion for these defaulting exposures is expected to decline substantially.

The Expected Loss percentage, EL%, for all non-defaulted exposures within the scope of IRB at December 31, 2006 was 0.46%, distributed among 0.25% for credits secured by real estate properties and 1.62% for other retail exposures. Credit losses for defaulting exposures in 2007 were 0.13%, distributed among 0.05% for credits secured by real estate properties and 0.71% for other retail exposures. Since the recovery period was relatively short, this share is expected to decline significantly.

Loans and accounts receivable

Loans are initially reported in the balance sheet at cost – the amount loaned to the borrower – less fees received and supplements for costs. Subsequently, loans are recognized continuously at cost after deductions for write-offs and individual and group-wise impairment of loan losses.

An assessment is made on the balance-sheet date as to whether there is objective proof indicating impairment of a loan receivable or a group of loans. If one or more incidents have occurred after the loan receivable was first recognized that have a negative effect on estimated future cash flows and whose impact can be reliably estimated, the receivable is impaired. In determining the impairment of credit losses, the bank applies individual and group-wise loan appraisals. The Group first determines if there is objective support of impairment. Loans for which there is no such support are included in portfolios as is the case if the product is deemed to be included in a homogenous group of similar credit risks and the amount can be considered to be insignificant. These portfolios are assessed collectively in the event of there being objective support of impairment.

The group-wise appraisal is based on an assessment of future loss trends, after which standard provisions are reserved. Apart from what is described above, no requirement is deemed to exist for establishing group-wise provisions for individually appraised receivables.

If the impairment requirement declines in subsequent periods, a maximum of the previously posted impairment is reversed.

The impairment of loans is conducted as a write-off of loan losses confirmed during the year or as an allocation to the reserve for loan losses.

The impairment of loans is recognized in the income statement as a loan loss, conducted as a write-off of loan losses confirmed during the year or as an allocation to the reserve for loan losses.

Confirmed loan losses are those losses whose amount is regarded as finally established through acceptance of a composition proposal or through other claim remissions.

Non-performing receivables are receivables for which interest, amortization or overdrafts fell due for payment more than 60 days previously. Doubtful receivables are non-performing receivables or receivables for which payment is unlikely to be met in accordance with the contractual terms and conditions and for which the value of the collateral does not cover, with an adequate margin, both the principal and accrued interest, including compensation for any delays.

Recovered funds for doubtful receivables for which provisions have been made, are settled primarily against the principal and secondarily, against interest. Interest on doubtful debts is reported in the income statement as of 2007.

Impairment for losses on guarantees is recognized as a provision.

Counterparty risk

Counterparty risk is the risk of a counterparty being unable to fulfill his commitments to Länsförsäkringar Bank, which could lead to losses. In this context, counterparty refers to counterparties for interest-rate and currency swaps. The Banking Group has a number of swap counterparties, all with high ratings and established ISDA agreements. For Länsförsäkringar Hypotek's covered bond operations, ISDA agreements are in place, as well as accompanying unilateral CSA agreements. CSA agreements involve commitments concerning delivery and receipt of collateral in the event of market changes affecting swap exposure.

Concentration risk

Concentration risk is defined as the risk of large, important or significant volumes and/or commitments being concentrated to a limited number of customers, a certain industry, product or geographic area. Accordingly, this means that such positions and relations increase vulnerability since the effect on the operations could be relatively great. Risk spreading is therefore limited.

Concentration risk can be divided into two types of categories. The first takes a bearing on individual exposure to a certain counterparty or a group of counterparties that can be grouped together from a risk perspective. This category can primarily be attributed to large exposure. Large exposure is regulated by and reported to the Swedish Financial Supervisory Authority. As this reporting is completed, a quarterly report is prepared detailing all exposure larger that exceeds 10% of the own funds. It is not until exposure exceeds 20% (intra-Group) and 25% (external) of the own funds that large exposure becomes impermissible.

The second type of concentration risk takes a bearing on general exposure that can be divided into a certain category that is driven by an underlying variable, for example a geographic division, product, market, collateral type. The Banking Group must take into account the following sectors when assessing the existence of concentrations:

- Geographic division
- Product and market division
- Types of collateral
- Nature of the customer and counterparty

Total and average EAD

SEK 000s	Dec. 31, 2007	Average 2007
Exposure classes, IRB Approach		
Retail exposures	61,364,658	57,538,167
Non credit obligation assets	20,596	17,341
Total IRB Approach	**61,385,254**	**57,555,508**
Exposure classes, Standardized Approach		
Governments and central banks	8,052,372	3,217,804
Regional and local authorities	164,297	46,635
Institutions	9,513,353	9,194,386
Corporates	4,285,609	4,286,590
Retail	357,833	333,683
Exposures secured on residential property	3,441,072	2,039,065
Past due items	22,473	31,659
Other items	286,551	170,085
Total, Standardized Approach	**26,123,560**	**19,319,906**

Recognizable collateral

Average, 2007 Dec. 31, 2007, SEK 000s	EAD	Secured through recognizable collateral
Exposure classes, Standardized Approach		
Central governments and central banks	8,052,372	0
Regional and local authorities	164,297	0
Institutions	9,513,353	0
Corporates	4,285,609	1,175,016
Retail	357,833	0
Exposures secured on residential property	3,441,072	3,441,072
Past due items	22,473	0
Other items	286,551	0
Total, Standardized Approach	**26,123,560**	**4,616,088**

EAD for property-related credits broken down by country

Dec. 31, 2007, SEK 000s County	EAD	Percentage
Stockholm	7,780,585	15.7%
Västra Götaland	7,324,865	14.8%
Skåne	6,885,689	13.9%
Östergötland	3,110,240	6.3%
Halland	3,050,980	6.2%
Dalarna	2,850,351	5.7%
Uppsala	2,768,744	5.6%
Jönköping	1,779,523	3.6%
Södermanland	1,748,759	3.5%
Västerbotten	1,621,067	3.3%
Gävleborg	1,535,012	3.1%
Västmanland	1,364,722	2.8%
Jämtland	1,225,187	2.5%
Örebro	1,074,375	2.2%
Blekinge	957,283	1.9%
Kalmar	917,123	1.9%
Gotland	915,174	1.8%
Kronoberg	779,584	1.6%
Västernorrland	729,697	1.5%
Värmland	589,136	1.2%
Norrbotten	563,860	1.1%
Total	**49,571,957**	**100.0%**

EAD, distributed by remaining contractual maturity*

Dec. 31, 2007, SEK 000s	< 3 months	3–6 months	6–12 months	1–3 years	3–5 years	> 5 years
Exposure classes, IRB Approach						
Retail exposures	37,017,453	239,282	5,205,989	11,240,449	5,546,130	2,115,355
Non credit obligation assets	20,596	0	0	0	0	0
Total IRB Approach	**37,038,049**	**239,282**	**5,205,989**	**11,240,449**	**5,546,130**	**2,115,355**
Exposure classes, Standardized Approach						
Central governments and central banks	8,052,372	0	0	0	0	0
Regional and local authorities	164,297	0	0	0	0	0
Institutions	9,513,353	0	0	0	0	0
Corporates	2,585,239	16,711	363,578	785,015	387,333	147,733
Retail	215,858	1,395	30,357	65,546	32,341	12,335
Exposures secured on residential property	2,075,783	13,418	291,930	630,317	311,004	118,620
Past due items	22,473	0	0	0	0	0
Other items	286,551	0	0	0	0	0
Total, Standardized Approach	**22,915,927**	**31,524**	**685,865**	**1,480,878**	**730,677**	**278,688**

* Remaining contractual maturity for agreements with periodically fixed conditions are counted as the period up to the date of the next reset date.

Average risk weight for IRB exposures

Group Dec. 31, 2007, SEK 000s	Exposure	EAD	RW	RWA	Capital requirement
Exposure classes, IRB Approach					
Retail exposures	61,690,413	61,364,658	28%	16,923,249	1,353,859
Non credit obligation assets	20,596	20,596	100%	20,596	1,648
Total IRB Approach	**61,711,009**	**61,385,254**	**28%**	**16,943,845**	**1,355,507**
Exposure classes, Standardized Approach					
Central governments and central banks	8,052,372	8,052,372	0%	0	0
Regional and local authorities	200,390	164,297	0%	0	0
Institutions	9,561,259	9,513,353	20%	1,902,671	152,214
Corporates	5,286,456	4,285,609	100%	4,285,609	342,849
Retail	465,822	357,833	75%	268,374	21,470
Exposures secured on residential property	3,519,699	3,441,072	35%	1,219,999	97,600
Past due items	124,180	22,473	126%	28,242	2,259
Other items	286,551	286,551	100%	286,551	22,924
Total, Standardized Approach	**27,496,729**	**26,123,560**	**31%**	**7,991,446**	**639,316**

Average risk weight for IRB exposures, cont.

Dec. 31, 2007, SEK 000s	Credits secured by real estate properties		Other retail exposure	
PD class	**EAD**	**RW**	**EAD**	**RW**
A	15,401,616	10%	3,616,568	20%
B	23,401,051	13%	2,938,467	43%
C	6,899,447	33%	2,705,809	71%
D	2,259,941	65%	1,224,397	85%
E	863,374	102%	1,066,099	126%
F	342,068	142%	65,325	118%
G	340,703	175%	80,765	176%
Default	63,757	263%	95,271	61%
Total	**49,571,957**	**21%**	**11,792,701**	**56%**

Exposure-weighted LGD for IRB exposures

Dec. 31, 2007	Exposure-weighted LGD*
Retail	27.8%

* Note that this value is forward-looking as of December 31, 2007 as opposed to the value recognized in conjunction with the expected losses, which were forward-looking as of December 31, 2006.

Unutilized undertakings for IRB exposures

Dec. 31, 2007, SEK 000s	Exposure	Average CF
	2,393,658	**86.4%**

Loans

SEK 000s	Dec. 31, 2007	Dec. 31, 2006
Doubtful loans		
Corporate sector	73,906	55,898
Retail sector	208,270	192,451
Total	**282,176**	**248,349**
Non-performing loans included in doubtful loans		
Corporate sector	59,560	42,647
Retail sector	136,886	109,225
Total	**196,446**	**151,872**
Impairment		
Corporate sector	–59,705	–57,278
Retail sector	–195,446	–180,539
Total	**–255,151**	**–237,817**

Loan losses, net

SEK 000s	2007	2006
Specific provisions for individually appraised loans		
Write-off of confirmed loan losses during the year	61,904	67,791
Reversed earlier impairment of loan losses recognized in the year-end accounts as confirmed losses	–59,508	–61,908
Impairment for loan losses during the year	78,742	78,771
Payment received for prior loan losses	–28,119	–39,725
Reversed impairment for loan losses no longer required	–29,175	–29,041
Net expense for the year for individually appraised receivables	**23,844**	**15,888**
Group-wise impairment of individually appraised receivables	**–**	**–**
Group-wise appraisal of homogenous groups of loans with limited value and similar credit risk		
Write-off of confirmed loan losses during the year	12,261	7,032
Payment received for previously confirmed loan losses	–	–211
Provision/reversal of impairment for loan losses	291,906	16,598
Net expense for the year for group-wise appraised receivables	**42,167**	**23,419**
Net expenses for the year for fulfillment of guarantees	**–14,948**	**–1,511**
Net expense of loan losses for the year	**51,063**	**37,796**

All information pertains to receivables from the public.

	Dec. 31, 2007	Dec. 31, 2006
Reconciliation of impairment for loan losses		
Opening balance	–237,816	–233,355
Reversed impairment for loan losses reported in the year-end accounts as confirmed losses	59,508	61,908
Reversed impairment no longer required for loan losses	64,862	59,241
Impairment for the year for loan losses	–203,555	–186,705
Payment pertaining to probable loan losses for the year	50,914	52,439
Value of collateral pertaining to probable loan losses for the year	10,936	7,510
Change due to changes in accounting principles		1,146
Closing balance	**–255,151**	**–237,816**

Financial risks

Financial risk is a natural part of a bank's operations. Risks must continuously be identified, measured, controlled and reported in a structured and homogeneous manner and according to the methods established by the Board. The overall framework for the financial operations within the Banking Group is defined in the Financial Policy adopted by the Board. The aim of the Financial Policy is to state the Board's approach to the management of financial risk. The Financial Policy primarily comprises the management of:

- Liquidity risk
- Interest-rate risk
- Financing risk
- Currency risk

Liquidity risk

Länsförsäkringar Bank's Treasury unit is responsible for liquidity management within the Banking Group.

Liquidity risk is defined as the risk of the Banking Group, due to insufficient cash and cash equivalents, being unable to fulfill its commitments or only being able to fulfill its commitments by borrowing cash and cash equivalents at a significantly higher cost. This definition is closely linked to the definition of financing risk below. Liquidity risk also refers to the risk of financial instruments that cannot immediately be converted to cash and cash equivalents without decreasing in value.

Liquidity is defined as cash and cash equivalents and securities. Liquidity must be accessible within not more than three days.

Liquidity risks associated with the risk of financial investments decreasing in value are minimized by essentially investing exclusively in high-liquidity instruments in the form of domestic government securities, domestic covered bonds and mortgage certificates that are pledgeable at the Riksbank.

Liquidity risk is quantified using liquidity forecasts that contain all financial cash flows and expected cash flows with the net lending increases adopted.

Monitoring of liquidity is conducted as follows:

- Liquidity is observed every day.
- Risk Control creates a weekly compilation of liquidity.
- Liquidity limits are reviewed quarterly by ALCO on the initiative of the CFO.
- According to a company mandate, the CFO also has the option of immediately raising the limit.

Due to the substantial expansion in lending in recent years, the Banking Group has gone from a surplus of deposits to capital market issues in the domestic and international markets. In June 2007, the company also began issuing covered bonds through Länsförsäkringar Hypotek with the aim of diversifying borrowing sources and minimizing liquidity risk.

Interest-rate risk

Interest-rate risk arises if assets, liabilities and derivatives do not have matching terms. Whenever possible, fixed lending should be matched by corresponding borrowing or through interest-rate derivatives. In principle, this means that no time differences should exist. In practice, this is impossible, so the Board has established interest-rate risk limits. However, these limits are so conservative that the basic principle for matching still applies.

The Financial Policy defines interest-rate risk as a parallel shift in the yield curve of 100 points.

Interest-rate risk for the Banking Group is normally between SEK 5 M and SEK 20 M. As of December 31, 2007, a one-percentage-point increase in the market rate would result in an increase in the value of interest-bearing assets and liabilities, including derivatives, in the amount of SEK 29 M (15).

Financing risk

Financing risk means that the Banking Group, in the event of maturity financing, does not successfully refinance the maturity or only succeeds in borrowing at substantially increased costs. This definition is closely linked to the definition of liquidity risk. By using the largest possible number of financing sources with expanded investor bases and by distributing financing maturities over time, the Banking Group's financing risk decreases. The Banking Group also received an improved rating to a current rating of A from Standard & Poor's and to a current rating of A2 from Moody's. In 2007, Länsförsäkringar Hypotek also received a rating of AAA/Aaa for the covered bonds it issues.

Currency risk

Currency risk refers to the risk of a currency changing in value in relation to another currency. Currency risks arise because losses may be incurred if the exchange rate changes negatively. All borrowing that takes place in a foreign currency is swapped before settlement in SEK in accordance with the Financial Policy, thereby eliminating currency risk in its entirety.

Operational risk

Operational risk is defined as the risk of losses arising due to inappropriate or unsuccessful internal processes, human error, incorrect systems or external events. This definition also includes legal risks. Based on this definition, operational risk encompasses the entire Banking Group.

Operational risk is primarily categorized into the following areas:

- Internal fraud
- External crime
- Legal risks
- Damage to physical assets
- Business disruption and system failures
- Risk of error

All significant processes within the Banking Group and the banking operations of the regional insurance companies are required to perform an analysis of the operational risk associated with the process. These risk analyses are included in the Banking Group's total risk assessment in accordance with the Basel regulations. Since the business operations, the external environment as well as threats are constantly changing, quality assurance of the processes must be regularly performed. This is carried out to ensure that the risks remain within the Banking Group's tolerance level. Risk analysis is one of the tools used to prepare develop documentation basis for decision-making to introduce measures for handling significant risks. The purpose of the analysis is to:

- Identify and reduce significant operational risks
- Plan security activities
- Create awareness of operational risks
- Comply with the Swedish Financial Supervisory Authority's requirements for measuring and assessing operational risk

Every part of the organization is responsible for planning an annual risk analysis, carrying out the analysis and managing the results in an action list. The risk analysis model is based on:

- Predefined events
- Other events

The analysis is normally performed in two stages:

- Stage 1, Risk analysis – Risks are defined and assessed based on their consequences and probability. Risk analyses are conducted once per year.
- Stage 2, Action planning – Action is to be taken for significant risks. Proposed solutions are discussed and implemented. This is carried out continuously within the process in order to manage risk.

Incident management

The Banking Group has developed an IT system for reporting operational risk events or incidents. This system enables all employees to report possible incidents. The system automatically divides the incidents into the categories established by the Swedish Financial Supervisory Authority. Risk Control periodically prepares a summary of the incidents in its reports.

Incident management is an important part of the Banking Group's operational risk management. Incident statistics contribute to the annual assessment and forecast of operational risk incident reporting enables the company to quickly identify critical problems and act upon these.

Model for assessing operational risk

Assessment of identified operational risk is based on a model that is applied throughout the operation. Each identified risk is assessed on the following basis:

- Consequence – how will the operation be affected if the risk occurs?
- Probability – how likely is it that the risk will occur?

These factors are totaled to determine a risk value for the operational risk. Management within the Banking Group are responsible for performing the risk analyses – that is, identifying and assessing operational risk – within the framework of their area of responsibility. All employees have a responsibility to report incidents. Management is responsible for taking action against intolerable risks within their areas of responsibility. Management is responsible for reporting their analyses and actions to Risk Control.

The President bears the main responsibility for managing operational risk. The process of identifying, measuring, controlling and reporting operational risk is delegated to the Risk Control unit and the risk manager, who reports directly to the President and Board of Directors. Accordingly, assessments of operational risk are reported continuously as new products, markets and activities are introduced.

Business risk

According to the Banking Group's definition, business risk comprises the following risks:

- Strategic risk
- Earnings risk
- Reputation risk

Strategic risk

The Banking Group has identified strategic risk as a significant business risk that must be taken into consideration. Strategic risk refers to institutional changes and changes in basic market conditions that may occur. Strategic risk also includes the ability of the Board of Directors and President to plan, organize, follow up on and control the operations and to continuously monitor market conditions.

Earnings risk

Earnings risk is defined by the Banking Group as volatility in earnings that creates a risk of lower income due to an unexpected decrease in income as a result of such factors as competition or volume reductions. Earnings risk is associated with all of the Banking Group's products and portfolios. A considerable portion of Banking Group's business operations is mortgage lending. Mortgage lending has a low level of volatility.

Reputation risk

Reputation risk is difficult to assess, but this type of risk could be devastating for an operation like Länsförsäkringar, which is based on a well-established brand. Reputation risk is the risk of a tarnished reputation among customers, owners, employees, authorities and other parties resulting in reduced income.

Internal capital adequacy assessment process (ICAAP)

The Banking Group's internal capital adequacy assessment process (ICAAP) was designed based on the requirements of the Basel II rules, the requirements established by the Board of Directors and the internal demands of an increasingly complex business operation. The regulations aimed at financial companies' internal capital adequacy assessment processes are based on principles and are comprehensive in nature. To a large extent, this means that Länsförsäkringar Bank has the option and an obligation to design its process and, ultimately, its scope and level of sophistication. The Banking Group's procedures, implementation and results are to be reported to the Swedish Financial Supervisory Authority annually.

The CFO of Länsförsäkringar Bank is responsible for conducting the process work that leads to an internal capital adequacy assessment for the Banking Group and forms the basis for business planning and Board decisions concerning capital goals and capital forecasts. The CFO is responsible for developing a methodology document that describes the process and shall include at least the following:

- A detailed description of the capital assessment process and the areas of responsibility associated with the process.
- A detailed description of methods for calculating total capital that take Pillar I risks, Pillar II risks and conducted stress tests into consideration.

The process shall be carried out annually. The process shall include at least the following activities:

- Review of all risks
- Risk assessment
- Stress tests
- Capital calculations

At least once per year, the basic prerequisites for stress tests are to be discussed by the Board of Directors. This discussion should act as a guide for the company's continuing work involving stress tests. Work involving stress tests is based on a number of scenarios and the impact of these scenarios on risk within the Banking Group. Risk Control is to participate in the ICAAP in its entirety and, in particular, assume responsibility for carrying out the stress tests.