

# Risk and capital management at the Länsförsäkringar Banking Group 2008

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 IRB Approach provides the greatest opportunities to strategically and operationally manage credit risks and is used for all retail exposures. The Standardised Approach is currently applied to agricultural 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. This means that Basel II will be fully implemented on January 1, 2010.

### Länsförsäkringar Banking 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. The regional insurance companies offer customer products via their three core businesses: banking operations, 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). All companies have their registered offices in Stockholm.

### Operations

The Group offers private individuals and farmers payment services, savings and lending products. It also carries out commercial lending activities through the wholly owned subsidiary Wasa Kredit in the form of leasing and instalment plans.

Länsförsäkringar Bank works through 24 independent regional insurance companies who account for service, distribution and sales of the bank's products. Customers are served through any of the more than 110 (100) branches of the regional insurance companies that conduct banking operations for advisory and other services. The bank branches are located at, or adjacent to, the regional insurance branches. Regional insurance companies are reimbursed for sales, administration and customer care through a reimbursement system based on volumes managed.

The total number of customers in the Banking Group amounted to 700,000 (665,000).

### Risks and risk management

The Board of Directors is ultimately responsible for the Banking Group's operations and, as a result, for safeguarding the Group's assets and creating risk awareness in the Group. This is achieved by the Board annually establishing central risk strategy and risk policy documents that ensure a sound and well-balanced process for risk-taking and risk management. A sound and well-balanced process should be characterised 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 regulatory 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), whose main task is to follow up on capital and financial matters arising in the Banking Group. Risk Control reports to the President. Risk Control is an independent unit and has an independent position in relation to the corporate 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, risk limits are monitored and non-compliance is reported to Board. Risk Control's responsibility for managing risks includes identifying, 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 2008 for a description of the various risk categories.

## Capital base and capital requirements

In February 2009, the bank's Board of Directors decided on a new capital adequacy target since the Basel II regulations will take full effect in 2010. The Tier 1 ratio shall amount to 12 percentage points when Basel II is fully implemented. A deviation of +/- 0.5 percentage points is permitted for the target. The basis for determining the capital adequacy target is the Banking Group's internal capital adequacy assessment process, which considered all risks requiring capital. The highly specific market conditions that have prevailed and are expected to last for a protracted period were also taken into account. Internal calculations show that the Banking Group is well capitalised in relation to its total risks.

Capital base		
SEK 000s	2008	2007
Tier 1 capital, gross	4,591,798	4,113,732
Less intangible assets	-327,306	-246,805
Less deferred tax assets	-14,415	-5,077
Less IRB deficit	-48,733	-103,771
Tier 1 capital, net	4,201,344	3,758,079
Tier 2 capital	960,000	860,000
Deductions for Tier 2 capital	-48,733	-103,771
<b>Total capital base</b>	<b>5,112,611</b>	<b>4,514,309</b>
<b>Risk-weighted assets excluding transition rules</b>	<b>28,859,120</b>	<b>26,189,250</b>
<b>Risk-weighted assets including transition rules</b>	<b>49,124,533</b>	<b>42,457,725</b>

Capital requirement		
SEK 000s	2008	2007
<b>Credit risk according to Standardised Approach</b>		
Exposures to institutions	71,155	152,214
Exposures to corporates	379,074	342,849
Retail exposures	25,284	21,470
Exposures secured on residential property	149,827	97,600
Past due items	5,548	2,259
Covered bonds	40,423	-
Other items	26,718	22,924
<b>Total</b>	<b>698,029</b>	<b>639,316</b>

Credit risk according to IRB Approach		
<i>Retail exposures</i>		
Exposures secured by real estate collateral	977,559	829,632
Other retail exposures	521,320	524,226
Non credit-obligation assets	1,640	1,648
<b>Total</b>	<b>1,500,519</b>	<b>1,355,506</b>

Operational risk		
Standardised Approach	110,182	100,318
<b>Total capital requirement for operational risk</b>	<b>110,182</b>	<b>100,318</b>

Total capital requirement for credit risk		
Capital requirement for credit risk according to Standardised Approach	698,029	639,316
Capital requirement for credit risk according to IRB Approach	1,500,519	1,355,506
Capital requirement for operational risk	110,182	100,318
<b>Capital requirement</b>	<b>2,308,730</b>	<b>2,095,140</b>
Adjustment according to transition rules	1,621,233	1,301,478
<b>Total capital requirement</b>	<b>3,929,963</b>	<b>3,396,618</b>

Tier 1 ratio as a percentage, before adjustment according to transition rules, %	14.56	14.35
Capital adequacy ratio as a percentage, after adjustment according to transition rules, %	17.72	17.24
Total capital ratio excluding transition rules*	2.21	2.15
Tier 1 ratio as a percentage, after adjustment according to transition rules, %	8.55	8.85
Capital adequacy ratio as a percentage, after adjustment according to transition rules, %	10.41	10.63
Total capital ratio including transition rules*	1.30	1.33

\* Capital ratio = capital base/capital requirement.

## Credit risks

### Implementation plan for the IRB Approach

In December 2006, Länsförsäkringar Bank was granted permission by the Swedish Financial Supervisory Authority to apply the Internal Ratings-based Approach (IRB Approach) in the calculation of the capital requirement for credit risk for retail exposures, which accounts for most of the credit portfolio, and the IRB Approach has been applied for these exposures since February 2007. Permanent exemptions have been granted for exposure to governments, local governments, county councils 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.

### IRB system

The IRB 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 IRB 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 IRB system are described below. The probability of default (PD) is the probability that a counterparty will default over a 12-month period. A counterparty is considered to be in default if a payment is more than 60 days past due or if there is reason to expect that the counterparty cannot meet its undertaking to the bank.

A PD is initially calculated for each counterparty and is to reflect the risk of default within the next 12 months. This PD is subsequently adjusted to reflect the average proportion of default over several economic cycles. Finally, a safety margin is added to the PD to ensure that the risk is not underestimated. Following the calculation of PD, all counterparties are ranked and are divided into a PD scale. The PD scale comprises 11 risk classes (grades) for non-defaulted counterparties and one risk class for defaulted counterparties.

PD grade, Dec. 31, 2008 SEK 000s	PD (%)	EAD
1	0.05	2,531,411
2	0.10	4,374,143
3	0.20	17,777,607
4	0.40	26,046,538
5	0.80	9,198,127
6	1.60	5,550,225
7	3.20	2,216,537
8	6.40	1,120,618
9	12.80	566,059
10	25.60	344,337
11	51.20	289,225
Default	100.00	358,024
<b>Total</b>		<b>70,372,851</b>

The information that is most relevant to each type of counterparty has been taken into consideration in the development of models for calculating PD. Accordingly, the division of PD into grades can either occur through an individual expert assessment or using models based on statistical analysis (credit scoring). These models take both internal and external information into consideration.

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. A safety margin is added to these estimates 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 utilise upon default. For commitments completely within the balance sheet, EAD is defined as capital liability plus accrued and past due amounts, unpaid interest and fees. For commitments wholly or partly off the balance sheet, EAD is calculated by multiplying the counterparty's granted 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 realisation, degree of utilisation and products. A safety margin is added to these estimates to ensure that the risk is not underestimated.

Expected Loss percentage (EL, %) is the PD multiplied by LGD. The expected loss amount is gained by multiplying EAD by the EL percentage. 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 RWA.

### Expected Loss in relation to outcome

The presentation below shows the PD-, LGD- and EL-data to be used in capital adequacy reports, meaning those that include safety margins and adjustments for economic conditions. The exposure-weighted PD estimate for all non-defaulted exposures encompassed by IRB at December 31, 2007 was 1.19%, distributed in the form of 0.81% for exposures secured through real estate and 2.78% for other retail exposures. The percentage of these exposures in default in 2007 was 0.66%, distributed in the form of 0.46% for exposures secured through real estate and 1.51% 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 exposures secured through real estate and 59.4% for other retail exposures. The actual loss rate for the exposures in default in 2007 was 19.4%, distributed in the form of 11.5% for exposures secured

through real estate and 33.1% for other retail exposures. The calculation of actual loss portions took into account recoveries up to and including December 31, 2008, meaning that the average recovery period is one and a half years. 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 exposures secured through real estate and 1.62% for other retail exposures. Loan losses for defaulting exposures in 2007 were 0.12%, distributed among 0.04% for exposures secured through real estate and 0.46% for other retail exposures.

#### **Loan receivables and accounts receivable**

Loan receivables are initially recognised in the balance sheet at cost – the amount loaned to the borrower – less fees and supplements for costs received. Subsequently, loan receivables are recognised continuously at amortised cost after deductions for the impairment of loan losses.

Loan losses are primarily assessed at the group-wise level because the loans do not total significant amounts individually. The group-wise valuation is based on the experiences and historical loan losses of the companies, adjusted to reflect current circumstances.

When an impairment requirement exists, the loan receivable is impaired to the present value of expected future cash flows, including the fair value of collateral, less selling expenses discounted at the original effective interest rate. The impairment of loan receivables is conducted as an allocation to the reserve for loan losses. When a financial asset is impaired due to loan losses, a deposit account is used. If the impairment requirement declines in subsequent periods, the maximum impairment carried out is reversed.

In the income statement, the impairment of loan receivables is recognised as loan losses, carried out 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. In such situations, the receivable is derecognised from the balance sheet and is recognised as a confirmed loss in the income statement.

A loan receivable is considered doubtful if a payment is more than 60 days past due or if there is reason to expect that the counterparty cannot meet its undertaking.

Impairment for losses on guarantees is recognised in the liabilities side of the balance sheet as a provision.

#### **Counterparty risk**

Counterparty risk is the risk of a counterparty being unable to fulfil its 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 exposures.

#### **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 that exceeds 10% of the capital base. It is not until exposure exceeds 20% (intra-Group) and 25% (external) of the capital base 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, 2008	Average 2008
<i>Exposure classes, IRB Approach</i>		
Retail exposures	70,372,851	67,920,610
Non credit-obligation assets	20,505	22,023
<b>Total IRB Approach</b>	<b>70,393,356</b>	<b>67,942,633</b>
<i>Exposure classes, Standardised Approach</i>		
Governments and central banks	14,736,239	8,731,305
Regional and local authorities	168,077	162,574
Exposures to institutions	4,447,160	8,616,436
Exposures to corporates	4,738,424	4,555,137
Retail exposures	421,394	394,326
Exposures secured on residential property	5,314,906	3,867,239
Past due items	51,453	45,020
Exposures in the form of covered bonds	5,052,873	3,639,001
Other items	408,002	311,544
<b>Total Standardised Approach</b>	<b>35,338,529</b>	<b>30,322,580</b>

## Recognisable collateral

Dec. 31, 2008, SEK 000s	EAD	Secured through recognisable collateral
<i>Exposure classes, Standardised Approach</i>		
Governments and central banks	14,736,239	0
Regional and local authorities	168,077	0
Exposures to institutions	4,447,160	0
Exposures to corporates	4,738,424	0
Retail exposures	421,394	0
Exposures secured on residential property	5,314,906	5,314,906
Past due items	51,453	15,998
Exposures in the form of covered bonds	5,052,873	0
Other items	408,002	0
<b>Total Standardised Approach</b>	<b>35,338,529</b>	<b>5,330,905</b>

## EAD, by contractual maturity\*

Dec. 31, 2008, SEK 000s	< 3 months	3–6 months	6–12 months	1–3 years	3–5 years	> 5 years
<i>Exposure classes, IRB Approach</i>						
Retail exposures	42,451,532	274,408	5,970,216	12,890,522	6,360,289	2,425,885
Non credit-obligation assets	20,505	0	0	0	0	0
<b>Total IRB Approach</b>	<b>42,472,037</b>	<b>274,408</b>	<b>5,970,216</b>	<b>12,890,522</b>	<b>6,360,289</b>	<b>2,425,885</b>
<i>Exposure classes, Standardised Approach</i>						
Governments and central banks	14,736,239	0	0	0	0	0
Regional and local authorities	168,077	0	0	0	0	0
Exposures to institutions	140,747	0	813,722	2,742,923	749,767	0
Exposures to corporates	2,858,394	18,477	401,993	867,959	428,258	163,342
Retail exposures	254,201	1,643	35,750	77,189	38,086	14,526
Exposures secured on residential property	3,206,150	20,725	450,900	973,556	480,361	183,215
Past due items	51,453	0	0	0	0	0
Exposures in the form of covered bonds	0	0	1,050,906	3,033,656	968,310	0
Other items	408,002	0	0	0	0	0
<b>Total Standardised Approach</b>	<b>21,823,263</b>	<b>40,845</b>	<b>2,753,272</b>	<b>7,695,284</b>	<b>2,664,782</b>	<b>361,084</b>

\* The residual maturity of agreements with periodically restricted terms should be calculated as the time up until the next date for a change in terms.

## EAD for exposures secured through real estate, by county

Dec. 31, 2008, SEK 000s	EAD	Proportion of EAD (%)
<b>County</b>		
Stockholms	9,229,865	15.7
Västra Götaland	8,709,538	14.8
Skåne	8,289,077	14.1
Östergötland	3,671,343	6.3
Halland	3,606,787	6.1
Dalarna	3,247,155	5.5
Uppsala	3,205,759	5.5
Södermanland	2,019,586	3.4
Jönköping	2,015,109	3.4
Gävleborg	1,972,176	3.4
Västerbotten	1,907,732	3.2
Västmanland	1,612,075	2.7
Jämtland	1,354,359	2.3
Örebro	1,297,376	2.2
Gotland	1,198,035	2.0
Blekinge	1,153,072	2.0
Kalmar	1,077,714	1.8
Västernorrland	902,123	1.5
Kronoberg	894,194	1.5
Värmland	718,490	1.2
Norrbottn	636,431	1.1
<b>Total</b>	<b>58,717,996</b>	<b>100.0</b>

## Average risk weight for IRB exposures

Dec. 31, 2008, SEK 000s	Exposure	EAD	RW (%)	RWA	Capital requirement
<i>Exposure classes, IRB Approach</i>					
Retail exposures	70,650,191	70,372,851	27	18,735,988	1,498,879
Non credit-obligation assets	20,505	20,505	100	20,505	1,640
<b>Total IRB Approach</b>	<b>70,670,696</b>	<b>70,393,356</b>	<b>27</b>	<b>18,756,493</b>	<b>1,500,519</b>

### *Exposure classes, Standardised Approach*

Central governments and central banks	14,736,239	14,736,239	0	0	0
Regional and local authorities	204,321	168,077	0	0	0
Exposures to institutions	4,451,932	4,447,160	20	889,432	71,155
Exposures to corporates	5,775,306	4,738,424	100	4,738,424	379,074
Retail exposures	439,603	421,394	75	316,046	25,284
Exposures secured on residential property	5,502,835	5,314,906	35	1,872,843	149,827
Past due items	51,453	51,453	135	69,348	5,548
Exposures in the form of covered bonds	5,052,873	5,052,873	10	505,287	40,423
Other items	408,002	408,002	82	333,971	26,718
<b>Total Standardised Approach</b>	<b>36,622,564</b>	<b>35,338,529</b>	<b>25</b>	<b>8,725,351</b>	<b>698,028</b>

Dec. 31, 2008, SEK 000s	Exposures secured through real estate collateral		Other retail exposures	
	EAD	RW (%)	EAD	RW (%)
1	1,505,768	4	1,025,642	7
2	4,145,390	6	228,753	14
3	15,288,443	11	2,489,164	20
4	24,259,948	16	1,786,590	37
5	7,092,356	29	2,105,771	55
6	3,813,881	45	1,736,344	75
7	1,274,153	68	942,384	84
8	612,094	101	508,524	94
9	263,217	127	302,842	108
10	145,649	150	198,688	142
11	184,283	132	104,943	163
Default	132,814	282	225,209	328
<b>Total</b>	<b>58,717,996</b>	<b>21</b>	<b>11,654,855</b>	<b>56</b>

## Exposure-weighted LGD for IRB exposures

Dec. 31, 2008	Exposure-weighted LGD (%)*
Retail exposures	29.1

\* Note that this value is forward-looking as of December 31, 2008 as opposed to the value recognised in conjunction with expected losses, which was forward-looking as of December 31, 2006.

## Unutilised undertakings for IRB exposures

Dec. 31, 2008, SEK 000s	Exposure	Average CF (%)
Total	2,051,795	86.5

## Loan receivables

SEK 000s	2008	2007
<b>Doubtful loan receivables</b>		
Corporates	38,318	45,411
Retail	216,286	130,676
<b>Total doubtful loan receivables</b>	<b>254,604</b>	<b>176,087</b>

A loan receivable is considered doubtful if a payment is more than 60 days past due or if there is reason to expect that the counterparty cannot meet its undertaking.

SEK 000s	2008	2007
<b>Impairment of collectively assessed loan receivables</b>		
Corporates	-30,091	-21,490
Retail	-196,373	-155,167
<b>Total group-wise</b>	<b>-226,464</b>	<b>-176,657</b>
<b>Total impairment</b>	<b>-307,158</b>	<b>-262,506</b>

## Loan losses

SEK 000s	2008	2007
<i>Specific provisions for individually assessed loan receivables</i>		
Write-off of confirmed loan losses during the year	61,120	61,904
Reversed impairment recognised in the year-end accounts as confirmed loan losses	-58,401	-59,508
Loan losses during the year	71,437	78,742
Payment received for prior confirmed loan losses	-35,654	-28,119
Reversed loan losses no longer required	-26,344	-29,175
<b>Net expense for the year for individually assessed receivables</b>	<b>12,158</b>	<b>23,844</b>
<i>Collective impairment of individually assessed receivables</i>		
	-	-
<i>Collective assessment of homogenous groups of loan receivables with limited value and similar credit risk</i>		
Write-off of confirmed loan losses during the year	5,286	12,261
Payment received for prior confirmed loan losses	-	-
Provision/reversal of impairment for loan losses	52,450	29,906
<b>Net expense for the year for collectively assessed receivables</b>	<b>57,736</b>	<b>42,167</b>
<b>Net expense for the year for fulfilment of guarantees</b>	<b>-4,832</b>	<b>-14,948</b>
<b>Net expense of loan losses for the year</b>	<b>65,062</b>	<b>51,063</b>

All information pertains to receivables from the public.

SEK 000s	2008	2007
<b>Reconciliation of impairment covering loan losses</b>		
Opening balance	-262,506	-244,473
Reversed earlier impairment of loan losses recognised in the year-end accounts as confirmed losses	58,401	66,165
Reversed impairment of loan losses no longer required	67,451	64,862
Impairment of loan losses during the year	-253,980	-210,910
Payment pertaining to probable loan losses for the year	64,171	50,914
Value of collateral pertaining to probable loan losses for the year	19,305	10,936
<b>Closing balance</b>	<b>-307,158</b>	<b>-262,506</b>

## Financial risk

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 Financial Policy states 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 fulfil its commitments or only being able to fulfil 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 three days. Liquidity risks associated with the risk of financial investments decreasing in value are minimised 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, as well as 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 its borrowing sources and minimising 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 means of 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 bp. Interest-rate risk for the Banking Group is normally between SEK 5 M and SEK 20 M. On December 31, 2008, an increase in market interest rates of 1 percentage point would have resulted in an decrease in the value of interest-bearing assets and liabilities, including derivatives, of SEK 8 M (increase: 29).

### Financing risk

Financing risk means that the Banking Group, in the event of financing maturity, 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 in recent years to a current rating of A from Standard & Poor's and a current rating of A2 from Moody's. In 2008, Länsförsäkringar Hypotek also received a rating of AAA/Aaa for the covered bonds issued by Länsförsäkringar Hypotek.

### 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 categorised into the following areas:

- Internal fraud
- External crime
- Legal risks
- Damage to physical assets
- Interruptions and disturbances to operations and systems
- 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 operations, external environment and threat profile are constantly changing, quality assurance must be regularly performed of the processes. 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 the 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 organisation 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, and
- 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 annually.
- 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 operations. Each identified risk is assessed on the following basis:

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

These factors are aggregated to determine a risk value for the operational risk. Management within the Banking Group is responsible for performing the risk analyses – that is, identifying and assessing operational risk – within its area of responsibility. All employees have a responsibility to report incidents. Management is responsible for taking action against intolerable risks within its areas of responsibility. Management is responsible for reporting its analyses and actions to Risk Control. The President has overall responsibility for managing operational risk. The process to identify, measure, control and report 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, for example, when new products are introduced and new markets are entered.

## 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, organise, 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 the Banking Group's business operations is retail mortgage lending. Retail 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 for the operations and the internal demands of an increasingly complex business operation. The regulations aimed at the internal capital adequacy assessment processes of financial companies 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 independently design its process and, in the long run, 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 and shall include at least the following activities:

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

At least once annually, the basic prerequisites for stress tests are to be reviewed by the Board of Directors. This review 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.