

Risk and capital management at the Länsförsäkringar Bank Group 2009

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. Since then, Länsförsäkringar has applied the Internal Ratings-based Approach (IRB Approach) in accordance with a permit issued by 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 risk and is used for all retail exposures. As of 2010, the IRB Approach is also used for agricultural customers and the Standardised Approach is applied to other exposures to calculate the capital requirement for credit risk. The changes in capital requirements will emerge gradually since the transition rules involve a multi-year adaptation period. This means that Basel II will be fully implemented on January 1, 2012.

Länsförsäkringar Bank Group

Länsförsäkringar Bank AB (publ) is part of the Länsförsäkringar AB Group, with Länsförsäkringar AB (publ) 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 Bank 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.

Focus of operations

The Bank 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 AB in the form of leasing and hire purchase.

The 24 independent regional insurance companies account for service, distribution and sales of the Bank Group's products. Customers are served through any of the more than 116 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 Bank Group amounted to 759,000 (700,000) as of December 31, 2009.

Risks and risk management

The Board of Directors is ultimately responsible for the Bank Group's operations and, as a result, for safeguarding the Group's assets and creating risk awareness in the Group. The Board achieves this goal by annually establishing central risk tolerances and risk strategies that ensure a sound and well-balanced process for risk-taking and risk management. Such a process should be characterised by a 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 continuous administration in accordance with the risk tolerances and risk strategies 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 the Asset Liability Committee (ALCO), whose main task is to follow up on capital and financial matters arising in the Bank 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 includes identifying, measuring, following up on, controlling and reporting risks.

The Bank Group is exposed to several risks:

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

Refer to Länsförsäkringar Bank's Annual Report for 2009 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 2012. 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 was the Bank Group's internal capital adequacy assessment process, which considered all risks requiring capital. Consideration was also given to the Tier 1 ratios of comparable financial companies. Internal calculations show that the Bank Group is well capitalised in relation to its total risks.

Capital-adequacy analysis

SEK M	2009	2008
Tier 1 capital, gross	4,960.1	4,591.8
Less intangible assets	-329.8	-327.4
Less deferred tax assets	-2.1	-14.4
Less IRB deficit	-106.6	-48.7
Tier 1 capital, net	4,521.6	4,201.3
Tier 2 capital	960.0	960.0
Deductions for Tier 2 capital	-106.6	-48.7
Total capital base	5,375.0	5,112.6
Risk-weighted assets excluding transition rules	36,331.3	28,859.1
Risk-weighted assets including transition rules	55,197.5	49,125.5
Total capital requirement for credit risk		
Capital requirement for credit risk according to Standardised Approach	1,004.0	698.0
Capital requirement for credit risk according to IRB Approach	1,774.6	1,500.5
Capital requirement for operational risk	127.9	110.2
Capital requirement	2,906.5	2,308.7
Adjustment according to transition rules	1,509.3	1,621.3
Total capital requirement	4,415.8	3,930.0
Tier 1 ratio as a percentage, before adjustment according to transition rules, %	12.45	14.56
Capital adequacy ratio before adjustment according to transition rules, %	14.79	17.72
Capital ratio excluding transition rules *	1.85	2.21
Tier 1 ratio as a percentage after adjustment according to transition rules, %	8.19	8.55
Capital adequacy ratio, after adjustment according to transition rules, %	9.74	10.41
Capital ratio including transition rules *	1.22	1.30
Special disclosures		
IRB provisions surplus (+)/deficit (-)	-213.2	-97.4
- IRB Total reserves (+)	249.2	255.9
- IRB Anticipated loss (-)	-462.4	-353.3

SEK M	2009	2008
Capital requirement		
Credit risk according to Standardised Approach		
Exposures to institutions	93.4	71.2
Exposures to corporates	396.6	379.1
Retail exposures	30.3	25.3
Exposures secured on residential property	313.8	149.8
Past due items	8.0	5.5
Covered bonds	143.6	40.4
Other items	18.3	26.7
Total	1,004.0	698.0
Credit risk according to IRB Approach		
<i>Retail exposures</i>		
Exposures secured by real estate collateral	1,230.9	977.6
Other retail exposures	542.2	521.3
Non credit-obligation assets	1.5	1.6
Total	1,774.6	1,500.5
Operational risk		
Standardised Approach	127.9	110.2
Total capital requirement for operational risk	127.9	110.2
Capital-adequacy analysis according to earlier rules		
Tier 1 capital	4,628.2	4,250.1
Tier 2 capital	960.0	960.0
Total capital base	5,588.2	5,210.1
Risk-weighted assets	72,328.6	55,936.4
Capital requirement for credit risk	5,786.3	4,474.9
Tier 1 ratio, %	6.40	7.60
Capital adequacy ratio, %	7.73	9.31
Capital ratio	0.97	1.16

* Capital ratio = total capital base/total capital requirement.

The capital base includes the Board's proposed appropriation of earnings.

In addition to the Parent Company Länsförsäkringar Bank AB publ (556401-9878), the financial corporate group includes the wholly owned and fully consolidated subsidiaries Länsförsäkringar Hypotek AB publ (556244-1781), Wasa Kredit AB (556311-9204) and Länsförsäkringar Fondförvaltning AB publ (556364-2783).

Credit risk

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 loan portfolio. The IRB Approach has been applied for these exposures since February 2007. In December 2009, Länsförsäkringar Bank was then granted permission by the Swedish Financial Supervisory Authority to apply the basic IRB Approach in the calculation of the capital requirement for credit risk for agricultural exposures, and the IRB Approach has been applied for these exposures since January 1, 2010. Permanent exemptions have been granted for exposures to governments, local governments, county councils and banks. For other components of the loan portfolio, internal models will be implemented during the period up to January 1, 2012. This complies with the implementation plan approved by the 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 the bank's PD scale. The PD scale comprises 11 risk classes (grades) for non-defaulted counterparties and one risk category for defaulted counterparties.

Dec. 31, 2009, SEK 000s		
PD grade	PD (%)	EAD
1	0.05	0
2	0.10	5,900,710
3	0.20	17,031,282
4	0.40	37,883,732
5	0.80	13,977,461
6	1.60	5,711,702
7	3.20	2,506,103
8	6.40	1,083,439
9	12.80	645,063
10	25.60	231,691
11	51.20	359,355
Default	100.00	396,652
Total		85,727,191

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 ratios 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 period of economic downturn.

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 unutilised amount by a conversion factor (CF). In the case of exposures for which the company 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. Finally, the estimate is adjusted to reflect conversion factors in a period of economic downturn.

Expected loss percentage (EL, %) is the PD multiplied by LGD. The expected loss amount is obtained 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 estimates to be applied in capital adequacy reports, meaning those estimates 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, 2008 was 1.08%, distributed on the basis of 0.85% for exposures secured by real estate collateral and 2.31% for other retail exposures. The percentage of these exposures in default in 2009 was 0.72%, distributed on the basis of 0.37% for exposures secured by real estate collateral and 2.50% for other retail exposures. The exposure-weighted LGD estimate for all non-defaulted exposures encompassed by IRB at December 31, 2007 was 30.5%, distributed on the basis of 25.3% for exposures secured by real estate collateral and 52.9% for other retail exposures. The actual loss rate for the exposures in default in 2008 was 12.2% for exposures secured by real estate collateral and 58.0% for other retail exposures. The calculation of actual loss rates took into account recoveries up to and including December 31, 2009, meaning that the average recovery period is one and a half years. The EL percentage for all non-defaulted exposures within the scope of IRB at December 31, 2007 was 0.36%, distributed on the basis of 0.21% for exposures secured by real estate collateral and 1.47% for other retail exposures. The percentage of loan losses for exposures in default in 2008 was 0.33%, distributed on the basis of 0.06% for exposures secured by real estate collateral and 0.87% for other retail exposures.

Loan receivables and accounts receivable

Loans and receivables are financial assets that are not derivatives, that have fixed or determinable payments and that are not quoted on an active market. These receivables are represented by the balance-sheet items Lending to credit institutions, Lending to the public and Other assets in the balance sheet. For further information, see Länsförsäkringar Bank's Annual Report 2009, Note 2 on page 40.

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, the term counterparty refers to counterparties for interest-rate and currency swaps. The Bank 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. This means that such positions and relations increase in vulnerability since the effect on the operations could be relatively substantial. Risk spreading is therefore limited. Concentration risk can be divided into two types of categories. The first involves individual exposures 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 a large exposure. Large exposures are regulated by and reported to the Swedish Financial Supervisory Authority. As this reporting is completed, a quarterly report is prepared detailing all exposures that exceed 10% of the capital base. It is not until an exposure exceeds 20% (intra-Group) or 25% (external) of the capital base that large exposures become impermissible. The second type of concentration risk involved general exposures that can be divided into a certain category driven by an underlying variable, for example a geographic division, product, market or collateral type. The Bank 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 customer and counterparty

Total and average EAD

SEK 000s	Dec. 31, 2009	Average 2009
<i>Exposure classes, IRB Approach</i>		
Retail exposures	85,727,191	79,721,973
Non credit-obligation assets	18,095	19,042
Total IRB Approach	85,745,286	79,741,015
<i>Exposure classes, Standardised Approach</i>		
Governments and central banks	4,627,265	10,851,269
Regional and local authorities	201,798	186,904
Exposures to institutions	7,824,914	9,266,901
Exposures to corporates	4,957,833	4,966,423
Retail exposures	505,709	494,960
Exposures secured on residential property	11,104,610	9,264,874
Past due items	71,400	61,309
Exposures in the form of covered bonds	17,952,922	12,190,240
Other items	1,075,254	474,820
Total Standardised Approach	48,321,706	47,757,698

Recognisable collateral

Dec. 31, 2009, SEK 000s	EAD	Secured through recognisable collateral
<i>Exposure classes, Standardised Approach</i>		
Governments and central banks	4,627,265	0
Regional and local authorities	201,798	0
Exposures to institutions	7,824,914	0
Exposures to corporates	4,957,833	0
Retail exposures	505,709	0
Exposures secured on residential property	11,104,610	11,104,610
Past due items	71,400	15,024
Exposures in the form of covered bonds	17,952,922	0
Other items	1,075,254	0
Total Standardised Approach	48,321,706	11,119,634

EAD for exposures secured by real estate, by county

Dec. 31, 2009, SEK 000s County	EAD	Proportion of EAD (%)
Stockholm	12,346,945	16.9%
Västra Götaland	10,903,966	14.9%
Skåne	9,469,335	12.9%
Östergötland	4,473,824	6.1%
Halland	4,302,639	5.9%
Dalarna	4,139,298	5.7%
Uppsala	3,863,087	5.3%
Södermanland	2,608,393	3.6%
Jönköping	2,479,027	3.4%
Gävleborg	2,411,737	3.3%
Västerbotten	2,293,136	3.1%
Västmanland	2,184,448	3.0%
Jämtland	1,820,608	2.5%
Örebro	1,611,073	2.2%
Gotland	1,519,212	2.1%
Blekinge	1,361,491	1.9%
Kalmar	1,358,461	1.9%
Västernorrland	1,167,050	1.6%
Kronoberg	1,138,507	1.6%
Värmland	901,312	1.2%
Norrbottn	768,820	1.1%
Total	73,122,370	100.0%

EAD, by contractual maturity*

Dec. 31, 2009, 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	64,287,657	4,574,550	3,926,323	9,213,742	2,155,283	1,569,635
Non credit-obligation assets	18,095	0	0	0	0	0
Total IRB Approach	64,305,752	4,574,550	3,926,323	9,213,742	2,155,283	1,569,635
<i>Exposure classes, Standardised Approach</i>						
Governments and central banks	4,627,265		0	0	0	0
Regional and local authorities	201,798	0	0	0	0	0
Exposures to institutions	5,471,387	470,705	1,882,822	0	0	0
Exposures to corporates	3,717,928	264,559	227,070	532,855	124,646	90,776
Retail exposures	379,236	26,986	23,162	54,352	12,714	9,259
Exposures secured on residential property	8,327,456	592,561	508,593	1,193,496	279,183	203,322
Past due items	71,400	0	0	0	0	0
Exposures in the form of covered bonds	0	4,380,247	3,700,971	5,865,660	4,006,044	0
Other items	1,075,254	0	0	0	0	0
Total Standardised Approach	23,871,723	5,735,057	6,342,618	7,646,363	4,422,587	303,357

* 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.

Average risk weight for IRB exposures

Dec. 31, 2009, SEK 000s	Exposure	EAD	RW (%)	RWA	Capital requirement
<i>Exposure classes, IRB Approach</i>					
Retail exposures	86,070,207	85,727,191	26	22,164,104	1,773,128
Non credit-obligation assets	18,095	18,095	100	18,095	1,448
Total IRB Approach	86,088,302	85,745,286	26	22,182,199	1,774,576
<i>Exposure classes, Standardised Approach</i>					
Governments and central banks	4,627,265	4,627,265	0	0	0
Regional and local authorities	267,226	201,798	0	0	0
Exposures to institutions	19,447,602	7,824,914	15	1,167,662	93,413
Exposures to corporates	6,184,972	4,957,833	100	4,957,833	396,627
Retail exposures	524,718	505,709	75	379,282	30,343
Exposures secured on residential property	11,336,484	11,104,610	35	3,922,599	313,808
Past due items	71,400	71,400	140	99,633	7,971
Exposures in the form of covered bonds	17,952,922	17,952,922	10	1,795,292	143,623
Other items	1,075,254	1,075,254	21	227,691	18,215
Total Standardised Approach	61,487,843	48,321,706	26	12,549,993	1,003,999

Dec. 31, 2009, SEK 000s	Exposures secured by real estate collateral		Other retail exposures	
	EAD	RW (%)	EAD	RW (%)
PD grade				
1	0	0	0	0
2	3,869,804	6	2,030,906	11
3	15,460,416	10	1,570,866	20
4	35,267,275	16	2,616,457	35
5	11,773,165	28	2,204,295	62
6	4,058,089	43	1,653,612	67
7	1,479,152	68	1,026,952	90
8	474,932	99	608,507	94
9	318,776	130	326,288	109
10	63,503	158	168,188	154
11	245,530	133	113,825	169
Default	111,727	335	284,926	188
Total	73,122,370	21	12,604,821	54

Exposure-weighted LGD for IRB exposures

Dec. 31, 2009	Exposure-weighted LGD (%)*
Retail exposures	28.2

* Note that this value is forward-looking as of December 31, 2009.

Unutilised undertakings for IRB exposures

Dec. 31, 2009, SEK 000s	Exposure	Average CF (%)
Total	2,431,522	85.9

Lending to the public

Loan receivables are geographically attributable in their entirety to Sweden.

SEK M	Dec. 31, 2009	Dec. 31, 2008
Loan receivables, gross		
Public sector	169.6	138.9
Corporate sector	6,862.1	5,521.0
Retail sector	92,847.1	73,210.7
Other	10.8	0.4
Total loan receivables, gross	99,889.6	78,871.0
Impairment of individually reserved loan receivables		
Corporate sector	-44.7	-31.1
Retail sector	-98.8	-49.6
Total individual reserves	-143.5	-80.7
Impairment of collectively reserved loan receivables		
Corporate sector	-23.5	-30.1
Retail sector	-141.0	-196.4
Other	0	-
Total collective reserves	-164.5	-226.5
Total impairment	-308.0	-307.2
Loan receivables, net		
Public sector	169.6	138.9
Corporate sector	6,793.9	5,459.8
Retail sector	92,607.3	72,964.7
Other	10.8	0.4
Total loan receivables, net	99,581.6	78,563.8
Payable on demand	-	-
Remaining term of not more than 3 months	909.8	510.6
Remaining term of more than 3 months but not more than 1 year	3,042.3	2,117.0
Remaining term of more than 1 year but not more than 5 years	6,939.1	6,761.5
Remaining term of more than 5 years	88,980.0	69,316.1
	99,871.2	78,705.2
Impaired loans		
Corporate sector	57.6	39.1
Retail sector	155.0	153.4
	212.6	192.5

Definitions:

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

Loan losses, net

SEK M	2009	2008
Specific reserve for individually assessed loan receivables		
Write-off of confirmed loan losses during the year	92.4	61.1
Reversed earlier impairment of loan losses recognised in the annual accounts as confirmed losses	-77.6	-58.4
Impairment of loan losses during the year	37.4	71.4
Payment received for prior confirmed loan losses	90.2	-35.7
Reversed impairment of loan losses no longer required	-22.6	-26.3
Net expense for the year for individually appraised receivables	119.8	12.1
<i>Collective reserves for individually assessed receivables</i>	-	-
Collective assessment of homogenous groups of loan receivables with limited value and similar credit risk		
Write-off of confirmed loan losses during the year	-	5.3
Payment received for prior confirmed loan losses	-	-
Provision/reversal of impairment for loan losses	-63.7	52.5
Net expense for the year for collectively assessed receivables	-63.7	57.8
Net expense for the year for fulfilment of guarantees	-5.7	-4.8
Net expense of loan losses for the year	50.4	65.1

All information pertains to receivables from the public.

Reconciliation of impairment of loan losses

	Dec. 31, 2009			Dec. 31, 2008		
	Individual impairments	Collective impairments	Total	Individual impairments	Collective impairments	Total
Opening balance	-80.7	-226.5	-307.2	-85.9	-176.6	-262.5
Reversed earlier impairment of loan losses recognised in the annual accounts as confirmed losses	77.6	-	77.6	58.4	-	58.4
Reversed impairment of loan losses no longer required	18.9	64.6	83.5	27.7	39.7	67.5
Impairment of loan losses during the year	-159.3	-2.6	-161.9	-81.0	-89.6	-170.6
Closing balance	-143.5	-164.5	-308.0	-80.7	-226.5	-307.2

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 in the Bank 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 Bank Group. Liquidity risk is defined as the risk of the Bank 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 (Sweden's central bank). 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. Liquidity is monitored on a daily basis.

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 basis points.

Financing risk

Financing risk means that the Bank 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 Bank Group's financing risk decreases. The Bank 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. Also, Länsförsäkringar Hypotek's covered bonds have rating AAA/Aaa since 2007.

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 Bank 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
- Business conditions
- Transaction management and process control
- Working conditions and work environment

All significant processes in the Bank 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 Bank Group's total risk assessment in accordance with the Basel regulations. Since the operations, their external environment and threat profile are constantly changing, the processes must be subjected to regular quality assurance. This is carried out to ensure that the risks remain within the Bank Group's tolerance level. Risk analysis is one of the tools used to prepare the basis for decision-making in order to introduce measures for managing significant risks. The purpose of risk 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 Bank 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 Bank 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 target value for the operational risk. Management of the Bank Group is responsible for performing the risk analyses, meaning 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 in their areas of responsibility.

Business risks

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

- Strategic risk
- Earnings risk
- Reputation risk

Strategic risk

The Bank 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 Bank 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 Bank Group's products and portfolios. A considerable portion of the Bank Group's business operations involves 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 Bank 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 Bank 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 Bank Group and forms the basis for business planning and Board decisions concerning capital targets 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 in the Bank Group. Risk Control is to participate in the ICAAP in its entirety and, in particular, assume responsibility for carrying out the stress tests.