

# Risk and capital management in the Länsförsäkringar Bank Group 2012

Pillar III of the Basel II regulatory  
framework



# Table of contents

Introduction .....	3
Focus of operations .....	4
Risks and risk management.....	5
Capital base and capital requirements.....	6
Credit risk .....	7
Market and liquidity risks .....	13
Business risk.....	14
Operational risks .....	15
Future capital adequacy rules .....	16
Internal Capital Adequacy Assessment Process (ICAAP).....	17

## Introduction

The aim of this report is to provide detailed information about Länsförsäkringar Bank's risks, risk management and capital adequacy in accordance with the reporting requirements (known as Pillar III) stipulated in the Capital Requirements Directive (CRD) through which Basel II was implemented within the EU. Information requirements were introduced in Sweden on the basis of regulation FFFS 2007:5 of the Swedish Financial Supervisory Authority.

Under the Basel II rules, an option for calculation of the capital requirement for credit risk was introduced by utilising either the Standardised Approach or the Internal Ratings-based Approach (IRB Approach). The Bank Group applies the IRB Approach in accordance with a permit issued by the Financial Supervisory Authority. The advanced IRB Approach is applied to all retail exposures including counterparty exposures to corporates and the agricultural sector up to SEK 5 M. The Foundation Internal Ratings-based Approach is used for counterparty exposures to corporates and the agricultural sector in excess of SEK 5 M. The Standardised Approach is used for other exposure.

### 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 23 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.

### Business and mission

The business concept of the banking operations is to offer a complete range of banking services to private individuals, farmers and small-sized businesses. This offering is to be simple and tailored to deliver high quality and a high level of service to customers. Länsförsäkringar Bank's mission is to develop and administer products and concepts, and to support the regional insurance companies in their sales and service to customers.

### Strategy and distribution network

The strategy is to offer primarily the Länsförsäkringar Alliance's customers attractive banking and insurance services. Success is based on Länsförsäkringar's strong brand, local presence and the regional insurance companies being customer-owned. The bank has access to the joint distribution network and the established customer relationships that exist in the Länsförsäkringar Alliance.

All customer contact takes place in personal meetings at the 130 branches of the 23 regional insurance companies and via mobile services, the Internet and telephone. The real estate brokerage Läns-

försäkringar Fastighetsförmedling also mediates customer contacts at its 150 branches.

### Large customer base

The bank has the opportunity to develop existing relationships with the almost 3.5 million customers of the Länsförsäkringar Alliance.

The prioritised target groups are the 2.9 million retail customers, of which 1.8 million are home-insurance customers. Agricultural customers is considered another prioritised target group. The offering to agricultural customers and small-sized businesses is growing and continuously enhanced. With banking and insurance solutions from a single provider, customers can receive a secure, personal and attractive commitment with Länsförsäkringar.

### A strong brand

Länsförsäkringar's reputation is the highest among banking and insurance companies in Sweden, according to Nordic Brand's brand ranking and the Reputability Barometer for 2012.

### More than 200 years in Sweden

Security for customers is inherent in Länsförsäkringar's mission that dates back 200 years. Growth with low risk has been the focal point ever since the federal partnership was initiated within the Länsförsäkringar Alliance. Länsförsäkringar Bank was founded in 1996 to further broaden the offering. In 2000, the strategy of becoming a full-service bank was adopted and in 2001 the bank started retail mortgage lending operations in Länsförsäkringar Hypotek.

### Local customer-owned

The banking operations, which are conducted only in Sweden, have a local presence with customer-owned regional insurance companies that manage all contact with customers. The insurance customers of the Länsförsäkringar Alliance own the regional insurance companies, meaning that the bank is operated based on the principles of customer ownership. The regional insurance companies' involvement, network and local decision-making, provide a broad and in-depth local presence. According to the Swedish Quality Index's surveys, Länsförsäkringar has the highest customer satisfaction in the industry. Strong customer relationships are based on genuine commitment and personal service from bank advisors. According to the Swedish Quality Index, Länsförsäkringar has met customers' high expectations for many years and has Sweden's most satisfied retail bank customers for the eighth time in nine years. Länsförsäkringar also has Sweden's most satisfied retail mortgage customers for the eighth consecutive year.

### Objectives

The objectives are to continue to generate profitable growth, have the most satisfied customers and increase the share of customers who have both banking and insurance commitment Länsförsäkringar.

### A strong position

Länsförsäkringar Bank is Sweden's fifth largest retail bank and the market position was strengthened in 2012 with business volumes growing 13% to SEK 283 billion. Business volumes have grown on in all business areas at an average of 12% over the past five years. The number of customers amounts to 954,000, up 7% or 65,000 during the year. The number of customers who have chosen Läns-

försäkringar as their primary bank rose 14% or 35,000 to 290,000, and of these customers, 93% are also insurance customers with Länsförsäkringar. According to the Swedish Quality Index, Länsförsäkringar has Sweden's most satisfied retail bank and mortgage customers. The banking operations have about 1,200 advisors and employees.

## Focus of operations

### Savings

Länsförsäkringar focuses on giving customers secure savings and the offering for planned savings was improved during the year. An Investment Savings Account (ISK) was one of the products launched in January. Deposits from the public increased 26% to SEK 62 billion and the market share strengthened to 4.3% during the year. Deposits are growing stably and are distributed between different types of accounts, such as fixed-income, transaction and savings accounts. The number of deposit accounts rose 17% to 1,200,000 (1,029,000).

### Fund offering

Länsförsäkringar is Sweden's fifth largest fund company with a market share of 3.8%. The fund offering includes some 80 mutual funds, of which 30 are under Länsförsäkringar's own brand. Several of Länsförsäkringar's mutual funds have the highest rating from Morningstar. A number of changes to own mutual funds were made in 2012 in order to further improve them.

Länsförsäkringar Fondförvaltning works responsibly with investments in partnership with the analyst firm GES Investment Services on its own mutual funds. The aim of this partnership is to influence the companies that the mutual funds invest in to encourage them to follow the international conventions and guidelines on such matters as the environment and human rights. The volume of managed mutual funds rose 5% to SEK 70 billion during the year. Mutual funds are available as direct fund savings, Individual Pension Savings (IPS), Investment Savings Accounts (ISK), unit-linked insurance and PPM savings.

### Equities and structured products

Trading in equities and other securities is growing steadily among customers and the number of securities depositories rose during the year. Customers are also offered structured products.

### Household and retail mortgages

Retail mortgages accounted for 71% of total lending. Mortgages up to 75% of the market value on the granting date are deposited with Länsförsäkringar Hypotek and other mortgages are offered by Länsförsäkringar Bank. The credit card for private individuals was one of the new products launched during the year. Loans to the public rose 12% to SEK 150 billion during the year and the market share strengthened to 4.9%.

### Agricultural offering

Länsförsäkringar is the fourth largest company in agricultural loans in Sweden and the percentage of agricultural customers that have both banking and insurance with Länsförsäkringar was 98% at year-end. The offering to farmers, which is broad, was supplemented with a fixed-interest forestry account during the year. The primary target group is family-owned agricultural operations that are offered first-lien mortgages for agricultural and forestry properties. Agricultural loans increased 15% to SEK 19.3 billion and the share of first-lien mortgages for agricultural and forestry properties rose to 86%. Agricultural deposits amounted to SEK 5.3 billion at year-end.

### Small-sized business offering

The offering to small-sized businesses is being continuously developed based on customer needs and volume growth is taking place at a sustained low risk level. Deposits from small-sized businesses are higher than loans to small-sized businesses, and rose 55% to SEK 7.5 billion during the year. Loans to small-sized businesses amounted to SEK 1.6 billion.

### Offering to young people

A favourable offering to young people aged 12–17 was launched in 2012. The offering includes a young person's account with a bank card, Internet and telephone banking and mobile services. Additional services can be added once the account holder has turned 16, such as payment services and higher withdrawals limits.

### Bank cards and payments

Bank cards are being continuously developed to ensure that customers can feel secure and receive a high level of service in their payment services. All bank cards were fully migrated from Mastercard to VISA during the year. Swish was launched at year-end to make it easier for retail customers to pay using their mobile telephones. The service allows for payments to be sent directly to the recipient's account number using the number of the payer's mobile telephone. The number of bank cards rose 13% to 346,000. Income from payment mediation continued to increase in 2012. In-store bank card transactions rose 23% to 69 million and payment transactions increased a total of 15% to 149 million.

## Risks and risk management

Risk management is to be performed by the employees working in the banking operations. Accordingly, risk awareness is prevalent in all day-to-day business decisions. This decentralised method of working and managing risk is a requirement for compliance with the risk tolerance set forth by the Board. The banking operations are to be characterised by a low risk profile whose lending operations focus on private housing and family-owned agricultural operations. The Bank Group's risks can be divided into the following groups:

- Credit risks
- Market risk
- Liquidity risks
- Business risks
- Operational risks

Credit risk consists of the counterparty's inability to fulfil its commitments whereby the Bank Group is affected by a financial loss. Market risks, which primarily comprise interest-rate risk and currency risk, are managed in accordance with a Financial Policy adopted by the Board, which stipulates that interest-rate risks should be as low as possible and that liquidity be invested almost exclusively in Swedish securities with high credit quality. Only 1% of the liquidity reserve comprises foreign (German) government securities. Operational risks are measured against a risk-tolerance scale established by the Board. Business risk mainly comprises earnings risk, and pertains to fluctuations in the Bank Group's earning capacity. The overall guidelines for risk tolerance and the strategies for risk-taking state that volume growth and higher profitability should not be generated at the expense of a higher number or greater risks. This requires that risks inherent in the business activities be independently identified, measured, controlled, valued and reported on a continuous basis and that risks be proportionate to the size, product development and growth of the operations. Total risks are complied and compared with the capital in the Bank Group to ensure a favourable level of capitalisation.

### Board of Directors

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, for example, 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 Bank Group's Compliance, Risk Control and Internal Audit functions, the Board is also responsible for ensuring that the company's regulatory compliance and risks are managed in a satisfactory manner.

### President

The President is responsible for the ongoing administration of the company 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

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 under the supervision of the President and 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 the President and Board. In addition, Risk Control is responsible for the risk-classification system (the IRB Approach) and continuously validating its quantitative components and its use in the operations.

One of the most important tasks for Risk Control is to ensure that the operations have active risk management and that the risk tolerance established by the Board is converted into limits upon which the operations can conduct their activities. Risk Control is responsible for reporting violations of limits to the President and the Board.

Risk Control is responsible for continuously reporting to management, the ALCO and Board. For credit risk, these reports include information on developments and trends in exposure amounts, risk weights and capital requirements. For financial risk, these reports primarily contain information about interest-rate risk and liquidity positions. In addition, the reports include information about operational risk.

## Capital base and capital requirements

In 2012, the bank's capital adequacy target was defined as a Tier 1 ratio of 12 percentage points when Basel II is fully implemented. A deviation of 0.5 percentage points was permitted for the capital 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. Pending a decision on the final structure of the new capital adequacy regulations, the Board of Directors of the bank withdrew the above-mentioned capital target in February 2013. In conjunction with this, the Board made the assessment that the Bank Group's Core Tier 1 ratio should be at approximately 13% and the total capital ratio at approximately 16%. The Board intends to announce a new capital target once the final structure of the capital adequacy regulations has been determined.

### Capital-adequacy analysis

SEK M	Dec 31, 2012	Dec 31, 2011
Tier 1 capital, gross	7,336.0	6,454.0
Less intangible assets	-445.8	-438.6
Less deferred tax assets	-12.3	-6.0
Less/plus IRB deficit/surplus	-265.9	-261.9
<b>Tier 1 capital, net</b>	<b>6,612.0</b>	<b>5,747.4</b>
Tier 2 capital	1,200.0	1,200.0
Deductions for Tier 2 capital	-265.9	-261.9
<b>Total capital base</b>	<b>7,546.1</b>	<b>6,685.5</b>
<b>Risk-weighted assets according to Basel II</b>	<b>48,359.4</b>	<b>47,617.4</b>
<b>Risk-weighted assets according to transition rules</b>	<b>83,233.6</b>	<b>71,572.8</b>
<b>Capital requirement</b>		
Capital requirement for credit risk according to Standardised Approach	678.4	679.3
Total capital requirement for credit risk according to IRB Approach	3,034.2	2,984.2
Capital requirement for operational risk	156.2	145.9
<b>Capital requirement according to Basel II</b>	<b>3,868.8</b>	<b>3,809.4</b>
Adjustment according to transition rules	2,789.9	1,916.4
<b>Total capital requirement</b>	<b>6,658.7</b>	<b>5,725.8</b>
Tier 1 ratio according to Basel II, %	13.7	12.1
Core Tier 1 ratio according to Basel II, %	13.1	11.5
Capital adequacy ratio according to Basel II, %	15.6	14.0
Capital ratio according to Basel II <sup>1)</sup>	1.95	1.75
Tier 1 ratio according to transition rules, %	7.9	8.0
Core Tier 1 ratio according to transition rules, %	7.6	7.6
Capital adequacy ratio according to transition rules, %	9.1	9.3
Capital ratio according to transition rules <sup>1)</sup>	1.13	1.17
<b>Special disclosures</b>		
IRB Provisions surplus (+)/deficit (-)	-531.8	-523.8
- IRB Total provisions (+)	291.1	237.8
IRB Anticipated loss (-)	-822.9	-761.7

<sup>1)</sup> Capital ratio = total capital base/total capital requirement

SEK M	Dec 31, 2012	Dec 31, 2011
<b>Credit risk according to Standardised Approach</b>		
Exposures to institutions	104.4	77.8
Exposures to corporates	167.9	195.2
Retail exposures	108.6	93.1
Exposures secured on residential property	0.0	126.3
Past due items	0.0	0.4
Covered bonds	259.4	169.2
Other items	38.2	17.2
<b>Total capital requirement for credit risk according to</b>	<b>678.4</b>	<b>679.3</b>
<b>Standardised Approach</b>		
Credit risk according to IRB Approach		
Retail exposures	1,537.0	1,420.3
Other retail exposures	709.3	670.5
<b>Total retail exposures</b>	<b>2,246.3</b>	<b>2,090.7</b>
Exposures to corporates	787.1	892.7
Non credit-obligation assets	0.7	0.8
<b>Total capital requirement for credit risk according to IRB Approach</b>	<b>3,034.2</b>	<b>2,984.2</b>
<b>Operational risks</b>		
Standardised Approach	156.2	145.9
<b>Total capital requirement for operational risk</b>	<b>156.2</b>	<b>145.9</b>
<b>Capital-adequacy analysis according to Basel I</b>		
Tier 1 capital	6,877.9	6,009.4
Tier 2 capital	1,200.0	1,200.0
<b>Total capital base</b>	<b>8,077.9</b>	<b>7,209.4</b>
Risk-weighted assets	112,351.2	97,651.5
Capital requirement for credit risk	8,988.1	7,812.1
Tier 1 ratio, %	6.12	6.15
Capital adequacy ratio, %	7.19	7.38
Capital ratio <sup>1)</sup>	0.90	0.92

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

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

Credit risk is defined as the risk of losses occurring as a result of a counterparty not being able to fulfil its commitments to the Bank Group and the risk that the counterparty's pledged collateral will not cover the company's receivables. The Bank Group calculates all retail exposures in accordance with the Advanced Internal Ratings-based Approach (IRB), which corresponds to about 87% (81) of the Bank Group's loan portfolio. This means that a considerable portion of its credit exposure is calculated using a method that aims to identify and classify risk for each individual counterparty. The bank uses the Foundation Internal Ratings-Based Approach for the portion of the loan portfolio pertaining to agricultural operations. The percentage of retail mortgages of the total loan portfolio is 71% (72) and agricultural loans 13% (12). The Standardised Approach is used for other exposures. The lending portfolio is entirely comprised of loans in Sweden, which is well-diversified geographically throughout the country. Concentration risk is primarily attributable to the product concentration in mortgages.

### Credit process

The banking operations carry out balanced and consistent loan origination, with a strong system support. Loan origination is to achieve favourable and homogeneous credit quality. Origination is primarily targeted toward retail mortgages for private individuals and small-scale family-owned agricultural operations with a low risk level. The maximum lending level for various types of loans and limits for the regional insurance companies loan origination are stipulated in the Board's guidelines. Decision-making authorities are dependent on the size of the loans.

The banking operations impose strict requirements in terms of customer selection and customers repayment capacity.

Credit scoring almost exclusively takes place supported by a central, highly automated credit research system, which includes the integrated sub-processes of quality checks, decision-making steps and risk assessments under the IRB Approach. Loan origination is primarily managed by the regional insurance companies, which also have credit responsibility for all loans. The credit rules are established by the bank's Board of Directors and apply to all regional insurance companies.

The regional insurance companies are knowledgeable about their customers, possess excellent local market awareness and have a full-service customer approach that benefits the entire business. The knowledge and credit responsibility of the regional insurance companies, combined with the joint systems support for automated risk classification under the IRB Approach, provides excellent conditions for balanced and consistent loan origination. The regional insurance companies continuously monitor and review the quality of the loan portfolio and borrowers' repayment capacity.

### Credit quality

The loan portfolio exclusively comprises loans in Sweden, with lending for private housing in the form of single-family homes and tenant-owned apartments accounting for 71% (72) of lending. First-lien mortgages with loan-to-value ratios amounting up to 75% of

the market value at the time the mortgage is granted account for the largest percentage of retail mortgages. Low loan-to-value ratios, combined with a well-diversified geographic distribution and local presence, are the core pillars in ensuring that the loan portfolio maintains a high level of credit quality. Loan origination for mortgages takes place at a maximum loan-to-value ratio of 85%.

Loans to the agricultural segment accounted for 13% (12) of the loan portfolio. The lending segment is an excellent complement to the bank's mortgages since a large share pertains to loans to family-owned farming businesses. Together with mortgages, this segment accounts for approximately 84% (84) of the Bank Group's loan portfolio.

### Implementation plan for the IRB Approach

In December 2006, Länsförsäkringar Bank was granted permission by the Swedish Financial Supervisory Authority to apply the advanced 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. After receiving permission in December 2009, the Foundation Internal Ratings-Based Approach was applied to the calculation of the capital requirement for credit risk for exposures to corporates and the agricultural sector. In June 2012, the bank received permission to apply an internal approach for all exposures to corporates and permission to allocate exposures to corporates up to SEK 5 M to the Retail exposure class and thus apply the Advanced IRB Approach to such exposures. These approaches have been applied to calculations of capital requirements since June 30, 2012. Internal models will be implemented by 2014 for other minor loan portfolios in the Bank Group. Permanent exemptions have been granted for exposures to governments, local governments, county councils and banks. 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:

- 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.

PD grade Dec 31, 2012, SEK 000s	PD (%)	EAD
1	0.05	15,945,980
2	0.10	22,181,142
3	0.20	38,629,899
4	0.40	31,925,185
5	0.80	22,765,728
6	1.60	8,631,479
7	3.20	4,192,140
8	6.40	2,446,924
9	12.80	1,557,022
10	25.60	786,028
11	51.20	639,226
Default	100.00	794,793
<b>Total</b>		<b>150,495,546</b>

Comparisons of PD grades	PD (%)	Indicative credit rating from Standard & Poor's
Internal		
1-4	< 0.53	AAA to BBB-
5-6	0.53-2.13	BB+ to BB-
7-8	2.13-8.53	B+ to B-
9-11	> 8.53	C
Default	100	D

The information that is most relevant to each type of counterparty has been taken into consideration in the development of models for calculating PD. The division of PD into grades for retail exposures takes place using models based on predictive statistical analysis (credit scoring), while the division of PD into grades for exposures to corporates, in addition to a strict predictive statistical analysis, is partly based on individual expert assessment. These risk 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 retail exposures. 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 recession. The LGD amounts prescribed by the Financial Supervisory Authority are applied to exposures to corporates with agricultural businesses.

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 unpaid interest and fees. For commitments wholly or partly off the balance sheet, EAD is calcu-

lated by multiplying the counterparty's unutilised amount by a conversion factor (CF). Internal estimates of conversion factors are calculated for retail exposures. 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. The CF amounts prescribed by the Financial Supervisory Authority are applied to exposures to corporates with agricultural businesses.

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 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, 2011 was 1.24%, distributed on the basis of 0.81% for exposures secured by real estate collateral and 2.55% for other retail exposures. The percentage of these exposures in default in 2012 was 0.49%, distributed on the basis of 0.23% for exposures secured by real estate collateral and 2.03% for other retail exposures.

The exposure-weighted LGD estimate for all non-defaulted exposures encompassed by IRB at December 31, 2010 was 28.1%, distributed on the basis of 23.9% for exposures secured by real estate collateral and 53.6% for other retail exposures. The actual loss rate for the exposures in default in 2011 was 15.7% for exposures secured by real estate collateral and 60.2% for other retail exposures. The calculation of actual loss rates took into account recoveries up to and including December 31, 2012, 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, 2010 was 0.43%, distributed on the basis of 0.23% for exposures secured by real estate collateral and 1.65% for other retail exposures. The percentage of these exposures in default in 2011 was 0.17%, distributed on the basis of 0.03% for exposures secured by real estate collateral and 1.19% for other retail exposures. Most loan losses derive from unsecured loans and personal accounts with only one borrower.

### Loan receivables and accounts receivable

Loans receivable and accounts receivable are financial assets that are not derivatives, that have fixed or fixable payments and that are not listed on an active market. These receivables are represented by the balance-sheet items "Loans to credit institutions," "Loans to the public" and "Other assets" in the balance sheet. For further information, see Länsförsäkringar Bank's 2012 Annual Report.

## Impaired loans

A loan receivable is considered impaired if a payment is more than 60 days past due or if the counterparty for other reasons cannot meet its undertaking. The loan receivable is considered impaired to the extent that its whole amount is not covered by collateral. A non-performing loan receivable has a non-performing payment that is more than nine days and up to 60 days past due. This analysis pertains exclusively to loans to the public.

There are no loans within the banking and mortgage operations whose terms were renegotiated during the year and that would otherwise have been recognised as impaired.

Agreements concerning payment plans are made to a limited extent within the leasing and hire purchase operations if it is deemed beneficial for the customer and lessor.

Impaired loans amounted to SEK 298 M (233), corresponding to 0.19% (0.17) of the total loan portfolio before reserves. Loan losses totalled SEK 91 M (48), corresponding to a loan loss of 0.06% (0.04). Impaired loans and loan losses continued to account for a minor percentage of total loans.

Impaired loans by product, SEK M	Dec 31, 2012	Dec 31, 2011
Retail mortgages	5.4	2.7
Agricultural loans	4.1	0.3
Unsecured loans	112.5	114.8
Leasing	115.7	69.3
Hire purchase	46.5	37.6
Multi-family housing	–	–
Industrial properties	–	–
Other	13.7	8.7
<b>Total</b>	<b>297.9</b>	<b>233.4</b>

Non-performing loan receivables not included in impaired loans, SEK M	Dec 31, 2012	Dec 31, 2011
Receivables overdue by 10–19 days <sup>1)</sup>	0.8	0.0
Receivables overdue by 20–39 days	472.7	292.7
Receivables overdue by 40–60 days	30.3	5.9
<b>Total</b>	<b>503.8</b>	<b>298.6</b>

<sup>1)</sup> Excluding Wasa Kredit.

Non-performing loan receivables not included in impaired loans, Dec 31, 2012, SEK M	Länsförsäkringar Bank	Länsförsäkringar Hypotek	Wasa Kredit	Group
Receivables overdue by 10–19 days <sup>1)</sup>	0.4	0.3	0.0	0.8
Receivables overdue by 20–39 days	87.6	66.2	319.0	472.7
Receivables overdue by 40–60 days	0.1	12.2	18.0	30.3
<b>Total</b>	<b>88.1</b>	<b>78.7</b>	<b>337.0</b>	<b>503.8</b>

<sup>1)</sup> Excluding Wasa Kredit.

## Impairment

A continuous assessment is made as to whether objective circumstances exist, suggesting indications of impairment for both impaired loans and the part of the loan portfolio where the assessment is that cash flow has deteriorated. Indications of impairment are based on objective circumstances, for example delayed or non-payment, bankruptcy or a decline in the value of the collateral, and on a reduced repayment capacity according to risk-based assessments and assumptions.

## 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 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.

Derivatives, fair value SEK M	Positive values Dec 31, 2012
AA-/Aa3	–
A+/A2	518.3
A/Aa2	188.5
A+/Aa3	–
A/A2	–
<b>Total</b>	<b>706.8</b>

Positive and negative values netted per counterparty. Only positive values, netted, are included in the table.

## 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 great. 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 Financial Supervisory Authority. As this reporting is completed, a quarterly report is prepared detailing all exposure that exceeds 10% of the capital base.

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, 2012	Average 2012
<i>Exposure classes, IRB Approach</i>		
Retail exposures	133,846,444	126,217,133
Exposures to corporates	16,648,988	16,400,212
Non credit-obligation assets	9,164	10,050
<b>Total IRB Approach</b>	<b>150,504,596</b>	<b>142,627,395</b>
<i>Exposure classes, Standardised Approach</i>		
Governments and central banks	8,121,568	7,557,612
Regional and local authorities	1,925,449	1,317,718
Exposures to institutions	6,941,480	6,807,230
Exposures to corporates	2,098,456	2,253,946
Retail exposures	1,809,994	1,806,523
Exposures secured on residential property	0	976,609
Past due items	0	2,097
Exposures in the form of covered bonds	32,426,162	30,329,407
Other items	1,446,547	1,302,836
<b>Total Standardised Approach</b>	<b>54,769,683</b>	<b>52,353,976</b>

## Eligible collateral

Dec 31, 2012, SEK 000s	EAD	Secured through eligible collateral
<i>Exposure classes, IRB Approach</i>		
Exposures to corporates	16,648,988	14,405,123
<b>Total IRB Approach</b>	<b>16,648,988</b>	<b>14,405,123</b>
<i>Exposure classes, Standardised Approach</i>		
Governments and central banks	8,121,568	0
Regional and local authorities	1,925,449	0
Exposures to institutions	6,941,480	0
Exposures to corporates	2,098,456	0
Retail exposures	1,809,994	0
Exposures secured on residential property	0	0
Past due items	0	0
Exposures in the form of covered bonds	32,426,162	0
Other items	1,446,574	0
<b>Total Standardised Approach</b>	<b>54,769,683</b>	<b>0</b>

## EAD for exposures secured by real estate collateral, by geographic region

Dec 31, 2012, SEK 000s Geographic division	Retail exposures		Exposures to corporates	
	EAD	Proportion of EAD (%)	EAD	Proportion of EAD (%)
Western Sweden	24,660,844	21.7	3,140,923	21.8
Eastern Central Sweden	24,742,220	21.8	4,122,708	28.6
Stockholm	16,360,917	14.4	1,140,610	7.9
Southern Sweden	15,171,281	13.3	2,501,698	17.4
Northern Central Sweden	11,524,062	10.1	677,434	4.7
Småland	11,625,468	10.2	2,010,330	14.0
Northern Norrland	5,191,730	4.6	390,218	2.7
Central Norrland	4,372,659	3.8	421,202	2.9
<b>Total</b>	<b>113,649,181</b>	<b>100.0</b>	<b>14,405,123</b>	<b>100.0</b>

## EAD, by contractual maturity<sup>1)</sup>

Dec 31, 2012, 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	87,785,787	4,759,190	9,938,741	26,270,727	4,358,998	733,000
Exposures to corporates	10,919,562	591,990	1,236,267	3,267,782	542,210	91,177
Non credit-obligation assets	9,164	0	0	0	0	0
<b>Total IRB Approach</b>	<b>98,714,513</b>	<b>5,351,179</b>	<b>11,175,008</b>	<b>29,538,510</b>	<b>4,901,209</b>	<b>824,177</b>
<i>Exposure classes, Standardised Approach</i>						
Governments and central banks	3,371,050	0	0	3,817,245	933,273	0
Regional and local authorities	3,682	8,812	20,985	1,370,984	506,704	14,282
Exposures to institutions	4,287,348	3,948	4,268	2,431,563	8,191	206,161
Exposures to corporates	1,376,313	74,615	155,820	411,875	68,341	11,492
Retail exposures	1,187,120	64,358	134,401	355,257	58,946	9,912
Exposures secured on residential property	0	0	0	0	0	0
Past due items	0	0	0	0	0	0
Exposures in the form of covered bonds	0	3,117,147	3,200,482	20,996,095	5,112,438	0
Other items	1,446,574	0	0	0	0	0
<b>Total Standardised Approach</b>	<b>11,672,086</b>	<b>3,268,880</b>	<b>3,515,956</b>	<b>29,383,019</b>	<b>6,687,894</b>	<b>241,847</b>

## Average risk weight for IRB exposures

Dec 31, 2012, SEK 000s	Exposure	EAD	RW (%)	Risk-weight assets	Capital requirement
<i>Exposure classes, IRB Approach</i>					
Retail exposures	134,526,274	133,846,444	21	28,079,009	2,246,321
Exposures to corporates	16,862,484	16,648,988	59	9,839,336	787,147
Non credit-obligation assets	9,164	9,164	100	9,164	733
<b>Total IRB Approach</b>	<b>151,397,922</b>	<b>150,504,596</b>	<b>25</b>	<b>37,927,509</b>	<b>3,034,201</b>
<i>Exposure classes, Standardised Approach</i>					
Governments and central banks	8,121,568	8,121,568	0	0	0
Regional and local authorities	2,032,003	1,925,449	0	0	0
Exposures to institutions	6,953,956	6,941,480	19	1,304,485	104,359
Exposures to corporates	2,497,007	2,098,456	100	2,098,456	167,876
Retail exposures	6,289,421	1,809,994	75	1,357,496	108,600
Exposures secured on residential property	0	0	0	0	0
Past due items	0	0	0	0	0
Exposures in the form of covered bonds	32,426,162	32,426,162	10	3,242,616	259,409
Other items	1,446,574	1,446,574	33	476,993	38,159
<b>Total Standardised Approach</b>	<b>59,766,691</b>	<b>54,769,683</b>	<b>15</b>	<b>8,480,046</b>	<b>678,404</b>

## Distribution by PD grade

PD grade	Retail exposures					
	Exposures secured by real estate collateral		Other retail exposures		Exposures to corporates	
	EAD	RW (%)	EAD	RW (%)	EAD	RW (%)
Dec 31, 2012, SEK 000s						
1	13,960,971	3	674,657	5	1,310,352	16
2	19,425,757	6	2,215,012	12	540,372	25
3	30,245,086	10	3,042,794	15	5,342,019	37
4	25,319,656	17	3,650,220	29	2,955,310	52
5	15,988,059	27	3,610,244	45	3,167,425	71
6	4,266,291	43	2,953,182	64	1,412,006	89
7	1,755,506	61	1,724,088	71	712,546	105
8	1,261,318	93	816,604	78	369,002	130
9	601,782	118	577,314	89	377,926	172
10	317,860	146	325,394	119	142,773	211
11	275,926	131	202,873	126	160,427	195
Default	230,969	293	404,994	126	158,830	0
<b>Total</b>	<b>113,649,181</b>	<b>17</b>	<b>20,197,376</b>	<b>44</b>	<b>16,648,988</b>	<b>59</b>

## Exposure-weighted LGD for IRB exposures

Dec 31, 2012	Exposure-weighted LGD (%) <sup>1)</sup>
Retail exposures	25.2

<sup>1)</sup> Note that this value is forward-looking as of December 31, 2012.

## Unutilised undertakings for IRB exposures

Dec 31, 2012, SEK 000s	Exposure	Average CF (%)
Retail exposures	3,041,299	82.1

## Loan losses, net

SEK M	2012	2011
<b>Specific reserve for individually assessed loan receivables</b>		
Write-off of confirmed loan losses during the year	-136.2	-92.7
Reversed earlier impairment of loan losses recognised in the year-end accounts as confirmed losses	102.8	92.5
Impairment of loan losses during the year	-147.7	-200.7
Payment received for prior confirmed loan losses	85.4	41.5
Reversed impairment of loan losses no longer required	22.4	62.2
Covering of losses from related companies	-	-
<b>Net expense for the year for individually assessed loan receivables</b>	<b>-73.3</b>	<b>-97.2</b>
<b>Collective reserves for individually assessed receivables</b>		
	-	-
<b>Collectively assessment of homogenous groups of loan receivables with limited value and similar credit risk</b>		
Provision/reversal of impairment for loan losses	-19.1	48.7
<b>Net expense for the year for collectively assessed receivables</b>	<b>-19.1</b>	<b>48.7</b>
Net expense for the year for fulfilment of guarantees	1.1	0.3
<b>Net expense of loan losses for the year</b>	<b>-91.3</b>	<b>-48.2</b>

All information pertains to receivables from the public.

## Loans to the public

Loan receivables are geographically attributable in their entirety to Sweden.

SEK M	Dec 31, 2012	Dec 31, 2011
<b>Loan receivables, gross</b>		
Public sector	982.0	2,246.1
Corporate sector	12,754.8	9,658.6
Retail sector	136,530.5	122,390.4
Other	0.0	0.0
<b>Total loan receivables, gross</b>	<b>150,267.3</b>	<b>134,295.1</b>

<b>Impairment of individually reserved loan receivables</b>		
Corporate sector	-69.1	-61.3
Retail sector	-135.3	-120.6
<b>Total individual reserves</b>	<b>-204.4</b>	<b>-181.9</b>

<b>Impairment of collectively reserved loan receivables</b>		
Corporate sector	-32.4	-24.0
Retail sector	-88.6	-77.9
Other	0.0	0.0
<b>Total collective reserves</b>	<b>-121.0</b>	<b>-101.9</b>
<b>Total impairment</b>	<b>-325.4</b>	<b>-283.8</b>

<b>Loan receivables, net</b>		
Public sector	982.0	2,246.1
Corporate sector	12,653.3	9,575.3
Retail sector	136,306.6	122,191.9
Other	0.0	0.0
<b>Total loans to the public</b>	<b>149,941.9</b>	<b>134,011.3</b>

Remaining term of not more than 3 months	1,605.1	2,921.1
Remaining term of more than 3 months but not more than 1 year	5,051.0	3,599.6
Remaining term of more than 1 year but not more than 5 years	10,693.0	9,212.3
Remaining term of more than 5 year	134,082.0	118,529.4
Without maturity	0.0	-152.2
<b>Total nominal cash flows</b>	<b>151,431.0</b>	<b>134,110.2</b>

<b>Impaired loans</b>		
Corporate sector	132.9	87.8
Retail sector	165.0	145.5
<b>Total impaired loans</b>	<b>297.9</b>	<b>233.3</b>

### 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 for any other reason cannot meet its undertaking. The loan receivable is considered impaired to the extent that its whole amount is not covered by collateral.

## Reconciliation of impairment of loan losses

SEK M	Dec 31, 2012			Dec 31, 2011		
	Individual impairments	Collective impairments	Total	Individual impairments	Collective impairments	Total
<b>Opening balance</b>	<b>-181.9</b>	<b>-101.9</b>	<b>-283.8</b>	<b>-135.8</b>	<b>-150.7</b>	<b>-286.5</b>
Reversed earlier impairment of loan losses recognised in the year-end accounts as confirmed losses	102.8	-4.3	98.5	92.5	0.0	92.5
Reversed impairment of loan losses no longer required	22.3	-14.8	7.5	62.1	48.8	110.9
Impairment of loan losses during the year	-147.6	0.0	-147.6	-200.7	0.0	-200.7
<b>Closing balance</b>	<b>-204.4</b>	<b>-121.1</b>	<b>-325.4</b>	<b>-181.9</b>	<b>-101.9</b>	<b>-283.8</b>

## Market and liquidity risks

The overall framework for the financial operations in the Bank Group is defined in the Financial Policy adopted by the Board. The Financial Policy stipulates the Board's approach to the management of market and liquidity risks.

### Interest-rate risk

Interest-rate risk arises if assets, liabilities and derivatives do not have matching fixed-interest periods. Whenever possible, fixed lending should be matched by means of corresponding funding 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 the effect of a one percentage point parallel shift in the yield curve. On December 31, 2012, an increase in market interest rates of 1 percentage point would have resulted in an increase in the value of interest-bearing assets and liabilities, including derivatives, of SEK 70 M (33).

### 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 funding that takes place in a foreign currency is swapped before settlement in SEK in accordance with the Financial Policy to eliminate currency risk.

### Liquidity risk and financing strategy

The Board of Directors of Länsförsäkringar Bank AB decides on a Financial Policy every year which provides a framework for the financial operations of the bank and its subsidiaries. The Board stipulates the objective of market and liquidity risks management in this Policy.

The Board's main target is that liquidity and financing management should be assured by maintaining suitable long-term planning, explicit functional definitions and a high level of control. Limits and guidelines have been established for each type of risk in both the bank's own operations and the Bank Group, and are updated whenever necessary.

The Board also decides on a liquidity and financing strategy, which is based on the business plan for the forthcoming year and supports the fulfilment of established business objectives and financial risk management. Deviations for the established business plan result in updates to the liquidity and financing strategy. This strategy is determined annually and is reviewed at least every six months and continuously by the ALCO, and is updated whenever necessary. Major material deviations are immediately reported to the Board.

Liquidity risks are to be minimised as far as possible. Future liquidity requirements and access to funds are secured by preparing accurate forecasts for the next 12-month period. The strategy is specified in a financing plan containing key figures and targets for fulfilment of the objectives designated by the Board. The financing

plan is prepared every year and adopted by the CFO. The plan is reviewed every day in relation to targets by weekly reports to the CFO. Updates are made as necessary within the framework stipulated in the liquidity and financing strategy and the Financial Policy.

A satisfactory liquidity reserve is to be in place to ensure that sufficient liquidity is always available. The management of and investments in the reserve take place in accordance with the established limits stated in the Financial Policy.

Internal pricing is to reflect the actual cost of maintaining the required liquidity levels to achieve transparency and correct business governance.

### Liquidity reserve

The liquidity reserve totalled a nominal amount of SEK 37.5 billion (30.5) at December 31, 2012. The liquidity reserve is invested in securities with very high credit quality, of which 77% comprises Swedish covered bonds, 18% Swedish government bonds, 4% other Swedish bonds with the credit rating of AAA/Aaa, and 1% German government securities.

The liquidity of the investments is high and all Swedish securities included in the liquidity reserve are eligible for transactions with the Riksbank and, where appropriate, with the ECB.

By utilising the liquidity reserve, contracted undertakings for about 1.5 years can be met without needing to secure new funding in the capital market. The Group's Liquidity Coverage Ratio (LCR) amounted to an average of 248% during the fourth quarter of 2012.

The LCR in EUR amounted to 158% on December 31, 2012.

### Liquidity management

Liquidity risk is managed by the Treasury unit. 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. The liquidity portfolio is continuously subjected to stress tests according to three scenarios. These scenarios illustrate how long cash and cash equivalents will last, given that

- The operations are being conducted according to plan but no market financing is available
- The growth in loans and deposits remains unchanged, while no market financing is available
- The growth in loans remains unchanged and deposits declined, while no market financing is available.

The Treasury unit is also responsible for the liquidity portfolio. Daily report follow-ups are conducted on the size and structure of the liquidity portfolio. Accordingly, liquidity can be monitored daily based on these reports. The liquidity portfolio is dimensioned to be able to handle approximately three months of normal operations without funding activities in the capital market, under all circumstances. Normal operations also encompass the expected growth of the loan portfolio. 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 funding cash and cash equivalents at a significantly higher cost. This definition is closely linked to the definition

of financing risk. 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 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.

### Contingency plans

Plans for managing disruptions that affect the Bank Group's liquidity are in place and updated annually. A contingency plan group has been appointed and action plans prepared and adopted by the ALCO.

### General objectives of refinancing strategy

The general objective of funding is to ensure that the operations have the requisite refinancing for both the short and long terms and for the desired maturity periods. In addition, funding should contribute to the overall profitability and competitiveness of the operations by managing the price and composition of liabilities to ensure that they are in line with those of relevant competitors. Targets are set to control various activities in terms of the market, instruments and composition of funding and are based on the following two objectives.

Funding is to:

- Secure the short and long-term capital requirements
- Ensure that the price of debt securities in issue is in parity with the prices of relevant competitors.

### Strategy for ensuring short and long-term refinancing

The Group regularly meets with both current and potential investors to ensure that these investors have a clear overview of the

operations that facilitates the existence of limits and a willingness to invest in the Group's securities over time. The Group's refinancing activities are also based on diversification in terms of a variety of investors and markets. To ensure the success of diversification, the Group also needs to issue the type of securities sought after by the investors in each selected market. This secures access to refinancing over time. The instruments that the Bank Group is permitted to use are regulated in the Financial Policy. Investor activities encompass banks, fund managers, insurance companies and central banks. Furthermore, as part of these activities the Group strives to ensure that as favourable liquidity as possible is maintained in the Group's investments. This also aids the work to secure refinancing options.

Bonds and other interest-bearing securities	Dec 31, 2012, SEK M	Dec 31, 2011, SEK M
AAA/Aaa	31,111.7	20,628.2
<b>Total</b>	<b>31,111.7</b>	<b>20,628.2</b>

### 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 funding 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 Financial Policy also stipulates that the average term of funding is to exceed the average term of the loan portfolio. In recent years, the Bank Group has also had a stable rating from Standard & Poor's and Moody's. In addition, Länsförsäkringar Hypotek's covered bonds have the highest rating from both Moody's and Standard & Poor's.

## Business risk

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 mortgages. Retail mortgages have 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.

## Operational risks

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 risk
- 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 scenario 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:

- Consequence – how will the operations 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.

## Future capital adequacy rules

Basel III is a new international capital adequacy and liquidity standard that was adopted by the Basel Committee on Banking Supervision in December 2010. This third Basel agreement was produced in response to the shortcomings in the current banking-supervision regulations, which came to the fore during the recent global financial crisis. In brief, Basel III involves higher capital-requirement levels, changes to what may be credited as capital, changed calculations of capital requirements, new rules regarding liquidity risk and the introduction of a non-risk-sensitive leverage ratio.

### Basel III to be implemented in the EU through CRD IV/CRR

Basel III will be implemented into EU law through a revised Capital Requirement Directive (CRD IV) and a Capital Requirements Regulation (CRR), pending a decision in 2013, and will subsequently be implemented over a six-year period and be fully implemented by 2019.

The directive comprises such areas as bank authorisation, supervision principles (including Pillar II measures), corporate governance, capital buffers and sanctions. The directive contains more detailed provisions in regard to the capital base, calculation of capital requirements for credit risk, market risk and operational risk, and regulations for large exposures, liquidity, gross leverage and disclosure requirements. By establishing detailed provisions in the form of a regulation (CRR), the aim is to create conditions for a harmonised framework for all European banks and thereby avoid divergences in national rules.

### Capital base

The proposed new capital adequacy regulations contain a revised definition of the capital base. The aim is to provide incentive for banks to hold the highest quality form of capital, thus strengthening the loss-absorption capacity of the financial system.

In future, the dominant form of Tier 1 capital will be ordinary shares and/or retained earnings. Requirements for including instruments in the Core Tier 1 capital will also become stricter and deductions from the capital base will primarily be taken from the Core Tier 1 capital rather than other parts of the capital base, which is often the case today.

According to the applicable proposal for CRD IV/CRR, these adjustments will be introduced gradually and be fully implemented as of 2018.

### Capital requirement

Implementation of the CRD IV/CRR will apply the following minimum standards on bank capital adequacy:

- Minimum common equity Tier 1 of 4.5%
- Minimum Tier 1 of 6%
- Minimum total capital of 8% (unchanged in relation to current regulations)

The minimum standards on common equity Tier 1 and Tier 1 will be introduced gradually and be fully implemented as of 2015. However, the regulations also allow Member States to implement the changes more quickly.

In addition to minimum standards on bank capital adequacy above, the CRD IV/CRR also contain a number of capital buffers:

- Capital Conservation Buffer amounting to 2.5% of risk-weighted assets,
- Counter-cyclical buffer of between 0 to 2.5% of risk-weighted assets
- Buffer for system risk, of which the amount is proportionate to the bank's significance for the financial system

Breaching any of these buffers will entail restrictions on a bank's opportunities to distribute capital, such as dividends and repurchasing shares, or paying bonuses to employees.

### Risk-weighted assets

For banks that apply an IRB Approach to the calculation of risk-weighted assets for credit risk, the current regulatory framework contains a transition rule, prescribing that risk-weighted assets must not be less than 80% of the risk-weighted assets required under Basel I. This floor requirement should have expired by December 2012, but according to the current proposal, the transition rules will continue to apply until at least December 31, 2014. Implementation of the CRD IV/CRR will also entail that the calculation of risk-weighted assets for counterparty credit risk, such as derivative transactions will become more stringent.

In November 2012, the Financial Supervisory Authority also published a proposal for the implementation of a risk weight floor of 15% for Swedish mortgage portfolios. This risk weight floor will be introduced as part of the Financial Supervisory Authority's combined capital assessment (Pillar II) by companies under supervision. Since implementation of the risk weight floor is proposed as part of Pillar II, the recognised capital ratios will not be affected since these calculations were conducted under Pillar I. The floor entails that institutions must hold a higher amount of capital, where they do not at present hold capital that exceeds the floor level for the Swedish mortgages.

### New liquidity risk regulations

Implementation of the CRD IV/CRR also entails new regulations regarding liquidity risk, in the form of quantitative requirements for the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).

Briefly, the LCR aims to regulate the amount of liquid assets a company needs to hold in its liquidity reserve in order to manage a situation where financial markets are principally closed for a period of 30 days. If a bank has liquidity problems, it must be possible to

convert the liquidity reserve into cash, thus enabling management of the outflows that take place during the period. The requirement is expressed as a ratio comparing the relationship between the liquid assets and the net cash flow during a 30 calendar-day stress scenario.

Sweden has chosen not to await EU regulations on liquidity risk and has introduced quantitative LCR requirements for credit institutions, securities companies and financial corporate groups with total assets in excess of SEK 100 billion. These Swedish rules are valid from January 1, 2013.

As a supplement to the LCR, a long-term, structural measurement known as the NSFR has also been introduced. The purpose of this measurement is to ensure that banks increasingly finance their long-term assets with long-term liabilities. The idea is that the financial system will become more stable if banks better match the durations in their financing. However, international discussions around the NSFR have not progressed as far as for the LCR and implementation is not expected until 2018 at the earliest, following a more detailed evaluation.

## 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 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.

A methodology document is also produced 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 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 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.