

Länsförsäkringar Bank

# 2018

Risk and capital management



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# 1 | Introduction

This document "Risk and capital management Länsförsäkringar Bank AB" has been prepared in accordance with the requirements set out in the Regulation CRR (EU) 575/2013 and the Capital Requirements Directive CRD 2013/36/EU. The purpose of the document is for the institution to provide detailed and clear information on the risks to which the institution is exposed, the structure of its risk management and the compliance of the institution's capital situation with the regulatory capital requirements.

The Bank Group comprises the Parent Company Länsförsäkringar Bank AB and its subsidiaries, Länsförsäkringar Hypotek AB, Wasa Kredit AB and Länsförsäkringar Fondförvaltning AB (referred to below as the "Bank Group").

With the introduction of CRR and CRD IV, the parent mixed financial holding company, Länsförsäkringar AB, is also subject to prudential and reporting requirements. As a result, Länsförsäkringar AB is consolidated with the Bank Group. The consolidated situation comprises Länsförsäkringar AB, Länsförsäkringar Bank AB, Länsförsäkringar Hypotek AB, Wasa Kredit AB, Länsförsäkringar Fondförvaltning AB and the property company Utile Dulci 2 HB (referred to below as the "Consolidated Situation"). The comparative period is per 31 December 2017.

## 1.1 LÄNSFÖRSÄKRINGAR BANK AB IN BRIEF

### 1.1.1 Strategy and goals

Länsförsäkringar Bank AB was founded in 1996 and is the fifth largest retail bank in Sweden with a business volume of SEK 561 billion. The banking operations are conducted only in Sweden and business volumes are continuing to grow in all areas. The strategy is to offer banking services to the Länsförsäkringar Alliance's customers and leverage Länsförsäkringar's strong brand and local presence through the customer-owned regional insurance companies. The banking operations have a large potential customer base with the Länsförsäkringar Alliance's slightly more than 3.9 million customers. The main target groups are the 3.2 million retail customers, of whom 2.4 million are home-insurance customers. Other target groups are agricultural customers and small businesses. The aim is, based on low risk, to maintain healthy growth in volumes and profitability, have the most satisfied customers and increase the share of customers who have both banking and insurance with Länsförsäkringar. According to the 2018 Swedish Quality Index customer satisfaction survey, Länsförsäkringar Bank is the player on the banking market with the most satisfied retail customers, an accolade that Länsförsäkringar Bank has won 13 times in the past 15 years. For the second time, Länsförsäkringar was also named the player with the most satisfied mortgage customers. This is confirmation of the banking operations' clear customer focus and high quality. With a comprehensive banking and insurance offering from Länsförsäkringar, customers receive a secure, total solution for their private finances.

### **Customer ownership**

The Länsförsäkringar Alliance consists of 23 local, customer-owned regional insurance companies and the jointly owned Länsförsäkringar AB, which is Länsförsäkringar Bank AB's Parent Company. The insurance customers own the regional insurance companies, which means that the principles of customer ownership also apply

to the banking operations. Long-term respect for customers' security is fundamental to Länsförsäkringar, since customers are both the principal and owner. The Bank Group has low risk tolerance, which provides a stable performance over time. Lending is characterised by low risk and the in-depth, local customer and market knowledge of the regional insurance companies, combined with the conservative view of risk, generates growth with high credit quality.

### **Customer meetings and local market knowledge**

The regional insurance companies are responsible for the local business operations and customer relationships. Business decisions are made locally and the regional insurance companies' commitment and network provide broad and in-depth customer and market knowledge. Banking services are offered at the 128 branches of the regional insurance companies throughout Sweden. Trust, security and long-term relationships – high priorities for Länsförsäkringar – are created through personal customer meetings.

### **Forefront of digital services**

That bank's goal is to be the leading company in digital banking, and digital services are an important supplement to local customer meetings. The digital services in the mobile app and Internet bank make it convenient and easy for customers to do all their banking. The renewal of Länsförsäkringar Bank's platform for deposits, lending and payments entered the final stage in 2018. The new platform, which will be implemented in 2019, will mean a major shift in the bank's ability to develop the digital offering and create opportunities to further advance the bank's position in this area.

### **Customer-driven and effective business model**

Länsförsäkringar Bank supports the regional insurance companies in their customer meetings and sales. Product development takes place in close cooperation between the regional insurance companies and Länsförsäkringar Bank. This cooperation features continuous efficiency enhancements to implement improvements that lead to improved service to customers, more efficient processes and lower expenses.

### **A strong brand**

Länsförsäkringar Bank's successful growth and position in the market is based on customer ownership as well as Länsförsäkringar's strong brand and local presence.

### **Risk in the operations**

The operations are characterised by a low risk profile. The Bank Group is exposed to a number of risks, primarily comprising credit risk, liquidity risk, operational risk and market risk. The macroeconomic situation in Sweden is critical for credit risk, since all loans are granted in Sweden. Loan losses remained low. The Bank Group has highly diversified funding and a liquidity reserve comprising securities with high liquidity and creditworthiness. Lending improved to SEK 290 billion (261) and the loan portfolio continued to maintain high credit quality.

### **Rating**

Länsförsäkringar Bank's long-term credit rating is A/Stable from Standard & Poor's and A1/Stable from Moody's. The short-term credit ratings are A-1 from Standard & Poor's and P-1 from Moody's. Länsförsäkringar Hypotek's covered bonds maintained the highest credit rating of Aaa from Moody's, and AAA/Stable from Standard & Poor's. Länsförsäkringar Hypotek is thus one of three issuers in the Swedish market for covered bonds with the highest rating from both Standard & Poor's and Moody's.

### **Regulatory development**

The development of new financial regulations is expected to continue at a rapid pace and will have a major impact on banks moving forward. Several agreements were reached on the "banking package" at the end of 2018. Final approval is expected at the start of 2019 and parts of the banking package are expected to come into effect in 2021. The measures in the banking package are to aid the implementation of risk-reduction global standards at EU level and are also part of completing the Banking Union.

The work on completing the Basel III regulations is in progress. The Basel Committee presented its revisions in December 2017. These revisions entail major changes for banks and include restrictions on the use of internal models, changes to the Standardised Approach and the introduction of a capital floor. The purpose of the changes is to introduce standardised capital requirements and reduce the risk of unwarranted differences between countries and

banks. The European Commission has not yet presented a bill. The new rules are expected to take effect in 2022.

In December 2018, the Swedish National Debt Office established its annual decisions on resolution plans and minimum requirement for own funds and eligible liabilities (MREL) for the institutions that the Debt Office deems to be systemically important, which includes Länsförsäkringar Bank. The Debt Office also decided on individual minimum requirements for Länsförsäkringar Bank's subsidiaries, Länsförsäkringar Hypotek and Wasa Kredit, that will start to apply in 2019.

The application of the risk weight floor for Swedish mortgages was changed at the end of 2018. As a result, the capital requirement that is currently applied in Pillar II will be replaced by a capital requirement in Pillar I. This change means that the capital requirement will increase in Pillar I but is unchanged in nominal terms.

The implementation of the new accounting standard on leases, IFRS 16, was completed during the year. The new standard will impact how leases are recognized in the balance sheet and income statement going forward.

In addition to capital adequacy and accounting-related rules, the Bank is also impacted by other operational regulations. Examples include changes to the PSD2 Payment Services Directive that will come into effect in autumn 2019.

Länsförsäkringar Bank AB maintains high readiness and is well capitalised for impending changes, even if it is slightly unclear at this stage what the effects will be.

## 2 | Organisation

This section describes the Consolidated Situation based on the consolidation requirements of the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV) and how these differ from the consolidation requirements under accounting regulations.

### 2.1 The Bank Group

The accounting regulations define the Bank Group based on its legal ownership structure and on Länsförsäkringar Bank AB. The Bank Group comprises Länsförsäkringar Bank AB, and the wholly owned subsidiaries Länsförsäkringar Hypotek AB, Wasa Kredit AB and Länsförsäkringar Fondförvaltning AB.

### 2.2 Consolidated Situation

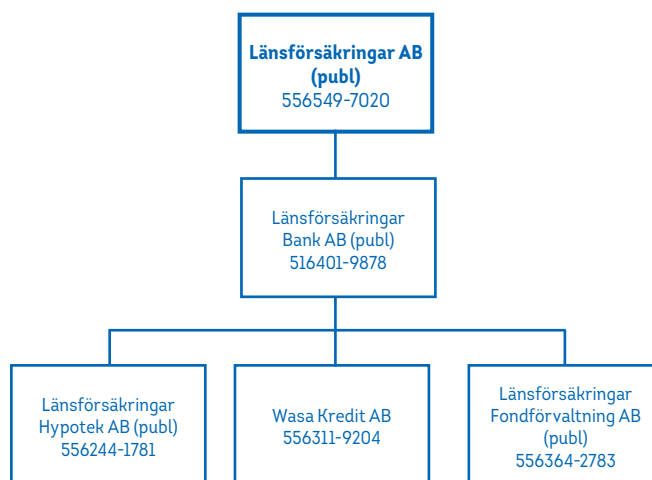
The Consolidated Situation encompasses: Länsförsäkringar AB, Länsförsäkringar Bank AB, Länsförsäkringar Hypotek AB, Wasa Kredit AB, Länsförsäkringar Fondförvaltning AB and the property company Utile Dulci 2 HB. Länsförsäkringar AB owns 46% of the property company and it is considered to be an associated company in the Consolidated Situation. This structure is defined in the CRR and CRD IV as the Consolidated Situation and its composition does not correspond to the accounting structure.

In addition to Länsförsäkringar Bank AB, Länsförsäkringar AB has the subsidiaries of Länsförsäkringar Fondliv Försäkrings AB, Länsförsäkringar Sak Försäkrings AB and Länsförsäkringar Liv Försäkrings AB. These companies are not subject to prudential requirements for credit institutions and are thus not included in the Consolidated Situation. They are instead subject to the solvency rules for insurance companies. Only capital from companies

included in the Consolidated Situation may be included in own funds. The capital adequacy rules impose requirements that investments in financial entities above a certain level are to be deducted from own funds. For more information about the Group, refer to Länsförsäkringar AB's Annual Report.

There is no current or foreseen material practical or legal impediment in the Consolidated Situation for transferring funds from own funds or repayment of liabilities between parent company and subsidiary.

**Figure 2.1 Legal entities in the Consolidated Situation<sup>1)</sup>**



All of the Boards of Directors of the companies have their registered offices in Stockholm.

<sup>1)</sup> The Consolidated Situation also includes Utile Dulci 2 HB.

**Table 2.1 Carrying amount and Parent Company's participating interests**

Company name	Carrying amount SEK M	Parent Company's participating interest (%)	Corporate Registration Number	Consolidation method
<b>Länsförsäkringar AB Parent Company</b>				
Länsförsäkringar Bank AB	9,229.6	100	516401-9878	Complete
Länsförsäkringar Fondliv Försäkrings AB	5,305.4	100	516401-8219	Deducted from own funds
Länsförsäkringar Sak Försäkrings AB	3,206.5	100	502010-9681	Deducted from own funds
Länsförsäkringar Liv Försäkrings AB	8.2	100	516401-6627	Deducted from own funds
Utile Dulci 2 HB	1,016.8	45.6	916601-0067	Complete
<b>Länsförsäkringar Bank AB Parent Company</b>				
Länsförsäkringar Hypotek AB	8,560.5	100	556244-1781	Complete
Länsförsäkringar Fondförvaltning AB	165.0	100	556364-2783	Complete
Wasa Kredit AB	1,039.8	100	556311-9204	Complete

# 3 | Risk management and risk governance

This section outlines the Consolidated Situation's risks and the Board's risk appetite. It also explains how risks are managed in the business based on the Consolidated Situation's risk-management and risk-governance system.

## 3.1 CONSOLIDATED SITUATION'S RISKS

Risks are a natural element of a bank's business activities and are defined in the Risk Policy as the possibility of negative deviations from an expected financial outcome.

A summary of the Consolidated Situation's main risks is presented below.

<b>Credit risk</b>	Credit risk pertains to the risk that a counterparty is unable to fulfil its commitments and that any collateral provided does not cover the receivable. Credit risk encompasses lending risk, issuer risk, counterparty risk, settlement risk and creditworthiness risk.
<b>Market risk</b>	Market risk pertains to the risk of loss arising that are directly or indirectly caused by changes in the level or volatility in the market price of assets, liabilities and financial instruments, including losses caused by shortcomings in the matching between assets and liabilities. Market risk includes interest rate risk, currency risk, spread risk, equities risk, property risk, commodities risk, infrastructure risk, option risk and pension risk.
<b>Liquidity risk</b>	Liquidity risk is defined as the risk that payment commitments cannot be fulfilled due to insufficient cash funds. Liquidity risk includes structural liquidity risk, financing risk, rollover risk and intraday liquidity risk.
<b>Operational risk</b>	Operational risk refers to the risk of losses arising due to inappropriate or faulty internal processes, human error, faulty systems and external events, and includes legal and compliance risks. Operational risk includes product and process risk, personnel risk, security risk, IT risk, legal risks, compliance risks and model risk.
<b>Business risk</b>	Business risk pertains to the risk of lower earnings, higher expenses or loss of confidence from customers or other stakeholders. Business risk encompasses strategic risk, reputation risk and conduct risk.

Risks are continuously monitored and evaluated. As the external business environment changes new risks emerge to manage, one of which is climate risk. Climate risk refers to risks arising from the direct and indirect consequences of climate change, such as a higher average temperature on Earth, more instances of extreme weather conditions and gradually rising sea levels.

## 3.2 RISK APPETITE

The risk appetite is defined as the overall level per risk type to which the Consolidated Situation intends to be, and can be, exposed in order to achieve established strategic targets. The Board approves both the Consolidated Situation's risk appetite and the strategic targets that form the basis of the Consolidated Situation's risk strategy. The Consolidated Situation is to expose itself only to those risks necessary for achieving established targets. The Consolidated Situation's risk appetite is to be characterised by a low risk profile whose lending operations focus on private housing and family-owned agricultural operations. Risk is limited within the framework of the risk limits established by the Board.

## 3.3 RISK-MANAGEMENT SYSTEM AND INTERNAL-CONTROL FUNCTIONS

The Consolidated Situation has an effective risk-management system, comprising risk frameworks and risk-management processes that ensure correct monitoring, management and reporting of the Consolidated Situation's risks. A well-functioning risk-management system aims to maintain a healthy risk culture throughout the entire operations and ensure that the Board has an objective and clear understanding of the overall risk profile of the operations.

### 3.3.1 Three lines of defence

The Consolidated Situation's risk management follows the division of roles and responsibilities according to the three lines of defence:

#### *First line of defence*

The first line of defence pertains to all risk-management activities performed in the business operations. The operations that are exposed to risk also own the risk, which means that the daily risk management takes place within the operations. The operations are also responsible for ensuring that control processes for monitoring are in place, implemented and reported. All employees assume individual responsibility for working towards a well-functioning risk culture by complying with the established risk-management guidelines and framework.

#### *Second line of defence*

The second line of defence pertains to the independent Risk Management and Compliance functions, which establish principles and frameworks for risk management and regulatory compliance. Accordingly, duality in risk management and risk control, risk culture and risk awareness is prevalent in all day-to-day business decisions. Risk Management controls and monitors the Consolidated Situation's risks and ensures that risk awareness and correct and consistent risk management takes place on a daily basis. Risk Management also provides assistance when the operations introduce procedures, systems and tools for maintaining this continuous risk management. The role of compliance is to provide support and control for ensuring that the operations comply with regulatory requirements.

#### *Third line of defence*

The third line of defence is Internal Audit, which comprises the Board's support for quality assurance and evaluation of the organisation's risk management, governance and internal controls. Internal Audit performs independent and regular audits to control, evaluate and ensure, for example, the procedures and processes for financial reporting, the operation and management of information systems and the operations' risk-management system.

### 3.3.2 Risk-management system

The risk-management system consists of strategies, processes, procedures, internal rules, limits, controls and reporting procedures needed to ensure that the Consolidated Situation is able to continuously identify, measure, monitor, govern, manage, report and have control over the risks to which the operations are, or could

be expected to become, exposed to, and the interdependence of these risks.

All risk activities are based on the risk framework that is adopted by the Board. The risk framework is described in governance documents, including a risk policy, a policy for risk and risk limits, and guidelines for the independent Risk Management function.

The Consolidated Situation's risk framework is designed to meet internal needs, sound market practice and regulatory requirements. Accordingly, the risk framework is an integrated part of the decision-making processes and contributes to achieving the business objectives with a high degree of certainty.

The Consolidated Situation manages and evaluates its exposure to the risks to which its operations are exposed on the basis of:

- Clear and documented descriptions of processes and procedures.
- Clearly defined and documented responsibilities and authorities.
- Risk-measurement methods and system support that are customised to the requirements, complexity and size of the operations.
- Regular incident reporting of the operations according to a documented process.
- Sufficient resources and expertise for attaining the desired level of quality in both the business and control activities.

- Documented and communicated business contingency, continuity and recovery plans.
- Clear instructions for each respective risk area and a documented process for approving new or considerably amended products, services, markets, processes and IT systems, as well as major changes to operations and organisation.

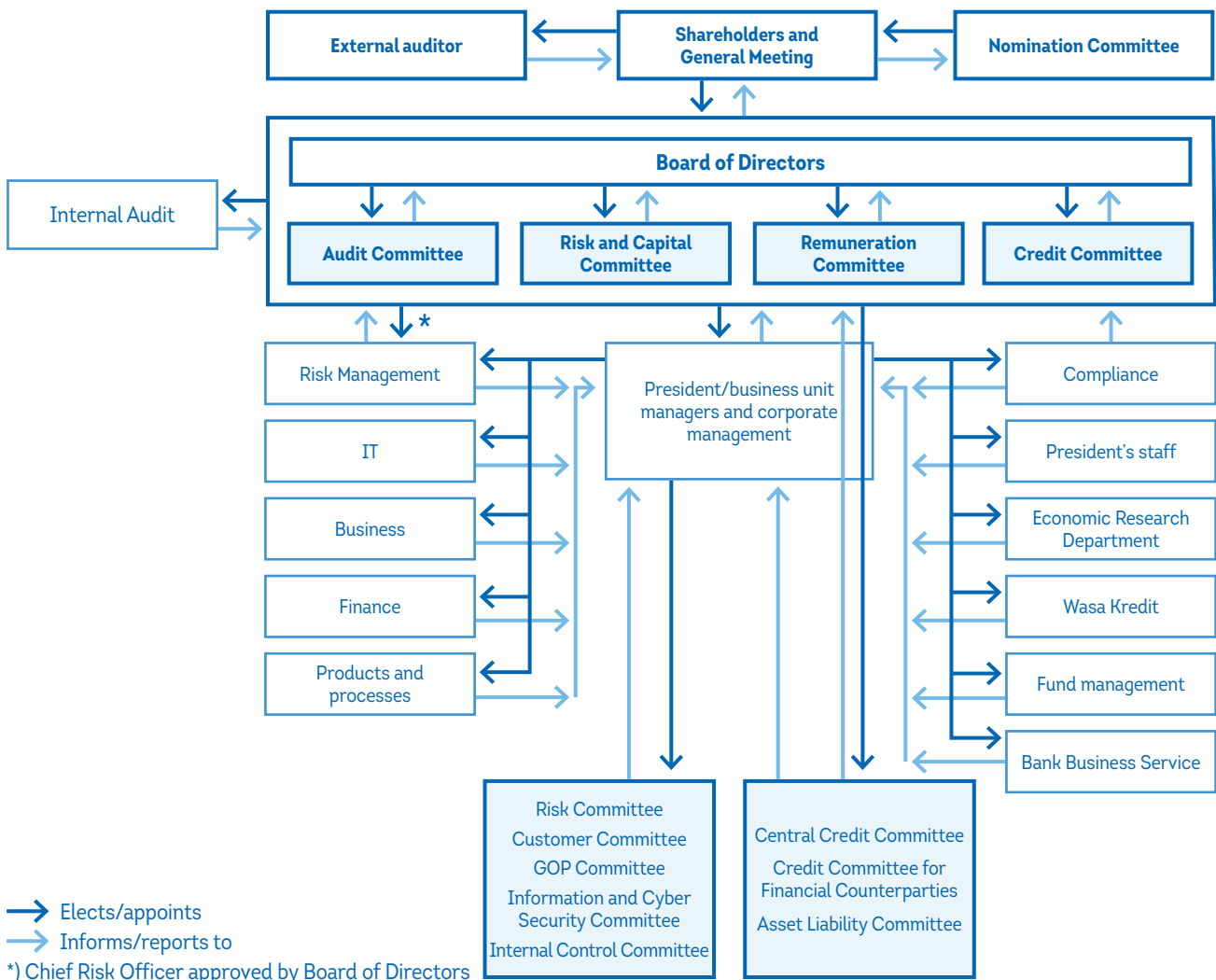
### 3.4 RISK GOVERNANCE

The Consolidated Situation's risk governance is based on governance documents adopted by the Board and a clear decision process in the operations.

#### Board of Directors

The Board is responsible for ensuring that an efficient risk-management system is in place and that it is customised to the Consolidated Situation's risk profile. The Board determines risk appetite and risk limits by adopting relevant governance documents. The Board approves all significant elements of the internal models used within the Consolidated Situation and is also responsible for ensuring that regulatory compliance and risks are managed in a satisfactory manner through the independent Risk Management, Compliance and Internal Audit functions.

Figure 3.1. Länsförsäkringar Bank's governance structure



The Board's Risk and Capital Committee supports the Board in risk and capital issues, and prepares cases ahead of Board decisions that pertain to market, liquidity and credit risk, and capital and internal capital adequacy assessments.

#### **President**

The President is responsible for ensuring that daily management takes place in accordance with the strategies, guidelines and governance documents established by the Board.

The President also ensures that the methods, models, systems and processes that form the internal measurement and control of identified risks work in the manner intended and decided by the Board. The President is to continuously ensure relevant reporting from each unit, including Risk Management, to the Board. The President is the Chairman of the Asset Liability Committee (ALCO), which follows up on capital and financial matters, as well as the Chairman of the Risk Committee, which follows up on all risks, limits and internally assessed capital requirements.

#### **Operations**

Company managers have the overall responsibility for day-to-day risk management in their respective areas and for ensuring that such risk management takes place in accordance with the risk framework. The operations assume risk and also own the risk.

#### **Risk Management**

The task of Risk Management is to provide support to the business, Board, President and management to ensure that proper risk man-

agement and risk control have been carried out for all business operations and to evaluate that risks are managed in line with the risk framework established by the Board. Risk Management is to carry out its activities independently from the business activities, based on the structure of an independent support section and an independent control section.

The individual responsible for Risk Management is the Chief Risk Officer (CRO), who is directly subordinate to the President and reports directly to the President, the Risk and Capital Committee, the Audit Committee and the Board. The Board approves the appointment and replacement of the CRO. Risk Management's areas of responsibility are defined and documented in the guidelines adopted by the Board. Risk Management is also responsible for the Consolidated Situation's capital-adequacy process.

#### **3.4.1 Monitoring and reporting**

Risk Management reports on the Consolidated Situation's risk development to the Board, the Risk and Capital Committee, the Risk Committee, the ALCO and the President.

Monitoring risks is a significant part of the Consolidated Situation's ongoing operations. Controls and risk reports of market and liquidity risk and credit risk with financial counterparties take place every day. Other types of risk reporting take place on an ongoing basis. In addition, an aggregated risk and capital report, containing all risk areas, is submitted to the Board and the Board's Committees every quarter.



# 4 | Capital management

## 4.1 CAPITAL ADEQUACY

Capital requirements are divided into Pillar I requirements, which are general minimum requirements for all institutions, and Pillar II requirements that are based on individual assessments performed by each institution. The minimum capital requirements under Pillar I are expressed as a percentage of the Risk Exposure Amount (REA), which at all times must meet the following:

- A Common Equity Tier 1 capital ratio of 4.5%
- A Tier 1 ratio of 6%
- A total capital ratio of 8%

Alongside the minimum capital requirement, there are additional capital requirements in the form of a combined buffer. These capital buffers are regulated in the Swedish Capital Buffers Act (2014:966). There are five different buffers, three that cover systemic risk, a capital conservation buffer and a countercyclical capital buffer. All of these are to be held in the form of Common Equity Tier 1 capital. If these buffer requirements are breached, restrictions are introduced on paying dividends and interest payments on Additional Tier 1 instruments. The Consolidated Situation is subject to the requirements of satisfying a capital conservation buffer of 2.5% and a countercyclical capital buffer of 2% on 31 December 2018.

There is the additional requirement that institutions are to make their own assessments of their internal capital requirement, usually named Pillar II, which is to include a margin for the risks that the institution is exposed to but that are not managed under Pillar I. Capital requirements are described in detail in section 4.3 below.

As shown in Table 4.1, the Consolidated Situation's Common Equity Tier 1 capital ratio on 31 December 2018 amounted to 15.7% (23.3) and the total capital ratio to 18.3% (28.1). The decline for the year was due to the changed application of the risk weight floor for Swedish mortgages.

### *Internal capital and liquidity adequacy assessment processes*

The Consolidated Situation's internal capital adequacy assessment process (ICAAP) is part of the capital planning and is to ensure that the Consolidated Situation, at any given time, has a sufficiently large amount of capital in relation to its current and future risk exposure level. A buffer of the statutory minimum capital requirements, the owner's yield requirements and external requirements from investors and rating agencies are taken into account in capital planning in addition to the assessment of the Consolidated Situation's internal capital requirements performed under the ICAAP. The ICAAP is also to take the development of the operations into consideration. A capital forecast is prepared when the capital requirement is determined and reported four times a year to the ALCO, the Risk and Capital Committee and the Board. The forecast is prospective and is to provide a view of the capital requirements over both the long and the short term. The purpose of the forecast is to ensure that the Consolidated Situation has sufficient own funds base and the correct capital composition.

The CRO of Länsförsäkringar Bank is responsible for conducting the process work that leads to an ICAAP for the Consolidated Situation and forms the basis of business planning and Board decisions concerning capital policy and forecasts. The Consolidated Situation's ICAAP is designed based on the requirements of CRR and CRD IV and the requirements established by the Board of Directors for the operations. The process, which is to be performed at least once annually, is to be documented in respect of the approach taken, the implementation and the results of the ICAAP, and reported to the Swedish Financial Supervisory Authority. The process includes the following activities:

- Identifying all risks
- Risk assessment
- Stress tests
- Capital calculations

**Table 4.1 Trend in capital adequacy measures**

SEK M	Consolidated Situation		Bank Group	
	31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
Common Equity Tier 1 capital	17,749.3	14,991.9	13,639.3	11,767.4
Tier 1 capital	18,676.9	15,936.2	14,839.3	12,967.4
Tier 2 capital	2,035.5	2,163.3	2,589.7	2,591.7
Own funds	20,712.4	18,099.5	17,429.0	15,559.1
Risk Exposure Amount	113,283.1	64,379.2	95,927.8	48,432.2
Capital requirement	9,062.6	5,150.3	7,674.2	3,874.6
Common Equity Tier 1 capital ratio	15.7%	23.3%	14.2%	24.3%
Tier 1 ratio	16.5%	24.8%	15.5%	26.8%
Total capital ratio	18.3%	28.1%	18.2%	32.1%
Capital conservation buffer	2,832.1	1,609.5	2,398.2	1,210.8
Countercyclical capital buffer	2,265.7	1,287.6	1,918.6	968.6
Capital requirement according to Basel I floor	-	12,880.4	-	12,511.5
Own funds adjusted to Basel I floor	-	18,543.8	-	16,003.4
Surplus capital according to Basel I floor	-	5,663.4	-	3,491.9

All of the Consolidated Situation's identified risks are included in the calculation of the capital requirements in the ICAAP. The Consolidated Situation applies methods used to calculate the capital requirement under the framework of Pillar I. For risks not included in Pillar I, known as Pillar II risks, internal models are used to allocate a capital requirement to each risk. The following additional risks are taken into account in the calculation of capital requirements under the Pillar II framework:

- Credit-related concentration risk
- Credit risk in exposures to governments
- Credit risk related to exposures to corporates
- Market risk, comprising currency risk, interest-rate risk in the bank book and spread risk
- Pension risk

The Financial Supervisory Authority's method for assessing the total capital requirement also includes for the Consolidated Situation the capital conservation buffer and the countercyclical capital buffer.

The internal capital requirement provides a view of the Consolidated Situation's current position. Scenario analyses and stress tests are performed under the ICAAP framework to ensure that the Consolidated Situation is well-capitalised for the future. The basic prerequisites for stress tests are to be reviewed by the Board of Directors at least once annually. This discussion provides guidance for the continuing work involving stress tests. Work on stress tests is based on a number of scenarios and the impact of these scenarios on the Consolidated Situation. The base scenario is based on the business plan and the most probable trend in volumes, earnings and credit losses. Assumptions in this base scenario are stress-tested by applying the most unfavourable conditions in the external business world for the Consolidated Situation that could be expected to occur once every 20–25 years. The purpose of the stress-test scenario is to ensure that the amount and composition of own funds are sufficient to absorb losses arising as a result of a serious financial stress. The performance in this scenario forms the basis for calculating a capital planning buffer by taking into account the change in the capital requirement and own funds. The capital planning buffer comprises the part of the capital requirement that exceeds the capital conservation buffer.

The Consolidated Situation also carries out an ILAAP every year, with the aim of ensuring a satisfactory liquidity situation, robust strategies and processes to manage liquidity risk over time. The ILAAP describes the internally assessed liquidity requirements and the liquidity reserve that the Bank Group has at its disposal, in relation to the liquidity and financing risk to which the Consolidated Situation is exposed.

## 4.2 OWN FUNDS

Own funds is the total of Tier 1 capital and Tier 2 capital, less items indicated in the capital adequacy rules.

Tier 1 capital comprises the institution's Common Equity Tier 1 capital and a limited share of perpetual subordinated debt (Tier 1 instruments). Common Equity Tier 1 capital comprises equity according to applicable accounting regulations with deductions for certain items as defined in the capital adequacy rules.

Tier 2 capital comprises perpetual and dated loans with subordinated preferential rights.

### **Common Equity Tier 1 capital**

Equity comprises share capital, capital contributed, reserves and net profit for the year. During the period, equity included in the Common Equity Tier 1 capital in the Consolidated Situation

increased net, primarily due to profit generated from the Bank Group. Profit may be included prior to a decision by a general meeting only if approved by the Swedish Financial Supervisory Authority, after deductions have been made for proposed dividends or other foreseeable charges and the company's auditors have verified the profit. In accordance with the Board's proposed appropriation of profits, no deductions for dividends are made.

Changes in equity attributable to cash-flow hedges may not impact own funds, which is why this effect is excluded. Common Equity Tier 1 capital is also adjusted due to the regulatory requirements regarding prudent valuation of items measured at fair value. Adjustments for the IRB deficit when, according to the accounts, the reserves for credit losses ("loss allowance") are less than the expected losses in capital adequacy, are to be made within Common Equity Tier 1 capital. If the reserves in the accounts exceed the expected loss, a limited portion may be included in the Tier 2 capital. IRB surplus and IRB deficit are evaluated separately for the defaulted and non-defaulted portfolio.

Common Equity Tier 1 capital is to be reduced by deductions for significant investments in financial companies if the invested capital comprises Common Equity Tier 1 instruments and exceeds 10% of gross Common Equity Tier 1 capital, or 17.65% of the net Common Equity Tier 1 capital when aggregated with deferred tax assets. Amounts under the threshold are risk-weighted at 250%. The deduction in the Consolidated Situation derives from Länsförsäkringar AB's holdings in the insurance sector.

Deferred tax assets recognised in the balance sheet are to reduce Common Equity Tier 1 capital if they meet certain criteria and exceed certain threshold amounts. The deferred tax assets that existed on 31 December 2018 did not give rise to any deduction but are included in the calculation of the threshold levels above.

Other deductions from Common Equity Tier 1 capital that are applicable to the Consolidated Situation are intangible assets and goodwill. Common Equity Tier 1 capital after applicable deductions amounted to SEK 17,749 M (14,992).

### **Tier 1 capital**

Additional Tier 1 capital in the Consolidated Situation solely comprises Additional Tier 1 instruments. Additional Tier 1 capital comprises subordinated liabilities that fulfil certain conditions in order to be included as Tier 1 capital when calculating the size of own funds. Länsförsäkringar Bank issued an Additional Tier 1 Capital loan of SEK 1,200 M (1,200). However, when consolidated own funds are compiled, Tier 1 instruments issued by Länsförsäkringar Bank may only be included to the extent required to cover the Bank Group's Tier 1 capital requirements, including Pillar II and the buffer requirements. Eligible Tier 1 capital amounted to SEK 928 M (944).

### **Tier 2 capital**

Tier 2 capital must be subordinate to other receivables from the company, except for equity instruments and Additional Tier 1 capital. Fixed-term subordinated debt that is included may not be covered or guaranteed in any form by an issuing institution or institution in the Consolidated Situation.

Tier 2 capital comprises fixed-term subordinated debt issued by Länsförsäkringar Bank. The instruments are subject to the same rules as for Tier 1 instruments above. Eligible Tier 2 capital amounted to SEK 2,036 M (2,163). Table 4.2 presents own funds and capital requirements.

**Table 4.2 Own funds and capital requirements**

SEK M	Consolidated Situation		Bank Group	
	31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
<b>Common Equity Tier 1 capital: instruments and reserves</b>				
Capital instruments and the related share premium accounts	6,513.4	11,314.6	2,864.6	954.9
<i>Of which: share capital</i>	1,042.5	1,042.5	2,864.6	954.9
Retained earnings	11,613.1	8,781.4	10,545.9	10,626.4
Accumulated Other comprehensive income	4,938.9	474.8	314.1	310.1
Independently reviewed interim profits net of any foreseeable charge or dividend	2,488.3	2,550.2	1,179.5	1,235.1
<b>Common Equity Tier 1 capital before regulatory adjustments</b>	<b>25,553.7</b>	<b>23,121.0</b>	<b>14,904.1</b>	<b>13,126.5</b>
<b>Common Equity Tier 1 capital: regulatory adjustments</b>				
Additional value adjustments	-54.4	-52.1	-53.5	-51.4
Intangible assets (net related tax liability)	-1,734.2	-1,739.3	-989.6	-969.3
Fair value reserves related to gains or losses on cash-flow hedges	151.2	105.9	151.2	105.9
Negative amounts resulting from the calculation of expected loss amounts	-372.9	-444.3	-372.9	-444.3
Direct, indirect and synthetic holdings by the institution of Common Equity Tier 1 instruments of financial sector entities where the institution has a significant investment in those entities	-5,794.1	-5,999.3	-	-
Amounts exceeding threshold of 15%	-	-	-	-
Of which: direct, indirect and synthetic holdings by the institution of Common Equity Tier 1 instruments of financial sector entities where the institution has a significant investment in those entities	-	-	-	-
<i>Of which: deferred tax assets arise from temporary differences</i>	-	-	-	-
<b>Total regulatory adjustments to Common Equity Tier 1 capital</b>	<b>-7,804.4</b>	<b>-8,129.1</b>	<b>-1,264.8</b>	<b>-1,359.1</b>
<b>Common Equity Tier 1 capital</b>	<b>17,749.3</b>	<b>14,991.9</b>	<b>13,639.3</b>	<b>11,767.4</b>
<b>Additional Tier 1 capital: instruments</b>				
Capital instruments and the related share premium accounts	-	-	1,200.0	1,200.0
<i>Of which: classified as equity within the meaning of the applicable accounting standards</i>	-	-	1,200.0	1,200.0
Qualifying Tier 1 capital included in consolidated Additional Tier 1 capital issued by subsidiaries and held by third parties	927.6	944.3	-	-
<b>Additional Tier 1 capital</b>	<b>927.6</b>	<b>944.3</b>	<b>1,200.0</b>	<b>1,200.0</b>
<b>Tier 1 capital (Tier 1 capital = Common Equity Tier 1 capital + Additional Tier 1 capital)</b>	<b>18,676.9</b>	<b>15,936.2</b>	<b>14,839.3</b>	<b>12,967.4</b>
<b>Tier 2 capital: instruments and provisions</b>				
Capital instruments and the related share premium accounts	-	-	2,589.7	2,591.7
Qualifying own funds instruments included in consolidated Tier 2 capital issued by subsidiaries and held by third parties	2,035.5	2,163.3	-	-
<b>Tier 2 capital</b>	<b>2,035.5</b>	<b>2,163.3</b>	<b>2,589.7</b>	<b>2,591.7</b>
<b>Total capital (total capital = Tier 1 capital + Tier 2 capital)</b>	<b>20,712.4</b>	<b>18,099.5</b>	<b>17,429.0</b>	<b>15,559.1</b>
<b>Total risk-weighted assets</b>	<b>113,283.1</b>	<b>64,379.2</b>	<b>95,927.8</b>	<b>48,432.2</b>
<b>Capital ratios and buffers</b>				
Common Equity Tier 1 capital (as a percentage of total risk exposure amount)	15.7%	23.3%	14.2%	24.3%
Tier 1 capital (as a percentage of total risk exposure amount)	16.5%	24.8%	15.5%	26.8%
Total capital (as a percentage of total risk exposure amount)	18.3%	28.1%	18.2%	32.1%
Institution-specific buffer requirements	9.0%	9.0%	9.0%	9.0%
<i>Of which: capital conservation buffer requirement</i>	2.5%	2.5%	2.5%	2.5%
<i>Of which: countercyclical capital buffer requirement</i>	2.0%	2.0%	2.0%	2.0%
<i>Of which: systemic risk buffer requirement</i>	-	-	-	-
<i>Of which: Global Systemically Important Institution or Other Systemically Important Institution buffer</i>	-	-	-	-
Common Equity Tier 1 capital available to meet buffers (as a percentage of risk exposure amount)	10.3%	18.8%	9.5%	19.8%
<b>Capital requirement according to Basel I floor *)</b>	<b>-</b>	<b>12,880.4</b>	<b>-</b>	<b>12,511.5</b>
Own funds adjusted according to Basel I floor	-	18,543.8	-	16,003.4
<b>Surplus capital according to Basel I floor</b>	<b>-</b>	<b>5,663.4</b>	<b>-</b>	<b>3,491.9</b>

Presentation of own funds in accordance with Article 5 of the European Commission Implementing Regulation (EU) No 1423/2013.

There are no items encompassed by the provisions applied before Regulation (EU) No 575/2013 or any prescribed residual amounts under the Regulation.

Empty rows in the presentation template in the Regulation have been excluded to provide a better overview.

\*) From 1 January 2018, the capital requirement under the Basel I floor based on Article 500(1) of the Regulation No 575/2013/EU on prudential requirements ceases to apply.

Table 4.3 presents outstanding subordinated loans on 31 December 2018.

**Table 4.3 Outstanding subordinated loans 31 December 2018**

Borrower	Loan amount	Loan date	Repayment date	Premature redemption (break-off date)
<b>Additional Tier 1 capital – External</b>				
Länsförsäkringar Bank AB	SEK 1,200 M	9 June 2015	Perpetual	9 June 2020
<b>Tier 2 capital – External</b>				
Länsförsäkringar Bank AB	SEK 500 M	26 April 2016	26 April 2026	26 April 2021
Länsförsäkringar Bank AB	SEK 1,000 M	26 April 2016	26 April 2026	26 April 2021
Länsförsäkringar Bank AB	SEK 400 M	1 Mar 2018	1 Mar 2028	1 Mar 2023
Länsförsäkringar Bank AB	SEK 700 M	1 Mar 2018	1 Mar 2028	1 Mar 2023

Disclosures on own funds on the Länsförsäkringar Bank AB website.

### 4.3 CAPITAL REQUIREMENT

#### *Risk Exposure Amount*

The advanced Internal Ratings-based Approach (IRB) for retail exposures is applied in order to calculate REA. The Foundation IRB Approach (F-IRB) is used for exposures to corporates and the Standardised Approach is used for other exposure classes. The Standardised Approach is applied to the calculation of capital requirements for operational risk and credit valuation adjustment risk.

As shown in Table 4.4, total REA in the Consolidated Situation on 31 December 2018 amounted to SEK 113,283 M (64,379). The increase was attributable to the Swedish Financial Supervisory Authority's introduction of additional macroprudential measures under the framework of Article 458 in CRR to counteract asset bubbles in the residential property sector. The application of these measures entails that the risk weight floor of 25% that was previously applied in Pillar II is now recognised as an REA in Pillar I. REA for operational risk has increased since the preceding year due to the annual update of the income included in the calculation according to the Standardised Approach.

#### *Buffer requirement*

The purpose of the capital conservation buffer is that it can be used during critical periods and is to amount to 2.5% of REA, which corresponded to SEK 2,832 M on 31 December 2018. The aim of the countercyclical capital buffer is to strengthen banks' resilience and ensure that sufficient capital exists for maintaining access to credit during stressed scenarios in the financial system. The Financial Supervisory Authority has set the requirement of the countercyclical capital buffer in Sweden at 2%, which corresponded to SEK 2,266 M on 31 December 2018. The Financial Supervisory Authority decided on 19 September 2018 to raise the countercyclical capital buffer to 2.5%, which is to be applied from 19 September 2019.

Both buffers are to be covered by Common Equity Tier 1 capital. The Pillar I capital requirement for the Consolidated Situation amounted to 12.5% (12.0), including the capital conservation buffer and countercyclical capital buffer.

#### *Internally assessed capital requirement*

The internally assessed capital requirement for the Consolidated Situation on 31 December 2018 amounted to SEK 11,290 M. This amount includes an assessment of the increased capital requirement due to the application of the Financial Supervisory Authority's new assessment method for the probability of default for exposures to corporates. The Bank Group has applied to apply a model compatible with this method.

Own funds that meet the capital requirement under the Pillar I and Pillar II requirements, including buffers, amounted to SEK 20,712 M.

### 4.4 NEW AND AMENDED RULES

#### *New IFRS and interpretations that have not yet been applied and their effect on capital adequacy*

IFRS 16 Leases will apply from 1 January 2019 and will then replace the existing standard IAS 17. For lessees, the new standard means that essentially all leases are to be recognised in the balance sheet. This new standard is not deemed to have any material effect on capital adequacy.

For detailed information about forthcoming accounting standards and their effects on the consolidated financial statements, refer to the accounting policies in the Annual Report.

#### *Capital adequacy rules*

##### *Impending changes to capital adequacy rules*

Several agreements were reached on the "banking package" at the end of 2018. Final approval is expected at the start of 2019 and parts of the banking package are expected to come into effect in 2021. The proposed amendments to the regulation include a binding minimum requirement for the leverage ratio and net stable funding ratio. New methods are also proposed for calculating market risk, counterparty risk as well as stricter rules on large exposures. The new directive proposal includes a revised Pillar II framework. The measures in the banking package are to aid the implementation of risk-reduction global standards at EU level and are also part of completing the Banking Union. An effect of the proposal is that the capital adequacy requirements will be raised. The proposal includes amendments and revisions to the Capital Requirements Regulation, the Capital Requirements Directive and the Crisis Management Directive. Certain parts of the proposal need to be incorporated into Swedish law before they come into force.

The completion of the Basel III regulations is in progress. The Basel Committee presented its revisions in December 2017. These revisions entail major changes for banks and include restrictions on the use of internal models, changes to the Standardised Approach for both credit and operating risk as well as the introduction of a capital floor of 72.5%. The capital floor entails that the risk-weighted assets for a bank that applied internal models may not, in total, be lower than 72.5% of the risk-weighted amount calculated according to the Standardised Approach. The purpose of the changes is to introduce standardised capital requirements and reduce the risk of unwarranted differences between countries and banks. The rules also aim to increase comparability between the banks. The rules must first be incorporated into EU law before they can come into effect. No proposal on how the rules are to be implemented has been published to date. An evaluation of the effects of the Basel Committee's proposal is under way at European level and these proposals

**Table 4.4 Capital requirement and Risk Exposure Amount**

SEK M	Consolidated Situation 31 Dec 2018		Consolidated Situation 31 Dec 2017		Bank Group 31 Dec 2018		Bank Group 31 Dec 2017	
	Risk exposure amount	Capital requirement	Risk exposure amount	Capital requirement	Risk exposure amount	Capital requirement	Risk exposure amount	Capital requirement
<b>Credit risk according to Standardised Approach</b>								
Exposures to institutions	1,344.9	107.6	1,293.5	103.5	1,303.1	104.2	1,242.7	99.4
Exposures to corporates	2,041.3	163.3	1,723.9	137.9	2,039.2	163.1	1,695.8	135.7
Retail exposures	1,978.8	158.3	1,730.7	138.5	1,978.8	158.3	1,730.7	138.5
Defaulted exposures	20.0	1.6	56.2	4.5	20.0	1.6	56.2	4.5
High risk items	0.4	0.0	15.0	1.2	0.4	0.0	15.0	1.2
Covered bonds	3,060.1	244.8	2,989.4	239.2	2,971.0	237.7	2,917.3	233.4
Equity exposures	5,971.7	477.7	5,296.0	423.7	78.4	6.3	40.6	3.2
Other items	4,736.3	378.9	4,538.0	363.0	1,014.9	81.2	1,002.7	80.2
<b>Total capital requirement and Risk Exposure Amount</b>	<b>19,153.6</b>	<b>1,532.3</b>	<b>17,642.7</b>	<b>1,411.4</b>	<b>9,405.9</b>	<b>752.5</b>	<b>8,701.0</b>	<b>696.1</b>
<b>Credit risk according to IRB Approach</b>								
<i>Retail exposures</i>								
Secured by immovable property, small and medium-sized businesses	1,932.1	154.6	2,217.4	177.4	1,932.1	154.6	2,217.4	177.4
Secured by immovable property, other	14,841.4	1,187.3	13,118.6	1,049.5	14,841.4	1,187.3	13,118.6	1,049.5
Other retail exposures, small and medium-sized businesses	4,332.5	346.6	4,375.0	350.0	4,332.5	346.6	4,375.0	350.0
Other retail exposures	6,879.4	550.4	7,087.4	567.0	6,879.4	550.4	7,087.4	567.0
<b>Total retail exposures</b>	<b>27,985.3</b>	<b>2,238.8</b>	<b>26,798.4</b>	<b>2,143.9</b>	<b>27,985.3</b>	<b>2,238.8</b>	<b>26,798.4</b>	<b>2,143.9</b>
Exposures to corporates	7,496.3	599.7	7,349.7	588.0	7,496.3	599.7	7,349.7	588.0
<b>Total capital requirement and Risk Exposure Amount</b>	<b>35,481.6</b>	<b>2,838.5</b>	<b>34,148.1</b>	<b>2,731.8</b>	<b>35,481.6</b>	<b>2,838.5</b>	<b>34,148.1</b>	<b>2,731.8</b>
<b>Operational risk</b>								
Standardised Approach	12,305.6	984.4	11,346.2	907.7	4,697.9	375.8	4,340.9	347.3
<b>Total capital requirement for operational risk</b>	<b>12,305.6</b>	<b>984.4</b>	<b>11,346.2</b>	<b>907.7</b>	<b>4,697.9</b>	<b>375.8</b>	<b>4,340.9</b>	<b>347.3</b>
<b>Credit valuation adjustment, Standardised Approach</b>	<b>1,323.4</b>	<b>105.9</b>	<b>1,242.2</b>	<b>99.4</b>	<b>1,323.4</b>	<b>105.9</b>	<b>1,242.2</b>	<b>99.4</b>
<b>Additional Risk Exposure Amounts according to Article 458 CRR</b>	<b>45,018.9</b>	<b>3,601.5</b>	-	-	<b>45,018.9</b>	<b>3,601.5</b>	-	-
<b>Total capital requirement and Risk Exposure Amount</b>	<b>113,283.1</b>	<b>9,062.6</b>	<b>64,379.2</b>	<b>5,150.3</b>	<b>95,927.8</b>	<b>7,674.2</b>	<b>48,432.2</b>	<b>3,874.6</b>

will form the basis of the final regulations. The new rules are expected to take effect in 2022 with a phase-in period of five years.

In November 2017, the European Banking Authority also published new guidelines on the treatment of defaulted exposures and PD and LGD estimation that will be introduced in 2019 and in 2020-2021, respectively.

Combined, this will entail extensive changes for many banks. Länsförsäkringar Bank is following regulatory developments and is highly prepared and well capitalised for impending changes, even if it is unclear at this stage what the effects of a capital requirement will be.

The Financial Supervisory Authority has decided to raise the countercyclical capital buffer from the current 2.0% to 2.5%. The higher buffer amount is to be applied from 19 September 2019.

#### **Crisis management**

Sweden has had new rules for managing failing banks since February 2016. These rules are based on the European Parliament and Council's Crisis Management Directive (2014/59/EU). The key aim is to prevent banks' problems from becoming a burden for the tax payer. The Swedish National Debt Office is responsible for applying the regulations. The rules establish a special procedure for handling a failing institution without putting it into bankruptcy. This procedure is called resolution. It means that the government, through the Debt Office, can take control of the failing bank. The Debt Office has a number of tools available to reconstruct or discontinue banks in a structured manner. To facilitate efficient resolution, the Debt Office has prepared resolution plans for the institutions that it considers have critical operations for the financial system. As part of its work, the Debt Office will

determine minimum requirements for own funds and eligible liabilities that can be used to cover losses in a failing institution.

In December 2018, the Debt Office announced its decisions on resolution plans and minimum requirements for own funds and eligible liabilities (MREL) for the institutions that have business activities that are deemed to be critical to the Swedish financial system, including Länsförsäkringar Bank. The Debt Office decided on a minimum requirement for own funds and eligible liabilities at group level. The liabilities issued that may be used to meet the requirements are to be issued by Länsförsäkringar Bank. In addition, the Debt Office also made a decision on a minimum requirement for the individual institutions Länsförsäkringar Bank, Länsförsäkringar Hypotek and Wasa Kredit.

The Debt Office's decision on MREL involves only the amount of the minimum requirement. In addition to this decision, the Debt Office has decided to apply a number of principles (that are not part of this decision) on how the minimum requirement should be met. For example, the minimum requirement at group level is to be met with a certain amount of debt instruments (the liabilities proportion principle) and the requirement from 2022 that MREL should be fully met in full with subordinated liabilities (subordinated liabilities principle). The Debt Office announced in 2018 that Länsförsäkringar Bank will be subject to the subordinated liabilities requirement.

MREL for the Consolidated Situation is 6.3% of total liabilities and own funds. On 31 December 2018, Länsförsäkringar Bank had SEK 32.7 billion in outstanding senior unsecured funding with a remaining term of more than one year, which exceeded the minimum requirement by a high margin.

# 5 | Credit risk

Credit risk refers to the risk that a counterparty is unable to fulfil its commitments and that any collateral provided does not cover the receivable so that a financial loss arises.

## 5.1 RISK APPETITE

The risk-taking for credit risk is based on a sound credit process and the credit portfolio is highly diversified with an overall low risk level. Risk is limited within the framework of the Consolidated Situation's established risk appetite and risk limits.

## 5.2 RISK MANAGEMENT

This section presents the credit process, risk-classification system and method for calculating the Consolidated Situation's capital requirement for credit risk.

### 5.2.1 Credit process

The banking operations impose strict requirements in terms of customer selection, customers' repayment capacity and the quality of collateral.

Länsförsäkringar Bank is responsible for ensuring that loan origination is carried out according to uniform procedures based on the Board's adopted guidelines, which ensures a common view on loan origination throughout the organisation. The quality of the loan portfolio and borrowers' repayment capacity are continuously monitored and reviewed. Combined with system support for risk classification, this leads to balanced and consistent lending.

The Board's adopted credit regulations form the foundation of all lending that takes place. The size of the loan and level of risk determine the decision level, where the highest instance is the Board and the lowest instance a decision by an advisor. Mandates for granting credit at the respective decision-making instance are set out in the credit regulations.

The credit regulations also set out minimum requirements for underlying documentation for credit-granting decisions. Compliance with the credit regulations is regularly monitored. The credit regulations and credit process, combined with local customer and market knowledge, create a loan portfolio that maintains high credit quality.

### *Environmental and climate risks*

Environmental risks and environmental responsibility for agriculture and companies are regulated by the extensive external rules of a variety of supervisory authorities. Environment-related risks are addressed in the loan application process based on, for example, licensable and non-licensable operations and a comprehensive assessment of the company's operations. In 2018, a first scenario analysis and stress tests of the mortgage portfolio were carried out following the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). Stress tests will also be conducted on the agricultural loan portfolio in 2019.

### 5.2.2 IRB system

An Internal Ratings-based Approach is used in the area of credit risk, or IRB Approach, to calculate the capital requirement for credit risk. This complies with the requirements set by the CRR and forms

the basis of the IRB risk-classification 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. The IRB system is specifically used in:

- Credit process for risk assessment and credit-granting decisions
- Calculation of loss allowances
- Calculation of risk-adjusted returns
- Monitoring and reporting to management and the Board
- Calculation of capital requirement
- Capital allocation

Some of the core concepts in the IRB system are described below.

### *Exposure at Default (EAD)*

Exposure at Default is the exposure amount that the counterparty is expected to utilise upon default. For commitments for on-balance sheet item, EAD is defined as capital liability plus accrued and overdue unpaid interest and fees. For off-balance sheet commitments, EAD is calculated by using a conversion factor.

### *Probability of Default (PD)*

The Probability of Default is the probability that a counterparty will default within a 12-month period. A counterparty is considered to be in default if a payment is more than 60 days past due<sup>1)</sup>. A counterparty is also considered to be in default if there are other reasons to expect that the counterparty cannot meet its undertakings.

An initial PD is calculated for each counterparty, adjusted to reflect the average proportion of default over business cycles. Finally, a safety margin is added to the PD to ensure that the risk is not underestimated. Following the calculation of PD, all non-defaulted counterparties are ranked and are divided into eleven risk classes.

The information that is most relevant to each type of counterparty has been taken into consideration in the development of models for estimating PD. The PD estimate for retail exposures is calculated entirely by using models based on predictive statistical analysis, while the PD estimate for exposures to corporates is based on a strict predictive statistical analysis combined with individual expert assessments. These risk models take both internal and external information into consideration.

### *Loss Given Default (LGD)*

Loss Given Default is defined as the expected loss percentage of the total counterparty exposure given default.

An internal estimate of LGD is used for the Advanced IRB Approach, which is based on internal information about such factors as loss portions, loan-to-value (LTV) ratio and product type. A safety margin is added to these estimates to ensure that the LGD is not underestimated, before a final LGD adjustment is made to reflect the loss ratio in a period of recession.

### *Conversion Factor (CF)*

The Conversion Factor is used to calculate off-balance sheet commitments that are expected to be utilised by the counterparty in the

<sup>1)</sup> 90 days is applied for Wasa Kredit.

event of default. An internal estimate of CF is calculated for the Advanced IRB Approach, which is based on internal information about such factors as degree of realisation, degree of utilisation and type of product. A safety margin is added to these estimates to ensure that the CF is not underestimated.

#### **Validation**

The entire IRB system is validated every year in accordance with applicable regulation and internally adopted guidelines. The quantitative risk models applied to risk estimates are evaluated based on predictive ability and risk-differentiating properties. Great importance is attached to ensuring that the models are stable over time. In addition to the purely quantitative aspects of the IRB system, the use and integration of the system in the operations is evaluated to ensure that the credit risk is consistently and uniformly measured. The entire validation process is performed by the Risk Management department.

### **5.2.3 Method for calculating capital requirements for credit risk**

This section provides an overview of which exposures are subject to each of the respective methods (Standardised Approach and IRB Approach), and the dates on which approval for applying the IRB Approach to each portfolio was received.

#### **Standardised Approach (SA)**

Exposures calculated according to the Standardised Approach primarily comprise exposures to governments and institutions, and holdings of covered bonds. All holdings in securities have a very high credit rating.

#### **Internal Ratings-based Approach (IRB)**

The IRB Approach is applied to lending to the retail exposures and exposures to corporates classes<sup>2)</sup>. The Foundation Internal Ratings-Based Approach is applied to exposures to corporates, with PD estimated by using internal models, while prescribed amounts are used for LGD and CF. Permission to apply the IRB Approach was obtained or applied for as follows:

- In December 2006, permission was granted by the Financial Supervisory Authority to apply the IRB Approach to retail exposures. This Approach has been applied to capital requirement calculations since February 2007.
- In December 2009, permission was granted to apply the Foundation IRB Approach to capital requirement calculations for credit risk for companies with agricultural operations, which comprises most of the corporate portfolio. This Approach has been applied since March 2010. In May 2012, permission was received to apply the IRB Approach for exposures to corporates, excluding Wasa Kredit AB. This Approach has been applied since June 2012.

- In April 2015, Länsförsäkringar Bank AB and the subsidiary Länsförsäkringar Hypotek AB received permission from the Financial Supervisory Authority to change their IRB model for calculating LGD for loans secured by immovable property. This Approach has been applied to capital requirement calculations since May 2015.
- In April 2015, Länsförsäkringar Bank AB and its subsidiaries Länsförsäkringar Hypotek AB and Wasa Kredit AB received approval for all IRB portfolios in the Bank Group to change the limit for what is classified as retail exposures and exposures to corporates. The new limit has been applied to capital requirement calculations since May 2015.
- In December 2016, an application was submitted to the Financial Supervisory Authority for permission to adjust the PDTTC levels of the models for corporates to meet the requirements of the Authority's new directive<sup>3)</sup>.
- In February 2017, an application was submitted to the Financial Supervisory Authority for permission to adjust the PDTTC levels of the models for retail to meet the requirements of the Authority's new directive<sup>3)</sup>.
- In December 2018, an application was submitted to the Financial Supervisory Authority regarding a new definition of default for the Consolidated Situation to meet the requirements of the Authority's new directive.

#### **The following IRB applications were withdrawn during the year:**

- In July 2015, an application was submitted to the Financial Supervisory Authority for permission to use a new PD model for corporate counterparties in the retail exposure class and exposures to corporates for Wasa Kredit AB. The application was withdrawn in November 2018, due to an application for a new definition of default that was submitted in December 2018.
- In February 2017, an application was submitted to the Financial Supervisory Authority for permission to change the definition of default in Länsförsäkringar Bank and Hypotek from the current 60 days past due to 90 days past due. The application was withdrawn in November 2018, due to an application for a new definition of default that was submitted in December 2018.

### **5.3 CREDIT QUALITY**

This section describes the Consolidated Situation's credit risk exposure based on approach, exposure class and geographic and industry distribution. The IRB exposure is also reported specified by risk class and an evaluation of the credit risk models is provided.

As described in Table 5.1, the IRB retail exposure increased SEK 23,139 M (9%), while exposures to corporates rose SEK 825 M (4%), primarily due to volume growth in mortgages in the retail segment. Volumes grew while retaining the risk weight level, as shown in Table 5.1.

<sup>2)</sup> Some exposures in Wasa Kredit to which the Standardised Approach is applied are included in the IRB roll-out plan approved by the Financial Supervisory Authority.

<sup>3)</sup> Refer to the Swedish Financial Supervisory Authority's memorandum: "FI's supervision of banks' calculations of risk weights for exposures to corporates."

**Table 5.1 Exposure by exposure class**

SEK M	31 Dec 2018			31 Dec 2017			Period average <sup>1)</sup>		
	Original exposure	EAD	RW (%)	Original exposure	EAD	RW (%)	Original exposure	EAD	Average RW (%)
<b>Standardised Approach</b>									
Central governments and central banks	18,987	20,280	0	13,489	13,488	0	18,247	19,266	0
Regional governments or local authorities	196	4,424	0	4,018	4,018	0	1,240	4,238	0
Multilateral development banks	1,355	0	0	0	0	-	1,066	0	0
Institutions	1,555	1,555	0	1,699	1,699	0	1,653	1,653	0
Corporates	13,702	4,735	28	6,992	4,228	31	18,701	5,579	30
of which, SMEs	2,287	2,275	90	2,034	2,033	85	2,197	2,186	87
Retail	1,497	1,492	84	1,298	1,298	76	1,463	1,458	81
of which, SMEs	4,115	2,639	75	3,549	2,308	75	3,896	2,502	75
Defaulted exposures	2	2	58	0	0	-	1	1	75
Covered bonds	45	18	112	70	39	142	43	16	106
Exposures associated with particularly high risk	30,601	30,601	10	29,894	29,894	10	30,460	30,460	10
Claims in the form of CIU	0	0	-	10	10	150	3	3	150
Equity exposures	2,428	2,428	246	2,135	2,135	248	2,294	2,294	247
Other items	4,672	4,672	101	4,529	4,529	100	4,448	4,448	100
<b>Total, Standardised Approach</b>	<b>79,943</b>	<b>73,627</b>	<b>26</b>	<b>68,419</b>	<b>64,381</b>	<b>27</b>	<b>84,248</b>	<b>72,645</b>	<b>26</b>
<b>IRB Approach</b>									
Corporates	20,333	20,141	37	19,502	19,316	38	20,107	19,924	38
of which, SMEs	20,323	20,133	37	19,492	19,308	38	20,097	19,917	38
Retail	279,813	276,112	10	256,600	252,973	11	272,721	268,516	10
of which, SMEs	36,877	36,412	17	36,048	35,668	18	36,417	35,947	17
of which, secured by immovable property	250,123	247,169	7	226,734	223,803	7	242,672	239,239	7
of which, other retail credits	29,690	28,943	39	29,866	29,170	39	30,049	29,280	38
<b>Total, IRB Approach</b>	<b>300,146</b>	<b>296,253</b>	<b>12</b>	<b>276,102</b>	<b>272,289</b>	<b>13</b>	<b>292,828</b>	<b>288,440</b>	<b>12</b>
<b>Total</b>	<b>380,089</b>	<b>369,880</b>	<b>15</b>	<b>344,521</b>	<b>336,670</b>	<b>15</b>	<b>377,076</b>	<b>361,085</b>	<b>15</b>

<sup>1)</sup> Average exposure and risk weight in 2018, calculated by quarter.

Table 5.2 presents the exposure by country calculated according to the Standardised Approach (Consolidated Situation).

**Table 5.2 Distribution of exposure per country, Standardised Approach**

SEK M	31 Dec 2018		31 Dec 2017	
	Original exposure	EAD	Original exposure	EAD
Sweden	67,450	65,092	60,900	59,072
Germany	1,294	1,294	1,030	1,030
Finland	2,028	1,717	462	462
Switzerland	1,160	38	938	269
Denmark	7,607	5,086	4,481	2,944
Norway	404	400	608	604
<b>Total</b>	<b>79,943</b>	<b>73,627</b>	<b>68,419</b>	<b>64,381</b>



The Consolidated Situation applies external credit rating for exposures to institutions and exposures in the form of covered bonds. The external rating used is the rating from Moody's or Standard & Poor's that gives rise to the highest risk weight. Table 5.3 shows exposure before and after credit-risk-reducing measures by credit quality step.

**Table 5.3 Exposure by credit quality step**

SEK M	31 Dec 2018		31 Dec 2017	
	Original exposure	EAD	Original exposure	EAD
1	38,982	33,572	32,742	32,060
2	5,321	1,764	4,144	2,061
3	-	-	-	-
4	-	-	-	-
5	-	-	-	-
6	-	-	-	-
<b>Total</b>	<b>44,303</b>	<b>35,336</b>	<b>36,886</b>	<b>34,122</b>

All IRB exposure is found in Sweden and Table 5.4 presents the exposure per county. Exposure is well-diversified throughout Sweden with a slight concentration to the metropolitan areas, specifically the counties of Stockholm, Skåne and Västra Götaland. Exposures secured by immovable property amounted to SEK 266 billion of a total of SEK 296 billion at 31 December 2018.

**Table 5.4 Distribution of IRB exposure per county**

SEK M	31 Dec 2018				31 Dec 2017			
	Total		Of which, exposures secured by immovable property		Total		Of which, exposures secured by immovable property	
County	EAD	%	EAD	%	EAD	%	EAD	%
Blekinge	5,615	1.9	4,993	1.9	5,016	1.8	4,258	1.8
Dalarna	12,384	4.2	11,081	4.2	11,474	4.2	10,310	4.3
Gotland	5,679	1.9	5,218	2.0	5,560	2.1	5,021	2.1
Gävleborg	7,638	2.6	6,747	2.5	7,360	2.7	6,262	2.5
Halland	13,855	4.7	12,765	4.8	13,144	4.8	12,078	5.0
Jämtland	5,962	2.0	5,371	2.0	5,549	2.0	4,823	2.0
Jönköping	12,955	4.4	11,917	4.5	11,358	4.2	10,300	4.3
Kalmar	7,828	2.6	6,924	2.6	7,147	2.6	6,108	2.4
Kronoberg	5,647	1.9	5,018	1.9	5,506	2.0	4,682	1.9
Norrbottnen	3,927	1.3	3,251	1.2	4,008	1.5	3,056	1.3
Skåne	37,672	12.7	33,248	12.5	33,375	12.3	29,522	12.2
Stockholm	40,975	13.8	35,860	13.5	38,370	14.1	33,087	13.7
Södermanland	8,160	2.8	7,255	2.7	8,232	3.0	7,048	2.9
Uppsala	14,431	4.9	13,318	5.0	13,430	4.9	12,193	5.0
Värmland	5,363	1.8	4,637	1.7	5,002	1.8	4,002	1.6
Västerbotten	10,200	3.4	9,510	3.6	9,473	3.5	8,722	3.6
Västernorrland	4,661	1.6	3,943	1.5	4,532	1.7	3,579	1.5
Västmanland	9,856	3.3	8,970	3.4	9,271	3.4	8,256	3.4
Västra Götaland	50,818	17.2	46,395	17.4	45,153	16.6	41,643	17.2
Örebro	11,230	3.8	10,016	3.8	10,253	3.8	9,085	3.8
Östergötland	21,397	7.2	19,536	7.3	19,076	7.0	18,106	7.5
<b>Total</b>	<b>296,253</b>	<b>100.0</b>	<b>265,973</b>	<b>100.0</b>	<b>272,289</b>	<b>100.0</b>	<b>242,141</b>	<b>100.0</b>

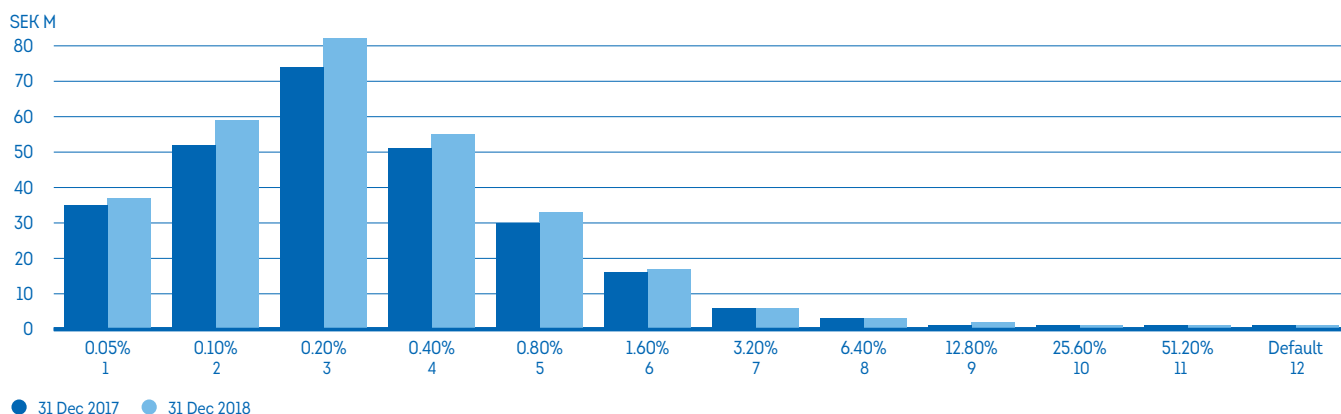
Table 5.5 describes the IRB exposure by industry and exposure class. Most of the exposure comprises loans to private individuals and agricultural customers representing 92% of the total IRB exposure.

**Table 5.5 Exposure by industry and class, IRB**

SEK M		31 Dec 2018			31 Dec 2017		
Exposure class	Industry	EAD	%	RW (%)	EAD	%	RW (%)
Retail	Private individuals	237,135	80	9	217,262	80	9
	Agriculture	22,737	8	9	20,832	8	10
	Other business	16,240	5	30	14,879	5	30
<b>Total retail</b>		<b>276,112</b>	<b>93</b>	<b>10</b>	<b>252,973</b>	<b>93</b>	<b>11</b>
	of which, SMEs	36,412	-	17	35,668	-	18
Corporates	Agriculture	11,510	4	34	11,038	4	36
	Other business	8,631	3	41	8,278	3	41
	<b>Total corporates</b>	<b>20,141</b>	<b>7</b>	<b>37</b>	<b>19,316</b>	<b>7</b>	<b>38</b>
	of which, SMEs	20,133	-	37	19,308	-	38
<b>Total</b>		<b>296,253</b>	<b>100</b>	<b>12</b>	<b>272,289</b>	<b>100</b>	<b>13</b>

Figure 5.1 and Table 5.6 present the credit risk exposure, calculated according to IRB, specified according to risk grades. The results show a distribution of exposure, with 79% (78) of exposure found in the best grades 1-4. A contributing reason for the higher amount in these grades is that a high percentage of lending takes place in the form of mortgages to private individuals, for which the probability of default is significantly lower than in other portfolios.

**Figure 5.1. Exposure by risk class, IRB**



**Table 5.6. Exposure by PD grade and class, IRB**

SEK M	Retail exposures						Exposures to corporates			Total	
	Secured by immovable property		Other exposures		Total		EAD	RW (%)	EAD	RW (%)	
PD grade, 31 Dec 2018	EAD	RW (%)	EAD	RW (%)	EAD	RW (%)					EAD
1	33,782	1	933	6	34,715	1	2,579	12	37,294	2	
2	55,473	2	2,304	13	57,777	3	749	18	58,526	3	
3	73,635	5	3,485	20	77,120	5	5,135	26	82,255	7	
4	46,060	8	2,376	29	48,436	9	6,478	37	54,914	12	
5	22,833	13	7,026	34	29,859	18	2,947	50	32,806	21	
6	10,111	24	5,755	47	15,866	32	1,075	63	16,941	34	
7	2,404	31	3,387	56	5,791	45	483	79	6,274	48	
8	1,376	46	1,732	58	3,108	52	361	96	3,469	57	
9	788	65	842	68	1,630	67	61	120	1,691	69	
10	307	73	522	93	829	86	51	172	880	91	
11	248	62	213	100	461	80	152	144	613	96	
Default	152	120	368	80	520	92	70	0	590	81	
<b>Total</b>	<b>247,169</b>	<b>7</b>	<b>28,943</b>	<b>39</b>	<b>276,112</b>	<b>10</b>	<b>20,141</b>	<b>37</b>	<b>296,253</b>	<b>12</b>	

**Table 5.7. Exposure-weighted PD, LGD and CF, IRB**

	Retail exposures			Exposures to corporates		Total
	Secured by immovable property	Other exposures	Total			
PD (%) <sup>1)</sup>	0.49	2.58	0.71	1.08	0.73	
LGD (%) <sup>1)</sup>	10.8	42.0	14.0	-	-	
CF (%) <sup>2)</sup>	50.3	86.6	67.5	-	-	

<sup>1)</sup> Exposure-weighted average, non-defaulted exposures.

<sup>2)</sup> Only for unutilised undertakings.

A correlation between the internal grades for IRB exposures and external rating that is considered a reasonable comparison is presented below.

**Table 5.8. Correlation between internal PD grades and external rating (Standard & Poor's)**

Internal	PD (%)	Indicative credit rating from S&P
1-4	< 0.5	AAA to BBB-
5-6	0.5-2.1	BB+ to BB-
7-8	2.1-8.5	B+ to B
9-11	> 8.5	B- to C
Default	100	D

#### Expected loss and actual outcome

The Expected Loss (EL) is expressed as a percentage of the exposure and calculated based on the internal parameter estimates of PD and LGD.

EL on 31 December 2016 as a percentage for all non-defaulted exposures in the retail exposure class was 0.20% and the actual outcome was 0.08%<sup>3)</sup>. EL for retail exposures secured by immovable property was 0.07% and the outcome was 0.00%. For other retail exposures, EL was 1.10% and the outcome was 0.74%. One of the reasons that EL is higher than the actual outcome is that the parameter estimate for PD is significantly higher than the observed default percentage.

<sup>3)</sup> The estimate is based on non-defaulted exposures at 31 December 2016. Outcome is calculated as confirmed credit losses for default in 2017 with a follow-up period until 31 December 2018.

#### 5.3.1 Risk-reducing measures and contractual maturities

The starting point of the credit assessment is always the customer's repayment capacity, with the approach that collateral received can never compensate for a low repayment capacity. Collateral received can significantly counteract the losses in the event of a credit default. Loans are mostly granted against collateral in property, for which the operation has extensive experience and robust procedures in place. The market value of properties is updated on an annual basis, or when necessary, following established procedures. The relationship between the loan portfolio and the underlying assets expressed as the weighted average loan-to-value (LTV) ratio was 61% (60).

**Table 5.9. Retail mortgages by loan-to-value ratio interval (LTV)**

EAD, SEK M	31 Dec 2018	%	31 Dec 2017	%
0-50%	177,526	80	161,801	82
51-60%	21,699	10	18,891	9
61-70%	13,998	6	11,477	6
71-75%	4,083	2	2,976	2
75%-	4,364	2	2,828	1
<b>Total</b>	<b>221,670</b>	<b>100</b>	<b>197,973</b>	<b>100</b>

Other significant risk-reducing measures in the Consolidated Situation are the netting agreements signed with institutional counterparties.

Table 5.10 presents exposure amounts covered by eligible collateral. Collateral for exposures to institutions comprises financial collateral, while collateral for the corporate and retail exposure classes comprises properties for which the covered amount totalled SEK 264 billion on 31 December 2018.

**Table 5.10. Eligible collateral for capital adequacy purposes**

SEK M	31 Dec 2018		31 Dec 2017	
	Original exposure	Exposure amount covered by collateral	Original exposure	Exposure amount covered by collateral
<b>Standardised Approach</b>				
Central governments and central banks	18,987		13,489	
Regional governments or local authorities	196		4,018	
Exposures to public sector entities	1,355			
Multilateral development banks	1,555		1,699	
Institutions	13,702	4,798	6,992	2,763
Corporates	2,287		2,034	
– of which, SMEs	1,497		1,298	
Retail	4,115		3,549	
– of which, SMEs	2		0	
Defaulted exposures	45		70	
Covered bonds	30,601		29,894	
Exposures associated with particularly high risk	0		10	
Equity exposures	2,428		2,135	
Other items	4,672		4,529	
<b>Total, Standardised Approach</b>	<b>79,943</b>	<b>4,798</b>	<b>68,419</b>	<b>2,763</b>
<b>IRB Approach</b>				
Corporates	20,333	17,331	19,502	17,213
– of which, SMEs	20,323	17,331	19,492	17,213
Retail	279,813	246,887	256,600	223,244
– of which, SMEs	36,877	22,468	36,048	21,653
<b>Total, IRB Approach</b>	<b>300,146</b>	<b>264,218</b>	<b>276,102</b>	<b>240,457</b>
<b>Total</b>	<b>380,089</b>	<b>269,016</b>	<b>344,521</b>	<b>243,220</b>

Table 5.11 presents exposures distributed by exposure class and remaining fixed-interest periods.

**Table 5.11. Exposures by fixed-interest periods**

31 Dec 2018, SEK M	<3 months	3-12 months	1-5 years	>5 years	Total
<b>Standardised Approach</b>					
Central governments and central banks	14,574	0	5,706	0	20,280
Regional governments or local authorities	976	0	3,448	0	4,424
Exposures to public sector entities	0	0	0	0	0
Multilateral development banks	0	224	1,331	0	1,555
Institutions	4,735	0	0	0	4,735
Covered bonds	2,164	7,105	20,917	415	30,601
Corporates	2,654	0	0	0	2,654
Retail	2,173	83	22	0	2,278
CIUs	0	0	0	0	0
Equities	2,428	0	0	0	2,428
Other items	4,672	0	0	0	4,672
<b>Total, Standardised Approach</b>	<b>34,376</b>	<b>7,412</b>	<b>31,424</b>	<b>415</b>	<b>73,627</b>
<b>IRB Approach</b>					
Corporates	11,505	4,538	3,810	287	20,140
Retail	165,569	60,549	48,148	1,847	276,113
– Of which, secured by immovable property	136,842	60,452	48,076	1,799	247,169
– Of which, other exposures	28,727	97	72	47	28,943
<b>Total, IRB Approach</b>	<b>177,074</b>	<b>65,087</b>	<b>51,958</b>	<b>2,134</b>	<b>296,253</b>
<b>Total</b>	<b>211,450</b>	<b>72,499</b>	<b>83,382</b>	<b>2,549</b>	<b>369,880</b>

#### 5.4 NON-PERFORMING RECEIVABLES, CREDIT LOSSES AND LOSS ALLOWANCE

This section describes the Bank Group's non-performing receivables, credit losses, and reserves for credit losses ("loss allowance") that are based in their entirety on the total loan portfolio from an accounting perspective.

##### 5.4.1 NON-PERFORMING RECEIVABLES

A loan receivable is considered non-performing if it has an outstanding payment that is more than nine days past due and is not credit-impaired. Table 5.12 shows the non-performing receivables that are not credit-impaired. Note that the comparative figures are based on the definition of non-performing receivables applicable on 31 December 2017 and thus are not fully comparable.

**Table 5.12.**

**Non-performing loan receivables that are not credit-impaired, by company**

31 Dec 2018, SEK M	Länsförsäkringar Bank AB	Länsförsäkringar Hypotek AB	Wasa Kredit AB	Total
Receivables overdue by 1-30 days	30.6	50.8	44.2	125.6
Receivables overdue by 31-60 days	7.8	0.0	340.4	348.2
Receivables overdue by 61-90 days	0.0	0.0	69.0	69.0
<b>Total</b>	<b>38.4</b>	<b>50.8</b>	<b>453.5</b>	<b>542.8</b>

**Non-performing receivables not included in impaired loans, by company**

31 Dec 2017, SEK M	Länsförsäkringar Bank AB	Länsförsäkringar Hypotek AB	Wasa Kredit AB	Total
Receivables overdue by 10-39 days	34.5	49.3	280.6	364.4
Receivables overdue by 40-60 days	0.0	0.4	7.9	8.3
<b>Total</b>	<b>34.5</b>	<b>49.7</b>	<b>288.5</b>	<b>372.7</b>

#### 5.4.2 Credit losses

Credit losses comprise expected credit losses, confirmed credit losses, recoveries of credit losses previously recognised as confirmed and reversals of expected credit losses no longer required. Confirmed credit losses could refer to the entire receivable or parts of it when there is no realistic possibility of recovery. A confirmed credit loss is recognised as a write-off of the gross carrying amount and an add-back of the portion of the allowance for expected credit losses that pertains to a written-off loan or portions of a loan. Recoveries comprise payments of loans that were previously recognised as confirmed credit losses. Expected credit losses are reversed when no impairment requirement is deemed to exist.

Only the Bank Group's share of expected and confirmed credit losses are recognised. The settlement model, which was introduced on 1 January 2014, regarding the commitment that the regional

insurance companies have for credit losses, entails that the regional insurance companies cover 80% of the provision requirement in the Bank Group (excluding Wasa Kredit AB), on the date when an impairment is identified, by off-setting this against accrued commission. On 31 December 2018, the total recognised loss allowance for loan receivables under IFRS 9 amounted to SEK 498.9 M, of which the Bank Group's recognised loss allowance for loan receivables amounted to SEK 425.4 M. The remainder of SEK 73.5 M was settled against the regional insurance companies' withheld funds, according to the model described above.

Credit losses in the Bank Group remain low at SEK 95 M (58), net, corresponding to a credit loss level of 0.04% (0.02). Credit-impaired loan receivables and credit losses continued to account for a minor percentage of total loans.

Table 5.13. Credit losses

SEK M	2018	2017
<b>Change in loss allowance for loan receivables</b>		
Stage 1 (not credit-impaired)	-6.3	
Stage 2 (not credit-impaired)	22.8	
Stage 3 (credit-impaired)	53.2	
<b>Total change in loss allowance for loan receivables</b>	<b>69.7</b>	<b>17.3<sup>1)</sup></b>
Expense for confirmed credit losses	119.3	131.0
Recoveries	-83.7	-90.3
<b>Net expense for credit losses for loan receivables</b>	<b>105.4</b>	<b>58.0</b>
Change in loss allowance for commitments and guarantees	-2.0	-
Net expense for other credit losses	-8.7	-0.3
Net expense of modification result	0.0	-
<b>Net expense for credit losses for the year</b>	<b>94.7</b>	<b>57.7</b>

<sup>1)</sup> Refers to change in loss allowance for loan receivables. The change has not been specified by stage since the comparative figures are recognised in accordance with IAS 39.

Table 5.14. Loss allowance for loan receivables, commitments and guarantees, by industry

SEK M		31 Dec 2018				Total
		Not credit-impaired		Credit-impaired		
		Stage 1	Stage 2	Stage 3 (Excluding purchased and new credit-impaired)	Stage 3 (Purchased and new credit-impaired)	
Standardised Approach	Industry	Loss allowance	Loss allowance	Loss allowance	Loss allowance	Loss allowance
	Private individuals	6.6	15.8	25.0	0.0	47.4
	Agriculture	0.0	0.0	0.0	0.0	0.0
	Other business	7.6	8.8	2.0	0.0	18.4
<b>Total, Standardised Approach</b>		<b>14.3</b>	<b>24.6</b>	<b>27.0</b>	<b>0.0</b>	<b>65.8</b>
<b>IRB Approach</b>						
<b>Retail</b>	Private individuals	38.1	54.8	124.6	0.2	217.8
	Agriculture	0.8	1.2	1.4	0.2	3.6
	Other business	23.1	39.1	86.0	0.0	148.3
<b>Total retail</b>		<b>62.1</b>	<b>95.1</b>	<b>212.0</b>	<b>0.4</b>	<b>369.6</b>
<b>Corporates</b>	Private individuals	0.1	0.1	0.0	0.0	0.2
	Agriculture	0.5	2.1	2.3	0.1	4.9
	Other business	0.5	0.3	0.6	0.0	1.4
<b>Total corporates</b>		<b>1.1</b>	<b>2.4</b>	<b>2.9</b>	<b>0.1</b>	<b>6.5</b>
<b>Total, IRB Approach</b>		<b>63.2</b>	<b>97.5</b>	<b>214.9</b>	<b>0.5</b>	<b>376.1</b>
<b>Total</b>		<b>77.5</b>	<b>122.1</b>	<b>241.9</b>	<b>0.5</b>	<b>442.0</b>

## 5.5 COUNTERPARTY RISK FOR DERIVATIVES

Counterparty risk is the risk of a counterparty being unable to fulfil its commitments, which could lead to losses. The Board determines limits on the maximum exposure amount per counterparty. The market value method is used for calculating capital requirements for counterparty risk regarding derivatives. The Consolidated Situation has only swap counterparties with a high credit rating and for which ISDA agreements have been prepared. ISDA agreements allow net accounting of positive and negative derivatives, which reduces the risk to the net position per counterparty. The ISDA agreements also have associated CSA agreements. CSA agreements involve commitments concerning delivery and receipt of collateral in the event of market changes. These agreements are unilateral for Länsförsäkringar Hypotek's covered-bond operations, with

only the counterparty providing collateral. There are no CSA agreements for which the Consolidated Situation is required to provide collateral for downgrades. Table 5.15 presents the derivative exposure for the Consolidated Situation. Exposure to central counterparties is recognised without any rating. The entire exposure to central counterparties and banks on 31 December 2018 comprised exposure to Nasdaq Clearing AB. Nasdaq Clearing AB does not have any rating but is a very strong counterparty due to the strong statutory regulations that apply to Nasdaq Clearing AB and other central counterparties. Nasdaq Clearing AB has been certified by the Swedish Financial Supervisory Authority as an EMIR counterparty and is subject to the supervision of the Authority.

Table 5.15. Derivatives at fair value

Rating, SEK M	31 Dec 2018					31 Dec 2017				
	Gross	Netting gain	Collateral	Net exposure	EAD	Gross	Netting gain	Collateral	Net exposure	EAD
AA-/Aa3	1,629	362	389	1,061	1,823	1,680	379	199	1,120	1,846
A+/A1	407	217	197	3	213	731	279	306	147	1,481
A/A2	3,487	132	3,859	9	1,559	2,624	285	2,390	8	148
n/a	533	113	434	0	503	90	90	6	0	226
<b>Total</b>	<b>6,055</b>	<b>824</b>	<b>4,879</b>	<b>1,073</b>	<b>4,098</b>	<b>5,125</b>	<b>1,034</b>	<b>2,900</b>	<b>1,274</b>	<b>3,701</b>

# 6 | Market risk

Market risk pertains to the risk of loss arising due to changes in the market price of assets, liabilities and financial instruments.

## 6.1 RISK APPETITE

The Board of Directors determines the risk appetite for market risk. The Consolidated Situation has a low appetite for market risks, meaning that these risks are to be limited to a reasonable extent. The Consolidated Situation does not have a trading book.

## 6.2 RISK MANAGEMENT

The aim of risk management is to reduce the immediate effect that an unexpected change in the market could have on the Consolidated Situation. Day-to-day management of market risks takes place in the Treasury unit. The management takes place in a cost-effective manner, within set limits. The Consolidated Situation applies a number of supplementary risk measures and stress tests to measure market risk.

The Consolidated Situation's primary market risk is interest-rate risk. Interest-rate risk is primarily minimised by matching fixed lending with corresponding funding. Secondly, interest-rate risk is reduced by utilising interest-rate derivatives.

### 6.2.1 Governance

The overall framework for the financial operations is adopted by the Board in the Risk Policy. The Board also adopts the limits for interest-rate risk, spread risk and currency risk. Limits are determined by the Board of each company. The methods for calculating market risks are established by the Risk Committee.

### 6.2.2 Interest-rate risk

Interest-rate risk is defined as the risk of losses due to changes in market interest rates.

Interest-rate risk arises in the Consolidated Situation primarily through different interest-rate fixing periods for assets and liabilities, but also in ensuring access to a large liquidity reserve and funding in foreign currency.

Interest-rate risk is calculated as the effect of a sharp momentary stress scenario. The capital requirement calculation for interest-rate risk in Pillar II uses a Value-At-Risk model.

Table 6.1 shows the changes in present value arising from a 100-basis-point shift in market interest rates, specified by currency. The analysis does not include equity that the Consolidated Situation has or the possibility of adapting to changed interest-rate levels. Interest-rate risk is almost exclusively in SEK and has changed due to natural fluctuations arising from different interest-rate fixing periods for assets and liabilities. Table 6.3 shows the interest-rate fixing period of assets, liabilities and derivatives for the Consolidated Situation. Non-interest-bearing assets and liabilities have been excluded.

Table 6.1. Interest-rate risk by currency

SEK M	31 Dec 2018	31 Dec 2017
SEK	46.2	39.1
CHF	0.0	0.0
EUR	-0.5	-0.1
NOK	-0.1	-0.1
GBP	0.0	0.0
USD	0.0	0.0
<b>Total</b>	<b>46.7</b>	<b>39.3</b>

Net interest income risk is the risk of a negative effect on net interest income, some of the causes of which are changes in market interest rates or the company's financing costs. Table 6.2 presents the two scenarios and their impact on net interest income over the next three years.

Table 6.2. Net interest income risk

Net interest income, SEK M	2019	2020	2021
Market interest rate down 50 bp	-101.9	-79.8	-82.0
Market financing up 50 bp	-41.0	-154.2	-342.2

**Table 6.3. Interest-rate fixing period of assets, liabilities and derivatives - Interest-rate exposure, nominal values**

2018, SEK M	Up to 3 months	3-12 months	1-5 years	More than 5 years	Total
Loans	229,324.1	16,538.2	46,929.9	1,351.0	294,143.2
Bonds, etc.	8,815.0	7,808.8	29,614.7	382.0	46,620.6
<b>Total</b>	<b>238,139.1</b>	<b>24,347.1</b>	<b>76,544.6</b>	<b>1,733.0</b>	<b>340,763.8</b>
Deposits	109,490.9	2,695.3	437.9	0.0	113,848.0
Debt securities in issue, etc.	22,698.5	11,152.2	141,716.5	33,658.6	209,225.9
<b>Total</b>	<b>133,413.3</b>	<b>13,847.6</b>	<b>142,154.4</b>	<b>33,658.6</b>	<b>323,073.8</b>
<b>Difference assets and liabilities</b>	<b>104,725.9</b>	<b>10,499.5</b>	<b>-65,609.8</b>	<b>-31,925.6</b>	
Interest-rate derivatives, net	-89,217.4	-7,546.6	68,119.8	32,099.6	
<b>Net exposure</b>	<b>15,508.5</b>	<b>2,952.9</b>	<b>2,510.0</b>	<b>174.0</b>	

### 6.2.3 Spread risk

Spread risk is defined as the risk of losses arising due to changes in spreads between market interest rates.

In the Consolidated Situation, credit-spread risk arises in the liquidity reserve and currency-basis spread risk arises when hedging funding in foreign currency. Credit-spread and currency-basis spread risk are measured using sensitivity measures for each spread. The capital requirement calculation for spread risks in Pillar II uses a Value-At-Risk model.

### 6.2.4 Currency risk

Currency risk is the risk of losses arising due to exchange-rate fluctuations and is calculated as the total of the absolute amounts of the change in value per currency.

Currency risk arises in funding in foreign currency, primarily in EUR, CHF and NOK, and is measured as the effect of a momentary +/-10% change in the exchange rate. This risk is managed for each funding by converting the funding to SEK using swap contracts, which then results in no significant currency risk. Total currency risk on 31 December 2018 amounted to SEK 0.6 M (0.7).

### 6.2.5 Monitoring and reporting

All market risks are measured and controlled on a daily basis. Risk Management monitors the Board's limits every day. The CRO makes continuous reports to the Board, both in writing and verbally, at least once every quarter.



# 7 | Liquidity risk

Liquidity risk is defined as the risk that payment commitments cannot be fulfilled due to insufficient cash funds, or are only able to be fulfilled by funding at a significantly higher cost than normal or by divesting assets at a substantial deficit price.

## 7.1 RISK APPETITE

The Consolidated Situation's risk appetite for liquidity risk is low. The Board establishes the risk appetite, liquidity risk limits and the direction of liquidity risk management.

## 7.2 RISK MANAGEMENT

Liquidity risk is minimised and prevented by forecasting future liquidity requirements, high access to funds, explicit functional definitions and a high level of control. Liquidity risk is managed by the Treasury unit, which is also responsible for meeting the limits for liquidity risk set by the Board. The objective of liquidity-risk management is that the Consolidated Situation, at any given time, is to have sufficient liquid assets to fulfil its commitments under both normal and stressed market conditions.

The overall strategy for managing liquidity risk is based on highly diversified funding regarding investor base, instruments, currencies and maturities, and a satisfactory liquidity reserve. The operational liquidity risk management is based on the Bank Group, but also takes into account Länsförsäkringar AB with regard to LCR, NSFR and ALMM, with the requirement that the operations at all times are to meet their liquidity and financing undertakings.

## 7.2.1 Governance

Governance of the Consolidated Situation is based on limits, governance documents and established business targets. The central measure in the management of liquidity risk comprises the Bank Group's "survival horizon," meaning the period of time during which the Bank Group is able to meet its commitments without requiring access to new financing. The liquidity limit for the survival horizon has been set at 12 months.

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.

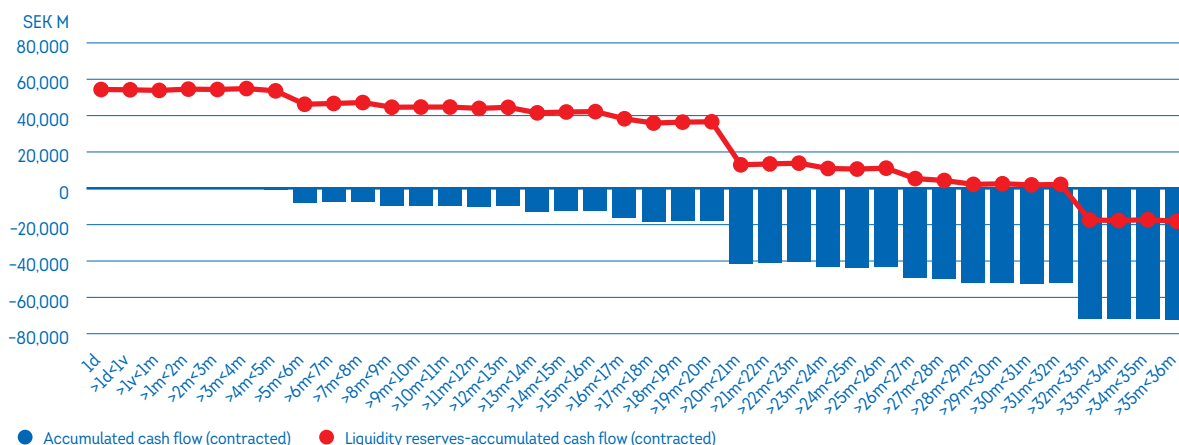
Figure 7.1 illustrates the Bank Group's survival horizon at 31 December 2018. The graph shows that contractual undertakings can be satisfied for 32 months (29) by utilising the liquidity reserve alone.

### Liquidity reserve

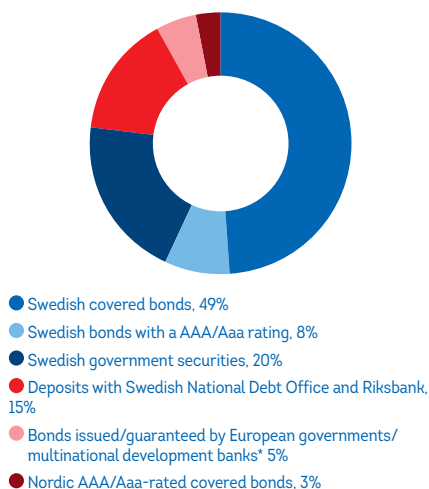
The Bank Group's liquidity reserve comprises securities of very high liquidity and credit quality, as well as deposits with the Riksbank or the Swedish National Debt Office. Most of the securities holdings are eligible for transactions with the Riksbank and, where applicable, with the ECB or the Federal Reserve, and can be quickly converted to cash and cash equivalents. The Treasury unit monitors and manages the liquidity reserve on a daily basis and is responsible for the amount of the reserve totalling the limits set by the Board.

On 31 December 2018, the liquidity reserve amounted to SEK 54.3 billion (48.1) and 49% (58) of the reserve comprised Swedish covered bonds. For a specification of the liquidity reserve, see Figure 7.2.

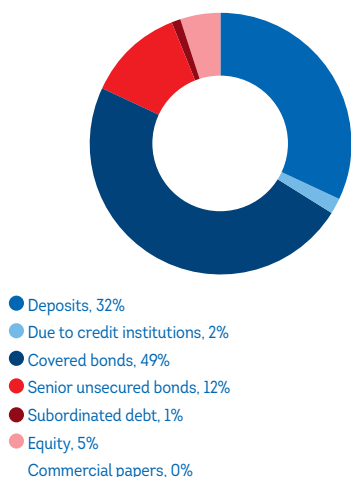
Figure 7.1 Survival horizon



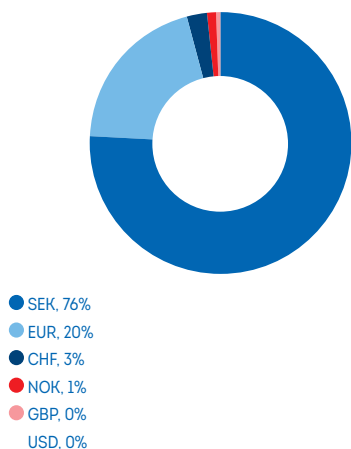
**Figure 7.2 Liquidity reserve**



**Figure 7.3 Funding sources**



**Figure 7.4 Funding by currency**



### Funding

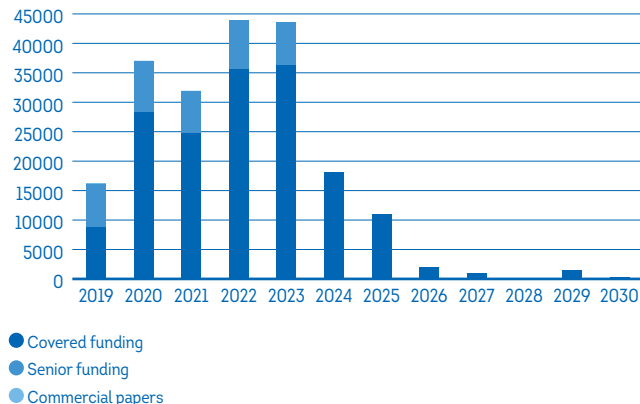
Every year, the Board decides on a funding plan that states the funding requirements and planned liquidity for the Bank Group. The financing plan contains key figures and targets for fulfilment of the objectives. Outcomes are monitored against the plan at every ALCO and Board meeting, and the plan is updated as required.

Funding takes place in a manner that creates a sound maturity profile without maturity concentrations, and is broadly diversified in terms of investors and markets. The Bank Group also endeavours to regularly launch issuances to build trust in the international capital markets. Funding takes place primarily through covered bonds since the majority of the Bank Group's lending comprises Swedish mortgages, although senior debt and short-term commercial paper programmes are also used. Wholesale funding primarily takes place in the Swedish market and in SEK. Other funding primarily takes place in SEK, EUR, CHF and NOK. For a specification of the Bank Group's financing and maturity structure, see Figure 7.3, 7.4 and 7.5.

In its funding operations, the Bank Group is to act predictably and actively in the market and aim at achieving as high liquidity as possible in outstanding debt to ensure healthy diversification and maintain investors' interest and credit limits. Regular meetings are held with both Swedish and international investors to ensure that these investors have a clear overview of the Consolidated Situation's operations, low risk profile and high-quality risk management.

Länsförsäkringar Bank's credit rating from Moody's and S&P remained unchanged at A1/Stable and A/Stable, respectively, during 2018. The stability of Länsförsäkringar Bank's credit rating from rating agencies is positive for the bank's ability to finance its operations at low costs in the capital markets. In addition, Länsförsäkringar Hypotek's covered bonds have the highest rating from both Moody's and Standard & Poor's.

**Figure 7.5 Maturity structure**



## 7.2.2 Risk measurement

Liquidity risk is quantified using daily liquidity forecasts based on all contracted cash flows and expected business volumes of deposits and lending.

The liquidity portfolio is regularly stress-tested using highly disadvantageous scenarios for the Bank Group. Two stress tests illustrate how long the liquid assets will last, given that the funding market is entirely closed and:

- Business volumes are constant (survival horizon).
- Lending growth is modelled according to the business plan and deposits reduce markedly.

Furthermore, the cover pool is stress tested in various scenarios with housing prices assumed to fall between 5% and 30%.

To comprehensively analyse the liquidity risk, the liquidity limit is supplemented with a number of structural and quantitative risk measures adapted to the Consolidated Situation's risk profile, including a minimum requirement for unutilised amount in the cover pool for the issuance of covered bonds.

The Consolidated Situation's Liquidity Coverage Ratio, as defined by the European Commission delegated act (LCR DA), amounted to 305% (339) at total level on 31 December 2018 and to 6,487% (-)<sup>1)</sup> in EUR.

The Net Stable Funding Ratio (NSFR) for the Consolidated Situation amounted to 115% (116) on 31 December 2018<sup>2)</sup>.

## 7.2.3 Monitoring and reporting

Liquidity risk is measured, controlled and reported on a daily basis. Outcomes are monitored against the Board's established guidelines and strategies at every ALCO and Board meeting. Material deviations are immediately reported to the Board, following guidelines established by the Board.

## 7.2.4 Encumbered assets

Encumbered assets are the portion of the company's assets that are pledged in some form. Asset encumbrance entails restrictions on the asset's area of use since the assets serve as collateral and its availability must be ensured at all times. The Consolidated Situation's main business area is mortgages and to enable market financing via covered bonds, the Consolidated Situation has a high percentage of encumbered assets that comprise the cover pool in Länsförsäkringar Hypotek AB.

<sup>1)</sup> No comparative figure is available since the Consolidated Situation on 31 December 2017 did not have any flows for the next 30 days in EUR.

<sup>2)</sup> The calculation is based on Länsförsäkringar Bank's interpretation of the Basel Committee's most recent Net Stable Funding Ratio proposal.

Table 7.1 Encumbered assets

SEK M	Carrying amount of encumbered assets	Fair value of encumbered assets	Carrying amount of unencumbered assets	Fair value of unencumbered assets
<b>Consolidated Situation's assets</b>	<b>190,366.3</b>		<b>173,237.7</b>	
Shares and participations	-	-	82.8	82.8
Bonds and other interest-bearing instruments	1,636.7	1,597.9	46,891.4	46,000.4
Other assets	188,729.6		125,727.1	

Table 7.2 Encumbered collateral

SEK M	Fair value of encumbered collateral for received and own issued bonds	Fair value of collateral received or issued own bonds
Consolidated Situation's collateral received	-	0
Bonds and other interest-bearing instruments	-	0

# 8 | Operational risk

Operational risk refers to the risk of losses due to inadequate or failed internal processes, human error, erroneous systems or external events and includes legal and compliance risk.

## 8.1 RISK APPETITE

The risk appetite for operational risk is determined by the Board. The Consolidated Situation has a low appetite for operational risk, meaning that these risks are limited as far as possible.

## 8.2 RISK MANAGEMENT

Operational risk encompasses the entire banking operations. All employees are responsible for actively managing operational risk within their individual operations. The department that takes the risk owns the risk, which means that the daily management of operational risk primarily takes place in the business operations. Risks are mitigated by proactive preventive measures and awareness of operational risk in every decision-making situation. There is also a structured monitoring of trends in operational risk.

### 8.2.1 Risk assessment

Operational risk is categorised according to Table 8.1, which are the main operational risk categories to which the Consolidated Situation is exposed.

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 – Effect on the operations
- Probability – how likely it is that an incident will occur.

**Table 8.1 Consolidated Situation's operational risk categories**

<b>Product and process risks</b>	Refers to the risk of losses arising due to established work procedures not functioning well, being unknown to employees or not being appropriate.
<b>Personnel risks</b>	Refers to the risk of losses arising due to unclear areas of responsibility, inadequate know-how needed for work duties, or a shortage of personnel in relation to work duties.
<b>Legal risks</b>	Refers to the risk of the Consolidated Situation not ensuring or monitoring compliance with laws, regulations or other relevant rules and recommendations, or that signed agreements or other legal documents are correct and valid, not archiving agreements and other legal documents or not managing and following up legal processes.
<b>Compliance risks</b>	Refers to the risk that the Consolidated Situation does not comply with laws and regulations, general advice from the Financial Supervisory Authority or European authorities or equivalents.
<b>IT risks</b>	Refers to the risk of IT systems not being available to the extent decided or not being sufficiently secure. Cyber risk, defined as risks inherent in the use or transfer of digital data, is included in IT risk.
<b>Security risks</b>	Refers to the risk of losses arising due to the Consolidated Situation being exposed to external crimes or internal fraud. It also encompasses the risk of damage to physical assets in the Consolidated Situation.
<b>Model risks</b>	Refers to the risk of losses arising due to decisions that are primarily based on the results of models on the basis of errors in the production, implementation or use of such models.

### 8.2.2 Risk management process

The risk management process for operational risk comprises the following main stages:

#### *Risk evaluation and monitoring controls for assessing operational risk*

A risk evaluation of the operational risk is regularly performed for all significant processes in the banking operations to highlight changes in the operations, external business environment or threat scenarios. Process analyses, incidents and implemented and future changes in the process are part of each business area's risk evaluation. These analyses are part of the operations' overall risk assessment. Risk evaluations are one of the tools used to identify operational risks and to plan risk-limiting measures.

#### *Risk indicators*

The aim of using risk indicators is to create conditions for better insight into the Consolidated Situation's risk profile and the risks that are increasing or decreasing at that point in time and over time. The Consolidated Situation has established a number of risk indicators tailored to the Consolidated Situation's operations. The Consolidated Situation works continuously on revising these risk indicators, which are updated every year.

#### *Approval process*

The Consolidated Situation has a process for approving new or significantly changed products, services, markets, processes, IT systems, and for major changes to the Consolidated Situation's operations and organisation or in the case of exceptional transactions. The purpose of the Consolidated Situation's approval process is to achieve efficient and appropriate management of the risks that may arise in connection with change work, to ensure compliance with applicable regulations, to impact capital, to ensure that approved products and changes are compatible with the risk strategy and risk appetite and to create customer value. The established risk model is applied to the assessment of each individual risk, as it is to all operational risks. Risk Management and Compliance are two of the stakeholders in implementing the approval process.

#### *Incident reporting*

Incidents that occur in the Consolidated Situation's operating activities are to be reported using the incident reporting system, which all employees have access to. Incidents are to be reported and managed as far as possible in the business area or the process in which the risk arises. The responsibility for analysing incidents and taking measures lies with the head of the process or operations.

Risk Management continuously monitors incidents reported in the business activities. Reported incidents are categorised in one of the following established incident types:

- Clients, products and business practice
- Business disruption and systems failures
- Execution, delivery, and process management
- Employment practices and workplace safety
- Damage to physical assets
- Internal fraud
- External fraud

***Continuity management***

Serious incidents may lead to a crisis. A crisis may arise, for example, due to fire, IT failure, liquidity disruptions or due to other serious incident. The Consolidated Situation works constructively to prevent this type of incident from arising. Relevant plans have been produced to support employees and managers in a crisis situation. Crisis training is conducted periodically to ensure that the plans are suitable.

**8.2.3 Monitoring and reporting**

Risk Management continuously monitors trends in the Consolidated Situation's operational risks. In addition, an aggregated operational risk report is submitted to the Board and relevant committees every quarter.

## 9 | Remuneration policy

Information about the company's remuneration policies available on the website:

[↗ lansforsakringar.se/stockholm/privat/om-oss/om-lansforsakringsgruppen/lansforsakringar-ab/ersattningsstruktur/](https://lansforsakringar.se/stockholm/privat/om-oss/om-lansforsakringsgruppen/lansforsakringar-ab/ersattningsstruktur/)

