Risk Management Report 2009

FØROYA BANKI

Board of Directors and Executive Board

Group objectives of the Risk Management Report

To inform shareholders and other interested stakeholders of the Group's risk and capital management policies, including risk management methodologies and practices.

CONTENTS

1. New requirement

Implementation of the revised executive order on capital adequacy (Pillar 3 of the Basel II Directive) means that banks have a new duty to provide information. This document constitutes Pillar 3 of the Basel II directive. The purpose of Pillar 3 is to enhance the transparency of banks and it is expected that the transparency will be increased by the disclosure requirements.

Implementing Pillar 3 implies that specific disclosure requirements are imposed on banks.

Føroya Banki will publish the information annually on the Bank's website when releasing the annual report. The information will be available as a separate unaudited document. There are no audit requirements for the Risk Management Report, but much of the information in the Risk Report Management Report will also be provided in the Annual Report.

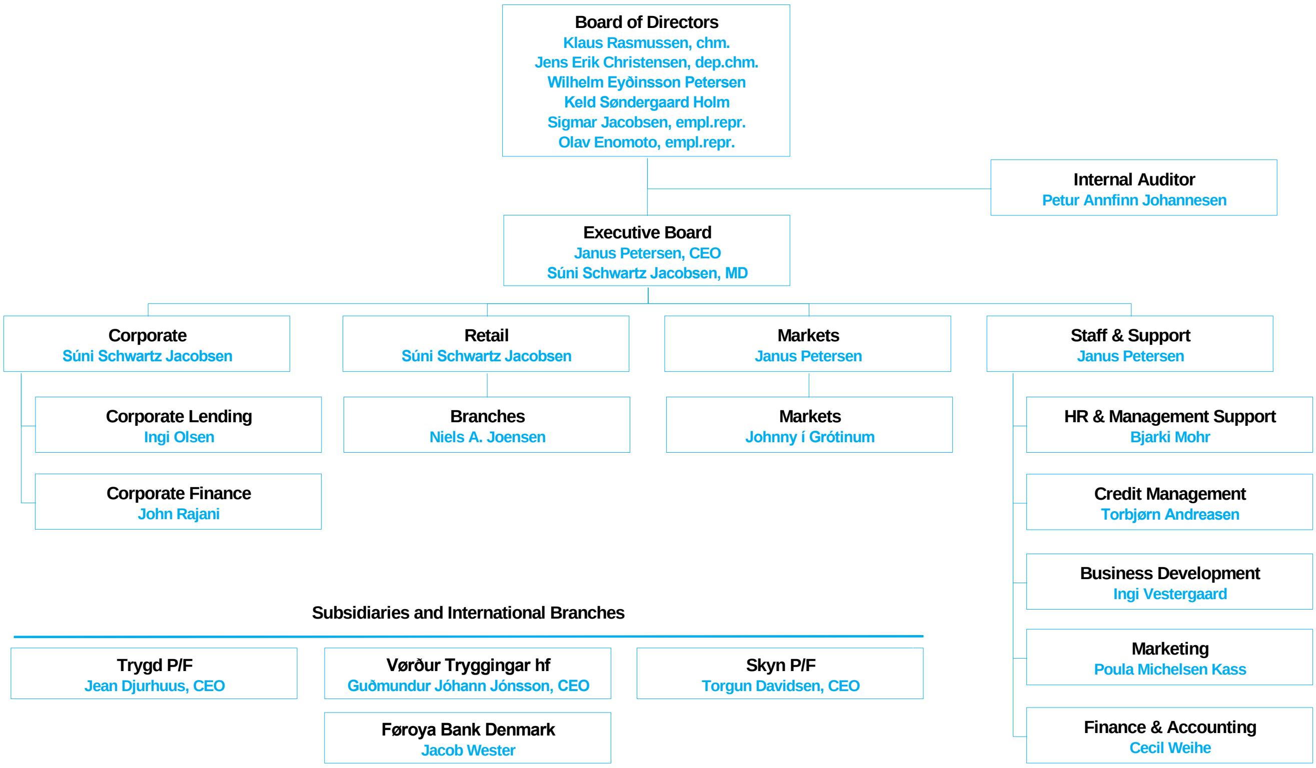
The purpose of Risk Management Report is to increase the transparency of the Group and to make available information on how the Group manages the risks it encounters.

2. Organisation

Understanding and ensuring transparency in risk taking are key elements of the Føroya Banki Group's business strategy. The Group's ambition is to set high standards in risk management. Its risk organisation supports this ambition, and it has developed expertise in risk management.

The Board of Directors sets out the overall risk policies for all types of material risk. The Executive Board is responsible for the day-to-day management of the Group. The Group uses the risk profile as a strategic concept to determine its risk-based exposure limits in accordance with its overall risk policies.

Figure 1 Group Organisation



The Group allocates considerable resources to managing and monitoring risk and to ensuring ongoing compliance with approved risk limits. The Group has a firm reporting cycle to ensure that the relevant management bodies, including the Board of Directors and the Executive Board, are kept informed of developments in risk measures at all times.

The following section describes the Group's organisational framework for risk management.

2.1. Risk policies and limits

The Board of Directors sets out the overall risk policies and limits for all material risk types. The Board also determines the general principles for managing and monitoring risk, and it reviews the risk policies and limits annually. The Group uses risk appetite as a strategic concept to determine its risk-based limits. Risk appetite represents the maximum risk the Group is willing to assume in pursuit of its business targets. The risk appetite framework offers an overview of various risk dimensions and enables the Group to manage risk measurement across these dimensions in accordance with its overall risk policies.

The framework is based on an analysis of the Group's and the major business units' current risk profiles. It includes setting explicit targets, limits and contingency plans in accordance with the risk policies. It also includes monitoring of risk levels.

The Group implemented the risk appetite framework in its major business units in 2009. Key risk elements are identified on an ongoing basis in a dynamic process driven by new products, procedures, risk measurement applications and developments in the economic environment. The Group conducts risk management at the customer and industry levels as well as on the basis of geographical location and collateral type. It takes a comprehensive approach to the core risk dimensions:

- Credit risk
- Market risk
- Liquidity risk
- Operational risk

Other risk dimensions are incorporated at the Group and business unit levels where appropriate. They include insurance, pension and concentration risk, financial strength, and earnings robustness. Specific risk instructions for the main business units are prepared on the basis of the overall risk policies and limits. These instructions are used to prepare business procedures and reconciliation and control procedures for the relevant units and for system development purposes.

2.2. Risk Organisation

Føroya Banki's "Rules of procedure" for the Board of Directors and the Executive Board specifies the responsibilities of the two boards and the division of responsibilities between them. This two-tier management structure was developed in accordance with Danish legislation, and the "Rules of procedure" is a key document on the Group's management structure, including the organisation of risk management and authorisations.

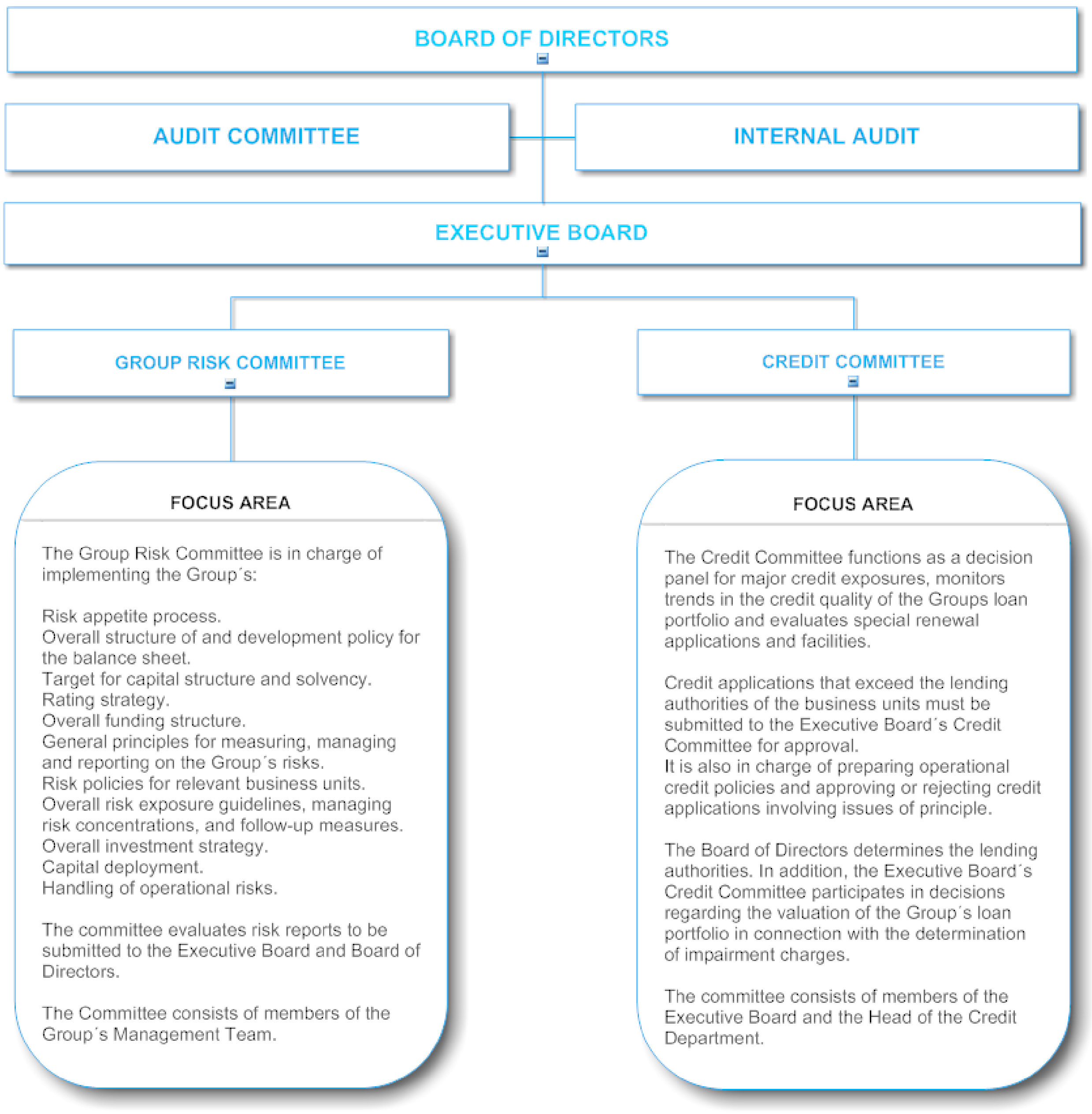
The Board of Directors lays down overall policies, while the Executive Board is in charge of the Group's day-to-day management and reports to the Board of Directors. None of the Group's executive managers serve on the Board of Directors of the parent company. The risk and capital management functions are separate from the credit assessment and credit-granting functions, as shown in figure 2.1.

The Group's management structure also reflects the statutory requirements governing listed Danish companies in general and financial services institutions in particular. The Føroya Bank Group applies the comply-or-explain principle in respect of the recommendations issued by the Danish Committee on Corporate Governance. These recommendations apply to companies listed on NASDAQ OMX Copenhagen and NASDAQ OMX Iceland.

The Audit Committee examines accounting, auditing and security issues that the Board of Directors, the Audit Committee, the internal auditor and the external auditors believe deserve attention. The committee also reviews the internal control and risk management system.

The Audit Committee consists of members of the Board of Directors.

Figure 2 Risk Organisation of the Føroya Banki Group



2.2.1. Board of Directors

The Board of Directors must ensure that the Group is appropriately organised. As part of this duty, it appoints the members of the Executive Board and the group chief internal auditor.

The largest credit facilities are submitted to the Board of Directors for approval, and the Board defines overall limits for market risk and liquidity risk. Regular reporting enables the Board of Directors to monitor whether the overall risk policies and systems are being complied with and whether they meet the Group's needs. In addition, the Board of Directors reviews reports analysing the Group's portfolio, particularly information about industry concentrations, large exposures and weak portfolios.

Internal Audit examines accounting, auditing and security issues. These are issues that the Board of Directors or the external auditors believe deserve day-to-day attention. The Internal Audit also reviews the internal control and risk management systems.

Due to the size and complexity of The Føroya Banki Group, the Board of Directors has not established other risk committees.

2.2.2. Executive Board

The Executive Board is responsible for the day-to-day management of the Group as stated in the "Rules of procedure" for the Board of Directors and the Executive Board.

The Executive Board sets forth specific risk instructions and supervises the Group's risk management practices. It reports to the Board of Directors on the Group's risk exposures and approves material business transactions, including credit applications up to a defined limit.

The Executive Board has established two committees to be in charge of ongoing risk management, the Group Risk Committee and the Credit Committee. The Group has also organised various subcommittees/functions for specific risk management areas such as asset and liability management and the management of risk parameters and models affecting the Group's capital and risk-weighted assets. The subcommittees consist mostly of members of the management team.

2.2.3. Group Risk Committee

The Group Risk Committee consists of

- the Risk Officer
- the Head of Finance & Accounting
- the Head of Business Development
- the Head of Markets
- the Head of HR & Management Support
- the CEO of TRYGD representing subsidiaries TRYGD and Vørður.

The Group Risk Committee is in charge of implementing the Group's

- risk appetite process
- overall structure of the balance sheet
- targets for capital structure and solvency
- rating strategy
- overall funding structure
- general principles for measuring, managing and reporting on the group's risks
- risk policies for relevant business units
- overall risk exposure guidelines
- investment strategy
- capital deployment.

In addition, the Committee evaluates risk report to be submitted to the Board of Directors. The Committee also assists the Executive Board in its functions and processes related to operational risk management, including

- implementing a programme that addresses and manages the group's current and potential risk
- processing reports from operational risk management functions
- monitoring the development and mitigation of the group's key operational risks
- handling "critical risks"
- processing management information on issues such as IT security, physical security, business continuity and compliance.

2.2.4. Credit Committee

The Credit Committee consists of members of the Executive Board and the Head of the Credit Department.
Credit applications that exceed the lending authorities of the business units must be submitted to the Credit Committee for approval. The local business units review these applications before the respective department heads submit them to the Credit Committee for approval.
The Committee is in charge of preparing operational credit policies and approving or rejecting credit applications involving issues of principle.
The Board of Directors determines the lending authorities. In addition, the Credit Committee participates in decisions regarding the valuation of the Group's loan portfolio in connection with the determination of impairment charges.

2.2.5. Staff Departments

The Group's overall risk issues including credit, market, liquidity and operational risks are monitored by the Risk Officer and the heads of Finance and Accounting, Business Development, Markets, Human Resources & Management Support and the CEO of TRYGD representing the Group's subsidiaries, in co-operation with managers of business units and subsidiaries, reporting directly to the Executive Board.

The Finance and Accounting department oversees the Group's financial reporting, budgeting, liquidity and capital structure, and the performance and analytical tools used by the business units. It also has overall responsibility for the Group's compliance with the Capital Requirements Directive and for the internal capital adequacy assessment process.

The Group has established a functional separation between units that enter into business transactions with customers or otherwise expose the Group to risk on the one hand, and units in charge of overall risk management on the other.

The Group's Risk Management unit is a separate function of the Group's Credit Department. Risk Management has overall responsibility for monitoring the Group's risk portfolio and reporting on overall risk measures. In addition, Risk Management is responsible for the implementation of risk models and risk analysis. Risk Management also handles relations with rating agencies.

The Credit Department has the overall responsibility for the credit process in all of the Group's business units. This includes responsibility for developing credit classification and valuation models and for seeing that they are used in day-to-day credit processing in the local units.

The Credit Department is in charge of determining the utilisation of portfolio limits for industries and countries and of the quarterly process of calculating the impairment of exposures. It also keeps track of the credit quality of the Group's loan portfolio by monitoring trends in unauthorised overdrafts and overdue payments, new approvals to weak customers and other factors.

In addition, the Credit Department reports to the Group management and to business units on developments in the Group's credit risk. Finally, the department is in charge of providing management information about credits, of monitoring credit approvals in the business units, and of determining the Group's requirements relating to its credit systems and processes.

HR & Management Support is in charge of analysing and monitoring the strategic business risk and corporate governance, while the Group's IR is handled by the Head of Markets. The Business Development unit is responsible for monitoring the Group's operational risk.

2.2.6. Business units

Core risk dimensions such as market risk and liquidity risk are managed centrally in the organisation. For credit risk, however, lending authority for specific customer segments and products has been granted to the individual business units. The business units carry out the fundamental tasks required for optimal risk management. This includes updating the necessary registrations about customers that are used in risk management tools and models, as well as maintaining and following up on customer relationships.

Each business unit is responsible for preparing carefully drafted documentation before business transactions are undertaken and for properly recording the transactions. Each business unit is also required to update information on customer relations and other issues as may be necessary.

The business units must ensure that all risk exposures comply with specific risk instructions as well as the Group's other guidelines. Loan and credit approvals to retail customers and small business customers are given according to the lending authorities delegated to the individual branches (see Figure 3 on page 16).

Customer advisers are responsible for the basic credit assessment of customers. Their lending authority depends on customer ratings, and they can approve credits up to certain amounts. Advisers must forward applications for credit facilities beyond their lending authority to the branch management, which may decide to submit applications to the Credit Department.

2.3. Reporting

The Group has a fixed reporting cycle to ensure that the relevant management bodies, including the Board of Directors and the Executive Board, are kept informed of among other things developments in risk measures, the credit portfolio, non-performing loans, market risk, strategic and operational risk.

The Board of Directors receives the principal risk reports annually (see Table 1) and interim reports quarterly (see Table 2). The report is updated quarterly in a condensed format, and once a year the full report is submitted to the Board of Directors for approval.

Table 1 Annual Reporting to the Board Of Directors

Risk appetite	Strategic determination of risk-based limits, representing the maximum risk that the Group is willing to assume in pursuit of business targets and in accordance with its overall risk policies.
Risk policy	Review of the Group's overall risk policy to determine whether revisions are required.
Models and parameters	Update on the use of risk models and risk parameters.
Quality of credit portfolio	Analysis of impairment charges and losses by business unit and portfolio break-downs by category, size, business unit, etc.

Table 2 Quarterly Reporting to the Board Of Directors

Føroya Banki Group Methodology	Evaluation of the preferred risk and the level of capital in relation to the internal Group methodology. The report contains the conclusions drawn from stress testing and the effect on expected losses and capital requirements.
Key figures for the credit portfolio	An overview of credit-quality indicators, classifications and trends in lending volumes.
Market risk	Analysis of the Group´s current equity, fixed income and currency positions and report on the utilisation of Board approved limits since the preceding report.
Large exposures	An overview of exposures equal to or exceeding 10% of the Group´s capital base and the sum of these exposures, including the percentage of the Group´s capital base it represents.

The Group Risk Committee evaluates risk reports to be submitted to the Executive Board and the Board of Directors. It also reviews annual reports identifying all of the Group's risks and providing information on risk trends. The Committee regularly receives reports on the Group's risks and reviews trends in the regional business units.

The Group Risk Committee regularly reviews trends in the Group's key operational risks and the progress on concrete action plans regarding these risks. The committee receives reports and acts on key risk indicators.

3. Capital Management

Føroya Banki is well capitalised with a high solvency ratio and excess capital relative to the regulatory requirements. The Board of Directors is focused on maintaining the necessary capital base to fulfil its strategic goals and sustain the Bank's continued business development.

In February 2009, the Danish parliament passed a bill allowing Danish credit institutions that meet the regulatory solvency requirement to apply for hybrid core capital. In September, Føroya Banki received DKK 204m in hybrid core capital, which brought the core capital ratio to 25 per cent.

A constant monitoring and valuation of the Group solvency ratio forms an integral part of the Group's capital management. The Board of Directors has established a dynamic solvency target for the purpose of ensuring that the Bank's solvency will be sufficient in turbulent times to withstand the effects of an economic downturn. Whenever there is an increase in RWA, the Group will raise its solvency target in order to respond to a potential increase in impairments and vice versa.

3.1. Framework of the Group's capital management

The basis of Føroya Banki Group's capital management is the regulatory framework in BASEL II that consists of three pillars.

- Pillar I contains a set of rules for a mathematical calculation of the capital requirement based on risk weighted assets (RWA).
- Pillar II describes the supervisory review and evaluation process and contains the framework for the internal capital adequacy assessment process.
- Pillar III deals with market discipline and sets forth disclosure requirements for risk and capital management.

3.2. Pillar I

In accordance with the Basel II requirements, the total RWA is calculated as the sum of RWA for operational, market and credit risk.

3.2.1. Approach to capital adequacy statement

The Bank's capital adequacy statement was completed in accordance with the executive order on capital adequacy for the Faroe Islands of 21 May 2008. This executive order applies from 1 January 2009, replacing executive order of 16 November 2001 as amended.

As a result of the change in the regulatory framework, the Bank applies the Basel II rules effective from 1 January 2009. These rules generally require that the capital adequacy statement divides the Bank's risks into credit risk, market risk and operational risk. Under s. 71(1) of the current executive order, banks in the Faroe Islands may, until 1 September 2010, substitute the standard method for calculating credit risk outside the trading portfolio, see ss. 9–18, and instead calculate the risk-weighted items relating to credit risk outside the trading portfolio in accordance with part 2 of the executive order of 16 November 2001.

Pursuant to s. 71(2), the Bank has notified the Danish Financial Supervisory Authority (FSA) that it applies the alternative allowed under s.71(1). As this alternative is being applied, the Bank has also elected not to calculate the risk-weighted items for operational risk, as permitted under s.71(6).

Accordingly, the Bank's capital adequacy statement complies with the executive order of 21 May 2008 and the Bank applies the exemption provisions of the executive order, meaning that credit risk outside the trading portfolio is calculated in accordance with the executive order of 16 November 2001. For the same reason, risk-weighted items for operational risk are not included.

Table 3 sets out the Bank's capital adequacy statement at 31 December 2009, including the basis for calculating risk-weighted items, core capital, the core capital after deductions, the capital base, the capital base after deductions and equity.

Effective from H1 Interim Report 2010, Føroya Banki will apply the standardised approach to calculating its RWA in accordance with Basel II.

Table 3 Statement of capital – P/F Føroya Banki

DKK 1,000	2009	2008
Core capital inclusive of hybrid core capital after deduction	1,768,845	1,496,906
Base capital after deduction	1,743,017	1,484,989
Risk-weighted items not included in the trading portfolio	6,029,519	6,674,214
Risk-weighted items with market risk etc.	618,176	526,678
Total risk-weighted items after group-wise write-downs	6,647,695	7,200,892
Core capital ratio	26.6%	20.8%
Solvency ratio	26.2%	20.6%
Core capital and shareholders' equity		
Share capital	200,000	200,000
Net profit	110,661	87,727
Retained earnings	1,308,584	1,236,315
Shareholders' equity	1,619,245	1,524,042
Deduction of intangible assets	27,857	0
Deduction of deferred tax assets	0	15,219
Deduction of insurance subsidiaries	25,827	11,917
Core capital exclusive of hybrid core capital after deduction	1,565,560	1,496,906
Hybrid core capital	203,285	0
Core capital inclusive of hybrid core capital after deduction	1,768,845	1,496,906
Base capital		
Core capital inclusive of hybrid core capital after deduction	1,768,845	1,496,906
Addition of revaluation reserve		
Deduction of insurance subsidiaries	25,827	11,917
Base capital after deduction	1,743,017	1,484,989

3.3. Pillar II

While Pillar I contains uniform rules for capturing a financial institution's risk and determining the capital requirements of the Capital Requirements Directive, Pillar I does not, however, necessarily capture all risk affecting individual institutions. Pillar II contains a framework for an internal capital adequacy assessment process based on the situation and characteristics of the individual institution.

The underlying aim of the Pillar II process is to enhance the link between an institution's risk profile, its risk management systems and its capital. Institutions are expected to develop sound risk management processes that properly identify, measure, aggregate and monitor their risk.

Pillar II is underpinned by four principles

- Assessment of capital adequacy in relation to its risk profile and capital strategy
- Review and evaluation of the assessment and its ability to monitor and ensure compliance with its own requirement.
- The expectation that the institution will operate above the minimum own funds requirements and the ability of the Danish FSA to require a firm to hold capital in excess of the minimum requirement.
- FSA intervention at an early stage to prevent capital from falling below the minimum level required to support the risk profile or to require rapid remedial action if capital is not maintained or restored.

In order to measure and identify all risk exposure to the Group, the Group applies a Danish FSA approved capital adequacy assessment process from The Association of Local Banks, Savings Banks and Cooperative Banks in Denmark (LOPI). The process is designed to pick up on any potential increase in risk.

3.3.1. Solvency requirement

The Group's Executive Board and Board of Directors are responsible for determining a sufficient base capital and lay down requirements for individual solvency. The Group's All Risk Committee have the responsibility for the ongoing monitoring and for making sure that solvency requirements determined by the Executive Board and the Board of Directors is complied with at all times. The overall responsibility for reporting to the Executive Board and the Board of Directors regarding solvency requirements lies with Finance & Accounting.

3.3.2. The methodology

To make sure that Føroya Banki can expose any potential risk and meet requirements set by the Executive Board and the Board of Directors, the Group has implemented methology from LOPI.

The methodology forms an integral part of the Group's organisation and requires the Group Risk Committee to meet on a regular basis to review checklists and make sure that every possible risk is exposed and evaluated. This translates into a quarterly report that is sent to Finance & Accounting. The report is then submitted to the Executive Management. The Board of Directors receives a condensed quarterly report and a full annual solvency requirement report that is submitted to the Board for approval.

The model (see Table 4) can be split in two main parts.

The first part involves stress-testing seven variables in the financial report to simulate how the result is affected under given circumstances. In its stress test, the Group assesses the amount of capital needed to withstand the effects of a downturn in the economy.

In addition to stress testing different risk parameters, the second part of the model involves additional capital requirements for individual risk exposures, where every potential material risk specific to Føroya Banki is taken into account and any potential risk is included in order to determine a possible additional capital requirement.

The summary of the stress test and any individual additional capital requirement constitute Føroya Banki's individual capital requirement.

Table 4 Føroya Banki's solvency model

	Derivetives	Impairmets	Shares	Interest rate	Exchage rate	Turnover	Other income		
Budget								√	
Stress test									General stress test
Credit risk		√							
Market risk			√	√	√				
Other risk	√					√	√		
Stress test total									
Capital for growth of business volume								√	Individual additional capital requirement
Aditional capital to cover credit risk									
Customers with financial problems								√	
Large exposure								√	
Commercial concetration								√	
Geographical exposure								√	
Concentration of collateral								√	
Deduction of impairmets								√	
Others								√	
Total aditional capital to cover credit risk									
Total aditional capital to cover marketrisk								√	
Total aditional capital to cover operational risk								√	
Aditional capital to cover other risk									
Strategic risk								√	
Reputation risk								√	
Risk related to institute size								√	
Real estate risk								√	
Group risk								√	
Raising capital								√	
Liquidity risk								√	
Other								√	
Total aditional capital to cover other risk									
Total aditional capital to legal requirements								√	
Total solvency-/capital requirements									

3.3.3. Group solvency requirement

The Group's solvency requirement has been calculated using the method illustrated above. As of December 2009, the solvency requirement was 6.9%, the risk-weighted items were DKK 6.6bn and the capital requirement was DKK 459m.

4. Credit Risk

Credit risk is the greatest risk facing the Group constituting about three-quarters of the total capital requirement. Føroya Banki has loans and advances of DKK 6,938m, the vast majority of which has been provided to customers in the Faroe Islands. The Bank pursues an overall credit policy calling for a balanced distribution of loans and advances.

Set out below is a presentation of the Bank's credit policy, credit scoring process, credit exposure and credit management. The Bank's procedures for writing off bad and doubtful debts form an integral part of this presentation.

4.1. Definition

The Group defines credit risk as the risk of losses arising because counterparties fail to meet all or part of their payment obligations to the Group. Credit risk also includes country, settlement and counterparty credit risks among other things.

Føroya Banki manages its overall credit risk by way of its general credit policy. One of the purposes of the credit policy is to ensure a balanced relationship between earnings and risk.

4.2. Policy

The Board of Directors sets the overall policies for the Group's credit risk exposure. The Group's risk appetite framework is determined in accordance with these policies. The key components of the credit risk policies are described below.

The Group's aim is to build long-term relationships with its customers. For the vast majority of products, credit is granted on the basis of the customer's financial circumstances and specific individual assessments. Ongoing follow-up on developments in the customer's financial situation enables the Group to assess whether the basis for the credit facility has changed. The credit facilities should match the customer's creditworthiness, capital position and assets.

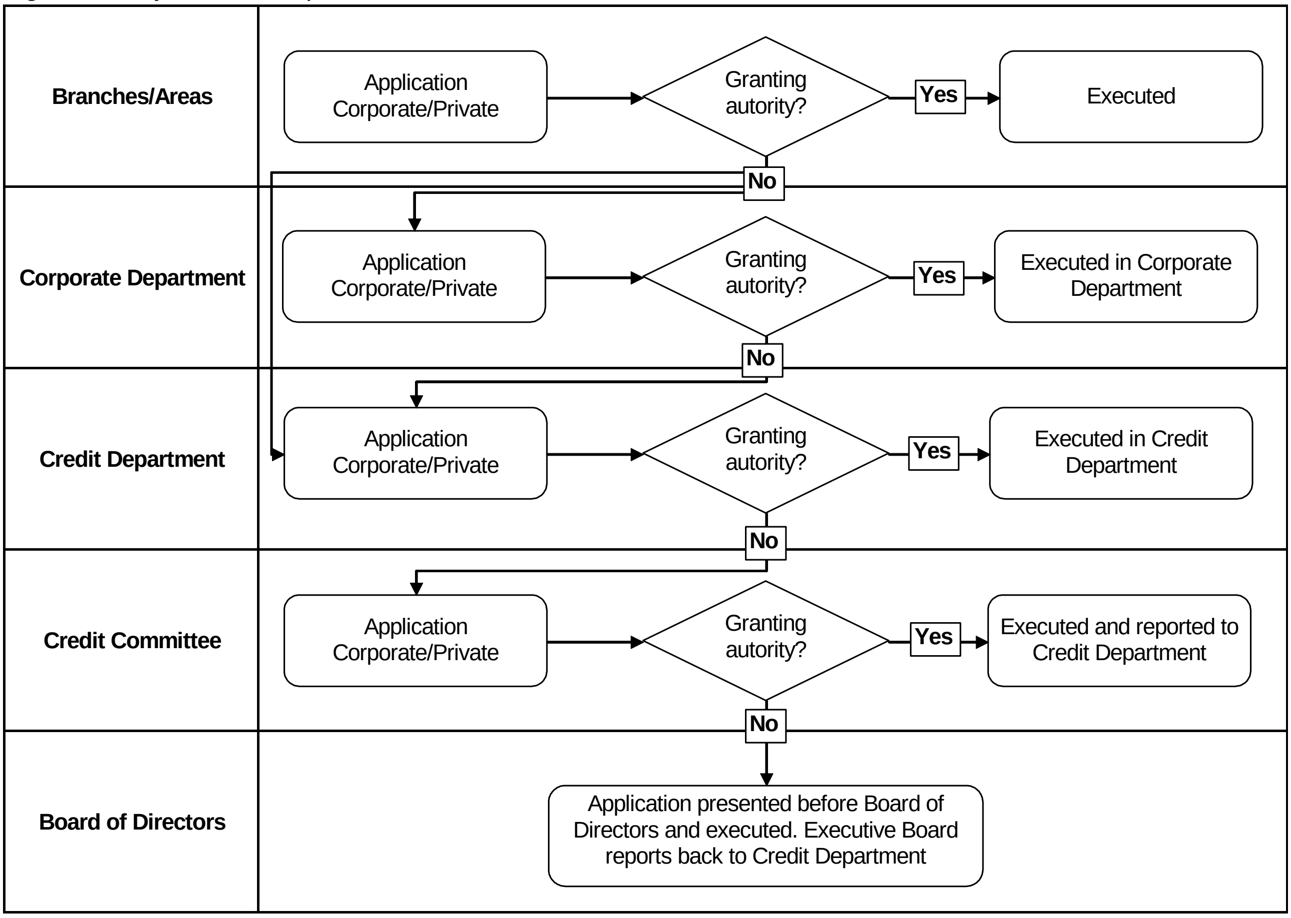
The Group aims to assume risks only within the limits of applicable legislation and other rules, including rules on best practices for financial undertakings. The Group normally considers requiring collateral in order to mitigate credit risk.

4.3. Credit process

In order to ensure a consistent, coordinated credit granting process of a high quality, the Bank has introduced a credit approval procedure that can be adjusted to market conditions (see section 2).

All credit applications are handled according to a pre-defined procedure that provides a consistent, high credit processing quality and ensures that our credit advisory services meet the Bank's guidelines. The figure below sets out the credit processing procedures.

Figure 3 Føroya Banki Group Credit Process



Bank branches: All branch managers can process and decide on credit applications within branch manager credit lines. Credit applications exceeding credit instructions are submitted to the Credit Department (retail customers) or to the Bank's Corporate Department (corporate customers) along with a credit recommendation.

Corporate Department: The central corporate department handles all of the Bank's major corporate accounts. Credit applications exceeding the Corporate Department's credit lines are submitted to the Credit Department for approval.

The Credit Department: Applications that exceed a branch credit line are submitted to the Credit Department. The Credit Department also processes all staff loan applications.

In addition to processing credit applications, the Credit Department coordinates and prepares credit recommendations to the Bank's Credit Committee and recommendations submitted to the Board of Directors.

The Credit Committee: The Credit Committee reviews all applications that are beyond the Credit Department's granting authority. The Credit Committee conducts credit meetings on an ongoing basis. The purpose of the Credit Committee is to:

- process credit applications exceeding the granting authority of the Credit Department;
- process and provide recommendations for all credit applications to be submitted to the Bank's Board of Directors;
- implement the guidelines for the credit area as approved by the Board of Directors; and
- to supervise the overall credit granting procedure.

Credit processing must be conducted on the basis of extensive knowledge of the risks inherent in each individual exposure for the purpose of striking a balance between risk and earnings opportunities and in compliance with the overall goals defined by the Board of Directors.

4.4. Risk classification

Føroya Banki's lending exposure is subject to very careful management as part of the day-to-day follow-up conducted by the departments with the day-to-day responsibility for the individual portfolios. The follow-up and management process is split into the following categories:

- day-to-day management is conducted by the relevant account manager;
- commitments meeting specific criteria are tested individually for impairment four times per year in connection with the Bank's quarterly financial statements;
- reports on exposures due for review by the Credit Department in cooperation with the relevant branch;
- largest exposures are reviewed annually with the Executive Board;
- constant monitoring of largest exposures is a key priority.

The Bank does not perform an actual rating of customers involving classification into homogenous groups. However, the Bank is currently working towards implementing a customer rating system.

4.5. Credit exposure

The following section provides a presentation and review of the Bank's loan portfolio. The review deals with the overall loan portfolio, followed by a report on the individual subportfolios.

The Bank's total loan portfolio listed by the categories is set out in Table 5. As can be seen, the Bank's credit facilities are largely equally distributed between the retail and the corporate segments. The Bank had granted credit to public, retail and corporate for a total amount of DKK 8,232m at 31 December 2009, which was DKK 664m less than at 31 December 2008.

Table 5 Loan portfolio

(DKKm)	**2009**	**2008**
Credit institutions and central banks	1,356	971
Public	530	505
Retail	3,964	3,980
Corporate	3,738	4,411
Total	**9,587**	**9,867**

In 2009, the Bank had DKK 1,356m placed with credit institutions and central banks. These funds are money market placements, not committed lines. In addition, the Bank had loans and advances of DKK 530m to the public sector, equal to 6% of the overall portfolio.

4.5.1. Credit exposure, lending activities

In connection with the quarterly IFRS review, the on-going follow-up on the Bank's loan portfolio is classified in the following categories (see section 4.4). Table 6 shows the Bank's portfolio based on the IFRS review.

Table 6 Quality of loan portfolio excl. financial institutions

(DKKm)	**2009**	**2008**
Portfolio without OEI or impairment/provision	7,472	8,362
Portfolio with OEI	313	N/A
Portfolio with impairment/provision	447	534
Total	**8,232**	**8,896**

4.5.2.1. Credit exposure, lending activities – Corporate

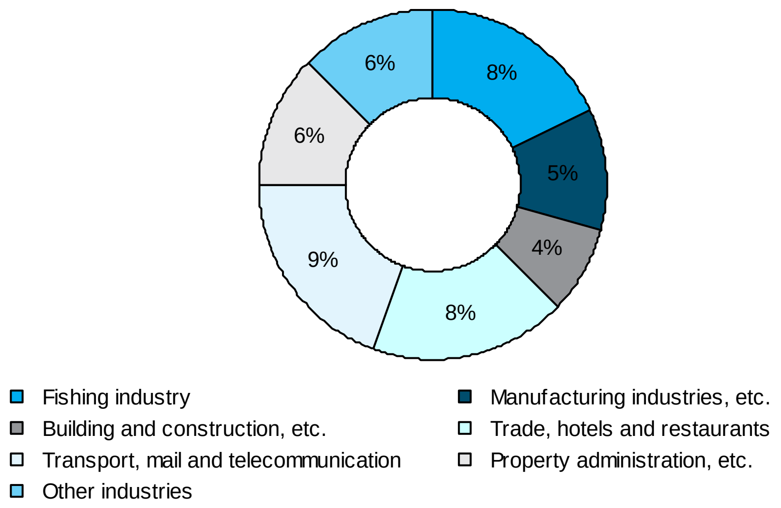
The Bank's overall target is for no industry to make up more than 10% (see Figure 4) of the Bank's total exposure. In addition, the Bank's long-term target is for no single exposure (on a Group basis) to make up more than 10% of the Bank's equity.

As can be seen from Table 7 below, the Bank has a total corporate loan exposure of DKK 3.7bn. The table also provides the portfolio breakdown by industry.

Table 7 Corporate exposure

(DKKm)	**2009**	**2008**
Fishing industry	680	914
Manufacturing industries, etc.	414	516
Building and construction, etc.	299	311
Trade, hotels and restaurants	680	776
Transport, mail and telecommunication	727	804
Property administration, etc.	464	415
Other industries	474	675
Total corporate sector	**3,738**	**4,411**

Figure 4 Corporate exposure relative to the overall credit exposure 2009



4.5.2.2. Credit exposure, lending activities – Retail

Having a strong position in the retail segment is a great priority for the Bank. Retail loans account for about 50% of the Bank's total loans and advances. The vast majority of the retail loans involves loans for purchases of real estate in which the Bank holds a first mortgage secured against the property.

Table 8 Retail exposure

(DKKm)	**2009**	**2008**
Real Estate	2,954	2,959
Car	184	209
Investment credit	21	24
Consumer credit	274	304
Other	531	485
Total retail	**3,964**	**3,980**

4.5.3. Credit exposure, trading and investment activities

Investment credits are a product the Bank provides to its customers only to a limited extent. The Bank had provided investment credits for a total of DKK 51m at the end of 2009, equal to 0.7% of the total loan portfolio. Table 9 shows the credit exposure of trading and investment activities by segment.

Table 9 Credit exposure of trading and investment activities

(*DKKm*)	**2009**	**2008**
Retail	21	24
Corporate	30	29
Total	**51**	**54**

Under the Bank's investment credit policy, investment credits can be geared by a factor 2.5 (foreign shares) up to a factor 7.5 (corporate bonds). The Bank takes a very prudent stance when offering investment credits to its customers.

4.6. Risk mitigation

As provided in the Bank's overall credit policy, the Bank seeks to minimise the actual risk. Accordingly, the Bank generally requires collateral for any credit facility granted. The kind of collateral the Bank may require when granting a loan depends on the account involved and is subject to an individual assessment of each credit application.

The Group applies the various instruments available to reduce the risk on individual transactions, including collateral in the form of tangible assets, netting agreements and guarantees. The most important instruments with which to reduce risk are charges in tangible and intangible assets, guarantees and netting agreements under derivative master agreements.

The types of collateral most frequently provided are real estate, ships/aircraft and motor vehicles.

The Group regularly assesses the value of collateral provided in terms of risk management. It calculates the value as the price that would be obtained in a forced sale less deductions reflecting selling costs and the period during which the asset will be up for sale. To allow for the uncertainty associated with calculating the value of collateral received, the Group reduces such value by way of haircuts. For real estate, haircuts reflect the expected costs of a forced sale. For listed securities, haircuts are calculated on the basis of an internal price volatility model. As a general rule, collateral for loans to public authorities is not calculated if there is no mortgage in real estate. For unlisted securities, guarantees by third party and collateral in movables, the haircut is 100%.

Table 10 Credit exposure and collateral for 2009

	Retail	**Corporates**	**Public**	**Total**
Exposure (*DKKm*)	3,964	3,738	530	8,232
Loan balance (*DKKm*)	3,588	2,916	433	6,938
Collateral (*DKKm)*	3,011	2,045	28	5,084
Unsecured (*DKKm*)	953	1,693	501	3,147
Unsecured balance (*DKKm*)	577	871	405	1,853
Unsecured ratio	24%	45%	95%	38%
Unsecured ratio balance	16%	30%	93%	27%

Table 10 shows the Bank's total credit exposure and the collateral for the loans granted divided into retail, corporate and public sector. Unsecured exposures accounted for 16% of the retail exposure and for 30% of the corporate exposures.

4.6.1. Mortgages on real property

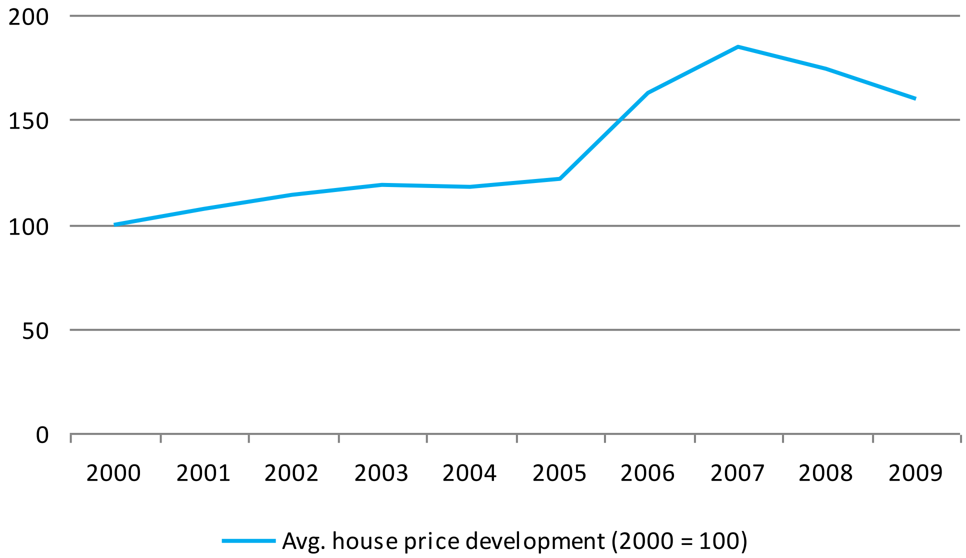
The largest part of the Bank's credit is granted against collateral in real estate. As can be seen from Table 11, collateral in real estate amounts to 74% of the total collateral. Data for collateral are only available for 2009 and are not specified by industry.

Table 11 Types of collateral 2009

(*DKKm*)	Retail	Corporates	Public	Total
Real estate	2,781	935	25	3,741
Deposits	36	30	3	69
Securities	2			2
Vehicles	136	237		372
Plant & machinery	1	54		55
Ship/aircraft	15	667		682
Guarantees	2			2
Other	39	122	0	161
Total	**3,011**	**2,045**	**28**	**5,084**

After several years of rising property prices, we saw declines in 2008 and 2009. Figure 5 below illustrates the general price developments.

Figure 5 Average House Price Development



Føroya Banki began cooperating with the Danish mortage instituton DLR in the summer of 2009. In Denmark, DLR focuses on mortgage loans for the financing of agricultural properties and urban properties.

4.7. Monitoring and portfolio management

Føroya Banki monitors credit facilities centrally through its credit systems. Costumers showing a weak financial performance are transferred to a watch list enabling the Bank to monitor them more closely and reduce the risk of losses. At least once a year, Føroya Banki reviews all exposures above a certain level.

Unauthorised overdrafts are automatically referred to the customer’s adviser, who decides whether or not to accept the overdraft. For good customers, the bank often accepts one or more accounts being overdrawn for a certain period of time. If the overdraft is not accepted, a reminder procedure is initiated.

Table 12 Outstanding amount

(DKKm)	**2009**	**2008**
Public authorities	14	8
Corporate sector	151	188
Retail customers	41	57
Total	**206**	**253**

4.7.1. Credit risk management

Credit portfolio risk management involves two sets of portfolios.

One set is used to monitor the overall credit risk broken down by industry. The risk appetite for each portfolio is based on a combination of industry input and the current credit quality of the portfolio.

The other set of portfolios concerns specific areas in which the Bank has identified a need to monitor exposure more closely. The largest exposures are monitored very closely.

Additionally, the business units monitor and review credit quality on a quarterly basis and report to the Credit Committee and the Group Risk Committee. The Credit Committee may take steps to counter negative developments in the portfolio. Detailed monitoring reports are made by the Credit Departments, and general reports are submitted to the Senior Management and the Board of Directors.

4.7.2. Risk concentration

The main objective of the Bank's credit policy is to optimise the risk/return ratio. A key factor of this objective is to have a well-diversified portfolio, both as regards industry composition and individual facility amounts. Føroya Banki has made a dedicated effort to balance the loan portfolio.

Table 13 Risk exposure concentrations

(DKKm)	**2009**	**2008**
Public authorities	530	505
Corporate sector:		
Fishing industry	680	914
Manufacturing industries, etc.	414	516
Building and construction, etc.	299	311
Trade, hotels and restaurants	680	776
Transport, mail and telecommunications	727	804
Property administration, etc.	464	415
Other industries	474	675
Total corporate sector	3,738	4,411
Retail customers	3,964	3,980
Total	**8,232**	**8,896**

4.8. Impairment/Losses

The Group estimates the future cash flow on the basis of the most likely scenario. The Bank tests the entire loan portfolio for impairment four times per year. Table 14 shows the Bank's total losses by industry from 1998 to 2009. As the table shows, the average losses ratio during the overall period was 0.7%. As can be seen from the data, there are relatively large variations from year to year and from industry to industry.

Table 14 Historical losses

	Weighted	2009	2008	2007*	2006*	2005*	2004*	2003*	2002*	2001*	2000*	1999*	1998*
Retail	0.5%	0.1%	0.0%	0.1%	0.1%	0.2%	0.3%	0.3%	0.5%	0.7%	1.0%	1.1%	1.2%
Agriculture	1.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	10.3%	0.0%	0.0%	0.0%	4.0%
Aqua Culture	4.3%	0.0%	0.0%	0.2%	0.0%	17.7%	31.5%	4.7%	0.5%	0.1%	0.0%	0.2%	0.0%
Fishing industry	0.9%	5.7%	0.0%	0.0%	0.0%	0.6%	0.0%	3.0%	0.3%	0.0%	0.1%	1.1%	0.7%
Manufacturing industries etc.	0.7%	0.0%	0.0%	1.9%	0.1%	5.6%	0.0%	0.0%	0.0%	0.1%	0.1%	2.2%	0.7%
Building and construction etc.	2.4%	16.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	2.0%	9.0%
Trade, hotels and restaurants	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	6.4%	1.9%
Transport, mail and telecommunication	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	6.4%	1.9%
Service	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.4%	1.0%
Property adm. purchace and sale etc.	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	1.0%	0.0%	0.0%	0.0%	0.0%
Retail, other	0.1%	0.0%	0.0%	0.0%	0.3%	0.0%	0.0%	0.6%	0.7%	0.9%	0.4%	0.7%	0.3%
Public authorities	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total	0.7%	1.1%	0.0%	0.2%	0.1%	1.3%	2.7%	0.9%	0.4%	0.4%	0.5%	0.9%	1.2%

*Provisions

According to IAS 39, OEI of a financial asset may appear before default, for example when a debtor is found to be in financial difficulty, likely to go bankrupt or enter into financial restructuring.

If OEI of a loan, advance or amount due exists, the Group determines the individual impairment charge. The charge equals the difference between the carrying amount and the present value of the estimated future cash flow from the asset, including the realisation value of collateral. Loans and advances without OEI are included in an assessment of collective impairment.

Table 15 Exposures and impairment charges by sector

	2009		2008	
(*DKKm*)	Exposures	Individual impairments	Exposures	Individual impairments
Public	530	-	505	-
Corporate	3,738	251	4,411	204
Retail	3,964	35	3,980	30
Total	**8,232**	**286**	**8,896**	**234**

Some of the impairment charges are directly linked to the international financial crisis. Although the Bank's credit policy has been to generally refrain from providing investment credits and from financing investments in securities, the Bank has financed a few investment companies based on their high solvency. The financial crisis has had a negative effect on some of these exposures, since the customers have realised losses on securities to an extent that has considerably weakened their financial strength. The Bank has taken impairment charges on these exposures that are considered to be sufficient and the risks on the remaining exposures related to these customers are considered to be limited.

5. Market Risk

In 2009, Føroya Banki's market risk exposures were stable and as planned at a low level.

5.1. Definition

The Group defines market risk as the risks taken in relation to price fluctuations on the financial markets. Several types of risk may arise and the Bank manages and monitors these risks closely.

Føroya Banki's market risks are

- Interest rate risk: risk of loss caused by changes in interest rates
- Exchange rate risk: risk of loss from positions in foreign currency when exchange rates change.
- Equity market risk: risk of loss from falling equity values

5.2. Policy and responsibility

The Group's market risk management relates to the Group's assets, liabilities and off-balance-sheet items.

The Board of Directors defines the overall policies/limits for the Group's market risk exposures, including its overall risk limits. The limit on market risk is set with consideration to the risk they imply, and how they match the Group's strategic plans.

On behalf of the Executive Board, the Group Risk Committee is responsible for allocating the market risk to the Group's major business areas, mainly to Markets in Føroya Banki, reflecting the Group's conservative approach to market risk.

Markets takes positions for the Group's own account. This primarily involves positions in Danish mortgage bonds for the purpose of placing liquidity. Finance and Accounting monitors and reports these risks to the Executive Board on a monthly basis.

Table 16 Reporting of market risk to the Board of Directors and the Executive Board

	Board of Directors
Quarterly	Overview of - Interest rate risk - Exchange rate risk - Equity market risk - Liquidity risk

	Executive Board
Monthly	Overview of - Interest rate risk - Exchange rate risk - Equity market risk - Liquidity risk
Daily	Overview of - Interest rate risk - Liquidity - Value adjustment of securities and bonds

Counterparty risk is the risk of not receiving the agreed value for any payment/trade. The Bank incurs counterparty risk when participating in clearing and settlement systems with counterparties. Føroya Banki participates in the Danish securities settlement system.

Danish mortgage and government bonds are the primary asset classes in the Group's portfolio of securities. This is due to the fact that these asset classes have high liquidity, good credit rating, no currency risk, and have limited interest rate and credit risk. Limits for interest rate and counterparty risk are set by the Board of Directors.

5.3. Control and management

Table 17 Market risk management

	Board of Directors	Executive management	Head of Finance & Accounting	Head of Markets
Strategic	Defines the overall market risk			
Tactical		Delegates risk authorities to relevant divisions	Manages the Bank's market risk	Implementing
Operational			Controlling & reporting	Trading

Head of Finance & Accounting monitors and draft reports on market risk to the Board of Directors on a quarterly basis and to the Executive Board on a monthly basis.

5.4. Market risk

Table 18 Market risk

	2009	2008
Interest rate risk, %	1.3	2.2
Foreign exchange position, %	1.5	1.3
Foreign exchange risk, %	0.0	0.0

The table of market risk shows that the Bank’s interest rate risk, exchange rate risk were at comfortable levels in 2009 and broadly in line with the figures prevailing in 2008.

5.5. Interest rate risk

The Group’s policy is to invest most of its excess liquidity in highly liquid bonds. As a consequence, Føroya Banki holds a large portfolio of bonds and most of the Group’s interest rate risk stems from this portfolio. Furthermore, as can be seen from the table below, the credit quality of the bond portfolio is high. Føroya Banki does not hold unlisted bonds.

Table 19 Rating of bonds

	2009	2008
AAA	84%	88%
AA1-A2	14%	11%
Other	2%	1%

The Group’s interest rate risk is calculated according to the requirements of the Danish FSA. The interest rate risk is defined as the effects of a one percentage point parallel shift of the yield curve.

Føroya Banki offers fixed rate loans to corporate customers. The interest rate risk from these loans is significantly reduced with interest rate swaps on a one to one basis. Føroya Banki has also granted fixed-rate mortgage loans and rate cap loans to retail customers. These loans are hedged in portfolios significantly reducing the interest rate risk. Fixed rate mortgage loans to retail customers are now offered in cooperation with DLR Realkredit.

Table 20 Interest rate risk broken down by currency

(*DKKm*)	2009	2008
DKK	22	32
EUR	1	2
JPY	0	
USD		0
CHF		0
GBP	0	
Interest rate risk	**23**	**34**

Table 20 shows the Group's overall interest rate risk measured as the expected loss on interest rate positions that would result from a parallel upward shift of the interest rate curve – in line with DFSA requirements.

5.6. Exchange rate risk

Føroya Banki's base currency is DKK and assets/liabilities in other currencies therefore imply an extra risk as they can vary over time relative to DKK. Føroya Banki's core business as a commercial bank makes it necessary to have access to foreign currencies and to hold positions in the most common currencies. Given the uncertainty of currency fluctuations, Føroya Banki´s policy is to keep the currency risk at a low level.

The Group's exchange rate risk mainly stems from:

- customer loans/deposits in foreign currency
- treasury's positions in foreign currency; and
- funding in foreign currency.

Table 21 Foreign exchange risk

(*DKKm*)	2009	2008
Assets in foreign currency	1,546	1,828
Liabilities and equity in foreign currency	1,547	1,889
Exchange rate indicator 1	26	21
Exchange rate indicator 2 (% of core capital)	0	0

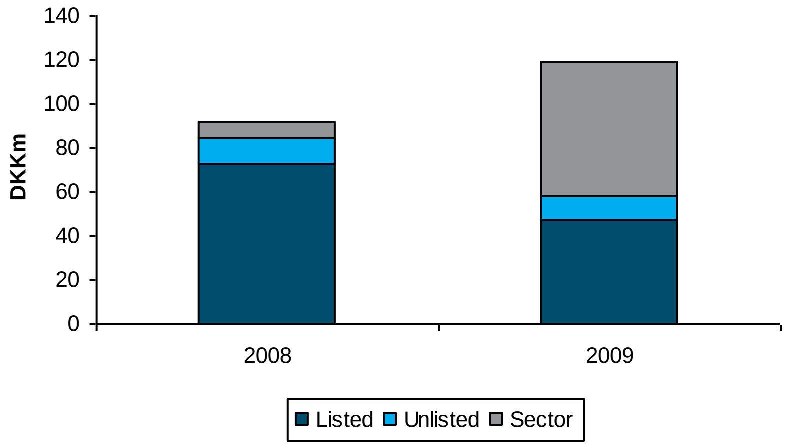
The Bank's exchange rate risk is measured by way of two key figures, the currency position and the currency risk calculated according to the requirements of the Danish FSA. The exchange rate risk is monitored on a daily basis with respect to the limits defined for each currency.

5.7. Equity market risk

Føroya Banki's stringent risk policy restricts positions in equities to listed and liquid shares and shares related to the Danish banking sector, but occasionally the Bank holds unlisted shares, if they are part of the enforcement of a defaulted loan.

The Group has acquired holdings in a number of unlisted banking-related companies. These are mainly investments in companies providing financial infrastructure and financial services to the Bank. For some of these investments, Føroya Banki's holding is rebalanced yearly according to the business volume generated by the Bank to the company. These unlisted shares are recognised at their acquisition price. The Group has increased the amount of unlisted shares as a consequence of the strategic cooperation with DLR and SDC.

Figure 6 Group equity risk



At 31 December 2009, the Group held listed shares valued at DKK 47m, unlisted shares of DKK 11m and sector shares amounting to DKK 61m.

6. Liquidity Risk

6.1. Definition

Liquidity risk is defined as the risk of losses resulting from

- increased funding costs
- a lack of funding of new activities
- a lack of funding to meet the Group's commitments

The Board of Directors has set the Bank's liquidity limits at the daily operational level and for budgeting plans.

6.2. Control and management

Liquidity risk is a fundamental part of the Group's business strategy.

The Group's liquidity is managed by Markets and reported to the Executive Board by Finance & Accounting in accordance with the limits set by the Board of Directors.

A liquidity report with stress tests is submitted to the Executive Board and the Group Risk Committee on a monthly basis.

Markets has the operational responsibility for ensuring that the Group observes the operational liquidity risk limits while Finance & Accounting is responsible for reporting and monitoring liquidity. The Group has implemented contingency plans to ensure that it is ready to respond to unfavourable liquidity conditions.

Table 22 Liquidity management

	Board of Directors	Executive Board	Finance & Accounting	Head of Markets
Objective	Defines the objectives for the liquidity policy			
Tactical		Sufficient and well diversified funding	Planning	Providing background materials
Operational			Monitoring	Establish contact

6.2.1. Operational liquidity risk

The objective of the Group's operational liquidity risk management is to ensure that the Group has sufficient liquidity at all times to handle customer's transactions and changes in liquidity.

Føroya Banki's bond portfolio forms a major part of the Bank's liquidity. It is therefore essential that the portfolio can be traded at fair prices at any time. Føroya Banki believes that a solid rating is one of the conditions for ensuring a fair price in the market. Hence, Føroya Banki's policy is to invest in bonds with high ratings and thereby minimize the liquidity risk of the Bank's bond portfolio. These bonds are also accepted by the Danish central bank for performing repurchase transactions.

The Bank has obtained a DKK 673m committed facility with the Danish central bank expiring in September 2010.

The current status of the liquidity is reported daily to the Executive Board.

6.2.2. Liquidity stress testing

Føroya Banki has incorporated a liquidity stress testing model. This model is used at least monthly to forecast developments in the Bank's liquidity on a 12-month horizon and to forecast whether, on a 3-month horizon, the Bank will achieve the Board of Directors' target of excess liquidity equal to at least 100% of the statutory requirement. The test is based on the business-as-usual situation with outflows from undrawn committed facilities and further stress measures. If the 3-month target is not met, the Executive Board can implement a contingency plan.

6.2.3. Twelve-month liquidity

In its rating methodology, "Bank Financial Strength Ratings: Global Methodology", Moody's, the international rating agency, has established a range of qualification criteria to be met in the liquidity management of a credit institution. One of these criteria is that the liquidity curve must, when submitted to a stress test, in general be positive for the following 12 months. The calculations in such a liquidity stress test are based on a condition of no access to unsecured capital markets during the period. The Bank would have positive net funding throughout the following 12-month period under such stressed circumstances.

6.2.4. Structural liquidity risk

Deposits are generally considered a secure funding source. Deposits are generally short term but their historical stability enables Føroya Banki to grant customers loans with much longer terms e.g. 25 years to fund residential housing. This maturity mismatch and associated risk is crucial for any bank to handle, and therefore it is essential to have a reputation as a safe bank for deposits.

Table 23 Loans and advances specified by maturity

(DKKm)	**2009**	**2008**
On demand	206	116
3 months or less	238	303
3 months to 1 year	489	521
Over 1 year to 5 years	1,721	1,791
Over 5 years	4,284	4,999
Total	**6,938**	**7,729**

External medium to long-term funding in the international credit markets has proven uncertain and cannot be relied on entirely at all times. Hence, the Board of Directors has set a strategic goal of reducing the dependency on this source of funding to a maximum borrowing level amounting to the statutory requirement of the Bank's liquidity.

To enhance access to international funding, the Bank has obtained a rating from Moody's and has taken initial steps to address the factors that Moody's have pointed out. A possible downgrade of the Bank's external rating would have a negative impact on the ability to attract competitive funding. An upgrade of the rating would be positive and improve access to funding. With the possibility of applying for a state guarantee for bond issues, Føroya Banki would not in the short term be affected by rating changes.

In order to minimise liquidity risk, Føroya Banki's policy is to have strong liquidity from many different funding sources. It is therefore the Bank's policy to further diversify the deposit base in terms of amounts, products and, to an increasing extent, geography.

Føroya Banki has entered into a cooperation with DLR Kredit A/S for the purpose of providing mortgage loans in the Faroe Islands. The agreement with DLR Kredit strengthens the Bank's funding base.

6.2.5. Funding sources

The Group monitors its funding mix to make sure that there is a satisfactory diversification between deposits, equity, hybrid capital, and long-term loans from the financial markets.

Table 24 Funding

(*DKKm*)	**2009**	**2008**
Due to credit institutions and central banks	1,498	2,317
Issued bonds	1,000	500
Deposits	5,497	5,494
Core hybrid capital	204	-

Føroya Banki's long term policy is to diversify the deposits by type, maturities and counterparty

Table 25 Deposit by maturity

(DKKm)	**2009**	**2008**
On demand	2,223	1,968
3 months or less	3,128	3,381
3 months to 1 year	4	1
Over 1 year to 5 years	140	145
Over 5 years	1	0
Total	**5,497**	**5,494**

6.3. Collateral provided by the Group

The only collateral provided by the Group is DKK 56m provided to the Danish central bank to give the Bank access to the intra-day draft facility with the central bank as part of the Danish clearing services for securities.

7. Operational Risk

The capital adequacy regulation stipulates that banks must disclose all operational risks.

7.1. Definition

According to the Basel Committee, operational risk is defined as follows:

"Risk of loss resulting from inadequate or faulty internal procedures, human errors and system errors, or because of external events, including legal risks."

Operational risk is thus often associated with specific and one-off events, such as clerical or record-keeping errors, defects or breakdowns of the technical infrastructure, fraud by employees or outsiders, failure to comply with regulatory requirements, fire and storm damage, litigation or codes of conduct or adverse effects of external events that may affect the operations and reputation of the Bank.

7.2. Policy

The Bank seeks to minimize its operational risks throughout the organisation by an extensive system of policies and control arrangements, which are constructed for the purpose of optimising procedures.

7.3. Measurement and control

At the organisational level, banking activities are kept separate from the control function. Independent auditors perform the internal auditing in order to ensure that principles and procedures are complied with at all times.

Disaster recovery plans are in place for all of the Bank's core systems, all of which have been tested satisfactorily. The Bank has a back-up system for all of its core systems and other critical systems at a location different from the primary system, with full back-up of the primary system every 24 hours.

Although the Bank has implemented risk controls and taken loss-mitigating actions, and substantial resources have been devoted to developing efficient procedures and training staff, it is not possible to implement procedures that are fully effective in controlling all operational risks. The Bank therefore holds insurance policies in respect of property, office equipment, vehicles and employee compensation as well as general liability and directors' and officers' liability. In addition, the Bank holds insurance policies in respect of theft, robbery, transportation between branches and conveyance by post of amounts below a reasonable figure. The Bank believes that the type and relative amounts of insurance that it holds are in accordance with customary practice in its business area.

The Bank has not been involved in any governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Bank is aware) during a period covering at least the previous 12 months, which may have, or have had in the recent past, significant effects on the Bank's financial position or profitability.

7.4. Calculation of the capital requirement

Føroya Banki applies the Basic Indicator Approach to determine the capital requirement for operational risk as outlined in the Capital Requirements applying to the Faroe Islands of 21 May 2008, Annex 18. This implies that the capital requirement for operational risk is calculated as: 15 per cent of the average "basic income" over the previous three years. Basic income is the sum of net interest income and non-interest net income.

Føroya Banki continually monitors the level of operational risk and assesses on a quarterly basis the capital requirement for operational risk. If the capital requirement is estimated to be higher than the limit mentioned above, this will be taken into account in the Bank's solvency requirements.

Figure 7 Basic Indicator Approach

(DKKm)	2009	2008	2007	Total	Average	15%
Basic Indicator	461	392	364	1,217	406	61

The basic indicator is as a three-year average of the sum of net interest income and non-interest net income. Net interest income and non-interest net income is calculated as the sum of the following items:

+	Interest income
-	Interest expense
+	Dividends on shares and other investments
+	Fees and commission income
-	Fee and commission expenses
+/-	Rate adjustments
+	Other operating income
	Basic Indicator

Long-term goals in operational risk management

In addition to monitoring the level of risk for assessing the capital requirement for operational risk, the Bank's monitoring system is designed to gather new statistics on operational risk. Thus, the long-term objective is that the monitoring system, which monitors the level of operational risk in the Bank's branches on a monthly basis, will have a preventive effect and thus help to minimise the Bank's operational risk.

8. Other Risk

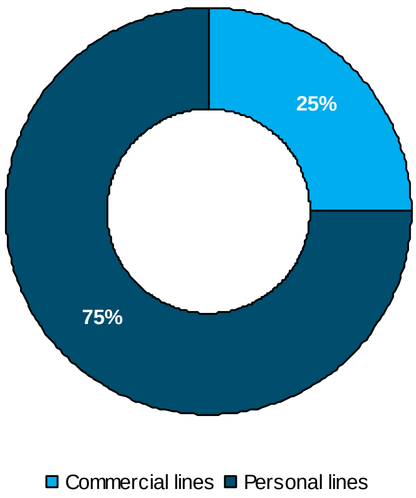
8.1. Insurance risk

Other risk types are measured and assessed under Pillar II. This includes insurance risk even though insurance risk is not included in the calculation of the minimum capital requirements. Insurance risk in the Group mostly involves non-life risk. The Group has two non-life insurance companies: TRYGD, which is wholly owned and Vørður, which is 51%-owned. Vørður holds a 30%-stake and the Bank holds 21%-stake in life insurance company Vørður Life.

Careful and prudent risk management is central to any insurance operation. The nature of insurance is to deal with unknown future incidents resulting in a payment obligation. An important part of managing insurance risk is reinsurance. The Group has to protect itself against dramatic fluctuations in technical results by entering into agreements on reinsurance so that the risk of the Group having to pay claims from its own funds is reasonable in relation to the size of the risks assumed, their composition and TRYGD and Vørður's equity. Such obligations are met through a statistical spread of risk and accumulation of funds, quantified by statistical methods.

A part of risk management is to hold a well diversified insurance portfolio. The combined insurance portfolio of TRYGD and Vørður is well diversified in personal and commercial lines (see table)

Figure 8 Insurance portfolio of TRYGD and Vørður



8.1.1. Definition

Risk exposure for an insurance company can be defined as a contingency event, chain of events or bad management which can on its own, or by accumulation, seriously affect the annual results of the insurer and in extreme cases make it unable to meet its liabilities. Risks for an insurance operation are traditionally categorised as insurance risk, credit and market risk, operational risk, currency exchange risk and investment risk.

8.1.1. Control and management

The Board of Directors sets out the instructions under which the companies operate. The Executive Management's role is to have internal procedures to monitor any risk on an ongoing basis to ensure compliance with the framework and to be able to meet future obligations.

8.1.2. TRYGD insurance

Insurance for personal customers is primarily written by the Group´s employees at TRYGD and in Føroya Banki´s branches, and secondarily through selected collaboration partners. Insurance to corporate clients is mainly written at TRYGD.

The size of provisions for claims is based on individual assessments of the final costs of individual claims, supplemented by statistical analysis.

TRYGD policies

- Acceptance policy
- Business and service policy
- Reinsurance policy
- Claims policy
- Reserves policy

The Company's acceptance policy is based on a full-service customer relationship, which is expected to contribute to the overall profitability of the Group. In relation to acceptance of corporate insurance products, the Board of Directors has approved a separate acceptance policy, which has been implemented in the handling process of the corporate department.

Insurance provisions to cover future payments for claims arising are calculated using appropriate and generally recognised methods. Insurance provisions are made to cover the future risk on the basis of experience from previous and similar claims. These methods and analyses are subject to the natural uncertainty inherent in estimating future payments, both in terms of size and date of payment.

An important part of managing insurance risk is reinsurance. The Group buys protection against dramatic fluctuations in technical results by entering into reinsurance agreements, so that the Group's retention is reasonable in relation to the size of the risks assumed, their composition and TRYGD´s equity.

TRYGD has set up a reinsurance programme which ensures that large natural disasters and significant individual claims do not threaten TRYGD´s ability to meet its obligations. For large natural disasters, the total loss to TRYGD is capped at DKK 10m. The reinsurance program is reviewed once a year and approved by the Board of Directors. TRYGD uses reputable reinsurance companies with good ratings and financial positions.

The Board of Directors at TRYGD has defined a low risk investment policy. Acording to the statutory requirements, Trygd holds reserves in respect of its liabilities under insurance contracts. These reserves are invested in Danish bonds, with at least 60% placed in government bonds. TRYGD's strategy for safe investment in Danish bonds makes the exchange rate risk for the company negligible. Trygd does not hold positions in equities.

The Claims Department at TRYGD is responsible for handling all claims. Only claims employees may deal with claims matters or advise claimants in specific claim cases. If this is not possible according to the terms of the insurance policy, an ex-gratia compensation may be granted in exceptional circumstances, if this is appropriate following an overall assessment of the claim, the history of the claim, and the customer's relationship with the Group.

Insurance provisions to cover future payments for claims arising are calculated using appropriate and generally recognised methods. Insurance provisions are made to cover the future risk on the basis of experience from previous and similar claims.

These methods and analyses are subject to the natural uncertainty inherent in estimating future payments, both in terms of size and date of payment.

8.1.3. Vørður insurance

Vørður tryggingar hf. was established in Iceland in 2002 but can trace its roots to 1926 as a small marine mutual operating in Akureyri, Iceland. Vørður tryggingar hf. is headquartered in Reykjavik and operates four branches outside the Reykjavik area. Vørður tryggingar hf. is 51%-owned by Føroya Banki and 49%-owned by Eignarhaldsfélagið ehf.

Vørður tryggingar hf. sells all classes of non-life insurance except aviation.

Vørður tryggingar hf. operates risk management under the supervision and guidelines of the Icelandic FSA and according to recognized best practices within the insurance industry. The responsibility of risk management lies with the Board of Directors and the CEO of Vørður.

8.1.4. Risk exposure and sensitivity analysis

Careful analysis of insurance risk exposure is performed annually in connection with reinsurance renewals. The objective of this analysis is to identify possible worst case scenarios, especially in relation to property and marine risks with regards to known and unknown accumulation of risks which might involve a loss from a single event. Reinsurance placements are tailored to meet those risks. The company purchases “Clashes of Retention” reinsurance to meet possible worst case scenarios such as a major storm, affecting many different classes of insurance.

Another factor of risk exposure is the number of risks underwritten by the company within different portfolios of insurance classes. These numbers are monitored and reported monthly to the management team.

Insurance risk:
Correct pricing is set in rating tariffs based on analysis of historical experience within the relevant portfolio. The Claims Department issues a monthly report setting out both frequency and value of losses within the portfolios and enabling early warning of any adverse changes. Tariffs, deductibles and/or insurance conditions are changed to meet developments in losses.

The companies protect their balance sheet from large losses by purchasing reinsurance. Maximum losses payable by the companies are therefore fully known factors. The companies’ own risk is determined by known recognised principles based on their own assets, annual premiums of the relevant portfolio and actuarial calculations to ensure efficiency.

The reserving for outstanding losses is based on a case-by-case assessment of the final cost of each claim, supplemented by statistical and historical analysis and actuarial calculations. Reserves are adjusted individually as new information is gathered and the claim develops. In addition, a complete review is performed at least twice a year and by the end of each year an actuarial calculation is performed.

Credit and market risk
The current investment strategies are based on utmost caution with both predetermined spread of investments and type of assets. Furthermore the companies are bound by regulation that determines allowable investments and how they are spread.

Current investment strategy is based on investments which ensure stable and reliable returns, such as government and mortage bonds with high ratings or deposits. Furthermore, the company applies prudent operational planning as regards expected investment income.

A monthly report is issued and presented to the Board of Directors of all outstanding default premiums. Accordingly, the default rate is carefully monitored. In addition, a procedure has been applied to ensure that the company gets off risk if premiums are not paid within 90 days of the due date.

Vørður only deals with reinsurance companies with an S&P A rating or better for all long-tail business and BBB or better for short-tail business. Current reinsurers of the company are all rated A or better with the exception for one small marine line for which the reinsurer is rated BBB. The risk of each reinsurance treaty is also spread to 2-10 different reinsurance companies according to the capacity of the treaty, spreading the risk of reinsurance default. The company sends quarterly reports on assets to the Icelandic FSA as required.

Operational risk
A detailed operational plan is in force for the company which is reviewed once a year and approved by the Board of Directors. Yearly reviews take into account recent changes and information to make all underlying factors as precise as possible.

A detailed security plan is in operation regarding the security of the IT-systems and data banks. All data are backed-up at least once daily and kept in secure off-site locations.

Vørður has an emergency plan for how to react if the company's offices are hit by a natural disaster as well as security arrangements such as off-site access to the data banks storing the operational back-ups. This plan is reviewed once a year.

At Vørður, the financials of the company are updated monthly and balanced. Procedures are in place regarding signatures on all invoices or claims received by the company. Actual payments are handled by a different employee. Co-signatures are needed if payments exceed certain amounts.

The Claims Department monitors court rulings in areas affecting the insurance operations for possible changes or clarification of legal principles which might result in added exposure for the company. The company is a member of the Icelandic Financial Services Association which monitors and reports to members any proposed changes of statutes relating to the insurance industry.

Currency risk
Vørður tryggingar hf. operates only in ISK and only issues insurance policies in ISK. All reinsurance agreements prior to 1 January 2008 were in ISK whereas premiums and claims are settled in ISK. Following the collapse of the Icelandic banking sector, this policy was changed effective from 1 January 2008. Current reinsurance treaties are strictly in ISK, but a clause has been added to the treaties, under which it is agreed that the parties to the contract may exchange premiums as well as claims to EUR/ISK four times a year applying the Icelandic Central Bank's official exchange rate prevailing at the date of payment. This means that Vørður does not carry any currency risk, as reinsurers are always obliged to pay ISK-denominated claims amounts in EUR at the Icelandic Central Bank's official exchange rate applying at the time of payment. Accordingly, Vørður always receives correct settlements in ISK.

Natural disaster risk
Vørður tryggingar hf. does not write any policies which include any natural disaster risk other than storm. In Iceland, there is a separate government-owned insurance company, the Icelandic Natural Catastrophe Fund, which insures property in Iceland against natural disasters such as earthquakes, volcanic eruption, avalanches, landslides and floods. As for storm coverage in relation to possible exposure, Vørður's standard property reinsurance with a limit of ISK 1,500,000,000 is deemed sufficient to cover possible loss due to a major storm, whereas the MPL (Maximum Probable Loss) is less than ISK 200m for such incident.

8.1.6. Vørður Life

Vørður Liftryggingar hf. is a small life insurance company established in 2007. The company began operations in early 2008. The company is owned by NBI hf. (49%), Vørður tryggingar hf. (30%) and Føroya Banki P/F (21%).

Vørður Liftryggingar hf. conducts regular life and critical illness business in the Icelandic market. The insurance portfolio has grown slowly but steadily and the number of issued policies is now at just over 3,000.

Traditionally, life insurance is a very stable business as the underlying risks are statistically very well known and calculated. All life insurance companies operate with mortality rates derived from the entire population and calculated by qualified actuaries.

Vørður Liftryggingar hf. has proportional reinsurance treaties for all of its business with a AA- rated reputable reinsurance company in Europe, resulting in a large diversification of insurance risk and therefore stable underwriting results. This is a common method among small life insurance companies as the reinsurance company becomes a direct partner in the operation, which provides access to large databases of statistical support for the ceding company.

As Vørður tryggingar hf. operates Vørður liftryggingar hf. through an outsourcing contract, all of the risk management processes for Vørður tryggingar hf. described above also apply exact to Vørður liftryggingar hf.