Risk Management Report 2012

BANKNORDIK

Board of Directors and Executive Board

Group objectives of Risk Management Report

To keep our shareholders and other stakeholders informed of the group's risk and capital management policies, including risk management methodologies and practices, both short term and long term.

P/F skr. nr. 10, Tórshavn

Contents

1 Introduction

The purpose of BankNordik's Risk Management Report is to ensure transparency in the BankNordik Group and to make available information on how the Group manages the risks it encounters.

BankNordik's Risk Management Report is published annually on the Group's website, www.banknordik.fo, simultaneously with the release of the Group's Annual Report. The Risk Management Report is a separate unaudited document. There are no audit requirements for the Risk Management Report, but much of the information in the Risk Management Report will also be provided in the audited Annual Report.

2 Organisation

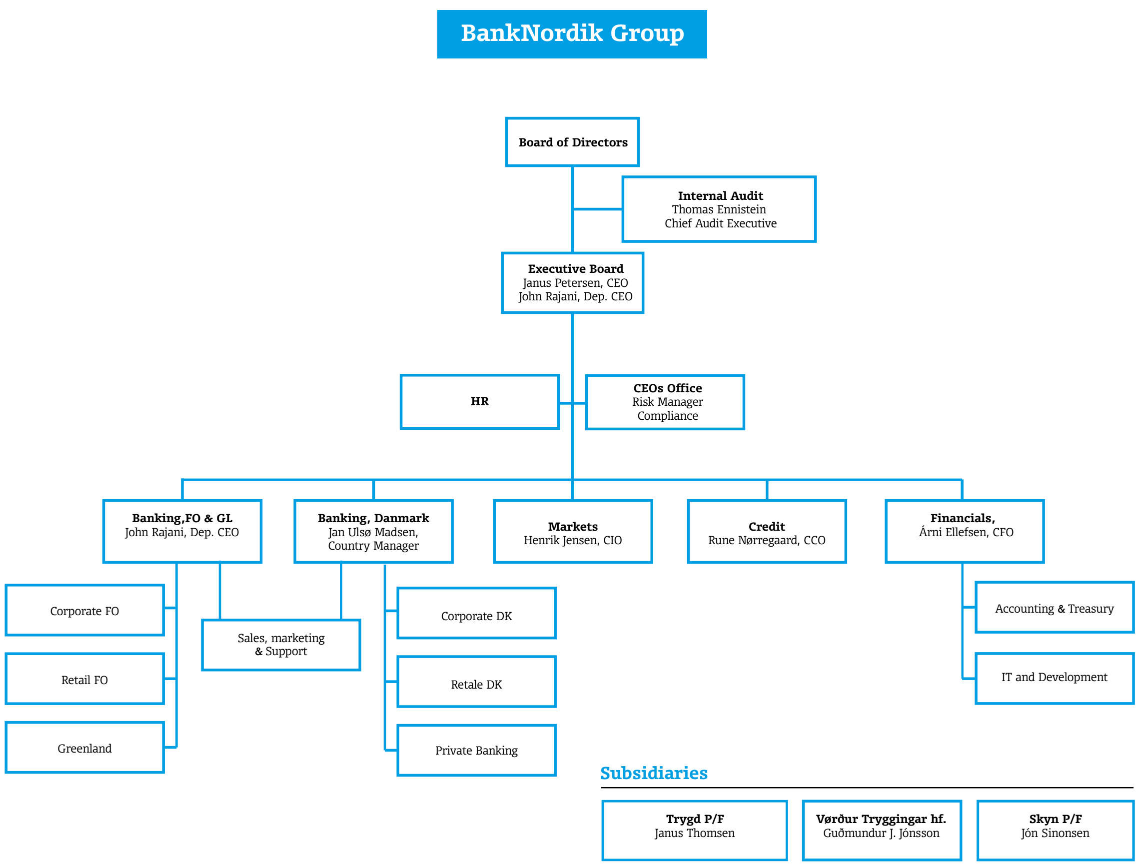
2.1 Introduction

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

The Board of Directors sets out the overall risk policies for all types of material risk while the Executive Board is responsible for the day-to-day management of the Group, including implementation of the risk policies and risk management.

The Executive Board consists of Group CEO Janus Petersen and Deputy CEO John Rajani, as shown in figure 1.

Figure 1



At the chief operational level, the Group is divided into three main business units:

- Banking operations, sales and marketing in the Faroe Islands and Greenland, headed by John Rajani, BankNordik's Deputy CEO
- Banking operations, sales and marketing in Denmark, headed by Jan Ulsø Madsen, Country Manager
- Markets, headed by Henrik Jensen, Chief Investment Officer

The Faroese and Icelandic insurance activities, along with the CEO'office and Human Resources report to Janus Petersen, Chief Executive Officer

The business units are supported by the following units:
- Credit, headed by Rune Nørregaard, Chief Credit Officer
- Finance, Accounting, Treasury & IR, IT and Development headed by Árni Ellefsen, Chief Financial Officer

The Group's risk officer and compliance officer are members of CEO'office.

The Group's Executive Board, the Country Manager, Chief Investment Officer, Chief Financial Officer and Chief Credit Officer constitute the Group Executive Management Team.

The Board of Directors and the Group Executive Management Team have established various sub-committees, including an Audit Committee, a Credit Committee and a Risk Committee.

The Group allocates resources to manage and monitor risk and to ensure on-going compliance with approved risk limits. The Group has a reporting cycle to ensure that the relevant management bodies, including the Board of Directors, the Executive Board and the Group Executive Management Team, are kept informed of relevant developments in risk measures.

The Group's risk policies as well as its limits and organisational framework for risk management are described in greater detail in the following sections.

2.2 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 current risk profiles of the Group and its major business units. 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 on-going basis in a dynamic process driven by new products, procedures, risk measurement applications as well as economic developments. 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 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.

2.3 Risk organisation

BankNordik's »Rules of procedure« for the Board of Directors and the »Board of Directors' Instructions to the Executive Board« specifies the responsibilities of the Board of Directors and the Executive Board and the division of responsibilities between them. This two-tier management structure has been developed in accordance with Faroese and Danish legislation, and the »Rules of procedure« and »Board of Directors' Instructions to the Executive Board« are key documents in 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.

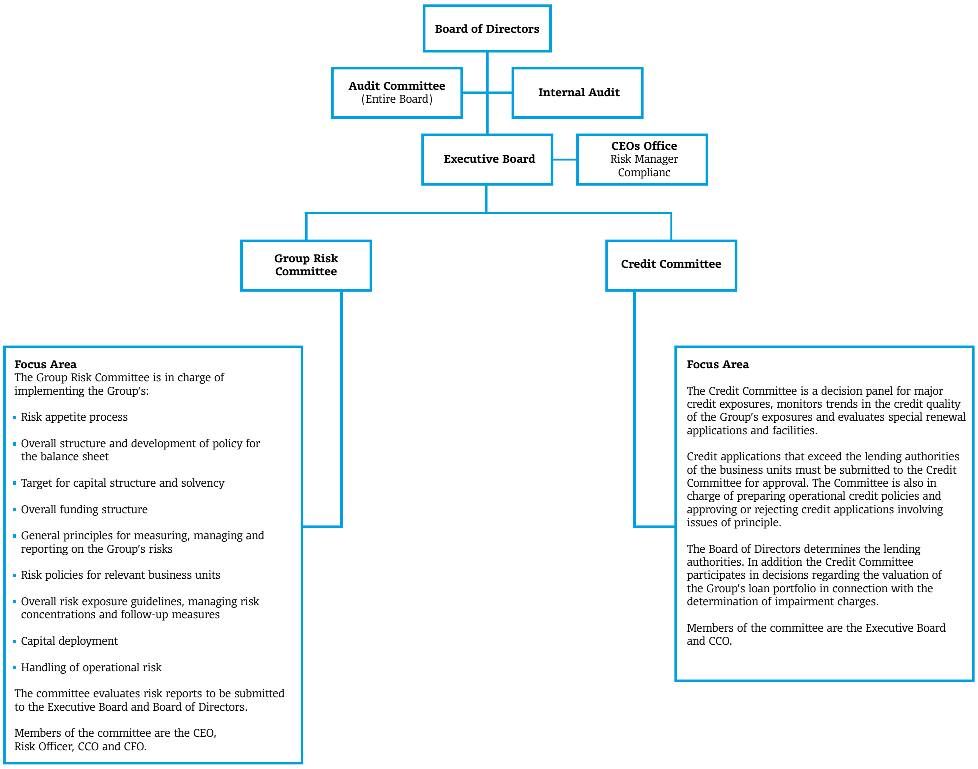
The Group's management structure also reflects the statutory requirements governing listed Faroese companies in general and financial services institutions in particular. The BankNordik Group applies the comply-or-explain principle in respect of the recommendations on Corporate Governance issued by the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

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

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

The Executive Board has assembled the Group Executive Management Team and established the two risk-orientated sub-committees, the Group Risk Committee and the Group Credit Committee.

Figure 2



2.3.1 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's 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 impaired exposures.

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. Internal Audit also reviews the internal control and risk management systems.

2.3.2 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 »Board of Directors' Instructions to 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 assembled the Group Executive Management Team and established two committees to be in charge of day-to-day risk management, the Group Risk Committee and the Group 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.

2.3.3 Group Risk Committee

The Group Risk Committee consists of:

- the Chief Executive Officer
- the Risk Officer
- the Chief Financial Officer and
- the Chief Credit Officer

The Group Risk Committee is in charge of identifying all main risks of the Group with the aim of optimising the Group's revenue compared to risk, e.g. by setting out guidelines for implementing and changing internal procedures for measuring and controlling risk, modelling principles etc.

The Group Risk Committee processes all risk-related matters, including

- the Capital Requirements Directive and related legislation
- internal procedures for measuring and controlling risk
- the capital structure and targets for and levels of solvency and liquidity
- allocation of risk capital to units and risk types, e.g. as part of the solvency requirement
- material changes in model principles for risk management and yearly evaluations of such principles and models

In addition, the Committee evaluates the 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.

2.3.4 Group Credit Committee

The Credit Committee consists of members of the Executive Board and the CCO.

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.

2.3.5 Staff departments

The Group's overall risk issues including credit, market, liquidity and operational risks are monitored by the Group Risk Committee, 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 related legislation 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 is carried out by the Group's Risk Officer which is a part of the Executive Board Secretariat with reporting rights and obligations to the Executive Board and reporting rights to the Board of Directors in risk-related matters. 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 and for providing support to the Group Risk Committee.

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 by the local units in their day-to-day credit processing.

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.

The CEO's office are in charge of analysing and monitoring strategic business risk and corporate governance. The Business Development unit is responsible for monitoring the Group's operational risk, and the Group's investor relations are handled by the Finance and Accounting department.

2.3.6 Business units

Core risk dimensions such as market risk and liquidity risk are managed centrally. For credit risk, however, lending authority for specific customer segments and products has been delegated 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 personal customers and small business customers are given according to the lending authorities delegated to the individual branches (see Figure 4).

Customer advisers are responsible for the basic credit assessment of customers. Their lending authority depends on customer credit risk classification, 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.

2.4 Reporting

The Group has a reporting cycle to ensure that the relevant management bodies, including the Board of Directors, the Executive Board and the Group Executive Management Team, 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 (see Table 1) and the principle solvency requirement in the form of the Group's annual solvency handbook. As part of the quarterly evaluation of the Group's solvency requirement, the Board of Directors receives up-to-date information on any material changes in the Group's risk profile. The Board of Directors receives interim risk reports on a quarterly basis with the main contents as set out in table 2 below. On a monthly basis the Board of Directors receives a report on the Group's market and liquidity risk.

The Group Risk Committee will review the annual and quarterly risk reports to be submitted to the Group Executive Management Team, 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. On a regular basis, the Committee receives reports on the Group's risks and reviews trends in the regional business units.

Table 1

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

BankNordik Group Methodology	Evaluation of the preferred risk and the level of capital in relation to the Group methodology. The report contains the conclusions drawn from the stress testing and the effect of scenarios 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 capital base and the sum of these exposures, including the percentage of the Group's capital base it represents.

Table 3

Liquidity risk	Analysing and stress tests of the Group's current liquidity
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.

3 Capital Management

BankNordik is well capitalised with a high solvency ratio and excess cover relative to the statutory requirements. The Board of Directors is focused on maintaining the capital base necessary to fulfil its strategic goals and sustain the Bank's continued business development. Constant monitoring and valuation of the Group solvency ratio forms an integral part of the Group's capital management.

3.1 Framework of the Group's capital management

The basis of the BankNordik Group's capital management is the Basel II regulatory framework, which 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 ll requirements, total RWA is calculated as the sum of RWA for credit, market and operational risk.

3.2.1 Approach to solvency statement

The Bank's solvency statement was completed in accordance with the executive order on capital adequacy for the Faroe Islands of 25 May 2011.

Table 4 sets out the Bank's capital adequacy statement as of 31 December 2012, including the basis for calculating risk-weighted items, core capital, core capital after deductions, capital base, capital base after deductions and equity.

Statement of capital – P/F BankNordik

Table 4

Solvency DKK 1,000	2012	2011
Core capital	1,537,748	1,522,756
Base capital	1,764,115	1,921,288
Risk-weighted items not included in the trading portfolio	9,644,767	9,827,802
Risk-weighted items with market risk etc.	1,172,371	1,406,647
Risk-weighted items with operational risk	1,084,613	1,078,250
Total risk-weighted items	11,901,750	12,312,700
Core capital rato, excl. hybrid core capital	9.6%	9.1%
Core capital ratio	12.9%	12.4%
Solvency ratio	14.8%	15.6%
Core Capital and Shareholders' eguity		
Share capital	200,000	200,000
Reserves	99,826	56,472
Net profit	103,099	24,560
Retained earnings, previous years	1,643,331	1,666,845
Shareholders' equity	2,046,255	1,947,877
Deduction of dividend	10,000	0
Deduction of Foreign currency translation reserve	18,443	16,373
Deduction of intangible assets	797,779	779,964
Deduction of deferred tax assets	26,333	4
Deduction of insurance subsidiaries	51,008	30,520
Core capital exclusive of hybrid core capital	1,142,692	1,121,016
Hybrid core capital	395,055	401,739
Core capital	1,537,748	1,522,756
Base capital		
Core capital	1,537,748	1,522,756
Addition of revaluation reserve		
Subordinated loan capital	277,375	429,052
Deduction of insurance subsidiaries	51,008	30,520
Base capital	**1,764,115**	**1,921,288**

3.2 Pillar II

While Pillar I contains uniform rules for capturing a financial institution's risk and calculating the capital requirements in accordance with the Capital Requirements Directive, it does not necessarily capture all risk affecting individual institutions. Pillar II contains a framework for an Own Risk Solvency 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 the institution's 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 Capital Requirement and the ability of the Danish FSA to require a financial institution to maintain a capital buffer relative to the MCR.
- 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.

The method is based on an 8+ approach. For credit calculation purposes this corresponds to applying the so-called credit reservation approach applied by the Danish FSA when reviewing exposures during bank inspections. An 8+ approach means that a review takes as its baseline the minimum requirement of 8 per cent of the risk-weighted items (pillar 1) plus a margin for risks and matters that are not fully reflected in the statement of risk-weighted items. In other words, ordinary risks are assumed to be covered by the 8 per cent requirement, and the question to consider is whether a bank is exposed to other risks that necessitate an increase in the solvency requirement (pillar II).

3.3.1 Solvency requirement

The Group's Executive Board and Board of Directors are responsible for maintaining a sufficient capital base and lay down requirements for individual solvency. The Group's Risk Committee is responsible for monitoring and making sure on an ongoing basis that the solvency requirements (methodological) determined by the Executive Board and the Board of Directors are complied with at all times. The overall responsibility for reporting to the Executive Board and the Board of Directors regarding solvency requirements lies with the Finance Department.

3.3.2 The methodology

The Group has implemented a methodology approved by the Danish FSA to ensure that BankNordik can expose/identify any potential risk and meet the requirements set by the Executive Board and the Board of Directors.

The methodology forms an integral part of the Group's organisation and the finance department prepares a quarterly report. The report is then submitted to the Executive Board. 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 method (see Figure 3) can be split into two main parts.

The first part involves the calculation of the general capital requirement (see the 8+ approach).

The second part consists of seven underlying risk factors:

- Earnings
- Growth in lending
- Credit risk
- Market risk
- Liquidity risk
- Operational risk
- Statutory requirements

In addition to these seven risk factors, the Bank calculates potential premiums for special risks believed not to be covered by the calculation of general risk. See the calculation of the 8+ capital requirement above. If any other areas of special risk are identified that are not listed in the model set out above, the Bank must calculate an extra capital requirement for such risk.

In addition to stress testing different risk parameters, the second part of the model involves additional capital requirements for specific additional individual risk exposures, where every potential material risk specific to BankNordik is taken into account and any potential risk is included in order to determine a possible additional capital requirement. The summary of the general 8+ capital requirement and any possible individual additional capital requirement constitute BankNordik's total individual capital requirement.

Figure 3: BankNordik's solvency model

Calculation of solvency need for P/F BankNordik
(DKK '000)

	Capital requirement, DKK		RWA capital requirement, per cent
1) Pillar 1 requirement (8% of risk-weighted items)			
+ 2) Earnings (capital for risk coverage due to weak earnings)			
+ 3) Growth in lending (capital to cover organic growth in business volume)			
+ 4) Credit risk, of which:	DKK	%	
4a) Credit risk on major customers in financial distress			
4b) Other credit risk			
4c) Concentration risk on individual exposures			
4d) Concentration risk on industries			
Total			
+ 5) Market risk, of which:	DKK	%	
5a) Interest risk			
5b) Equity risk			
5c) Foreign exchange risk			
Total			
+ 6) Liquidity risk (capital to cover more expensive liquidity)			
+ 7) Operational risk (capital to cover operational risk in excess of pillar I)			
+ 8) Margins due to statutory requirements			
Total capital requirement/solvency requirement:	DKK	%	
of which credit risk (4)			
of which for market risk (5)			
of which for operational risk (7)			
of which for other risks (2 + 3 + 6)			
of which for margins due to statutory requirements (1 + 8)			

3.3.3 Group solvency requirement

The Group's solvency requirement has been calculated using the method illustrated above. At the end of December 2012, the solvency requirement was 8.6%, the risk-weighted items were DKK 11.9bn and the capital requirement was DKK 1,022m.

4 Credit Risk

Credit risk is the most crucial risk facing the Group. BankNordik has loans and advances (exposures) of DKK 16,219m, the vast majority of which has been provided to customers in the Faroe Islands, Denmark and Greenland. 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 risk classification process, credit exposure and credit management. The Bank's procedures for writing off bad and doubtful debts form an integral part of this presentation.

In connection with the acquisition of Sparbank (2010) and Amagerbanken (2011), the Bank took over the individually impaired exposures. These impairment charges were included in the determination of the booked value of the acquired exposures or recorded as goodwill. Total is recorded DKK 476m on this account (see Table 16 for more details). Whether these impairments should be redeemed/repaid, these will be recorded as other income.

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.

BankNordik 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 connection between earnings and risk taking.

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.

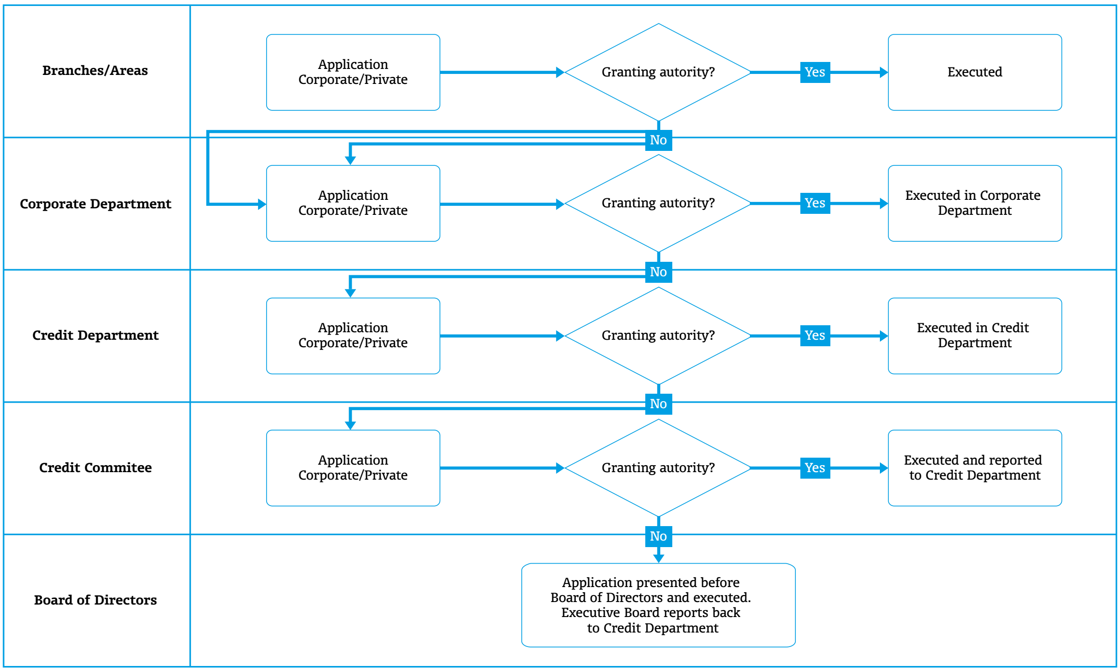
The Group's aim is to build long-term relationships with its customers. For the vast majority of products, credit is granted on the basis of the customer's financial circumstances and specific individual assessments. Ongoing follow-up on developments in the customer's financial situation enables the 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. Further and in order to increase the mitigation of credit risk, the Group as a general rule requires collateral.

The Group aims to assume risks only within the limits of applicable legislation and other rules, including rules on best practices for financial undertakings.

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. The figure below sets out the credit processing procedures.

Figure 4: BankNordik Group Credit Process



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

Corporate Department: The central corporate departments in the Faroe Islands, Denmark and Greenland 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 / Corporate Department credit line are submitted to the Credit Department for approval. The Credit Department also processes staff loan applications exceeding the limit of the branch credit lines. 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 (see section 2). 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.

Board of Directors: The Board of Directors reviews all applications that are beyond the Credit Committee granting authority (see section 2.4 for further details).

Credit processing must be conducted on the basis of extensive knowledge of the risks inherent to 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 Credit risk classification

BankNordik's lending exposure is subject to very careful management as part of the day-to-day follow-up conducted by the departments with day-to-day responsibility for the individual portfolio. 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;
- the largest exposures are reviewed annually with the Executive Board;
- constant monitoring of the largest exposures is a key priority.

The Bank does not apply an automatic rating model that classifies customers into homogenous groups. However, the Bank is currently working on implementing such a rating model for its Personal customers. The Bank has in recent years classified its customers in accordance with the methodology used by the Danish FSA (see table 8). Currently, about 84% of the overall exposure is individually classified (see table 7 for more details).

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 sub-portfolio. The figures includes individual and group impairments, which are itemized in part 4.8.

The Bank's total loan exposures portfolio listed by category is set out in Table 5. As shown, the Bank's credit facilities are largely equally distributed between the Personal and the corporate/public segments. At 31 December 2012, the Bank had granted credit to public, Personal and corporate customers for a total amount of DKK 16,219m at 31 December 2012 (not including credit institutions and central banks), which was DKK 852m less than at 31 December 2011.

Credit exposure — Table 5

(DKKm)	2012	2011
Credit institutions and central banks	816	726
Public	631	717
Personal	9,038	9,143
Corporate	6,550	7,166
Customers total	**16,219**	**17,025**
Total	**17,035**	**17,751**

At 31 December 2012, the Bank had DKK 816m 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 631m to the public sector, equal to 3.7% of the overall credit portfolio. The Personal sector accounted for 53% and the Corporate sector for 38% of total exposures (excluding credit institutions and central banks).

In the annual report 2012, figures for loans and guarantees are adjusted in accordance with the applicable accounting terms and are therefore not directly compareable to the exposure listed in this Risk Management Report.

4.5.1 Credit exposure, quality and concentration

In connection with the quarterly review, the on-going follow-up on the Bank's loan portfolio is classified in the following categories:

- Portfolio without weakness (3, 2a5)
- Portfolio with some weakness (sb15, 2b30)
- Portfolio with weakness (2c50)
- Portfolio with impairment/provision (1)

Table 6 shows the Bank's portfolio based on the review. The classification is based on the methodology used by the Danish FSA.

In their regular inspections, FSA classifies all larger exposures based on the same methodology as the bank does. If there is any difference in classification, the bank adjusts its classification according to the views of FSA. Thus the classification of the larger exposures will be in line with FSA's classification, adjusted for developments since their last inspection.

Quality of loan portfolio excl. financial institutions 2012 — Table 6

(DKKm)		> 50m	< 50m	Total
Portfolio without weakness (3, 2a5)	Exposure in DKKm	2,161	4,846	7,006
Portfolio with some weakness (2b15, 2b30)	Exposure in DKKm	399	4,344	4,743
Portfolio with weakness (2c50)	Exposure in DKKm	0	723	723
	Unsecured	0	372	372
Portfolio with impairment/provision (1)	Exposure in DKKm	135	970	1,105
	Unsecured	31	513	544
	Impairments/provisions	33	343	376
Portfolio without individual classification	Exposure in DKKm	0	2,642	2,642
Total	**Exposure in DKKm**	**2,695**	**13,524**	**16,219**

One advantage of using the FSA clasification is transparancy and that it gives a frame of reference, since all exposures in Danish banks are classified by FSA. As such the FSA classification constitute a market standard.

The Danish FSA performed inspections in the bank in 2011 and 2012. The outcome of the inspection was an extra impairment of DKK 7.4m, which is of course an insignificant amount, and their conclusion was that BankNordik's portfolio was above average compared to similar Danish banks.

As shown in table 6, 84% of total exposures are individually classified. The unclassified part of the portfolio has been steadily decreasing and upon classification such costumers are mainly classified without weakness (3 and 2a5) or with some weakness (2b15 and 2b30).

The impairments from the acquired portefolio in Sparbank and Amagerbanken of DKK 476m is not included in the total exposure.

The classification give some important insights to the credit quality of the portfolio. 87% of all classified exposures are labeled without weakness or with less significant weakness. This is of importance bearing in mind, that banks with high risk portfolios normally fail in their larger loans.

Another important insight is that BankNordik has a relatively low unsecured exposure in weak exposures (2c50). Above DKK 50m there are no weak exposures and in exposures less than DKK 50m there are only DKK 372m unsecured. This would indicate a relatively low likelyhood for new impairments coming from larger exposures. There is clearly a risk that a part of the weak exposures in retail will turn into impairments but because of the large number of exposures it must be expected that this will happen in the course of a longer timespan.

In 2012 the profit before impairments and special items was DKK 303m. Thus the Group has a comparatively good ability to absorb losses in the future. Almost all unsecured weak exposures can be covered in one years earnings.

The Bank's overall target is for no industry to make up more than 10% (see figure 5) of the Bank's total exposure. In special cases, such exposures may be above 10%, but only for customers of a high credit quality, and where the Bank has accepted collateral. 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 base capital. The Bank has three customers with exposures exceeding 10% of the base capital. These three exposures are found in the aquaculture, energy sector and the property administration (owned by public authorities).

Large exposures — **Table 7**

	2012	2011
Exposures › 10% of Capital base (%)	36%	23%
Exposures › 10% of Capital base (DKKm)	641	448
Capital base (DKKm)	1,764	1,922

Credit exposure by Geographical area

Table 8

(DKKm)	2012				2011			
	Exposures	in%	Loan/Credits	Garanties	Exposures	in%	Loan/Credits	Garanties
Faroe Islands	7,568	47%	6,220	661	7,872	46%	6,631	535
Denmark	7,111	44%	4,503	676	7,732	45%	4,746	789
Greenland	1,540	9%	954	444	1,422	8%	771	422
Total	**16,219**	**100%**	**11,677**	**1,780**	**17,025**	**100%**	**12,148**	**1,746**

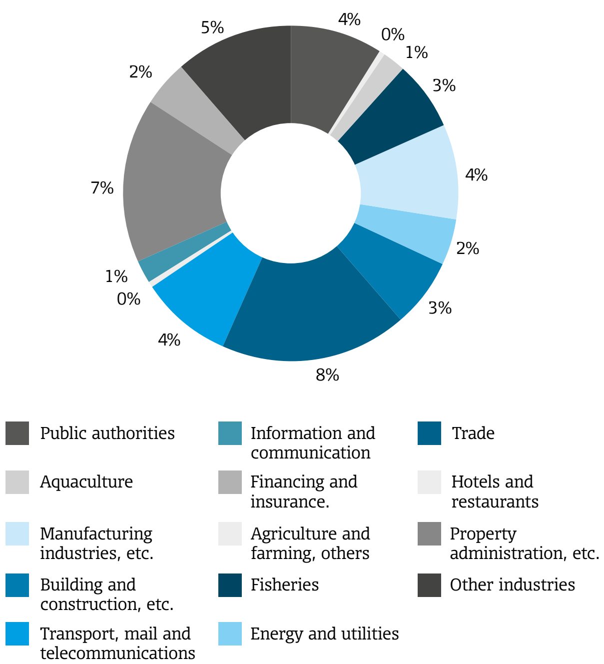
Risk exposure concentrations

Table 9

	2012		2011	
(DKKm)	DKKm	In %	DKKm	In %
Public authorities	631	4%	717	4.2%
Corporate sector:				
Agriculture and farming, others	68	0%	79	0.5%
Aquaculture	146	1%	250	1.5%
Fisheries	469	3%	630	3.7%
Manufacturing industries, etc.	575	4%	539	3.2%
Energy and utilities	346	2%	174	1.0%
Building and construction, etc.	559	3%	895	5.3%
Trade	1,245	8%	1,319	7.7%
Transport, mail and telecommunications	616	4%	461	2.7%
Hotels and restaurants	24	0%	91	0.5%
Information and communication	173	1%	243	1.4%
Property administration, etc.	1,120	7%	1,103	6.5%
Financing and insurance	360	2%	441	2.6%
Other industries	850	5%	943	5.5%
Total corporate sector	6,551	40%	7,166	42.1%
Personal customers	9,038	56%	9,143	53.7%
Total	**16,219**	**100%**	**17,025**	**100.0%**

Figure 5

Risk exposure concentrations 2012



As can be seen from table 9 above, the Bank has a total corporate loan exposure of DKK 6.6bn. The table also provides the portfolio breakdown by industry. No single industry exceeds 8% of total exposures.

Personal loans/guarantees balance distribution table 10

(in%)	2012	2011
Real estate	64%	54%
Car	5%	6%
Credits	10%	8%
Guarantees	10%	10%
Other	12%	22%
Total	**100%**	**100%**

Having a strong position in the Personal segment is a crucial priority for the Bank. Personal loans account for about 56% of the Bank's total loans and advances. The vast majority of the personal loans in the Faroe Islands involves loans for the purchase of real estate in which the Bank holds a first mortgage secured against the property.

4.6 Risk mitigation

As provided in the Bank's overall credit policy, the Bank seeks to minimise actual risk taking. Accordingly, the Bank generally requires collateral for any credit facility granted. What kind of collateral the Bank may require when granting a loan depends on the account/customer 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 on 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 in addition to guarantees provided by owners or, in the Danish market, by floating charge (virksomhedspant).

The Group regularly assesses the value of collateral provided in terms of risk management. The value is calculated 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, see table 12. For real estate, haircuts reflect the expected costs of a forced sale and a margin of safety. This haircut is 20% of the expected market value. 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 (exclusive of guarantees from public authorities and banks) and collateral in movables, the haircut is 100%.

Credit exposure and collateral for 2012

Table 11

(DKKm)	Personal	Corporates	Personal & Corporate	Public	Total
Exposure	9,038	6,550	15,588	631	16,219
Loans, advances and guarantees, amount drawn	7,515	5,388	12,903	557	13,460
Collateral	5,398	3,771	9,169	185	9,354
Unsecured (of Exposures)	3,640	2,779	6,419	446	6,865
Unsecured (Loans, advances and guarantees, amount drawn)	2,117	1,617	3,733	372	4,105
Unsecured ratio	40%	42%	41%	71%	42%
Unsecured ratio balance	28%	30%	29%	67%	31%

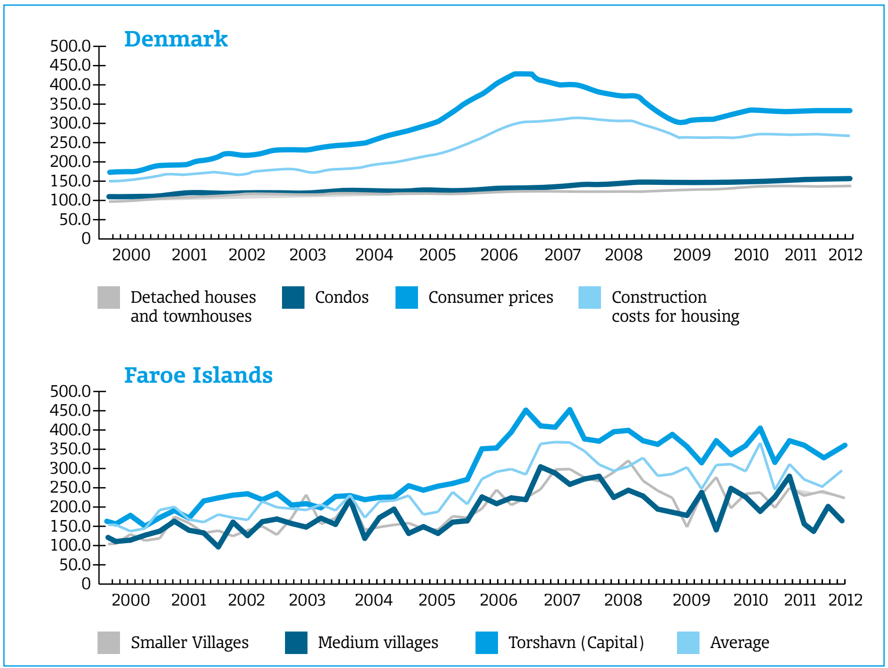
Credit exposure and collateral for 2011

(DKKm)	Personal	Corporates	Personal & Corporate	Public	Total
Exposure	9,143	7,166	16,308	717	17,025
Loans, advances and guarantees, amount drawn	6,879	6,510	13,389	505	13,894
Collateral	5,122	3,610	8,732	258	8,990
Unsecured (of Exposures)	4,021	3,556	7,577	458	8,035
Unsecured (Loans, advances and guarantees, amount drawn)	1,757	3,143	4,900	247	5,146
Unsecured ratio	44%	50%	46%	64%	47%
Unsecured ratio balance	26%	48%	37%	49%	37%

Table 11 shows the Bank's total credit exposure and the collateral for the loans granted divided into Personal, corporate and public sector. Unsecured exposures accounted for 41% of Personal exposures and for 42% of corporate exposures. Most of the Bank's credit is granted against collateral in real estate.

After several years of rising property prices, there were moderate declines in the period in the Faroe Islands. Denmark experienced a higher rate of decline. Figure 6 below illustrates the general price developments in the Faroe Islands and Denmark.

Figure 6: Developments in average house prices in Denmark and the Faroe Islands (1995 = 100)



Source: Statistics Danmarks and the Association of Danish Mortgage Banks Source: Own research

There are no publicly available statistics illustrating developments in house prices in Greenland. The Bank estimates that house prices are relatively stable at a high level. The Bank offers mortgage loans to Personal customers in the Faroese market in cooperation with Danish mortgage provider DLR Kredit. In the Danish and Greenlandic markets, mortgage loans are distributed in cooperation with Danish mortgage providers Totalkredit and DLR Kredit.

4.7 Monitoring and portfolio management

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

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 on collection procedure is initiated.

Distrubution of past due amount

Table 12

	2012				2011		
(DKKm)	Exposure	Past due total	Past due > 90 days	Total balance with past due	Exposure	Past due total	Past due > 90 days
Portfolio without weakness	7,006	72	2	843	5,091	27	4
Portfolio with some weakness	4,743	51	6	769	2,381	35	12
Portfolio with weakness	723	14	4	164	492	18	9
Portfolio with impairment/provision	1,105	39	18	318	1,020	89	60
Portfolio without individual classification	2,642	21	1	228	8,041	56	16
Total	**16,219**	**197**	**32**	**2.322**	**17,025**	**225**	**102**
Past due in % of exposure		1.21%	0.20%			1.32%	0.60%

As shown in the table above, DKK 32m is more than 90 days past due, which is a reduction of DKK 70m compared to 2011.

4.7.1 Credit risk management

The Bank monitors on a continuing basis and reviews at least once a year the segments wich should be given extra attentation.

On a continuing basis credit audits are conducted and additionally, based on monthly generated credit risk reports, the business units and the Credit Department monitor and review credit quality and on a quarterly basis the Credit Department prepares a credit risk report to the Credit Committee and the Board of Directors.

4.8 Impairment/Losses

The Group estimates the future cash flows on the basis of the most likely scenario. The Bank tests the entire loan portfolio for impairment four times per year. Table 13 shows the Bank's total losses by industry from 1999 to 2012. As the table shows, the average loss ratio during the overall period was 0.8%. As can be seen from the data, there are relatively large variations from year to year and from industry to industry.

Historical losses

Table 13

Sector:	Veighted	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999
Personal	0.3%	0.2%	0.3%	0.1%	0.1%	0.03%	0.1%	0.1%	0.2%	0.3%	0.3%	0.5%	0.7%	1.0%	1.1%
Agriculture	0.3%	0.0%	0.0%	0.0%	0.0%	0.00%	0.0%	0.0%	0.0%	0.0%	0.0%	10.3%	0.0%	0.0%	0.0%
Aquaculture	4.0%	0.0%	0.0%	0.0%	0.0%	0.00%	0.2%	0.0%	17.7%	31.5%	4.7%	0.5%	0.1%	0.0%	0.2%
Fisking indurstry	1.6%	6.6%	14.0%	2.8%	5.7%	0.00%	0.0%	0.0%	0.6%	0.0%	3.0%	0.3%	0.0%	0.1%	1.1%
Manufacturing industries etc.	1.0%	0.0%	0.3%	0.6%	0.0%	0.00%	1.9%	0.1%	5.6%	0.0%	0.0%	0.0%	0.1%	0.1%	2.2%
Building and construction etc.	2.5%	0.9%	0.3%	6.2%	16.0%	0.00%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	2.0%
Trade, hotels and restaurants	0.3%	2.4%	0.0%	0.0%	0.0%	0.00%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	6.4%
Transport, mail and telephone	0.3%	2.4%	0.0%	0.0%	0.0%	0.00%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	6.4%
Service	1.6%	1.2%	3.0%	1.6%	0.0%	0.00%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.4%
Property adm., purchace and sale and business services	1.3%	0.4%	0.5%	5.7%	0.0%	0.00%	0.0%	0.0%	0.0%	0.0%	0.1%	1.0%	0.0%		
Personal other	0.1%	0.0%	0.0%	0.0%	0.0%	0.00%	0.0%	0.3%	0.0%	0.0%	0.6%	0.7%	0.9%	0.4%	0.7%
Public Autorities	0.0%	0.0%	0.0%	0.0%	0.0%	0.00%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total	**0.8%**	**1.1%**	**0.9%**	**1.5%**	**1.1%**	**0.01%**	**0.2%**	**0.1%**	**1.3%**	**2.7%**	**0.9%**	**0.4%**	**0.4%**	**0.5%**	**0.9%**

According to IAS 39 and Executive Order on Financial Reports for Credit Institutions and Investment Firms, etc. as valid in the Faroe Islands, OEI (Objective evidence of impairment) 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.

Exposures and individual impairments by sector

Table 14

(DKKm)	2012		2011	
	Exp.	Impair.	Exp.	Impair.
Public	631	0	717	0
Personal	9,038	116	9,143	62
Corporate	6,550	260	7,166	257
Total	**16,219**	**376**	**17,025**	**320**
In % of total exposure.		2.3%		1.9%

In addition to the individual impairment charges above the Bank is required to test the remaining loan portfolio collectively for impairment. Table 16 below provides a breakdown of individual and collective impairment by geographical areas.

In connection with the acquisition of Sparbank (2010) and Amagerbanken (2011), the Bank took over some of the exposures that were individually impaired. These impairments are recognised as part of purchase price for the acquired exposures. DKK 476m of the impairments reflected in the tabel below are impairments recognised on the date of the take over and up to 12 months after the acquisition of the relevant exposure (see Table 15 second column).

Specification of individual and collective Impairments

Table 15

DKKm	2012 Individual impairments	2012 Impairments from acquired portfolio	2011 Individual impairments	2011 Impairments from acquired portfolio
Faroe Islands	178	0	230	0
Denmark	181	469	74	474
Greenland	18	3	15	3
Total individual impairments	376	471	320	477
Collective impairments:				
Faroe Islands	17	0	20	0
Denmark and Greenland	6	3	5	5
Collective impairments total	24	3	25	5
Total impairments	**400**	**474**	**345**	**482**

4.9 The Danish FSA's »Supervisory Diamond«

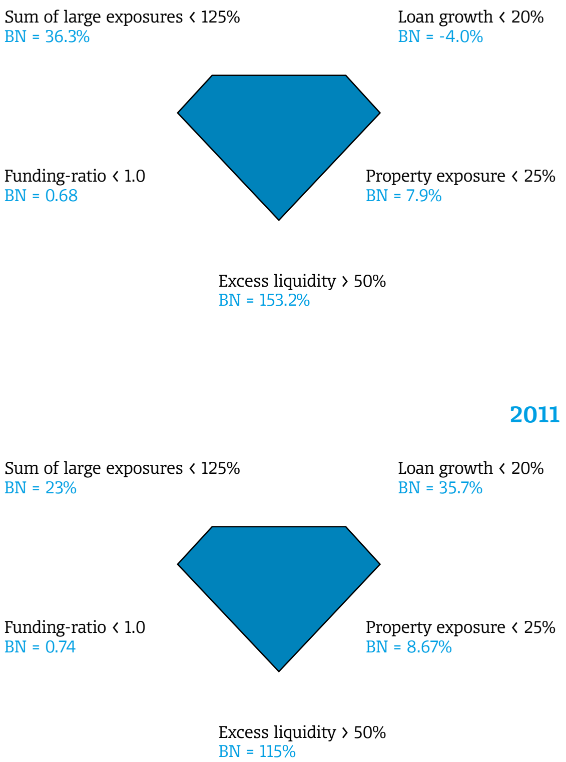
The Danish Financial Supervisory Authority (the Danish FSA) applies a model for measuring whether a bank has a high-risk profile – the so-called Supervisory Diamond or in Danish »Tilsynsdiamanten«. The model identifies five areas considered to be indicators of increased risk if not within certain limits.

The Bank meets by a wide margin the limits for large exposures, exposures towards real estate, excess liquidity and stable funding.

Figur 7

The Supervisory Diamond 2012

BankNordik (BN)



5 Market Risk

5.1 Organisation

The Bank has established an Investment Working Group to monitor the financial markets and continuously update its expectations for the financial markets. The Investment Working group meets once a month to discuss the outlook for the financial markets and determine the Bank's official position on strategic asset allocation.

The Investment Working Group refers to the Executive Management. The decisions are communicated throughout the organisation and forms the basis for all advice provided to customers. Participants in the Investment Working Group are the CFO, the CIO, Treasury and the Head of Portfolio Management.

The Markets department monitors developments in the financial markets on a daily basis, and at least every two months the Bank's investment working group receives an update containing a recommendation on strategic asset allocation on about a 12-month horizon.

The Head of portfolio management (PM), who is responsible for preparing the recommendation on forecasts for the asset classes to the Investment Working Group, presents the recommendation to the Investment Working Group. Based on the recommendation, the Investment Working Group then decides whether to retain or revise the Bank's official outlook. If the Working Group decides to change the outlook, the recommendation is submitted to the Executive Board. Decisions are evaluated before they are announced internally and included in the Bank's official Markets Update, which is forwarded by e-mail to a wide range of recipients and published on the Bank's website.

5.2 Definition

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

BankNordik'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

5.3 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 the overall risk limits. The limits on market risks are set with consideration of 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. Historically, lines have mainly been granted to Treasury.

Markets risk appétite		Table 16
Factors:	**Limits**	**Year end 2012**
Interest rate risk	4% of Base Capital	1.3% of Base Capital
Exchange rate risk	16% of Base Capital	14.9% of Base Capital
Equity market risk	Listed equities < 20 % of Base Capital	13.7% of Base Capital

Treasury is responsible for monitoring and handling the Bank's market risk's and positions. Markets has been granted small market risk lines for its daily operations. The Finance Department reports market risks to the Executive Board on a monthly basis.

Reporting of Market risk	Table 17
	Board of Directors
Monthly	Overview of – Interest risk – Exchange risk – Equity market risk – Liquidity risk
	Executive Board
Monthly	Overview of – Interest risk – Exchange risk – Equity market risk – Liquidity risk
Daily	Overview of – Interest risk – Equity market risk – Liquidity risk

5.4 Control and management

The stringent exchange rate risk policies support the Group's investment policy of mainly holding listed Danish government and mortgage bonds, and to a lesser extent investing in other markets and currencies.

Market Risk Management — Table 18

Level	Board of Directors	Executive Board	CFO	Treasury
Strategic	Defines the overall market risk			
Tactical		Delegating risk authorities to relevant divisions	Managing the Bank's market risk	Implementing
Operational			Controlling & Reporting	Trading

The Finance Department monitors and reports market risk to the Board of Directors and the Executive Board on a monthly basis.

5.5 Market risk

The table below shows the likely effects on the Group's share capital from likely market changes to the Group's assets and liabilities.

Likely effects from changes in markets value — Table 19

	Change	2012	% of Base Capital	2011	% of Base Capital
Equity risk DKKm (+/-)	10%	41.2	2.3%	39.1	2.0%
Exchange risk DKKm (+/-) EUR	2.25%	1.6	0.1%	0.3	0.0%
Exchange risk DKKm (+/-) Other currencies	10%	19.5	1.1%	15.5	0.8%
Interest rate risk DKKm (parallel shift)	100 bp	22.7	1.3%	35.0	1.8%

Table 19 shows the calculated loss expected from a likely change in market values

- All equity prices fall by 10%.
- All currencies change by 10% (EUR by 2.25%).
- Upwards parallel shift of the yield curve of 100 bp.

The calculation is based on all factors developing in an unfavourable direction for the Group.

5.6 Interest rate risk

The Group's policy is to invest most of its excess liquidity in highly liquid bonds. As a consequence, BankNordik 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 Bank's bond portfolio is high. BankNordik does not hold unlisted bonds.

Rating of bonds — Table 20

	2012
Aaa	74%
Aa3	10%
Baa2	12%
Ba1	5%
B1	1%
Other / No rating	3%

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. BankNordik offers fixed rate loans to corporate customers. The interest rate risk from these loans is hedged with interest rate swaps on a one-to-one basis.

Interest rate risk broken down by Currency — Table 21

(DKKm)	2012	2011
DKK	6	20
ISK	16	13
EUR	1	1
Other	0	0
Interest rate risk	23	35

Table 21 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 yield curve. The exposure in ISK comes from the Group's Icelandic subsidiaries.

5.7 Exchange rate risk

BankNordik's base currency is DKK and assets and liabilities in other currencies therefore imply an extra risk as they may vary in value over time relative to DKK. BankNordik'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, BankNordik´s policy is to maintain a low currency risk.

The Group's exchange rate risk mainly stems from:

- customer loans/deposits in foreign currency
- Treasury's positions in foreign currency

Foreign exchange position — Table 22

(DKKm)	2012	2011
Assets in foreign currency	265	234
Liabilities and equity in foreign currency	0	133
Exchange rate indicator 1	265	234

In the 2011 Risk Management Report table 22 was not consolidated for the currency position from the investment in Vörður and Vörður Life. In order to have comparable figures we have updated the 2011 figures with the investment in Vörður and Vörður Life. The exchange rate position is monitored on a regular basis with respect to the limits defined for each currency.

5.8 Equity market risk

BankNordik's stringent risk policy restricts equity positions to listed and liquid shares and shares related to the Danish banking sector. The Bank occasionally holds unlisted shares, for example in connection with taking over and reselling collaterals from defaulted loans.

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, BankNordik's holding is rebalanced yearly according to the business volume generated by the Bank to the company in question.

Equity risk — Table 23

DKKm	2012	2011
Unlisted	31	7
Listed	242	252
Sector	138	132
Total	**411**	**391**

In the 2011 Risk Management Report table 23 was not consolidated for the Equity risk in Vörður and Vörður Life's trading portfolio. In order to have comparable figures we have updated the 2011 figures with the trading portfolio on Vörður and Vörður Life.

6 Liquidity Risk

6.1 Definition

Liquidity risk is defined as the risk of loss 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 defined the Bank's liquidity limits for 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 monitored and managed by Treasury in accordance with the limits set by the Board of Directors and reported to the Executive Board by the Finance Department. A liquidity report with stress tests is submitted to the Executive Board and the Group Risk Committee on a monthly basis. Treasury has the operational responsibility for investment of the liquidity, while Finance Department 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.

Liquidity Management — Table 24

	Board of Directors	Executive Board	CFO	Treasury
Objective	Defines the objectives for liquidity policies			
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 transactions and changes in liquidity.

BankNordik's bond portfolio forms a substantial part of the Bank's liquidity. It is therefore essential that the portfolio can be traded at fair prices at any time. BankNordik believes that a solid rating is a prerequisite for ensuring a fair price in the market. Hence, BankNordik's policy is to invest in bonds with high ratings and thereby minimise the liquidity risk of the Bank's bond portfolio. Most of these bonds are also accepted by the Danish central bank for repo transactions.

6.2.2 Liquidity stress testing

BankNordik 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 6-month horizon, the Bank will comply with the Board of Directors' target that excess liquidity should equal 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 6-month forecast shows that liquidity surplus is below 80% of statutory requirements, the executive board implements the contingency plan.

6.2.3 Twelve-month liquidity

The Bank's 12-month funding requirements are based on projections for 2013, which were revised in December 2012 taking the market outlook into account. The projections show similar volume growth in deposits and loans, and as a consequence the Bank will not need to go to the capital markets in 2013.

6.2.4 Structural liquidity risk

Deposits are generally considered a secure source of funding. Deposits are generally short term but their historical stability enables BankNordik to grant customer loans with much longer terms e.g. 20 years to fund residential housing. It is crucial for any bank to handle such maturity mismatch and associated risk, and therefore it is essential to have a reputation as a safe bank for deposits.

Loans and advances, net specified by maturity — Table 25

(DKKm)	2012	2011
On demand	113	42
3 months or less	108	1,963
3 months to 1 year	1,384	1,786
1-5 years	3,712	3,577
Over 5 years	5,985	4,401
Total	**11,303**	**11,769**

In order to minimise liquidity risk, BankNordik's policy needs 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 maturity, amounts and products.

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 loans from the financial markets.

Funding sources — Table 26

(DKKm)	2012	2011
Due to credit institutions and central banks	1,288	329
Issued bonds	0	98
Deposits	12,746	13,032
Subordinated debt (fair value)	672	831
Total	**14,706**	**14,290**

In 2011, the Bank issued subordinated debt of a nominal value of DKK 600m in connection with the acquisition of the Amagerbanken branches. In August 2012, BankNordik repaid DKK 150m of this debt. For further informations see note 32 in the annual report 2012.

The Group's excess liquidity to statutory requirements was above its strategic goal of 100% throughout 2012. As a result, BankNordik on 16 February 2012 announced its decision to eliminate the direct and indirect costs associated with the credit rating.

Deposit by maturity — Table 27

(DKKm)	2012	2011
On demand	8,825	8,709
3 months or less	1,899	2,228
3 months to 1 year	212	247
1-5 years	386	640
Over 5 years	1,424	1,208
Total	**12,746**	**13,032**

6.3 Collateral provided by the Group

BankNordik has entered into ISDA and CSA agreements with derivatives counterparties. These agreements commit both parties to provide collateral for negative market values. As a consequence of these agreements BankNordik at year-end 2012 had pledged bonds and cash deposits valued at DKK 60m under these agreements.

BankNordik also provides collateral to the Danish central bank to give the Bank access to the intra-day draft facility with the central bank. At year-end 2012, this collateral amounted to DKK 257m.

In September 2012 the bank obtained a loan from the Danish Central bank of DKK 1bn. As security for this loan, the bank has pledged loans for the value of DKK 1,3bn and bonds for the value of DKK 165m.

7 Operational Risk

The capital adequacy regulations require banks to disclose all operational risks.

7.1 Definition

The Basel Committee defines operational risk 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 non-recurring events, such as clerical or record-keeping errors, defects or breakdowns of the technical infrastructure, fraud by employees or third parties, failure to comply with regulatory requirements, fire and storm damage, litigation or codes of conduct or adverse effects of external events that may have an impact on the operations and reputation of the Bank.

7.2 Policy

The Bank seeks to minimise its operational risks throughout the organisation by means of an extensive system of policies and control arrangements, which are designed to optimise 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.

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 has therefore taken out insurance in respect of property, office equipment, vehicles and employee compensation as well as general liability and directors' and officers' liability. In addition, the Bank has taken out insurance against theft, robbery, amounts lost in cash transports between branches or in the post up to 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.

Assessing the Bank's operational risks in the IT field is considered an important area. The Bank's IT department and management regularly review IT security, including contingency plans for IT breakdowns, etc., that are designed to ensure that operations can continue at a satisfactory level in case of extraordinary events. All IT systems running at BankNordik and from the bank's service providers must adhere to documented schedules and guidelines. IT operations must be safe and stable, a requirement complied with through the greatest possible degree of automation and capacity adjustments. IT services run by service providers must be based on written agreements.

The Bank has not been involved in any governmental, legal or arbitration proceedings (nor is the Bank aware of any such proceedings pending or being threatened) during a period covering at least the preceding 12 months, which may have, or have had in the recent past a material adverse impact on the Bank's financial position or profitability.

Pursuant to the Executive Order on Capital Adequacy and the Danish FSA's guidelines, the Bank is required to perform a qualitative assessment of its control environment. Control environment is a collective term for the resources the Bank applies to minimise the risks involved in carrying on financial business. Such resources would include an assessment of the scope of internal business procedures, the degree of functional segregation, and whether the necessary management and control tools are in place in all relevant business areas.

The Bank has reviewed the general operational risks and considered whether to increase the solvency need in order to cover any significant operational risks that are presumably not covered by the Pillar I requirement.

In light of the Bank's control environment and the extent of risk management processes, as well as the insignificant number of cases encountered in recent years, Management believes that it is not necessary to increase the solvency need to cover any significant operational risks that are presumably not covered by the Pillar I requirement.

7.4 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. The long-term objective is for the system monitoring the level of operational risk in the Bank's branches on a monthly basis to have a preventive effect and to help to minimise the Bank's operational risk.

8 Insurance Risk

8.1 Insurance risk

Insurance risk in the Group consists mostly of non-life insurance risk. The Group has two non-life insurance companies: Trygd and Vörður, both wholly owned. Vörður holds a 100%-stake in life insurance company Vörður Life.

Risk exposure for an insurance company can be defined as a contingency event, chain of events or bad management which can by itself, 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 typically categorized as insurance risk, credit and market risk, operational risk, currency exchange risk and investment risk. Careful and prudent risk management forms an integral part of any insurance operations. 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 must 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 risks assumed, their composition, TRYGD's and Vörður's equity. This is done with statistical spread of risks and accumulation of funds, quantified by statistical methods, to meet these obligations.

The Group has defined internal procedures to minimise the possible loss regarding insurance liabilities. TRYGD and Vörður evaluate their insurance risk on a regular basis for the purpose of optimising the risk profile. Risk management also involves holding a well diversified insurance portfolio. The insurance portfolio of TRYGD and Vörður is well diversified in personal and commercial lines (see table 28).

Distrubution of portefolio of Vørður and Trygd — Table 28

(in %)	2012	2011
Commercial lines	31%	30%
Personal lines	69%	70%

Insurance risk

The companies cover the insurance liabilities through portfolio of securities and investment assets exposed to market risk.

Financial assets linked to insurance risk — Table 29

(mDKK)	2012	2011
Listed securities on stock exchange	120	301
Accounts receivable (total technical provisions)	62	60
Cash and cash equivalents	151	122
Total	**334**	**482**
Incurance contracts, short term, net	326	314

The companies have invested in investment securities, cash and cash equivalents in the effort to balance the exposure to market and currency risk.

Likely effects from changes in markets value	Table 30		
	Change	2012	2011
Equity risk DKKm (+/-)	10%	12.7	1.8
Exchange risk DKKm (+/-) in euro	2.25%		
Exchange risk DKKm (+/-) others currency	10%		
Interest rate risk DKKm (parallel shift) - Trygd	100 bp	0.9	0.8
Interest rate risk DKKm (parallel shift) - Vørður Lif	100 bp	15.1	12.4
Interest rate risk DKKm (parallel shift) - Vørður	100 bp	1.1	0.5
Interest rate risk DKKm (parallel shift) Total	**100 bp**	**17.1**	**13.7**

The Bank reviews its market risk exposure on a regular basis, and the likely effect of market changes on the Bank's results. The likely changes are revised on an ongoing basis and may be assessed in the context of historic or anticipated market fluctuations.

Markets risk

Market risk is the risk of changes in market prices, such as foreign exchange rates, interest rates and equity prices affecting the Company´s income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return.

Trygd holds shares, bonds and cash in DKK only and Vörður is only exposed in ISK.
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.

8.2 Trygd insurance

The Board of Directors and Executive Management of Trygd must ensure that the company has an adequate capital base and internal procedures for risk measurement and risk management to assess the necessary capital base applying a spread appropriate to cover Trygd's risks.

In order to meet these requirements Trygd´s policies and procedures are regularly updated.
Risk management at Trygd is based on a number of policies, business procedures and risk assessments which are reviewed and must be approved by the Board of Directors annually.

Run-off gains/losses in Trygd (mDKK)					Table 31
Sector:	2012	2011	2010	2009	2008
Industry	-4.9	1.66	0.92	-1.35	0.81
Personal	0.48	0.63	-0.59	-0.04	0.25
Accidents	0	0.02	-0.09	0.01	0.01
Automobile	2.8	2.54	1.30	-1.00	0.90
Total	**-1.62**	**4.84**	**1.53**	**-2.38**	**1.97**

Financial risk is related to insurance obligations and assets available to cover these obligations. Financial risk includes insurance risk and market risk.

Insurance risk is the risk related to pricing insurance products and making provisions to cover the insurance obligations. Price setting is when insurance is taken out on the basis of tariffs calculated from analyses of historical and market experience.

The market risk is the risk that fluctuations in the financial markets affect the operating profit and financial position of Trygd. In this respect interest rate risk, credit risk, exchange risk and property risk are examined. The size of provisions for claims is based on individual assessments of the final costs of individual claims, supplemented with statistical analyses.

The Company´s acceptance policy is based on a full 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 is implemented in the handling process of the corporate department.

Insurance is primarily sold by the Group´s employees at Trygd and through BankNordik branches, and secondarily through selected collaboration partners. Insurance to commercial customers is mainly sold by employees at Trygd.

Reinsurance is an important aspect of managing insurance risk. The Group must protect itself against dramatic fluctuations in technical results by entering into agreements on reinsurance so as to make the risk of the Group having to pay claims from its own funds reasonable in relation to the size of the risk assumed, the risk composition and TRYGD´s equity.

TRYGD has organised a reinsurance programme which ensures that e.g. large natural disasters and significant individual claims do not compromise TRYGD´s ability to meet its obligations. For large natural disasters, the total cost to Trygd will amount to a maximum of DKK 15m. 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.

Trygd’s Claims Department is responsible for handling all claims and only claims employees may deal with claims matters or advise claimants in specific claim cases.

Technical 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.

The board of directors of Trygd applies a low risk investment policy. The company´s main investments are in bonds and deposits. There is no exchange rate risk, as all business is done in DKK.

8.3 Vörður insurance

Vörður 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 Vörður.

Run-off gains/losses in Vørður (DKKm) Table 32

Sector:	2012	2011	2010	2009	2008
Automobile	-6.45	4.85	-3.54	-12.29	-12.30
Other sectors	7.22	-2.98	-9.75	-7.95	-1.81
Total	**0.77**	**1.87**	**-13.29**	**-20.23**	**-14.11**

8.3.1 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 portfolio 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 portfolio and enabling early warning of any adverse changes. Tariffs, deductibles and/or insurance conditions are adjusted to meet developments in losses.

The company protect it's balance sheet from large losses by purchasing reinsurance. Maximum losses payable by the company is 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 extremely conservative with both predetermined spread of investments and with respect to type of assets. Furthermore, the company is bound by regulation that determines allowable investments and how they are spread.

The current investment strategy is based on investments which ensure stable and reliable returns, such as government and mortgage 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.

Vörður only deals with reinsurance companies with an S&P A-rating or better for long-tail business and at least BBB or better for short tail business. Current reinsurers of the company are all A rated 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 on 2-10 different reinsurance companies according to the capacity of the treaty, spreading the risk of reinsurance default. The company sends quarterly reports of assets to the Icelandic Financial Supervisory Authority as required.

Operational risk

The company applies a detailed operational plan, 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 daily and kept in secure off-site locations.

Vörður 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 Vörður, 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

Vörður tryggingar hf. operates only in ISK and only issues insurance policies in ISK. All reinsurance agreements prior to October 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 October 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 Vörður 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, Vörður always receives correct settlement in ISK.

Natural disaster risk

Vörður tryggingar hf. does write a few policies which include natural disaster risk, mainly storm. In Iceland, there is, however, a separate government-owned insurance company, the Icelandic Natural Catastrophe Fund, which insures most property in Iceland against natural disasters such as earthquakes, volcanic eruption, avalanches, landslides and floods. However, the NatCat fund does not cover all property against the aforementioned disasters, the most notable category being ships. Therefor Vörður covers ships against natural catastrophes but that exposure is fully and specifically reinsured with a maximum exposure of approx. ISK 50 m.

As for storm coverage in relation to possible exposure, Vörður's standard property reinsurance with a limit of ISK 2,000 m is deemed sufficient to cover possible loss from a major storm, whereas the MPL (Maximum Probable Loss) is less than ISK 200m for such incidents based on current reinsurance contracts.

8.4 Vörður Life

Vörður 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.

Vörður 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 Vörður tryggingar hf. operates Vörður liftryggingar hf. through an outsourcing contract, all of the risk management processes for Vörður tryggingar hf. described above also applies to Vörður liftryggingar hf.