Landshypotek Bank

Landshypotek Bank Pillar III

Information regarding capital adequacy and risk management 2014

For a richer life in the country

Contents

1. Introduction

This report contains information about Landshypotek Bank's risks, risk management, capital adequacy and liquidity situation under Pillar III of the capital adequacy rules.

1.1. Introduction and objective

The objective of this report is to publish information about material risks for Landshypotek Bank, the management of these risks and the current capital adequacy and liquidity situation. In combination with the Annual Report and the information on the Bank's website (www.landshypotek.se), the objective of this report is to meet the disclosure requirements for annual reporting as defined in EU Regulation No. 575/2013 and the Swedish Financial Supervisory Authority's regulations regarding prudential requirements and capital buffers (FFFS 2014:12). This report is published in conjunction with the Annual Report on Landshypotek Bank's website. This report has been prepared by the Bank Management and the Board's Risk and Capital Committee.

Unless stated otherwise, the text and figures in the report pertain to the Landshypotek Bank AB Group (the Parent Company Landshypotek Bank AB and the wholly owned subsidiary Landshypotek Jordbrukskredit AB), which is referred to in the report as "Landshypotek Bank" or "the Bank" and pertains to conditions as of 31 December 2014. In certain cases, information regarding the Landshypotek Bank AB Group and the consolidated situation differs, since the latter also includes Landshypotek Ekonomisk Förening. In these cases, the figures refer to the consolidated situation, which is made apparent in the text. Landshypotek Ekonomisk Förening owns 100 percent of the shares in Landshypotek Bank AB and is the Parent Association of the Landshypotek Group. All borrowers of Landshypotek Bank AB are also members of Landshypotek Ekonomisk Förening. All licensable operations are conducted in the Landshypotek Bank AB Group.

Diagram 1 **Corporate structure**

1.2. Basel III

After the latest financial crisis, the Basel Committee prepared a more comprehensive international regulatory framework for banks. The regulatory framework is known as Basel III and, in addition to regulatory capital requirements also includes liquidity requirements and diverse management requirements. The EU has adjusted the international rules to apply for credit institutions and securities companies within the EU, and the EU rules have since been implemented in Sweden through directly applicable EU regulations that took effect on 1 January 2014 and through the implementation of EU directives, which were, largely, incorporated in new Swedish legislation and regulations at the beginning of August 2014.

In relation to the earlier Swedish implementation of the Basel II rules, the new regulations entailed a raised regulatory capital requirement for Landshypotek Bank. This was a consequence of items including a new regulatory capital requirement for credit valuation adjustment risk (CVA) and loss given default floors (LGD) for internal ratings-based (IRB) exposures. The rules based on the Capital Requirements Directive include, among other items, rules pertaining to capital buffers and, with regard to Landshypotek Bank, an additional requirement for a capital conservation buffer of 2.5 percent of the total risk-weighted exposure amount, over and above previous Basel III regulatory capital requirements of 8 percent of total risk-weighted assets. The capital conservation buffer, like 4.5 of the 8 percent, must be covered by Common Equity Tier 1 (CET1) capital. From 13 September 2015, an additional requirement will be introduced of a countercyclical capital buffer and this will, initially, be 1.0 percent of the total risk-weighted exposure amount. The countercyclical buffer may vary between 0 and 2.5 percentage points and must also be covered by CET1 capital, but any increase within this interval should be announced by the Swedish Financial Supervisory Authority at least one year ahead of the implementation date. If an institute has insufficient capital to cover the buffer requirements, it must submit a plan to the Swedish Financial Supervisory Authority disclosing how it will meet the buffer requirements within a reasonable period of time. In addition, the

Table 1 **Companies included in the Consolidated situation**

	Corporate Registration Number	Domicile
Landshypotek Ekonomisk Förening	769600-5003	Stockholm
Landshypotek Bank AB	556500-2762	Stockholm
Landshypotek Jordbrukskredit AB	556263-8808	Stockholm

institution will be subject to restrictions in the form of bans proscribing actions, such as, the payment of dividends and certain types of variable remuneration[1]. However, the buffer requirements differ from other regulatory capital requirements, since not meeting them is allowed on a temporary basis. Accordingly, the buffer requirements are not included under the own funds requirement recognised under the Basel III rules (table 5). In 2014, the Swedish Financial Supervisory Authority also implemented raised risk weights for exposures secured by real estate from 15 percent to 25 percent under the Pillar II framework. However, the actual capital requirement for Landshypotek Bank has not changed because of the new Basel III rules. Due to the high risk weighting under the Basel I rules for loans with collateral in agricultural and forest properties, the transitional rule under Basel I continues to set the highest regulatory capital requirement for Landshypotek Bank.

Liquidity requirements in the form of the liquidity coverage ratio[2] (LCR) will apply from 1 October 2015 (60 percent), which will then be successively raised to 100 percent. Implementation of the net stable funding ratio[3] (NSFR) is planned, at the earliest, for 2018.

In addition to the aforementioned requirements and expanded reporting to regulatory bodies in this regard, the Swedish Financial Supervisory Authority implemented a number of regulations in 2014 pertaining to governance and control, operational risks, information security, recovery plans and disclosure of information.

[1] *Provided that the institute does not meet the requirement for the maximum distributable amount.*

[2] *The liquidity coverage ratio is defined as the size of the liquidity reserve in relation to net outflows over a 30-day significant stress period.*

[3] *The net stable funding ratio: requirements applying to maturity matching.*

2. Description of Landshypotek Bank and its operations

Landshypotek Bank AB is a member-owned bank for financing agriculture and forestry and has a tradition that dates as far back as 1836. The business operations mainly consist of lending against real property as collateral.

2.1. General description

Landshypotek Bank AB is a member-owned bank tasked with providing competitive financing to Sweden's farmers and foresters. The company's history dates back to 1836. Borrowers with Landshypotek Bank automatically become members of the association and thereby also owners of the operations. The association currently has about 43,000 members.

Landshypotek Bank AB is a wholly owned subsidiary of Landshypotek Ekonomisk Förening, and accounts for approximately 99 percent of the Group's lending. Landshypotek Bank AB grants loans against mortgage deeds in agricultural and forest properties within 75 percent of an internally determined collateral value. All funding in the Group takes place in Landshypotek Bank AB.

Lending at Landshypotek Jordbrukskredit AB is primarily performed against collateral in the form of mortgage deeds in real property within 75-85 percent of the internally determined collateral value. In addition, the company offers loans with EU support as collateral (EU loans) and, to a degree, loans with other collateral. Following individual assessment, Landshypotek Jordbrukskredit AB also issues short-term guarantees for Sparbanken Syd, when Sparbanken Syd has granted a credit facility to one of the Landshypotek Bank's customers. Collateral in the form of mortgage deeds in real property is also required for the guarantee (counter-obligation) and the maximum LTV ratio is 85 percent of the guaranteed amount.

In order to offer customers a broader range of financial products, in addition to credit facilities, corporate and private accounts as well as various payment services are offered through the partnership with Sparbanken Syd. Leasing and hire purchase of agricultural and construction machinery, and light and heavy vehicles with the item as collateral are offered in partnership with DNB. Farm and forestry insurance are examples of insurance provided through the collaboration with Gjensidige Försäkringsbolag.

2.2. 2014 and the future

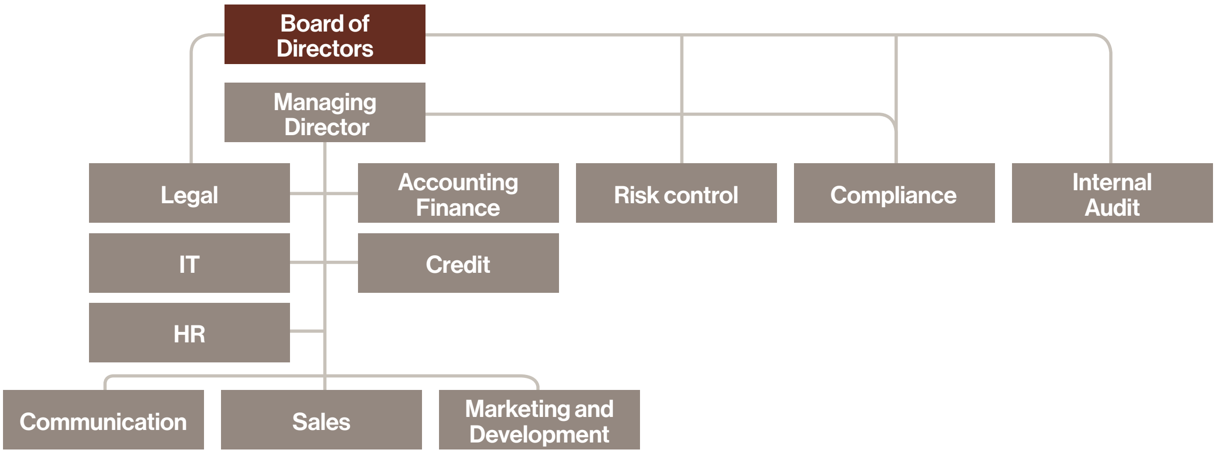
Landshypotek Bank holds a strong position in the Swedish credit market for financing agriculture and forestry with a market share of almost 30 percent. The conditions for operating financial companies are undergoing substantial change in the wake of the 2008 financial crisis. One effect is significantly increased regulation, which leads to higher personnel costs, for example, at risk control and compliance units. Another effect is increased liquidity requirements, which, all things being equal, reduces net interest income. This means that Landshypotek Bank needs to adjust its operations to continue to fulfil its role of undercutting market prices. The company's objectives are to expand operations and increase market shares. This will be achieved through increased customer focus and greater market efficiency. To this end, Landshypotek Bank has strengthened the number of employees and will expand its product offering to be able to offer a complete range of financing solutions for agriculture and forestry in the future. Landshypotek Bank's vision is to be:

The first choice for financing agriculture and forestry

Growth is to take place at low risk and with healthy and stable profitability. To, among other goals, improve liquidity in any market stress situation and, thereby, also improve preconditions for a favourable external rating, Landshypotek Bank has started to offer deposit accounts to the public. Landshypotek Bank's target is for deposits to account for 20 percent of funding within four years. Landshypotek offered deposit accounts for the first time in 2011. In 2012, Landshypotek Bank was granted a banking licence by the Swedish Financial Supervisory Authority thus improving possibilities for offering efficient deposit services. In spring 2013, the Bank supplemented the existing deposit account range with a forest account and forest-damage account and in February 2014, Landshypotek Bank launched three more deposit accounts and an online bank to allow customers to digitally open deposit accounts and transfer funds to and from other banks. In 2014, deposits increased SEK 3.7 billion and amounted to SEK 5.8 billion at year-end.

The Bank's target for return on equity corresponds to a return of five percentage points above the interest rate on a two-year swap contract which, at year-end, gave a target for return on equity of 6.3 percent.

Diagram 2 **Organisational chart for Landshypotek Bank**



2.3. Organisation

Landshypotek Bank AB is organised into eight districts and has 19 offices across Sweden. The number of employees is 152. Account managers are available at all offices and are organised under the Sales department. The Group's subsidiaries have no employees. Landshypotek Ekonomisk Förening has 70 elected members in ten different regional boards of directors whose work duties include appraising properties.

2.4. Corporate governance

Landshypotek Ekonomisk Förening owns the Landshypotek Bank AB Group and governs Landshypotek Bank AB through the Annual General Meeting (AGM), which is the joint-stock company's highest decision-making body. The owners' control of Landshypotek Bank AB is also exercised through the Board of Directors and the Managing Director in accordance with the Swedish Companies Act and Articles of Association as well as adopted policies and instructions.

The AGM of Landshypotek Bank AB appoints a Board of Directors and auditors, and also decides fees. The Meeting also adopts income statements and balance sheets, and decides on the matter of discharge from liability of the Board of Directors and the Managing Director. In addition, the members of the Election Committee of Landshypotek Bank AB are appointed, and are tasked with preparing election and remuneration issues prior to the next AGM. The Election Committee currently comprises three members.

The principle task of the Board of Directors of Landshypotek Bank AB (the Board) is to administer the company's affairs. The Board is ultimately responsible for the organisation and administration of the company. According to the Articles of Association, the Board comprises a minimum of four and maximum of eight members who are elected each year at the AGM. The Board currently comprises eight elected members and two employee representatives. One member is a Board member of Landshypotek Ekonomisk Förening. Seven of the members are independent in relation to the Company and the Bank Management. Four of the Board members have member contribution in Landshypotek Ekonomisk Förening through their membership in the association. The Board's members have extensive experience from trade and industry and/or agriculture and forestry. The Board's work follows the formal work plan adopted at the statutory Board meeting.

The Board has established three committees: the Board's Risk and Capital Committee, the Board's Credit Committee and the Audit Committee. Minutes are taken of the committees' meetings and submitted to the Board. The Board has adopted a written instruction governing the role and work of the Managing Director. The Managing Director bears responsibility for day-to-day operations pursuant to the Board's instruction and reports regularly to the Board.

The external auditors at Landshypotek Bank must be authorised public accountants. The mandate period of the auditors appointed by the AGM is one year. The auditors are responsible for examining the Annual Report and accounts and also the Board's and Managing Director's administration of the company. The auditors' report to the General Meeting and, accordingly, are independent in relation to the Board and company management.

The Board has adopted a remuneration policy that specifies the principles behind the remuneration system at Landshypotek Bank AB. Information regarding the remuneration policy is available on the Bank's website. Employees are entitled to remuneration, which may consist of a combination of basic salary, benefits, profit sharing via Landshypotek Bank's profit-sharing trust, bonuses, retirement pension and severance pay. In 2014, the Bank replaced the defined-benefit pension system BTP2 with the new defined-contribution pension system BTP1 for all new employees and for those other employees who wished to do so. This is primarily because provisions made under the defined-contribution system are known and thus reduce uncertainty with regard to pension costs.

Remuneration in Landshypotek Bank is reviewed annually through the employees' salary appraisals. Internal audit is tasked with reviewing how remuneration paid by Landshypotek Bank complies with the remuneration policy.

3. Risk management and risk organisation

Landshypotek Bank's objective is to maintain a low general risk profile. The Bank strives to achieve a high degree of risk awareness and a low degree of risk undertaking throughout the operation.

3.1. Objectives and basis of risk management

A proper risk culture is a high priority at Landshypotek Bank. The Bank strives to achieve a high degree of risk awareness and a low degree of risk undertaking. A high degree of risk awareness means that each employee understands the risks implied for the company by the individual's work duties, the degree of risk undertaking that is acceptable and how to behave to avoid exceeding the acceptable level of risk. A low degree of risk undertaking means that the operations are to be conducted in such a manner that expected and unexpected losses are kept low. This is achieved through a clear decision-making structure with a high level of risk awareness among the staff, shared definitions and assessment policies, as well as sophisticated tools for risk assessment.

The operations aim for high quality in all of the activities undertaken, are sensitive to changes in the macro environment and understand the impact of these changes on customers, the value of assumed collateral and the business model.

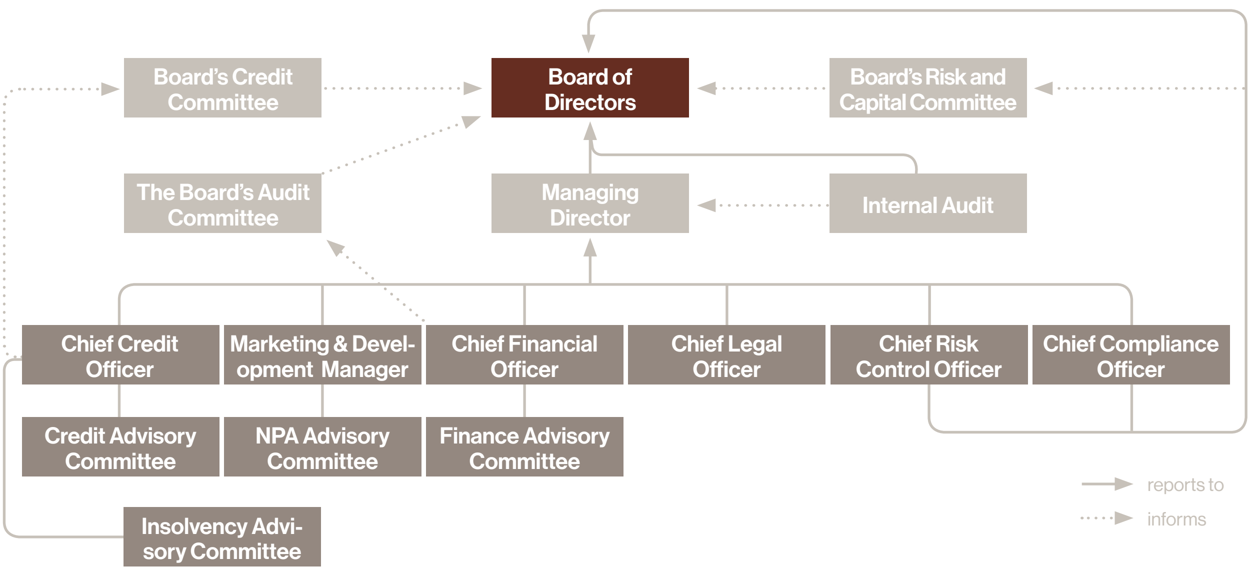
3.2. General risk profile

Landshypotek Bank's objective is to maintain a low risk profile. A low risk profile contributes to lower borrowing costs and, thereby, creates favourable conditions for expanding the operations and increasing market shares. Under its overriding risk appetite, Landshypotek Bank aims to retain its AAA rating on its covered bonds. At present, achieving this requires a long-term rating from Standard & Poor's of at least A- for Landshypotek Bank AB, which is the rating the company has following the downgrading in December 2014.

To maintain a low general risk profile, the Bank has identified, categorised and limited all material risks to be able to understand, manage and, if possible, quantify each individual risk. The Bank focuses on assuming the types of risks that the operations are best able to understand and manage.

The single largest risk to which the Bank is exposed is the credit risk associated with lending to customers. This risk is directly linked to the business concept and is managed throughout the credit process.

Diagram 3 Risk management and control organisation



Conducting business activities also requires taking certain other risks, including liquidity, market and operational risks. A certain level of acceptance for these types of risks must exist, although the Bank aims to keep them at a low level.

3.3. Risk organisation

It is essential that carefully prepared and clear internal governance and control permeate the organisation in order to manage risks satisfactorily. The Board and Managing Director of Landshypotek Bank AB have ultimate responsibility for the above.

As mentioned earlier, the Board has established three committees to assist it in its work: the Risk and Capital Committee, the Credit Committee and the Audit Committee. The Board's Risk and Capital Committee is a preparatory body and prepares the Board's governance documents on areas related to the Bank's risk appetite, risk limits and risk management. The latter includes, inter alia, the management of operational and financial risks, the responsibilities of the risk control unit and rules for the internal capital adequacy assessment process (ICAAP). Furthermore, the Committee prepares the ICAAP and the Bank's Pillar III report, and discusses parts of the risk control unit's control reports and validation of the Bank's credit risk models. The Board's Credit Committee is the highest credit-granting body and also prepares governance documents for the Board pertaining to the management of credit risks. The Board's Audit Committee is tasked with promoting proper financial reporting, receiving the audit reports and ensuring that outstanding observations in the audit reports are rectified, and with proposing an internal audit plan for the Board.

The Bank applies a three lines of defence approach in its risk management process. Each of the lines of defence are responsible for managing the risks inherent in the operations. The first line of defence consists of the business operations, which has daily operational responsibility for risk. The operational risk organisation comprises four committees: the Credit Advisory Committee, the Finance Advisory Committee, the New Product Approval Advisory Committee and the Insolvency Advisory Committee. The Credit Advisory Committee, chaired by the Chief Credit Officer, is responsible for regularly reviewing credit-granting rules and submitting proposals for changes to the Board's Credit Committee. The Finance Advisory Committee, chaired by the Chief Financial Officer, makes decisions concerning base interest rates on borrowing and lending. The New Product Approval Advisory Committee is chaired by the Marketing and Development Manager and makes decisions on whether the organisation is ready to implement significantly changed or new products, services, procedures, IT systems, etc. This aims to reduce operational risk at the Bank. The Insolvency Advisory Committee is chaired by the Chief Credit Officer and is responsible for all decisions regarding provisions, accounting for realised losses and unwinding reserves. In the business operations, the Credit Department is responsible for the management and governance of the credit approval process. It is also responsible for analysing the credit portfolio and managing insolvency matters. The Chief Credit Officer reports to the Managing Director and, normally, presents reports on credit matters to the Board's Credit Committee. The Finance Department is responsible for the Bank's financial risk management with regard to funding and management of equity, liabilities and liquidity. The Chief Financial Officer is responsible for the Finance Department and reports to the Managing Director of Landshypotek Bank AB.

The Risk Control Function and the Compliance Function represent the second line of defence. These functions operate independently of business operations and reports directly to the Managing Director and Board of Landshypotek Bank AB. The Risk Control function is responsible for control, analysis and reporting of all material risks on a portfolio basis for the Bank. The function also maintains certain risk-management frameworks. Furthermore, the function is responsible for the credit-risk models (IRB models) that the Bank has had approved for use in calculating the regulatory capital requirement for its credit risks. The Chief Risk Control Officer is the secretary and presents agenda items at the Board's Risk and Capital Committee. The Compliance Function is responsible for monitoring that the operations are conducted in compliance with the laws and regulations applicable for the licensable activities of the Bank. Both the Chief Risk Control Officer and the Chief Compliance Officer are co-opted members of the Bank's Management Group.

The Internal Audit Function comprises the third line of defence and aims to examine and evaluate internal governance and controls as well as provide an image of how well processes and procedures contribute to the operational goals. This includes, not least, the evaluation of the effectiveness of the risk management efforts, including the work of the second line of defence. The examinations performed by the Internal Audit are carried out in line with an audit plan determined annually by the Board. The Internal Audit also reports the results of its examinations to the Board. In 2014, the Bank's internal audit was carried out by KPMG.

4. Own funds and regulatory capital requirements

The need for sound risk management and a substantial buffer of capital and liquidity was clearly illustrated by the most recent financial crisis. More stringent requirements have been imposed by government agencies, rating agencies and the market.

4.1. Own funds

The items permitted to be included under own funds are regulated in the capital adequacy rules.

For capital adequacy purposes, own funds at Landshypotek Bank comprise equity (CET1 capital) and subordinated loans (T2 capital). CET1 capital comprises only paid-up share capital (contributed capital) and retained earnings. The Bank does not have any capital contributions of any kind. At 31 December 2014, own funds for the consolidated situation, comprising Landshypotek Bank and Landshypotek Ekonomisk Förening, totalled MSEK 4,936, of which MSEK 4,236 was CET1 capital, as shown in table 2.

Deductions are made from CET1 capital for deferred tax assets. The difference between actual provisions and expected losses in line with the IRB model for credit risk is deducted from CET1 capital. T2 capital comprises subordinated term loans with a nominal value of MSEK 700.

4.2. Regulatory capital requirement

The calculation of the regulatory capital requirement is based on the minimum rules (Pillar I) that encompass credit risk, market risk and operational risk. For the majority of the Bank's lending, the regulatory capital requirement for credit risk is calculated by applying the IRB model, the use of which Landshypotek Bank AB has received approval for from the Swedish Financial Supervisory Authority. For the remaining credit risk, the standardised approach is used for capital adequacy purposes.

For capital adequacy purposes, the basic indicator approach is applied for operational risks and the standardised approach for CVA risk with derivative counterparties and with any repos. The Bank has no other risks for which capital adequacy is required in accordance with the Pillar I rules.

The own funds requirement for the consolidated situation is presented in table 5.

Table 2 **Own funds, Consolidated situation**

SEK thousand	2014-12-31
Own funds, Basel III	**4,936,116**
Tier 1 capital	4,236,195
CET1 capital	4,236,195
Capital instruments included as CET1 capital	1,369,473
Retained earnings	3,090,538
Accumulated other comprehensive income	–29,660
Adjustment of CET1 capital due to prudential filters	38,888
(–) Other intangible assets	–36,517
(–) Deferred tax assets that rely on future profitability and do not arise as a result of temporary differences, net of associated tax liabilities	–14,643
(–) IRB shortfall of credit-risk adjustments to expected losses	–172,883
(–) Defined-benefit pension plans	–9,001
T2 capital	699,921
Capital instruments and subordinated loans eligible as T2 capital	699,921

Table 3 **Subordinated loans**

Name of loan	Currency	Nominal amount, SEK thousand	Nominal amount outstanding, SEK thousand	First possible redemption date	Interest rate	Interest rate after first possible redemption date	Due date
EMTN31	SEK	200,000	200,000	18 Jun 2015	4.60 %	3 M STIBOR +2.30 %	8 Jun 2020
EMTN47	SEK	70,000	70,000	1 Jun 2017	5.82 %	3 M STIBOR +3.85 %	1 Jun 2022
EMTN48	SEK	430,000	430,000	1 Jun 2017	3 M STIBOR +3.85 %	3 M STIBOR +3.85 %	1 Jun 2022

4.3. Capital requirement

At any point in time, a company must have own funds that as a minimum correspond to the total own funds requirement (8 percent of risk-weighted assets) within the Pillar I framework. This own funds requirement is calculated in accordance with EU Regulation 575/2013 and is presented in table 5. In addition, the Bank should have in place a capital conservation buffer of 2.5 percentage points and a countercyclical capital buffer of 1 percent from 13 September 2015[4].

It is also the responsibility of each credit institution to describe and assess the capital requirement for material risks not covered by the Pillar I rules. The total capital requirement is to be evaluated in light of the overall risk for the operations. The supporting data and conclusions in this ICAAP must be communicated to the Swedish Financial Supervisory Authority on an annual basis. The Bank's ICAAP is described in section 9. The capital requirement is calculated based on the highest of the Basel III rules including the Pillar II assessment, 80 percent of the Basel I own funds requirement (transitional rule) and the capital the Bank needs to obtain a AAA rating for covered bonds. In the current situation, the highest of these is the transitional rule related to the Basel I requirements. The background for this is, among other things, that the IRB Approach, for which Landshypotek received permission from the Swedish Financial Supervisory Authority in 2007 to apply for calculation of the capital adequacy requirement for credit risks, indicates that there is a very low level of credit risk in the Bank's lending with collateral in Swedish agricultural and forest properties. However, under the current transitional rules, own funds may not fall below 80 percent of the regulatory capital requirement calculated with Basel I. In accordance with the Basel I rules, lending with collateral in agricultural and forest properties has a risk weight of 100 percent, which is just as high as lending against, for example, unsecured loans. Accordingly, the regulatory capital requirement under the Basel I rules are not particularly sensitive to risk and, in the Bank's assessment, overestimate the risks associated with the Landshypotek Bank's operations.

[4] *See section 1.2 regarding the consequences of not meeting the buffer requirement.*

As presented in table 5, the consolidated situation's Pillar I own funds requirement without buffers under Basel III is about 40 percent of the regulatory capital requirement under the current transitional rules related to Basel I, namely, MSEK 1,612 compared with MSEK 4,086. Even after taking into consideration the Bank's ICAAP, including Pillar II risks and buffer requirements, the requirement under the Basel I rules is substantially higher. Since the capital required under the Basel I transitional rules is sufficiently high to obtain a AAA rating for the Bank's covered bonds, the Bank sees no risk-based need to have any more capital than that required by the current transitional rules. However, the Bank must comply with the Swedish Financial Supervisory Authority's rules and, therefore, must maintain a buffer over and above the regulatory capital requirement under the transitional rules linked to Basel I to allow, to a degree, for meeting possible losses and to grow.

In time, the Bank aims to replace its subordinated loans with CET1 capital.

Table 4 Capital adequacy, Consolidated situation

SEK thousand	2014-12-31
Tier 1 capital	4 236 195
Tier 2 capital	699 921
Total capital	**4 936 116**
Without transitional rules	
CET1 capital ratio (%)	21,02
Tier 1 capital ratio (%)	21,02
Total capital ratio (%)	24,50
Institution-specific CET1 capital requirement including buffer requirements (%)	7,00
of which: capital conservation buffer requirement (%)	2,50
CET1 capital available to meet buffers (as a share of total risk-weighted exposure amounts, %)	15,02
Capital quotient	3,06
With transitional rules	
Own funds	5 109 000
Own funds requirement	4 085 668
Total capital ratio (%)	10,00
Capital quotient	1,25

5. Credit risks

Credit risk is the greatest risk in Landshypotek Bank and represents 83 percent of the regulatory capital requirement[5] under Pillar I rules without taking the transitional rules into consideration. Accordingly, it is of paramount importance that Landshypotek has clear rules for credit risk management.

5.1. Definition

Landshypotek Bank defines credit risk as follows:

The risk that Landshypotek Bank does not receive payment as agreed and that the value of the collateral is not adequate and therefore will not cover the outstanding claim.

5.2. Credit process

All granting of credit at the Bank is to be based on customers' repayment capacity and loans are only granted if, based on sound reasoning, commitments can be expected to be fulfilled. To further protect the Bank against loan losses, agricultural and forest properties are taken as collateral, in addition to other collateral in accordance with the credit instruction. The collateral is to guarantee the loan receivable by a healthy margin. However, collateral of a high value may never replace the requirements imposed on the repayment capacity of the customers. Credit granting must always be in proportion to the cash flows that are to cover loan payments.

The credit policy provides frameworks and guidelines for the principles applicable, at any time, for granting credit in the Bank. Credit granting is the result of analysis of the individual customer and/or household as a whole when applicable. This results in risk classification reflecting the risk of default being performed on a scale of 1-6 for private individuals or alternatively A-H for legal entities. Furthermore, in addition to the customer's/household's total repayment capacity, collateral is analysed, which principally comprises real property in the form of agricultural and forest properties.

All granting of credit is performed pursuant to a credit mandate matrix approved by the Board, which is governed by parameters such as loan limits, risk class and LTV ratio. All credit decisions are taken by a credit advisory committee utilising a level structure that complies with the aforementioned credit mandate matrix. A credit advisory committee requires that a minimum of two officers jointly form a committee. The highest decision-making body for day-to-day credit cases is the Board's Credit Committee.

[5] *Excluding the capital requirement for credit valuation adjustment risk.*

5.3. Credit portfolio

5.3.1. Overview of credit portfolio

At 31 December 2014, Landshypotek Bank's total loans to customers amounted to slightly more than SEK 61.7 billion. Lending encompasses lending to farmers and foresters primarily against collateral in agricultural and forest properties. All lending takes place in Sweden. The geographic distribution of the Bank's credit portfolio presented in diagram 8 mirrors where the districts to which customers belong and shows that the geographic distribution in Sweden is favourable. The credit portfolio has grown by SEK 15 billion since 2009, corresponding to average lending growth of 5 percent per year over the past five years. Average lending per customer of Landshypotek Bank AB amounted to MSEK 1.43 on 31 December 2014. The exposure-weighted LTV ratio on the same date was 48.4 percent.

Landshypotek Bank divides its customers into two different categories: Rural Living (RL); the repayment capacity of these customers is more dependent on income from employment rather than on any operations that may be conducted on the property and Rural Enterprise (RE), who conduct agricultural or forestry activities and whose income is mostly derived from business activity. Furthermore, most RE customers have diversified their operations and thus have incomes from several different types of business activities. Loans outstanding amounted to SEK 28 billion to RL customers and SEK 34 billion to RE customers on 31 December 2014.

5.3.2. Definition and classification of credit portfolio

One of the fundamental conditions for applying the IRB models to regulatory capital requirement calculations is that each counterparty is defined and classified in accordance with IRB rules. The documentation and systems support that have been prepared provide detailed descriptions of the division of exposure classes.

The Bank reports the vast majority of its loans to private individuals as exposures secured by real estate, in line with the IRB approach's retail exposure class. The exposure value including accrued interest for these assets amounted to SEK 60 billion. The capital requirement for other loan exposures, among others legal entities, is calculated using the standardised approach.

The IRB approach is also used for the exposure class of "non credit-obligation assets." Non credit-obligation assets exposures are defined as exposures which does not require any deliveries from a counterparty (for example, intangible and tangible non-current assets).

The average risk weight for retail exposures recognised under the IRB Approach amounted to 18 percent and the risk weight for exposures recognised using the standardised approach was 23 percent.

5.4. Description of credit risk management

All credit decisions are to be preceded by a careful risk assessment and risk classification. Consequently, making a credit decision requires knowledge about regional and industry-specific factors that may impact customers' repayment capacity and the value trend of the collateral. Before new products or services are introduced, the operations are to carefully analyse any potential credit risks that these may give rise to and ensure that the risks can be satisfactorily managed.

The Credit Department is responsible for the credit approval process and ensuring compliance with the internal rule book for credit granting. The sales organisation are responsible for carrying out yearly credit monitoring for all limit groups with credit limits over MSEK 5. In addition, an annual review of accounts is required for customers with poorer PD risk classes.

The Bank applies individual valuation of problem loans. An insolvency group is in place within the Credit Department that manages problem loans at an operational level. The provision requirement is assessed for doubtful credits and provisions are made on an individual basis following a decision according to the assigned decision mandate. A loan receivable is recognised as a doubtful receivable when an individual assessment indicates that it is unlikely to be paid in accordance with the terms of the loan agreement and where the value of the collateral is feared to be insufficient to cover the value of the receivable with a sufficient margin.

The Risk Control function is responsible for measuring, analysing and reporting the status of credit risks at portfolio level and at district level.

5.5. Application of the IRB models

In addition to the IRB models being used for calculation of the regulatory capital requirement and capital requirement, they are integrated into the credit process. The customer's/limit group's Probability of Default (PD) risk class and LTV ratio, which impacts Loss Given Default (LGD) risk class, combined with the customer's/limit group's loan limit determine the credit decision

Table 5 **Own funds requirement by risk, method and exposure class, Consolidated situation**

31 Dec. 2014, SEK thousand	Exposure value*	Own funds requirement	Risk-weighted exposure amount	Average risk weight	Expected loss
Credit risk – IRB approach	**59,842,400**	**883,302**	**11,041,269**	**18 %**	**233,517**
Retail – real estate collateral	59,755,565	876,355	10,954,434	18 %	233,517
Other non-credit-obligation assets	86,835	6,947	86,835	100 %	
Credit risk – Standardised approach	**24,182,822**	**450,987**	**5,637,343**	**23 %**	
National governments or central banks	246,301	0	0	0 %	
Regional governments or local authorities or agencies	4,768,236	0	0	0 %	
Institutions	3,838,012	109,626	1,370,322	36 %	
Corporates	259,547	20,372	254,650	98 %	
Retail	180,408	8,674	108,428	60 %	
Secured through liens on real property	2,943,326	213,201	2,665,018	91 %	
Non-performing exposures	35,964	3,826	47,822	133 %	
Covered bonds	11,911,027	95,288	1,191,103	10 %	
Operational risk – Basic indicator approach		**96,994**	**1,212,430**		
Credit valuation adjustment risk – Standardised approach	**2,492,341**	**180,763**	**2,259,540**	**91 %**	
Total "Basel III"		**1,612,047**	**20,150,582**		
Supplements for the transitional rules linked to Basel I		**2,473,621**	**30,920,266**		
Total including supplements for the transitional rules linked to Basel I		**4,085,668**	**51,070,848**		

** Exposure value under EU Regulation 575/2013.*

procedure and any credit decision is based on the aforementioned risk classes. In addition, the Board and Bank Management receive regular reports on the status of the credit portfolio, based on such factors as PD risk classes, LTV ratios and expected losses.

The Board assumes the ultimate responsibility for the IRB system as a whole and is to make decisions on any significant changes to it. The Risk Control function has overriding operational responsibility for ensuring that the IRB models adequately measure risk for the Bank and meet the applicable requirements set by the Swedish Financial Supervisory Authority for the IRB models. Other parts of the organisation have a substantial share in the responsibility for this.

The Bank's PD estimates are based on the long-term default rate for the respective risk classes. Since the Bank's risk-classification model is not entirely point-in-time, in other words, it is not fully impacted by economic fluctuations, for individual years, the outcome at a portfolio level can exceed the average portfolio PD estimate in years that are slightly below average for Sweden's farmers and foresters. In 2014, the outcome at portfolio level exceeded the average portfolio PD estimate.

In terms of LGDs, the estimates represent a period of decline which means that, as long as a real downturn does not occur, they are above the outcome. Table 6 shows that this is the case in 2014.

5.6. Description of the IRB Approach

5.6.1. Method

Landshypotek Bank calculates its own risk estimates for PD, exposure at default (EAD) and LGD, which are used for almost the entire retail exposure class at Landshypotek Bank AB to calculate regulatory capital requirements and expected losses for credit risk.

5.6.2. Models and permits for calculation of regulatory capital requirements

The Bank's PD model comprises internal payment statistics and a UC model (UC AB, the business and credit information provider) as explanatory factors. However, new customers are risk graded based only on the UC model. The PD model is a statistical model that is used to predict the probability of the customer defaulting within one year. The Bank uses two default categories: soft defaults and technical defaults. Soft defaults are registered manually, if the Bank's assessment is that the customer will not be able to meet its commitments and collateral will have to be realised. Technical defaults occur automatically when customers, who are not already in a soft default process, are late by more than 90 days with their payments to the Bank. The PD model allocates credits to various risk classes (1-6), where risk class 1 represents the highest credit quality and risk class 6 is for credits in default. The Bank estimates the PD for each risk class. For the purpose of calculating the PD per risk class for an average year, the past ten years of actual data is used as a basis and, in addition, a conservative business cycle adjustment is applied that also takes into account outcomes from the financial crises years in the early 1990s as well as a safety margin. Further stress is applied to the above risk class PD through a formula from the Swedish Financial Supervisory Authority for the calculation of the regulatory capital requirement. Diagram 4 illustrates the retail exposure by PD risk class.

The assessment of how much of the outstanding claim the Bank stands to lose in the event of default, LGD, is based on internal loss data gathered during the period 1995 to 2008, where the time value of money and administrative expenses were also taken into account. This data is then adjusted upwards to correspond to an LGD during unfavourable economic conditions (downturn LGD). The Bank has used data from 1994 to perform this upwards adjustment. LGD classes are divided into five classes in terms of LTV ratios. Diagram 5 illustrates the retail exposure by LGD risk class.

EAD is the amount of exposure that the counterparty is expected to have in the event of a default. For standard loans, EAD is calculated as the outstanding loan debt. For the Bank's "flexible first lien mortgage loans"[6], where parts of the commitments are off-balance-sheet items, EAD is calculated by multiplying the counterparty's total credit limit granted by a conversion factor (CF). This conversion factor is calculated on the

[6] *The customer utilises when needed as much as wanted within the granted limit.*

Table 6 Estimate 31 December 2013 vs. outcome in 2014*

%	PD estimate weighted by number of loans for capital adequacy	Realised default outcome weighted by number of loans	Exposure-weighted LGD estimate for capital adequacy**	Realised exposure-weighted LGD outcome
Retail exposure	2.1 %	1.7 %	7.4 %	3.6 %

* *For "Realised default outcome weighted by number of loans," the numerator takes in to consideration the performing loans at 31 December 2013 that defaulted in 2014 and the denominator takes in to consideration the total of performing loans at 31 December 2013 that were performing or non-performing at the end of 2014. For the benefit of comparison, only those loans included in the above denominator are included in the calculation of the "PD estimate weighted by number of loans for capital adequacy" and in "The Exposure-weighted LGD estimate for capital adequacy".*

** *Downturn LGD.*

entire credit ceiling of the flexible first lien mortgage loans and, conservatively, amounts to 107 percent.

The purpose of validating the models is to ensure that the Bank estimates credit risk in a sufficiently conservative manner and that the models adequately grade lending according to risk. The PD, LGD and CF models are validated on an annual basis. The analysis results in a validation report, a summary of which is presented to and discussed with instances including the Board's Risk and Capital Committee.

Landshypotek Bank's PD risk-classification model captures fluctuations in the business cycle relatively well and, accordingly, customers migrate between risk classes as an effect of fluctuations in the business cycle, which can lead to a cyclical "Basel III" regulatory capital requirement. The same applies for the LGD model.

Conservative adjustments and safety margins are applied for those risk estimates that are used for capital adequacy, but not for internal purposes, which means that the capital adequacy estimates differ from the internal estimates.

5.7. Collateral

Landshypotek Bank AB grants loans against mortgage deeds in real property within 75 percent of an internally determined collateral value. This value should represent the long-term sustainable value of the assumed collateral. Lending at Landshypotek Jordbrukskredit AB is primarily performed against collateral in the form of mortgage deeds in real property within 75-85 percent of the internally determined collateral value. In addition, the company offers loans with EU support as collateral (EU loans) and, to a degree, loans with other collateral, such as sureties and chattel mortgages.

District office employees are assisted in the property valuation process by Landshypotek Ekonomisk Förening's organisation of representatives. The network of representatives ensures that all properties are correctly valued and that the valuations are based on documented industry expertise and a high degree of familiarity with local conditions. All of the ten regions of Landshypotek Ekonomisk Förening have a local Board comprising up

Table 7 **LGD estimate per LGD class**

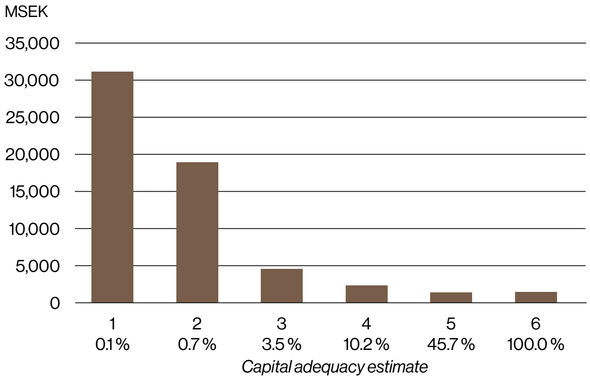
LGD class	LTV ratio	LGD including downturn adjustment and safety margin*
1	0-20 %	0.94 %
2	21-40 %	7.51 %
3	41-60 %	16.21 %
4	61-75 %	36.79 %
5	>75 %	88.93 %

** Excluding LGD-floor.*

Table 8 **Exposure specified by sales district of Landshypotek Bank AB**

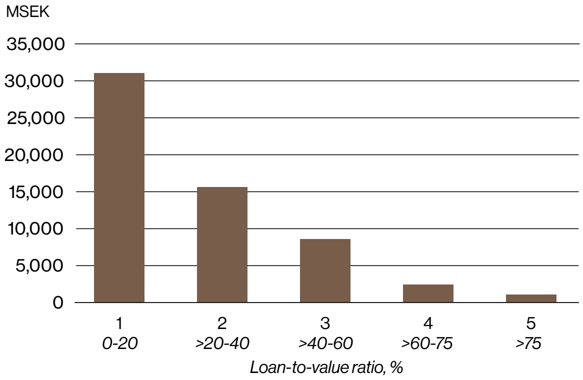
31 Dec. 2014, SEK thousand	Amount lent, incl. accrued interest	Of which: overdue receivables
Gotland	2,610,784	69,322
Mälardalen	8,188,828	237,251
The North	6,513,299	214,689
Skåne	9,227,264	86,330
Småland, etc.	6,946,227	194,457
Västra Götaland	9,278,055	235,754
Örebro, Värmland	8,496,946	309,969
Östergötland	10,544,791	111,941
Total	**61,806,193**	**1,459,713**

Diagram 4 **Exposure per PD risk class***



** PD estimates used for capital adequacy purposes are shown under the respective PD risk class.*

Diagram 5 **Exposure per LGD risk class***



** An exposure with a loan-to-value ratio of above 75 % is distributed over all five LGD risk classes.*

Table 9 **Derivative instruments and liquidity portfolio specified by rating***

SEK thousand	Positive gross market-value excl. premium for potential future exposure	Covered bonds	Municipal bonds	Bonds issued by Kommuninvest Sverige AB
AAA		11,912,141	1,311,367	322,337
AA+	754,323		3,445,201	
AA-	424,076			
A+	628,351			
A-	423,699			
Total	**2,230,449**	**11,912,141**	**4,756,568**	**322,337**

** Market values including accrued interest.*

to eight members. It is these members who together comprise the network of representatives in Landshypotek Ekonomisk Förening.

5.8 Loan losses

In 2014, realised loan losses were MSEK 56.3, which was higher than the same period in 2013 (MSEK 27.4), and the provision for probable loan losses increased to MSEK 104.5 (82.4). Net recognised loan losses totalled MSEK 79.6 (54.4) in 2014. The exposure value for defaulted loans was 1 477 MSEK at the end of 2014 considering default contagion within the counterparty. Losses and provision were significantly higher year-on-year. Over the past two years, the Bank has developed its work on the credit portfolio, thereby enabling earlier identification of companies with weak profitability and low liquidity. Provisions over the past two years pertain to a few isolated commitments and customers with financial difficulties cannot be directly linked to specific sectors or industries but, rather, largely pertain to the prerequisites of the individual entrepreneur. As stated previously, loans outstanding amounted to SEK 61.7 billion. The Bank has a credit risk appetite that states that loan losses over a business cycle should not exceed 5 basis points of loans outstanding. Given the assumption of the last five-year period as a business cycle, the risk appetite was exceeded by 0.7 basis points. Due to this, a pro active effort to reduce credit risk has started.

5.9 Counterparty risk

Landshypotek Bank's counterparty risks comprise the risk of default by counterparties in funding operations. Counterparty risks arise as a consequence of the Bank's management of liquidity, interest-rate and currency risks. Risk tolerance is generally low.

The Bank's total counterparty exposure comprises:
- the market value of securities
- monetary deposits
- the exposure of derivative instruments calculated based on the mark-to-market method stipulated in the EU Regulation 575/2013.

Counterparty risk may only be undertaken against:
- public bodies that are assigned 0 percent in risk weight for capital adequacy
- covered bonds issued by financial institutions
- financial institutions.

New counterparties are to be approved by the Finance Advisory Committee and limited by the Board. The following aspects are taken into account when approving new counterparties:
- New counterparties for derivative agreements, repurchase agreements and deposits must have a credit rating that is the same as or better than that of Landshypotek Bank AB measured using the long-term rating from S&P or the equivalent from another rating agency. International Swaps and Derivatives Association master agreements (ISDAs) and credit support annexes (CSAs) are to be in place with each counterparty for derivative agreements and these agreements regulate the collateral that the counterparties have to pledge should their credit rating decline below the S&P rating of A[7].
- New counterparties for investments must have a long-term rating of at least AA from S&P, or the corresponding level from another rating agency, and the security must meet the requirements for permissible collateral with the Riksbank, Sweden's central bank.

[7] *Landshypotek Bank does not pledge collateral for derivative transactions, which means that derivative transactions are not considered a potential source for encumbrances on assets but also, indirectly, that no liquidity reserve needs to be allocated for derivatives.*

6. Liquidity risks and funding

Since Landshypotek Bank's operations are naturally exposed to liquidity risks, liquidity risk management is assigned high priority. The tolerance level is low and a liquidity reserve exists that means the Bank will be able to operate even during extended periods of stressed liquidity.

6.1. Definition

Landshypotek Bank defines liquidity risk as follows:

The risk of being unable to refinance maturing loans or being unable to meet demand for additional liquidity as well as needing to borrow at disadvantageous interest rates.

6.2. Management and funding

Landshypotek Bank's operations are naturally exposed to liquidity risk and the consequences of a lack of liquidity can be serious. Therefore, risk tolerance for liquidity risks is low and management of liquidity risks is of high priority. As stated in Section 2.2, the Bank has started to accept deposits to diversify its sources of funding and to increase funding stability during periods of market stress. Deposits increased substantially in 2014 and the Bank's target is for deposits to account for 20 percent of funding within four years.

Landshypotek Bank funds operations primarily through the issue of covered bonds, but also through senior bonds, by using commercial paper financing as a bridge between major bond issues and through deposits, equity and subordinated loans. The Bank has previously achieved the desired maturity for funding through taking up long-term funding in foreign currencies, where the market risks were hedged with cross currency interest rate swaps. Due to volatility in the basis component of the swaps and thereof undesired impact on the Bank's income statement, no further funding has been performed in foreign currencies since 2011, nor will be as long as the current accounting rules are in effect. Therefore, Landshypotek Bank works actively with increasing the maturity of the bonds issued on the Swedish market. In 2014, the average maturity of issues was 5.9 years.

Table 10 **Maturity analysis for financial assets and liabilities, Consolidated situation**

SEK thousand	<3 months	3-12 months	1-3 years	3-5 years	> 5 years	Total
Financial assets						
Loans to credit institutions	483,158					483,158
Loans to the public	40,630,020	9,902,422	8,265,066	3,007,827	1,123,321	62,928,656
Bonds and other interest-bearing securities	59,369	1,395,750	12,856,482	2,159,982	613,000	17,084,583
Derivatives	1,912,914	645,138	3,665,830	4,113,217	5,667,771	16,004,870
Total	**43,085,460**	**11,943,309**	**24,787,378**	**9,281,026**	**7,404,093**	**96,501,266**
Financial liabilities						
Liabilities to credit institutions	447,322					447,322
Borrowing/deposits from customers	5,828,821					5,828,821
Granted credit facilities	813,480					813,480
Debt securities in issue	4,367,912	11,930,127	29,935,031	15,916,254	9,668,976	71,818,300
Derivatives	2,132,042	490,403	2,970,652	3,643,251	3,983,414	13,219,762
Subordinated liabilities	4,476	213,274	508,148	-	-	725,898
Total	**13,594,055**	**12,633,804**	**33,413,831**	**19,559,505**	**13,652,390**	**92,853,584**
Net contractual cash flow	**29,491,406**	**–690,495**	**–8,626,453**	**–10,278,479**	**–6,248,297**	3,647,682
Net accumulated contractual cash flow	29,491,406	28,800,911	20,174,458	9,895,979	3,647,682	

The above table includes all contracted cash flows. The amounts are not discounted and are recognised during the time slot when the Bank is entitled to request payment or has an obligation or right to repay. Future variable rates of interest have been included in the calculation for derivatives and financial liabilities, but not for loans to the public, which reflects what would happen if operations were to cease as of 31 December 2014. The calculation of future rates of interest is based on forward rates plus any credit spreads.

Furthermore, Landshypotek Bank works actively with the buyback and extension of bonds to minimise liquidity risks and accommodate investors.

Investors and regulators are increasingly setting more stringent requirements for increased transparency pertaining to banks' pledged assets and in pace with a shrinking price differential between covered and senior funding, Landshypotek Bank has been able to reduce the encumbrance ratio without any significant negative economic impact. Landshypotek Bank strives continuously to ensure that unprioritised lenders are not perceived as being excessively subordinated to the Bank's covered lenders. At 31 December 2014, the Bank's encumbrance ratio, that is the ratio of encumbered assets to total assets pursuant to Article 100 in EU Regulation 575/2013, was 71 percent where the assets in the cover pool for issuing covered bonds comprised the sole source of encumbrance. In total, assets amounting to SEK 58.3 billion were encumbered in conjunction with the issue of covered bonds. The portion of the Bank's liquidity reserve that comprises supplemental collateral in the cover pool is treated as unencumbered assets on calculation of the above encumbrance ratio. At 31 December 2014, SEK 12.8 billion of the liquidity reserve is counted as supplemental collateral in the cover pool, which had excess cover of SEK 15 billion in relation to the legal requirement for covered bonds. On the same occasion, the amount of unsecured funding amounted to SEK 11.6 billion.

The Bank endeavours to secure longer maturities for its borrowing than its lending. The maturity analysis (table 10) illustrates that the Bank's liabilities have longer average tenors than its assets based on the date the Bank is entitled to request payment or has an obligation or right to make a repayment.

In order to maintain good payment capacity, the Board has decided that cash and cash equivalents corresponding to the liquidity requirements of various periods in time must be available. One of the levels is that the liquidity reserve must be able to cover all payment obligations for the forthcoming 180 days of normal operations without the possibility of refinancing. On 31 December 2014, the Bank had sufficient funds available to cover all payment obligations for about 390 days. The Bank also applies limits for the liquidity reserve pursuant to the LCR that the Bank reported until autumn 2014 to the Swedish Financial Supervisory Authority based on the Regulations Regarding the Reporting of Liquidity Risks for Credit Institutions and Investment Firms (FFFS 2011:37) with the amendment that the Bank should withstand a 33-day period for contracted flows instead of the Swedish Financial Supervisory Authority's 30-day period. This ratio, with a limit value of 1.0, was 7.3 as of 31 December 2014. None of the liquidity limits was exceeded in 2014. In good time prior to implementing the EU's latest LCR rules on 1 October 2015, the Bank will, in its internal limits, start using the ratio that the quantitative requirement will be based on. At

Table 11 Disclosures, encumbered assets, Consolidated situation

MSEK	Carrying amount of encumbered assets	Carrying amount of unencumbered assets
Bonds and other interest-bearing securities*	0	16,798
Other assets	58,257	7,048
Total	**58,257**	**23,846**

MSEK	Pledged collateral received or own issued interest-bearing securities, fair value	Collateral received or own issued interest-bearing securities that can be encumbered, fair value
Bonds and other interest-bearing interest-bearing securities	0	0
Other collateral received	0	0
Total	**0**	**0**

MSEK	Matching liabilities, contingent liabilities or securities lent	Assets encumbered, collateral received and own interest-bearing securities issues excluding covered bonds and asset-backed securities
Total	**56,460****	**58,257**

** Bonds and other interest-bearing securities are recognised at fair value.*

*** Liabilities that have arisen on the issuance of covered bonds, carrying amount.*

31 December 2014, the LCR reported by the Bank to the Swedish Financial Supervisory Authority under Article 415 in EU Regulation 575/2013 was 11.43. The ratio used in the internal limits takes into consideration all liquidity reserves within the pool for covered bonds with the exception of any liquidity reserve that brings the opportunity cost (OC*) up to zero. Under current reporting to the Swedish Financial Supervisory Authority, any liquidity reserve in the pool for covered bonds that brings the opportunity cost up to zero after stress has been applied to property values and the proportion of loans 60 days overdue are exempted, which at year-end reduces the loans that can be considered as collateral in the pool by 0.83 percent. Since the Bank had an OC of 3.19 percent at year-end, even if the liquidity reserve in the pool may not be taken into consideration, there is no differential in regard to this difference in measurement method.

The Bank's holdings in its liquidity portfolio are of the type that may be sold or used as collateral for loans from the Riksbank. In this case, the Riksbank is the "lender of last resort". The liquidity reserve consists of covered bonds issued by Nordic credit institutions with a high credit rating and to a certain extent bonds issued by Swedish municipalities and county councils, including Kommuninvest Sverige AB.

This liquidity reserve gives the Bank the opportunity of bridging temporary strains on liquidity, but also provides the opportunity of procuring the necessary funds at times of severe liquidity crises by selling assets in an orderly fashion, or reducing the financing need by calling in maturing loans. The market value of the liquidity reserve was SEK 17.0 billion on 31 December 2014, of which 80 percent was placed as collateral in the pool for covered bonds and of which 80 percent comprised securities with a AAA rating.

The Chief Financial Officer is responsible for ensuring that liquidity risk management is carried out in the manner stipulated by the Board's and Managing Director's instructions. The Risk Control function is responsible for daily measurements and reporting of liquidity risks in accordance with the Board's adopted policies. The function is also responsible for continuous stress testing of the Bank's liquidity situation.

** OC = Over collateralisation, the value of cover pool assets in relation to cover pool liabilities.*

6.3. Stress tests

In addition to daily limit checks, the Bank performs continuous stress tests to ensure that liquidity is sufficient even during unfavourable market conditions. Examples of scenarios that are tested include:

- a stop in the borrowing market, no new deposits are available and external credit facilities have been withdrawn,
- lower market values of the investments in the liquidity reserve (–10 percent),
- customers stop making interest and amortisation payments on their loans (only 50 percent of contracted interest payments and capital repayments are carried out),
- full utilisation of flexible loans in the first month, and
- withdrawals from deposits (50 percent) in the first month.

The stress tests carried out by the Bank have indicated a very healthy payment capacity even if several different events that have a negative effect on liquidity were to occur simultaneously. At 31 December 2014, the Bank was able to meet its payment obligations for about 166 days when stress was applied to all parameters. With the same level of stress applied, but with a stop on new lending, the Bank was able to meet its payment obligations for about 254 days. A withdrawal from deposits of 50% is the single scenario that has the most significant negative impact on liquidity. The Bank believes that the current payment capacity is satisfactory and corresponds well to the established low level of tolerance.

7. Market risks

The market risks to which Landshypotek Bank's operations are primarily exposed are interest-rate risk, currency risk, credit-spread risk, basis-spread risk and CVA risk. The last two risks arise as a consequence of the reduction of the first two risks through the use of derivatives.

7.1. Definition

Landshypotek Bank defines market risk as:

The risk, excluding the risk of default, that the value of assets, liabilities and/or financial contracts is negatively affected by changes in general economic conditions or events that affect a large part of the market as well as by events that are company-specific.

7.2. Management

The management of market risks is primarily described in the Bank's Finance Policy, which is adopted by the Board. This policy regulates how risks are to be measured and reported and sets the framework for the risk tolerance for market risks in the form of internal limits. The Chief Financial Officer has the overall responsibility for the management of the Bank's market risks, and the Chief Risk Control Officer is responsible for the independent control and reporting of the limits established by the Board.

To manage market risks, the Bank also makes use of derivative instruments. These instruments are used to efficiently reduce the effects on assets and liabilities in conjunction with fluctuations in the interest-rate and currency markets.

7.2.1. Interest-rate risks

Interest-rate risks arise when fixed-interest terms for assets and liabilities are mismatched. The Bank seeks to always have the same fixed-interest term on borrowing as on lending. Due to actual conditions and availability in the capital market, there may be certain instances of imbalance between borrowing and lending, which gives rise to an interest-rate risk for the Bank. Interest-rate risk is measured as the change in value that occurs if the interest-rate curve makes a parallel move up or down by one percentage point. The total risk is measured daily and limited, and divided into different time slots (three months, one year, two years, etc.). The risk appetite is set by placing equity in customers' loans outstanding, which have an average maturity of about two and a half years. Measured with the aforementioned market valuation method[8], this corresponded to an interest-rate risk of about MSEK negative 100 at 31 December 2014. In addition, the Finance Department has a deviation mandate[9] within an interval of MSEK negative 40 to positive 120 under the market valuation method. Therefore, the total interest-rate risk exposure was limited within the interval of MSEK negative 140 to positive 20 at the end of the year and, in parallel, the actual interest-rate risk was MSEK negative 88.

The Bank utilises interest-rate swaps as a tool for managing interest-rate risks. For cases in which the fixed-interest terms of borrowing are longer than the fixed-interest terms of lending, interest-rate swaps are made, whereby the Bank receives fixed interest and pays variable interest. For cases in which the fixed-interest terms of borrowing are shorter than the fixed-interest terms of lending, interest-rate swaps are made in the opposite direction. These mechanisms are an efficient way for the Bank to manage interest-rate risks and maintain the level of risk exposure within the established parameters.

[8] *Assuming an increase in the interest rate.*

[9] *The deviation mandate also applies for each time slot. Restrictions are also in place for the amount of interest-rate risk permitted within two or more consecutive deviations with the same risk direction.*

7.2.2. Currency risks

Currency risk entails the risk of losses related to changes in exchange rates. Currency risk arises for the Bank when certain funding takes place in a currency other than SEK. At 31 December 2014, approximately SEK 10.6 billion of the Bank's funding was in foreign currencies.

Landshypotek Bank manages currency risk that arises in conjunction with funding in a currency other than SEK by using derivative instruments to convert the Bank's cash flows in foreign currency back to SEK.

Table 12 **Currency exposure including derivative payments**

Currency	Assets	Liabilities	Exposure
CHF	400,000	400,000	0
EUR	350,000	350,000	0
NOK	3,988,000	3,988,000	0

The limit for currency risk is set extremely low (MSEK 1) and is monitored and controlled by the Risk Control function. At the end of the year, all currency risk had been covered.

7.2.3. Basis-spread risk and credit-spread risk

Basis-spread risk arises for the Bank when the currency risk from borrowing in a currency other than SEK, is reduced through interest and currency swaps. As a consequence of the volatility in basis spreads in recent years, measurement of basis spreads at market value can contribute to relatively substantial impacts on earnings. The largest three-month movements in basis spreads (decreases and increases) since September 2008 would

Table13 **Fixed-interest terms for the Group's interest-bearing assets and liabilities, Consolidated situation**

SEK thousand	<3 months	3-12 months	1-3 years	3-5 years	> 5 years	Total
Assets						
Loans to credit institutions	483,158					483,158
Loans to the public	40,338,972	9,485,319	7,717,966	2,839,681	1,021,219	61,403,157
Bonds and other interest-bearing securities	6,080,000	600,000	7,850,000	1,106,000	400,000	16,036,000
Derivatives	20,799,389	0	10,069,072	5,591,860	6,836,888	43,297,209
Total assets	**67,701,519**	**10,085,319**	**25,637,038**	**9,537,541**	**8,258,107**	**121,219,524**
Liabilities						
Liabilities to credit institutions	447,322					447,322
Borrowing/deposits from the public	5,828,821					5,828,821
Debt securities in issue	38,385,622	1,654,000	12,299,072	6,596,860	7,536,888	66,472,442
Derivatives	28,788,362	3,250,000	10,350,000	704,000	710,000	43,802,362
Subordinated liabilities	430,000	200,000	70,000	0	-	700,000
Total liabilities	**73,880,127**	**5,104,000**	**22,719,072**	**7,300,860**	**8,246,888**	**117,250,947**
Net	**–6,178,609**	**4,981,319**	**2,917,966**	**2,236,681**	**11,219**	**3,968,577**
Interest-rate sensitivity, net	46,638	–41,313	–47,630	–75,734	29,742	
Cumulative interest-rate sensitivity	46,638	5,325	–42,305	–118,039	–88,297	

Nominal amounts are carried under the time slots when interest is reset.

have, with the application of measurement of market value on the Bank's portfolio at year-end, generated an impact of about negative MSEK 140 and positive MSEK 145 on earnings. However, if the Bank does not exit the swap agreements, the net earnings impact on expiry of the swap agreements would be zero. Since 2011, the Bank has elected not to take up funding in foreign currencies as a consequence of the substantial temporary impacts that basis-spread changes can generate.

Credit-spread risk arises from fluctuations in credit spreads in the Bank's liquidity portfolio.

7.2.4. Credit valuation adjustment risk

The previous Basel II rules included Pillar I capital requirements for the risk of default for counterparties in derivative transactions including repurchase agreements. In the latest financial crisis, it was discovered that in certain cases this resulted in substantial swings in the valuation of derivative instruments due to the impaired credit quality of derivative counterparties. Accordingly, the Basel Committee and also the EU decided that a Pillar I capital requirement should also be in place for impaired credit risk of counterparties comprising credit institutions and securities companies with which bilaterally cleared derivative agreements and repos were concluded (credit valuation adjustment risk or CVA risk). At year-end, Landshypotek Bank made a provision of MSEK 180.7 for CVA risk. All of the Bank's derivative contracts are included in the pool for covered bonds and, since the rules for covered bonds do not allow the pool to pledge collateral, all of the Bank's derivatives are bilaterally cleared. The Bank uses gross exposure figures for capital-adequacy calculations, but the Bank has recently applied to the Swedish Financial Supervisory Authority for permission to henceforth calculate the capital adequacy requirement using net exposures per derivative counterparty, since the Bank has netting agreements with all derivative counterparties.

During the year, Landshypotek Bank has also developed a valuation model for calculating the impact of CVA and the funding value adjustment (FVA) and the debit value adjustment (DVA) when valuing the Bank's derivative instruments. FVA is impacted by the amount paid by the counterparty for pledging collateral to Landshypotek Bank and DVA is affected by the Bank's own creditworthiness. The CVA component is affected by the credit worthiness of the counterparty and is reduced by the fact that Landshypotek Bank is contractually obliged to accept cash collateral when a counterparty's rating corresponds to A– or lower and if a counterparty has to replace itself in the event it receives a rating of BBB+ or lower. The DVA component is reduced by the fact that the derivatives are placed in the pool for covered bonds, which have a AAA rating and extremely good creditworthiness. This model was first taken into consideration in the fourth quarter of 2014. Due to the relatively low value adjustment that was implied by taking these components into account, the effect would have led to an increase in the valuation and, since a number of uncertainties exist in the valuation, at year-end, the Bank chose not to let these components influence the valuation.

8. Operational risks

Operational risk occurs in all forms of business activities and Landshypotek Bank's operations are no exception. Efficient incident identification and management of operational risks reduces the risk of losses.

8.1. Definition

Landshypotek Bank defines operational risk as:

The risk of losses as a result of inappropriate or failed internal processes, human error, faulty systems, external events and legal risks.

Operational risk is mainly categorised into the following areas:

- Internal fraud
- External fraud
- Employment conditions and safety in the workplace
- Customers, products and business practice
- Damage to tangible assets
- Disruptions to the business operations and defective systems
- Transaction management and process control

8.2. Management

Operational risk occurs in all of the Bank's operations. All employees are obligated to act to reduce operational losses in business activities. In addition, an individual is designated with separate responsibility for information security and physical security and reports directly to the Managing Director.

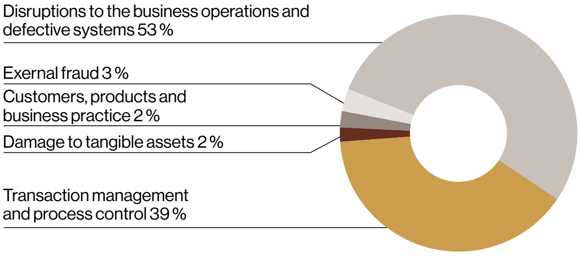
One of the tools used by the Bank to identify operational risks is an incident reporting system. All employees have access to an online tool for reporting incidents, either suspected or real, and are responsible for reporting these incidents. The Risk Control function is responsible for compiling reported incidents and reporting these to the person responsible, the Bank Management and the Board as well as for following up the implementation of communicated action plans to reduce the risk of similar incidents recurring. Anonymous reporting can take place, so the system also functions as a "whistle-blower system". The division of reported incidents in 2014 is illustrated in diagram 6. A total of 88 incidents were reported in 2014, for which the cost of restoring the business to its position prior to the incident was TSEK 178.

As a complement to the ongoing incident management, regular risk analysis is carried out of the Bank's operations. Identified risks are assessed based on probability and consequence, meaning how likely it is that the risk will occur and the effect the risks are assessed as having on the operations if they were to occur. The results of the risk analysis and proposed actions are presented to the Bank Management and Board and the implementation of action plans is followed up. The main purpose of the risk analysis is, as far as possible, to identify material operational risks and take measures to ensure these risks do not materialise. The incident reporting and the risk analysis are also used, to a certain extent, as supporting data for the annual ICAAP.

A new enhanced process was prepared for quality assurance and approval of new and significantly changed services, products and systems, etc. The New Product Approval Process (NPAP) was introduced in 2014, which should increase the likelihood of the Bank being prepared to manage the changes and, thereby, reduce operational risk. During the year, nine NPAP cases were approved by the New Product Approval Advisory Committee for implementation.

Further risk reduction measures for operational risk were implemented in 2014, partly driven by new regulations for operational risk, IT security, governance and control.

Diagram 6 Specification of reported incidents 2014



No incidents were reported in other categories

8.3. Regulatory capital requirement for operational risk

The Bank utilises the basic indicator approach under Pillar I to calculate its regulatory capital requirement for operational risk, which amounted to MSEK 97 in 2014.

9. Internal Capital Adequacy Assessment Process

Landshypotek Bank performs an internal capital adequacy assessment process (ICAAP) on an annual basis, which results in a comprehensive assessment of the bank's risks and their associated capital requirements.

The ICAAP under Pillar II of the Basel rules is to ensure that the Bank and the consolidated situation have sufficient capital. This assessment takes into consideration the existing and planned business operations and the consequent risk exposure of these operations, rating targets, return targets and regulatory requirements. The ICAAP results in a detailed report of the capital position including the Bank's current risk profile and risk profile in the medium term (covering at least the next three years), the methods the Bank uses to measure and manage risks, risk limits and an assessment of capital requirements per relevant risk category. Own funds constitutes a buffer against unexpected losses.

The ICAAP includes all types of risks that are believed to have an impact on operations. In addition to credit risks and operational risks, the capital requirement is also assessed for risks including interest-rate risks, currency risk, credit-spread risk, basis-spread risk, liquidity risk, rating risk, reputational risk and strategic risks. Stress tests are also used for the assessment of the capital requirement.

The Board has overall responsibility for the capital adequacy assessment process. The ICAAP is established by the Board and the Board's Risk and Capital Committee is used as the preparatory body. The Risk Control Function and the Chief Financial Officer have substantial operational responsibility for work with the ICAAP but several other functions within the Bank are involved in the process.

Landshypotek Bank