Landshypotek Bank

Landshypotek Bank Pillar III

Information regarding capital adequacy and risk management 2015

For a richer life in the countryside

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1. Introduction

This report contains information about Landshypotek Bank's risks, risk management, capital adequacy and liquidity under Pillar III of the Capital Adequacy Rules.[1)]

1.1. Introduction and objective

The objective of this report is to publish information about material risks for Landshypotek Bank AB (Landshypotek Bank), the management of these risks and the current capital adequacy and liquidity situation. In combination with the information in the bank's Annual Report and on its website (www.landshypotek.se), the objective of this report is to meet the disclosure requirements under the Capital Requirements Regulation (CRR), the Swedish Financial Supervisory Authority's regulations regarding prudential requirements and capital buffers (2014:12) and the Special Supervision of Credit Institutions and Investment Firms Act (2014:968). This report is published in conjunction with the Annual Report on Landshypotek Bank's website. This report has been prepared by the Board's Risk and Capital Committee and adopted by the Board of Directors.

During the year, Landshypotek Bank acquired all of the assets and liabilities of its subsidiary Landshypotek Jordbrukskredit AB, which is no longer subject to licensing. This means that all licensable activities are now conducted by Landshypotek Bank and the winding up of Landshypotek Jordbrukskredit AB will be completed in 2016. The report describes operations at Landshypotek Bank but the capital and liquidity-related figures in the report pertain to the consolidated situation.

[1)] *The Basel III regulatory framework has been implemented in Sweden through, inter alia, Regulation (EU) No 575/2013 (CRR) and is referred to in this report as the "Capital Adequacy Rules" or "Basel III".*

2. Description of Landshypotek Bank and its operations

Landshypotek Bank is a member-owned bank for financing ownership and entrepreneurship in farming 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 is a member-owned bank tasked primarily with providing competitive financing to Sweden's farmers and foresters. The company's history dates back to 1836. Borrowers with Landshypotek Bank are members of Landshypotek Ekonomisk Förening and thereby also owners of the bank. The association currently has about 42,000 members.

Landshypotek Bank grants loans mainly against mortgage deeds in agricultural and forest properties within 75 percent of an internally determined loan-to-value (LTV) ratio. The bank also collaborates with Sparbanken Syd, DNB and Gjensidige Försäkringsbolag with the aim of offering its customers a broader range of financial products.

2.2. Development at the bank

Landshypotek Bank holds a strong position in the Swedish credit market for financing farming and forestry with a market share of almost 27 percent. Requirements have been raised for financial companies. One element comprises the operating environment's more stringent capital and liquidity requirements. Other development requirements are set by customers and, in the case of Landshypotek Bank, the changes in farming and forestry also set requirements for development. Therefore, Landshypotek Bank is developing its operations to meet customer expectations, structural changes in the farming and forestry sectors and more stringent regulations. The change in farming and forestry businesses and other necessary developments will continue to require a robust capital base. The aim is to grow in terms of number of customers and in volumes. This will be achieved through the addition of more and improved services as well as broader target groups in agriculture and forestry and in the countryside.

In 2015, Landshypotek Bank strengthened its workforce and expanded its service offering. Growth is to take place at low risk and with healthy and stable profitability. The bank has recently created a new district with a focus on customers who live on farms and who have smaller loans with the bank. This will allow the possibility of growing and diversifying the loan portfolio.

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 savings accounts to the public. Landshypotek Bank's target is for deposits to account for 20 percent of funding within three years. In 2015, deposits increased SEK 4.5 billion and represented 13 percent of the bank's funding at the end of the year.

2.3. Organisation

Landshypotek Bank is organised into nine districts and has 19 offices across Sweden. The number of employees amounts to approximately 160. Account managers are available at all offices and are organised under regional managers who, in turn, report to the bank's Commercial Director. Landshypotek Ekonomisk Förening has 69 elected members in ten different regional boards of directors whose work duties include appraising the properties that the bank accepts as collateral.

2.4. Corporate governance

A corporate governance report is included in the bank's Annual Report.

3. Risk management and risk organisation

Landshypotek Bank applies a low level for its risk appetite and strives to achieve a high degree of risk awareness together with a low degree of risk undertaking throughout operations.

3.1. Objectives for 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 bank 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 is achieved through setting low levels for risk appetite and risk limits, a clear decision-making structure with a high level of risk awareness among the staff, shared definitions and assessment policies, sophisticated tools for risk assessment as well as responsibility and decision making based on solid knowledge of the bank's customers.

The bank's employees are tasked with maintaining high quality in all of the activities undertaken, being sensitive to changes in the macro environment and understanding the impact of these changes on customers, the value of assumed collateral and the bank's business model.

3.2. General risk appetite

Landshypotek Bank's overriding risk appetite is defined, inter alia, as follows:

– to retain its AAA rating on its covered bonds,
– to ensure that the bank's average losses due to credit risk and operational risk over an average economic cycle do not exceed 0.0525 percent of the bank's total volume of loans outstanding, and
– to keep average loss rates for other significant risk categories close to zero.

To ensure risk undertaking does not exceed the risk appetite, the bank has identified, categorised and limited all material risks. 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.

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

Landshypotek Bank's risk management is based on three lines of defence.

The bank's business operations comprise the first line of defence, which has full responsibility for the risks and the results that arise out of these operations. This is where the employees are located with the best knowledge of the customers and the local market.

The second line of defence comprises the risk organisation, which is independent from business operations. It is responsible for identification, quantification, analysis and reporting of all risks. The risk organisation maintains policies and frameworks that facilitate risk assessment as well as contributes expert knowledge, it also functions as an advisor during decision making and ensures that decisions are consistent with the risk tolerances established by the Board. The overriding task of the Compliance Department is to identify, measure and report compliance risks.

The third line of defence, Internal Audit, comprises an independent auditing body, directly subordinate to the Board. This function examines the first and the second lines of defence. It improves operations by evaluating risk management, governance and internal control.

The Board of Directors has the ultimate responsibility for risk management and ensuring that operations are conducted with a satisfactory level of internal control. The Board decides, inter alia, the policies that determine the manner in which the various business risks should be managed and the acceptable level of risk undertaking. Three Board Committees are in place to support this work; the Risk and Capital Committee, the Credit Committee and the Audit Committee. Subordinated to the Board, its committees and the CEO are advisory committees with different mandates.

The Credit Department, which is part of the risk organisation, is responsible for managing and controlling the bank's credit granting process. The department is also responsible for analysing the credits and assessing their risks. Its work is governed at an overriding level by the risk and credit policies as established by the Board. The department also issues internal instructions for credit granting and supplementary requirements for the operations that aim to create duality between the business operations and the independent risk organisation. The head of the independent risk organisation reports to the CEO and Board of Landshypotek Bank.

The Chief Financial Officer is responsible for Landshypotek Bank's borrowing, management of equity, liabilities and liquidity as well as risk management related to these areas. Operations are regulated by the risk and finance policies established by the Board. The Chief Financial Officer reports to the CEO of Landshypotek Bank.

Diagram 1 **Overview of the bank's policies**

A-H Internal governance and control policies							
A.1 Board Diversity Policy	**B.1** Risk Policy	**C.1** Ethics Policy	**D.1** Communication Policy	**E.1** Product & Partner Policy	**F.1** IT Policy	**G.1** Security Policy	**H.1** HR Policy
A.2 Suitability Assessment Policy	**B.2** Credit Policy	**C.2** Sustainability Policy				**G.2** Contingency Planning Policy	**H.2** Remuneration Policy
A.3-6 Formal work plans for the Board and committees	**B.3** Operational Risk Policy	**C.3** Customer Complaints Policy					
A.7 Board's Reporting Plan	**B.4** Finance Policy	**C.4** Policy for KYC and counteracting money laundering and financing of terrorism					
A.8 CEO's Terms of Reference	**B.5** Policy for Capital and Liquidity Development						
A.9 Risk Control Policy	**B.6** Dividend Policy						
A.10 Compliance Policy							
A.11 Internal Audit Policy							

The policies are adopted by the Board of the Bank.

4. Own funds and regulatory capital requirements

Government agencies are setting increasingly stringent capital requirements for banks and other financial companies. These are implemented, inter alia, through increased countercyclical buffer requirements and other additional capital requirements. The ongoing structural transition in the farming and forestry sectors is also expected to lead to changed capital requirements.

4.1. Own funds under the Basel III rules

For capital adequacy purposes, own funds at Landshypotek Bank comprise equity (Common Equity Tier 1 capital) and subordinated term loans (Tier 2 capital). At 31 December 2015, own funds for the consolidated situation amounted to MSEK 4,934, of which MSEK 4,434 was Common Equity Tier 1 (CET1) capital, as shown in Table 1.

When calculating own funds, deductions are made from CET1 capital for deferred tax assets. The difference between actual provisions and expected losses in line with the internal ratings-based (IRB) model for credit risk is also deducted from CET1 capital. The bank's Tier 2 (T2) capital comprises subordinated term loans with a nominal value of MSEK 500.

4.2. Regulatory capital requirements under the Basel III rules

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 has received approval for from the Swedish Financial Supervisory Authority. For other 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 credit valuation adjustment (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.

4.3. Capital requirement

At any point in time, an institute 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 the Basel III rules 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 percentage point of the total risk exposure amount. The countercyclical buffer will, as planned, be raised to 1.5 percent from 27 June 2016 and, if the proposal following circulation is applied, to 2.0 percent from 19 March 2017. 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 institute will risk restrictions in the form of bans proscribing actions, such as, the payment of dividends and certain types of variable remuneration[2]. However, the buffer requirements differ from other capital requirements, since not meeting them is allowed on a temporary basis.

Within the framework of the Basel III rules, the institute is also responsible for describing and assessing the capital requirement for other material risks not covered by the aforementioned requirements (Pillar II requirements). In addition to the bank evaluating whether further capital requirements exist for the three Pillar I risk categories, it also assesses the capital requirement for risks such as credit-spread risk, basis risk, interest-rate risk, currency risk and strategic risk.

Since the bank uses IRB models to calculate capital requirements for credit risk, the bank also has to meet the transitional rules linked to Basel I. The bank also needs to maintain a capital planning buffer so as not to risk breaching the transitional rule in a highly stressed scenario.

The bank also aims to maintain adequate capitalisation to reach the bank's rating target for covered bonds.

2) *Provided that the bank does not meet the requirement for the maximum distributable amount.*

Therefore, the bank bases the internal capital and liquidity adequacy assessment processes (ICAAP and ILAAP), as notified to the Swedish Financial Supervisory Authority on an annual basis, on all three aforementioned capital assessment methods (Basel III, the transitional rule linked to Basel I and rating targets) and the capital requirement is determined by the method that sets the highest capital requirement. In 2015, the capital requirement was assessed as SEK 4.6 billion. The ICAAP and ILAAP for 2016 have not yet been finalised.

4.4. Leverage ratio

From 2015, a non-risk based leverage ratio must be reported externally. The metric is to be evaluated by the regulatory bodies and a binding capital requirement may be based on this metric from 1 January 2018.

Table 1 **Own funds, Consolidated situation**

SEK thousand	31 Dec. 2015
Own funds, Basel III	**4,934,226**
Tier 1 capital	4,434,254
CET1 capital	4,434,254
Capital instruments included as CET1 capital	1,489,178
Retained earnings	3,221,844
Accumulated other comprehensive income	–42,650
Adjustment of CET1 capital due to prudential filters	15,936
(–) Other intangible assets	–20,654
(–) Deferred tax assets that rely on future profitability and do not arise as a result of temporary differences, net of associated tax liabilities	–4,756
(–) IRB shortfall of credit-risk adjustments to expected losses	–198,454
(–) Defined-benefit pension plans	–26,191
T2 capital	499,972
Capital instruments and subordinated loans included as T2 capital	499,972

Table 2 **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
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

Table 3 Capital adequacy, Consolidated situation

SEK thousand	31 Dec. 2015
Capital adequacy, Basel III	
CET1 capital	4,434,254
T2 capital	499,972
Total capital	**4,934,226**
CET1 capital ratio (%)	23.43
Tier 1 capital ratio (%)	23.43
Total capital ratio (%)	26.08
Institution-specific CET1 capital requirement (%)	8.00
capital conservation buffer requirement (%)	2.50
countercyclical capital buffer requirement (%)	1.00
CET1 capital available to meet buffers (as a share of total risk-weighted exposure amounts, %)	17.43
Capital quotient	3.26
Capital adequacy under the transitional rules linked to Basel I	
Own funds	5,132,679
Own funds requirement	4,220,222
Total capital ratio (%)	9.73
Capital quotient	1.22

Table 4 Leverage ratio

SEK thousand, consolidated situation	31 Dec. 2015
Balance Sheet according to the accounting standards	80,717,347
Adjustment for differences between carrying amounts and leverage exposure - derivatives	–449,572
Assets recognised off the balance sheet, net	2,395,867
Other adjustments	–62,828
Assets used to calculate the leverage ratio	82,600,814
Capital used to calculate the leverage ratio	
Tier 1 capital	4,434,254
Leverage ratio	
Leverage ratio calculated using Tier 1 capital	5.37 %

5. Credit risks

Credit risk is the greatest risk at Landshypotek Bank and represents 83 percent of the regulatory capital requirement [3)] under Pillar I rules, Basel III. Accordingly, it is of paramount importance that the bank 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, the collateral taken primarily comprises agricultural and forest properties. 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 income or 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 the limit group to which the customer is linked. The bank's customers, excluding legal entities, are risk classified as described in Section 5.6.

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. The highest decision-making body for day-to-day credit cases is the Board's Credit Committee.

5.3. Credit portfolio

5.3.1. Overview of credit portfolio

At 31 December 2015, Landshypotek Bank's loans to the public amounted to slightly more than SEK 64.5 billion. Lending encompasses lending to entrepreneurs and residents in the countryside 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 Table 8 mirrors the districts to which customers belong and shows that the geographic distribution in Sweden is favourable. The credit portfolio has grown by SEK 13 billion since 2010, corresponding to average lending growth of four percent per year over the past five years. Average lending per customer of Landshypotek Bank amounted to MSEK 1.5 on 31 December 2015. The exposure-weighted LTV ratio on the same date was 48 percent.

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 bank reports the vast majority of its loans 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 62 billion. Other loan exposures, such as legal entities, are calculated using the standardised approach.

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 25 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 regulating the credit approval process through internal governance documents and the district organisations are responsible for ensuring compliance with the internal rules for credit granting. The district organisations are responsible for carrying out yearly credit monitoring for all limit groups with credit limits over MSEK 5. More frequent reporting applies for customers with a higher risk level.

The bank's Insolvency Department manages problem loans. The need for a provision is assessed for defaulted loans and a provision made if the value of the collateral in the case of a forced sale is estimated as less than the banks' claim on the customer.

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

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 highly integrated into the credit process. The customer's/limit group's Probability of Default (PD) risk class and LTV ratio, which combined with the customer's/limit group's loan limit determine the credit decision procedure. The risk classes are also part of the decision data for credit decisions. 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 and expected losses.

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 Loss Given Default (LGD). Internal risk estimates are used for almost the entire retail exposure class at Landshypotek Bank 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 history 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 estimate the probability of the customer defaulting within one year.

The bank uses two default categories: soft defaults and hard 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. Hard defaults occur automatically when customers, who are not already in a soft default process, are late by more than 90 days with a significant credit obligation 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 defaulted loans. The bank estimates the PD for each risk class. With the aim of calculating the PD per risk class for capital adequacy purposes, the last 11 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

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

31 Dec. 2015, SEK thousand	Exposure value*	Own funds requirement	Risk-weighted exposure amount	Average risk weight	Expected loss
Credit risk – IRB approach	**62,385,011**	**921,718**	**11,521,473**	**18 %**	**270,461**
Retail – real estate collateral	62,266,067	912,202	11,402,529	18 %	270,461
Other non-credit-obligation assets	118,944	9,516	118,944	100 %	
Credit risk – Standardised approach	**18,792,822**	**374,808**	**4,685,103**	**25 %**	
National governments or central banks	24,883	0	0	0 %	
Regional governments or local authorities or agencies	5,115,182	0	0	0 %	
Institutions	1,792 728	47,372	592,156	33 %	
Corporates	281,079	21,817	272,714	97 %	
Retail	121,592	5,804	72,548	60 %	
Secured through liens on real property	3,143,428	229,674	2,870,925	91 %	
Non-performing exposures	43,446	3,977	49,713	114 %	
Covered bonds	8,270,485	66,164	827,048	10 %	
Operational risk – Basic indicator approach		**105,625**	**1,320,311**		
Credit valuation adjustment risk – standardised approach	**1,494,479**	**111,650**	**1,395,630**	**93 %**	
Total "Basel III"	**82,672,312**	**1,513,801**	**18,922,518**		
Supplements for the transitional rules linked to Basel I		**2,706,421**	**33,830,263**		
Total including supplements for the transitional rules linked to Basel I		**4,220,222**	**52,752,775**		

** Exposure value under the CRR.*

Table 6 **Estimate 31 December 2014 vs. outcome in 2015***

%	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 %	1.5 %	9.5 %	2.6 %

** For "Realised default outcome weighted by number of loans," the numerator takes into consideration the performing loans at 31 December 2014 that defaulted in 2015 and the denominator takes into consideration the total of performing loans at 31 December 2014 that were performing or non-performing at the end of 2015. 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 "Exposure-weighted LGD estimate for capital adequacy."*

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 2 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) under unfavourable economic conditions, is based on internal loss data gathered during the period 1995 to 2008. The outcome for the risk class is then adjusted upwards to, on a portfolio basis, correspond to the portfolio LGD value for 1994 and, thereafter, a safety margin increment is applied to all risk classes and certain risk classes have been adjusted up further to create a healthy margin between latter years' risk class outcomes and risk class estimates. LGD classes are divided into five classes in terms of LTV ratios. Diagram 3 illustrates the retail exposure by LGD risk class.

Exposure At Default (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"[4], 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 CF is calculated on the entire credit ceiling of the flexible first lien mortgage loan and 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, which is presented to and discussed with instances including the Board's Risk and Capital Committee. In 2015, portfolio PD estimate and the portfolio LGD estimate exceeded the corresponding outcome for the year, as shown in Table 6.

4) *The customer utilises when needed as much as wanted within the granted limit.*

5.7. Collateral

Landshypotek Bank grants loans against mortgage deeds in real property within 75 percent of an internally determined LTV ratio. This value should represent the long-term, sustainable value for the pledged collateral, in other words, certain downward adjustments related to the estimated market value are made for items such as harvestable wood. In addition, the company offers loans with EU support as collateral (EU loans). To reduce the risk of loss, some borrowers need to provide additional collateral such as sureties and chattel mortgages.

District office account managers 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 experience and a high degree of familiarity with local conditions. Valuations are also outsourced to other third parties.

5.8. Loan losses

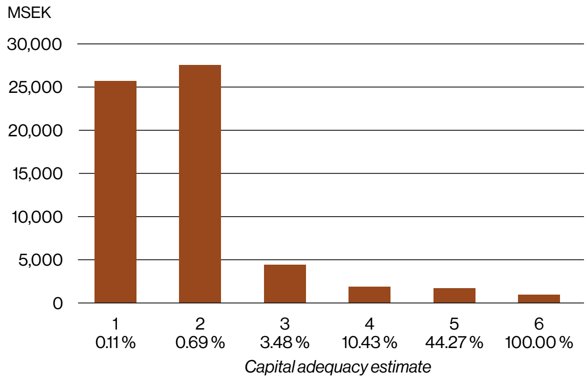
In 2015, confirmed losses were MSEK 50.3, which was lower than the same period in 2014 (MSEK 56.3), and the provision for probable loan losses declined to MSEK 82.2 (104.5). Net loan losses amounted to MSEK 45.9 (79.6). The exposure value for defaulted loans was MSEK 1,017 (1,477) at the end of 2015. Over the past two years, the bank has developed its work on the credit

Table 7 **LGD estimate per LGD class**

LGD class	LTV ratio	LGD including downturn adjustment and safety margin*
1	0-20 %	3.30 %
2	21-40 %	7.51 %
3	41-60 %	18.30 %
4	61-75 %	36.79 %
5	>75 %	88.93 %

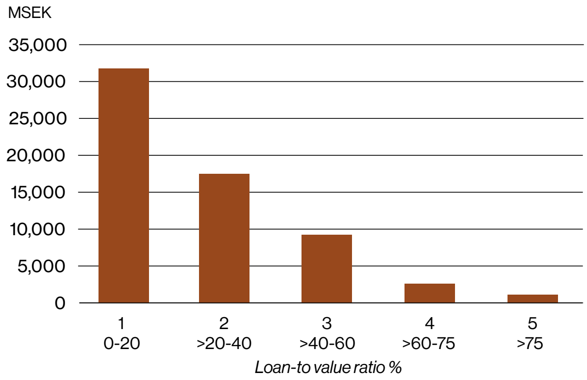
** LGD during unfavourable economic conditions, excluding LGD floor.*

Diagram 2 **Exposure per PD risk class***



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

Diagram 3 **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 8 **Lending broken down by sales district of Landshypotek Bank**

31 Dec. 2015 SEK thousand	Amount lent, incl. accrued interest	Of which: overdue receivables	Of which provisions*
Gotland	2,634,145	28,374	6,614
Mälardalen	8,979,841	196,386	19,653
The North	6,438,995	95,386	17,090
Skåne	9,794,180	55,975	463
Småland, etc.	7,368,060	147,427	11,593
Västra Götaland	9,272,881	81,245	9,032
Örebro, Värmland	8,988,138	235,069	19,477
Östergötland	11,266,545	170,023	7,184
Total	**64,742,786**	**1,009,885**	**91,106**

** Provisions for probable loan losses including past-due interest payments and fees*

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.

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 for counterparty risk is generally low.

The bank's total counterparty exposure comprises:

- the market value of securities,
- monetary deposits, and
- the exposure of derivative instruments calculated based on the mark-to-market method stipulated in the CRR.

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, and
- financial institutions.

New counterparties are to be approved and limited by the Board. Several factors are taken into account when setting limits. All of Landshypotek Bank's derivative contracts are registered in the pool for covered bonds, which means that International Swaps and Derivatives Association (ISDA) agreements and unilateral Credit Support Annexes (CSAs) are in place for each counterparty. These agreements regulate the collateral pledged by the counterparty when its rating falls below specified levels. Under these agreements, Landshypotek Bank can never be obligated to post collateral.

During the year, the bank has received approval from the Swedish Financial Supervisory Authority to net derivative exposures with the same counterparty for capital adequacy purposes.

Table 9 Derivative instruments and specified by rating

Liquidity portfolio

SEK thousand	Covered bonds	Municipal bonds	Bonds issued by Kommuninvest Sverige AB
AAA	8,270,485	1,758,969	736,222
AA+		2,619,812	
Total	**8,270,485**	**4,378,781**	**736,222**

Derivative instruments

SEK thousand	Positive gross market-value excl. premium for potential future exposure	Positive gross market value	Positive gross market-value incl. premium for potential future exposure, adjusted for bilateral netting agreements
AA-	1,178,458	921,203	643,775
A	262,639	98,352	65,715
A-	898,842	683,965	593,811
BBB*	398,555	361,086	398,555
Total	**2,738,494**	**2,064,606**	**1,701,856**

** Landshypotek Bank received SEK 393,603,000 in cash collateral under derivative contracts. This cash collateral has not been taken into account in the above figures.*

6. Liquidity risks and funding

Since Landshypotek Bank's operations are naturally exposed to liquidity risks, liquidity risk management is assigned high priority. The risk appetite 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 discharge its payment obligations without a substantial increase in the cost of obtaining funds.

6.2. Liquidity management

Landshypotek Bank's operations are naturally exposed to liquidity risk and the consequences of a lack of liquidity can be serious. Therefore, the appetite for liquidity risks is low and the management of liquidity risks is of high priority. The bank reduces its liquidity risk by maintaining a liquidity reserve. This 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 and reducing the financing need.

In order to maintain good payment capacity, the Board has decided that a liquidity reserve should be available that correspond to the forecast, accumulated net cash outflows for the next 180-day period and the outflows of deposits in periods of stress, without any possibility of refinancing[5]. On 31 December 2015, the bank had sufficient funds available to cover all payment obligations for about 327 days.

The bank also applies limits for the liquidity reserve, based on it covering net outflows over a 30-day significant stress period in accordance with the external liquidity coverage ratio (LCR) regulations. For contracted flows, the bank applies a 33-day period however. At 31 December 2015, the bank's LCR under the CRR and Commission Delegated Regulation (EU) 2015/61 was 374 percent for Landshypotek Bank's consolidated situation[6], as compared to the external LCR requirement of 60 percent.

[5] *Under this measurement method, the liquidity reserve in the pool for covered bonds may only be used to meet outflows from the pool for covered bonds.*

[6] *In this regard, the bank takes into consideration the entire liquidity reserve in the pool for covered bonds.*

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	396,214					396,214
Loans to the public	37,813,347	9,162,408	13,309,868	4,394,415	1,071,702	65,751,739
Bonds and other interest-bearing securities	219,170	6,691,247	3,876,500	2,641,000	0	13,427,917
Derivatives	113,545	3,062,295	3,239,033	2,156,189	4,908,880	13,479,942
Total	**38,542,276**	**18,915,950**	**20,425,401**	**9,191,603**	**5,980,583**	**93,055,813**
Financial liabilities						
Liabilities to credit institutions	393,227					393,227
Borrowing/deposits from the public	10,309,718					10,309,718
Granted credit facilities	643,919					643,919
Debt securities in issue	5,217,649	14,085,153	23,532,197	15,032,352	7,838,833	65,706,184
Derivatives	86,572	2,671,732	2,430,931	2,002,375	3,546,602	10,738,212
Subordinated liabilities	3,740	4,074	504,074	-	-	511,888
Total	**16,654,826**	**16,760,959**	**26,467,202**	**17,034,727**	**11,385,434**	**88,303,148**
Contracted cash flows	**21,887,450**	**2,154,991**	**–6,041,800**	**–7,843,123**	**–5,404,852**	**4,752,666**

The above table includes all contracted cash flows. The amounts are not discounted and are recognised during the time slot when Landshypotek 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 2015. The calculation of future rates of interest is based on forward rates plus any credit spreads.

The holdings in the liquidity reserve comprise covered bonds issued by Nordic credit institutions with high credit ratings and bonds issued by Swedish municipalities and county councils, including Kommuninvest Sverige AB.

The market value of the liquidity reserve was SEK 13.4 billion on 31 December 2015, of which 53 percent was placed as collateral in the pool for covered bonds and of which 82 percent comprised securities with a AAA rating.

6.3. Funding

Landshypotek Bank funds operations primarily through the issue of covered bonds, but also through unsecured debt, commercial paper financing and through deposits, equity and subordinated loans. As mentioned above in Section 2.2, in 2015, Landshypotek Bank substantially increased its deposits, which amounted to SEK 10.3 billion at year end.

In 2015, the average maturity of the bank's issues was 4.5 years. Furthermore, the bank works actively with the buyback and extension of bonds to minimise liquidity risks and accommodate investors.

6.4. Encumbered assets

Investors and regulators are increasingly setting more stringent requirements for increased transparency pertaining to banks' encumbered assets. At 31 December 2015, the bank's encumbrance ratio, that is the ratio of encumbered assets to total assets pursuant to Article 100 in the CRR, was 79 percent where the assets in the cover pool for issuing covered bonds comprised the source of encumbrance[7)]. A total of SEK 64 billion of the bank's assets were encumbered at 31 December 2015.

The bank's Treasury Department manages the bank's liquidity. The Head of Treasury reports to the bank's Chief Financial Officer.

[7)] *Assets in the pool for covered bonds are counted as encumbered up to the over collateralisation (OC) level, which S&P deems necessary to reach a AAA rating for the bank's covered bonds.*

Table 11 **Disclosures, encumbered assets, Consolidated situation**

MSEK	Carrying amount of encumbered assets	Carrying amount of unencumbered assets
Bonds and other interest-bearing securities*	3,811	9,441
Other assets	59,829	2,567
Total	**63,640**	**17,078**

MSEK	Fair value of pledged collateral received or own issued interest-bearing securities	Fair value of collateral received or own issued interest-bearing securities that can be encumbered
Bonds and other 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 issued excluding covered bonds and asset-backed securities
Total	**53,510****	**63,640**

* *Bonds and other interest-bearing securities are recognised at fair value.*
** *Liabilities that have arisen on the issuance of covered bonds, carrying amount.*

6.5. 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,
- 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 payments),
- full utilisation of customers' flexible loans in the first month, and
- withdrawals from deposits (50 percent).

The stress tests carried out by the bank have indicated a healthy payment capacity even if several different events that have a negative effect on liquidity were to occur simultaneously. At 31 December 2015, the bank was able to meet its payment obligations for about 81 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 116 days. Withdrawals from deposits of 50 percent 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 risk appetite.

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 company-specific events.

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 bank's appetite for market risks. The bank's Treasury Department manages the bank's market risks. Derivative 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 risk arises when fixed-interest terms for assets and liabilities are mismatched and is measured, inter alia, as the changes in the market values that occur if there is a parallel shift in the interest-rate curve of one percentage point. The total risk is measured daily and limited, and divided into different time slots (three months and thereafter per calendar year). The risk appetite is set by placing equity in customers' loans outstanding, which have an average maturity of about two to three years. In addition to the risk appetite, the Treasury Department also has a smaller deviation mandate related to the investment of equity. At year end, the actual interest-rate risk was a negative amount of MSEK 111 according to this metric.[8)]

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.*

7.2.2. Currency risks

Currency risks comprise 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 2015, approximately SEK 9.4 billion of the bank's funding was in foreign currencies.

Landshypotek Bank reduces currency risk by using swaps to convert the bank's cash flows in foreign currency back to SEK.

The limit for currency risk is set extremely low (MSEK 1). At the end of the year, all currency risk had been hedged.

Table 12 **Currency exposure including derivative payments**

Currency	Assets	Liabilities	Exposure
CHF	400,000	400,000	0
EUR	350,000	350,000	0
NOK	2,925,000	2,925,000	0

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 cross-currency interest-rate swaps. As a consequence of the volatility in basis spreads in recent years, measurement of basis spreads can contribute to relatively substantial impacts on earnings. The largest three-month movements in basis spreads (decreases and increases) since September 2008 would have, with the application of mark-to-market approach on the bank's portfolio at 31 December 2015, generated an impact of about negative MSEK 113 and positive MSEK 109 on earnings. However, if the bank does not terminate 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. During the year, the bank has introduced maturity limits with such aims as reducing credit-spread risk.

Table 13 **Fixed-interest terms for 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	396,214					396,214
Loans to the public	37,530,509	8,840,954	12,898,375	4,249,251	1,013,913	64,533,001
Bonds and other interest-bearing securities	5,555,000	4,900,000	1,800,000	700,000	0	12,955,000
Derivatives	26,635,728	7,144,316	8,911,368	6,709,316	5,950,031	55,350,759
Total assets	**70,117,451**	**20,885,270**	**23,609,743**	**11,658,567**	**6,963,944**	**133,234,974**
Liabilities						
Liabilities to credit institutions	393,227					393,227
Borrowing/deposits from the public	10,309,718					10,309,718
Debt securities in issue	25,918,000	2,194,316	6,346,368	6,590,316	5,480,031	46,529,031
Derivatives	32,530,153	11,800,000	9,035,000	1,669,000	710,000	55,744,153
Subordinated liabilities	430,000	0	70,000	0	-	500,000
Total liabilities	**69,581,098**	**13,994,316**	**15,451,368**	**8,259,316**	**6,190,031**	**113,476,129**
Net	**536,353**	**6,890,954**	**8,158,375**	**3,399,251**	**773,913**	**19,758,845**
Interest-rate sensitivity, net	13,192	–6,410	–30,711	–85,400	–2,131	–111,460
Cumulative interest-rate sensitivity	13,192	6,782	–23,929	–109,329	–111,460	

The above table includes all the nominal amounts (absolute values) under the time slots when interest is reset. This differs from the maturity analysis, which includes all contracted flows, that is, nominal amounts plus contracted interest payments.

7.2.4. Credit valuation adjustment risk

The Pillar I rules under the Basel III regulations set regulatory capital requirements for deterioration in counterparty credit quality with regard to derivative transactions and repos (known as CVA risk). At 31 December 2015, Landshypotek Bank had made a provision of MSEK 112 in capital for CVA risk. This was a significantly lower amount than the preceding year, which was attributable to the bank receiving permission from the Swedish Financial Supervisory Authority to calculate the capital adequacy requirement using net exposures per derivative counterparty.

Landshypotek Bank has also developed a valuation model for calculating the impact of CVA, 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 influenced by counterparties' credit ratings and reduced by the fact that Landshypotek Bank is contractually obliged to accept cash collateral when a counterparty's rating reaches specific levels. 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. Due to the relatively low value adjustment that was implied by taking these components into account, as the effect would have led to an improved result and as several uncertainties existed in the valuations, the bank elected as of 31 December 2015 not to let these components influence the valuation.

8. Operational risks

Operational risk occurs in all forms of business activities. 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 and external events including legal risks.

Operational risk is mainly categorised into the following areas:

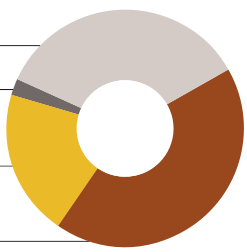
- Internal fraud
- External fraud
- Employment conditions and safety in the workplace
- Customers, products and business practice
- Damage to tangible assets
- Disruptions to the business operations and defective systems
- Transaction management and process control

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. The Security Manager and the Risk organisation have special supportive roles in parts of the bank's work with operational risks.

Among other measures, the bank uses an incident management system to manage its operational risks. This enables managers to efficiently distribute action plans aimed at reducing the risk of repeated incidents and, of obtaining a good overview of incidents and action plans. The Risk Control function compiles reported incidents and reports these to the CEO and the Board as well as follows up the implementation of communicated action plans. The division of reported incidents in 2015 is illustrated in Diagram 4. A total of 54 incidents were reported in 2015, for which external costs for restoring the business to its position prior to the incidents was TSEK 74.

Diagram 4 Specification of reported incidents 2015



No incidents were reported in other categories.

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 risk will have on the operations. The results of the risk analysis and proposed actions are presented to the CEO 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 actions to ensure these risks do not materialise. The incident reporting and the annual risk analysis are also used, to a certain extent, as supporting data for the annual ICAAP.

Landshypotek Bank has a developed procedure for New Product Approval (NPAP). This is to ensure the bank is prepared to manage new products, services, etc. A key element of this procedure comprises the participation of representatives from all internal functions at Landshypotek Bank in the approval procedure. During the year, six NPAP cases were approved by the New Product Approval Advisory Committee for implementation.

In 2015, the bank implemented several risk management controls in the first and second lines of defence with the aim of reducing operational risk. The bank has also developed its continuity management.

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 106 at 31 December 2015.

Landshypotek Bank