

## Note 3 - Risk factors

### Risk management

SpareBank 1 SMN aims to maintain a moderate risk profile and to apply risk monitoring of such high quality that no single event will seriously impair the Bank's financial position. The Bank's risk profile is quantified through targets for rating, risk-adjusted return, expected loss, necessary economic capital and regulatory capital adequacy.

The principles underlying SpareBank 1 SMN's risk management are laid down in the Bank's risk management policy. The Bank gives much emphasis to identifying, measuring, managing and monitoring central risks in such a way that the Group progresses in line with its adopted risk profile and strategies.

Risk management within the Group is intended to support the Group's strategic development and target attainment. The risk management regime is also designed to ensure financial stability and prudent asset management. This will be achieved through:

- a strong organisation culture featuring high risk-management awareness
- a sound understanding of the risks that drive earnings and risk costs, thereby creating a better basis for decision-making
- striving for an optimal use of capital within the adopted business strategy
- avoiding unexpected negative events which could be detrimental to the Group's operations and standing in the market

The Group's risk is quantified by calculating expected loss and the need for risk-adjusted capital (economic capital) needed to meet unexpected losses.

Expected loss is the amount which statistically can be expected to be lost in a 12-month period. Risk-adjusted capital is the volume of capital the Group considers it needs to meet the actual risk incurred by the Group. The Board has decided that the risk-adjusted capital should cover 99.9 per cent of all possible unexpected losses. Statistical methods are employed to compute expected loss and risk-adjusted capital, but calculation none the less requires expert assessments in some cases. In the case of risk types where no recognised methods of calculating capital needs are available, the bank defines risk management limits to ensure that the likelihood of an event occurring is extremely low. For further details see the bank's Pillar III reporting which is available on the bank's website.

The Group's overall risk exposure and risk trend are followed up through periodic risk reports to the administration and the Board of Directors. Overall risk monitoring and reporting are carried out by the Risk Management Division which is independent of the Group's business areas.

### Credit risk

Credit risk is the risk of loss resulting from the inability or unwillingness of customers or counterparties to honour their commitments to the Group.

The Group is exposed to credit risk through all customer and counterparty receivables. The main exposure is through ordinary lending and leasing activities, but the Group's credit risk also has a bearing on the liquidity reserve portfolio through counterparty risk arising from interest rate and foreign exchange derivatives.

Credit risk associated with the group's lending activity is the largest area of risk facing the Group. Through its annual review of the Bank's credit strategy, the Board of Directors concretises the Bank's risk appetite by establishing objectives and limits for the Bank's credit portfolio. The Bank's credit strategy and credit policy are derived from the Bank's main strategy, and contain guidelines for the risk profile, including maximum expected loss (EL) for the retail and corporate market divisions respectively, maximum portfolio default probability (PD) and maximum economic capital (UL) allocated to the credit business.

Concentration risk is managed by distribution between the retail and corporate market divisions, limits on loan size and loss given default on individual exposures, limits to maximum application of economic capital within lines of business and special requirements as to maximum exposure, credit quality and number of exposures above 10 per cent of own funds.

Compliance with credit strategy and limits adopted by the Board of Directors is monitored on a continual basis by the Risk Management Division and reported quarterly to the Board of Directors.

The Bank's risk classification system is designed to enable the Bank's loan portfolio to be managed in conformity with the Bank's credit strategy and to secure the risk-adjusted return. The Board of Directors delegates lending authorisation to the Group CEO and the divisional directors. The Group CEO can further delegate authorisations to levels below divisional director. Lending authorisations are graded by size of commitment and risk profile.

The Bank has a division dedicated to credit support which takes over dealings with customers who are clearly unable, or are highly likely to become unable, to service their debts unless action is taken beyond ordinary follow-up.

The Bank uses credit models for risk classification, risk pricing and portfolio management. The risk classification system builds on the following main components:

### 1. Probability of Default (PD)

The Bank's credit models are based on statistical computations of probability of default. The calculations are based on scoring models that take into account financial position along with internal and external behavioural data. The models are based on point-in-time ratings, and reflect the probability of default in the course of the next 12 months under current economic conditions. The Bank's estimates for probability of default in the loan portfolio were recalibrated in 2011 to reflect a long-term outcome.

Customers are assigned to one of nine risk classes based on PD, in addition to two risk classes for exposures in default and/or subject to individual impairment write down.

The models are validated at least once per year both with respect to their ability to rank customers and to estimate PD levels. The validation results confirm that the models' accuracy meets internal criteria and international recommendations.

### 2. Exposure at Default (EAD)

EAD is an estimate of the size of exposure in the event of default at a specific date in the future. For drawing rights, a conversion factor (CF) is used to estimate how much of the present unutilised credit ceiling will have been utilised at a future default date. For guarantees, CF is used to estimate what portion of issued guarantees will be brought to bear. CF is validated monthly for drawing rights in the retail and corporate market. The Bank's EAD model takes account of differences both between products and customer types.

### 3. Loss Given Default (LGD)

The Bank estimates the loss ratio for each loan based on expected realisable value of the underlying collateral, recovery rate on unsecured debt, as well as direct costs of recovery. Values are determined using standard models, and actual realised values are validated to test the models' reliability.

The three above-mentioned parameters (PD, EAD and LGD) underlie the Group's portfolio classification and statistical calculation of expected loss (EL) and need for economic capital/risk-adjusted capital (UL).

### Counterparty risk

Counterparty risk in derivatives trading is managed through ISDA and CSA contracts set up with financial institutions that are the most used counterparties. ISDA contracts regulate settlements between financial counterparties. The CSA contracts limit maximum exposure through market evaluation of the portfolio and margin calls when the change in portfolio value exceeds the maximum agreed limit or threshold amount. The Bank will continue to enter CSA contracts to manage counterparty risk.

For customers, counterparty risk is hedged through use of cash depots or other collateral which must at all times exceed the market value of the customer's portfolio. Special procedures have been established to call for further collateral or to close positions if market values exceed 80 per cent of collateral values.

### Market risk

Market risk is the risk of loss resulting from changes in observable market prices such as interest rates, exchange rates and securities prices.

Market risk arises at SpareBank 1 SMN primarily in connection with the Bank's investments in bonds, short-term money market paper and shares, and as a result of activities designed to underpin banking operations such as funding, fixed income and currency trading.

Market risk is managed through detailed limits for investments in shares, bonds and positions in the fixed income and currency markets.

The Group defines limits on exposure to equity instruments with a basis in stress tests employed in Finanstilsynet's (Financial Supervisory Authority of Norway) scenarios. The limits are reviewed at least once a year and are adopted yearly by the Bank's Board of Directors. Compliance with the limits is monitored by the Risk Management Division, and exposures relative to the adopted limits are reported monthly to the board of Directors. The limits are well within the maximum limits set by the authorities.

Interest rate risk is the risk of loss resulting from interest rate movements. Interest rate risk arises mainly on fixed interest loans and funding in fixed interest securities. The risk on all interest rate positions can be viewed in terms of the change in value of interest rate instruments resulting from a rate change of 1 basis point. The Group utilises analyses showing the effect of this change for various maturity bands, with separate limits applying to interest rate exposure within each maturity band and across all maturity bands as a whole. Interest rate lock-ins on the Group's instruments are essentially short, and the Group's interest rate risk is low to moderate.

Exchange rate risk is the risk of loss resulting from exchange rate movements. The Group measures exchange rate risk on the basis of net positions in the various currencies. Limits on exchange rate risk are expressed in limits for the maximum aggregate foreign exchange position in individual currencies. Foreign exchange risk is regarded as low.

Securities price risk is the risk of loss resulting from changes in the value of bonds, money market instruments and equity securities in which the Group has invested. The Group's risk exposure to this type of risk is regulated via limits on maximum investments in the various portfolios.

### **Liquidity risk**

Liquidity risk is the risk that the Group will be unable to refinance its debt or unable to finance increases in its assets.

The Bank's most important source of finance is customer deposits. At end-2011 the bank's ratio of deposits to loans was 65 per cent, compared with 61 per cent at end-2010 (Group).

The Bank reduces its liquidity risk by diversifying funding across a variety of markets, funding sources and instruments, and by employing long-term funding. Excessive concentration of maturities heightens vulnerability with regard to refinancing. The Bank seeks to mitigate such risk by applying defined limits.

The Bank's Finance Division is responsible for the Group's financing and liquidity management. Compliance with limits is monitored by the Risk Management Division which reports monthly to the Board of Directors. The Group manages its liquidity on an overall basis by assigning responsibility for funding both the bank and the subsidiaries to the Finance Division.

Governance is based in the Group's overall liquidity strategy which is reviewed and adopted by the board at least once each year. The liquidity strategy reflects the Group's moderate risk profile. As part of the strategy a contingency plan has been prepared to handle the liquidity situation in periods of turbulent capital markets featuring bank-specific and industry-related crisis scenarios. The Bank's objective is to survive for 12 months with moderate growth without fresh external funding.

The turbulence in international and domestic financial markets has affected the funding situation of most actors in 2011. Access to long-term funding has still not fully normalised.

The Group's liquidity situation as of 31 December 2011 is considered satisfactory.

### **Operational risk**

Operational risk can be defined as the risk of loss resulting from:

- People: Breaches of routines/guidelines, inadequate competence, unclear policy, strategy or routines, internal irregularities.
- Systems: Failure of ICT or other systems.
- External causes: Criminality, natural disaster, other external causes.

Operational risk is a risk category that captures the great majority of costs associated with quality lapses in the Bank's current activity.

Management of operational risk has acquired increased importance in the financial industry in recent years. Contributory factors are internationalisation, strong technological development and steadily growing demands from customers, public authorities and other interest groups. Many substantial loss events in the international financial industry have originated in failures in this risk area.

Identification, management and control of operational risk are an integral part of managerial responsibility at all levels of SpareBank 1 SMN. Managers' most important aids in this work are professional insight and leadership skills along with action plans, control routines and good follow-up systems. A systematic programme of risk assessments also contributes to increased knowledge and awareness of current needs for improvement in one's own unit. Any weaknesses and improvements are reported to higher levels in the organisation.

SpareBank 1 SMN attaches importance to authorisation structures, good descriptions of procedures and clear definition of responsibilities in supply contracts between the respective divisions as elements in a framework for handling operational risk.

The Bank has put to use a registration and monitoring tool (Risk Information System) for better structure and follow up of risk, events and areas for improvement in the Group.

Operational losses are reported to the Board of Directors.

The Board receives each year from the internal audit function and statutory auditor an independent assessment of the Group's risk and of whether the internal control systems functions as intended and is adequate.

For further information see Risk and Capital Management and notes:

Note 17: Max. credit risk exposure, excluding collateral furnished

Note 40: Market risk related to interest rate risk

Note 41: Market risk related to currency exposure