Pillar III

2012

Report capital adequacy and risk management

Contents

1. Introduction

This document describes SpareBank 1 Nord-Norge's risk and capital management in each risk area individually and together as a whole. The information is also intended to satisfy the requirements for disclosing risk information pursuant to the "Capital Requirements Regulations".

The document is updated annually with the exception of the information on capital adequacy and minimum capital requirements, which is updated quarterly.

2. Important events and lessons in 2012

Northern Norway is experiencing a period of record growth. This can be seen in all sectors of society. The labour market is still very tight. New growth is, to some extent, being hampered by a shortage of skilled labour, despite the region's significant population growth and high commuting rates. The strong growth is due to the region's abundant natural resources and their exploitation. The substantial oil and gas discoveries in the Norwegian Sea and Barents Sea are generating strong growth both in the oil industry directly and indirectly through related industries.

The situation for aquaculture and traditional fisheries is good. There is considerable available capacity for growth in aquaculture in the north, and all the most important fish stocks are enjoying good, sustainable development. Historically, tourism has been important, especially in the summer season. Winter tourism is now becoming as significant as summer tourism, which is making this industry even more important.

This growth, in conjunction with large public sector investment, has also resulted in a very high level of activity in the building and civil engineering sector. At the same time, recoverable and very high value deposits of minerals and rock types have been discovered. A more detailed analysis of the economy in the region is documented in the Bank's Business Barometer.

This expansion in economic activity in Northern Norway is reflected in SpareBank 1 Nord-Norge through high growth in both customers' loans and deposits. Loans to the retail sector increased by 11% in 2012, and deposits rose by 9%. Lending growth in the corporate sector was 12.9% and the growth in deposits was 3.4%.

In 2011, the Bank successfully completed an equity issue aimed at ensuring both the Bank's financial strength and its ability to be a good partner in developing the 'new Northern Norway'. The high rate of growth was expected, but has naturally resulted in pressure on the Group's capital adequacy ratio.

New regulatory requirements for equity in financial institutions also entail a requirement to increase the core tier 1 capital in SpareBank 1 Nord-Norge. The strategic capital target for SpareBank 1 Nord-Norge has been amended to a core tier 1 capital ratio of 12.5% or higher in 2015. Reference is made to a separate section later in the annual report describing the Group's capital adequacy ratio.

Through a combination of growth and higher net interest rates, SpareBank 1 Nord-Norge has successfully increased the Group's net interest income (including commissions from the transferred home mortgage loan portfolio) by 11.5% from NOK 1 203 million in 2011 to NOK 1 341 million in 2012. This indicates that balance sheet growth and income have developed similarly, and that interest margins have stopped declining. This is due to the banks generally seeking to raise revenues, as one of the measures to comply with the authorities' new financial strength requirements.

In 2012, the Group recognised losses on lending of NOK 195 million, an increase of NOK 94 million from 2011. In addition, a loss on equity investments in Northern Norway of NOK 147 million was recognised. The substantial loan losses are due to a small number of sizeable individual losses incurred by the Bank. One example being the consequences of closing down the solar cell industry at Glomfjord in Nordland, which alone has resulted in a loss of over NOK 100 million for the Bank. Substantial measures have been taken to reduce the likelihood of similar incidents occurring in the future.

Despite increased lending losses, the quality of the Bank's loan portfolio is good and further improved during 2012. Group net commissions (excluding commissions from the transferred home mortgage loan portfolio) totalled NOK 481 million in 2012, NOK 49 million more than last year. The Group will continue to work on increasing commissions and other income.

Financial key figures for 2012 (2011):

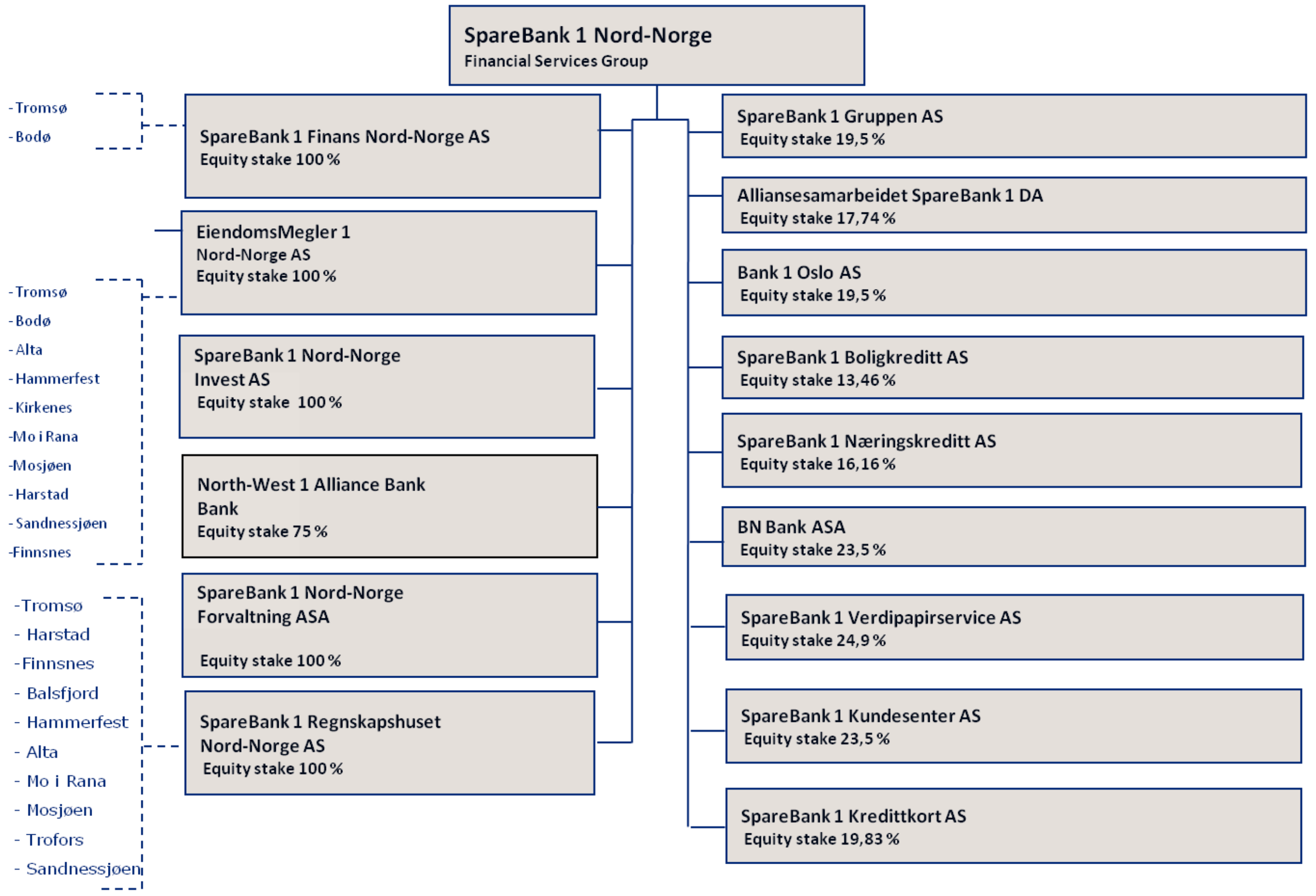
- Pre-tax profit of NOK 767 million (NOK 682 million)
- Net profit for the year of NOK 595 million (NOK 525 million)
- Return on equity (Group) was 9% (8.5%)
- Earnings per equity certificate (Group): NOK 3.78 (NOK 3.07)
- The 2012 results were characterised by:
    - Large losses/write-downs in SNN Invest
    - High lending losses in the corporate market
    - Higher net result from basic operations - important for the Group's total result
    - The trend in the interest contribution from the retail market was affected by the downturn in NIBOR
    - Measures implemented to improve interest margin in corporate and retail markets
- Cost/income ratio (Group) of 53.8% (57.0%)
- High loan losses of NOK 195 million (NOK 101 million)
- Good lending growth of 11.6% (7.4%) including loans transferred to SpareBank 1 Boligkreditt
- Decrease in deposits over the last 12 months of 1.3% (6.0%)
- Deposit coverage ratio 75.6% (80.9%)
- Satisfactory financial strength with tier 1 capital ratio (Group) of 12.11% (11.61%) and total capital adequacy ratio of 13.19% (12.50%) Core tier 1 capital was 10.31%
- Funding remains satisfactory

3. Organisation, internal control and management model

3.1. Group structure

The SpareBank 1 Nord-Norge Group consists of the following companies:

Figure 1 Group structure



Brief description of the companies:

SpareBank 1 Finans Nord-Norge AS
The company bears commercial responsibility for the product areas leasing and secured loan financing, and its primary market area is in Northern Norway. The parent bank and capital goods suppliers are important distribution channels for the company.

EiendomsMegler 1 Nord-Norge AS
The company is wholly owned by SpareBank 1 Nord-Norge and is engaged in estate agency in Northern Norway. The company is a member of a nationwide alliance with other companies owned by the SpareBank 1 banks. EiendomsMegler 1 Nord-Norge owns 60% of EiendomsMegler 1 Lofoten AS.

EiendomsMegler 1 Lofoten AS
The company is engaged in estate agency in Lofoten and is a member of a nationwide alliance with other companies owned by the SpareBank 1 banks.

SpareBank 1 Nord-Norge Invest AS
The company is wholly owned by SpareBank 1 Nord-Norge. The company's purpose is to participate, on a commercial basis, with equity capital, networks and competence in companies that conduct business primarily within the Bank's market area.

The company is being liquidated/restructured and in connection with this the company's portfolio is scheduled to be transferred to the parent bank.

North-West 1 Alliance Bank
In September 2010, SpareBank 1 Nord-Norge established banking operations in Russia through North-West 1 Alliance Bank. SpareBank 1 Nord-Norge holds a 75% stake in the bank, while 25% of the shares are owned by SpareBank 1 Nord-Norge's Russian partner Bank Tavrichesky i St. Petersburg. The head office is located in St. Petersburg and it has a branch in Murmansk.

North-West 1 Alliance Bank employed 71 full-time equivalents as of 31 December 2012. On the same date, the bank's balance sheet total was equivalent to NOK 392 million.

The principal purposes of North-West 1 Alliance Bank are to provide financial products and services to Nordic companies and people operating businesses in Russia. A secondary target group is Russian retail customers and smaller companies. Importance is attached to operating the business with a low to moderate level of risk.

SpareBank 1 Nord-Norge Forvaltning ASA
The company is a wholly owned investment firm that provides discretionary investment management of client assets.

SpareBank 1 Regnskapshuset Nord-Norge AS
The Bank founded SNN Økonomihus Holding AS in 2011. The purpose of the company is to participate in other companies and activities in the field of financial management and accounting, and other businesses with a natural connection to the Bank's activities. At year-end the company had no employees. **SNN Økonomihus Holding AS** has been wholly owned by the Bank since its inception and owns 100% of **SNN Økonomipartner Alta AS** and **Merkantilservice AS**.

The three aforementioned companies were merged at the start of 2013 with Merkantilservice as the acquiring company. The name of the merged company has been changed to SpareBank 1 Regnskapshuset Nord-Norge AS.

SpareBank 1 Regnskapshuset Nord-Norge AS had a total of 55 employees in Hammerfest, Alta, Tromsø, Balsfjord, Finnsnes and Harstad as of 31.12.2012.

3.2 Direct ownership in companies in the SpareBank 1 Alliance and strategic ownership interests

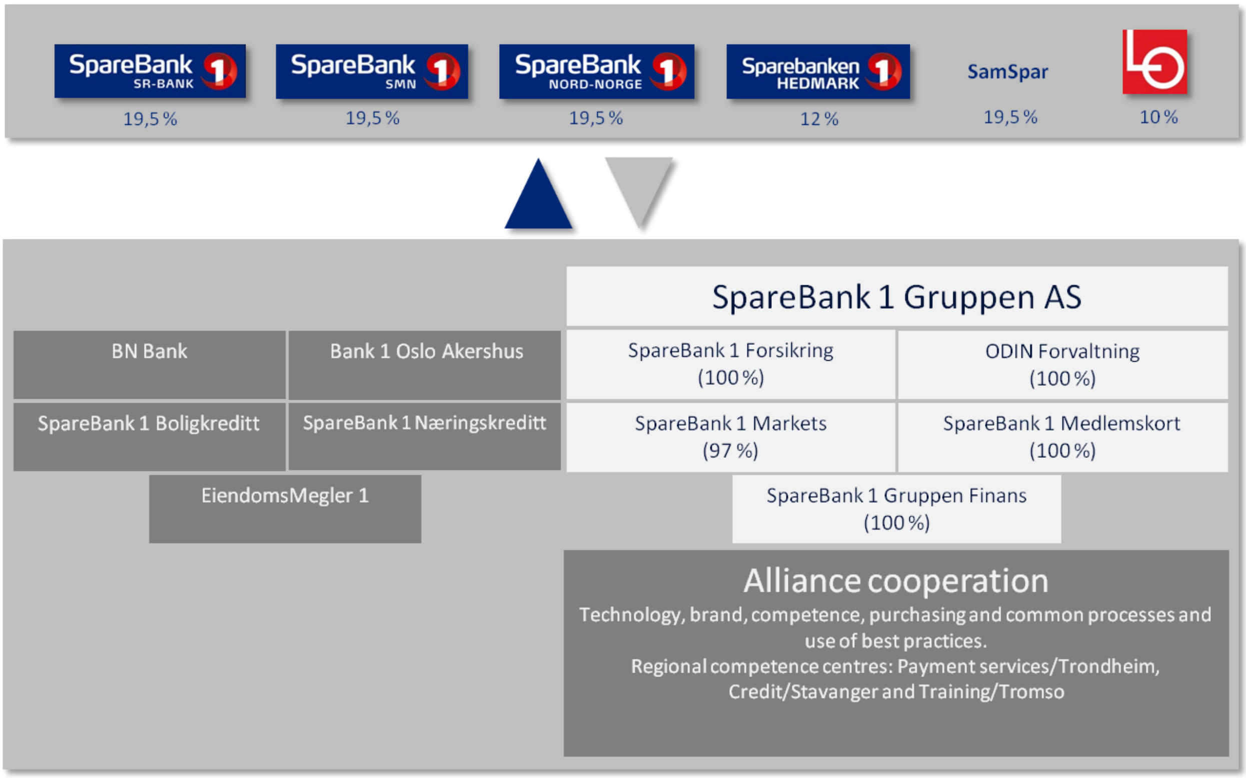
The SpareBank 1 Alliance and SpareBank 1 Gruppen AS
The purpose of the SpareBank 1 Alliance is to acquire and provide competitive financial products and services, and to take advantage of economies of scale in the form of lower costs and/or higher quality. Accordingly the Alliance provides retail and corporate customers with local roots, competence and an easier day-to-day life. In addition, the Alliance helps ensure the creation of value by the banks to the benefit of their own regions and the banks' owners.

The SpareBank 1 banks run the Alliance and develop product companies through the holding company SpareBank 1 Gruppen and the jointly-owned company SpareBank 1 Utvikling.

SpareBank 1 Gruppen bears administrative responsibility for all the alliance processes in the SpareBank 1 Alliance, where technology, brand names, competence, joint processes and the application of best practices and purchasing are all key factors.

EiendomsMegler 1, Norway's second largest chain of estate agents, is part of the SpareBank 1 Alliance. EiendomsMegler 1 has a jointly owned head office, but the individual branches are owned directly by the SpareBank 1 banks.

Figure 2 The SpareBank 1 Alliance



BN Bank
BN Bank provides financial services in the retail and corporate markets. It is purely an online bank in the retail market. In the corporate market, BN Bank is a significant player in the field of commercial real estate financing, and BN Bank has corporate market offices in Oslo and Trondheim. SpareBank 1 Nord-Norge owns 19.5% of BN Bank.

SpareBank 1 Boligkreditt AS
SpareBank 1 Boligkreditt's purpose is to fund first priority home mortgages for the banks in the SpareBank 1 Alliance. The banks transfer home mortgages to SpareBank 1 Boligkreditt before the company borrows in the Norwegian and international capital markets by issuing covered bonds. SpareBank 1 Boligkreditt's covered bonds are rated Aaa and AAA by Moody's and Fitch, respectively. SpareBank 1 Nord-Norge owns 13.26% of SpareBank 1 Boligkreditt.

SpareBank 1 Næringskreditt AS
SpareBank 1 Næringskreditt's purpose is to fund first priority commercial property mortgages for the banks in SpareBank 1 Alliance. The banks transfer first priority commercial property mortgages to SpareBank 1 Næringskreditt before the company borrows in the Norwegian and international capital market. SpareBank 1 Næringskreditt's bonds are rated Aa3 by Moody's rating agency. SpareBank 1 Nord-Norge owns 17.50% of SpareBank 1 Næringskreditt.

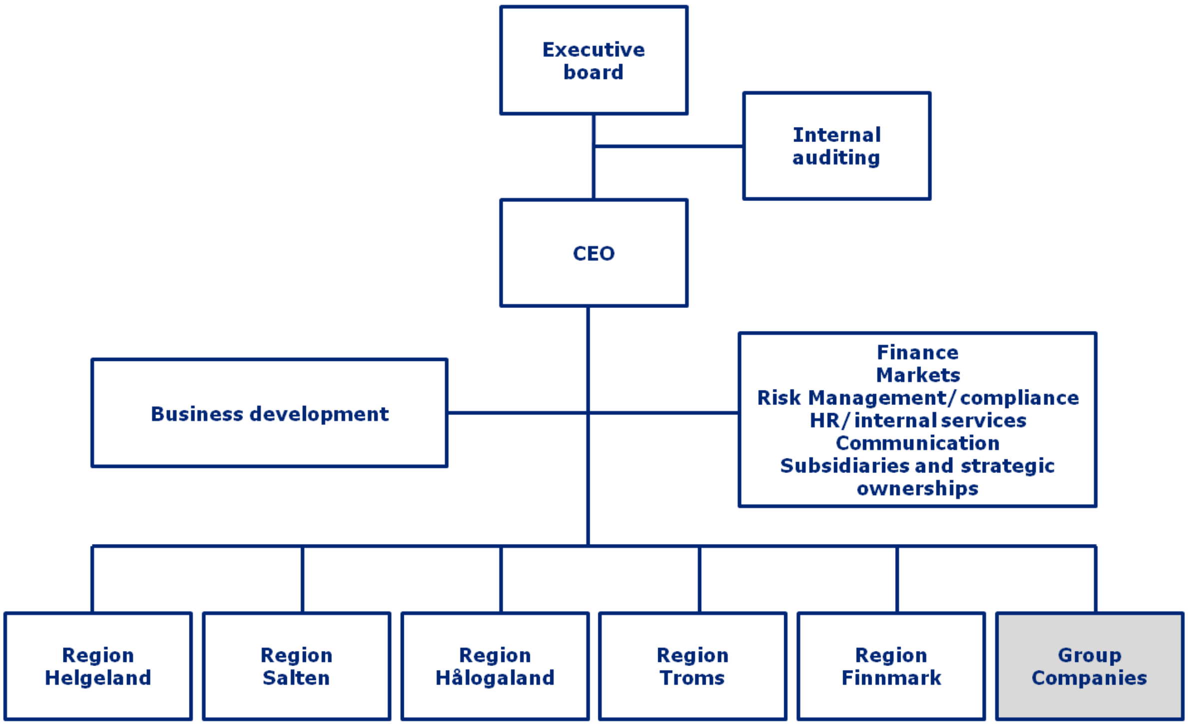
Bank 1 Oslo Akershus
Bank 1 Oslo Akershus operates under the market name SpareBank 1 Oslo Akershus and has 17 local branches. The main customer groups are the retail market, small and medium-sized companies and the organisation market, primarily the trade union movement. SpareBank 1 Nord-Norge owns 19.5% of Bank 1 Oslo Akershus.

Bank Tavrichesky
In 2010, SpareBank 1 Nord-Norge started banking operations in Russia through North-West 1 Alliance Bank, which is owned 75% by SpareBank 1 Nord-Norge and 25% by SpareBank 1 Nord-Norge's Russian partner Bank Tavrichesky. Bank Tavrichesky's head office is in St. Petersburg and it has branches in seven Russian cities, including Murmansk. The bank is the 11th largest regional bank in north-western Russia and its services are primarily targeted at small and medium-sized corporate customers. SpareBank 1 Nord-Norge owns 10% of Bank Tavrichesky.

3.3 Organisation of the bank

The organisation of customer-oriented business and specialist departments in SpareBank 1 Nord-Norge is illustrated in the organisational chart below:

Figure 3 Organisation chart



The CEO is responsible for implementing strategies and risk management that contributes to achieving the targets set by the Main Board of Directors for the business, including efficient management systems and internal control.

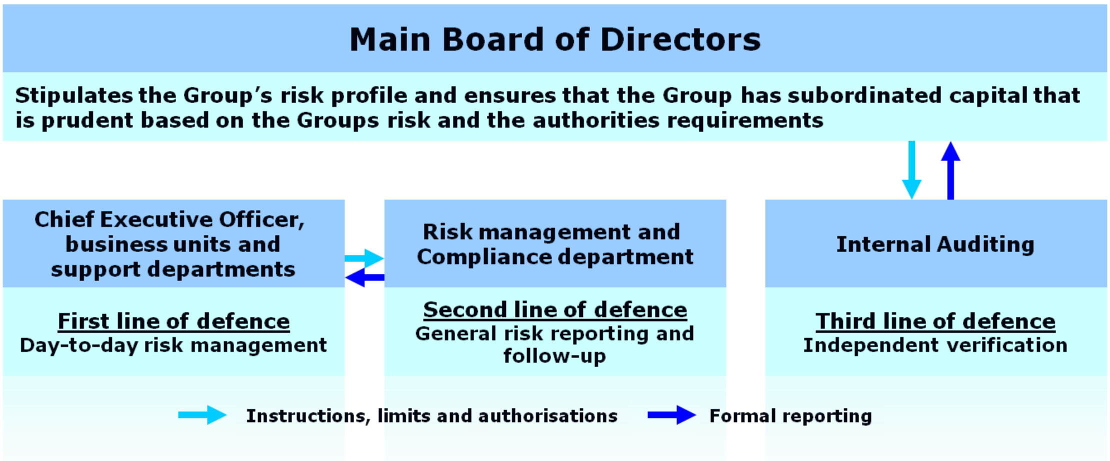
The Group Management Meeting is the CEO's collegium for the overall management of the bank, and it consists of the CEO, Deputy CEO, Executive Vice President Corporate and Retail Market, CFO, Executive Vice President Support Functions, Communications Director, and Executive Vice President Risk Management and Compliance.

3.4 The Group's internal control and management model

The Group's internal control and management model addresses the organisational requirements concerning the independence of risk reporting, in which responsibilities and roles in day-to-day risk management are in particular stressed.
SpareBank 1 Nord-Norge has invested a great deal of resources in the development of effective risk management processes for the identification, measurement and management of risk under its own direction and through the SpareBank 1 Alliance over many years.

All managers are responsible for maintaining a full overview of the risk picture in their own business areas and/or area of expertise at any given time. In order to satisfy the Group's primary goals, the Group has chosen to divide the risk management process into three parts:

Figure 4 Responsibilities and roles in the risk management process



The most central roles in the risk management process are:

- an executive function (includes both line (customer responsibility) and specialist departments (management/support/control))
- an independent monitoring function (Risk Management and Compliance Department)
- an independent verification function (Internal Audit)

The Group's internal control and management model should ensure the independence of decisions and reporting, and importance is in particular attached to responsibilities and roles in the day-to-day risk management. It is, therefore, an important principle that the risk management process is an integral part of day-to-day activities.

The Risk Management and Compliance Department shall follow up and support the line and specialist departments in their work on quality and risk management.

3.4.1 Responsibility for internal control and risk management
An important foundation for effective risk management is a strong risk culture that is characterised by a high degree of awareness of risk and risk management throughout the entire group. Such a foundation entails that each employee must have a good understanding of the Bank's operations and their own actions, as well as the risks that are associated with this.

The responsibility for risk management is divided between the Main Board of Directors, boards of the subsidiaries, executive management team and line management. Risk management and control are part of SpareBank 1 Nord-Norge's corporate governance, which is described under 'Corporate Governance' (see our website). Emphasis is placed on responsibility through personal authority and independence between the business areas and the organisational units that monitor the business areas.

The Main Board of Directors of SpareBank 1 Nord-Norge bears overall responsibility for the Group's risk exposure and management of the various risk areas. This entails responsibility for stipulating the overall objectives such as the risk profile, return targets and how the capital should be divided between the various business areas. The Main Board of Directors also stipulates the overall limits, authorisations and guidelines for risk management in the Group, as well as significant aspects of the risk management models and decision-making processes.

The Main Board of Directors' tasks are set out in a separate annual plan that is revised annually. This is to ensure that the Main Board of Directors focuses on and sets time aside for these key duties.

The Main Board of Directors has established a compensation committee to assess the CEO's salary and bonus terms/schemes. The committee consists of the Chairman of the Main Board of Directors, the Deputy Chairman and one member of the Board.

The Main Board of Directors has established an audit committee. The Audit Committee is a preparatory body for the Main Board of Directors in matters concerning the monitoring of financial information and the company's internal control and risk management. The CEO is responsible for making information and recommendations available to the committee as required and upon request.

The Audit Committee consists of three members from the Board. These members are independent in accordance with the definition in the "Norwegian Code of Practice for Corporate Governance".

The **Chief Executive Officer** (CEO) is responsible for the Group's risk management, including the development of efficient management systems, internal control and continuous follow-up. The CEO is also responsible for the delegation of authority and reporting to the Main Board of Directors.

The **business areas** are responsible for the overall risk management within their own area. This means that the managers must establish and execute responsible risk management within their areas of responsibility and make sure that this responsibility is exercised in an active manner in accordance with the Bank's policy for risk management, authority, instructions and routines.

The **Risk Management and Compliance Department** is organised independently of the business areas and reports to the CEO. The department bears overall responsibility for comprehensive risk management, internal control and the Group's compliance with rules and provisions, including responsibility for the Group's risk models and the further development of effective risk management systems.

The **Credit Department** is the Group's key department in the area of credit. The department is responsible for the preparation and maintenance of targets, strategies, guidelines and routines, operative management and follow-up of the Group's credit operations and credit risk management. The credit department has an independent role in relation to the business areas and local banks.

The **Internal Audit** is tasked with providing objective advice to the Board and management concerning the Group's risk management and formulation of controls, as well as compliance with established routines, procedures and guidelines. An external supplier of auditing services bears professional responsibility for the Group's internal auditing function, which ensures independence, competence and capacity.

The **Group Credit Committee** makes recommendations on any matter that shall be reviewed by the Main Board of Directors in accordance with the Group's guidelines. The committee plays a central role in connection with the formulation of the Group's credit strategies, credit policies and credit regulations.

The **Balance Sheet Committee** is headed by the Deputy CEO. The committee deals with matters related to the management of market and financial risk, and it is responsible for following up compliance with the frameworks stipulated by the Main Board of Directors. The committee follows up and stipulates the transfer pricing of capital and the capital structure.

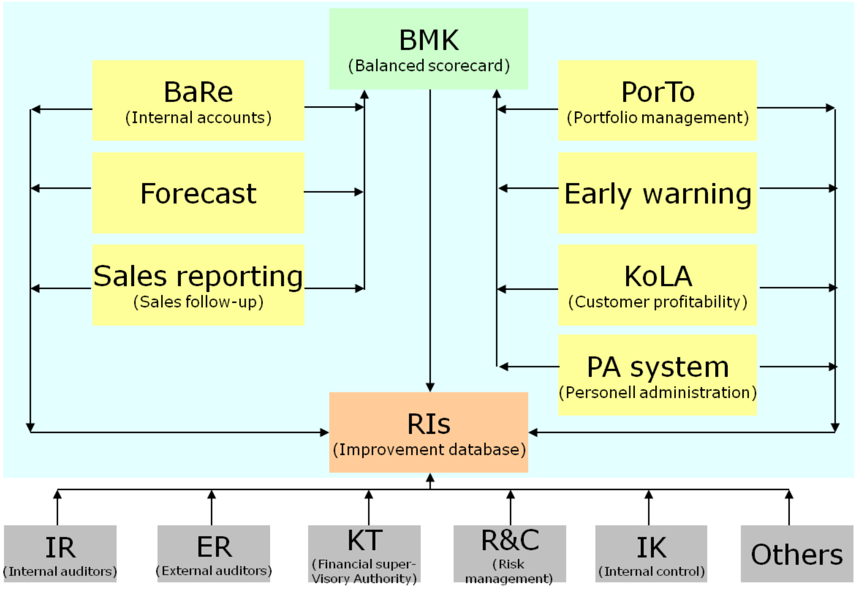
The **Validation Committee** is headed by the Deputy CEO. The committee's main duties are to ensure that:

- The IRB system is adapted to the portfolios on which it is used.
- The prerequisites on which the IRB system is based are reasonable.
- The IRB system measures what it is meant to measure.
- The IRB system is well-integrated throughout the organisation and represents a key part of the Group's risk management and decision-making process.
- SpareBank 1 Nord-Norge complies with the Capital Requirements Regulations.

3.4.2 Management information systems and reporting/follow-up

In recent years the Bank has spent a great deal of time and resources on the development of good management systems/management information systems.

Figure 5 Management information systems



Several of the management information systems are key to the reading, analysis, documentation, reporting and storage of information related to important parameters in the Group's IRB system and commercial follow-up and management, as well as the follow-up of improvement measures. The most important systems in this context are:

- Balanced scorecards (BSC)
  - Measures key indicators that are closely related to the IRB system. Applies, for example, to the risk-adjusted return, share of high risk exposure and credit quality.

- Portfolio management system (PorTo)
  The Group's central system for reading and reporting key risk parameters:
  - Probability of default (PD)
  - Loss given default (LGD)
  - Exposure at default (EAD)
  - Expected loss (EL)
  - Unexpected loss (UL)
  - Risk-adjusted return
  - Doubtful commitments

  The portfolio management system also provides a summary of the actual migration and master data for validation and stress testing.

- Early warning
  The Group's early warning allows it to constantly monitor key risk drivers: these are important indicators for better following up of customers and the development of potential defaults. The information from the early warning system is important for detecting key trends at the earliest possible point in time.

- Risk and information system (RIs) and the loss and incident database
  - The improvement database for the structured and documented follow-up of work on improvement areas and measures related to various main and sub-processes, incidents or important areas of expertise within the Group. A key system in connection with the monitoring and management of operational risk.

Internal control reporting/manager verification
Management personnel, defined as bank managers, specialist managers, department managers and directors, shall report upwards in the organisation in their respective areas of responsibility how the risk management has been carried out in relation to the approved framework and risk exposure. This should give the CEO and Main Board of Directors adequate material to determine whether the risk management is carried out properly. Such verification or reporting shall take place at least once a year or when dictated by major circumstances. The manager verification is coordinated by the Risk Management and Compliance Department.

The purpose of the annual reporting is primarily:

- to fulfil the managers' responsibility for proper and goal-oriented operations and to ensure that this responsibility is fulfilled in a systematic and uniform manner throughout the Bank/Group.
- to lay the foundation for the active involvement of the Bank's boards, Audit Committee and general managers
- to help the Bank's organisation and its managers regularly assess the various commercial and control-related risks, as well as the choice of control measures.

The recording is important to the Group's management development process to create a better understanding of the importance of good risk management and quality. This reporting should be a key tool in connection with training in the bank.

<u>Risk report to the CEO and the Main Board of Directors</u>
The Risk Management and Compliance Department prepares a risk report every four months that is presented to the CEO and the Main Board of Directors. The purpose of this risk report is to:

- Brief the CEO and Main Board of Directors of SpareBank 1 Nord-Norge on the status and expected development of the risk profile of the bank and the Group
- Give the CEO and Main Board of Directors a better basis for management and making decisions
- Give the CEO and Main Board of Directors a confirmation of compliance with and fulfilment of the strategic key figures and limits that are defined in the Bank's strategies
- Give the CEO and Main Board of Directors an opportunity to fulfil their statutory control responsibility

4. Capital adequacy

4.1 Capital adequacy regulations

The EU's Capital Adequacy Directive was implemented in Norway on 1 January 2007. The regulations build on a capital adequacy calculation standard issued by the Bank for International Settlements (BIS).
Financial activities entail a need to control and manage risk. The purpose of the capital adequacy regulations is to strengthen the stability of the financial system through:

- More risk sensitive capital requirements
- Better risk management and control
- Closer supervision
- Disclosure of more information to the market

Good corporate governance in SpareBank 1 Nord-Norge is a strategic instrument to increase the creation of value by the Group.

The Ministry of Finance stipulated capital requirements regulations for commercial banks, savings banks, finance enterprises, holding companies in financial services groups, securities firms and management companies for security funds (Capital Requirements Regulations) on 14 December 2006. The regulations entered into force on 1 January 2007. Part IX of the regulations regulates the publication of financial information (corresponding to pillar 3 of the Basel II Accord).

The regulations entail that there will be greater agreement between how the authorities stipulate the capital adequacy requirements for financial institutions and the methods that the financial institutions themselves used to calculate their capital requirements.

The new capital requirements are based on three pillars:

- Pillar 1: Minimum capital requirements
- Pillar 2: Supervisory review process of capital adequacy follow-up
- Pillar 3: Institution's market discipline and disclosure

<u>Pillar 1 – Minimum capital requirements</u>
The first pillar concerns the minimum capital requirements and represents a further development of the former capital adequacy regulations, Basel I. The new regulations do not entail any change

to the fundamental structure of the capital requirement, which is still 8%, but some changes were made to the regulations with regard to what can be considered primary capital and the composition of such capital. This applied to the calculation of the capital requirement for credit risk and the introduction of an explicit capital requirement for operational risk. The capital adequacy requirements for market risk were affected to a lesser extent by the new regulations.

$$\frac{\text{Tier 1 capital + tier 2 capital}}{\text{Credit risk + Market risk + Operational risk}} \geq 8\ \%$$

The capital adequacy regulations contain various methods for calculating capital requirements. The various methods are illustrated in the figure below:

Figure 6 Methods for calculating the capital requirement

Credit risk	Market risk	Operational risk
Standard method	Standard method	Basic method
Foundation IRB method (1)	Internal measuring methods (1)	Standardised approach
Advanced IRB method (1)		AMA method (1)

1) The methods require the approval of the Financial Supervisory Authority of Norway.

For banks that have received approval to use internal measuring methods (Internal Rating Based Approach) for credit risk, the statutory minimum requirement for capital adequacy will be based on the Group's internal risk assessments. The statutory minimum requirement for capital adequacy makes it more risk-sensitive, meaning that the capital requirement will to a larger extent correspond to the risk in the underlying portfolios.

When Foundation IRB is used, the risk parameter probability of default (PD) and size parameter (S) are calculated using the Bank's own models. The risk parameters conversion factor (CF) used to determine exposure given default and loss given default (LGD) are standard value rules stipulated in the Capital Requirements Regulations.

When Advanced IRB is used for the mass market, the risk parameters PD, S, CF and LGD are calculated using special models for calculating capital requirements.

Pillar 2 – Supervisory review process of capital adequacy
The second pillar is based on two main principles. The banks are to have a process for the evaluation of their overall capital in relation to the risk profile and a strategy for maintaining an adequate level of capital.

The risk assessment process includes an assessment of the risk profile and capital requirements in parent companies, important subsidiaries and stakes in associated companies. The review is conducted annually and the risk is quantified by calculating the risk-adjusted capital. The banks use both quantitative models and qualitative assessments to determine the capital requirement. Stress tests for credit risk and market risk provide important guidelines for final valuations.

The Financial Supervisory Authority of Norway shall also review and evaluate the banks' internal assessment of their capital needs and strategies, in addition to monitoring and ensuring

observance of the capital requirements imposed by the authorities. The Financial Supervisory Authority of Norway has the authority to implement suitable supervisory measures if they are not satisfied with the results of this process.
As part of the supervisory process the Financial Supervisory Authority of Norway shall prepare an annual overall risk assessment for the Group. The assessment provides feedback on the Group's capitalisation and risk level.

SpareBank 1 Nord-Norge has established processes to assess the capital requirements in light of the risk profile and the quality of the established internal control and risk management systems. The process and its results are documented in writing in an annual ICAAP report. The Group's ICAAP report was sent to the Financial Supervisory Authority of Norway in December 2012 and the Executive Vice President Risk Management and Compliance is responsible for conducting the capital assessment process.
The Group has systematically worked on quantifying risk in all parts of the organisation for a long time. Risk-adjusted capital is the Group's target for risk.

There is broad participation from the executive group management team, various specialist departments and risk experts in the work on risk assessments and capital requirements. The Group's capitalisation and capitalisation target form an important part of the Group's planning work and strategy process. The results of the quantitative and qualitative assessments are thoroughly checked by the specialist groups, Balance Sheet Committee and executive group management team before being considered by the Main Board of Directors.

Pillar 3 – Market discipline and disclosure
The purpose of the third pillar is to supplement the minimum requirements in the first pillar and the supervisory follow-up in the second pillar. The third pillar should contribute to greater market discipline through requirements for the publication of information that makes it possible for the market, including analysts and investors, to evaluate the institution's risk profile and capitalisation, as well as its management and control. The publication requirements are particularly important when the banks can use their own systems and methods to a greater extent to calculate the capital requirement.

The information requirements stipulate that all institutions must publish information on their organisational structure, risk management system, reporting channels and how their risk management is built up and organised. In addition, detailed requirements are stipulated for the publication of the capital level and structure, as well as the risk exposure, and the latter depends on what calculation methods the banks use in the first pillar.

It is a requirement that the publication take place on the Internet.

This document meets, together with the bank's annual report, the requirements for the publication of information in accordance with the current regulations.

Internal Audit
The Internal Audit shall regularly audit the IRB system and its use, including compliance with the Capital Requirements Regulations. This assessment shall, as a minimum, be conducted annually and form part of the independent reporting to the Main Board of Directors. The audit work also includes an assessment of the ICAAP process, embedding in the organisation and whether the capital is adequate in relation to the risk profile of the Group and the most important subsidiaries and joint ventures.

4.2 Financial strength targets

Effective capital management is closely related to the Group's strategic plans, market opportunities (including growth strategies), risk tolerance and capital targets.

SpareBank 1 Nord-Norge's capital management shall primarily ensure it has a sufficiently large amount of capital and that its application of capital is efficient in relation to protecting creditors against losses (creditor protection) i.e. avoiding situations in which the Group may 'go bust'.

SpareBank 1 Nord-Norge's capital management is based on the Group's general capital targets, which are also described in this document. The targets should be seen in the context of the Group's risk profile and the capital targets must be designed in line with the risk based approach in the capital adequacy regulations.

The **capital target set** shall ensure that SpareBank 1 Nord-Norge, for each company individually and at a Group level, has sufficient capital to satisfy:

a) *Internally set requirements* for capital in relation to underlying risk in the organisation, i.e. the Group's own assessment of its capital requirements pursuant to ICAAP (Pillar 2). This requirement should also be compared to the capital market's expectations concerning financial strength.

   Creditor protection: Creditor protection describes how probable it is that creditors may suffer a loss within a 1-year time horizon. Creditor protection is expressed as a level of confidence.

   The Group's capital plan should also ensure that the set minimum capital adequacy requirement (core tier 1 capital ratio) of 12.5% by year-end 2015 based on the risk profile and risk tolerance being satisfied (owner's perspective). This means that one should seek to ensure that the Group does not incur a deficit that could result in it losing its independence. Such calculations are based on stress tests over a 5-year economic downturn.

b) *Regulatory capital ratio:* Statutory capital adequacy requirement, i.e. regulatory capital (Pillar 1) that is used to determine the minimum capital adequacy requirement in relation to the rules of the Capital Requirements Regulations: total capital adequacy ratio and tier 1 capital ratio.

In addition to the above, the Group's capital management must also:

- ensure competitive terms in the funding market (rating perspective)
- satisfy the owners' return on equity requirements (competitive return on equity)
- ensure that the Group and its subsidiaries can take advantage of growth opportunities in the market (organic or via acquisitions)

The **capital targets must be reviewed annually** and approved by the Main Board of Directors.

The Group's capital adequacy target is set at:

Core tier 1 capital ratio 12.5% or higher in 2015

- *One of SpareBank 1 Nord-Norge's goals is to appear to be indisputably sound.*
- *The Group's set capital adequacy target shall be based on its internal process for calculating its capital requirements (ICAAP) and shall be reviewed annually. The capital target shall be expressed in relation to current capital adequacy legislation.*
- *The Group also has a goal that the Group's capital adequacy in a projected crisis scenario must have adequate buffers so that the tier 1 capital ratio does not fall below 10%. (2.5 percentage points below the target.)*

The set core tier 1 capital ratio shall not be regarded as a minimum requirement. The tier 1 capital ratio will actually vary depending on the economic situation. Adaptation to the target of 12.5% can take place over time, but the goal is for this to occur by no later than the end of 2015. A new assessment of the capital target will be conducted, at the latest, as part of the new regulatory capital requirements for Norwegian banks or as part of the consideration of the Group's ICAAP and capital plan towards the end of 2013.

Up to 50% of the accrued profit can be included for internal purposes in the calculations conducted during the year.

The aforementioned capital target applies for SpareBank 1 Nord-Norge at a Group level. It is up to the individual subsidiary to establish its own capital target based on the aforementioned criteria.

4.3 IRB ambitions

Credit risk

SpareBank 1 Nord-Norge has been approved by the Financial Supervisory Authority of Norway to use internal measuring methods (IRB) for credit risk since 2007. The Bank has received approval to use Foundation IRB (FIRB) for the corporate market and Advanced IRB (A-IRB) for the retail market. This means that the statutory minimum requirement for capital adequacy for credit risk will wholly or partially be based on the Group's internal risk models.

When the capital requirements for the retail market are calculated using the IRB method, separate models are used for calculating the risk parameters probability of default (PD), conversion factor (CF), used to determine exposure in the event of default, and loss given default (LGD).

In calculating the capital requirement according to the Foundation IRB method for the corporate market, the risk parameter probability of default (PD) is based on internal models. The risk parameters conversion factor (CF), used to determine exposure at default (EAD), and loss given default (LGD) are set according to standard value rules stipulated in the Capital Requirements Regulations. Loss given default is statutorily set at 45%. SpareBank 1 Nord-Norge's validation results show that losses from defaulted commitments in the corporate market are somewhere in the region of 20-30%.

SpareBank 1 Nord-Norge has started the job of qualifying for Advanced IRB for the corporate market so that the Group can also use its own models to calculate the risk parameters conversion factor (CF), used in determining exposure at default (EAD), and loss given default (LGD). Approval is expected to have a positive effect on the tier 1 capital ratio.

Operational risk
SpareBank 1 Nord-Norge reports operational risk in accordance with the standardised approach for the parent bank. The Bank has over time developed internal control and quality systems that enable it to report operational risk in accordance with the requirements of the standardised approach set forth in the Capital Requirements Regulations. The rest of the Group still reports using the basic method.

4.4 Capital adequacy

The figure below illustrates the methods that SpareBank 1 Nord-Norge uses for calculating its capital requirements for credit, market and operational risk, respectively.

Figure 7 SNN's methods for calculating the capital requirement

Risk type	Portfolio	Regulatory method
Credit risk	States	Standard method
	Institutions	Standard method
	Housing cooperatives, clubs and associations	Standard method
	Businesses	Foundation IRB
	Mass market	Advanced IRB
	SpareBank 1 Finans Nord-Norge	Standard method
	SpareBank 1 Nord-Norge Invest AS	Standard method
	SpareBank 1 Nord-Norge Securities ASA	Standard method
	SpareBank 1 Nord-Norge Forvaltning AS	Standard method
	Mass market - SpareBank 1 Boligkreditt AS	Advanced IRB
	SpareBank 1 Næringskreditt AS	Standard method
	BN Bank AS	Standard method
Market risk	Equity positions	Standard method
	Bonds and commercial paper	Standard method
	Currency positions	Standard method
	Subsidiaries and other associated companies	Standard method
Operational risk	SpareBank 1 Nord-Norge, incl. subsidiaries	Standardised approach/

		basic method
	Other associated companies	Standard method

For the subsidiary SpareBank 1 Finans Nord-Norge AS, there are plans for a transition to the IRB method, and the portfolio in this company will be reported based on the standard method until further notice. The company's principal operations are lease financing and secured car loans At the start of the year, credit risk calculations for SpareBank 1 Finans Nord-Norge AS in accordance with the new capital adequacy rules were based on 5.5% of the Group's basis for calculation.

SpareBank 1 Nord-Norge owns 13.46% of the shares in SpareBank 1 Boligkreditt AS as of 31.12.2012. SpareBank 1 Boligkreditt AS operates as a mortgage company and has been granted a licence by the Financial Supervisory Authority of Norway. The main purpose of the mortgage company is to ensure the owners of stable and long-term financing at competitive prices. SpareBank 1 Boligkreditt AS received IRB approval in 2009. The ownership interest has been included in the capital adequacy ratio based on the proportional consolidation rules upon approval by the Financial Supervisory Authority of Norway.

The ownership interests in BN Bank ASA (23.5%) and SpareBank 1 Næringskreditt AS (16.16%) have also been included in the capital adequacy ratio based on the proportional consolidation rules.

The Group has set aside a capital adequacy reserve for 2012 related to its shareholding in SpareBank 1 Gruppen AS and Bank 1 Oslo AS. This capital adequacy reserve has reduced the Bank's primary capital by NOK 1,413 million, NOK 706 million of which will be deducted from the tier 1 capital.

4.5 Consolidations/subsidiaries/associated companies

Figure 8 Consolidation principles

Subsidaries	Org.number	Number of shares	Cost value	Book value	Voting rights	Accounting purpose	Capital requiremen t	Net equity and related capital	Capital adequacy ratio
Companies which have been fully consolidated									
North-West 1 Alliance Bank, Russia	0	3.450.000	91	91	75,00 %	Acquisition method 75 %	0	0	0
EiendomsMegler 1 Nord-Norge AS	931262041	21.100	30	30	100,00 %	Acquisition method 100 %	0	0	NA
SpareBank 1 Nord-Norge Finans AS	930050237	38.400	251	251	100,00 %	Acquisition method 100 %	3.275	321	9,80 %
SpareBank 1 Nord-Norge Invest AS	935491533	252.000	252	17	100,00 %	Acquisition method 100 %	0	0	NA
SpareBank 1 Nord-Norge Forvaltning /	982699355	200.000	7	7	100,00 %	Acquisition method 100 %	13	6	42,76 %
SNN Økonomihus AS	997580095	2.100	7	7	100,00 %	Acquisition method 100 %	0	0	NA
BN Bank ASA	914864445	3.141.558	165	780	23,50 %	Equity method 23,50 %	30.925	4.662	15,08 %
SpareBank1 Boligkreditt AS	988738387	6.768.693	1.016	1.053	13,46 %	Equity method 13,46%	71.650	7.494	10,46 %
SpareBank1 Næringskreditt AS	894111232	1.654.400	207	211	16,16 %	Equity method 16,16 %	10.588	1.304	12,32 %
Companies which are not consolidated where there are no deposits of equity and related capital which have been deducted from the insitiution's equity and related capital									
SpareBank 1 Gruppen AS	975966372	381.498	715	1.109	19,50 %	Equity method 19,50 %			
Bank 1 Oslo Akershus AS	910256351	694.435	248	304	19,50 %	Equity method 19,50 %			
Bank Tavrichesky, Russia	0	90.822.001	115	97	10,00 %	Acquisition method 10,00 %			
Companies which are not consolidated where there are no deposits of equity and related capital which have been deducted from the institution's equity and related capital									
Alliansesamarbeidet SpareBank 1 DA	986401598	2	18	18	17,74 %	Equity metod 17,74 %			
SpareBank 1 Kredittkort AS	975966453	99.340	31	31	19,83 %	Equity metod 19,83%			
SpareBank 1 Verdipapirservice AS	998240603	16.434	8	8	24,90 %	Equity metod 24,90%			
SpareBank 1 Kundesenter AS	998830124	1.491	0	0	23,50 %	Equity metod 23,50 %			

SpareBank 1 Nord-Norge attaches importance to the fact that all the units in the Group have satisfactory capital at any given time. The Group's governing bodies have not imposed any restrictions on the Board's opportunity to transfer capital between the parent bank and the subsidiaries or between the subsidiaries beyond what follows from regulatory and other statutory restrictions. Nor are there any provisions in the Articles of Association that impose any such restrictions.

Figure 9 Capital adequacy ratio calculation - Group

Amounts in NOK million	31.12.12		31.12.11		31.12.10	
Core capital						
PCC-capital	1.655		1 655		896	
Premium Fund	245		245		123	
Saving Bank's Fund	3.083		2 898		2 829	
Dividend Equalisation Fund	456		333		566	
Donations	150		133		133	
Fund for unrealised gains	-3		- 4		- 2	
Other equity	1.224		1 148		1 121	
Total equity capital	6.810		6 408		5 666	
Deduction set asite dividend	-106		- 175		- 103	
Deduction net pension fund	-29		- 8		0	
Deduction Fund for unrealised gains	41		66		46	
Adjusted subordinated capital from consolidated financial institutions	-58		- 17		- 18	
Hybrid Tier 1 bonds	989		512		473	
Deferred tax, goodwill and other intangible assets	-66		- 40		- 20	
Deduction subordinated capital in other financial institutions (50 %)	-106		- 27		0	
Deduction adjusted expected amount lost (50 %)	-97		- 71		- 86	
Capital adequacy reserve	-706		- 646		- 624	
Core capital	**6.672**		**6 002**		**5 334**	
Supplementary capital						
Prepetual non-call bonds	0		0		0	
Subordinated loan capital	1.507		1 207		1 225	
Deduction subordinated capital in other financial institutions (50 %)	-106		- 27		0	
Deduction adjusted expected amount lost (50 %)	-97		- 71		- 86	
Capital adequacy reserve	-706		- 646		- 624	
Supplementary capital	**598**		**463**		**515**	
Net equity and related capital	**7.270**	**Capital requirement (8%)**	**6 465**	**Capital requirement (8%)**	**5 849**	**Capital requirement (8%)**
Risk-weighted asset base						
Credit risk - IRB	25.966	2.077	23 689	1.895	23 000	1.840
Credit risk - Standardised approach	21.261	1.701	20 975	1.678	18 650	1.492
Debt risk	141	11	113	9	1 575	126
Equity risk (Market risk)	479	38	640	51	575	46
Currency risks	396	32	367	29	213	17
Operational risk (Basic approach)	3.317	265	3 406	272	3 550	284
Deduction subordinated capital in other financial institutions	-269	-22	- 54	-4	0	0
Deduction adjusted expected amount lost (50 %)	-57	-5	- 241	-19	- 177	-14
Capital adequacy reserve	-1.411	-113	-1 292	-103	-1 248	-100
Total risk-weighted assets base - 100 %	49.823	3.986	47 603	3.808	46 138	3.691
Complements to overall floor Capital Requirements	5.275	422	4 101	328	2 825	226
Total risk-weighted assets base IRB	**55.098**	4.408	**51 704**	4.136	**48 963**	3.917
Risk-weighted asstes base IRB in 2008 are 90 % of Basel I assets base.	20 %		20,00 %		20,00 %	
Capital adequacy ratio	**13,19 %**		**12,50 %**		**11,95 %**	
Core capital adequacy ratio	12,11 %		11,61 %		10,90 %	
Supplementary capital adequacy ratio	1,08 %		0,89 %		1,05 %	

1) Capital bonds may account for up to 15 per cent of core capital, whereas the remaining part counts as perpetual supplementary capital.

Figure 10 Specification of primary capital

Amounts in NOK million Specification of capital requirements (Pilar I)	31.12.2012 Capital requirement	31.12.2011 Capital requirement	31.12.2010 Capital requirement	31.12.2009 Capital requirement
Credit risk	3.639	3.446	3.218	3.026
Market risk	81	90	189	109
Operational risk	265	272	284	227
Additional capital requirement according to transition rules	422	328	226	257
Total capital requirements	**4.408**	**4.136**	**3.917**	**3.619**

Figure 11 Subordinated loan capital and hybrid tier 1 capital

Amounts in NOK million	31.12.12	31.12.11	31.12.10	31.12.09
Maturity structure				
Subordinated loan capital with definite maturities				
2018 3 months Nibor + margin 1.25 (call opt. 2013)	112	350	350	350
2018 3 months Nibor + margin 2.75 (call opt. 2013)	200	200	200	200
2019 3 months Nibor + margin 2.40 (call opt. 2014)	100	100	100	100
2019 Fixed rate of interest 8,35 (call opt. 2014)	350	350	350	350
2015 3 months Euribor + margin 0.45 (call opt. 2010) EUR				264
2013 mnd Euribor + 2,75 (Call option 2017)	500			
Premium/discount relating to subordinated loans	-3	-4	-5	-5
Currency premium, limited in time				3
Total sunordinated capital with definite maturities	**1.259**	**996**	**995**	**1.262**
Perpetual capital bonds				
2033 6 months Libor + margin (US$ 60 mill.)(call opt. 2013)	370	370	370	370
2099 3mnd Nibor + 4,75 (Call option 2017)	500			
Capital bonds - currency premium	-34	-10	-18	-24
Total perpetual capital bonds	**836**	**360**	**352**	**346**
Total subordinated loan capital and capital bonds	**2.095**	**1.356**	**1.347**	**1.608**
Average interest rate NOK	**5,33 %**	**6,09 %**	**5,71 %**	**4,44 %**
Average interest rate USD	**2,92 %**	**2,54 %**	**3,01 %**	**4,05 %**

The hybrid capital (NOK 370 million) does not satisfy the new regulatory requirements and the plan therefore is to satisfy these in 2013.

Figure 12 Capital adequacy ratio calculation - SpareBank 1 Nord-Norge Finans

Amounts in NOK 1000

Core capital per 31.12.12	SpareBank 1 Nord-Norge Finans AS	
Common equity	192.000	
Premium fund	59.000	
Other equity	123.038	
Total equity capital	374.038	
Deduction set aside dividend	-52.151	
Deduction net pension fund	-711	
Defered tax, goodwill and other intangible assets		
Core capital	**321.176**	
Supplementary capital	-	
Sum supplementary capital		
Net equity and related capital	**321.176**	
Risk weighted asset base		**Capital requirements (8 %)**
Credit risk - IRB		
Credit risk - Standarised approach	3.079.213	246.337
Debt risk		
Equity risk (Marked risk)		
Currency risks		
Operational risk	202.313	16.185
Deduction subordinated capital in other financial institutions		
Deduction adjusted expected amount lost (50 %)		
Capital adequacy reserve		
Total risk weighted assets	3.281.525	262.522
Capital adequacy ratio	**9,79 %**	
Core capital adequacy ratio	9,79 %	
Supplementary capital adequacy ratio	0,00 %	

Figure 13 Capital adequacy ratio calculation - SpareBank 1 Nord-Norge Forvaltning

Amounts in NOK 1000

Core capital per 31.12.12	ASA
Common equity	2.000
Premium fund	3.617
Other equity	63
Total equity capital	5.680
Deduction set aside dividend	
Deduction net pension fund	
Defered tax, goodwill and other intangible assets	-63
Core capital	**5.617**
Risk weighted assets	13.138
Capital adequacy ratio	42,76 %

The capital requirement for SpareBank 1 Nord-Norge Forvaltning AS is a minimum 25% of the company's fixed costs for the preceding year. As of 31.12.2012, these amounted to NOK 1 051 000 and provide a basis for calculation of 1 051 000 x 12.5 = 13 138 000 and a capital adequacy ratio of 5 617 000/13 138 000 = 42.76%.

5. Risk and capital management

5.1 Risk management

SpareBank 1 Nord-Norge's Main Board of Directors is responsible for assessing and monitoring the risk that arises throughout the Group. The Main Board of Directors determines the policy document and instructions that describe how the various risks shall be managed and reported. The Main Board of Directors also determines the authorisation structure and credit authorisations.

Responsibility for monitoring and managing risk within the framework and guidelines adopted by the Main Board of Directors lies with the various business areas and disciplines in the Group. This corresponds with the Group's internal control and management model which is described in more detail below.

Ongoing responsibility for the overall risk assessment and risk reporting lies with the Risk Management and Compliance Department, which reports to the CEO. The quarterly risk report, ICAAP and annual management confirmation are drawn up by the Risk Management and Compliance Department and are also reported to the Main Board of Directors together with the CEO's supplementary comments.

The Group's management structure reflects the legal requirements for listed companies generally and financial institutions.

5.2 ICAAP

5.2.1 Purpose

The management of risk and capital employment is a key instrument that SpareBank 1 Nord-Norge uses to achieve the Bank's objectives as they are defined in the Bank's business strategy. The Group's profitability and opportunities to achieve its objectives in relation to its equity certificate holders, employees and society in general are dependent on its ability to identify, measure, manage and price the risks that arise in connection with offering financial products and services. The risk management shall ensure financial stability and safe and secure asset management through:

- A strong organisational structure characterised by high risk management awareness and high quality
- A good understanding of what risks drive earnings.
- Striving towards an optimal application of capital within the adopted business strategy
- Preventing unexpected incidents from seriously damaging the Group's financial position
- Exploitation of synergy and diversification effects

The Group's objective is to have a moderate risk profile and to maintain its current international rating in order to ensure a long-term ample supply of ordinary borrowing from the capital markets.

5.2.2 Framework and process for risk and capital management

The renewal and revision of overarching and central government documents is subject to an annual discussion and review by the Main Board of Directors. This is to ensure broad comprehension of the relationship between a good framework for management and control and the active use of limits/targets for the management of risk in relation to the requirements in the capital adequacy regulations.

To ensure that all the significant commercial and risk areas are managed satisfactorily by the Group management and Main Board of Directors, an annual plan is prepared for the Board. This annual plan shall ensure:

- a regular review and revision of important commercial documents and areas
- a focus on commercial opportunities and threats – increased competitiveness
- the revision of priority areas and management targets
- an evaluation of the organisation's capabilities and competence – including opportunities and vulnerabilities
- an evaluation of responsibilities and roles – management model

SpareBank 1 Nord-Norge's framework for the identification and management of risk is illustrated in the diagram below:

Figure 14 Risk and capital management framework

Through the "Policy for Risk Management and Compliance" for the Group the Main Board of Directors has established guidelines on the structure, responsibilities and methods related to comprehensive risk management in SpareBank 1 Nord-Norge.

Work on comprehensive risk management is a key part of the Group's overall business process. Central specialist departments are involved in the process through the analysis, monitoring, management and reporting of risk. The responsibility for the execution of various processes/reporting at SpareBank 1 Nord-Norge is as follows:

- Development Department - strategic analysis, strategic revision and business barometer
- Accounting Department - financial reporting, capital adequacy, public bank statistics and analysis tasks
- Treasury and Market - funding and equity, reporting of market risk, corporate responsibility, securities undertakings
- Credit Department - operation and credit process/system operation and training, IRB models, credit risk reporting
- Risk Management and Compliance Department - comprehensive risk analysis, risk reporting and compliance, monitoring, portfolio management system, reporting of operational risk

In order to ensure an efficient and appropriate process for risk and capital management, the framework has been based on significant elements that reflect the manner in which the Main Board of Directors and management manages the Group:

- Strategic goals
- Organisation and organisational culture
- Identification of risk
- Risk analysis
- Risk strategies
- Capital management (including return and capital adequacy)
- Reporting
- Follow-up
- Contingency plans
- Compliance

In the process for risk and capital management the organisational culture is the foundation for the other elements.

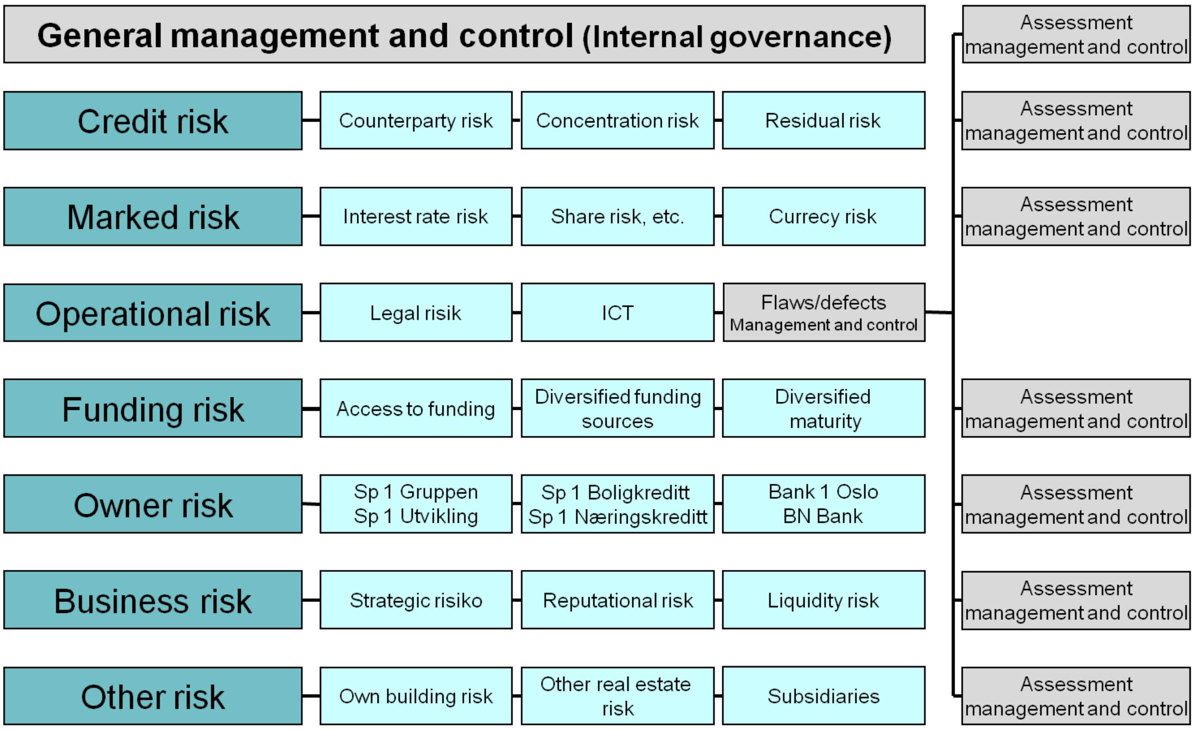
Business strategy
SpareBank 1 Nord-Norge revises the Group's business strategy on an ongoing basis. This entails a review of changes in the regulatory framework, including the competitive situation, requirements from public authorities, changes in customer behaviour and requirements for competence and organisation.

Organisational culture
The organisational culture is the foundation of the Group's risk and capital management and comprises management philosophy, management style and the people in the organisation with their individual qualities such as integrity, values and ethical attitudes. It is difficult to compensate for an adequate organisational culture by out of control and management measures, and SpareBank 1 Nord-Norge has, therefore, established clear values and ethical guidelines (the SNN code) which is communicated and made known throughout the entire organisation.

The Group's framework and guidelines for Corporate Governance and the 'SNN code' play an important role in the commercial management of the business. The guidelines focus on attitudes and ethics and how we do business with customers and other associates at SpareBank 1 Nord-Norge. These constitute an important element in the Bank's management of its reputation risk.

Risk and capital management
All significant risks are subject to continuous assessment throughout the year. The most important risks are quantified through the expected losses and need for economic capital, and this is an important foundation for the Bank's capital management process. The capital assessment process includes main and sub-risk groups as illustrated below. The assessment of the management and control related to the various business and risk areas is also key to the assessment of the capital requirements.

Figure 15 Risk types, control and management



SpareBank 1 Nord-Norge's capital management process shall ensure to the greatest possible extent:

- Efficient procurement and application of capital in relation to the Group's strategic target and adopted business strategy
- A competitive return
- Satisfactory capital adequacy ratio based on the chosen risk profile
- Competitive terms and a good long-term supply of funding from the capital markets
- That the Group manages at least to maintain its current international ratings
- Exploitation of growth opportunities in the Group's defined market area
- That no single incident is able to seriously damage the Group's financial position

It is a fundamental goal that the risk-adjusted capital shall be allocated within the adopted business strategy to the areas that give the highest risk-adjusted return.

SpareBank 1 Nord-Norge's capital has different purposes:

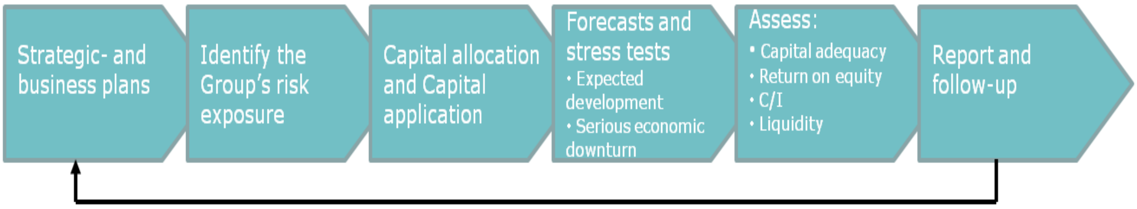
- The equity shall cover the Group's defined requirements for economic capital. Economic capital describes how much capital is required to cover the actual risk that is generated by the Group's overall activities.
- The purpose of the subordinated loans/hybrid tier 1 capital is to be a safety buffer that is not to be exposed to risk.

SpareBank 1 Nord-Norge is subject to minimum capital adequacy and financial strength regulations through legislation. The CEBS (Committee of European Banking Supervisors) has issued guidelines for supervisory authorities when they are to assess the institutions' processes for the management of risk and capital requirements in the form of an Internal Capital Adequacy Assessment Process (ICAAP).

The Board is responsible for initiating the ICAAP process and capital planning, as well as approval of the structure and methods chosen. In addition, the Board is responsible for setting targets for the Group's capital level that are adapted to the risk profile and commercial framework conditions. This process is an integral part of the Group's overall risk management:

The process should be risk-driven and consist of:

Figure 16 ICAAP



The risk and capital assessment process takes the Group's strategic goals as its starting point. Forecasts of the expected financial development, as well as future scenarios with an economic downturn and capital stress that lasts for a minimum of 5 years, are then drawn up based on the strategic goals and business plan.

5.2.3 Prognoses and stress tests

5.2.3.1 Description of forecast models and stress tests
In the last few decades, financial stability analysis has played an increasingly important role in many central banks and thus new requirements for financial institutions. This must be viewed in the context of the financial markets having become deeper and financial crises having occurred more frequently. One important element in the analysis of financial stability is investigating how vulnerable the financial system is with respect to macroeconomic disturbances. This can be done using prognoses and stress tests.

The main purpose of the forecast model is to assess the development of the Group's results, risk and financial strength in various scenarios when economic growth is weak and produce the associated estimates for capital requirements. The challenge is to identify relevant future scenarios in which risk increases, and to construct a good relationship between the macroeconomic developments in the scenarios and the microeconomic developments for all the key variables that affect the results, balance sheet and risk levels. The scenarios should be relevant in the sense that they cover the situations that are regarded as capable of disturbing the macroeconomic stability of the Norwegian economy and thus increase the risk in the Group.

The forecast model must satisfy the requirements set by the capital adequacy regulations. These are the requirements that are stipulated for IRB banks through the Capital Requirements Regulations (Pillar 1) and guidelines on the assessment of risk levels and calculation of capital requirements in institutions (Pillar 2).

5.2.3.2 External requirements for stress tests and scenarios
Section 16-1 of the Capital Requirements Regulations states:
1. The institution shall identify factors that could have a negative impact on credit risk and capital adequacy and conduct stress testing. The stress tests shall reflect situations which involve changes that could particularly affect credit risk, including economic downturns. The stress tests shall include all significant elements of the institution's portfolio, as well as an assessment of the impact on the Group's financial strength.
2. Stress testing shall be conducted regularly and at least once a year.
3. The Financial Supervisory Authority of Norway can lay down further rules for stress testing.

In other words, stress testing is a condition for IRB approval. The stress tests must show the impact on capital adequacy and the ability to satisfy the minimum capital requirement. The regulations say nothing about the severity of the scenario one should analyse, but point out that the impact an economic downturn would have on credit risk must be discussed. The minimum requirement set by the EU Council[1] is a 'mild recession' scenario. We also note that 'all significant elements of the institution's portfolio' shall be stress tested.

[1] Source: Directive 2006/48/EC of the European Parliament and of the Council; Relating to the Taking up and Pursuit of the Business of Credit Institutions

The Committee of European Banking Supervisors (CEBS)[2] published revised guidelines on stress testing in a circular dated 26 August 2012. The Financial Supervisory Authority of Norway underscores that the guidelines on stress testing form part of the guidelines on the Pillar 2 process and supplement circular 21/2006 "Pillar 2 of the revised capital adequacy framework – guidelines for assessing risk profile and calculating capital needs at institutions".
The new guidelines came into force from 31.12.2010. ICAAP 2012 calculations are based on the new guidelines.

As far as Pillar 2 is concerned, the set of documents that can be said to constitute a framework for stress tests is a bit wider. In general, one can say that there is a requirement that the effects of a serious recession (capital stress) must be analysed in connection with the ICAAP. With reference to the Financial Supervisory Authority of Norway's circular 21/2006[3]:

- Stress testing constitutes a key part of ICAAP and capital planning.
- The institution shall consider how it can survive an economic downturn with negative results and in which raising new equity could be problematic.
- An extraordinary but probable scenario shall include:
  - The recession shall last for at least 3 years
  - Show the impact on earnings and financial strength
  - Show the impact on complying with the minimum requirement
  - Show how the capital requirements will be satisfied through the recession, including management measures
  - Forecast of the financial situation/funding situation

Another important reference is the CEBS's 'Technical Aspects of Stress Testing under the Supervisory Review Process – CP12', which also provides a number of guidelines on what Pillar 2 stress tests should include. We particularly note chapter IV.3.b. 'Stress testing for IRB institutions' and the definition of 'scenario stress test' and 'sensitivity stress test' in section 16:

- Scenario stress test – shows the impact on the result/financial strength of movements in a number of risk drivers (simulation); due to a well-defined stress event. Expected to be used by larger institutions.
- Sensitivity stress test – shows the impact on the result/financial strength of movement in a specific risk driver; where the stress event is unknown. May be enough for smaller banks.

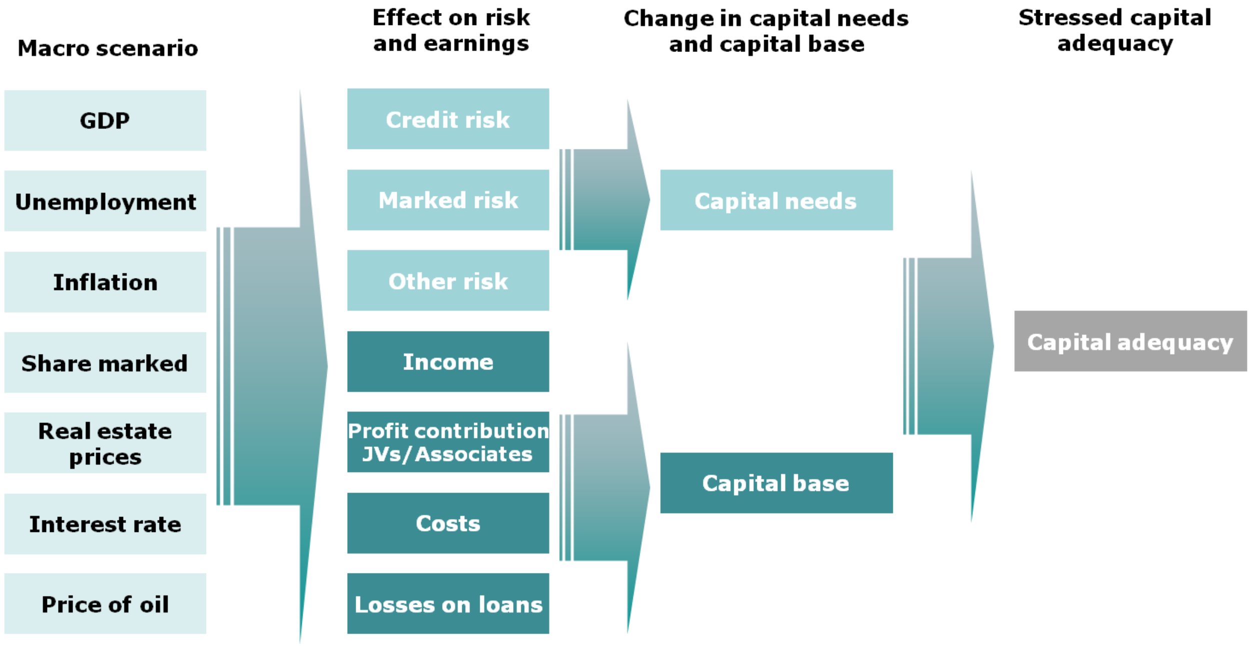
5.2.3.3 Relationship between scenarios and stress tests

The Group's model for stress tests and scenarios can be illustrated as follows:

Figure 17 Forecast/stress test model

[2] New guidelines on stress testing called 'CEBS Guidelines on Stress Testing (GL32)' applicable from 31.12.2010

[3] This section is based on the presentation by Jon Hellevik of the Financial Supervisory Authority of Norway on 18 September 2007 at Norges Bank.



One significant challenge is to use macro assumptions and convert them to business variables when assessing:

- credit score models - assessment of migration and changes in default probability, expected and unexpected losses
- financial strength and profitability - forecasts for normal development and various economic recessions
- liquidity (funding) – the Group's challenges and vulnerability associated with changes in funding levels and situations associated with any general financial crises or special situations for the bank (SpareBank 1 Nord-Norge)
- financial performance of associated companies
- impact of market and competition situations in Northern Norway and reputation risk

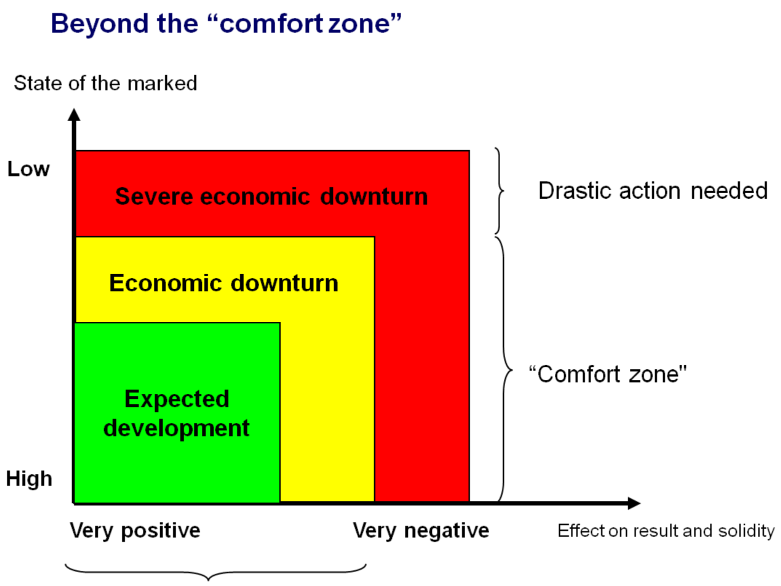
5.2.3.4 Setting the scenarios

In order to define the macro scenarios we have used a simple macro model that maintains a required minimum consistency between the macro variables. The model has many similarities with Norges Bank's macro models, but it has been significantly simplified so that it can be used in Excel.
This model has been implemented in all the macro scenarios when assessing the effect on the development of the balance sheet, result and risk.

For the Bank it is important that the scenario and stress test for capital stress is based on serious - but possible - disturbances in the economy so that it provide answers about how much could be lost, not necessarily how much it is likely will be lost. This means that these do not need to express changes we regard as likely because in the assumptions we say that all events occur at the same time (correlation = 1).

The figure below illustrates the purposes of the various stress tests/forecasts.

Figure 18 Forecast/stress test model



As far as the effects of "capital stress" are concerned, this is a basis for illustrating the effects of major disturbances in the economy that have an impact on several key results and risk areas simultaneously. This is to stress financial strength and profitability to the maximum. The results from the capital stress will form the basis for the management's discussions concerning potential and necessary measures more of out of contingency considerations than the fact that such a crisis would probably occur.

It is important to the authorities that the banks carry out scenarios and stress tests to reveal the robustness of the financial sector. The results from joint national stress tests and the banks' stress tests will also be important input in a discussion about future capital levels and capital targets.

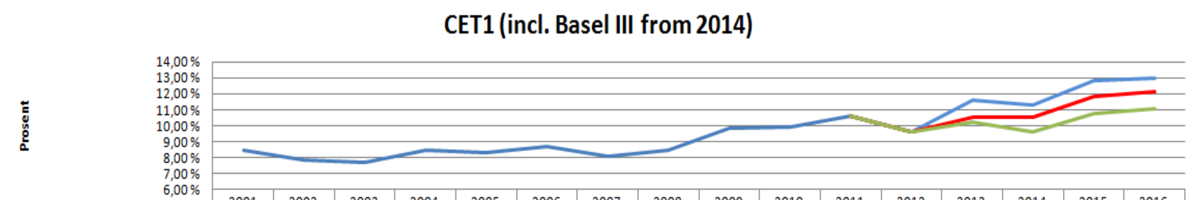
The results from the scenarios and stress tests are processed as an important part of the annual ICAAP. In the assessments the Bank attaches importance to presenting the results from the forecast "LTP reference track" (expected development) and the forecasts "LTP economic downturn" (probably economic cycle in an economic downturn) and "LTP capital stress" (powerful negative impact on the economy). The Bank also conducts a sensitivity analysis in relation to the development of the reference track, and a reverse stress test to see which events could cause a powerful negative impact on the Group's results and capital adequacy.

Figure 19 Forecasts and stress tests

LTP Exp.dev	Forecast of expectet development in the parent bank, the Group and JVs.
Sensitivity analysis	Effect on core capital ratio when changing condition on one single growth- of result parameter
LTP Economic downturn	Forecast of an economic downturn in the parent bank, the Group and JVs.
LTP Severe economic downturn	Forecast of an severe economic downturn in the parent bank, the Group and JVs.
Reverse stress test	Assessment of areas that can generate severe negative effects. Special considereations are given to solidity and liquidity.

The effects on the Group's tier 1 capital ratio of the various forecasts/stress tests are shown in the figure below. In the calculations the Bank has included the full effects of Basel III from 2014 and assumed that today's hybrid tier 1 capital that matures in 2013 is renewed during the course of the year.

Figure 20 Development of tier 1 capital ratio in the scenarios



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Annual accounts	8,44 %	7,88 %	7,67 %	8,49 %	8,29 %	8,71 %	8,05 %	8,45 %	9,82 %	9,93 %	10,62 %					
Expected deveolpment											10,62 %	9,64 %	11,61 %	11,28 %	12,83 %	12,95 %
Economic downturn											10,62 %	9,64 %	10,55 %	10,51 %	11,83 %	12,17 %
Severe economic downturn											10,62 %	9,64 %	10,24 %	9,62 %	10,80 %	11,06 %

5.4 Risk measurement and risk-adjusted capital

Internally the Group uses risk-adjusted capital as a measure for the calculation of risk.

Risk-adjusted capital indicates how great a loss an enterprise can incur under extreme conditions. The calculation of the risk-adjusted capital is thus a key element in the assessment of the Group's need for equity to do business in a responsible manner. Risk-adjusted capital enables the comparison of risk across types of risk and business areas.

The Group's revised target is a core tier 1 capital adequacy ratio of 12.5% or higher, before 2015. At year-end 2012, the Group's capital adequacy ratio was 13.19%, 10.31% of which was core tier 1 capital.

Both the external and internal requirements are compared with the Group's tier 1 capital, and the book equity and tier 1 capital will normally be higher than the risk-adjusted capital. This gives a buffer in relation to the stipulated external and internal minimum requirements, which gives the Group the necessary strategic freedom of action and long-term stability.

5.5 Reporting and follow-up

One important element of effective risk management is the monitoring of the ongoing risk exposure. All managers are responsible for the day-to-day risk management within their own areas of responsibility, and they must make sure at any given time that the risk exposure is within the limits that have been determined by the Board or the CEO.

The Group's overall risk exposure and risk development are followed up through periodic risk reports to the CEO and Board. Overall risk monitoring and reporting are performed by the Risk Management and Compliance Department, which is independent of the individual business units in the Group.

5.6 Compliance

The Group stresses the importance of good processes to ensure compliance with the current laws and regulations. Effective tools for achieving this include:

- Clear values that are clearly communicated and understood throughout the organisation
- A process to identify, communicate and implement changes in acts and regulations
- A process to follow up and report compliance with acts and regulations

6. Key risk groups and measuring methods

SpareBank 1 Nord-Norge is exposed to various types of risk, and the most important risk groups are:

- Operational risk: Risk of loss as the result of inadequate or defective internal processes or systems, human error, or external circumstances. Operational risk encompasses legal risk, but not strategic or reputation risk.
- Compliance risk: Risk that the Group incurs government sanctions/fines, financial losses or a weakened reputation as a result of the failure to comply with acts/regulations, standards or internal guidelines.
- Market risk: Risk of loss due to changes in observable market variables such as interest rates, foreign exchange rates and securities markets.
- Credit risk: Risk of loss due to customers not having the ability or willingness to fulfil their obligations.
- Funding risk: Risk of the Group being unable to fund increases in assets and being unable to meet its obligations as its overall funding requirements increase.
- Owner risk: Risk of losses in subsidiaries, SpareBank 1 Gruppen AS, SpareBank 1 Boligkreditt AS, SpareBank 1 Næringskreditt AS and BN Bank AS, is related to the risk that the individual companies assume in their operations, as well as the risk of a need for the injection of fresh capital into one or more of these companies.
- Business risk: Risk of inadequate earnings and funding related to a lack of diversification in the commercial basis or the lack of adequate and permanent profitability due, for example, to a high cost/income rate.
- Strategic risk: Risk of inadequate earnings or generation of capital attributed to changes in the framework conditions, poor business decisions, poor implementation of decisions or failure to adapt to changes in the commercial framework conditions.
- Reputation risk: Risk of inadequate earnings and funding due to declining confidence and reputation in the market, i.e. customers, contracting parties, primary capital certificate holders and the authorities.

Statistical methods are used for the calculation of expected losses in the risk-adjusted capital (economic capital), but the calculations require nevertheless the use of expert assessments in some cases. For risk types where there are no recognised methods for the calculating capital requirements, the Bank attaches importance to defining limits for management of the risk that seek to ensure a low probability that a greater loss incident will occur.

The Group's risk is quantified, for example, through calculation of the expected loss and the requirements for risk-adjusted capital (unexpected loss).

Expected loss: Describes the amount that the Bank must statistically expect to lose during a 12-month period.

Risk-adjusted (financial) capital: Describes how much capital the Group believes it needs to cover the actual risk the Group has assumed. The Main Board of Directors has decided that the risk-adjusted capital should cover 99.9% of possible, unexpected losses.

The return on risk-adjusted capital is an important strategic result-related target in the internal management of SpareBank 1 Nord-Norge. The most important business areas are allocated capital in relation to the calculated risk relating to the activities, and the return on capital is followed up continuously. The calculation of risk-adjusted capital enables the comparison of risk across risk groups and business areas.

A detailed description of the most important risks is given in the following sections.

6.1 Operational risk

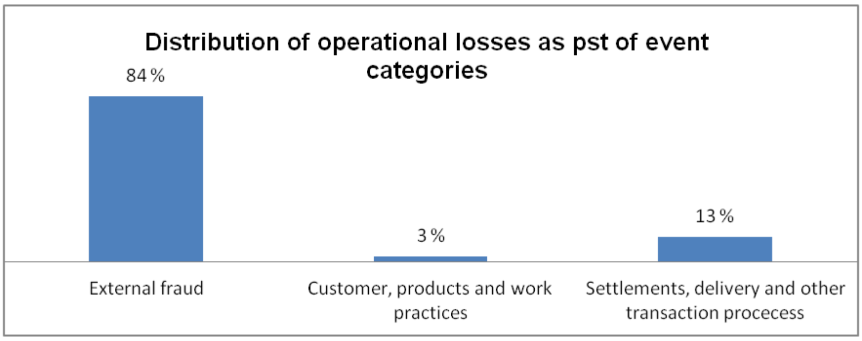
6.1.1 Management and control

In the opinion of the Bank, the management of the operational risk is closely associated with how the Bank manages its overall risk. The management of operational risk is, therefore, an important part of the Group's comprehensive risk management. The Bank's ability to work systematically with management and control, including the systematic follow-up of weaknesses/improvement areas is the foundation of the bank's management of operational risk.

The daily risk management is performed as a direct line function, but to improve the comprehensive operational risk management, the Bank has developed/implemented new systems and methods in this area in recent years. This includes a special Risk Information System for the systematic documentation and follow-up of risk. This includes:

- An improvement database where, for example, all the reporting from internal auditing, external auditing and the Financial Supervisory Authority of Norway is followed up.
- A database for incident reporting, which is a Basel II oriented reporting system with 7 defined "Basel categories" and the associated subcategories and causal relationships.

Registered operational losses are at a low level (NOK 1.7 million) and are spilt among the different base categories:



A self-assessment of the management and control is performed annually. The Financial Supervisory Authority of Norway's modules for risk-based supervision with the addition of the CoBiT framework for the assessment of ICT (IT Governance and Control) are used in this assessment. This review is an important part of the Group's annual ICAAP.

The Group performs a comprehensive manager verification process annually. One important goal is to ensure that the work that is invested in the annual manager verification process contributes to learning and the development of quality, as well as the development of local ownership of quality and risk management. The reporting is standardised, process-oriented and follows a fixed structure for the following areas:

- policy/strategy/routines
- competence
- laws/regulations
- organisational culture

The improvement areas are included as part of a special action program and the CEO presents the report to the Bank's Board. The Risk Management and Compliance Department is responsible for the ongoing, independent monitoring of the operational risk. Each year, the Main Board of Directors receives an independent assessment from the internal auditor and the responsible auditor for the group’s risk management, confirming whether the internal control works in an appropriate and reassuring manner.

SpareBank 1 Nord-Norge participates in an R&D project in the area of operational risk. The main goal of the project is to create a professional forum for new ideas, innovation and learning vis-à-vis the management of operational risk in the banking and financial industry. The project shall develop appropriate frameworks, methods and models aimed at increasing the understanding of the events and factors that impact operational risk and capital requirements.

<u>6.1.2 Minimum capital requirements</u>
The minimum capital requirement is calculated using the standardised approach for the parent bank and the basic method for subsidiaries and associated companies.
The Group's capital requirements as of 31.12.2012 related to operational risk are calculated as follows:

SpareBank 1 Nord-Norge (Group):
Standardised approach parent bank NOK 225 million
Basic method for subsidiaries and associated companies <u>NOK 40 million</u>

Total	**NOK 265 million**

The minimum capital requirement calculated using the standardised approach for operational risk is calculated as a percentage of average income for each business area for the past 3 years. Own account and procurement 18%, brokering for mass market customers 12%, banking services for mass market customers 12%, banking services for corporate customers 15%, payment and settlement services 18%, associated services 15%, asset management 12%.
The minimum capital requirement calculated using the basic method for operational risk is calculated using 15% of the total average income of the business areas for the past 3 years.

The capital for operational risk is included in the Group's process for the assessment of economic capital in accordance with Pillar 2. In Pillar 2 an assessment is made as to whether the Group requires additional buffers beyond the calculated minimum capital requirements. Our assessment includes an assessment of the quality of the management and control as well as other circumstances that can affect the capital requirements.

6.2 Compliance risk

6.1.2 Management and control
The Group's must efficiently monitor and manage compliance risk so that no events are capable of seriously harming the Group's reputation and financial position. The Group therefore manages this area according to the following principles:

- Clear responsibilities and roles within compliance work
- Effective routines for identifying, communicating and implementing changes in acts/regulations and industry standards
- Efficient routines and uniform system for monitoring and reporting compliance to the CEO and Board
- Reporting system that ensures uniform monitoring and reporting within the area of compliance for the Group
- Independent assessment of compliance conducted by internal and external auditors within their respective areas of responsibility

The Risk Management and Compliance Department is responsible for coordinating general compliance work, including frameworks, receiving part-reports and drawing up the Group's overall compliance report which must be presented to the CEO and Board.

The Group has its own compliance manager for the investment firm who is responsible for ensuring the Bank's activities associated with the performance of investment services comply with the regulations for securities trading.

The managers in the Group are operationally responsible for the practical implementation of and compliance with acts/regulations and industry standards. All employees are responsible for ensuring day-to-day compliance.

Events and breaches in the area of compliance are recorded and followed up in the Bank's Risk Information System.

6.3 Market risk

SpareBank 1 Nord-Norge's market risk is related primarily to long-term investments in equity instruments and interest-bearing securities. There will also be a certain degree of market risk as a result of trading activities and traditional banking activities such as customer loans and deposits.

6.1.3 Management and control

SpareBank 1 Nord-Norge reviews the Bank's capital market activities every year.
Individual matters are presented to the Board concerning the Bank's capital market activities based on this review. The matters include status within the area with a view to the Bank's own capital market activities - Treasury and SNN Markets, where all customer activities within the capital market area are gathered. Proposed new exposure limits are also considered.

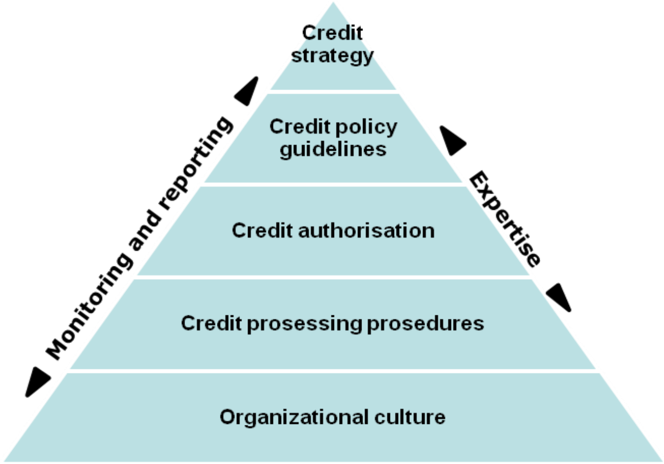
The limits are determined based on stress tests and analysing market movements, as well as the risk capacity and willingness.

The Group's market risk is otherwise managed and controlled primarily through the daily follow-up of risk exposures against the limits stipulated by the Main Board of Directors and ongoing analysis of outstanding positions.
The Risk Management and Compliance Department is responsible for the ongoing, independent monitoring of market risk. Monthly reports for each portfolio are submitted to the Bank's Balance Sheet Committee and Main Board of Directors.

6.4 Credit risk

6.1.4 Management and control

Figure 21 Elements in the Group's overall framework for credit management



Credit risk is managed through the Group's overall credit strategy, credit policy, appropriation regulations and credit management routines. The individual elements are described in greater detail in the sections below:

- The Group's credit strategy is determined by the Board and updated at least once a year. The Group's credit strategy limits are defined so that they measure and identify changes in the ongoing risk exposure in the most appropriate and efficient manner through, for example, the expected loss and need for economic capital. In addition, the Bank's credit strategy limits place special restrictions on the concentration risk related to exposure and the risk profile of individual customers, customer groups and industries.

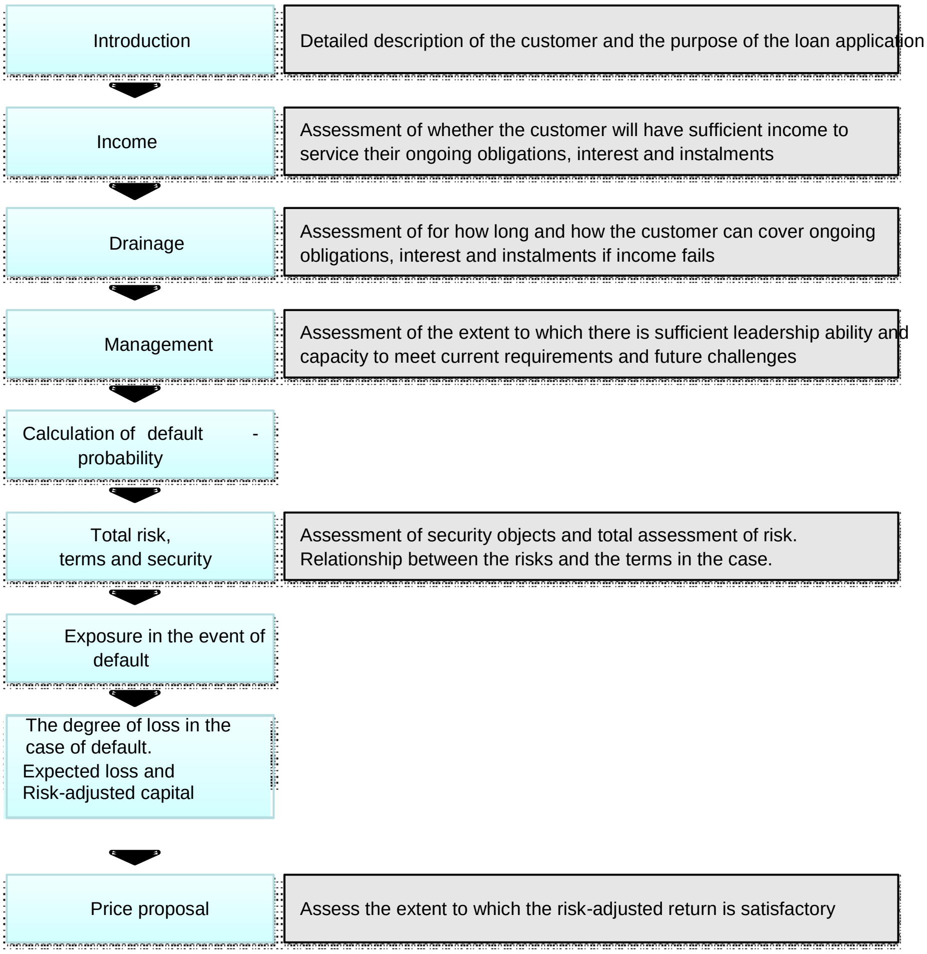
- The Group's credit policy is determined by the CEO and updated at least once a year. The credit policy describes the principles for granting credit both at the general level and related to certain specific areas such as real estate financing and project financing. Examples of such principles include requirements for the percentage of equity financing and restrictions for the financing of commitments with a high level of risk and for individual industries.

- The Group's appropriation regulations are determined by the Board and updated at least once a year. The Board delegates authority, within certain limits, for the operational responsibility with respect to decisions in loan and credit cases to the CEO. The CEO can delegate authority to others within the scope of his own authority. Credit authorities are personal and can be differentiated, for example, based on a risk perspective.

- The credit management routines regulate in detail all the circumstances related to the Group's granting of credit and follow-up of commitments.

The credit granting process can be described as shown in figure 10 below.

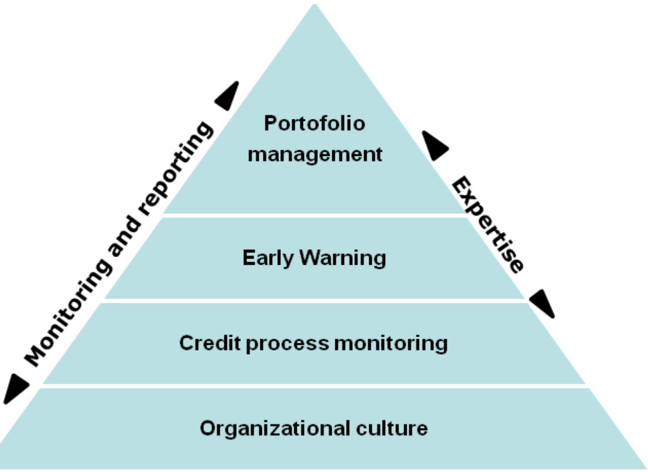
Figure 202 Credit rating process



The ongoing monitoring and follow up of commitments and credit portfolios are central to the Group's risk management. The Group's risk exposure is followed up by means of the Group's portfolio management system. The system contains information on individual customers and portfolios, and provides efficient follow-up of the risk profile and management of the portfolio. SpareBank 1 Nord-Norge updates the portfolio information monthly by means of internal and external customer data. The risk-related development of the portfolio is followed up monthly, with special emphasis on the development of the risk classification (migration), and expected loss, economic capital requirements and the risk-adjusted return.

The framework for commitment and portfolio monitoring is shown in figure 23 below.

Figure 23 Framework for credit monitoring



The Risk Management and Compliance Department performs independent risk monitoring and reports the overall risk exposure to the executive management team and Board.

6.5 Funding risk

6.5.1 Management and control

The management of the Group's financial structure is based on an overall funding strategy that is reviewed and approved by the Main Board of Directors at least annually. The funding strategy reflects the desire for low to moderate funding risk.

An analysis is conducted of the Bank's stress scenarios as part of the annual review of the funding strategy. The stress test includes a minimum of 4 stress scenarios in which the impact on the Bank's funding needs is analysed in the event of changed market conditions for the Bank. Different development trends for the Bank's most important asset and liability items are stress tested on the basis of given assumptions.

These stress tests are based on various scenarios under the assumption of full utilisation of the limits stipulated by the Bank's Board.

The principal objective of the funding strategy is to maintain the Bank's ability to survive in a normal situation without any external funding for a period of 12 months. The Bank must also survive for a minimum of 30 and 90 days in a 'major stress situation' for the Bank, banking market and a combination of these. Survival is based on a predefined liquidity buffer/reserve. The scenarios involve no access to funding from the capital market.

The Bank's funding strategy also attaches importance to adaptation to the international and Norwegian trends with regard to the management of the funding area for banks. This applies in particular in relation to BIS's 14 principles for good liquidity management. This entails, for example, that the liquidity management strategy is defined specifically in the form of limits and guidelines adopted by the Main Board of Directors.

Balance Sheet Committee
The Balance Sheet Committee is an advisory body in relation to the market and liquidity area in the Bank.
The Balance Sheet Committee's field covers the Bank's total balance sheet, including funding risk, market risk, credit risk and interest rate risk. The Balance Sheet Committee meets regularly and the Bank's funding strategy is reviewed annually or more frequently if special circumstances otherwise dictate a need for this.

The Balance Sheet Committee reviews funding risk, limit utilisation, balance sheet composition and funding structure once a month. Maturity diversification is reported once a month to the Main Board of Directors and the Balance Sheet Committee via a graphical presentation of the maturity structure. The frequency of meetings depends on the situation in the market.

Contingency plan
The Group has prepared a contingency plan for the management of the liquidity situation during periods of unrest in the financial markets. The contingency plan forms part of the Bank's funding strategy and is approved by the Main Board of Directors. The contingency plan is updated as needed and at least once a year as part of the Board's annual review of the Bank's funding strategy.
The purpose of the contingency plan is to describe the management's strategy for handling funding crises. The contingency plan also describes the procedures for releasing capital in a crisis situation. It also identifies and explains which events can trigger use of the contingency plan.

The contingency plan has 3 levels:
- Level 1: Risk of funding crisis in the market or Bank
- Level 2: Mid-level crisis in the Bank/market/Bank and market
- Level 3: Major crisis in the Bank/market/Bank and market

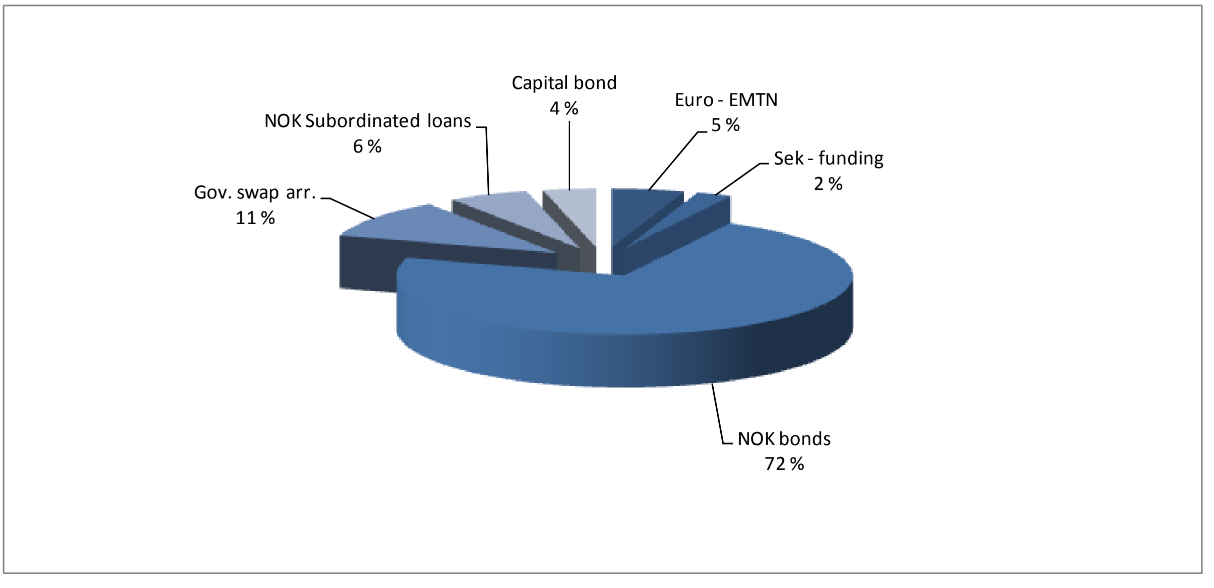
The treasurer is responsible for:
- Identifying potential funding crises
- Determining the contingency level
- Situational reporting to the CFO and contingency group

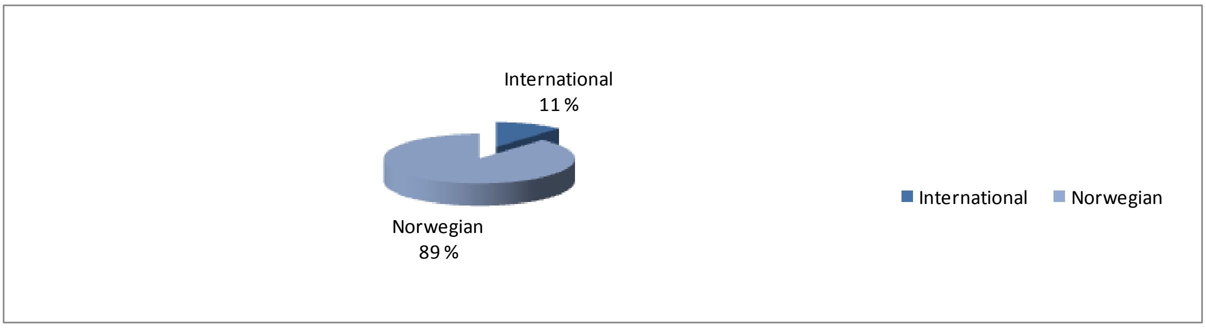
The funding risk is reduced by diversifying funding across several markets, funding sources, instruments and maturities. Too much maturity concentration increases the vulnerability of refinancing. An attempt is made to limit this risk through defined limits.

It is the Group's Treasury Department that is responsible for operative funding management through day-to-day monitoring and measuring. Compliance with the limits is monitored by the Risk Management and Compliance Department. The statuses of the limits adopted by the Board are reported monthly to the Main Board of Directors.

6.5.2 Diversification and maturity information

Figure 24 Diversification of the Group's funding sources and markets



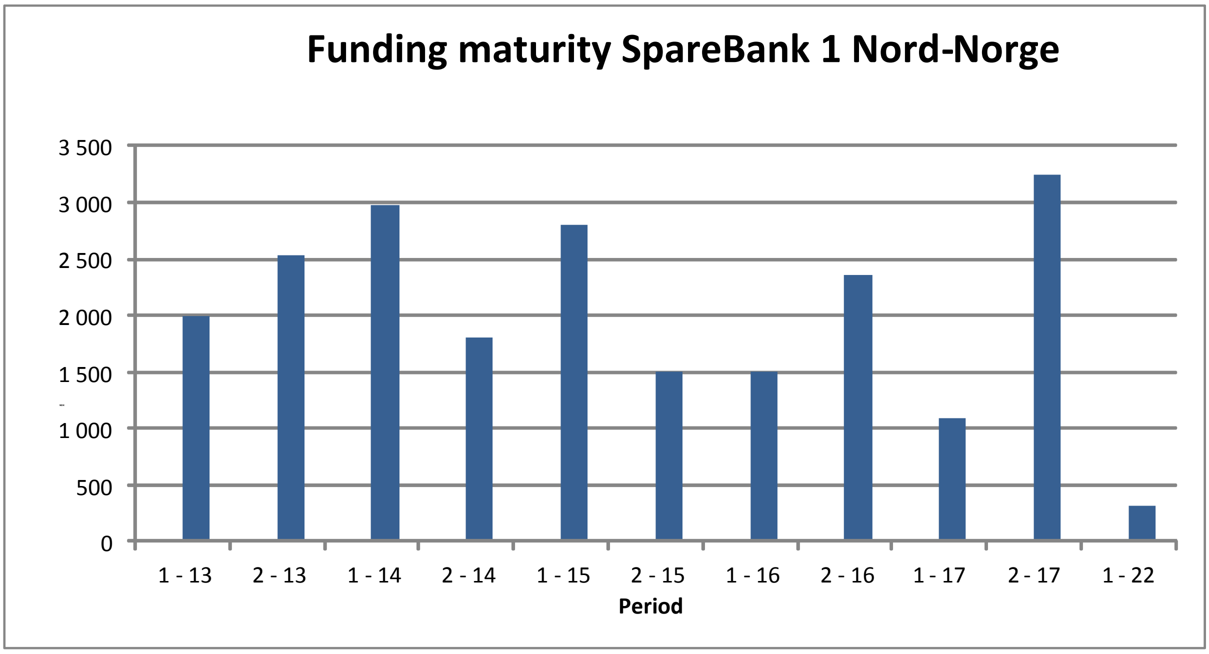


At the end of 2012 the Group obtained 89% of its funding from the Norwegian market, while the share from the international market was 11%. The market shares were 92% and 8%, respectively, as of 31.12.2011.

Customer deposits are the most important source of funding for the Group. The ratio between deposits from and lending to customers for the Group was 75.6% as of 31.12.2012, compared with 80.9% and 80.4%, respectively, one and two years ago.

The funding risk of SpareBank 1 Nord-Norge is reduced by transferring well-secured home mortgages to SpareBank 1 Boligkreditt, which is an issuer of covered bonds. As of 31.12.2012, the Bank had transferred a total of NOK 21.363 billion in home mortgages to SpareBank 1 Boligkreditt.

Figure 25 Funding portfolio's maturity structure every six months from year-end 2012



The Bank's funding risk in the future will also be affected by developments in other risk areas – particularly the development of the credit risk. An increasing/long-term system crisis in the financial services industry could also affect the Bank's funding risk. The risk borders on the Bank's strategic/commercial risk.

SpareBank 1 Nord-Norge's funding situation was considered satisfactory as of 31.12.2012.
The Bank's defined funding reserve at year-end was NOK 13.3 billion.
Of the Group's total funding volume of NOK 21 billion at the end of the year, NOK 3.8 billion must be refinanced in 2013.

The risk of inadequate refinancing of debt is managed through the Group's overall funding strategy and contingency plan.

Risk-adjusted capital funding risk
Economic capital is calculated for the risk of the Group incurring additional costs for refinancing during periods of unrest in the capital markets. This is calculated as part of the Group's commercial risk.

6.6 Owner risk

Owner risk varies from company to company depending on the company's operations and the underlying risk, and SpareBank 1 Nord-Norge's stake.

At the end of the fourth quarter 2012, SpareBank 1 Nord-Norge was primarily exposed to owner risk through stakes in:

- SpareBank 1 Gruppen (19.5%)
- SpareBank 1 Boligkreditt AS (13.46%)
- SpareBank 1 Næringskreditt AS (16.16%)

- BN Bank ASA (23.5%)
- Bank 1 Oslo AS (19.5%)
- SpareBank 1 Utvikling DA (17.74%)

SpareBank 1 Gruppen is owned by SpareBank 1 Nord-Norge (19.5%), SpareBank 1 SR-Bank (19.5%), SpareBank 1 SMN (19.5%), SpareBank 1 Hedmark (12%), Samarbeidense Sparebanker AS (19.5%) and the Norwegian Federation of Trade Unions/trade unions affiliated with LO (9.29%).

SpareBank 1 Gruppen AS owns 100% of the shares in SpareBank 1 Livsforsikring AS, SpareBank 1 Skadeforsikring AS, ODIN Forvaltning AS, SpareBank 1 Medlemskort AS and SpareBank 1 Gruppen Finans Holding AS, as well as 75% of the shares in Argo Securities AS. SpareBank 1 Gruppen Finans Holding AS owns SpareBank 1 Factoring (100%), Actor Fordringsforvaltning (100%), Actor Portefølje AS (100%) and Actor Verdigjenvinning (100%). In addition, SpareBank 1 Gruppen AS is a partner in SpareBank 1 Utvikling DA.

SpareBank 1 Gruppen also bears administrative responsibility for all the cooperation processes in the SpareBank 1 Alliance, where technology, brand names, competence, joint processes/application of best practices and purchasing are all key factors. The alliance also conducts development work through three competence centres, involving Training (Tromsø), Payment Transmission Services (Trondheim) and Credit (Stavanger).

6.1.6 Management and control

SpareBank 1 Nord-Norge has a strong focus on management and control in companies in which the Bank has full or partial ownership.

In companies that are partially owned, either through direct ownership by SpareBank 1 Nord-Norge or indirectly through ownership of 19.5% of SpareBank 1 Gruppen, SpareBank 1 Nord-Norge is represented on the boards of all the major companies.

A good supply of information is provided through active board participation, which safeguards SpareBank 1 Nord-Norge's ownership interests. In cases that are of importance to SpareBank 1 Nord-Norge's other operations, the individual board chairman/member will submit the matter for a plenary discussion by the group management, which meets every week.

6.6.2 Risk-adjusted capital owner risk

Calculation of the risk-adjusted capital is based on the results from the companies' own risk and capital assessment process, taking into account SpareBank 1 Nord-Norge's ownership interest.

The owner risk related to ownership interests in BN Bank ASA, SpareBank 1 Boligkreditt AS and SpareBank 1 Næringskreditt AS are included in the capital adequacy in accordance with the principle of proportional consolidation, and the risk is in Pillar 2 allocated to the individual risk types.
Of the companies owned by **SpareBank 1 Gruppen AS** the ownership of SpareBank 1 Livsforsikring is considered entailing the highest owner risk. This is due primarily to the company's investment of customer funds in the equity and bond markets, where the return varies over time.

BN Bank ASA's head office is in Trondheim and it has a commercial property development in Oslo. BN Bank ASA serves its customers throughout the country via its online bank and the telephone. BN Bank ASA is owned by the SpareBank 1 banks and offers a wide range of banking services to corporate and retail customers. The bank operates within traditional banking services directed at the home mortgages in the retail market and commercial property. SpareBank 1 Nord-Norge's owner risk mainly consists of the underlying credit risk in this company.

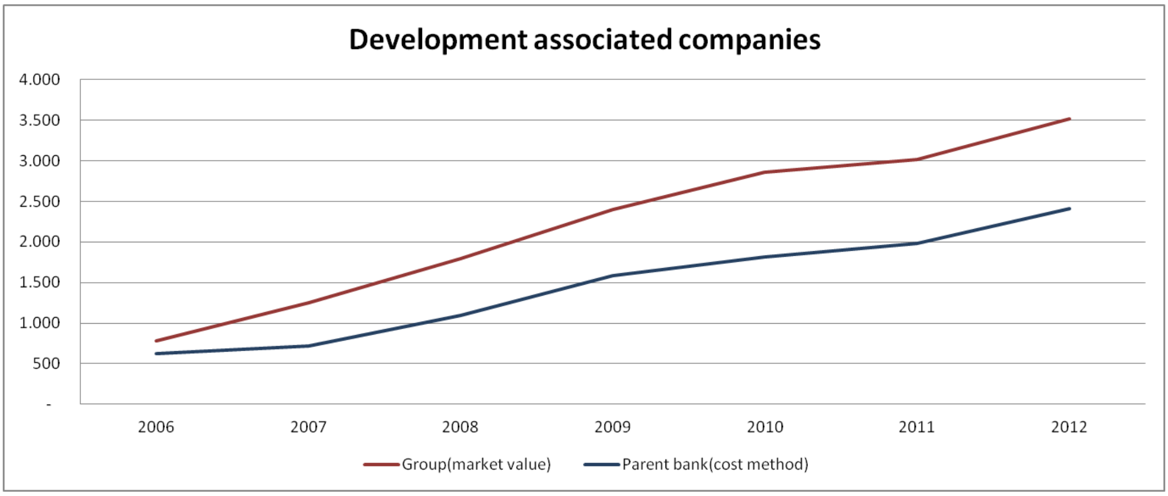
Bank 1 Oslo AS's head office is in Oslo. The bank operates within traditional banking services directed at the home mortgages in the retail market and commercial market. SpareBank 1 Nord-Norge's owner risk mainly consists of the underlying credit risk in this company.

SpareBank 1 Næringskreditt AS's portfolio only includes mortgages for commercial properties in central districts. The mortgages can be for a maximum of 60% of market value. SpareBank 1 Nord-Norge's owner risk mainly consists of the underlying credit risk in this company.

SpareBank 1 Nord-Norge owns as of the fourth quarter 2012 13.46% of **SpareBank 1 Boligkreditt AS**. The company's activities are financing mortgages for retail customers with security within 75% of the value of the real estate. At the end of the fourth quarter 2012 SpareBank 1 Nord-Norge had transferred NOK 21.3 billion to the company. The owner risk generally corresponds to the proportion of the transferred portfolio and the risk is, therefore, monitored and reported as credit risk.

The development in exposure measured as the booked amount for associated companies in the consolidated financial statements is shown in the graph below (NOK million).

Figure 26 Development of book value of stakes in associated companies



As can be seen from the graph the historic cost price (book value parent bank) and book value in the consolidated balance sheet have increased in the last few years. The fact that the book value of stakes in associated companies has risen to 4.7% of the total assets in the Group (3.2% in the parent bank) is in of itself not dramatic, but the stakes' significance vis-à-vis tying up capital and financial performance has a major impact on the Bank's and the Group's financial strength and results. It is the capital associated with the Bank's ownership of Boligkreditt that has in particular increased significantly in the last few years. This, together with the stake in Næringskreditt, is important when one considers the Bank's ability to reduce its funding risk through transferring portfolios to these companies. The stakes in Boligkreditt, Næringskreditt and SpareBank 1 Gruppen are strategically important items viewed in the context of the Bank's total business model and ability to operate efficiently and with competitive products and prices.

6.7 Business risk

Business risk manifests itself by an unexpected weakening in earnings. This decline may be attributed to competitive conditions that result in lower volumes and pressure on the prices, competitors that introduce new products, government regulations or negative media coverage. A loss arises if the Group is not able to adapt its costs to such changes.

Good strategic planning is the most important tool for reducing business risk. Reputation risk is governed through policies and business activities, including compliance.

Since business risk can arise as a result of different risk factors, a broad range of methods (quantitative and qualitative) are used to identify and report such risks.

Reputation risk and strategic risk are treated as part of the Group's business risk.

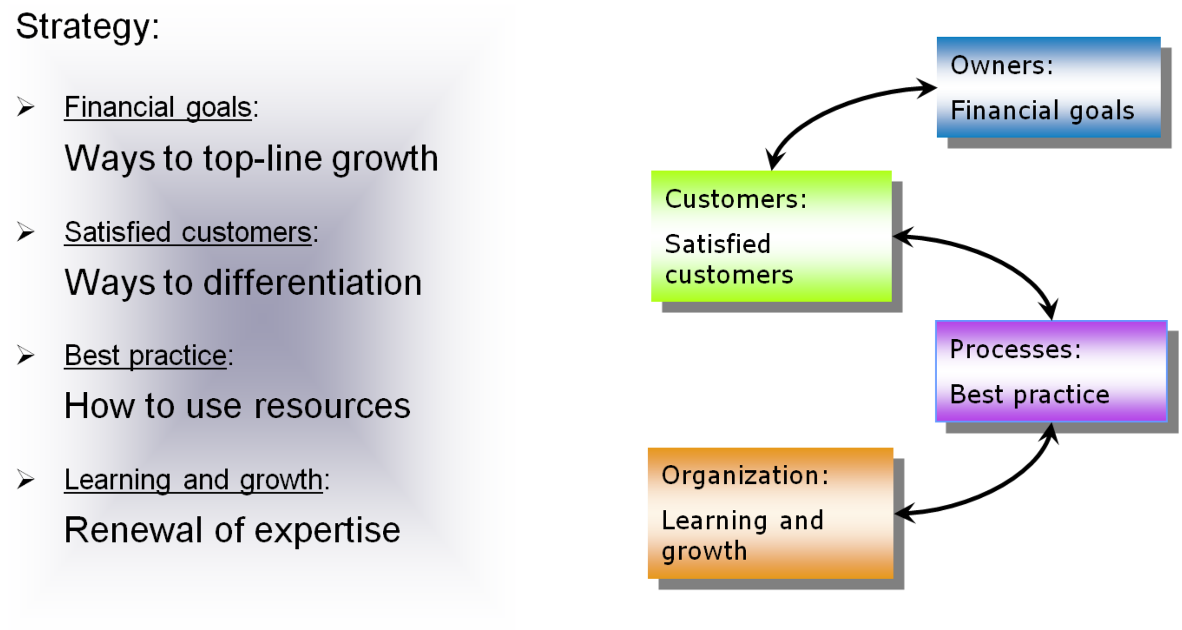
6.7.1 Strategic risk

In 2008, the Bank chose to change the way it works from having a continuous strategy process to defining targets within central business and product areas.

Continuously monitoring competitors and the market keeps the management team and Board constantly apprised of external changes that are significant enough to warrant minor or larger strategic changes.

The Bank operationalises the strategy through various indicators within the various perspectives used in balanced goal management.

Figure 27 Strategy and perspective in the scorecard are closely related



Main strategies

Employees:

As the Bank's most important resources, we will continuously seek to develop the employees' skills and knowledge so they can meet the requirements of both customers and the authorities. Continuous training is ensured via our own 'academy'. To safeguard expertise and reduce vulnerability, employees will belong to larger market areas. The culture will be characterised by transparency, both internal and external, so that the Bank's integrity can never be questioned.

Process:

The Bank has a unique competitive advantage thanks to its broad distribution. The local banks will remain the most important sales units in the Bank. The division of work between the local bank and the digital channels (online bank and mobile bank) will be clearer. The vast majority of daily banking services will be provided electronically. Simple advice will also be offered online or in combination with a customer service centre. Corporate customers will be served by a limited number of local banks and via digital solutions.

Customers:

The main focus will be on ensuring the most profitable customers remain with the Bank and developing them. However, over its long history the Bank has had a relationship with around 45% of everyone who lives in its market area. This huge 'customer base' provides important access to more sales and new sales. Obtaining new customers is the main strategy in market areas where market share is low.
Our cooperation in the SpareBank 1 Alliance will ensure that our customers always have access to modern, effective products.

The Bank has for a long time dedicated resources and expertise to analysing and assessing the Bank's strategic focuses and priorities. The Bank's Development Department bears formal responsibility for executing and documenting this process. The Main Board of Directors plays a central role in the discussion and final determination of priorities and focuses within various central business areas and disciplines.

Strategy and policy reviews look at all key factors (both external and internal) that could impact the Bank's financial strength and profitability over time. The process involves regions, specialist departments, the executive management team and Main Board of Directors before the matter is finally presented to the Main Board of Directors for discussion and a decision.

6.7.2 Reputation risk

Reputation risk is defined as the risk of losses due to a diminished reputation. This includes the risk of inadequate earnings and funding due to declining confidence and reputation in the market, i.e. customers, contracting parties, equity certificate holders and the authorities.

Social involvement strategy
SpareBank 1 Nord-Norge adopted its new social involvement strategy in September 2012. The strategy was initiated and adopted by the Bank's Main Board of Directors and executive management team and shall be a living management tool for all managers in the organisation.

The strategy is intended to turn our social involvement into the best possible tool for enhancing our reputation among relevant interested parties. The strategy is a management tool that sets targets and areas for where our main focus should be directed. It also states the responsibilities and authorities relating to this work and forms a natural part of the work of maintaining/enhancing our reputation.

Reputation management
Good reputation management entails raising awareness about all important factors that create a good reputation and establishing standards against which it is possible to measure performance and conduct. Internal communication is the key to this work. This is because everybody needs to understand how each person contributes to creating a reputation. Only then it is possible to establish a culture in which everyone takes responsibility and feels as if they are participating in the development of the company's standing.

Our social involvement is placed in a larger context in our strategy document:

- Historic
- Our role as a savings bank and leading financial institution in Northern Norway
- Our vision and our values
- Our customer-oriented strategy and the promises we make to customers
- The importance of reputation

7. Credit exposure

7.1 Definition of default, etc.

Probability of default (PD)
Commitments are classified in risk classes according to the probability that the will customer default on their commitments during a 12-month period. The probability of default is calculated based on a long-term average, which is to represent the probability of default throughout an economic cycle. The probability of default is calculated, for example, on the basis of historical data series.

In order to classify customers according to the probability of default, nine risk classes (A–I) are used. In addition, the Group has two risk classes (J and K) for customers with commitments in default or commitments that have been written down. Classification into high, medium and low risk is determined based on the probability of default.

Figure 28 Definition of default classes

Risk classes of default(PD)	Lower level	Upper level
A	-	0,10 %
B	0,10 %	0,25 %
C	0,25 %	0,50 %
D	0,50 %	0,75%
E	0,75 %	1,25 %
F	1,25 %	2,50 %
G	2,50 %	5,00%
H	5,00 %	10,00%
I	10,00 %	99,99%
J	Non-performing commitments, not impaired	
K	Non-performing commitments, impaired	

A commitment is deemed to be in default if one of the following criteria applies:

- a claim has been due for more than 90 days and the amount is over NOK 1 000, or
- when the Bank considers it unlikely that the customer will meet their payment obligations as a result of:
    - the debtor suffering significant financial problems
    - non-payment or other type of significant breach of contract
    - customer is granted new terms (special concessions) due to financial problems
    - debt negotiations or bankruptcy are probable (over 50% probability)
    - it is deemed that the customer will not meet his payment obligations to two of the reasons

Defaults and write-downs

Individual commitments, and thereby the entire portfolio, are scored monthly based on objective data. The Bank makes individual write-downs for loans where there is objective evidence that the loan in question is doubtful. Individual write-downs for impaired value are calculated as the difference between the loan's book value and the present value of the discounted cash flow based on the effective interest rate at the time of the initial write-down. Subsequent changes in interest rates are taken into account for loan agreements with adjustable interest rates.

The Bank assesses its entire portfolio of business customers each year, and large and especially risky commitments are examined on a quarterly basis. Quarterly assessments form the basis for individual write-downs or other measures in relation to individual customers. The assessment is mandatory and is performed on commitments with the following characteristics:

- large commitment
- high risk
- negative migration in the risk class
- commitments subject to special follow-up (watch list)

Beyond this an ongoing assessment is performed on the actual commitments that are in default or written off.

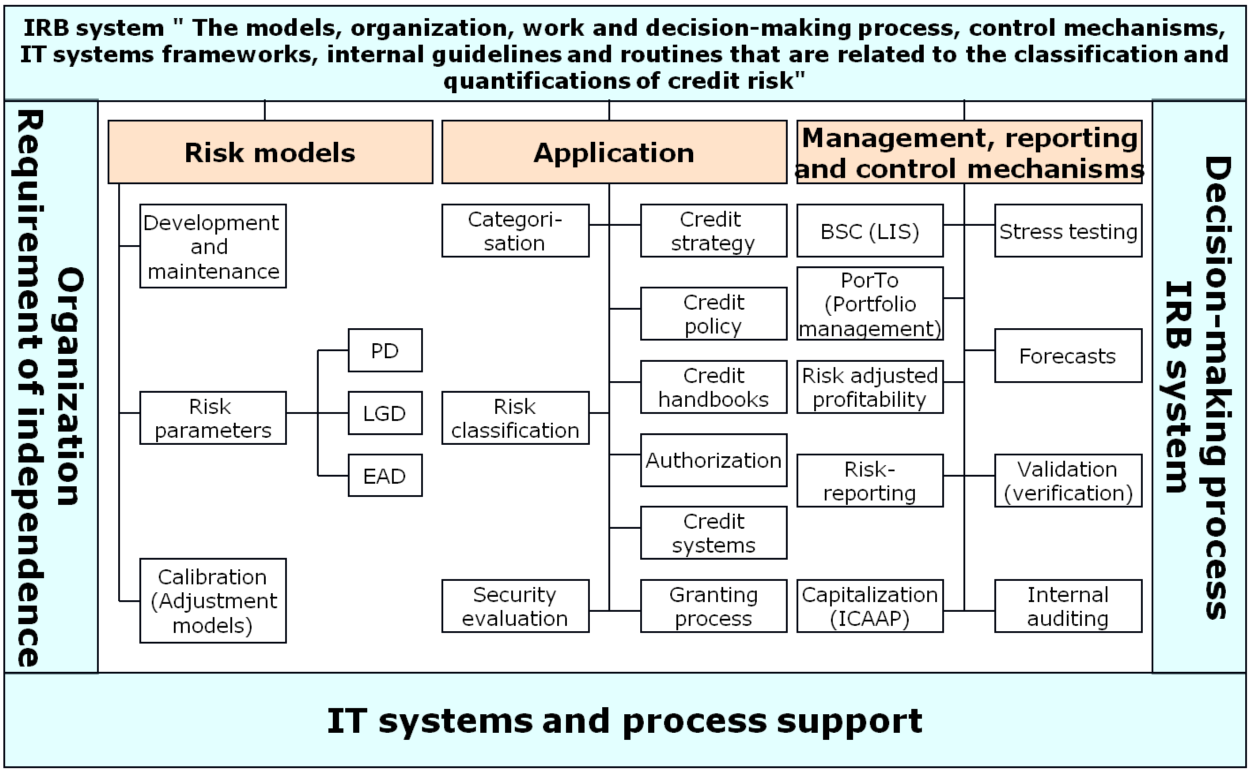
Loans to private individuals are assessed when more than 55 days have elapsed since a default or when there are indications of or loss incidents actually exist.

Commitments that are not written down individually are included in the basis for group write-downs. Group write-downs for impaired value are calculated for sub-groups of loans, where there is objective information showing an increase in the credit risk, but where it is not possible to examine all the commitments on an individual basis or where it is not possible to specify the information at the commitment level. Such information may consist of a negative development in the credit risk classification or information about a negative development in the value of assets pledged as collateral security, the profitability in a particular industry, or the solvency of groups of debtors.

7.2 Structure of the IRB system

The schematic diagram below illustrates how the IRB system affects several key areas in the Bank. The objective is to ensure satisfactory fulfilment of the capital adequacy requirements stipulated for the banks. This objective presupposes high quality, involvement, compliance and transparency throughout the entire value chain up until the Board's assessment and stipulation of strategies and the level of satisfactory capitalisation for the entire operations. This includes quantitative methods for the measurement of risk, the quality of the administrative processes that produce data for the quantitative risk estimates and requirements that the organisation integrate and use this data at all the relevant levels of the organisation.

Figure 29 Organisation of IRB



The Board assesses the capital adequacy requirements on an ongoing basis, based on the risk that is measured and an overall assessment of the framework conditions and commercial and strategic goals. To monitor and verify all the links in the value chain, they must be validated with a focus on whether the authorities' requirements and the internal quality requirements have been met. This validation shall take place at least once a year. An annual validation report shall be prepared that is to be reviewed by the Main Board of Directors, where both the quantitative and qualitative areas are validated to verify the adequacy of the system and identify needs for adaptations and improvements.

7.3 Description of model and application

<u>Credit models and risk classification system</u>
The risk models used in the risk classification system for the credit process are based on statistical calculations, and they are subject to continuous development and testing. The models are based primarily on the following components:

Figure 30 Risk classification system

<u>Probability of default (PD)</u>
Statistically calculated probability of the customer defaulting on their payment obligations during a 12-month period calculated on the basis of a long-term outcome.

<u>Expected exposure at default (EAD):</u>
The EAD is an estimate of what the exposure will be if a customer defaults. The calculation is based on the customer's overall exposure, including facilities and guarantees that have been granted, but have not been drawn on.

The conversion factor for the expected exposure at default is set at 0.75 for facilities and guarantees to the corporate market that have not been drawn on, and 1 for the remainder of the portfolio. This is in accordance with section 12-1, subsection 3 of the Capital Requirements Regulations.

<u>Loss given default (LGD):</u>
LGD is an assessment of how much the Group could potentially lose if the customer defaults on their commitments.

Seven different classes are used (1–7) for classifying commitments in relation to security cover.

Figure 31 Definition of security classes

Security class	Corresponds to the collateral coverage (Realisation value)
1	Over 120 %
2	Over 100 %
3	Over 80 %
4	Over 60 %
5	Over 40 %
6	Over 20 %
7	Up to 20 %

For the mass market, the assessment takes into consideration the value of the assets that the customers have pledged as security, and the costs incurred by the group in connection with recovering commitments in default. The Group stipulates the realisation value of the security pledged based on its own experience over time, and this value should reflect a conservative assessment of the realisation value in a recession.

The types of security that are used for the mass market are primarily mortgages on real estate. The realisation value is calculated as the object's market value after the deduction of a standard reduction factor and any additional value adjustments.

In calculating the minimum regulatory capital for the business market (states, institutions and enterprises) factors stipulated by the authorities are used.

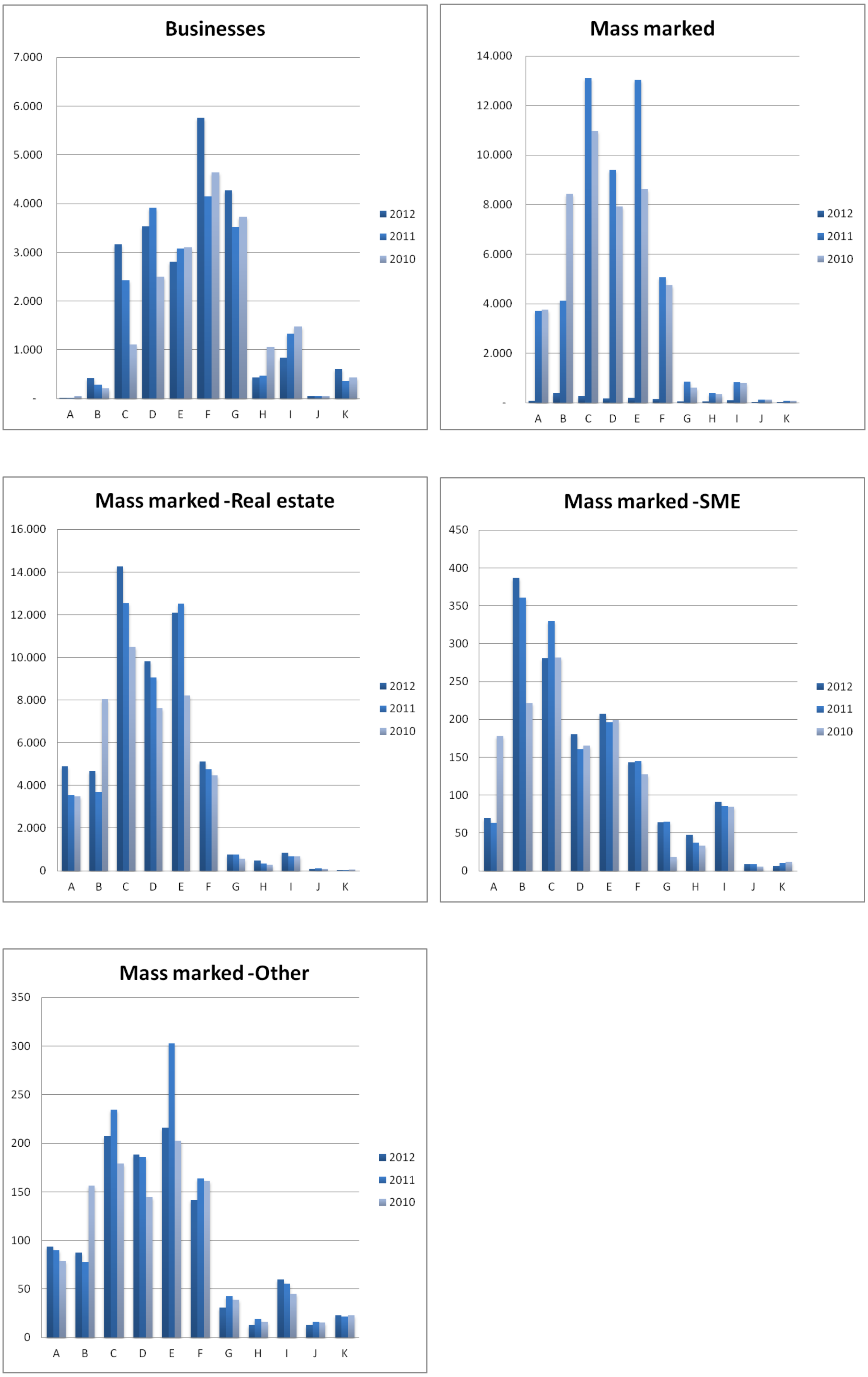
Risk pricing
SpareBank 1 Nord-Norge is concerned about pricing risk, and it measures, therefore, the risk-adjusted return in connection with the granting of credit and follow-up. The risk pricing model is based on the same main components as the Group's risk classification system, and these components establish the basis for the calculation of the return on the economic capital for the individual commitment.

Figure 32 Risk class by commitments when the IRB method is used

Amounts in NOK mill

Category	Risk class	EAD	EAD off-balance	Average risk weight	Average LGD	Average CCF
Enterprise	A	4	1	30 %	45 %	96 %
	B	420	252	44 %	45 %	84 %
	C	3.162	840	56 %	45 %	92 %
	D	3.529	576	66 %	45 %	95 %
	E	2.813	468	80 %	45 %	95 %
	F	5.762	593	99 %	45 %	97 %
	G	4.270	383	119 %	45 %	97 %
	H	438	83	153 %	45 %	94 %
	I	839	52	182 %	45 %	98 %
	J	48	1	0 %	45 %	100 %
	K	607	3	0 %	45 %	100 %
Total enterprise		21.894	3.252	89 %	45 %	95 %
Mass marked -SME	A	70	22	2 %	10 %	99 %
	B	387	70	4 %	11 %	99 %
	C	281	23	8 %	13 %	100 %
	D	180	13	13 %	14 %	99 %
	E	207	13	18 %	14 %	100 %
	F	144	14	29 %	18 %	100 %
	G	64	1	39 %	16 %	100 %
	H	47	2	34 %	9 %	100 %
	I	91	1	77 %	15 %	100 %
	J	9	0	27 %	19 %	100 %
	K	6	-	21 %	27 %	100 %
Total mass marked -SME		1.487	160	17 %	13 %	99 %
Mass marked -real estate	A	4.891	1.206	2 %	9 %	100 %
	B	4.664	435	4 %	9 %	100 %
	C	14.264	957	6 %	10 %	100 %
	D	9.826	434	10 %	10 %	100 %
	E	12.107	455	13 %	10 %	100 %
	F	5.121	113	20 %	11 %	100 %
	G	769	16	31 %	11 %	100 %
	H	489	14	44 %	10 %	100 %
	I	833	6	55 %	10 %	100 %
	J	76	-	13 %	12 %	100 %
	K	37	0	23 %	29 %	100 %
Total mass marked -real estate		53.077	3.635	11 %	10 %	100 %
Mass marked -other	A	94	26	7 %	45 %	99 %
	B	87	16	22 %	48 %	100 %
	C	207	21	29 %	45 %	100 %
	D	188	14	39 %	46 %	100 %
	E	216	17	46 %	43 %	100 %
	F	141	9	54 %	42 %	100 %
	G	31	1	59 %	39 %	100 %
	H	13	1	65 %	39 %	99 %
	I	60	2	89 %	42 %	100 %
	J	13	0	9 %	42 %	100 %
	K	23	0	22 %	70 %	100 %
Total mass marked -other		1.073	107	39 %	45 %	100 %
Total mass marked		55.637	3.902	11 %	11 %	100 %

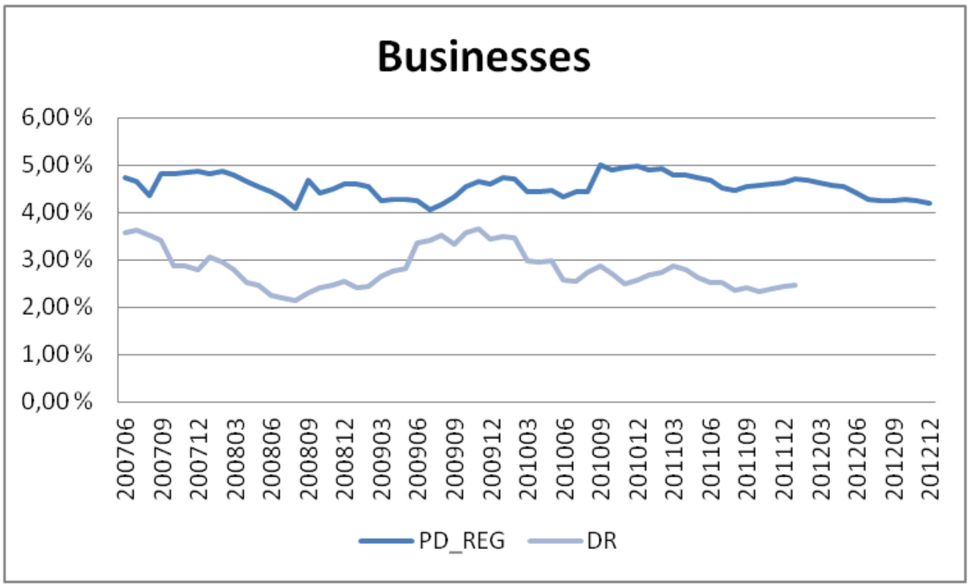
Figure 33 Distribution of risk classes

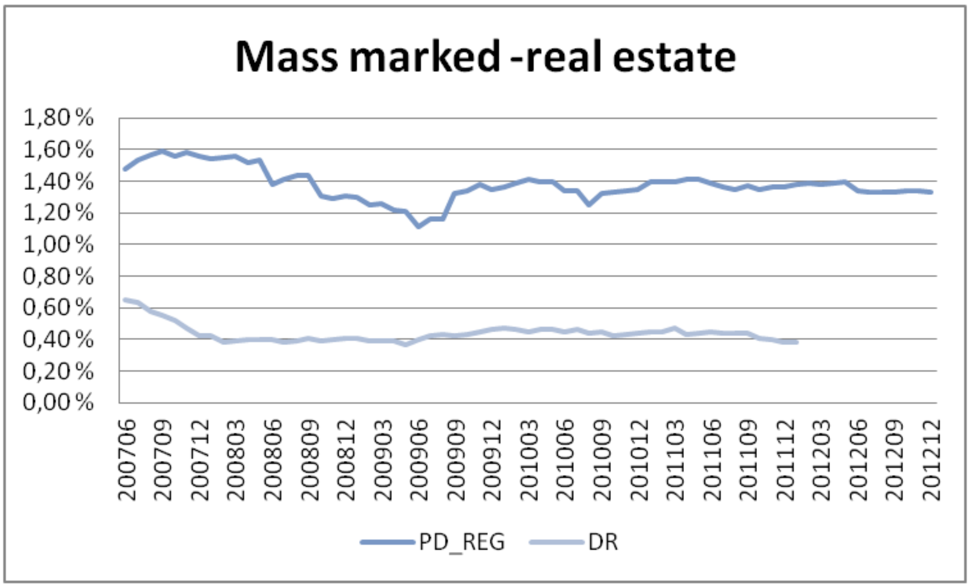


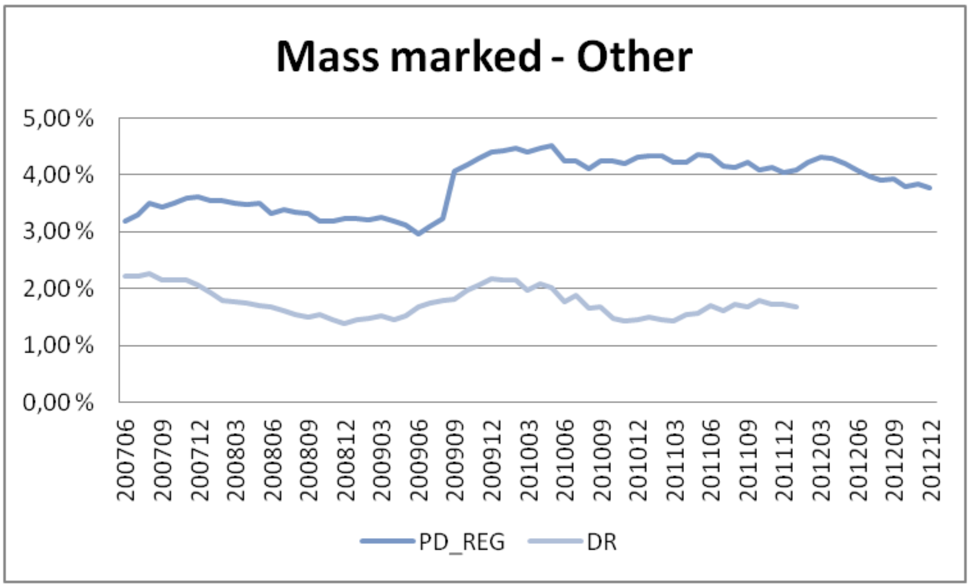
When we compare the calculated default probability with the actual outcome for the next 12 months, we compare on the basis of the scoring model and not on the basis of the regulatory classification. This entails some differences, e.g. sole proprietors that are scored using a retail customer model are not necessarily classified as mass market.

The differences between PD and the observed default rate (DR) are continuously monitored using monthly measurements over the last 12-month period.

Figure 34 Comparison of the risk parameters with the actual outcomes







7.4 Credit exposure incl. defaulted commitments

Figure 35 Group's exposure in various geographic areas, as well as the distribution of commitments that are in default, doubtful and written off in relation to this

Amount in NOK million

Type of commitment	Finnmark	Troms og Svalbard	Nordland	Others	Total
Gross lending to customers	9.130	18.456	21.488	5.477	54.551
Unutilised credit and guarantees	934	2.765	2.243	310	6.253
Total gross customer commitments	10.064	21.222	23.731	5.787	60.804
Defaulted and doubtful commitments	109	330	517	33	989
Individual write-downs	19	72	182	31	303
Net defaulted and doubtful sommitments	90	259	335	2	686
Individual losses	24	55	92	23	195

Figure 36 Group's overall commitments broken down by commitment type

Amounts in NOK million Type of commitment	Commitment amount as at 31.12.2012	Average commitment amount in 2012	Commitment amount as at 31.12.2011	Average commitment amount in 2011
Businesses(business customers)	28.292	26.936	25.580	24.508
Mass marked(retail customers)	31.555	31.624	31.693	31.316
Public sector(central and local government)	957	924	890	870
Gross customer commitment	60.804	59.484	58.163	56.693
Individual write-downs	303		206	
Write-downs of groups of loans	198		226	
Write-downs of guarantees	0		2	
Net customer commitment	60.303	59.016	57.729	56.240
Cash and deposits with central banks	271	1.084	1.896	2.199
Loans and deposits with instistusions	1.871	1.421	970	882
Total commitment amount	62.445	61.520	60.595	59.320

Figure 37 Group's overall commitments, and commitments in default and written off broken down by customer group

Amounts in NOK million

Type of commitment	Gross lendi	Commitment	Gross defaulted and doubtful commitments	Individual write-downs	Net defaultet and doubtful sommitments	Individual losses
Mining and Extraction	81	92	-	-	-	-1
Building and Construction	1.037	1.484	16	8	8	4
Ship and boat building	12	15	-	-	-	1
Power, Gas, Steam and Hot Water Supply	1.434	2.426	-	-	-	1
Professional and Financial Services	705	821	5	3	2	4
Finance and Insurance	-	-	-	-	-	-1
Fishing and Hunting	1.619	2.367	-	-	-	-
Fish Farming and Hacheries	257	286	37	21	16	1
Business Services	577	612	6	2	4	-1
Insurance, Securities Funds and Other Finacial Enterpris	807	863	-	-	-	-
Industry	1.677	2.029	19	1	18	3
Information and Communication	150	169	-	-	-	2
Agriculture and Related Services	971	1.064	13	2	11	4
International Business	286	286	10	-	10	-
Sale and Management Of Real Estate	7.081	7.553	374	125	249	96
Accomondation and Food Services	359	381	-	8	-8	-
Forestry and Related Services	11	12	1	-	1	-
Services Related To Extraction Of Crude Oil and Natura	-	-	-	-	-	-
Other Service Sector Industries	766	891	7	9	-2	1
Other Transport and Storage	2.689	2.991	6	13	-7	-1
International Shipping and Pipeline Transport	671	815	156	22	134	10
Development Of Construction Projects	704	908	142	52	90	49
Extraction Of Crude Oil and Natural Gas	-	-	-	-	-	-3
Unspecified	-	3	-	-	-	-
Water Supply, Sewerage and Sanitation Services	290	301	-	-	-	39
Retail Trade, Repair Of Motor Vwehicles	1.527	1.923	15,00	4	11	-1
Total business customers	23.711	28.292	807	270	537	207
Central government and social security funds	1	1	-	-	-	-
Counties and Municipalities	199	956	-	-	-	-
Retail Banking Marked	30.506	31.419	182	33	149	-1
Retail Banking Marked - International	134	136	-	-	-	-
Totalt	54.551	60.804	989	303	686	206

Figure 38 Gross loans broken down by the remaining term to maturity

Amounts in NOK million

	On demand	1 - 3 months	3 - 12 months	1 - 5 years	Over 5 years	No maturity	Total
Gross loans to customers	8 284	538	1 860	8 251	35 618	0	54 551
Guarantees and unutilised credit facilities	0	0	0	0	0	6 253	6 253
Toral commitments to customers and financial institutions	8 284	538	1 860	8 251	35 618	6 253	60 804

Figure 39 Development of loss write-downs

Amounts in NOK million

	Individual write-downs	2012	2011	2010
	Individual write-downs to cover losses on loans and guarantees as at 1. January	208	273	232
-	Write-off of loans and guarantees previously written down individually for the period	144	150	88
-	Reversal of write-downs from prior years	24	24	52
+	Increase in write-downs on commitments previously written down individually	9	17	21
+	Write-downs on commitments not previously written down individually	254	92	160
=	**Individuelle nedskrivninger til dekning av tap på utlån og garantier per 31.12.**	303	208	273

Amounts in NOK million

	Group write-downs	2012	2011	2010
	Group write-downs to cover losses and guarantees as at 1. January	226	200	238
+	Group write-downs to cover losses and guarantees for the period	-28	26	-38
=	**Group write-downs to cover losses and guarantees as at 31. December**	198	226	200

Amounts in NOK million

Recognised losses	2012	2011	2010
Change in individual write-downs for the period	97	-68	38
Change in group write-downs/change in long-term monitoring for the period	-40	26	-39
Write-offs for the period, for witch individual write-downs were made earlier	144	151	88
Write-offs for the period, for witch individual write-downs were not made earlier	5	1	7
Recoveries on loans, guarantees, etc. previously written down	-11	-9	-7
Total losses on loans and guarantees	195	101	87

Figure 40 Development of loss write-downs (balance sheet) when the IRB method is used, Mass market

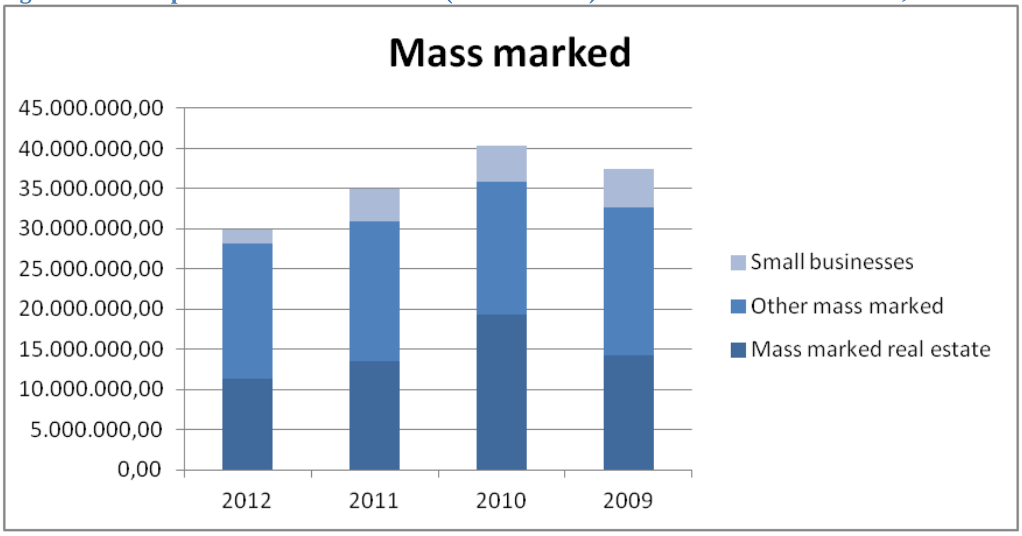
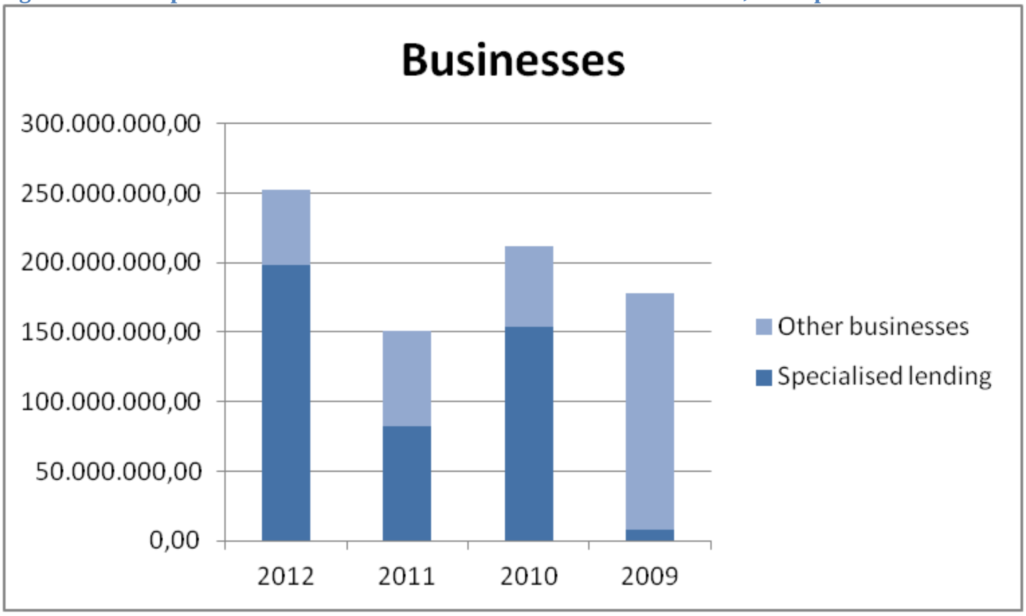


Figure 41 Development of loss write-downs when the IRB method is used, Enterprises



7.5 Security – credit risk

The following main types of security are used: security in real estate, receivables, movable property, stock, operating equipment and farming licences. As far as guarantors are concerned, the main categories are private people through guarantees for consumer loans, enterprises, banks and the public sector.

Figure 42 Total commitments and percentage that are secured by a mortgage, broken down by commitment category

Amounts in NOK million

Type of commitment		Commitment	Of witch secured by a mortage on real estate 1) 2)	Of witch secured by other type of mortgage/security 1)	Of witch unsecured 1)
Mass marked	Commitment secured by a mortgage on real estate	53.080	100 %	0 %	0 %
	Mass marked - SME	1.495	91 %	8 %	1 %
	Other mass marked commitments	1.075	22 %	26 %	52 %
Total		55.650	98 %	1 %	1 %

1) Share of total commitment with provision of security that matches the total commitment for the current commitment category.
2) A commitment for a retail customer, where the realization value of residential property is valued at less than 30% of the customer's commitment is not classified as a real estate commitment.

SpareBank 1 Nord-Norge does not provide any security that entails a reduced commitment amount. No account is taken of the pledged security in LGD calculations for enterprises, but factors set by the authorities are used.

The Bank uses the realisation value of the security for new approvals. The realisation value is determined by valuing the individual object/security and then reducing the value in line with an extensive framework of reduction factors associated with various types of security and security objects. The valuation takes place for new approvals and in annual reviews.

SpareBank 1 Nord-Norge is entitled to set-off in accordance with the general provisions of Norwegian law. Our standard debt certificates, covenants and account agreements incorporate special provisions concerning access to set-off. The access to set-off is not added to the value when calculating risk/capital.

The Group has no specific guidelines on managing concentration risk in relation to types of security. However, the Group does have guidelines on concentration within industries, which necessarily also use the same types of security. Therefore, SpareBank 1 Nord-Norge has indirectly addressed the management of concentration risk in relation to types of security.

8 Counterparty risk derivatives

Figure 43 Financial derivatives

Amounts in NOK thousand	Nominal value	Market value gross	Market value net	Commitment amount
Foreign currency instruments	**6.674.875**	**187.364**	**113.385**	**123.367**
Forward exchange contracts (formards	1.678.457	39.407	33.013	31.912
Currency swap agreements (swap)	4.996.418	147.957	80.372	91.455
Interes rate instruments	**24.013.636**	**998.644**	**588.012**	**382.926**
Interest rate swaps	24.013.636	998.644	588.012	382.926
Non-standardised contracts	0	0	0	0
Credit derivatives	**0**	**0**	**0**	**0**
Type 1	0	0	0	0
Type 2	0	0	0	0
Type 3	0	0	0	0

9 Equity positions outside the trading portfolio

Figure 44 Equities outside the trading portfolio

P/L shares outside trading port. (1.000 NOK)	Booked value	Capital requirement	Unrealised gain/(loss)	Realised gain/(loss)
Strategic purpose				
NETS Holding AS	195.165	195.165	62.447	
Front Exploration	17.950	17.950	(97.922)	
Nord I IS	61.785	61.785	(49.464)	-
Tavrichesky Bank	97.306	97.306	(17.702)	-
Other	(59.432)	(59.432)	(238.868)	-
Total strategic shares outside trading portfolio	312.774	312.774	(341.509)	-

Shares outside trading portfolio (1.000 NOK)	Risk weigthed	Mehtod	Capital Basis	requirement
Stategic purpose	100 %	Std.approach	312.774	25.022
Other	100 %	Std.approach	0	0
Total capital requirement equity capital instruments outside trading portfolio calculated by standard approach included in Credit risk				25.022

10 Interest rate risk outside the trading portfolio

The interest rate risk for all interest rate positions can be expressed by looking at the change in the value of the interest rate instruments in the event of a parallel interest rate change of 2%.

The Group uses analyses that show the effect of the aforementioned interest rate change for various repricing intervals and in total. All the interest rate sensitive balance sheet items on the asset and liability sides are included in the analysis. In addition, all the off-balance items that are used in the Bank's risk management are included. The analyses assume parallel shifts in the interest rate curve, and the calculations are simulated for a 2 percentage point change in the interest rate.
The interest rate risk is managed within the limits stipulated by the Bank's Main Board of Directors and is followed up daily. The interest rate risk is reported to the Board every month, both the status at the time of the report and the highest utilisation of the limits during the period since the last report.

The interest rate fixing for the Group's financial instruments is mainly short, and the Group's interest rate risk is characterised as low.

Figure 45 Change in value with interest rate rise of 2 percentage points

Figure 44: The table illustrates the change in value from an interest rate increase of two percentage point as at 31 December 2012

Interest rate risk associated with a two percentage point change in the interest rate
(Amounts in NOK millions)

NOK	5,0
USD	0,3
CHF	1,6
EUR	0,4

Interest rate risk arises through the group`s assets and liabilities having different lock-in periods. The interest rate risk is handled within limits set by the Board. The overall limits for interest rate risk define the maximum loss for a 2 percentage point change in the interest rates. The total interest rate risk on the bank`s balance sheet must not exceed NOK 60 million. Within the defined repricing interval (0-3 months, 3-6 months, 6-12 months, etc.), the limit is NOK 40 million. The limit for maximum losses associated with interest risk on the currency balance is NOK 4 million. The limit applies in total, within the defined repricing interval and for each individual currency.

Figure 46 Effect on the result of stress tests conducted using book values and full limit utilisation

Type	Stress	Severe stress	Full utilisation of the limit
Strategic shares	91.582.222	109.898.666	109.898.666
Available for sale - long-term investments	6.520.395	13.040.791	13.040.791
Held for trading	16.520.381	19.824.457	21.600.000
Total shares parent bank	**114.622.998**	**142.763.914**	**144.539.457**
Shares SNN Invest	51.253.097	102.506.194	108.831.077
Forward interest	1.437.479	1.581.227	4.400.000
Balance sheet interest	5.021.076	7.029.506	84.000.000
Foreign currency - shares	32.291.389	32.291.389	32.291.389
Foreign currence	466.700	606.710	6.500.000
Spread	179.225.446	215.070.536	271.200.000
Credit	48.001.259	48.001.259	57.601.511
Sum tapspotensial markedsrisiko SNN	**432.319.445**	**549.850.735**	**709.363.433**

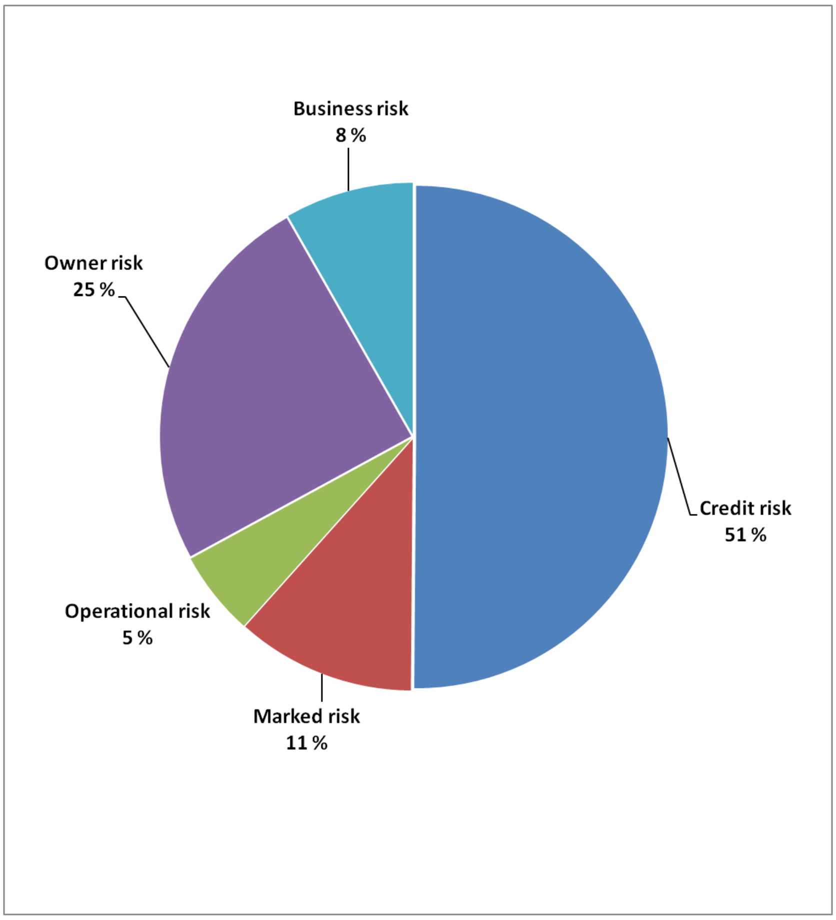
11. Summary – calculation of capital requirements

Economic capital describes how much capital the Group believes it needs to cover the actual risk the Group has assumed. Since it is impossible to fully protect against all losses, the group has stipulated that the economic capital shall cover 99.9% of possible unexpected losses in the course of one year.

Statistical methods are used for the calculation of the economic capital, but the individual risk types require nevertheless the use of expert models and qualitative assessments.

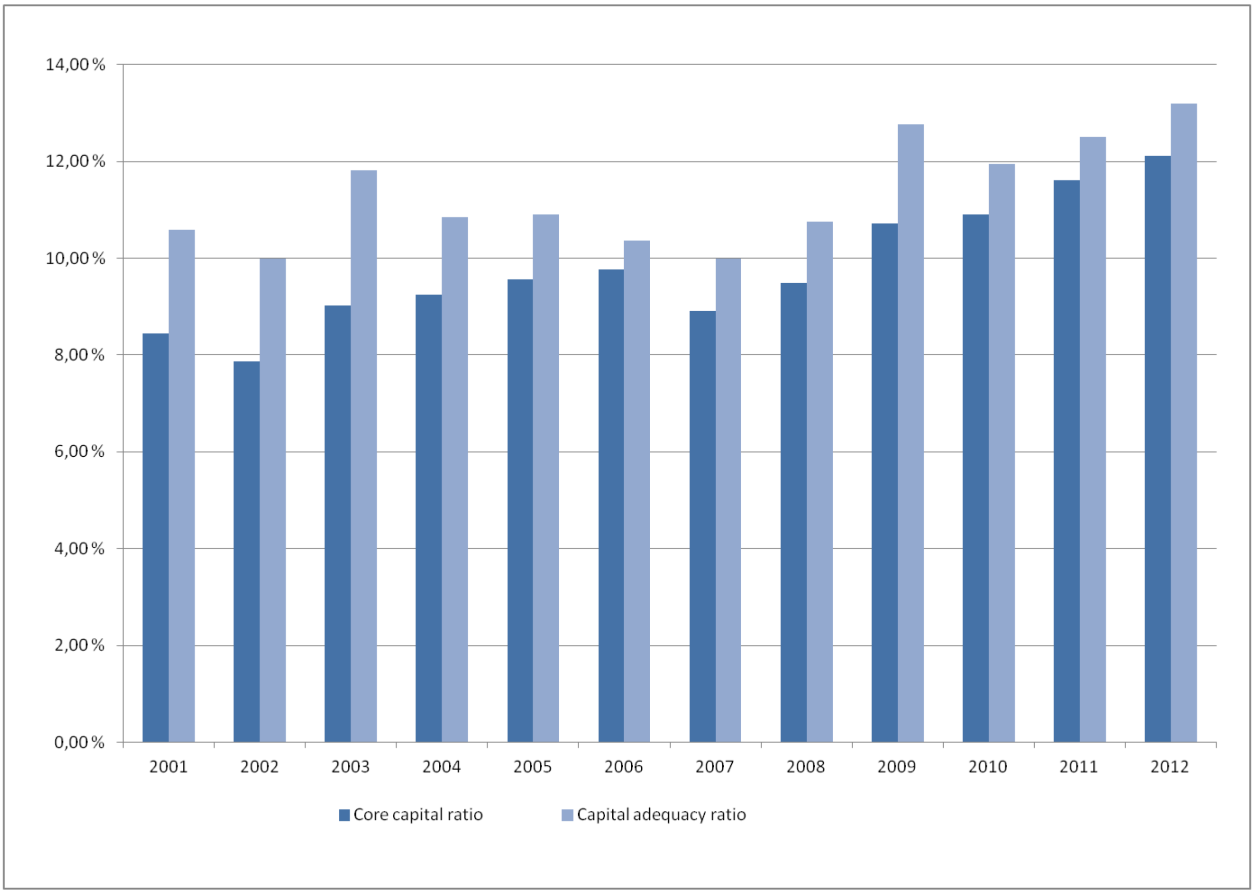
The diagram below shows the distribution of the economic capital across various risk groups based on the risk exposure as of 31.12.2012. The economic capital was calculated for the credit, market, operational, owner and commercial risk (including strategic risk).

Figure 47 Economic capital by risk group



The table below illustrates the economic capital as of 31.12.2012. In addition, a comparison has been made of the need for economic capital in relation to available risk capital (equity and hybrid tier 1 capital) and tier 2 capital as of 31.12.2012.

Figure 48 Capital adequacy ratio development



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Core capital ratio	8,44 %	7,87 %	9,02 %	9,24 %	9,57 %	9,77 %	8,92 %	9,49 %	10,71 %	10,90 %	11,61 %	12,11 %
Capital adequacy rati	10,58 %	9,99 %	11,82 %	10,85 %	10,91 %	10,36 %	10,00 %	10,75 %	12,76 %	11,95 %	12,50 %	13,19 %

12. Comparison of regulatory and financial capital requirements

The table below compares the minimum capital requirements (Pillar 1) and the economic capital requirements (Pillar 2) as of 31.12.2012. An account is also given of the main reason for the differences between the two pillars.

Figure 49 Regulatory and economic capital requirements

	Pillar 2	Pillar 1	Difference
Credit risk	**2.901**	**3.945**	**-1.044**
** unutilised limits*	*158*		
** stress tests*	*248*		
Marked risk	**652**	**81**	**571**
** unutilised limits*	*150*		
** stress tests*	*118*		
Operational risk	**315**	**265**	**50**
** herav kapitalkrav stresstest*	*50*		
Owner risk	**1.414**	**-**	**1.414**
** stress tests (diff from ICAAP)*	*417*		
Business risk	**478**	**-**	**478**
** stress tests*	*228*		
Trnsitional floor	**-**	**256**	**-256**
Deductions	**-**	**-139**	**139**
Total gross risk	**5.760**	**4.408**	**1.352**
** stress tests*	*641*		
** unutilised limits*	*328*		
** increased capital need SP1G and B1O (diff from ICAAP)*	*417*		
Diversification	**584**	**-**	**584**
Net capital need	**5.176**	**4.408**	**768**

Available capital inkl. hybrid	**7.821**	**6.672**
Available capital eks. hybrid	**6.832**	**5.683**
Net available capital	**1.507**	**598**

The main differences between the economic capital (Pillar 2) before the diversification effects of NOK 5.25 billion kroner and the minimum capital requirements (Pillar 1) of NOK 4.55 billion (incl. transitional rules) are due primarily to:

- *Credit risk:*
  - *Loss Given Default:* When the economic capital is calculated for the credit risk for states, institutions and enterprises the risk parameter Loss Given Default is calculated based on internal models, while it is stipulated based on a standard value in accordance with the Capital Requirements Regulations for the calculation of the minimum primary capital.

    The Group stipulates the realisation value of the security pledged based on its own experience over time, and this value should reflect a conservative assessment of the realisation value in a recession. SpareBank 1 Nord-Norge's internal estimates for the Loss Given Default are lower than the standard values stipulated by the authorities.

  - *Concentration risk:* Economic capital takes the concentration risk into account.

- *Owner risk:* The economic capital (Pillar 2) for owner risk in SpareBank 1 Gruppen AS and Bank 1 Oslo AS is estimated to be NOK 1.3 billion. In connection with the calculation of the minimum capital requirement (Pillar 1) the ownership interest in SpareBank 1 Gruppen AS and Bank 1 Oslo AS will be deducted (capital adequacy reserve) with 50% from the tier 1 capital and 50% from the tier 2 capital, and it will thus not be reflected directly in the minimum capital requirement. The Bank has used proportional consolidation to calculate the regulatory capital requirement for the ownership interests in BN Bank ASA, SpareBank 1 Boligkreditt AS and SpareBank 1 Næringskreditt AS.

- *Business risk (including strategic risk):* The economic capital (Pillar 2) is calculated for the business risk (including strategic risk), while this is not a separate type of risk for calculation of the minimum primary capital requirement and the funding risk.

13 Changes in framework conditions

In the last few years banks have had to adapt to significantly more stringent general conditions. A number of new regulations and requirements for the financial industry have also been announced. The new requirements have been announced for a variety of reasons but their common denominator is that they will have major financial consequences for the industry.

The changes are so extensive that they will significantly affect how the institutions must organise important parts of their activities. They will also result in higher costs, both because the regulations in of themselves entail higher costs and because the work of complying with the requirements will be more extensive and complicated.

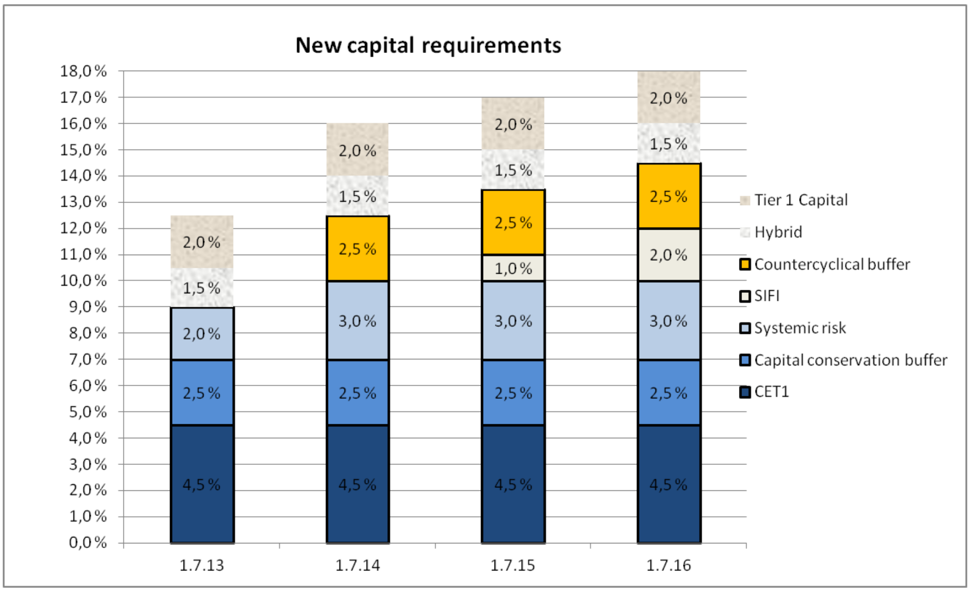
The most extensive requirements are due to the financial crisis and are an expression of the regulatory authorities' ambitions to improve financial strength, funding and financing in the financial institutions.

CAPITAL REQUIREMENTS DIRECTIVE, CRD IV

In the first quarter of 2013, political agreement was reached in the EU on new regulations for financial institutions and investment firms: the Capital Requirements Regulation and Capital Requirements Directive IV (CRR and CRD IV). The regulations build on the Basel Committee's recommendations for new and stricter capital and funding standards, Basel III. The EU compromise entails national authorities being given a relatively large degree of flexibility with respect to introducing extra capital requirements beyond the minimum rules. This includes imposing a requirement for a systemic risk buffer and specific requirements for system-critical institutions. National systemic risk premiums on risk weighting for loans secured by real estate, such as those the Norwegian authorities want for home mortgages, will be allowed. However, this will not fully apply to branches of foreign banks unless a principle concerning the mutual recognition of capital requirements is negotiated and agreed between individual countries.

In March 2013, the Ministry of Finance circulated a consultation paper on four different proposals concerning the minimum requirements for weighting home mortgages in capital adequacy. The proposals entail a weighting of between 20-35%, which is a significant increase on the current average in SpareBank 1 Nord-Norge of 11.84%. The four proposals have each been designed as a possible replacement to ensure that the overall capital requirements are not weakened if the current floor of 80% of the Basel I basis (transitional rule in Basel II) is removed.

The Ministry of Finance has also presented a bill concerning new capital requirements for banks upon the implementation of the Basel III rules in Norway. The new capital requirements are subject to the following composition and implementation plan:



According to the bill the core tier 1 capital ratio requirement will gradually be increased to 12% by 1 July 2016. The Ministry also proposes authority to require a countercyclical capital buffer of up to 2.5%. Norges Bank has in a memo expressed that such a buffer should be set on the basis of the level of total credit, housing prices in relation to income, sales prices for commercial proportion, the share of market funding in Norwegian financial institutions, as well as an expert judgement. At the same time the central bank says that the level of any countercyclical capital buffer must be viewed in the context of the total of all the other capital requirements imposed on the banks.

If the buffer requirements are not satisfied, there will be automatic restrictions on, for example, dividend payments, buying back own shares/equity certificates and awarding variable remuneration. The greater the gap to the imposed buffer, the greater the share of the profit that must be withheld. There are four thresholds for withholding: 100%, 80%, 60% and 40% of the profit.
There is also a requirement concerning a plan for increasing capitalisation. The institution shall, if the buffer requirements are not satisfied, within 5 days of identifying that the requirement will not be satisfied, submit such a plan for the approval of the supervisory authorities. The plan shall estimate the institutions' result and balance sheet trends, measures for increasing capital adequacy, and specify when the requirement is expected to be fully covered. The supervisory authorities have a number of sanction options and are entitled to step in if the banks do not fulfil these requirements, or if the supervisory authorities deem the plans unrealistic.

SpareBank 1 Nord-Norge has a solid basis for satisfying the capital requirements and views favourably the fact that the requirements will be introduced gradually. However, the proposals mean that SpareBank 1 Nord-Norge must build up a significant amount of capital in the future in line with what has so far been assumed in the Group's adaptation to the new regulatory requirements.

In the latter part of 2012, the Ministry of Finance asked the Financial Supervisory Authority of Norway to assess whether the covered bond system contributes to increased systemic risk. The Ministry wanted an assessment of a rule that banks will not be able to transfer more of their own assets to mortgage companies than is prudent. The Financial Supervisory Authority of Norway concluded in its reply that such a general rule should not be introduced, and that it would be most appropriate to evaluate each group individually within the authorisations that already exist. The Financial Supervisory Authority of Norway emphasises that covered bonds have developed into an important source of funding for Norwegian banks and have contributed to lower funding costs, reduced funding risk and a more diversified funding structure. The Ministry of Finance has not yet taken a position on the response.

SpareBank 1 Nord-Norge is working to ensure it is ready to meet the new requirements in the various areas and at the same time points out that there is a strong need to harmonise the regulations internationally. The Group will gradually adapt to the new requirements up until the final regulations are in place.

Minimum equity ratio requirement
In addition to the capital adequacy requirements, which are based on a risk weighting of assets and positions, a minimum requirement will be introduced for equity or tier 1 capital as a percentage of the total assets, but without any form of risk weighting. An important aim of the minimum equity ratio requirement is to set an absolute limit on the size of the debt financing. The minimum equity ratio requirement will contribute to reducing the significance of weaknesses in models and other faults in the system for risk weighting and capital adequacy ratio. The authorities will also evaluate how the actual ratio will be formulated and calibrated. Preliminary calculations show that SpareBank 1 Nord-Norge will do well with regard to this requirement compared with most other banks.

IFRS – NEW AMENDMENTS/REQUIREMENTS
New accounting rules for valuing and recording loans
The standards setting body the International Accounting Standards Board, IASB, prepared draft new rules for the accounting-related measurement of loan losses in November 2009. In May 2011, the IASB and American Financial Accounting Standards Board, FASB, launched a joint draft impairment model for financial assets recorded at amortised cost in an addendum to the original consultation paper. The model was refined further in 2011 and the standard setting bodies continued to discuss the regulations in 2012. The IASB eventually presented a "Tree-bucket approach" as a new impairment model. However, the FASB decided to develop an alternative model. The IASB continued to work on its model and a revised consultation draft was presented in March 2013. The changes could have significant consequences for the banking industry and the market in general.

Current rules for assessing loan losses
According to the current rules a financial asset must be written-down if there is objective evidence of impairment, i.e. once a loss has been occurred. Standard setting bodies, auditors and users have been critical of the write-down rules, including because the current rules delay recognition of losses because the loss event must have occurred in order for the loss to be recognised. Additionally, it will not always be clear when a loss has occurred, which can result in different regulatory practices.

New rules for assessing loan losses
In the new IASB model loss provisions for financial assets are based on an expected loss approach. The proposal is that provisions for expected losses shall be measured based on either the 12-month expected losses or expected losses over the asset's lifetime. The latter shall apply if there has been a significant deterioration in the customer's credit quality between when the asset is initially recorded and the reporting date. The company's assessment shall be based on the probability of not receiving some or all of the contractual cash flows instead of including the 'degree of loss' in the valuation. The rules are expected to include indicators for when recognising expected losses over the asset's lifetime will be appropriate. If a financial asset measured at amortised cost is initially recorded with a credit loss, additional losses shall be calculated using the expected loss over the asset's lifetime.

The new methods are intended to reflect the underlying economic characteristics of a loan commitment better. There will be no need to identify triggering events to assess changes in expected losses. According to the IASB the method is intended to ensure greater consistency between the various reporting entities. The IASB expects the new rules to provide useful information for users of financial statements when they are evaluating companies' provisions and the consequences of any changes to an asset's estimated useful life.

A high degree of judgement will be needed to determine when assets should be moved from a group where provisions are based on expected losses within a 12-month period to a group where expected losses are calculated over the asset's useful life. It will also be very difficult to estimate expected future cash flows and useful life, as well as good and reliable
expected losses. The calculations would thus be subject to significant uncertainty.

The new rules are expected to result in greater volatility in financial reporting. Because of limited experience and a lack of relevant and reliable statistics, the assumptions on which calculations of expected losses are based will be subject to constant changes. Such changes will be reflected in the financial statements cumulatively, meaning that the full effect of the new estimates will be recognised immediately in the income statement.

The implementation of the new rules is expected to reduce the equity of most financial institutions since it must be assumed that there is a need for larger loss provisions in their accounts.
The expected implementation date for the new standard is 1 January 2015.

New rules for the recognition of defined-benefit pensions
In 2011, the IASB adopted amendments to IAS 19 Employee Benefits. The amendments mean that the corridor method can no longer be used to recognise estimate deviations. Estimate deviations must now be recognised in full in total comprehensive income in the period in which they occur. The amendment also means that pension costs must be split between the ordinary result and total comprehensive income. The expected return on pension assets must be calculated using a discount rate, like when calculating pension liabilities. The period's accrued pension rights and net interest cost must be presented under the ordinary result, while estimate deviations must be presented under other operating income and costs in total comprehensive income. The disclosure requirements related to defined-benefit pension contracts have also been amended.
The amendments apply for the financial year starting 1 January 2013.