Risk- and capital management 2010

SpareBank 1 SR-Bank
Risk- and capital management in SpareBank 1 SR-Bank 2010

This document has been prepared to provide the market with the best possible information on SpareBank 1 SR-Bank's risk and capital management. It is also intended to cover the stipulated requirements for publication of risk information in accordance with the "Capital Requirements Regulations".

The Group’s information strategy emphasises an extended dialogue with the different stakeholder groups, where openness, predictability and transparency are vital factors. The information shall be correct, relevant and timely with regard to the Group's development and results, and it shall ensure that the Group's different stakeholder groups can keep continuously updated and create confidence in the investment market.

The core purpose of the banking industry is to create value by assuming deliberate and acceptable risk. SpareBank 1 SR-Bank therefore invests significant resources in the further development of risk management systems and processes in line with leading international practice. SpareBank 1 SR-Bank makes extensive use of risk models in their risk management, and it is with satisfaction that the Group can ascertain that the models have so far proved to be robust throughout the financial crisis.

Risk and capital management in SpareBank 1 SR-Bank supports the Group’s strategic development and achievement of goals while ensuring financial stability and sound management of assets. The combined risk exposure in SpareBank 1 SR-Bank is moderate, and has been marginally reduced in 2010 as a result of strengthened capital adequacy, reduced operational risk and reduced credit risk.

Global economic growth increased significantly in 2010 after the severe downturn in the aftermath of the financial crisis. There is great uncertainty related to the future economic development in the OECD area, while for several emerging economies there are reports of strong growth. The primary risk for the future Norwegian economy will be unrest in Europe, since this is Norway's largest export market. There is reason to believe that Norwegian export-oriented businesses will experience moderate growth in demand in the global market in the coming years.

Credit risk represents a significant part of the Group's risk. The credit quality was strengthened throughout 2010 as part of the improvement in the economy and as a result of a significant internal focus on risk-reducing measures aimed at existing customers.

The core capital adequacy ratio for the Group increased from 9.6 per cent at the end of 2009 to 10.2 per cent at the end of 2010 as a result of retained equity.

Internationally, a recognised method for identifying and quantifying operational risk has not been established. The regulatory capital requirements for operational risk reflect the organisation-specific risk of the individual bank to very little extent. In addition, the measurement methods are very computer-driven and the focus will therefore be retrospective rather than forward-looking.

SpareBank 1 SR-Bank has therefore taken the initiative to establish a R&D project in cooperation with the SpareBank 1 Alliance, DnB NOR, the Research Council of Norway and the University of Stavanger for the development of advanced methods and models in order to become even better at identifying, measuring and managing operational risk where the aforementioned weaknesses are taken into account.

The inherent risk of crime is increasing in society. In 2010 the Group has therefore had a special focus on implementing improvement measures with an aim to reduce the probability and any consequences of crime. This work will continue in 2011.

A systematic evaluation of the quality of the management and control systems in the Group was carried out in 2010. The review shows that the quality of the Group's limits for management and control are satisfactory. A number of improvement areas have been identified that we will continue to work with.
At the beginning of 2011 SpareBank 1 SR-Bank is well-equipped to create value for the region the Group is part of.
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1. **SpareBank 1 SR-Bank**

1.1 **Vision, objective and core values**

- **We shall be Southern and Western Norway's most attractive supplier of financial services**
  - Good customer experiences
  - Strong team spirit and professionalism
  - Local roots and decision-making power
  - Financial strength, profitability and confidence in the market

1.2 **Strategic target**

SpareBank 1 SR-Bank shall be Southern and Western Norway's most attractive supplier of financial services based on:

- Good customer experiences
- Strong team spirit and professionalism
- Local roots and decision-making power
- Financial strength, profitability and confidence in the market

1.3 **SpareBank 1 SR-Bank in brief**

SpareBank 1 SR-Bank is currently Southern and Western Norway's leading financial group with total assets of NOK 135 billion. SpareBank 1 SR-Bank has been one of the most profitable banks in the Nordic region over the past 15 years. The profit before tax for the Group was NOK 1.614 billion in 2010. The Group's market area is Rogaland, Hordaland and the Agder counties, and the number of customers is approaching 300,000. There are approximately 1,200 employees.

The Group has 54 offices in 38 municipalities and is the market leader with 26 municipalities/county authorities as main bank customers in the market area. SpareBank 1 SR-Bank is a financial group with a complete product range in the retail market, corporate market and the public sector. In addition to the actual banking operations, the Group possesses expertise in funding, foreign exchange advice, funds management, securities trading, insurance, real estate brokering and financial advice.
The Group's headquarter is located in Stavanger. Summary of companies in the SpareBank 1 SR-Bank Group is illustrated in the figure below.

**Figure 1: Wholly-owned and partly owned companies in the SpareBank 1 SR-Bank Group**

### 1.4 Key financial figures for 2010

- Profit before tax: NOK 1,614 million
- Profit after tax: NOK 1,317 million
- Return on equity after tax: 15.5 per cent
- Impairment losses on loans: NOK 234 million
- Net interest income: NOK 1,742 million
- Net commission and other income: NOK 1,101 million
- Net return on investment securities: NOK 571 million
- Lending growth (including loans transferred to SpareBank 1 Boligkreditt AS and SpareBank 1 Næringskreditt AS) over past 12 months: 11.6 per cent
- Growth in deposits over past 12 months: 11.8 per cent
- Earnings per equity certificate: NOK 6.84
1.5 Conversion of SpareBank 1 SR-Bank from an equity certificate savings bank to a limited savings bank

At a supervisory board meeting of 28 June 2010 the Supervisory Board requested that the Board of Directors of SpareBank 1 SR-Bank prepare a report on the advantages and disadvantages of a possible conversion of SpareBank 1 SR-Bank to a limited savings bank.

After an overall assessment the Board of Directors decided that it would be right for SpareBank 1 SR-Bank to strengthen itself as much as possible in the equity and debt capital market in order to still be able to remain in the forefront of development in the region where the Group operates. On 28 October 2010 the Board of Directors therefore decided to submit a proposal to the Supervisory Board to convert SpareBank 1 SR-Bank to a limited savings bank. In its proposal the Board of Directors attached great importance to the limited savings bank maintaining its regional affiliation, the bank's history and the savings bank tradition.

After two subsequent supervisory board meetings, the Supervisory Board adopted the proposal to convert SpareBank 1 SR-Bank to a limited savings bank on 25 November 2010. All the resolutions were unanimous. At the same time the Board of Directors was granted the authority to submit an application to the Financial Supervisory Authority of Norway/Ministry of Finance for permission to reorganise and a tax abatement. The reorganisation resolution was made contingent on the Ministry of Finance granting permission for the reorganisation on satisfactory terms and that SpareBank 1 SR-Bank is granted a tax abatement for the conversion to a limited savings bank. The Supervisory Board will make further decisions concerning the execution of the reorganisation after permission for reorganisation has been granted.

The reorganisation application was sent to the Financial Supervisory Authority of Norway, as the advisory authority, in December 2010. The Board of Directors assumes that the conclusion made by the Financial Supervisory Authority of Norway/Ministry of Finance will be available in 2011.

1.6 SpareBank 1 Alliance

The SpareBank 1 Alliance is a banking and product alliance in which the SpareBank 1 banks in Norway cooperate through the holding company SpareBank 1 Gruppen AS. The paramount goal of the SpareBank 1 Alliance is to secure the individual bank's independence and regional ties through robust competitiveness, profitability and financial strength. The SpareBank 1 Alliance is one of the largest providers of financial services in Norway, and it is a competitive alternative to traditional financial groups.

The SpareBank 1 Group owns and develops companies that provide financial services and products. The SpareBank 1 Alliance is Norway's third-largest financial group. The Group is a binding banking and product alliance in which the SpareBank 1 banks cooperate through the jointly-owned SpareBank 1 Gruppen AS.
The Norwegian Confederation of Trade Unions (LO) is another owner and partner through SpareBank 1 Gruppen AS.

Figure 2 below provides a summary of the ownership structure of the SpareBank 1 Alliance.

*Figure 2: SpareBank 1 Alliance*
2.  CAPITAL ADEQUACY REGULATIONS

2.1  Introduction to current capital adequacy regulations - Basel II

The EU’s capital adequacy directive was introduced in Norway on 1 January 2007. The regulations are based on a standard for capital adequacy calculations from the Bank for International Settlements (BIS). The object of the capital adequacy requirements is to strengthen stability in the financial market by means of:

- More risk-sensitive capital requirements
- Improved risk management and control
- Closer supervision
- More information to the market

The capital adequacy regulations are based on three pillars:

Pillar 1: Minimum regulatory capital requirements
Pillar 2: The bank's internal risk and capital adequacy assessment and individual supervisory review
Pillar 3: Disclosure of information

Further information on the various pillars can be found in Section 3 (Pillar 1), Section 4 (Pillar 2) and Section 5 (Pillar 3). In Section 6 a comparison has been made of the need for regulatory capital in relation to internal calculations based on risk-adjusted capital.

Amendments to Basel II from 1 January 2011

As a result of the amendments to EU’s capital adequacy directive the Norwegian regulations for calculation of capital requirements and regulatory capital have been amended with effect from 1 January 2011. The most important changes include stricter requirements for hybrid capital (tier 1 perpetual capital), increased capital requirements for equity risk in the trading portfolio, and increased capital requirements and stricter requirements for risk management related to securitisation positions and by means of Value at Risk methods in the trading portfolio.

2.2  Introduction to the proposal for new regulations - Basel III

On 12 September 2010 the Basel Committee presented the specific quantification of the new minimum requirements for the bank’s capital adequacy. The new minimum requirements will take effect from 1 January 2013 with various transitional arrangements, which entail that they will be in full effect from 1 January 2019. Furthermore, the effects of the transitional arrangements for outstanding hybrid capital and subordinated loan capital will mean that the proposed Basel III regulations will not have full effect until 2023 at the earliest.

The Basel Committee has decided that pure core capital (common equity Tier 1) and core capital (Tier 1) will comprise 4.5 per cent and 6 per cent of the calculation basis, respectively. Combined with the stricter qualitative requirements for core capital, in general, and pure core capital, in particular, which the committee has already proposed, it will entail stricter requirements compared with the current minimum requirements of 2 per cent and 4 per cent, respectively. The requirements for regulatory capital will remain unchanged at 8 per cent.
To prevent the banks from experiencing any problems meeting the minimum requirements during periods of major losses in the banking sector, the banks shall maintain two different capital buffers. The requirement for a capital conservation buffer means that the banks shall maintain a pure core capital of 2.5 per cent of the calculation basis, in addition to the minimum requirement.

In order to protect the banking system against the consequences of strong credit growth, the banks shall also maintain a countercyclical buffer of up to 2.5 per cent during periods with very strong credit growth. Banks that do not meet the buffer requirements will be faced with restrictions on their dividend policies, discretionary interest payments, etc. on hybrid capital securities, bonus payments and buyback of shares. These restrictions will increase, the less the difference is between the actual capital and minimum requirements, including the necessary buffers.

The figure below illustrates the changes in the requirements for the core capital in Basel III as described above:

*Figure 3: Structure of the core capital*

The Basel Committee will also introduce requirements for the unweighted leverage ratio, which is a supplement to the risk-based capital requirements. This requirement will be finalised in 2017 and become effective in 2018. The transition period will be used to test a requirement that the core capital shall amount to at least 3 per cent of the bank's exposure, where off-balance sheet items will be included to varying degree.

In addition to introducing increased quality requirements for the regulatory capital and increased minimum capital requirements, the Basel III proposal also includes an expansion of the risks that capital requirements shall be calculated for in the form of higher capital requirements for counterparty risk in derivative transactions etc.

The Basel Committee will also introduce quantitative liquidity requirements and aims to introduce the short-term liquidity indicator, the Liquidity Coverage Ratio (LCR) in 2015 and the long-term indicator Net Stable Funding Ratio in 2019.

Table 1 below provides a summary of the transitional rules in connection with the Basel III proposals.
However, Norwegian Central Bank and the Financial Supervisory Authority of Norway have, in a joint consultative response to the EU Commission, suggested the possibility of stipulating a higher countercyclical capital requirement than 2.5 per cent. It also argues for an earlier implementation of the Basel III regulations in Norway than in the rest of Europe.

The new hybrid capital requirements entered into force on 1 January 2011. Based on these regulations, the hybrid tier 1 securities as they are normally defined in Norwegian banks today will not be considered as core capital. However, a transitional arrangement has been introduced that entails that the hybrid tier 1 securities count as hybrid capital until 2041, but for a maximum of 20 per cent of the core capital from 2021, and 10 per cent from 2031. A maximum limit of 15 per cent has already been introduced for Norwegian banks.

As a result of Basel III, these transitional arrangements will, in practice, only be of significance until 2013. The Basel III proposal stipulates additional new requirements for hybrid capital that is to count as core capital. The Basel III proposal also includes new requirements for subordinated loan capital that is to be included in the supplementary capital. The transitional arrangement for the hybrid capital and subordinated loan capital means that 90 per cent of the already outstanding capital that does not meet the new requirements will, nevertheless be included in 2013, and then there will be a subsequent reduction of 10 percentage points annually. Such loans will then not be included from 2013.

### 2.2.1 Consequences of the Basel III proposals internationally

The Basel Committee and the Committee of European Banking Supervisors (CEBS) has conducted a study to assess the effects of the proposed changes to the capital adequacy regulations. The results have been used to stipulate the quantitative requirements for pure core capital, core capital, regulatory capital and capital buffers, as well as the transitional rules that will be used for the further work with the definition of target figures for the unweighted leverage ratio.

<table>
<thead>
<tr>
<th>Table 1: Proposal for a Basel III transitional arrangement</th>
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<tr>
<td><strong>Minimum Tier 1 Capital</strong></td>
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<tr>
<td><strong>Capital Conservation Buffer</strong></td>
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<tr>
<td><strong>Minimum Tier 1 Capital including Capital Conservation Buffer</strong></td>
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<tr>
<td><strong>Minimum Total Capital</strong></td>
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<tr>
<td><strong>Minimum Total Capital plus conservation buffer</strong></td>
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<tr>
<td><strong>Leverage ratio</strong></td>
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<td><strong>Liquidity coverage ratio</strong></td>
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<tr>
<td><strong>Net stable funding ratio</strong></td>
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Some preliminary main conclusions are:

- The quantitative and qualitative requirements for pure core capital will have a major impact, especially for the large banks, but with significant variations between the various countries and banks.

- For Norwegian institutions the impact on capital is relatively insignificant and among the lowest in Europe.

Thus, the preliminary results also show that changes in the definition of capital have a major impact on the core capital levels internationally, especially for the large banks. It is primarily the harmonisation of deduction items and the fact that the deductions shall be made in full from the pure core capital (as opposed to the current distribution of deductions between core capital and supplementary capital) that drives the results. Together with stricter requirements for the pure core capital adequacy ratio and the core capital adequacy ratio this entails a significant capitalisation requirement for many banks.

The first calculations of the unweighted leverage ratio indicate that many of the largest European banks lie below the proposed limit of 3 per cent. The estimates are very sensitive to both exposure and capital targets, which will be subject to further assessment prior to when the requirement is introduced in 2018. Most of the smaller banks appear to be able to meet such a requirement. The calculations show great differences for the results of banks in different countries. The C-QIS results indicate that Norwegian savings and commercial banks do not initially need to limit their lending or increase their capital as a result of the 3 per cent requirement.

The international calculation studies also indicated that the largest banks have the greatest need for adaptation in relation to the future liquidity requirements. On average, the largest banks met 83 per cent of the liquidity requirements and 93 per cent of the funding requirements, while the figures for the smaller banks were 98 per cent and 103 per cent, respectively. Calculation of liquidity indicators LCR (Liquidity Coverage Ratio) and NSFR (Net Stable Funding Ratio) indicate that the Norwegian banks do not distinguish themselves significantly from the other European banks.

2.2.2 Assessment of proposal for new regulations

At a general level, SpareBank 1 SR-Bank supports the proposal to increase the capital requirements for banks to create a more robust financial system, and with this, to prevent economic and financial shocks.

One of the primary weaknesses of the capital adequacy regulations so far has been the fact that several significant risks have not been identified by the regulatory capital requirements. This applies to the concentration risk, business risk, reputation risk, strategic risk and a number of off-balance-sheet items. In addition, the regulatory capital tied up in equity investments has been significantly underestimated.

The financial crisis has shown that the regulatory capital has not adequately managed to identify the banks' overall risk.

The introduction of the requirements for unweighted leverage ratio is an attempt to rectify some of these weaknesses, but the proposal in its current form will excessively impact the institutions that specialise in lending to the low risk segment. The unweighted leverage ratio requirement should be differentiated according to the banks' different business models. However, these are problems that have been recognised, and the Basel Committee has notified that it will consider this.

SpareBank 1 SR-Bank finds that the operational risk is still not covered in a satisfactory manner in the Basel III proposal. This is primarily due to the fact that an international recognised method for identifying and quantifying the operational risk has not been established. The regulatory capital requirements for operational risk reflect the organisation-specific risk of the individual bank to very little extent. In addition, the measurement methods are very computer-driven and the focus will therefore be retrospective rather than forward-looking.
With regard to the proposal for the implementation of the countercyclical buffer, SpareBank 1 SR-Bank agrees that it is sensible that the banks create a capital buffer in good times in order to withstand losses during negative economic shifts in a better way. However, SpareBank 1 SR-Bank feels that the proposed solution has a number of weaknesses that the banks must consider when evaluating future capitalisation strategies.

The calculation method used as a basis is theoretically complex, and provides a poor expression of at what point in time the countercyclical capital buffer should be introduced or phased out. The intention therefore is to give the supervisory authorities broad authority to use other indicators, such as the development of real estate prices, credit spreads, interest rate conditions or GDP growth as a criterion for introducing or phasing out the capital buffer. This can result in measures with inadequate consistency globally, since the supervisory authorities can rely of different assessments, independently of each other. In other words, a country can choose to introduce the measure while another country may choose not to implement the requirement, even though the indicator performance is the same.

To give the banks a certain degree of predictability in capital planning, a notification deadline of 12 months has been proposed before the supervisory authorities can introduce a capital buffer.

In addition to the aforementioned weaknesses, the preservation buffer or the countercyclical capital buffer do not take into consideration the individual banks’ different business models or risk management systems, and they are thus not motivation in themselves for better risk management.

During the implementation of the Basel II regulations, one of the main objectives was to give an incentive for better risk management.

In addition to the counter cyclical buffer, a new regulation for losses will most likely be introduced. The proposed principle will build on the recognition of losses based on the expected losses. During periods of very insignificant losses, the difference between the actual losses and expected losses will be set aside as an additional reserve, while during periods when the losses are higher than expected, the provisions will be reduced. This approach will give a lower volatility for the banks’ earnings throughout an economic cycle, and the approach may also dampen credit growth during economic expansion. SpareBank 1 SR-Bank supports this approach.

However, the countercyclical economic buffer and the proposed change in the method for the recognition of losses point in the same direction. Both methods result in stricter requirements during economic expansion and more lenient requirements during economic downturns. It is therefore important that the combined effect of the two approaches does not result in unintentional economic restrictions during economic downturns.

### 2.2.3 Consequences of Basel III for SpareBank 1 SR-Bank

As of the 4th quarter of 2010 SpareBank 1 SR-Bank had a core capital adequacy ratio of 10.2 per cent, which is significantly higher than the proposed new regulatory minimum requirement of a core capital adequacy ratio of 6.0 per cent. The Group is also well above the proposed level for the core capital adequacy ratio, including the preservation buffer of 8.5 per cent, which will not take full effect until 2019.

Furthermore, it has been proposed that the regulatory deductions that are currently deducted 50 per cent from the core capital and 50 per cent from the supplementary capital shall be set at a 100 per cent deduction from the core capital from the end of 2012. For SpareBank 1 SR-Bank this primarily applies to the deduction items for ownership risk in the SpareBank 1 Group and Bank 1 Oslo, and the difference between ”expected losses IRB” less loss provisions. This will have a limited negative effect on the core capital in the Group.

SpareBank 1 SR-Bank has an ownership interest in SpareBank 1 Gruppen AS of 19.5 per cent. Pursuant to current regulations this ownership interest is treated as a capital adequacy reserve and the recognised value of the ownership interest will be deducted in its entirety from SpareBank 1 SR-Bank.
Bank's consolidated regulatory capital. In the calculation of capital adequacy for the parent bank the ownership interest in SpareBank1 Gruppen AS is treated as an investment in another financial institution and the main portion of the investment's book value is therefore deducted when calculating the parent bank's regulatory capital.

In the proposed Basel III regulations the ownership interest in the SpareBank 1 Group will be considered as a so-called ownership interest exceeding 10 per cent, but an interest that is outside of the so-called regulatory consolidation.

This will mean that the book value of the ownership interest, together with other corresponding ownership interests (Bank 1 Oslo AS), will be deducted from the regulatory capital of both the consolidated and the parent bank, but only for the portion of the combined amount that exceeds 10 per cent of the pure core capital. The portion of the investment that is not deducted from the regulatory capital will be included in the calculation basis with a weighted risk of 250 per cent. Provided that the Basel III regulations are introduced as currently described, the investments in SpareBank1 Gruppen AS and Bank 1 Oslo will have a limited negative effect on the core capital adequacy ratio in relation to the current regulations.

From 2018, the Basel Committee will also introduce requirements for the unweighted leverage ratio, which is a supplement to the risk-based capital requirements. Norwegian banks, including SpareBank 1 SR-Bank, generally operate with higher equity ratios, so that the equity requirements will not be a problem for the Group. However, the requirement may become a challenge for certain institutions that specialise in lending to low-risk segments, such as SpareBank 1 Boligkreditt AS, for example. Nevertheless, this is a known problem, and the Basel Committee has notified that it will evaluate whether this requirement is suitable for different business models.

Preliminary calculations indicate that SpareBank 1 SR-Bank will meet the quantitative liquidity requirements for Liquidity Coverage Ratio (LCR) and Net Stable Funding (NSF) that are to be introduced from 2015 and 2019, respectively, with an observation period from 2011 and 2012.
3. **PILLAR 1 – MINIMUM REQUIREMENTS FOR SUBORDINATED LOAN CAPITAL**

In Pillar 1 different methods the banks can choose from when calculating capital requirement are described. The different methods are illustrated in Figure 4.

*Figure 4: Alternative methods for calculating the minimum regulatory capital requirement*

<table>
<thead>
<tr>
<th>Credit risk</th>
<th>Market risk</th>
<th>Operational risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard method</td>
<td>Standard method</td>
<td>Basic method</td>
</tr>
<tr>
<td>Basic IRB method *</td>
<td>Internal ratings method *</td>
<td>Standardised method *</td>
</tr>
<tr>
<td>Advanced IRB method *</td>
<td></td>
<td>AMA method *</td>
</tr>
</tbody>
</table>

* These methods require the approval of the Financial Supervisory Authority of Norway, Supervisory A

The minimum requirements for regulatory capital amounts to 8 per cent of the weighted balance (calculation basis). In principle, there are two different approaches to the calculation of the minimum regulatory capital requirement according to the capital adequacy regulations. One approach is based on template rules while the other is based on the application of internal ratings. In the internal ratings based (IRB) approach, the minimum regulatory capital requirements will be based on the banks’ internal risk assessments. Consequently, the statutory minimum capital adequacy requirement is more risk sensitive, so that the capital requirement corresponds more closely to the risk in the underlying portfolios or activities. Use of internal models must be approved in advance by the supervisory authorities.

### 3.1 Choice of methods at SpareBank 1 SR-Bank

Table 2 shows the methods that SpareBank 1 SR-Bank uses for calculation of its capital requirements for credit, market and operational risk, respectively.

*Table 2: SpareBank 1 SR-Bank’s methods for calculating the minimum regulatory capital requirement*

<table>
<thead>
<tr>
<th>Type of risk</th>
<th>Portfolio</th>
<th>Regulatory method</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk</td>
<td>States - parent bank</td>
<td>Standard method</td>
</tr>
<tr>
<td></td>
<td>Institutions - parent bank</td>
<td>Standard method</td>
</tr>
<tr>
<td></td>
<td>Housing cooperatives, clubs and associations - parent bank</td>
<td>Standard method</td>
</tr>
<tr>
<td></td>
<td>Businesses - parent bank</td>
<td>IRB - Basic</td>
</tr>
<tr>
<td></td>
<td>Mass market - parent bank</td>
<td>IRB - mass market (advanced)</td>
</tr>
<tr>
<td></td>
<td>SpareBank 1 SR-Finans AS - subsidiary</td>
<td>Standard method</td>
</tr>
</tbody>
</table>
For the subsidiary SpareBank 1 SR-Finans AS, plans have been prepared for a subsequent transition to the IRB method and the portfolio reports are therefore based on the standard method for the time being. The company’s principal activities are lease funding and secured car loans. The calculation basis for SR-Finans AS is approximately 3.5 per cent of the overall calculation basis.

SpareBank 1 SR-Bank owns 28.6 per cent of SpareBank 1 Boligkreditt AS, 24.1 per cent of SpareBank 1 Næringskreditt AS and 19.5 per cent of BN Bank ASA as of 31 December 2010. SpareBank 1 SR-Bank's share of the capital requirement for these companies are consolidated in SpareBank 1 SR-Bank's reporting capital adequacy based on the Group's ownership interest.

SpareBank 1 SR-Bank owns 19.5 per cent of the SpareBank 1 Group and Bank 1 Oslo. The part of the investment in the SpareBank 1 Group's book value that exceeds 2 per cent of the SpareBank 1 Group's regulatory capital is deducted from the regulatory capital and calculation basis in SpareBank 1 SR-Bank.

SpareBank 1 SR-Bank has received approval from the Financial Supervisory Authority of Norway to make use of internal ratings based (IRB) measurement methods for credit risk. The bank has been approved for the use of the Basic IRB for businesses (hereinafter referred to as the corporate market) and IRB (Retail IRB) for the mass market (hereinafter referred to as the retail market). This means that the statutory minimum capital adequacy requirement for credit risk will be based on the Group’s internal risk models.

When calculating the capital requirement according to the Basic IRB method for the corporate market, the probability of default (PD) risk parameter is estimated on the basis of internal ratings. The risk parameters conversion factor (CF) used in determining the exposure at default (EAD) and the loss given default (LGD) are determined based on the template rules in the Capital Requirements Regulations.

When calculating the capital requirement according to the IRB method for the private market, internal models are used for calculation of the risk parameters probability of default (PD), conversion factor (CF) used in determining the exposure at default and loss given default (LGD).
3.2 Financial strength targets

The capital situation of SpareBank 1 SR-Bank is evaluated based on two different criteria.

a) Regulatory capital: The Board of Directors has decided that the minimum target for the core capital adequacy ratio for the Group is 9.0 per cent, while the goal for capital adequacy has been set at a minimum of 11.0 per cent.

b) Risk-adjusted capital: The Board of Directors has decided that the Group's equity and hybrid tier 1 securities shall cover the risk-adjusted capital (unexpected loss) from all the Group's risks, calculated based on a confidence level of 99.97 per cent\(^1\).

3.2.1 Regulatory capital

At end of the 4th quarter of 2010, the Group had a capital adequacy ratio of 12.4 per cent and a core capital adequacy ratio of 10.2 per cent. This development is positive and in line with SpareBank 1 SR-Bank's goals for the area.

Figure 5: Development of capital adequacy as of the 4th quarter of 2010

Transitional rules in the IRB system

In connection with the introduction of the Basel II regulations in 2007, two temporary transitional arrangements still apply for the IRB banks.

\(^1\) The Board of Directors has decided that the ownership risk in the SpareBank 1 Group shall be calculated based on a confidence level of 99.5 per cent as a result that the risk in the SpareBank 1 Group is insurance risk to a significant extent. Insurance risk has a different loss distribution than traditional banking risk, and a confidence level of 99.5 per cent is in line with the Solvency II regulations.
According to the Capital Adequacy Regulations the IRB calculation basis in 2011 shall not be lower than 80 per cent of the minimum requirement calculated using the old capital adequacy regulations (Basel I). The transitional arrangement was initially supposed to be terminated in 2009, but was extended until the end of 2011. Based on the portfolio as of the 4th quarter of 2010, the current capital requirements would have been NOK 566 lower and the core capital adequacy ratio 0.8 percentage points higher without the transitional rule.

According to the Capital Adequacy Regulations the LGD for mass market commitments with a mortgage on residential property will be adjusted upwards by a common factor, if necessary in order to achieve an EAD-weighted average LGD of at least 10 per cent. This transitional rule is assumed to continue until the end of 2012.

Based on the portfolio as of the 4th quarter of 2010, the current capital requirement would have been NOK 260 million lower and the core capital adequacy ratio would have been 0.4 percentage points higher without the transitional rule.

As of the 4th quarter of 2010 the core capital adequacy ratio of SpareBank 1 SR-Bank would have been 11.4 per cent without the two temporary transitional rules.

### 3.2.2 IRB ambitions for SpareBank 1 SR-Bank

SpareBank 1 SR-Bank has received approval from the Financial Supervisory Authority of Norway to make use of internal ratings based (IRB) measurement methods for credit risk. The bank has been approved by use of IRB Basic for the corporate market. When estimating capital requirement according to the Basic IRB method for the corporate market, the probability of default (PD) risk parameter is estimated on the basis of internal models. The risk parameters conversion factor (CF) used in determining the exposure at default and loss given default (LGD) are established according to the template rules in the Capital Requirements Regulations. The loss given default has been set on a regulatory basis at 45 per cent.

SpareBank 1 SR-Bank has begun work with preparing the application to the Financial Supervisory Authority of Norway for approval to use an internal ratings based approach for calculation of the risk parameters conversion factor (CF) for use in determining the exposure at default (EAD) and the loss given default (LGD). It is expected that an approval will have a significant positive effect on the core capital adequacy.

### 3.2.3 Risk-adjusted capital

SpareBank 1 SR-Bank focuses on risk-adjusted capital in the internal management of the Group as a result of several circumstances. Experience from the financial crisis shows that the regulatory calculations in many cases significantly underestimate the need for regulatory capital to cover potential losses from operational risk and equity investments. Another important factor is the fact that the regulatory capital requirement only covers credit, market and operational risk. Concentration risk, business risk, reputation risk and strategic risk are not covered by the regulatory capital requirement for example.

Figure 6 below shows the development of risk-adjusted capital and buffer capital since 2008. The buffer capital is defined as the difference between equity/hybrid tier 1 securities and risk-adjusted capital after the diversification effects. From 2010 it was decided to increase the confidence level for creditor protection to 99.97 per cent in line with international practice.
In order to be able to compare risk-adjusted capital for 2008 and 2009 with 2010, the risk-adjusted capital has been recalculated, as well as the safety buffer for 2008 and 2009 based on the new confidence level.

The figure shows that the need for risk-adjusted capital has been reduced in 2010. This is primarily due to less need for risk-adjusted capital for credit risk as a result of a positive portfolio development.

The buffer capital is at NOK 4.3 billion at the end of 2010 and has shown a significant improvement from 2008. The improvement is primarily due to the fact that SpareBank 1 SR-Bank strengthened its core capital during the 4th quarter of 2009 by NOK 1,228 million in private offerings and NOK 800 million in hybrid tier 1 securities. In addition, the buffer capital was strengthened in 2010 as a result of the merger with Kvinnherad Sparebank, as well as retained earnings.
4. **PILLAR 2: GROUP'S INTERNAL RISK AND CAPITAL ADEQUACY ASSESSMENT**

4.1 **Objective of risk and capital management in SpareBank 1 SR-Bank**

The core business of the banking industry is to create value by assuming deliberate and acceptable risk. The Group therefore invests significant resources in the further development of risk management systems and processes in line with leading international practice.

Risk and capital management in SpareBank 1 SR-Bank shall support the Group’s strategic development and achievement of goals while ensuring financial stability and sound management of assets. This is to be achieved by:

- A strong organisational structure characterised by high awareness of risk management
- A good understanding of what risks drive earnings.
- Striving towards an optimal application of capital within the adopted business strategy
- Preventing unexpected single events from damaging the Group’s financial position to a serious extent.
- Making the most of synergy and diversification effects

4.2 **Risk exposure at SpareBank 1 SR-Bank**

4.2.1 **Trade and industry structure of the Group's market areas**

SpareBank 1 SR-Bank's market area is in Southern and Western Norway. The bank is currently located in the Agder, Hordaland and Rogaland counties. Even though the Group has shown relatively good growth in Agder and Hordaland in the past years, the Group's main activity is still in Rogaland. The description and analysis below is therefore mainly based on Rogaland.

The "Economic Barometer for Rogaland - Autumn 2010" concludes that most sectors in the county are emerging from the turbulent times and that growth appears to be driven by the activities in the oil and gas sector. The petroleum cluster will likely secure the industry in Rogaland for many years still, while the export-oriented industries are facing challenges as a result of the international financial situation. The future challenges of the industries will be their ability to change and to seize new opportunities. It is a matter of using the experience and knowledge gained over many years in the international petromarine sector for new products and new expertise.

Below is a short description of the largest industries in Rogaland, measured by the number of employees. The description is based on the "Economic Barometer for Rogaland - Autumn 2010". The figure below shows employment distributed by sector in Rogaland.
Energy sector

The energy sector is comprised of oil and gas production, power and water supply. The energy sector employs around 20,000 people, which account for just under 9 per cent of the workforce in the county. It is oil and gas that dominates and accounts for 72 per cent of the revenues in the county. The activities in the sector are sensitive to oil price fluctuations. The higher oil prices in 2007 and parts of 2008 resulted in good times and high level of activity. However, the significant fall in oil prices from the middle of 2008 resulted in challenges for the sector in the form of investment delays and a shift towards maintenance rather than new investment. Despite these major fluctuations in activity, we have not experienced significant changes in employment. Throughout 2010 the level of optimism and activity has increased, which has resulted in a higher investment level for 2011. It appears as though the investments that were put on hold early in the economic downturn period are now emerging, which will, in turn, result in great opportunities for the local industries in Rogaland. The sector's main challenges in the future will be the competition with other emerging global oil and gas markets, technology and access to qualified expertise.

Industry

Industry in Rogaland mainly consists of three areas, mechanical and metal goods, food and other industry. The combined employment in industry is around 29,000, which amounts to around 12 per cent of employment in the county. Almost half of the employees work in the mechanical and metal goods sector, which is closely linked to the oil and gas activities. The investment level in industry lags somewhat behind since the financial crisis and estimates show that growth will not be seen until well into 2011 or 2012. Pressure on costs and greater competition from international companies in the home market and the need for product development are some of the challenges industry faces. The decline in employment appears to have stopped, and Rogaland, which appears more optimistic than the rest of the country, is anticipating employment growth already for the current year.
Building and construction

Building and construction employs around 17,000 persons, which accounts for 7.5 per cent of employment in the county. The sector is very exposed to cyclical fluctuations and the financial crisis has resulted in negative outcomes, but employment for permanent employees has been relatively stable. The market in Rogaland showed signs of improvement in the autumn of 2010. Rogaland has a great need for new residences due to strong population growth, and it appears that this increase will initially be in the housing market. Commercial buildings and plant growth is also expected as a result of relatively high employment and the fact that local business and industry is doing well.

Distributive trades

This sector employs just over 30,000 persons, which accounts for 13 per cent of overall employment in the county. The entire sector experienced lower revenues in connection with the financial crisis. Revenues have increased now, but we do not expect the same strong growth as before the crisis in the next few years.

Public sector

There are around 65,000 employees in the public sector in Rogaland, which is almost 30 per cent of the overall employment in the county. During the financial crisis this sector showed the most growth in employment. To a great extent the public sector has been a buffer for increased unemployment during economic downturns. A levelling off growth in the public sector is assumed. In the long term the sector will have a significant need for labour, and the county's population growth will give rise to a greater demand for public services. Furthermore, there are significant investment requirements, especially in the health sector.

4.2.2 Macroeconomic outlook

General

Global economic growth increased significantly in 2010 after the severe downturn in the aftermath of the financial crisis. There is a great deal of uncertainty related to the future economic development in the OECD area, while for several emerging economies there are reports of strong growth.

The economic situation in Norway in the past year has significantly improved, the decline in business investments has bottomed out, the real household income is increasing and the increase in unemployment appears to be levelling off.

The primary risk for the future Norwegian economy will be the unrest in Europe, since this is Norway's largest export market. Norwegian banks are dependent on funding in the international banking market, and further unrest into 2011 will have a dampening effect on the Norwegian economy. There is reason to believe that Norwegian export-oriented businesses will experience moderate growth in demand in the global market in the coming years.

Rogaland

Unemployment

While unemployment in many countries in Europe is continuing to rise, from already high levels, it has stabilised in Norway. The LFS figures showed unemployment of 3.6 per cent at the end of 2010. The labour market in Rogaland is good. In the past year unemployment in Rogaland has decreased,
and it decreased in the last quarter of 2010 in particular. Unemployment in Rogaland at the end of 2010 was 2.14 per cent. Otherwise in the bank’s market area unemployment was 3.4 per cent in Vest-Agder and 3.5 per cent in Hordaland at the same time. Continued growth in the world economy and rising oil prices and oil investments are important factors for why low unemployment was maintained.

Figure 8: Development of unemployment Unemployed as a percentage of the workforce

Housing prices

Overall, the housing prices in 2010 were 8.3 per cent higher on average than in 2009. The housing prices in Stavanger increased the most, by 14.5 per cent. From the 3rd quarter to the 4th quarter of 2010, the housing prices in Norway decreased by 0.1 per cent on average. The prices for the entire country were 6.6 per cent higher in the 4th quarter of 2010 than for the same period the previous year. For the bank’s market area this represented an increase of 8.4 per cent in Rogaland, 8.3 per cent in Hordaland and 4.4 per cent in Agder.

The figure below shows the percentage change in housing prices from the previous year.
Figure 9: Percentage change in housing prices from previous year

Oil prices

The oil price has increased by around 9 per cent in 2010 and was just over USD 90 per barrel at the end of the year. At the end of January 2011 the oil price exceeded USD 100 per barrel. This is the first time since October 2008 that the oil price could be measured in a three-digit dollar figure. Strong growth in emerging economies and increased uncertainty in the Middle East are important factors for the increasing oil price. It is feared that the riots will create unrest in other countries in the Middle East and North Africa. This region accounts for around a third of the world's oil production. Egypt itself is not a major oil producer, but if the unrest spreads it could have great consequences since three million barrels of oil are transported through Egypt every day.

Figure 10: Development of the price of oil
4.2.3 Overall risk exposure for SpareBank 1 SR-Bank

The core purpose of the banking industry is to create value by assuming deliberate and acceptable risk. SpareBank 1 SR-Bank therefore invests significant resources in the further development of risk management systems and processes in line with leading international practice. To a great extent, SpareBank 1 SR-Bank uses risk models in its risk management, and the Group has found that the models have proven to be robust throughout the financial crisis.

Risk and capital management in SpareBank 1 SR-Bank supports the Group’s strategic development and achievement of goals, while ensuring financial stability and sound management of assets.

The combined risk exposure in SpareBank 1 SR-Bank is moderate, and it has been marginally reduced in 2010 as a result of strengthened capital adequacy, reduced operational risk and reduced credit risk.

Global economic growth increased significantly in 2010 after the severe downturn in the aftermath of the financial crisis. There is a great deal of uncertainty related to the future economic development in the OECD area, while for several emerging economies there are reports of strong growth. The primary risk for the future Norwegian economy will be the unrest in Europe, since this is Norway's largest export market. There is reason to believe that Norwegian export-oriented businesses will experience moderate growth in demand in the global market in the coming years.

The core capital adequacy ratio for the Group increased from 9.6 per cent at the end of 2009 to 10.2 per cent at the end of 2010 as a result of retained equity.

Credit risk represents a significant part of the Group's risk. The Credit quality was strengthened throughout 2010 as part of the improvement in the economy and as a result of a significant internal focus on risk-reducing measures aimed at existing customers.

Internationally, a recognised method for identifying and quantifying operational risk has not been established. The regulatory capital requirements for operational risk reflect the organisation-specific risk of the individual bank to very little extent. In addition, the measurement methods are very computer-driven and the focus will therefore be retrospective rather than forward-looking.

SpareBank 1 SR-Bank has therefore taken the initiative to establish a R&D project in cooperation with the SpareBank 1 Alliance, DnB NOR, the Research Council of Norway and the University of Stavanger for the development of advanced methods and models in order to become even better at identifying, measuring and managing operational risk where the aforementioned weaknesses are taken into account.

The inherent risk of crime is increasing in society. In 2010 the Group has therefore had a special focus on implementing improvement measures with an aim to reduce the probability and any consequences of crime. This work will continue in 2011.

A systematic evaluation of the quality of the management and control systems in the Group was carried out in 2010. The review shows that the quality of the Group's limits for management and control are satisfactory. A number of improvement areas have been identified that we will continue to work with.

EU’s goal-oriented effort to completely harmonise the regulations in the EU/EEA area continuously entails new directives and regulations that the Group must adapt to. Stringent regulatory requirements related to the Group's activities (licences) entail an increased scope and places high demands on the follow-up of compliance. There has been a strong focus on operationalisation and satisfactory compliance of the MiFID directive, and the implementation of the new money laundering regulations
in 2010. This focus must be maintained in order to meet both the internal requirements and external requirements.

Risk-adjusted capital provides a description of how much capital the Group believes it requires 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 risk-adjusted capital shall cover 99.97 per cent of the potential unexpected losses.

For the ownership risk in SpareBank 1 Group a confidence level of 99.5 per cent has been chosen as a result of the fact that the risk to a great extent consists of insurance risk with a different loss distribution. A confidence level of 99.5 per cent for insurance risk is in line with the international Solvency II regulations.

The figure below shows the composition and requirement for risk-adjusted capital as of the 4th quarter of 2010. In addition, the figure shows the necessary risk-adjusted capital after the diversification effects measured against the available risk capital.
Risk-adjusted capital is estimated at NOK 6.4 billion after the diversification effects. The combined risk capital for the Group is NOK 10.7 billion, distributed by NOK 9.4 billion in equity and NOK 1.3 billion in hybrid capital. The buffer capital is thus NOK 4.3 billion. In addition, the Group has subordinated loan capital totalling NOK 2.9 billion as an extra buffer in excess of this.

Credit risk represents 60 per cent of the overall risk picture as measured by the risk-adjusted capital. After credit risk, ownership risk represents the largest risk category, at 18 per cent.

### 4.2.4 Credit risk

On the following pages more detailed information is provided on SpareBank 1 SR-Bank’s credit risk exposure at the end of the 4th quarter of 2010. All figures and numbers apply to the parent bank and include portfolios transferred to SpareBank 1 Boligkreditt AS unless otherwise specified.

SpareBank 1 SR-Bank owns 28.6 per cent of the shares in SpareBank 1 Boligkreditt AS. This is a mortgage company with status as an independent legal entity that was primarily established to ensure the Group stable and competitive funding. SpareBank 1 SR-Bank is one of several shareholders, and as a shareholder the Group has an ownership interest in SpareBank 1 Boligkreditt AS that shall be consistent with the Group’s share of the transferred portfolio over time.

When loans are transferred from the Group to SpareBank 1 Boligkreditt AS, SpareBank 1 SR-Bank will still manage these (operational handling of customer inquiries, follow-up, etc.). SpareBank 1 SR-Bank also has the right to transfer loans back if they are defaulted. Accordingly, the Group has chosen to include the portfolio transferred to SpareBank 1 Boligkreditt AS in the follow-up and reporting of the Group’s credit risk.

The combined transfers to SpareBank 1 Boligkreditt AS at the end of the 4th quarter of 2010 totalled a loan exposure at default (EAD) of NOK 30.5 billion. This represents an actually drawn lending volume of NOK 25.9 billion. The quality of this portion of the portfolio is very good, with low probability of default and high collateral coverage.

The credit portfolio in the subsidiary SpareBank 1 SR-Finans is not included in the portfolio summaries below. This is because the Group's credit models have not yet been fully implemented for
these portfolios. The credit portfolio of SpareBank 1 SR-Finans represents around 4 per cent of the Group’s combined lending exposure. SpareBank 1 SR-Finans has a greater share of marginal funding (vehicles, capital equipment, etc.) than is the case for the Group as a whole. This means that the inherent credit risk will generally be somewhat higher in SpareBank 1 SR-Finans than in the parent company.

**SpareBank 1 SR-Bank Group**

A further assessment of the portfolio quality and portfolio development for the loan portfolio in SpareBank 1 SR-Bank at the end of the 4th quarter of 2010 is provided in the paragraphs below.

The figure below summarises the risk-related development of the portfolio at the end of the 4th quarter of 2010.

*Figure 12: Development of SpareBank 1 SR-Bank's portfolio*

Figure 12 shows that the Group has a moderate risk profile and that the profile has improved further over the past year. The persistently low interest rate levels are contributing to a high level of activity, low unemployment and still climbing housing prices in the Group’s market area. These development trends, together with the ongoing focus on risk-reducing measures, are contributing to maintenance of the high credit quality for the Group’s portfolio.

A total of 92.9 per cent of the loan exposure level satisfies the criteria for low/lowest risk. Expected loss (long-term outcome) in this part of the portfolio is 0.05 per cent. Exposure to the high/highest risk categories totals 1.6 per cent of the loan exposure. Expected loss (long-term outcome) in this part of the portfolio is 4.4 per cent.

Over the past 12 months the share of the loan exposure in the low/lowest risk categories has increased by 3 percentage points, while the share of loan exposure in the medium risk category has been reduced correspondingly. This change in the portfolio quality throughout the year can be explained based on three different factors:

- Customer attrition: Granted financing has been redeemed
- New customers: Granting of financing to new customers
• Change in existing customers: Changes in granted financing as a result of repayment/borrowing or as a result of a changed risk group

On the basis of the aforementioned breakdown, figure 13 below shows the main reasons for the change in SpareBank 1 SR-Bank's portfolio at the end of the 4th quarter of 2010.

Figure 13: Migration in SpareBank 1 SR-Bank's portfolio over the past 12 months

Figure 13 shows that most of the commitments to new customers are classified in the lowest/low risk categories, and that the volume of new customers in this group is greater than the attrition. However, the figure also shows that the Group in general has had a somewhat greater volume of new customers in the medium risk category than the attrition. This development is counteracted by a positive development in the existing customer base, where loan exposure in the medium risk category has been reduced. The combined change is therefore positive, with an increasing share of the loan exposure in the low and lowest risk categories.

When the credit risk of a portfolio is assessed it is also important to take into account any concentration risks in the portfolio. Concentration risk is the risk that occurs when there is an accumulation of exposure to an individual customer, sector or geographical area.

SpareBank 1 SR-Bank has a significant focus on concentration risk. In order to ensure a diversified portfolio, separate credit strategic limits have been established for concentration risk that sets limits, not only related to exposure, but also to the risk profile at the portfolio level, and for different sectors and individual customers. In addition, financial institutions have been subject to regulatory requirements that limit the concentration risk related to major individual customers isolated and to the accumulation of major individual customers overall.

The development of the concentration risk is continuously monitored, and further assessment of the individual concentration risks will be provided in the following paragraphs:

• Concentration of potential major losses\(^2\)
• Sector concentration
• Geographic concentration

\(^2\) Concentration of potential major losses is defined as companies with a potential loss given recovery in an economic downturn of over NOK 100 million (LGR > NOK 100 million).
Concentration of potential major losses

SpareBank 1 SR-Bank evaluates the concentration risk surrounding commitments with the greatest loss potential as the most significant concentration risk.

The figure below shows the distribution of commitments according to loss potential (LGR).

Figure 14: SpareBank 1 SR-Bank’s portfolio by LGR

At the end of the 4th quarter of 2010 the Group had a total of 17 large commitments with a loss potential exceeding NOK 100 million. These commitments account for 4.1 per cent of the overall loan exposure, but 14 per cent of the overall risk-adjusted capital. The quality of this portion of the portfolio is good and the probability of default is significantly lower than the average for corporate market commitments as a whole. The number of commitments with a loss potential exceeding NOK 100 million has been reduced throughout the past year.

Also the number of commitments with an average loss potential (LGR) above NOK 25 million has been reduced. At the end of the 4th quarter of 2010 there are 92 such commitments, and these account for a total of 11 per cent of the combined loan exposure and 33 per cent of the combined risk-adjusted capital.

There is no internationally recognised and precise method for calculating the concentration risk for potential major losses. The Group has therefore developed a separate simulation method to illustrate the concentration risk. The internal model shows that the concentration risk represents a mark-up of NOK 220 million (5.3 per cent) on the risk-adjusted capital. The quality of this part of the portfolio measured by the probability of default is also significantly better than the average for the corporate market portfolio in general. This indicates that the concentration risk is limited. The mark-up for the concentration risk for potential major losses has also been reduced somewhat over time.

Reporting imposed by the authorities is also carried out for major commitments in accordance with the Regulations relating to large commitments. Reports are submitted each quarter to the Financial Supervisory Authority of Norway, the Norwegian Central Bank and the Guarantee Fund. The regulation stipulates that all commitments that represent more than 10 per cent of the regulatory capital shall be reported. The maximum total of these commitments cannot exceed 800 per cent of the regulatory capital, while the limit for the largest individual commitment is 25 per cent of the regulatory capital.
The regulation stipulates that the limits for the highest combined commitment with a single counterparty also apply to commitments with two or more counterparties when a controlling influence or economic association between these counterparties are such that economic difficulties experienced by one of them will likely result in payment difficulties for more than one of the parties.

The figure below shows the percentage of these commitments in relation to the regulatory capital (the maximum limit is 800 per cent).

*Figure 15: Reporting in accordance with the Regulations relating to large commitments*

At the end of the 4th quarter of 2010 SpareBank 1 SR-Bank had net regulatory capital of NOK 11,192 million. Thus, all commitments exceeding NOK 1,119 million must be reported in accordance with the regulations. This means reporting of four commitments that represent 29.3 per cent of the regulatory capital combined. In comparison, at the end of the 3rd quarter of 2010 five commitments that amounted to 40.3 per cent of regulatory capital were reported.

Another type of concentration risk that the Group must also deal with actively is sector concentration.
Sector concentration

The figure below shows SpareBank 1 SR-Bank's portfolio (EAD) by various sectors/segments.

Figure 16: SpareBank 1 SR-Bank's portfolio by sector

Figure 16 shows that the retail market accounts for around 65 per cent of the total portfolio measured by loan exposure. The quality of the retail market portfolio is very good. Most of the portfolio has a very low probability of default and has been granted with real property as collateral. Earnings from the retail market are good and have showed very low losses over time.

The greatest concentration, except for the retail market, is the property rental sector, which accounts for 11 per cent of the combined loan exposure. The other sectors individually represent up to 3.9 per cent of the combined loan exposure. The figure above shows that SpareBank 1 SR-Bank has a limited sectoral concentration. As a result of significantly stronger growth in the retail market than in the corporate market in recent years, the sectoral concentration has also been reduced.

The degree of volatility in the individual sectors varies significantly. Volatility results in fluctuation in the companies' earnings, which in turn affect their ability to service (probability of default) loans and credits. The greater the volatility, the greater the fluctuation in earnings. In order to analyse SpareBank 1 SR-Bank's sector concentration (including the retail market segment) compared with the sector volatility and exposure to individual sectors, the individual sectors have been ranked based on the degree of volatility (low, average and high). The sector categories are primarily based on the Group's own empirical data.

Volatility is defined as fluctuations in earnings in the sectors, which affects in turn their ability to service debt. When evaluating the volatility of the individual sector, special consideration has been taken to the sensitivity to changes in interest rates and the price of oil.
<table>
<thead>
<tr>
<th>Sector</th>
<th>Share of portfolio</th>
<th>Volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail market</td>
<td>65.2%</td>
<td>Low</td>
</tr>
<tr>
<td>Property rental</td>
<td>10.8%</td>
<td>Low</td>
</tr>
<tr>
<td>Property project</td>
<td>3.9%</td>
<td>Low</td>
</tr>
<tr>
<td>Oil-related operations</td>
<td>3.7%</td>
<td>High</td>
</tr>
<tr>
<td>Shipping</td>
<td>2.9%</td>
<td>High</td>
</tr>
<tr>
<td>Building and construction</td>
<td>2.3%</td>
<td>High</td>
</tr>
<tr>
<td>Other sectors with low volatility</td>
<td>3.6%</td>
<td>Low</td>
</tr>
<tr>
<td>Other sectors with average volatility</td>
<td>6.8%</td>
<td>Medium</td>
</tr>
<tr>
<td>Other sectors with high volatility</td>
<td>0.7%</td>
<td>High</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.0%</strong></td>
<td>-</td>
</tr>
</tbody>
</table>

SpareBank 1 SR-Bank has chosen to evaluate the volatility of the property segment that the Group is exposed to at a relatively low level. The Group's portfolio consists of buildings for rent, construction of residential housing and commercial projects and the financing of land for future development. The property portfolio intended for rental primarily consists of centrally located properties with long-term leases and solid tenants, and a great deal of this portfolio has been interest rate hedged. In general, there is a minimum requirement of 70 per cent advance sales when financing residential housing projects. It is only a small part of the portfolio that applies to financing of land, and the majority of these have already been zoned.

Retail market customers represent a stabilising factor related to sector volatility, and they contribute to a great extent to the fact that as much as 83.5 per cent of the loan exposure is considered to have low volatility. 9.6 per cent of the portfolio has high volatility, and this primarily applies to exposure in the shipping, oil-related activity and building and construction sectors. This means that SpareBank 1 SR-Bank will have limited volatility with respect to earnings and the size of losses as a result of sector concentration. The retail market share shows a tendency to increase, which further limits volatility. Specific credit strategic limits regulate the maximum share of the risk-adjusted capital that can be linked to an individual sector. This contributes to a diversified portfolio where the sector concentration is limited.
**Geographic concentration**

Figure 17 below shows the portfolio by geographic region.

*Figure 17: SpareBank 1 SR-Bank’s portfolio by geographic region*

The figure shows that 76 per cent of the combined loan exposure is linked to customers in Rogaland, while the remaining portfolio is divided between customers in Agder, Hordaland and other counties, respectively. The share of loan exposure related to Rogaland is relatively stable, but further geographic diversification is expected in the coming years as a result of the Group's focus on Agder and Hordaland.

SpareBank 1 SR-Bank is a regional bank, which entails that the bank will have a geographic concentration in Rogaland. The activity in oil-related activities is sensitive with regard to fluctuations in the oil price, but the variation in oil prices in recent years has had a relatively small direct effect on employment and activity in Rogaland. The reason for this may be the fact that the activity on the Norwegian continental shelf is steadily marked by operations, maintenance and modification of the existing fields.

Fluctuations in oil prices are assumed to have the greatest impact on the development of new fields and exploration. Forecasts show that the price of oil is expected to be around USD 80 per barrel for the coming years.

Based on the aforementioned there are no factors to indicate that the Group's market area will be more exposed to an economic downturn than the rest of the country. The Group does therefore not see it as necessary to have a special capital mark-up for geographic concentration.
Corporate market

A further assessment of the portfolio quality and portfolio development for the corporate market’s loan portfolio at the end of the 4th quarter of 2010 is provided in the paragraphs below.

The figures below summarises the risk-related development of the portfolio at the end of the 4th quarter of 2010.

*Figure 18: Development in the corporate market portfolio*

![Graph showing portfolio development](image)

Figure 18 shows that the quality in the corporate market portfolio is good. The development is positive and the portfolio’s risk profile is further strengthened throughout the 4th quarter of 2010. This is due to the fact that the volume of new commitments with a low risk profile is greater than attrition and the fact that the existing portfolio is marked by a positive migration where the share of commitments with a low risk profile is increasing. The portfolio’s average probability of default, its expected loss and risk-adjusted capital requirements are moving in a positive direction in the 4th quarter of 2010 as a result of this.

The loan exposure level of 81 per cent satisfies the criteria for low/lowest risk. Expected loss (long-term outcome) in this part of the portfolio is 0.12 per cent. The high/highest risk category represents 4.2 per cent of the loan exposure. Expected loss (long-term outcome) in this part of the portfolio is 4.4 per cent.

Over the past 12 months the share of the loan exposure in the low/lowest risk categories has increased by 7 percentage points, while the share of loan exposure in the medium risk category has been reduced correspondingly. This change in the portfolio quality throughout the year can be explained based on three different factors:

- Customer attrition: Granted financing has been redeemed
- New customers: Granting of financing to new customers
- Change in existing customers: Changes in granted financing as a result of repayment/borrowing or as a result of a changed risk group

On the basis of the aforementioned breakdown, figure 19 below shows the main reasons for the change in the corporate market portfolio at the end of the 4th quarter of 2010.
Figure 19: Migration of the corporate market portfolio over the past 12 months

Figure 19 shows that around 85 per cent of the volume of commitments to new customers is classified in the lowest/low risk categories, and that the volume of new customers in this group is greater than the attrition. However, the figure also shows that the Group in general has had a somewhat greater volume of new customers in the medium risk category than attrition. This development is counteracted by a positive development in the existing customer base, where loan exposure in the medium risk category has been reduced. The combined change is therefore positive, with an increasing share of loan exposure in the low and lowest risk categories.

The positive development in the existing portfolio can be illustrated by looking at how customers have migrated between the default classes over the past 12 months.

Figure 20: Migration of the existing corporate market portfolio over the past 12 months
Figure 20 shows that around 45 per cent of the corporate customers are in the same default class over the past 12 months. Of the remaining 55 per cent of corporate customers, 26 per cent migrated negatively, while 28 per cent migrated positively. This supports the image of high stability in the portfolio, but with a weakly positive development. Five per cent of the corporate customers migrated more than two default classes (positively or negatively) during the year.

The Group's risk groups (lowest to highest) are based on the commitments' expected loss over time. Expected loss is calculated based on the probability of default and the loss given default. Below is a summary of the corporate market portfolio divided into these two parameters.

**Figure 21: Corporate market portfolio by default class**

The portfolios are given a default class from A - I based on the customer's probability of default. The probability of default reflects a long-term outcome through an economic cycle. The figure shows that the main portion of the loan exposure has a probability of default between 0.25 per cent (the lowest value in class C) and 5 per cent (the highest value in class G).

The portfolios are also assigned a class from 1 - 7 based on the commitment's loss given default. The loss given default represents the loss potential of a commitment during an economic downturn.
Security classes 1 and 2 entail that customers have furnished security for their commitments that, based on the realisation value during an economic downturn, exceeds the size of the commitment. The loss given default in these two classes will therefore be limited to any recovery costs. Figure 22 shows that 36 per cent of the loan exposure belongs to these security classes. Eleven per cent of the loan exposure has security with a realisation value of less than 20 per cent of the commitment (security class 7). SpareBank 1 SR-Bank assesses collateral conservatively, and this means that security in the form of a negative mortgage, guarantees and unlisted securities are not normally assigned any realisation value.

For the overall corporate market portfolio the expected loss is estimated at 0.43 per cent of the loan exposure during an economic downturn, but the variations for each default class are significant. The average expected loss in the different default classes are illustrated in figure 23 below.

Figure 23: Expected loss in the corporate market portfolio by default class
Average expected loss in default class A is 0.02 per cent, increasing to 3.49 per cent in default class I.

The amount of capital tied up (risk-adjusted capital) will also vary significantly between the default classes. Risk-adjusted capital indicates a maximum loss during a 12-month period with a 99.97 per cent confidence level. Average capital tied up in the different default classes is illustrated in figure 24 below.

Figure 24: Risk-adjusted capital in the corporate market portfolio by default class

For the combined corporate market portfolio the risk-adjusted capital is estimated at 5.56 per cent of the loan exposure. Average risk-adjusted capital in default class A is 1.74 per cent and increasing to 17.28 per cent in default class I.

Since the risk-adjusted capital indicates necessary capital in order to cover unexpected loss in a given confidence level, it means that this requirement for risk-adjusted capital increases proportionate to the increasing probability of default. This is in accordance with the fundamental principle of the Group's risk management that the capital tied up in a commitment shall be linked directly to its calculated risk.

The figure below shows the distribution of commitments according to loss potential (LGR).
At the end of the 4th quarter of 2010 the corporate market had a total of 17 commitments with a loss potential exceeding NOK 100 million. These commitments account for 12 per cent of the corporate market's combined loan exposure, but represent 19 per cent of the corporate market's combined tied up capital. There is a clearly defined strategy behind this portfolio composition. The growth and risk profile are managed, for example, through specific credit strategic limits for concentration risk. This part of the portfolio generally has a lower probability of default than the average in the rest of the portfolio. The portion of the loan exposure with a loss potential exceeding NOK 100 million has been reduced from 16 per cent to 12 per cent over the past year.

In shipping and shipyard financing the individual commitments are also subject to relief on the part of the Norwegian Guarantee Institute for Export Credits (GIEK) and Eksportfinans. The scope of such relief is, however, limited.
Figure 26 shows that the corporate market portfolio has a satisfactory distribution across the various sectors. Property rental is the largest single sector and comprises 31 per cent of the loan exposure in the corporate market. The property portfolio intended for rental primarily consists of centrally located properties with long-term leases and solid tenants, and a great deal of this portfolio has been interest rate hedged. In addition, the loan exposure is widely diversified among various sectors.

There is a significant focus on the risk related to loan exposure in property rental, shipping, oil-related activities and acquisition finance. Based on this, further reviews of these sectors are presented below.

**Property rental**

The property rental portfolio represents the Group's greatest concentration in a single sector, and comprises just under 11 per cent of the total exposure (EAD) including retail market customers.
Figure 27: Property rental portfolio by risk group

Figure 27 shows that the property rental portfolio is dominated by commitments with low risk. These account for 84 per cent of the loan exposure, while only 2 per cent of the exposure is classified as high risk.

The portfolio related to the financing of property rental is well-diversified, robust and with a substantial share of properties where the underlying rental contracts are long-term contracts. In addition, good lessees and a great deal of interest rate hedging indicate that the risk in the portfolio is moderate. To a great extent, the portfolio is comprised of commitments where the loan yield exceeds 7.5 per cent at the same time as the weighted remaining rental period exceeds 5 years, which confirms the impression of a robust portfolio. In general the outlook for the Group’s commercial property portfolio is considered good in 2011.

Most of the portfolio is related to property rental in the Group's market area (Rogaland, Agder and Hordaland). But around 15 per cent of the portfolio is related to property rental outside the Group’s market area, primarily in Eastern Norway. This is based on property acquired by customers living in the Group’s market area, participation in syndicates with other banks in the SpareBank 1 Alliance and certain major commitments with an individual entity domiciled in Eastern Norway, respectively.

Shipping

The figure below shows that the shipping portfolio is dominated by commitments with low risk. These account for 85 per cent of the loan exposure, while only 3 per cent of the exposure is classified as high risk.
The main portion of the Group's shipping portfolio is in the offshore and rig markets. The remaining portfolio is mainly linked to a few companies engaged in seismic vessels and product or chemical tankers. The Group’s general assessment, seen in relation to the market outlook, is that the risk in the shipping portfolio is medium. This is because the commitments are primarily aimed at solid entities with long experience, and good contract coverage with solid charterers for the next few years.

In general the Group finances companies engaged in offshore service vessels who we have had long-term relationships with. A limited amount of financing is granted to totally new customers, and these customers are evaluated thoroughly before financing is granted. Most of the vessels financed are engaged in North Sea activities and overall the contract coverage is good. Counterparty risk is limited since the contracts are entered into with solid charterers.

The Group has a moderate exposure in shipping to chemical and product tankers. The portfolio consists of a relatively young fleet of vessels that are primarily built at well-renowned shipyards. The Group also has a moderate exposure to seismic vessels. The market for these vessels is challenging, but an improvement in the market situation is anticipated in the future.

To a limited extent the Group is exposed to gas tankers, mainly LNG tankers on long-term charters. Furthermore, the Group is, to a limited extent, exposed to dry bulk carriers, with exposure to financially solid ship-owning companies. The Group has limited exposure to container vessels, ro-ro vessels and tankers.

Oil-related activities

The figure below shows that the portfolio for oil-related activities is dominated by commitments with low risk. These account for 90 per cent of the loan exposure, while 8 per cent of the exposure is classified as high risk.
The past years have been marked by falling order reserves and few new contracts. The tendency has in particular been negative for newbuilds, but the same tendency has also been prevalent in operations, maintenance and modifications. The reason for this has been the postponement of planned projects and a strong focus on costs by the oil companies. The market for newbuilds, operations and maintenance appears somewhat brighter for 2011.

The Group's portfolio for oil services is considered to be robust, also based on the fact that a number of our customers have benefited from the contracts awarded for operations and maintenance from Statoil, as well as contracts awarded for newbuilds. Most companies in the Group's portfolio have the main portion of their revenues in the operations and maintenance segment, and the Group has a limited portfolio linked to newbuilds.

**Acquisition financing**

In the autumn of 2008 the market for acquisition transactions came to a stop, and after this time the Group has not financed any significant new acquisition transactions. The Group has a limited portfolio that can be linked to acquisition financing. The portfolio is dominated by companies in oil services and is divided into both acquisition debt and operations financing. Around 40 per cent of the acquisition financing is secured by a charge against the target companies, while 60 per cent is operations financing secured by a charge against any significant assets in the target companies. The share of operations financing is increasing. In general, the risk related to the acquisition portfolio is considered medium. A significant portion of the Group's acquisition portfolio is oil-related, and an expected positive development in this sector in the future will therefore have a dampening effect on the risk associated with the Group's acquisition portfolio.
Retail market

A further assessment of the portfolio quality and portfolio development for the loan portfolio in the retail market at the end of the 4th quarter of 2010 is provided in the paragraphs below.

At the end of the 4th quarter of 2010 a portfolio of NOK 30.5 billion was transferred to SpareBank 1 Boligkreditt AS. In accordance with the criteria for the transfer of loans, the quality of this portion of the portfolio is very good and better than the rest of the portfolio. While the average probability of default of SpareBank 1 Boligkreditt's transferred portfolio is 0.49 per cent, the corresponding figure for the remaining retail market portfolio is 0.72 per cent.

Figure 30 below summarises the risk-related development of the retail market portfolio at the end of the 4th quarter of 2010.

![Figure 30: Development of the retail market portfolio](image)

The above figure shows that the quality of the retail market portfolio is very good, and 99 per cent of the loan exposure satisfies the criteria for the low/lowest risk categories. The development is marked by enduring stability. This means that the good portfolio growth that the Group has experienced over a long period of time has not affected the portfolio's risk profile. Most of the portfolio is secured by way of mortgages on real property. Collateral coverage is good, which would indicate that there is only a limited risk of loss so long as the values of the collateral pledged are not significantly impaired.

The development in the existing portfolio can be illustrated by looking at how customers have migrated between the default classes over the past 12 months.
Figure 31: Migration of the existing retail market portfolio over the past 12 months

The figure shows that 54 per cent of the retail customers are in the same default class over the past 12 months. Of the remaining 46 per cent of the customers there is a slight majority that migrate positively (24 per cent). There is great stability in the retail market portfolio, and only 4 per cent of the customers migrate more than two default classes (positively or negatively) throughout the year.

The Group's risk groups (lowest to highest) are based on the commitments' expected losses over time. Expected losses are calculated based on the probability of default and the loss given default. Below is a summary of the retail market portfolio divided into these two parameters.

Figure 32: Retail market portfolio by default class

The portfolios are given a default class from A - I based on the commitment's probability of default.

Figure 32 shows that 82 per cent of the portfolio has an estimated probability of default of under 0.75 per cent (classes A - D). For portfolios transferred to SpareBank 1 Boligkreditt AS the estimated
The probability of default is mainly below 0.50 per cent (classes A - C). The probability of default reflects a long-term average through an economic cycle.

The portfolios are also assigned a class from 1 - 7 based on the commitment's loss given default. The loss given default represents the loss potential of a commitment during an economic downturn. The graph below summarises the retail market portfolio (EAD) by loss given default.

Figure 33: Retail market portfolio (EAD) by loss given default (security classes)

Security classes 1 and 2 entail that customers have furnished security for their commitments that, based on the realisation value during an economic downturn, exceeds the size of the commitment. The loss given default in these two classes will therefore be limited to any recovery costs. Figure 22 shows that 72 per cent of the loan exposure belongs to security classes 1 or 2.

Figure 33 shows that 94 per cent of the loan exposure (EAD) lies within security class 3. This means that the realisation value of the securities pledged represent a minimum of 80 per cent of the loan exposure and entails a limited loss given default. To a limited extent, financing is granted that entails that the realisation value of the collateral furnished represents less than 80 per cent of the loan exposure. However, 12 per cent of the customers have been granted smaller credits where the realisation value of the security pledged is less than 20 per cent of the credit granted.

The Group focuses on a commitment's estimated loss given default when the loss potential is to be calculated. The realisation value of the securities pledged will be used as the basis then. This is significantly lower than the market value (for home mortgages a reduction factor of 20 per cent is used) and shall reflect the security-related value upon realisation in an economic downturn.

However, players in the financial industry still focus a great deal on measurement of the loss potential measured as the loan exposure as a percentage of the market value of the securities pledged.

As a supplement, the figure below therefore shows how much of the retail market portfolio with a mortgage on real property lies within 60 per cent, 60 - 75 per cent, 75 - 100 per cent and more than 100 per cent, respectively, of the market value of the collateral.
Figure 34 shows loans as a percentage of the value of the collateral (Loan to value) for retail market customers, including portfolios transferred to SpareBank 1 Boligkreditt AS. The LTV is calculated based on the market value of the collateral. In a balance-distributed LTV, for loans that exceed 60 per cent of the collateral’s market value, the excess is distributed among the other intervals. In a total-distributed LTV, the entire loan is assigned to a single interval. The figure shows that there is moderate borrowing in general in relation to the value of the collateral. Only 6 per cent of the loan exposure exceeds 75 per cent of the value of the collateral.

For the overall retail market portfolio the expected loss is estimated at 0.03 per cent of the loan exposure through an economic cycle, but the variations for each default class are significant. The average expected loss in the different default classes are illustrated in Figure 35 below.

Figure 35: Expected loss in the retail market portfolio by default class

Average expected loss in default class A is almost 0 per cent, increasing to 1.25 per cent in default class I for the retail market portfolio combined.
The amount of capital tied up (risk-adjusted capital) will also vary significantly between the default classes. Risk-adjusted capital indicates a maximum loss during a 12-month period with a confidence level of 99.97 per cent. Average capital tied up in the different default classes is illustrated in figure 36 below.

Figure 36: Risk-adjusted capital in the retail market portfolio by default class

For the combined retail market portfolio the risk-adjusted capital is estimated at 1.07 per cent of the loan exposure. Average risk-adjusted capital in default class A is 0.3 per cent, increasing to 8.6 per cent in default class I.

Since the risk-adjusted capital indicates the capital necessary to cover unexpected loss in a given confidence level, it means that this requirement for risk-adjusted capital increases with increasing probability of default. The fact that the capital tied up in a commitment shall be linked directly to its calculated risk is in accordance with the fundamental principle of the Group's risk management.
SpareBank 1 SR-Finans

SpareBank 1 SR-Finans has a greater share of marginal funding (vehicles, capital equipment, etc.) than is the case for the Group as a whole. This means that the inherent credit risk will generally be somewhat higher in SR-Finans than in the parent company.

In 2010 SpareBank 1 SR-Finans delivered the second best results in the history of the company. However, almost NOK 10 million was recognised as a loss in the 4th quarter of 2010 as a result of a significant review of unsecured commitments. The loan portfolio has been stable throughout the entire year and gross lending was NOK 5.1 billion at the end of the 4th quarter of 2010.

Defaults were greatly reduced in the 4th quarter of 2010 and ended up at 2.5 per cent for the corporate market and 1.8 per cent for the retail market. The portfolio volume and risk profile of the portfolio has not changed significantly in the 4th quarter of 2010.

There has been a particular focus on large commitments. The number of large commitments reported pursuant to the Regulations related to large commitments is eleven. No new large commitments have been included in the portfolio in the 4th quarter of 2010. At the present time, SpareBank 1 SR-Finans receives relief from SpareBank 1 SR-Bank for four of the large commitments.

Bond portfolio

The Group has two different portfolios consisting of bonds and commercial paper - the liquidity portfolio and trading portfolio, respectively. The respective portfolios are governed by separate management mandates.

The liquidity portfolio consists of interest-bearing papers that either satisfy the requirements for depositing with Norwegian Central Bank or have a term to maturity of less than 6 months. The size of the portfolio will at all times depend on the Group's balance sheet and thereby the need for liquid assets. At the end of the 4th quarter of 2010 the value of the combined liquidity portfolio totals NOK 18.2 billion. The volume of the portfolio has been increased by NOK 1.9 billion since the 3rd quarter of 2010.

In accordance with the Group's internal guidelines, the securities that do not satisfy the aforementioned requirements entail a special credit risk, and these are governed by special processing rules. At the end of the 4th quarter of 2010 the portfolio contains investments in a total of five different interest-bearing securities valued at NOK 136 million, which entail a special credit risk in accordance with the internal guidelines.

The trading portfolio consists of financially oriented investments in interest-bearing securities. The current limit for such investments is NOK 1,000 million. All investments in the trading portfolio that do not satisfy the criteria for uncommitted credit lines stipulated by the Board of Directors shall be subject to ordinary credit processing. At the end of the 4th quarter of 2010 the trading portfolio includes investments in 36 companies valued at NOK 510 million.

The Group has a separate risk model for calculating the risk-adjusted capital associated with the bond portfolios.

SpareBank 1 SR-Bank has no activities related to credit derivatives.
The table below provides a summary of SpareBank 1 SR-Bank's exposure to bonds in the different portfolios:

*Table 4: Securities exposure, bonds and securities (NOK million)*

<table>
<thead>
<tr>
<th>Sub-portfolio</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Treasury</strong></td>
<td>18,172</td>
</tr>
<tr>
<td>- Norwegian state/municipality</td>
<td>2,306</td>
</tr>
<tr>
<td>- Covered bonds</td>
<td>11,832</td>
</tr>
<tr>
<td>- Norwegian bank/finance</td>
<td>2,647</td>
</tr>
<tr>
<td>- Norwegian industry</td>
<td>124</td>
</tr>
<tr>
<td>- Foreign bank/finance</td>
<td>1,164</td>
</tr>
<tr>
<td>- Other</td>
<td>100</td>
</tr>
<tr>
<td><strong>Trading/sales</strong></td>
<td>510</td>
</tr>
<tr>
<td>- Norwegian bank/finance</td>
<td>180</td>
</tr>
<tr>
<td>- Foreign bank/finance</td>
<td>2</td>
</tr>
<tr>
<td>- Norwegian industry</td>
<td>323</td>
</tr>
<tr>
<td>- Other</td>
<td>5</td>
</tr>
</tbody>
</table>

4.2.5 Risk exposure, market risk

Interest rate risk

The Group's overall limits for interest rate risk define the maximum loss from a change in the interest rate of 1 percentage point. Total maximum loss shall not exceed NOK 30 million on the Norwegian krone balance positions in 2010 and within each maturity band (0-3 months, 3-6 months, 6-12 months, 1-2 years etc.) the maximum loss shall not exceed NOK 15 million. Maximum net loss related to interest rate risk on the foreign currency balance positions is NOK 8 million. No single currency may have an interest rate risk higher than NOK 5 million. The table shows the effect on earnings for a parallel shift in the yield curve of one percentage point (100 basis points) at the end of the last three years (figures in NOK million).

*Table 5: Effect on earnings of a parallel shift in the yield curve of one percentage point (NOK million)*

<table>
<thead>
<tr>
<th>Currency</th>
<th>2010</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOK balance sheet</td>
<td>18</td>
<td>14</td>
<td>30</td>
</tr>
<tr>
<td>Foreign currency balance sheet</td>
<td>-1</td>
<td>-1</td>
<td>3</td>
</tr>
<tr>
<td>Total</td>
<td>17</td>
<td>13</td>
<td>33</td>
</tr>
</tbody>
</table>

For the year 2011 the maximum net loss shall not exceed NOK 60 million in the balance sheet total. The following sub-limits will apply to the various maturity bands:
Table 6: Sub-limits within the different maturity bands

<table>
<thead>
<tr>
<th>Maturity bands</th>
<th>Limit of the effect of an interest rate change of 1% on the balance sheet</th>
<th>Maturity bands</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 – 3 months</td>
<td>NOK 50 million</td>
<td>0 – 3 months</td>
</tr>
<tr>
<td>3 – 6 months</td>
<td>NOK 50 million</td>
<td>3 – 6 months</td>
</tr>
<tr>
<td>6 – 9 months</td>
<td>NOK 40 million</td>
<td>6 – 9 months</td>
</tr>
<tr>
<td>9 months – 1 year</td>
<td>NOK 40 million</td>
<td>9 months – 1 year</td>
</tr>
<tr>
<td>Each year (1-10)</td>
<td>NOK 30 million</td>
<td>Each year (1-10)</td>
</tr>
<tr>
<td>10 years or more</td>
<td>NOK 30 million</td>
<td>10 years or more</td>
</tr>
</tbody>
</table>

Foreign currency risk

The Group has prepared limits for the net exposure to each individual currency, and limits for the aggregate net currency exposure. The overnight price risk for spot trading in foreign currencies shall not exceed NOK 100 million for each individual currency, and NOK 125 million in aggregate. The table shows the net foreign currency exposure including financial derivatives as defined by Norwegian Central Bank.

Table 7: Foreign currency exposure including financial derivatives (million)

<table>
<thead>
<tr>
<th>Foreign currency</th>
<th>2010</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR</td>
<td>22</td>
<td>5</td>
<td>23</td>
</tr>
<tr>
<td>USD</td>
<td>15</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>CHF</td>
<td>4</td>
<td>1</td>
<td>-7</td>
</tr>
<tr>
<td>GBP</td>
<td>26</td>
<td>-1</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>11</td>
<td>32</td>
<td>-46</td>
</tr>
<tr>
<td>Total</td>
<td>78</td>
<td>38</td>
<td>-28</td>
</tr>
</tbody>
</table>

Securities risk, shares

Shares, units and other equity interests are classified within the categories of fair value and available for sale. Securities that can be measured reliably and are reported internally at fair value are classified as fair value through profit and loss. Other shares are classified as available for sale.

The table below provides a summary of the Group’s shareholdings at the end of the last three years (figures in NOK million).

Table 8: Group’s shareholdings at the end of current year (NOK million)

<table>
<thead>
<tr>
<th></th>
<th>2010</th>
<th>2009</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value</td>
<td>657</td>
<td>437</td>
<td>402</td>
</tr>
<tr>
<td>- Listed shares</td>
<td>79</td>
<td>14</td>
<td>164</td>
</tr>
<tr>
<td>- Unlisted shares</td>
<td>578</td>
<td>423</td>
<td>238</td>
</tr>
<tr>
<td>Available for sale</td>
<td>4</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>- Listed shares</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>- Unlisted shares</td>
<td>4</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>
The above table shows that the Group’s total shareholding has increased overall compared with the last year. Shares in Nordito AS (previously Teller and BBS) have during the year been replaced by shares in the Danish PBS Holding, which in turn has been replaced by shares in Nets Holding AS. The combination of an increase in paid-in capital and a change in the market value totalled around NOK 69 million for the 4th quarter, and investment of around NOK 69 million have been made in Sandnes Sparebank in the same quarter. Last year SpareBank 1 SR-Bank invested NOK 129 million divided among SpareBank 1 SR-Fondsfvøltning’s three unlisted mutual funds. These mutual funds have increased in value by around NOK 20 million overall.

**Market risk - bonds and securities**

At the end of 2010, the Group’s holdings of liquid assets in the form of bonds that qualify for access to borrowing in Norwegian Central Bank (liquidity portfolio) compromise around NOK 18.1 billion. NOK 9.3 billion of these bonds are covered bonds used in the authorities' swap scheme. Of the liquidity portfolio's total holdings corresponding to NOK 18.2 billion, bonds classified as "held to maturity" account for NOK 10.8 billion. These investments are recognised at amortised cost and are therefore not exposed to market risk. The table below provides a summary of the portion of the bond portfolio that is exposed to market risk. The Portfolio totals NOK 7.4 billion.

**Table 9: Bond portfolio that is exposed to market risk (NOK million)**

<table>
<thead>
<tr>
<th>Sub-portfolio</th>
<th>Fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Treasury</strong></td>
<td>7,363</td>
</tr>
<tr>
<td>- Norwegian state/municipality</td>
<td>2,198</td>
</tr>
<tr>
<td>- Covered bonds</td>
<td>2,357</td>
</tr>
<tr>
<td>- Norwegian bank/finance</td>
<td>2,249</td>
</tr>
<tr>
<td>- Norwegian industry</td>
<td>124</td>
</tr>
<tr>
<td>- Foreign bank/finance</td>
<td>435</td>
</tr>
<tr>
<td><strong>Trading/sales</strong></td>
<td>505</td>
</tr>
<tr>
<td>- Norwegian bank/finance</td>
<td>180</td>
</tr>
<tr>
<td>- Foreign bank/finance</td>
<td>2</td>
</tr>
<tr>
<td>- Norwegian industry</td>
<td>323</td>
</tr>
</tbody>
</table>
4.2.6 Operational risk

New technology, automation of processes and increased specialisation in the various fields entails that the complexity in society is increasing. At the same time the external threat has changed from physical assaults against banks to the use of technology for the unlawful acquisition of assets and information.

A risk assessment is carried out annually with respect to the most important business areas/processes in the Group. The results show that the Group has satisfactory management and control of the operational risk. The risk assessment of the business areas/processes provides good information and a summary of any improvement areas, and measures are continuously implemented for the areas where improvement areas are identified.

The inherent risk of crime is increasing in society. In 2010 the Group has therefore had a special focus on implementing improvement measures with an aim to reduce the probability and any consequences of crime. This work will continue in 2011.

The Group's ICT security is considered to be good. The ICT routine is based on the "need-to-know" principle and duty of confidentiality. In the IT area a great deal of importance is attached to the protection of customer information and data from unauthorised individuals and maintenance of stable operations. The Group had an operational interruption in 2010 that resulted in some instability in the online banking access. An operational interruption resulted in online banking, ATMs, payment terminals in stores, system access to the office network and a number of other banking systems becoming unavailable. The network fault affected all of the SpareBank 1 banks and other banks that use EDB Business Partner AS's core solution. There is ongoing work with the Group's partners to ensure the best possible stability of the network operations.

In 2010 the external risk picture showed an increased trend of assaults against ATMs. The security code that Norwegian ATMs have been equipped with, which has functioned well for several years, was broken, and it is estimated that around 60 Norwegian ATMs were attacked and exposed to skimming (card copying). A Supreme Court Judgment from October 2010 stated that there were no restrictions against bringing skimming equipment, advanced equipment for copying Norwegian bank cards, into Norway. However, after this judgment, a quick legislative amendment was performed, and in December 2010 the legislative amendment that ensures a ban against the import of skimming equipment into Norway was introduced.

Experience shows that the operational risk is often a contributing cause of the losses that are incurred in the lending area. For example, losses are incurred as a result of a lack of response from the bank on negative incidents with customers. This means that the banks become involved in the credit protection process later than they would have otherwise, and thus incur higher losses as a result of this. Another reason can be that the collateral value is registered incorrectly. Furthermore, all losses as a result of economic crime related to the lending area are considered to be an operational risk. In the accounts, however, these losses are reported as ordinary losses on loans with banks.

SpareBank 1 SR-Bank evaluates all significant losses from the lending area against possible operational risk, and tries in this context to continuously improve competence and processes in areas where losses from operational risk occur.

Reporting of undesired incidents

All significant undesired incidents shall be reported in the Group's database for the reporting and follow-up of such incidents. An ongoing effort is being made to improve the reporting systems and reporting culture in order to identify as many incidents as possible.

Figure 37 below shows how the Group's reported undesired incidents are distributed within the Basel categories for the period 2009 – 2010.
In 2010 there has been active work with regards to describing processes and structuring of the routines, and that the routines have been made electronically available. In addition, certification of advisors via the authorisation scheme for financial advisors and the authorisation scheme for insurance and the Group's general focus on the development of competence, have been of importance to reducing the degree of severity for the registered incidents. The increase in the number of incidences in certain categories can be assumed to be connected to an increased customer base and more registered incidents.

The focus must still be on developing an even better reporting culture. With good reporting of undesired incidents the organisation can extract good knowledge and experience, and thus safeguard continuous improvement to the benefit of the employees and the Group.

Measures have been implemented to increase the focus on incident registration with regard to the number of incidents and the quality of the incidents that are registered. The existing database for the registration of incidents is not optimal for SpareBank 1 SR-Bank's requirements, and requirement specifications for a new database for reporting incidents are under preparation. Establishing a good reporting module will help provide a better and broader learning effect for the organisation.

Figure 37: Distribution of reported undesired incidents for the period 2009 - 2010
### 4.2.7 Funding risk

In 2010 the Group issued a net amount of NOK 9.5 billion in bonds with maturity dates from 2012 to 2020. At the same time loans corresponding to approximately NOK 1.8 billion have been redeemed. The redemptions apply primarily to loans with short terms to maturity. In addition, the Group has acquired NOK 3.3 billion in liquidity through the transfer of home mortgage loans to SpareBank 1 Boligkreditt and business loans to SpareBank 1 Næringskreditt. Net funding, including transfers to SpareBank 1 Boligkreditt and SpareBank 1 Næringskreditt, totalled NOK 10.7 billion in 2010.

The unrest in the financial markets has affected the Group’s access to liquidity also in 2010. The Group finds that the confidence and willingness to invest is good both nationally and internationally, but the price the investors demand is still at a historically high level. For the first time since the beginning of the financial crisis SpareBank 1 SR-Bank has issued unsecured senior loans in the European market. In 2010 the Group issued two bonds in the European market, both with a nominal value of EUR 500 million.

As an issuer of specially secured bonds (covered bonds), SpareBank 1 Boligkreditt contributes to reducing the Group’s funding risk. The transferred balance comprises around 20 per cent of the Group’s total lending balance. In the 4th quarter of 2010 around NOK 300 million was transferred to SpareBank 1 Næringskreditt. It is therefore expected that the transfer of loans with a mortgage on commercial property to SpareBank 1 Næringskreditt will contribute to reducing the Group’s funding risk.
Customer deposits are the most important source of financing for the Group. For the Group as a whole the volume of deposits increased from NOK 6.4 billion (11.8 per cent) in 2010. During the same period the Group’s lending excluding home mortgage and commercial credit has increased by NOK 12.3 billion (13.2 per cent). This means that the deposit coverage has decreased somewhat from 58.1 per cent to 57.4 per cent. The deposit coverage is still able to meet the target with regard to the Group’s liquidity strategy guidelines that specify a target of maintaining the deposit coverage at a minimum of 55 per cent.

At the end of the 4th quarter of 2010, the Group had surplus liquidity in the form of deposits in Norwegian Central Bank and short-term investments in banks and credit institutions corresponding to NOK 1.3 billion. The Group’s buffer capital, in the form of liquid assets, totals NOK 17.6 billion. By the end of next year, debt corresponding to NOK 9.1 billion is to be refinanced, NOK 1.0 billion of which are F loans from Norwegian Central Bank.

The net refinancing requirement, excluding the F loans, is thus NOK 8.1 billion. The figure below illustrates the maturity structure for the funding portfolio excluding the F loans as of the 4th quarter of 2010.

*Figure 39: The funding portfolio's maturity structure, excluding F-loans, as of 31 December 2010*

A sensitivity analysis that measures the Group’s ability to survive in the event of closed capital markets is prepared on a monthly basis. The primary objective of the analysis is to measure whether the funding risk is in accordance with the definition of targets for liquidity management, which specify that SpareBank 1 SR-Bank must be able to survive for a minimum 12 months without external access to liquidity in a normal situation. The analysis is based on different scenarios. In the basis scenario the growth in net funding requirements is set at zero, i.e. the relationship between deposits and loans are kept constant. Other scenarios project the liquidity situation based on the fact that the growth in the net funding requirements are in accordance with the budgeted growth figures or follow the 12-month trend growth rate.
The figure below illustrates a sensitivity analysis as of 31 December 2010, which is based on the basis scenario:

*Figure 40: Sensitivity analysis of the funding risk*

In the scenario above, the Group's liquidity buffer, which is NOK 21.7 billion as of the 4th quarter of 2010, ensures that the Group can survive until September 2013. The liquidity buffer consists of cash, short-term deposits, drawing rights in Norwegian Central Bank and home mortgage loans ready to be transferred to SpareBank 1 Boligkreditt AS.

4.2.8 Ownership risk

The ownership risk varies from company to company depending on the company's operations and the inherent risk, as well as SpareBank 1 SR-Bank's ownership interest.

At the end of the 4th quarter of 2010 SpareBank 1 SR-Bank has ownership interests through ownership in the SpareBank 1 Group (19.5 per cent), BN Bank ASA (23.5 per cent), and SpareBank 1 Næringskreditt AS (24.1 per cent).

SpareBank 1 Group is owned by SpareBank 1 SR-Bank (19.5 per cent), SpareBank 1 Nord-Norge (19.5 per cent), SpareBank 1 SMN (19.5 per cent), SpareBank Hedmark (12 per cent), Samarbeidende Sparebanker AS (19.5 per cent), and the Norwegian Federation of Trade Unions (LO) and affiliated unions (10 per cent).

SpareBank 1 Gruppen AS owns 100 per cent of the shares in SpareBank 1 Livsforsikring, SpareBank 1 Skadeforsikring AS, ODIN Forvaltning AS, SpareBank 1 Medlemskort AS and SpareBank 1 Gruppen Finans Holding AS, as well as 75 per cent of the shares in Argo Securities AS. SpareBank 1 Gruppen Finans Holding AS owns SpareBank 1 Factoring (100 per cent), Actor Fordringsforvaltning (100 per cent), Actor Portefolje (100 per cent) and Actor Verdigjenvinning (100 per cent). SpareBank 1 Gruppen AS also has an interest in SpareBank 1 Utvikling DA.

The SpareBank 1 Group also has 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 at
three Centres of Expertise – Training (Tromsø), Payment Services (Trondheim), and Credit Control (Stavanger).

Of the companies owned by SpareBank 1 Group, the ownership of SpareBank 1 Livsforsikring is considered to have the highest ownership 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 has its head office in Trondheim and an office for commercial property in Oslo. BN Bank ASA services customers in the entire country by online banking and over the phone. BN Bank ASA is owned by the SpareBank 1 banks and offers a broad range of banking services to businesses and private customers. The bank's operations are based on traditional banking operations aimed at home mortgage loans in the retail market and commercial property. SpareBank 1 SR-Bank's ownership risk consists primarily of the underlying credit risk in this company.

In SpareBank 1 Næringskreditt's portfolio there is only lending to commercial properties with leases in central locations. Lending cannot make up more than 60 per cent of the total market value. SpareBank 1 SR-Bank's ownership risk consists primarily of the underlying credit risk in this company.

As of the 4th quarter SpareBank 1 SR-Bank owns 28.6 per cent of the shares in SpareBank 1 Boligkreditt AS. The company's operations include the financing of loans to retail customers with security within 75 per cent of the basic value of real property. At the end of the 4th quarter of 2010 SpareBank 1 SR-Bank had transferred NOK 30.5 billion (EAD) to the company. The ownership risk corresponds primarily to the share of the transferred portfolio, and the risk is thus followed up and reported as credit risk.

### 4.2.9 Commercial risk

Analysis of the Group’s income and cost structure in relation to economic cycles shows that the greatest volatility is in the Group's capital gains from equity investments and bonds, earnings from the savings areas and commission income from real estate brokering. A decline in income is compensated for in part by means of cost reductions.

The Group has developed a well-diversified revenue base over a long period of time, and this means that any reduction in the individual product groups or customer segments will not have significant consequences over time.

### 4.2.10 Reputation risk

No specific investigations were made in 2010 to measure the Group's position with regard to its reputation. This was based on the fact the Group had consistently scored better in customer satisfaction measurements in 2010 than in previous years. Together with a significant customer recruitment of 9,000 customers in 2010 (excluding the merger with Kvinnherad Sparebank) and very few negative and critical media incidents, the conclusion is that the Group's reputation has not been weakened in 2010.

In general, the measures that are continuously utilised to uncover the Group's reputation are considered satisfactory. The Group's reputation is still good, which means that the risk picture is comfortable. Various small incidents in 2010 have been handled in accordance with the guidelines and routines.
4.2.11 Strategic risk

The Group's strategic direction towards 2013 will be marked by a focus on customer growth and balanced growth in lending greater than the market growth. The project "a possible conversion to a limited savings bank" is an important catalyst for access to capital. A strengthened deposit coverage and good access to capital at competitive terms are important prerequisites for growth.

In order to maintain the Group's position and ambition to be among the most profitable financial groups in the Nordic region and at the same time be competitive in the market, succeeding with a major cost shift through the improvement of processes and systems will be required.

Focusing on a further strengthening of the value chain and other business opportunities will be important to achieve greater breadth in the operations and thereby improve profitability.

4.2.12 Compliance risk

The EU's goal-oriented effort to completely harmonise the regulations in the EU/EEA area continuously entails new directives and regulations that SparBank 1 SR-Bank must adapt to.

The most important follow-up areas have been and/or are in the:

- Implementation of new money laundering regulations
- Ensuring good compliance with the Securities Trading Act (MiFID)
- Adaptations in accordance with the clarification of licences for handling personal information granted by the Data Inspectorate
- Implementation and adaptation of sound recordings as a result of amended regulations in Chapter VIII Sound Recordings of the Securities Trading Regulations, which will apply from 1 January 2011
- Implementation and adaptation of the "Regulations relating to remuneration schemes in the financial sector"
- Implementation and adaptation of new capital regulations for banks etc., Regulations relating to the calculation of regulatory capital, limits for major commitments and liquidity management

The Group's compliance policy shall ensure that the laws, regulations, standards and recommendations that regulate the operations and have been stipulated by government bodies etc. are implemented and complied with on an ongoing basis.

4.3 Stress test

The stress scenario is based on an imagined situation with a negative development in the Norwegian economy for the coming years.
The purpose of a stress test is to:

- Evaluate the potential loss situation based on different economic situations, including major, but credible shocks.
- Evaluate the vulnerability of portfolios/activities with respect to major, but credible shocks.
- Increase the understanding of how shocks affect the Group's profitability, liquidity situation and capital adequacy.
- Evaluate the potential loss situation based on different strategic opportunities.
- Identify weaknesses in the Group's risk strategies and processes to help develop risk-reducing measures and prepare contingency plans.

In order to evaluate the consequences of a stress test for SpareBank 1 SR-Bank, the Group focuses to a great extent on the areas of the economy that affect the financial development. This is primarily the development in the demand for credit, the stock market, interest rate market and the development of credit risk. In addition to having consequences for the return on the underlying assets, an economic backlash will also have consequences for the customers' savings behaviour.

The stress scenario is built on an imagined situation with a negative development in the Norwegian economy for the years 2011-2013 as described in the Financial Supervisory Authority of Norway's common macroeconomic stress test of 15 October 2010. The stress test will be carried out as a joint project by Norwegian Central Bank and the Financial Supervisory Authority of Norway. SpareBank 1 SR-Bank does not make any geographic adaptations to the variables. The following year 2014 has been prepared by SpareBank 1 SR-Bank.

In the imagined stress scenario from the Financial Supervisory Authority of Norway it is presupposed that the growth in the GDP will be very low in the coming years. The growth is significantly lower than the potential growth. This means that the production gap decreases and the production gap becomes just as low as in the early 1990s. This entails that the real economic costs of the stress scenario must be seen as very large, which results in significant stress on the profitability of the corporate sector.

Unemployment increases to 3.5 per cent in 2013. This is around half of what unemployment was early in the 1990s in Norway. An interpretation of this is that the low growth in GDP does not result in any dramatic outcomes for the unemployment in the Norwegian workforce, but will impact the foreign workforce in Norway to a greater extent.

Lower demand entails that inflation decreases significantly and falls below the inflation goal of 2.5 per cent. This means that Norwegian Central Bank tries to stimulate demand by means of lower interest rates.

Wage inflation decreases in the stress scenario, but nevertheless stays at a relatively high level. The relatively high wage inflation, in combination with low interest rates and moderate unemployment has a limited effect on household defaults. Due to the increased uncertainty of the economy the households are cautious about investing in new homes. In the stress scenario the house prices fall just under 15 per cent in the years 2011 to 2012, and then increase slightly in the last two years of the period by 2.4 per cent and 4.0 per cent, respectively. The fall in house prices and lower demand for houses results in weak growth of the lending volumes for the retail market. However, the relatively high wage inflation gives cost growth in the corporate market.

Due to the increase in government debts and the international financial sector the mark-up in international money markets increases in the stress scenario. This affects the Norwegian money market rates. Since the key rates abroad and at home are already low the monetary policies have limited room to compensate for the increased mark-up. Furthermore, lower demand abroad will result
in a fall in oil prices to around USD 50. Lower energy prices result in a postponement of projects and development applications.

The securities market falls in the stress scenario by 20 per cent in 2011, and subsequently increases by 5 and 7 per cent, respectively, each year thereafter. It is assumed that the foreign stock markets will follow the same market development.

On the assumption that there is a negative development in the Norwegian economy, the development of the central macroeconomic variables in the stress scenario will be as follows:

Table 10: Macro variables - Stress scenario

<table>
<thead>
<tr>
<th>Macro variables</th>
<th>2011  (Stress scenario)</th>
<th>2012  (Stress scenario)</th>
<th>2013  (Stress scenario)</th>
<th>20143 (Stress scenario)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment for the entire country</td>
<td>3.0%</td>
<td>3.4%</td>
<td>3.5%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Inflation</td>
<td>0.7%</td>
<td>1.2%</td>
<td>1.5%</td>
<td>2.0%</td>
</tr>
<tr>
<td>GDP growth for mainland Norway</td>
<td>-0.2%</td>
<td>1.7%</td>
<td>2.3%</td>
<td>2.8%</td>
</tr>
<tr>
<td>House prices / Commercial property prices</td>
<td>-10.0%</td>
<td>-4.1%</td>
<td>2.4%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Disposable household real income</td>
<td>1.0%</td>
<td>2.4%</td>
<td>1.6%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Oil price USD</td>
<td>50.0</td>
<td>50.0</td>
<td>52.0</td>
<td>60.0</td>
</tr>
<tr>
<td>Three-month money market rate (NIBOR)</td>
<td>2.5%</td>
<td>2.0%</td>
<td>2.0%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Development of the securities market</td>
<td>-20.0%</td>
<td>5.0%</td>
<td>5.0%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Development of the lending volume RM</td>
<td>3.7%</td>
<td>2.6%</td>
<td>2.3%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Development of the lending volume CM</td>
<td>-1.5%</td>
<td>0.0%</td>
<td>0.4%</td>
<td>0.4%</td>
</tr>
</tbody>
</table>

SpareBank 1 SR-Bank has assumed its own values based on the stress scenario for variables such as lending/deposit margins and growth in deposits, since these are not stated in the stress scenario described by the Financial Supervisory Authority of Norway.

The following paragraphs show the projected results for the stress scenario.

Credit risk

Figure 41 shows the assumed development of the IRB default rate for the corporate market and retail market broken down by mortgage loan customers and other customers in a stress scenario as described above. The IRB default rate is the number of customers that will default over the course of a 12-month period. Customers with smaller loan commitments carry the same weight as customers with large loan commitments. Customers with smaller loan commitments have historically been overrepresented in commitments in default.

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3 Norwegian Central Bank stress alternative involves the years 2011-2013. The following year 2014 has been prepared by SpareBank 1 SR-Bank.
The figure shows that in a stress scenario as described above, the IRB default rate for corporate customers could increase from 2.5 per cent in 2010 to 4.5 per cent in 2011, and then subsequently fall to 2.5 per cent. In 2008 the IRB default rate was 1.7 per cent.

The IRB default rate for mortgage loan customers could increase from 0.36 per cent in 2010 to 0.7 per cent in 2012, and subsequently fall back again to a default rate before the downturn. In 2008 the IRB default rate was 0.3 per cent. The IRB default rate for retail customers could increase from 2.9 per cent in 2010 to 4.0 per cent in 2012, and subsequently fall back again to the default rate prior to the downturn. In 2008 the IRB default rate was 2.4 per cent.

In the figure below an estimate is given of the accounting losses in a stress scenario as described earlier in this section. The losses are shown in NOK million and as a percentage of gross lending. 

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4 Includes portfolio transferred to SpareBank 1 Boligkreditt AS
Figure 42: Loss in NOK million and as a percentage of gross lending

The calculations show that the losses for the Group could increase from NOK 234 million in 2010 (0.19 per cent of gross lending, including SpareBank 1 Boligkreditt) to NOK 668 million in 2011 (0.51 per cent of gross lending). As a comparison, the loss in 2007 was NOK 10 million (0.01 per cent of gross lending, including SpareBank 1 Boligkreditt).

The Group wishes to emphasise that there is uncertainty in the above calculations as a result that the losses on individual customers could affect the losses unsystematically during an economic downturn.

The losses from the retail market are lower throughout the entire period, but may reach a peak in 2012. The losses as a percentage of gross lending could increase from 0.05 per cent in 2011 to 0.06 per cent in 2012. The actual losses in the retail market amounted to 0.01 per cent in 2010. In the calculation of losses in the retail market it is presupposed that any defaulted loans in SpareBank 1 Boligkreditt AS that were previously transferred from SpareBank 1 SR-Bank will be transferred back for default follow-up and possible recognition of loss in the bank. The losses from loans transferred back from SpareBank 1 Boligkreditt AS are marginal.

The relatively low losses in the retail market throughout the period are reflected in the Group's solid portfolio that primarily consists of lending with a mortgage on real property. As of the 4th quarter of 2010, 94 per cent of the loan exposure is secured within 75 per cent of the market value of real property. In the stress scenario the market value of housing is assumed to fall by 14 per cent overall in 2011 and 2012, before the prices rise again by 2.4 per cent and 4.0 per cent in the following years.

The above calculations show that the main portion of the losses will likely arise in the corporate market.

**Market risk**

Figure 43 below shows that in a stress scenario as described above, the Group could incur a loss of NOK 94 million on equity investments during the stress period's first year. The stress scenario presupposes that no realisations or reinvestments are made during the four-year period. The equity investments that were valued at NOK 661 million at the beginning of 2011 would therefore be valued at NOK 567 million at the end of 2012. The rising stock market during the period from 2013 to 2014
contributes to the Group recouping NOK 80 million of the losses. During the period from 2013 to 2014 the value of the equity investments will increase to NOK 636 million, which is an increase of NOK 69 million from the bottom at the end of 2011.

Figure 43: Stress test of equity investments

Core capital adequacy ratio

It is uncertain what the final capital adequacy regulations (Basel III) will be for the coming years. There is also uncertainty regarding the phasing out of the IRB transitional rules that were introduced in connection with Basel II. According to the Capital Adequacy Regulations the IRB calculation basis in 2011 shall not be lower than 80 per cent of the minimum requirement calculated using the old capital adequacy regulations (Basel I). The transitional rule was to be phased out initially at the end of 2009, but was extended to the end of 2011. In addition, the LGD for mass market commitments with a mortgage on residential property will be adjusted upwards, by a common factor, if this is necessary in order to achieve an EAD-weighted average LGD of at least 10 per cent. This transitional rule will continue until the end of 2012.

In the calculation of the projected core capital adequacy ratio in the stress scenario it is presupposed that the transitional rules will be phased out in accordance with the current regulations. SpareBank 1 SR-Bank also takes into account the planned Basel III effect where all deductions shall take place in the core capital. In addition, SpareBank 1 SR-Bank presupposes that the hybrid tier 1 securities that fall due during the period will be replaced with new hybrid tier 1 securities of at least a corresponding quality.

The stress scenario shows that the core capital adequacy ratio will increase from 10.2 per cent in 2010 to 10.9 per cent at the end of 2014. The improvement in the core capital adequacy ratio is due primarily to the planned phasing out of the transitional rules. The removal of the transitional "80 per cent floor" rule gives a positive effect of around 0.8 per cent and the elimination of the minimum LGD mass market transitional rule will have a positive effect of around 0.4 per cent. In addition, in a stress
scenario with low lending growth and positive earnings throughout the entire period will strengthen the equity, which will have a positive effect on the core capital adequacy ratio.

![Figure 44: Development of the core capital adequacy ratio with the transitional rule up to and including 2011](image)

**Risk-adjusted capital**

Calculations have also been made for the Group's total risk-adjusted capital (Pillar 2) requirements in the stress scenario. While the minimum regulatory capital requirement only takes credit, market and operational risk into consideration, the risk-adjusted capital also takes into consideration all other important risks in the Group. The point of departure for the calculations is a confidence level of 99.97 per cent for creditor protection.  

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5 The confidence level for ownership risk in SpareBank 1 Group will be maintained at 99.5 per cent
The need for risk-adjusted capital increases by around NOK 700 million (9 per cent) during the period from 2011 to 2014. This increase is primarily due to increased capital requirements in order to cover the development of the credit risk as a result of the weakened credit quality and weak lending growth during the period.

The projection shows that SpareBank 1 SR-Bank’s buffer capital increases from NOK 2.4 billion to NOK 3.2 billion during the period from 2011 to 2014 in the stress scenario. This is primarily due to the fact that the core capital was strengthened by the retained earnings. There are relatively low losses when the economic situation is taken into account. The retained earnings for the period are greater than the requirement for increased risk-adjusted capital.

SpareBank 1 SR-Bank presupposes that the hybrid tier 1 securities that fall due during the period will be replaced with new hybrid tier 1 securities with at least a corresponding quality.

**Liquidity situation**

In the stress scenario low net lending growth is assumed for both the retail and corporate markets. Furthermore, a relatively stable development of the volume of deposits is also assumed throughout the entire period. Experience from the financial crisis of recent years indicates that the volume of deposits is in general a very stable funding source.

Another assumption in the stress scenario is the fact that SpareBank 1 SR-Bank will be affected by the situation in the same way as other players in the market.

The Group’s funding strategy indicates that in a normal situation the Group should be able to survive for a minimum of twelve months without external access to capital. In the figure below SpareBank 1 SR-Bank illustrates its tolerance for the loss of access to capital measured against the aforementioned twelve-month limit. The liquidity forecast is based on the surplus liquidity, available buffer capital and

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6 Difference between risk-adjusted capital and equity, including hybrid tier 1 securities.
existing maturity for funding as of 31 December 2010. The analysis takes into consideration the increase in or reduction of the funding requirement that could arise as a result of an economic downturn.

Figure 46: Sensitivity analysis of the funding risk

The funding forecast represents a simulation of the Group's liquidity situation in a stress scenario provided there is an absence of external access to capital. In the given stress scenario SpareBank 1 SR-Bank could survive for 25 months until February 2013 without any external access to capital. The survival ability is reduced in the stress scenario compared with the zero growth scenario, cf. figure 40.
4.4 Framework for management and control

4.4.1 Description of the framework for management and control

In order to ensure an efficient and appropriate process for risk and capital management, the framework established is based on a number of elements that reflect the way in which the Board of Directors and management control the Group. The main elements are described in figure 47.

Figure 47: Main elements of SpareBank 1 SR-Bank's risk and capital adequacy assessment process

The next paragraphs will describe the various elements in more detail.

4.4.2 Strategic target for the Group

The framework for management and control are based on the Group's strategic target in effect at any given time. The strategic target is described in Section 1.2.

4.4.3 Risk identification and analysis

The risk identification process is based on the Group’s strategic target. The process is forward-looking and covers all significant risk areas. Thorough analyses are carried out of the risk identified in order to understand the risk characteristics and to assess the impact of the established control and management measures. For those areas where the impact of the established control and management measures do not appear satisfactory, new improvement measures will be implemented. Alternatively, it will be assessed whether the activity should be eliminated. Measures that reduce probability take precedence over measures that reduce the consequences.

4.4.4 Capital allocation

Allocation of risk capital to the individual business areas is an important tool to strengthen the risk profile and activity of the individual business unit. The risk capital is defined as the Group's recognised equity with the addition of hybrid tier 1 securities.
The business units apply to the Board of Directors for risk capital annually, and the Board of Directors allocates the capital to the business areas based on the calculated risk in the business area, expected risk-adjusted return and strategic target.

Risk-adjusted return and utilisation of the limits for the allocated risk capital is monitored on a monthly basis.

4.4.5 Financial projections and stress testing

Two financial projections are performed at least once a year:

- A financial projection of the expected development
- A financial projection of a situation in an economic downturn (stress test)

Financial projection of expected development

Based on the strategic target, business plan and expected development of the macroeconomic situation, a projection of the financial development for the next five years is prepared. The objective of the projection is to provide an important contribution to the strategy process on how the macroeconomic situation and the strategic target affects the Group's financial performance measured by the return on equity, funding situation and capital adequacy, among others.

Financial projection of a situation in an economic downturn (stress test)

The purpose of a financial projection of an economic downturn is to:

- Evaluate the potential loss situation based on different economic situations, including major, but credible shocks.
- Evaluate the vulnerability of portfolios/activities with respect to major, but credible shocks.
- Increase the understanding of how shocks affect the Group's profitability, liquidity situation and capital adequacy.
- Evaluate the potential loss situation based on different strategic opportunities.
- Identify weaknesses in the Group's risk strategies and processes to help develop risk-reducing measures and prepare contingency plans.

In order to evaluate the consequences of an economic downturn for SpareBank 1 SR-Bank the Group focuses to a great extent on the areas of the economy that affect the financial development. This is primarily the development in the demand for credit, the stock market, interest rate market and the development of credit risk. In addition to having consequences for the return on the underlying assets, an economic backlash will also have consequences for the customers' savings behaviour.

4.4.6 Evaluation and measures

The aforementioned financial projections provide the administration and Board of Directors with a good understanding of the risks so that the correct strategic choices can be made, and at the same time ensure a satisfactory risk profile.

Based on the analyses, SpareBank 1 SR-Bank prepares funding plans for achieving long-term and efficient capital management and ensuring that the Group has sound capital adequacy based on the risk exposure and strategic target.
In addition, SpareBank 1 SR-Bank has compiled contingency plans in order to be able to handle crises to the greatest possible extent in the event they should nevertheless arise. The Group's contingency plans cover:

- Capital adequacy
- Funding risk
- Operational risk

4.4.7 Reporting and follow-up

The Group's risk reporting and follow-up is an integral part of the Group's corporate governance and reporting to the Board of Directors.

General risk monitoring and reporting is performed by the Risk Management and Compliance Department which is organised independently of the business units. The department reports directly to the CEO.

4.4.8 Organisation and organisational structure

Organisational culture

SpareBank 1 and SR-Bank aim to maintain a strong and healthy organisational culture characterised by a high level of awareness of risk management. It can be difficult to compensate for an unhealthy organisational culture by other control and management measures. The organisational culture comprises management philosophy and human resources in the organisation, with individual qualities such as integrity, core values and ethical attitudes.

SpareBank 1 SR-Bank has established clearly defined core values that are clearly communicated and made known throughout the entire organisation.

"Courage to speak your mind, strength to create"

By being

- able to view things in a long-term perspective
- open and sincere

By showing

- responsibility and respect
- a will and an ability to improve

SpareBank 1 SR-Bank shall attract, develop and challenge the most capable employees. SpareBank 1 SR-Bank has existed for 170 years, and in the last 15 years the Group has created top class value and generated first rate earnings in the Nordic region. An important explanation of SpareBank 1 SR-Bank’s success is a clear and long-term focus on values and attitudes as the pillars of the organisational structure.

The human capital is the actual backbone of the Group. Without competent employees the Group would have no product to offer to the market. The Group believes that the value creation for our customers, owners and employees will take place by having clear performance targets and a broad level of activity that is created by competent employees with good attitudes and values.
By developing a value-based culture this can result in a strategic tool that can result in a competitive advantage over time. Four factors have been prepared below that illustrate how the Group systematically works to create a healthy organisational culture at all levels in the organisation by means of recruitment, competence development, reward systems, employee satisfaction and a good reputation.

Focus on ethics and values in the recruitment process

SpareBank 1 SR-Bank is an attractive employer. A long and qualitatively good process takes place before being employed by the Group. Most positions are advertised both internally and externally. Good routines and employment procedures have been established to ensure against hiring the wrong persons. In addition to thorough interviews, various tests and recruitment methods that focus on job motivation, the right competence and last, but not least, good attitudes and ethics are used. Before an employment contract is offered the individual's credit rating is checked, and a police certificate of good conduct and feedback from a minimum of two references are obtained. After acceptance, a declaration of non-disclosure and comprehension/compliance with the ethical guidelines is obtained.

Group instruction in the Group's history, business concept, strategic target and thorough training in security and ethics is carried out for all new employees. At these gatherings the CEO and part of group management always participate in order to anchor the content. An Ethics Council was established in 2009 that will be an advisory body for practical training and implementation of the Group's ethical guidelines, as well as an advisory body for product development and innovation.

Competence development for managers and employees

SpareBank 1 SR-Bank defines competence as "Knowledge, Skills and Attitudes". Knowledge means the education and experience the individual person has acquired, skill is the manner in which the individual uses this knowledge and attitude reflects the individual's values and day-to-day conduct. A bachelor's degree is set as a minimum requirement for a formal education for new recruits. For the Group's advisors, who comprise 2/3 of the human capital, internal advisor schools have been established.

The advisor school is mandatory for everyone who interfaces with customers. The advisor school focuses on good advice, the best customer processes, ethics and attitudes for the Group's advisory services. For employees and managers who have undergone a new certification scheme ethics is one of the six subjects in the theoretical part. In the practical examination, which is the actual foundation for completion of the certification, ethics and advisory services make up half of the test.

Reward systems

The Group has a reward strategy that primarily emphasises good team achievements and a long-term focus in relation to remuneration. The reward strategy primarily consists of three elements, a fixed salary, bonus and other benefits such as pension and insurance schemes, reimbursement of studies, subsidised loans, health and well-being measures.

Five criteria have been defined for what should be rewarded on an individual basis. These criteria include effort/performance, customer orientation, quality, competence and the ability/willingness to cooperate.

A bonus is paid annually provided the Group's general goals have been met. The basis for the bonus is primarily team results, but with a possibility for an individual bonus that is assumed to cover 20-25 per cent of the best achievements in the Group. A main principle in the Group's bonus scheme is that the maximum bonus amount is set at 25 per cent of the fixed salary and that the bonus amount can be reduced if the quality of the work performed does not meet the quality standards of the Group. In this way the Group wishes to avoid that employees and managers make short-term decisions or poor credit decisions motivated by external motivation and rewards.
Employee satisfaction, ethics and reputation

SpareBank 1 SR-Bank finds it to be very important that the Group has employees who comply with the established core values and the ethical guidelines.

The most important in a value-based culture is openness and trust between the management and employees. Trust is not something that is decided, but something that is achieved through conduct. A compulsory two-day course is arranged for all new managers, where ethics and values are important topics that are discussed. Management training emphasises that the manager has a responsibility to set a good example for desired conduct.

The Group's four-monthly employee evaluations indicate a high degree of satisfaction and a good score on the questions concerning attitudes and values. The hypothesis is that a good working environment influenced by openness and trust is preventative for the development of poor attitudes and actions that can harm a good culture and good reputation. Results from employee evaluations are reviewed and discussed by the group management, by the Board of Directors, and by the Audit Committee at least twice a year, with a great deal of openness.

Organisation

SpareBank 1 SR-Bank focuses on independence in management and control, and responsibility for risk management is distributed between various roles within the organisation:

The Supervisory Board's main task is to monitor the Board of Directors' management of the company. The Board of Directors has the overall responsibility for the management and organisation of the Group in accordance with laws, statutes and regulations. The Board of Directors is responsible for safe and prudent management of all the funds controlled by the Group. It follows from this that the Board of Directors also has a duty to ensure that the accounting and asset management are subjected to proper scrutiny. The board members shall exercise due care in executing their responsibilities and duties.

The Board of Directors is responsible for ensuring that the Group has regulatory capital that is adequate based on the adopted risk profile and requirements imposed by the authorities. The Group’s Board of Directors adopts the principal goals such as the risk profile, hurdle rates and distribution of capital to the different business units. The Board of Directors also determines the overall framework, authorities and guidelines for risk management within the Group. The Board of Directors has adopted an ethical code that helps raise awareness and ensure compliance with the ethical standards adopted by the Group.

With respect to resolutions by the bank's Board of Directors, the boards of the subsidiaries fulfil their duties in the individual companies. An attempt shall be made to have a composition of the Board of Directors in companies that are wholly-owned by SpareBank 1 SR-Bank that ensure good knowledge of the industry and good integration with the individual company's activities and associated business areas in SpareBank 1 SR-Bank. The Board Chairman of the individual companies is the member of group management who has the largest interface between day-to-day business area and the subsidiaries' business areas. Based on this principle, important factors are safeguarded with regard to the Group's combined strategy and optimisation through the value chain.

In some companies up to 40 per cent of the board members are external representatives. This is evaluated from company to company with regard to balancing between the need for external industry competence/ideas, versus internal employees who have good knowledge of the Group's combined activities.
The Board of Directors has established a Compensation Committee and an Audit Committee. The committees shall assist the Board of Directors in preparing cases, but the decision shall be made jointly by the Board of Directors.

Audit Committee: The Audit Committee shall assist the Board of Directors in carrying out its control tasks and propose measures with regard to the bank's framework for management and control of risk and financial reporting. Instructions for the committees are defined by the Board of Directors.

Compensation Committee: The Compensation Committee shall keep itself informed about the guidelines and remuneration for the Group's senior executives and assist the Board of Directors in preparing the remuneration scheme for the CEO.

The CEO is responsible for the day-to-day management of the Group's activities in step with the laws, by-laws, powers of attorney and instructions. Matters that are of an unusual nature or of great importance to the Group shall be submitted to the Board. The CEO can, however, settle a matter if so authorised by the Board of Directors or a matter when waiting for a decision by the Board of Directors would be significantly detrimental to the company. The CEO shall implement the Group's strategy and develop the strategy further, in cooperation with the Board of Directors. The CEO advises the Board of Directors on the Group's operations, position and earnings performance every month.

The managers of the business areas and support units are responsible for the day-to-day risk management within their area of responsibility and shall continuously ensure that risk management and risk exposure comply with the framework and main control principles adopted by the Board of Directors or CEO.

The Risk Management and Compliance Department is organised independently of the business units and reports directly to the CEO. The department is responsible for further development of the framework for risk management, including risk models and risk management systems. The Department of Risk Management and Compliance is also responsible for independent monitoring and reporting of risk situation and for ensuring compliance by the Group with applicable laws and regulations. In addition to an executive vice president, the department consists of three risk managers and four risk analysts. The capacity of the credit risk department has been strengthened in 2010, while the capacity in the areas operational risk and compliance will be strengthened during the 1st quarter of 2011.

The department works closely with SpareBank 1 SR-Bank's Centre of Expertise for Credit Models, which is located within SpareBank 1 SR-Bank. The Centre of Expertise is responsible for developing and quality assuring credit models in line with leading international practice. In addition, the department consists of four risk analysts.

The departments work closely together with the academic risk environment at the University of Stavanger in order to ensure the exchange of experience and development of competence.

In addition to the aforementioned roles several committees in the risk and capital management area have been established that assist the CEO with establishing a decision-making basis and follow-up.

The Risk and Capital Management Committee safeguards the general monitoring of the Group's risk profile, funding and capital adequacy situation. The committee also discusses draft versions of risk strategies, capital allocations, validation reports and recommends new risk models. The Risk and Capital Management Committee is headed by the executive vice president for risk management and compliance and has a diversified staff with senior executives from the business units, accounting/finance and the Risk Management and Compliance Department.

The credit committees are responsible for making independent recommendations to authority holders. When making their recommendations, the credit committees evaluate loan and credit applications in
accordance with the current credit strategy, credit policy guidelines, loan granting regulations and credit review routines. The credit committees place a particular emphasis on the identification of risk in relation to individual applications and carrying out an independent assessment of credit risk, which clarifies the consequences of the various risks for the bank.

A set of independent control bodies has also been established:

_The Control Committee_ shall monitor that the Group operates in an appropriate and satisfactory manner in accordance with the applicable legislation, regulations, statutes, and guidelines adopted by the Supervisory Board, in addition to directives from the Financial Supervisory Authority of Norway.

_The internal auditing_ monitors the risk management process to ensure that it is goal-oriented, effective and functions as intended. The Group's internal auditing function has been outsourced, and this ensures that the function has the required independence, competence and capacity. The internal auditing function reports to the Board of Directors. The internal auditing function's reports and recommendations for risk management improvements are reviewed and implemented on an ongoing basis in the Group.

_The external auditor's_ primary task is to assess whether the Group's annual financial statements have been prepared in accordance with the applicable laws and regulations. In addition, the external auditor shall ascertain whether the Bank’s asset management is handled properly and subjected to proper scrutiny. The external auditor is elected by the Supervisory Board.

The framework for management and control of the individual risk group is described in this section. In addition, the quality of the framework is assessed. The assessment is primarily based on periodic risk identification and assessment of operational risk in the processes, reporting of undesired incidents, reports from the internal audit, internal control and reports, as well as an annual manager's verification of risk management.

### 4.4.9 Credit risk

_Credit risk is defined as the risk of loss if customers or counterparties are unable or unwilling to meet their financial obligations to the Group._

Credit risk is managed through the framework for granting credit, follow-up of commitments and portfolio management. The main elements of the limits can be described as shown in figure 48 below.
Credit strategy

The Group’s primary market areas for credit risk exposure are Rogaland, Agder and Hordaland. The general credit strategy stipulates that the Group shall have a moderate risk profile where no single event shall be capable of seriously harming the Group's financial position.

The credit strategy supports the Group's strategic development and target achievement through:

- A healthy credit environment, where clear requirements are stipulated for an employee's knowledge, skill and attitude
- An appropriate process for granting credit where additional requirements for quality and compliance of the Group's framework for credit management
- Effective risk management
- Striving towards an optimal application of capital within the adopted business strategy
- Trying to achieve the same risk-adjusted return on customers over time within the Bank’s adopted business strategy
- A diversified portfolio

The customer's activities shall have a long-term perspective, and the customers shall operate in accordance with the current laws and regulations.

The general credit strategy is revised and approved by the Board of Directors annually.

In addition, the Group's credit strategy consists of general credit strategy framework for ensuring a diversified portfolio and a satisfactory risk profile. The framework defines limits for the probability of default, expected loss, risk-adjusted capital and how much of the combined loan exposure can be to the corporate market. A more detailed description of the limits is given in the paragraphs below.

- **Probability of default** indicates the portion of the loan portfolio that statistically is assumed to default during a 12-month period (long-term outcome). The weighted probability of default
shall not exceed 1.60 per cent in 2010 for the Group. At the end of the 4th quarter of 2010 the weighted probability of default was 1.04 per cent.

- **Expected loss** describes the loss the Group can statistically expect on the loan portfolio during a 12-month period (long-term outcome). The weighted expected loss shall not exceed 0.35 per cent of exposure (EAD) in 2010 for the Group. At the end of the 4th quarter of 2010 the expected loss was 0.17 per cent of exposure (EAD).

- **Risk-adjusted capital** describes how much equity the Group thinks it needs to cover the actual risk the Group has assumed based on a given confidence level. For the Group the risk-adjusted capital for 2010 shall not exceed 3.75 per cent of the exposure (EAD) at a confidence level of 99.97 per cent. At the end of the 4th quarter of 2010 the risk-adjusted capital was 2.46 per cent of the exposure (EAD).

- **Lending volume, corporate market portfolio**: The lending volume outside the retail market shall not exceed 45 per cent of the total lending (EAD) in 2010. At the end of the 4th quarter of 2010 the lending volume outside the retail market was 35 per cent of the total lending.

SpareBank 1 SR-Bank's portfolios that are or will be transferred to the mortgage companies SpareBank 1 Boligkreditt and SpareBank1 Næringskreditt are included in the aforementioned credit strategy limits.

The general credit strategy framework is redistributed among the individual business areas. For the corporate market there are also specific limits for the maximum share of risk-adjusted capital to individual sectors, group of major customers and maximum exposure to high risk customers, respectively. In addition, it has been decided that the maximum loss on an individual customer shall not exceed NOK 425 million (it has been decided that the limit will be increased to NOK 450 million in 2011). In this context, an individual customer also includes commitments with two or more counterparties when the controlling influence or financial connections between these are such that financial difficulties with one party will likely entail payment difficulties for himself or the other parties.

The aforementioned limits shall ensure a diversified portfolio within the corporate market.

The sector's rental of real estate is allocated the largest limit for risk-adjusted capital in a sector, and it is also this sector where SpareBank 1 SR-Bank has the greatest exposure. At the end of the 4th quarter of 2010 exposure to this sector totals 19 per cent of the combined risk-adjusted capital, and 11 per cent of the combined loan exposure.

SpareBank 1 SR-Bank uses risk-adjusted capital as a measurement parameter for the limits above since the risk-adjusted capital reflects the actual risk exposure significantly better than what the traditional focus on lending volume does.

The credit strategy framework is stipulated by the Board of Directors, and any deviations from these shall therefore be submitted to the Board of Directors for approval. The Credit Risk Management Department reports the development in the credit strategy framework to the Board of Directors each quarter. The credit strategy framework is revised annually through cooperation between representatives for the business units and the credit risk management department. This contributes to a satisfactory anchoring of the guidelines in the business units. The limits for the largest commitments (loss potential) are very well known in the credit environments that need to know these, and deviations do not occur.

Commitments with a high risk require significantly more risk-adjusted capital than commitments with low risk. In summary, the connection between risk and risk-adjusted capital is as follows:
Commitments with low risk tie up on average 4 times more risk-adjusted capital than commitments with the lowest risk. Commitments with average risk tie up on average 11 times more risk-adjusted capital than commitments with the lowest risk. Commitments with high risk tie up on average 19 times more risk-adjusted capital than commitments with the lowest risk. Commitments with the highest risk tie up on average 28 times more risk-adjusted capital than commitments with the lowest risk.

This means that significantly less money can be loaned to customers with high risk than customers with low risk.

The clearly defined credit strategy for the Group provides a comprehensive summary of the general guidelines for credit granting, with a particular focus on the corporate market. Correspondingly, a limited number of unambiguous, operative and risk-sensitive limits for the various business units in the Group are defined. The general feeling is that the limits represent a good balance between consideration for effective risk management and operative follow-up.

The credit risk manager will, through his presence on the Group's main credit committee, follow up any deviations from the credit strategy and point these out in a recommendation and to the authority holder (CEO) before a final decision is made.

Credit policy guidelines

The credit policy guidelines stipulate the minimum requirements that apply to all types of financing, except for commitments granted as part of exercising a special credit assurance authority. In addition to the general credit policy guidelines, a set of more specific credit policy guidelines related to sectors or segments that can entail a special risk have been prepared.

The credit policy guidelines are revised at least once a year and approved by the CEO, and reported to the Board of Directors. Any deviations from the credit policy guidelines must be justified and approved at the director level.
General credit policy guidelines

The general credit policy guidelines are based on general requirements of due care related to equity, which stipulate that a company must at all times have robust equity that is adequate based on the risk and scope of the company’s activities.

In some case the Group shall not have a credit risk. This applies in the following cases:

- There is a write-down on the customer
- The customer's recognised equity is negative
- Funding of shares or financial instruments
- Funding of intangible fixed assets
- Security compensates for insufficient risk capital from the owner
- The customer's estimated probability of default exceeds 10 per cent

However, when financing shares and financial instruments an opportunity is given to take a credit risk in connection with investing in market-based securities and for contingent industrial acquisitions. The latter also applies when financing intangible assets. In addition, under certain conditions, there is an opportunity for the financing of shares or financial instruments in connection with the VP financing product (loan financing of share investments), but in the latter case special limitations apply related to the customer's probability of default, maximum degree of financing for the individual securities and minimum requirements for the diversification of the portfolio.

Credit policy guidelines related to specific segments or sectors

When financing land and the development of real property the maximum degree of financing shall be 20 per cent. The degree of financing is differentiated for the different financing purposes in accordance with the following guidelines:

- Degree of financing 80 per cent for acquisition of already zoned land
- Degree of financing 50 per cent for acquisition of unzoned land
- Degree of financing 50 per cent for the financing of infrastructure

Financing shall not be granted for the acquisition of unregulated land that have been set aside for purposes other than the relevant purpose in accordance with the municipal plan.

When financing the development of real estate the maximum degree of financing shall be 20 per cent. In addition, there is a requirement for minimum 70 per cent advance sales before discounting. In general, the customer's self-financing shall always be used first in a project. A qualified building loan inspector must be used for the financing of major individual projects.

When financing real estate for rental the combined financing shall not exceed 11 times the annual gross rental income. Combined financing up to 11 times the annual gross rental income can only take place if it is indicated by a combined assessment of the rental level, duration of the lease, lessee's goodness, location of the property, the condition of the property and the degree of interest rate hedging.

When financing shipping only tonnage with a low level of risk shall be financed, and as a main rule financing shall not be granted for vessels older than 25 years. In addition, a minimum value clause (MVC) of a minimum of 125 per cent and insurance of a minimum of 120 per cent of the loan balance is required. There are also requirements with respect to the classification society and flag state.

For participation in syndicates it is required that the customer, based on a separate evaluation by the Group, is classified as an average risk or better. The customer must have a clear Norwegian affiliation,
and the agent bank must be among the Norwegian main banks and also have the necessary competence to handle the commitment.

The guidelines for participation in syndicates also apply to financing abroad, but here it is a requirement that SpareBank 1 SR-Bank is among the main Norwegian banks.

For financing market-based securities there are strict requirements for the degree of financing. The degree of financing is limited to 70 per cent for bonds and 50 per cent for shares and equity certificates listed on Oslo Børs, respectively. Other market-based securities are generally not financed. The degree of financing for the VP financing product is limited to a maximum of 70 per cent.

For shipyard financing a contract with a reputable and financially solid shipowning company is required, in addition to payments from the shipowner of a minimum of 20 per cent in the early phase of the project. The hull shipyard must be able to provide the necessary repayment guarantees. It is also required that the shipyard has its own liquidity.

Acquisition financing For acquisition financing there must be a third-party review of all the acquired companies, and the Group must approve the acquisition and sales agreement. The loan agreement shall be prepared by an approved attorney.

The credit policy guidelines are revised annually through an extensive cooperation between representatives for the business units and the Credit Risk Management Department, respectively. This contributes to a good anchoring of the guidelines in the credit environments.

The credit risk manager will, through his presence on the Group's main credit committee, follow up any deviations from the credit policy guidelines and point these out in a recommendation and to the authority holder (CEO) before a final decision is made.

Credit authorisation

The Board of Directors is responsible for granting loans and credit, but it delegates the credit authority, within certain limits, to the CEO, who can in turn delegate this authority to others. Delegated credit authority is linked to a commitment's expected loss and the probability of default.

The authority is personal. This means that the credit committees do not have decision-making authority, but make recommendations to the authority holder. If there is no credit committee, then the authorisation limits will be reduced. In general the authority is ample if a commitment's expected loss and probability of default indicates a low risk, but the authority will be restricted progressively with increasing risk.

The credit authority regulations are reviewed annually, and changes are approved by the CEO and reported to the Board of Directors. However, this does not apply to changes in the CEO's credit authority since this is approved by the Board of Directors. The annual revision of the authority is made through extensive cooperation between representatives for the business units, in particular, and the Credit Risk Management Department. This contributes to a good anchoring of the guidelines in the credit environments.

The credit risk manager will, through his presence on the Group's main credit committee, follow up any deviations from the credit authority regulations and point these out in a recommendation and to the authority holder (CEO) before a final decision is made.
Credit review routines

The credit review routines regulate in detail all factors related to the granting of credit by the group and follow-up of commitments. The credit granting process can be described as illustrated in figure 49 below.

Figure 49: Credit rating process

<table>
<thead>
<tr>
<th>Introduction</th>
<th>Detailed description of the customer and the purpose of the loan application</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>Valuation of whether the customer will have sufficient earnings to serve current commitments, interest and amortization</td>
</tr>
<tr>
<td>Corrosion</td>
<td>Valuation of how long and how the customer can cover current commitments, interest and amortizations if earnings fail</td>
</tr>
<tr>
<td>Management</td>
<td>Valuation of whether there is sufficient management capacity and ability to meet current requirements and future challenges</td>
</tr>
<tr>
<td>Estimation of probability of default</td>
<td>Valuation of security objects and total valuation of risk. Correlation between risk and the conditions stipulated</td>
</tr>
<tr>
<td>Total risk, conditions and security</td>
<td>Valuation of security objects and total valuation of risk. Correlation between risk and the conditions stipulated</td>
</tr>
<tr>
<td>Exposure at default</td>
<td></td>
</tr>
<tr>
<td>Loss given default</td>
<td></td>
</tr>
<tr>
<td>Expected loss</td>
<td></td>
</tr>
<tr>
<td>Risk adjusted capital</td>
<td>Evaluate whether risk adjusted return is satisfactory</td>
</tr>
<tr>
<td>Price proposal</td>
<td></td>
</tr>
</tbody>
</table>

The credit rating routines are well described in the bank's system for process and routine descriptions. Processing steps and routines are continuously updated so that the last valid version is always available. The routines are relatively comprehensive and work is continuously carried out in order to optimise the system for easier and quicker access to the correct routine description.

Both the corporate market and retail market division have established a satisfactory credit process through established routines and guidelines, as well as continuous follow-up and monitoring.

The credit management routines are adapted to the Financial Supervisory Authority of Norway's guidelines, including guidelines for appropriate lending practices for loans for housing purposes as described in Directive 11/2010.

Monitoring and reporting

After the commitments have been granted, continuous commitment and portfolio monitoring is carried out. The credit risk is followed up in general by means of the Group's portfolio management systems,
systems for early notification of key development trends (early warning) and systems for monitoring the quality of the actual credit granting process. The framework is shown in figure 50 below.

There is a good focus on information and communication in the Group. The Group's overall risk exposure and risk development are followed up through periodic risk reports to the administration and Board. General risk monitoring and reporting are performed by the Department for Risk Management and Compliance.

Figure 50: Framework for credit risk monitoring

*Portfolio management*

The Group's risk exposure is followed up by means of a general portfolio management system. The system contains a large amount of information on the risk at both the aggregate and detailed levels. This is made possible by efficient monitoring and management of the risk development in the portfolio. All the portfolio information is updated monthly, including updates of the customers’ probability of default. The development of risk in the portfolios is followed up with special emphasis on the development of the risk classification (migration), expected loss, risk-adjusted capital and risk-adjusted return.

*Early warning*

The Group's early warning system provides access to continuous follow-up of the key risk drivers for customers as an important indicator for the potential default trend. The aim is to identify key development patterns at the earliest possible point in time.

Examples of such risk drivers are:

- Short-term and repeated defaults
- Development of utilisation of limits - credit facilities, construction loans and flexible loans
- Development in the number of instalment postponements
- Official announcements
Monitoring of credit processes

The Group's systems for monitoring the credit granting process provides the opportunity for a continuous follow-up of the credit quality and the risk-adjusted return on new commitments. The system is well suited for the comparison of quality across the departments, and makes early handling possible if individual departments have an undesired development in the ongoing credit practice.

4.4.10 Market risk

Market risk is a collective term that comprises the risk of loss related to items on and off the balance sheet as a result of changes in the market prices. Securities risk, currency risk, interest rate risk, risk associated with own holdings and/or use of equity in syndicates, as well as guarantees for the full subscription of offerings are included in this risk class.

The market risk is managed through the framework illustrated in figure 51 below.

Figure 51: Framework for monitoring of market risk

Risk strategy

Market risk in SpareBank 1 SR-Bank is mainly related to the Group’s long-term investments in securities. In addition, the Group has a certain exposure to market risk from trading activities in the interest rate and currency markets and from activities that support ordinary funding and lending activities. The Group’s exposure to market risk is moderate.

The risk strategy defines the Group's willingness to assume risk in own-account trading and customer trading in interest rate and currency-related products, management of bond issues, etc. The strategy and the associated specification of necessary risk limits, reporting lines and authorities are reviewed.
and approved by the Group's Board of Directors at least once a year. The risk strategy is complied with satisfactorily.

**Risk analyses**

The Risk Management and Compliance Department is responsible for carrying out risk and sensitivity analyses in the market and funding risk area. A number of risk analyses are fixed periodic analyses, while the majority of the analysis work is carried out on an ad hoc basis. The risk and sensitivity analyses are important decision-making tools in the operative management of the Group's market risk.

The scope and frequency of the reports and analyses are at an acceptable level. A number of analyses area carried out on an ad hoc basis. It is assumed that the demand for reports and analyses in the future will increase since the level of activity and complexity in the market is increasing. The capacity to meet these requirements is evaluated at the end of the year to fulfill this need.

**Monitoring and reporting**

The Group’s market risk is measured and monitored on the basis of conservative framework that is renewed and approved by the Board of Directors at least once a year. The size of the limits are stipulated on the basis of stress tests and analysis of negative market movements. The Risk Management and Compliance Department is responsible for the continuous and independent monitoring of the Group's market risk.

The responsibility for continuous position reconciliation and measurement of the Group's market risk exposure lies with the middle office in SR-Markets. The risk manager for the market and funding risk is responsible for maintaining continuous control of the risk measurements and independent risk reporting, both internally and externally.

Interest rate risk is the risk of loss incurred due to changes in interest rates. The Group’s interest rate risk is regulated by limits established for the maximum value change resulting from a change in interest rates by 1 percent.

Currency risk is the risk of loss caused by changes in foreign exchange rates. The Group measures currency risk based on net positions in the different currencies in which the Group has exposure. Currency risk is regulated by nominal limits for maximum aggregate currency positions and maximum positions within individual currencies.

The price risk related to securities is the risk of loss caused by changes in the value of the Group’s bonds, commercial paper and equity instruments. When quantifying risk related to the impairment of the liquidity portfolio, SpareBank 1 SR-Bank distinguishes between systematic risk (market risk) and non-systematic risk (default risk). Default risk associated with the aforementioned portfolio is quantified as credit risk. Investments that are classified as "held to maturity" are recognised at amortised cost and are therefore not exposed to market risk in terms of accounting. The Group’s risk exposure in terms of this kind of securities risk is regulated by limits for maximum investments in the different portfolios.

Risk-adjusted capital associated with market risk is measured and followed-up in accordance with the Value at Risk (VaR) principle. The VaR model covers the Group's interest rate and currency risk on and off the balance sheet, as well as the securities risk associated with the Group's investments in the short-term and long-term equity investments.

The VaR model does not cover the general spread risk (systematic risk) connected with the Group’s investments in bonds and securities. General spread risk is the risk that the securities' market value decreases due to a general increase in the credit spreads. The model that is used to quantify risk-adjusted capital for the general spread risk has been taken from the Financial Supervisory Authority of Norway's module for market and credit risk in life insurance companies.
The models that are used to calculate risk-adjusted capital for market risk are important tools in connection with the Group's allocation of capital and measurement of the risk-adjusted return, but they are not used in the day-to-day management of market risk.

4.4.11 Operational risk

Operational risk is the risk of losses resulting from inadequate or failed internal processes, people and systems, or from external events.

Analyses of previous national and international bankruptcies and financial scandals show that operational risk is often the triggering cause. SpareBank 1 SR-Bank is therefore interested in being one of the leading banks in the Nordic region for the measurement management and control of operational risk.

SpareBank 1 SR-Bank has financed a professorship in operational risk at the University of Stavanger (UiS), and is also a significant contributor to the master's programme in comprehensive risk management. In addition, SpareBank 1 SR-Bank has been a promoter for a major research project in operational risk in cooperation, with organisations such as UiS, SpareBank 1 Alliance, DnB NOR, The Research Council of Norway and the Financial Supervisory Authority of Norway.

The purpose of the project is to establish Norway and the banks as a European centre of expertise for the management and measurement of operational risk. This will be carried out through research, education and the transfer of information from the professional environments in risk analysis at UiS. This professional environment is renowned as one of the leading research environments in the world in this field.

SpareBank 1 SR-Bank's framework for management of operational risk is based, for example, on CoSo, which is an internationally renowned framework for risk management. The key elements of the framework for management of operational risk are illustrated in figure 52 below.
Strategy for operational risk

The risk strategy for operational risk is stipulated at least once a year by the Board of Directors. The risk strategy sets limits for the expected loss and risk-adjusted capital. The Group has an efficient risk management and monitoring system to prevent any incidents generated by operational risk from severely damaging the Group’s financial position.

Risk analyses

A risk assessment and analysis is performed at least once a year of all significant business and support processes in the Group in order to identify the operational risks. For each of the risks an evaluation is made of the quality of the established control and management measures, as well as a calculation of expected loss and unexpected loss (risk-adjusted capital) over time. In order to calculate the risk exposure scenario, analyses and statistical models are used. Finally, an overall assessment on whether the risk profile is acceptable or whether further measures must be implemented is carried out.

The risk assessments and analyses are carried out by means of workshops where risk management, the process manager and professional experts with a high degree of knowledge and long expertise in the field participate. The use of internal banking data and history from previous national and international incidents is also included as important input. The review is headed by the Department of Risk Management and Compliance.

The result of the analyses entail that significant risks are identified, and it provides a good summary of the risk profile of the relevant business and support process. The analysis work also results in a good understanding and ownership of the risks, as well as a good basis for assessing any risk-reducing measures. Work is continuously carried out to develop the analyses so that they provide good added value for the business and support process and for the risk environment.
Furthermore, a broader understanding of the causal mechanisms and causal relationships of the risks will provide a better point of departure for establishing better control and management measures. An improved methodology is being prepared in cooperation with UiS.

In accordance with the *Regulations relating to risk management and internal control* it is a statutory requirement to conduct a manager's verification of the Group's risk management. Good processes and framework for risk management have been established and the annual manager's verification is part of this. Questions in the manager's verification are adapted to the unit the manager is affiliated with, and they are amended/adapted from year to year. The managers also carry out an assessment of whether the established control and management measures function appropriately and they report the most significant risks based on self-assessment.

For the Group, the manager's verification is a supplement to the risk analyses that are carried out for all significant business and support processes, and provides the Group's management with an indicator for compliance and quality of the risk management that is carried out in the organisation. The analyses and identification provide knowledge on, and ownership of, the risks in a much more detailed manner than through the manager's verification of risk management.

The Group has established a separate quality assurance routine and model for launching new products and the implementation of new activities. The objective is to ensure that new activities and products are adequately risk-assessed before implementation or launching. Important areas that are assessed are profitability, complexity, system solutions and security, legal assessments with regard to licences, laws and regulations, and whether the Group is exposed to new types of risk. The use of models show that this works satisfactorily for the quality assurance of new products, but it is not as effective for the quality assurance of changes in processes or activities.

In addition, a separate approval committee has been established for new products that perform a joint risk assessment based on the analysis that has been carried out.

**Reporting of undesired incidents**

The Group has its own database for the reporting and monitoring of undesired incidents. All significant operational incidents that could potentially result in losses or where losses have occurred shall be registered in the Group's database. Undesired incidents are followed up and improvement measures shall be evaluated and implemented where this is deemed appropriate. The Group works continuously to develop the database and improve the reporting culture.

The objective is for the Group to identify all the significant incidents that occur and be able to learn from this to the greatest possible extent. The research project being carried out at the University of Stavanger is researching the problem of how to learn as much as we can from registered incidents in addition to what motivates the organisation to register undesired incidents. By establishing a good reporting culture and good system support, this can help provide a better and broader learning effect for the organisation.

Based on the results from risk analyses, manager's verification of risk management and the reporting of undesired incidents, risk-reducing measures are evaluated and implemented where they are found to be necessary. The Group has a policy that probability-reducing measures shall be prioritised over consequence-reducing measures. Important risk-reducing measures that are used actively are preventative analyses, competence development, division of work, system controls, documentation of routines, re-examination, outsourcing and insurance. The insurance schemes have been established in order to cover the losses resulting from a fire, serious operational shutdown or crime.

Customer complaints are registered and followed up on a continuous basis. All written complaints are registered and handled by the Complaints Board. Short-term complaints, fraud cases, crime etc. are also registered continuously and measures are implemented as required.
Contingency plans

Contingency plans have been prepared that describe how crisis situations shall be handled in the Group. The purpose of the contingency plans is to limit the negative effects of such an incident, and to maintain responsible operations.

The Group's contingency plans cover the areas of safety and ICT (Information and Communications Technology) for example. The contingency plan for safety covers contingencies for physical injuries from natural disasters, water damage, long-term power outages, etc. Furthermore the plan covers areas such as pandemics, terrorism, corruption, etc.

The contingency plans are tested regularly and evaluated and updated in accordance with test results, and have been evaluated as satisfactory. The contingency plans are continuously being improved and will encompass more detailed descriptions and more frequent updates.

The contingency plan for ICT describes how the Group shall handle unexpected system interruptions as a result of hacking, server problems or other technical problems, as well as how to protect critical services and systems against negative consequences in the event of a fault or accident. In addition, the plan gives a description on how further operations shall be safeguarded in the event of an incident.

The contingency plan for power outages and system interruptions has been tested during the year by a controlled power outage in connection with maintenance work in ICT.

Should a catastrophe or incident occur, the transfer of experience and learning will contribute to reducing the probability that a similar incident occurs again.

Monitoring and reporting

The Group has effective risk management and monitoring to ensure that individual incidents caused by operational risk will not severely damage the Group’s financial position. The individual business units, areas of responsibility and processes are responsible for the daily follow-up and monitoring of operational risk. The Risk Management and Compliance Department is responsible for the ongoing and independent monitoring of operational risk.

The independent follow-up of the Group's operational risks are efficient and reporting is carried out on a quarterly basis through the risk report to the Board of Directors. In addition, ad hoc reports are prepared as required.

4.4.12 Funding risk

Funding risk is the risk that the Group is not able to refinance its debt or is not able to finance an increase in assets.

The funding risk is managed through the framework illustrated in figure 53 below.
Liquidity strategy

The rating level, composition of the funding portfolio and access to the capital markets will all be of significance for the Group’s capacity to manage the prevailing liquidity situation at all times. Management of the Group’s financial structure is based on an overall liquidity strategy that is assessed and approved by the Board of Directors at least annually. The liquidity strategy specifies the Group’s general strategic guidelines for liquidity management.

The liquidity strategy shall reflect the bank’s conservative risk profile and contribute to the Group achieving its strategic goals. The following goals apply to the Group’s liquidity management:

"In a normal situation the Group must be able to survive for a minimum of twelve months without external access to capital."

Risk and Capital Management Committee

The Risk and Capital Management Committee in SpareBank 1 SR-Bank shall function as an advisory body with regard to strategic management of the bank’s balance sheet within the limits that have been drawn up by the bank’s Board of Directors through the liquidity strategy.

The primary focus of the Risk and Capital Management Committee shall be monitoring and control of the factors that directly and indirectly affect the bank’s funding and refinancing risk. The Risk and Capital Management Committee’s area of responsibility includes recommendations for the liquidity preparedness level and the implementation of a contingency plan.

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 defines areas of responsibility and defines specific crisis measures for the involved employees in the Group. The purpose of the contingency plan is to make it possible for the Board of Directors and the group management to carry
out necessary measures based on a correct and adequate information basis.

The contingency plan's main elements include:

- Identification and assessment of the level of a liquidity crisis
- Reporting obligation and reporting guidelines for given contingency levels
- Distribution of responsibility for a given contingency level
- Detailed work plan for a given contingency level (measures for compensating a loss of cash flow)

SpareBank 1 SR-Bank's contingency plan includes three different contingency levels:

- **Level 1**: There is a risk that a liquidity crisis can affect the Group
- **Level 2**: the liquidity crisis affects the Group to a certain extent
- **Level 3**: The liquidity crisis affects the Group to a great extent

The contingency plan is part of the Group's liquidity strategy and is updated as required, but at least once a year. The division of responsibility and reporting lines in a crisis situation is satisfactorily defined in the contingency plan. The contingency plan's stress tests are considered to be conservative and adequately realistic.

In addition to contingency planning, SpareBank 1 SR-Bank has also developed a stress test that analyses the Group’s liquidity-related vulnerability during periods without external access to liquidity. The stress test is based on a number of scenarios under the assumption of the full utilisation of limits and thereby represents a worst case simulation of the Group’s net refinancing requirements in a crisis situation. All scenarios are of such a nature that the Group’s contingency plans are implemented.

The prerequisites for the stress scenarios include the crises arising suddenly and full utilisation of the limits for funding risk. The authorities do not establish any rescue packages, etc. The Group has three measuring points for each scenario: 30, 180 and 360 days.

**Reporting and monitoring**

The Group’s lending is mainly financed by customer deposits and long-term security debt. The funding risk is limited due to the fact that the securities debt is distributed over a number of markets, sources of funding, instruments and maturities.

It is the Group’s treasury department that is responsible for the operative liquidity management and daily measurement and monitoring of the Group's funding risk. Back office and middle office in SR-Markets is responsible for the control function at the transaction level, while risk analysis, risk measurement and reporting on the utilisation of limits are carried out by the risk manager for the market and funding risk.

### 4.4.13 Ownership risk

*Ownership risk is the risk that SpareBank 1 SR-Bank will incur negative results from equity positions in strategically owned companies and/or must inject fresh capital into these companies. Owned companies are defined as companies where SpareBank 1 SR-Bank has a significant shareholding and influence.*

SpareBank 1 SR-Bank 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 SR-Bank or indirectly through ownership of 19.5 per cent of SpareBank 1 Group, SpareBank 1 SR-Bank, as the largest bank in the alliance, is represented as a board member in all companies of significant importance.

All monitoring of ownership interests is performed under the Group's Chief Financial Office. All reporting from the individual companies and questions regarding capital increases etc. are reported here. Through active participation in the board of directors of a number of the partially owned companies, a good supply of information is assured, which safeguards SpareBank 1 SR-Bank’s ownership interests. In cases that are of importance to SpareBank 1 SR-Bank’s other operations, the individual board chairman/member will submit the matter for a plenary discussion by the group management. With this structure for corporate governance the quality of the management and control is perceived as being well safeguarded.

Risk limits and the allocation of equity to the individual companies is stipulated annually by the Group's Board of Directors. This is based on a framework for the assessment of risk. Seen in connection with the framework for risk identification in the Group's operations on the credit side, the framework is not as well developed on the ownership side, but a continuous effort is being made to develop this further in order to achieve even better management of the risk related to ownership.

The individual areas are closely monitored through the fixed structure at corporate governance meetings in the Group and reporting at level of the Group's Board of Directors. The business areas that are organised as separate subsidiaries have the same structure at board meetings as the rest of the Group. As a result of this, corrective measures can quickly be implemented since the development of important management parameters or circumstances of an external nature require measures to maintain the creation of value and risk management.

### 4.4.14 Commercial risk

*Commercial risk is the risk of unexpected fluctuations in revenues and expenses resulting from changes in external circumstances, such as the market situation or government regulation.*

The Group has developed a well-diversified revenue base over a long period of time, and this means that any reduction in the individual product groups or customer segments will not have significant consequences over time. Over time, the Group has developed cost-effective operations in combination with a continuous development of competence and expansion of the operations with regard to the range of products and geography. SpareBank 1 SR-Bank has systematically focused on the value chain philosophy and development of products and services for several years.

Through its systematic work today, the Group has a great deal of interaction across the divisions and subsidiaries. Nevertheless, this interaction can be improved and the potential is there for realising more business through the value chain.
4.4.15 Reputation risk

Reputation risk is the risk for a decline in earnings and capital access due to deterioration in confidence and reputation in the market, i.e. among customers, counterparties, the equity market and the authorities.

SpareBank 1 SR-Bank has established an overall communication strategy to ensure the communication of information internally and externally in a way that supports the Group’s core values, goals and vision. “A proper bank” is the main element of the Group’s communication strategy.

In order to evaluate the reputation of SpareBank 1 SR-Bank, the Group regularly conducts reputation surveys. The surveys are conducted among our various stakeholders. TNS Gallup conducts the surveys by means of their TRI*M model.

SpareBank 1 SR-Bank has also implemented an internal process for identifying and evaluating the Group’s overall reputation risk situation. The evaluation is carried out annually. All reputation risks are evaluated in relation to the inherent risk and established control and management measures. Improvement measures are implemented when required. Through the analyses based on scientific methods and the harmonisation of these, any incorrect evaluations are eliminated. The results of the annual analyses are reviewed, discussed and possibly operationalised after reviews for the different levels in the organisation, including the Board of Directors and group management.

The Group continuously monitors its reputation. Both through day-to-day monitoring and evaluation of the media, as well as the continuous monitoring of discussions in different social channels. The continuous day-to-day evaluations are carried out as objectively as possible. Members of the group management and other key personnel receive daily media reports.

4.4.16 Strategic risk

Strategic risk is the risk of losses resulting from the unsuccessful strategic decisions.

SpareBank 1 SR-Bank carries out an annual strategy process once a year that involves the Board of Directors, key personnel, departments and subsidiaries. This work results in a strategic target for the next three-year period, with a related business plan and plan of action. The business plan clearly shows the priorities the Group has made for the period based on scenarios and the competition and market situation. The business plan and plan of action is the most detailed for the nearest year.

The group management carries out monthly and quarterly evaluations of the Group’s achievements and strategic direction. The four-month evaluation also evaluates relevant new initiatives and measures that must be implemented based on changes in assumptions or changes in the market situation. Strategic work is therefore flexible in its approach and can safeguard both short-term and long-term goals.

4.4.17 Compliance risk

Compliance risk is the risk that the Group incurs public sanctions/penalties or financial loss as a result of failure to comply with legislation and regulations.

In figure 54 below the key elements in the framework for compliance are illustrated.
The framework for compliance are based primarily on CEBS Internal Governance, Basel Committee on Banking Supervision; "Compliance and the compliance function in banks" and the Financial Supervisory Authority of Norway's "Module for the evaluation of general management and control".

**Compliance policy**

The compliance policy shall ensure that the Group does not incur public sanctions/penalties or financial loss as a result of failure to comply with legislation and regulations. The Group's compliance policy is adopted by the Board of Directors and describes the main responsibility and organisation principles.

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 that detects, communicates and implements changes in legislation and regulations
- A process to monitor and report compliance with legislation and regulations

**Guidelines and Routines**

The Group's compliance function is performed by the Risk Management and Compliance Department, which is organised independently of the business units. The department has the overall responsibility for the framework, monitoring and reporting in the area of compliance.

The Group also has a designated compliance manager for the Group's securities firm, who is responsible for ensuring that the bank's activities related to the provision of investment services are carried out at all times in compliance with the regulations for securities trading. The compliance manager for the securities firm reports directly to the general manager of the securities firm and also reports to the Risk Management and Compliance Department.
The assessment of the quality of the implementation and compliance with the current laws and regulations are carried out simultaneously with the performance of annual risk analyses for all significant business and process areas. In the manager's verification the Group's managers verify that the compliance with laws and regulations are satisfactory. The routines are updated on a continuous basis for changes to the regulatory requirements.

Laws and regulations that regulate the Group's operations are included in the routines that are well described in the bank's process and routine description system. The Group's managers have an operational responsibility for practical implementation and compliance with laws and regulations. All employees are responsible for ensuring that they comply and understand the laws and regulations on a day-to-day basis.

**Monitoring and reporting**

The identification of compliance risks, as well as the follow-up of measures, are carried out on a regular basis. Any incidents or breaches of the compliance policy are registered in the Group's database for the reporting and monitoring of undesired incidents.

Compliance is included in the quarterly risk reports to the Board of Directors and CEO. In addition, compliance is reported annually to the Audit Committee and through separate compliance reports for the securities firm.
4.5 Description of risk models and methodology

4.5.1 Scenario model

SpareBank 1 SR-Bank's scenario model consists of 4 steps: (1) scenario selection, (2) effect on market values, credit demand and savings behaviour (3) changes in strategy or risk policy and (4) evaluation of results.

The main elements of the stress test process can be illustrated as shown in figure 55 below.

*Figure 55: The main elements of the Group’s stress test model*
In step 1 a scenario is selected. Important inputs in the scenario are growth in GDP, real interest rate, unemployment, inflation and price of oil.

In step 2 an evaluation is made on how the scenario is assumed to affect the market values of the asset groups that the Group has as collateral from customers in connection with lending activity. An evaluation is also made of the assumed effect on the credit demand and savings rate in Norway.

In step 3 any planned changes in the Group's risk strategy are incorporated. This can for example be planned changes in the risk profile for lending as a result of economic cycles. An evaluation is also made of the effect of any changes to the strategic target.

Scenarios with the associated prerequisites are submitted to the Board of Directors for review and approval.

In step 4 calculations are carried out on how the effects of step 1 to 3 affect:

- the income statement including financial key figures such as return on equity, margins, deposit coverage and capital adequacy.
- balance sheet such as lending volume, volume of deposits, debt and equity. A third element that is key is the development of the capital requirements for the various risk groups.
- capital requirements for regulatory capital (credit, market and operational risk) and for risk-adjusted capital (all significant risk types).
- funding requirements

### 4.5.2 Credit risk

**Risk classification system**

The Group utilises credit models for risk classification, risk pricing and portfolio management. The risk classification system is based on the main components as illustrated in figure 56 below:
The Group continuously develops and tests the risk management system and the credit granting process to ensure that it maintains high quality over time. This validation work can be divided into two main areas:

1. **Quantitative validation**: The quantitative validation shall ensure that the estimates used for the probability of default, exposure at default and loss given default maintain adequate good quality. Analyses are performed to assess the capacity of the rating models to rank customers according to risk (discrimination capacity) and the ability to establish the correct level of risk parameters. In addition, the stability of the models' estimates and the models' cyclical sensitivity are analysed. The quantitative validation will, in certain circumstances, be supplemented by more qualitative valuations, this applies in particular if the scope of statistical data is limited. The results from SpareBank 1 SR-Bank's quantitative validation are described in more detail in the following paragraphs.

2. **Application**: The verification shall show whether the system for management and measurement of credit risk is well integrated in the organisation, and that it represents a key part of the Group's risk management and decision making. Validation shows that the system for management and measurement of credit risk is well integrated in the organisation, and that it represents a key part of Group's risk management and decision making.

**Responsibilities and roles**

The *Board of Directors* is responsible for evaluating and deciding whether:

- The risk parameters (PD, EAD and LGD) maintain an adequately level of quality and estimate the level of risk and capital requirements in a reassuring manner.
The risk management system and process is well integrated in the organisation and represents a key part of the bank's risk management and decision making process.

The Capital Requirements Regulations are fulfilled.

The results from the validation work are submitted to the Board of Directors at least once a year or more often if special circumstances so indicate.

The CEO is responsible for submitting a recommendation to the Board of Directors on the aforementioned elements based on the evaluations made by the Risk and Capital Management Committee.

The Risk and Capital Management Committee is responsible for:

- Preparing a plan and scope for the validation work
- To assess whether the result of the validation work is sufficient to conclude that the risk parameters have adequate good quality, including that they are based on reasonable prerequisites and a good data base that is representative for the bank's exposure.
- Whether sufficient processes and routines for handling irregularities, including adjustments of the credit models have been established.
- To recommend changes to the risk management system or the process.

The Risk Management and Compliance Department is responsible for preparing and quality assuring the decision basis for the Risk and Capital Management Committee. This applies to both the quantitative validation and the validation of application.

SpareBank 1’s Centre Expertise for Credit Models is responsible for performing the quantitative validation for SpareBank 1 SR-Bank.

The individual credit models, including the results from the quantitative validation will be described in more detail in the next sections.

**Probability of default - PD**

**Description of models**

The customers are classified into default classes based on the probability of default over a 12-month period, based on a long-term outcome.

A commitment is seen to be in default if:

1. A claim has been due for more than 90 days and the amount is over NOK 1,000, or
2. The bank has reason to assume that the debtor is not able to repay (in full) in accordance with his obligations:
   - The bank makes write-downs due to impaired creditworthiness.
   - The bank sells a claim at a discount as a result of impaired creditworthiness.
   - As a result of payment problems by the counterparty the bank grants a postponement of payment or new credit until payment of the instalment, or agrees on changes to the interest rate or other terms and conditions of the agreement.
   - The counterparty is subject to debt settlement, bankruptcy or public administration proceedings, or voluntary debt negotiations have been initiated.
   - The bank assumes due to other reasons that the obligation will not be fulfilled.
The probability of default is calculated on the basis of historical series of data for financial key figures related to earnings and deterioration, as well as the basis of non-financial criteria such as conduct and age. Nine default classes (A - I) are used to classify the customers according to the probability of default. Definitions of the individual default classes are shown in table 11 below.

**Table 11: Definition of default classes**

<table>
<thead>
<tr>
<th>Default class</th>
<th>Lower limit for default</th>
<th>Upper limit for default</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>-</td>
<td>0.10%</td>
</tr>
<tr>
<td>B</td>
<td>0.10%</td>
<td>0.25%</td>
</tr>
<tr>
<td>C</td>
<td>0.25%</td>
<td>0.50%</td>
</tr>
<tr>
<td>D</td>
<td>0.50%</td>
<td>0.75%</td>
</tr>
<tr>
<td>E</td>
<td>0.75%</td>
<td>1.25%</td>
</tr>
<tr>
<td>F</td>
<td>1.25%</td>
<td>2.50%</td>
</tr>
<tr>
<td>G</td>
<td>2.50%</td>
<td>5.00%</td>
</tr>
<tr>
<td>H</td>
<td>5.00%</td>
<td>10.00%</td>
</tr>
<tr>
<td>I</td>
<td>10.00%</td>
<td>99.99%</td>
</tr>
</tbody>
</table>

The Group has two additional default classes (J and K) for customers with defaulted and/or written-down commitments.

When calculating the probability of default for customers there are primarily two different main approaches used in the market.

**Point in Time (PIT):** The first is a "Point in Time" approach that calculates the probability of default for the next 12 months based on the current economic situation. The level of default will then be fairly accurate for the respective year. This approach is well suited for calculating defaults in the short term, however, it will be less suited for long-term planning. Too much focus on short-term probability of default may result in unpredictable credit granting and pricing for the customer. If the probability of default varies a lot over time, then the banks’ capital requirements will vary proportionately with the economic cycles in such a way that it will be low during economic expansion and high during economic recession. Thus, the capital requirement will have a procyclical effect and contribute to strengthening the economic fluctuations in society.

**Through the Cycle (TTC):** The second approach that is used is the “Through the Cycle” approach that calculates the probability of default for the next 12 months based on a long-term outcome. In this approach the default will be somewhat underestimated during economic downturns and correspondingly overestimated during economic expansion. The level of default will, however, be fairly accurate over time, and the banks’ capital requirements will vary less during an economic cycle.

The differences between the two approaches are illustrated in figure 57 below:
To what extent sensitivity to economic cycles affects the probability of default is dependent on the emphasis and choice of different risk variables in the models for calculating the probability of default. A model that places a lot of emphasis on short-term liquidity and behavioural data will typically be more sensitive to economic cycles than a model that places a lot of emphasis on accounting data, such as profitability and the debt ratio over time.

SpareBank 1 SR-Bank focuses on stable and predictable credit granting and capitalisation over time, and the Group therefore develops the models for calculating the probability of default on the basis of a "Through the Cycle" approach. This also corresponds with the approach for the rating methods in the most renowned rating companies.

Besides predicting the long-term outcomes of probability of default, regardless of the economic situation, the models must also manage to rate the customers based on risk (from the lowest probability of default to the highest probability of default) based on the current economic situation. This is important so that the banks can predict what customers will experience problems during the course of the next 12 months. In order to achieve this, the model must also include variables that identify changes in the economic cycles.

In practice, SpareBank 1 SR-Bank's models for calculating probability of default will thus be defined as something in between a "Point in Time" approach and a "Through the Cycle" approach. The estimated probability of default will therefore fluctuate less than the actual default in an economic cycle. The relationship between the fluctuations of estimated default and actual default is illustrated in figure 58 below.
An analysis carried out based on simulations and experience from the financial crisis shows that the estimated probability of default will most likely vary between 30 and 40 per cent of the fluctuations in the actual default rate as a result of various economic situations. The capital requirements are based, for example, on the estimated probability of default. The fluctuations in the estimated probability of default therefore entails that the capital requirement will also vary somewhat over time. Analyses show that the capital requirements will vary by around 10 per cent of the fluctuations in the calculated probability of default, or 3 to 4 per cent of the actual default rate. The core capital adequacy ratio will as a result of this most likely varies by +/- 0.5 percentage points during a normal economic cycle.

We have previously described that the probability of default will predict the long-term outcome. The long-term outcome can be calculated in different ways. Experiences from Norway and other countries show that the default rate varies a lot between the economic cycles. Defaults vary with the economic cycles in such a way that the default rate is high when the GDP is relatively low and low when the GDP is relatively high. In special economic situations the default rate can be very high. One example of this is from the Norwegian economy in the beginning of the 1990s, when the GDP was low and the interest rate level was high at the same time. It is uncommon to have a very high default rate. This also applies during years with an economic downturn, examples of which we experienced in 2002 and 2003, as well as 2008 and 2009.

Analyses show that the distribution of defaults over time is concentrated around relatively low levels of default, but that the distribution has a so-called "heavy tail" as a result of some years with very high default rates. The default distribution is therefore not symmetrical around an average, in the way a normal distribution is. For non-symmetrical distributions there will be a difference between the normal measurements at the centre point (average and median) of a distribution. For a non-symmetrical distribution the heavy tail could influence the average so much that the median in many cases becomes the best measurement for the most common outcome. SpareBank 1 SR-Bank has therefore chosen to use the historical median as the basis for calibrating the long-term outcome for the internal models.
Validation results

a) Ranking ability - probability of default (PD)

The analysis of the model's discriminating properties (ranking ability) shows to what extent the model of calculating the probability of default actually manages to rank the customers, from those with the highest probability of default to the customers with the lowest probability of default.

The scoring model's ability to rank the customers is measured first and foremost by means of the internationally renowned AUC method (Area Under Curve). The AUC method is a method for compiling information from statistical measurements taken over a period of time. The AUC method is a useful method for comparing different default models and thereby finds out what models are best suited for ranking customers.

Because of the limited estimation basis, there will always be a certain statistical uncertainty related to the results. The uncertainty is due to the fact that SpareBank 1 SR-Bank can only measure the ranking ability of the scoring models for customers in the SpareBank 1 Alliance, and not for all customers in Norway. It follows from this that the uncertainty will be greater at the bank level than at the alliance level.

With the use of AUC as the method, the ranking ability is categorised in accordance with the table below. SpareBank 1 SR-Bank has defined 70 per cent as the lower limit for an acceptable AUC.

Table 12: Description of the AUC scale

<table>
<thead>
<tr>
<th>AUC</th>
<th>Ranking ability</th>
</tr>
</thead>
<tbody>
<tr>
<td>0% – 50%</td>
<td>None</td>
</tr>
<tr>
<td>50% – 70%</td>
<td>Weak</td>
</tr>
<tr>
<td>70% – 80%</td>
<td>Acceptable (minimum requirement)</td>
</tr>
<tr>
<td>80% – 90%</td>
<td>Very good</td>
</tr>
<tr>
<td>90% – 100%</td>
<td>Exceptionally good</td>
</tr>
</tbody>
</table>

Figures 59 and 60 below show the scoring model's ranking ability for retail market customers during the period from 2007 to 2010 by customers with mortgage loans and other customers. The analysis shows that the ranking ability for customers in SpareBank 1 SR-Bank and for all the customers in the SpareBank Alliance.
The above figures show that SpareBank 1 Alliance’s scoring models for calculating the customers’ probability of default has a very good ranking ability. This means that the models are very good at distinguishing between customers with high and low risk. This applies to both mortgage loan customers and for other retail market customers. The ranking ability is very good whether SpareBank 1 SR-Bank’s customers are used as the basis or whether all customers in the SpareBank 1 Alliance are used as the basis. The analysis also shows that the ranking ability has been stable over time and robust during the financial crisis.

Figure 61 below shows the scoring model's ranking ability for corporate market customers during the period from 2007 to 2010. The analysis shows that the ranking ability for customers in SpareBank 1 SR-Bank and customers in the SpareBank Alliance, respectively.
The validation results show that SpareBank 1’s scoring model for calculating the customers’ probability of default has a very good ranking ability at both the bank and alliance level. The analysis also shows that the ranking ability has been stable over time and robust during the financial crisis.

b) Stability in the default estimates (PD)

SpareBank 1 SR-Bank’s target is to calculate a probability of defaults that predict long-term outcomes. This means that the estimated probability of default among customers should be relatively stable throughout an economic cycle. It is, however, natural to expect a somewhat greater migration (change between the default classes) in connection with sudden economic fluctuations.

Figures 62 and 63 below show the migration of retail market customers during the period from 2007 to 2010, divided among mortgage loan customers and other customers. In the figure a customer migrates if it changes its default class in the course of a year.
Figure 62: Migration for customers with mortgage loans

Figure 62 above shows that migration has been stable for mortgage loan customers during the period. At the end of the 4th quarter of 2010 the graph shows that 53 per cent of the customers did not change their default class during the past twelve months. At the same time 24 per cent of the customers have migrated to a better default class, while 23 per cent of the customers have migrated to a poorer default class. This does not deviate significantly from the level at the end of the 2nd quarter of 2007, which indicates that the financial crisis has not resulted in any significant increase in migration in the portfolio.

Figure 63: Migration for other retail market customers

Figure 63 above shows that migration has been relatively stable for other retail customers during the period. At the end of the 4th quarter of 2010 the figure shows that 51 per cent of the customers did not change their default class during the past twelve months. At the same time 29 per cent of the
customers have migrated to a better default class, while 21 per cent of the customers have migrated to a poorer default class. However, the figure shows somewhat more migration over time than is the case with mortgage loan customers. The financial crisis has thus affected the portfolio to some extent. This coincides well with previous experience indicating that there is higher volatility in the default rate for loans to retail market customers without real property collateral than retail market customers with mortgage loans.

Negative migration is due primarily to the fact that customers receive internal or external remarks. Positive migration is due primarily to the fact that customers receive improved remarks over time.

Figure 64 below shows the migration of corporate market customers during the period from 2007 to 2010.

Figure 64: Migration of corporate customers

![Migration of corporate customers graph]

Figure 64 shows that the financial crisis has resulted in increased negative migration in the corporate market portfolio, while the more positive market outlook lately has resulted in increased positive migration in the corporate market portfolio. During the period the portion of customers that have not changed their default class increased from 36 per cent to 45 per cent. At the end of the 4th quarter of 2010, 27 per cent of the customers have migrated negatively over the last twelve months, compared with 16 per cent at the end of the 2nd quarter of 2007, and 39 per cent at the end of the 3rd quarter of 2009. The positive migration has been reduced from 49 per cent at the end of the 2nd quarter of 2007 to 28 per cent at the end of the 4th quarter of 2010, but it was at its lowest at the end of the 3rd quarter of 2009 when it was 22 per cent.

The analysis further shows that around 68 per cent of the customers that migrate only migrate one default class. This migration is primarily due to a change in the score for the earnings and liquidity variables.

c) Accuracy of the probability of default (PD)

The analysis of the accuracy of the level of default shows to what extent the estimated default levels correspond with the actual default level over time (long-term outcome). The actual default rate is the

---

7 Long-term outcome for the probability of default is estimated on the basis of a complete loss cycle. A complete loss cycle entails an average default over a period of around 25 years, where the period is assumed to contain at least one deep crisis.
number of customers that are in, or have been in default over the course of a 12-month period. Customers with smaller loan commitments count just as much as customers with large loan commitments. Customers with small loan commitments have historically been overrepresented in commitments in default.

Figures 65 and 66 below show the accuracy of the default level for retail market customers from 2007 to 2010 by customers with mortgage loans and other customers. The figures show that SpareBank 1 SR-Bank has, over time, overestimated the default for the retail market segment with real property collateral. For the segment without real property collateral, the estimated probability of default has been almost the same as the actual default rate for almost all periods, but with a weak underestimation towards the end of the period. In the revised scoring model it has been proposed to reduce the number of scorecards from four to two; one scorecard for customers with mortgage loans and one scorecard for other customers. This will result in the level being calibrated more correctly for the individual segments. The model is planned for implementation in the first half of 2011. The new scoring model will be introduced internally first, since regulatory application requires approval from the Financial Supervisory Authority of Norway.

Figure 65: Accuracy of the default level for customers with mortgage loans

Figure 65 shows that at the end of the 4th quarter of 2010 the estimated default rate for retail customers with mortgage loans was 0.67 per cent, while the actual default rate was 0.33 per cent. This is around the same level as for the period from 2007 to 2010 overall. There has been a significant overestimation of the default rate for the period. Accordingly SpareBank 1 SR-Bank is considering a reduction of the default estimates for long-term outcomes in 2011. The adjustment will have limited consequences for the size of risk-adjusted capital.
Figure 66: Accuracy of the default level for other retail market customers

Figure 66 shows that at the end of the 4th quarter of 2010 the estimated default for other customers was 2.36 per cent, while the actual default rate was 2.22 per cent. During the period from 2007 to 2010 the estimated default rate was 2.31 per cent, while the actual default rate was 2.51 per cent. There has been an underestimation of the default rate with regard to long-term outcomes. Based on this, SpareBank 1 SR-Bank is considering an increase of the default estimates for long-term outcomes in 2011. The adjustment will have limited consequences for the size of risk-adjusted capital.

Figure 67 shows that the accuracy of default for corporate customers with normal scores for the period 2007-2010.
Figure 67 shows that at the end of the 4th quarter of 2010 the estimated default rate for corporate market customers with a normal score was an estimated 2.67 per cent, while the actual default rate was 2.53 per cent. During the period from 2007 to 2010 the estimated default rate was 2.11 per cent, while the actual default rate was 2.24 per cent.

**Loss given default - LGD**

**Description of models**

The loss given default describes how much the Group potentially can lose if the customer defaults on his obligations. The valuation takes into account the value of underlying securities and the costs the Group has in recovering defaulted commitments. The Group establishes the realisation value for the collateral pledged on the basis of its own experience over time, and so that these reflect the assumed realisation value, based on a conservative valuation in an economic downturn.

SpareBank 1 SR-Bank takes into account the main types of collateral as illustrated in Table 13 below:

<table>
<thead>
<tr>
<th>Type of collateral</th>
<th>Retail market</th>
<th>Corporate market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real property</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Motor vehicles</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Leisure boats</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Securities</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Guarantees</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Machinery and plant</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Vessels</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Construction equipment</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Agricultural chattels</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Trade receivables</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Deposits</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

Deposits are not permitted as collateral for retail market customers that are encompassed by the consumer definition in the Financial Contracts Act.

In the retail market the market value of real estate is stipulated either by utilising a broker valuation/appraisal, value estimates from Eiendomsverdi (applies only to residential properties) or by self-assessment in exceptional cases. Eiendomsverdi is an information and analysis tool that gives access to an estimated market value for properties in Norway. Value estimates from Eiendomsverdi may be utilised in accordance with internal procedures if the property is located in a well-functioning residential market and if there is little uncertainty with regard to the value estimate. A self-assessment can only be used if the terms for this have been met, but a person other than the customer manager must approve the valuation that is used as the basis. The realisation value for real property is stipulated by using the market value as the basis, and reducing this by 20 per cent for residential properties and...
40 per cent for land and recreational properties, respectively. In the retail market, assets other than real property are used as collateral to a limited extent.

In the corporate market the lease value method is the primary method for calculating the collateral value of commercial properties. The market value is calculated by multiplying the net rental income by an interest rate that reflects risk-free investment + a general risk premium. On the basis of the calculated market value the realisation value is stipulated at between 60 and 80 per cent, dependent on the building's condition and what it is used for. Specialised industrial buildings with limited alternative application possibilities are given a realisation value of 25 per cent of the market value as a maximum.

Other security values are assessed in accordance with stipulated internal routines. The realisation value of the provided securities is stipulated by using the market value as the basis, and this is reduced by a factor that varies with the security object's properties and amounts to a minimum of 20 per cent. Securities in the form of negative mortgage and unlisted securities are not given any security-related realisation value, while guarantees can only be given a realisation value if certain terms are fulfilled.

Seven different classes are used (1 - 7) for the classification of commitments in accordance with the loss given default. Definitions of these classes for corporate market commitments are illustrated in Table 14 below. Retail market customers have somewhat higher estimated recovery levels on defaulted commitments, and similar loss given defaults for these will therefore be somewhat lower than for corporate market customers within the same collateral class.

<table>
<thead>
<tr>
<th>Class</th>
<th>Loss given default</th>
<th>Loss given default</th>
<th>corresponds to collateral coverage (realisation value)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lower limit</td>
<td>Upper limit</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>-</td>
<td>0.08%</td>
<td>(over 120%)</td>
</tr>
<tr>
<td>2</td>
<td>-</td>
<td>0.08%</td>
<td>(over 100%)</td>
</tr>
<tr>
<td>3</td>
<td>0.08%</td>
<td>13.62%</td>
<td>(over 80%)</td>
</tr>
<tr>
<td>4</td>
<td>13.62%</td>
<td>27.23%</td>
<td>(over 60%)</td>
</tr>
<tr>
<td>5</td>
<td>27.23%</td>
<td>40.85%</td>
<td>(over 40%)</td>
</tr>
<tr>
<td>6</td>
<td>40.85%</td>
<td>54.46%</td>
<td>(over 20%)</td>
</tr>
<tr>
<td>7</td>
<td>54.46%</td>
<td>68.08%</td>
<td>Up to 20%</td>
</tr>
</tbody>
</table>

**Validation results**

**Accuracy of loss given default (LGD)**

The analysis shows to what extent the calculated loss given default on defaulted commitments corresponds to the actual loss given default. While SpareBank 1 SR-Bank uses long-term outcomes when calculating the probability of default, the Group uses the so-called downturn estimates when calculating the loss given default. This means that the estimated loss given default shall predict the loss given default during an economic downturn.

When calculating the loss given default for the retail market the market value for guarantees is usually adjusted downwards by a minimum of 20 per cent in order to reflect the assumed realisation value during economic downturns.
Figure 68 below shows the estimated and actual loss given default for defaulted commitments in SpareBank 1 SR-Bank for the period 2000 to 2010, divided into defaulted retail market mortgage commitments and other defaulted commitments. Since validation of the loss given default requires a certain clarification period, the results from last year's validation will include the best loss estimate for defaulted unsettled commitments.

**Figure 68: Loss given defaulted commitments in the retail market**

The analysis shows that for defaulted commitments with real property collateral the actual loss given default is 4.1 per cent compared with an estimated loss given default\(^8\) of 6.0 per cent for the period. For other defaulted commitments the actual loss given default is 39.0 per cent, compared with an estimated loss given default of 48.5 per cent. Therefore, the analysis shows a general overestimation of the actual loss given default for both customers with a mortgage on real property and for other customers.

Figure 69 below shows the estimated and actual loss given default for defaulted commitments in the corporate market in SpareBank 1 SR-Bank for the period from 2000 to 2010. Since validation of the loss given default requires a certain clarification period, the results from the last year's validation will include the best loss estimate for defaulted unsettled commitments.

---

\(^8\) The estimated loss given default is estimated for all customers in default one month prior to default.
The analysis shows that the actual loss given default for defaulted commitments is 28 per cent, compared with an estimated 37 per cent. The loss data covers the period from 2000 to 2010, which includes largely years with high economic activity, while the estimated loss given default will predict the loss given default during an economic downturn. This is one of the explanations for the deviation between the estimated and actual loss given default.

**Exposure at default - EAD**

The conversion factor (CF) defines to what extent the unutilised credit limit is anticipated drawn up at default. For guarantees and allocated, but not drawn up limits for corporate market customers a drawing of 75 per cent (0.75 per cent). For allocated, but not drawn up limits for corporate market customers there is a drawing of 100 per cent (1).

**Accuracy of CF factor (EAD)**

The conversion factor (CF) defines to what extent the unused credit limit is expected to be drawn down at default. If the conversion factor (CF) is set at 1, the exposure at default (EAD) is equal to full utilisation of the limit.

For the retail market the CF factor for credit facilities are set conservatively at 100 per cent (1). The validation results show that the actual conversion factor is significantly lower, as is illustrated in figure 70 below. The figure shows that during the period from 2007 to 2010 the conversion factor has, on average, been 50 per cent, with a range from the lowest observed value of 36 per cent to the highest observed value of 65 per cent. If the Entire SpareBank 1 Alliance is seen as a whole the average conversion faction is 57 per cent, but there is a significantly lower range in the observed values over time as a result of a larger statistical data basis.
For the corporate market the CF factor for drawing rights including securities for facilities are set conservatively at 75 per cent (0.75). The validation results show that the actual conversion factor is significantly lower, as is illustrated in figure 71 below. The figure shows that during the period from 2007 to 2010 the conversion factor has, on average, been 44 per cent, with a range from the lowest observed value of 28 per cent to the highest observed value of 60 per cent. If the Entire SpareBank 1 Alliance is seen as a whole the average conversion faction is 43 per cent, but there is a significantly lower range in the observed values over time as a result of a larger statistical data basis.
Expected loss - EL

Expected loss describes the loss the Group can statistically expect to lose on the loan portfolio during a 12-month period (long-term outcome). Expected loss is calculated by multiplying the probability of default, exposure at default and loss given default, respectively.

Risk groups

A commitment is assigned a risk group from the lowest to the highest risk group based on the commitment’s expected loss. The risk groups are defined as illustrated in Table 15 below.

Table 15: Definition of risk groups

<table>
<thead>
<tr>
<th>Risk group</th>
<th>Expected loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest</td>
<td>0%</td>
</tr>
<tr>
<td>Low</td>
<td>0.0125%</td>
</tr>
<tr>
<td>Average</td>
<td>0.50%</td>
</tr>
<tr>
<td>High</td>
<td>2.00%</td>
</tr>
<tr>
<td>Highest</td>
<td>2.40%</td>
</tr>
</tbody>
</table>
Risk-adjusted capital - UL

There are many factors that affect the Group's losses on loans and credits. The expected loss is based on the amounts that are uncertain. The uncertainty is to a great extent related to the properties of the commitments. There is relatively little uncertainty connected to well-secured commitments for borrowers with a good capacity to service loans, while there is relatively great uncertainty connected with secured commitments and with customers with an unstable capacity to service loans.

To take these factors into account an unexpected loss on all commitments is calculated. By totalling the unexpected losses among all the commitments we get an estimate of how much the Group can lose beyond the expected loss. This estimate takes into account that all the customers do not generate losses at the same time. Therefore a correlation of 0.2 is used between the customers in order to take this into consideration. Based on available international studies this correlation is assessed as a conservative approach.

In other words, risk-adjusted capital describes how much capital the Group finds it requires to cover the actual risk the Group believes it requires to cover the actual risk assumed. Since it is impossible to fully protect against all losses, the Group has stipulated that the risk-adjusted capital shall cover all possible unexpected losses based on a stipulated confidence level of 99.97 per cent.

Risk pricing - Rorac

SpareBank 1 SR-Bank is concerned about pricing risk correctly. This means that commitments with a high risk are priced higher than commitments with low risk. The general level of risk pricing will, however, also depend on the Group's general return targets and the consideration to the competition situation.

SpareBank 1 SR-Bank therefore uses models that calculate the correct risk price that should be taken into consideration when pricing the expected loss and return on risk-adjusted capital. The risk pricing model uses the same main components as in the Group's risk classification system as the basis.

The model is based on a standard "RARORAC" model (Risk Adjusted Return On Risk Adjusted Capital) for measuring risk-adjusted return.

The pricing model is primarily used for granting and renewing credit and also to calculate the customer's price and to measure and follow up profitability.
4.5.3 Market risk

The Group reports regulatory capital in accordance with the standard approach for market risk. Risk-adjusted capital for interest rate, currency and securities risk is calculated in connection with Pillar 2 according to the Value at Risk (VaR) principle. The purpose of the tool is to estimate the level of the bank’s market risk and necessary economic capital as a result of the calculated risk exposure. The VaR model uses historic observations to estimate future variances and co-variances. The figure below shows the different sequences that are used as the basis for the VaR calculation:

*Figure 72: Steps in the VaR model*

The VaR model is an important tool in connection with the internal limits and capital allocation. However, the model is not used in the day-to-day management of the Group’s market risk.

Quantification of the risk-adjusted capital for spread risk in the bond portfolios is calculated in accordance with the Financial Supervisory Authority of Norway’s model for risk-based supervision of market risk in insurance companies. The method is primarily based on Solvvens II (QIS5 specifications) and uses a confidence level of 99.5 per cent as its basis. Since SpareBank 1 SR-Bank calculates risk-adjusted capital at 99.97 per cent an adjustment factor has been included to account for the difference in the confidence level.

4.5.4 Operational risk

Operational risk identifies significant business and support processes in the Group. In order to identify operational risk a combination of workshops with process teams are used and possibly other expert resources. Data on loss incidents obtained from SpareBank 1 SR-Bank’s own loss and incident database are included, as well as external incidents.
For each business and support process a general analysis is carried out based on a CoSo recommendation.

The operational risk for business and support processes is identified through the workshop with the process teams. In order to identify operational risk a special tool called Orbit (Operational Risk in Banking Identification Tool) is used. This tool has been developed by the University of Stavanger. The method focuses on future potential incidents and creating awareness of the operational risk that the process is exposed to. The method benefits from collective knowledge and experience while at the same time contributing to increased knowledge of operational risk.

Based on the detailed analysis an estimate is prepared of the number of incidents based on operational risk for the individual business and support process compared with the pre-defined loss intervals, cf. figure 74 below.

**Figure 74: Quantifying operational risk**

<table>
<thead>
<tr>
<th>Process/Sub process</th>
<th>Scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk</td>
<td>Source</td>
</tr>
<tr>
<td>High</td>
<td>Medium</td>
</tr>
</tbody>
</table>

Estimated number of incidents each year is based on the following factors;

**Loss incidents and undesired incidents.** For internal incidents the type of loss incident and undesired incidents are evaluated, as well as the consequences of these, i.e. actual losses or potential losses. Internal incidents and the loss history provide a good indication of the effect of established control and management measures. Experience from external incidents is used to say something about the potential for any internal incidents, provided the point of departure for the incident is representative for the organisation and product range.
Expert assessments The process manager and professional experts with broad knowledge and long experience from the individual process areas participate in estimating the number of incidents. The experts have no established incentives for quantifying operational risk and therefore emerge as independent.

The number of incidents each year includes the estimated expected loss with relatively small amounts and more numbers than for unexpected loss. The estimated number of incidents each year within an amount interval may vary from a single incident per month to a single incident per year, or an incident every 10 years (0.10/year), every 50 years (0.02/years), etc.

The amount intervals are based on internal bank and historic data from previous internal, national and international incidents. In addition to the estimated number of incidents within given amount intervals, a maximum loss for each identified risk shall be defined. A maximum loss is stipulated based on expert assessments as well as internal data and national/international incidents.

The risk profile is prepared based on EL (expected loss) and UL (unexpected loss, 99.75 per cent confidence level).

The utilised scenario analyses and statistical models (Monte Carlo simulation) is used to calculate the Group's risk exposure to operational risk. The factors in the scenario analyses are based on identified risks, loss data and expert assessments. A picture is created of what risks are faced, and statistical distributions are linked to each variable that is included in the calculation models and simulates random draws from each of them at the same time. Minimum and maximum values, as well as the expected number of incidents, are defined in the table, see figure 74.

When the risk profile is stipulated for each business and support process an overall calculation of the risk profile for operational risk based on the same method as describe above is carried out. Any correlation between the different business and support processes are taken into account in the calculation.

4.5.5 Ownership risk

When calculating risk-adjusted capital for ownership risk the companies' own ICAAP or similar capital calculations are used as the basis.

4.5.6 Commercial risk

Commercial risk is calculated based on the volatility in the Group's income and any additional costs as a result of unrest in the funding market.

4.5.7 Reputation risk

When calculating the risk-adjusted capital for reputation risk scenario analyses and statistical models (Monte Carlo simulation) are used. The factors in the scenario analyses are based on identified risks and expert assessments.

4.5.8 Strategic risk

Risk adjusted capital for strategic risk is stipulated on the basis of expert knowledge and shall reflect the downside risk of strategic projects.
4.5.9 Diversification effects

The diversification effect illustrates the risk reduction achieved by the Group by incorporating more risk areas that are not expected to incur a loss simultaneously. The combined risk is a result of the calculated risk of the different areas and the degree of covariance between the different risks.

The Group is aware that little empirical data exists in Norway and internationally for estimating, using, validating and testing calculated diversification effects between different risk types. The Group is also aware that there is significant scepticism among international supervisory authorities with regard to the methods that are used for calculating diversification effects in the institutions. The Financial Supervisory Authority of Norway shares this scepticism and will be careful about allowing the use of diversification effects for the institution's calculation of capital requirements.

Based on the aforementioned factors, SpareBank 1 SR-Bank has chosen a conservative approach when calculating the correlation coefficients so that responsible deductions are made from the combined capital requirements.

Attempts have been made to estimate the correlation effect with the help of historical data where this has been possible (for credit risk and market risk). In these areas the Group has looked at both the correlation effect over a long period of time (1988-2004) and for a given stress period (1990-1995). The Group has subsequently chosen to use the most conservative estimates in the calculation of the diversification effects. In the credit area the credit losses for Norwegian banks during the period from 1988 to 2004 have been used as the basis.

In areas where no data exists conservative estimates based on qualitative assessments have been used.
5. **PILLAR 3: DETAILED INFORMATION ON REGULATORY CAPITAL ADEQUACY**

5.1 Consolidation

*Table 16: Consolidation basis (figures in NOK 1,000)*

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>No. shares</th>
<th>Book value</th>
<th>Voting right</th>
<th>Consolidation method</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Companies which are wholly consolidated</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SpareBank 1 SR-Finans AS</td>
<td>334 000</td>
<td>418 686</td>
<td>100 %</td>
<td>Acquisition method</td>
</tr>
<tr>
<td>EiendomsMegler 1 SR-Eiendom AS</td>
<td>150</td>
<td>45 365</td>
<td>100 %</td>
<td>Acquisition method</td>
</tr>
<tr>
<td>Westbroker Finans AS</td>
<td>100</td>
<td>-</td>
<td>100 %</td>
<td>Acquisition method</td>
</tr>
<tr>
<td>SR-Investering AS</td>
<td>3 500</td>
<td>174 087</td>
<td>100 %</td>
<td>Acquisition method</td>
</tr>
<tr>
<td>SR-Forvaltning ASA</td>
<td>6 000</td>
<td>29 019</td>
<td>100 %</td>
<td>Acquisition method</td>
</tr>
<tr>
<td>SR-Forretningsservice AS</td>
<td>1 000</td>
<td>125</td>
<td>100 %</td>
<td>Acquisition method</td>
</tr>
<tr>
<td>Kvinnherad Sparebank Eigedom</td>
<td>3 000</td>
<td>15 061</td>
<td>100 %</td>
<td>Acquisition method</td>
</tr>
<tr>
<td>SpareBank 1 SR-Fondsforvaltning ASA</td>
<td>10 000</td>
<td>11 636</td>
<td>100 %</td>
<td>Acquisition method</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>693 979</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Consolidation method is equal for accounting purposes and capital adequacy purposes

**Investments in associated companies**
Investments in associated companies are recognised according to the equity method for the Group and according to the acquisition method for the parent bank. Investments are recognised in the same way as for capital adequacy, with the exception of the Group’s investments of 28.57 % in SpareBank 1 Boligkreditt AS and 24.13% in SpareBank 1 Næringskreditt AS. Proportionate consolidation is utilised for the Group’s capital adequacy.

**Investments in joint ventures**
The Group has a shareholding of 19.5% in SpareBank 1 Gruppen AS, 19.5 % in Bank 1 Oslo AS and 23.5 % in BN Bank ASA. These investments are recognised according to the equity method. For the Group, the book value of the investment in SpareBank 1 Gruppen is deducted from subordinated loan capital and in the calculation basis for capital adequacy. In relation to the investment in BN Bank ASA, proportionate consolidation is applied to the Group’s capital adequacy. Investments in SpareBank 1 SR-Bank parent bank are recognised according to the acquisition method. The share of the investment in SpareBank 1 Gruppen AS’ book value which exceeds 2% of SpareBank 1 Gruppen AS’ subordinated loan capital is deducted from subordinated loan capital and the calculation basis.
Table 17: Subordinated loan capital in other financial institutions

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Book value</th>
</tr>
</thead>
<tbody>
<tr>
<td>SR-Pension fund</td>
<td>35</td>
</tr>
<tr>
<td>Sandnes Sparebank</td>
<td>65</td>
</tr>
<tr>
<td>Other financial institutions</td>
<td>21</td>
</tr>
<tr>
<td>Total</td>
<td>121</td>
</tr>
</tbody>
</table>

SpareBank 1 SR-Bank places an emphasis on maintaining satisfactory capitalisation at all times for all business units within the Group. The Group’s control bodies have not imposed any limitations on the Board of Directors’ authorisation to transfer capital between the parent bank and its subsidiaries and from subsidiary to subsidiary with the exception of regulatory and other statutory limitations. Neither are there any articles of association which impose such limitations.

For the same reason, the bank and its subsidiaries do not enter into agreements which impose limitations on the Board of Directors’ capacity to transfer capital as mentioned above. This applies to funding agreements and agreements with suppliers and customers.

Based on the above, the Board of Directors has an unlimited authorisation to transfer capital between the different business units in the parent bank. Moreover, the transfer of capital between the companies will be regulated by ordinary legislation for these companies and for the financial group as a whole. As with investments in subsidiaries, the Group has a strategic interest in supporting the activities of SpareBank 1 Boligkreditt AS and SpareBank 1 Gruppen AS. In this context, the Group avoids entering into agreements or adopting measures and the like which imply a limitation on the owner banks’ capacity to transfer capital to these companies, should this be necessary to generate satisfactory capital adequacy/solidity. The Group is not aware of any such limitations with the exception of those imposed by legislation and the regulation. The Group assumes that the transfer of capital from these two companies to the owner banks will not be practical, with the exception of ordinary dividend payments, and has based the Group’s own risk profile on this assumption. The Group is not aware of any retail-law limitations which restrict payment of dividends from these companies.

5.2 Subordinated loan capital

Table 18: Subordinated loan capital, including core capital and supplementary capital and actual supplements, deductions and limitations as of 31 December 2010.

<table>
<thead>
<tr>
<th>Group (NOK million)</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity certificate capital</td>
<td>3 183</td>
<td>3 023</td>
</tr>
<tr>
<td>- Own equity certificates</td>
<td>-3</td>
<td>-9</td>
</tr>
<tr>
<td>Share premium reserve</td>
<td>625</td>
<td>458</td>
</tr>
<tr>
<td>Equalisation fund</td>
<td>1 175</td>
<td>759</td>
</tr>
<tr>
<td>Provision for dividends</td>
<td>336</td>
<td>212</td>
</tr>
<tr>
<td>Savings bank’s reserve</td>
<td>2 477</td>
<td>2 241</td>
</tr>
<tr>
<td>Compensation fund</td>
<td>55</td>
<td>20</td>
</tr>
<tr>
<td>Endowment fund</td>
<td>372</td>
<td>240</td>
</tr>
<tr>
<td>Fund for unrealised gain</td>
<td>43</td>
<td>127</td>
</tr>
<tr>
<td>Other equity</td>
<td>1 139</td>
<td>1 002</td>
</tr>
<tr>
<td>Total equity carried on balance sheet</td>
<td>9 402</td>
<td>8 073</td>
</tr>
</tbody>
</table>

Deferred tax, goodwill and other intangible assets | -77  | -42   |
Fund for unrealised gains, held for sale          | -2   | -1    |
<table>
<thead>
<tr>
<th>Description</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction for dividend provision</td>
<td>-336</td>
<td>-212</td>
</tr>
<tr>
<td>50% of subordinated loan capital in other financial institutions</td>
<td>-21</td>
<td>-17</td>
</tr>
<tr>
<td>50% of expected loss IRB deduction provision for loss</td>
<td>-268</td>
<td>-337</td>
</tr>
<tr>
<td>50% capital adequacy reserve</td>
<td>-645</td>
<td>-552</td>
</tr>
<tr>
<td>Share of non-performing non amortised estimate deviations</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Perpetual capital security 1)</td>
<td>1 389</td>
<td>1 218</td>
</tr>
<tr>
<td><strong>Total core capital</strong></td>
<td>9 442</td>
<td>8 130</td>
</tr>
<tr>
<td>Supplementary capital in addition to core capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Perpetual subordinated loan capital 1)</td>
<td>783</td>
<td>760</td>
</tr>
<tr>
<td>Time-limited subordinated loan capital 1)</td>
<td>2 191</td>
<td>2 045</td>
</tr>
<tr>
<td>50% of subordinated loan capital in other financial institutions</td>
<td>-21</td>
<td>-17</td>
</tr>
<tr>
<td>50% of expected loss IRB deduction provision for loss</td>
<td>-268</td>
<td>-337</td>
</tr>
<tr>
<td>50% capital adequacy reserve</td>
<td>-645</td>
<td>-552</td>
</tr>
<tr>
<td><strong>Total supplementary capital</strong></td>
<td>2 040</td>
<td>1 899</td>
</tr>
<tr>
<td><strong>Net subordinated loan capital</strong></td>
<td>11 482</td>
<td>10 029</td>
</tr>
<tr>
<td>Minimum requirement subordinated loan capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit risk (see table 34)</td>
<td>6 112</td>
<td>5 864</td>
</tr>
<tr>
<td>Market risk (see table 40)</td>
<td>348</td>
<td>319</td>
</tr>
<tr>
<td>Operational risk (see table 41)</td>
<td>374</td>
<td>320</td>
</tr>
<tr>
<td>Capital requirement related to transitional schemes</td>
<td>566</td>
<td>264</td>
</tr>
<tr>
<td><strong>Minimum requirement subordinated loan capital</strong></td>
<td>7 400</td>
<td>6 767</td>
</tr>
<tr>
<td><strong>Capital adequacy</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Of which core capital</td>
<td>10.21%</td>
<td>9.61%</td>
</tr>
<tr>
<td>Of which supplementary capital</td>
<td>2.21%</td>
<td>2.26%</td>
</tr>
<tr>
<td><strong>Capital adequacy</strong></td>
<td>12.41%</td>
<td>11.86%</td>
</tr>
</tbody>
</table>

Time-limited subordinated loan capital sees a reduction in equity value of 20% every year over the last 5 years before maturity. To the extent that the Group has subordinated loan capital in other financial institutions, this is directly deducted from the Group’s own subordinated loan capital for the share which exceeds 2% of the recipient financial institution’s subordinated loan capital.

If the Group has subordinated loan capital in other financial institutions which constitutes less than 2% of the individual financial institution’s subordinated loan capital, the total amount of such capital is deducted from the Group’s subordinated loan capital for the share which exceeds 10% of the Group’s subordinated loan capital. If the Group is obliged to have 100% capital adequacy reserve for specific assets, a figure corresponding to the asset’s book value shall be deducted from the subordinated loan capital and the calculation basis. The calculation basis is evaluated in relation to risk.
Table 19: Subordinated loan capital and perpetual capital security (figures in NOK million)

<table>
<thead>
<tr>
<th>Principal</th>
<th>Terms</th>
<th>Maturity</th>
<th>First instalment</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time-limited</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>JPY 13 000</td>
<td>3 month Libor + margin</td>
<td>2035</td>
<td>2012</td>
<td>960</td>
<td>853</td>
</tr>
<tr>
<td>NOK 500</td>
<td>3 month Libor + margin</td>
<td>2018</td>
<td>2013</td>
<td>499</td>
<td>499</td>
</tr>
<tr>
<td>NOK 450</td>
<td>3 month Nibor + margin</td>
<td>2017</td>
<td>2012</td>
<td>450</td>
<td>450</td>
</tr>
<tr>
<td>NOK 75</td>
<td>3 month Nibor + margin</td>
<td>2019</td>
<td>2014</td>
<td>86</td>
<td>-</td>
</tr>
<tr>
<td>Total time-limited</td>
<td></td>
<td></td>
<td></td>
<td>1 995</td>
<td>1 802</td>
</tr>
</tbody>
</table>

Perpetual:

<table>
<thead>
<tr>
<th>Principal</th>
<th>Terms</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>USD 75</td>
<td>3 month Libor + margin</td>
<td></td>
<td></td>
<td>439</td>
<td>429</td>
</tr>
<tr>
<td>SEK 200</td>
<td>3 month Stibor + margin</td>
<td></td>
<td></td>
<td>179</td>
<td>173</td>
</tr>
<tr>
<td>NOK 170</td>
<td>3 month Nibor + margin</td>
<td></td>
<td></td>
<td>170</td>
<td>170</td>
</tr>
<tr>
<td>Total perpetual</td>
<td></td>
<td></td>
<td></td>
<td>788</td>
<td>772</td>
</tr>
</tbody>
</table>

Perpetual capital security:

<table>
<thead>
<tr>
<th>Principal</th>
<th>Terms</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>USD 75</td>
<td>3 month Libor + margin</td>
<td></td>
<td></td>
<td>495</td>
<td>493</td>
</tr>
<tr>
<td>NOK 684</td>
<td>3 month Nibor + margin</td>
<td></td>
<td></td>
<td>686</td>
<td>669</td>
</tr>
<tr>
<td>NOK 116</td>
<td>3 month Nibor + margin</td>
<td></td>
<td></td>
<td>115</td>
<td>113</td>
</tr>
<tr>
<td>NOK 40</td>
<td>3 month Nibor + margin</td>
<td></td>
<td></td>
<td>40</td>
<td>-</td>
</tr>
<tr>
<td>Total perpetual capital security</td>
<td></td>
<td></td>
<td></td>
<td>1 336</td>
<td>1 275</td>
</tr>
</tbody>
</table>

Accrued interest

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued interest</td>
<td></td>
<td>25</td>
<td>22</td>
</tr>
</tbody>
</table>

Total subordinated loan capital

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total subordinated loan capital</td>
<td></td>
<td>4 144</td>
<td>3 871</td>
</tr>
</tbody>
</table>

Subordinated loan capital and perpetual capital security against foreign currency are included in the Group’s total currency position such that there is no currency risk related to the loans. Of total NOK 4,144 million in subordinated loan capital, a figure of NOK 1,268 million is core capital, NOK 783 million is perpetual subordinated loan capital and NOK 1,961 million is time-limited subordinated loan capital. Capitalised costs for taking out loans are reflected in the calculation of amortised cost. The maximum limit for perpetual capital security is 15% of total core capital. Any excess amounts are deemed to be perpetual subordinated loan capital.

Financial institutions encompassed by the consolidation

Table 20: Capital requirements, net subordinated loan capital and the individual consolidated companies' capital adequacy.

<table>
<thead>
<tr>
<th>Figures in NOK 1,000</th>
<th>Capital requirement</th>
<th>Net subordinated loan capital</th>
<th>Capital adequacy as percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>SpareBank 1 SR Finans AS</td>
<td>355 192</td>
<td>500 329</td>
<td>11,27</td>
</tr>
<tr>
<td>SpareBank 1 Boligkreditt AS</td>
<td>3 185 482</td>
<td>4 648 942</td>
<td>11,68</td>
</tr>
<tr>
<td>BN Bank ASA</td>
<td>2 525 863</td>
<td>4 424 881</td>
<td>14,01</td>
</tr>
<tr>
<td>SpareBank 1 Næringskreditt AS</td>
<td>557 459</td>
<td>728 291</td>
<td>10,45</td>
</tr>
</tbody>
</table>

SpareBank 1 Boligkreditt AS utilises the IRB method when reporting capital adequacy. The other companies make use of the standard method when reporting capital adequacy.
5.3 Credit risk - general information on credit risk, default and impairment

5.3.1 Portfolio information based on regulatory estimations

The tables below present a summary of the bank’s commitments in relation to credit risk.

Table 21: Total size of commitment, defined as gross lending to customers + guarantees + unutilised credit in the Group, after any write-downs and without consideration for any securities provided and the average size of the commitments during the period, according to type of commitment.

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Size of commitment as of 31.12.10</th>
<th>Average size of commitment in 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate market</td>
<td>64 452</td>
<td>60 724</td>
</tr>
<tr>
<td>Retail market</td>
<td>61 765</td>
<td>54 245</td>
</tr>
<tr>
<td><strong>Gross commitment customers</strong></td>
<td><strong>126 217</strong></td>
<td><strong>118 504</strong></td>
</tr>
<tr>
<td>Individual write-downs</td>
<td>-402</td>
<td>-366</td>
</tr>
<tr>
<td>Write-downs of groups of loans</td>
<td>-357</td>
<td>-339</td>
</tr>
<tr>
<td>Write-down guarantees</td>
<td>-3</td>
<td>-6</td>
</tr>
<tr>
<td><strong>Net commitment customers</strong></td>
<td><strong>125 455</strong></td>
<td><strong>117 795</strong></td>
</tr>
<tr>
<td>Governments (Norges Bank)</td>
<td>1 023</td>
<td>3 643</td>
</tr>
<tr>
<td>Institutions</td>
<td>1 273</td>
<td>1 359</td>
</tr>
<tr>
<td><strong>Total size of commitment</strong></td>
<td><strong>127 751</strong></td>
<td><strong>119 864</strong></td>
</tr>
</tbody>
</table>

Table 22: Size of commitment for every type of commitment divided into significant geographical areas before deduction for write-downs

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Rogaland</th>
<th>Agder counties</th>
<th>Hordaland</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross lending to customers</td>
<td>75 869</td>
<td>9 657</td>
<td>13 139</td>
<td>7 127</td>
<td>105 792</td>
</tr>
<tr>
<td>Unutilised credit</td>
<td>8 997</td>
<td>1 116</td>
<td>936</td>
<td>864</td>
<td>11 913</td>
</tr>
<tr>
<td>Guarantees</td>
<td>5 733</td>
<td>572</td>
<td>1 134</td>
<td>1 073</td>
<td>8 512</td>
</tr>
<tr>
<td><strong>Total gross commitment customers</strong></td>
<td><strong>90 599</strong></td>
<td><strong>11 345</strong></td>
<td><strong>15 209</strong></td>
<td><strong>9 064</strong></td>
<td><strong>126 217</strong></td>
</tr>
</tbody>
</table>

Table 23: Size of commitment for every type of commitment divided into significant branches before deduction for write-downs

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Loans</th>
<th>Unutilised credit</th>
<th>Guarantees</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture/forestry</td>
<td>3 430</td>
<td>738</td>
<td>13</td>
<td>4 181</td>
</tr>
<tr>
<td>Fishing/aquaculture</td>
<td>365</td>
<td>30</td>
<td>1</td>
<td>396</td>
</tr>
<tr>
<td>Mining/extraction</td>
<td>2 236</td>
<td>106</td>
<td>800</td>
<td>3 142</td>
</tr>
<tr>
<td>Industry</td>
<td>2 591</td>
<td>616</td>
<td>1 213</td>
<td>4 420</td>
</tr>
<tr>
<td>Power and water supply/building and construction</td>
<td>3 882</td>
<td>1 438</td>
<td>1 831</td>
<td>7 151</td>
</tr>
<tr>
<td>Commodities, hotel and restaurants</td>
<td>2 504</td>
<td>772</td>
<td>439</td>
<td>3 715</td>
</tr>
<tr>
<td>International shipping, pipe transport, other transport</td>
<td>6 127</td>
<td>136</td>
<td>2 299</td>
<td>8 562</td>
</tr>
<tr>
<td>Property management</td>
<td>22 105</td>
<td>1 860</td>
<td>963</td>
<td>24 928</td>
</tr>
</tbody>
</table>
Services & 5 011 & 1 380 & 499 & 6 890 
Public administration and financial services & 726 & 0 & 383 & 1 109 
Not allocated (added value fixed interest loans) & 323 & -323 & - & - 
**Total corporate market** & 49 300 & 6 753 & 8 441 & 64 494 
Retail market & 56 492 & 5 160 & 71 & 61 723 
**Total gross commitment customers** & 105 792 & 11 913 & 8 512 & 126 217 

Table 24: Size of commitment for each type of commitment according to remaining maturity

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>On request</th>
<th>&lt;1 year</th>
<th>1-5 years</th>
<th>over 5 years</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross loans to customers</td>
<td>37</td>
<td>4 243</td>
<td>12 016</td>
<td>52 199</td>
<td>105 792</td>
</tr>
<tr>
<td>Unutilised credit</td>
<td>12</td>
<td></td>
<td></td>
<td></td>
<td>12 955</td>
</tr>
<tr>
<td>Guarantees</td>
<td>290</td>
<td>1 564</td>
<td>6 658</td>
<td></td>
<td>8 512</td>
</tr>
<tr>
<td><strong>Total gross commitment customers</strong></td>
<td>50 289</td>
<td>4 533</td>
<td>13 580</td>
<td>58 857</td>
<td>127 259</td>
</tr>
</tbody>
</table>

Governments (Norges Bank) & 1 023 & | | | 1 023 |
Institutions & 1 273 & | | | 1 273 |

Table 25: Credit and impairment risk according to significant branches

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Total size of commitment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commitments with impairment</td>
<td>Overdue commitments</td>
</tr>
<tr>
<td>Agriculture/forestry</td>
<td>5</td>
</tr>
<tr>
<td>Fishing/aquaculture</td>
<td>2</td>
</tr>
<tr>
<td>Mining/extraction</td>
<td>-</td>
</tr>
<tr>
<td>Industry</td>
<td>60</td>
</tr>
<tr>
<td>Power and water supply/building and construction</td>
<td>22</td>
</tr>
<tr>
<td>Commodities, hotel and restaurants</td>
<td>45</td>
</tr>
<tr>
<td>International shipping, pipe transport, other transport</td>
<td>96</td>
</tr>
<tr>
<td>Property management</td>
<td>313</td>
</tr>
<tr>
<td>Services</td>
<td>102</td>
</tr>
<tr>
<td>Public administration and financial services</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total corporate market</strong></td>
<td>645</td>
</tr>
</tbody>
</table>

Transferred from write-down of groups of loans & 23 |
Retail market & 117 | 150 | 61 | 7 |
**Total** | 762 | 443 | 402 | 234 |
Table 26: Actual loss per default class for the period

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>A (0.00-0.10 %)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>B (0.10-0.25 %)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>C (0.25-0.50 %)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>D (0.50-0.75 %)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>E (0.75-1.25 %)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>F (1.25-2.50 %)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>G (2.50-5.00 %)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>H (5.00-10.00 %)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>I (10.00- )</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>J</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>K</td>
<td>234</td>
<td>368</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>234</strong></td>
<td><strong>368</strong></td>
</tr>
</tbody>
</table>

Table 27: Separate specification of the total size of commitment with impairment and defaulted commitments according to significant geographical area, including total changes in value and write-downs

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Commitments with impairment</th>
<th>Defaulted commitment</th>
<th>Total value changes and write-downs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rogaland</td>
<td>447</td>
<td>220</td>
<td>229</td>
</tr>
<tr>
<td>Agder-counties</td>
<td>208</td>
<td>55</td>
<td>99</td>
</tr>
<tr>
<td>Hordaland</td>
<td>95</td>
<td>164</td>
<td>70</td>
</tr>
<tr>
<td>Other</td>
<td>12</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>762</strong></td>
<td><strong>443</strong></td>
<td><strong>402</strong></td>
</tr>
</tbody>
</table>

Table 28: Reconciliation of changes in value changes and write-downs respectively for commitments with impairment

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Opening balance as of 01.01.2010</th>
<th>Figure recognised for write-downs</th>
<th>Provisions for or reversals from estimated loss</th>
<th>Closing balance as of 31.12.2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual write-downs</td>
<td>329</td>
<td>258</td>
<td>331</td>
<td>402</td>
</tr>
<tr>
<td>Write-downs of groups of loans</td>
<td>320</td>
<td>-</td>
<td>37</td>
<td>357</td>
</tr>
<tr>
<td>Specific loss provisions for guarantees</td>
<td>8</td>
<td>-</td>
<td>-5</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>657</strong></td>
<td><strong>258</strong></td>
<td><strong>363</strong></td>
<td><strong>762</strong></td>
</tr>
</tbody>
</table>
Table 29: Distribution according to risk class based on the IRB-method

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Default class</th>
<th>Total EAD</th>
<th>Total unutilised facility</th>
<th>Average risk weight</th>
<th>Average loss given default</th>
<th>Average conversion factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate market</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>509</td>
<td>213</td>
<td>0.27</td>
<td>0.45</td>
<td>0.93</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>2 500</td>
<td>970</td>
<td>0.50</td>
<td>0.45</td>
<td>0.89</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>7 163</td>
<td>2 112</td>
<td>0.62</td>
<td>0.45</td>
<td>0.91</td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>6 165</td>
<td>1 561</td>
<td>0.71</td>
<td>0.45</td>
<td>0.92</td>
<td></td>
</tr>
<tr>
<td>E</td>
<td>10 085</td>
<td>1 868</td>
<td>0.91</td>
<td>0.45</td>
<td>0.94</td>
<td></td>
</tr>
<tr>
<td>F</td>
<td>9 520</td>
<td>1 397</td>
<td>1.03</td>
<td>0.45</td>
<td>0.95</td>
<td></td>
</tr>
<tr>
<td>G</td>
<td>10 503</td>
<td>1 629</td>
<td>1.29</td>
<td>0.45</td>
<td>0.95</td>
<td></td>
</tr>
<tr>
<td>H</td>
<td>1 940</td>
<td>181</td>
<td>1.59</td>
<td>0.45</td>
<td>0.97</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>1 696</td>
<td>112</td>
<td>2.15</td>
<td>0.45</td>
<td>0.98</td>
<td></td>
</tr>
<tr>
<td>J</td>
<td>51</td>
<td>6</td>
<td>0.00</td>
<td>0.45</td>
<td>0.96</td>
<td></td>
</tr>
<tr>
<td>K</td>
<td>651</td>
<td>18</td>
<td>0.00</td>
<td>0.45</td>
<td>0.99</td>
<td></td>
</tr>
<tr>
<td>Total corporate market</td>
<td>50 783</td>
<td>10 066</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail market</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>11 879</td>
<td>3 164</td>
<td>0.02</td>
<td>0.10</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>B</td>
<td>21 756</td>
<td>2 178</td>
<td>0.06</td>
<td>0.11</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>24 590</td>
<td>1 854</td>
<td>0.09</td>
<td>0.11</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>14 508</td>
<td>830</td>
<td>0.13</td>
<td>0.11</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>E</td>
<td>11 919</td>
<td>481</td>
<td>0.17</td>
<td>0.12</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>F</td>
<td>4 478</td>
<td>135</td>
<td>0.24</td>
<td>0.12</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>G</td>
<td>905</td>
<td>30</td>
<td>0.36</td>
<td>0.13</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>H</td>
<td>921</td>
<td>17</td>
<td>0.55</td>
<td>0.14</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>684</td>
<td>12</td>
<td>0.78</td>
<td>0.15</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>J</td>
<td>94</td>
<td>0</td>
<td>0.06</td>
<td>0.11</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>K</td>
<td>179</td>
<td>0</td>
<td>0.41</td>
<td>0.30</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>Total retail market</td>
<td>91 912</td>
<td>8 703</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

A commitment is deemed as defaulted if a claim is overdue by more than 90 days and the amount exceeds NOK 1,000, or when the bank has reason to believe that it is probable that the debtor does not have the capacity to repay in accordance with the commitment. The table below illustrates the average estimated and actual default for the portfolio last year and the period from 2007 to 2010. The percentage of default is defined as the total number of customers which are, or which have been in default within a 12 month period, in relation to the total number of customers in the portfolio. This implies that a customer in default with a small commitment carries as much weight as a customer in default with a large commitment.
Table 30: Level of default (IRB)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail market with securities against property</td>
<td>0,98 %</td>
<td>0,35 %</td>
<td>0,90 %</td>
<td>0,35 %</td>
</tr>
<tr>
<td>Other retail market</td>
<td>4,36 %</td>
<td>2,87 %</td>
<td>3,49 %</td>
<td>2,55 %</td>
</tr>
<tr>
<td>Corporate market</td>
<td>3,25 %</td>
<td>2,67 %</td>
<td>2,88 %</td>
<td>2,16 %</td>
</tr>
</tbody>
</table>

Table 31 illustrates estimated and actual loss given default for defaulted loans in SpareBank 1 SR-Bank. The regulation concerning capital requirement stipulates that the estimated loss given default shall represent an economic downturn. The estimated default for retail loans is derived from the loss given default one month prior to default as this is the last data point available. The estimated loss given default of 45% for the corporate market has been stipulated by the authorities in the Regulation concerning capital requirement. The data set contains losses 2000-2010. The estimated default is higher than the actual default since the former is a downturn, whereas actual default is an alternate business cycle estimate.

Table 31: Loss given default for defaulted loans

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Estimated loss given default</th>
<th>Actual loss given default</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail market with security against property</td>
<td>14,20%</td>
<td>4,10%</td>
</tr>
<tr>
<td>Other retail market</td>
<td>53,50%</td>
<td>39,00%</td>
</tr>
<tr>
<td>Corporate market</td>
<td>45,00%</td>
<td>28,00%</td>
</tr>
</tbody>
</table>

Table 32: Total size of commitment and share secured against property, according to commitment category (IRB).

<table>
<thead>
<tr>
<th>Commitment category</th>
<th>Size of commitment</th>
<th>Of which secured against property 1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail market</td>
<td>84 950</td>
<td>96%</td>
</tr>
<tr>
<td>Retail market SMB</td>
<td>4 423</td>
<td>88%</td>
</tr>
<tr>
<td>Other retail market commitments</td>
<td>2 563</td>
<td>2% 2)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>91 936</strong></td>
<td></td>
</tr>
</tbody>
</table>

1) The share is the total commitment with such securities in relation to total commitment for prevailing commitment category.
2) A commitment with a retail market customer where the realisation value of the house is valued at lower than 30% of the customer’s commitment is not categorised as a commitment secured against property, but as other retail market.
SpareBank 1 SR-Bank has no securities which imply a reduced size of commitment. For the corporate market, securities are not taken into consideration in the calculation of LGD. Instead, the LGD factors stipulated by the authorities are applied. Consequently, there is no list of such commitments in the table above.
Table 33: The actual value changes for individual commitment categories and development from previous periods (IRB)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail market commitments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-retail market SMB</td>
<td>4 423</td>
<td>9,0 %</td>
<td>4 057</td>
<td>11,4 %</td>
<td>3 641</td>
<td>22,8 %</td>
<td>2 965</td>
</tr>
<tr>
<td>-retail market secured against property</td>
<td>84 950</td>
<td>14,9 %</td>
<td>73 956</td>
<td>33,6 %</td>
<td>55 342</td>
<td>0,0 %</td>
<td>55 323</td>
</tr>
<tr>
<td>-other retail market</td>
<td>2 563</td>
<td>-7,8 %</td>
<td>2 780</td>
<td>97,3 %</td>
<td>1 409</td>
<td>5,3 %</td>
<td>1 338</td>
</tr>
<tr>
<td>Corporate market</td>
<td>28 018</td>
<td>18,4 %</td>
<td>23 665</td>
<td>17,1 %</td>
<td>20 216</td>
<td>35,1 %</td>
<td>14 965</td>
</tr>
<tr>
<td>Specialised enterprise</td>
<td>26 784</td>
<td>1,0 %</td>
<td>26 515</td>
<td>-19,1 %</td>
<td>32 765</td>
<td>23,8 %</td>
<td>26 474</td>
</tr>
<tr>
<td>Sum</td>
<td><strong>146 738</strong></td>
<td><strong>12,0 %</strong></td>
<td><strong>130 973</strong></td>
<td><strong>15,5 %</strong></td>
<td><strong>113 373</strong></td>
<td><strong>12,2 %</strong></td>
<td><strong>101 065</strong></td>
</tr>
</tbody>
</table>
5.3.2 **Minimum regulatory capital requirements**

Table 34: Minimum requirement for subordinated loan capital to credit risk according to commitment categories

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Commitment</th>
<th>Commitment EAD</th>
<th>Minimum requirement for subordinated loan capital consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate market</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Specialised enterprise</td>
<td>26 784</td>
<td>25 617</td>
<td>1 953</td>
</tr>
<tr>
<td>Other enterprises</td>
<td>28 018</td>
<td>25 800</td>
<td>2 042</td>
</tr>
<tr>
<td>Retail market</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail market SMB</td>
<td>4 423</td>
<td>4 416</td>
<td>38</td>
</tr>
<tr>
<td>Retail market persons</td>
<td>84 950</td>
<td>84 938</td>
<td>680</td>
</tr>
<tr>
<td>Retail market other</td>
<td>2 563</td>
<td>2 558</td>
<td>87</td>
</tr>
<tr>
<td>Minimum requirement, credit risk IRB</td>
<td>146 738</td>
<td>143 329</td>
<td>4 800</td>
</tr>
<tr>
<td>Governments</td>
<td>1 420</td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>Institutions</td>
<td>7 372</td>
<td></td>
<td>113</td>
</tr>
<tr>
<td>Corporate market</td>
<td>1 703</td>
<td></td>
<td>88</td>
</tr>
<tr>
<td>Retail market</td>
<td>550</td>
<td></td>
<td>15</td>
</tr>
<tr>
<td>Consolidated companies</td>
<td>13 083</td>
<td></td>
<td>982</td>
</tr>
<tr>
<td>Other assets</td>
<td>2 797</td>
<td></td>
<td>213</td>
</tr>
<tr>
<td>Minimum requirement standard method</td>
<td>26 925</td>
<td></td>
<td>1 413</td>
</tr>
<tr>
<td>Intangible assets</td>
<td></td>
<td></td>
<td>6</td>
</tr>
<tr>
<td>Deduction</td>
<td></td>
<td></td>
<td>-107</td>
</tr>
<tr>
<td>Total minimum requirement for subordinated loan capital connected to credit risk</td>
<td></td>
<td></td>
<td>6 112</td>
</tr>
</tbody>
</table>
5.4 Market risk

5.4.1 Portfolio information

Table 35: Investments (equity position outside of the trading portfolio) according to objective

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Investments</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial investments at fair value over result</td>
<td>Austevoll Seafood</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Sparebanken Vest</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Borea Opportunity II</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>Progressus</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>Viking Fotball</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>Viking Venture II</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>Hitec Vision RetailEquity IV LP</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>Hitec Vision Asset Solution</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>OptiMarin</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>RPT Gass</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>Other financial investments</td>
<td>37</td>
</tr>
<tr>
<td>Total financial investments at fair value over result</td>
<td></td>
<td>120</td>
</tr>
<tr>
<td>Strategic investments at fair value over result</td>
<td>Nordito Property</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>Nets Holding</td>
<td>264</td>
</tr>
<tr>
<td>Total strategic investments at fair value over result</td>
<td></td>
<td>276</td>
</tr>
<tr>
<td>Strategic investments held for sale</td>
<td>Other strategic investments</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>400</td>
</tr>
</tbody>
</table>

Shares and units are classified either as fair value over result or held for sale. Change in fair value from opening balance sheet is recognised as income from financial investments.

Table 36: Overview of book value and fair value, gain and loss

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Book value</th>
<th>Fair value</th>
<th>Total realised gain or loss in 2010</th>
<th>Unrealised gain or loss in 2010</th>
<th>Figure included in core capital or supplementary capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial investments at fair value over result</td>
<td>120</td>
<td>120</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Strategic investments at fair value over result</td>
<td>276</td>
<td>276</td>
<td>199</td>
<td>-73</td>
<td>0</td>
</tr>
<tr>
<td>Strategic investments held for sale</td>
<td>4</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>400</td>
<td>400</td>
<td>200</td>
<td>-73</td>
<td>1</td>
</tr>
</tbody>
</table>

Table 37: Overview of type and value of listed shares, unlisted shares in diversified portfolios and other commitments

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Value 2010</th>
<th>Value 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unlisted</td>
<td>391</td>
<td>248</td>
</tr>
<tr>
<td>Traded on stock exchange</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Other</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>400</td>
<td>254</td>
</tr>
</tbody>
</table>
Table 38: Overview of counterpart risk for derivatives etc. outside of the trading portfolio

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Nominal value</th>
<th>Fair value</th>
<th>Size of commitment</th>
<th>Minimum requirement for subordinated loan capital 1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency forwards</td>
<td>3 972</td>
<td>69</td>
<td>126</td>
<td>2</td>
</tr>
<tr>
<td>Currency swaps</td>
<td>14 845</td>
<td>240</td>
<td>452</td>
<td>8</td>
</tr>
<tr>
<td>Currency options</td>
<td>94</td>
<td>2</td>
<td>2</td>
<td>-</td>
</tr>
<tr>
<td><strong>Currency instruments on the trading portfolio</strong></td>
<td><strong>18 911</strong></td>
<td><strong>311</strong></td>
<td><strong>580</strong></td>
<td><strong>10</strong></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>97 528</td>
<td>1 001</td>
<td>1 224</td>
<td>47</td>
</tr>
<tr>
<td>Non-standardised contracts</td>
<td>6 391</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Interest rate instruments on the trading portfolio</strong></td>
<td><strong>103 919</strong></td>
<td><strong>1 002</strong></td>
<td><strong>1 224</strong></td>
<td><strong>47</strong></td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>25 250</td>
<td>1 486</td>
<td>179</td>
<td>27</td>
</tr>
<tr>
<td><strong>Interest rate instruments outside of the trading portfolio</strong></td>
<td><strong>25 250</strong></td>
<td><strong>1 486</strong></td>
<td><strong>179</strong></td>
<td><strong>27</strong></td>
</tr>
<tr>
<td>Credit derivatives</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Accrued interest</strong></td>
<td></td>
<td>442</td>
<td>229</td>
<td>18</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>148 080</strong></td>
<td><strong>3 241</strong></td>
<td><strong>2 212</strong></td>
<td><strong>102</strong></td>
</tr>
</tbody>
</table>

1] Minimum requirement for subordinated loan capital is calculated in whole according to the standard method.

Table 39: The sensitivity of net interest cost before tax (interest rate change of 1 percentage point) at year-end 2010 (figures in NOK million)

<table>
<thead>
<tr>
<th>Sensitivity of net interest cost</th>
<th>31.12.10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Currency</td>
<td></td>
</tr>
<tr>
<td>NOK</td>
<td>17</td>
</tr>
<tr>
<td>EUR</td>
<td>3</td>
</tr>
<tr>
<td>USD</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
</tr>
</tbody>
</table>

Interest rate risk occurs as the Group may have different fixed-rate periods for assets and liabilities. Trading activities related to sale of interest rate instruments shall comply with adopted limits and authorisations at all times. The Group’s limits define quantitative targets for maximum potential loss. The commercial risk is quantified and continuously monitored. The Group’s principal limits for interest rate risk define maximum loss in the event of changes in interest rates of 1 percentage point. Maximum loss in total shall not exceed NOK 30 million on the Norwegian krone balance sheet, and within a maturity limit (0-3 months, 3-6 months, 6-12 months, 1-2 years etc.) maximum loss shall not exceed NOK 15 million. Maximum net loss related to interest rate risk on the foreign currency...
balance sheet is NOK 8 million before tax. The maximum interest rate risk for individual currencies is NOK 5 million.

5.4.2 Minimum requirement for subordinated loan capital

Table 40: Minimum requirement for subordinated loan capital for market risk, including position risk, counterparty risk, settlement risk, currency risk and commodity risk

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Consolidated 2010</th>
<th>Consolidated 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Position risk</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Of which equito instruments</td>
<td>34</td>
<td>47</td>
</tr>
<tr>
<td>- Of which debt instruments market portfolio</td>
<td>116</td>
<td>82</td>
</tr>
<tr>
<td>- Of which debt instruments bank portfolio</td>
<td>110</td>
<td>129</td>
</tr>
<tr>
<td><strong>Counterparty risk (derivatives in trading portfolio)</strong></td>
<td>88</td>
<td>61</td>
</tr>
<tr>
<td>- Of which derivatives in trading portfolio</td>
<td>61</td>
<td>42</td>
</tr>
<tr>
<td>- Of which derivatives outside of trading portfolio</td>
<td>27</td>
<td>19</td>
</tr>
<tr>
<td><strong>Currency risk</strong></td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>348</td>
<td>319</td>
</tr>
</tbody>
</table>

5.5 Operational risk

Table 41: Minimum requirement for subordinated loan capital for operational risk according to standardised method

<table>
<thead>
<tr>
<th>Figures in NOK million</th>
<th>Consolidated</th>
<th>EiendomsMegler 1</th>
<th>SR-Finans</th>
<th>SR-Forvaltning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking services for retail market customers</td>
<td>211</td>
<td>33</td>
<td>0</td>
<td>8</td>
</tr>
<tr>
<td>Banking services for corporate customers</td>
<td>146</td>
<td>0</td>
<td>21</td>
<td>0</td>
</tr>
<tr>
<td>Payment and settlement services</td>
<td>17</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>374</td>
<td>33</td>
<td>21</td>
<td>8</td>
</tr>
</tbody>
</table>

The minimum requirement for subordinated loan capital for operational risk is calculated as a percentage of average income for each business segment over the past 3 years. Banking services for the retail market 12%, banking services for the corporate market 15% and 18% for other services.
6. **COMPARISON OF REGULATORY CAPITAL AND RISK-ADJUSTED CAPITAL**

The figure below shows the regulatory capital and risk-adjusted capital as of the 4th quarter of 2010.

Figure 75: Comparison of regulatory capital and risk-adjusted capital

![Comparison of Regulatory Capital and Risk-Adjusted Capital](image)

Figure 75 shows that the minimum regulatory capital requirement is NOK 6.8 billion before the IRB transitional arrangement and NOK 7.4 billion including the transitional arrangement. For a transitional period, the Capital Requirements Regulations stipulate that the requirement for regulatory capital in 2009 cannot be lower than 80 per cent of the minimum requirement calculated according to the old regulations (Basel 1 from 2006). It has been adopted that the current floor will be continued in 2010 and 2011. The floor entails that the regulatory capital requirement is NOK 566 million higher than it would have been.

The requirement for risk-adjusted capital is NOK 7.4 billion before diversification effects and NOK 6.4 billion after diversification effects. The diversification effect totals NOK 979 million, or 14.7 per cent. The diversification effect illustrates the risk reduction achieved by the Group by incorporating more risk areas that are not expected to incur a loss simultaneously.

The main reasons for discrepancies in the capital requirements between regulatory capital and risk-adjusted capital are, as described in the document, the somewhat different approaches with respect to the methodology and categorisation of risk.

The IRB capital requirement is estimated at NOK 6.8 billion, and including the IRB transitional arrangement (the “Floor”) the minimum regulatory capital requirement is NOK 7.4 billion. Regulatory capital covers credit, market and operational risk.

Risk-adjusted capital is estimated at NOK 7.4 billion before diversification effects, and NOK 6.4 billion after diversification effects. Risk-adjusted capital covers all significant risk groups.

The discrepancy between risk-adjusted capital and regulatory capital including the IRB transitional arrangement (the “Floor”) is around NOK 1 billion, and around NOK 400 billion excluding the IRB transitional arrangement (the “Floor”).