betri

Betri Banki P/F

Risk Report 2016

Contents

Risk Report

Betri Banki P/F

1 Introduction

The aim of this risk report is to provide an insight into Betri Banki P/F's capital and risk management practices.

The report has been prepared in accordance with the legal disclosure requirements in *Executive Order No 900 of 13 July 2015 for the Faroe Islands on Calculation of Risk Exposures, Own Funds and Solvency Need* and the *Capital Requirements Regulation (CRR) (Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms).*

The risk report is published annually when the Bank's annual report is released. The risk report is available on the Bank's webpage www.betri.fo.

The information in this risk report relates to Betri Banki P/F. The risk report is a separate unaudited document.

The risk report is also available in Faroese. In the event of any discrepancy between the Faroese and the English version, the Faroese version shall prevail.

2 Risk Management

Betri Banki assumes risk based on the business model and the strategic goals set by the Board of Directors.

The Board of Directors approves risk management policies for the various areas in the Bank based on the business model and the strategic targets. The Board of Directors also gives authorities to the CEO within these risk areas.

The purpose of Betri Banki's risk management is to ensure that the Bank does not take on more risks than stipulated by the Board of Directors, and that the risk profile is appropriate in relation to the Bank's own funds.

2.1 Risk Statement

The risk report was approved by the Board of Directors on 17 February 2017.

The Board of Directors finds that Betri Banki's risk management is appropriate in relation to the Bank's business model and business strategy. Also, the Board of Directors considers the description below of the Bank's overall risk profile associated with the business strategy, to give an accurate view of the risk management in the Bank.

The statement from the Board of Directors is based on the business model, material and reports submitted to it by the CEO, Internal Audit, Risk Manager and Compliance Officer.

A review of the business model and policies shows that the overall requirements for the individual risk areas are reflected in policies and carefully specified limits in e.g. instructions from the Board of Directors to the CEO in addition to authorities passed on to other organisational units. The carefully specified limits are constructed so that they are transparent and easily monitored.

Betri Banki's business model is based on the Bank's vision and mission. Betri Banki strives to be the preferred banking choice of the Faroese people and to create opportunities and secure financial affairs for its customers. The Bank also wants to offer customers a wide range of traditional banking services. Sensible risk management and healthy business operations are important factors in managing the Bank soundly. The Board of Directors wishes growth to be steady in order to manage risks on sustainable and safe foundations. Risk diversification ensures that risks are not concentrated on individual customers or branches.

Betri Banki wants to maintain safe and robust own funds that support the business model and ensure independence at all times.

The review also shows that the actual risks are within the limits laid down in policies and delegated authorities, and based on this the Board of Directors finds that there is consistency between the business model, policies, guidelines and the actual risks within the individual areas.

Further information and key ratios regarding the risk profile can be found in this risk report and the Bank's annual report.

2.2 Risks

In the daily operations Betri Banki is exposed to the following risks:

Credit risk, defined as the risk of financial losses arising from counterparties or debtors failing to meet all or part of their payment obligations.

Market risk, defined as the risk that the market value of assets and liabilities, as well as off-balance items, will be affected as a result of changing market conditions. Betri Banki's market risk is divided into interest rate risk, equity risk, foreign exchange risk and other price risks.

Liquidity risk, defined as the risk that arises from differences in scheduled outgoing and incoming cash flows in the Bank.

Operational risk, defined as the risk arising from inadequate and inefficient internal processes, human errors, IT-failures and external factors, including legal risks.

2.3 Division of responsibility

The Board of Directors approves risk policies for the various risk areas based on the business model and the strategic targets of the Bank. The Board of Directors also determines guidelines for management and control of risks in the Bank.

The individual risk policies are reviewed and approved by the Board of Directors at least once a year.

The Board of Directors is responsible for ensuring that the Bank is organised appropriately and risk policies and limits being established for all important risk areas. In addition, all major credit facilities must be submitted to the Board of Directors for approval. The Board of Directors receives regular reports enabling it to check compliance with risk policies and pre-defined limits.

The CEO is responsible for the day-to-day management of the Bank, and must ensure that the Bank is managed according to approved policies, guidelines, and authorities that have been granted in relation to the different risk areas.

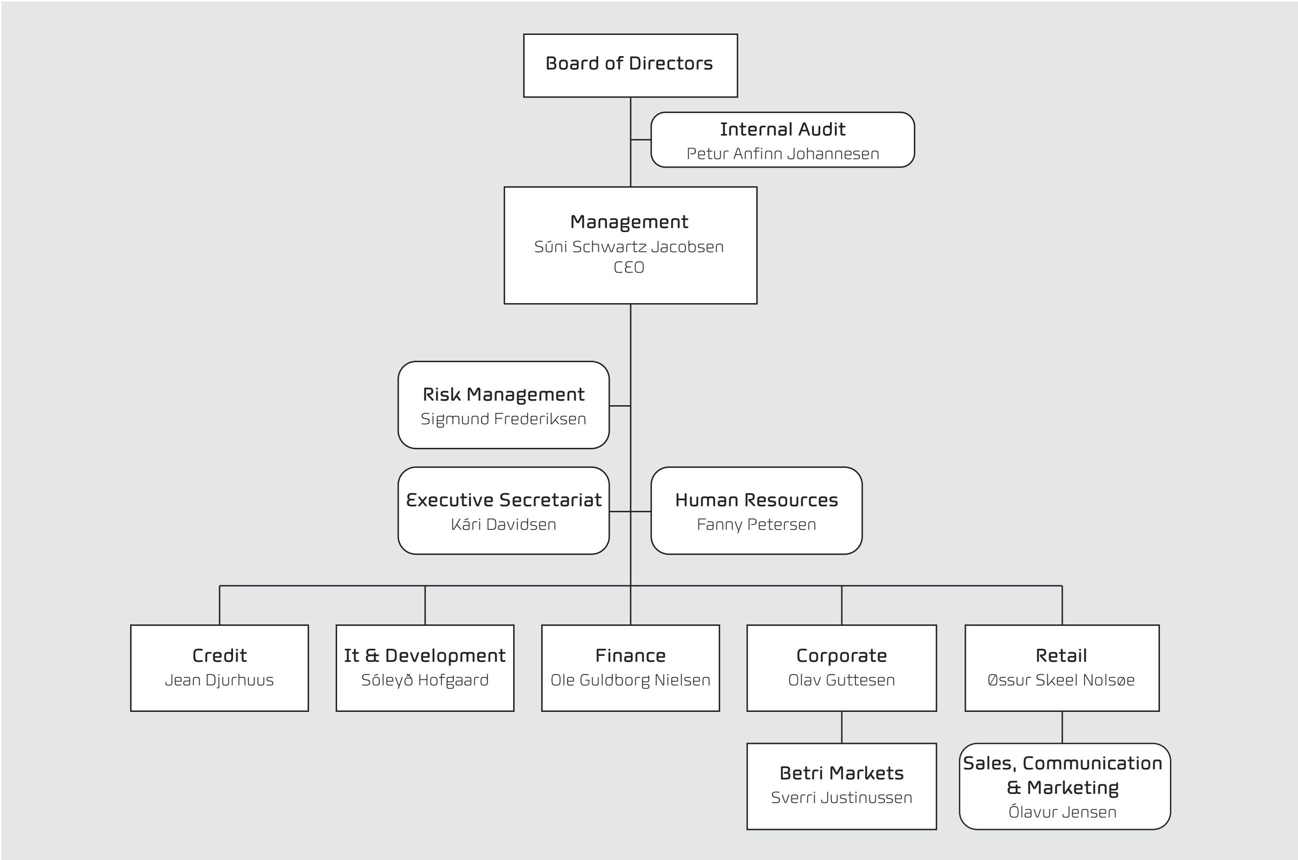
The CEO reports regularly to the Board of Directors on the development of risk exposures and pre-defined limits.

General management and control of risks is centralised with organised reporting to the CEO and Board of Directors. Daily management, control and reporting is carried out in separate business units in the Bank.

Further information regarding governance arrangements cf. CRR Article 435 (2) and remuneration policy cf. CRR Article 450 can be found in the Bank's annual report and on the Bank's webpage.

Betri Banki's organisational structure is illustrated below.

Table 1: Organisational structure



2.3.1 Risk Management function

The Bank has a separate risk management function. The Risk Manager heads the risk management function and reports to the CEO.

Risk Management monitors credit risk, market risk, liquidity risk and operational risk on behalf of the CEO. This also includes monitoring risks across various risk areas and organisational units, in addition to risks deriving from outsourced functions. Risk monitoring is performed in accordance with the tasks of the risk management function as stipulated in the *Danish Financial Business Act, section 71,* and *Executive Order No. 902 of 13 July 2015 for the Faroes on the management and control of banks etc.*

Each year Risk Management prepares a plan for the coming year's activities. The annual plan is approved by the CEO.

Risk Management reports to the CEO every quarter on the risks that are associated with the Bank's operations. In addition to this, Risk Management reports to the Board of Directors annually.

3 Capital and solvency requirement

In 2015 the common European capital requirement rules became effective for Faroese credit institutions. CRD IV and CRR are the European implementation of the Basel III rules. The rules contain comprehensive transitional and phase-in provisions regarding capital and liquidity requirements.

In November 2015 the Danish FSA identified Betri Banki as a systemically important financial institution (SIFI) in the Faroe Islands. SIFI institutions are subject to more rigorous supervision by the FSA. SIFI institutions are also subject to additional requirements, e.g. additional solvency requirements. For Betri Banki this entailed a SIFI buffer to the capital requirement of 0.8 % in 2016, increasing annually to 2 % in 2019.

The implementation of the capital buffers pursuant to CRD IV started in 2016. The buffers are added to the solvency requirement. The table below shows the buffers that Betri Banki must comply with.

Table 2: Buffer requirements

	2016	2017	2018	2019
Capital conservation buffer	0.625%	1.250%	1.875%	2.500%
Countercyclical buffer for FO, maximum	1.000%	1.500%	2.000%	2.500%
SIFI-buffer - Betri Banki	0.800%	1.200%	1.600%	2.000%
Buffer requirement, maximum	**2.425%**	**3.950%**	**5.475%**	**7.000%**

The countercyclical buffer for the Faroes is fixed by the Danish Minister for Business, Industry and Financial Affairs. The countercyclical buffer has so far been fixed at 0%. The countercyclical buffer is reviewed once every quarter.

3.1 Own funds and solvency

Own funds are calculated in accordance with the *Danish Financial Business Act* in addition to guidelines on adequate capital base and solvency requirement for credit institutions *(Vejledning om tilstrækkeligt kapitalgrundlag og solvensbehov for kreditinstitutter)* issued by the Danish FSA.

Solvency is calculated as own funds as a percentage of the risk-weighted assets. Own funds are determined in accordance with the requirements in chapter 10 of the *Danish Financial Business Act*, while the weighted assets are calculated in accordance with *Executive Order for the Faroe Islands on Calculation of Risk Exposures, Own Funds and Solvency Need*. The risk-weighted assets are divided into three main categories: credit risk, market risk and operational risk.

The table below shows the Bank's solvency statement.

Table 3: Solvency statement as of 31 December 2016 (DKK 1,000).

Tier 1 Capital	1,438,771
Own Funds	1,438,771
Credit risk - weighted assets not included in trading portfolio including off balance-sheet items	4,457,653
Market risk - weighted items	715,160
Operational risk	589,220
Total risk weighted assets	**5,762,032**
Total capital ratio	25%
T1 Capital ratio	25%
Capital	
Core Capital before statutory deductions	1,466,685
Proposed dividend	25,000
Intangible assets	0
Tax assets	118
Value adjustments due to the requirements for prudent valuation	2,796
Tier 1 Capital	**1,438,771**
Supplementary capital	
Share capital, not included in Core capital	0
Own Funds	**1,438,771**

3.2 Solvency requirement

The solvency requirement is calculated using the Bank's risk profile, external factors and budget assumptions for the coming year, in addition to other factors such as increased provisions for poor and non-performing customers.

The calculation of the Bank's solvency requirement is based on a model developed by the Association of Local Banks (The Association of Local Banks, Savings Banks and Cooperative Banks in Denmark) and on guidelines on adequate capital base and solvency requirement for credit institutions issued by the Danish FSA.

The model developed by the Association of Local Banks and the guidelines from the Danish FSA are both based on the 8+ approach (table 4), where the basis is a minimum requirement of 8% of the risk-weighted items (Pillar I). A supplement is added for risks and circumstances, which are not fully reflected in the calculation of the risk-weighted items.

Through the use of the abovementioned model and the guidelines issued by the Danish FSA, the management considers the Bank's calculated solvency requirement to be fair.

The method applied by Betri Banki for its calculation of the solvency requirement reserves capital within four main risk areas; credit risk, market risk, operational risk and other risks.

The purpose of calculating the solvency requirement is to determine the size of adequate own funds in the event of adverse developments in the Bank's operations.

Table 4 shows the 8+ approach that is used when calculating the solvency requirement.

Table 4: Solvency requirement based on the 8+ approach

1) Pillar I requirement (8 % of the risk-weighted items)
+ 2) Earnings (capital for risk coverage due to weak earnings)
+ 3) Growth in lending (capital to cover organic growth in business volume)
+ 4) Credit risk, of which: 4a) Credit risk on major customers with financial problems 4b) Other credit risks 4c) Concentration risk on individual exposures 4d) Concentration risk on industries
+ 5) Market risk, of which 5a) Interest rate risk 5b) Equity risk 5c) Foreign exchange risk
+ 6) Liquidity risk (capital to cover more expensive liquidity)
+ 7) Operational risk (capital to cover operational risk in excess of pillar I)
+ 8) Gearing (capital to cover risk related to high gearing)
+ 9) Possible supplement caused by regulatory maturity of capital instruments
+ 10) Possible supplement due to statutory requirements
Total = Capital requirement and solvency requirement
- of which credit risk (4) - of which market risk (5) - of which operational risk (7) - of which other risks (2+3+6+8+9) - of which supplement due to statutory requirements (1+10)

The management considers the risk factors included in the model to be adequate to cover all risk areas, which the Bank's management is required by law to take into account when determining the solvency requirement, as well as the risks that the management finds that the Bank has assumed.

In addition, the Board and management must assess whether the capital base is adequate to support future activities. In Betri Banki, this assessment is part of the assessment of the solvency requirement. An annual assessment is made to determine how expected growth affects the calculation of the solvency requirement. Stress factors are chosen based on the Association of Local Banks' model, in addition to guidelines on adequate capital base and solvency requirement for credit institutions issued by the Danish FSA.

The conditions that have to be present for using the model are based on sector information, the Bank's performance, in addition to e.g. conditions in the coming year's budget.

Credit risk is calculated using the guidelines from the Danish FSA on adequate capital base and solvency requirement for credit institutions. For customers with OEI and weak customers (rating category 1 and rating category 2c, – see 4.1.6) where the exposure is larger than 2% of the Bank's own funds, the unsecured exposure is fully reserved. Analyses are also made to determine how much to reserve for exposures smaller than 2% of own funds.

Market risk is calculated using stress factors related to the maximum risks that the Bank can assume within the authorities that the Board of Directors has granted to the CEO.

The Bank uses the basic indicator approach for calculating operational risk.

To calculate other risks the Bank mainly uses the Danish FSA's guidelines on adequate capital base and solvency requirement for credit institutions.

Table 5: Adequate own funds and solvency requirement.

Risk area	Adequate own funds DKK 1,000	Solvency requirement
Statutory requirements	460,963	8.00%
Credit risk	94,827	1.65%
Market risk	29,306	0.51%
Operational risk	0	0.00%
Other risks	0	0.00%
Total	**585,096**	**10.15%**

At year end 2016, Betri Banki's solvency ratio was 25% (DKK 1,439 million) and the solvency requirement was 10.15%.

3.3 Leverage ratio

The leverage ratio is calculated as the Tier 1 capital divided by the total unweighted exposures. The leverage ratio is monitored and reported regularly to the Board of Directors.

As yet, a final statutory leverage target has not been determined. In a proposal for a revision of the CRD IV and CRR the European Commission has proposed a limit of 3%, equal to a maximum leverage of 33 times the Tier 1 capital. At the end of 2016, the Bank's leverage ratio was 14.84%.

4 Credit Risk

In this section Betri Banki's credit risk is described, including objective, policy and actual credit risk exposures.

4.1 Objective and risk policy

Betri Banki offers loans, credits, guarantees and other services as part of its business model and thereby incurs credit risk. Credit risk is defined as the risk of financial losses arising from counterparties or debtors failing to meet all or part of their payment obligations.

Credit risk is managed according to Betri Banki's credit policy and instructions from the Board of Directors to the CEO, which define responsibilities and lending authorities.

The credit policy is updated, if the Bank wishes to change the credit terms in order to take into account external or internal changes that could affect the creditworthiness of customers. Such factors may be that the Bank changes its terms for financing certain customer groups. The credit policy is submitted to and approved by the Board of Directors annually.

The credit policy is prepared in accordance with the *Danish Financial Business Act* and *Executive Order No. 902 of 13 July 2015 for the Faroes on the management and control of banks etc*. The credit policy sets the guidelines that apply to the Bank's managing of credit risks, taking into account the Bank's business organisation, area of operation and the framework posed by the Danish FSA.

4.1.1 Authority and division of labour

It is Betri Banki's policy to provide lending authorities according to competence and needs, and with regard to the Bank's risk profile. The Board of Directors has provided the CEO with lending authorities, which have, in part, been delegated to the Head of Credit. The CEO also delegates lending authorities to the Head of Retail Banking and the Head of Corporate Banking – these are, to some extent, passed on to customer advisers. Betri Banki's credit granting is overseen by the Credit Department, which regularly checks compliance with the credit policy and lending authorities.

The Credit Department is responsible for day-to-day credit granting. This includes developing credit management tools, such as ratings, drawing up procedures for credit granting and value assessment of collateral. The Credit Department must also ensure compliance with limits regarding e.g. customer concentration and industry concentration. The Credit Department is responsible for the Bank's valuation of loans and impairment procedures, in addition to credit risk management, including monitoring the development in overdrafts and arrears.

The Credit Department reports to the CEO on developments in the Bank's credit risk and whether the respective branches operate within their lending authorities and comply with the Bank's credit policy. The CEO presents this report to the Board of Directors on a quarterly basis.

4.1.2 Credit management and control

Credit is granted on the basis of the individual customer's financial situation with regard to the ability and attitude to repay the loan, as well as collaterals. As a general rule, credit is not granted solely on the basis of collateral.

The Credit Department supervises the Bank's credit systems and credit granting processes. The Credit Department has higher lending authorities than the individual branches and is therefore involved in the granting of larger credit facilities, as well as more complicated exposures.

Customer advisers, together with their branch manager, are responsible for the daily credit control.

Credit exposures above a certain size are submitted to the Board of Directors for renewal annually. Credit applications must include the customer's financial situation and the conditions for the exposure to be continued by the Bank.

The Bank's Credit Department must ensure that the annual renewal is performed on time and properly, however, the respective branches, where the customer is registered, are responsible for the exposures being submitted for renewal.

The quality of the overall portfolio is assessed during the annual review of assets carried out by the Credit Department. This review is presented to the CEO and Board of Directors.

4.1.3 Collaterals

Credit is granted on the basis of willingness and ability to repay. In addition to this, the Bank wants to limit risk by requiring collaterals. The types of collateral most frequently provided are real estate, ships and personal property. The value of the collateral is estimated using set procedures, thus ensuring uniform estimations. The Bank regularly assesses the value of the collateral provided. The value of the collateral is calculated as the price that would be obtained in a sale.

4.1.4 Risk concentration

In order to ensure diversification in the loan portfolio, the credit policy stipulates that no single exposure, with deduction of certain guaranteed claims and collaterals received, must generally be higher than 10% of the Bank's own funds. Additionally, it is the Bank's aim that the total amount of these exposures does not exceed 125% of own funds.

In addition to these limits, the Bank aims for an even distribution between retail and corporate lending and no single industry should account for more than 10% of the Bank's total gross loans.

4.1.5 Impairments

The need for impairment charges is assessed on a quarterly basis. Impairment charges are based on individual estimations and group estimations. The Credit Department is responsible for making impairment evaluations together with the branches concerned. Clear procedures have been adopted for selecting customers and evaluating possible impairments to ensure quality and uniform criteria in the evaluations of customers.

If the Bank registers an objective evidence of impairment on a loan (OEI), an assessment is made of the impairment charge. An objective evidence of impairment is assessed to be present, if one or more of the following events have occurred:

- The borrower is in financial difficulties
- The borrower does not comply with the terms of contract, e.g. not making repayments and interest
- The Bank has relaxed loan conditions due to the debtor experiencing financial difficulties
- High probability of the debtor going bankrupt or being in need of financial restoration

The impairment charge is calculated as the difference between the carrying amount and the discounted value of the expected cash-flows, including the realization value of any collateral. Any subsequent increase of this discounted value of the expected cash-flows results in full or partial reversal of impairments. For fixed interest rate loans and advances, the original effective interest rate is used to calculate the discounted value, while the current effective interest rate is used for floating rate loans and advances.

Exposures above a certain size are subjected to individual review on a quarterly basis, regardless of the customer's financial situation.

4.1.6 Rating of customers

The Bank uses a rating model to describe the credit quality of individual customers. The rating model is used for credit granting, selection of customers to be reviewed for impairments and conditions for the frequency in single customer follow-ups.

The Bank uses the following rating categories:

3	Unconditionally good customers
2a	Good customers
2b	Average customers
2c	Weak customers
1	Customers with OEI (objective evidence of impairment)

4.1.7 Customers

The Bank's market segment is Faroese retail, corporate and public sector customers with good repayment abilities.

4.1.8 Circumstances that are considered when granting credit

The Bank considers credit applications based on an assessment of the individual customer's financial situation.

Retail customers: Credit granting is based on the customer's personal income and assets, in addition to a calculation of disposable income.

Corporate customers: Credit granting is based on the company's revenues, solidity, state of collateral, in addition to the owner's experience and willingness to repay the loan.

BRF: Betri Banki collaborates with BRF-Kredit providing mortgage credit loans for Faroese homeowners. The agreement stipulates that Betri Banki handles all customer communication, conducts customer ratings and forwards loan applications to BRF-Kredit. BRF-Kredit provides financing for up to 80% of the market value of the properties.

4.2 Actual credit risk

This section shows credit risk exposures, risk-weighted items and capital requirements as of 31.12.2016.

4.2.1 Risk-weighted exposures and capital requirements

The table below shows risk-weighted items and capital requirements for credit risk, broken down by exposure groups.

Table 6: Risk-weighted exposures in relation to credit risk (DKK 1,000).

Exposure group	Risk-weighted items	Capital req. 8%
Central governments or central banks	0	0
Local authorities	0	0
Public sector entities	77,729	6,218
Financial institutions	82,119	6,570
Retail customers[1]	788,137	63,051
Corporate customers	1.637,207	130,977
Exposures secured by mortgage in real estate	849,605	67,968
Exposures with arrears or overdrafts	686,498	54,920
Exposures in other items, including assets without counterparties	206,571	16,526
Covered bonds	15,199	1,216
Equity exposures	114,586	9,167
Total	**4,457,653**	**356,612**

[1] Includes exposures ≤ DKK 7.5 million.

4.2.2 Credit risk exposures

The Bank adheres to the *Executive Order for the Faroes on Financial Reports for Credit Institutions etc*. and uses the accounting definition of non-performing and impaired exposures as defined in sections 51-54.

Individual impairments are made in accordance with section 52 of the *Executive Order for the Faroes on Financial Reports for Credit Institutions etc.*; this applies to all loans. Group impairments are made in accordance with section 53 of the above mentioned executive order; this applies to loans without individual impairment charges.

Total value of the exposures after value adjustments and before considering credit risk reduction was DKK 8,126 million as of 31.12.2016.

The table below shows the exposures after value adjustments before credit risk reduction.

Table 7: Exposures after value adjustments before credit risk reduction (DKK 1,000).

Exposure group	Exposure after value adjustment	Average exposure during the year after value adjustment
Central governments or central banks	116,020	193,497
Local authorities	501,771	606,787
Public sector entities	184,731	231,916
Financial institutions	282,206	269,279
Retail customers[1]	1,372,370	1,385,522
Commercial customers	2,030,306	2,014,112
Exposures secured by mortgage in real estate	2,439,262	2,373,364
Exposures with arrears or overdrafts	694,011	759,764
Exposures in other items, including assets without counterparties	238,490	252,952
Covered bonds	151,992	161,985
Equity Exposures	114,586	56,824
Total	**8,125,746**	**8,306,000**

[1] Includes exposures ≤ DKK 7.5 million.

As more than 95% of the Bank's credit exposure is to the Faroese market, the Bank has chosen not to provide information on the geographical spread of the loan portfolio.

The table below shows the exposures in accordance with CRR regulations, broken down by industry. The table also shows the breakdown between retail customers and corporate customers.

Table 8: Exposures broken down by industry (DKK 1,000).

Industries	Central govern-ments or central banks	Local authori-ties	Public sector entities	Financial institu-tions	Retail custom-ers[1]	Com-mercial customers	Expo-sures secured by mort-gage in real estate	Expo-sures with arrears or over-drafts	Expo-sures in other items, in-cluding assets without counter-parties	Covered bonds	Equity Expo-sures	Total
Public authorities	**202**	**444,771**	**181,925**	**0**	**6,173**	**0**	**0**	**1**	**0**	**0**	**0**	**633,072**
Agriculture, hunting, forestry and fishing	0	0	0	0	11,086	357,514	2,234	41,813	0	0	0	412,647
Industry and raw materials extraction	0	57,000	0	0	17,887	396,474	2,061	67,123	0	0	0	540,546
Energy supply etc.	0	0	0	0	0	0	0	0	0	0	0	0
Building and construction	0	0	0	0	55,107	158,220	4,018	33,276	0	0	0	250,620
Trade	0	0	0	0	78,692	413,887	12,851	64,950	0	0	0	570,381
Transport, hotels and restaurants	0	0	0	0	35,939	286,009	2,251	150,862	0	0	0	475,061
Information and communication	0	0	0	0	2,601	16,778	1,143	19,266	0	0	0	39,788
Finance and insurance	115,581	0	0	282,206	20,099	198,366	0	756	33,327	151,992	26,781	829,107
Real estate	0	0	0	0	55,429	131,732	7,866	38,167	0	0	0	233,194
Other industries	237	0	2,806	0	158,893	63,722	16,698	17,598	205,164	0	87,805	552,923
Total corporate	**115,819**	**57,000**	**2,806**	**282,206**	**435,733**	**2,022,702**	**49,123**	**433,812**	**238,490**	**151,992**	**114,586**	**3,904,269**
Retail	**0**	**0**	**0**	**0**	**930,463**	**7,604**	**2,390,139**	**260,198**	**0**	**0**	**0**	**3,588,405**
Total	**116,020**	**501,771**	**184,731**	**282,206**	**1,372,370**	**2,030,306**	**2,439,262**	**694,011**	**238,490**	**151,992**	**114,586**	**8,125,746**

[1] Includes exposures ≤ DKK 7.5 million.

The table below shows the residual maturity of credit exposures.

Table 9: Credit exposures broken down by residual maturity (DKK 1,000).

Exposure group	On demand	0-3 months	3 months – 1 year	1-5 years	Over 5 years	Total
Central governments or central banks	198	0	0	115,819	2	116,020
Local authorities	254,958	0	0	47,507	199,306	501,771
Public sector entities	130,351	0	0	7,406	46,974	184,731
Financial institutions	527	0	0	264,892	16,787	282,206
Retail customers[1]	222,963	14,785	15,249	246,771	872,603	1,372,370
Commercial customers	409,323	85,689	218,829	296,473	1,019,993	2,030,306
Exposures secured by mortgage in real estate	4,301	4,165	5,138	161,793	2,263,866	2,439,262
Exposures with arrears or overdrafts	70,016	2,957	5,081	195,943	420,015	694,011
Exposures in other items, including assets without counterparties	0	0	1,436	74,565	162,489	238,490
Covered bonds	0	0	39,819	80,159	32,014	151,992
Equity Exposures	0	0	0	21,297	93,289	114,586
Total	**1,092,636**	**107,595**	**285,551**	**1,512,624**	**5,127,338**	**8,125,746**

[1] Includes exposures ≤ DKK 7.5 million.

4.2.3 Past due and impaired claims

This section shows past due exposures and impaired claims.

The table below shows risk-weighted exposures that are more than 90 days past due and impaired claims. The exposures are broken down by industry. The table also shows the breakdown between retail customers and corporate customers.

Table 10: Past due exposures and impaired claims broken down by industries (DKK 1,000).

Industries	Past due exposures	Impaired claims	Impairments/ provisions end of year	Amounts booked as costs concerning value adjustments and impairments/ provisions during the period
Public authorities	**0**	**0**	**0**	**-2**
Agriculture, hunting, forestry and fishing	1,647	62,425	26,388	-7,316
Industry and raw materials extraction	71,729	186,071	139,081	21,652
Energy supply etc.	0	0	0	0
Building and construction	586	28,743	13,667	7,337
Trade	15,802	19,745	20,166	-3,810
Transport, hotels and restaurants	1,915	130,756	93,451	7,053
Information and communication	422	3,254	2,197	998
Finance and insurance	0	752	516	-3,200
Real estate	3,503	15,041	9,782	-7,167
Other industries	325	10,480	26,121	4,106
Total corporate	**95,930**	**457,267**	**331,368**	**19,654**
Retail	**83,978**	**138,496**	**56,136**	**-5,651**
Total	**179,908**	**595,763**	**387,504**	**14,000**

As more than 95% of the Bank's credit exposure is to the Faroese market, the Bank has chosen not to provide geographical information on past due exposures and impaired claims.

The table below shows movements on impaired claims caused by value adjustments and impairment charges. These are divided into individual and group impairments.

Table 11: Movements on impaired claims as a consequence of value adjustments and impairment charges (DKK 1,000).

	Individual impairments/ provisions		Group impairments	
	Loans	**Guarantee debtors**	**Loans**	**Guarantee debtors**
Accumulated impairments/provisions on loans and guarantee debtors at the beginning of the year	314,614	9,042	41,673	
Impairments/provisions during the year	77,072	12,170	10,233	
Reversal of impairments/provisions from previous years, where there is no longer OEI or the impairment has been reduced	-67,949	-108	-10,921	
Other changes	18,156	0	1,122	0
Value adjustment of acquired assets	112	0	0	0
Loss (written off), previously individually impaired/provisions made	-17,711	0	0	
Total impairments/provisions on loans and guarantee debtors at year end	**324,293**	**21,104**	**42,107**	
Total loans and guarantee debtors, where there have been made individual impairments/provisions (calculated before impairments/ provisions)	**567,515**	**28,248**	**4,010,162**	**0**

4.2.4 Financial collateral

The Bank uses the financial collateral comprehensive method as its credit risk mitigation technique for computing its capital ratio. This means that the Bank can reduce a commitment's strain on the capital by accepting certain financial items as collateral.

The table below shows financial collaterals broken down by exposure group.

Table 12: Financial collateral (DKK 1,000).

Exposure group	Collateral with substitution	Financial collateral comprehensive method
Central governments or central banks	0	0
Local authorities	0	0
Public sector entities	0	501
Financial institutions	-176	0
Retail customers[1]	176	47,315
Commercial customers	0	23,413
Exposures secured by mortgage in real estate	0	0
Exposures with arrears or overdrafts	0	71,025
Exposures in other items, including assets without counterparties	0	0
Covered bonds	0	0
Equity Exposures	0	0
Total	**0**	**142,255**

[1] Includes exposures ≤ DKK 7.5 million.

4.3 Counterparty risk - derivatives

Counterparty risk is the risk of loss because a financial counterparty defaults on its obligations under a financial contract.

Betri Banki uses the mark-to-market method when calculating the size of the exposure and risk-weights for derivatives.

The value of the exposure when using the mark-to-market method for counterparty risk is derived from the procedure below:

1. All contracts are computed at market value and all contracts with a positive value are included.

2. The contracts' nominal principals or the underlying values are multiplied by percentages fixed in the CRR to establish the potential future credit exposure.

3. The counterparty exposure value is calculated as the sum of positive market values and potential future credit exposures.

The Bank does not apply netting in the statement of risks on items with counterparty risk.

No extra capital has been allocated for counterparty risk except for what is included in the capital requirement of 8%.

When Betri Banki enters into an agreement with a counterparty regarding derivatives, credit limits must be observed.

At the end of 2016, the positive fair value of derivatives etc. was DKK 4.9 million. The Bank's total counterparty risk calculated using the mark-to-market method cf. CRR Article 274 was DKK 5.3 million.

4.4 ECAI

Betri Banki has appointed the Standard & Poor's Ratings Services as its external credit assessment institution (ECAI). The Bank uses Skandinavisk Data Center (SDC), which receives external credit ratings from Standard & Poor's Ratings Services via SIX Financial. Regular IT updates are undertaken in relation to the credit ratings from Standard & Poor's Ratings Services.

SDC has converted Standard & Poor's Ratings Services' credit rating classes to credit quality steps using the conversion table from the Danish FSA. Each individual credit quality step is given a weight to be applied to the exposures in the individual credit quality steps, when calculating total risk-weighted exposures according to the standard approach for credit risk pursuant to Articles 111-134 of the CRR.

The table below shows exposure groups where ratings from Standard & Poor's Ratings Services have been used.

Table 13: ECAI exposures (DKK 1,000).

Exposure group	Exposure before risk weighting	Exposure after weighting with credit quality steps
Central governments or central banks	0	0
Local authorities	0	0
Public sector entities	0	16,044
Financial institutions	17,267	82,119
Retail customers[1]	0	0
Commercial customers	171,356	180,324
Exposures secured by mortgage in real estate	0	0
Exposures with arrears or overdrafts	0	2
Exposures in other items, including assets without counterparties	0	0
Covered bonds	152,000	15,200
Equity Exposures	0	0
Total	**340,622**	**293,690**

[1] Exposures ≤ DKK 7.5 million.

5 Market Risk

Market risk is described below, including objective, policy and actual market risk exposures.

5.1 Objective and risk policy

Market risk is defined as the risk that the market value of assets and liabilities, as well as off-balance items, will be affected as a result of changing market conditions.

Taking on market risk is an integral part of banking. The market risk in Betri Banki is divided into interest rate risk, equity risk, foreign exchange risk and other price risks.

The Board of Directors of Betri Banki annually approves a market risk policy, which defines and sets limits for the market risk that the Bank is willing to accept for each market risk area.

5.1.1 Interest rate risk

Interest rate risk is the risk of loss caused by changes in market rates.

As a rule, interest rate risk on fixed interest loans is hedged. The largest interest rate risk is in the portfolio of fixed interest rate bonds. This risk is managed within certain limits in relation to the interest rate outlook.

5.1.2 Equity risk

Equity risk is the risk of loss caused by changes in share prices. Equity risk is managed by managing and monitoring the portfolio of shares closely.

5.1.3 Foreign exchange risk

Foreign exchange risk is the risk of loss caused by fluctuating exchange rates.

As a rule, Betri Banki hedges foreign exchange risk. The exception is foreign exchange risk between Danish kroner and Euros, which is only hedged under special circumstances.

Foreign exchange risk is calculated as the higher figure of foreign exchange assets or debt and is determined as a percentage of the core capital corresponding to the Danish FSA's currency indicator 1.

5.1.4 Other price risks

Other price risk is the risk of loss caused by fluctuating market prices of other assets than those mentioned above, e.g. changes in commodity prices.

At year end 2016, Betri Banki had no risks in this category.

5.1.5 Reporting and division of responsibility

The market risk policy stipulates the division of responsibility concerning risk taking, monitoring and reporting to the CEO and Board of Directors.

The Board of Directors and CEO receive regular reports on the market risk and compliance with the limits defined in the policy and instructions from the Board of Directors to the CEO. The Finance Department is responsible for these reports.

Betri Markets has day-to-day responsibility for the Bank's liquidity, securities portfolio and foreign exchange deposits, on behalf of the CEO. Thus, Betri Markets is also responsible for ensuring that the market risk is within the limits that are specified in the instructions from the Board of Directors to the CEO.

This is conducted by regularly calculating the interest rate risk on the Bank's bond portfolio, a weekly statement on the currency positions and continuous monitoring of the Bank's equity portfolio. These calculations and statements are then compared to the limits for market risk that have been authorised to the CEO and the authorisation provided to Betri Markets in this area.

5.2 Actual market risk

The sections below show the actual market risk exposures as of 31.12.2016. These concern risks related to the trading portfolio, exposures in securities, which are not part of the trading portfolio, and interest rate risk outside the trading portfolio.

5.2.1 Risk-weighted exposures with market risk

The solvency requirements for the various risks that constitute market risk are detailed in the table below.

Table 14: Risk-weighted exposures with market risk (DKK 1,000).

	Risk-weighted items	Capital requirement 8%
Bonds	431,173	34,494
Shares	122,454	9,796
Currency position	161,533	12,923

5.2.2 Exposures in securities not included in the trading portfolio

Exposures in securities that are not included in the trading portfolio include shares relating to the Bank's suppliers and securities held without trading intent.

The table below shows exposures in securities not included in the trading portfolio.

Table 15: Exposures in securities not included in the trading portfolio (DKK 1,000).

	Exposure 31.12.2016	Operating effect
Shares relating to the Bank's suppliers	24,889	1,121
Corporate bonds	171,650	740
Corporations	0	66

5.2.3 Interest rate risk outside the trading portfolio

Interest rate risk outside the trading portfolio primarily derives from fixed-interest deposits and loans. Interest rate risk or the modified duration is measured as the expected capital loss, when the interest curve is displaced in parallel by one percentage point up.

At year end 2016, interest rate risk outside the trading portfolio was DKK 4.6 million.

6 Liquidity Risk

Liquidity risk is described below, including objective and policy.

6.1 Objective and risk policy

Betri Banki's liquidity risk can be defined as the risk that arises from differences in scheduled outgoing and incoming cash flows in the Bank.

The Board of Directors of Betri Banki has approved a risk policy for liquidity risk, which stipulates clear requirements for daily liquidity and statement of liquidity risks. Further requirements for the liquidity management are detailed in the instructions from the Board of Directors to the CEO. The Bank also has a contingency plan, which lists initiatives to be taken, if liquidity falls below specific limits.

Betri Banki identifies the following as liquidity risks:

- Significant increases in funding expenses
- Lack of funding preventing the Bank from maintaining its approved business model
- The Bank being unable to fulfil its payment obligations due to a lack of funding

The Bank's liquidity policy is to maintain liquidity, which is at least 50% above the statutory minimum requirement. Betri Banki's excess liquidity at the end of 2016 was 249.5% when compared to the statutory minimum requirement.

The implementation of CRD IV and CRR and the LCR and NSFR requirements entail stricter requirements for the management of liquidity in the Bank. For most banks the LCR requirements are gradually phased in during the period until 2018. However, the fully phased-in LCR requirements became effective for Betri Banki, when the Bank was identified as a systemically important financial institution (SIFI) in November 2015.

The Bank has reported the LCR to the Danish FSA since October 2015. At year end 2016, Betri Banki had a LCR of 137.

6.1.1 Reporting and division of responsibility

The liquidity policy determines the division of responsibility regarding risk taking, control and reporting to the CEO and the Board of Directors.

The Board of Directors and the CEO receive a monthly statement on the Bank's liquidity situation from the Bank's Finance Department. The statement is prepared in accordance with section 152 in the *Danish Financial Business Act*, which stipulates that the total liquidity must be at least 10% of the Bank's debt and guarantee obligations and at least 15% of the Bank's total debt, which has a term to maturity less than one month. Moreover, the report contains a statement on liquidity risk. This is determined by conducting a 12 month projection of the liquidity under normal market conditions and a 12 month projection of the liquidity under stressed conditions. The LCR is also included in the monthly statement on the Bank's liquidity.

Betri Markets has been given day-to-day responsibility of liquidity by the CEO. Betri Markets is also responsible for the daily monitoring of liquidity and liquidity projections. This is done on the basis of known future cash flows.

The Finance Department is responsible for reporting on daily and monthly liquidity; this also includes checking that the Bank has sufficient liquidity.

6.2 Encumbered assets

Betri Banki has, to a certain extent, encumbered assets in connection with collateral agreements with other financial institutions. Since November 2015 Betri Banki has reported data regarding encumbered assets to the Danish FSA.

The table below shows the specifications regarding encumbered assets.

Table 16: Encumbered assets at year-end 2016 (DKK 1,000)

Assets		Carrying amount of encumbered assets	Fair value of encumbered assets	Carrying amount of non-encumbered assets	Fair value of non-encumbered assets
		010	*040*	*060*	*090*
010	**Assets of reporting institution**	151,900		8,692,168	
030	Equity instruments	0	0	168,760	168,760
040	Debt securities	151,900	151,900	2,613,640	2,613,640
120	Other assets	0		5,909,768	

Collateral received - off balance		Fair value of encumbered collateral received	Fair value of non-encumbered collateral received
		010	*040*
130	**Collateral received by the reporting institution**	0	0
150	Equity instruments	0	0
160	Debt securities	0	0
230	Other collateral received	0	0
240	**Own debt securities issued**	0	0

Liabilities for encumbered assets		Matching liabilities, contingent liabilities or securities lent	Assets, collateral received and own debt securities issued
		010	*030*
010	**Carrying amount of selected financial liabilities**	419,798	151,900

7 Operational Risk

Operational risk is described below, including objective, policy and actual operational risks.

7.1 Objective and risk policy

Operational risk is defined as the risk arising from inadequate and inefficient internal processes, human errors, IT-failures and external factors, including legal risks.

The Board of Directors approves the risk policy for operational risk, decides on procedures and how monitoring and follow-up on the risks is to be organised.

Betri Banki identifies the following as possible operational risks. The risk of financial loss due to:

- operational risks in the areas of credit, liquidity, securities, markets and real estate
- operational risks in relation to advising retail, corporate and public sector customers
- operational risks in staff functions and management
- manual procedures, guidelines and/or quality of these
- ineffective internal controls
- insufficient integration, stability, and usability of IT-systems
- operational risks of hosted services
- inadequate insurance
- insufficient employee competences in relation to diversity of tasks
- inadequate security in premises

Increased risk may also be a result of new services, products as well as external factors.

7.1.1 Reporting and division of responsibility

The operational risk policy stipulates procedures, registration and reporting obligations.

Operational risk is managed through business procedures and internal control measures developed to ensure an optimal process environment. Operational risks are reduced by among other things separating the execution and control of activities.

Employees are responsible for reporting all risk events to their nearest manager and Risk Management. Risk Management registers risk events and briefs the CEO every quarter.

7.2 Actual operational risk

Operational risk can be limited but not eliminated. Regular processes are in place to check for risks that may have a negative impact on Betri Banki. The Bank continuously focuses on developing and improving the management of risks, e.g. by strengthening and reviewing procedures and controls, ensuring documentation, controlling changes and registering, reporting and reassessing risks.

Betri Banki's IT-systems are hosted by Skandinavisk Data Center (SDC). A risk analysis of significant IT-systems is made annually in order to determine what business impact the risk has on Betri Banki. This is conducted in accordance with the Business Impact Assessment framework from ISF, International Security Forum. The latest risk analysis was carried out in February 2017.

The capital needed to cover Betri Banki's operational risk is calculated using the basic indicator approach. In 2016 the capital requirement for operational risk was DKK 47 million, which is included in the solvency requirement.

Appendix 1: Leverage ratio – disclosure template

Summary reconciliation of accounting assets and leverage ratio exposures

		Applicable amounts
1	Total assets as per published financial statement	8,844,067,959
2	Adjustment for entities which are consolidated for accounting purposes but are outside the scope of regulatory consolidation	0
3	(Adjustment for fiduciary assets recognised on the balance sheet pursuant to the applicable accounting framework but excluded from the leverage ratio exposure measure in accordance with Article 429(13) of Regulation (EU) No 575/2013 "CRR")	0
4	Adjustments for derivative financial instruments	4,302,928
5	Adjustments for securities financing transactions "SFTs"	0
6	Adjustment for off-balance sheet items (i.e. conversion to credit equivalent amounts of off-balance sheet exposures)	881,233,123
EU-6a	(Adjustment for intragroup exposures excluded from the leverage ratio exposure measure in accordance with Article 429 (7) of Regulation (EU) No 575/2013)	0
EU-6b	(Adjustment for exposures excluded from the leverage ratio exposure measure in accordance with Article 429 (14) of Regulation (EU) No 575/2013)	0
7	Other adjustments	-32,217,030
8	**Total leverage ratio exposure**	**9,697,386,980**

Leverage ratio common disclosure

		CRR leverage ratio exposures
On-balance sheet exposures (excluding derivatives and SFTs)		
1	On-balance sheet items (excluding derivatives, SFTs and fiduciary assets, but including collateral)	8,839,765,031
2	(Asset amounts deducted in determining Tier 1 capital)	-32,217,030
3	**Total on-balance sheet exposures (excluding derivatives, SFTs and fiduciary assets) (sum of lines 1 and 2)**	**8,807,548,001**
Derivative exposures		
4	Replacement cost associated with all derivatives transactions (ie net of eligible cash variation margin)	0
5	Add-on amounts for PFE associated with all derivatives transactions (mark-to-market method)	4,302,928
EU-5a	Exposure determined under Original Exposure Method	0
6	Gross-up for derivatives collateral provided where deducted from the balance sheet assets pursuant to the applicable accounting framework	0
7	(Deductions of receivables assets for cash variation margin provided in derivatives transactions)	0
8	(Exempted CCP leg of client-cleared trade exposures)	0
9	Adjusted effective notional amount of written credit derivatives	0
10	(Adjusted effective notional offsets and add-on deductions for written credit derivatives)	0
11	**Total derivative exposures (sum of lines 4 to 10)**	**4,302,928**

		CRR leverage ratio exposures
SFT exposures		
12	Gross SFT assets (with no recognition of netting), after adjusting for sales accounting transactions	0
13	(Netted amounts of cash payables and cash receivables of gross SFT assets)	0
14	Counterparty credit risk exposure for SFT assets	0
EU-14a	Derogation for SFTs: Counterparty credit risk exposure in accordance with Article 429b (4) and 222 of Regulation (EU) No 575/2013	0
15	Agent transaction exposures	0
EU-15a	(Exempted CCP leg of client-cleared SFT exposure)	0
16	**Total securities financing transaction exposures (sum of lines 12 to 15a)**	**0**
Other off-balance sheet exposures		
17	Off-balance sheet exposures at gross notional amount	1,779,851,170
18	(Adjustments for conversion to credit equivalent amounts)	-898,618,047
19	**Other off-balance sheet exposures (sum of lines 17 to 18)**	**881,233,123**
Exempted exposures in accordance with CRR Article 429 (7) and (14) (on and off balance sheet)		
EU-19a	(Exemption of intragroup exposures (solo basis) in accordance with Article 429(7) of Regulation (EU) No 575/2013 (on and off balance sheet))	0
EU-19b	(Exposures exempted in accordance with Article 429 (14) of Regulation (EU) No 575/2013 (on and off balance sheet))	0
Capital and total exposures		
20	Tier 1 capital	1,438,770,612
21	**Total leverage ratio exposures (sum of lines 3, 11, 16, 19, EU-19a and EU-19b)**	**9,693,084,052**
Leverage ratio		
22	**Leverage ratio**	**14.84%**
Choice on transitional arrangements and amount of derecognised fiduciary items		
EU-23	Choice on transitional arrangements for the definition of the capital measure	
EU-24	Amount of derecognised fiduciary items in accordance with Article 429(11) of Regulation (EU) NO 575/2013	0

Split-up of on balance sheet exposures (excluding derivatives, SFTs and exempted exposures)

		CRR leverage ratio exposures
EU-1	Total on-balance sheet exposures (excluding derivatives, SFTs, and exempted exposures), of which:	
EU-2	Trading book exposures	2,498,055,147
EU-3	Banking book exposures, of which:	
EU-4	Covered bonds	151,992,188
EU-5	Exposures treated as sovereigns	170,062,761
EU-6	Exposures to regional governments, MDB, international organisations and PSE NOT treated as sovereigns	246,812,727
EU-7	Institutions	265,310,190
EU-8	Secured by mortgages of immovable properties	2,034,287,551
EU-9	Retail exposures	1,090,325,172
EU-10	Corporate	1,440,376,001
EU-11	Exposures in default	593,651,401
EU-12	Other exposures (eg equity, securitisations, and other non-credit obligation assets)	353,076,710

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