Eik

Risk Management Report

Eik Banki P/F

'14

Table of contents

Risk Management Report

Eik Banki P/F

1 Introduction

The objective of this risk management report is to give an overview of Eik Banki P/F's risk management practices. The report is made to meet the disclosure requirements set out in Annex 20 of the *Executive Order on Capital Adequacy.*

The risk management report is published on the Bank's webpage www.eik.fo when the Bank's annual report is released. The risk management report is a separate unaudited document.

Risk and risk management are an integral part of banking. The purpose of Eik Banki's risk management is to ensure that the Bank does not take on more risks than stipulated by the Board of Directors.

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

Credit risk, defined as the risk of financial loss arising when customers are unable to meet their financial obligations to Eik Banki.

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. Eik 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.

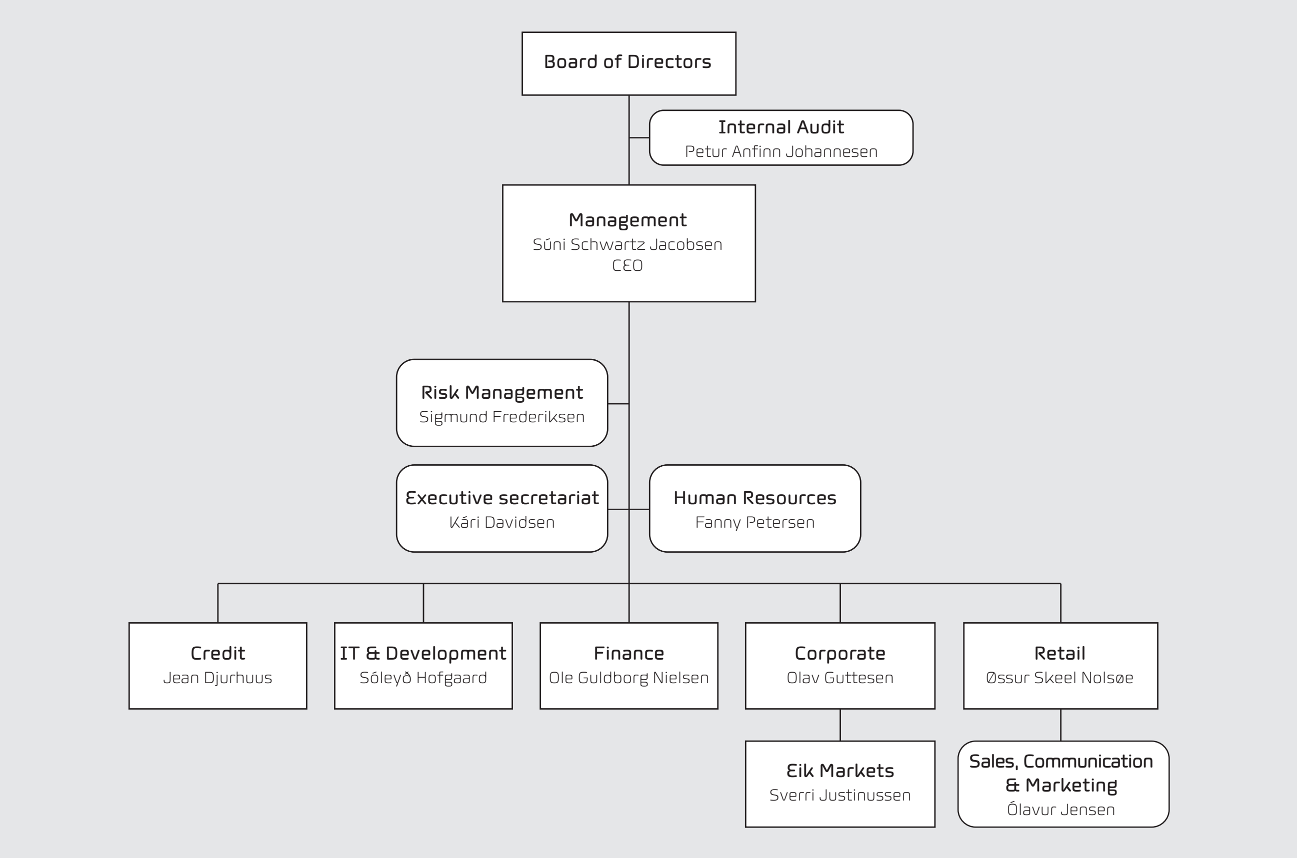
Operational risk, defined as the risk arising from inadequate and inefficient internal processes, human errors, IT-failures and external factors.

In the risk management report an assessment is made of solvency and individual solvency requirement. The difference between the two is as follows:

Solvency is calculated in accordance with the *Executive Order No. 510 of 25 May 2011 for the Faroes on Capital Adequacy*, where all assets are risk assessed in separate risk categories.

Individual solvency requirement is calculated using Eik Banki'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.

Each risk group will be analysed in the following sections in terms of objective, risk policy and actual risk exposure.



2 Organisation

Eik Banki's organisational structure is illustrated above.

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

Risk Management monitors credit risk, market risk, liquidity risk and operational risk on behalf of the CEO. 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. 336 of 12 April 2012 for the Faroes on the management and control of banks etc.*

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 base

This section describes the capital base, including policy and statement of capital base.

3.1 Policy

The capital base is calculated in accordance with the *Danish Financial Business Act* in addition to guidelines on adequate capital base and solvency requirement for financial institutions *(Vejledning om tilstrækkeligt kapitalgrundlag og solvensbehov for kreditinstitutter)* issued by the Danish Financial Supervisory Authority.

3.2 Statement of capital base

The table below shows the statement of capital base as of 31 December 2014.

Table 1: Statement of capital base as of 31 December 2014 (DKK 1,000).

Capital requirement	
Core capital before statutory deductions	1,335,493
Proposed dividend	60,000
Intangible assets	155
Tax assets	153
Core capital less statutory deductions	**1,275,185**
Share capital, not included in core capital	0
Capital base	**1,275,185**

4 Solvency

This section describes how the solvency and sufficient capital are determined, in addition to the individual solvency requirement.

The solvency is determined in accordance with the *Executive Order on Capital Adequacy*, where all assets are risk assessed in separate risk categories.

In addition to the solvency, the Bank is also required to determine the individual solvency requirement. This is to ensure that the Bank has sufficient capital to weather difficult periods and in order to meet the demands by the Danish Financial Supervisory Authority. The individual 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.

4.1 Solvency statement

Solvency is calculated as core capital as a percentage of the risk-weighted assets. The capital base is determined in accordance with the requirements in chapter 10 of the *Danish Financial Business Act*, while the weighted assets are calculated in accordance with the *Executive Order on Capital Adequacy*. 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 2: Solvency statement as of 31 December 2014 (DKK 1,000).

Capital requirement	
Core capital before statutory deductions	1,335,493
Proposed dividend	60,000
Intangible assets	155
Tax assets	153
Core capital less statutory deductions	**1,275,185**
Share capital, not included in core capital	0
Capital base	**1,275,185**
Weighted assets	
Weighted assets not included in trading portfolio including off balance-sheet items	4,078,239
Weighted items with market risk	598,962
Operational risk	715,998
Total risk weighted assets	**5,393,198**
Solvency ratio pursuant to FIL section 124, subsection 2 (1)	**23.6%**
Core capital after deductions in per cent of weighted assets	**23.6%**

4.2 Individual solvency requirement

The calculation of the Bank's individual 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 financial institutions issued by the Danish Financial Supervisory Authority.

The model developed by the Association of Local Banks and the guidelines from the Danish Financial Supervisory Authority are both based on the 8+ approach, where the basis is a minimum requirement of 8% of the risk-weighted items (Pillar I) with a supplement 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 Financial Supervisory Authority, the Management considers the Bank's calculated individual solvency requirement to be fair.

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

The purpose of calculating the individual solvency requirement is to determine the size of the capital base necessary in the event of adverse developments in the Bank's operations.

Table 3 shows the 8+ approach that is used when calculating the individual solvency requirement.

Table 3: Individual solvency requirement based on the 8+ approach

1) Pillar I requirement (8 % of the risk-weighted items)
+ 2) Earnings (capital for risk cover 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 higher gearing)
+ 9) 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)
- of which supplement due to statutory requirements (1+9)

The Management considers the risk factors included in the model as adequate to cover all risk areas, which the Bank's management is required by law to take into account when determining the individual 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 Eik Banki, this assessment is part of the general assessment of the individual 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 financial institutions issued by the Danish Financial Supervisory Authority.

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.

The guidelines from the Danish Financial Supervisory Authority are used when calculating credit risk. These guidelines are outlined in the Danish Financial Supervisory Authority's guidelines on adequate capital base and solvency requirement for financial institutions. For customers with OEI and weak customers (rating category 1 and rating category 2c, – see 5.1.6) where the exposure is larger than 2% of the Bank's capital base, the unsecured exposure is fully reserved.

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 base indicator method for calculating operational risk.

To calculate other risks the Bank mainly uses the Danish Financial Supervisory Authority's guidelines on adequate capital base and solvency requirement.

Table 4: Individual solvency requirement (DKK 1,000).

Risk area	**Adequate capital base DKK 1,000**	**Solvency require-ment**
Statutory requirements	431,463	8.00%
Credit risk	173,734	3.22%
Market risk	23,675	0.44%
Operational risk	0	0.00%
Other risks	9,269	0.17%
Total	**638,140**	**11.83%**

At the end of 2014, Eik Banki's solvency ratio was 23.6% (DKK 1,275 million) and the individual solvency requirement was 11.83%.

4.3 Counterparty risk – derivatives

Eik Banki uses the market value method for counterparty risk, when calculating the size of the exposure and risk-weight for derivatives covered by the *Executive Order on Capital Adequacy,* Annex 17.

The value of the exposure when using the market value 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 by the Danish Financial Supervisory Authority 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 allocates capital equivalent to 8% of the positive market value of the derivatives. When Eik Banki enters into an agreement with a counterparty regarding derivatives, credit limits must be observed. At the end of 2014 the positive fair value of derivatives etc. was DKK 19.3 million.

5 Credit Risk

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

5.1 Objective and risk policy

Credit risk is defined as the risk of financial loss arising when customers are unable to meet their financial obligations to Eik Banki.

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

The credit policy is updated, should the Bank wish 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. 336 of 12 April 2012 for the Faroes on the management and control of banks etc*. The credit policy establishes the basic rules that apply as to how the Bank handles credit risk in relation to the Bank's business organisation, operations and within the framework set by the Danish Financial Supervisory Authority.

5.1.1 Authority and division of labour

It is Eik 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 granting 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. Eik Banki's credit granting is overseen by the Credit Department, which conducts regular checks to see if the lending authorities are being complied with.

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 impairment procedures and 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.

5.1.2 Credit management and control

Credit is granted on the basis of the individual customer's financial situation with regard to 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. The 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 implemented timely and properly, however, the respective branches, where the customer is registered, are responsible for the exposures being submitted for renewal.

5.1.3 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.

5.1.4 Risk concentration

In order to ensure a spread 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 capital base. Additionally, it is the Bank's aim that the total amount of these exposures does not exceed 125% of the capital base.

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.

5.1.5 Impairments

Quarterly assessments are made of the need for impairment charges, in accordance with guidelines from the Danish Financial Supervisory Authority. 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 for all 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.

5.1.6 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)

5.1.7 Customers

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

5.1.8 Circumstances that are considered when granting credit

The Bank considers credit applications based on an assessment of the individual customer's financial situation. This assessment must be thoroughly prepared and well documented.

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: Eik Banki collaborates with BRF-Kredit providing mortgage loans for Faroese homeowners. The agreement stipulates that Eik 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. Eik Banki guarantees repayment of the loans, within certain limits.

5.2 Actual credit risk

This section shows credit risk exposures, risk-weighted items and capital requirements as of 31.12.2014. These are broken down by industry and residual maturity. The Bank also analyses past due exposures and impaired claims, movements on impaired claims caused by value adjustments and impairment charges, and financial collaterals.

5.2.1 Risk-weighted exposures and capital requirements

This section shows risk-weighted items and capital requirements.

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

Table 5: 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	747	60
Financial institutions	46,853	3,748
Retail customers[1]	681,993	54,559
Corporate customers	1,890,874	151,270
Exposures secured by mortgage in real estate	865,047	69,204
Exposures with arrears or overdrafts	402,513	32,201
Exposures in other items, including assets without counterparties	237,210	18,977
Total	**4,125,236**	**330,019**

[1] Includes exposures ≤ DKK 7.5 million.

Table 6: Exposures after value adjustment before credit risk reduction (DKK 1,000).

Exposure group	Exposure after value adjustment	Average exposure during the year after value adjustment
Governments or central banks	80,371	230,648
Local authorities	388,779	387,540
Public sector entities	4,267	126,467
Financial institutions	231,646	332,374
Retail customers[1]	1,170,526	1,153,584
Commercial customers	2,435,291	2,379,009
Exposures secured by mortgage in real estate	2,468,271	2,418,839
Exposures with arrears or overdrafts	359,411	294,790
Exposures in other items, including assets without counterparties	269,525	269,920
Total	**7,408,085**	**7,593,171**

[1] Includes exposures ≤ DKK 7.5 million.

5.2.2 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 53-56.

Individual impairments are made in accordance with section 54 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 55 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 7,408 million as of 31.12.2014.

Table 6 shows the exposures after value adjustments before credit risk reduction.

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 the *Executive order on Capital Adequacy,* Annex 3, broken down by industry. The table also shows the breakdown between retail customers and corporate customers.

Table 7: Exposures broken down by industry (DKK 1,000).

Industries	Central governments or central bank	Local authorities	Public sector entities	Financial institutions	Retail customers[1]	Commercial customers	Exposures secured by mortgage in real estate	Exposures with arrears or overdrafts	Exposures in other items, including assets without counterparties	Total
Public authorities	**438**	**388,429**	**589**	**0**	**3,229**	**0**	**0**	**0**	**0**	**392,685**
Agriculture, hunting, forestry and fishing	0	0	0	0	16,034	402,858	3,597	9,446	0	431,935
Industry and raw materials extraction	0	0	0	0	25,894	519,093	5,110	48	0	550,145
Energy supply etc.	0	0	0	0	0	196,954	0	0	0	196,954
Building and construction	0	0	0	0	56,701	70,311	8,983	1,109	0	137,104
Trade	0	0	0	0	106,567	338,483	24,310	21,267	0	490,628
Transport, hotels and restaurants	0	0	0	0	37,964	47,610	4,438	208,539	0	298,550
Information and communication	0	0	0	0	6,060	0	263	0	0	6,324
Finance and insurance	79,932	0	0	231,646	-18,631	250,511	960	385	269,525	814,328
Real estate	0	0	0	0	45,960	216,326	22,969	28,312	0	313,567
Other industries	0	0	3,678	0	168,999	368,903	26,054	5,173	0	572,807
Total corporate	**79,932**	**0**	**3,678**	**231,646**	**445,548**	**2,411,048**	**96,684**	**274,280**	**269,525**	**3,812,340**
Retail	**0**	**350**	**0**	**0**	**721,749**	**24,243**	**2,371,587**	**85,131**	**0**	**3,203,059**
Total	**80,371**	**388,779**	**4,267**	**231,646**	**1,170,526**	**2,435,291**	**2,468,271**	**359,411**	**269,525**	**7,408,085**

[1] Includes exposures ≤ DKK 7.5 million.

The table below shows the residual maturity of credit exposures.

Table 8: 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	79,916	0	0	453	2	80,371
Local authorities	104,408	0	1,326	36,514	246,531	388,779
Public sector entities	544	0	201	203	3,319	4,267
Financial institutions	214,908	15,477	416	844	0	231,646
Retail customers[1]	255,826	28,252	13,210	184,118	689,121	1,170,526
Commercial customers	697,343	53,861	23,691	380,306	1,280,091	2,435,291
Exposures secured by mortgage in real estate	12,983	-14,160	3,988	148,900	2,316,559	2,468,271
Exposures with arrears or overdrafts	9,778	1,676	1,367	21,945	324,646	359,411
Exposures in other items, including assets without counterparties	33,254	0	0	78,606	157,665	269,525
Total	**1,408,960**	**85,105**	**44,199**	**851,887**	**5,017,934**	**7,408,085**

[1] Includes exposures ≤ DKK 7.5 million.

5.2.3 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 9: 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	**20**	**20**	**23**	**-5**
Agriculture, hunting, forestry and fishing	17,843	28,105	17,736	1,684
Industry and raw materials extraction	12,050	101,307	59,023	8,504
Energy supply etc.	0	0	736	695
Building and construction	5,147	30,974	12,687	1,777
Trade	35,452	30,725	25,040	-3,548
Transport, hotels and restaurants	260,147	73,324	43,858	-18,796
Information and communication	0	0	93	-218
Finance and insurance	785	33,614	14,044	-39,793
Real estate	29,206	38,844	20,955	7,051
Other industries	29,197	37,330	34,710	9,518
Total corporate	**389,827**	**374,224**	**228,883**	**-33,127**
Retail	**122,089**	**143,894**	**77,377**	**4,219**
Total	**511,936**	**518,138**	**306,282**	**-28,914**

Amounts booked as costs are calculated as: impairments/provisions at the end of 2014 less impairments/provisions at the start of 2014, including total annual loss.

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

Table 10: 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**
Accumulated impairments/provisions on loans and guarantee debtors at the beginning of the year	305,619	1,658	53,875
Impairments/provisions during the year	98,657	7,525	7,547
Reversal of impairments/provisions from previous years, where there is no longer OEI or the impairment has been reduced	-85,110	-108	-16,514
Other changes	48,177	0	2,173
Value adjustment of acquired assets	-36,551	0	
Loss (written off), previously individually impaired/provisions made	-80,666	0	
Total impairments/provisions on loans and guarantee debtors at year end	**250,126**	**9,075**	**47,081**
Total loans and guarantee debtors, where there have been made individual impairments/provisions (calculated before impairments/ provisions)	**492,545**	**25,593**	**3,596,043**

5.2.4 Financial collateral

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

Table 11: Financial collateral (DKK 1,000).

Exposure group	Collateral with substitution	Financial collateral expanded
Governments or central banks	0	0
Local authorities	0	0
Public sector entities	0	384
Financial institutions	0	0
Retail customers[1]	414	39,161
Commercial customers	3	17,093
Exposures secured by mortgage in real estate	0	0
Exposures with arrears or overdrafts	0	62,393
Exposures in other items, including assets without counterparties	0	0
Total	**416**	**119,031**

[1] Includes exposures ≤ DKK 7.5 million.

6 Market Risk

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

6.1 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 Eik Banki is divided into interest rate risk, equity risk, foreign exchange risk and other price risks.

The Board of Directors of Eik Banki has approved 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.

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 to the CEO.

6.1.1 Interest rate risk

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

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.

6.1.2 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.

6.1.3 Foreign exchange risk

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

As a rule, Eik 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 Financial Supervisory Authority's currency indicator 1.

6.1.4 Other price risks including commodity risk

Other price risk is the risk of loss caused by fluctuating market prices of other assets than those mentioned in 6.1.1 – 6.1.3, e.g. changes in commodity prices.

At year end 2014 Eik Banki had no risks in this category.

6.1.5 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 to the CEO. The Finance Department is responsible for these reports.

6.1.6 Responsibility and monitoring

Eik Markets has day-to-day responsibility for the Bank's liquidity, securities portfolio and foreign exchange deposits on behalf of the CEO. Thus, Eik 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 Eik Markets in this area.

The Finance Department checks that the market risk policy and limits are complied with.

6.2 Actual market risk

The sections below show the actual market risk exposures as of 31.12.2014. These concern risks related to the trading portfolio, exposures in securities, which are not part of the trading portfolio, and interest rate risk.

6.2.1 Risk-weighted exposures with market risk

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

Table 12: Risk-weighted exposures with market risk (DKK 1,000).

	Risk-weighted items	Capital requirement 8%
Bonds	322,843	25,827
Shares	95,315	7,625
Currency position	180,804	14,464

6.2.2 Exposures in securities not included in the trading portfolio

Exposures in securities not included in the trading portfolio are listed below:

Table 13: Exposures in securities not included in the trading portfolio (DKK 1,000).

Type	Exposure 31.12.2014	Operating effect
Shares relating to the Bank's suppliers	16,337	-2,390
Corporate bonds	166,499	2,569
Corporations	10,024	-11,179

6.2.3 Interest rate risk

Interest rate risk separated into various items is shown in the table below.

Table 14: Interest rate risk in and outside the trading portfolio (DKK 1,000).

	Interest rate risk
Interest rate risk on items outside the trading portfolio	
Balance (loans, deposits, receivables/debt with financial institutions)	5,979
Total outside the trading portfolio	**5,979**
Interest rate risk broken down by items in the trading portfolio	
Securities in balance (incl. spot market)	19,613
Futures, forwards etc.	-23
Total in trading portfolio	**19,590**
Total interest rate risk	**25,569**

7 Liquidity Risk

Liquidity risk is described below, including objective and policy.

7.1 Málsetningur og váðapolitikkur

Eik 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 Eik Banki has approved an overall risk policy for liquidity risk, which stipulates clear requirements for daily liquidity and statement of liquidity risks.

Eik 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 per cent above the statutory minimum requirement. Eik Banki's excess liquidity at the end of 2014 was 136.4 per cent when compared to the statutory minimum requirement.

7.1.1 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.

7.1.2 Responsibility and monitoring

Eik Markets has been given day-to-day responsibility of liquidity by the CEO. Eik 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.

8 Operational Risk

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

8.1 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.

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.

Eik 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 risk 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.

8.1.1 Reporting and division of responsibility

The operational risk policy stipulates procedures, registration and reporting obligations. Employees are responsible for reporting all risk events to their nearest manager and Risk Management. Risk Management registers the events and briefs the CEO every quarter.

8.2 Actual operational risk

Operational risk can be limited but not eliminated. Regular processes are in place to determine if risks that may have a negative impact on Eik Banki appear. 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.

Eik 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 Eik Banki. This is conducted in accordance with analyses from BIR, Business Impact Assessment from ISF, International Security Forum. The latest risk analysis was done in February 2015.

The solvency requirement for operational risk is DKK 57.3 million, and this is included in the individual solvency requirement.

Eik Banki P/F
Yviri við Strond 2
FO-100 Tórshavn
Faroe Islands
www.eik.fo