



RISK REPORT

2007



## CONTENTS

3	Overview
4	Risk management and risk policies
8	Credit risk
17	Market risk
18	Share price exposures outside the trading portfolio
19	Exposures to interest rate risk on positions outside the trading portfolio
20	Liquidity risk
22	Counterparty risk – derivatives
23	Operational risk
25	Capital structure
29	Models for reducing credit risks

This document is an unofficial translation of the Danish original.  
In the event of any inconsistencies, the Danish version shall apply.

# OVERVIEW

Risk report 2007 is the first risk report of Max Bank, which has been prepared according to the disclosure requirements in pillar 3 of the capital adequacy regulations. The report contains information on Max Bank's organisation and processes relating to identification and management of the risk types that are considered to have an impact on the Bank's business volume.

Max Bank has in 2007 applied the transitional scheme of the new capital adequacy requirements. The transitional scheme implies that the new capital adequacy requirements, including a number of the new disclosure requirements in pillar 3, are not implemented in full until 2008. In 2008, the Bank will on this background continue its efforts to enhance the disclosure requirements as the transition to the new requirements is carried through in the Bank.

From 2008, the Bank's risk-weighted items will be calculated under the standard method, whereas the extended method will be applied to calculate the commitments, allowing for financial securities. Operational risk will be calculated applying the basic method, whereas market risk will be calculated under the simple method.

## Disclosure requirements

The adoption of Basel II pillar 3 has imposed enhanced disclosure requirements on banks. The disclosure requirements are intended to contribute to increased transparency and, accordingly, strengthen eg investors' and credit rating agencies' possibilities of assessing the Bank's risk profile and capital requirement.

The disclosure requirements are broken down by the following main areas:

- Risk management and risk policies
- Capital base
- Credit risk
- Market risk
- Operational risk

## Publication policy

Max Bank publishes pillar 3 information at least once a year in connection with the publication of the annual report.

The Bank regularly assesses whether a more frequent publication of information is required.

Pillar 3 information is published in a separate risk report on the Bank's homepage. Some of the information in the report is also disclosed in the annual report.

## Audit

As a main rule, information stated in this risk report relates to the financial year 2007 unless otherwise specified.

The report has not been audited by internal or appointed auditors.

# RISK MANAGEMENT AND RISK POLICIES

Max Bank defines risk as any event that can have material negative influence on the Bank's commercial activities and objectives.

## Risk management

Risk management is an important focus area for Max Bank's Supervisory Board, Executive Board and other executive staff.

The Executive Board has put particular focus on the Bank establishing the necessary risk management rules and procedures to ensure that the Bank identifies, administers, monitors and reports on the risks to which the Bank may be exposed, including in particular risks in connection with securities trading and capital adequacy.

## Risk types

The Bank is exposed to different types of risks. To manage these risks, the Bank has prepared risk policies targeting relevant levels and business areas in the Bank.

The most important risk types to which the Bank is exposed are:

- Credit risk
- Market risk
- Operational risk
- Liquidity risk
- Business risk, etc.

Each risk type is reviewed in the paragraphs below.

## Risk policies

The Bank's Supervisory Board defines

the general risk policies and risk limits for all material risk types. The Supervisory Board also considers the general principles for management and monitoring of risks.

Based on the general risk policies, operational risk policies are prepared for material business areas and are approved by the Supervisory Board.

The operational risk policies make up the basis for developing business processes as well as reconciliation and control procedures for relevant areas and for the Bank's system development.

Within the set limits, management in each business area is responsible for the risks incurred by this area, just as the business area management is responsible for active control of these risks.

## Organisation

Risk management in Max Bank is rooted in the Credit Secretariat, the Finance Department and the Bank's Investment Centre.

Each business area moreover has a number of authorities matching their fields of responsibility, including responsibility for the daily control and monitoring.

In accordance with its plan of 8 focus areas, Max Bank's Supervisory and Executive Boards have placed

particular emphasis on organisational development. Targeted efforts are made to constantly develop and adjust the Bank's organisation in order to ensure optimal management of the Bank's business risks, etc.

## Supervisory Board

The Supervisory Board lays down the general guidelines for the Bank's affairs.

The Supervisory Board is responsible for ensuring a proper organisation and for appointing the Executive Board and the Head of the Internal Audit Department. The rules of procedure for the Supervisory Board and the Executive Board include elaborations on the Supervisory and Executive Boards' tasks and the distribution of work, authorisations and management of risks between them.

The Supervisory Board has directed the Executive Board to present all cases which in relation to Max Bank are of an unusual nature or considerable significance to the Supervisory Board for consideration and resolution.

The Supervisory Board also lays down guidelines and directions for the Executive Board as to management of Max Bank and verifies that:

- The Bank's capital resources is always reasonable in relation to its operations



- Bookkeeping and asset management are controlled satisfactorily in relation to Max Bank's situation
- Internal processes, methods and descriptions of factors included in the calculation of adequate capital and capital adequacy requirement are approved by the Supervisory Board at least once a year. The Supervisory Board should also approve the calculated capital adequacy requirement

In addition, the Supervisory Board performs an overall review of assets once a year in November, including a review of the bank's major commitments.

Particularly as regards risk management rules and procedures, the Supervisory Board ensures that the Bank can:

- Determine what risks are linked to the Bank's activities, processes and systems
- Define the risk level which is acceptable to the Bank
- Manage the risks in connection with activities, processes and systems
- Ensure that relevant staff comply with the risk management rules and procedures
- Remedy any deficiencies in risk management rules and procedures.

In the event of material changes in Max Bank's risk profile, eg triggered by new business areas, the Supervisory Board reconsiders method, process and the calculated capital adequacy requirement.

The Executive Board must also at least once every year approve the Executive Board's plan and emergency plan for raising of capital as well as a contingency plan for handling of liquidity.

### Executive Board

The Executive Board attends to the daily management of Max Bank.

In compliance with chapters 10 and 11 of the Danish Financial Business Act and the Danish Financial Supervisory Authority's (FSA) directions in section 71 of the Danish Financial Business Act, the Executive Board prepares the necessary and appropriate guidelines and authorisations for Max Bank's branches for the practical implementation of the guidelines and policies adopted by the Supervisory Board. On this basis, the Executive Board ensures that written business processes are prepared for all material fields of activity.

### Internal Audit Department

The Bank's Internal Audit Department

puts considerable focus on assessment of the Bank's processes in order to test and report whether they comply with the objectives and guidelines laid down by Management.

This comprises the Bank's risk management, including assessment of whether risk management policies fall within the scope of law, and assessment of the established risk management within each risk type, including whether the defined limits, reporting structure and business processes are adequate and efficient to handle the identified risks.

### Compliance function

In 2007, the Bank established a compliance function which is to contribute to ensuring the Bank's compliance with laws and executive orders at all times as well as internal policies and processes.

### Credit Secretariat

The credit process is the central and overall responsibility of the Bank's Credit Secretariat.

The Secretariat sets out limits for lending in all the Bank's business entities. It is also responsible for the preparation of:

- Business processes
- Lending authorities

- Risk models for customer segmentation

The Bank's Credit Manager and Executive Board set out the framework for policies and limits for lending in Max Bank based on the Supervisory Board's general strategy.

Max bank has developed a lending structure with authorities in the individual business entities that matches the composition of customer groups, products and competencies. The Supervisory Board defines the lending authorities for the Executive Board.

Max Bank's lending structure has been used throughout a number of years. It is adjusted in step with the changes in the markets. The credit process ensures conformity between the customer's financial capability and the lending authorities assigned to the individual employee.

Max Bank's lending structure can be outlined as follows:



Any material loan application contains information on:

#### For private customers

- The debtor's finances with disclosure of disposable funds, income/assets. Granting of a loan presupposes that the finances do not deviate significantly from the Bank's business process.

#### For corporate customers

- Detailed corporate description of debtor and group companies
- Detailed examination of the debtor's and group companies' financial statements
- An analysis of the company's/group's business concept and assessment of strengths/weaknesses and risk involved in the commitment.

Loan applications are processed and stored electronically on all lending levels and supported by Max Bank's computer centre, BEC. The loan applications contain a considerable number of master data on the customer's aggregate commitment, finances, etc, which are collected automatically on all new loans. To this is added the data, see above, for private and corporate customers. Both new and historical master data are included to support all bases for decision, including a description of the collateral provided for the commitment.

The Credit Secretariat is also responsible for:

- Preparing quarterly and annual reports on the Bank's credit risk broken down by customer risk classes and assessment of risk for significant customers and significant industries
- Rendering support to the Supervisory and Executive Boards
- Establishing systems for internal monitoring of customer risk
- Performing current credit reviews in all customer-oriented entities
- Drawing random samples in the business entities' new lending and customers with overdraft
- Current support/handling of non-performing loans



- Attending to the current process of managing loans and advances subject to write-down for impairment
- Considering loan applications exceeding the business entities' lending authorities

## Finance Department

The Finance Department has the overall responsibility for financial reporting and strategic business analyses in close cooperation with the Credit Secretariat and the Bank's Executive Board.

Within the set limits, the management of each business area is also responsible for the risks that each area incurs as well as for actively managing these risks.

## Investment Centre

The Bank's Investment Centre has the overall responsibility for management, calculation and processing within the market risk and liquidity areas. It is also responsible for preparing of business processes and process descriptions within the area.

In addition to the Investment Centre's tasks, a number of control functions are performed by the Bank's Backoffice (organisationally placed in Filialservice (Branch Service)).

# CREDIT RISK

Credit risk is the risk of losses because one or more counterparties fail to meet all or part of their payment obligations with the Bank.

## Credit policy

In its lending activities, Max Bank attaches considerable importance to the establishment of a sound and controlled business development that is attractive for both private and corporate customers.

The lending activities are to a large extent based on openness and mutual knowledge ensuring that we can offer specialised and professional advisory services. The customers are, accordingly, subject to requirements of openness, honesty and information, providing the Bank with a full picture of the individual customer's financial situation/latitude.

Max Bank considers the rendering of advisory services on all kinds of loans and credits to private as well as small and medium-sized corporate customers an essential part of its business area.

The principal elements in the credit policy are as follows:

- The Bank attaches importance to establishing and cultivating long-term relations to its customers
- Lending activities are based on insight into the customer's situation, including specific assessments of personal, financial and economic factors
- Customers should have healthy

finances and a reasonable disposable amount

- The commitment should match the customer's creditworthiness, capital position or assets, and the customer should be able to substantiate his/her repayment ability
- Customers' financial situation and their ability to honour commitments to the Bank are followed up on an ongoing basis
- Collateral should be taken where possible
- Clear directions on the limits and preconditions that apply for the Bank when accepting commitments exceeding 10% its capital base
- The share of 10% commitments may not exceed 400% of the capital base (statutory requirement is max 800% of capital base)
- The Bank may only accept risks defined by applicable legislation and other rules, including the rules on best practices for financial businesses
- Acceptance of recourse guarantees from individuals should preferably be avoided, unless warranted by special conditions
- The Bank is particularly cautious when granting credits to businesses in troubled or cyclical industries
- In connection with the manage-

ment of the Bank's country risks, particular caution must be exercised when assuming risks in countries with an unstable economic or political climate

- When processing customers' and own orders in the liquidity, foreign currency and securities markets, the Bank maintains a comprehensive cooperation with other financial businesses that also need to trade in these areas
- The Bank participates in local clearing when so required by business considerations, and in doing so, it assumes credit risks relating to payment settlement
- The Bank has clear guidelines for investment products funded by loans and provision of guarantees

Generally, the Bank contributes to the financing of:

- Individuals or businesses with healthy finances, ie the customer should be capable of honouring his/her commitments as they fall due
- Project funding

The Bank does, however, not contribute to the financing of:

- Illegal and evidently unethical projects



- Non-transparent projects
- Businesses or individuals characterised by shady business areas that may inflict damage on the Bank's reputation
- Commitments solely based on third party recourse guarantee

## Valuation of collateral

Credit rating and assessment of a commitment is conducted on the basis of yearly statements/financial statements and earnings capacity/budgets as well as the customer's requirements. The Bank does assess the commitment based on collateral alone.

The following is emphasised in connection with provision of collateral:

- Identifying possible lapses in the preconditions
- Controlling and safeguarding the Bank against other creditors
- Realisation of collateral should always be a secondary method of honouring a commitment
- Collateral should be valued critically based on the assumption that it is the value in a compulsory sale that needs to be identified
- Assets are commonly subject to impairment once they have been delivered. This applies particularly to cars, trucks, computers, machinery and custom-built factory facilities

- Some assets are specialised in character, implying they only have value for a certain type of businesses. As a result, such assets have none or only limited value as collateral.

The detailed rules for valuing the most commonly occurring collateral is specified in the Bank's internal business processes and policies.

## Industries

The Bank aspires to have spread on industries to prevent it from becoming dependent on one specific industry and this industry's cyclical conditions.

The Bank is aware that the agricultural sector is presently under great pressure. The Bank believes that only the big and most effective breeders will be able to survive in the long run. So far, increasing land prices have, for most breeders, compensated for the situation.

The Bank is also aware that its customer portfolio comprises a relatively large portion of construction businesses, an industry also experiencing a downturn. So far, the majority of the Bank's customers have, however, been able to adapt to the changed market situation. The Bank generally handles all building projects in closed systems, where lending is commenced

only, when three quarters of the building project have been sold.

The Bank does not wish to single out any other industries as particularly favourable or particularly risky. When assessing the customer relationship, primary focus is on the customer profile and risk profile as well as the individual company's capacity to generate earnings.

## Geographical concentration

The Bank's primary market area is Denmark. Commitments outside Denmark are granted only, when the risk is deemed very modest, eg when the customer holds a large Danish asset portfolio or the commitment has been secured by mortgage in assets on Danish soil. More than 95% of the Bank's claims are against debtors in Denmark.

## Risk classification of all loan commitments

At the operational level, Max Bank launched a risk classification of its customers as early as 2005, which is supported by extensive control systems for identifying and managing quantitative credit risks. By the end of 2007, the existing systems have been supplemented with new and more advanced IT systems to identify the

## Customers with loans broken down by risk class



Lending volume calculated as credit max granted to the customers. 1 is best and 5 is worst.

quantitative risks on loans and advances.

On this basis, the Bank risk classifies all private and corporate customers with a commitment exceeding DKK 5,000. The classification is conducted based on both objective and subjective criteria.

The private customer classification is based on:

- The household's disposable amount
- The household's asset portfolio
- Collateral security and other issues, including financial danger signals

The Bank operates with five private customer risk classes, which have been defined based on the above criteria:

- Good
- Satisfactory
- Weak (customers with modest or somewhat negative asset portfolio)
- Customers with danger signals (watch customers)
- Customers selected for assessment of impairment/with indication of impairment

The corporate customer classification is based on the individual company's:

- Earnings/profit margin
- Capital adequacy/equity

- Collateral security and other issues, including financial danger signals

The bank operates with five corporate customer risk classes, which have been defined based on the above criteria:

- Good
- Satisfactory
- Weak (customers with modest or somewhat negative equity)
- Customers with danger signals (watch customers)
- Customers selected for assessment of impairment/with indication of impairment.

The private and corporate customer classification is also directional for the advisors' lending authorities. Lending authority is reduced in line with dropping quality of private and corporate customers. In the "customers with danger signals" risk class, all private customers' section 145 commitments exceeding DKK 200,000 and all corporate customers' section 145 commitments exceeding DKK 500,000 are processed under "4 eyes approval". In the weakest risk class, "customers selected for assessment of impairment/with indication of impairment" are also processed under "4 eyes approval". The majority of commit-

ments with private and corporate customers in the weakest segment are approved by the Credit Secretariat/ Executive Board.

For the two weakest customer groups, action plans are prepared for strategies to minimise risks.

The allocation on each of the five risk classes is shown in the table above.

The Bank has in 2007 focused on the weakest risk classes through intensive work on improving commitments or completely shedding them. This process has contributed to a general improvement of the already high quality of the Bank's total loans and advances.

### Credit responsibility

Overall credit responsibility often lies with the Branch Manager or someone appointed by the Branch Manager.

The responsibility covers monitoring of the branch's credit quality and assessment of the need for initiating targeted activities in the branch as a whole or in relation to one or more colleagues that ensure:

- That the Bank's credit policy is known and observed.
- That new employees and junior clerks are introduced into the Bank's credit policy/credit directions.

- That the credit quality of the branch's exposures meets the Bank's credit directions.
- That each advisor identifies and records risk exposures with or without indication of impairment.
- That credit management is performed in compliance with the Bank's credit directions.

The Credit Manager must ensure that the necessary activities are performed, either himself/herself or through others.

To ensure the quality of lending, the Credit Manager should monitor the following areas:

- Quality control of a representative segment of the branch's lending.
- Review of action plans and strategies for risk exposures with or without value adjustments (impairment).
- Treatment of daily overdrafts in the branch.

## Monitoring commitments

### Overdrafts and arrears

The Bank's overall purpose of overdraft treatment and management is to reduce the overdrafts of the Banks to an appropriate level that can be handled by the individual customer advisor, branch manager etc. In terms

of amount, the Bank aims for an "appropriate" overdraft level seen in relation to the individual branch's loans and advances as well as guarantees.

If overdrafts arise, a decision must be made to grant or reject a credit. For corporate customers, the decision depends on the customer's business conditions as well as such customer's overall financial situation (earnings capacity and capital position).

The Credit Secretariat monitors large overdrafts exceeding DKK 50,000 on a daily basis, supplemented with current follow-ups on a sample basis. The Credit Secretariat prepares weekly overdraft statistics and enters into constructive dialogue with the branch in this respect. Also, the Credit Secretariat follows up on the branch's overdraft in connection with its current credit review.

### Danger signals

Max Bank defines a watch customer as an existing commitment estimated to entail a risk for the Bank, but where the risk is not presently of such nature that it is necessary to make individual bad debt provisions.

When the Bank fears that a debtor cannot meet his or her financial obligations, and danger signals have been observed, such commitments are

treated in accordance with the Bank's policy for watch customers.

## Renegotiation of commitments

When initiating a loan, the Bank fixes a renegotiation date as specified in its business processes.

### Corporate customers

- Annual renegotiation of corporate customer commitments. Renegotiation takes place on the basis of the customer's financial statements and budgets for the coming year. This happens after the accounting records have been submitted to the Danish Tax Authorities.
- Corporate customers with total commitments of less than DKK 500k and large actual asset portfolios can renegotiate for two years at a time. The Bank assumes overall positive consolidation, actual asset portfolio of more than DKK 1m. Also, the commitment must not give rise to comments. The Bank assumes that financial statements are submitted once a year, and the advisor is responsible for an extraordinary renegotiation of the commitment if the financial statements vary from what has been assumed.

- If the exposure gives rise to intensified monitoring, the Bank requests financial statements etc as soon as possible after financial year-end.

#### Private customers

- Renegotiation only take place in cases where credits "effective until further notice" have been granted.
- Renegotiation takes place on the basis of tax returns, pay slips and budgets and at least every third year.
- The advisor is responsible for renegotiation taking place.

#### Investment commitments

At the end of 2007, investment and guarantee credits amounted to approx DKK 1.7bn of the Bank's total loans and advances as well as guarantees of approx DKK 8bn. The Bank considers these commitments to carry a low credit risk due to the underlying security and exposure management. Of the DKK 1.7bn, credit guarantees of DKK 0.5bn are expected repaid in Q1 2008.

In Max Bank, investment credits are typically monitored on the basis of a "stop loss agreement" with customers. A specially appointed unit is responsible for following up on concluded "stop loss agreements" at least once a

day. Results thereof are reported internally in the Bank to customer advisors, Corporate and Investment Centre and the central Credit Secretariat.

Approval of investment credits is contingent upon the establishment of a clear and operational set of approval assumptions, by which the Corporate and Investment Centre/the advisor can manage large commitments and related investments and that a written investment strategy and agreement on a "stop loss" exist with the customer. The development in the ratio between the market value of the credits and collaterals are described in green, yellow or red zone.

**In green zone**, the distance to the stop loss limit is more than 5%.

**In yellow zone**, the distance to the stop loss limit is between 0 and 5%. In yellow zone, the customer is contacted to agree on measures that will take the credit back into green zone by eg additional deposits.

**In red zone**, the stop loss limit has been reached/exceeded. If the customer cannot be reached or the collateral cannot be immediately re-established, the Bank is entitled, but not obliged, to divest the securities in full or in part to reduce the draw on credit.

#### Securitisations

Max Bank does not apply securitisations.

#### Impairment losses

Individual and group-based write-downs for impairment are made in accordance with the rules of the Danish Executive Order on Financial Reports for Financial Credit Institutions and Investment Companies, etc. Write-downs for impairment are made when objective evidence of impairment exists.

Indication of impairment is currently estimated via a process managed by the Credit Secretariat.

The aggregate value of the exposures after impairment losses and before allowing for effects of the credit risk reduction amounts to DKK 4,958m.



## Impairing claims and impairment losses broken down by industry

DKK '000	Impairing claims	Impairment losses year-end	Amounts relating to value adjustments and impairment losses in the period
Public authorities	0	0	0
Agriculture, hunting and forestry	658	1,262	232
Fishery	0	0	0
Manufacturing, raw material extraction, utilities	13,426	12,784	-892
Building and construction	20,450	15,990	6,516
Trade commerce, restaurants and hotels	11,768	10,753	-3,870
Transport, mail and telephone	2,316	1,760	-1,528
Credit, finance and insurance	0	47	-550
Property management and trade, business services	7,499	6,220	2,779
Other industries	5,235	5,181	-1,686
<b>Corporate customers, total</b>	<b>61,352</b>	<b>53,997</b>	<b>1,001</b>
<b>Private</b>	<b>19,803</b>	<b>16,012</b>	<b>-249</b>

## Changes in impairing claims as a result of translation/ market value adjustments and impairment losses

	Individual impairment losses		Group-based impairment losses		Impairment losses for receivables from credit institutions and other items with credit risks	
	Loans and advances	Guarantee debtors	Loans and advances	Guarantee debtors	Loans and advances	Guarantee debtors
Accumulated impairment losses for loans and advances and guarantee debtors at beginning of year	75,029	3,097	3,104	0	0	0
Changes during the year						
1. Translation adjustment	0	0	0	0	0	0
2. Impairment losses during the year	21,711	392	0	0	0	0
3. Reversals of impairment losses in previous financial years, where objective evidence of impairment no longer exists or the impairment has been reduced.	22,531	1,772	808	0	0	0
4. Other changes	-3,292	0	0	0	0	0
5. Market value adjustments of assets acquired	0	0	0	0	0	0
6. Finally lost (written off) previous individual write-down	8,212	0	0	0	0	0
Accumulated impairment losses for loans and advances and guarantee debtors at year-end	62,705	1,717	2,296	0	0	0
Total loans and advances and guarantee debtors subjected to individual write-down for impairment (calculated before impairment losses)	79,180	1,975	2,089,114	0	0	0

## Model for group-based impairment losses

The group-based assessment is performed on groups of loans, advances and receivables with uniform characteristics as regards credit risk. The Bank has 11 groups containing one group of public authorities, one group of private customers and nine groups of corporate customers as the corporate customers are broken down by sector groups.

The group-based assessment is made by applying a segmentation model developed by Lokale Pengeinstitutter, which is responsible for current maintenance and development of the model. The segmentation model determines the correlation of the individual groups between realised losses and a number of significant explanatory macroeconomic variables through a linear regression analysis. The explanatory macroeconomic variables include unemployment, real property prices, interest rate, number of bankruptcies/compulsory sales, etc.

The macroeconomic segmentation model has been set up on the basis of loss data for the entire banking sector. Max Bank has assessed the model estimates and adjusted them.

This assessment has led to an adjustment of the model estimates to

own conditions after which the adjusted estimates form the background for the calculation of the group-based impairment loss. An estimate is produced for each group of loans and receivables that reflects the percentage impairment related to a given group of loans and receivables at the balance sheet date. When comparing with the individual loan's original risk of loss at the time of establishment and the loan's risk of loss in the beginning of the current financial period, the individual loan's contribution to the group-based impairment results. The impairment loss is calculated as the difference between the carrying amount and the discounted value of the expected future payments.

The model is expected to be further developed in 2008.

## Risk reporting

Max Bank draws up comprehensive and regular reporting in order to manage and mitigate risks. The most material reporting areas are listed below.

### Advisor

- Daily overdraft on customers > DKK 1,000
- Daily report on customers with stop loss investment commitments

- Weekly report on customers to be placed in risk classes
- Weekly report on customers to be placed in money laundering classes

### Branch Manager/Credit Manager

- Daily overdraft on customers with risk marking
- Daily overdraft > DKK 5,000 in private customer branches
- Daily overdraft > DKK 25,000 in corporate customer branches
- Daily report on customers with stop loss investment commitments
- Weekly report on new lending
- Weekly report on overview of risk commitments
- Annual credit report based on random tests of the branch's portfolio
- Annual report on new lending and overdrafts based on random tests

### Credit Secretariat

- Daily report on overdraft > DKK 50,000 in all branches
- Daily report on development in commitments > DKK 40m
- Daily report on the portion of mortgaged equity investments
- Daily report on customers with stop loss investment commitments
- Monthly report on lending > DKK 5m

- Monthly report on customers to be placed in risk classes
- Monthly report on commitments broken down by customer risk classes
- Quarterly report from the branches on risk customers

#### **Executive/Supervisory Board**

- Quarterly report on selected and significant loans and advances to industries
- Quarterly report on commitments broken down by risk classes

#### **Credit rating agencies**

Max Bank does not use external credit rating agencies to calculate the extent of risk-weighted exposures.



# MARKET RISK

A market risk indicates a risk that the market price of a financial instrument will change on the basis of changes in market conditions.

A market risk indicates the risk of loss as a result of:

- Changes in market rate
- Foreign currency fluctuations
- Share price changes

Managing the Bank's excess liquidity includes investment of the Bank's funds in the share, bond, and currency market to optimise the return on the Bank's cash.

Max Bank's market risk is managed on a day-to-day basis through fixed limits for a wide range of risk targets, and Max Bank's Supervisory and Executive Boards have laid down fixed directions as to what risks the Bank wants to accept on shares, bonds, currencies and interest etc. Within the framework of the Supervisory and Executive Boards' policies, the Bank's specialists in market risks are authorised to take on positions in selected business areas.

Basically, the Bank does not accept material market risks as it aims to generate earnings through ordinary banking activities and not through speculative transactions.

The main features of the Bank's risk strategy are as follows:

- **Currency risk.** Currency risk is a measurement of how changes in exchange rates may affect the fair value of the Bank's currency posi-

tions. Max Bank only has limited exposures in this area as the Bank's foreign currency balances are hedged on an ongoing basis. At year-end 2007, total currency risk accounted for 0% of the capital base.

- **Interest rate risk.** Interest rate risk is a measurement of how changes in the actual interest rate level may affect the fair value of the Bank's fixed-interest assets. Interest risk is calculated on a daily basis – measured as the financial effect of an interest rate increase of 1 percentage point – and is managed across the Bank for all products entailing interest rate risks. The interest rate risk primarily arises in connection with the Bank's bond portfolio and fixed-interest loans and advances, and the overall interest rate risk must not exceed 5% of the capital base. The Bank's own portfolio primarily consists of Danish bonds, and at year-end 2007, the Bank's total interest rate risk accounted for approx 4.6% in relation to the core capital.

- **Share price exposure.** Share price exposure is a measurement of how changes in share prices may affect the fair value of the Bank's shares. The Bank's share investments are divided into items within and outside the trading portfolio, respectively.

The trading portfolio is spread on a number of companies – typically in European main share indexes. The portion of shares of the total own portfolio is below 10%, for which reason the corresponding share price exposure is relatively low. The currency risk for shares denominated in currencies other than Danish kroner is included in the Bank's currency risks, which are hedged on an ongoing basis.

Max Bank does not use internal models (VaR models) for calculating risks on positions in the trading portfolio.

## Capital adequacy requirements for specific risks in the market risk area

Below a calculation is shown of the capital adequacy requirements for the risks in the market risk area.

### Calculation of capital adequacy in the market risk area

	DKK '000 (weighted amount)
ITEMS WITH POSITION RISKS:	
Debt instruments	422,292
Shares, etc (incl collective investment undertakings)	100,731
Currency positions	6,376

# SHARE PRICE EXPOSURES OUTSIDE THE TRADING PORTFOLIO

Max Bank has in cooperation with other banks acquired shares in a number of sector companies. The object of these sector companies is to support the banks' activities in mortgage financing, payment services, IT, investment funds etc. Max Bank does not plan to sell these shares as participation in these sector companies is considered necessary to operate a local bank. The shares are therefore considered to stand outside the trading portfolio.

In several of the sector companies, the shares are reallocated so as to constantly reflect each bank's business volume with the sector company. The shares are typically reallocated on the basis of the sector company's equity value. Max Bank accordingly adjusts

the carrying amount of these shares on a quarterly, half-yearly or annual basis, dependant on the frequency of new information from the individual sector company. In accordance with the rules, the current adjustment is recognised in the income statement.

Other sector companies do not reallocate the shares, however typically perform valuation on the basis of the latest known transaction. Alternatively the value is calculated based on a recognised valuation method. Adjustments to the carrying amount of the shares in these companies are also recognised in the income statement.

# EXPOSURES TO INTEREST RATE RISK ON POSITIONS OUTSIDE THE TRADING PORTFOLIO

Max Bank's exposures to interest rate risk on positions outside the trading portfolio primarily take the form of fixed-rate loans and advances, mortgage deeds, deposits and subordinate debt.

The Bank generally hedges interest rate risk on positions outside the trading portfolio, and alternatively such risk on for instance fixed-rate deposits or loans and advances forms part of the Bank's day-to-day management of the overall interest rate risk.



# LIQUIDITY RISK

Liquidity risk is the risk of not being able to raise sufficient capital in the market for the Bank's current operations. Measured in relation to statutory requirements, the Bank's cash resources accounted for an excess cover of 85.2% by the end of 2007.

Together with credit risk, liquidity risk is one of Max Bank's top priority risk areas. Seen in a risk perspective, managing the Bank's cash resources and funding has for several years been subject to much focus by Max Bank's Supervisory Board and other executive staff. This focus has remained intensive in 2007 when the global banking industry has experienced a serious liquidity crisis.

Generally, Danish banks have in recent years moved from profiting from deposits to generating net losses from deposits. The reason is that the relatively low interest rate makes it less attractive to have money on traditional deposit accounts with the bank and more attractive to borrow money from the bank. This situation implies that more and more banks, including Max Bank, embarked on the international loan markets to raise the liquidity required to continue growth. Since 2003, the Bank's external funding has gone from below DKK 250m to almost DKK 3bn in 2007.

Until the summer of 2007, liquidity on the international loan markets has been inexpensive and abundant, but the liquidity crisis has limited the availability of liquidity. Overall, Max Bank has sound cash resources by means of good and long-term liqui-

dity planning. In early 2007, before the liquidity crisis broke out, the Bank secured new solid cash resources when this was still fairly inexpensive. Measured in relation to statutory requirements, the Bank's cash resources accounted for an excess cover of 85.2% by the end of 2007.

In the light of the crisis in the international liquidity market, which broke loose in the summer of 2007, Max Bank's Supervisory and Executive Boards have paid particular attention to the Bank's cash resources in the second half of 2007. In this context, the Supervisory Board adopted a liquidity strategy, including an extended emergency plan, to ensure that the Bank can regularly raise sufficient liquidity and funding in the market. The turbulence on the liquidity market has not prevented Max Bank from enhancing its cash resources further by expanding into several new lines on sound terms. For instance, the Bank has obtained liquidity in the order of DKK 300m from international cooperation partners in the end of 2007. At year-end 2007, the Bank's total cash resources had increased to DKK 1.7bn from DKK 1.2bn the year before. So, the Bank has enough liquidity to cover more than one year's estimated growth without having to raise additional capital.

The lenders include a broad range of liquidity providers in a number of countries. So, the Bank is not dependant on single lenders.

Most of the Bank's funding from the Danish money market and international cooperative partners etc has a long term of up to 10 years.

## Cash management

Max Bank's cash management is based on its liquidity strategy that has been submitted to and approved by the Supervisory Board.

The liquidity strategy includes many strategic considerations and objectives, also with regard to size of liquidity, provision, spread and reporting on developments in liquidity.

The Bank's strategic objective is not to be dependent on one liquidity market or one source of liquidity. This is why liquidity must be raised in different markets, from different sources and have fixed differing terms, depending on available facilities, prices and liquidity budgets.

The Bank has allocated resources to assessing and managing day-to-day liquidity developments, and this includes forecasting and planning the Bank's placement and funding requirements in the short term as well as the long term. Assessments and manage-

ment are conducted on the basis of applicable rules/internal instructions.

## Liquidity reporting

Based on preparatory material from the Executive Board, the Supervisory Board every year prepares an overall plan for provision of capital/liquidity. This plan defines the strategic objectives for excess cover, spread etc. The liquidity plan serves as a basis for subsequent practical initiatives where the Bank's liquidity area performs the following assessments and reporting:

- **Day-to-day reporting.** The Bank's cash management system provides daily reports on the size of cash resources. Cash resources are assessed on a daily basis for purposes of being able to act on, optimise and monitor them. The assessment is made both with and without unutilised drawing rights to show total cash resources. The Bank's Executive Board and executives of the liquidity area receive reports on this together with other daily risk assessments.
- **Weekly reporting.** Every week, a continuous cash budget estimating future cash 12 months ahead is revised based on realised and forecasted deposits, loans and advances as well as changes in liquidity.

### ■ Monthly reporting

- Executive Board meeting: Every month, developments in liquidity and planned activities for liquidity are reviewed with the Executive Board.
- The monthly balance sheet includes a liquidity report that is reviewed by the Executive Board/Supervisory Board. The monthly balance sheet is submitted to the Danish FSA according to existing rules.
- The Supervisory Board is briefed in the liquidity report about developments in liquidity on an ongoing basis.

■ **Quarterly reporting.** A quarterly status report is prepared for a number of fields in the market area. This reporting follows from instructions by the Supervisory Board and also contains a status on a number of liquidity items pursuant to section 70 of the Danish Financial Business Act.

■ **Current reporting.** Proposals are currently presented to the Supervisory and Executive Boards for long-term cash management, for instance, when long-term loans are raised.

■ **Statutory reporting.** Cash resources are disclosed in the statutory quarterly, half-yearly and annual announcements of financial statements.

# COUNTERPARTY RISK – DERIVATIVES

Max Bank applies the market value method to counterparty risk to calculate the size of exposures to derivatives that fall within the definition in Appendix 17 to the Danish Executive Order on Capital Adequacy.

The positive gross fair value of financial contracts after netting, see Appendix 17 to the Executive Order on Capital Adequacy, is DKK 3,081,021k.

The value of the Bank's total counterparty risk as determined under the market value method for counterparty risk, see Appendix 16, items 8-12, to the Executive Order on Capital Requirements, is DKK 18,151k (weighted).



# OPERATIONAL RISK

Operational risk is defined as the risk of financial losses resulting from errors in internal processes, human errors, system errors or losses as a result of external events.

Operational risks comprise all risks arising from the Bank's activities, and which are not included in the other credit and market risks mentioned.

The Danish Executive Order on Capital Adequacy requires banks to hedge operational risks by means of capital. The capital requirement for operation risks must cover: "Risk of losses resulting from inappropriate or inadequate internal processes, human errors and system errors or as a result of external events, including legal risks".

Max Bank uses the basis indicator method, see Appendix 18 of the Executive Order on Capital Adequacy, to calculate the capital requirement for operational risks. This means that the capital requirement for operational risks is calculated as 15% of the average "core income" in the last three years.

The core income is the sum of net interest income and non-interest-related net income

The Bank does, however, conduct current assessments of the capital requirement for operational risks.

If the capital requirement is deemed to be higher than the above, this will be considered in the Bank's calculation of the capital adequacy requirement.

## Interest rate risk by type of instrument

<b>Positions included in the trading portfolio</b>		DKK '000
1. Securities in the balance sheet including spot transactions		18,984
2. Futures, forward contracts and forward rate agreements		9,072
3. Options		0
4. Swaps		111
Total, included in the trading portfolio		28,167
<b>Positions outside the trading portfolio</b>		
1. On-balance sheet items (excluding positions in 2 and 3)		-2,602
2. Positions with limited or hedged interest rate risk		0
3. Positions with special interest rate formula		0
Total, outside the trading portfolio		-2,602
All positions		25,565

In addition to the risks stated above, Max Bank has identified a number of other risks, among them:

**Compliance risk:** With a view to complying with laws and executive orders etc, and to reduce losses, the Bank has prepared a number of policies and processes that describe the Bank's internal processes and how the Bank's employees should approach them.

**Control risk:** The Bank has set up an internal control environment with a satisfactory segregation of functions and a number of standards as to how controls should be carried through and reported on a daily basis.

**Employee risk:** In general, staff shortage in the financial sector constitutes a great risk of non-development of the Bank's business activities. However, in by virtue of a progressive staff policy with the object of ensuring that Max Bank is considered an attractive place of work with a high level of employee satisfaction, the Bank has a relatively low staff turnover.

**IT risk:** A central part of the Bank's guard against the risk of suffering financial losses as a result of errors in IT systems is the Bank's IT security policy and IT security code of practice. These policies and rules place a number of demands on the employees'

conduct and on the structure of the IT systems etc. They also place a number of minimum requirements as to the handling of sensitive information. In addition, the Bank is currently working on a contingency plan to reduce losses in the event of non-accessible IT systems or other emergencies.

**Reputational risk:** The Bank's image among customers and cooperative partners is crucial to the Bank's success. The Bank currently assesses whether measures and activities may damage the Bank's image.

**Supply chain risk:** The Bank has concluded a number of strategic alliances with external cooperative partners. A number of them have been jointly concluded with all or parts of other local banks. This implies that Max Bank is part of joint solutions that have such great business volumes that we are jointly an interesting partner to a supplier at all times.

**Force majeure risk:** The Bank has prepared plans for handling robberies as well as bomb threats. Other force majeure incidents, eg fire and power failure are described in the Bank's contingency plan.

The Bank is presently working on models and methods as part of the new capital adequacy requirements. It is the Bank's policy that the operational

risks should at all times be kept low considering the related costs.

As a safeguard against suffering losses resulting from operational risks, the Bank has implemented an insurance strategy. This strategy implies that, together with an insurance broker, the Bank will continuously evaluate and hedge significant risks, other than financial risks, through insurance solutions if possible and financially sound.

Also, as already mentioned, the Bank has established a compliance function in 2007.

# CAPITAL STRUCTURE

Basically, the Bank's capital structure is built up of three elements: Equity, subordinate loan capital and hybrid core capital. Combined they constitute the three entities in the capital base.

Today, Max Bank has a capital structure based on approx 60% equity and hybrid core capital and approx 40% subordinate loan capital.

## Capital base

Max Bank's capital base is built up as shown in the table below.

## Calculation of capital base

	DKK '000	DKK '000
<b>1. Core capital</b>		
1.1. Share capital/capital adequacy	41,400	
1.2. Share premium account	91,997	
1.3. Reserves	2,305	
1.4. Retained earnings	3351,439	
1.5. Profit for the year	0	
1.6. Capital adequacy of incorporated savings banks	0	
<b>2. Statutory deductions from core capital</b>		
2.1. Proposed dividends	6,210	
2.2. Intangible assets	0	
2.3. Deferred capitalised tax assets	6,746	
2.4. Loss for the year	0	
2.5. Accumulated value adjustment of hedging instruments used to hedge cash flows	0	
2.6. Accumulated changes in value of liabilities at fair value resulting from changes in own credit risk	0	
<b>3. Core capital net of statutory deductions</b>	474,185	
<b>4. Hybrid core capital</b>	83,632	
<b>5. Core capital including hybrid core capital net of statutory deductions</b>	557,865	
<b>6. Other deductions</b>		
6.1. Half of the capital requirement of subsidiaries or associates carrying on insurance business	0	
6.2. Half of investments > 10%	0	
6.3. Half of the sum of investments etc > 10%	0	
6.4. Half of difference between estimated losses and accounting value adjustments and provisions	0	
6.6. Half of value of transferred payments etc subject to delivery risk	0	
6.7. Excess deduction	0	
<b>7. Core capital including hybrid core capital net of statutory deductions</b>		557,865
<b>8. Supplementary capital</b>		
8.1. Subordinate loan capital		425,000
8.2. Revaluation reserve		2,357
8.3. Hybrid core capital		16,320
8.4. Difference between estimated losses and accounting value adjustments and provisions		0
8.5. Repayable serial reserve funds		0
<b>9. Supplementary capital included</b>		443,677
<b>10. Capital base before deductions</b>		1,001,542
<b>11. Deductions in capital base</b>		
11.1. Half of the capital requirement of subsidiaries or associates carrying on insurance business		0
11.2. Half of investments > 10%		0
11.3. Half of the sum of investments etc > 10%		0
11.4. Half of difference between estimated losses and accounting value adjustments and provisions		0
11.6. Half of value of transferred payments etc subject to delivery risk		0
11.7. Directly and indirectly held investments in subsidiaries and associates		0
11.8. Investments > 15%		0
11.9. Investments > 60%		0
11.10. Less solvency impairment of assets etc		0
11.11. Setoff of excess deduction		0
<b>12. Capital base net of deductions</b>		1,001,542

## Capital adequacy requirements and capital adequacy

Statutory regulations require the Supervisory and Executive Boards to define the Bank's individual capital adequacy requirement. At Max Bank, we have implemented a model to calculate the capital adequacy requirement based on a model developed by Lokale Pengeinstitutter. In this model, capital is allocated in four risk areas – credit risk, market risk, property risk and other risk.

The first element of the model includes some stress tests. In these stress tests, the individual financial statement items are subjected to stress via seven variables.

### Variables subjected to stress testing when calculating capital adequacy requirements

Capital for coverage of credit risks	Increase in losses on customers
Capital for coverage of market risks	Declines in share prices Increase in interest rates
Capital for coverage of risks on own properties	Declines in property prices
Capital for coverage of other risks	General decline in earnings Increase in currency risk Increase in counterparty risk



Management has defined what risks the Bank should be able to withstand and, accordingly, what variables need to be stress tested. Basically, stress tests are an attempt to expose the Bank's accounting figures to a number of negative events – in order to see how the Bank reacts in the given scenario.

The result of the implemented

stress tests has been incorporated in the capital adequacy requirement model implying that Max Bank at least needs to have a capital to cover the loss which will arise if the scenario in question occurs. The collective effect of the stress test on the capital adequacy requirement is calculated by matching the aggregate impact on results to the

weighted items. This provides a target for how much capital is required for the Bank to survive the scenario set up.

Aside from the risk areas comprised via stress tests, the Bank has included a large number of risk areas which it has found relevant in the assessment of the capital adequacy requirement.

## Other risk areas assessed in relation to the definition of the capital adequacy requirement comprise

Additional capital for coverage of credit risks	<b>Including</b>
	Large commitments
	Weak commitments
	Geographical concentration
	Concentration on corporate customers
	Concentration of collateral
Additional capital for coverage of market risks	
Additional capital for coverage of risks on own properties	
Additional capital for coverage of other risks	<b>Including</b>
	Operational risk and control environment
	Strategic risks
	Reputational risks
	Risks in relation to the Bank's size and funding
	Liquidity risk
	Group risks
	Settlement risks

The determination of these areas' impact on the capital adequacy requirement percentage has either been calculated directly based on supplementary calculations or by Management estimating these risk areas' impact on the calculation of the capital adequacy requirement.

In the opinion of the Bank, the risk factors included in the model meet the coverage requirements for all the risks which the law requires the Bank to allow for in the identification of the capital adequacy requirement as well as the risks which the Supervisory Board defines that the Bank has assumed. Max Bank has calculated the

capital adequacy requirement at 8.3%. The Bank's capital adequacy ratio of 14.5% accordingly constitutes a considerable excess cover.

The Supervisory and Executive Boards moreover need to assess whether the capital base is sufficient to support future activities. This assessment is part of the general determination of the capital adequacy requirement. Accordingly, Management assesses every year how the growth expectations impact the calculation of the capital adequacy requirement. This implies that Management estimates the future growth rate, the growth's average capital adequacy weight and

earnings margin after tax in the model. The growth expectations' estimated capital adequacy charge will in the model be reflected directly in the capital adequacy requirement by an addition. The capital adequacy charge is, however, disregarded if initiatives have been taken for a capital increase capable of absorbing the loan growth.

### Capital adequacy requirements for market risks

The table below outlines the Bank's capital adequacy requirements for market risks:

### Risk-weighted items with a market risk

DKK 'ooo	Risk-weighted items	Capital requirement (8% of exposure)
Weighted items with a market risk	529,399	42,352
Instruments of debt	422,292	33,783
Shares	100,655	8,052
Collective investment undertakings	76	6
Currency risk	6,376	510

# MODELS FOR REDUCING CREDIT RISKS

Max Bank has in 2007 followed the transitional scheme and will therefore not apply the new calculation methods of the Executive Order on Capital Adequacy until the financial year 2008.

From 2008, the Bank's risk-weighted items will be calculated under the standard method, whereas the extended method will be applied to calculate the commitments, allowing for financial securities.

In connection with the implementation of Basel II – a cross-firm group comprising the Credit Manager, the Financial Manager, the Investment Manager and the Compliance Officer was appointed in mid-2007. The Group is responsible for the current implementation of all Basel II phases in Max Bank.



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