

# RISK REPORT 2012



**DANISH  
SHIP FINANCE**

CVR NO. 27 49 26 49

# INTRODUCTION

The purpose of this risk report is to provide a description of 1) risk and capital management and 2) the composition of the capital base and risks in relation thereto in accordance with the disclosure requirements set out in annex 20 to the Executive Order on Capital Adequacy. In addition, the report includes a description of the various types of balance sheet and off-balance sheet risks that the company is exposed to.

The risk report is published once every year in connection with the presentation of the annual report. The risk report is available on [www.shipfinance.dk/InvestorRelations/Risiko-rapport](http://www.shipfinance.dk/InvestorRelations/Risiko-rapport). The company regularly assesses whether there is a need for publication more frequently than once a year.

There is no audit requirement in respect of the risk report, and it has been decided not to have the Risk Report for 2012 be subject to an audit.

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# RISK MANAGEMENT

Risk management is given top priority, because the various risks may have an adverse impact on financial performance and solvency and, by extension, materially weaken future business opportunities.

## ALLOCATION OF RESPONSIBILITIES

The Board of Directors has the overall responsibility for ensuring appropriate risk management procedures. The risk policies established by the Board of Directors, including written guidelines for the Management Board, and the legislative framework govern the company's risk management.

The Management Board has the overall practical responsibility for managing the company's risks and for reporting such risks to the Board of Directors. Risk management forms an integral part of the day-to-day operations and is pursued through policies and control measures prepared to retain an effective control environment. Based on regular reports about developments in the company's risks, the Management Board continuously assesses the company's exposures and resolves on any steps to mitigate identified risks.

In accordance with the Executive Order on governance, the company must appoint an employee as its risk manager. The risk manager is responsible for ensuring an adequate risk management process in the company and that an overview is established of the company's risk and total risk exposure. The Management Board has appointed a member of the Management Board as the company's risk manager. The background is an assessment of the company's size and complexity, and the Management Board has found that it was unnecessary and inappropriate to appoint an employee with no other responsibilities than risk management.

In addition, the company has appointed a compliance manager, whose duties involve ensuring compliance with applicable legislation, market standards and internal rules and also ensuring that the company applies effective methods and procedures suitable for identifying and mitigating the risk of non-compliance.

## REGULATION

Danish Ship Finance is governed by its own regulation in the form of the Act on a Ship Finance Institute (the Act) and the Executive Order on a Ship Finance Institute (the Executive Order). Pursuant to the Executive Order, the company is governed by parts of the Danish Financial Business Act. The company is also governed by the Executive Order on bond issuance, the balance principle and risk management (the Bond Executive Order), the Executive Order on Capital Adequacy, the Executive Order on Governance, Risk Management, etc. for Financial Institutions (the Executive Order on Governance) and, like other financial enterprises, it is supervised by the Danish Financial Supervisory Authority.

Pursuant to the Bond Executive Order, the company must pursue a balance principle and has decided to pursue the specific balance principle. The balance principle entails fixed absolute limits for the size of allowable interest rate, foreign exchange and liquidity risks when there is a difference between payments on loans and funding. Under these rules, the company is prevented from assuming any noteworthy interest rate, foreign exchange or liquidity risk in connection with its lending operations.

## INTERNAL AUDIT

In accordance with applicable legislation, the Board of Directors, including the Audit Committee, regularly assesses the need for an internal audit function. The Board of Directors has decided that the combination of an internal control function whose efforts are supervised by the external auditors, which regularly monitors compliance with the company's in-house business processes and control procedures in all significant areas and sharp attention by the external auditors helps to provide a satisfactory audit and control level.

## REPORTING

The Board of Directors is provided with regular reports to ensure that its members have the necessary information about risk developments etc. On the basis of these reports, the Board of Directors revises the overall policies, framework and principles for risk and capital management.

## RISK EXPOSURE

## REPORTING TO THE BOARD OF DIRECTORS

Report	Frequency
Compliance reporting	Yearly
CRO reporting	Yearly
Authorisation list*	Each ordinary board meeting
Financial reporting	Quarterly
Internal financial reporting	Quarterly
Credit reports	Quarterly
Memorandum on weak exposures	Quarterly
Statement to be used for risk assessment	Yearly
Stress test	Quarterly
Annual asset review	Yearly

\* Definition: "Loans or guarantees, increases, debtor replacements and other changes to loans, including the granting of any breach of loan agreements granted by the Management Board"

Danish Ship Finance's main business activity is to provide loans against a first mortgage in ships. Credit risk represents the bulk of the overall risk exposure. Market risk and operational risk represent the other risks, whilst the company has limited liquidity exposure due to the rules of the Bond Executive Order.

The credit risk should be seen primarily as the risk associated with the borrower's inability to repay interest and instalments on the loan in due time and potentially extraordinary instalments on the loan in case of a decline in the value of the mortgaged vessels pursuant to a minimum value clause. The company only provides financing against a first mortgage in vessels and in special cases financing of instalments to a shipyard. The company's credit policy defines overall targets to ensure a controllable lending risk. As part of the credit policy, in its loan portfolio the company seeks to ensure good credit quality and risk diversification in respect of borrowers and vessel types. When granting credit to new as well as existing customers, focus will be on vessel characteristics, the financial standing of the borrower, the terms of the loan and on the loan's contribution to compliance with the diversification rules.

Market risk covers primarily interest rate, foreign exchange and liquidity risks, governed by lines defined in the Bond Executive Order and the Executive Order. As a result of the company's dedication to the bondholders' security for timely repayment, the principal financial risks are now centred on the securities portfolio. The overall goal is to avoid financial positions jeopardising the company's solvency or continued existence, and to make sure that interest rate and foreign exchange risks are managed by hedging or through intended open positions and that the company achieves the highest possible return with due consideration to the risk targets defined.

As stated above, liquidity risk represents a limited part of the overall risk exposure, as the company applies the specific balance principle in accordance with the Bond Executive Order. In addition, the liquidity policy defines liquidity risk limits, the purpose of which is to ensure consistently adequate liquidity.

Operational risks primarily concern the credit area, the finance area, compliance and IT application. Operational risks are managed by way a policy for operational risks, business procedures and internal controls.

# CAPITAL MANAGEMENT

Pursuant to the Executive Order on Capital Adequacy, Danish Ship Finance must maintain a certain amount of capital relative to its activities, so that the capital adequacy as a minimum matches the company's risk profile and complies with the legislative framework.

There must be capital to cover the requirement at the existing and the expected level of activity in order to comply with the statutory rules and in-house company regulations.

The regulatory framework for capital management is defined in the Executive Order on Capital Adequacy, which contains provisions implementing parts of the Capital Requirements Directive (CRD). The framework builds on three pillars:

- Pillar I contains a set of rules for calculating the solvency requirement, which is 8% of risk-weighted assets for the three types of risk – Credit, Market and Operational risk.
- Pillar II contains a set of rules for how to calculate the adequate capital base, taking into consideration the company's individual characteristics, and all relevant risk types are included, irrespective of whether they are included in Pillar I or not.
- Pillar III sets forth rules on disclosure obligations, as a result of which the company, at least once annually, must disclose information on capital matters, its risk profile etc.

Pursuant to the Executive Order on Capital Adequacy, companies have some freedom when selecting how to calculate their adequate capital base. The reason is that companies must match their calculation methods to their risk profile. The company's management believes that the company has shown the necessary prudence.

## NEW CAPITAL ADEQUACY RULES

The European Commission is working on a number of initiatives that will lead to significant changes to the capital adequacy rules. The rules are expected to include stricter requirements on tier 1 capital, including a significant increase of the tier 1 capital (excl. hybrid tier 1 capital) and the introduction of countercyclical capital requirements, which will be lowered during times of crisis. Since the company's capital predominantly consists of tier 1 capital in the form of tied-up reserve

capital, it expects to be able to comply with the stricter statutory requirements.

## CAPITAL TARGET

The capital target defined by the Board of Directors is based on a solvency that is sufficient for the company to continue its lending operations even in case of large cyclical fluctuations and difficult business conditions and to ensure compliance with statutory requirements.

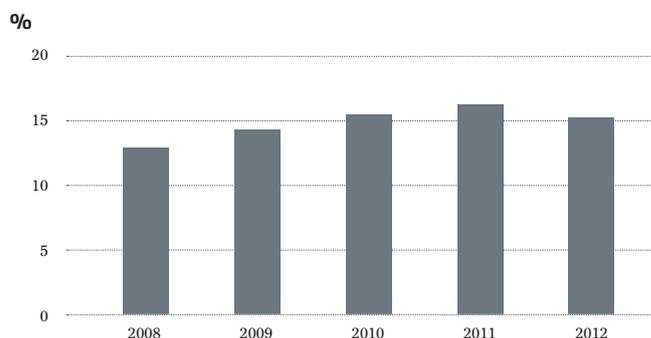
At the end of 2012, the solvency ratio was 15.2, against 16.3 at the end of 2011. The solvency ratio is believed to be adequate to meet the above-mentioned target.

The lower solvency ratio in 2012 is due to the company's full repayment in December 2012 of the hybrid tier 1 capital of DKK 900 million raised in connection with the Second Bank Package. After this repayment, the capital base consists almost

## CALCULATION OF SOLVENCY AND TIER 1 CAPITAL RATIOS

DKKm/%	2012	2011
Capital base less deductions	8,963	9,760
Risk-weighted items	59,128	59,899
<b>Solvency ratio</b>	<b>15.2</b>	<b>16.3</b>
Tier 1 capital ratio		
Incl. hybrid tier 1 capital	15.1	16.3
Tier 1 capital ratio		
Excl. hybrid tier 1 capital	15.1	14.8

## SOLVENCY



exclusively of tier 1 capital. The company maintains a modest revaluation reserve, which is included in the tier 2 capital.

### **CAPITAL BASE**

The capital base is characterised by the fact that it is subordinated to ordinary creditors in the event that a financial undertaking goes bankrupt. The capital base can be composed of three different types of capital: core (tier 1) capital, hybrid tier 1 capital and supplementary (tier 2) capital, and the relationship between capital base and risk-weighted assets is the solvency ratio.

#### **Tier 1 capital**

Tier 1 capital is the capital that represents the core of the capital base of financial enterprises. The tier 1 capital primarily consists of paid-up share capital or guarantee capital and reserves in a credit institution.

#### **Hybrid tier 1 capital**

Hybrid tier 1 capital is a mixture of share capital and loan capital. There are special rules on how large a proportion of the hybrid tier 1 capital can be included as part of the tier 1 capital. The part of the hybrid tier 1 capital that cannot be included in tier 1 capital may instead be included in tier 2 capital.

#### **Tier 2 capital**

Tier 2 capital is the capital that supplements the tier 1 capital and the hybrid tier 1 capital in financial enterprises. Tier 2 capital consists, among other things, of subordinated loan capital subject to high risk exposure.

The capital base must consistently be higher than both the adequate capital base and the capital requirement. Under the Danish Financial Business Act, the capital requirement is defined as the solvency requirement or the minimum capital requirement (EUR 5 million), whichever is the higher.

#### **Adequate capital base**

The adequate capital base is calculated on the basis of the risk profile of the financial institution.

#### **Individual solvency need**

The individual solvency need is calculated as the adequate capital base as a percentage of the risk-weighted assets. The individual solvency need must not be lower than 8% of the risk-weighted assets (solvency requirement) or the minimum capital requirement.

#### **Solvency requirement**

The solvency requirement describes the statutory requirements for financial enterprises. In a credit institution, the capital base must represent at least 8% of the institution's risk-weighted assets.

#### **Minimum capital requirement**

The minimum capital requirement is a capital base of at least EUR 5 million.

Movements in the capital base are determined primarily by the profit/loss for the year and the company's dividend policy.

The company's capital base consists predominantly of core capital (tier 1) in the form of tied-up reserve capital. The tied-up reserve capital may only be used to cover losses which cannot be covered by amounts available for dividend distribution. The tied-up reserve capital shall as far as possible be restored by advance transfer of the profit for the year, if, in prior years, it was wholly or partly used to cover losses. Hence, no dividends shall be paid and no distributions shall be made in connection with capital reductions until the tied-up reserve capital has been restored to the same nominal amount as the undistributable reserve had before being used wholly or partly to cover losses.

A small part of the capital base consists of share capital, retained earnings and revaluation reserves.

The company's capital base less deductions at 31 December 2012 amounted to DKK 8,963 million, against DKK 9,760 million in 2011.

#### CALCULATION OF CAPITAL BASE LESS DEDUCTIONS

DKKm	2012	2011
<i>Tier 1 capital</i>		
Share capital	333	333
Tied-up reserve capital	8,343	8,343
Retained earnings	1,087	980
<b>Total tier 1 capital</b>	<b>9,763</b>	<b>9,656</b>
<i>Deductions from tier 1 capital</i>		
Reduction due to additional straining	(213)	(323)
Proposed dividends	(267)	(207)
Deferred tax assets	(330)	(275)
<b>Total deductions from tier 1 capital</b>	<b>(810)</b>	<b>(805)</b>
<b>Tier 1 capital less statutory deductions</b>	<b>8,953</b>	<b>8,851</b>
<i>Subordinated debt</i>		
Subordinated debt	-	899
<b>Total tier 1 capital</b>	<b>8,953</b>	<b>9,750</b>
<i>Tier 2 capital</i>		
Revaluation reserves	10	10
<b>Total capital base less deductions</b>	<b>8,963</b>	<b>9,760</b>

#### RISK-WEIGHTED ASSETS/EXPOSURES

DKKm	Risk-weighted exposure		Solvency requirement	
	2012	2011	2012	2011
Weighted assets outside the trading portfolio	48,902	49,028	3,912	3,922
Weighted off-balance sheet items	2,953	4,490	236	359
Weighted items with counterparty risk outside the trading portfolio	780	696	62	56
Weighted items with a market risk	4,781	3,827	383	306
Operational risk	1,712	1,859	137	149
<b>Total weighted items</b>	<b>59,128</b>	<b>59,899</b>	<b>4,730</b>	<b>4,792</b>

#### SOLVENCY REQUIREMENT

Pursuant to legislation, a ship finance institute must have a capital base which as a minimum amounts to the sum of the solvency requirement for credit risk, market risk and operational risk.

Because the CRD has been implemented in Danish legislation, the company may choose between different methods for calculating its risk-weighted items for each of the three overall types of risk, and thus also the solvency requirement. The company has not applied for a permission from the Danish FSA to apply one of the internal methods. The company applies the standard method for calculating risk-weighted assets and the solvency requirement concerning credit risk and market risk. When using the standard method, the risk weights are defined in the legislation. In addition, the company applies the basic indicator method to calculate the risk-weighted assets for operational risk.

The table below shows the company's risk-weighted exposures/assets and solvency requirement for each exposure category. The total weighted items at the end of 2012 were reduced by DKK 772 million relative to the end of 2011. Weighted items outside the trading portfolio were reduced because of a decline in the loan portfolio, whilst weighted off-balance sheet items were also reduced, primarily on account of a decline in the portfolio of loan offers at the end of 2012. Weighted items with a market risk increased primarily as a result of a small increase in the foreign currency position and a position in fixed-income derivatives which does not allow for netting between the currencies for accounting purposes.

#### AVERAGE VALUES OF RISK-WEIGHTED EXPOSURES

DKKm	Risk-weighted exposure		Solvency requirement	
	2012	2011	2012	2011
Due from credit institutions	213	154	17	12
Loans and guarantees to shipowners	48,631	47,098	3,890	3,768
Of which exposures with arrears and overdrafts	207	12	17	1
Mortgage and government bonds	4,209	5,138	337	411
Exposures in other items, including irrevocable credit guarantees	6,606	7,106	528	568
<b>Total, average weighted items</b>	<b>59,658</b>	<b>59,496</b>	<b>4,773</b>	<b>4,760</b>

#### SOLVENCY REQUIREMENT – CREDIT RISK

The standard method is used to calculate the solvency requirement for credit risk, as a result of which all loans generally carry a weight of at least 100%. Under the standard method, the values of the ships' mortgages cannot be deducted, and in terms of solvency the loans are treated as unsecured loans. The Executive Order sets out that the following loans or shares of loans each carry a weight of more than 100%:

- Pursuant to section 21(5) of the Executive Order, building loans carry a weight of 200% if the sum of building loans does not exceed 125% of the solvency-related excess cover. If the sum of the building loan exceeds 125%, the excess amount must be deducted from the tier 1 capital. Building loans are secured through debtor's liability, assignment and subrogation in the building contract and assignment in the shipyard's collateral for payments under the building contract.

- Loans in which the loan exceeds 70% of the value of the mortgage at the date of grant must, in respect of the part that regularly exceeds 70%, result in a deduction in the tier 1 capital. The maximum deduction is determined at the date of grant in Danish kroner.
- When the borrower is domiciled in a country where the country risk calls for a higher weighting, the loan will have a weighting 150%.

Building loans amounted to DKK 373 million at 31 December 2012. The sum of the company's building loans does not exceed 125% of the solvency-related excess cover. Deductions in the tier 1 capital concerning loans, which at the time of grant exceeded 70% of the value of the mortgage, amounted to DKK 213 million at 31 December 2012. Loans where the borrower is domiciled in a country where the country risk calls for a higher weighting amounted to DKK 1,030 million at 31 December 2012.

#### RISK-WEIGHTED ITEMS WITH CREDIT RISK

DKKm	Unweighted amount		Weighted amount		Solvency requirement	
	2012	2011	2012	2011	2012	2011
Due from credit institutions	1,627	597	325	119	26	10
Loans and guarantees to shipowners	47,116	47,748	47,335	47,989	3,787	3,839
Mortgage bonds	9,010	7,124	901	712	72	57
Derivatives	1,646	1,259	780	696	62	56
Other balance sheet items with credit risk	585	621	467	445	37	36
<i>Irrevocable credit commitments</i>	4,400	7,377	2,200	3,688	176	295
<b>Total risk-weighted items with credit risk</b>	<b>64,383</b>	<b>64,724</b>	<b>52,008</b>	<b>53,650</b>	<b>4,161</b>	<b>4,292</b>

### SOLVENCY REQUIREMENT - MARKET RISK

The standard method is used to calculate the solvency requirement for market risk. Positions with market risk are items in the trading portfolio and positions with foreign exchange risk outside the trading portfolio. Set out below is a table showing the solvency requirements for the risks in question.

### SOLVENCY REQUIREMENT - OPERATIONAL RISK

The solvency requirement for the operational risks must cover the risk of losses as a result of inappropriate or insufficient internal processes, human error and system error or as a result of external events, including legal risks.

The company uses the basic indicator model to calculate its solvency requirement for operational risks. As a result, the risk-weighted items for operational risks are calculated at 15% of a three-year average of net interest income and non-interest related net income.

An assessment of the solvency requirement for operational risks is performed regularly. If the solvency requirement is deemed to be higher than mentioned above, the company will make corresponding adjustments to its solvency requirement.

### RISK-WEIGHTED ITEMS WITH MARKET RISK

DKKm	Unweighted amount		Weighted amount		Solvency requirement	
	2012	2011	2012	2011	2012	2011
<i>Debt instruments, specific risk</i>						
Total specific risk*)	22,662	23,107	1,958	1,838	157	147
<i>Debt instruments, general risk</i>						
Total general risk	7,976	5,237	1,964	1,308	157	105
<i>Shares, etc.</i>						
Total shares, etc.	630	558	631	560	51	45
<i>Currency positions</i>						
Total long-term currency positions	853	675	853	675	68	54
<b>Total risk-weighted items with market risk</b>	<b>32,121</b>	<b>29,577</b>	<b>5,407</b>	<b>4,381</b>	<b>433</b>	<b>350</b>

\*) Specific risk for debt instruments is calculated for all debt instruments in the trading portfolio, including unweighted and weighted amounts for repo transactions.

### RISK-WEIGHTED ITEMS WITH OPERATIONAL RISK

DKKm	2012	2011	2010	Average
<b>Accounting items</b>				
Interest income	2,825	3,028	3,218	3,024
Interest expenses	(1,939)	(2,204)	(2,337)	(2,160)
Dividends from shares, etc.	6	5	6	6
Fees and commission income	53	58	61	58
Fees and commissions paid	(5)	(2)	(3)	(3)
Market value adjustments	105	(135)	(2)	(10)
<b>Sum of accounting items</b>	<b>1,045</b>	<b>750</b>	<b>944</b>	<b>913</b>
<b>Risk weight under the basic indicator model</b>				
2012				1,712
2011				1,859

**INDIVIDUAL SOLVENCY NEED AND ADEQUATE CAPITAL BASE**

The Board of Directors and the Management Board ensure that the company maintains an adequate capital base. The considerations made by the Board of Directors and Management Board in this regard must lead to the determination of an individual solvency need. An adequate capital base covers the minimum amount of capital which, in the opinion of the Board of Directors, is required to ensure that the bondholders are only exposed to a minute risk of suffering a loss in case the company becomes insolvent during the next 12 months.

The individual solvency need is calculated by dividing the adequate capital base with the risk-weighted assets.

**INTERNAL PROCESS**

The method used to calculate the adequate capital base and the individual solvency need must, as a minimum, be approved by the Management Board and the Board of Directors once a year, whereas the calculations are made quarterly. The company has established segregation of duties to the effect that the adequate capital base and the individual solvency need are not calculated by the same persons who are in charge of the risk management process.

**INDIVIDUAL SOLVENCY NEED AND ADEQUATE CAPITAL BASE**

DKKm	2012	2011
Internally calculated individual solvency need, %	5.9 *	5.6*
Internally calculated total adequate capital base	3,464	3,354
The internally calculated adequate capital base is divided into sub-components:		
Credit risks	3,112	2,614
Market risks	933	1,084
Operational risks	137	149
Other	(719)	(491)

\* The company's adequate capital base must not be lower than the solvency requirement, equal to 8% of the risk-weighted items pursuant to the Danish Executive Order on Capital Adequacy, and the individual solvency need has been fixed at 8%.

**METHODOLOGY**

The method for calculating the adequate capital base must, as a minimum, include an assessment of the institute's business profile, concentration of risks and control environment.

The method selected is a combination of stress tests and individually assessed factors believed to be of importance for the size of the capital which the company, as a minimum, must maintain to ensure that the company's capital adequacy as a minimum matches its risk profile and complies with the legislative framework. An adequate capital base is calculated for each of the factors; positive, negative or neutral. The overall solvency need is calculated as the sum of all (negative and positive) contributions and expressed as a percentage of the risk-weighted assets. Tests are made within four risk areas: credit risk, market risk, operational risk and other risks.

**RISK FACTORS SUBJECTED TO STRESS TESTS IN RELATION TO DETERMINATION OF THE ADEQUATE CAPITAL BASE:**

- An increase in interest rates (market risk)
- A widening of credit spreads (market risk)
- A decline in equity prices (market risk)
- An appreciating USD (market risk)
- A reduced credit quality of the loan portfolio (credit risk)
- A decline in the value of domicile properties (market risk)
- A decline in the budgeted operating profit (general risks)

The Board of Directors and the Management Board have defined the risks which the company should be able to withstand and thus also the factors that need to be subjected to a stress test. In a stress test, the company's financial figures are exposed to a number of adverse events in order to illustrate how the company would respond in such a scenario.

The result of the stress tests performed is included in the solvency need model in such a way that the company must as a minimum maintain capital sufficient to cover the loss that would arise if the scenario in question were to materialise.

In addition to the risk areas included using stress tests, there is a large number of other risk areas identified by the company as being relevant for an assessment of the solvency need.

#### OTHER RISK AREAS ASSESSED IN RELATION TO THE DETERMINATION OF THE ADEQUATE CAPITAL BASE:

- Risk concentration (credit risk)
- Growth in lending (credit risk)
- Settlement risks (credit risk)
- Counterparty risks concerning financial derivatives (credit risk)
- Asset quality (credit risk)
- Consolidation outside the trading portfolio (credit and market risk)
- Interest risks outside the trading portfolio (market risk)
- Currency risks (market risk)
- Liquidity risks (market risk)
- Operational risks (operational risk)

The determination of the impact of these areas on the adequate capital base is either calculated directly using supplementary calculations or by way of a management estimate of the impact of these risk areas on the calculation of the adequate capital base.

The company believes that the risk factors included in the calculation cover all the risk areas that, pursuant to legislation, the Board of Directors and Management Board must take into consideration when determining the adequate capital base.

In addition, the Board of Directors and the Management Board must assess whether the company's capital base is sufficient to support upcoming activities. This assessment is part of the general determination of the adequate capital base. Management therefore regularly assesses how the growth expectations affect the calculation of the adequate capital base.

#### SPECIFICATION OF STRESS TESTS

The tests are made on the basis of the following assumptions:

- **An increase in DKK-denominated interest rates.** The calculation is made on the basis of the volatility of the 5-year swap rate computed on a daily basis in the preceding 12-month period. Based on this volatility, the company calculates the maximum rise in interest rates in one year with a 99% probability. The capital need is calculated as the capital loss on the securities portfolio caused by the interest rate increase.

- **A widening of credit spreads.** The starting point applied is the credit spread on a fixed-rate non-callable mortgage bond. Against this background, the volatility is computed on a daily basis in the preceding 12-month period, and the company calculates the maximum widening of the credit spread in one year with a 99% probability. The capital need is calculated as the capital loss on the securities portfolio caused by the widened credit spread.

- **A decline in equity prices.** The calculation is made on the basis of the volatility of the MSCI world index computed on a daily basis in the preceding 12-month period. Based on this volatility, the company calculates the maximum decline in equity prices in one year with a 99% probability. The capital need is calculated as the specific market value adjustment caused by the price fall.

- **An appreciating USD.** The calculation is made on the basis of the volatility of the USD/DKK exchange rate computed on daily observations in the preceding 12-month period. Based on this volatility, the company calculates the maximum rise in the USD/DKK exchange rate in one year with a 99% probability. The effect is measured as the capital need arising in the form of higher impairment.

- **A reduced credit quality of the loan portfolio in combination with an appreciating USD resulting in higher impairment charges.** When reserving capital caused by a fall in credit quality, the calculation is based on the internal model for impairment charges. In this context, it is assumed that objective evidence of impairment has been found within all vessel types and an appreciation of the USD/DKK exchange rate (see above), which will increase the capital need.

- **A decline in the value of domicile property.** Based on the Danish Financial Supervisory Authority's guidelines for adequate capital base and solvency need for banks, the company assumes a decline of 18% in the carrying amount of the domicile property.

- **A decline in the budgeted operating profit.** The budgeted operating profit is reduced by DKK 100 million as a buffer in case the company fails to achieve the budgeted income. The budgeted operating profit less the DKK 100 million reduces the capital need.

The sum of the items represents the stress test capital reservation in the amount of DKK 3,464 million at 31 December 2012. Correlations or tax are not taken into consideration, although this would reduce the requirement.

#### SPECIFICATION OF OTHER RISK AREAS

In addition to the risk areas included using stress tests, there is a number of other risk areas identified by the company as being relevant for an assessment of the solvency need. The following assumptions are applied:

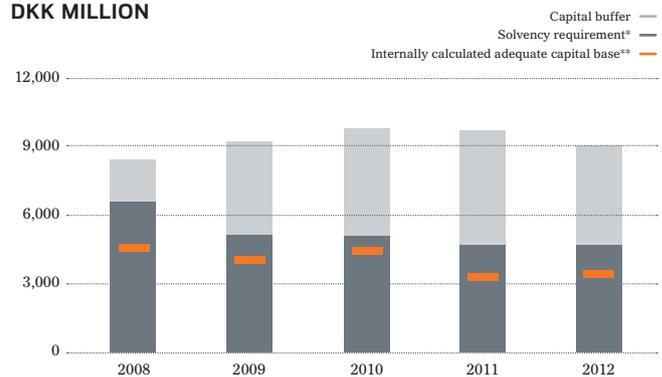
- **Risk concentration.** Danish Ship Finance exclusively grants loans for the financing of vessels against a mortgage. The loan portfolio is characterised by concentration at debtor level. The company therefore reserves capital, which is calculated as the maximum risk-weighted loss which the company may incur with 99.97% probability in a stressed market scenario. The capital need is calculated on the basis of the company's five largest exposures (or the number of exposures required to represent at least 50% of lending). Exposures for which the outstanding credit risk has been written off and which would otherwise be recognised at a value of nil in the calculation of risk concentration have been left out of the calculation. Instead the following exposure/exposures is/are included until a minimum of 50% of the loan portfolio is included in the calculation. Impairment charges already made on the selected exposures are deducted.
- **Lending growth.** Lending growth in the company affects the size of the adequate capital base, and the solvency need is therefore raised if there is strong lending growth and such growth is expected to persist. By reserving capital for lending growth, the company has reserves for weak as well as strong lending growth. In practice, lending growth consists of expected loans disbursed less any run-off on existing loans. In addition, the capital reservation is based on the most recently calculated impairment ratio.
- **Settlement risks.** Settlement risk is a natural part of running a financial institution. These risks are mitigated through the use of clearing centres and internal procedures but cannot be completely eliminated. A capital reservation is thus made, corresponding to an average payment transfer.
- **Counterparty risks concerning financial derivatives.** The capital need concerning counterparty risk on financial derivatives is calculated as a percentage of the market value of receivables for each financial counterparty. No capital is allocated to banks with a particularly high credit rating.
- **Asset quality.** Where there is no objective evidence of impairment of the credit quality, but there is a strong assumption that it could be impaired, or where an impairment charge is expected to be significantly increased in connection with the next semi-annual review, capital will also be reserved to cover such a situation in the form of preliminary impairment charges. Preliminary impairment charges may also be fixed on the basis of a management estimate. In that case, the charges will not be attributable to specific exposures.
- **Consolidation and capital procurement.** The company's earnings ability, earnings stability, dividend policy and alternative capital procurement opportunities are included in the assessment of the adequate capital base. If there is an unconditional commitment for transferring subordinate capital that can form part of the capital base, the company may also make a similar deduction in its capital reservation.
- **Interest risks outside the trading portfolio.** Unless the company can prove that the risk is 'modest and immaterial', the solvency need must take into consideration any interest exposure outside the trading portfolio. The company complies with the specific balance principle and therefore regularly makes a number of yield curve shocks and calculates the impact of changing yields. Among the different yield scenarios, the company selects the one that causes the biggest decline in the market value, and this value is then applied in the calculation of the individual solvency need as an extra capital reservation.

- **Currency risks.** The adequate capital base to cover liquidity risks is calculated as the maximum currency risks that the company is allowed to assume. Under the specific balance principle, the company's currency risk must not represent more than 2% of its capital base. Stricter limitations have been defined within the company. The calculation of the capital reservation is based on the maximum currency risks permitted according to the in-house policies.
- **Liquidity risks.** The company is only exposed to very limited liquidity risks. In addition to the limitations defined in the specific balance principle, in-house rules have currently been defined, requiring that the company maintains a positive liquidity coverage in the first-coming 18 months. Against this background, the liquidity risks are considered minimal, and no capital reservation is made to cover liquidity risks.
- **Operational risks.** Under the basic indicator method, the risk-weighted items are calculated at 15% of a three-year average of net interest income and non-interest related net income, defined as net interest and fee income with the addition of other operating income and adjusted for price fluctuations. The company has positively assessed that there is no need for additional capital reservation to cover operational risks.

#### SOLVENCY NEED AND CAPITAL BUFFER

Danish Ship Finance's internally calculated adequate capital base and weighted items amounted to DKK 3,464 million and DKK 59,128 million, respectively, at 31 December 2012, corresponding to an internally calculated individual solvency need of 5.9%. The capital base less deductions amounted to DKK 8,963 million at 31 December 2012, resulting in a solvency ratio of 15.2%. This gives the company a capital buffer of DKK 5,499 million relative to the internally calculated adequate capital base. At a solvency need of 8%, in accordance with the statutory solvency requirement, the adequate capital base amounted to DKK 4,730 million, which corresponded to a capital buffer of DKK 4,233 million.

#### STATEMENT OF CAPITAL DKK MILLION



\* At 1 January 2009, the solvency requirement was lowered from 10% to 8% of the risk-weighted assets.

\*\* The company's internally calculated adequate capital base must not be lower than the solvency requirement, equal to 8% of the risk-weighted items pursuant to the Danish Executive Order on Capital Adequacy, and the individual solvency need has been fixed at 8%.

The company finds that the capital buffer is sufficient for the company to continue its lending activities during a period of difficult business conditions.

# CASH MANAGEMENT

The purpose of the company's cash management is to ensure that it maintains consistently adequate liquidity.

Through bond issues and the existence of a liquid portfolio of bonds, the company has secured liquidity coverage for all existing loans and loan offers until expiry. The company is therefore not exposed to any refinancing risk. A potential downgrade of the company's external rating would not change the company's robust liquidity situation, but it is expected to lead to higher funding costs in connection with new loans.

The cash management is consistent with the framework of the company's liquidity policy.

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Moreover, a liquidity stress test is performed, consisting of the following components:

- An appreciating USD
- An increase in interest rates
- A widening of credit spreads
- A decline in equity prices
- Losses on customers

The results of the stress tests performed confirm that the company maintains a solid liquidity coverage.

# CREDIT RISK

Credit risk reflects the risk of a loss due to default on the part of a counterparty. This applies to counterparties in the form of shipowners and financial institutions.

The limits for credit risk management are stipulated in the company's credit policy and policy on counterparty management. The policies build on the provisions in the Act and the Executive Order. These provisions stipulate that the board of directors shall lay down risk diversification rules.

In its risk management activities, the company distinguishes between credit risk derived from lending operations and credit risks derived from transactions with financial counterparties. The day-to-day responsibility for the credit policy, the policy on counterparty management and for the periodical risk calculation and reporting rests with the credit department.

## LOANS

Danish Ship Finance provides ship financing against a first mortgage in ships and, on a limited scale, also financing of the shipowner's payment of instalments to a shipyard. The company is a leading provider of ship financing in Denmark, and it focuses primarily on large, reputable shipowners in Denmark and abroad.

The most significant risk facing Danish Ship Finance is believed to be credit risk on the company's loans. Credit risk on the company's loans is the risk of losses because the mortgage cannot cover the residual debt if the customers default on their loans.

When considering potential loans, focus will be on vessel characteristics, the financial standing of the borrower, the terms of the loan and the loan's contribution to compliance with the diversification rules.

## LOAN LIMITS AND ADDITIONAL STRAINING

Danish Ship Finance may grant loans up to 70% of the value of the mortgaged vessel(s).

However, the company may, on certain conditions, grant loans beyond 70% of the value against other collateral and/or against additional straining. The additional straining is maximised in Danish kroner, usually when the loan offer is submitted.

As a result of the additional straining, for this part of the lending operations a deduction is calculated in the company's tier 1 capital in connection with the solvency calculation. The deduction equals the part of loan in question that exceeds 70% of the mortgaged vessel(s) at the time of calculation, although capped by the maximum defined.

## CREDIT EXPOSURE BY MATURITY

DKK m	Credit institutions		Shipowners		Total credit exposure	
	2012	2011	2012	2011	2012	2011
On demand	63	83	0	0	63	83
0-3 months	1,564	513	1,875	1,343	3,439	1,856
3 months – 1 year	0	0	5,117	4,883	5,117	4,883
1 – 5 years	0	0	26,649	25,516	26,649	25,516
More than 5 years	0	0	12,723	15,207	12,723	15,207
<b>Total</b>	<b>1,627</b>	<b>597</b>	<b>46,364</b>	<b>46,948</b>	<b>47,991</b>	<b>47,545</b>

The calculation of the additional straining is made on the basis of an evaluation made or approved by the company on the basis of independent broker assessments of the market value of the mortgage.

The company's weighted average loan-to-value ratio (LTV) after impairment charges at 31 December 2012 was 67%.

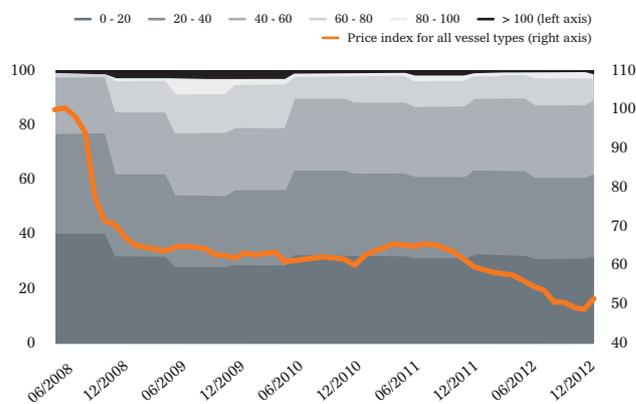
**PERCENTAGE DISTRIBUTION OF LOANS INCLUDING GUARANTEES AFTER IMPAIRMENT CHARGES CALCULATED IN THE LTV RANGES (BY NOMINAL OUTSTANDING DEBT)**

LTV range %	Share of lending	
	2012	2011
0 - 20	31	33
20 - 40	31	31
40 - 60	27	26
60 - 80	8	8
80 - 90	1	1
90 - 100	1	0
Over 100	1	1

**PERCENTAGE DISTRIBUTION OF LOANS WITH INDIVIDUAL CHARGES. THE DISTRIBUTION IS MADE AFTER IMPAIRMENT CHARGES CALCULATED IN THE LTV RANGES (BY NOMINAL OUTSTANDING DEBT)**

LTV range %	Share of lending	
	2012	2011
0 - 20	28	36
20 - 40	27	34
40 - 60	25	26
60 - 80	16	4
80 - 90	4	0
90 - 100	0	0
Over 100	0	0

**LTV RANGES VS. PRICE INDEX FOR ALL VESSEL TYPES**



The chart above shows a breakdown of the loan portfolio into LTV ranges, which are calculated every six months. The LTV ranges show the proportion of the loans placed within a given range. For example, 97% of the loans at 31 December 2012 were within 80% of the valuations at this time. The breakdown is compared with developments in ship prices based on a price index from Clarksons, showing price developments for all vessel types. The chart shows that even major declines in ship prices do not materially change the collateral securing the loan. The reason is that instalments are regularly received and that a number of loan agreements include a right for the company to demand reduction and/or additional collateral if the value of the ship mortgage drops below a pre-arranged minimum threshold.

**LARGE EXPOSURES**

Danish Ship Finance is exempt from the EU's credit institution directive and any related directives. The most important consequence of this exception is that the company will not be subject to a limitation in respect of large customers and therefore is not subject to the executive order on large exposures. As a result, unlike other financial institutions the company is not bound by any statutory limits for maximum loans to an individual borrower. The Board of Directors shall instead lay down rules concerning risk diversification, including for its lending operations.

At 31 December 2012, the company had no financial counterparties exceeding 25% of its capital base. The company thus has no financial counterparty that would have exceeded the limit under the calculation method applied in the regulations.

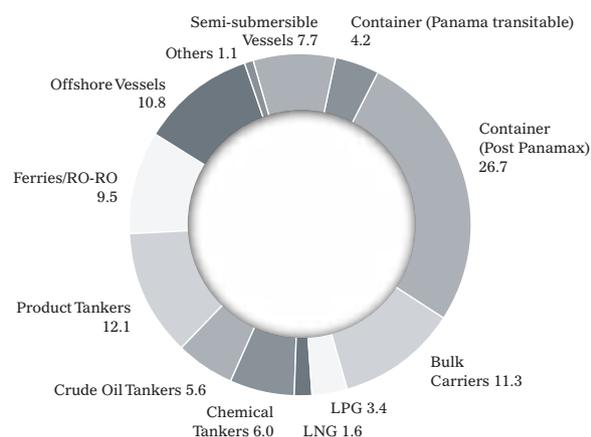
**DIVERSIFICATION**

The composition of the loan portfolio is governed by a set of diversification rules. The purpose of the diversification rules is to ensure adequate diversification by vessel type, borrower and country risk.

**RISK DIVERSIFICATION ON VESSEL TYPES**

Adequate loan portfolio diversification must be in place regarding vessel types. No single vessel type (tanker, dry bulk, etc.) may be provided as security for more than 50% of the company’s gross lending. Within each vessel type, no segment (crude oil tanker, product tanker, etc.) may be provided as security for more than 33% of the company’s gross lending.

**LOAN PORTFOLIO BY MORTGAGED VESSELS (PERCENTAGE OF TOTAL LENDING)**



**RISK DIVERSIFICATION ON BORROWERS**

The composition of borrowers must be adequately diversified in the loan portfolio. The diversification rule is related to the objects clause in the articles of association:

“The object of the company is to provide ship financing in Denmark. In addition, the company may provide ship financing in the international market, so long as such activities do not unnecessarily limit the company’s Danish operations.”

For large loans, the company should seek to diversify the risk on vessel types within the individual account.

For financing as defined in the second sentence of the objects clause, the overall account per borrower may not, at a consolidated level, exceed 25% of the most recently calculated capital base. There are no formal limits on the size of individual loans in respect of funding pursuant to the company’s main objective (ship financing in Denmark).

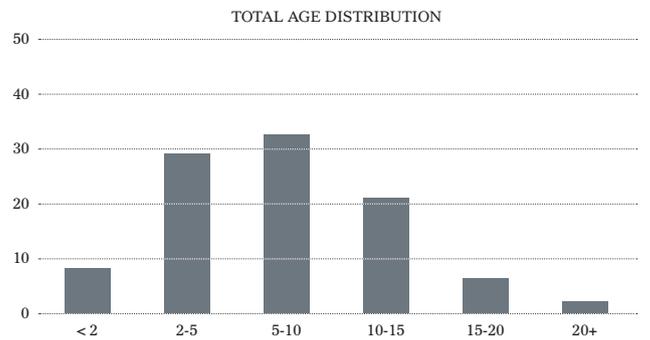
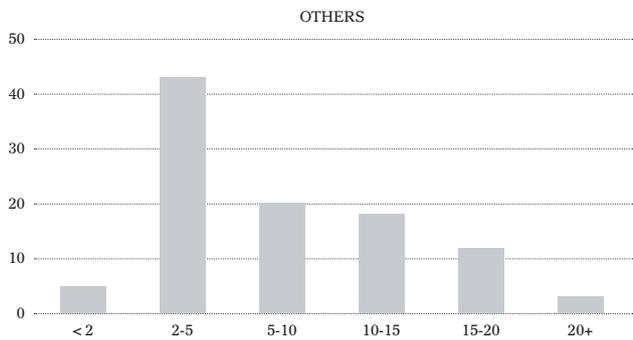
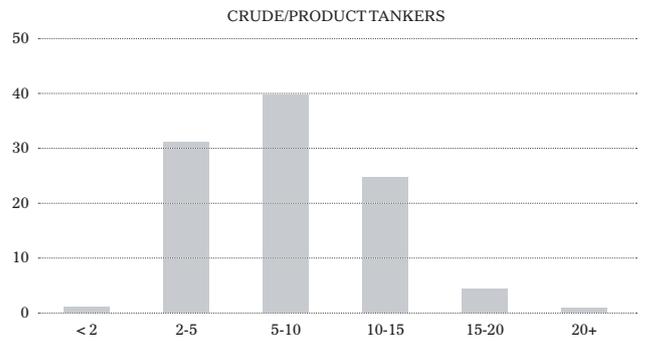
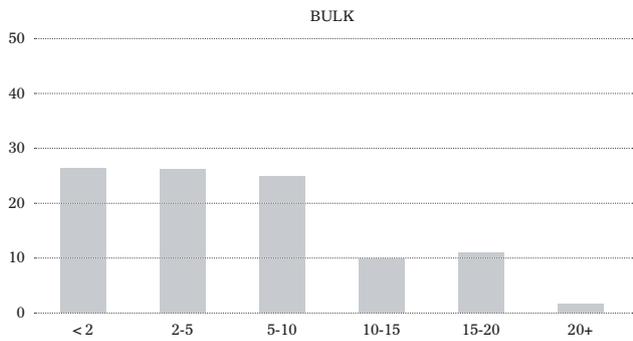
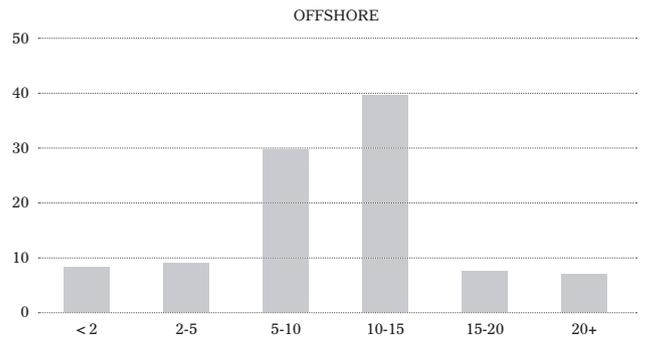
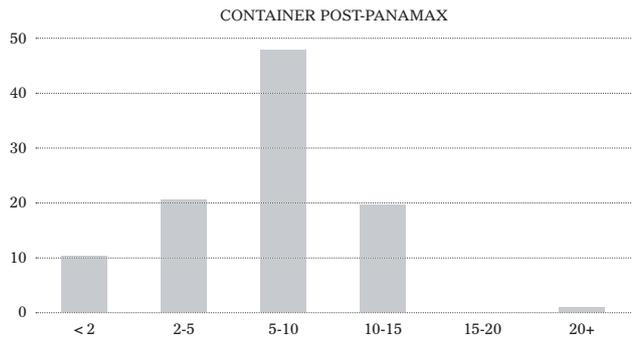
**MOVEMENTS IN THE FIVE LARGEST DEBTORS BEFORE IMPAIRMENT CHARGES**

DKK m	2012	2011
Five largest debtors	24,052	23,893
Total loans and guarantees	50,131	50,177

The five largest loans at 31 December 2012 were secured by mortgages in 141 vessels comprising 14 vessel types. One loan is substantially larger than the rest and typically represents about 40% of total lending.

The risk diversification on borrowers focuses on diversification on vessel types in each loan. The largest loan was thus secured through mortgage on vessels distributed on five different vessel segments (loans for container vessels accounted for about 83%, semi-submersible vessels about 7% and offshore vessels about 6%). The other four loans were secured through mortgages in eight different vessel segments.

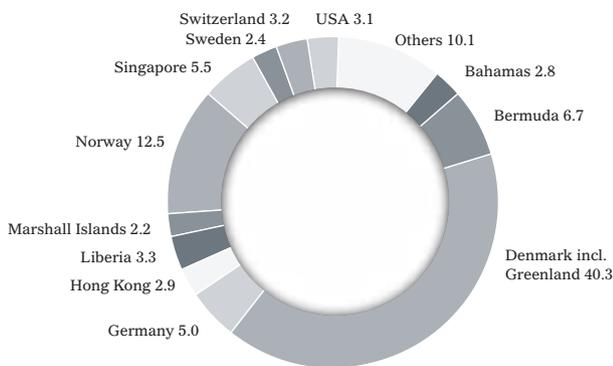
**AGE DISTRIBUTION OF MORTGAGED VESSELS  
(AS A PERCENTAGE OF TOTAL LOANS FOR THE TYPE OF VESSEL)**



**RISK DIVERSIFICATION ON COUNTRIES**

The loan portfolio must be adequately diversified on countries. The country risk is calculated on the basis of the borrower’s home country, or, in the case of guarantees, the guarantor’s home country. If there is only a guarantee for part of the loan, the country risk is distributed proportionally between the countries. Loans to borrowers in Norway, Switzerland and the USA and in certain EU countries are not subject to restrictions as to country risk. For loans to borrowers in other countries, the company has defined an overall limit per country of up to 10% of its gross lending.

**DEBTOR DISTRIBUTION BY COUNTRY INCLUDING DANISH GOVERNMENT RISK (PERCENTAGE OF TOTAL LENDING)**



Countries with a share of at least 2% are shown separately. Other countries are grouped into ‘Others’.

The risk calculation method was selected on the basis of a wish to calculate and control the company’s overall risk exposure using the legal system of a single country in case the need for a court order arises. The situation typically occurs in connection with default of a loan in which the mortgaged collateral – usually vessels – have been realised and the company must seek to collect a residual claim. In such situations, it is important for the company’s risk of loss that the local court recognises the claim put forward by the company as being legally valid.

The company endeavours to eliminate the risk that may be associated with having to obtain a local court order by incorporating venue agreements into the loan documentation.

The company has deliberately avoided using the flag states of the vessels as an expression of the country risk, as the risk of loss associated with having to arrest and subsequently effect a forced sale of a vessel relies more on which jurisdiction the vessel is arrested in than the flag under which the vessel is sailing.

**CREDIT RISK ON SHIPOWNERS**

The credit policy contains specific guidelines for the ongoing risk management in the loan portfolio. A number of predefined procedures are used in the ongoing credit risk management process, the most important of which are described below.

**GRANTING OF LOANS**

The Management Board and the credit manager have been allocated authorities by the Board of Directors allowing them to grant loans up to pre-determined limits. The granting of loans must be disclosed at the subsequent ordinary board meeting.

If the Management Board authorises loans involving an increase of the risk on existing loans, such authorisation must be approved by the Board of Directors.

As in previous years, the Board of Directors was the authorising body in the majority of all loans granted in 2012.

### ONGOING MONITORING

As part of the risk management process, all loans are assessed at least twice a year. All loans are assessed, and the current credit risk is assessed on the basis of current market valuations of the financed vessels and the most recent accounting data from the borrower.

In addition, the portfolio is monitored in an ongoing process in relation to the borrowers' fulfilment of the individual loan agreement, comprising:

- Half-yearly updating of the market values of all financed vessels and verifying that any agreed requirements on maximum loan-to-value ratios are complied with.
- Verifying that any other collateral meets the specified minimum requirements.
- Verifying the existence of adequate insurance cover on financed vessels.
- Verifying compliance with all other material loan covenants.

If a loan is deemed to entail increased risk, the monitoring will be intensified to safeguard the company's interests to the best possible extent.

### INSURANCE OF SHIP'S MORTGAGES

All vessels mortgaged as collateral for loans must be insured. Insurance is taken out by the borrower. Borrowers' insurances concerning financed vessels are assigned to Danish Ship Finance.

As a general rule, the insurance includes:

- Hull and machinery insurance, which covers damage to the vessel or total loss.
- P&I (Protection & Indemnity) insurance, which is a third party liability insurance to cover damage against persons or equipment.
- War Risks, which covers damage to the vessel, potential total loss and retention, etc. caused by war or war-like conditions.

On the basis of individual assessments, borrowers who must also be covered by Mortgagee Interest Insurance and Mortgagee Additional Perils Pollution Insurance are identified. Most of the loans are covered by Mortgage Interest Insurance and Mortgagee Additional Perils Pollution Insurance. This insurance covers the risk in most situations which the primary insurance policies do not cover, for example due to shortcomings in relation to the ship's seaworthiness.

### INSPECTION OF SHIPS

As a supplement to the half-yearly market valuations, physical inspections of the financed vessels are made on a spot-check basis. The inspection may be performed both during the loan period or prior to submitting a financing offer.

### MARKET VALUATIONS

The company values each vessel twice annually. The valuation is generally fixed by an external broker, who fixes a price for the financed vessels on the basis of supply and demand. The company may also determine the value itself, for example on the basis of a specific independent market price or if external assessments have been received for similar vessels.

Market valuations are used for example to determine the loan-to-value ratio on the company's loans and for control purposes in connection with the half-yearly impairment charges on loans, advances and receivables.

### LOSSES AND LOAN IMPAIRMENT CHARGES

Twice a year, all loans are reviewed in order to re-assess the current need for impairment charges. The assessment of any impairment on the individual loans is based on the borrower's present and expected future financial position and on the value of the ship's mortgage and any other collateral.

The overall guidelines for the company's impairment charges are laid down in the Danish Financial Supervisory Authority's "Executive order on financial reports of credit institutions, investment companies, etc.". It appears from the executive order that, in addition to individual impairment charges, the company must also make collective impairment charges.

The Danish Financial Supervisory Authority has accepted that Danish Ship Finance may omit to make collective impairment charges provided that the assessment of the individual loans be planned in such a manner that the assessment in practice covers an assessment consistent with that which would take place in a collective assessment and that impairment charges be made accordingly for each loan. Furthermore, it is a precondition that the assessment of any impairment of the individual loans be made on the basis of a probability weighting of the expected outcome in respect of payments from the borrowers.

The Danish Financial Supervisory Authority's guidelines for the company's impairment charges thus assume:

- 1) that all loans are subjected to an individual assessment;
- 2) that the criteria for objective evidence of impairment at the individual assessment in addition to the individually conditioned criteria comprise all external developments, factors and events (observable data) that increase the likelihood of losses on the type of loans that the specific loan belongs to; and
- 3) that each loan is tested for impairment for all the criteria for objective evidence of impairment based on the likelihood with which they are expected to reduce the cash flow from the loan.

Based on the above guidelines, all loans are reviewed in order to identify any objective evidence of impairment or expectations of objective evidence of impairment within each vessel type.

Furthermore, all loans have been reviewed to evaluate whether the existing classification and pertaining impairment ratio still provides the best estimate of the cash flows due from the specific borrower. Where this is estimated not to be the case, the loan is reclassified.

#### Calculation of loan impairment charges at exposure level

The company makes individual impairment charges on loans with objective evidence of impairment and also charges with a collective component on loans to customers who operate in stressed shipping segments but on which loans no objective evidence of impairment has been found.

#### The technical calculation model, which is the same for both impairment models, looks as follows:

Loan impairment = (loss given default (i.e. a stressed LGD) x probability of default (PD)) – potentially dividends (prudent estimate).

The individual customer's PD is determined on the basis of an internal classification system (rating) and it reflects a conservative likelihood of the customer defaulting on his payment obligations within the next 12 months.

**LGD is calculated in the following manner:**

$LGD = \text{Balance on the loan (B)} - \text{NV of the mortgage value under the mortgage (Sx)} - \text{value of other collateral } (\emptyset)$ .

For customers where individual objective evidence of impairment is established because of substantial financial difficulty on the part of the customer, the PD is set at 100%. For impairment with a collective component, the customer's current PD is used.

The following serves to illustrate the calculation method for impairment with a collective component.

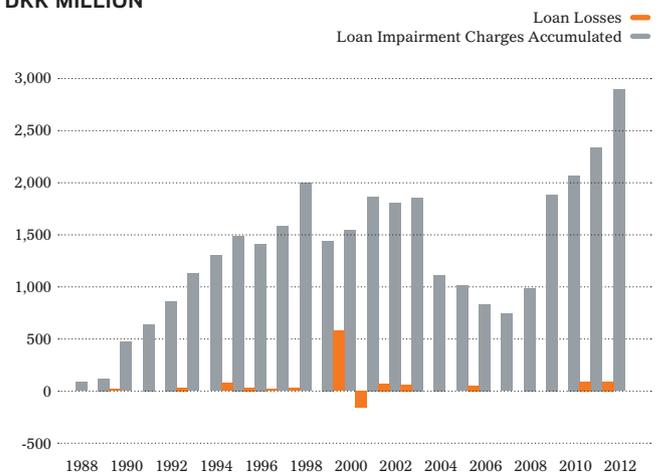
Customer's PD = 22%  
 Loans (B) = DKK 103 million  
 Market value of vessel = DKK 124 million  
 NV of stressed value of vessel (Sx) = DKK 68 million  
 Other collateral ( $\emptyset$ ) = DKK 0 million  
 Dividends (D) = DKK 0 million  
 $LGD = B - Sx - \emptyset = \text{DKK } 103 \text{ million} - \text{DKK } 68 \text{ million} - 0 = \text{DKK } 35 \text{ million}$   
 $\text{Impairment} = (LGD \times PD) - D = (\text{DKK } 35 \text{ million} \times 0.22) - 0 = \text{DKK } 7.7 \text{ million}$

If the customer had individual objective evidence of impairment (with PD = 100) in the above example, the impairment charge would instead have been DKK 35 million.

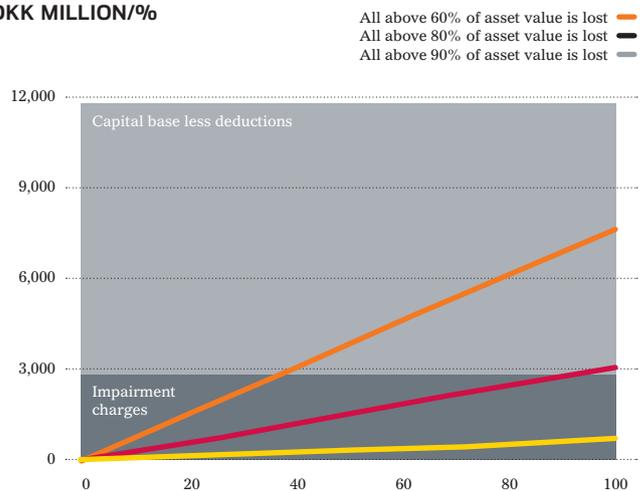
The company's accumulated impairment charges amounted to DKK 2,884 million at 31 December 2012 against DKK 2,328 million previous year. This represented an increase of DKK 556 million.

The accumulated impairment charges accounted for 5.8% of the company's total loans and guarantees, which was 1.2 percentage point higher than the year before. The increase was due to adverse trends in the financial standing of a small number of borrowers in 2012 triggered by the crisis in parts of the shipping industry. Danish Ship Finance incurred losses of DKK 1 million in 2012, against DKK 85 million in 2011. Losses actually incurred thus remain at a very low level.

**LOANS, IMPAIRMENT CHARGES AND LOSSES**  
DKK MILLION



**LOAN LOSSES AT GIVEN DEFAULT RATES**  
DKK MILLION/%

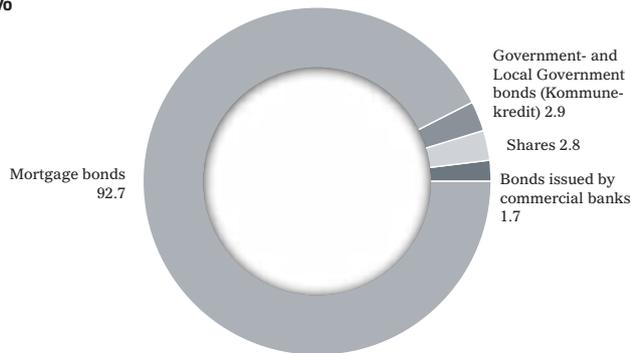


Accumulated losses since the company was established in 1961 were DKK 867 million at 31 December 2012. This corresponded to 1.8% of total gross lending at 31 December 2012.

## DEVELOPMENTS IN IMPAIRED CLAIMS DUE TO VALUE ADJUSTMENT AND IMPAIRMENT CHARGES

At 31 december 2012	Loans		Financial counterparties	
DKKm	2012	2011	2012	2011
<b>Individual impairment charges/provisions</b>				
Impairment charges/provisions for loans and counterparties, 1 January	1,209	747	0	28
Impairment charges/provisions during the year	792	698	0	0
Reversal of impairment charges/provisions made in previous financial years, where there is no longer any objective evidence of impairment or the impairment is reduced	302	154	0	28
Other movements	306	0	0	0
Final loss (written off) on previous impairment charges/provisions	1	85	0	0
Accumulated impairment charges/provisions for loans and financial counterparties, 31 December	2,003	1,209	0	0
Sum of loans and financial counterparties where individual impairment charges/provisions have been made (calculated before impairment charges/provisions)	6,756	4,157	0	0
<b>Impairment charges with collective component/provisions</b>				
Accumulated impairment charges/provisions for loans and financial counterparties, 1 January	1,119	1,284	0	0
Impairment charges/provisions during the year	468	629	0	0
Reversal of impairment charges/provisions, where there is no longer any objective evidence of impairment or the impairment is reduced	401	791	0	0
Other movements	(306)	0	0	0
Accumulated impairment charges/provisions for loans and financial counterparties, 31 December	881	1,119	0	0
Final loss (written off)	0	0	0	0
Sum of loans and financial counterparties where collective impairment charges/provisions have been made (calculated before impairment charges/provisions)	15,479	20,059	0	0
<b>Final loss</b>				
Final loss with no previous individual impairment charges	0	0	0	0
Received on claims previously written off	0	1	0	0

**DISTRIBUTION OF SECURITIES PORTFOLIO**  
%



**FINANCIAL COUNTERPARTIES**

In addition to loans, the company’s securities portfolio also represents a significant part of the assets. The securities portfolio comprises government and mortgage bonds, money market transactions, interest-sensitive financial instruments and equities (by way of unit trust certificates).

Most of the portfolio consists of government and mortgage bonds, which leads to an excess cover relative to the statutory requirement that at least 60% of the capital base requirement must be invested in investment grade assets. At 31 December 2012, the company had invested DKK 11,083 million in investment grade securities, corresponding to 124% of the capital base.

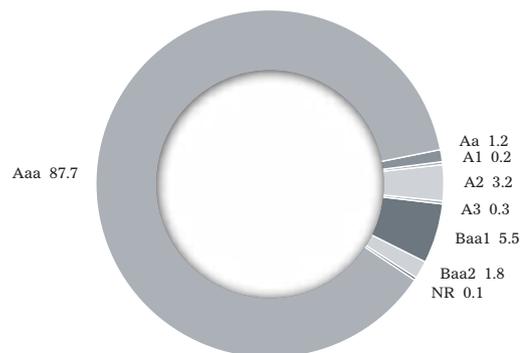
Transactions with financial counterparties are made in connection with investing own funds as well as excess liquidity from issued bonds. These transactions involve cash deposits, securities and financial instruments.

Financial contracts may entail a risk of losses if the contract has a positive market value to the company, and the financial counterparty cannot fulfil his part of the agreement. This type of risk also includes settlement risk.

The policy for managing counterparty risk quantifies and defines limits for the exposure to individual financial counterparties and the countries in which such counterparties are residents – both in relation to compliance with the company’s policies for managing market risk and liquidity risk, respectively, and in connection with receivables under loans to and guarantees from credit institutions, export guarantee institutions and insurance companies. The policy also includes the Management Board’s guidelines and options for delegating granting authorities.

Emphasis is on financial counterparties having high credit ratings, as a substantial proportion of business transactions with the counterparties involves long-term contracts with a potentially large increase in market value.

**EXPOSURE ON FINANCIAL COUNTERPARTIES BY CREDIT RATING**  
%



**ONGOING MONITORING**

Exposures to each counterparty are monitored in an ongoing process, partly to ensure that the financial counterparties consistently comply with the requirements, partly to ensure compliance with the granted lines. The responsibility for ongoing monitoring is independent of the executing departments.

**GRANTING OF LINES**

Financial counterparties are granted lines on the basis of defined criteria. Such grants are made on the basis of, among other things, ratings assigned by recognised international rating agencies, when such ratings are available. Twice a year and when the creditworthiness of the counterparty changes, the allocated lines are re-assessed.

The Management Board and the credit manager have been allocated authorities by the Board of Directors allowing them to grant lines to financial counterparties within certain limits. The granting of such lines must be disclosed at the subsequent board meeting. Credit grants over and above the predefined limits are decided by the Board of Directors.

**CONTRACTUAL BASIS**

The contractual basis for transactions with financial counterparties is based primarily on market standards such as ISDA and GMRA agreements, which allow netting in the case of default on the part of the financial counterparty.

**COUNTERPARTY RISK**

DKKm	2012	2011
<b>Netting of exposure value:</b>		
The positive gross fair value of financial contracts after netting, cf. appendix 17 to the Executive Order on Capital Adequacy		
Counterparty with risk weight of 0%	-	2
Counterparty with risk weight of 20%	1,691	1,257
Counterparty with risk weight of 100%	0	0
The value of the total counterparty risk calculated according to the market value method for counterparty risk		
Counterparty with risk weight of 0%	-	2
Counterparty with risk weight of 20%	3,262	2,773
Counterparty with risk weight of 100%	0	0

**COUNTERPARTY RISK ON DERIVATIVE FINANCIAL INSTRUMENTS AND CALCULATION OF CAPITAL**

The company applies the market value method of the Executive Order on Capital Adequacy for counterparty risk to calculate the size of the exposures for derivatives.

When determining the value of the exposure using the market value method for counterparty risk, the following method is applied:

1. Contracts are calculated at market value to obtain the current replacement cost for all contracts with a positive value.
2. In order to generate a figure for the potential future credit exposure, the nominal principal of the contracts or the underlying values are multiplied by percentages determined by the Danish Financial Supervisory Authority. Swaps based on two floating rates in the same currency are exempt, because only the current replacement cost needs to be calculated.
3. The sum of the applicable replacement costs and the potential future credit exposures represents the counterparty risk.

In its loan granting process and the ordinary monitoring of loans, the company takes into consideration the calculated exposure value to ensure that this value does not exceed the granted credit line on the counterparty in question.

**COLLATERAL**

The company does not apply netting, whether on or off the balance sheet.

The company receives financial collateral in the following principal areas:

- Deposit funds
- Securities (bonds, shares, unit trust certificates), primarily listed
- Government and credit institution guarantees

**FINANCIAL COLLATERAL**

<b>DKKm</b>	<b>Exposure</b>		<b>Collateral</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Municipality and export guarantees	18	696	6	317
Bank guarantees	0	16	0	4
Deposited bonds and cash deposit	1,824	1,093	500	111
<b>Total financial collateral</b>	<b>1,842</b>	<b>1,805</b>	<b>506</b>	<b>432</b>

The company has business procedures in place for the management and valuation of collateral, and the procedures form an integral part of the ordinary risk monitoring process.

The company uses the simple credit risk-reducing method. This means that the capital charge on an exposure can be reduced when financial collateral is mortgaged. Appendix 7 of the Executive Order on Capital Adequacy sets out the financial collateral that may be used under the simple credit risk-reducing method. In this connection, it should be noted that the executive order includes a requirement that the financial collateral used must be issued by a business or country holding a premium rating.

In accordance with the rules of the Executive Order on Capital Adequacy, the company uses financial collateral to hedge its credit risk exposure. The table above shows for each exposure category the coverage of the collateral, i.e. the fully adjusted size of the collateral within each exposure category.

# MARKET RISK

Market risk is the risk of losses caused by changes in the market value of assets and liabilities as a result of changing market conditions. The overall market risk is calculated as the sum of fixed income, exchange rate and equity positions. The most significant market risks are associated with the securities portfolio, as the company is governed by the limits of the Bond Executive Order, which includes restrictions on interest rate, exchange rate and liquidity risk between the bond issues (funding) and the loans.

The company pursues a market risk policy to manage its market risks. The policy lays down clear and measurable limits for interest rate, exchange rate and equity risks and builds on the provisions of the Bond Executive Order, among other things. In some cases, the guidelines for market risks are stricter than such external rules.

The company's treasury department has the day-to-day responsibility for the market risk policy, while the responsibility for the current calculation and reporting of market risks lies with a function outside the treasury department. Market risks are monitored in an ongoing process and reported to the Board of Directors on a quarterly basis. In case of breach of the limits defined in the market risk policy, the Management Board must be informed immediately and the Board of Directors not later than at the next board meeting.

## INTEREST RATE RISKS

Interest rate risk is the risk that the company will incur a loss as a result of a change in interest rates. Rising interest rates have an adverse impact on the market value of the securities portfolio, which, in the case of a large increase in interest rates, may result in an overall negative financial performance and a resulting negative impact on the solvency ratio.

Pursuant to the Bond Executive Order, the interest rate risk between funding and lending must not exceed 1% of the capital base. The company seeks to minimise the interest rate risk between funding and lending by applying conservative principles, but a loss or a gain may arise due to changes in interest rates.

The Bond Executive Order also stipulates that the interest rate risk on the company's assets, liabilities and off-balance sheet items must not exceed 8% of the company's capital base. Interest rate risks are adjusted using a minimum and a maximum for the option-adjusted duration. The current maximum adjusted duration on the securities portfolio has been restricted to six years. The company has calculated the option-adjusted duration at approximately 0.91 years at 31 December 2012. Furthermore, there are restrictions for the interest rate risk distributed on maturities between 0.5 years and 30 years. The table below shows the interest rate risk broken down by maturities.

Using the Danish FSA's guidelines for calculating interest rate risks, the risk was calculated at DKK 224 million at 31 December 2012, corresponding to 2.5% of the capital base, against DKK 68 million in 2011.

As the company is governed by the rules of the Bond Executive Order, it only has limited exposure to interest rate risk outside the trading portfolio.

## INTEREST RATE RISK BY MATURITIES

DKKm	0.5 years	2 years	5 years	10 years	15 years	30 years
2012	40	138	(13)	(16)	(15)	(30)
2011	57	69	12	(31)	(5)	(47)

### EXCHANGE RATE RISK

The Bond Executive Order stipulates that the combined foreign exchange risk on assets, liabilities and off-balance sheet items must not exceed 2% of the capital base.

The market risk policy does not accept currency risks arising due to mismatch of funding and lending except for inevitable, limited foreign exchange risks resulting from the ongoing cash management. The company's lending margin is collected in the same currency in which the loan was granted. Accordingly, net interest income from lending operations is affected by exchange rate fluctuations. The primary impact derives from the USD, which is the currency in which the vessels primarily generate earnings and are valued, and therefore also the preferred lending currency.

Exchange rate indicator 1 at 31 December 2012: DKK 853 million. Exchange rate indicator 1 corresponds to the company's overall net exposure in foreign currency on the total balance sheet items, calculated according to the guidelines of the Danish Financial Supervisory Authority.

### EQUITY RISK

Equity risk is the risk of losses because of changes in equity prices. The market risk policy defines limits for the equity risk. Equity investments may not represent more than 10% of the capital base.

At 31 December 2012, the company had shares totalling DKK 630 million, corresponding to 7.0% of the capital base less deductions.

### DERIVATIVES

Danish Ship Finance uses derivatives in specific areas. The market risk policy specifies which derivatives the company may use and for which purposes. These are transactions made to hedge risks between funding and lending and in connection with investment activities.

The policy also includes guidelines on structured notes. Structured notes refer to funding with conditions other than standard fixed/floating-rate conditions. Issues may only be structured using interest rate and exchange rate instruments, and they must not represent more than 5% of the total loan amount. At the end of 2012, the company had no structured notes.

# LIQUIDITY RISK

Liquidity risk is the risk that the company is unable to meet its payment obligations as they fall due.

Pursuant to the Bond Executive Order, the company must pursue a balance principle. The company has decided to pursue the specific balance principle. The balance principle entails fixed absolute limits for the size of allowable interest rate, foreign exchange and liquidity risks when there is a difference between payments on loans and funding.

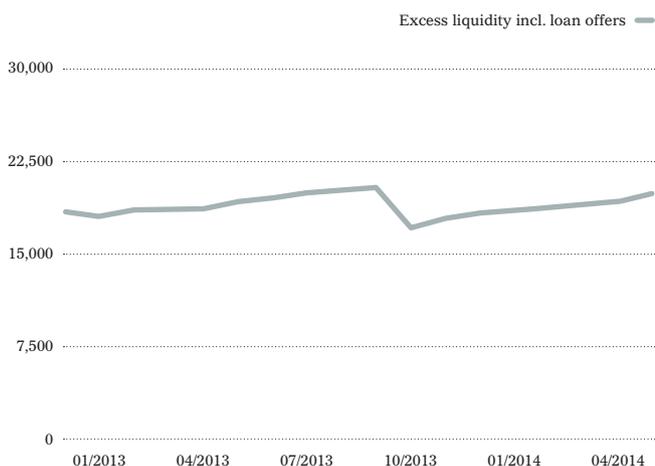
The specific balance principle permits a cash deficit between issued bonds and loans provided. Such a cash deficit – resulting from the future payments related to bonds issued by Danish Ship Finance, other funding and financial instruments which exceed the future incoming payments on loans, financial instruments and investments – may not exceed 100% of the capital base. Through in-house policies, the company has defined stricter requirements for any cash deficits between issued bonds and loans provided.

Pursuant to the company's liquidity policy, the company must have overall positive liquidity within the first-coming 18-month period. The calculation of the limit includes the securities portfolio at market value, and loan offers are included if they are expected to be disbursed during the period.

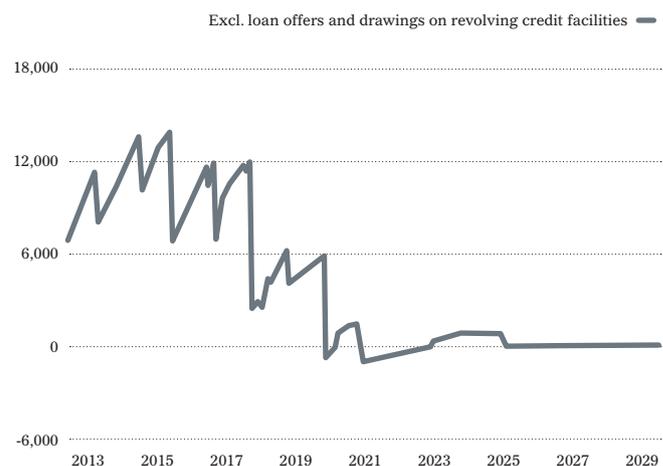
Bonds are typically issued in DKK, whereas most of the loans are disbursed in USD. The company has sourced USD for funding of all loans disbursed via so-called base swaps. The risk caused by lack of access to convert DKK funding into USD involves higher financing costs or the loss of business opportunities. The opportunities for sourcing USD liquidity rely on an efficient financial market. Through in-house policies, the company has defined in-house limits for the need for USD over time.

The average maturity of the bonds exceeds the average maturity of the loans.

## SHORT-TERM LIQUIDITY DKK MILLION



## LONG-TERM LIQUIDITY BETWEEN FUNDING AND LENDING DKK MILLION



# OPERATIONAL RISK

Operational risk is the risk of direct or indirect losses caused by deficient or faulty internal procedures and processes, human errors, system errors or losses prompted by external events or incidents. Operational risk is often associated with specific and one-off events.

The Executive Order on Governance, which has entered into force, contains rules on the management of operational risks. Against this background, the company has defined a policy in this area. The Board of Directors will update the policy at least once a year. In addition, operational risks are managed through business procedures and internal controls. The control is performed, among others, by the company's internal control function, which is independent of the executing departments.

The key operational risks relate to credit and finance functions, compliance and the use of information technology.

In the credit function, the risk relates to the handling of agreements and security documents and regular follow-up on loan covenants. In addition, the risk relates to the handling of any ship's mortgages which it proves necessary to take over in case the borrower defaults on his loan.

In the finance function, the risk relates to the conclusion and implementation of financial contracts, deposits and general money transfers.

In the compliance area, there is a risk that sanctions will be imposed on the company, a risk of loss of reputation or that the company or its customer suffer material financial losses due to lack of compliance with applicable legislation, market standards or internal rules.

In the area of information technology, the risk relates to the derived consequences of a system breakdown or serious system errors.

## CALCULATION OF OPERATIONAL RISK

DKKm	Operational risk
2012	137
2011	149

**DANISH SHIP FINANCE A/S (DANMARKS SKIBSKREDIT A/S)**

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