

R I S K R E P O R T 2 0 0 9



**DANISH
SHIP FINANCE**

CVR NR. 27 49 26 49

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Introduction

Like the rest of the Danish financial sector, Danish Ship Finance is subject to disclosure obligations pursuant to appendix 20 of the Danish Executive Order on Capital Adequacy.

The disclosure of various detailed information on key issues in respect of capital structure, capital adequacy, risk exposure and accounting policies helps to create greater transparency, providing the authorities and the market in general with access to relevant information for use in assessing risk in connection with decision-making procedures.

The risk report is published once every year in connection with the presentation of the annual report. The risk report is available at www.shipfinance.dk/Investor-Relations/Risk-Report. 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. However, Danish Ship Finance must ensure adequate control of information not covered by the audit of the annual report.

Goals and risk policies

Risk management is given high priority at Danish Ship Finance, because uncontrolled development of the various risks may have an adverse impact on financial performance and solvency and, by extension, materially weaken future business opportunities.

The company is exposed to several types of risk. The company's risk management efforts are adjusted according to the special characteristics of each type of risk. The company is exposed to credit risks, market risks, liquidity risks and operational risks.

The most significant risk facing Danish Ship Finance is believed to be credit risk on the company's loans, which is the risk of losses due to customers defaulting on their loans.

The Board of Directors has the overall responsibility for ensuring appropriate risk management procedures. Risk management efforts are determined by the guidelines established by the Board of Directors and the legislative framework.

The company 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 Capital Adequacy), 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 risk, foreign exchange risk or liquidity risk in connection with its lending operations.

Written in-house business procedures and control procedures are in place for all significant areas and activities. The internal control function regularly verifies that these procedures are adhered to and reports its findings via the external auditors to the Board of Directors.

Danish Ship Finance is not subject to a requirement about internal audit. The internal control function regularly verifies that the company's internal business and control procedures are adhered to. The Board of Directors regularly assesses whether it will be necessary for the company to be subject to internal audit.

Credit risk

The limits for credit risk management are stipulated in the company's credit policy. The policy builds 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 and for the periodical risk calculation and reporting rests with the credit department.

Granting of loans

The Management Board and the credit manager have been allocated authorities allowing them to grant or reject loans up to predetermined limits and to allocate risk lines to financial counterparties within a predefined framework. The granting of loans and risk lines must be disclosed at the subsequent board meeting.

Loans over and above the predefined limits are approved by the Board of Directors.

Diversification rules

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. As a result, 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. The composition of the loan portfolio is thus governed by a set of diversification rules, which form part of the credit policy.

The purpose of the diversification rules is to ensure 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.

Risk diversification on borrowers: The composition of borrowers must be adequately diversified in the loan portfolio. For large loans, the company should seek to diversify the risk on vessel types within the individual account. 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 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 and reserves. Thus, 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 loans to shipowners

(amounts are before any impairment charges, DKK)

<i>mio. DKK</i>	31.12 2009	31.12 2008
5 largest loans to shipowners	27,427	25,850
Total lending	50,748	49,126

The five largest loans to shipowners at 31 December 2009 are secured by mortgages in 165 vessels comprising 17 vessel types. One of the loans is substantially larger than the rest.

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. 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 20% of its gross lending

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 and budgets from the borrower.

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

- Verifying the existence of adequate insurance cover on financed vessels.
- Half-yearly updating of the market values of all financed vessels.
- Verifying that any other collateral meets the specified minimum requirements.
- Verifying compliance with all other 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, Danish Ship Finance determines which borrowers must also be covered by Mortgage Interest Insurance and Mortgagee Additional Perils Pollution Insurance. Vessels owned by most of the borrowers are covered by Mortgage Interest Insurance and Mortgagee Additional Perils Pollution Insurance. This insurance covers the risk in most situations which the borrower's primary insurance policies do not cover.

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 an offer to finance second-hand tonnage. When financing second-hand tonnage, focus is on the age of the vessel and its condition.

Market valuations

Values are sourced regularly from independent brokers who fix a price for the financed vessels on the basis of supply and demand.

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

Financial counterparties

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 Danish Ship Finance, and the financial counterparty cannot fulfil his part of the agreement. This type of risk also includes settlement risk.

The guidelines for managing financial counterparty risk are laid down in a separate in-house policy. The policy contains limits

for acceptable credit risks. Emphasis is on the 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.

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

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 mortgage and any other collateral.

Market risk

Market risk is the risk of losses as a result of changes in the market value of assets and liabilities as a result of changing market conditions. The company's over-

all market risk is calculated as the sum of fixed income, exchange rate and equity positions. The company pursues a finance policy to manage its market risks. The policy lays down clear and measurable limits for interest rate, exchange rate and equity risks.

The treasury department has the day-to-day responsibility for the finance policy, while the responsibility for the current calculation and reporting of financial 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 defined limits, the Board of Directors must be informed not later than at the next board meeting.

Interest rate risk by duration

<i>mio. DKK.</i>	0-1 year	1-5 year	5-10 year	over 10 year	Total portfolio
2009	4,805.0	17,969.4	2,008.7	5,833.3	30,616
2008	82.0	16,307.8	2,919.5	7,211.3	26,521

Interest rate risk

Interest rate risk is the risk that Danish Ship Finance 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 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 finance policy accepts interest rate risks between funding and lending solely when caused by timing differences in determining the reference interest rate (such as LIBOR) for variable rate funding and lending. 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.

The table below shows the distribution of interest rate risk on the total bond portfolio.

Foreign exchange risk

The finance 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 borrowers' preferred lending currency.

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.

Exchange rate indicator 1 at 31 December 2009: 1.2

Exchange rate indicator 1 corresponds to the company's overall

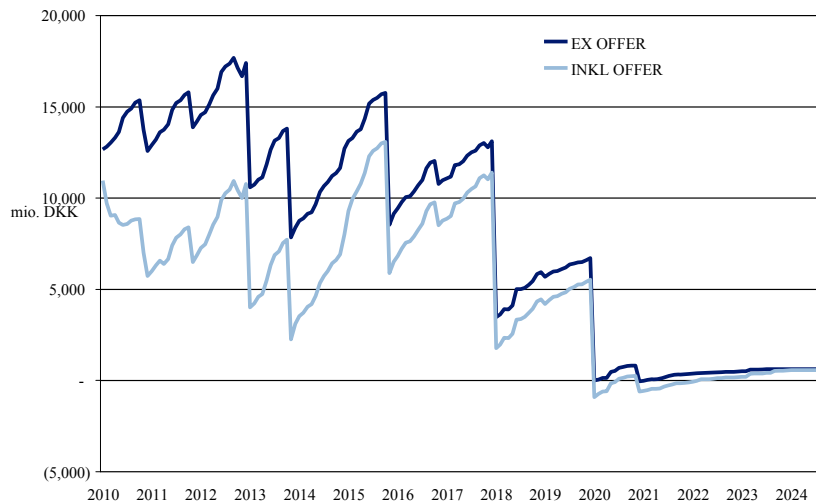
net exposure in foreign currency on the total balance sheet items, calculated according to the guidelines of the Danish Financial Supervisory Authority

Equity risk

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

At 31 December 2009, the company had shares totalling DKK 519.7 million, corresponding to 5.6% of the capital base.

Liquidity and duration mismatch at 31 December 2009



Derivatives

Danish Ship Finance uses derivatives in specific areas. The finance 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 10% of the total loan amount. The company does not presently have any issued structured bonds.

Liquidity risk

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.

Pursuant to the company's in-house 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 loan disbursements and for most of the loan offers submitted. 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.

Operational risk

Operational risk is the risk of direct or indirect losses as a result of insufficient or faulty internal processes, human error, system error or losses resulting from external events. Operational risk is often associated with specific and one-off events.

Danish Ship Finance manages operational risks through business procedures and internal controls. The control is performed by the company's internal control function, which is independent of the executing departments.

The key operational risks relate to credit and finance functions 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 con-

tracts, deposits and general money transfers. In the area of information technology, the risk relates to the derived consequences of a system breakdown or serious system errors.

Scope

Danish Ship Finance A/S (Danmarks Skibskredit A/S)
Sankt Annæ Plads 3
DK- 1250 Copenhagen K
T: +45 33 33 93 33 · F: +45 33 33 96 66 · E: danish@shipfinance.dk
CVR-nr.: 27 49 26 49

www.shipfinance.dk

Capital base

Danish Ship Finance's capital base consists predominantly of core capital in the form of tied-up reserve capital. Movements in the

capital base are determined by factors such as the profit/loss for the year and the company's dividend policy. The company's

solvency ratio is calculated as the capital base less deductions in percentage terms of the risk-weighted items.

Calculation of capital base less deductions at 31 December 2009

<i>mio. DKK</i>	
<i>Tier 1 capital</i>	
Share capital	333.3
Tied-up reserve capital	8,343.1
Retained earnings	356.9
Total tier 1 capital	9,033.3
<i>Deductions from tier 1 capital</i>	
Reduction due to additional straining	432.9
Proposed dividends	39.4
Deferred tax assets	210.8
Total deductions from tier 1 capital	683.1
<i>Subordinated debt</i>	
Subordinated debt	897.3
<i>Supplementary capital</i>	
Revaluation reserve	9.6
Total capital base less deductions	9,257.1

Risk-weighted items and the solvency requirement

Risk-weighted assets/exposures at 31 December 2009

<i>mio. DKK</i>	Risk-weighted exposure	Capital requirement 8%
Weighted assets outside the trading portfolio*)	52,349.7	4,188
Weighted off-balance sheet items	4,830.8	386
Weighted items with counterparty risk outside the trading portfolio	793.2	63
Weighted items with a market risk	5,527.8	442
Operational risk	1,377.1	110
Total weighted items	64,878.5	5,190.0

The table above shows the company's risk-weighted exposures/assets and capital requirement for each exposure category.

The standard method is used to calculate 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 following loans or shares of loans each carry a weight of more than 100%:

1. Pursuant to the Executive Order, building loans must carry a weight of 200%. Building loans are secured through debtor's liability, assignment and subrogation in the building contract and assignment in the collateral for payments under the building contract.

2. 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 core capital. The maximum deduction is determined at the date of grant.

3. Where the borrower is domiciled in a country where the country risk calls for a higher weighting, the loan will carry a weight of 150%.

Calculation of solvency ratio at 31 December 2009

<i>mio. DKK</i>	
Capital base less deductions	9,257.1
Risk-weighted items	64,878.6
Solvency ratio	14.3

Counterparty risk

Danish Ship Finance applies the market value method 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 poten-

tial 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.

Counterparty risk at 31 December 2009

<i>mio. DKK</i>	
Netting of exposure value:	
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%.	158.3
Counterparty with risk weight of 20%.	1,557.5
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%.	158.3
Counterparty with risk weight of 20%.	3,307.5
Counterparty with risk weight of 100%.	0.0

Credit risk and dilution risk

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:

- that all loans are subjected to an individual assessment;
- 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
- that each loan is tested for impairment for all the identified 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.

Average values of risk-weighted exposures

<i>mio. DKK</i>	Risk-weighted exposure	Capital requirement 8%
Credit balances in banks	7.0	0.6
Loans and guarantees to shipowners	50,732.3	4,058.6
Of which exposures with arrears and overdrafts	3.0	0.2
Bonds, central and local government	0.0	0.0
Mortgage bonds	6,701.8	536.1
Exposures in other posts, incl. irrevocable credit guarantees	9,611.7	768.9
Average weighted posts	67,055.8	5,364.5

Credit exposure by maturity at 31 December 2009

<i>mio. DKK</i>	On demand	0-3 months	3 months-1 year	1 – 5 years	More than 5 years	Total
Banks	29.7	715.6	0	14.1	0	759.4
Shipowners	0	1,609.1	4,851.7	23,291.8	18,685.0	48,437.6
Total credit exposure	29.7	2,324.7	4,851.7	23,305.9	18,685.0	49,197.0

Developments in impaired claims due to value adjustment and impairment charges at 31 December 2009

<i>mio. DKK</i>	Loans	Financial counter- parties
Individual impairment charges/provisions		
Impairment charges/provisions for loans and counterparties, 1 January	710.1	40.0
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	467.6	0.0
Final loss (written off) on previous impairment charges/provisions	3.5	0.0
Accumulated impairment charges/provisions for loans and financial counterparties, 31 December	1,045.7	45.0
Sum of loans and financial counterparties where individual impairment charges/provisions have been made (calculated before impairment charges/provisions)	8,384.6	400.6
Collective impairment charges/provisions		
Accumulated impairment charges/provisions for loans and financial counterparties, 1 January	235.5	0.0
Reversal of impairment charges/provisions, where there is no longer any objective evidence of impairment or the impairment is reduced	0.0	0.0
Accumulated impairment charges/provisions for loans and financial counterparties, 31 December	781.0	0.0
Final loss (written off)	0.0	0.0
Sum of loans and financial counterparties where individual impairment charges/provisions have been made (calculated before impairment charges/provisions)	15,710.3	0.0

Market risk

Danish Ship Finance must disclose the solvency requirements for a number of risks calculated under the market risk area. Set out below is a statement of the solvency requirements for the risks in question

Risk-weighted assets with market risk at 31 December 2009

<i>mio. DKK</i>	Unweighted amount	Weighted amount	Capital requirement 8%
<i>Debt instruments, specific risk</i>			
Total specific risk	17,227	890	71
<i>Debt instruments, general risk</i>			
Total general risk	2,915	2,884	231
<i>Shares, etc.</i>			
Total shares, etc.	524	522	42
<i>Currency positions</i>			
Total long-term currency positions	1,232	1,232	99
Total risk-weighted items with market risk	21,898	5,528	442

Operational risk

Pursuant to the Danish Executive Order on Capital Adequacy, Danish Ship Finance must hedge operational risks by means of capital. The capital 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”.

Danish Ship Finance uses the basic indicator model, cf. appendix 18 to the Executive Order on Capital Adequacy, to calculate its solvency requirement for operational risks. As a result, the capital requirement for operational risks is calculated at 15% of the average core income over the past three years. Core income is the sum of net income and non-interest-related net income.

Danish Ship Finance regularly performs an assessment of the capital requirement for operational risks. If the capital requirement is deemed to be higher than mentioned above, the company will make corresponding adjustments to its solvency requirement.

Exposures to interest rate risk in positions outside the trading portfolio

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

Disclosures concerning credit risk-reducing methods

Financial collateral at 31 December 2009

<i>mio. DKK</i>	Exposure	Collateral
Municipality and export guarantees	536	247
Bank guarantees	0	29
Deposited bonds and cash deposit	1,260	77
Deposited bonds	1,796	352

Danish Ship Finance 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

Pursuant to the company's policy for the valuation of financial collateral, the valuation is a conservative market value assessment. 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 handled by the company's credit department.

Danish Ship Finance applies the simple method as a credit risk-reducing mechanism. This means that the company can reduce the capital charge on an exposure, when financial collateral is mortgaged. Appendix 7 of the Executive Order on Capital Adequacy sets out the financial collateral the company may use 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, Danish Ship Finance 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.

Individual solvency need and adequate capital base

Pursuant to appendix 1 of the Executive Order on Capital Adequacy, the Board of Directors and Management Board must 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 as required under section 20(2) of the Executive Order. The solvency need may not be lower than the solvency requirement. 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. Tests are made within three risk areas (credit risk, market risk and operational risk).

Variables subjected to stress tests in relation to the determination of the individual solvency need:

- An increase in DKK-denominated interest rates (market risk)
- A decline in equity prices (market risk)
- An appreciating USD (market risk)

- A reduced credit quality of the loan portfolio in combination with an appreciating USD resulting in higher impairment charges (credit risk)

The Board of Directors and the Management Board have defined the risks which Danish Ship Finance should be able to withstand and thus also the variables that need to be subjected to a stress test. As a general rule, a stress test is an attempt to expose the company's financial figures to a number of adverse events in order to see how the company would respond in such a scenario.

The result of the stress tests performed is included in the solvency need model such 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. The overall effect of stress tests on the solvency need is calculated by comparing the overall profit impact with the weighted items. This approach provides a measurement of how much capital is required for the company to withstand the given scenario.

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 solvency need:

- Risk concentration (credit risk)
- Growth in lending (credit risk)
- Settlement risks (credit risk)
- Preliminary impairment charges (credit risk)
- Liquidity risks (market risk)
- Operational risks (operational risk)

The determination of the impact of these areas on the solvency need percentage 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 solvency need.

The company believes that the risk factors included in the model cover all the risk areas that, pursuant to legislation, the Board of Directors and Management Board must take into consideration when determining the solvency

need and the risks that the Board of Directors and Management Board find that the company is exposed to.

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 solvency need. Management therefore regularly assesses how the growth expectations affect the calculation of the solvency need.

Internal process

The method used to determine 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. Danish Ship Finance 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 manage the risks.

The company's Middle Office is responsible for the quarterly calculation of the adequate capital base and the individual sol-

venency need, and also for reporting results to the Board of Directors and Management Board. The company's Middle Office also reports to the company's finance department, which incorporates the result in the company's internal reports to the Board of Directors.

The company's method

The adequate capital base is calculated as the amount appropriate to cover current risks and future risks. The adequate capital base relative to the risk-weighted assets expresses the individual solvency need.

The model applied consists partly of a stress test, partly of an individual assessment of a number of relevant factors considered to be of importance to the size of the adequate capital base. The fact that certain matters are not included indicates that these factors are considered immaterial in relation to the company.

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 interest rates 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 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 loss 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. 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 an objective evidence of impairment has been found within all vessel types and a sharp appreciation of the USD/DKK exchange rate, which will increase the capital need.

The sum of the items represents the stress test capital reservation for 2010 in the amount of DKK 4.1 billion.

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.

The company exclusively grants loans for the financing of vessels against a mortgage. Consequently, the risk concentration at industry level is a factor considered in the calculation of the adequate capital base. Furthermore, the loan portfolio is characterised by a high concentration at debtor level. One or more

losses on debtors may therefore have a significant impact on the risk of losses. In spite of sound credit quality in the loan portfolio, the company therefore reserves capital for bad debts. In practice, it is assumed that the company's five largest customers will experience financial difficulty. The company thus reserves capital of the maximum loss which the company may incur with a 99.7% probability, less impairment charges already made on the five loans.

Lending growth in the company affects the size of the adequate capital base. By reserving capital for lending growth, the company has reserves for weak as well as strong lending growth. In practice, lending growth consists of loan offers submitted less any run-off on existing loans. In addition, the capital reservation is based on the most recently calculated impairment ratio.

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.

Where there is no objective evidence of impairment of the credit quality, but there is a strong assumption that it will be impaired, capital will also be reserved in the form of preliminary impairment charges.

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.

Pursuant to the company's in-house 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 loan disbursements and

Adequate capital base and solvency need at 31 December 2009

<i>mio. DKK</i>	
Individual solvency need	6,28%
Total capital requirement	4,073.6
Capital requirement divided into sub-components	
Credit risks	3,225.2
Market risks	1,338.3
Operational risks	110.2
Other	(600.0)

for most of the loan offers submitted. 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 liquidity rely on an efficient swap market. Lack of liquidity is managed as a liquidity risk and forms part of the stress test.

The operational risks are calculated using the basic indicator method and thus account for 15% of a three-year average of net interest income and non-interest-related net income.

