DANISH SHIP FINANCE 2019

› Risk Report

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SCOPE

This Risk Report is presented for the Danish Ship Finance Group on a consolidated basis (referred to as Group) as well as the subsidiary Danish Ship Finance A/S on a standalone basis (referred to as DSF).

All economic activity is located in DSF. The holding company, Danish Ship Finance Holding A/S (DSH), has no business activities apart from its ownership of DSF. The nouns 'we' and 'our' is used to refer to DSF and the Group where the specific entity is not important.

The Risk Report describes the various risks to which the Group and DSF are exposed and the associated risk capital requirements. The report also includes an account of the composition of the capital base and risk and capital management methodologies.

In addition, the Annual Report contains information about risks and risk management. Reporting pursuant to the statutory disclosure requirements is conducted annually in conjunction with the presentation of financial statements. The capital adequacy assessment is published quarterly.

As there is no audit requirement, the Risk Report 2019 is presented in unaudited form.

Additional Pillar 3 disclosures required under Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 (CRR) and the Danish Executive Order on Calculation of Risk Exposure, Own Funds and Solvency Need can be downloaded from **www.shipfinance.dk.**

Legal framework

DSF is governed by its own dedicated legislation 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).

DSF is also governed by:

- The Executive Order on the Issue of Bond, the Principle of Balance and Risk Management (the Bond Executive Order)
- The Executive Order on Calculation of Risk Exposures, Own Funds and Solvency Need
- The Executive Order on Governance for Credit Institutions (the Executive Order on Governance)
- The Executive Order on Financial Reports for Credit Institutions and Investment Firms, etc. (the Executive Order on Financial Reports)

Pursuant to the Act and the Executive Order, the Group is governed by parts of the Danish Financial Business Act and the Regulation on prudential requirements for credit institutions and investment firms (CRR) via the Executive Order.

The Group is supervised by the Danish Financial Supervisory Authority (Danish FSA).

RISK PROFILE

RISK PROFILE

DSF is a leading domestic and international provider of ship financing and among the 20 largest lenders to the shipping industry globally.

We only provide financing to shipowners secured by first lien mortgages on vessels. On a limited scale, we may also finance clients' payment of instalments to shipyards. Our lending to shipowners, in line with market practice, is typically denominated in USD and to a lesser extent other currencies.

We fund our lending activity through the issuance of Danish DKK denominated ship mortgage bonds from the DSF Capital Centre Institute in General and, since March 2019, issuance of EUR denominated CRR compliant covered bonds (SDO) from the newly established DSF Capital Centre A. Although EUR bonds remain a smaller share of our overall funding compared to DKK bonds, it has been a significant priority from the outset to ensure robust operating procedures and controls around Capital Centre A as well as Capital Centre Institute in General.

Bonds issued out of either capital center are listed on Nasdaq Copenhagen and have been assigned ratings of 'A' by Standard & Poor's Global Ratings.

The business model naturally leads to a foreign exchange mismatch between loans and bonds in different currencies. This mismatch is hedged with financial counterparties, subject to the requirements of the strict Danish balance principle.

Credit risk, defined as the risk of losses arising from clients or financial counterparties failing to meet their payment obligations, is the primary risk related to this business model. Credit risk primarily stems from the risk that shipowners default on their obligations towards us or, more remotely, the default of a financial counterparty with a credit exposure to the Group.

The Group is also exposed to market risk, liquidity risk, and various types of operational risk.

Market risk is the risk of losses due to factors that affect the overall performance of the financial market. Our exposure to market risk mainly stems from direct and indirect effects of changes in interest rates and USD/DKK, EUR/USD or NOK/DKK exchange rates on our loan book or capital reserves.

Liquidity risk is the risk of not being able to fulfil a payment obligation when due. Liquidity risk primarily arises from a maturity mismatch between the Group's payment obligations in DSF to e.g. bondholders, financial counterparties, or lending clients and the amount of liquidity available at any one time. This risk is partly mitigated by a requirement to pre-fund all loans and commitments to clients under the Danish strict balance principle, and further managed subject to strict liquidity limits and regularly stress tested.

Operational risk is the risk arising from breakdowns in our internal procedures, or failures of people or systems. In this category we also consider structural risks to our business model and the risk of material damage to our reputation.

RISK MANAGEMENT FRAMEWORK AND POLICIES

Prudent risk management is pivotal to our activities and crucial to ensure the long-term viability of our highly focused business model. We have a strong culture of risk-awareness and decision making for the long-term and stringent requirements for day-to-day monitoring and management of risks. Furthermore, we maintain strong capital and liquidity buffers well beyond regulatory minimum requirements.

The Board of Directors defines risk policies and principles of risk and capital management. The purpose of the risk management policies is to establish acceptable limits for risks.

Capital

The Board of Directors requires DSF to maintain sufficient own funds for the lending activity in DSF to continue, even in the event of large cyclical fluctuations in the shipping industry and difficult business conditions. Additionally, capital is managed at a level deemed sufficient to underpin the credit rating of the issued bonds.

Credit and counterparty risk

The limits applicable to credit risk management are set out in the credit policy and the counterparty risk policy. The policies build on the provisions of the company's own Act and the Executive Order, stipulating, among other things, that the Board of Directors must lay down risk diversification rules. The counterparty risk policy sets out limits for credit exposure to individual financial counterparties, and also sets limits for country exposures.

When granting loans to new or existing clients, the creditworthiness of the client, the characteristics of the financed vessel, the terms of the loan and the loan's contribution to credit diversification are among the factors considered.

In our credit risk management activities, we distinguish between credit risk relating to lending to clients and credit risk relating to transactions with financial counterparties. The credit department has day-to-day responsibility for the credit policy, the counterparty risk policy, credit risk monitoring, periodic risk calculations and reporting of credit risk.

Market risk

Market risk is governed by limits laid down in the Bond Executive Order and the Executive Order. Limits specified in our internal policy further mitigate market risk.

The overall objective is to safeguard our capital adequacy, to make sure that interest rate- and foreign exchange risks are managed either by hedging or through controlled open positions and to achieve an adequate financial return within the risk targets defined.

Liquidity risk

Liquidity risk is prudently managed under the specific balance principle in accordance with the Bond Executive Order. In addition, the liquidity risk policy defines risk limits to ensure adequate liquidity at all times.

Liquidity is managed with the objective of ensuring continued access to funding on adequate terms and to avoid any situation where lack of funding could challenge the business model. Ultimately, the aim of the liquidity management framework is to ensure that we are consistently able to meet our payment obligations even under stressed market conditions.

Operational risk

Operational risk is governed by the operational risk policy issued by the Board of Directors. The policy sets out the overall framework for identifying, evaluating and managing operational risk and is supplemented by operating procedures and internal controls.

On an ongoing basis, we register losses and potential loss events deemed to be attributable to operational risk. The registration is used as a basis for assessing the adequacy of controls, processes, operating procedures, etc. If required, these may from time to time be adjusted to increase the resilience to operational risks.

RISK GOVERNANCE

We have a two-tier management structure, reflecting statutory requirements for listed Danish companies and the provisions laid down in the Danish Financial Business Act. The Board of Directors lays down overall policies, while the Executive Board is responsible for the day-to-day management of the Group.

The Board of Directors is responsible for ensuring that the Group has an appropriate organisational structure and that risk policies and limits are established for all important risk categories, including handling and monitoring of such risks. The Board of Directors has laid down guidelines for the Executive Board, specifying clearly the areas of responsibility and scope of action for management. In addition, new credit facilities above certain limits must be submitted to the Board of Directors for approval.

The Board of Directors has appointed a Chief Risk Officer with the responsibility for monitoring and reporting on the design and risk management processes for the Group. The Executive Board has established a Risk Management function with the purpose of identifying, analysing, monitoring all risks except for credit risk. The Credit department is responsible for monitoring and reporting on credit risk from lending activities and on financial counterparties.

The Head of Compliance is responsible for compliance with applicable legislation, market standards and internal rules, and for ensuring that the Group applies effective techniques and procedures suitable for identifying and mitigating the risk of non-compliance. The Head of Compliance is also in charge of implementing and ensuring management focus on measures to prevent financial crime.

Reporting

The Board of Directors is provided with reports on a regular basis to ensure that its members possess the necessary information concerning our risk levels and trends. Based on these reports, the Board of Directors assesses the overall policies, framework and principles for risk and capital management.

Overview of risk reports

Report	Frequency	Applicable legislation
Compliance reporting	Annually	The Executive Order on Governance for Credit Institutions
Report from the Chief Risk Officer	Annually	The Executive Order on Governance for Credit Institutions
Treasury reporting	Quarterly	The Executive Order on Financial Reports
Internal management report	Monthly/Quarterly	The Executive Order on Governance for Credit Institutions
Internal solvency, ICAAP	Annually	Guidelines on Adequate Capital Base and Solvency Needs for Credit Institutions
Internal Liquidity Adequacy Assessment, ILAAP	Annually	Guidelines on Calculation and Assessment of the Liquidity Position and Liquidity Risks
Stress test	Quarterly	The Executive Order on Governance for Credit Institutions
Statement to be used for risk assesment	Annually	The Executive Order on Governance for Credit Institutions
Credit reporting	Quarterly	The Executive Order on Governance for Credit Institutions
Recovery plan	Annually	The Danish Financial Business Act
Loan impairment review	Semi-annually	The Executive Order on Governance for Credit Institutions
Annual asset review	Annually	The Executive Order on Governance for Credit Institutions
Sustainability report	Annually	The Executive Order on Financial Reports

Board committees

The Board of Directors has set up two committees: The Audit Committee and the Remuneration Committee. These committees are responsible for preparatory work and assist the Board of Directors in decision-making.

The Audit Committee is responsible for overseeing accounting and audit matters and for preparing accounting and audit-related topics for consideration by the Board of Directors. The Audit Committee consists of four members of the Board of Directors. The Chairman of the Board of Directors is not a member of the Audit Committee.

The Remuneration Committee undertakes preparatory work and assists the Board of Directors in preparing the Group remuneration policy. The remuneration policy is adopted at the general meeting. The chairman of the Board of Directors is chairing the remuneration committee. The total remuneration of the Board of Directors, the Executive Board and employees whose activities are deemed to have a material impact on the risk profile is specified in Annex 8.

The Executive Board has set up a Credit Committee, which is responsible for reviewing loan applications.

Internal audit

The Group is not required to have, and currently does not have, an internal audit function. To promote a robust control environment and support the work of the external auditors, an internal control function is in place. This function reports to the Executive Board.

In accordance with applicable legislation, the Board of Directors, including the Audit Committee, regularly assesses the need for an internal audit function.

CAPITAL MANAGEMENT

CAPITAL MANAGEMENT

The Board of Directors and the Executive Board are mandated to prudently manage capital such as to ensure that adequate own funds are maintained at all times.

Adequate own funds are defined as the minimum amount of capital required, in the view of the Board of Directors and the Executive Board, to ensure only a remote risk of the Group becoming distressed or insolvent during the following 12-month period, in which case bondholders could be exposed to a potential loss. Bondholders are, however, subject to further protection ensured by the Danish strict balance principle.

The Group and DSF total capital ratios are deemed to be adequate to meet the above-mentioned objective. As of 31 December 2019, the Group's total capital ratio was 18.0%. The total capital ratio for DSF stand-alone (the risk-bearing entity) was 18.5%.

AVAILABLE OWN FUNDS

The Group's own funds net of deductions amounted to DKK 8,911 million at 31 December 2019, (against DKK 8,142 million in 2018). In DSF, own funds amounted to DKK 9,065 million (against DKK 8,972 million in 2018).

The Group's own funds consist of common equity Tier 1 capital (CET1) in the form of share capital and tied-up reserve capital in DSF, retained earnings from previous years, and a subordinated Tier-2 debt instrument in DSH.

The tied-up reserve capital was established in 2005 when DSF was converted from a foundation into a limited liability company. The amount has remained unchanged at DKK 8,343 million.

Calculation of capital ratio

	Group		DSF	
DKK MILLION / %	**2019**	**2018**	**2019**	**2018**
Own funds less deductions	8,911	8,142	9,065	8,972
Total risk exposure amount	49,406	47,751	49,020	47,233
Total capital ratio	**18.0**	**17.0**	**18.5**	**19.0**

The FSA has ruled that the tied-up reserve capital shall be included in the determination of consolidated capital adequacy at an amount corresponding to the tied-up reserve capital's proportionate share of the capital requirement.

The share of the tied-up capital that may be included is calculated according to the following formula:

$$\text{Share} = \frac{\text{Tied-up reserve capital}}{\text{Total CET1 capital}} * (\text{Capital requirement} * \text{Total exposure})$$

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DSH has issued Tier 2 capital on terms and conditions that meet the requirements for inclusion in Group own funds as a Tier 2 instrument under the CRR. The Group Tier 2 capital, amounting to a nominal amount of DKK 2 billion, was provided by the pension fund PFA and pension funds under management by PKA. These pension funds are shareholders of DSH. Annex 2 provides a more detailed description of the terms and conditions of the Tier 2 capital.

The tied-up reserve capital may only be used to cover losses that cannot be covered by the amounts available for dividend distribution. In the event the tied-up reserve capital is used to cover losses, the tied-up reserve capital must to the greatest possible extent be restored by a priority claim on profit for the subsequent years. Hence, no dividends may be paid, and no distributions made in connection with capital reductions until the tied-up reserve capital has been restored to the original nominal amount.

The development in available own funds is determined primarily by net profit for the year and the dividend policies of the Group companies DSH and DSF.

Calculation of available own funds less deductions

	Group		DSF	
DKK MILLION	**2019**	**2018**	**2019**	**2018**
Common equity Tier 1 capital				
Share capital	1,224	1,224	333	333
Tied-up reserve capital	5,528	4,784	8,343	8,343
Retained earnings	208	192	545	523
Revaluation reserve	-	-	38	29
Total common equity Tier 1 capital before deductions	**6,961**	**6,199**	**9,260**	**9,229**
Deduction from common equity Tier 1 capital				
Proposed dividends	-	-	133	205
Deferred tax assets	-	-	-	-
Position of own shares	1	1	-	-
Additional capital charge pursuant to the Executive Order	0	-	-	-
Prudent valuation of trading portfolio	28	25	28	25
Deductions pursuant to transitional rules	-	-	33	27
Total deductions from common equity Tier 1 capital	**29**	**26**	**195**	**257**
Common equity Tier 1 capital less statutory deductions	**6,931**	**6,173**	**9,065**	**8,972**
Tier 2 capital	1,979	1,968	-	-
Own funds less deductions	**8,911**	**8,142**	**9,065**	**8,972**

Definitions

Own funds: Own funds can be composed of three different types of capital: Common Equity Tier 1 capital, Additional Tier 1 capital and Tier 2 capital. Own funds are subordinated to the claims of ordinary creditors in the event of bankruptcy or other forms of financial restructuring.

The ratio of own funds to the total risk exposure amount is referred to as the total capital ratio.

Common Equity Tier 1 capital: A firm's Common Equity Tier 1 capital (CET1) is the aggregate of the share capital, other reserves and retained earnings after certain statutory supplements and deductions.

Additional Tier 1 capital: Additional Tier 1 (AT1) capital consists of loans that form part of Tier 1 capital and is senior to shareholders' equity.

Tier 2 capital: The Tier 2 capital consists of subordinated debt subject to certain restrictions. Tier 2 capital is senior to AT1.

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CAPITAL REQUIREMENTS

CAPITAL REQUIREMENTS		
PILLAR 1	PILLAR 2	COMBINED CAPITAL BUFFERS

The internal capital adequacy requirement including the combined capital buffer requirement totalled 12.5% for both DSF and the Group at 31 December 2019. Own funds after deductions totalled DKK 9,065 million for DSF and DKK 8,911 million for the Group, resulting in a total capital ratio of 18.5% and 18.0% respectively. This corresponds to excess coverage in the amount of DKK 2,929 million, or 6.0 percentage points for DSF, and DKK 2,731 million, or 5.5 percentage point for the Group.

Our capital requirement is calculated based on the 8+ approach and the FSA's Guidelines on Adequate Capital Base and Solvency Needs for Credit Institutions.

The guidelines issued by the FSA contain benchmarks for stress tests etc. These benchmarks define the limits within which the FSA assesses the institution's risks as being covered by 8% of the total risk exposure. If these limits are exceeded, the institution is required to increase its adequate own funds.

The Group shall have own funds at least equal to the sum of the own funds requirements associated with each of the risk types defined as pillar 1 requirements, pillar 2 requirements and combined capital buffer requirement.

Adequate own funds and internal capital adequacy requirement

	Group		DSF	
DKK MILLION	**2019**	**2018**	**2019**	**2018**
Total risk exposure amount	**49,406**	**47,751**	**49,020**	**47,233**
Pillar 1 requirements (8% of total risk exposure amount)	3,952	3,820	3,922	3,779
Pillar 2 requirements				
Earnings	-	-	-	-
Growth in lending	-	-	-	-
Credit risks				
- Credit risks for large clients in financial difficulty	50	65	50	65
- Other types of credit risk	75	-	75	-
- Concentration risks	32	36	32	36
Market and liquidity risks	397	378	397	378
Operational and control risks	21	10	21	-
Leverage risk	-	-	-	-
Other risks	-	-	-	-
Total adequate own funds	**4,527**	**4,309**	**4,497**	**4,258**
Total capital less deductions	8,911	8,142	9,065	8,972
Total adequate own funds	4,527	4,309	4,497	4,258
Capital conservation buffer	1,235	895	1,226	886
Countercyclical capital buffer	417	150	414	148
Excess capital	**2,731**	**2,788**	**2,929**	**3,680**

Adequate own funds and internal capital adequacy requirement

	Group		DSF	
%	**2019**	**2018**	**2019**	**2018**
Solvency ratio	**18.0**	**17.0**	**18.5**	**19.0**
Internal capital adequacy requirement	9.2	9.0	9.2	9.0
Capital conservation buffer	2.5	1.9	2.5	1.9
Countercyclical capital buffer requirement	0.8	0.3	0.8	0.3
Internal capital adequacy requirement, including combined capital buffer requirement	**12.5**	**11.2**	**12.5**	**11.2**
Excess capital	**5.5**	**5.8**	**6.0**	**7.8**

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PILLAR 1 REQUIREMENTS

PILLAR 1	PILLAR 2	COMBINED CAPITAL BUFFERS

Pillar 1 requirements

The Pillar 1 own funds requirement is a regulatory requirement for financial institutions. Own funds must represent at least 8% of an institution's total risk exposure (risk weighted assets). Non-compliance with the own fund's requirement will lead to withdrawal of the institution's license.

We apply the standardized approach to calculate the total risk exposure amount and the own funds requirement for credit and market risks. When using the standardized approach, the risk weights are pre-defined. In addition, we apply the basic indicator approach to calculate the risk exposure amount for operational risk.

Credit risk

In its guidelines, the FSA divides credit risk into three subgroups; credit risk exposure to large clients in financial difficulty, other credit risks and credit risk concentration.

The standardized approach is used to calculate the own funds requirement for credit risk. According to the standardized approach, all loans generally carry a weight of at least 100%. In addition, the value of the ship mortgages cannot be deducted, and for capital adequacy purposes the loans are thus treated as unsecured loans.

CREDIT RISK

- Pursuant to the Executive Order, the following loans or shares of loans each carry a risk weight of more than 100%:
- Pursuant to section 24(3) of the Executive Order, construction loans carry a risk weight of 200% if total construction loans do not exceed 125% of the excess capital coverage. If total construction loans exceed 125%, the excess amount must be deducted from Tier 1 capital.
- Construction loans are secured through the client's liability, assignment and subrogation in the construction contract and assignment of the shipyard's collateral for payments according to the construction contract.
- Pursuant to the definition in Article 178 of CRR, loans in default (equivalent to internal DSF rating 11 and 12) have a weight of 150%.
- Under certain conditions, we may grant loans exceeding 70% of the value against other collateral and/or against additional reservations of its own funds. The maximum deduction is determined in DKK at the date of approval.
- Where the client either has an external rating corresponding to credit quality steps 5 and 6 or is unrated and is domiciled in a country where the country risk calls for a higher weighting, the loan has a risk weighting of 150%.

At 31 December 2019, we held no shipbuilding loans in the portfolio.

Credit risk exposure by risk weights

Risk weight	Group Credit risk exposure (weighted)	Group Own funds requirement
DKK MILLION	**2019**	**2019**
0	-	-
10	594	47
20	243	19
50	2,111	169
100	38,964	3,117
150	1,387	111
200	-	-
250	209	17
Total credit risk exposure	**43,508**	**3,481**

The table shows that the majority of our risk exposures have a weight of 100%.

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Counterparty risk on derivatives and calculation of capital

We apply the mark-to-market method to calculate derivative exposures. Using the mark-to-market method to determine the exposure value for counterparty risk involves the following:

- Contracts are calculated at fair value to obtain the current replacement cost for all contracts with a positive value.
- To obtain the potential future credit exposure, the notional principal of the contracts or the underlying values are multiplied by percentages determined by the FSA.
- The sum of the current replacement cost and the potential future credit exposure represents the counterparty risk.

In the ordinary monitoring of counterparty credit risk, we take into consideration the calculated exposure value to ensure that approved credit limits for the counterparty are not exceeded.

Counterparty risk

	Group Exposure (weighted)
DKK MILLION	**2019**
Netting of exposure value	
Gross positive fair value of financial contracts after netting	
Counterparty with risk weight of 0%	-
Counterparty with risk weight of 20%	256
Counterparty with risk weight of 50%	1,510
Counterparty with risk weight of 100%	110
Total counterparty risk exposure value calculated according to the mark-to-market method for counterparty risk	
Counterparty with risk weight of 0%	-
Counterparty with risk weight of 20%	593
Counterparty with risk weight of 50%	2,373
Counterparty with risk weight of 100%	31

Credit valuation adjustment (CVA)

Pursuant to the CRR, institutions shall calculate a credit valuation adjustment (CVA) charge. The CVA charge is a separate capital requirement for OTC derivatives to cover the risk of loss due to a value adjustment caused by a deterioration of a counterparty's credit quality.

We have decided to use the standardised approach for CVA, which allows the use of risk mitigation techniques such as netting and collateral.

The counterparty risk on financial derivatives is reduced through netting agreements as well as through margin calls and collateral provided in accordance with standard documentation from the International Swaps and Derivatives Association (ISDA) and the International Capital Market Association (ICMA). Bilateral collateral agreements (CSAs) have been signed with the largest financial counterparties, which means that collateral is received or posted automatically if the positive market values exceed a specified minimum threshold.

The CVA charge for the Group amounted to DKK 631 million at 31 December 2019.

CVA charge

	Group Exposure (unweighted)	Group Exposure (weighted)	Group Own funds requirement
DKK MILLION	**2019**	**2019**	**2019**
Standardised approach	1,619	631	50

Collateral and guarantees

We may receive the following types of financial collateral and guarantees:

- Deposit funds
- Securities (debt instruments, investment fund units), primarily listed
- Government and credit institution guarantee

Funded credit protection

	Group Exposure (weighted)	
DKK MILLION	**2019**	**2018**
Deposits in cash or cash assimilated instruments	97	1
Debt securities issued by central governments or central banks	-	-
Debt securities issued by institutions	6	22
Equities	-	-
Total financial collateral	**104**	**23**

We have operating procedures in place for the management and valuation of collateral. These procedures form an integral part of the regular risk monitoring process.

We use the simple method for valuing financial collateral in our credit risk mitigation assesment. This means that the capital charge on a credit exposure can be reduced by means of collateralisation. The CRR specifies the financial collateral eligible for credit risk mitigation purposes.

In accordance with the rules of the CRR, we use financial collateral and guarantees to hedge credit and counterparty risk. The table above shows the level of protection in each exposure category, i.e. the fully adjusted size of the collateral within each exposure category.

Market risk

We use the standardised approach to calculate the own funds requirement for market risk. Positions involving market risk are instruments in the trading book and positions involving foreign exchange risk outside the trading book.

Operational risk

We use the basic indicator approach to calculate the own funds requirement for operational risk. The risk exposure amount for operational risk is thus calculated at 15% of a three-year average of net interest income and non-interest related net income.

An assessment of the own funds requirement for operational risk is performed quarterly. If the own funds requirement is deemed to be higher than the level mentioned below, we adjust the own funds reservation accordingly.

Risk exposure amount and own funds requirement for market risk

DKK MILLION	Group Credit risk exposure (weighted) 2019	Group Own funds requirement 2019
Debt instruments, specific risk		
Total specific risk *)	1,524	122
Debt instruments, general risk		
Total general risk	2,427	194
Shares, etc.		
Total shares, etc.	7	1
Foreign currency positions		
Total long foreign currency positions	253	20
Total amounts for market risk	**4,211**	**337**

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

Risk exposure amount for operational risk, DSF

DKK MILLION	2019	2018	2017	AVERAGE
Accounting items				
Interest income	941	1,075	1,176	1,064
Interest expenses	(310)	(435)	(540)	(428)
Dividends on equity investments	-	-	-	-
Fee and commission income	26	32	20	26
Fee and commission expenses	-	-	-	-
Market value adjustments	(197)	(135)	37	(98)
Sum of accounting items	**460**	**537**	**692**	**563**
Risk exposure amount (weighted) under the basic indicator approach	**1,056**	**1,374**	**1,497**	

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Summary of Pillar 1 requirements

The following table details the risk exposure amounts and own funds requirements for each exposure category.

Risk exposure amount

DKK MILLION	Group Credit risk exposure (weighted)		Group Own funds requirement		DSF Risk exposure amount (weighted)		DSF Own funds requirement	
	2019	2018	2019	2018	2019	2018	2019	2018
Credit risk								
- Central governments or central banks	209	186	17	15	123	86	10	7
- Regional governments or local authorities	-	-	-	-	-	-	-	-
- Public sector entities	-	-	-	-	-	-	-	-
- Institutions	730	608	58	49	687	571	55	46
- Corporates	38,832	36,484	3,107	2,919	38,575	36,100	3,086	2,888
- Covered bonds and mortgage bonds	634	271	51	22	634	271	51	22
- Exposures in default	2,753	3,296	220	264	2,753	3,296	220	264
- High-risk exposures	-	-	-	-	-	-	-	-
- Exposures with short-term credit assessment	-	-	-	-	-	-	-	-
- Equity exposures	-	-	-	-	-	-	-	-
- Other items	349	395	28	32	349	395	28	32
Total credit risk	**45,508**	**41,240**	**3,481**	**3,299**	**43,122**	**40,719**	**3,450**	**3,258**
Of which, Counterparty risk	862	760	69	61	772	690	62	327
Market risk								
- Debt instruments	3,952	4,089	316	327	3,952	4,089	316	327
- Shares, etc.	7	7	1	1	7	7	1	1
- Foreign exchange risk	253	432	20	35	253	432	20	35
- Commodity risk	-	-	-	-	-	-	-	-
Total market risk	**4,211**	**4,528**	**337**	**362**	**4,211**	**4,528**	**337**	**362**
Credit valuation adjustment (CVA)	**631**	**612**	**50**	**49**	**631**	**612**	**50**	**49**
Total operational risk	**1,056**	**1,374**	**84**	**110**	**1,056**	**1,374**	**84**	**110**
Total risk exposure amount	**49,407**	**47,754**	**3,952**	**3,820**	**49,020**	**47,233**	**3,922**	**3,779**

PILLAR 2 REQUIREMENTS

PILLAR 1	PILLAR 2	COMBINED CAPITAL BUFFERS

Pillar 2 requirements

While Pillar 1 entails the calculation of risks and the capital requirement on the basis of uniform rules for all credit institutions, Pillar 2 takes into account the individual characteristics of a given institution and covers all relevant risk types, including risks not addressed under Pillar 1.

Own funds requirements for specific risk areas

This review describes the risk areas and general considerations that we take account of when calculating adequate own funds.

Based on predefined risk areas and other risk elements deemed relevant, the calculation of adequate own funds builds on the following eight risk areas:

1. Credit risk including counterparty risk
2. Market risk
3. Liquidity risk
4. Operational and control risk
5. Leverage risk
6. Earnings
7. Growth in lending
8. Other risks

A capital requirement deemed adequate to cover the underlying risks is determined for each risk area. Institutions shall consider if other elements of risk should be considered when calculating adequate own funds. Additionally, the Group's operating results are stress-tested to demonstrate, among other things, whether it will require additional capital within the next 12-month.

Credit risk. In its guidelines, the FSA divides credit risk into three sub-groups; credit risk exposure to large clients in financial difficulty, other credit risks and credit risk concentration.

Credit risk exposure to large clients in financial difficulty

For large clients in financial difficulty, a conservative loss estimate should be made for each loan. A large client in financial difficulty is defined as a client whose total credit risk exposure accounts for more than 2% of own funds and is either credit impaired in (stage 3) or showing significant signs of weakness since initial recognition without being credit impaired (stage 2), corresponding to rating 1 and 2c on the FSA rating scale.

A detailed description of the FSA rating steps is provided in Appendix 7 of the FSA's instructions for financial reports for credit institutions, etc.

A large client is defined as a client with a credit exposure of more than DKK 181 million (DKK 9,065 million times 2%). FSA rating steps 1 and 2c are applicable to clients with a rating between 9 and 12 on our internal 12-point rating scale (12 being the weakest, denoting that a client is in default).

Pursuant to the guideline method for calculating capital charges for large clients in financial difficulty, our Pillar 2 add-on amounted to DKK 50 million at 31 December 2019.

Other credit risk

Other credit risk primarily covers 'other credit risks in the loan portfolio' and 'other credit risk associated with financial counterparties'.

In our assessment of 'other credit risk in the loan portfolio', we consider areas laid down in the guidelines on adequate own funds and internal capital adequacy requirement for credit institutions and sensitivity analyses based on scenarios and their importance for the need to make loan impairment charges.

Based on these assessments and sensitivity analyses, we have made a Pillar 2 reservation of DKK 75 million to absorb potential credit risk impact arising from implementation of IMO 2020 sulphur regulations. As a significant emitter of CO2, with capital-intensive and long-lived assets the shipping industry is faced with, the challenges of reducing its climate impact to a sustainable economy, this will likely define the regulatory priorities in the coming decades. We will monitor the impact and may reassess the reservation.

The assessment of 'other credit risk associated with financial counterparties' is based on an evaluation of the financial standing of the financial counterparties. The principal risks relate to the investment of the trading book, the majority of which is placed in Danish covered bonds.

The financial standing of financial counterparties and, thereby the credit risk associated with the investment of the trading book, and interest rate and exchange rate hedging etc., is monitored continuously, including an assessment of the capital required to hedge the exposures. Furthermore, bilateral collateral agreements (CSAs) have been signed with financial counterparties to reduce the counterparty credit risk.

Based on the current financial standing of its financial counterparties, we conclude that the Pillar 1 requirement adequately covers the capital requirement concerning 'other credit risks associated with financial counterparties'.

Credit risk concentration

Concentration risk is calculated with respect to single name concentration and sector concentration pursuant to the Executive Order on Calculation of Risk Exposures, Own Funds and Solvency Need.

In its guidelines, the FSA notes that Danish mortgage lenders have a unique profile due to the nature of their core business. Against this background, the assessment of sector concentration does not apply to mortgage lenders as per the guidelines.

However, the guidelines stipulate that institutions exempt from these rules must consider the extent to which they have concentration risk that should be addressed and for which capital should be allocated. Based on the sensitivity analyses used in the assessment of 'ther credit risk in the loan portfolio', we find that there is no material risk of loss as a result of sector concentration not covered by the Pillar 1 requirement.

With respect to single-name concentration, we must consider any imbalances in the distribution of exposure sizes in its loan portfolio, irrespective of credit quality. We apply the calculation method stipulated in the guidelines with adjustments approved by the FSA. The Pillar 2 add-on for client concentrations has been calculated at DKK 32 million.

Market risk. According to the FSA guidelines, mortgage banks and similar institutions are exempt from Pillar 2 add-ons with respect to market risk. We have nonetheless assessed our market risks based on the guidelines and have adjusted the Pillar 2 add-on for spread risk accordingly.

Spread risk arises from rising spreads between individual bonds and the general level of near-risk-free interest rates. The Pillar 2 add-on for spread risk in 2019 has been calculated at DKK 397 million.

Liquidity risk. The specific balance principle limits the risk that we may assume. Limits specified in our internal policies further mitigate the risk.

Liquidity risks in the own-fund's portfolio is limited due to the long-term nature of our funding base. However, collateral obligations to derivative counterparties do impose liquidity demand. These are carefully managed and evaluated through risk-management tools including stress tests.

Mortgage banks and similar institutions are exempt from Pillar 2 add-ons with respect to liquidity risk. We also assess our liquidity risks based on the guidelines and concludes that the market risk is covered by the Pillar 1 requirement.

Operational and control risk. Operational risk and control risk under Pillar 2 include business risk i.e. external factors negatively influencing the business model.

In DSF, business risk would most likely arise from lower credit margins following increased competition or the risk of new regulatory requirements that jeopardise the covered bond status, LCR eligibility or repo access of our bonds. These risks are considered to be adequately monitored and managed.

Reputational risk can affect the size of the risk premium related to issuance of the bonds. We manage this risk by applying an overall conservative approach and hold substantial capital and liquidity reserves.

In 2019, the Pillar 2 capital reservation for operational risk amounts to DKK 21 million due to new risk introduced in the management of Capital Centre A. Pursuant to the Executive Order on a Ship Finance Institute, additional capital is required in the event that LTV exceeds 60% at the time the loan is added to the capital center.

Leverage. The leverage ratio is calculated as Tier 1 capital relative to the institution's total exposure value (unweighted). At 31 December 2019, the leverage ratio was calculated at 9.3% for the Group and 12.3% for DSF.

Pursuant to Article 451(1) of the CRR, institutions must disclose whether they use Tier 1 capital to measure capital, cf. Article 499(1)(a) of the CRR, and whether the leverage ratio is calculated at the end of the quarter.

According to the Basel Committee, the leverage ratio should not be lower than 3%. Therefore, there is no need for the Group to increase the internal capital adequacy requirement to reduce leverage.

Further information on the leverage ratio is provided in Annex 9.

Earnings. Mortgage lenders with core earnings representing less than 0.1% of loans and guarantees before loan impairment charges and market value adjustments must consider whether this gives rise to an increase in the internal capital adequacy requirement. Core earnings relative to loans and guarantees amounted to 1.2% for 2019.

In addition to the level of earnings, earnings stability also forms part of the internal capital adequacy assessment. Our earning capacity should be assessed in relation to the our dividend policy and access to capital. The results of the stress test on operating profit show that we will, even in a severe stress scenario, not require additional capital within the next 12-months.

We find that the Pillar 1 requirement is sufficient to cover risks relating to our earnings.

Growth in lending. The FSA defines total year-on-year lending growth of 10% or more as potentially exposing an institution to higher-than-normal credit risk. Consequently, institutions with lending growth at this level or above must allocate additional capital. The annual growth rate in lending was 5% from 2018-2019.

Other risks. Institutions must assess whether there is a need for a Pillar 2 add-on in respect of reputational risk, strategic risk, group risk and external risk.

No external risks have been identified that may challenge the business model. Therefore, no additional capital has been allocated to cover external risks.

COMBINED CAPITAL BUFFER REQUIREMENT

PILLAR 1	PILLAR 2	COMBINED CAPITAL BUFFERS

The combined buffer requirement is in addition to the capital adequacy requirements described above. Institutions must have sufficient regulatory capital available to cover the sum of the Pillar 1 and Pillar 2 requirements and the combined capital buffer requirement. If a credit institution does not meet this total capital requirement, it will only be permitted to make distributions, disburse variable pay and make payments relating to AT1 capital instruments if certain conditions are met.

Additional to the individual capital requirement, certain buffer requirements apply pursuant to the Danish Financial Business Act. The combined capital buffer requirement consists of:

- Capital conservation buffer
- Systemic risk buffer
- Countercyclical capital buffer

In 2019, the capital conservation buffer was 2.5% of the total risk exposure amount.

The institution-specific countercyclical capital buffer may be applied by the authorities if lending growth results in higher macroprudential risk. This buffer may be between 0% and 2.5% of the total risk exposure amount.

Based on the geographical distribution of credit risk exposures, the capital requirement for the countercyclical capital buffer was calculated at DKK 414 million at 31 December 2019. The capital requirement pertains to exposures to clients domiciled in Denmark, Norway, Sweden, France, Hong Kong, Iceland and United Kingdom, which have set the following countercyclical capital buffer rates:

- Denmark 1.00%
- Sweden 2.50%
- Norway 2.50%
- France 0.25%
- Iceland 1.75%
- United Kingdom 1.00%
- Hong Kong 2.00%

Institution-specific countercyclical capital buffer, DSF

DKK MILLION / %	2019	2018
Total risk exposure amount	49,020	47,233
Institution-specific countercyclical buffer requirement	414	148
Institution-specific countercyclical buffer requirement, %	0.8	0.3

Geographical distribution of credit exposures relevant for the calculation of the countercyclical buffer is provided in Annex 10. All EU member states can implement a systemic risk buffer applying to domestic exposures. The requirement may apply to the entire sector or to individual sub-sectors. The systemic risk buffer is aimed at preventing and mitigating long-term, non-cyclical systemic or macroprudential risks not covered by the Capital Requirements Regulation (CRR). Since the Danish systemic risk buffer rate only is only applied to systemically important financial institutions it is not relevant.

In accordance with the Executive Order on Management and Control of Banks, etc., a capital contingency plan included in our recovery plan has been prepared, which contains a catalogue of possible course of actions to strengthen the capital position in a critical situation.

The capital contingency plan would take effect in the unlikely event predefined triggers are activated.

LEVERAGE RATIO

The leverage ratio is defined as the relationship between Tier 1 capital and the balance sheet total (incl. off-balance sheet items). The ratio does not factor in any collateral.

The intention is to reduce the risk of excessive leverage and to allow for the potential uncertainty in the determination of capital requirements resulting from the internal models or the standardised approach.

All risks and the material Tier 1 capital are in the operating company Danish Ship Finance (solo). In DSF, the leverage ratio is 12.3%, in DSH the leverage ratio is 42.7% and the leverage ratio is 9.3% only at Group level.

The reason that the ratio is significantly lower for the Group compared to DSF and DSH alone is the calculation technique stipulated by the FSA whereby the tied-up reserve capital shall be included in the determination of consolidated capital adequacy at an amount corresponding to the tied-up reserve capital's proportionate share of the capital requirement. For further information, please refer to 'Available own funds'.

According to the FSA, policies that contain a total leverage ratio target are a requirement when the leverage ratio is less than 10%.

For the reasons above, the Group does not have a policy regarding a target for the total consolidated leverage ratio.

SUPPLEMENTARY COLLATERAL AND OVERCOLLATERALIZATION

Pursuant to the Executive Order, the issuance of covered bonds in Capital Centre A, requires DSF to post supplementary collateral for loans exceeding a LTV limit of 60% in the event of declining ship values.

The LTV ratios are closely monitored and the Capital Centre maintains a collateral buffer should the ship values decline.

The supplementary collateral requirement for Capital Centre A remained steady throughout the year and averaging 1.7% of the amount of issued bonds.

At the end of 2019 the requirement for supplementary capital amounted to DKK 133 million or 1.8% of amount of issued bonds.

The capital requirement for Capital Centre A consists of the mandatory 8% requirement plus the additional capital adequacy requirement and the combined capital buffer. DSF can use the capital from the Capital Centre Institute in General in the cover pool and post additional collateral or overcollateralization (OC) in the form of liquid securities.

Capital Centre A has a high OC ratio. The OC can be used as supplementary collateral to cover breaches of LTV.

At the end of 2019 the OC-ratio i.e. allocated capital in relation to amounts issued in Capital Centre A was 22.8%.

DANISH SHIP FINANCE

CREDIT RISK MANAGEMENT

CREDIT RISK MANAGEMENT

Credit risk is the risk of incurring losses as a result of clients or financial counterparties failing to meet their payment obligations towards us. We are mainly exposed to the credit risk of clients (shipping companies) through loans collateralised by ships. We are also exposed to the credit risk of financial counterparties (financial institutions) through the high-quality bonds we hold in our portfolio and the financial contracts we have entered into those counterparties.

Credit risk is managed pursuant to a credit policy approved by the Board of Directors, containing specific guidelines for credit risk appetite, risk taking and ongoing risk management relating to lending activities carried out.

Standard operating procedures have been put in place for the ongoing credit risk management, which ensures a consistent approach to assessing credit requests.

In 2019, we slightly increased the size of the loan book without compromising the high credit standards by lending to customers with adequate credit ratings and backed by collateral deemed sufficient to withstand stressed scenarios. Also in 2019, new impairment charges remain at a very low level.

GOVERNANCE STRUCTURE

The credit governance structure rest upon the three lines of defence principle, which ensures organisational separation of loan origination, credit risk management and control functions.

CLIENT SELECTION AND DIVERSIFICATION

We strive to maintain a conservative risk profile when structuring and originating loans, focusing on clients' credit quality at the present time and through the shipping cycle while at the same time ensuring adequate diversification on countries and vessel types. Thus, clients' financial standing and robustness, market position, track record in stressed markets, and reputation are criteria when assessing loan requests.

In addition, the composition of clients in the loan book must be adequately diversified. The diversification rule is related to the objectives clause in the Articles of Association of DSF:

"The objective of the company is to provide ship financing in Denmark. In addition, the company may provide ship financing in the international market if such activities do not unnecessarily limit the company's Danish operations"

In respect of financing as defined in the second sentence of the objects clause, credit exposure to a non-Danish client may not, as set out above, at a consolidated group level, exceed 25% of our eligible capital.

Five largest credit exposures before loan impairment charges, DSF

DKK MILLION	2019	2018
Five largest credit exposures	13,678	13,757
Loans and guarantees	41,440	39,591

At year-end 2019, the five largest credit exposures were secured by mortgages on 122 vessels comprising 10 vessel types.

Credit exposure to one client is substantially larger than the rest and represented approximately 20% of the loan book at year-end 2019. It is the only client where the aggregated exposure exceeds 25% of the eligible capital. This credit exposure was secured by mortgages on 53 vessels broken down by three different vessel types representing Container Liners, Product Tankers and Offshore Units.

LOAN-TO-VALUE

We grant loans with an initial loan-to-value (LTV) of up to 70%, subject to a 1st priority mortgage on the financed vessel(s).

We may, on certain conditions, grant loans above the 70% LTV limit against supplementary collateral and/or subject to an additional capital charge. The additional capital charge is maximised to an amount in DKK determined on the date of the granting of the loan or at disbursement of the loan at the latest.

The additional capital charge takes the form of a deduction from our Tier 1 capital. The deduction equals the part of the loan that exceeds 70% of the value of the mortgaged vessel(s) at the time of calculation, but not exceeding the maximum defined.

We have not granted loans with an initial LTV exceeding 70% for a number of years.

Loans held in Capital Centre A are subject to a maximum LTV of 60% after taking into account any additional collateral posted towards bondholders.

In 2019, we did not grant any loans for the financing of clients' payment of instalments to shipyards.

The loan book after loan impairment charges was on average secured by mortgages within 51% of the market valuation of vessels.

LOAN DOCUMENTATION

The lending operations involve the use of extensive loan and security documentation. The purpose of the loan documentation is to set out the contractual terms of the loan and the rights and obligations of both parties.

In the event that a client defaults on its representations, warranties or undertakings (payment or otherwise) and work-out proceedings are failing, the loan documentation provides for legal remedies whereby we can reduce our exposure to the client.

Ultimately, in the event that the client defaults on its payment obligations pursuant to the loan documentation and such default is continuing, the first priority ship mortgage gives us the right to apply for the issue of a warrant of arrest by way of levy of execution against the mortgaged vessel with the local enforcement court. The execution lien gives us the right to apply for a forced sale of the mortgaged vessel with the enforcement court or in a private sale, if permitted pursuant to the relevant arrest jurisdiction and apply the auction/sales proceeds against the defaulted loan. Such enforcement action takes time and is costly. The use will vary depending on the choice of arrest jurisdiction.

The majority of our loan and security documentation use 'one-sided exclusive jurisdictions clauses', which allows us to take up proceedings against the client in any court of competent jurisdiction to ensure that any legal disputes are resolved in an orderly fashion and in a jurisdiction favourable to us.

We have granted a number of loans to shipowners together with other lenders. In these transactions standard Loan Market Association documentation is typically applied in adapted form.

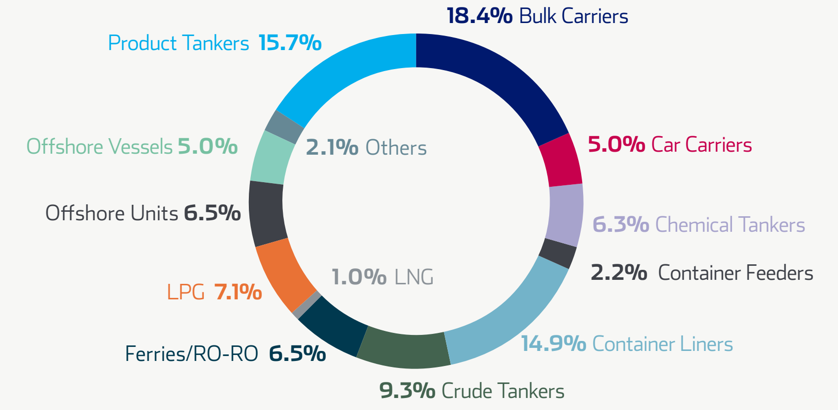
RISK MITIGATION

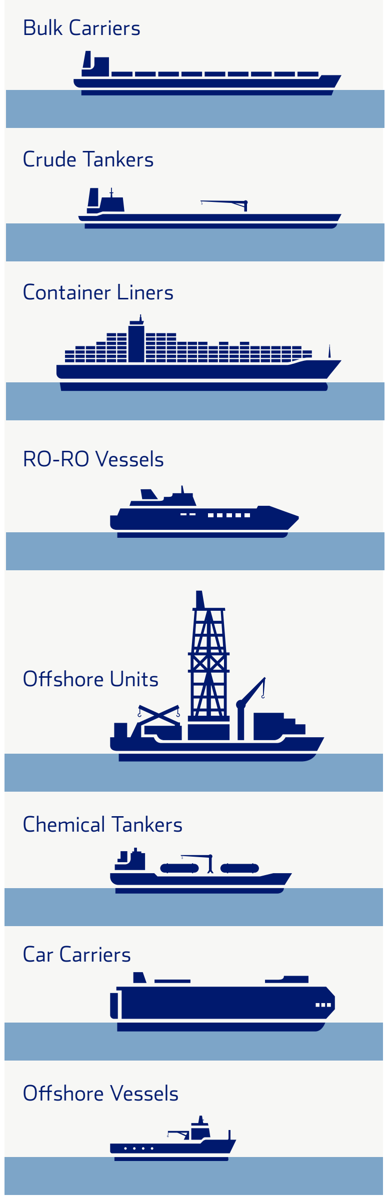
In addition to 1st priority mortgages on the financed vessels and assignment of each vessel's primary insurances, the composition of the loan book adheres to a set of diversification rules. The purpose of the diversification rules is to ensure adequate diversification by client, as outlined above, vessel type and country risk.

VESSEL TYPE DIVERSIFICATION

Adequate loan book diversification must be in place regarding vessel type. No single vessel type may be provided as security for more than 50% of our gross lending. Within each vessel type, no segment may be the basis for as security amounting to more than 33% of our gross loan book.

Loan book broken down by mortgaged vessel type at 31.12.2019



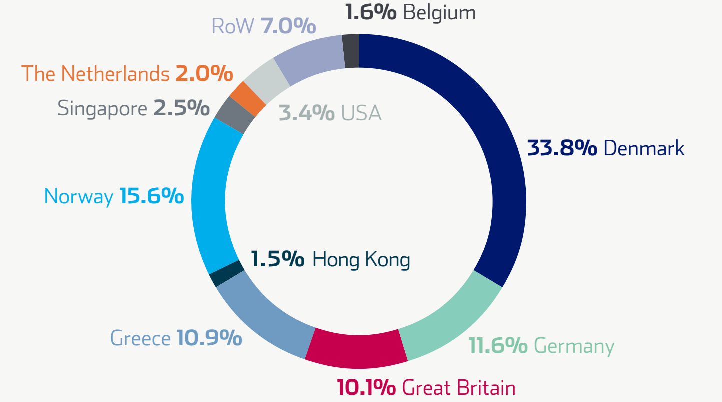


COUNTRY RISK DIVERSIFICATION

The loan book must be adequately diversified by country. In keeping with the Regulatory Technical Standards (RTS) on the method for the identification of the geographical location of the relevant obligor, the clients' operational head office or, in case of guarantees, the guarantor's home country.

As proceedings against a client could be dependent on the legal registration of the client, the latter is also monitored. Lending to clients in most EU countries, Norway, Switzerland and the US is not subject to any restrictions, but for lending to clients in other countries, the Group has set an overall limit per country of up to 25% of the loan book.

Debtor distribution by Operational Head Office at 31.12.2019



MITIGATION OF COLLATERAL RISK ON MORTGAGED VESSELS

Market value of mortgaged vessels

We obtain a valuation on each vessel semi-annually. The valuation is generally carried out by an external broker, which determines a price for the financed vessels based on supply and demand. We may in some cases assess the value itself, based on, for example, a specific independent market price or external valuations of similar vessels.

Among other things, market valuations of vessels are used to determine the LTV ratios on loans and for control purposes when reassessing the collateral value of mortgaged vessels (after haircuts) as part of our semi-annual loan impairment review. The valuations are also applied to monitor compliance with the 60% LTV limit in Capital Centre A.

Inspection of mortgaged vessels

As a supplement to the semi-annual market valuations, physical inspections of the financed vessels are made on a spot-check basis. An inspection may be performed both during the loan maturity period or prior to a loan offer being submitted.

Insurance of mortgaged vessels

All vessels mortgaged as security for a credit exposure must be insured. Insurances are taken out by the client and assigned to us.

Generally, the following primary insurances are required:

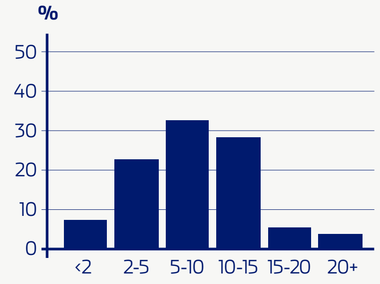
- Hull and machinery insurance, which covers damage to or total loss of the vessel.
- P&I (protection & indemnity) insurance, which covers oil pollution caused by the financed vessel and damage to equipment and injuries of seamen. This insurance is also a third-party liability insurance covering collision with another vessel.
- War risk insurance, which covers damage to the vessel, potential total loss and retention, etc. caused by war or war-like conditions.

In addition, most credit exposures are covered by a mortgagees' interest insurance and mortgagee additional perils pollution insurance. These insurances cover our risks in various situations where the primary insurances are not valid, for example if the vessel was not seaworthy at the time of the claim.

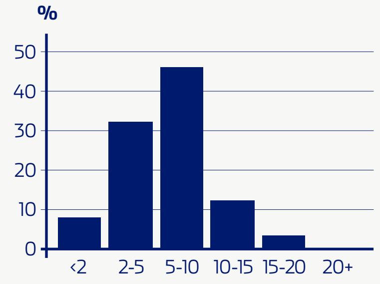
Age distribution of mortgaged vessels

The following charts display the age distribution of all mortgaged vessels as well as the age distribution of the largest vessel types in the current loan book.

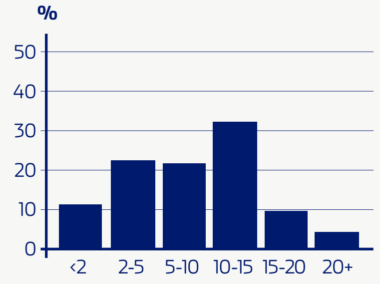
Age distribution of total ship portfolio



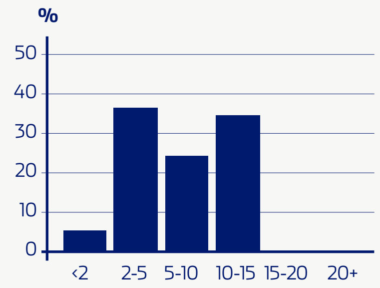
Bulk Carriers



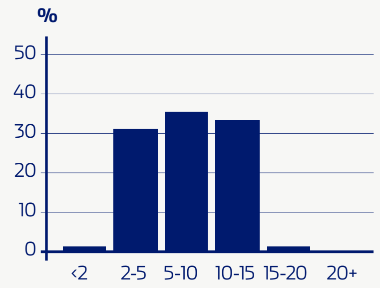
Chemical Tankers/ Crude Tankers/ Product Tankers



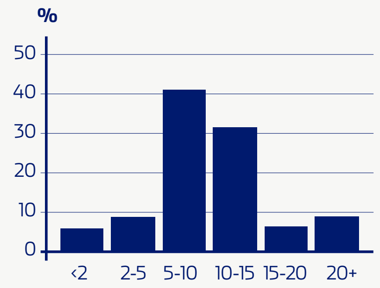
Container Liners



LPG



Others



LOAN BOOK DEVELOPMENTS

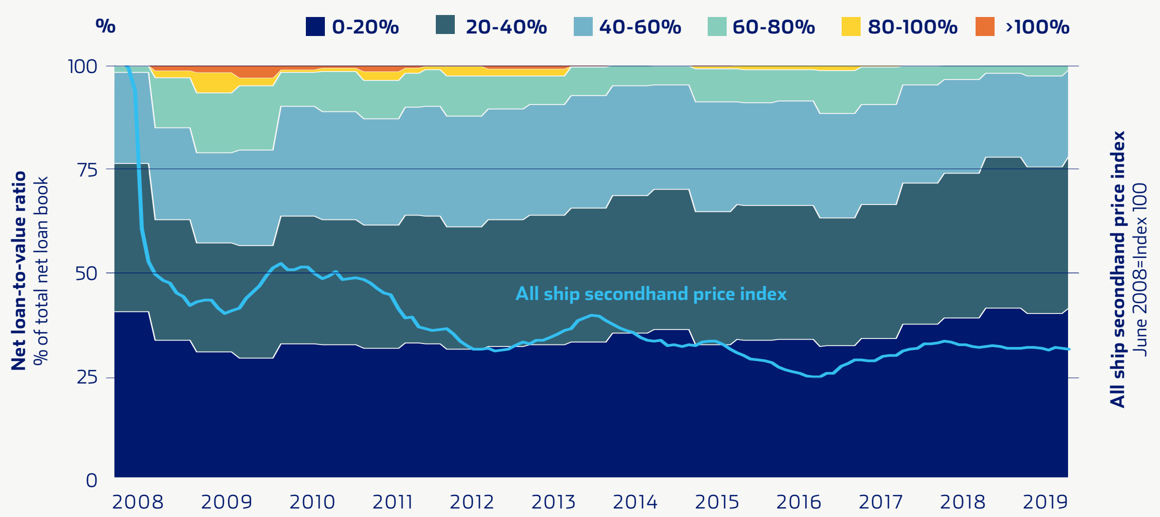
At 31 December 2019, the loan book comprised total loans and guarantees of DKK 41,440 million compared to DKK 39,591 million the year before.

The table below shows the loan book after loan impairment charges, broken down by LTV intervals.

LTV interval

%	2019	2018
0-20	41	41
20-40	37	37
40-60	21	20
60-80	1	2
80-90	-	-
90-100	-	-
Over 100	-	-

Loan-to-value ratio vs price index for all vessel types



Sources: Clarksons, Danish Ship Finance

99% of the loan book after loan impairment charges was secured by mortgages within 60% of the market valuation of vessels at year-end 2019.

The chart illustrates how market value clauses stabilise our portfolio loan-to-values even under significant changes in market values of vessels.

It is noteworthy that even major declines in vessel prices have not adversely affected the collateral coverage of the loan book. This is due to the positive effect of regular loan repayments and the benefit of minimum value clauses (MVC) in a significant number of loan agreements, i.e. the right for DSF to demand partial prepayment and/or additional collateral, if the market value of the mortgaged vessels fall below an agreed threshold.

The LTV intervals are shown together with the developments in vessel prices based on a price index for all vessel types (the solid line).

COLLATERAL VALUE OF MORTGAGED VESSELS (AFTER HAIRCUTS)

We have prudent methodologies in place for calculating the expected minimum realisation value of a vessel after costs in a low market (Sx Value).

The Sx value is calculated by discounting the expected earnings per day in a low market for each of the relevant vessel types. The calculation is based on fixed low earnings throughout the estimated residual life of the vessel and an expected sale of the vessel within 12 months. The interest rate originally agreed on the loan is used as the discount rate. Estimated selling costs are deducted from the value.

The estimated earnings per day of a mortgaged vessel are expected to gradually fall throughout the residual life of the vessel due to increasing maintenance costs and decreasing operational performance etc. The value of earnings per day in a low market is thus adjusted over the estimated life time.

This method for calculating the collateral value of the mortgaged vessels resulted in an average haircut of approximately 45% to the current market value (ranging from 30% to 60% depending on the vessel type) at year-end 2019. The method is monitored on an ongoing basis and is recalibrated when deemed necessary.

A client's unsecured credit exposure is calculated as the total credit exposure less (i) the Sx value of mortgaged vessel(s) and (ii) the value of any other collateral. Any such positive amount is applied in the calculation of loan impairment charges.

NON-PERFORMING LOANS

Non-performing loans (NPL) encompass all credit impaired and defaulted loans. This includes loans for which no loan impairment charges have been recognised, which may be the case when Sx exceeds the total credit exposure.

At 31 December 2019, gross NPL amounted to DKK 4,249 million, down from DKK 5,372 million the year before. NPL after deductions of loan impairment charges (Net NPL) are down from DKK 3,133 million at year-end 2018 to DKK 2,471 million at year-end 2019. The development in key NPL figures are displayed below.

A loan is in default if the client is subject to one of the following events, and hence is assigned an internal rating of 12:

- Bankruptcy or another in-court restructuring
- Arrears/past due for 90 days or more, unless the problem is short term and the amount concerned is limited in comparison to the clients' financial situation, or if this is due to errors or technical problems.
- A loss is deemed inevitable
- Non-accrual interest
- Foreclosure

Non-performing loans

DKK MILLION	Loan book	NPL	NPL ratio (%)	Net NPL	Net NPL ratio (%)
2019	41,440	4,249	10.3	2,471	6.3
2018	39,591	5,372	13.6	3,133	8.4

A loan is considered credit impaired if one of the following events occurs, and hence is assigned an internal rating of 11:

- The client is experiencing significant financial difficulty
- The credit exposure has lenient repayment terms, which could include forbearance measures, which we, for reasons relating to the financial difficulty, would not otherwise have granted

As part of a large legislative package aiming to reduce the amount of non-performing loans on the balance sheets across the European banking sector, an amendment to the CRR was agreed upon and implemented in April 2019 by the European parliament and the European commission.

The amendment will take effect from mid-2021.

Forbearance measures

We focus on having a credit risk management framework that ensures consistency between the credit risk profile, credit risk appetite and current legislation, and on having a robust capital structure. Risk management should ensure financial solutions that are viable in the short, medium and long term.

Forbearance plans may be adopted to assist clients in temporary financial difficulty. Given the cyclical nature of shipping, temporary forbearance measures are common in ship finance.

Concessions granted to clients include temporary partial payment deferrals, interest-only schedules and term extensions. Forbearance plans are granted solely in accordance with the credit policy with the aim of reducing the long-term risk of credit losses. At 31 December 2019, forbearance measures have been granted on a limited number of loans.

Loan impairment charges

Loan impairment charges are made subject to the International Financial Reporting Standard 9 (IFRS 9) which provides rules for classification and impairment of financial assets, including loans.

We comply with the Executive Order on Financial Reports, according to which the IFRS 9 principles, particularly Annex 10, have been implemented

This includes stage recognition of all loans in Stage 1, 2 and 3 and provides the overall rules and guidelines for calculating loan impairment charges for expected credit losses (ECL), based on a forward-looking approach.

We recognise 12-months ECL on initial recognition of loans. If a loan is subject to either significantly increased credit risk, significant signs of weakness or credit impairment since initial recognition, lifetime ECL are recognised.

Semi-annually, all credit exposures are reviewed in order to reassess the applicable stage of loans and the size of loan impairment charges. In addition, defaulted credit exposures are reviewed for partial or full write-off if a loan loss is considered unavoidable.

As part of this process and when obtaining new relevant information, it is evaluated whether the existing internal rating still provides the best estimate of the credit risk of the client and the loan. Where this is considered not to be the case, the client and the loan is reclassified accordingly.

Individual loan impairment charges are made based on the our ECL impairment model. The size of ECL for individual credit exposures is based on calculation of ECL as described below. In a few situations where the ECL impairment model is believed to either overestimate or underestimate ECL, an adjustment will be made based on a management judgement.

Loan impairment charges for 2019 amounted to an income of DKK 2 million compared to an expense of DKK 35 million the year before.

Stage recognition

All our credit exposures are subject to stage recognition in stage 1, 2 or 3 described in the following sectio based on the principles set out in the below table. The subsequent calculation of loan impairment charges in the form of ECL includes, depending on the stage of the loan in question, either the 12 months probability of default (PD) or the lifetime PD.

Loans in arrears/past-due for 30 days or more (but less than 90 days) are generally showing significant signs of weakness, and they are classified as stage 2 for calculating ECL. Loans in arrears/past-due for 90 days or more are in default, and they are classified as stage 3 for the purpose of calculating ECL.

Stage recognition, PD & ECL

Stage	Recognition	ECL
Stage 1	No increase in credit risk since initial recognition	12-months PD
Stage 2	The credit risk has increased significantly since initial recognition and/or loans are showing significant signs of weakness	Lifetime PD
Stage 3	Credit impaired and/or defaulted loans (NPL)	Lifetime PD

The development in the internal rating since initial recognition and the related stage development is monitored using a stage migration matrix. The actual stage depends on the state of the established credit risk.

Our stage migration matrix in which the internal rating determined by DSF is mapped to the credit risk rating determined by the FSA and external ratings determined by the external credit rating agencies can be found in Annex 11.

DANISH SHIP FINANCE

Rating scale mapping

Rating Scale		
	External rating	
DSF Rating	Standard & Poor´s	Danish FSA
1 2	AAA/AA A	3
3 4 5 6	BBB BB	2A
7 8	B	2B
9 10	CCC	2C
11 12	CC-C D	1

If the internal rating is 1 to 4 based on the mapping described in Annex 11, the client or financial counterparty is considered to have low credit risk, as such rating is equivalent to an investment grade rating from external credit rating agencies.

ECL impairment model

ECL is calculated as a function of PD, exposure at default (EAD) and loss given default (LGD), adjusted for forward-looking information using a macroeconomic factor (MEF) for each shipping segment.

ECL = PD * EAD * LGD * MEF

Scenario testing is involved as part of the ECL calculation, including MEF, which is based on the following scenarios:

- Base Case Scenario
- Worst Case Scenario
- Best Case Scenario

Below, the calculation of MEF is described in more detail.

Macroeconomic factor

MEF, which is used as a parameter in the calculation of ECL, is based on a semi-annual internal assessment.

The model consists of eight market indicators, which are considered for each vessel type.

Scenario testing is made based on three scenarios, the probability and a MEF effect. Based on this a score of 0-1 per market indicator is provided and accumulated, with an aggregate score close to eight indicating elevated risk.

For each client the PD is adjusted for the MEF in order to reflect the outlook for the segment to which the client is primarily exposed. The PD for each client can thus be below, at or above the standard PD.

Write-offs

A credit exposure is written-off, in whole or in part, when we have exhausted all practical recovery and restructuring efforts and has concluded that there is no reasonable expectation of full recovery. A corresponding amount is then written-off.

Indications that there is no reasonable expectation of full recovery include:

- Ceasing of enforcement activity
- The value of the collateral is such that there are no reasonable expectations of recovering the loan in full

We may write-off credit exposures that are still subject to enforcement activity. Amounts which are legally owed in full, but which have been partially written off, are still subject to full recovery initiatives.

Net write-offs amounted to DKK 485 million in 2019 compared to DKK 252 million in 2018. Write-offs are well within existing impairments made in earlier years, yet is elevated relative to previous years.

Total allowance account

The total allowance account amounted to DKK 2,035 million at 31 December 2019, down from DKK 2,514 million the year before.

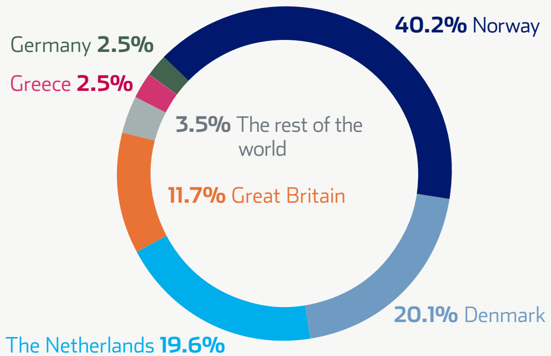
The following table display key figures related to the total allowance account:

Key figures

DKK MILLION	Gross loan book (year-end)	Total allowance account (year-end)	Net write-offs for the year	Loan impairment charges for the year (bps)
2019	41,440	2,035	485	0
2018	39,591	2,514	252	9

At 31 December 2019, the geographical distribution of the total allowance account was as displayed below:

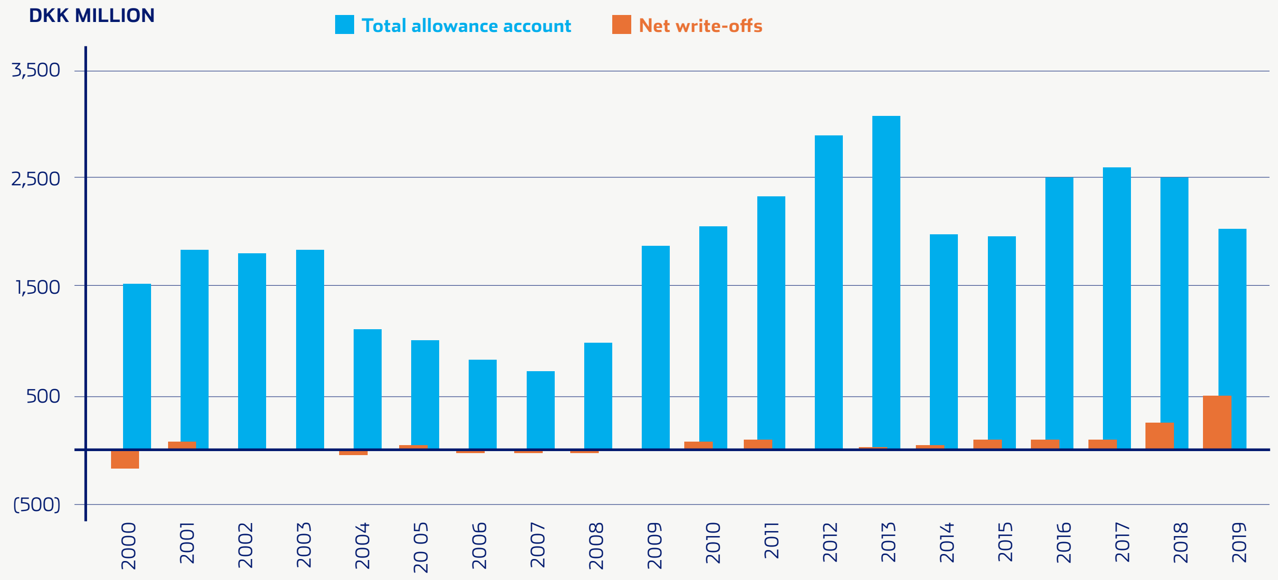
Geographical distribution of total allowance account at 31.12.2019



The development in the total allowance account and net write-offs for the period 2000 to 2019 is displayed in the below chart:

The 20-year average annual net write-offs amounted to 14 bps of the average loan book.

Total allowance account and net write-offs



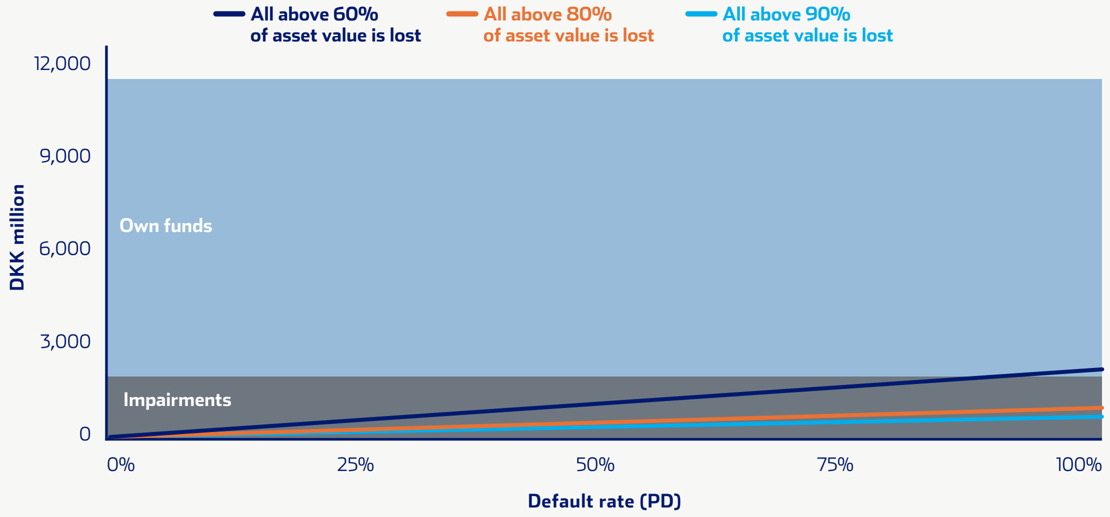
Loan losses at given default rates

The graph below illustrates our strong ability to absorb loan losses in the rather unlikely scenario where all or a certain percentage of the clients default, and the mortgaged vessels are subsequently sold.

In the extreme event of all clients defaulting, the loan impairment charges alone are almost sufficient to cover shortfalls, if the mortgaged vessels are sold with haircuts of 40% to current market values.

Loan losses at given default rates

DKK MILLION / %



Development in the total allowance account

DKK MILLION	Clients 2019	Clients 2018	Financial counterparties 2019	Financial counterparties 2018
Individual loan impairment charges				
Individual loan impairment charges at 1 January	2,514	2,380	-	-
Collective loan Impairment charges at 1 January	-	211	-	-
Initial impact at 1 January 2018 (IFRS 9)	-	132	-	-
New Loan impairment charges/loss allowances during the year	581	699	-	-
Reversal of loan impairment charges made in previous years	(575)	(610)	-	-
Gross write-offs debited to the allowance account	(486)	(298)	-	-
Total allowance account at 31 December	2,034	2,514	-	-

DANISH SHIP FINANCE

FINANCIAL COUNTERPARTIES

Credit exposure to financial counterparties, which may be credit institutions, export guarantee agencies and insurance companies, is entered into according to the counterparty risk policy. The policy sets out criteria, including that financial counterparties shall have an investment grade rating from recognised ECAIs (see section 5.12).

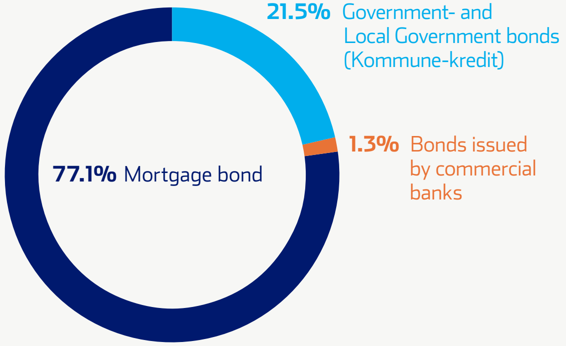
The counterparty risk policy quantifies and defines the principles for credit exposure to be granted to individual financial counterparties. The counterparty risk policy is also used in the management of market risk and liquidity risk and sets out limits to be made available to financial counterparties.

Furthermore, we endeavor to ensure that financial counterparties are global systemically important banks (G-SIB) or systemically important financial institution (SIFI).

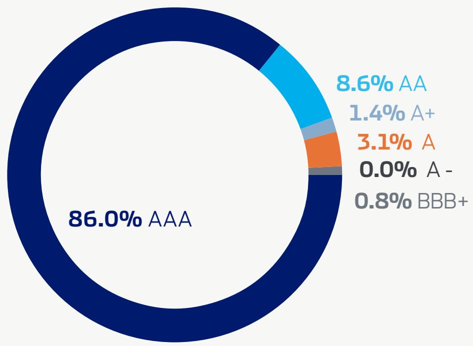
We carry out transactions, such as purchase of securities, with financial counterparties when investing our own funds or temporary excess liquidity from bond issuances.

Our securities portfolio, comprising high-grade government and mortgage bonds, and occasionally money market deposits and interest-sensitive financial instruments, represents a significant share of our assets.

Distribution of securities portfolio



Exposure on financial counterparties by credit rating



Contractual framework

A financial contract may entail risk of loss if it has a positive market value and the financial counterparty cannot perform its part of the contract. This type of risk also includes settlement risk.

The contractual framework for transactions with financial counterparties is based primarily on market standards such as ISDA and ICMA agreements, which allow netting in the event of default of the financial counterparty. Furthermore, we have agreements on market-value adjustments or collateral (CSAs) for derivatives trading with various financial counterparties.

We are subject to the European regulation on OTC derivatives, central counterparties and trade repositories (known as EMIR). EMIR stipulates an obligation to clear certain types of derivatives via a central counterparty. This obligation applies to financial counterparties and non-financial counterparties that exceed the clearing threshold.

EMIR defines financial counterparties as credit institutions approved pursuant to the Credit Institutions Directive. We are exempt from this directive and characterised as a non-financial counterparty (NFC). Non-financial counterparties only have a central clearing obligation if they exceed certain threshold trading volumes. As our trading volumes do not exceed these clearing thresholds, we are not under an obligation to perform central clearing.

Ongoing monitoring

The credit exposure to financial counterparties are continuously monitored to ensure that the financial counterparty consistently complies with our requirements and to ensure compliance with approved lines. The ongoing monitoring is carried out independently of the executing entities.

DANISH SHIP FINANCE

EXTERNAL CREDIT ASSESSMENT (ECAI)

We use Standard & Poor's Global Ratings (S&P) as our external credit assessment institution (ECAI).

The credit rating categories used by S&P are converted into credit quality steps by using the FSA's conversion table. To calculate the risk-weighted exposure amounts under the standardised approach for credit risk, each credit quality step is designated a risk weight to be used for the exposures at each credit quality step.

The table below shows the FSA's conversion of S&P's credit rating categories to credit quality steps for exposures to corporates, institutions, central governments and central banks.

Credit quality step	S&P's credit rating category	Exposures to corporates	Exposures to institutions with terms to maturity › three months	Exposures to central governments or central banks
1	AAA to AA-	20%	20%	0%
2	A+ to A-	50%	50%	20%
3	BBB+ to BBB-	100%	50%	50%
4	BB+ to BB-	100%	100%	100%
5	B+ to B-	150%	100%	100%
6	CCC+ and below	150%	150%	150%

Exposure classes using S&P credit assessments

Exposure class DKK MILLION	**Group** Exposure (unweighted)	**DSF** Exposure (unweighted)
Exposures to central governments or central banks	82	49
Exposures to public sector entities	-	-
Exposures to regional governments or local authorities	-	-
Exposures to institutions	2,271	2,181
Exposures to corporates	40,262	40,006
Exposures in the form of covered bonds and mortgage bonds	5,936	5,936
Exposures in default	2,451	2,451
Exposures associated with particularly high risk	-	-
Exposures to institutions and corporates with a short-term credit assessment	-	-
Exposures in the form of units or shares in collective investment undertakings (CIUs)	-	-
Equity exposures	-	-
Other items	349	349
Total	**51,351**	**50,972**

MARKET RISK MANAGEMENT

MARKET RISK MANAGEMENT

Market Risk is the risk of loss as a result of movements in financial markets and includes interest rates, yield spreads, foreign exchange, equity and volatility risks etc.

The main market risks we face are interest rate and yield spreads associated with the securities portfolio, as bond issuances and lending are subject to restrictions on interest rate, foreign exchange and liquidity risk between the bond issues (funding) and the loans under the Danish balance principle.

Our Treasury department has day-to-day responsibility for trading within the limits laid down in the market risk policy. Responsibility for the monitoring and reporting of adherence to the limits on market risk lies with the Risk Management department. Market risk is monitored daily and is reported to the Board of Directors quarterly. If the limits defined in the market risk policy are breached, the Executive Board must be informed immediately and the Board of Directors not later than at the next board meeting.

The market risk policy contains specific guidelines for the ongoing management of risks relating to changes in financial risk factors. The policy lays down clear and measurable limits on, inter alia, interest rate and foreign exchange risks, building on the Bond Executive Order and other provisions. Our market risk limits are typically more stringent than external regulatory requirements.

INTEREST RATE RISK

Interest rate risk is the risk that we will incur a loss due to a change in interest rates. Rising interest rates have an adverse impact on the market value of the securities bond portfolio.

We manage the interest rate risk between funding and lending below the applicable threshold by applying conservative principles, but a small loss or gain may arise due to changes in interest rates.

Due to the balance principle, we have only moderate exposure to interest rate risk outside the trading book. At 31 December 2019, the interest rate exposure outside the trading book was calculated at DKK 37 million, against DKK 79 million in 2018.

The Bond Executive Order also stipulates that the interest rate risk on assets, liabilities and off-balance sheet items must not exceed 8% of own funds. Using the FSA guidelines for calculating interest rate risk in the trading book, the interest rate exposure was DKK 135 million at 31 December 2019, corresponding to 1.5% of own funds, against DKK 122 million in 2018.

Furthermore, the interest rate risk is adjusted using a minimum and a maximum for the option-adjusted duration. The maximum option-adjusted duration of the securities portfolio, including financial instruments, is currently restricted to four years. The option-adjusted duration was calculated at approximately 0.7 years at 31 December 2019.

LIBOR

The Financial Conduct Authority has announced, that the interest benchmark LIBOR is expected to cease after end-2021. Other IBORs are, in the same context, expected to be replaced too.

We closely monitor the LIBOR transition to alternative relevant risk-free rates and will continuously track and incorporate market developments and standards to be prepared for the LIBOR transition.

Due to our business profile, we are exposed to IBORs through our cash products in our loan book, our bonds and derivatives. In this context, our greatest risk is, that the current close interaction between these components will come to an end. In this event, we will follow the proposals and recommendations from the Loan Market Association, ISDA, other market relevant working groups and participants.

CREDIT SPREAD RISK

Credit spread risk arises from changing spreads between individual bonds and typically Danish covered bonds near-risk-free interest rates due to difference in credit quality or imbalance between supply and demand.

The credit spread risk in the trading book was calculated at DKK 397 million at 31 December 2019, against DKK 378 million in December 2018.

FOREIGN EXCHANGE RISK

The market risk policy does not allow foreign exchange risk of principal amounts in capital centres arising from a mismatch between funding and lending. However, foreign exchange risk does exist related to net earnings which are typically in USD. Also minor foreign exchange risks are allowed in the investment portfolio.

Exchange rate indicator 1 at 31 December 2019: DKK 253 million, equal to 2.8% of own funds. Exchange rate indicator 1 corresponds to the Group's total net exposure to foreign currency in total balance sheet items, calculated according to the FSA guidelines.

EQUITY RISK

Apart from small holdings of sector shares and shares received in connection with the reconstruction of credit exposures, we have no equity interests in other companies.

DERIVATIVES

We use derivatives according to the market risk policy which specifies the types of derivatives we may use and for what purposes. Financial instruments may be applied to hedge risks between funding and lending and related to investment activities.

LIQUIDITY RISK MANAGEMENT

LIQUIDITY RISK MANAGEMENT

Liquidity risk is the risk of a loss arising from the inability to meet immediate and short-term payment obligations.

The purpose of our liquidity management framework is to ensure that we are consistently able to meet our payment obligations when due. Liquidity management is carried out to avoid a lack of funding preventing us from meeting our obligations, or from supporting planned lending activities, and to ensure that our funding costs do not become disproportionately high.

Liquidity risk is managed in currency, subject to strict limits and stress tests. The liquidity risk policy determines our overall liquidity risks and funding structure. It contains specific guidelines for the ongoing management.

BALANCE PRINCIPLE

The specific balance principle laid out in the Bond Executive Order, permits a future liquidity deficit between issued bonds and loans provided of up to 100% of own funds.

A deficit occurs if future payments related to bonds issued by Danish Ship Finance, other funding and financial instruments exceed future incoming payments on loans, financial instruments and positions.

In our internal policies, we have defined stricter requirements for any liquidity deficits between issued bonds and loans provided. We pre-fund all loan commitments well in advance of disbursement.

Funds from pre-funding or repayment on ship mortgages is placed in secure and liquid securities or as short-term money market deposits with credit institutions which qualify for credit quality step II or better.

FUNDING

Our main activity is match-funded mortgage lending on ships subject to the specific balance principle. The mortgage lending is funded through the issuance of covered bonds (SDO) and ship mortgage bonds on Nasdaq Copenhagen, and we are thus part of the OTC market.

Bonds are typically issued in DKK and EUR, whereas most of the loans issued are typically disbursed in USD. We source USD via basis swaps.

The opportunities for sourcing USD liquidity rely on an efficient capital market. Our ability to convert DKK or EUR funding into USD entails a risk of higher financing costs or a loss of business opportunities in the event of market disruption.

The liquidity policy set limits for USD liquidity requirements over time.

ENCUMBERED ASSETS

The funding and lending activities are ringfenced according to law to ensure timely payments to bond investor even without the initial ressources available. Due to this set-up the ringfenced assets are subject to encumbrance, cf. the European Banking Authority's (EBA) guidelines on disclosure of encumbered and unencumbered assets.

Apart from ringfenced assets the primary sources of asset encumbrance are; Supplementary collateral under Capital Centre A and collateral under CSA-agreements. Total encumbered assets account for 85.1% of total assets plus collateral received that may be subject to encumbrance.

The information disclosed on encumbered assets and collateral received is based on data at 31 December 2019 rather than median values for 2019. Encumbered assets are specified in Annex 7.

According to the Regulatory Technical Standards on disclosure of encumbered and unencumbered assets issued by the EBA in March 2017, credit institutions with less than EUR 30,000 million total assets or an encumbrance level below 15% are exempt from the disclosure requirements for high quality liquid assets (HQLA) and extremely high-quality liquid assets (EHQLA), and thus these are not specified in Annex 7.

MANAGEMENT, MONITORING AND REPORTING

Our liquidity management is anchored in the Internal Liquidity Adequacy Assessment Process (ILAAP), which is a review aimed at identifying liquidity risk exposures and determining liquidity targets.

STRESS TESTING

According to EBAs guidelines on institutions stress testing we have developed a stress test program. As a part of the program a liquidity stress test is performed to ensure that there is enough liquidity to maintain the business model and meet the obligations under the balance principle.

The liquidity stress test identifies the resilience of the short-term liquidity position in a stressed scenario where we have no access to usual funding sources. The liquidity stress test focuses on the shock effects of several interrelated risk factors, such as USD exchange rate, interest rates, credit spreads and write-downs on loans.

The results of the liquidity stress test shall be used to manage and adjust internal limits.

CONTINGENCY PLANS

In accordance with the Executive Order on Governance for Credit Institutions, we have prepared a liquidity contingency plan, containing a catalogue of possible initiatives with which to strengthen the liquidity position in a critical situation.

The liquidity contingency plan takes effect when predefined triggers are activated.

DANISH SHIP FINANCE

LIQUIDITY RISK PROFILE

Through bond issues and the existence of a liquid portfolio of bonds, we ensure enough liquidity coverage for all existing loans and loan offers until expiry. We are therefore not directly exposed to refinancing risk.

A potential downgrade of our external rating would not change the robust liquidity situation but could lead to higher funding costs for new loans not yet offered.

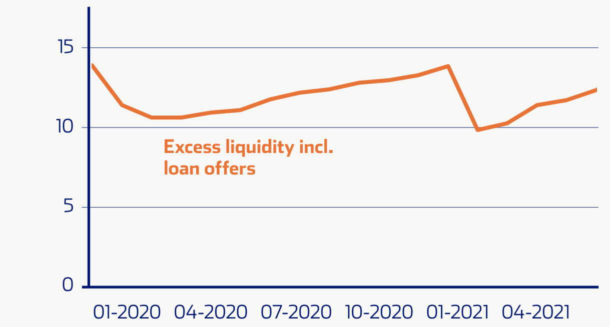
The charts below show for each capital center:

- Short-term excess liquidity including the market value of the securities portfolio.
- Liquidity mismatch between funding and lending.

Refinancing risk is limited as the average maturity of issued bonds exceeds the average maturity of loans outstanding.

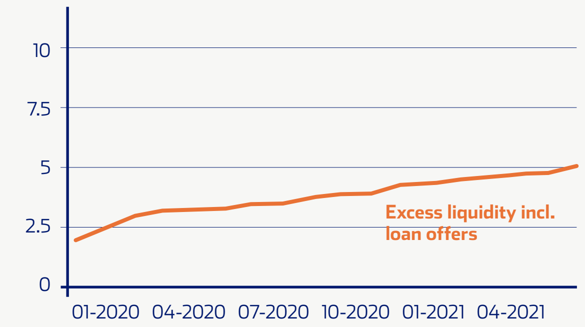
Short term liquidity in Capital Centre Institute in General

DKK BILLION



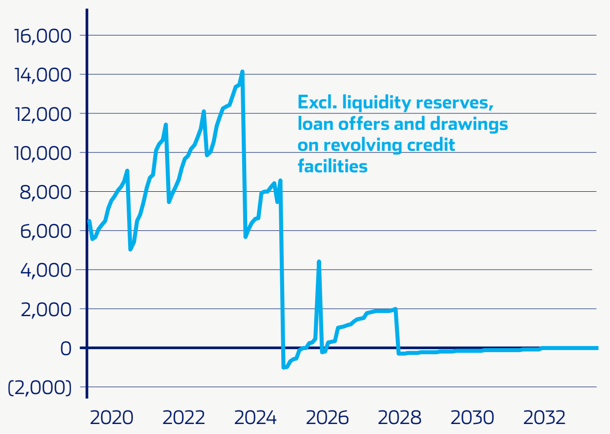
Short term liquidity in Capital Centre A

DKK BILLION



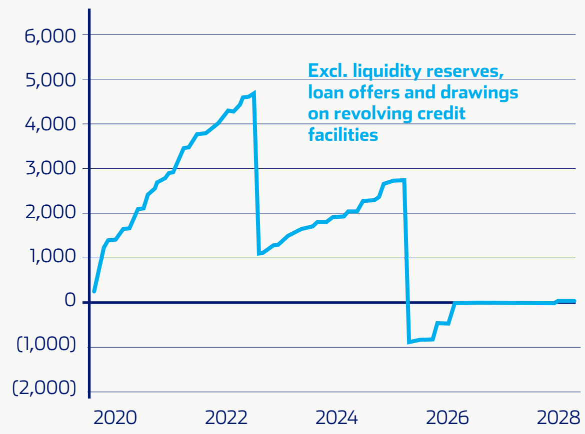
Liquidity mismatch between funding and Capital Centre Institute in General

DKK MILLION



Liquidity mismatch between funding and Capital Centre A

DKK MILLION



LIQUIDITY COVERAGE RATIO (LCR)

According to the CRR, liquidity is required to ensure that a credit institution has an adequate unencumbered High Quality Liquid Assets (HQLA) that consists of cash or assets that can be converted into cash at little or no loss of value in private markets, to meet its liquidity needs for a 30 calendar day liquidity stress scenario.

$$\text{Liquidity coverage ratio} = \frac{\text{HQLA}}{\text{Net liquidity outflow over a 30 day stress period}} \geq 100\%$$

The LCR at 31 December 2019 was 724%.

The securities portfolio represents a significant share of the liquid assets. The securities portfolio comprises government and mortgage bonds, money market transactions and interest sensitive financial instruments.

Annex 12 provides a more detailed description of LCR.

NET STABLE FUNDING RATIO (NSFR)

The purpose of the NSFR requirement is to ensure that the institutions use stable medium and long-term funding to support their lending operation and to ensure an appropriate liquidity level over a year.

$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

We maintain a high and stable NSFR level.

NSFR per 31 December 2019 was 152%.

OPERATIONAL RISK MANAGEMENT

DANISH SHIP FINANCE

OPERATIONAL RISK

Our operational risk policy stipulates that operational risks should be kept low. Operational risks are assessed on the basis of the expected probability of a given event occurring and the potential loss resulting from such event.

Given its nature and characteristics, operational risk is best mitigated and managed as part of the day-to-day business conduct. The responsibility for the day-to-day management of operational risks is decentralised and lies with the individual business areas. Operational risk management activities are coordinated by Risk Management to ensure coherence, consistency and effectiveness across the Group.

It is our policy to promote a culture where openness about and awareness of operational risk are natural elements of the everyday work of all staff members, and to ensure that the Executive Board and the Board of Directors are briefed regularly on key risk areas.

As part of operational risk management, operational risk events are systematically recorded, categorised and reported. Operational errors are divided into three main groups by value;

- Small errors (<DKK 25,000)
- Medium-sized errors (DKK 25,000 – DKK 5 million)
- Large errors (>DKK 5 million)

Errors can be upgraded to a more severe category by management judgement. We make regular use of this option.

Small errors are reported to the relevant head of department. Medium-sized and large errors are reported to the Executive Board, and the Board of Directors shall be notified of large errors.

The recording of operational risk events must include information about the type of product, process and risk concerned and plan action for more severe events.

COMPLIANCE

Operational risk includes compliance risk, which is subject to separate guidelines. This area is managed by the Compliance function headed by the Head of Compliance. Compliance risk is reported to the Board of Directors and the Executive Board.

The compliance function is an independent function which serves to assess and report on any non-compliance with applicable legislation, practice and market standards in the Group. This helps mitigate the risk of sanctions being imposed on the Group, a risk of loss of reputation or that the Group or its clients suffer material financial losses.

The compliance function applies a risk-based approach to identifying areas to review.

MONEY-LAUNDERING RISK

In relation to anti-money laundering (AML), we have laid down specific policies, business procedures and controls, and client transactions are monitored on a continuous basis. Furthermore, extensive efforts have been made to ensure compliance with requirements pertaining proof of client identity and the quality thereof. The prevention of money-laundering and terrorist financing is a high-priority area.

The AML function is charged with ensuring that we comply with the Danish Act on Measures to Prevent Money Laundering and Financing of Terrorism, EU Funds Transfer Regulation and EU anti-terrorism regulations. The AML function is anchored in the Legal & Compliance Department and reports directly to the Executive Board and Board of Directors.

IT SECURITY

Information and information systems are vital, and IT security is therefore essential to our credibility and continued existence. The IT security function reports to the Executive Board and Board of Directors, who regularly reviews the IT security measures.

DANISH SHIP FINANCE

The work of the IT security function is based on a defined security and risk level aimed at ensuring that our day-to-day business and activities are consistently supported by a secure and reliable IT infrastructure. The IT security function is responsible for complying with the adopted IT security level and IT contingency plan. The IT security function contributes to ensuring and controlling that our IT activities to the best possible extent are protected against internal and external threats. The IT security function is thus charged with ensuring compliance with legislative requirements and our own requirements.

Our activity in the area of IT security is based on regulatory requirements as well as considerations for day-to-day operations. The operation must be secure and stable, a requirement ensured through automation and ongoing capacity adjustments. Our IT security efforts include the preparation of contingency plans and recovery procedures and periodic testing of such measures aimed to ensure continued operation at a satisfactory level in the case of extraordinary events.

In our assessment of the IT risk, we have revised and described all our systems. For each single risk event, requirements to support and error handling have been included in the description. Levels for system availability and stability are determined and revised regularly and IT security is frequently tested with the use of external expertise.

As part of the IT security we consider cybersecurity to be of the upmost importance. To mitigate the exposure to cyber risk, we constantly keep the IT function informed on movements in the cybersecurity field. We also use the gathered knowledge, to inform our employees of pending cybersecurity threats and thereby heightening the inhouse awareness. Several external partners are used to monitor and periodically test the cybersecurity defenses, to ensure that we keep our infrastructure protected against the given cybersecurity threat level.

CRD V, CRR II AND CRR III

In May 2019 the revised Capital Requirement Directive and Regulation, commonly referred to as CRD V and CRR II, was adopted by the European Council and The European Parliament and published in the official Journal of the European Union in June.

Key changes to CRR II and CRD V includes a reporting requirement based on a revised market risk framework, a new standard approach for counterparty credit risk, a revised large exposure framework, revised leverage ratio requirement and revised net stable funding ratio requirement and revised disclosure requirements. We are preparing for this legislation, which will mainly come into force medio 2021.

In 2020, the European Commission is expected to present first draft of CRR III which will incorporate Basel IV into European legislation. The changes to CRR will include a revised standard approach for credit risk, a revised standard approach for operational risk, revised standard approach for market risk and a revised CVA framework. An output floor on IRB models will also be implemented with CRR III, but this will have no effect on our Group as we apply the standard approach.

MANAGEMENT DECLARATION

MANAGEMENT DECLARATION

The Board of Directors of Danish Ship Finance A/S (Danmarks Skibskredit A/S) and Danish Ship Finance Holding A/S (Danmarks Skibskredit Holding A/S) approved the Risk Report for 2019 on 26 February 2020.

The Board of Directors find that the Group's risk management procedures are adequate and provide assurance that the risk management systems in place are adequate in relation to the Group's risk profile and strategy.

The Board of Directors also finds that the Group's overall risk profile in relation to its business strategy, business model and key figures provides a relevant and comprehensive picture of the Group's risk governance, including how the risk profile and the risk tolerance defined by the Board of Directors affect each other.

The Board of Directors made its assessment on the basis of its adopted business model, the latest strategy report, material and reports presented to the Board of Directors by the Executive Board, risk managers and compliance officers, internal controls and any supplementary information or reports obtained. A review of the business model and policies shows that the overall requirements set out in the model for specific risk areas are fully reflected in the more specific limits of the individual policies.

Focus is on the most creditworthy shipowners in the industry. The Group seeks to maximise risk-adjusted earnings from lending by maintaining a satisfactory margin between the lending margins and the cost of funds. The own funds are invested in low risk government and mortgage bonds and through active management of the bond portfolio returns exceeding the benchmark is the aim. The Group seeks to ensure it has an appropriate and robust capital base supporting its business model.

The maximum risk tolerance defined by the Board of Directors is managed via limits set out in the individual policies. Shown below are key figures that provide external market participants with an overview of the Group's and the subsidiary's risk management.

	Legislation	Group Compliance at 31 Dec. 2019	DSF Compliance at 31 Dec. 2019
Capital requirement			
Total capital ratio	› 8%	18.0%	18.5%
Tier 1 capital ratio	› 6%	14.0%	18.5%
Common equity Tier 1 capital ratio	› 4.5%	14.0%	18.5%
Pillar 2 requirement			
Internal capital adequacy requirement	‹ Total capital ratio	Excess coverage is 8.9%	Excess coverage is 9.3%
Combined buffer requirement	‹ Total capital ratio	Excess coverage is 5.5%	Excess coverage is 6.0%
Liquidity			
Liquidity coverage ratio (LCR)	› 100%	724%	724%
Leverage			
Leverage ratio	› 3% (Basel III recommendation)	9.3%	12.3%
Write-offs			
Incurred loan losses	N/A	Write-offs represent 1.2% of gross lending	Write-offs represent 1.2% of gross lending

DANISH SHIP FINANCE

Copenhagen, 26 February 2020

Board of Directors

Eivind Drachmann Kolding (Chairman)	Peter Nyegaard (Vice Chairman)	
Marcus Freuchen Christensen	Anders Damgaard*	Povl Christian Lütken Frigast*
Thor Jørgen Guttormsen	Jacob Meldgaard	Michael Nellemann Pedersen*
Christopher Rex	Henrik Sjøgreen	Henrik Rohde Søgaard

** also signed in the capacity of board member of Danmarks Skibskredit Holding A/S*

Art Direction & Design : Lisa Lang Graphic Design

DANISH
SHIP FINANCE

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

Sankt Annæ Plads 3 / DK-1250 Copenhagen K
Tel. +45 33 33 93 33 / Fax +45 33 33 96 66 / CVR no. 27 49 26 49
danish@shipfinance.dk / www.shipfinance.dk