

# **Lunar Risk Report 2021 – Capital target and solvency requirements**



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## 1. Introduction

According to Capital Requirement Regulation (CRR) Lunar is required to publicly disclose our risk exposure. This is done in two reports;

- Risk Report on capital target and solvency requirements (this document)
- Risk Report on other information

The two reports are reviewed and updated once a year in relation to the disclosure of the annual financial statement and created with the purpose of complying with the disclosure obligations in CRR article 431 to 455. The reports are disclosed at Lunar Bank's homepage [www.Lunar.app](http://www.Lunar.app).

The reports are structured based on section eight of the CRR in relation to disclosure of a summary of Lunar Bank (the Bank) approach for assessing the adequacy of internal capital to support current and future activities, and with the objectives of informing stakeholders of Lunar's risk management approach.

This report will include information to comply with CRR article 438 regarding:

- a summary of the institutions approach to assessing the adequacy of its internal capital to support current and future activities;
- the result of the institutions internal capital adequacy assessment process including the composition of the additional own funds requirements based on the supervisory review process

This report is disclosed in connection with the publication of the Annual Report. The content of this report is based on financials as per December 31st 2021 and was last updated and approved in February 2022.

## 2. Method – CRR 438, litra a

The Bank's method for assessing whether the internal capital is sufficient to support the current and future activities (solvency adequacy) follows the Bank's ICAAP (Internal Capital Adequacy Assessment Process).

The Bank's management (Executive Management and Board of Directors) participates at least once a year in a process with the following purpose;

- the Bank's current and future activities and identified risks are assessed
- the Bank's solvency requirements are determined
- the Bank's current capital foundation is analyzed and concluded in the Board of Directors capital target

The process involves both the Executive Management and the Board of Directors. Executive Management prepares documentation and recommendations and the Board of Directors discuss and conclude.

The Bank's process for analyzing, assessing and documenting follows ICAAP, which identifies the risks that the Bank is or can be exposed to where after it is assessed whether the risks can be mitigated through proper procedures and processes or other mitigating activities (e.g. insurance) or whether further capital is required to cover the net risk(s).

The minimum requirement is 8% of the Bank's joint risk exposure (Pillar I) with add on (Pillar II) for risks and incidents which are not reflected in the statement of the joint risk exposure.

Normal credit-, market and operational risks are therefore assessed as being covered by the 8% requirement in Pillar I and only extraordinary risks should be covered by Pillar II.

Furthermore, there is an add on of regulatory requirements for capital buffer of 2.5%, NEP-requirement for 2% and minimum capital requirement of 5 mio. while the Countercyclical buffer is set to 0 in 2021.

ICAAP also includes a stress buffer, where consequences for the Bank are identified and calculated. The stress scenarios effect on the capital is part of the determination of the Capital target.

An important purpose of the ICAAP is that results of analysis must be discussed in the Board of Directors and found the basis for the determination of the Bank's solvency requirements and Capital target. The solvency requirement is a result of the Bank's own assessment of the capital requirement, which follows from the activities and risks that the Bank is willing to take. The discussions in the Board of Directors must be based on the recommendations set by the Executive Management. The ICAAP process at Lunar consist of four steps:

1. Calculation and determination of Pillar I – minimum capital requirements (8%)
2. Internal analysis of the need for additional capital requirements. The analysis follow the 8+ metode and the Danish FSA's detailed guidance, including requirements for documentation
3. Calculation of a stress buffer.
4. Preparation of the Executive Managements recommendations for the Board with clear indication of;
  - a. The Bank's calculated solvency requirement
  - b. Analysis of the Bank's capital foundation
  - c. The Boards of Directors capital target, including suggestion for potential buffer

The below table, presents the Bank's decided solvency and capital requirements as of December 31st 2021, in relation to the annual financial statements.

	Year 2021 Actual (1,000 DKK)	Year 2021 Actual (%)
Credit risk	932,188	
Market risk	2,558	
Operational risk	39,253	
<b>Total risk exposure</b>	<b>973,999</b>	
Pillar I (8% of total risk exposure)	77,920	8%
Pillar II		
1) Earnings (capital to cover risk due to weak earnings)	38,960	4%
2) Lending growth (capital to cover organic growth)	124,386	12.8%
3) Credit risk	9,740	1%
4) Market risk	14,179	1.5%
5) Liquidity risks		
6) Operational risk	19,480	2%
7) IKT		0%
8) Other (incl. residual req. for min. req.)		
<b>Solvency need</b>	<b>284,665</b>	<b>29.2%</b>
9) Capital preservation buffer	24,350	2.5%
10) Countercyclical buffer	0	0%
11) Min. req. of eligible liabilities (MREL/NEP)	19,480	2%
<b>Capital requirements</b>	<b>328,494</b>	<b>33.7%</b>
Capital base	792,299	81.3%
Coverage for buffer requirements	463,805	47.6%
Coverage for solvency need	507,634	52.1%

The credit risk and the market risk (REA) is determined by using the standard method, while operational risk is determined by using the basic indicator method.

**The Bank's comments to the individual elements:**

<b>8% Pillar I capital requirement</b>		
Area	Type	Comments
8% requirement (Pillar I)	Determined by regulation	The Bank calculates the 8% requirement based on the actual risk exposure, where each exposure related to credit- and market risk is weighted. In addition to this, the below elements are calculated. The Bank will therefore maintain a minimum capital ratio of 8% of the risk weighted assets.
<b>Supplement to the 8% capital requirement (Pillar II)</b>		
Area	Type	Comments
Earnings	Earning risk	A 4% supplement to cover budget uncertainties
Lending growth	Credit- and earnings risk	Lending growth up to 10% is covered by Pillar I capital requirements, while lending growth exceeding 10% should be covered by Pillar II capital reservations.. The expected lending growth causes an additional capital requirement of 124 mio. DKK corresponding to 12.8% .
Credit risk	Loans, guarantees etc.	The Bank has assessed that there is a need for an add on of 1% to cover other credit risks, that relates to the use of credit models
Market risk	Interest rate	The Bank has calculated an add on of 14,2 mio. DKK related to the interest rate risk corresponding to 1.5%
Operational risks	Besides Pillar I	Based on a precautionary principle Management has estimated an add on of 19.5 mio. DKK corresponding to 2%
<b>Further capital buffer</b>		
Capital preservation buffer	Determined by law	Calculated from the 2.5% requirement
NEP requirements	Determined by law	Calculated from a 2% requirement in 2020 with a perspective towards 2024 of a requirement of 4.3%

In addition, a stress buffer has been calculated, in the situation where, however, the countercyclical buffer is expected to lapse.

### **3. Individual solvency – CRR 438, litra b**

The solvency requirement is calculated for DKK 284.6 million as of December 31st 2021.

The capital target including regulatory buffer and minimum requirement for qualified duties (MREL) and stress buffer is calculated at DKK 662.5 million (68%). As of December 31st 2021, the excess of capital is set for DKK 129 million, which is assessed as being sufficient to support the further development of the Bank's future growth ambitions based on the budget.

The solvency requirement for DKK 284 million as of December 31st 2021:

- Credit risk: 1%
- Market risk 1.5%
- Operational risk 2%
- Regulatory: 24.7%

#### Solvency

According to regulatory requirements, 75% of Pillar I+II must relate to 'corecapital' (CET I) and 100% of the buffer must be covered by 'kernekapital' (CET I) and the remaining, which includes minimum capital, can be covered by additional capital.

NEP - requirement is 2 % in 2021 and is expected to increase to 4.3% after full implementation (2024).

#### Capital target for the Board of Directors

It is the conclusion from the Board of Directors, that the capital foundation is sufficient to cover Lunar Banks risks and support the current and future activities. The Bank's ICAAP has supported a thorough analysis which included a severe stress test, to make the analysis more robust. The conclusions of the stress test is incorporated in the capital target as a buffer add on to the solvency requirement. The conclusion from the Board of Directors is based on detailed discussions and on recommendations from the Executive Management.

The main conclusions in the Board of Directors capital target:

The Bank's capital target is formulated as current solvency requirements plus a supplement. This means that the target must always be larger than the internal solvency requirement. The size of the buffer is set based on the capital foundation, besides the requirements in Pillar I and II and capital buffers. The capital target based on the actual 2021 recalculation will now be a total of DKK 662 million (68 % of REA). Note that this capital target includes both solvency, capital conservation buffer, countercyclical buffer, MREL requirements and buffer for stressed break even.

#### 4. Risk Exposure – Credit risk, CRR 438, litra c

The requirement is applicable for institutions that calculate the joint risk exposure according to the standard principles.

The table below shows the Bank's 8% requirement for each exposure class with actual exposure.

Credit risk 31.12.2021	Risk exposure (1,000 DKK)	8% thereof (1,000 DKK)
Exposure towards institutions	30,184	2,413
Exposure towards customers	786,938	62,955
Exposure - intangible assets - non refundable CET 1 capital	30,290	2,423
Prepayment and other assets	84,793	6,783
<u>Total</u>	<u>932,188</u>	<u>74,575</u>

#### 5. Risk Exposure – CRR 438, litra d and CRR 445

The Bank calculates the joint risk exposure by use of the standard metode, whereas the articles are not relevant.

#### 6. Risk Exposure – Market Risk, CRR 438, litra e and CRR 445

The below table shows the Bank's 8% requirement related to Market Risk.

Market risk 31.12.2021	Risk exposure (1,000 DKK)	8% thereof (1,000 DKK)
Currency risk	2,558	204
<u>Total</u>	<u>2,558</u>	<u>204</u>



## 7. Risk Exposure – Operational Risk, CRR 438, litra f and CRR 446

The Bank uses the basis indicator method to assess the solvency requirement to operational risk. As of December 31st, 2021 the reserved capital for operational risk exposure is 3,140 million which is included in the 8% requirement.

Operational risk 31.12.2021	Risk exposure (1,000 DKK)	8% thereof (1,000 DKK)
Operational risk	39,253	3,140
<u>Total</u>	<u>39,253</u>	<u>3,140</u>