



# Risk and capital management 2017

Pillar 3 report

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## 1. Introduction

The purpose of this report (“**the Pillar 3 report**”) is to provide information to the market in order to assess the risk and capital management of Santander Consumer Bank AS (“SCB”) and its subsidiaries as required under the Pillar 3 of the capital adequacy regulations. When including the subsidiaries we refer to “SCB Group”. In the following chapters we will also refer to both “SCB” and “SCB Group” as “the bank”. The report meets the information requirements outlined in the capital adequacy regulation part IX (NO: “*Kapitalkravsforskriften del IX*”) and CRR regulation 575/2013 (part eight). In addition we publish an appendix to the report (see Pillar 3 Appendix, where we publish 1) capital position, 2) terms of capital instruments, 3) own funds disclosure template, as recommended in Circular 14/2014 “Publishing information regarding own funds”, 4) Leverage ratio calculations and 5) Countercyclical Buffer calculations). This Pillar 3 report is updated annually.

The capital adequacy regulations allows for different methods for calculating capital requirements. In December 2015, SCB received approval from the Norwegian Financial Supervisory Authority (hereinafter “**the Norwegian FSA**”) and Bank of Spain to use Advanced Internal Rating Based approach (hereinafter “**A-IRB**”) for calculating capital requirements for part of our credit portfolios. For the remaining credit portfolios and market risk we use the standardized approach, whilst for operational risk we use the Basic Indicator Approach. We expect to receive approval for using the A-IRB approach for additional credit portfolios in the coming years.

## 2. Santander Consumer Bank AS

### 2.1 Background

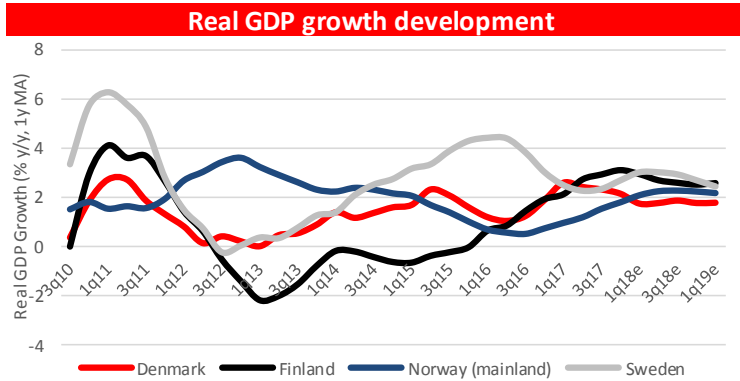
SCB is a commercial Nordic bank, operating in Norway, Sweden, Denmark and Finland, with the Nordic head office located at Lysaker in Norway. The bank is governed by Norwegian law and supervised by the Norwegian FSA. The bank is a leading consumer finance provider across the Nordic countries (Norway, Sweden, Denmark and Finland) and offers car financing, consumer loans, credit cards and sales financing. The bank also offers customer deposits in Norway, Sweden and Denmark. The bank operates through branches in Sweden and Denmark and a wholly-owned subsidiary in Finland. In this document we will refer to car financing as “secured financing” due to collateral in the vehicle and consumer loans, credit card and sales finance as “unsecured financing” as these loans are without collateral.

The bank is a 100% owned subsidiary of Santander Consumer Finance S.A., a leading player within car and consumer financing in Europe. Santander Consumer Finance S.A. (SCF) is again fully owned by Banco Santander, one of the world’s largest banking groups, with head office in Madrid. The bank has been operating under the Santander name since 2005, after Santander Consumer Finance’ acquisition of Elcon Finans AS in Norway in 2004. SCB is subject to the Norwegian Capital Requirement Regulation (“*kapitalkravsforskriften*”) and related requirements under Norwegian law. As SCB is part of a Spanish banking group, SCB also aims to comply with the Capital Requirements Directive IV (“CRD IV”) & Capital Requirements Regulation (“CRR”) legislative package applicable in the EU. Being part of the Banco Santander Group, SCB benefits from expertise and guidance within various risk management areas related to models, processes and methodology e.g. for the A-IRB system.

SCB Group had 1320 employees (excluding temporary hired employees) at year-end 2017. Of these, 541 worked in Norway, 358 in Sweden, 245 in Denmark and 176 in Finland.

### 3. Macroeconomic Developments

Being a Pan-Nordic bank, SCB is directly exposed to the macroeconomic developments in the four major Nordic countries. This diversification provides a natural hedge, as the economic environment across the countries are not perfectly correlated. Overall economic activity in the region is good, and expectations across our four domiciles are for 2-2.5% annualized real GDP growth going forward.

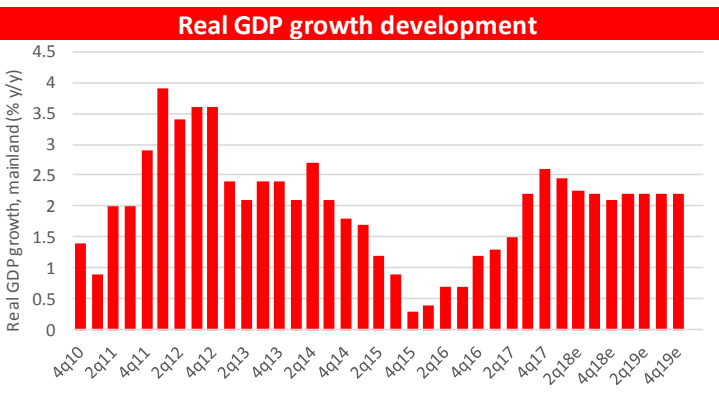


Source: Bloomberg

#### 3.1 Norway

The trough in Norway is behind us, with real GDP growth (mainland) at 2% in 2017 vs 1% in 2016. With the oil sector downturn in the past few years, the economy found support in a weaker NOK and Keynesian government policies. With energy prices having appreciated significantly since mid-2017 and energy majors' investment budgets on the rise, the oil & gas industry in Norway is experiencing newfound optimism and could soon become a net contributor to economic growth again. Real GDP growth (mainland) is forecasted to stabilize slightly above 2% in 2018/19.

A concern for many foreign investors has been the weakening housing market, but new statistical method from the real estate industry shows that this has and is mainly an Oslo-specific trend. Analysts believe prices could on average stabilize nationwide by mid-2018 and rise from August.



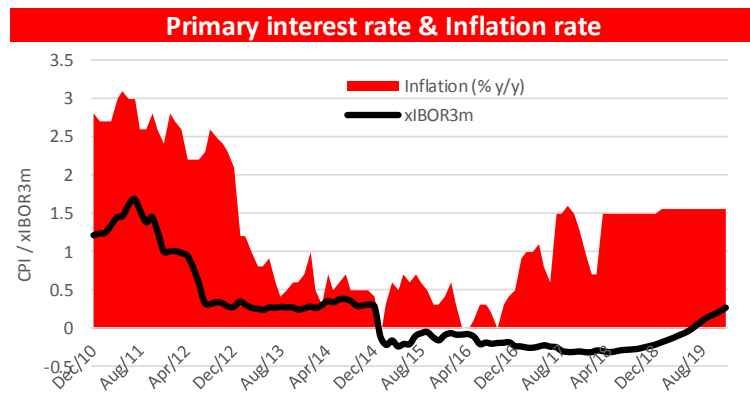
Source: Bloomberg

#### 3.2 Denmark

Denmark has experience a steady recovery since 2013, with real GDP growth estimated at 2% for 2017. The main growth driver has been strong consumer spending due to rising employment and a positive trend in real wage growth.

A significant rise in the current account surplus has further added to Denmark’s status as a “safe haven” amongst foreign investors, one reason behind Nationalbanken’s policy rate of -0.65% vs ECB at -0.4% despite the DKK being pegged to the EUR.

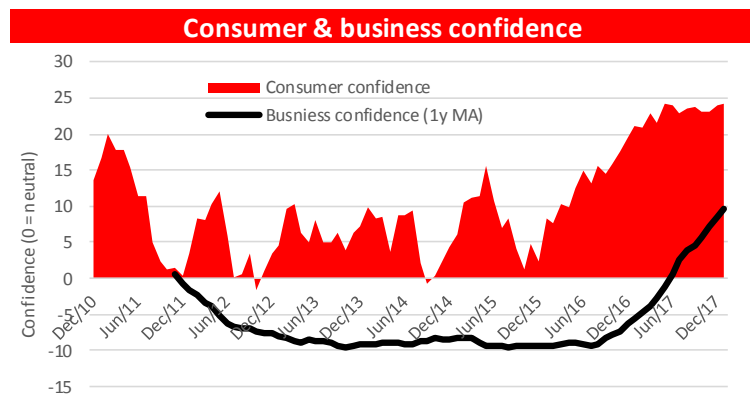
Strong outlook for global GDP growth is expected to support exports going forward, and consensus forecast for real GDP growth is 1.8% in 2018 and 2019. With the economy close to full utilization, the inflation is expected to rise towards 1.5%. This might not sound much, but is significant given that the inflation rate was close to zero from 2013 to 2016.



Source: Bloomberg

### 3.3 Finland

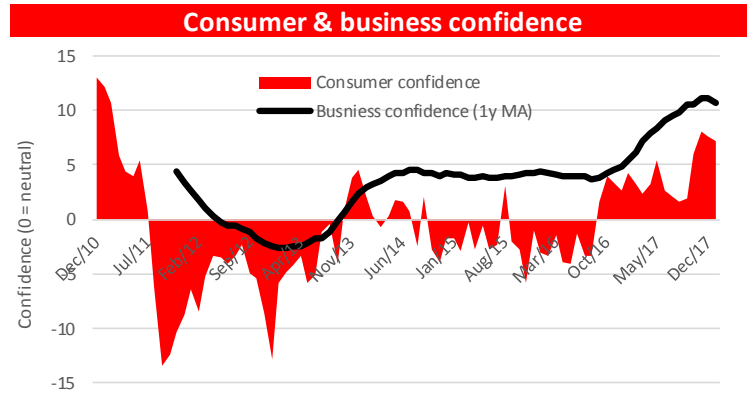
Economic growth in Finland picked up significantly from zero in 2015 to 2% in 2016. The trend continued in 2017, with expected growth of 3% for the year. A main driver behind the growth story has been the increased exports, which in turn has been fueled by increased demand from strong global economic growth and increased competitiveness from structural changes in the labor market. Rising economic activity has in turn spurred consumer confidence/spending and inflation is picking up from deflation in 2015 to a forecast of 1-1.5% in 2018/19. Looking ahead, global GDP growth is expected to continue, but availability of skilled labor could become a bottleneck for growth. Consensus is for a healthy 2.5% growth in real GDP in 2018, but down to 1.9% in 2019.



Source: Bloomberg

### 3.4 Sweden

The Swedish economic growth is still strong in a Nordic environment, but have slowed slightly from above 4% growth in GDP in 2015 to an expected growth of 2.7% in 2017. Housing prices started to decline in 2H17, raising concerns over a general slowdown in the economic growth. Lower construction activity will most likely have a net negative effect on growth, while consumer/business confidence could falter and impact spending/investments. However, the labor market is strong and household's economies seem strong with high income and savings buffer. Strong growth in global GDP could also lend some support to exports. Consensus' forecast for real GDP growth is 2.7% in 2018 and 2.2% in 2019.



Source: Bloomberg

## 4. Governance and control

### 4.1 Management of SCB

The Board of Directors of SCB is comprised of eight members and has extensive powers to manage, administer and govern all matters related to SCB's business, subject only to any powers exercisable solely by the General Meeting of shareholders (NO: "Generalforsamling").

In accordance with laws and regulations, the Board of Directors of SCB has established sub-committees whose functions is to serve as working committees preparing matters to be handled by the Board. SCB has a separate Audit Committee, consisting of three members from the Board of Directors, assisting the Board of Directors in relation to its administrative and supervisory tasks, control, financial management and reporting duties and follow-up of the internal and external audit of the bank. SCB also has a separate Board Risk Committee, consisting of three members from the Board of Directors, with the objective of advising the Board of Directors on the overall current and future risks, risk tolerance and risk strategy. The Board Risk Committee met 8 times during 2017. SCB has further established a Remuneration Committee, consisting of five members from the Board of Directors, advising the Board of Directors in the preparation of the bank's remuneration policy and monitoring the effects of the policy. SCB also has a Nomination Committee, consisting of three members, advising in the preparation of nominations and selections of candidates to the Board of Directors and the Nordic CEO.

The governance structure can be seen in Figure 1 SCB *Governance Structure*

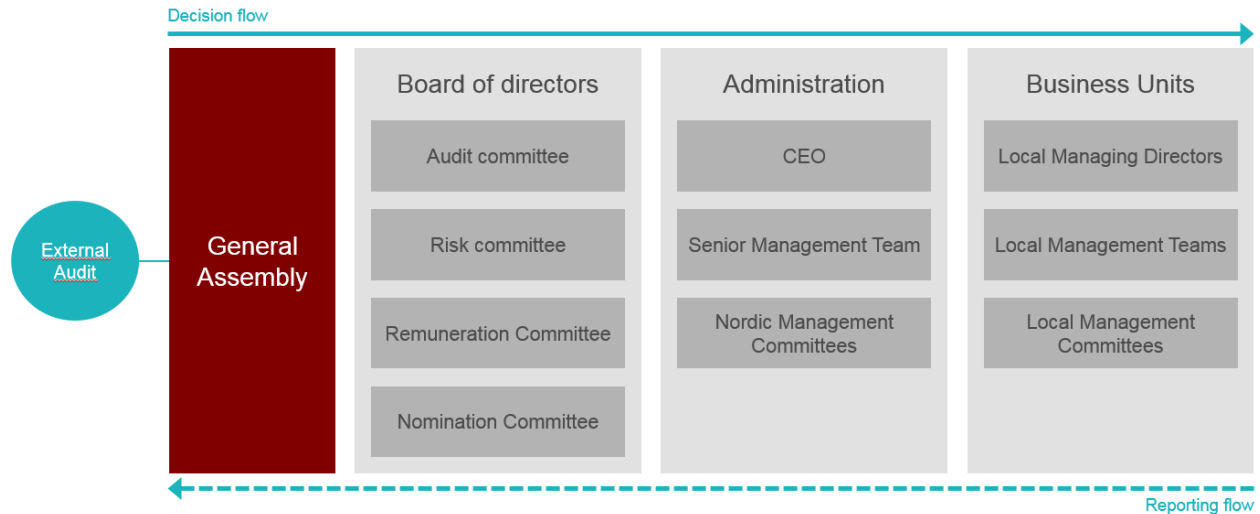


Figure 1 SCB Governance Structure

SCB has established management committees in order to facilitate the CEO and senior management, and to ensure effectiveness and efficiency of business and enhance the internal control of the bank. The main Nordic management committees are:

- Capital Committee. The purpose of the Capital Committee is to have an effective forum for supervising, authorizing and evaluating all aspects related to the capital and solvency of SCB within the framework decided by the Board of Directors.
- Nordic Internal Control Committee (NICC): The main purpose of the Internal Control Committee is to oversee and monitor SCB's risk profile, including oversight of all risks and the establishment of appropriate control systems and the compliance with laws, regulations and internal policies.
- Asset and Liability Committee (ALCO): The Asset and Liability Committee is a management committee which is delegated authority from the Board of Directors to oversee activities related to funding, liquidity, interest rate risk, FX risk, derivatives and any other products or activities related to Asset and Liability Management.
- Central Credit Committee (CCC): The CCC is a collegiate decision body responsible for the sanctioning of large credit proposals over a pre-established threshold defined in the bank's credit policy. Credit proposals exceeding SCB credit attributions, are processed and recommended for approval to the SCF Loan Committee in Madrid.
- Nordic Approval Committee (NAC): The NAC is a collegiate decision body responsible for the risk management in accordance with the authorities attributed by the Board of Directors.
- Bank Innovation Board (BIB): The BIB is to decide on project investment proposals for each local business or Nordic functions. BIB also approves ideas entering into project pipeline for the bank and tracks the overall project portfolio of the Bank's projects as well as prioritize the project portfolio.

The governance structure is set up so that there are committees at local level mirroring the Nordic Management Committees, except for the Capital Committee and ALCO.



## 4.2 Organisational set-up

SCB is organized into eight staff divisions and four business units, representing operations in Norway, Sweden, Denmark and Finland, in addition to Internal Audit which is functionally reporting to the Audit Committee, per delegation of the Board of Directors, and administratively to the Nordic CEO. The management of Customer Deposits is located with Financial Management, Marketing & communication is managed by the head of the Danish business unit, Insurance by the head of the Norwegian business unit and the overall Nordic responsibility for unsecured products are managed by the head of the Swedish business units, Cost and Org by Financial Control and External communication is handled by HR & Legal.



Figure 2 Organisation of Santander Consumer Bank

## 4.3 Control functions and “three-lines-of-defense” approach

To ensure a sound risk management approach and effective internal control, SCB is organized according to a ‘three-lines-of-defense’ model. The model creates a clear and transparent division of roles and responsibilities to ensure sound internal control throughout the bank. The roles and responsibilities in SCB’s three lines of defense model are organized as follows.

	1 <sup>st</sup> line of defence	2 <sup>nd</sup> line of defence	3 <sup>rd</sup> line of defence
<b>Function</b>	Business	Risk control and Compliance & Conduct function (C&C)	Internal Audit
<b>Role</b>	Acting risk owner and ensure sound internal control through documented control activities.	Risk control: Ensure sound risk management and internal control in business, on behalf of the CEO.  C&C function: Promote adherence to rules, supervisory requirements, principles of good conduct and values.	Ensure internal control and regulatory compliance in the entire bank, on behalf of the Board of Directors.

<b>Responsibilities</b>	<ul style="list-style-type: none"> <li>- Manage business so that all risks are identified, managed and controlled</li> <li>- Ensure that internal control is developed and maintained in areas of responsibility (e.g. Implement controls to detect non-compliance)</li> <li>- Take ownership and actions on deficiencies identified</li> </ul>	<p><b>Risk control:</b></p> <ul style="list-style-type: none"> <li>- Ensure risk level is in line with risk appetite</li> <li>- Monitor and control risk framework</li> </ul> <p><b>C&amp;C function:</b></p> <ul style="list-style-type: none"> <li>- Establish Compliance standards with internal and external regulations,</li> <li>- Define minimum requirements for employee training and 1st line compliance risk monitoring and reporting.</li> <li>- Analyse compliance risk reporting performed by 1st line.</li> <li>- Monitor Compliance risk framework.</li> </ul> <p><b>Both Risk control and C&amp;C function:</b></p> <ul style="list-style-type: none"> <li>- Manage Risk assessments,</li> <li>- Risk reporting with deficiencies and recommendations,</li> <li>- Challenge the work and reporting in the first line of defence and report 2nd line assurance to Management and Board.</li> </ul>	<ul style="list-style-type: none"> <li>- Audit and evaluate organisational and process effectiveness</li> <li>- Ensure business is in accordance with applicable internal and external regulations</li> <li>- Report deviations to Board of Directors on regular basis</li> </ul>
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## 5. Capital adequacy

### 5.1 Capital management governance

Governance and responsibilities related to capital management are outlined in the bank's Capital Policy. The objective with the policy is to ensure adequate solvency levels, regulatory compliance and efficient use of capital.

The Board of Directors have the ultimate responsibility for the solvency and capital adequacy of the bank.

Capital management decisions that need Board of Directors' approval should be approved and recommended by the Capital Committee before being recommended to the Board of Directors. Certain items will also need to be reviewed in the Board Risk Committee before being presented to the Board. Capital management decisions will include capital adequacy, capital targets and composition, capital plan, dividend policy and capital contingency plans. The Capital Committee consist of members of senior management (the Chief Financial Officer, Chief Risk Officer and the Chief Controlling Officer) who have voting power and representatives from Risk, Financial Management, Financial Control and Legal who have an advisory role.

The Board of Directors approves minimum and target capital ratios, at least on an annual basis. Capital positions and forecasts are presented to the Board of Directors on a regular basis. Capital reporting to the Norwegian FSA is approved by the Capital Committee before submission.

Dividend must be approved in the General Meeting of SCB, based on proposal by the Board of Directors.

Capital increases and capital reductions must be approved by the Board of Directors and in the General Meeting of SCB. Capital increases will also need approval by the owner both at SCF and at Banco Santander level. In case of repayment of hybrid capital and subordinated loan capital, approval from the Board of Directors will be sufficient.

Norwegian FSA has to approve both capital increases and capital decreases.

## 5.2 Capital requirements

SCB is supervised by the Norwegian FSA and has to comply with the capital requirements for banks in Norway. Norwegian banks are subject to ongoing capital adequacy requirements, which implement EU Directives and Regulations based on the Basel III regime. In line with the recommendations of the Basel Committee on Banking Supervision (the "Basel Committee"), the regulatory approach in the Financial Undertakings Act is divided into three pillars;

- Pillar 1 - Calculation of minimum regulatory capital: banks shall at all times satisfy capital adequacy requirements reflecting credit risk, operational risk and market risk. Equity can be in the form of core and supplementary capital. Core capital will typically consist of equity capital, while supplementary capital can be subordinated loan capital. The capital requirements must be complied with at all times. Banks are obligated to document their compliance with these requirements by reporting to the Norwegian FSA on a quarterly basis;
- Pillar 2 - Assessment of overall capital needs and individual supervisory review: banks must have a process for assessing their overall capital adequacy in relation to their risk profile and strategy for maintaining their capital levels. The Bank assess the capital needs according to circular 12/2016 from the Norwegian FSA. The Norwegian FSA shall review and evaluate such internal capital adequacy assessments process (ICAAP) and strategies and may take supervisory action if it is not satisfied with the result of such an evaluation process. Norwegian FSA publishes their review of the ICAAP process and also publishes the Pillar 2 requirement for the bank.
- Pillar 3 - Disclosure of information: banks are required to disclose relevant information on their activities, risk profile and capital situation to the market.

The bank is required to comply with capital requirements at both SCB AS level and SCB Group level. Figure 3 outlines the capital requirements for SCB Group and SCB AS for 2018.

Nordic - SCB Group		Nordic - SCB AS	
	Capital Requirement (%)		Capital Requirement (%)
<b>Estimate for 2018</b>		<b>Estimate for 2018</b>	
<b><u>CET1</u></b>		<b><u>CET1</u></b>	
Minimum requirement	4,50 %	Minimum requirement	4,50 %
Capital Conservation Buffer	2,50 %	Capital Conservation Buffer	2,50 %
Systemic Risk Buffer	3,00 %	Systemic Risk Buffer	3,00 %
Countercyclical Buffer*	1,14 %	Countercyclical Buffer*	1,47 %
<b>Total Pillar 1 requirement</b>	<b>11,14 %</b>	<b>Total Pillar 1 requirement</b>	<b>11,47 %</b>
Pillar 2 requirement	2,30 %	Pillar 2 requirement	2,30 %
<b>Total CET1 requirement</b>	<b>13,44 %</b>	<b>Total CET1 requirement</b>	<b>13,77 %</b>
<b><u>Tier1 (T1)</u></b>		<b><u>Tier1 (T1)</u></b>	
Additional T1 requirement	1,50 %	Additional T1 requirement	1,50 %
<b>Total T1 requirement</b>	<b>14,9 %</b>	<b>Total T1 requirement</b>	<b>15,3 %</b>
<b><u>Tier2 (T2)</u></b>		<b><u>Tier2 (T2)</u></b>	
Additional T2 requirement	2,00 %	Additional T2 requirement	2,00 %
<b>Total T2 requirement</b>	<b>16,9 %</b>	<b>Total T2 requirement</b>	<b>17,3 %</b>
<b><u>Leverage Ratio (LR)</u></b>		<b><u>Leverage Ratio (LR)</u></b>	
Minimum leverage requirement	3,0 %	Minimum leverage requirement	3,0 %
Buffer requirement for non-SIFI banks	2,0 %	Buffer requirement for non-SIFI banks	2,0 %
<b>Total LR requirement</b>	<b>5,0 %</b>	<b>Total LR requirement</b>	<b>5,0 %</b>
<i>* Based on local Countercyclical buffer req. per Dec17: NO 2%, SE 2%, DK 0%, FI 0%</i>		<i>* Based on local Countercyclical buffer req. per Dec17: NO 2%, SE 2%, DK 0%, FI 0%</i>	

Figure 3 Capital Requirement 2018

## 5.2.1 Pillar 1 requirement

On 1 July 2013, the Norwegian Parliament passed an act which implemented the CRD IV capital adequacy rules. The minimum capital adequacy requirement of 8% shall consist of at least 4.5% common equity tier 1 capital (“**CET1 capital**”) and the remaining 3.5% may consist of other eligible capital instruments. In addition, Norwegian banks are required to hold a capital conservation buffer of 2.5% CET1 capital and a systemic risk buffer of 3% CET1 capital. Systemic important financial institutions should hold an additional 2% buffer of CET1 capital. SCB is currently not considered to be a systemic important financial institution. In addition banks are required to hold a counter cyclical buffer ranging between 0% and 2.5%. Per 31.12.17 the countercyclical buffer requirement was 2% for Norway and Sweden. In Finland and Denmark, the countercyclical buffer requirement is 0%. In accordance with article 140 of the CRD IV, the bank calculates its countercyclical buffer as a weighted average of the country specific countercyclical buffers in Norway, Denmark, Sweden and Finland. As of 31.12.2017 the weighted average countercyclical buffer requirement for SCB AS was 1.47% while at SCB Group level the requirement was 1.14%.

In total, the Pillar 1 CET1 capital requirement per 31.12.17 was 11.47% for SCB AS and 11.14% for SCB Group.

Norwegian banks are required to meet and report the capital requirements to the Norwegian FSA on a quarterly basis.

## 5.2.2 Pillar 2 requirements

SCB conduct at least annually an internal capital adequacy assessment process (ICAAP) assessing capital adequacy and thus it's input to the Pillar 2 capital requirement. The combined Pillar 1 and Pillar 2 requirements will be the basis for the bank's target capital ratios set by the Board of Directors. Several departments are involved in the ICAAP process including the Risk function, Financial Control, Financial Management, Legal and Compliance & Conduct function. Stress scenarios, as well as outcomes of various analyses in the ICAAP report are reviewed and approved

by the Capital Committee. In addition, all analyses and governance processes leading to the ICAAP report is reviewed by Internal Audit.

Subsequently ICAAP is reviewed by the Board Risk Committee which gives its recommendations to the Board of Directors. Finally the ICAAP is reviewed and approved by the Board of Directors before being submitted to the Norwegian FSA.

The Pillar 2 requirement from the Norwegian FSA was set to 2.3% following the ICAAP delivered in 2017. The result was published on 19 December 2017 and applies from 1 January 2018. The Pillar 2 requirement must be met by CET1 capital.

### 5.2.3 Pillar 3 requirements

This Pillar 3 report is updated at least annually. In addition we publish an appendix to the report (see Pillar 3 Appendix), where we disclose 1) capital position, 2) terms of capital instruments and 3) own funds disclosure template, as recommended by the Norwegian FSA in Circular 14/2014 "Publishing information regarding own funds", 4) Leverage ratio calculations and 5) Countercyclical Buffer calculations). The senior management members of the Capital Committee, consisting of the Chief Risk Officer, the Chief Controlling Officer and the Chief Financial Officer, approve the content of the Pillar 3 report.

The Board of Directors has approved the guidelines and procedures for the Pillar 3 report. Internal Audit assesses the quality of the disclosure of information about the bank's capitalization, risk profile and management and control of risk. The report is approved by the Capital Committee before publication.

### 5.2.4 Leverage ratio requirements

In addition to the Pillar 1 and Pillar 2 capital requirements, banks must report their leverage ratio. Since June 30 2017, Norwegian banks have been required to have a minimum leverage ratio of 3%, in addition to a 2% buffer requirement for non-SIFI banks and 3% for SIFI<sup>1</sup> banks. Hence, SCB has to comply with a leverage ratio requirement of 5%, as we are not a SIFI bank.

## 5.3 Capital position per December 2017

Per December 2017, SCB AS had a CET1 capital ratio of 15.98%, Tier1-ratio of 18.16% and a Tier2-ratio of 19.82%. On SCB Group level the CET1 capital ratio was 15.50%, Tier1-ratio was 17.53% and the Tier2 ratio was 19.07%.

SCB calculates the leverage ratio in accordance with CRR article 429. The Leverage ratio for SCB AS as of 31.12.2017 was 13.04%. For SCB Group the Leverage ratio was 11.97%.

Please see Pillar 3 Appendix for further details on the capital position.

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<sup>1</sup> SIFI bank is systemic important banks.

## 5.4 IFRS 9 Financial Instruments

From January 1, 2018, the Group will apply IFRS 9 Financial instruments. The principle impact on the Group's regulatory capital from the implementation of IFRS 9 will arise from the new impairment requirements. The estimated impact of IFRS 9 is a reduction in the CET1 capital ratio of approximately 30 bps for SCB AS and 37 bps for SCB Group.

In December 2017, the Norwegian Ministry of Finance issued guidelines on transition requirements for the implementation of IFRS 9. The guidelines allow a choice of two approaches to the recognition of the impact on adoption of the standard on regulatory capital:

1. Phase-in the impact over a five- year period or;
2. Recognizing the full impact on the first day of adoption.

The bank has decided to adopt the first alternative using the transitional rule. The phase-in allows a 95% reversal of the impact the first year, so the net impact of the IFRS 9 in 2018 capital adequacy is estimated to be less than 2 bps on the CET1 ratio. The bank will publish capital ratios both with and without transitional rules.

## 6. Overview of Risk management

SCB Nordics operating under Banco Santander, has set itself the target of achieving excellence in risk management. Throughout the recent years, significant progress has been made across all risk types as part of the roll out of Banco Santander's Advanced Risk Management program aimed to upgrade and further standardize the risk practices across geographies and business areas.

SCB's policy is that the risk function is based on the following pillars, which are aligned with Banco Santander's strategy and business model that take on board the recommendations of supervisory bodies, regulators and best market practices:

1. **The business strategy is defined by the risk appetite.** The Board of Directors of SCB determines the quantity and type of risk it considers reasonable to assume in the execution of its business strategy and to create targets that are objective, comparable and consistent with the risk appetite for each key activity.
2. **A risk culture** which is integrated throughout the organization, composed of a series of values, skills and guidelines for action to cope with all risks. SCB Nordics believes that advanced risk management cannot be achieved without a strong and steadfast risk culture which is found in each and every one of its activities.
3. **All risks have to be managed** using advanced models and tools and integrated in the different businesses. SCB is promoting advanced risk management using models and metrics, and also a control, reporting and escalation framework in order to manage risks.
4. **The forward-looking approach** for all risk types must be part of the risk identification, assessment and management processes.
5. **The independence of the risk function** and the Compliance and Conduct (C&C) function encompasses all risks and provides an appropriate separation between the risk generating units and units responsible for controlling these risks. It implies that the controlling functions should also have sufficient authority and direct access to management and governance bodies which are responsible for establishing and overseeing risk strategy and policies.
6. **Risk management has to have the best processes and infrastructures.** A continuous effort in developing risk management support infrastructure and processes.

Figure 4 below outlines the 6 pillars described above.



Figure 4 Risk Strategy

### 6.1 Risk Governance

In terms of governance, SCB is organized as a Nordic cluster with central support functions and four business units: Norway, Sweden, Finland and Denmark. Additionally, each business unit has a local risk management function with a risk director reporting directly to the Nordic Chief Risk Officer.

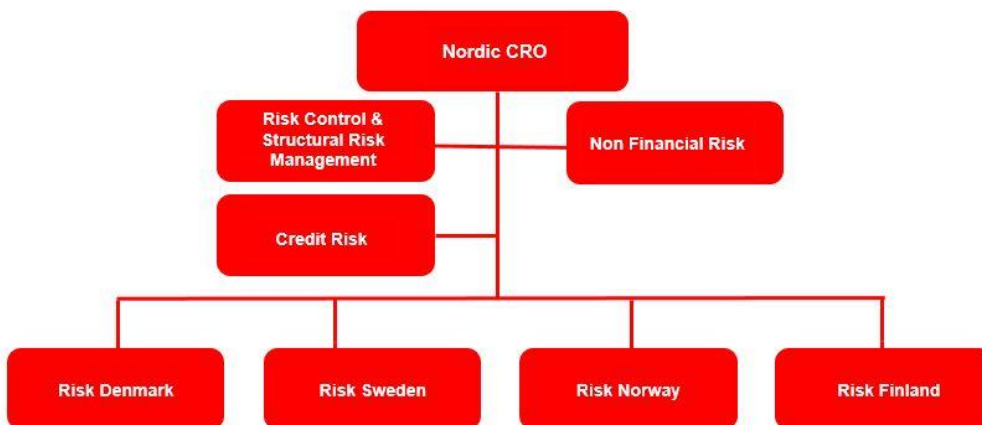


Figure 5 Risk Organisation

The Board of Directors receives, in accordance with article 435 2e of the CRR, relevant credit reports and instigates relevant actions in order to reduce undesired rise in risk levels. The Board of Directors shall approve the risk appetite statement, as well as any proposed remedial action when facing breach of risk appetite triggers.

## 6.2 Overview of risk weighted assets

Figure 6 provides an overview of the risk weighted assets (RWA) of the main risk categories that SCB Group is required to hold capital for and that are described in this report. The breakdown distinguishes between assets where we use the Standardized Approach and the IRB Approach.

<i>In '000 NOK</i>	RWA		Capital requirements
	Dec'17	Dec'16	Dec'17
<b>Credit risk (excluding counterparty credit risk)</b>	<b>97 902 625</b>	<b>86 064 559</b>	<b>7 832 210</b>
<i>Of which standardised approach (SA)</i>	66 870 958	60 365 366	5 349 677
<i>Of which internal rating-based (IRB) approach</i>	31 031 667	25 699 193	2 482 533
<b>Market risk</b>	<b>1 016 813</b>	<b>1 123 306</b>	<b>81 345</b>
<i>Of which Credit Value Adjustment (CVA)</i>	164 565	269 068	13 165
<i>Of which FX risk</i>	852 248	854 238	68 180
<b>Operational risk</b>	<b>11 895 843</b>	<b>9 835 184</b>	<b>951 667</b>
<i>Of which Basic Indicator Approach</i>	11 895 843	9 835 184	951 667
<b>Total RWA (Risk-based)</b>	<b>110 815 281</b>	<b>97 023 049</b>	<b>8 865 222</b>

Figure 6 Overview of risk weighted assets and capital requirements for the main risk categories for SCB Group

The total RWA for the bank increased with 14% from 2016 to 2017, driven mainly by the increase in the Credit Risk driven by organic portfolio growth. For Credit Risk the share of IRB increased during 2017, driven by the relatively higher increase in the Auto Private Persons segment.

In Figure 6 the Operational Risk RWA is calculated as 15% of the three year average gross income multiplied by 12.5. By replacing 2014 gross income, which was pre-merger with GE Money Bank AB, with 2017 gross income the Operational Risk RWA increased by 21%.

## 7. Credit risk

### 7.1 General information about credit risk

Credit risk is the most significant risk for the bank. Credit risk is governed by the risk appetite defined taking into account differences in product mix and collection processes.

The SCB organizational structure is designed to support the credit risk management of the bank. The bank leverages pan-Nordic initiatives and strategies resulting in highly homogeneous credit risk practices across the business units while also considering the local market's needs and operating climate.



Credit risk management is divided into “Standardized” and “Non-Standardized” risk areas, where Standardized includes Retail and Small-Medium enterprises (SMEs) and Non-standardized includes exposures managed individually.

Standardized (Retail) exposures are managed via a highly automated credit approval process using internally developed scorecards.

The Non-Standardized risk segment constitutes all stock finance related clients and also customers with a credit exposure of over 5 MM local currency in case of Norway, Sweden and Denmark and EUR 0.5 MM in case of Finland.

## 7.2 Scorecards

The main credit risk management tool for the retail portfolio in the bank is based on the use of scorecards. Admission and behavioral scorecards have been developed and implemented for all retail portfolios. The purpose of the admission scorecards is to separate the “good” customers from the “not so good customers”, whilst the purpose of the behavioral scorecards is to track how the customer is performing. Upon scoring the customer is assigned to Probability of Default (PD) bucket which, among other things, is used for risk monitoring purposes and in capital calculations under A-IRB.

All the scorecards are continuously monitored. The goal is to ensure that portfolio delinquency is within acceptable limits by adjusting the score limits in line with the risk appetite of the bank. All implemented scorecards are monitored for their stability, accuracy and predictability to ensure they work as intended.

## 7.3 Internal Rating Model

The non-standardized customers in the bank are composed of large and/or complex exposures evaluated individually by a risk analyst, and are not scored by the retail scorecards. Depending on the size of the loan the application will need to be escalated and submitted to the relevant Credit Committee for approval; this in compliance with delegated credit authorities’ structure established in the Credit Policy.

During 2010, an internal rating model developed centrally in Banco Santander (SCB’s ultimate parent) was implemented in all units. This involved risk analysts reviewing all Wholesale clients and setting a rating score, following the Santander Rating scale shown in Figure 7. Ratings from the Santander Internal Rating model method will result in an individual probability of default (PD) by Wholesale exposure.

→ **Comparison between Santander rating and main external agencies and default probability**

Internal rating	Moody's	Standard & Poors	Default probab. 1 year
9.3	Aaa	AAA	0.017%
9.2	Aa1	AA+	0.018%
9.0	Aa2	AA	0.022%
8.5	Aa3	AA-	0.035%
8.0	A1	A+	0.056%
7.5	A2/A3	A/A-	0.089%
7.0	A3/Baa1	A-/BBB+	0.142%
6.5	Baa1/Baa2	BBB+/BBB	0.226%
6.0	Baa2	BBB	0.361%
5.5	Baa3	BBB-	0.575%
5.0	Ba1	BB+	0.917%
4.5	Ba2	BB	1.461%
4.0	Ba3	BB-	2.330%
3.5	B1	B+	3.714%
3.0	B1/B2	B+/B	5.922%
2.5	B2	B	9.441%
2.0	B3	B-	15.051%
1.5	Caa1	CCC	23.996%
1.0	Ca	CC	38.257%

Note: This master scale can be used as a reference only in those cases which there is an automatic rating based on a historical statistics database.

Figure 7 Santander Internal Rating Model Comparison

The Santander Internal Rating Model is a hybrid model, which takes into account expert judgement as well as objective criteria from the clients' Financial Statements and an assessment of the obligor's shareholders and management.

## 7.4 Credit Risk Profile

### 7.4.1 Credit exposure

SCB Group consists of the following main business areas:

#### Auto Finance

- Auto loans and leasing offered to private persons and business customers. Mainly distributed through dealers, but also distributed direct online.
- Stock Finance provided to dealers. This includes demo financing and new and used car stock financing. Agreements with both importers and dealers.
- Business lines: Norway, Sweden, Finland and Denmark.

#### Consumer Loans

- Consists of unsecured loans to private persons of between EUR 2,000 and EUR 50,000. The product is distributed through direct online distribution, brokers and cross-selling from the SCB portfolio. Automated and stable business model with primarily risk based pricing.
- In Norway and Sweden there is a high level of distribution through brokers, while this share is increasing in Finland.
- Business lines: Norway, Sweden, Finland and Denmark.

### Credit Cards

- Revolving credit lines up to EUR 10,000 offered to private persons.
- The credit card holder can use their credit card up to a credit limit assigned based on the credit profile of the customer.
- Business lines: Norway, Sweden and Denmark.

### Sales Finance

- Loans offered to private persons for buying commodities at merchants.
- Predominant point of sales in physical stores but e-commerce is growing.
- Business lines: Norway, Sweden, Finland and Denmark.
- For Norway and Sweden Sales Finance is reported together with Credit Cards as it is a revolving product, while in Denmark and Finland it is reported together with Consumer Loans.

## 7.4.2 SCB Group Portfolio Mix

SCB Group's gross outstanding loans increased from NOK 128 billion to NOK 148 billion from 2016 to 2017 based on a robust growth observed across the geographies SCB group operates in. The country break-down for gross outstanding as of December 2017 and compared to December 2016 can be found in the graph below. Geographical distribution of assets are similar for 2016 and 2017, signifying the balanced growth in all operating markets in line with business strategy. As can be seen in the table below there are a relatively higher portfolio increase in Finland and Denmark. However, part of this is driven by the fact that the numbers are reported in NOK and thus is affected by NOK depreciation towards EUR and DKK in 2017 increasing the Danish and Finnish portfolios.

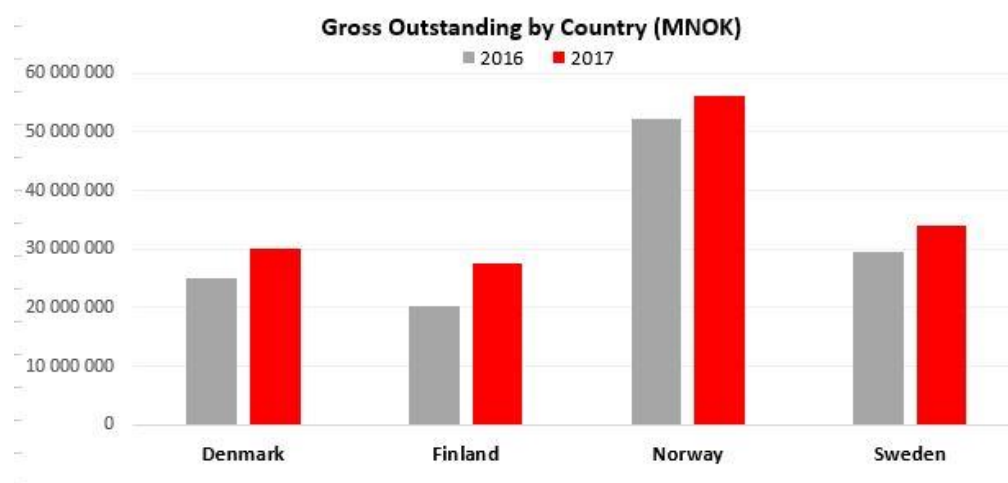


Figure 8 Gross Outstanding by Country

As can be seen in Figure 9, the growth is largely attributed to continuous growth in the Auto portfolio.

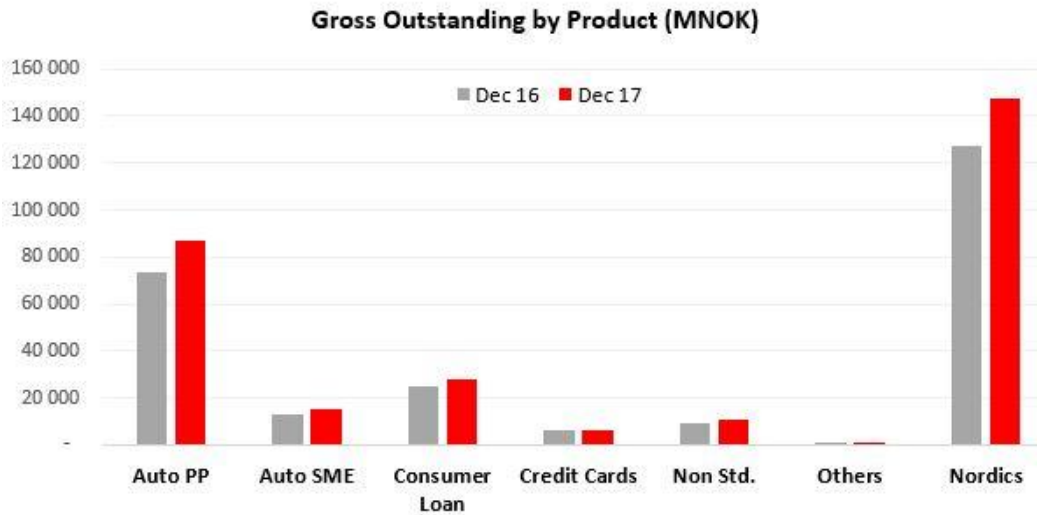


Figure 9 Gross Outstanding by Product

As can be seen in the figure 8 the relative share of gross outstanding has increased in Denmark and Finland both driven by the organic portfolio growths and the FX explained above.

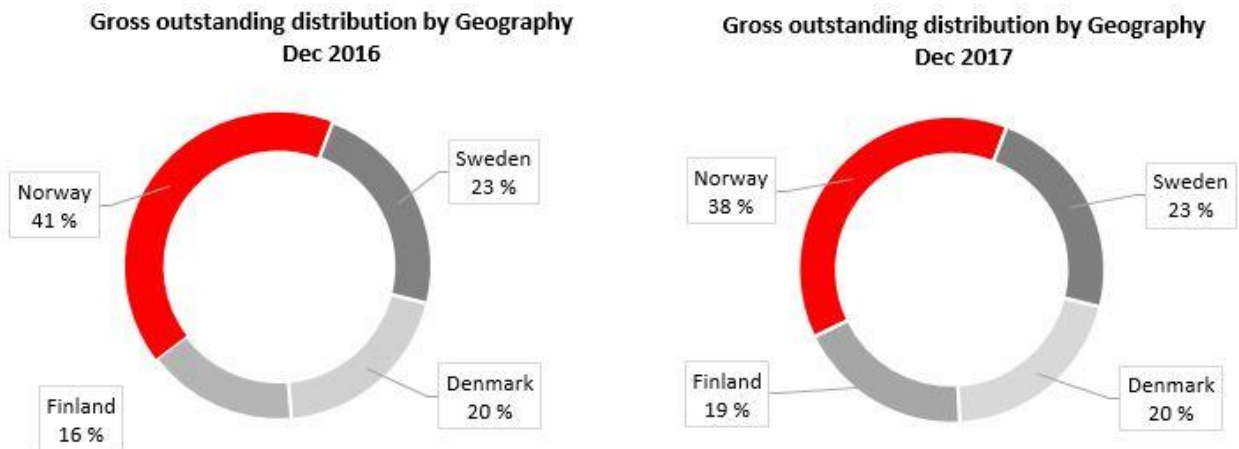


Figure 10 Share of Gross Outstanding by Country

The share of gross outstanding for SCB Group by product is shown below. As of December 2017, the biggest product exposure is to Auto Private Persons (PP), with Auto PP Norway being the largest single portfolio of the bank. Consumer Loans has the second biggest share of the bank. The secured part of the portfolio has increased its share slightly due to continued growth in the Auto segment.

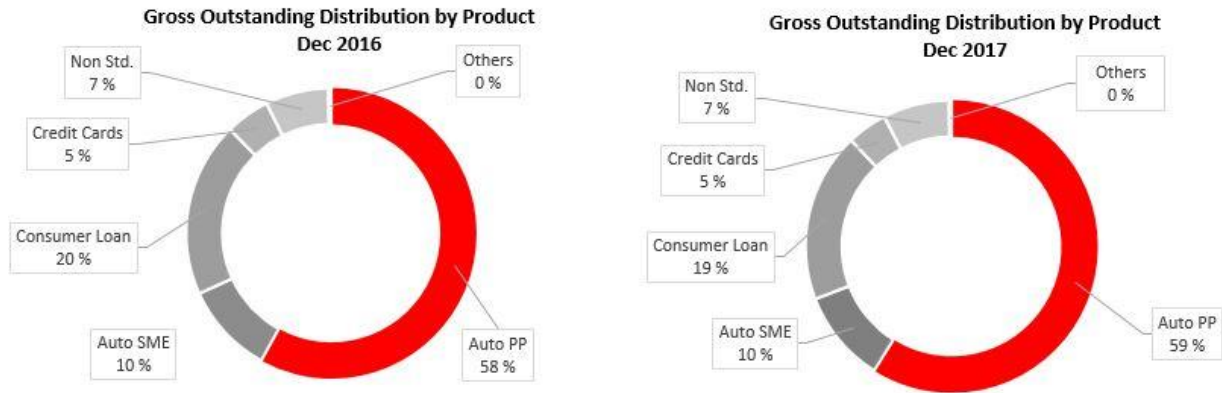


Figure 11 Share of Gross Outstanding by Product

Figure 12 show the share of gross outstanding for secured and unsecured portfolio at country and consolidated level. The exposure to secured products constitutes a significant part of the exposure representing more than 75% of gross outstanding at consolidated level.

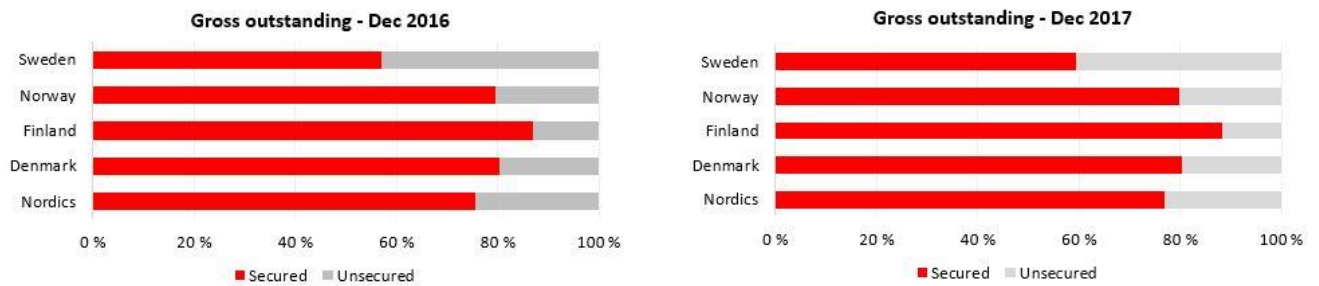


Figure 12 Share of Gross Outstanding by Secured/Unsecured

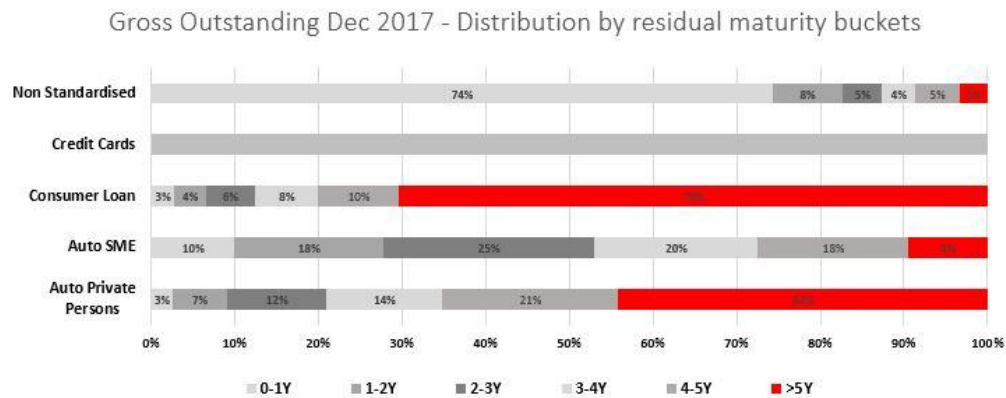


Figure 13 Share of Gross Outstanding by Maturity

Figure 13 above provides the distribution of gross outstanding by contractual residual maturity bucket. Credit card, being an open end loan, are reported without any maturity split. The actual maturity will be lower than the contractual maturities given the high level of pre-payments across products.

Figure 14 shows the credit exposure as of year- end 2017 by counterparty type according to article 442(g) of the CRR.

million NOK	In					
	Balance	Current	Arrears	NPL	Specific LLR	Generic LLR
Retail	122 030,9	112 044,5	7 341,8	2 574,0	1 446,7	1 075,7
Retail SME	15 152,8	13 992,9	931,9	227,9	125,9	78,6
Non-Std.	10 845,5	10 377,9	358,1	109,5	32,7	60,7
Others	419,8	406,3	13,2	0,3	0,2	1,4
<b>Total</b>	<b>148 449,0</b>	<b>136 821,7</b>	<b>8 645,0</b>	<b>2 911,7</b>	<b>1 605,5</b>	<b>1 216,5</b>

Figure 14 Credit Exposure CRR 442(g)

### 7.4.3 Materiality of Risks

The figure below provides an overview of the risk weighted assets for Credit risk for the SCB Group.

In '000 NOK	RWA		Common-Size (% CR RWA)	
	Dec'17	Dec'16	Dec'17	Dec'16
Regional governments or local authorities	78 134	62 940	0,08 %	0,07 %
Institutions	978 295	1 522 496	1,00 %	1,77 %
Corporates	5 528 323	6 177 816	5,65 %	7,18 %
Retail STD	51 402 180	45 017 196	52,50 %	52,31 %
Retail IRB	31 031 667	25 699 193	31,70 %	29,86 %
Exposures in default STD	1 050 571	901 448	1,07 %	1,05 %
Covered bonds	419 657	863 747	0,43 %	1,00 %
Other Exposures	7 413 798	5 819 723	7,57 %	6,76 %
<b>Total Credit Risk</b>	<b>97 902 625</b>	<b>86 064 559</b>	<b>100,00 %</b>	<b>100,00 %</b>

Figure 15 Overview of risk weighted assets for Credit exposure in SCB

Risk weighted assets in SCB Group is managed under the IRB Approach for the three Auto Private portfolios in Norway, Sweden and Finland and under the Standardized Approach (STD) for the rest of the portfolios. With subsequent roll-out of IRB portfolios<sup>2</sup>, most of the Retail STD and Corporates portfolios is expected to move into IRB approach in the coming years.

### 7.4.4 Non-performing assets, losses and write-offs

This section outlines the bank's default, write-offs and loan loss reserve definitions and describes the developments in these parameters. SCB uses the following definitions;

- **Default:** A default is considered to have occurred when the entity considers that the obligor is unlikely to pay for objective reasons such as bankruptcy, litigation, or special handling within collections or is past due

<sup>2</sup> see chapter 7.5.1 for more details on IRB Roll-Out

more than 90 days on credit obligation (in line with CRR Art.178 (1)). Defaults are also referred to as non-performing loans (“NPLs”).

- **NPL-ratio:** Defaulted outstanding loans over total outstanding loans
- **Write-off:** The entity considers that any credit obligation is written-off and removed from the on-balance exposure according to accounting standards which state that “financial assets are written off once the entity has no reasonable expectation of recovering a financial asset in its entirety or a portion thereof”. Write-off in SCB is based on indicators like number of days past due, status of the debtor (for example, liquidation or sequestration proceedings), the range of expected cash flows and security/collateral realization.
- **Loan Loss Reserves (“LLR”):** represents management’s best estimates of losses incurred in the bank’s loan portfolio at the balance sheet date. The LLR has been classified as Specific write-downs or Generic write-downs, where the former is related to the individual loan, while the latter is related more generally to the portfolio as a whole. Changes to LLR from one reporting period to the next, will impact the profit & loss account under item “Loan Losses”. If LLR increases, this will increase Loan Losses, while if LLR decrease this will decrease Loan Losses. Starting January 2018, the Bank will calculate LLR following IFRS 9 standards where LLR no longer will be classified as generic and specific reserves, but rather in three different stages. For details please refer to chapter 2.2.2 under accounting standards in the annual report published at Santander.no.

Figure 16 below shows the development in the NPL-ratios divided into the secured (auto) and the unsecured portfolio, for the period 2015-2017, where for 2015 and 2016 year end NPL ratios and for 2017 quarterly NPL ratios have been provided. As can be seen from the table, the NPL-ratio for the combined portfolio has remained stable around 2% during the last 3 years. Noticeably, both for secured and unsecured portfolio the NPL% has remained stable resulting from a stable underwriting, credit policy and credit management process.

NPL Ratio	Dec'15	Dec'16	Mar'17	Jun'17	Sep'17	Dec'17
Secured	1,0 %	1,1 %	1,1 %	1,0 %	1,1 %	1,1 %
Unsecured	4,9 %	4,9 %	4,9 %	4,8 %	5,0 %	4,9 %
<b>Nordic</b>	<b>2,1 %</b>	<b>2,0 %</b>	<b>2,0 %</b>	<b>1,9 %</b>	<b>2,0 %</b>	<b>2,0 %</b>

Figure 16 NPL-ratio developments 2015-2017 per secured (auto) and unsecured portfolio,

Figure 17 below shows the development in NPL-ratio broken down per country. As can be seen from the table, Norway has the highest NPL-ratio. This is largely due to a higher share of credit cards than in the other countries and partly due to different write-off policy than in the other Nordic countries.

NPL Ratio	Dec'15	Dec'16	Mar'17	Jun'17	Sep'17	Dec'17
Denmark	1,0 %	1,2 %	1,3 %	1,2 %	1,2 %	1,2 %
Finland	0,7 %	0,7 %	0,7 %	0,7 %	0,7 %	0,7 %
Norway	3,4 %	3,4 %	3,3 %	3,3 %	3,5 %	3,5 %
Sweden	1,5 %	1,2 %	1,2 %	1,1 %	1,1 %	1,1 %
<b>Nordics</b>	<b>2,1 %</b>	<b>2,0 %</b>	<b>2,0 %</b>	<b>1,9 %</b>	<b>2,0 %</b>	<b>2,0 %</b>

Figure 17 NPL-ratio developments 2015-2017 per country

NPL coverage ratio is shown in Figure 18. NPL coverage is defined as Loan Loss Reserve (LLR) set by the bank divided by Non-Performing Loans.

During 2015 and 2016, factors like development in the oil price, and the legal merger with the GE Money Bank business made SCB group build up additional reserves to address the risk for higher incurred but not yet recognized (IBNR) losses which were not expected to be fully captured in the LLR models. During 2017, work was done to ensure that these factors were reflected in the LLR models, which explains the reduction in NPL coverage.

From January 1 2018 the bank will apply the IFRS 9 for calculation of LLR which is expected to increase the NPL coverage going forward.

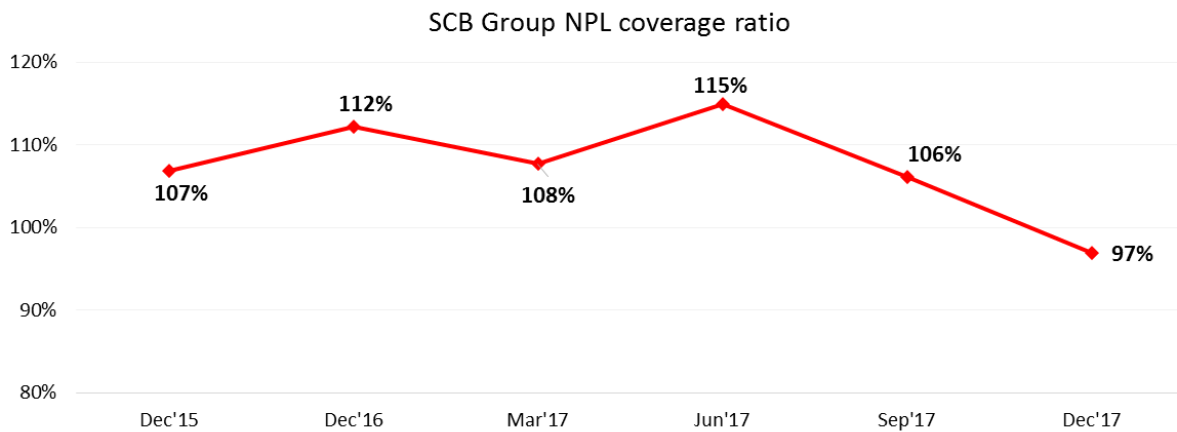


Figure 18 Coverage ratio developments 2015-2017

## 7.5 Credit risk under IRB approach

### 7.5.1 IRB Roll-Out

SCB considers the implementation of A-IRB to be strategically important and a key business driver for sustainable growth and future competitiveness. The operational benefits of A-IRB are related to improved client information, increased accuracy of models, and improved scoring, processes and routines and in general risk management practice of the bank.

The SCB credit portfolio can be divided to the following exposure classes under the Basel II accord:

- Corporate
- Retail
- Sovereigns
- Municipalities
- Financial Institutions/Banks

Of these segments, Corporates and Retail will be rolled out under the A-IRB Approach and the exposures under Sovereigns, Municipalities and financial institutions will remain under standardized approach. Additionally, Portfolios which are in run-off or where the materiality of the portfolio does not fulfill requirements of data availability for parameter estimations are excluded from IRB coverage.



Figure 19 below provides an overview of the Basel II approach by segments. As can be seen from the figure, some portfolios will remain under the standard approach based on the underlying obligor and the materiality of the portfolio.

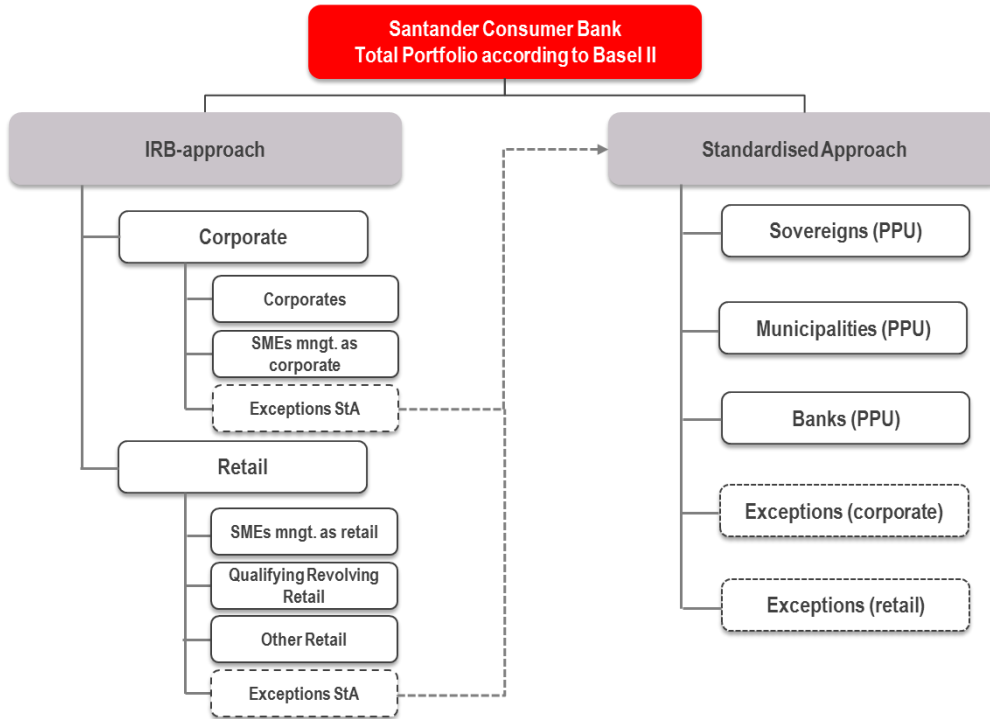


Figure 19 SCB Portfolio according to Basel

SCB has a three wave approach for the IRB Roll Out, with each wave incorporating different credit portfolios. The details for the Roll Out are provided in the table below. Wave I application was submitted in December 2013 and was approved for usage of A-IRB in December 2015 which included Auto Private Person portfolio of Norway, Finland and Sweden. Wave II application was submitted in December 2016 as planned which included Auto SME portfolio of Norway, Finland and Sweden, Auto Private Person portfolio of Denmark, Consumer loan portfolio of Norway and Finland and credit card portfolio of Norway. The application for Wave III portfolios is planned for submission in 2019.

The Basel Roll out Calendar is shown below:

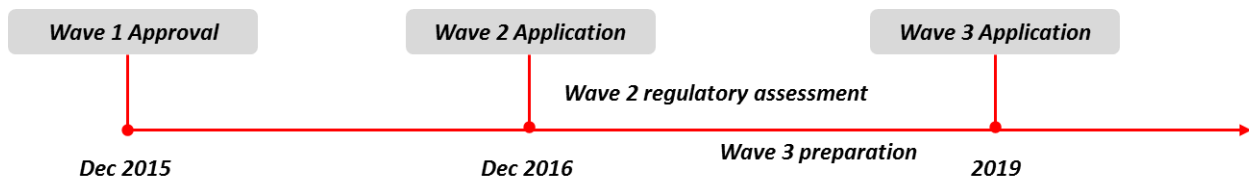


Figure 20 Basel Roll-Out Calendar

Existing coverage with Wave I approval and the estimated IRB coverage both in terms of Exposure at Default (EAD) and RWA with the subsequent approvals of the IRB portfolios (Wave II and Wave III) is shown in the charts below.

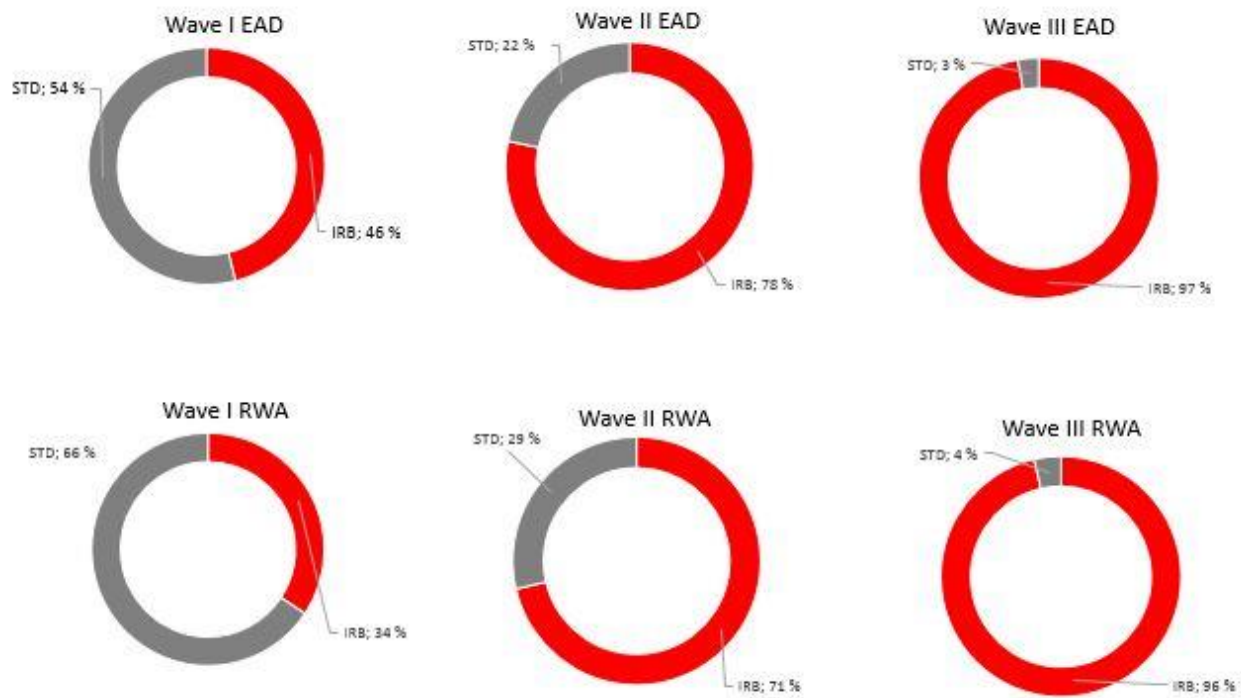


Figure 21 Estimated IRB Coverage of EAD and RWA for Wave I-III

Following the planned roll-out of the Wave III, close to 97% of eligible assets and 96% of the eligible RWA in the loan portfolio will be under IRB.

### 7.5.2 Approved IRB Portfolios

In December 2015, SCB received the approval from the Bank of Spain and the Norwegian FSA, to report the Auto Private Persons portfolios for Norway, Sweden and Finland under the IRB approach. The stability of the parameters and the underlying data for the portfolios performance has been monitored closely even before the IRB approval.

The EAD, RWA and Average Risk Weight (RW) development can be found in the graph above. The exposure to the three IRB portfolios shows a stable growth during 2017. The average risk weight of these three portfolios has remained stable during for 2017.

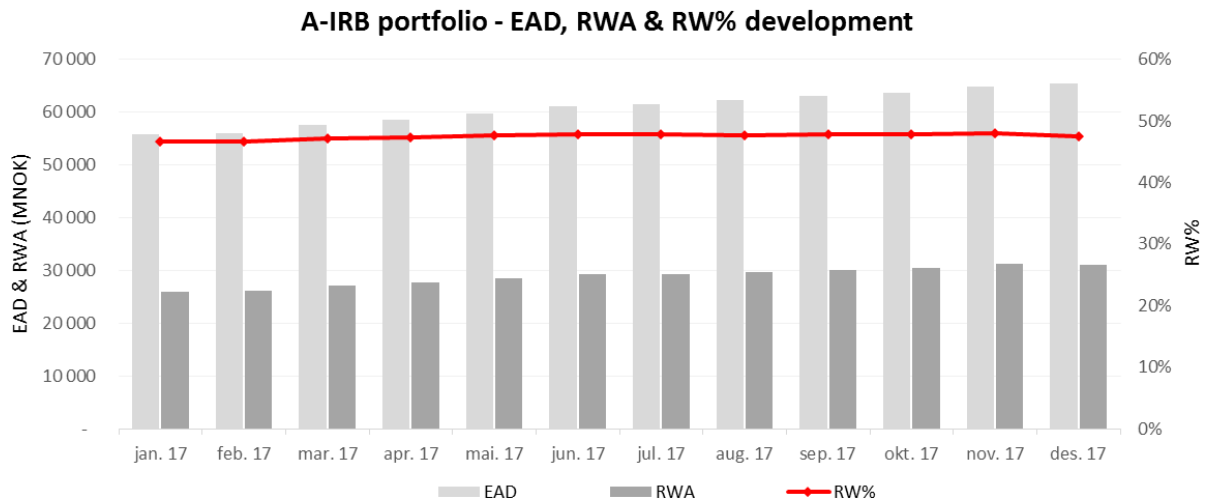


Figure 22 Wave I EAD,RWA and RW% Development during 2017

Figure 23 provides an overview of the IRB portfolio exposures and risk parameters. The table below follows the structure outlined by the Basel Committee on Banking Supervision (BCBS) table CR6 of the document entitled 'Revised Pillar 3 disclosure requirements', of January 2015. Since SCB Group IRB portfolio consists of installment loans without any assigned credit limit, Credit Conversion Factor (CCF) columns have not been reported.

PD_Bucket	On Balance Sheet gross exposure	EAD post CRM and post CCF	Average PD	# Obligors	Average LGD	Average Maturity	RWA	RWA Density	EL	Provisions
A [0.00-0.50]	9 116 800	9 116 800	0,26 %	55 317	34,3 %	4,07	1 600 638	17,6%	8 140	23 423
B [0.50-1.00]	19 106 981	19 106 981	0,72 %	151 627	45,7 %	3,82	8 184 124	42,8%	64 863	51 047
C [1.00-1.38]	16 178 321	16 178 321	1,09 %	108 446	41,1 %	3,96	7 448 813	46,0%	72 889	88 992
D [1.38-3.35]	9 537 310	9 537 310	2,06 %	77 343	42,3 %	3,91	5 550 735	58,2%	86 143	37 166
E [3.35-4.07]	852 143	852 143	3,39 %	6 274	43,7 %	4,21	560 012	65,7%	12 589	2 092
F [4.07-8.21]	5 796 009	5 796 009	5,53 %	41 336	40,8 %	4,01	3 742 258	64,6%	129 613	24 496
H [10.64-100]	4 230 702	4 230 702	24,37 %	30 247	37,7 %	3,92	3 857 998	91,2%	392 504	17 527
PD 100	655 347	655 347	100,00 %	5 905	38,0 %	2,52	87 090	13,3%	242 327	403 167
<b>Total</b>	<b>65 473 612</b>	<b>65 473 612</b>	<b>3,93 %</b>	<b>476 495</b>	<b>41,4 %</b>	<b>3,92</b>	<b>31 031 667</b>	<b>47,4%</b>	<b>1 009 069</b>	<b>647 911</b>

Figure 23 Overview of IRB portfolio exposure and parameters according to BCBS CR6

### 7.5.3 Regulatory Limits

In order to measure any significant variation within the IRB portfolios and ensure stability, regulatory limits are established on key performance indicators for the IRB portfolios. These limits are part of the “Management and Regulatory Limits” document which are reviewed on a yearly basis and approved by the Board of Directors.

For IRB portfolios, limits are set on following performance indicators:

- Risk Weight for total portfolio
- Expected Loss (EL) for total portfolio
- Probability of Default (PD) for non-defaulted portfolio
- Downturn Loss Given Default (LGD)
- Risk Weight (RW) for New business volume for the month
- Expected Loss (EL) for New business volume for the month

Actual performance of the IRB portfolios are then reviewed against the set limits on a monthly basis and are delivered to relevant stakeholders, with any point of attention clarified and managed in case necessary.

The regulatory limits have not been breached during 2017, and will be reassessed for 2018 considering the portfolio developments during 2017. The bank will expand the scope of regulatory limits to Wave II when receiving approval from the regulators on the Wave II portfolios.

### 7.5.4 IRB Portfolio Parameters Estimation and Rating Assignment

Measuring the credit risk of a transaction involves calculating both the expected and the unexpected loss of the transaction. The unexpected loss is the basis for the calculation of both regulatory and economic capital and refers to a very high, albeit improbable, level of loss that is not considered a recurring cost but must be absorbed by capital. Measuring risk involves two separate steps: estimating the risk, and then assigning the credit risk parameters: PD, LGD and EAD.

PD or probability of default estimates the likelihood that a client or a contract will default within 12 months. The PD used for regulatory capital is long-term, or ‘through-the-cycle’ PD, which is not conditioned to a specific point in the cycle. Modelling default events are based on the definition contained in Article 178 of the CRR which considers that default is defined for a client/contract when at least one of the following circumstances arises:

- The institution considers there is a reasonable doubt that the obligor will pay its credit obligations in full.
- The client/contract is past due more than 90 days on any material credit obligation.

Calculation of PDs are based on the banks internal historical data.

LGD or Loss Given Default is defined as the mathematical expectation of the percentage of economic loss in the event of a default event. Calculations of LGD are based on internal data for income and expenses incurred by the institution during the recovery process once the default event has arisen, discounted at the date of commencement of default.

The LGD calculated to determine regulatory capital is ‘downturn’ LGD, i.e. considered for a worst-case scenario in the economic cycle.

Lastly, EAD, or exposure at default, the value of the debt at the time of default, is also calculated. For lending products or any product with no off-balance sheet amount, EAD equals the balance of the outstanding loan plus any interest accrued and not paid.

Historical information on portfolios is essential for estimating regulatory parameters. The EU Regulation (UE NO 575/2013)<sup>1</sup> stipulates that the minimum period of data to be used in estimates for retail portfolios is five years. For this reason SCB Group has an internal data model containing past information on portfolios, which is subject to review by the internal supervisory divisions (Validation and Audit), and by the supervisory authorities.

As already mentioned, for regulatory purposes observations of frequency of default and the associated losses must be averaged out over an entire economic cycle, in the case of PD, or represent a downturn situation in the case of LGD or EAD.

It is for this reason that recent observations are not directly comparable to regulatory parameters, and back testing exercises should be treated with due caution. In general, the default frequencies recently observed are below regulatory PD during high growth period meaning growth rates above the average for the cycle. Conversely, when economic growth falls short of the average, default observations may exceed regulatory PD.

The major application of the PD, LGD and EAD credit risk parameters is to determine minimum capital requirements of the IRB portfolios within the legal framework. The legal framework states that these parameters and their associated metrics, including expected and unexpected loss, are to be used not only for regulatory purposes but also for internal credit risk management.

In SCB, the internal credit risk parameter estimates are used in a variety of management tools, including pre-classifications, RORWA (Return on Risk Weighted Asset) calculation, stress testing, and scenario analyses, the results of which are reported to senior management through various internal committees.

### 7.5.5 Recognition of credit risk mitigation

In the regulatory capital calculation, credit risk mitigation techniques affect the risk parameters. The IRB portfolios in SCB consists of Auto Loans to Private Persons where new and used vehicles serves as collateral. Following CRR article 199.1(c) these collaterals can be classified as “other physical collaterals” and is the only form of collateral that is used in the risk parameter estimations by bank. In the event of a customer default the bank will be able to repossess and sell the underlying collateral. Due to this the bank is able to use the underlying collateral as a credit risk mitigator in the LGD calculations. When calculating the LGD, the bank is using updated market values of the underlying collaterals.

### 7.5.6 Governance and Control of IRB Models

A fundamental part of the process implementing IRB models is to establish robust control and review mechanisms by Internal Validation and Internal Audit. This to ensure effective monitoring, validation and documentation of the capital models and their integration into risk management.

The governance model involves different levels of control structured around three lines of defense with an organizational structure and independent, clearly defined functions: 1st line (Model Owner and Methodology), 2nd line (Model Risk, Internal Validation, Risk Control and Supervision Units) and 3rd line (Internal Audit).

This governance meets the following regulatory requirements for IRB models:

- a) Existence of a strong governance model.

- b) Existence, separation and independence of the Risk Control and Supervision, Internal Validation and Internal Audit areas.
- c) Independent annual reviews by Internal Validation and Internal Audit, both at Banco Santander level.
- d) Communication processes with Management which ensure all associated risks are reported

SCB has defined a set of standards to develop, monitor and validate its models. Any models used must meet these standards. The standards provide a guarantee of quality for the models used by the Group for decision-making purposes.

One key feature of proper management of Model Risk is a complete exhaustive inventory of the models used. SCB has a model inventory containing all relevant information on each of the models, enabling to properly monitor according to their relevance.

This phase involves all those affected by the life cycle of models - users, developers, validators, data providers, IT etc. - and draws up and establishes priorities. Models are planned on an annual basis, approved by local governance bodies, and validated at Banco Santander level.

SCB, as part of Banco Santander, has wide experience in the use of models for risk management purposes. Internal Validation at Banco Santander level assess and reviews all IRB models prior to implementation. The assessment will cover methodological and technological aspects, data quality, their functionality and their application. Robustness, usefulness and effectiveness are validated prior to implementing any model.

The quality of the model is summed up in a final rating. The rating can fall into one of the following categories:

- 1) Low: The model's performance and use are appropriate. The quality of the data used in developing the model is good. The methodology used complies with the set standards and best practices.
- 2) Moderate-low: The model's performance and use are appropriate. The assumptions used in developing the model are reasonable.
- 3) Moderate: The model's performance and use are appropriate. The assumptions used in developing the model are reasonable. There are aspects of the model that need to be improved.
- 4) Moderate-high: There are deficiencies in the model's performance or use. The model's assumptions, the quality of the data in the development sample or the model's predictions are questionable.
- 5) High: The model's performance is inadequate, the model is not being used for the purpose for which it was developed, or the model's assumptions are incorrect.

Figure 24 summarizes the scores assigned to the credit risk models<sup>3</sup> for the existing IRB portfolios as a result of Internal Validation's review of credit risk parameters and rating models upon implementation of the models.

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<sup>3</sup> D: Data, IT: Technological environment, M: Model foundation, P: performance, U: model use

### Norway PD



### Sweden PD



### Finland PD



### Norway LGD



### Sweden LGD



### Finland LGD



Figure 24 Internal Validation Scorecard Review Auto Private Persons

Internal Audit is the third line of defense: The analysis carried out by this independent team covers five main areas of activity:

1. Review of compliance with both the Group and regulator's internal governance model
2. Integration in management and models rating. Detailed analysis on the importance of the model, valuation tools and implementation process as well as verifying the existence of procedures and compliance with rating policies.
3. Coherence and integrity of the databases and models construction. Review of the information control environment and the correct quality and integrity of the data
4. Review of the capital calculation process.
5. Analysis of the technical aspects and IT environment applications. Examination of the different processes' quality and environment supporting the models, as well as their involvement in management. Verification of the contingency plans to ensure strict compliance with the improvements laid down.

Once the review is finished, Internal Audit issues a report containing recommendations and observations arising from its review process, which in turn have a stipulated deadline to submit their action and resolution plans. Internal Audit also reports independently to SCBs Audit Committee, an independent body.

Following the approval from internal Validation, the model must be submitted for approval by the proper management bodies before being put into production. Nordic model committee at SCB level assesses and approves the model before the Consumer Model Committee at SCF level and Global Model Committee at Banco Santander level approves the model before implementation

Senior management at SCB periodically monitors Model Risk to assess whether measures needs to be taken.

### 7.5.7 Back-testing of IRB parameters

The aim of the PD Back test is to compare the regulatory PD used for calculating capital requirements with actual observed defaults (Observed Default Frequency (ODF)). The purpose of this exercise is to assess the predictive power of the IRB models.

In order to manage model risk for the PD's and LGD's used for capital requirement calculation, SCB group has set up validation processes to monitor the quality of the models on an ongoing basis. Back testing is a key quantitative validation tool in which predicted PD's and LGD's are compared with observed PD's and LGD's. Timely detection of inadequate performance of the PD's and LGD's are crucial since they are used in the capital requirement calculation, and back testing is thus conducted on a regular basis. Based on the result of the back test, appropriate actions are taken.

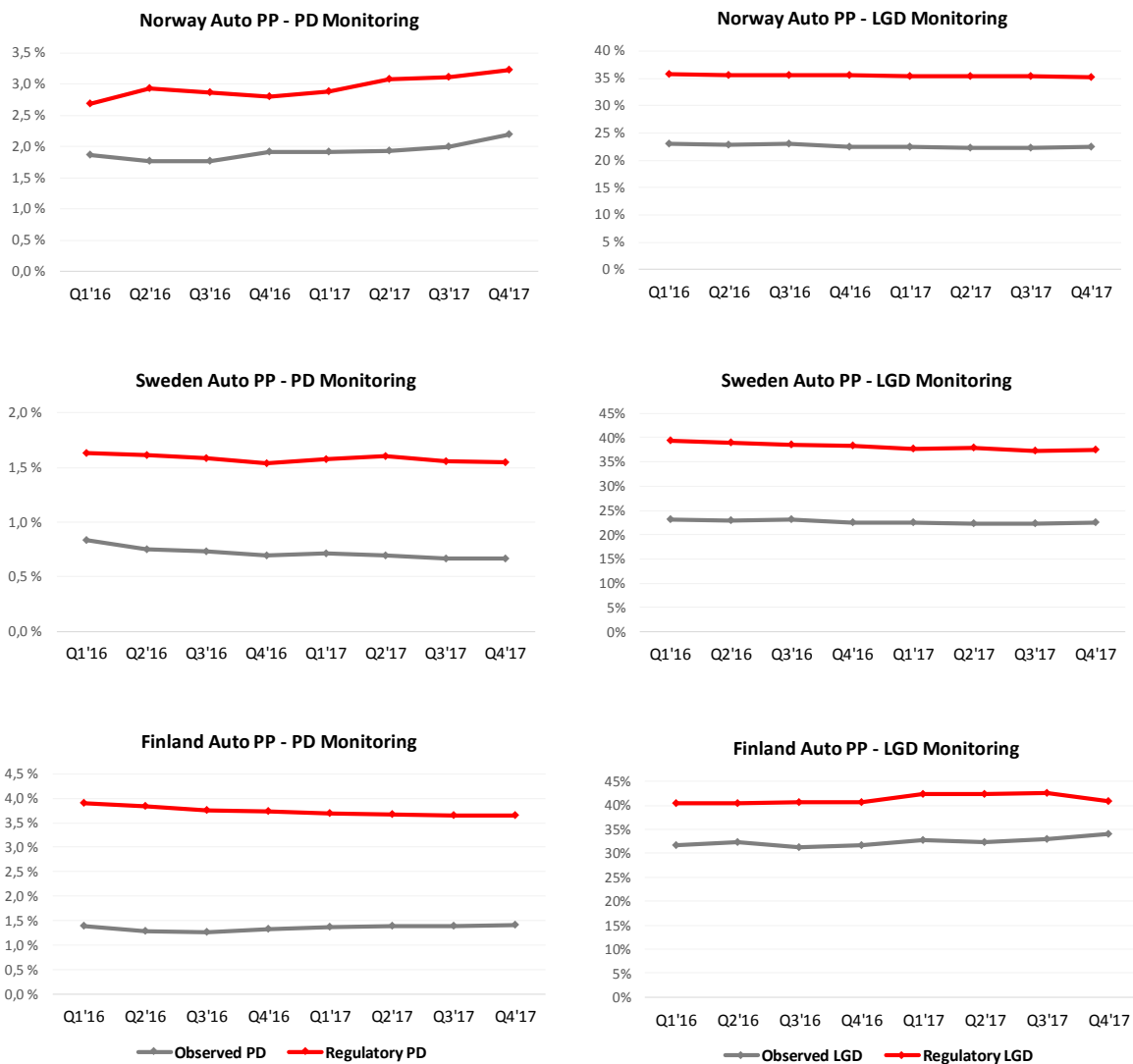


Figure 25 PD Back Testing of IRB portfolios



The back testing graphs above are at portfolio level monitored on a quarterly basis for the parameters PD and LGD. It is observed from the graphs above that the observed risk measurements (PD & LGD) for the A-IRB portfolios are significantly below the predicted measurements which are used in capital requirement calculation. Meaning, the calculation is sufficiently conservative.

For each portfolio, regulatory PD buckets, representing different PD levels, are established. For each of these the average PD assigned for regulatory capital purposes is compared with the ODF. To observe defaults, outstanding loans that were not in default at a reference date is selected, and the rate of new defaults among these outstanding loans over the subsequent 12-month period is observed.

The regulatory PD is a through-the-cycle (TTC) PD, i.e. a long-term average that is not tied to any particular point in the cycle. However, the default frequency is observed at a given point in time (2017). Given their different characteristics, the comparison between the two figures does not constitute a precise control of the regulatory PD, but it does serve to assess the size of the cyclical adjustment used in the calculation of the regulatory (TTC) PD.

To complete the analysis, the observed default frequency is also compared with the point-in-time (PIT) PD, which is influenced by the cyclical situation of the observation period. This allows the slope of the PD curve to be compared with the delinquency observed in each rating category.

Most of the following charts do not show the first PD bucket. This bucket includes very high values due to the inclusion of transactions in special situations: recovery process, irregular, etc. Including these would distort the scale of the graphs, hindering a proper assessment of the better-populated PD buckets.

The charts below summarize the information for the portfolios under IRB-Approach:

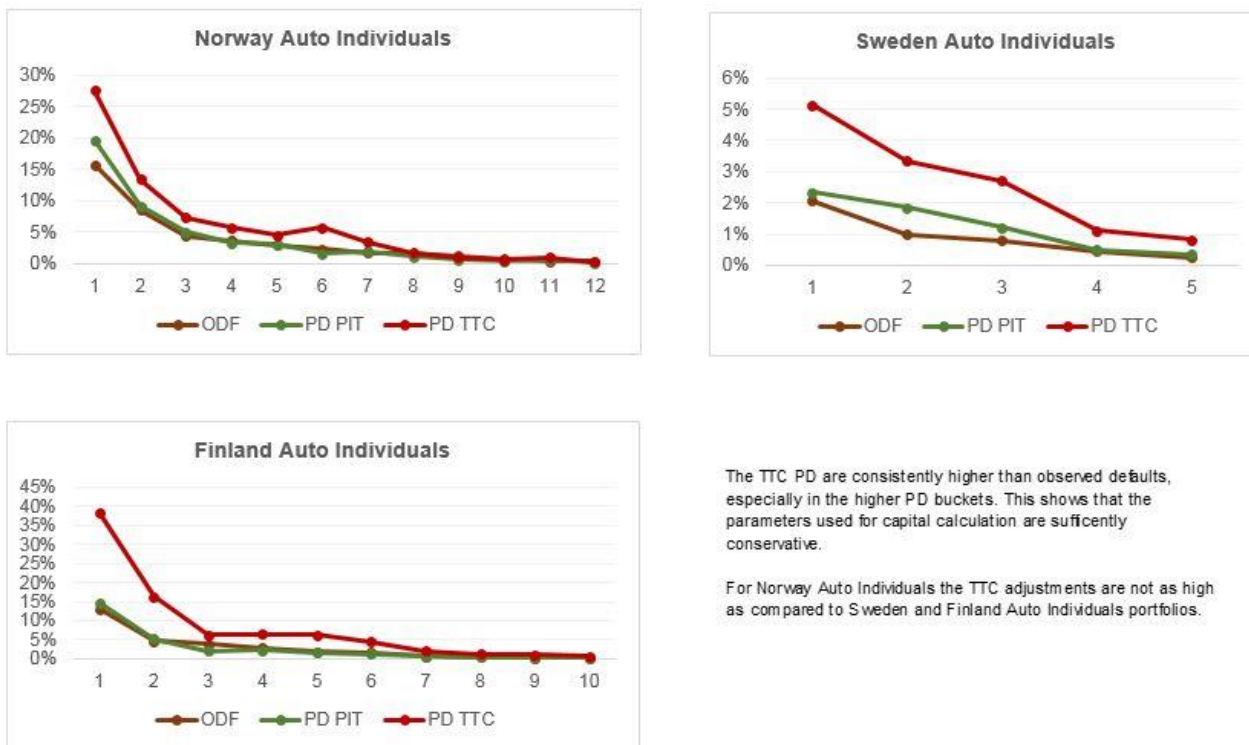


Figure 26 Observed Default Frequency by PD bucket and PD %

The above analysis is further complemented by the quantitative study suggested by the Basel Committee on Banking Supervision (BCBS) in table CR9 in Figure 27 of the document entitled ‘Revised Pillar 3 disclosure requirements’, of January 2015.

Nordics	PD Range	External Rating Equivalent	Weighted average PD	Arithmetic average PD by obligors	Number of obligors		Defaulted obligors in the year	Average historical annual default rate
					End of previous year	End of the year		
Nordics - Norway Auto Individuals	0 < 0,15%	AAA to A-	-	-	-	-	-	-
	0,15 < 0,25%	A- to BBB+	-	-	-	-	-	-
	0,25 < 0,50%	BBB+ to BBB-	0,26 %	0,26 %	53 000	55 317	208	0,27 %
	0,50 < 0,75%	BBB- to BB+	0,63 %	0,63 %	42 905	44 403	350	0,68 %
	0,75 < 2,50%	BB+ to BB-	1,39 %	1,42 %	59 291	57 569	793	1,02 %
	2,50 < 10,0%	BB- to B-	5,77 %	5,86 %	18 548	22 569	631	2,99 %
	10,0 < 100%	B- to C	22,98 %	23,23 %	14 886	18 362	1 914	21,75 %
	100% (Default) D		100,00 %	100,00 %	4 064	4 646	458	
Nordics - Sweden Auto Individuals	0 < 0,15%	AAA to A-	-	-	-	-	-	-
	0,15 < 0,25%	A- to BBB+	-	-	-	-	-	-
	0,25 < 0,50%	BBB+ to BBB-	-	-	-	-	-	-
	0,50 < 0,75%	BBB- to BB+	-	-	-	-	-	-
	0,75 < 2,50%	BB+ to BB-	0,85 %	0,85 %	93 406	106 239	260	0,42 %
	2,50 < 10,0%	BB- to B-	3,39 %	3,41 %	28 463	32 602	330	1,40 %
	10,0 < 100%	B- to C	67,45 %	67,21 %	319	328	130	56,62 %
	100% (Default) D		100,00 %	100,00 %	333	368	73	
Nordics - Finland Auto Individuals	0 < 0,15%	AAA to A-	-	-	-	-	-	-
	0,15 < 0,25%	A- to BBB+	-	-	-	-	-	-
	0,25 < 0,50%	BBB+ to BBB-	-	-	-	-	-	-
	0,50 < 0,75%	BBB- to BB+	0,62 %	0,62 %	14 148	16 297	30	0,19 %
	0,75 < 2,50%	BB+ to BB-	1,35 %	1,40 %	71 764	89 647	329	0,53 %
	2,50 < 10,0%	BB- to B-	4,87 %	4,87 %	13 137	15 700	248	2,14 %
	10,0 < 100%	B- to C	26,43 %	26,60 %	10 082	11 557	827	20,45 %
	100% (Default) D		100,00 %	100,00 %	625	891	199	

Figure 27 BCBS CR9 Table

It can be seen that there is no major difference between the average exposure-weighted PD and the simple average in each bucket, indicating that the different loans are fairly uniform with regard to exposure.

The column “number of obligors” is divided into two and contain the number of obligors (or loans in the case of retail) at two different dates: December 2016 and December 2017. The intention is to detect customers/transactions migrating between PD buckets, though sometimes the migration is due more to a recalibration of regulatory models than to the dynamics of the rating system. It can be observed that the distribution of obligors is fairly similar in these 2 years meaning no significant rating migration and stable portfolio quality.

From the back testing point of view, average historical default rate is very important, as it averages the default rates experienced in each of the past five years for each PD bucket. Comparing this column with columns weighted average PD and simple average PD gives an idea of how well our regulatory PD match actual experience over the medium term.

In general it is observed that the PD assigned to IRB portfolios for capital requirement are conservative when compared with average defaults over the last 5 years. This observation is in line with economic cycle development in the respective countries.

## 8. Counterparty credit risk

The bank defines Counterparty credit risk as defined in Article 272 of CRR: “Risk that the counterparty to the transaction could default before the final settlement of the transaction cash flows”.

Transactions within the scope of Counterparty credit risk in the bank are cross currency swaps and interest rate swaps. These type of derivatives are used in order to hedge currency and interest rate risk related to funding transactions. In all of the Bank's derivatives we have signed collateral agreement (VM CSAs) with the counterparty with bilateral daily collateral posting.

The bank holds derivatives for hedging purposes only and required capital for these transactions represent a very small share of total capital requirements, Counterparty credit risk is not considered a significant risk for the Bank.

## 9. Securitization

Securitization risk is defined as a reversal of capital relief obtained through securitization, which would result in an immediate and substantial increase in required capital.

None of the securitization transactions executed by SCB has resulted in capital relief and is thus not subject to any securitization risk. The securitization programs have been initiated purely for funding purposes. The intention of the securitization programs is to be able to access international debt capital markets and potentially to access the liquidity provided by Central Banks to ensure functional credit and money markets.

Securitization serves as one of the pillars in the bank's funding strategy. Since 2011, SCB has completed 16 asset backed securities transactions: seven securitizations from its Norwegian auto portfolio, two securitizations with Swedish assets, including a warehouse transaction, six securitizations from the Finnish business, and one out of Denmark. Per end December 2017, securitizations accounted for about 12% of the bank's funding. By year end 2017 8 transactions have been wound down, with full payment to external investors. This following a change in the legislation in Norway making it more challenging to securitize auto loans in Norway in the same manner as we have done in the past.

SCB securitizes auto loans by selling portfolios of auto loans to a special purpose company, which funds the purchase by issuing bonds with security in the assets.

The securitization program has not, and will not, affect the bank's front or back systems in any significant way. Other than additional information extracted for management and reporting purposes, all systems remain the same.

SCB issues Asset Backed Securities (ABS) but do not invest in any ABS'es issued by others. All currency and interest rate risk created by a mismatch between issued notes and underlying assets are hedged through currency and interest rate swaps.

## 10. Market risk

Market risk is considered as the potential loss of value in assets and liabilities due to changes in market variables. Market risk arises as a result of the bank holding open positions in various financial instruments. It can be subdivided into the following main categories:

- Currency risk is the risk of loss as a result of changes in foreign exchange rates, and the key metric is open exposure in the relevant currencies.
- Interest rate risk is the risk of loss as a result of changes in the interest rate and the key metrics are Net Interest Margin (NIM) and Market Value of Equity (MVE) sensitivities further explained below.

- Credit spread risk is the risk of loss as a result of changes in credit spreads

Market risk is managed by the Treasury department organized under the Financial Management Division and controlled by the Risk Division.

SCB has a strategy of not taking on market risk beyond what follows directly from our operations in the four countries where we are present. The bank is exposed to currency risk because it operates in four different countries and currencies, and through its use of international funding markets. The bank has interest rate risk to the extent there is a mismatch between interest rate exposure on the asset side and liability side. SCB does not have an active trading portfolio or positions in securities and commodities, but has a liquidity portfolio consisting of High Quality Liquid Assets where the intention is to hold the bonds to maturity.

The currency risk, interest rate risk and credit spread risk related to our liquidity portfolio is described in more detail below.

### 10.1 Currency risk

As the bank operates in four different countries with four different currencies, as well as using international funding markets, it will inevitably be exposed to currency risks.

The bank aims for a composition of the balance sheet that minimizes currency risk by ensuring that the assets and liabilities are primarily denominated in the same currency. When raising funding through the international debt market any open currency exposure is closed through the use of derivatives.

The currency exposure is continuously monitored and controlled through monthly reports. The limits for currency risk are approved by the Nordic Approval Committee and reviewed by the Board of Directors on an annual basis.

The actual FX positions towards the limits for 2017 can be seen below:

	Currency Position MNOK Equivalent	2017 Management Limit
Open Net Position EUR	786	1000
Open Net Position SEK	27	200
Open Net Position DKK	40	200
Open Net Position Total	852	1200

The EUR position stems from net assets built up through retained earnings in the Finnish subsidiary, SCF Oy.

### 10.2 Interest rate risk

Interest rate risk is the risk of reduced earnings or reduction in the economic value of the equity due to changes in market interest rates.

SCB aims to achieve a balance sheet composition that minimizes the interest rate risk by balancing the total weighted interest term for both assets and liabilities. The bank is only exposed to interest rate risk that follows directly from the bank's operations, as does not actively take on interest rate risk.

The strategy of managing interest rate risk involves the use of variable and fixed rate intragroup loans, interest rate derivatives and customer deposits at variable or fixed rate. The interest rate gap positions for all significant currencies are monitored and reported monthly. The bank also calculates the six interest rate risk scenarios as described by the

Basel committee in Interest rate risk in the banking book (IRRBB). In addition, a sensitivity analysis and a forecast of future interest rate risk is performed.

The Financial Management department, as the risk taker, proposes interest rate risk limits to the Risk department which assesses the proposal and submits it to the Board of Directors for final approval. The limits reflect the risk appetite of both the parent Santander Consumer Finance SA and SCB. Limits must be reviewed annually for each of the following metrics:

- **Net Interest Margin (NIM) sensitivity:** The sensitivity of the Net Interest Margin is a measure of the difference between the return on assets and the financial cost of the liabilities on a 12 month horizon. The impact is measured as the worst effect on Net Interest Margin of a +/-25, 50, 75 and 100 bps parallel movement in the interest rate curves of the changes (-/+ 100 bps).
- **Economic Value or Market Value of Equity (MVE) sensitivity:** The sensitivity of Market Value of Equity is a measure which complements the sensitivity of Net Interest Margin. It measures the implicit interest rate risk in the Market Value of Equity from a variation in interest rates (worst of +/-25, 50, 75 and 100 bps parallel movement in the interest rate curves) on the financial assets and liabilities in the bank.

The interest rate is calculated in the internally developed Asset and Liability Model by distributing all interest rate sensitive assets and liabilities into tenor buckets and then calculating the MVE and NIM sensitivities by applying certain mathematical formulas. The assets and liabilities are assigned their re-pricing maturities following certain assumptions that are regularly reviewed. The assumptions include the behavioral aspects of non-maturity deposits that do not have contractual maturity and the re-pricing criteria of the loan portfolio that are contractually neither fixed or floating rate products.

The 2017 year-end NIM and MVE was as follows, in the respective currencies:

	NOK	SEK	DKK	EUR
<b>MVE Sensitivity</b>				
Management limit	200	65	50	12
Actual December 31st 2017	108.32	38.26	5.5	8.7
<b>NIM Sensitivity</b>				
Management limit	70	35	35	6
Actual December 31st 2017	3,35	16.9	28.07	1.3

Figure 28 2017 Interest Rate risk limits and ratios per December 2017

### 10.3 Credit Spread risk

Credit spread risk is defined as the risk of changes in market value of securities or any credit derivatives as a result of an overall change in credit spreads. As mentioned, SCB's strategy is not to take on market risk in excess of what follows directly from the operations of the bank. Consequently, the bank's liquidity portfolio consists of high quality liquid assets. SCB did not have any credit derivatives per December 2017.

The market risk exposure of the liquidity portfolio is considered as low, since the investment mandate is limited to short term level 1 high quality liquid assets where the intention is to hold the bonds to maturity.

## 11. Operational risk

Operational risk is defined as “the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events”. It includes events that may arise due to legal or regulatory risk, but does not include events arising due to strategic or reputational risk.

SCB is applying the Basic Indicator Approach for calculating the bank’s capital requirement for operational risk. With the Basic Indicator Approach RWA for operational risk is calculated as a percentage (alpha) of the three last year’s gross income multiplied by 12.5. This alpha is given by article 315 (1) of the CRR and is currently 15%.

### 11.1 Operational risk appetite and operational risk loss budget

To ensure that the bank operates within the approved risk appetite, the operational loss risk appetite is set at least annually and require Board of Directors approval. The main metric of the risk appetite is “Operational risk losses” / “Gross margin”. Re-occurring Board of Directors meetings monitors the data related to operational loss risk appetite.

- **Limit of risk appetite:**
  - The defined 2018 operational risk appetite limit correspond to a medium-low operational risk profile.
- **Risk Appetite Alert:**
  - A risk appetite buffer is in use. It is calculated by using a percentage of the difference between the budget and the Risk Appetite limit. The resulting number is regarded as the Risk Appetite Alert figure. The risk appetite alert is considered as the management limit.
- **Operational loss budget:**
  - Each of the four Nordic SCB units, define operational risk loss budgets. For assessing and setting the operational risk loss budget, all operational risk categories provided by the Basel regime is used, and thus the budget process involve many different business units. The Local Internal Control Committees approves the budgets.

On a monthly basis, the budget is monitored, reconciled and reported to relevant stakeholders, including to Banco Santander. Specific general ledger operational risk accounts, both at local and corporate level, has been set for this purpose.

### 11.2 Santander Operational risk framework

SCB’s operational risk framework, as illustrated below, is based on Banco Santander governance and framework for Operational Risk. One of the objectives with this framework is to ensure that the bank is operating within the given risk appetite limits. To be able to monitor and manage the risk appetite limits, all relevant operational risk elements need to be detected, reported, monitored and managed. Therefore, the SCB operational risk model consist of six interlinked main processes.

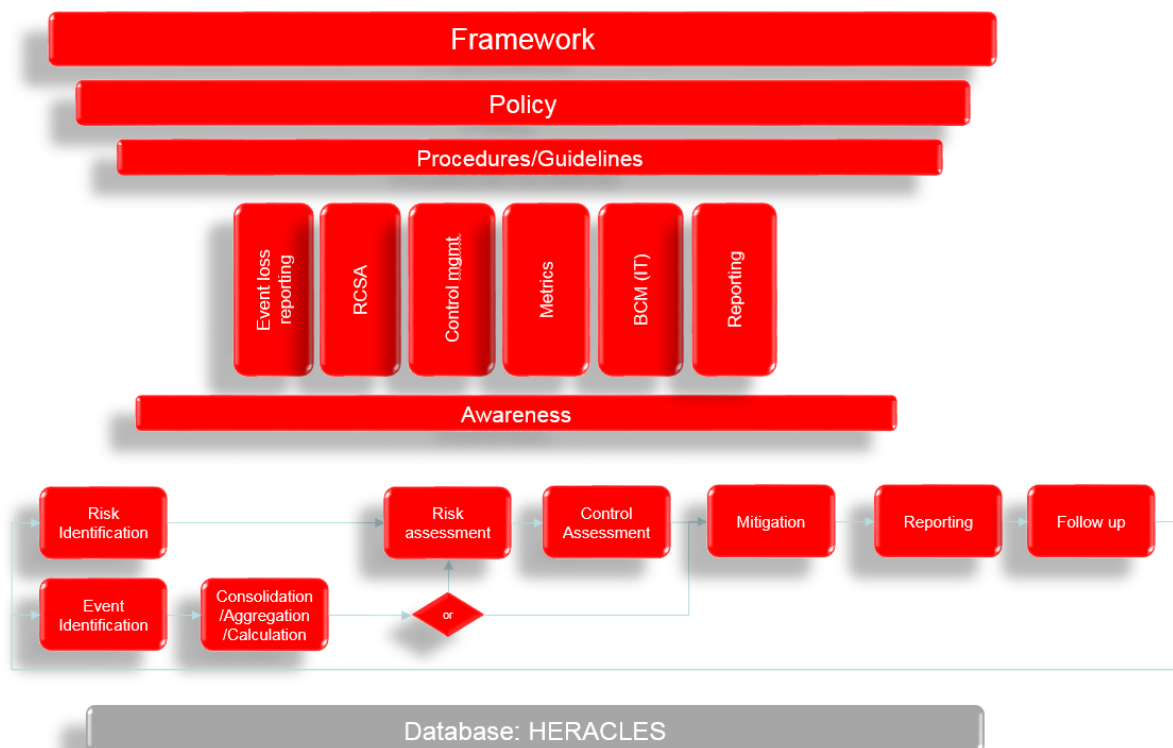


Figure 29 SCB's Operational Risk Management Framework

All of the six main processes use the Santander Corporate system called Heracles. Heracles is a holistic operational risk and internal control governance system which uses standardized processes and taxonomies. This methodology and system ensure a high standard of the management of operational risk and internal control processes and also a consistent report of data across all SCB units.

**Processes:**

- **Event loss reporting process** – This process includes the identification, consolidation, aggregation, calculation, development of mitigation plans/activities and the reporting of events that has occurred, or might potentially occur. Both non-accountable and accountable impacts are assessed. The Bank uses the 7 Basel categories for the classification of losses.
- **Risk and Control Self-Assessment (RCSA) process** – A yearly risk assessment identifying and evaluating potential risks and controls to proactively prevent risks of becoming materialized. Potential risks are also managed continuously during the year within the event loss reporting process. The Basel category IV on “Client, Product and Business Practices” are assessed through conduct risk questionnaires as part of the annual RCSA process. The conduct risks are considered in the RCSA workshops and included in order to assess the residual risk, and considered in the Operational Risks Statements. In addition to the RCSA process, various thematic risk assessments, such as IT risks assessment and Conduct risks assessment, are performed on an annual basis.
- **Control management** – Controls will constantly be a part of ‘business as usual’ within all processes and managed by both Operational Risk and Internal Control. The corporate tool Heracles ties together the operational risks and assessments with their respective controls in a holistic risk vs control environment.



- **Metrics** – The use of different metrics, or key risk indicators, is an important tool for detecting and remediating potential risks before they are materialized.
- **Business Continuity Management (BCM)** – In the BCM program, plans are defined to secure a quick recovery of systems or processes exposed for a major event or a disaster. In the potential event of an activation of a BCM plan the event will also be a part of the event loss management and reporting process.
- **Reporting** - Operational risk reporting is reported in the corporate tool Heracles and managed in various risk committees depending on the type or severity of the potential or materialized event or assessment.

In addition to the six main processes presented above, the following processes are important to acknowledge within the SCB operational risk management:

- **Santander Cyber Security Program** – This program is intended to assess, detect, prevent, and mitigate serious IT related security threats. The program is governed by the IT departments and monitored by the second Line of Defence (LoD) at the non-financial risk area.
- **Fraud management** – Internal and external fraud events is within the operational risk scope and thus there are policies and procedures governed by the risk area. The objective is to control and minimize the losses related to fraud events. Fraud is also governed by the Non-Financial risk area to assure that fraud events are detected, reported and managed in a consistent and proficient way across the countries.
- **Risk culture and awareness** – Banco Santander have initialized and implemented a Risk Pro concept with the objective to acknowledge the importance of the operational risk framework and mindset within all employees.
- **Compliance and reputational risks** – Within the operational risk scope also compliance and reputational risks are considered. The management of these risks, from the operational risk perspective, share and/or follow the methodology of the general operational risk management processes. These processes include the loss event process, key risk indicators, annual risk assessments, awareness, and the reporting process.

### 11.3 IT operational risk management

To ensure that the IT operational risks are covered within the operational risk scope, the IT area is involved in all of the main operational risk processes described above. Second line of defense for operational risk is overseeing IT governance in several areas, such as; Cyber Security, internal control and operational risks.

### 11.4 Operational Risk Management

Based upon SCB Corporate guidelines, the bank has adapted and established a Nordic operational risk framework, model, policy and procedures, which describe the operational risk management.

The operational risk management of SCB's follows three lines of defense (LoD) structure. 1st line are business units that owners of risks, 2nd line are specialized risk and compliance teams that oversee and monitor risks, 3rd line is Internal Audit. Each country have full time operational risk leaders within risk department, working as 2 LoD. The operational risk leaders have appointed operational risk coordinators (1st LoD) which are responsible for many operational risk processes, such as annual risk assessment process or the event reporting process. The operational risk coordinators are represented in all business units. Monthly meetings for operational risk leaders and the



coordinators are in place. The operational risk coordinators safeguard the operational risk loss processes and act as a promoter for operational risk processes within the bank.

The governance includes several risk committees that operates with the objective to assure that the senior management team and Nordic management team are updated with relevant non-financial risks and ongoing activities.

## 12. Liquidity risk

Liquidity Risk is the risk that a company becomes unable to meet its obligations as they fall due because of an inability to liquidate assets or obtain adequate funding.

Liquidity risk management in the bank aims to ensure sufficient funds to support the daily operations of the bank, a balance between weighted average life of the assets and liabilities, diversified funding sources and sufficient amount of liquidity reserves across all 4 currencies in order to survive a stress scenario.

The key ratios for the liquidity risk are LCR and NSFR.

- The LCR (Liquidity Coverage Ratio) is established as a metric to measure short-term liquidity risk. This ratio indicates the short-term resilience of the entity's liquidity risk profile, ensuring that there are sufficient high-quality liquid assets to withstand an event of combined systemic and global stress over a period of 30 calendar days. The consolidated LCR requirement for 2017 was 80%, increasing to 100% in 2018. Consolidated LCR for SCB Group was by end 2017, 148%. In addition to having LCR requirements on a consolidated level, the Norwegian legislations changed in 2017, introduction also a requirement to be compliant on a significant currency basis. These new regulations were effective from September 2017 and introduced limits of 50% in NOK and 80% in other significant currencies. For SCB, significant currencies are NOK, SEK, DKK and EUR. As of year-end 2017 the LCR levels per significant currency were NOK 125%, SEK 128%, DKK 283% and EUR 198%.
- The NSFR (Net stable funding ratio) is the long-term funding ratio which compares the structural funding needs to the entity's stable funding sources. This ratio requires the banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. The ratio for SCB group was by end 2017, 96%.

### 12.1 Diversification of funding sources

SCB aims to reduce reliance on funding from parent company (i.e. become self-funded) and to maintain a well-diversified funding source composition. Per end of 2017, the bank had a self-funding ratio of 77%<sup>4</sup>. Over the years, the bank has established the following funding sources:

- Customer deposits in Norway, Sweden and Denmark. The customer deposit products are demand deposits, fixed rate deposits and notification products
- Secured funding in the Nordic countries (asset backed securities)
- Senior Unsecured funding in the local Nordic markets and in international markets
- Intragroup funding from the parent company
- Repo capabilities with Nordic counterparties

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<sup>4</sup> Calculated as a proportion of senior debt, excluding equity and subordinated debt

Figure 30 below shows the funding composition on a consolidated Nordic level for end of year 2017:

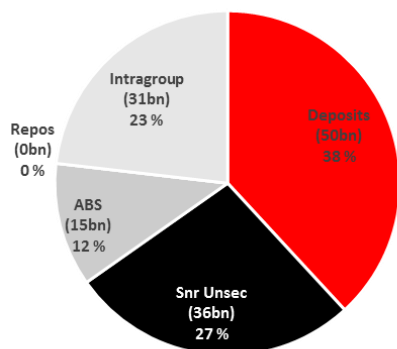


Figure 30 SCB Funding composition (figures in NOK)

Over the last few years retail deposits have been introduced in Norway, Sweden and Denmark. As of year-end 2017, deposits constituted about 38% of the bank's funding base, up from 35% in 2016.

The bank's securitization program has been implemented across the four Nordic units over the past five years, and serves as an integral part of the bank's funding program. Per year-end 2017, securitization constituted about 12% of the bank's funding, down from 13% in 2016. This is mainly due to a change in legislation governing ABS issuances in Norway applicable from 2016, making new issuances in Norway challenging.

The bank is well-established in the Norwegian senior unsecured bond market and has increased issuances under its Euro Medium Term Note program (EMTN), issuances under this program has since H2 2016 been issued under SCB's standalone credit ratings from Fitch (A-) and Moodys (A3). Per year-end 2017 external senior unsecured funding constituted about 27% of the bank's funding, up from 22% in 2016.

SCB has available draw-down facilities with its direct parent and with other entities within the Banco Santander Group. Per year-end 2017, senior funding from parent constituted about 23% of the bank's funding, down from 30% in 2016. In addition to senior funding, the SCB also has subordinated debt provided by the parent company.

In addition to drawdown facilities from the parent and Banco Santander Group, the bank has committed credit facilities provided by 3<sup>rd</sup> party banks. This is intended to cover short-term liquidity requirements of an operational nature and to serve as a liquidity buffer.

## 12.2 Liquidity portfolio

The bank holds a liquid bond portfolio to mitigate liquidity risk. The size of this liquidity portfolio is determined through the bank's liquidity stress tests as well as regulatory requirements, such as the Liquidity Coverage Ratio (LCR).

As of year-end 2017 the liquidity bond portfolio was about NOK 7.7 Billion equivalent, which is down from NOK 11 Billion equivalent in 2016. This is a short term movement, and the portfolio is expected to remain at levels close to NOK 11 Billion equivalent also in 2018. The bank has a conservative mandate for liquidity portfolio investments and only invests in LCR level 1 securities. The portfolio is invested in Nordic and European government bonds,

supranational bonds and AAA/Aaa rated Nordic covered bonds, issued in NOK, SEK, DKK and EUR. Further, the bank only invests in floating rate coupon bonds with a maturity up to 3 years and fixed rate bonds with a maturity up to 1 year. The intention is to hold the bonds in the liquidity portfolio to maturity. The bank can deposit bonds from the liquidity portfolio in the Norwegian Central Bank to provide intraday liquidity if needed.

### 12.3 Liquidity Stress Tests

SCB maintains a Liquidity Stress Test model, which is run on a monthly basis. The liquidity stress test of the bank complies with regulatory requirements and is used both as a tool for measuring liquidity risk and for managing funding and liquid assets.

The Liquidity Stress Test is regularly presented Senior Management on a quarterly basis and on a semi-annual basis to the Board of Directors. The object of the Liquidity Stress Test is to ensure that the bank has sufficient liquidity to survive a given period of time under the defined stress scenarios. The stress test is used as part of the liquidity risk management of the bank.

### 12.4 Encumbered assets

An asset is encumbered if the asset is pledged or collateralized and cannot be freely withdrawn. The source of encumbrance in SCB is securitization and repurchase agreements. Asset encumbrance (AE) are managed with a limit of 35%. By end 2017 the actual ratio observed was 13.7% for SCB Group.

Asset encumbrance is monitored and maintained within a limit for dual purposes. One is to prevent concern among unsecured creditors that they are unable to benefit from the liquidation of assets in case of insolvency, if too many assets of the bank are already encumbered. The other is to limit the amount of encumbered assets that are not available to obtain emergency liquidity in case of an unforeseen stress event.

The ratio of asset encumbrance is calculated as the ratio of the assets/collateral pledged for financing operations (encumbered assets) plus total collateral received and reused, divided by the sum of total assets and total collateral received, expressed as:

$$\% \text{ AE} = \frac{\text{Total encumbered assets} + \text{Total collateral received re-used}}{\text{Total assets} + \text{Total collateral received}}$$

## 13. Business and strategic risk

Business and strategic risk is the risk of lower earnings than expected. This may be due to lower than expected revenues, higher than expected operating cost, or a combination of the two. This risk is inherent in the operation of the bank and the macroeconomic environment where it operates.

The stress test conducted in the ICAAP uses different macro economical scenarios and shows how this impact the profitability and impact on the capital position of the bank. Due to the relative short duration of the bank's assets, a downturn stress-scenario will typically have some but limited impact on capital ratios since risk weighted assets will decrease in conjunction with reduced profit. The result of the stress test for Internal Capital Adequacy Assessment Process (ICAAP) forms part of our Pillar 2 assessment and Pillar 2 capital requirement.

By operating in Norway, Sweden, Denmark and Finland the bank is less vulnerable to any challenging macroeconomic development in the individual countries. With the merger with GE Money Bank in 2015, the diversification of customer and product portfolio has improved. Focus going forward will be more on increasing the number of products per customer, and consequently build customer loyalty and lasting customer relationships.

## 14. Compliance risk

The Compliance & Conduct (C&C) function consists of compliance professionals in the operations across the Nordics, overseen by the Chief Compliance Officer, who has a functional reporting line to the Chief Compliance Officer at Santander Consumer Finance S.A. To ensure the independence of the compliance function, the Chief Compliance Officer (CCO) has direct access to the Board and its Board Risk Committee. For matters connected to staff, the CCO reports to Nordic HR and Legal Director. The local Compliance Directors reports to the Chief Compliance Officer (except for SCF OY – where local Compliance Director reports to Managing Director and has functional reporting line to the CCO). The bank is planning changes to the reporting lines of the CCO within first half of 2018.

The C&C function promotes adherence to rules, supervisory requirements, principles of good conduct and values by acting as a second line of defense – establishing standards, challenging, advising and reporting – in the interest of employees, customers, shareholders and the wider community. Sound compliance in everything the bank does, helps to protect the bank's reputation and supports the achievement of its ambitious goals.

The C&C function covers all matters related to regulatory compliance, product governance and customer protection, anti-money laundering and terrorism financing, reputational risks, as well as any others the Group could place at compliance risk. Reputational risk is defined as the risk of current or potential negative economic impact to the bank due to damage to the perception of the bank on the part of employees, customers, shareholders/investors and the wider community.

The C&C function, as the second line of defense for regulatory compliance, product governance, customer protection, money laundering, terrorism financing and reputational risks, provides independent challenge and oversight of the risk management activities performed by the first line of defense, assessing the impact on risk appetite and the risk profile within these areas of the entity. The C&C function ensures that risks under its responsibility are managed in accordance with the risk appetite defined by senior management and approved by the Board, and promotes a strong risk culture throughout the organization. The C&C function reports its findings and recommendations to the Managing Directors in the business units and the Nordic CEO on a regular basis, to the Local Internal Control Committee and to the Nordic Internal Control Committee, as well as to the Board and its risk committee.

The compliance program relies on regular risk assessments on compliance and conduct risk, supporting a risk-based monitoring approach. The Bank is yearly assessing its risks, applying the risk assessment methodology of Banco Santander. The objective is to assess risks within core activity lines, in banking activities where customer relations need to be managed, and excludes therefore risks within Tax, Financial Accounting, HR, and similar non-core compliance areas. The mandatory risk assessments facilitates a homogenous approach to assess, report and escalate compliance risks to local and corporate management, as well as providing an effective supervision of risk management throughout the Group, and for the Bank within its Nordic operations.

The regulatory compliance risk assessment ensures that inherent risk is assessed based on its probability and impact, within main regulatory areas applicable to the business operations of each entity and measures the risk mitigating effect of the preventative and detective controls in place. In addition there are annual thematic risk assessments,

such as the anti-money laundering risk assessment and the conduct risk assessment, where client, product and business practices are assessed, and becomes part of the annual RCSA process.

An important part of the bank's management of reputational and conduct risks in 2017, was the implementation of the FSA circular 5/2017 "guidelines on prudent consumer lending practices" and the improvements made to the complaint handling process and oversight. Additional preventative and detective control measures will be implemented during 2018 to manage the increasing reputational and conduct risks within consumer loan and credit cards.

The risks arising from compliance and conduct risks are consolidated by the Risk control function, in such a way, as to present a complete picture of the full range of risks to which the entity or the Group is exposed.

## 15. Pension Obligation risk

Pension obligation risk is the risk to a firm caused by its contractual or other liabilities with respect to a pension scheme. According to the EU accounting standards, there are two categories of pension scheme: contribution-defined plan and benefit-defined plan.

A contribution-defined plan is a retirement savings program under which an employer promises certain contributions to a participant's account during employment, but with no guaranteed retirement benefit. While a benefit-defined scheme is a retirement plan, which offers a guaranteed future benefit for employees at retirement. This diverges from the contribution-defined scheme in the way that employer's obligation is not limited to the contributions made, and it is the employer that bears the actuary risk and investment risk, which gives rise to the pension obligation risk.

Santander Consumer Bank AS has both types of pension schemes in Norway and Sweden, while in Denmark and Finland only defined-contribution plans are offered to the employees. In Norway, all employees are currently on a defined-contribution pension scheme like Finland and Denmark with the exception of an executive plan which is defined-benefit. Previously, there was a defined-benefit plan for employees hired before 1 April 2007, but as of January 2018 those plans have all been converted to a defined-contribution plan.

The bank receives reports from the pension companies semi-annually where a detailed reconciliation of pension obligation are specified. By the end of 2017 the net pension liability for SCB was NOK 88 million which is below 0.1% of the total liabilities for the bank and hence does not represent any material risk for the bank.

## 16. Insurance risk

In general, insurance risk arises for entities providing insurance and it depends on the likelihood of occurrence of the insured event triggering costs for the insurer. To set the premium for an insurance product, the direct insurance provider makes assumptions regarding that likelihood and the expected size of the costs for future insurance events. Insurance risk is, therefore, the risk that the estimated insurance costs defining the premium differ from the actual costs to be incurred in case of an insurance event.

The majority of the insurance products, mediated by SCB AS, are on behalf of the insurer CNP Santander Insurance Life DAC (Company No. 488063) and CNP Santander Insurance Europe DAC (Company No. 488062) that provide the credit protection insurance. Both companies are registered in Ireland and regulated by The Central Bank of Ireland. They are also registered at the FSAs in Norway, Sweden, Denmark and Finland. The insurance products are in the form of Credit protection insurance (CPI) (also named Payment protection insurance (PPI)) and exist in all the four countries.

SCB AS does not provide insurance directly, but it is registered as an ancillary insurance mediator for several insurance companies. The bank mediates insurance policies on behalf of the insurer. In this case, the bank is just an intermediary and does not bear insurance risk.

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