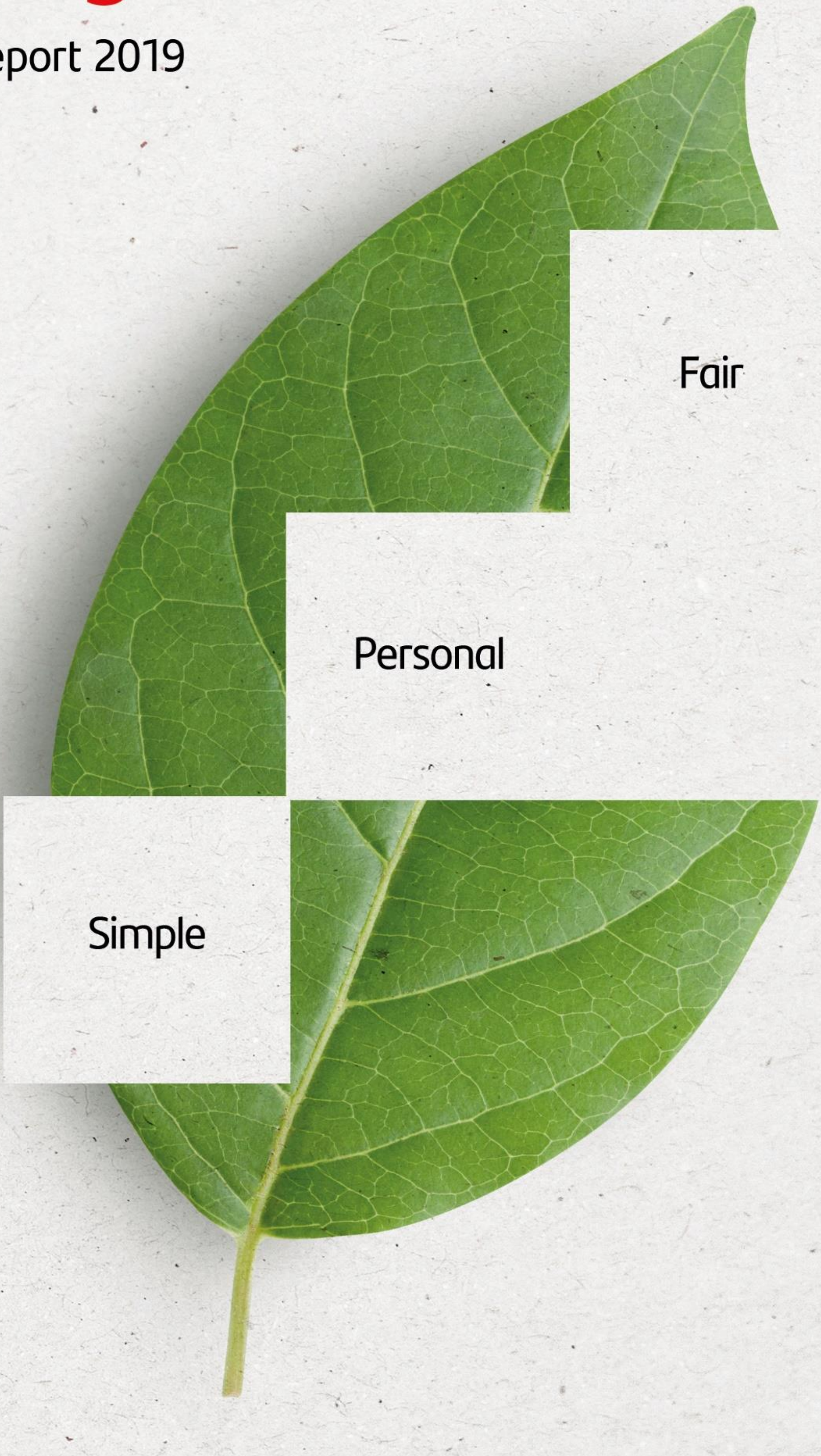
Risk and Capital Management

Pillar 3 Report 2019



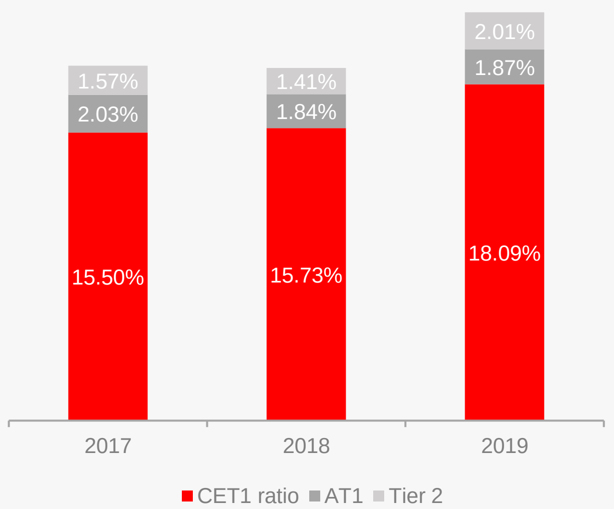
Santander Consumer Bank

SCB Group Overview

Key Capital Adequacy Metrics (2019)

Risk Weighted Assets (NOK Million) **120 201**	Total Capital Ratio (%) **21.98**
Common Equity Tier 1 Capital Ratio (%) **18.09**	Leverage Ratio (%) **13.08**

Development of Capital Ratios



Pillar 1 Capital Reporting Methodologies

Credit Risk	Market Risk	Operational Risk
Standardised Approach	**Standardised Approach**	**Basic Indicator Approach**
Foundation-IRB	Internal Models	Standardised Approach
Advanced-IRB		Advanced Measurement

Red boxes indicate those methods applied by Santander Consumer Bank

Contents

1. Purpose and scope of application

The purpose of this report ("**the Pillar 3 report**") is to provide information to the market in order to assess the risk management, risk measurement and capital adequacy of Santander Consumer Bank AS. When including its subsidiary, Santander Consumer Bank AS will be referred to in this document as "SCB", "the Bank" or "SCB Group". When excluding its subsidiary, reference will be made to "SCB AS". SCB is a commercial bank 100% owned by Santander Consumer Finance S.A. in Spain, which is again owned by Banco Santander. This Pillar 3 report covers SCB's operations in Norway, its branches in Sweden and Denmark and its subsidiary in Finland (SCF Oy).

The report meets the information requirements in accordance with the "Regulation on capital requirements and national adaptation of CRR/CRD IV", the Norwegian Finanstilsynet (NFSA) Circular 5/2018 in "Offentliggjøring av finansiell informasjon – kommisjonsforordninger og anbefalinger fra EBA" and the guidelines issued by the European Banking Authority (EBA) in "Guidelines on disclosure requirements under Part Eight of Regulation (EU) No 575/2013 (EBA-GL-2016-11)". In addition SCB publishes an appendix to the report (see Pillar 3 Appendix) displaying further information on capital adequacy position, terms of capital instruments, leverage ratio calculations, applicable countercyclical buffer calculations and own funds disclosure as recommended in the NFSA Circular 14/2014 in "Publishing information regarding own funds") and in the NFSA Circular 5/2018 mentioned above. Pillar 3 report is updated annually.

For information on SCB's remuneration policy see SCB's 2019 Annual Report under "*Note 30 – Remuneration*".

2. Santander Consumer Bank AS

SCB is a Nordic commercial bank, operating in Norway, Sweden, Denmark and Finland, with the head office located at Lysaker in Norway. As at 31 December 2019, the Bank had 1,192 employees (excluding temporary hired employees) of which 522 worked in Norway, 296 in Sweden, 215 in Denmark and 159 in Finland.

The Bank is a leading consumer finance provider across the Nordic region offering car financing, consumer loans, credit cards and sales financing. The Bank also offers customer deposits in Norway, Sweden and Denmark. Note that, in this document, car financing is referred to as "secured financing" due to collateral in the vehicle while consumer loans, credit card and sales finance are referred to as "unsecured financing" as these loans are without collateral. In addition, the Bank acts as an ancillary insurance mediator for insurance companies[1] in the respective jurisdictions.

The Bank is governed by Norwegian law and is supervised by the Norwegian Finanstilsynet (NFSA) and the European Central Bank (ECB) as a Joint Supervisory Team (JST). Effective from 31 December 2019, the EU Capital Regulation (CRR/CRD IV) is now applicable in Norway.

During 2019, the Group continued to develop its commercial footprint in the Nordic region, through the acquisition of Forso Nordic AB ("Ford Credit"), a transaction of strategic importance securing a long term partnership with Ford in the Nordic region. The agreement will allow SCB to offer financial services to Ford dealers and customers and will secure and strengthen the Bank's position as the market leader within auto financing. The acquisition has been subject to regulatory approval by the Norwegian and Swedish FSA and the deal was completed on the 28th of February 2020.

As at 31 December 2019, SCB possessed a strong capital adequacy position illustrated by a Common Equity Tier 1 (CET1) capital ratio of 18.09%. Following the implementation of IFRS 9 in January 2018, SCB elected to adopt the transitional rule, allowing for a gradual phasing in of the IFRS 9 capital impact. Hereafter, capital figures presented are on a transitional rules basis. The capital adequacy regulation allows for different methods for calculating capital requirements (as depicted in the introductory page to this report). The Bank is in the process of becoming an Advanced IRB (A-IRB) bank with approximately 1/3rd of its portfolios currently under this approach. The remaining amount of the portfolio is under the Standardized Approach. Following EBA's introduction of new

[1] CNP Santander Insurance Life DAC and CNP Santander Insurance Europe

default definitions (NDD) applicable from 2021, SCB needs to recalibrate its A-IRB portfolios and to postpone new applications.

3. Risk management governance and control

3.1 Role of the Board of Directors

In accordance with the Norwegian Financial Undertakings Act section 13-6, the Board of Directors (BoD) shall monitor and manage SCB's overall risk and regularly assess whether management and control arrangements are tailored to the risk level and scale of SCB's activities. The BoD has established a risk committee (the Board Risk Committee or BRC) consisting of three members chosen by and among board members, currently two of the Board's external directors and one internal director (non-executive), and carrying out the tasks set forth in section 13-6 of the Norwegian Financial Undertakings Act and regulations connected thereto. Future information on the BoD sub-committees is outlined in section 3.4.

The Board of Directors also instructs senior management to develop and maintain an appropriate, systematic and consistently applied process to determine risk levels, provisions for loan losses and management aligned with the corporate guidelines.

The Board of Directors adopts and participates in the reassessment of credit authorizations. It also receives relevant reports in the risk area and instigates relevant action to reduce any undesired rise in risk level. It is established in the Credit Policy that BoD shall approve parameter and management limits, as well as any proposed remedial action when facing breach of limits. All breaches of management limits must be reported to the BoD regardless of whether the breach is cured.

3.2 Risk management and control

The Bank has a program referred to as Advanced Risk Management (ARM), aimed at improving the management of Risk. The principles of ARM are listed below:

1. **An advanced and comprehensive risk management framework**, with a forward-looking approach that allows the bank to maintain a medium-low risk profile, through a **risk appetite** defined by SCB's Board of Directors and the **identification and assessment of all risks**.
2. The **forward-looking approach** for all risk types must be part of the risk identification, assessment and management processes.
3. **Lines of defense** that enable risk to be managed, controlled and monitored through a clear committee structure that separates the risk management and control functions.
4. Robust **data management** driven by a reliable IT infrastructure that facilitates decision-making. A continuous effort in developing risk management support infrastructure and processes.
5. A **risk culture integrated throughout the organization**, composed of a series of attitudes, values, skills and guidelines for action to cope with all risks. SCB believes that advanced risk management cannot be achieved without a strong and steadfast risk culture, which is found in each one of its activities.
6. All risks are managed by the units that generate them.

These principles, combined with a series of relevant interrelated tools, processes and ARM pillars are reflected in the bank's strategic planning process (Risk Appetite Statement, Risk Identification and Assessment, risk reporting framework, strategic commercial plan, etc.).

ARM initiatives provide a forward-looking approach to risk management and control processes focusing on: greater financial and operational efficiency, enhanced technical capabilities (Risk Data Aggregation/Risk Reporting Framework), portfolio optimization and enforcing a strong risk culture while continuously adapting the business model to the regulatory landscape.

Lines of Defense Framework

SCB adopts the three lines of defense mechanism for management and control of risk:

- **The business functions or activities that create exposure to a risk are the first line of defense.** The first line of defense is responsible for establishing an appropriate environment for the management of all risks associated with business, for proposing levels for risk appetite and limit, and for implementing the mechanisms to manage the risks and maintain them within risk appetite of the business.

- **The second line of defense consists of the risk control and oversight function and by the compliance function.** This line vouches for effective control of the risks and ensures they are managed in accordance with the level of risk appetite defined.

- **Internal audit is the third line of defense** and as the last layer of control in the Bank regularly assesses the policies, methods and procedures to ensure they are adequate and are being implemented effectively.

There is a sufficient degree of segregation between the risk control function, the compliance function and the internal audit function, to ensure that their functions are performed and that they have access to the Board of Directors and/or relevant committees through their heads.

Risk Identification and Assessment

Identifying and evaluating all risks is the first step to control and manage risks. The **Risk Map** covers the main risk categories in which SCB has its most significant exposures, current and/or potential.

The key risk types identified in the risk map are:

- **Credit Risk**: risk of financial loss arising from the default or credit quality deterioration of a customer or other third party, to which SCB has provided credit or for which it has assumed a contractual obligation.

- **Liquidity Risk**: risk that SCB does not have enough liquid resources to meet its obligations when they fall due.

- **Structural Risk**: the risk arising from the management of different balance sheet items (i.e. interest rate risk or currency risk).

- **Capital Risk**: the risk of the SCB not having an adequate amount or quality of capital to meet its internal business objectives, regulatory requirements or market expectations.

- **Operational Risk**: the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

- **Cyber and Technology Risk**: the risk of a financial loss, regulatory fines, loss of strategic advantage, disruption to the business or damage to the reputation of SCB, which results from the destruction, misuse, abuse and/or theft of information systems or information resources.

- **Reputational risk**: risk of losses caused by events that can worsen the public perception of the bank.

- **Model Risk:** the risk of losses arising from inaccurate predictions, causing a bank to make sub-optimal decisions, or from a model being used inappropriately.

- **Strategic Risk**: the risk of loss or damage arising from strategic decisions or their poor implementation, or from an inability to adapt to external developments.

Apart from the risks identified in the risk framework and classified in the risk map, the **Risk Identification and Assessment process** (RIA) also aims to identify and assess all the risks to which the bank is exposed to or could be exposed to in the future. The goal is to define SCB's risk through a quantitative and qualitative evaluation of the relevant risks composed of:

- **Risk performance**: assesses the current risk exposure and performance through a set of dimensions, metrics and thresholds.
- **Control environment:** evaluate the level of compliance of the Bank's target operating model, identifying possible gaps and weaknesses.
- **Top Risk assessment:** a process carried out to allow for the early identification of potential threats to the profitability, solvency or strategic objectives of the entity, promoting an effective risk management and mitigation. The Top Risk assessment has a three-year horizon, and two sorts of events are taken into account, depending on their estimated likelihood and/or severity: plausible and tail risk events.

The exercise is conducted semi-annually, with the involvement of 1st, 2nd and 3rd lines of defense, and with the purpose of monitoring the Bank's risk profile.

Material risks identified in the RIA are incorporated in the Risk Appetite Statement (RAS).

Risk Appetite

Risk Appetite is the maximum level and type of risk that SCB is willing to assume, within its risk capacity, to achieve its strategic objectives and the development of its business plan.

SCB aims to maintain a medium-low risk profile that is predictable. This profile is achieved by means of earnings stability (low P&L volatility), maintaining robust capital and liquidity position under both normal and stressed conditions, limiting the impact in earnings and capital base due to concentration on large exposures and individual counterparties, controlling and limiting non-financial risk events (fraud events, operative, technological, legal and regulatory breaches, conduct issues or reputational damage).

The Risk Appetite is defined by risk limits and alerts for the identified material risks: Credit risk, Liquidity risk, Structural risk, Capital risk, Operational risk, Cyber and Technology risk, Reputational risk, Model risk and Strategic risk. The limits are set according to their potential impact on: 1) Financial results volatility; 2) Solvency levels; 3) Liquidity; 4) Concentration; 5) Non-financial risk.

The limits and alerts are set by the Risk department in cooperation with Financial Management, Financial Control and Compliance departments and are approved by the BoD. For 2020, the new limits and alerts were approved on January 22nd 2020 by the BoD.

Most of the metrics are monitored on a monthly basis by SCB's Enterprise Risk Management function and reported at least quarterly to the BoD.

Risk Data Aggregation

In line with Basel Committee on Banking Supervision's standards number 239, the Risk Data Aggregation project ensures that the risk data reported to senior management reflects the basic principles enforced in the regulation: captures all types of risks with appropriate accuracy and timeliness.

During 2019, the Risk Data Quality Reporting System (DQRS) team continued to focus on providing a proper data governance along with the entire data life cycle, robust IT processes and reliable risk reporting. Data quality and traceability controls were set to ensure that risk reports contain accurate granularity and appropriate data sources.

Strategic Commercial Plan

The Strategic Commercial Plan (SCP) constitutes the basic instrument for managing and controlling SCB credit portfolios, defining sales strategies, risk policies and the means and infrastructures necessary to meet the annual budget.

Regular monitoring of the SCP will anticipate any undesirable deviations observed with respect to the initial budget, and will enable management to identify significant changes to risk, assess their potential impact, and apply any courses of corrective action that may be necessary.

This will also give management an updated view at all times of the creditworthiness of the portfolios, and identify any key weaknesses in terms of policies, processes and means to help the Bank implement the mitigation mechanisms required.

3.3 Monitoring and reporting

The main objective of risk monitoring and reporting is to ensure all risk types are managed in conformity with the risk appetite level approved by the Board. For this purpose, an array of different reports has been developed with different contents, audience and frequencies.

The responsibility for developing risk reports rests with the Risk department, which is also responsible for securing the quality, standards, content, timeliness, and the distribution of risk information. The scheduled risk management information flows via the corporate MIS (Management Information System) reporting tool, which is in use for Risk reporting purposes at the SCB consolidated level internally and towards SCF HQ Risk Area.

Reporting at SCB currently contains a series of standard reports aimed at capturing risk performance indicators on a regular basis (monthly/quarterly) for all risk types.

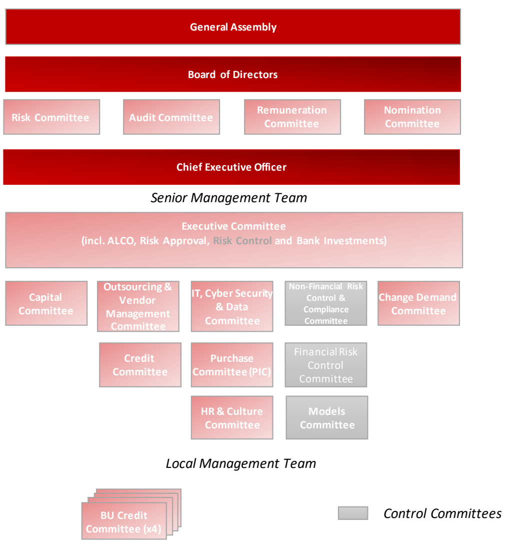
3.4 Internal control

The BoD has established sub-committees with powers of supervision, information advice and proposals. An overview of the main objectives of the sub-committee is detailed below:

- **Board Risk Committee (BRC):** advise the BoD on current and future risks, risk appetite and risk strategy. This includes ensuring the establishment of appropriate internal control systems and the compliance with laws, ordinances and internal regulations as well as generally accepted practices or standards.
- **Audit Committee:** review SCB's financial information and internal control systems and serve as the communication channel between the BoD and the external auditor. The committee also supervises the Internal Audit department. Further details on the Internal Audit function are detailed below.
- **Nomination Committee:** oversee the balance, knowledge, diversity and experience of the BoD and to identify, when applicable, candidates to fill vacant positions in the BoD.
- **Remuneration Committee:** preparation of remunerations decisions to be adopted by the BoD and ensure compliance with and transparency of the remuneration policy.

The figure below illustrates how SCB's corporate governance is structured. It identifies the allocation of authority and responsibilities and how decision-making and reporting lines between the shareholder, the BoD, management and Internal Audit are arranged.

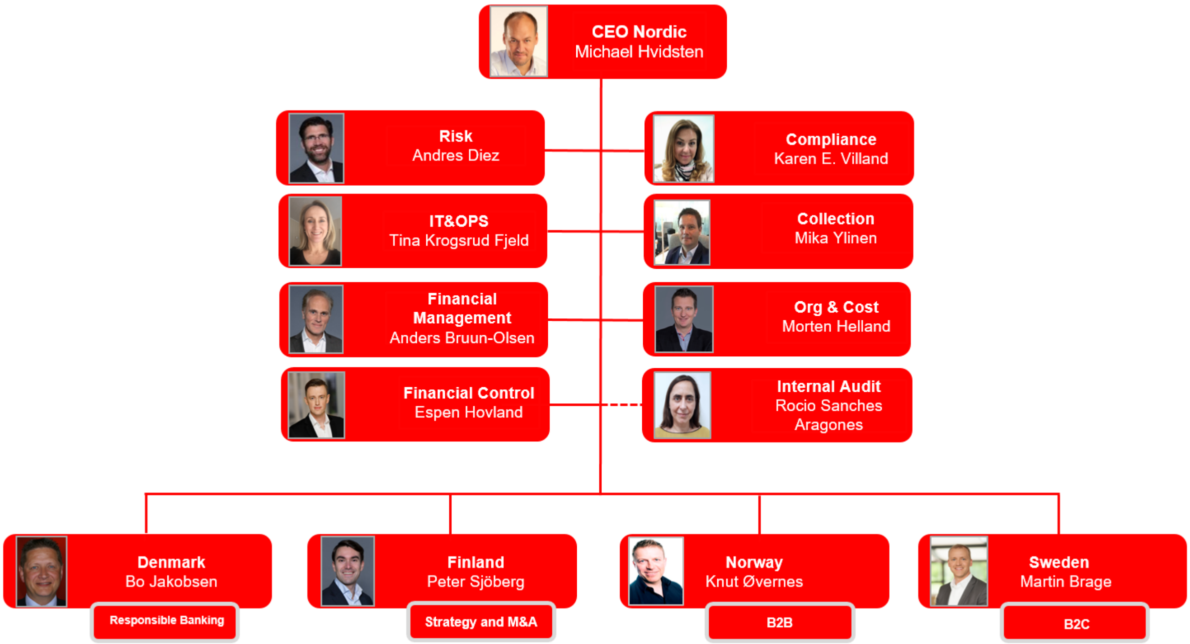
Figure 3.4.1 SCB governance structure overview



The Senior Management

As SCB is organized as a Nordic cluster, the Bank operates with a pan-Nordic management structure, consisting of the CEO, the heads of the different business units and the executives responsible for central staff functions.

Figure 3.4.2 SCB Senior Management



Internal Control Framework

The internal control framework within SCB is based on: (1) the Santander Internal Control Framework, (2) the requirements of The Sarbanes-Oxley Act (SOX), (3) the Committee of Sponsoring Organizations of the Treadway Commission Framework (COSO) and (4) the local requirements by Nordic regulators. The Santander Internal Control Framework sets the foundations for the Internal Control function in SCB and the internal control methodology.

4. Capital adequacy

4.1 Capital management governance

Governance and responsibilities related to capital management are outlined in the Bank's Capital Framework and Policy documents. The objective of the Capital Management governance framework is to ensure adequate solvency levels, regulatory compliance and efficient use of capital.

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

Capital management decisions requiring BoD approval must be approved and recommended by the Capital Committee before being recommended to the BoD. Certain items may also need to be reviewed in the Board Risk Committee before being presented to the Board. Capital management decisions will include those relating to capital adequacy, capital targets, capital 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 and Financial Control who have an advisory role.

The BoD approves target capital ratios, at least on an annual basis. Capital positions and forecasts are presented to the BoD on a regular basis. Capital reporting to the Norwegian FSA is approved by the Capital Committee before submission. Any dividends[2] proposed by the BoD, must be finally approved in the SCB General Meeting.

Capital increases and capital reductions must be approved by the BoD 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 BoD will be sufficient.

The Bank has a formal dividend policy that was approved by the BoD in 2019. The dividend policy states that *"As a reference criterion, the pay-out ratio shall, over time, be at least 50%. However, the policy will be adapted to SCB's specific circumstances".* SCB will assess its capital position prior to every potential dividend payment to ensure sufficient capitalization to cover all risks as well as all regulatory requirements.

4.2 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:** Minimum regulatory capital of 8% of risk-weighted assets: banks shall, at all times, satisfy capital adequacy requirements reflecting credit risk, operational risk and market risk;

- **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 Internal Capital Adequacy Assessment Process or ICAAP. The regulator evaluates the ICAAP and, following completion of the Supervisory Review and Evaluation Process (SREP), publishes the Pillar 2 requirement (P2R) for the bank. In addition, the FSA will assess SCB's own stress test performed in ICAAP and other stress tests conducted by other regulators (European Banking Authority and International Monetary Fund) to communicate FSA's expectations of a Pillar 2 guidance (P2G) over and above the overall capital requirement.

- **Pillar 3:** Disclosure of information: banks are required to disclose relevant information on their activities, risk profile and capital situation to the market.

The figure below outlines the evolution of capital requirements for SCB as per end of Q4-2019, Q1-2020 and Q4-2020 (expected). Capital requirements for SCB have increased as per end of Q4-2019 due to higher Pillar 2 requirements (2.6% to 3.3%) and higher countercyclical buffer (CCyB) in Norway (2% to 2.5%). In addition, a Pillar 2 guidance of 1.0% was introduced as a management buffer.

In light of the outbreak of coronavirus (COVID-19) and its significant shocks in our economies, regulators have provided temporary capital reliefs to banks. Finansdepartementet reduced the countercyclical buffer in Norway from 2.5% to 1% until Q1-2022. For Sweden, Denmark and Finland, the CCyB is set at 0%. For SCB, the result is a reduction of 1.3% in CCyB requirements (from 1.6% to 0.3%).

As per end of Q4-2020, capital requirements are expected to be reduced with further 1.4% due to the change in systemic risk buffer (SRB). Although SRB will increase from 3% to 4.5% in Norway, banks will be allowed to use the SRB in the jurisdiction where it operates, thus reducing overall SRB for the Bank.

[2] SCB notes that the Bank is following FSA's communications on allocation of profits from 2019 https://www.finanstilsynet.no/nyhetsarkiv/pressemeldinger/2020/finanstilsynet-foreslar-forskrift-om-overskudd-2019-banker-forsikringsforetak-inntil-videre-holdes-tilbake/

Figure 4.2.1 SCB capital requirements developments

Nordic - SCB Group end of Q4-2019	Capital Requirement (%)
CET1	
Minimum requirement	4.50 %
Capital Conservation Buffer	2.50 %
Systemic Risk Buffer	3.00 %
Countercyclical Buffer (CCB)*	1.60 %
Total Pillar 1 requirement	**11.60 %**
Pillar 2 requirement (PR)	3.30 %
Pillar 2 Guidance (P2G)	1.00 %
Total CET1 requirement	**15.9 %**
Tier1 (T1)	
Additional T1 requirement	1.50 %
Total T1 requirement	**17.4 %**
Tier2 (T2)	
Additional T2 requirement	2.00 %
Total T2 requirement	**19.4 %**
Leverage Ratio (LR)	
Minimum leverage requirement	3.0 %
Buffer requirement for non-SIFI bank	2.0 %
Total LR requirement	**5.0 %**

** Based on local CCB req. Dec19: NO 2,5%, SE 2,5%, DK 1,0%, FI 0%*

Nordic - SCB Group end of Q1-2020	Capital Requirement (%)
CET1	
Minimum requirement	4.50 %
Capital Conservation Buffer	2.50 %
Systemic Risk Buffer	3.00 %
Countercyclical Buffer (CCB)*	0.30 %
Total Pillar 1 requirement	**10.30 %**
Pillar 2 requirement (PR)	3.30 %
Pillar 2 Guidance (P2G)	1.00 %
Total CET1 requirement	**14.6 %**
Tier1 (T1)	
Additional T1 requirement	1.50 %
Total T1 requirement	**16.1 %**
Tier2 (T2)	
Additional T2 requirement	2.00 %
Total T2 requirement	**18.1 %**
Leverage Ratio (LR)	
Minimum leverage requirement	3.0 %
Buffer requirement for non-SIFI bank	2.0 %
Total LR requirement	**5.0 %**

** Based on local CCB req. March20: NO 1%, SE 0%, DK 0%, FI 0%*

Nordic - SCB Group end of Q4-2020 (estimate)	Capital Requirement
CET1	
Minimum requirement	4.50 %
Capital Conservation Buffer	2.50 %
Systemic Risk Buffer	1.58 %
Countercyclical Buffer (CCB)*	0.30 %
Total Pillar 1 requirement	**8.89 %**
Pillar 2 requirement (P2R)	3.30 %
Pillar 2 Guidance (P2G)	1.00 %
Total CET1 requirement	**13.2 %**
Tier1 (T1)	
Additional T1 requirement	1.50 %
Total T1 requirement	**14.7 %**
Tier2 (T2)	
Additional T2 requirement	2.00 %
Total T2 requirement	**16.7 %**
Leverage Ratio (LR)	
Minimum leverage requirement	3.0 %
Buffer requirement for non-SIFI banks	2.0 %
Total LR requirement	**5.0 %**

** Based on local CCB req. March20: NO 1%, SE 0%, DK 0%, FI 0%*

Pillar 1 requirements

The minimum capital adequacy requirement of 8% shall consist of at least 4.5% Common Equity Tier 1 capital (CET1 capital), at least 1.5% of Additional Tier 1 capital (T1 capital) and the remaining 2.0% may consist of subordinated capital instruments (T2 capital). In addition, banking institutions are subject to various regulatory buffer requirements referred to as combined buffer requirements (CBR) which must be met with CET1 capital. Per 31 December 2019, the Bank's CBR consisted of a 2.5% capital conservation buffer, a 3% systemic risk buffer and a 1.6% countercyclical buffer (CCyB) which is calculated as a weighted average of country specific CCyBs in accordance with CRD IV Article 140.

Systemic important financial institutions should hold an additional 2% buffer of CET1 capital. However, SCB is not considered a systemic important financial institution (“SIFI”) and therefore, has no SIFI buffer requirement.

In summary, the Pillar 1 CET1 capital requirement for SCB Group was 11.60% per 31 December 2019.

Pillar 2 requirements

SCB conducts, at least annually, an ICAAP which is used as one input to determine the Bank's Pillar 2 capital requirement. Several departments are involved in the ICAAP process including Financial Management, Risk, Financial Control, Legal and Compliance & Conduct and IT Risk. Stress scenarios, as well as outcomes of various analysis in the ICAAP report are reviewed and approved by the Capital Committee. In addition, all analysis and governance processes leading to the ICAAP report is reviewed by Internal Audit.

Thereafter, the 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 current Pillar 2 requirement set by the Norwegian FSA to SCB is 3.3% (of Risk Weighted Assets) limited to a minimum of at least NOK 4 billion. In addition, the FSA set a Pillar 2 guidance of 1.0% (of Risk Weighted Assets) meant to cover the impacts of a severe economic setback. Both P2R and P2G must be met with CET1 capital and are applicable from 31 December 2019.

Pillar 3 requirements

This Pillar 3 report is updated at least annually in conjunction with the Annual report, as outlined in the Capital Framework approved by the BoD. The report meets the information requirements in accordance with the "Regulation on capital requirements and national adaptation of CRR/CRD IV", the NFSA Circular 5/2018 “Offentliggjøring av finansiell informasjon – kommisjonsforordninger og anbefalinger fra EBA” and the guidelines issued by the European Banking Authority (EBA) in "Guidelines on disclosure requirements under Part Eight of Regulation (EU) No 575/2013 (EBA-GL-2016-11)". In addition, the Bank publishes an appendix to the report (see Pillar 3 Appendix), where terms of capital instruments, capital & own funds, leverage ratio, countercyclical buffer requirements and credit exposures are disclosed in accordance with the NFSA Circular 14/2014 in “Publishing information regarding own funds” and the NFSA Circular 5/2018 mentioned above.

The senior management members of the Capital Committee, consisting of the Chief Risk Officer, the Chief Controlling Officer and the Chief Financial Officer, as voting members, approve the content of 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.

Leverage Ratio requirements

In addition to the Pillar 1 and Pillar 2 capital requirements, banks are required to adhere to leverage ratio requirements. The leverage ratio is calculated in accordance with CRR Article 429 i.e., Tier 1 capital and total exposures (on and off-balance sheet). Since 30 June 2017, the Norwegian FSA has set a minimum leverage ratio requirement of 3%, a mandatory buffer of 2% for all banks and a 1% buffer for SIFI banks. SCB has to comply with a leverage ratio requirement of 5%.

Recovery Plan and Minimum Requirements for own funds and Eligible Liabilities

SCB does not have its own Recovery Plan and it is currently covered by the parent’s company Recovery Plan in line with Circular 10/2019 issued by the NFSA on “Finanstilsynets retningslinjer for gjenopprettingsplaner” - section 3.5 “Foretak med grensekryssende virksomhet”.The Recovery Plan will be the foundation for the Minimum Requirement for own funds and Eligible Liabilities (MREL) so that companies have sufficient capital and convertible debt to handle crisis without the use of public funds. On 23 December 2019, the NFSA published the MREL requirements for eight Norwegian banks (SCB not included). SCB is in continuous dialogue with the NFSA but it is still unclear whether the bank will be treated as a standalone Norwegian bank or subject to the same requirements as Banco Santander. MREL debt will in any event be an internal debt provided by the parent company.

4.3 Capital position per December 2019

SCB Group possesses a robust capital adequacy position. As at 31 December 2019, the CET1 capital ratio stood at 18.09% on a phased-in IFRS9 basis and 17.82% on a fully phased-in IFRS 9 basis, representing a significant buffer above the minimum regulatory requirement. Although official reporting to the NFSA is with transitional rules for IFRS 9 impact, the Bank manages its capital on a fully phased IFRS 9 basis. In addition, the Bank issued subordinated loans of SEK 1 500 million in December 2019, ensuring SCB meets its Total Capital Ratio going forward.

Due to the increased capital requirements applicable from the end of Q4-2019 (see section 4.2) and the Forso acquisition (see chapter 2), the BoD refrained from proposing dividend from 2019 to the General meeting that took place in January 2020 and proposed to increase the equity with NOK 2 billion. The new equity was paid by the owner Santander Consumer Finance S.A. on 28 February 2020, further strengthening the capital position of the Bank.

For more information with respect to capital adequacy of SCB Group and SCB AS, please refer to "*Note 9 – Capital Adequacy*" in the 2019 Annual Report. With regards to leverage, the Bank's leverage ratio was 13.08% (SCB AS: 14.55%) as per 31 December 2019, significantly above the 5% regulatory requirement. Figure 4.3.1 below details SCB Group's surplus of capital vs. regulatory capital requirements in 2019.

Figure 4.3.1 SCB capital adequacy vs. regulatory requirements as at 31 December 2019

Composition of SCB's capital adequacy requirements			
	2019		2020
	%	NOK m	%
Minimum CET1 requirement	4.5	5 394	4.5
Systemic Buffer	3.0	3 596	1.6
Counter cyclical buffer	1.6	1 918	0.3
Capital conservation buffer	2.5	2 997	2.5
Pillar 2 requirement	3.3	4 000	3.3
Pillar 2 guidance	1.0	1 199	1.0
CET1 requirement	**15.9**	**19 103**	**13.2**
Additional Tier 1	1.5	1 798	1.5
Tier 1 requirement	**17.4**	**20 900**	**14.7**
Tier 2	2.0	2 397	2.0
Total Capital requirement	**19.4**	**23 298**	**16.7**

SCB CET1	**17.8**	**21 361**
- Surplus of CET1	*1.9*	*2 259*
SCB Tier 1	**19.7**	**23 611**
- Surplus of Tier 1	*2.3*	*2 711*
SCB Total Capital	**21.7**	**26 028**
- Surplus of Total capital	*2.3*	*2 730*

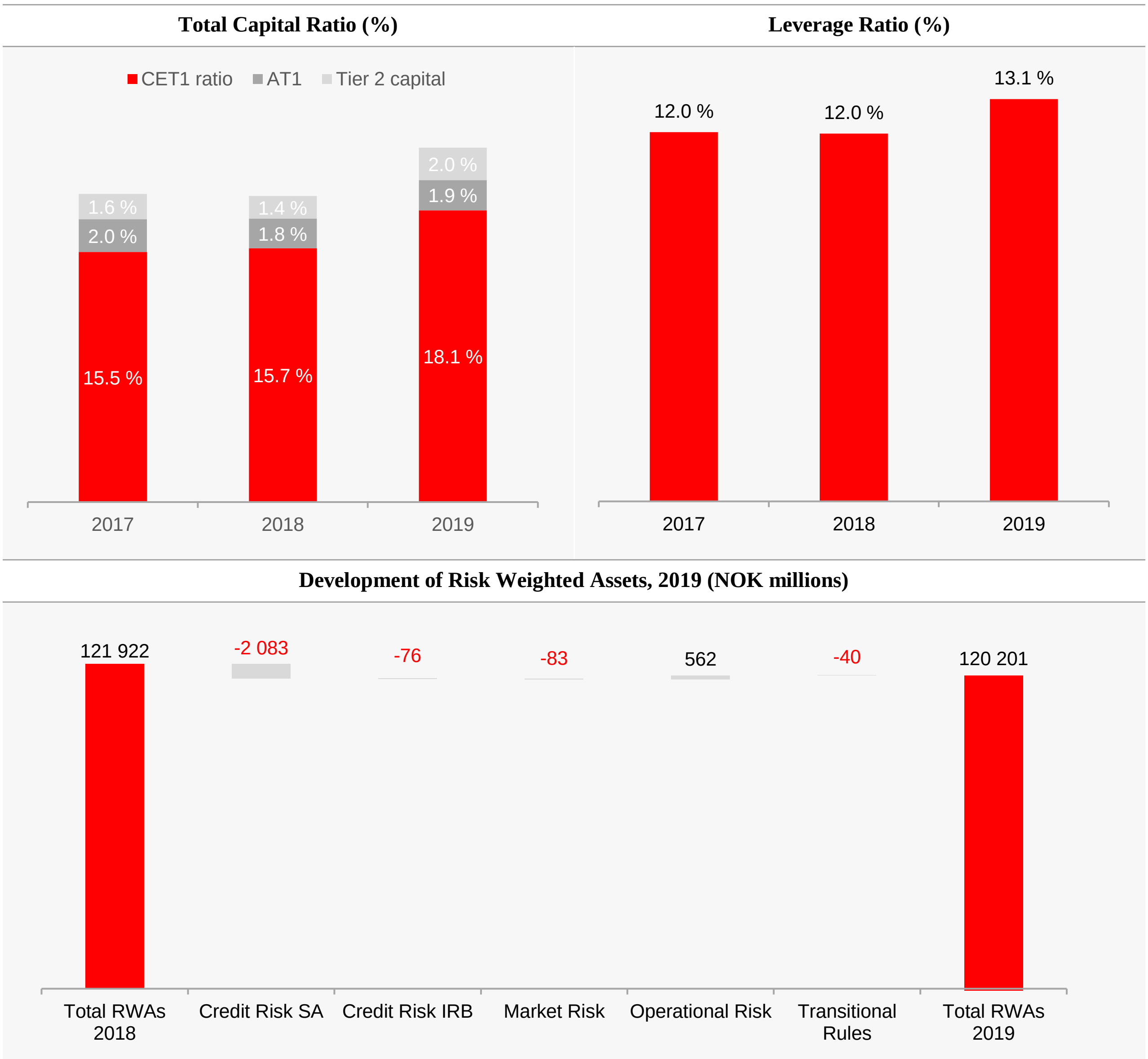
SCB uses both the Standardized approach and A-IRB approach for calculating risk weighted assets (RWAs) for credit risk, the Standardized method for calculating market risk and the Basic Indicator Approach for operational risk. The Bank's RWAs are used as the basis for calculating the combined buffer requirements. For 2019, RWAs decreased by NOK 1 721 million to NOK 120 201 million. The decrease was driven by a combination of lower portfolio growth and a strengthening of the NOK relative to EUR, SEK and DKK. As can be seen from the figure below, the majority of the Bank's RWA are related to retail customer loans under both the Standardized approach and under the A-IRB approach.

Figure 4.3.2 SCB risk weighted assets as at 31 December 2019

Risk-Weighted Assets ("RWAs")	2018	2019
Standardised Approach		
- Regional Governments	*73*	*64*
- Institutions	*836*	*694*
- Corporates	*9 156*	*8 713*
- Retail	*56 206*	*54 028*
- Default	*999*	*1 496*
- Covered Bonds	*466*	*385*
- Other	*3 490*	*3 763*
Total Standardised Approach	71 226	69 143
Internal Ratings Based Approach:		
- IRB	*35 571*	*35 495*
Total IRB Approach	35 571	35 495
Market Risk	1 472	1 463
Operational Risk	13 168	13 730
CVA	105	30
Total RWAs	**121 542**	**119 861**
IFRS 9 Transitional Adjustment	380	340
Total RWAs (after IFRS9 transitional rules)	**121 922**	**120 201**

The figure below depicts the development of the Bank's key capital adequacy metrics.

Figure 4.3.3 SCB development of key capital adequacy metrics



The Pillar 3 appendix and *"Note 9 - Capital Adequacy"* in the 2019 Annual Report, discloses more information on SCB's capital adequacy position and requirements.

5. Counterparty 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. All of the Bank's derivatives have signed collateral agreements (VM CSAs) with the counterparty with bilateral daily collateral posting.

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

6. Credit risk

SCB defines credit risk as the potential that a borrower or counterparty will fail to meet its obligations in accordance with agreed terms.

SCB's business is focused on auto (loan, leasing, subscription and stock finance) and unsecured products (consumer loans, credit cards and durables) and therefore, credit risk is the most significant risk for SCB.

6.1 Strategy and policies

The Bank's strategy and risk policies contain diversification requirements and therefore, SCB's credit portfolio must possess a diversified composition with regard to customers, business sectors, geographical areas and market segments.

SCB establishes the frameworks and general guidelines for all lending and credit-granting activities in the Nordic countries in the Nordic Retail Credit Policy. The objective of this Policy is to ensure a customer portfolio with a satisfactory risk profile and with good profitability in a long term perspective.

6.2 Credit risk monitoring and reporting

In order to fulfil SCB's ambitions on credit quality and portfolio composition, the Bank has put in place information systems supported by analytical techniques that measure and report credit risk on both individual and portfolio levels throughout the credit risk cycle.

While the Bank's retail customers are monitored on an aggregated / portfolio level, wholesale customers are monitored individually. Wholesale customers are assigned an internal rating based on the Banco Santander internal rating model, which will then derive an individual Probability of Default within 12 months (PD). The model takes in to consideration the Bank's internal knowledge and expertise as well as an objective assessment of the customers financial and management structure.

In order to monitor the retail and wholesale businesses, the Bank has a quarterly monitoring of the Strategic Commercial Plan. The business functions are responsible for performing regular monitoring of the degree of execution of the commercial strategies. The Risk department is responsible for monitoring the degree of execution of the portfolio policies, of the credit admission and management policies and of the recovery strategies. In the event of deviations from the Bank's objectives, the responsible parties will propose and develop the appropriate corrective actions in conjunction with Risk.

6.3 Admission and monitoring of standardized and non-standardized risk

To ensure business policy and practices are aligned with product features and characteristics, and with the needs of the Bank's customers, SCB divides its portfolios into two main segments:

- **Retail:** follows a standard, highly automated credit approval process primarily based on system-generated decisions (credit scorecards). Customers under this category include private persons, as well as sole proprietorships and SME companies without a permanently assigned risk analyst.
- **Wholesale** or "*Non-standardized risk*": applicable to all stock-finance customers and customers whose volume of risk exposure is more than NOK 5 million, DKK 5 million, SEK 5 million and EUR 0.5 million in Norway, Denmark, Sweden and Finland respectively. Specific risk analysts are assigned to these credits.

Credit 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 (except Denmark Auto SME and Credit Cards). The purpose of the admission scorecards is to distinguish between customers based on their creditworthiness, whilst behavioral scorecards monitor the customer's credit behavior over time. Upon scoring, the customer is assigned a Probability of Default (PD) bucket which is used for risk monitoring purposes and in capital calculations under Advanced Internal Ratings Based (A-IRB) or Standard (STD) approach depending on the portfolio/country. In addition, the scoring models are used also as main segmentation drivers in the Bank's IFRS9 PD estimation models for Expected Credit Loss (ECL) calculation purposes. All implemented scorecards are monitored quarterly for their performance i.e. stability, accuracy and predictability to ensure they work as intended. The goal is to ensure that portfolio delinquency rate is within acceptable limits by adjusting the score limits in line with the risk appetite of the Bank. In addition to performance monitoring, overall model risk level is also periodically monitored by senior management at SCB.

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. Ratings from the Santander Internal Rating model method will result in an individual PD by wholesale exposure.

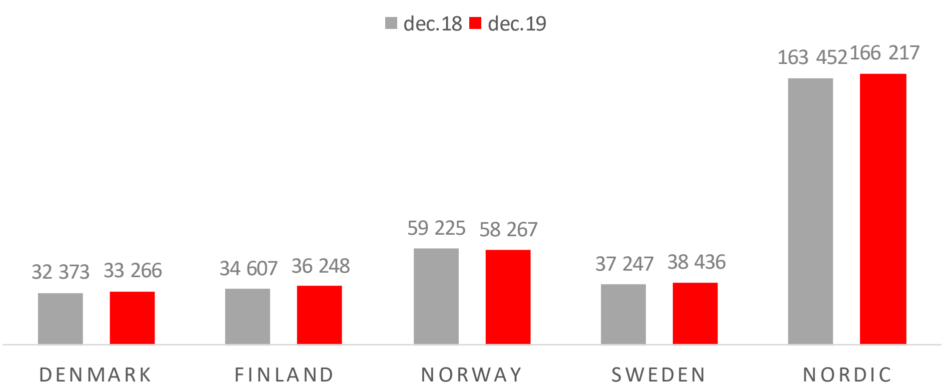
6.4 Credit risk profile

SCB's credit portfolio has a diversified risk composition across customers, sectors, geographies and industries. The Bank operates in four different countries and the consumer lending business is composed by the following products:

- Auto & Leisure – Loans and financial services provided to private customers, corporates and car dealers. The distribution is performed via dealers, cross sale from other products and online.
- Direct unsecured consumer loans are distributed via brokers, cross sale and online channel.
- Sales Finance / Durables are revolving products in Norway and Sweden and close-end products in Denmark and Finland, distributed via stores, cross sale and online.
- Credit Cards is a revolving product distributed in Norway, Sweden and Denmark via stores, cross sales, online and portfolio management.

Gross outstanding loans increased from NOK 163 billion to NOK 166 billion between 2018 and 2019 and was driven by growth in all countries but Norway.[3] As Figure 6.4.1 and 6.4.2 shows, the increase was driven by auto portfolios. Compared to 2018, the asset distribution per country has remained fairly stable.

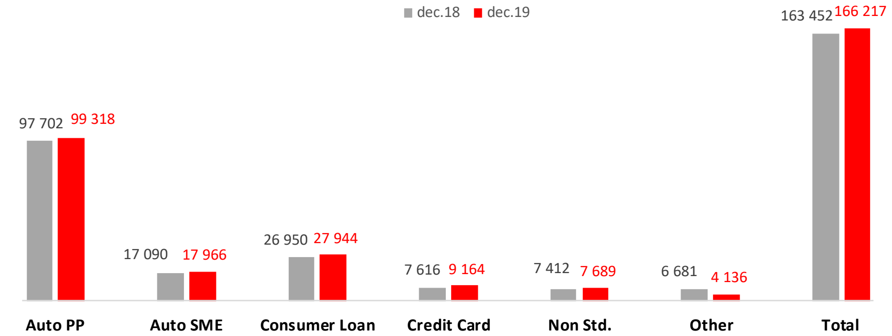
Figure 6.4.1 Gross outstanding amounts by country (NOK 000s)



[3] All figures presented hereafter include operational lease which are not classified as gross customer loans in SCB's Annual Report

Auto Private Persons (Auto PP) continues to be the largest portfolio of the Bank. Auto PP Norway accounts for a large part of the Auto portfolio. Note, "Non Std." refers to auto stock finance portfolios.

Figure 6.4.2 Gross outstanding amounts by product (NOK 000s)



The share of secured portfolios at the Nordic level remained fairly stable 78.3% to 78.2% from 2018 to 2019. The figure below shows the split between secured and unsecured portfolio per country.

Figure 6.4.3 Share of gross outstanding by product and geography

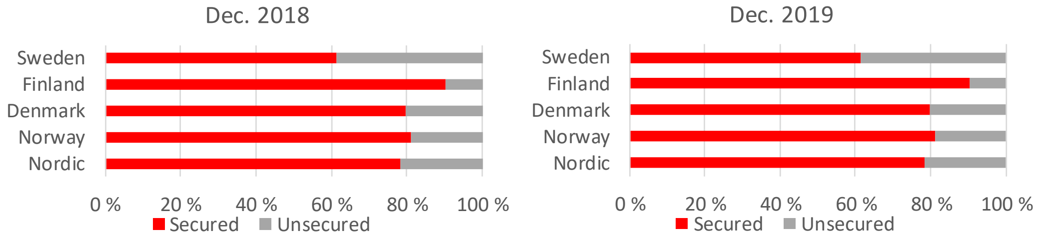
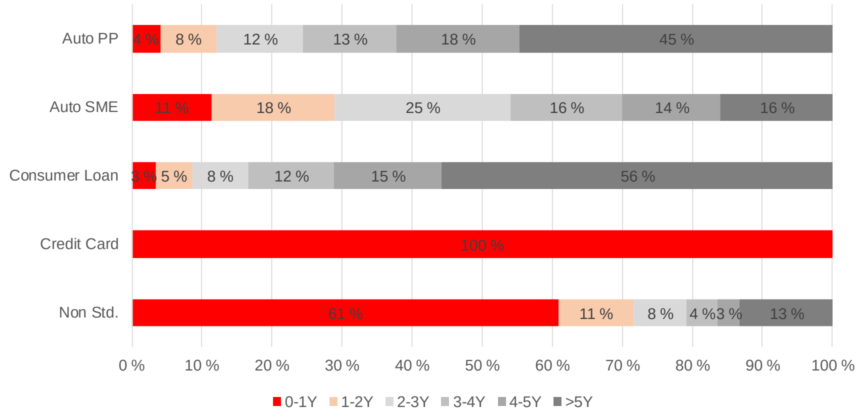


Figure 6.4.4 shows the distribution of gross outstanding by different residual maturity buckets. As can be seen, Auto PP and Consumer Loans have the longest maturity on a contractual basis. However, the behavioral maturity profile of these loans are often much shorter due to a relatively high prepayment rate. With new regulation restricting maturity on consumer loans in Norway set by NFSA circular on consumer lending practices, the contractual maturity profile over 5 years[4] fell from 59% (Dec-2018) to 56% (Dec-2019).

Figure 6.4.4 Maturity profile of gross outstanding amounts by product



[4] Rundskriv om krav til finansforetakenes utlånspraksis for forbrukslån
https://www.finanstilsynet.no/contentassets/adff29a42bcc4584acd7883a73e9eef1/krav-til-finansforetakenes-utlanspraksis-for-forbrukslan.pdf

The table below details the risk-weighted asset density of its exposures. As can be seen, the average risk weight of the Bank's exposures is c. 60%. As will be detailed in the following section, the Bank reports its credit exposures under the Standardised and Advanced Internal Ratings Based Approach.

Figure 6.4.5 Overview of gross exposures, exposure at default and RWAs as at 31 December 2019

NOK millions	Gross Total Exposure	Total EAD	Total RWA	RWA Density (RWA/EAD)	Capital Required
Regional and Governments	8 459	8 459	64	0.8 %	5
Institutions	4 447	4 447	694	15.6 %	56
Corporates	13 299	8 891	8 713	98.0 %	697
Retail (Standardised approach)	100 543	75 089	54 028	72.0 %	4 322
Retail (A-IRB approach)	75 680	75 680	35 495	46.9 %	2 840
Exposures in Default	3 501	1 496	1 496	100.0 %	120
Covered Bonds	3 849	3 849	385	10.0 %	31
Other Exposures	3 493	3 493	3 763	107.7 %	301
Total Credit Risk	**213 272**	**181 403**	**104 638**	**57.7 %**	**8 371**

6.5 SCB's application of credit risk methodologies

SCB uses both the Standardized Approach and the Advanced-IRB Approach to calculate its capital requirements for credit risk.

- **Standardized Approach:** general risk weights are prescribed in the Capital Requirements Regulation (CRR) for each exposure type in order to determine credit risk RWA amounts.
- **Advanced-IRB Approach (A-IRB):** banks use their own estimated risk parameters – Probability of Default, Loss Given Default and Exposure at Default – in order to determine credit risk RWA amounts. There are numerous and very stringent requirements that banks must adhere to in order to be able to report under A-IRB.

SCB considers the implementation of the A-IRB approach 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, improved scoring, processes and routines and in general risk management practice of the Bank. Greater information regarding the Bank's adoption and use of A-IRB is detailed in Section 6.8.

6.6 Key terminology: credit risk metrics and IRB parameters

The information below describes many important terms used to describe credit risk across the Bank's credit portfolio. These terms will be used throughout the remainder of this chapter.

Non-performing loans, impairments and write-offs

The Bank's definition of the default, write-off and loan loss reserves is detailed below.

- **Default:** a default is deemed to have occurred when it is considered that the obligor is unlikely to pay for objective reasons i.e., bankruptcy is more than 90 days past due (in line with CRR Art.178 (1)). Defaults are also referred to as non-performing loans. The EBA had published new recommendations on the definition of default (NDD), which will promote a standardized assessment of defaulted exposures across banks. SCB is working to implement the requisite changes ahead of the deadline of January 2021 but is following up on future possible changes in the deadline in light of the impacts caused by the outbreak of coronavirus (COVID-19).
- **Write-off:** credit obligation is written-off and removed from on-balance sheet exposure according to accounting standards, which states, "financial assets are written off once the entity has no reasonable expectation of recovering a financial asset in its entirety or part thereof". SCB uses indicators such as days past due, expected cash flows and collateral to determine write-offs. SCB's Board of Directors

approved a change in write-off policy for its unsecured portfolios in Sweden, Denmark and Finland in Oct-2018 and Norway in Jul-2019. The revised policy extends the time before contracts get written-off from 180 to 720 days past due.

- **Loan loss reserves (LLR):** represents management's best estimates of losses incurred in the Bank's loan portfolio at the balance sheet date. Since January 2018, the Bank amended its accounting policy from IAS 39 to IFRS 9. As a result, LLRs will be classified across Stage 1, Stage 2 and Stage 3. This replaces IAS 39 in which LLRs were classified as specific and collective impairments.
  - **Stage 1:** effectively compares to what was a "collective impairment" under IAS 39
  - **Stage 2:** exposures that have exhibited a substantial increase in credit risk (SICR), determined by the change in PD vs. the PD at origination.
  - **Stage 3:** defaulted exposures and compares to specific write-downs.

SCB has a model for calculating the Expected Credit Loss (ECL), in which all exposures are divided into the aforementioned stages. The impairment calculation for Stage 1 and Stage 2 is provided by models that estimate future losses based on forecasts of future economic development.

IRB Parameters

In order to measure the credit risk of an exposure for capital requirement purposes, Expected Loss and Unexpected Loss needs to be determined. Unexpected Loss relates to the very high but improbable level of losses not considered recurring but must be absorbed by capital. For Expected Loss, SCB determines Probability of Default, Loss Given Default, and Exposure at Default in order to derive an exposures' Expected Loss.

- **Probability of default (PD):** probability that a given customer will default on their credit exposure within the next 12 months. The PD used for regulatory capital is Through-the-Cycle (TTC) i.e., long term. A default is deemed to have occurred when either there exists reasonable doubt whether there will be a repayment or when a customer is more than 90 days past due on their credit obligation. Defaulted exposures are automatically assigned a PD of 100%. Calculation of PD is done based on the Bank's historical information.
- **Loss given default (LGD):** indicates how much the Bank expects to lose in the event of a default. For the purpose of regulatory capital, LGD is calculated based on a downturn economic cycle. In the calculation for LGD, customer collateral, future cash flows and other relevant factors are incorporated.
- **Exposure at default (EAD):** the value of the debt at the time of default.

The parameters and 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) calculations, stress testing, and scenario analyses. The results are subsequently reported to senior management through various internal committees.

6.7 SCB credit performance

SCB's credit portfolio have historically exhibited a stable non-performing loan (NPL) ratio providing a good indication regarding the underlying portfolio credit quality and the Bank's underwriting standards. The figure below shows the development in the NPL ratio, split by secured and unsecured and by geography, during the last 3 years. As mentioned previously, SCB's Board of Directors approved a change in write-off policy for its unsecured portfolios in Sweden, Denmark and Finland in Oct-2018 and for all products in Norway (except auto leasing) in Jul-2019 to ensure alignment with IFRS 9. The revised policy extended the time before contracts get written-off from 180 to 720 days past due resulting in an overall increase in NPL ratios especially for the unsecured portfolio. In addition, NPL sales expected to take place in Q4-2019 were postponed to 2020. The impacts can be seen in more details in the tables below.

Figure 6.7.1 NPL ratio developments per type of portfolio

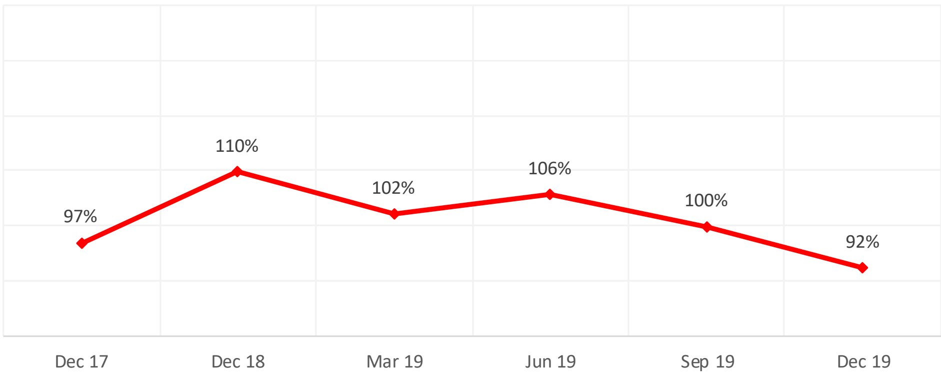
NPL ratio	Dec-17	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Secured	1.06%	1.12%	1.14%	1.14%	1.19%	1.32%
Unsecured	4.92%	5.34%	6.11%	5.16%	6.01%	7.26%
Nordic	***1.96%***	***2.03%***	***2.21%***	***2.00%***	***2.22%***	***2.60%***

Figure 6.7.2 NPL ratio developments per country

NPL ratio	Dec-17	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Denmark	1.17%	1.45%	1.77%	1.98%	2.24%	2.64%
Finland	0.74%	0.90%	1.09%	0.98%	1.23%	1.34%
Norway	3.50%	3.46%	3.41%	2.99%	3.56%	3.77%
Sweden	1.12%	1.34%	1.69%	1.39%	1.69%	2.01%
Nordic	**1.96%**	**2.03%**	**2.21%**	**2.00%**	**2.22%**	**2.60%**

NPL coverage is defined as Loan Loss Reserve set by the Bank divided by NPLs. NPL coverage is an important metric to consider as it identifies the amount of loan loss provisions already set aside to cover those exposures considered non-performing. The figure below demonstrates SCB's prudency in its approach to provisioning.

Figure 6.7.3 Coverage ratio development



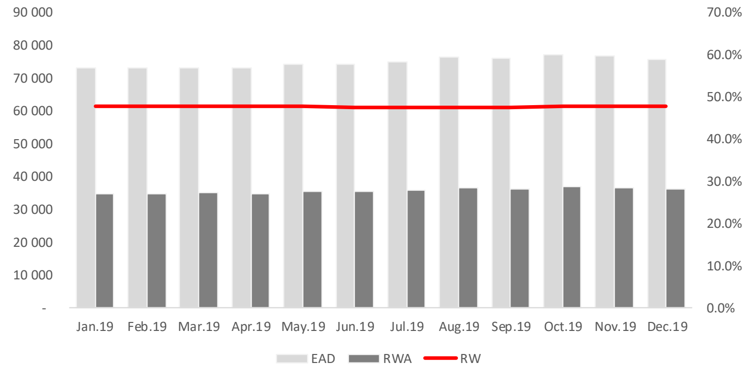
6.8 SCB credit risk under the A-IRB Approach

Approved IRB portfolios

In December 2015, SCB received approval from the Bank of Spain and the Norwegian FSA, to report under A-IRB approach for the Auto PP portfolios in Norway, Sweden and Finland only. These portfolios account for about one-third of the total assets of the Bank and are referred as "Wave 1" in the roll-out plan for portfolios under the A-IRB approach. Future portfolios to come under the A-IRB approach are referred to as "Wave 2" and "Wave 3".

The figure below shows the EAD, RWAs, and risk weights of the A-IRB Wave 1 portfolios. During 2019, EAD has grown 3%, while the risk weight remained stable.

Figure 6.8.1 A-IRB portfolio wave 1



The table below provides RWA and parameter details as at 31 December 2019 for the current A-IRB portfolios. The table is in accordance with CR6 as per the EBA's disclosure requirements "*EBA/GL/2016/11".*

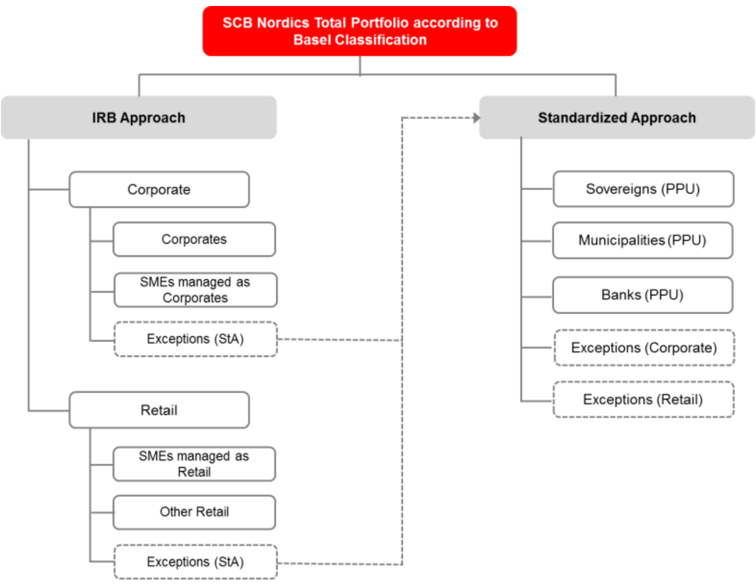
Table 6.8.2 A-IRB portfolio parameter information – EU CR6[5]

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)	9 735 238	9 735 238	0.26 %	54 951	34.0 %	4.00	1 694 397	17.4%	8 617	31 945
B [0.50-1.00)	22 104 607	22 104 607	0.72 %	175 985	45.9 %	3.73	9 513 347	43.0%	75 481	58 818
C [1.00-1.38)	20 012 310	20 012 310	1.09 %	128 159	41.3 %	3.83	9 228 328	46.1%	90 089	92 523
D [1.38-3.35)	11 659 434	11 659 434	2.08 %	93 374	42.3 %	3.89	6 795 634	58.3%	105 610	55 484
E [3.35-4.07)	434 869	434 869	3.37 %	3 786	49.7 %	3.98	324 819	74.7%	7 278	1 257
F [4.07-8.21)	6 001 685	6 001 685	5.46 %	44 203	41.5 %	3.87	3 933 515	65.5%	134 461	54 462
H [10.64-100)	4 914 892	4 914 892	25.75 %	33 782	37.8 %	3.92	4 548 067	92.5%	483 523	173 273
PD 100	814 831	814 831	100.00 %	6 636	38.5 %	3.34	109 987	13.5%	305 132	366 720
Total	***75 677 864***	***75 677 864***	***4.05 %***	***540 876***	***41.7 %***	***3.84***	***36 148 093***	***47.8%***	***1 210 191***	***834 483***

IRB Roll-out Plan

The figure below provides an overview of the Bank's portfolio classified under the Basel II accord. This represents the "end-state" portfolio classification i.e., when A-IRB has been fully rolled out. As can be seen, some portfolios will remain under the standard approach based on the characteristic of the obligor and materiality of the credit risk.

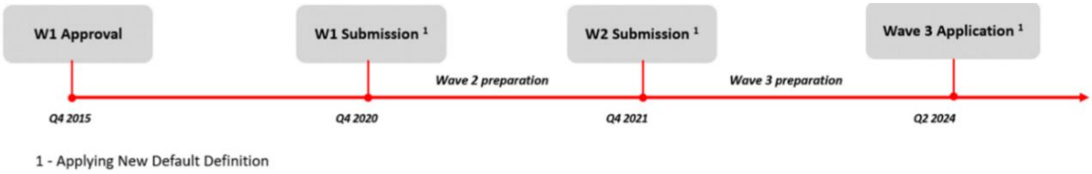
Figure 6.8.3 Portfolio classification by Basel II



[5] The Bank's A-IRB portfolios consist of instalment loans without assigned credit limits and therefore, CCF columns have not been reported.

SCB has a three "Wave" approach for the roll out of the portfolios under IRB approach. The details for the roll out are provided in the table below. Wave I was approved for IRB in December 2015 and constituted the Auto PP in Norway, Finland and Sweden and are thus used for assessing regulatory capital requirements today. The European Banking Authority's (EBA) introduction of new default definitions (NDD) applicable from 2021, obliges SCB to recalibrate its IRB portfolios under "Wave 1" and to postpone applications for new A-IRB portfolios currently under standard method. The Bank continues to focus on developing the necessary models, procedures, management integrations, controls and reporting in order to use the IRB approach for calculation of required capital for the majority of the Bank's assets. The figure below outlines the bank's updated roll-out plan.

Figure 6.8.4 A-IRB roll out calendar



IRB Regulatory Limits

In order to measure any significant variation within the A-IRB portfolios and ensure stability, regulatory limits are established on key performance indicators for the A-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 A-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 A-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 2019, and will be reassessed for 2020 considering the portfolio developments during 2019.

Credit Risk Mitigation

In the regulatory capital calculation, the application of credit risk mitigation affects the value of the risk parameters used for the calculation of capital. The identification and valuation of the collateral and/or guarantees associated with the contracts is essential. This process of mitigation is undertaken under the assumption that the validity of the collateral and/or guarantee has been checked and they are considered eligible to be applied. Under the A-IRB approach, the presence of collateral impacts on the final value of the LGD used in the calculation of capital. For LGD estimations on its A-IRB portfolios, SCB uses vehicles pledged as collaterals in form of other physical collaterals following the requirements specified under CRR article 199.1(c). With regards to the calculation, the Bank, in its LGD model, applies a pre-defined collateral value for each exposures group.

IRB Model Governance

A fundamental part of the process implementing A-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.

- Model owners, model users, model developers and model implementers (1 LoD) have responsibility for the primary management of model risk, which arises from their activities.
- Internal validation (IV) and Model Risk Control (2 LoD) functions comprehensively oversee, independently validate, asses, and control model risk management.
- Internal Audit function (3 LoD) is involved in all stages of the model lifecycle and they oversee all other functions

This governance model meets the regulatory requirements for IRB models:

1. Existence of a strong governance model.
2. Existence, separation and independence of the Risk Control and Supervision, Internal Validation and Internal Audit areas.
3. Independent annual reviews by Internal Validation and Internal Audit (also at Banco Santander level)
4. Communication processes with Management which ensure all associated risks are reported

Model Validation

Independent validation of models before implementation is not only a regulatory requirement in certain cases, but also a key feature for proper management and control of model risk. Thus at SCF level, a specialist unit, completely independent of both developers and users, draws up a technical opinion of the suitability of internal models to their purposes, and sets out conclusions concerning their robustness, utility and effectiveness. Validation requirements are higher for IRB models relative to other models.

After being validated, the validation opinion is converted into a score on a scale of 1 to 5, where 1 is low model risk, 2 is moderate low, 3 is moderate, 4 is moderate high and 5 is high.

In addition, the internal validation function provide recommendations, in case the model needs improvements, which are followed up on a regular basis by the model risk function and model owners. The Bank's A-IRB parameter models include a significant level of conservatism to account for model risk. As per 2019, A-IRB models are determined to be high quality with moderate risk level.

Model Monitoring

Models are designed and built based on certain information and circumstances, which may change over time. These models are subject to regular performance monitoring to ensure that they are still working properly and to aid in the planning of redevelopments and decommissions.

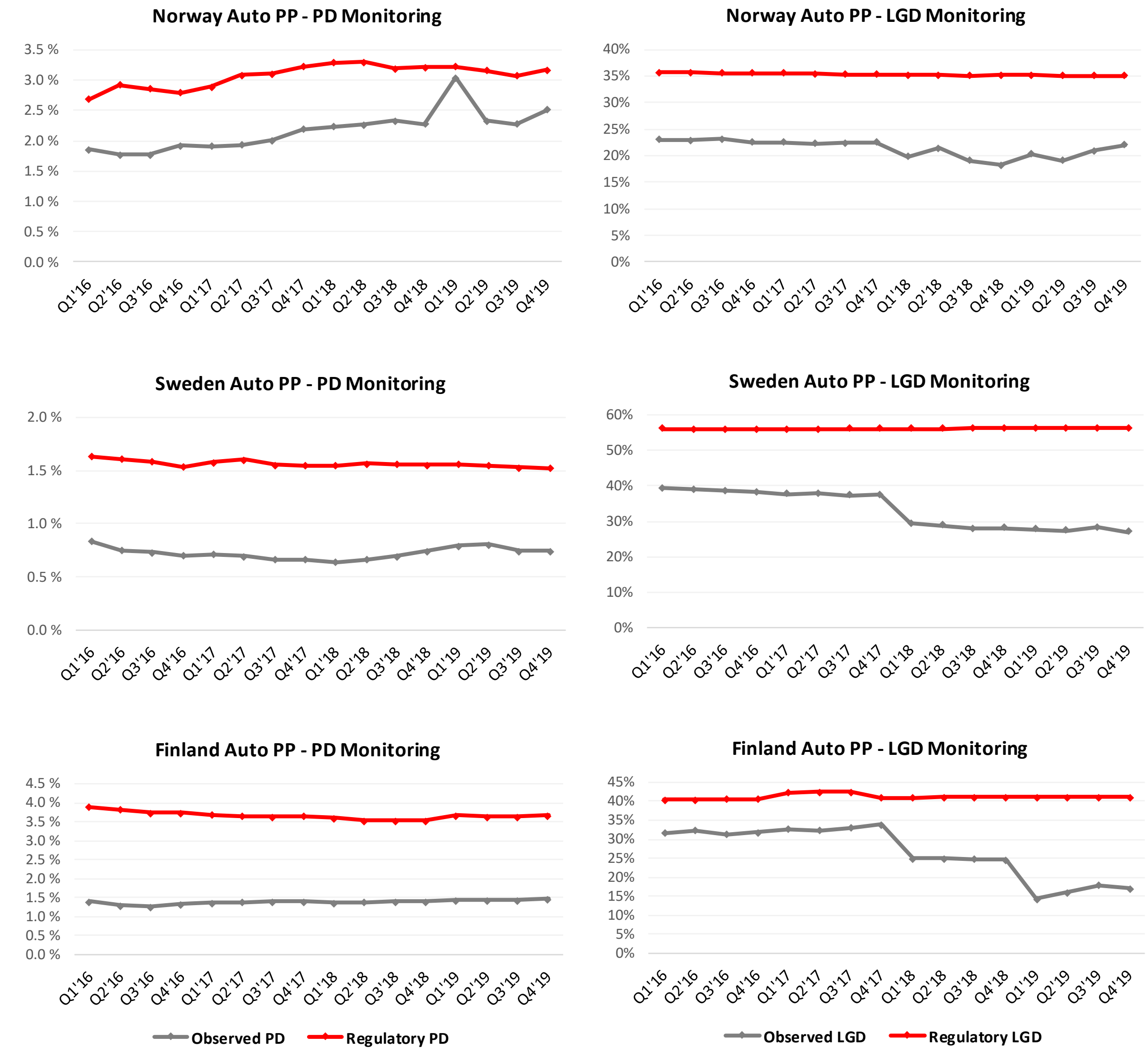
The model owner and model developer are in charge of performance monitoring of the models in use according to corporate standards for stability, calibration and performance. The monitoring results are presented to the relevant governance bodies and reviewed by the internal validation function independently.

Back-testing of IRB Parameters

SCB has a comprehensive back-testing framework to test the IRB parameters validity on a quarterly basis. The aim of the PD back-test is to compare the regulatory PD used for calculating capital requirements with actual PD point-in-time (PD PIT). 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 is crucial since they are used in the capital requirement calculation, and back-testing is thus conducted on a regular basis.

Figure 6.8.5 Back-testing of IRB Portfolios



As can be observed from the graphs above, the PDs PIT for the A-IRB portfolios are below the predicted measurements used in capital requirement calculation. This indicates that the calculation is sufficiently conservative. The peak in Q1-2019 in the PDs PIT in Norway is driven by a data issue in the score distribution. Levels were back again to actual average from the next quarter. The divergence in the observed LGD's in Sweden and Finland can be explained by corrections in recovery movements in Finland and the phasing out of an old portfolio with very high LGD levels in Sweden. In addition, higher BDS amounts (Bad Debt Sales) contributed to the decrease in observed LGDs.

For each portfolio, regulatory PD buckets, representing different PD levels, are established. For each of these, the average PD assigned 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 (2019). 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.

ODF is also compared with the point-in-time (PIT) PD, which is influenced by the cyclicality. This allows the slope of the PD curve to be compared with the delinquency observed in each rating category. The graphs below illustrates that the TTC PD is consistently higher than observed defaults for the vast majority of rating categories.

Figure 6.8.6 Norway A-IRB: Observed default frequency by PD bucket and PD rate

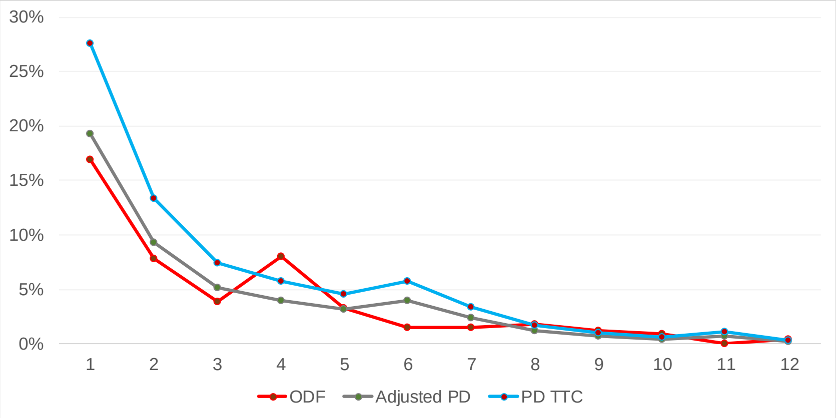


Figure 6.8.7 Sweden A-IRB: Observed default frequency by PD bucket and PD rate

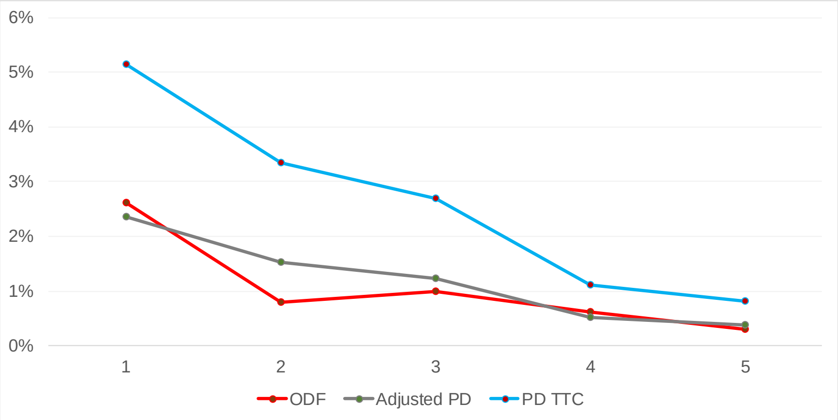
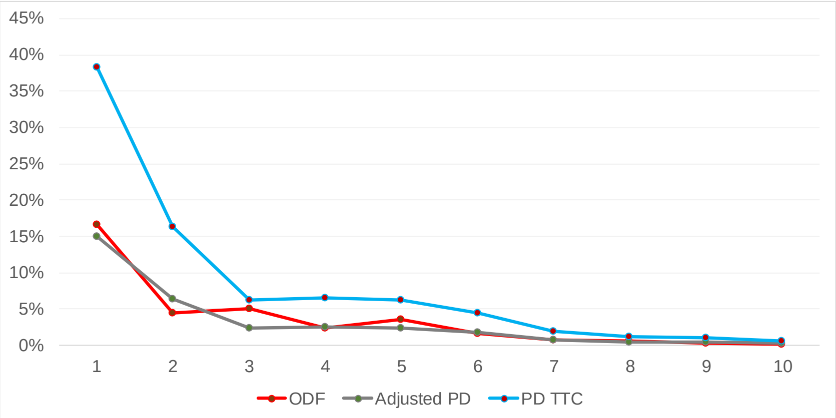


Figure 6.8.8 Finland A-IRB: Observed default frequency by PD bucket and PD rate



In addition to the above analysis, Figure 6.8.6.5 gives an overview of the back-testing exercise through the disclosure table CR9 as per EBA/GL/2016/11. In general it is observed that the PD assigned to IRB portfolios for capital requirement is conservative when compared with average defaults over the last 5 years. This observation is in line with economic cycle development in the respective countries.

Figure 6.8.9 Back-testing A-IRB parameters – 31 December 2019 - CR9

	des.19	des.19	des.19	des.19	des.18	des.19	dec18-dec19	
				Arithmetic	Number of obligors		Defaulted	Average
Nordics	PD Range	External Rating Equivalent	Weighted average PD	average PD by obligors	End of previous year	End of the year	obligors in the year	historical annual
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 %	55 050	54 952	170	0,30 %
	0,50 < 0,75%	BBB- to BB+	0,63 %	0,63 %	46 391	47 965	300	0,71 %
	0,75 < 2,50%	BB+ to BB-	1,36 %	1,40 %	65 397	64 793	778	1,02 %
	2,50 < 10,0%	BB- to B-	6,10 %	5,97 %	16 747	15 954	573	3,22 %
	10,0 < 100%	B- to C	24,19 %	24,23 %	18 590	18 559	2 475	21,88 %
	100% (Default)	D	100 %	100 %	4 136	4 712	0	
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 %	121 526	126 878	416	0,42 %
	2,50 < 10,0%	BB- to B-	3,38 %	3,39 %	34 526	34 389	467	1,40 %
	10,0 < 100%	B- to C	67,80 %	67,60 %	511	498	207	55,54 %
	100% (Default)	D	100 %	100 %	429	447	0	
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 %	19 186	19 202	36	0,19 %
	0,75 < 2,50%	BB+ to BB-	1,38 %	1,43 %	111 720	116 116	531	0,53 %
	2,50 < 10,0%	BB- to B-	27,38 %	27,24 %	13 675	14 723	1 340	2,44 %
	10,0 < 100%	B- to C	4,84 %	4,84 %	19 529	20 216	420	21,49 %
	100% (Default)	D	100 %	100 %	1 094	1 477	0	

From the back-testing perspective, the average historical default rate is important. It averages the default rates experienced in each of the past five years for each PD bucket. Comparing this with weighted average PD and simple average PD provides an idea of how well the Bank's regulatory PD matches actual experience.

In order to measure any significant variation within the portfolio and ensure the stability, management and regulatory limits are established on key risk performance indicators every year per country and product.

7. Market risk

Market risk is the potential loss of value in assets and liabilities due to changes in the market prices such as foreign exchange and interest rates. SCB's strategy is not to actively assume market risk other than what results directly from the Bank's operations. For SCB, market risk can be split into the following categories:

- **Currency risk:** risk of loss resulting from changes in foreign exchange rates. The key metric is the open exposure amount in the relevant currencies
- **Interest rate risk:** risk of loss resulting from changes in interest rates. The key metrics are Net Interest Margin (NIM) and Market Value of Equity (MVE) sensitivities
- **Credit spread risk:** risk of loss as a result of changes in credit spreads

Market risk is managed by the Financial Management Division and controlled by the Risk Division.

As alluded to above, SCB's strategy is not to take on market risk beyond what results directly from our normal business operations in the four countries where SCB is present. The Bank is exposed to currency risk because it operates in four different countries with different 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 does possess a liquidity portfolio consisting of High Quality Liquid Assets (HQLAs) where the intention is to hold the bonds to maturity. HQLAs comprises, amongst others, marketable securities backed by sovereigns and central banks and covered bonds.

7.1 Governance of market risk

SCB maintains two documents directly relating to Market Risk that are approved by the BoD. The high-level Structural Risk Model document outlines all requirements of the Bank's Market Risk organization and governance, and the more specific Liquidity and Market Risk Policy document details how these requirements are fulfilled. In addition, the Risk Appetite Model forms the foundation of the Bank's Market Risk limit structure.

The Bank maintains a balance sheet composition that ensures that the market risk is managed at prudent levels and within established limits, as detailed in the Liquidity and Market Risk Policy.

SCB's Risk Appetite statement (RAS) contains the Bank's risk appetite limits for Market Risk. In addition, the Bank has a set of Management limits, subject to annual review and approval by the Risk Approval Committee, which encompasses more metrics and stricter limits than the RAS. As per the governance structure specified in the Liquidity and Market Risk policy of the Bank, the limits are monitored by the Risk Control Committee and the Board Risk Committee. The Bank maintains limits for interest rate risk and currency risk but not for share risk, property risk, CVA risk or spread risk since the Bank has very limited exposure to these risks.

7.2 Currency risk

The Bank aims for a balance sheet composition 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 using derivatives.

The currency exposure is continuously monitored and controlled and it is reported monthly to the Risk Control Committee. The limits for currency risk are approved by the Risk Approval Committee and reviewed by the BoD on an annual basis.

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

7.3 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 / fixed rate intragroup loans, interest rate derivatives and variable / fixed rate customer deposits. 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 BoD for final approval. Limits must be reviewed annually for each of the following metrics:

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

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. The assets and liabilities are assigned 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 repricing distribution for non-maturity deposits is based on a run off assumption (exponential distribution), whose parameters are estimated based on historical deposits data. For the loan portfolio, the repricing distribution is based on a prepayment model, which is governed by a Constant Prepayment Rate, estimated by each business unit.

The table below shows, per currency, the 2019 year-end NIM and MVE sensitivities, considering the worst-case scenario of the earlier specified scenarios.

Figure 7.3.1 Interest Rate Risk per December 2019 (millions)

	NOK	SEK	DKK	EUR
MVE Sensitivity				
Actual 31 December 2019	148.74	69.96	53.04	5.48
NIM Sensitivity				
Actual 31 December 2019	99.55	17.38	26.56	4.58

7.4 Credit spread risk

Credit spread risk is defined as the risk of changes in market value of securities or any credit derivatives because of an overall change in credit spreads. As mentioned, SCB's strategy is not to take on market risk in excess of what occurs directly from the Bank's operations. Consequently, the Bank's liquidity portfolio consists of HQLAs amounting to NOK 11 633 million as per 31 December 2019.

Credit spread risk in the bank is managed through strict policy mandates setting the structure of our bond portfolio, only the highest quality bonds are allowed, and with the short maturities (fixed rate up to 1Y, floating rate up to 3Y). The bond portfolio is also classified as "Hold to collect" following the IFRS9 definitions which means that SCB is holding the bond portfolio to maturity and not making profit or loss from market changes. This results in a very low and stable credit spread risk, defined as non-material. The Bank monitors the credit spread risk on a weekly basis by monitoring changes in the market value of the bond portfolio, but has not established limits towards it based on a low materiality. SCB believes this is covered by LCR limits and liquidity stress test limits; should the credit spread risk materialize, it will decrease the value of the bond portfolio for the LCR and liquidity stress test horizon calculation.

7.5 Capital requirement for market risk

The Bank's market risk capital requirements are calculated in accordance with capital adequacy regulations and the CRD IV/CRR regulations. The approach to calculate market risk regulatory capital can be either the internal model approach or the standardized approach. SCB reports according to the standardized approach for market risk. The table below depicts SCB's Pillar 1 market risk capital over the previous three financial years.

Figure 7.5.1 SCB Pillar 1 Market Risk Capital (NOK millions)

SCB Pillar I Market Risk	2017	2018	2019
Interest Rate Risk	-	-	-
Currency Risk	68	118	117
CVA Risk	13	8	2
Total	**81**	**126**	**119**

The capital requirement for interest rate risk in 2019 was determined to be zero given that the Bank, through its balance sheet structure, runs minimal interest rate risk as is illustrated in Figure 7.5.1 above. The capital requirement for currency risk for 2019 was NOK 117 million due to the total net currency position exceeding 2% of total own funds. CVA risk is minimal due to the net mark-to-market value of derivatives and thus resulted in a minor Pillar 1 capital charge of NOK 8 million.

8. Exposure to securitization positions

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.

To date none of the securitization transactions executed by SCB has resulted in a reduction in capital for SCB[6]. The intention of the securitization programs has been to provide the Bank with access to the international debt capital markets and potentially to access the liquidity provided by Central Banks to ensure functional credit and money markets.

Securitization programs have been implemented across the four Nordic units over the past seven years, and serve as an integral part of the Bank's funding strategy. The Bank has completed 18 transactions:

- 7 transactions with Norwegian collateral;
- 8 from its Finnish business;
- 2 transactions from Sweden (including a warehouse structure); and,
- 1 in Denmark

Total external funding raised equals approximately NOK 14.5 billion and EUR 2.8 billion (swapped to NOK) from the Norwegian business, EUR 4.2 billion from Finland, SEK 17.4 billion from Sweden and DKK 4.2 billion from Denmark. Of the 18 transactions completed, 12 have been wound-down, with full payment to external investors.

Securitization initiatives completed in 2019 consist of one transaction from the Finnish subsidiary, which was issued in the public ABS markets and one Financial Guarantee through a synthetic securitization referencing Swedish Auto Loans.

The securitization programs have 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.

9. Non-financial risk

This chapter has been renamed to Non-Financial Risk (NFR) to address the broader scope of Operational Risk and to reflect the increasingly focus on an integrated framework for managing NFR. It includes the following risks:

- Operational risk according to Basel II, including compliance, conduct and legal risk
- Cyber and Technology risk
- Reputational risk

SCB is currently applying the Basic Indicator Approach for calculating the Bank's capital requirement for operational risk in accordance with the Basel capital adequacy framework .

9.1 Non-financial risk developments in 2019

SCB places increasingly importance on its non-financial risks and made significant strides in 2019 in cyber security, IT related risk and compliance and conduct risk. The main developments are summarized below:

- Implementation of a new simplified governance structure
- Compliance & Conduct function cross Nordics with a harmonized and risk based compliance program and plan with clear reporting and escalation routines
- Consolidation of IT systems into an eco-system of unified platform services providing stability and security benefits, enabling a cohesive security architecture
- Development of a solid process for certifying that all vendors and third-party services are aligned with SCB's cyber-security policies

[6] SCF HQ utilized the significant risk transfer obtained in the two transactions in 2019 to reduce their risk-weighted assets, with a corresponding reduction in capital.

- Active hiring of IT and cyber security specialists to ensure the Bank possesses sufficient knowledge and expertise
- Increased reporting and governance of IT and cyber security risk indicators to be on a monthly basis
- Development of a cyber-security plan based on the cyber-security framework
- Increased staff cyber-security training and awareness

9.2 Non-financial risk framework

SCB's Non-Financial Risk Framework 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 events need to be detected, reported, monitored and managed. Therefore, the SCB operational risk model consists of seven main processes, which all are interlinked to each other.

All of the main processes use the Corporate tool 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 in addition to a consistent report of data across all SCB units.

Internal control processes consists of the following:

- **Event loss reporting process** - process includes the identification and assessment of events as well as consolidation, aggregation, calculation, development of mitigation plans/activities for and the reporting of events that have occurred, or might potentially occur.

- **Risk and Control Self-Assessment (RCSA) process** - yearly risk assessment process identifying and evaluating potential risks and controls to proactively prevent risks from materializing.

- **Scenario analysis** - operational risk instrument that identifies relevant risks (low frequency, high severity) within the organization, establishes action plans and aims to reduce the probability and/or severity of the scenario should it occur.

- **Internal Control Model** - the internal control framework within SCB is based on: (1) the Santander Internal Control Framework, (2) the requirements of The Sarbanes-Oxley Act (SOX), (3) the Committee of Sponsoring Organizations of the Treadway Commission Framework (COSO) and (4) the local requirements by Nordic regulators. The Santander Internal Control Framework sets the foundations for the Internal Control function in SCB and the internal control methodology.

- **Action drivers and mitigation actions** - tools for recording issues and mitigation plans. More specifically, Action Driver is a problem to be solved (deficiency/issue) and Mitigating Action is the action plan to solve the issue.

- **Business Continuity Management (BCM)** - defines plans to quickly recover a system or a process exposed to 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.

- **Operational Risk Indicators (ORIs)** - the use of different metrics, or key risk indicators, is an important tool for detecting and remediating potential risks before they are materialized. The ORIs are based on corporate methodology but adapted to local conditions and needs.

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

- **Santander Cyber Security Program** – program is aligned with business and stakeholder needs and is intended to assess, detect, prevent, and mitigate serious IT related security threats.

- **Fraud management –** internal and external fraud events are 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.

- **Risk culture and awareness –** since it is important that all employees acknowledge the importance of the operational risk framework, and that the operational risk mindset is incorporated in the daily business activities, Santander Corporate have initialized the Risk Pro concept. The objective of the concept is to incorporate the "Risk DNA" in all employees. The risk pro concept includes a senior management promotion of risk thinking. Various operational risk awareness trainings are performed with employees.

- **Compliance and reputational risks –** within the non-financial risk scope also compliance, conduct and reputational risks are considered. The management of these risks, from the operational risk perspective, share and/or follow the methodology of the general non-financial risk management processes.

9.3 Non-financial risk governance

Based upon SCB Corporate guidelines, the Bank has adapted and established a Nordic model, appropriate policies and procedures, which describe the non-financial risk management hereunder operational risk management, cyber and technology.

The governance includes several risk committees that operate with the objective to assure that the senior management team, including the Board, are updated with relevant non-financial risks and ongoing activities. The committee provides oversight of the risk and control management, and when applicable makes recommendations or agree on corrective actions regarding low and medium risks and for high and critical risks escalated to the Risk Control Committee.

9.4 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, compliance and conduct risk, model risk and IT risk.

To ensure that the Bank operates within the BoD approved risk appetite, an operational loss risk appetite is set at least annually which requires BoD approval. The main risk appetite metric is "Operational risk losses" / "Gross margin". Ongoing BoD meetings monitors the data related to operational loss risk appetite.

- **Operational loss budget:**
  - Each of the four Nordic SCB units, define their respective operational risk loss budgets. For this process, the Bank uses the seven Basel categories of operating losses. The non-financial risk committee (NFRC) approves the budget.

On a monthly basis, the budget is monitored, reconciled and reported to SCF, NFRC and to the Risk Control Committee. Specific general ledger operational risk accounts, both at local and corporate level, has been set for this purpose.

9.5 Cyber & technology risk

The landscape is constantly shifting for financial services companies and throughout recent years, the Bank has seen a continued increase in the number of attacks that directly target financial organizations. This is combined with an increase in cyber terrorism as well as state sponsored cyber-attacks, to generate a complex and challenging threat landscape that use novel threat vectors and methods. In parallel, SCB sees new laws and regulations being introduced that maintain a focus on compliance and protecting against known directed threats.

In order to ensure that such challenges are met, the Bank has proceeded with a strategy that encompasses:

- Consolidation of IT systems into an eco-system of unified platform services providing stability and security benefits, enabling a cohesive security architecture.

- Development of a solid process for certifying that all vendors and third-party services are aligned with SCB's cyber-security policies.
- Active hiring of IT and cyber security specialists to ensure the Bank possesses sufficient knowledge and expertise
- Increased reporting and governance of IT and cyber security risk indicators to be on a monthly basis
- Development of a cyber-security plan based on the cyber-security framework
- Increased staff cyber-security training and awareness

9.6 Model risk

SCB uses models to support decision making, financial and regulatory reporting, and to provide predictive information in a number of business functions, such as credit risk management, market risk management, capital estimation and stress testing, and asset/liability management, among others.

The use of models entails exposure to model risk, which is defined as the potential for adverse consequences from decisions based on incorrect, inadequate or misused model outputs and reports, including the opportunity cost of lacking adequate models. Thus model development, implementation and use can all be potential sources of model risk. Model risk can ultimately lead to financial loss, poor business or strategic decision-making, or damage to SCB’s reputation.

The program at SCB was enhanced during 2019 and includes robust corporate governance around model risk management, comprehensive review mechanisms, stakeholder’s engagement and a complete and continuously updated model inventory. To support this process, Santander Consumer Finance (SCF) has defined clear frameworks, policies and guidelines for establishing common general principles for the management and control of model risk, which are adopted by SCB and adhered to by the Board of Directors.

Model Validation

Independent internal validation of models before implementation is not only a regulatory requirement in certain cases, but also a key feature for proper management and control of Model Risk. Thus at SCF level, a specialist unit, completely independent of both developers and users, draws up a technical opinion of the suitability of internal models to their purposes, and sets out conclusions concerning their robustness, utility and effectiveness.

After each model has been validated, the validation opinion is converted into a score on a scale of 1 to 5, where 1 is low model risk, 2 is moderate low, 3 is moderate, 4 is moderate high and 5 is high.

In addition to the score, the internal validation function provide recommendations, categorized by relevance, in case the model needs improvements, which are followed up on a regular basis by the model risk function and model owners. When in use, the models are subject to recurrent validation to review their use suitability with frequency and depth varying based on model type and taking into account regulatory requirements.

As per December 2019, the Bank had 122 models in force. The majority of these models in the inventory are classified as high quality based on the Internal Validation team’s model score. Model re-development and re-calibration plans ensure that they are under continuous improvement and maintenance under a well-defined methodology and model risk management framework.

9.7 Compliance and conduct risk

Compliance Risk is defined as a risk of legal and regulatory sanctions, financial loss or damage to the reputation of the Group arising from the Group or its directors, officers and employees not adhering to applicable laws, rules, regulations and internal policies. The Groups Compliance and Conduct Program covers the following risk taxonomies; Regulatory Compliance Risk, Anti-Money Laundering and Countering Terrorism Financing framework Risk, Product Governance and Customer Protection Risk as well as reputational risk.

The Group has adopted the three lines of defense mechanism with first line of defense as responsible for the risk management and control of the compliance risk. To oversee the compliance processes in the Group and to secure that management and the Board of Directors are provided with independent information regarding the compliance status in the business, the Group has an independent Compliance and Conduct function in second line of defense. The Compliance and Conduct 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. The function performs independent assessments by performing independent risk based monitoring, controls, testing, and thematic reviews. Annual risk assessment forms the risk based approach of the Compliance and Conduct function activities, and the prioritizing between the activities is concluded in the Annual Compliance Plan.

During 2019 the Compliance & Conduct function has been undergoing major organizational changes to secure that the Compliance & Conduct function is aligned, has the right capabilities and adapted to the Group's strategy and operations. The result is a Compliance & Conduct function cross Nordics with a harmonized and risk based compliance program and plan with clear reporting and escalation routines.

The new organization consists of compliance professionals across the Nordics, overseen by the Chief Compliance Officer (CCO), who reports to the CEO and has a functional reporting line to the Chief Compliance Officer at Santander Consumer Finance S.A. To ensure the independence of the Compliance & Conduct function, the Chief Compliance Officer (CCO) has direct access to the Board of Directors and the Board Risk Committee.

During 2019 the Compliance & Conduct functions has enhanced and further developed the Compliance and Conduct program within all compliance risk taxonomy areas, especially related to anti money laundering and consumer protection. The Compliance & Conduct function reports quarterly to the management on both local and Nordic level, as well as to the Board Risk Committee and the Board of Directors.

The Group continually improve and develop the conduct program to ensure that we treat costumers fairly throughout all stages of the customer lifecycle. This includes a "new product approval process" to ensure that the compliance and conduct risk is mitigated in the design and development of new and significantly changed products and services.

The Group has high focus on ensuring that they are not being used for any illegal activities and that the Group is complying with, and have focus on, all applicable financial crime regulations and mitigating actions. During 2019, the Group has initiated several measures to reduce the financial crime risk and further develop a robust financial crime prevention program with supporting IT systems. During 2019 the "Financial Crime Prevention Unit" was established and the number of resources dedicated to anti-money laundering and Fraud will consciously increase during 2020.

The Groups General Code of Conduct is applicable to all employees and members of the Board and sets the ethics principles and rules of conduct by which all activities of the Groups should be governed, and therefore comprises the central component of the Santander Group's Compliance Programme. All employees are required to complete a mandatory training in the Code of Conduct to ensure proper knowledge and awareness of the ethical principles.

The Group has two whistleblowing channels, one for internal purposes, and one for its supplier relationships. Reporting should be made on improper conduct that is believed illegal or which violates the Group's Code of Conduct and policies. Employees are free to report their concerns anonymously to the Compliance and Conduct function and employees who report such concerns in good faith are protected from retaliation.

9.8 Capital requirements for non-financial risk

SCB applies the Basic Indicator Approach (BIA) for calculating its capital requirement for non-financial risk. Under the BIA, the RWAs for operational risk are calculated as a percentage (alpha) of the three-year average gross income amount multiplied by 12.5. This alpha is given by article 315 (1) of the CRR and is currently 15%. The table below details the Bank's BIA calculation for 2019.

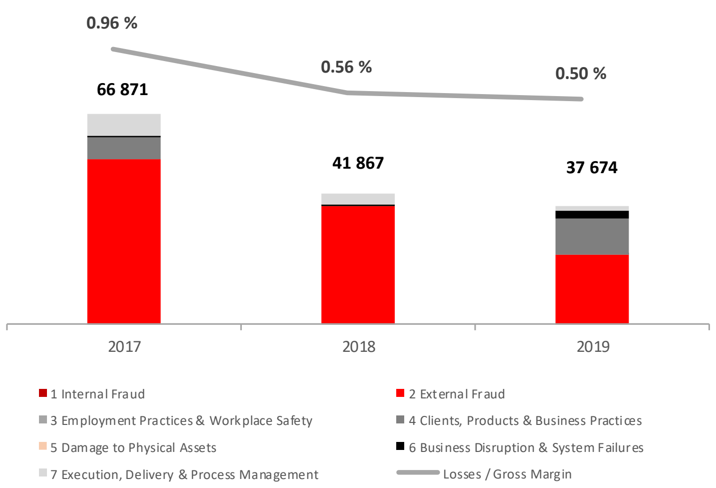
Figure 9.8.1 SCB application of Basel Indicator Approach (NOK million)

Basic Indicator Approach	**2017**	**2018**	**2019**
SCB Gross Margin	6 989	7 384	7 595
3-year average Gross Margin			7 323
15% BIA Capital Charge			1 098
RWA			**13 730**

9.9 Operational loss performance in 2019

As detailed above, for 2019 the Bank held NOK 1 098 million of operational risk capital under Pillar 1 whilst net operational losses amounted to NOK 37.7 million mostly focused in the external fraud category. The increase in category 4 "Clients, Products & Business Practices" was mostly driven by a non-compliance penalty set by the Norwegian FSA on SCB related to an AML incident. The chart below identifies SCB's operational losses by category over the three previous financial years and displays. On an overall level, total detected operational risk events were stable versus 2019 the loss amount was well within the Bank's risk appetite and there were no outstanding litigation cases.

Figure 9.9.1 Operational losses by Basel category (NOK 000s)



10. Liquidity risk

Liquidity Risk is the risk that an entity 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 daily operations, a balance between weighted average life of the assets and liabilities, diversified funding sources and sufficient amount of liquidity reserves across all four currencies in order to survive a stress scenario.

The key ratios for assessing liquidity risk are the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

- The LCR 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. SCB calculates this ratio on an ongoing basis and reports on a monthly basis according to CRD IV. Since September 2017, the Bank is compliant with the specific Norwegian legislations regarding LCR to meet the requirements both at a consolidated level and per significant currency. For the Bank, the significant currencies are NOK, SEK, DKK and EUR. The LCR levels were 187% at a consolidated level, 98% in NOK, 184% in SEK, 245% in DKK and 412% in EUR as of December 31st 2019.

- The NSFR is the long-term funding ratio that compares the structural funding needs to the entity's stable funding sources. This ratio requires banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. SCB calculates this ratio on a quarterly basis in accordance with CRD IV. As of December 31st 2019, the Bank's NSFR was 108%.

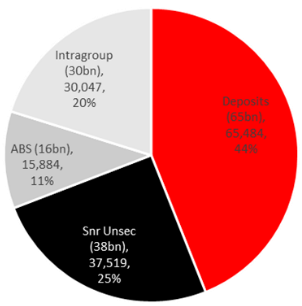
10.1 Diversification of funding sources

SCB's objective is to maintain a well-diversified funding composition and within that, to reduce its reliance on funding from the parent company. As of December 31st 2019, the Bank had a self-funding ratio of 80%[7]. The Bank is raising funds through the following 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

The figure below shows the funding composition on a consolidated Nordic level as of December 31st 2019.

Figure 10.1.1 SCB funding composition as of December 31st 2019



Over the last few years, retail deposits have been introduced in Norway, Sweden and Denmark. As of year-end 2019, deposits constituted about 44% of the Bank's funding base.

As of year-end 2019, the Bank has 11% of its funding coming from securitizations. SCB's overall funding from securitizations has decreased since 2016 due to the change of law in Norway, which has prevented the Bank from issuing asset backed securities (ABS) backed by Norwegian assets. 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 have, since H2 2016, been issued under SCB's standalone credit ratings from Fitch (A-) and Moody's (A3). Per year-end 2019, senior unsecured funding constituted about 25% of the Bank's funding, same % as in previous year.

SCB has available drawdown facilities from its parent Santander Consumer Finance (SCF). Per year-end 2019, senior funding from parent constituted about 20% of the Bank's funding, down from 27% in previous year. In addition to senior funding, SCB also has subordinated debt and hybrid capital provided by the parent company.

[7] Calculated as a proportion of senior debt, excluding equity and subordinated debt

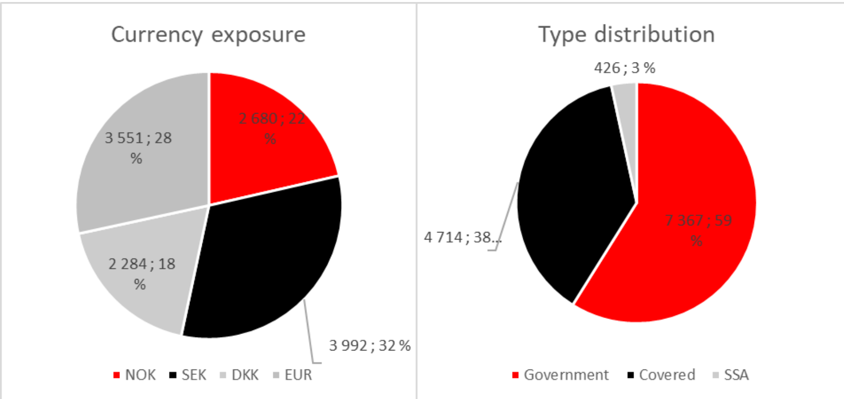
In addition to drawdown facilities from the parent and Banco Santander Group, SCB has committed credit facilities provided by third party banks. This is intended to cover short-term liquidity requirements of an operational nature and to serve as a liquidity buffer.

10.2 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 LCR.

As of year-end 2019, the liquidity bond portfolio was c. NOK 12.3 billion equivalent, up from c. NOK 10.4 billion equivalent 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, SCB 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, and is also active in the Repo market in managing the liquidity portfolio in the short term.

Figure 10.2.1 Overview of the HQLA allocations in NOK as of December 2019



10.3 Asset encumbrance

The asset encumbrance ratio is calculated and reported on a quarterly basis. As of December 2019, the main source of asset encumbrance in the Bank are auto ABS issued and retained or placed in the market. In addition, the Bank has pledged reserve fund amounts in the Special Purpose Vehicles (SPV) of the respective ABS transactions, which together with customer payments, amounted to NOK 850 million at year-end.

In addition, the Bank held at year-end one reverse repo of SEK 96 million, but it is not considered structurally encumbered and is not included in the calculation. No new ABS transactions have been issued in Sweden, Denmark or Norway since 2015, with only SCF Oy issuing Finnish ABS transactions annually. This has led to a decline in the encumbrance ratio, which is expected to remain well below the management limit going forward.

Figure 10.3.1 SCB Asset encumbrance ratio as at 31 December 2019

Total Encumbered assets	19 271 026
Loans on demand	*628 464*
Retained asset-backed securities issued	*2 389 748*
Sold asset-backed securities issued	*16 252 814*
Total Non-encumbered assets	161 932 486
Loans on demand	*3 667 789*
Debt securities	*11 536 850*
Loans and advances other than loans on demand	*142 749 172*
Other assets	*3 978 675*
Asset Encumbrance Ratio	**10.64 %**

10.4 Liquidity management and governance

The Risk Appetite framework defines the Bank's risk appetite limits for liquidity risk. The currently approved risk appetite limits for liquidity risk in SCB address NSFR, LCR and Liquidity Survival Horizon (form of stress scenario).

All three metrics are considered primary metrics in the risk appetite and any risk excess must be communicated to the BoD. The metrics are reported to the BoD in every meeting, at least on a quarterly basis and are monitored by the Board Risk Committee and the Risk Control Committee.

SCB also has a set of management limits on additional liquidity risk metrics including, amongst others, asset encumbrance, intraday liquidity limits and intragroup limits. The management limits must be reviewed annually, and must be approved by the Risk Approval Committee. The management limit metrics covered in the risk appetite statement must also be approved by the BoD, as detailed in the SCB governance structure.

The limits are managed by the Financial Management department, and controlled by the Market Risk department on a monthly basis, and some on a daily basis. Any breach of any management limits are reported to the relevant controlling committees in SCB.

10.5 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 results are presented to Senior Management on a quarterly basis and to the BoD on a semi-annual basis. The objective of the liquidity stress test is to ensure that the Bank has sufficient liquidity to survive a given period under defined stress scenarios. The stress test is used as part of the liquidity risk management of the Bank.