Risk and capital management 2015

Pillar 3 report

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2. Introduction

The purpose of this report (“**the Pillar 3 report**”) is to provide information to the market in order to assess the risk and capital management of Santander Consumer Bank AS and its subsidiaries (hereinafter referred to as “**SCB**” or “**SCB Group**”), as required under the Pillar 3 of the capital adequacy regulations. The report meets the information requirements outlined in the capital adequacy regulation part IX (*NO: “Kapitalkravsforskriften del IX”).* In addition we publish an appendix to the report (see Pillar 3 Appendix), where we publish 1) capital position, 2) terms of capital instruments and 3) own funds disclosure template, as recommended in Circular 14/2014 “Publishing information regarding own funds”. This Pillar 3 report is updated annually.

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

3. Santander Consumer Bank AS

3.1 Background

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

The bank is a 100% owned subsidiary of Santander Consumer Finance S.A., a leading player within car and consumer financing in Europe. Santander Consumer Finance S.A. is part of Grupo Santander, one of the world’s largest banking groups, with head office in Madrid.

The bank has been operating under the Santander name since 2005, after Santander Consumer Finance’ acquisition of Elcon Finans AS in Norway in 2004. In June 2014, Santander Consumer Finance S.A signed an agreement with GE Money Nordic Holding AB to acquire GE Capital’s business in Norway, Sweden and Denmark (hereinafter “**GE Money Bank**”). GE Money Bank’s main areas of business were consumer loans, sales-finance and credit cards offered across Norway, Sweden, and Denmark. The acquisition took place in November 2014 and the merger between SCB and GE Money Bank was completed on 1 July, 2015, with SCB as the surviving entity.

The inclusion of GE Money Bank provided further customer, product and geographical diversification across the Nordic countries.

The Nordic group employed approximately 1410 FTEs per year-end 2015.

4. Governance and control

4.1 Management of SCB

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

SCB has a separate Audit Committee, as a subcommittee of the Board of Directors, consisting of three members, assisting the Board of Directors in relation to its administrative and supervisory tasks, control, financial management and reporting duties and follow-up of the external audit of the bank. SCB also has a separate Board Risk Committee, consisting of three members, with the objective of advising the Board of Directors on the overall current and future risk, appetite and strategy, and assist them in overseeing the implementation of the bank's risk strategy. SCB has further established a Remuneration Committee, consisting of three members, advising the Board of Directors in the preparation of the bank's remuneration policy and monitoring the effects of the policy.

In addition SCB has established certain management committees, such as the Capital Committee, whose main purpose is to have an effective forum for supervising, authorising and evaluating all aspects related to the capital and solvency of SCB within the framework decided by the Board of Directors, and the Internal Control Committee whose main purpose is to oversee SCB's risk profile, including oversight of all risks and the establishment of appropriate control systems and the compliance with laws, regulations and internal policies.

4.2 Organisational set-up

SCB is organized into eight staff divisions and four business units, representing operations in Norway, Sweden, Denmark and Finland.

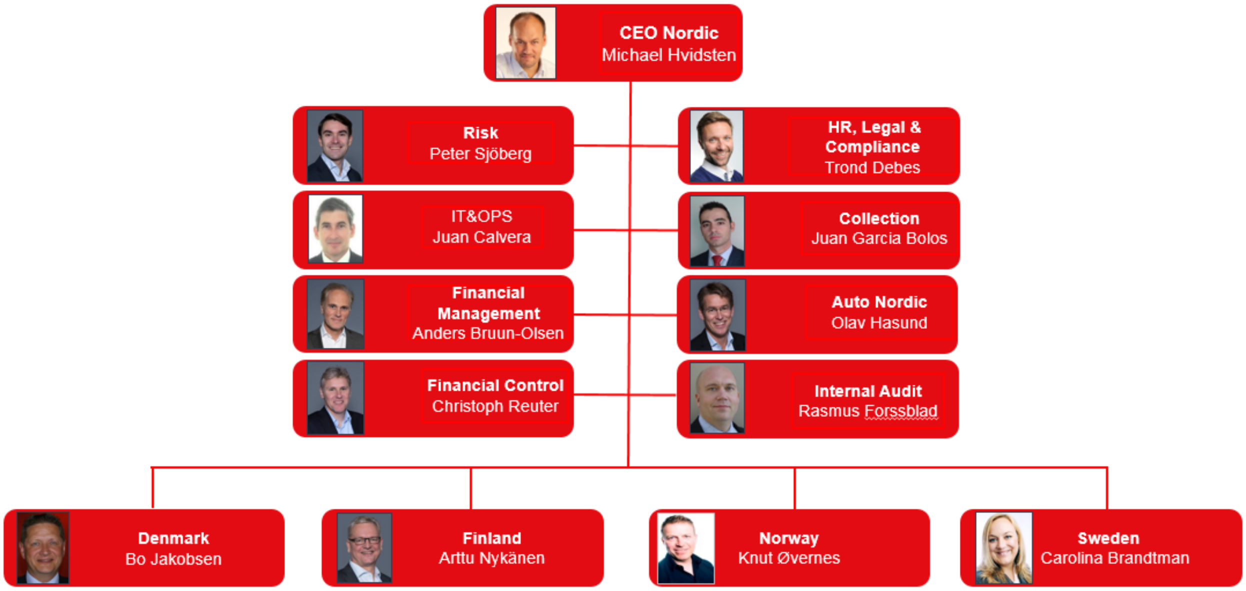
CEO Nordic
Michael Hvidsten
Risk
Peter Sjöberg
HR, Legal & Compliance
Trond Debes
IT&OPS
Juan Calvera
Collection
Juan Garcia Bolos
Financial Management
Anders Bruun-Olsen
Auto Nordic
Olav Hasund
Financial Control
Christoph Reuter
Internal Audit
Rasmus Forssblad
Denmark
Bo Jakobsen
Finland
Arttu Nykänen
Norway
Knut Øvernes
Sweden
Carolina Brandtman

Figure 1: Organisation of Santander Consumer Bank

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

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

	1st line of defence	2nd line of defence	3rd line of defence
Function	Business	Risk control and Compliance	Internal Audit
Role	Acting risk owner and ensure sound internal control through documented control activities.	Risk control: Ensure sound risk management and internal control in business, on behalf of the CEO. Compliance: Ensure regulatory compliance in business, on behalf of the CEO.	Ensure internal control and regulatory compliance in the entire bank, on behalf of the Board of Directors.
Responsibilities	- Manage business so that all risks are identified, managed and controlled - Ensure that internal control is developed and maintained in areas of responsibility (e.g. Implement controls to detect non-compliance) - Take ownership and actions on deficiencies identified	Risk control: - Ensure risk level is in line with risk appetite - Monitor and control risk framework Compliance: -Ensure compliance with internal/external regulations - Monitor and control Compliance risk framework Both: - Risk assessments -Risk reporting with deficiencies and recommendations - Challenge the work and reporting in the first line of defence and the risk management work (setting risk appetite etc.) of the Senior Management team and Board of Directors	- Audit and evaluate organisational and process effectiveness - Ensure business is in accordance with applicable internal and external regulations - Report deviations to Board of Directors on regular basis

5. Capital adequacy

5.1 Capital management governance

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

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

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

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

5.2 Capital requirements

SCB is supervised by the Norwegian FSA and has to comply with the capital requirements for banks in Norway.

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

- Pillar I - Calculation of minimum regulatory capital: banks shall at all times satisfy capital adequacy requirements reflecting credit risk, operational risk and market risk. Equity can be in the form of core and supplementary capital. Core capital will typically consist of equity capital, while supplementary capital can be subordinated loan capital. The capital requirements must be complied with at all times. Banks are obligated to document their compliance with these requirements by reporting to the Norwegian FSA on a quarterly basis;

- Pillar 2 - Assessment of overall capital needs and individual supervisory review: banks must have a process for assessing their overall capital adequacy in relation to their risk profile and strategy for maintaining their capital levels. The Norwegian FSA shall review and evaluate such internal capital adequacy assessments and strategies and may take supervisory action if it is not satisfied with the result of such an evaluation process; and

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

5.2.1 Pillar 1 requirement

On 1 July 2013 the Norwegian Parliament passed an act which implemented the CRD capital adequacy rules. The minimum capital adequacy requirement of 8% shall consist of at least 4.5% common equity tier 1 capital (“**CET1 capital**”) and the remaining 3.5% may consist of other eligible capital instruments. In addition, Norwegian banks need to hold a capital conservation buffer of 2.5% CET1 capital and a systemic risk buffer of 3% CET1 capital. Systemic important financial institutions should hold an additional 1% buffer of CET1 capital from 1 July 2015 increasing to 2% from 1 July 2016. SCB is currently not considered as a systemic important financial institution in Norway. In addition, there is a counter cyclical buffer ranging between 0 and 2.5%, which per 31.12.15 was 1% (to be increased to 1.5% from 30 June 2016). In total, SCB was per 31.12.15 required to hold 11% CET1 capital in addition to 3.5% of other capital instruments.

Norwegian banks must meet and report these capital requirements on a quarterly basis. In addition, banks must report their leverage ratio even though there is no legal minimum requirement for leverage ratio as of the date of this report. Introduction of a leverage ratio is however expected going forward.

5.2.2 Pillar 2 requirements

SCB conduct at least annually an internal capital adequacy assessment process (ICAAP) assessing capital adequacy and thus its Pillar 2 capital requirement. The combined Pillar 1 and Pillar 2 requirements will be the basis for the bank's target capital ratios set by the Board of Directors. Several division are involved in this process including the Risk function, Financial Control, Financial Management and Legal and Compliance department. Stress scenarios, as well as outcomes of various analyses in the ICAAP report are reviewed and approved by the Capital Committee. In addition, all analyses and governance processes leading to the ICAAP report is reviewed by Internal Audit.

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

5.2.3 Pillar 3 requirements

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

5.3 Capital position per December 2015

Per December 2015, SCB had a CET1 capital ratio of 15.26%, Tier1-ratio of 17.77%, Tier2-ratio of 19.4% and Leverage ratio of 11.43%.

Please see Pillar 3 Appendix for details of capital positions.

6. Overview of Risk management

The bank's risk culture and appetite corresponds to general principles of risk management. In that sense, the bank's instructions on internal control comply with the Norwegian FSA's modules regarding risk-based supervision (NO: "Risikobasert tilsyn"). The bank aims to have a supervisory control in line with the Norwegian FSA's module on Internal Governance in credit institutions, which contains the following concerning risk profile:

- The bank is not to take on significant risk outside of its ordinary scope of business.
- All exposures having a high denomination are reported to the Board of Directors even if the exposures carry a low or moderate risk profile
- The bank mitigates liquidity risk by ensuring a match in maturities between assets and liabilities
- SCB's strategy is not to take on market risk in excess of the risk generated by normal commercial operations. SCB AS does not have an active trading portfolio or positions in securities, commodities, etc.
- Operational risk, business and strategic risk, and reputational risk are to be kept at a low or moderate level.
- Credit risk is to be kept at a level that over time corresponds to the average credit risk of the companies within the parent company Santander Consumer Finance S.A. Group after adjusting for differences in product mix and collection processes. The bank shall establish credit policies that ensure good portfolio

diversification by customer segmentation. Large single name credit exposures are reported to the Board of Directors.

The risk function of SCB consists of a central Nordic risk function overseeing the overall cluster and local risk management in the business units. The local risk directors report directly to the Nordic Chief Risk Officer. All the local risk directors are aligned within the Nordic risk management culture.

The Board of Directors receives relevant credit reports and instigates relevant actions in order to reduce undesired rise in risk levels. The Board of Directors shall approve parameter and management limits, as well as any proposed remedial action when facing breach of limits.

6.1 Overview of risk weighted assets

The figure below provides an overview of the risk weighted assets and capital requirements of the main risk categories that we are required to hold capital for and that are described in this report.

	RWA		Capital requirements
In '000 NOK	Dec'15	Dec'14	Dec'15
Credit risk (excluding counterparty credit risk) (CCR)	**82 257 963**	**69 390 539**	**6 580 637**
Of which standardised approach (SA)	58 733 053	69 390 539	4 698 644
Of which internal rating-based (IRB) approach	23 524 909		1 881 993
Counterparty credit risk	**19 698**	**16 410**	**1 576**
Of which standardised approach for counterparty credit risk (SA-CCR)	19 698	16 410	1 576
Market risk	**-**	**353 540**	**-**
Of which standardised approach (SA)	-	353 540	-
Operational risk	**7 100 262**	**6 084 906**	**568 021**
Of which Basic Indicator Approach	7 100 262	6 084 906	568 021
Credit Valuation Adjustment (CVA)	**313 079**	**289 340**	**25 046**
Total RWA (Risk-based)	**89 691 001**	**76 134 735**	**7 175 280**

Figure 2: Overview of risk weighted assets and capital requirements for the main risk categories, for SCB Group

The two main drivers of the evolution of risk weighted assets are the legal merge with GE Money Bank and approval for using the Advanced-IRB approach.

In July 2015, the legal merger between SCB and GE Money Bank took place which led to an increase in assets. Risk weighted assets increased about 35% from December 2014 to December 2015 due to the merger.

In December 2015 the Norwegian FSA and Bank of Spain approved the application to use the Advanced-IRB approach for private auto finance assets in Norway, Finland and Sweden. This reduced the capital requirements of the bank with about 15%.

In total, the combined effects of the merger and the Advanced IRB approval, gave an overall increase in risk weighted assets of 19%.

As you can see from figure 2 above, the bank was not required to hold capital for Market Risk per December 2015. This was because the foreign-exchange position did not exceed the 2% of total own funds (ref. *Article 351, CRR*).

7. Credit risk

7.1 General information about credit risk

Credit risk is considered the most significant risk for the bank. Credit risk is kept at a level that (over time) corresponds to the average of companies within the Santander Consumer Finance S.A. Group, taking into account differences in product mix and collection processes.

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

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

Credit risk management is divided into “Standardized” and “Non-Standardized” risk areas, where Standardized includes Retail and SMEs and Non-standardized includes corporates.

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

The Non-Standardized risk segment is defined as auto and stock finance offered to corporate clients with a consolidated group turnover exceeding €50 MM and/or clients with credit exposure of over €0.5 MM.

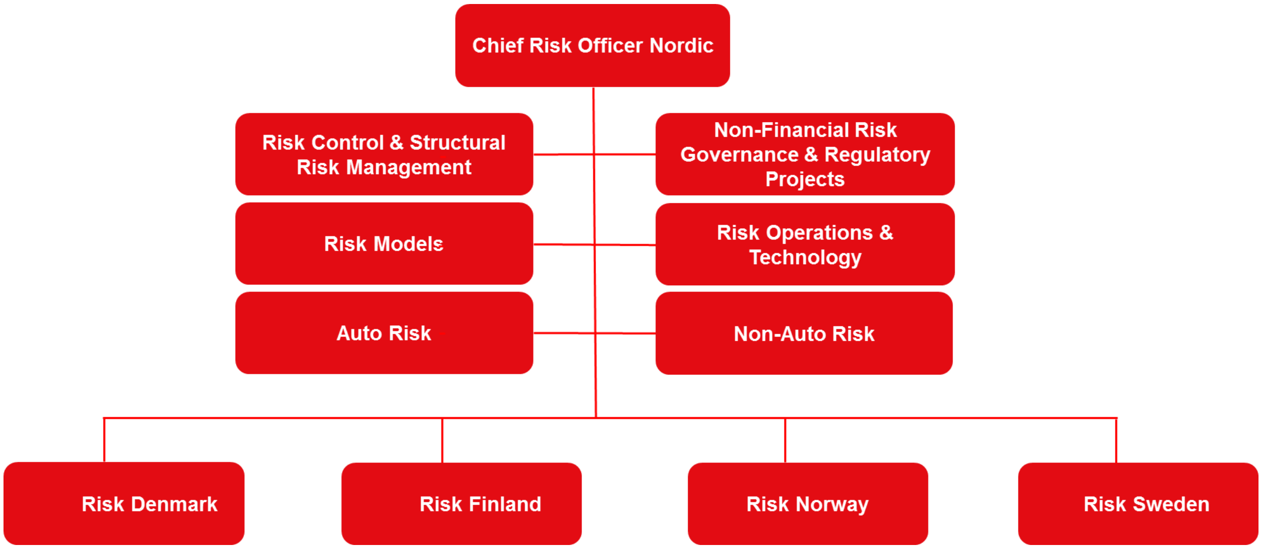
Chief Risk Officer Nordic
Risk Control & Structural Risk Management
Non-Financial Risk Governance & Regulatory Projects
Risk Models
Risk Operations & Technology
Auto Risk
Non-Auto Risk
Risk Denmark
Risk Finland
Risk Norway
Risk Sweden

Figure 3: Credit Risk Department of SCB Group

7.2 Credit Risk Profile

7.2.1 Materiality of Risks

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

	RWA		Common-Size (% CR RWA)	
In '000 NOK	Dec'15	Dec'14	Dec'15	Dec'14
Regional governments or local authorities	65 025	71 116	0,08 %	0,10 %
Institutions	1 643 007	1 659 640	2,00 %	2,39 %
of which: Counterparty Credit Risk	*19 698*	*16 410*	*0,02 %*	*0,02 %*
Corporates	5 735 249	5 556 252	6,97 %	8,01 %
Retail STD	45 865 473	58 168 760	55,74 %	83,81 %
Retail IRB	23 524 909	-	28,59 %	0,00 %
Exposures in default STD	706 547	686 137	0,86 %	0,99 %
Covered bonds	642 011	-	0,78 %	0,00 %
Other Exposures	4 095 439	3 265 045	4,98 %	4,70 %
Total Credit Risk	**82 277 661**	**69 406 949**	**100 %**	**100 %**

Figure 4: Overview risk weighted assets for Credit exposure in SCB Group and share of total risk weighted assets for the Credit exposure

As can be seen from figure 4 above, the largest segment for Credit risk is the Retail segment (SMEs and private customers). This segment further increased after the merger with GE Money Bank, but due to the change from standard approach to Advanced-IRB approach for part of our portfolio in December 2015, Retail's share of total risk weighted assets remained at about 84%. Also, there was an increase in Other Exposures from December 2014 to December 2015. Other Exposures are mainly related to repossessed assets, prepayments, consignment, fixed assets and other items.

The increase in exposure towards covered bonds is driven by the need to build up a liquidity reserve in order to meet the Liquidity Coverage Ratio requirements.

7.2.2 Credit exposure

SCB's main products are secured auto and leisure finance and unsecured credit cards and consumer loans. Through the acquisition of GE Money Bank, the exposure to unsecured credit cards and consumer loans has increased, enhancing product and geographical diversification. Although the exposure to unsecured products has increased, the exposure to secured products is still significant representing about two thirds of gross outstanding loans.

Figure 5 below shows Exposure at Default ("EAD") for each product category at group level per December 2014 and 2015. As can be seen, the auto segment accounted for about 73% of EAD per December 2015, compared to about 87% per December 2014. Further, figure 6 shows the share of capital requirements for each product category per December 2014 and 2015.

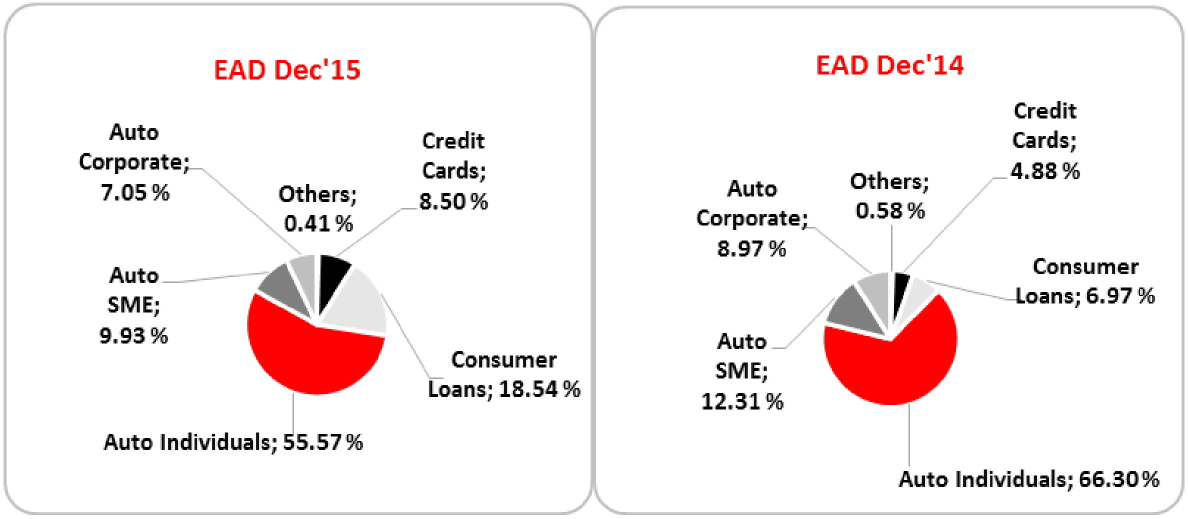

Figure 5: SCB Group Portfolio Breakdown by product

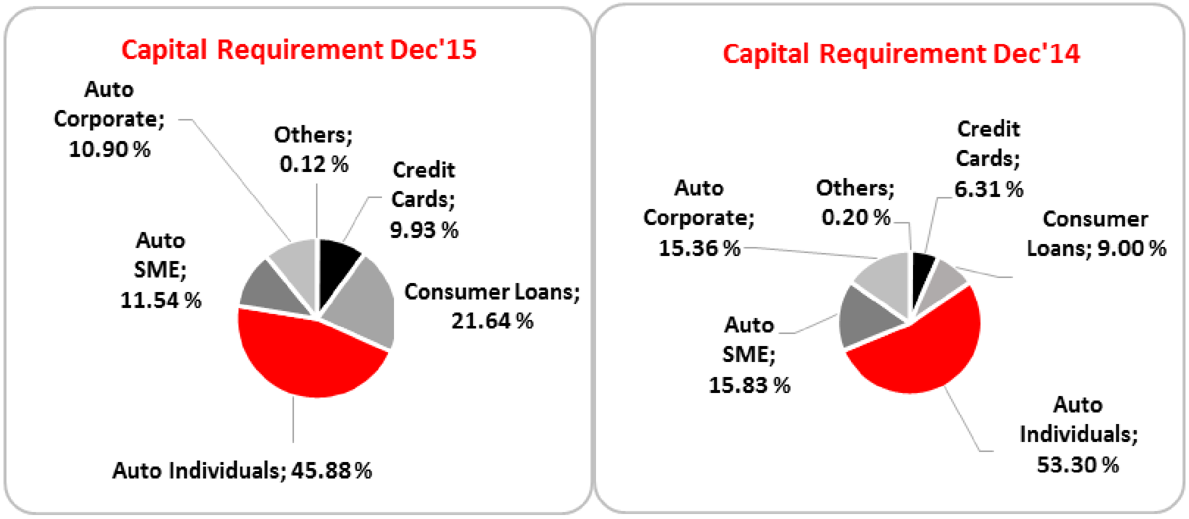

Figure 6: Share of Capital requirements for the various product segments for the SCB Group per December 2015 and 2014

Figure 7 below shows EAD per country per December 2014 and 2015. As can be seen from the figure, the share of EAD in Norway fell from 48.4% per December 2014 to 41.4% per December 2015, while the share of EAD in Sweden increased from 16.2% in December 2014 to 24.2% in December 2015. The shift is explained by the acquisition of GE Money Bank, which had a greater exposure in Swedish assets than in Norwegian assets. EAD measured in amount did however increase in all countries from December 2014 to December 2015. Figure 8 shows capital requirements for each country per December 2014 and 2015.

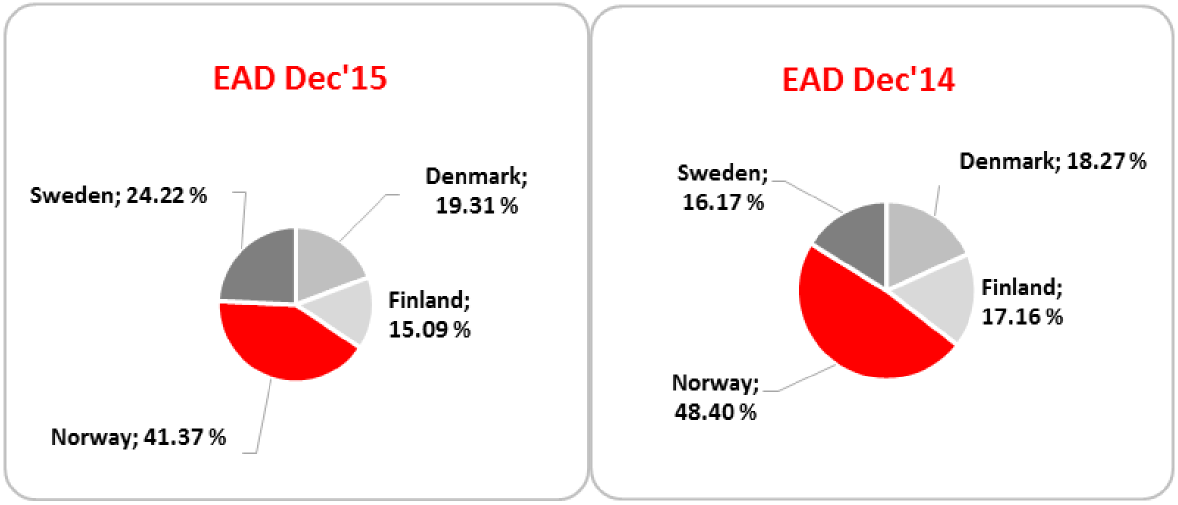

Figure 7: SCB Group Portfolio breakdown by country

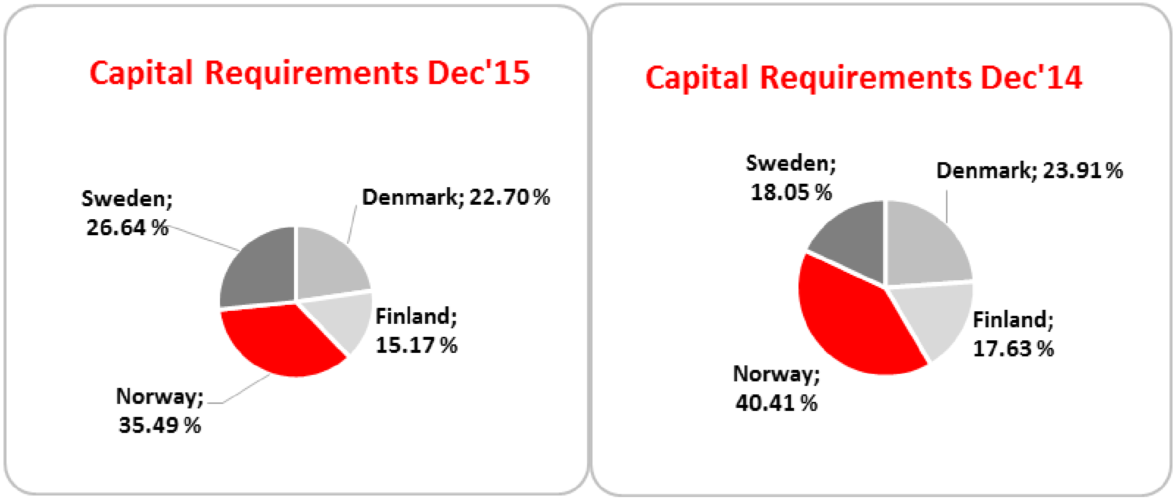

Figure 8: Capital requirements for the various countries where SCB Group operates per December 2015 and 2014

7.2.3 Non-performing assets, losses and write-offs

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

- *Default*: A default is considered to have occurred when the entity considers that the obligor is unlikely to pay its credit obligations or if the obligor is past due more than 90 days on any credit obligation (in line with CRR Art.178 (1)). Defaults are also referred to as non-performing loans ("**NPLs**").
- *NPL-ratio:* Defaulted outstanding loans over total outstanding loans
- *Write-off:* The entity considers that any credit obligation is written-off and removed from the on-balance exposure according to IAS 39.17 (a), which states that "an entity shall derecognize a financial asset when, and only when the contractual right to the cash flows from the financial asset expire". SCB interprets the contractual right also to mean low probability of receiving further payments.

- *Loan Loss Reserves ("LLR"):* represents management's best estimates of losses incurred in the bank loan portfolio at the balance sheet date. The LLR can be classified as Specific write-downs or Generic write-downs, where the former is related to the individual loan, while the latter is related more generally to the portfolio as a whole. Changes to LLR from one reporting period to the next, will impact the profit & loss account under item "Loan Losses". If LLR increases, this will increase Loan Losses, while if LLR decrease this will decrease Loan Losses.

Table 1 below shows the development in the NPL-ratio, divided into the secured (auto) and the unsecured portfolio, for the period 2011-2015. As can be seen from the table, the NPL-ratio for the combined portfolios has increased from 1.5% in 2014 to 2.1% in 2015. The increase was mainly driven by the legal merge with GE Money Bank and the corresponding increase in the share of unsecured loans. Further, there has been a slight increase in NPL-ratio for the unsecured portfolio, while there has been a decrease in the NPL-ratio for secured (auto) between 2014-2015.

NPL Ratio	2011	2012	2013	2014	2015
Auto&SF	1,35 %	1,30 %	1,20 %	1,09 %	1,01 %
Unsecured	6,42 %	6,24 %	5,32 %	4,77 %	4,97 %
Nordic	1,83 %	1,76 %	1,61 %	1,48 %	2,05 %

Table 1: NPL-ratio developments 2011-2015 per secured (auto) and unsecured portfolio

Table 2 below shows the development in NPL-ratio broken down per country. As can be seen from the table, Norway has the highest NPL-ratio. This is partly due to a higher share of credit cards than the other countries.

NPL Ratio	2011	2012	2013	2014	2015
Denmark	0,86 %	0,70 %	0,71 %	0,61 %	0,97 %
Finland	1,25 %	1,38 %	1,04 %	0,89 %	0,72 %
Norway	2,66 %	2,47 %	2,47 %	2,36 %	3,41 %
Sweden	0,61 %	0,74 %	0,48 %	0,61 %	1,53 %
Nordic	1,83 %	1,76 %	1,61 %	1,48 %	2,05 %

Table 2: NPL-ratio developments 2011-2015 per country

The Coverage Ratio in figure 9 below, is measured as LLR over Defaults/NPLs. The table shows that SCB has increased the Coverage Ratio in the period from 2011 to 2015, with a coverage ratio of 108% per year-end 2015.

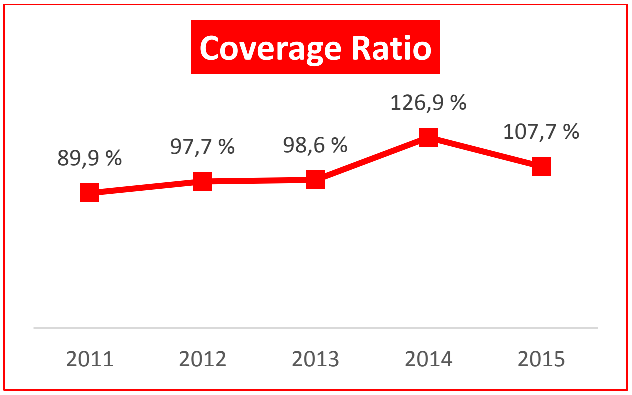

Figure 9: Coverage ratio developments 2011-2015

When GE Money Bank and SCB merged in 2015, GE Money Bank had a different write-off policy than SCB, resulting in much higher Defaults/NPLs than what would have been the case if they had followed SCB's write-off policies. In order to harmonize the write-off policies, SCB reported a loss of 5.2 billion NOK in December 2015. This had limited impact on Loan Losses in the profit and loss account, since the write-off was offset by a corresponding reduction in LLR of 4.02 billion NOK (please see note 8 in Annual Report 2015 for more details).

7.3 Credit risk under IRB approach

As mentioned, in December 2015, our application to use the A-IRB approach was approved by the Norwegian FSA and Bank of Spain. The implementation plan is divided into three phases or "Waves", where each wave constitutes different credit portfolios. These Waves represent the majority of SCB's risk exposure. For all other segments, the Standard Approach will be used.

Wave I, which has already been approved, consisting of private persons auto loans in Norway, Sweden and Finland, were submitted for A-IRB approval to the Norwegian FSA and Bank of Spain in 2015. After the supervisory validation process, the portfolios where approved for the A-IRB approach in December 2015. Hence, SCB has used the A-IRB approach for capital calculations for the private persons auto loan portfolios in Norway, Sweden and Finland since December 2015.

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

- Sovereigns/Municipalities
- Financial Institutions/Banks
- Corporate
- Retail
- Equity
- Other Assets without credit risk

Of these segments, Corporates and Retail will be handled under the A-IRB Approach once Wave II and Wave III have been approved by the regulators. As of the date of this report, Wave II and III has not yet been submitted to the regulators for approval. The plan is however to submit and have these Waives approved within the short to medium term.

Figure 10 below provides an overview of the Basel II approach by segments. As you can see from the figure, some portfolios will remain under the standard approach based on the underlying obligor and the materiality of the portfolio.

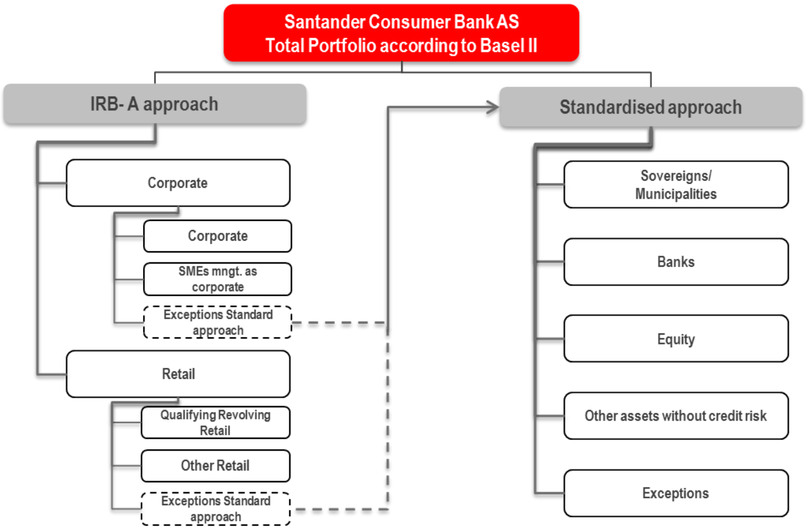
Santander Consumer Bank AS
Total Portfolio according to Basel II
IRB- A approach
Standardised approach
Corporate
Corporate
SMEs mngt. as corporate
Exceptions Standard approach
Retail
Qualifying Revolving Retail
Other Retail
Exceptions Standard approach
Sovereigns/ Municipalities
Banks
Equity
Other assets without credit risk
Exceptions

Figure 10: SCB total portfolio according to Basel II approach

7.4 Credit Risk Management Tools

7.4.1 Scorecards

Credit risk management under the A–IRB approach is based on the use of scorecards. Admission and behavioral scorecards have been developed and implemented for the retail portfolios. The purpose of the admission scorecards is to separate the “good” customers from the “not so good customers”, whilst the purpose of the behavioral scorecards is to track how the customer is performing.

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

The Wholesale (Corporates) segment is composed of large and/or complex exposures evaluated individually by a risk analyst. 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.

7.4.2 Internal Rating Model

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 (see below). Ratings from the Santander Internal Rating model method will result in an individual probability of default (PD) by Wholesale exposure.

Santander rating	PD %	Moody's	Standard & Poors
1.0	37,60 %	C	C
2.0	14,58 %	Ca	CC
2.5	9,08 %	Caa	CCC
3.0	5,56 %	B3	B-
3.5	3,52 %	B2	B-
4.0	2,19 %		
4.5	1,37 %	B1	B+
5.0	0,85 %	Ba3	BB-
5.5	0,53 %	Ba2	BB-
6.0	0,33 %	Ba1	BB+
6.5	0,21 %	Baa3	BBB-
7.0	0,13 %	Baa2	BBB-
7.5	0,08 %	Baa3	BBB+
8.0	0,05 %	A3	A-
8.5	0,03 %	A2-A1	A-A+
9.0	0,02 %	Aa3-Aa2	AA--AA
9.2	0,00 %	Aa1	AA+
9.3	0,00 %	Aaa	AAA

Table 3: Santander Internal Rating model for Wholesale exposures

The Santander Internal Rating Model is a hybrid model, which takes into account expert judgement as well as objective criteria from the clients' Financial Statements and an assessment of the obligor's shareholders and management. The six main rating categories are rated and weighted as illustrated below:

Area	Weighting
Product/Demand/Market	20 %
Shareholders/Management	15 %
Access to Credit	10 %
Profitability/Return	15 %
Generation of Funds	25 %
Solvency	15 %

Table 4: Santander Internal Rating Model weighting areas

7.4.3 Stress tests

Stress testing is one of the risk management tools, which allow for better understanding of the bank's risk profile and its resilience to internal and external shocks. Given the natural limitations of the methodologies, parameters and data used, as well as overall uncertainty about forward looking assessment and the actual occurrence of assumed scenarios, stress testing cannot provide for absolute safety. Therefore, stress testing is used by the bank in combination with other risk management and control tools to make informed business decisions.

8. Counterparty credit risk

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

Transactions within the scope of Counterparty credit risk 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.

Derivatives impact capital calculations in two ways; through an impact on the Counterparty credit risk and through a consideration of the valuation adjustment of their fair value ("**CVA**"), according to the EBA guidelines.

Since these derivatives are used for hedging purposes only and required capital for these transactions represent a very small share of total capital requirements, Counterparty credit risk is not considered a material risk for SCB.

9. Securitization

Securitization serves as an integral part of the bank's funding strategy. Since 2011, SCB has completed 14 securitization transactions: seven securitizations from its Norwegian auto portfolio, two securitizations with Swedish assets, including a warehouse transaction, four securitizations from the Finnish business, and one out of Denmark. Per end December 2015, securitizations accounted for about 20% of funding. Due to a change in legislation in Norway, it has become challenging to securitize auto loans in Norway in the same manner as we have done in the past. This does however not impact the securitization programs in the other Nordic countries.

SCB securitizes auto loans by selling the loans to a special purpose company, which funds the purchase by issuing bonds with security in the assets. The securitization program has been initiated for the purpose of funding operations. Mitigation of credit risk and/or achieving capital relief is currently not within the scope of the securitizations. The securitization program has not, and will not, affect the bank's front or back systems in any significant way.

10. Market risk

SCB defines market risk as the risk of a loss on a financial instrument or position as a result of changes in market variables and/or market conditions within a specified time frame. Market risk arises as a result of the bank holding open positions in various financial instruments. It can be subdivided into the following main categories:

- Currency risk is the risk of loss as a result of changes in foreign exchange rates
- Interest rate risk is the risk of loss as a result of changes in the interest rate
- Credit spread risk is the risk of loss as a result of changes in credit spreads

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

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

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

10.1 Currency risk

As the bank operates in countries with various currencies, as well as using international funding markets, it will inevitably be exposed to currency risks. The bank does not actively take on currency risk beyond what follows from the bank's operations in four different countries.

The bank aims for a composition of the balance sheet that minimizes currency risk by ensuring that the assets and liabilities are denominated in the same currency. When raising funding through the international debt market, such as EMTN or securitizations, any open currency exposure will be closed through the use of derivatives.

The currency exposure is continuously monitored and controlled through monthly reports. The limits for currency risk are reviewed by the Board of Directors on an annual basis. Per December 2015 the limits where set to 200 million NOK towards any individual currency and 400 million NOK in combined FX exposure for the SCB Group.

10.2 Interest rate risk

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

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

The strategy of managing interest rate risk involves the use of variable and fixed rate intragroup loans, interest rate derivatives and customer deposits at variable or fixed rate. The interest rate gap positions for all significant currencies are monitored and reported monthly. Also, a sensitivity analysis and a forecast of future interest rate risk is performed.

The Financial Management Division will propose interest rate risk limits to the Risk Division which will assess the proposal and send to the Board of Directors for final approval. The limits will reflect the risk appetite of both the parent Santander Consumer Finance SA and SCB. Limits must be reviewed annually for each of the following metrics:

Net Interest Margin sensitivity (NIM): The sensitivity of the Net Interest Margin is a measure of the difference between the return on assets and the financial cost of the liabilities on a 12 month horizon. The impact of the changes (-/+ 100 bps) in interest rates on NIM leads to changes in the Profit and Loss account and in the quality of the balance sheet.

Economic Value or Market Value of Equity sensitivity (MVE): The sensitivity of Market Value of Equity is a measure which complements the sensitivity of Net Interest Margin. It measures the implicit interest rate risk in the Market Value of Equity from a variation in interest rates (-/+ 100 bps) on the financial assets and liabilities in the bank.

	Limit
NIM	Norway: NOK 90 Million Denmark: DKK 45 Million Sweden: SEK 35 Million Finland: EUR 6 Million

MVE	Norway: NOK 170 Million Denmark: DKK 75 Million Sweden: SEK 50 Million Finland: EUR 12 Million

Table 5: Interest Rate risk limits per December 2015 (NIM and MVE as defined above)

10.3 Credit Spread risk

Credit spread risk is defined as the risk of changes in market value of securities or any credit derivatives as a result of an overall change in credit spreads. As mentioned, SCB's strategy is not to take on market risk in excess of what follows directly from the operations of the bank. Consequently, the bank's liquidity portfolio consists of high quality liquid assets. SCB did not have any credit derivatives per December 2015.

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

11. Operational risk

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

SCB is currently applying the Basic Indicator Approach for calculating the bank's capital requirement for operational risk. However, in accordance with Banco Santander Group's standards, the bank aims to convert to a more advanced method in the future.

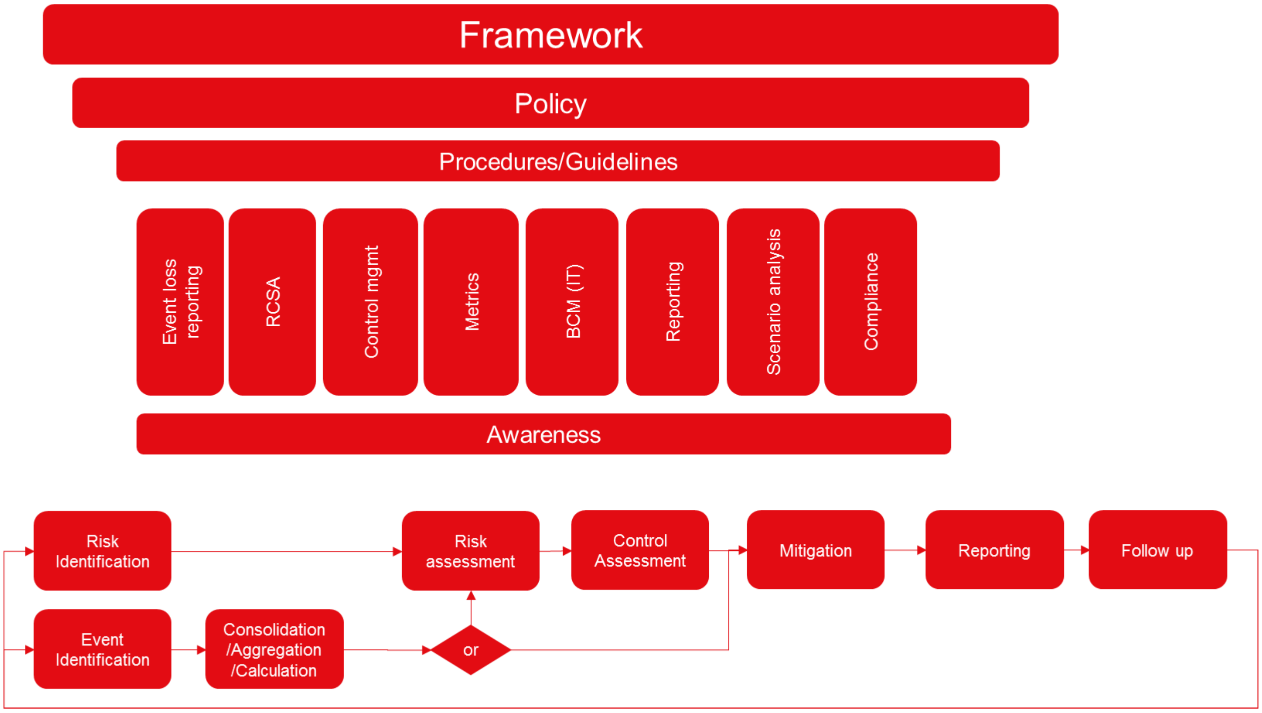
Framework
Policy
Procedures/Guidelines
Event loss reporting
RCSA
Control mgmt
Metrics
BCM (IT)
Reporting
Scenario analysis
Compliance
Awareness
Risk Identification
Risk assessment
Control Assessment
Mitigation
Reporting
Follow up
Event Identification
Consolidation /Aggregation /Calculation
or

Figure 11: SCB's Operational Risk Management Framework

SCB's framework, as illustrated above, is based on Banco Santander Group's governance and framework for Operational Risk. The model consist of six main processes, which all are interlinked to each other. All event data related to accountable losses are reported into the global database SIRO, while all event data related to both accountable and non-accountable data is reported in a local database, called NCM.

- **Event loss reporting process** – Identification, consolidation, aggregation, calculation, mitigations and reporting of events that has occurred, and in most case generates non-accountable or accountable losses.
- **Risk Control Self-Assessment process (RCSA)** – An annual risk assessment identifying and evaluating potential risks and controls to proactively prevent risks of becoming materialized. Potential risks are also managed continuously during the year within the event loss reporting process.
- **Control management** – Controls will constantly be a part of 'business as usual' within all processes and managed by both Operational Risk and Internal Control. Controls will be reviewed and assessed at least once a year.
- **Metrics** – Using different metrics, increasing risks can be prevented from being materialized.
- **Business Continuity Management (BCM)** – In the BCM program, plans are defined to quickly recover a system or a process exposed for a major event or a disaster. After the BCM plans have been activated the event will be a part of the event loss reporting process.
- **Reporting** – Risks, events, control deficiencies and mitigation plans are reported on both local, Nordic and Group level in different internal control forums, as well as to the Board of Directors, based on different escalation thresholds.

In November 2015, the new extended operational risk program was implemented in SCB. The bank's management emphasizes that operational risk is a continuous process and that it will be developed in accordance to the readiness and maturity of the organization.

From a governance perspective, the overall management of SCB operational risk is delegated to the Nordic Non-Financial Risk and Governance Director and the Nordic operational risk manager with local Operational risk controllers in each country. Each country is organized with approximately ten coordinators divided into each department with responsibility to support their unit in identification and reporting.

The bank has established a Nordic operational risk policy, which describes the Operational Risk Management Framework and processes.

The Bank assesses the capital need for operational risks based on the following:

1. Evaluation of the Operational Risk framework and Compliance framework, to ensure that processes are in place to identify, assess and mitigate actual and potential risks.
2. Evaluation of the Basic Indicator Approach methodology and need for adjustments
3. Evaluation of historical losses, forecasted losses and risk appetite

12. Liquidity risk

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

Liquidity risk management in the bank aims to ensure sufficient funds to support the daily operations of the bank, ensure a similar weighted average life of asset and liability, ensure diversified funding sources and ensure a sufficient amount of liquidity reserves in order to survive a stress scenario.

12.1 Diversification of funding sources

SCB aims to reduce reliance on funding from parent company (ie. become self-funded) and to maintain a well-diversified funding source composition. Per end of 2015, the bank had a self-funding ratio of 70%[1]. Over the years, the bank has established the following funding sources:

- Customer deposits in Norway, Sweden and Denmark. The customer deposit products are demand deposits, fixed rate deposits and notification products
- Secured funding in the Nordic countries (asset backed securities)
- Senior Unsecured funding in the local Nordic markets and in international markets
- Intragroup funding from the parent company
- Liquidity facilities with 3rd party banks
- Available credit line with the Norwegian Central Bank

Figure 12 below shows the evolution in funding sources and the funding composition on a consolidated Nordic level as of December 2015:

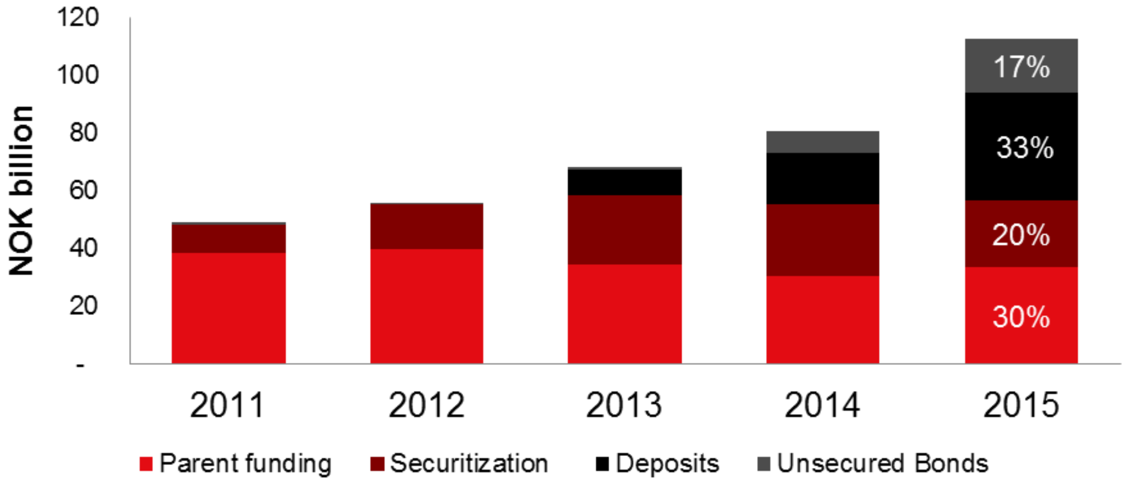

Figure 12: SCB Funding composition

Over the last few years retail deposits have been introduced in Norway, Sweden and Denmark. As of year-end 2015, deposits constituted about 33% of the bank's funding base.

The bank's securitization program has been implemented across the four Nordic units over the past five years, and serves as an integral part of the bank's funding program. Per year-end 2015 securitization constituted about 20% of the bank's funding.

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

The bank is well-established in the Norwegian senior unsecured bond market and has increased issuance under its Euro Medium Term Note program (EMTN), which so far has been guaranteed by the parent Santander Consumer Finance S.A. During H1 2016, SCB obtained a rating of A3 with stable outlook by Moody's and A- with stable outlook from Fitch. Going forward, issuance under the EMTN program will be on a standalone basis without guarantee from the parent. Per year-end 2015 external senior unsecured funding constituted about 17% of the bank's funding.

SCB has available draw-down facilities with its direct parent and with other entities within Banco Santander Group. Per year-end 2015, senior funding from parent constituted about 30% of the bank's funding. In addition to senior funding, the SCB also has also subordinated debt provided by the parent company.

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

12.2 Liquidity portfolio

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

The bank has since October 2015, been required to comply with LCR requirements. The LCR requirement for 2016 is 70%, increasing to 80% in 2017 and 100% in 2018. Per year-end 2015, SCB had a LCR-ratio of 83% and the liquidity bond portfolio was about EUR 1 Billion equivalent. The bank has a conservative mandate for liquidity portfolio investments and only invests in LCR level 1a securities. The portfolio is invested in Nordic government bonds, supranational bonds and AAA/Aaa rated Nordic covered bonds, issued in NOK, SEK, DKK and EUR. Further, the bank only invests in floating rate coupon bonds with a maturity up to 3 years and fixed rate bonds with a maturity up to 1 year. The intention is to hold the bonds in the liquidity portfolio to maturity. The bank can deposit bonds from the liquidity portfolio in the Norwegian Central Bank and provide intraday liquidity.

12.3 Stress tests

SCB is required by the regulator to have and maintain a Liquidity Stress Test model, which should be run on monthly basis. The liquidity stress test of the bank is complying with requirements from the Norwegian FSA and is used both as a tool for measuring liquidity risk and for managing funding and liquid assets.

The Liquidity Stress Test is to be presented to Senior Management on a quarterly basis and to the Board of Directors at least once a year. The object of the Liquidity Stress Test is to ensure that the bank has sufficient liquidity to survive the stressed scenarios. The stress test is used as part of the liquidity risk management of the bank.

13. Business and strategic risk

Business and strategic risk is the risk of lower earnings than expected. This may be due to lower than expected revenues, higher than expected operating cost, or a combination of the two. This risk is inherent in the chosen set of activities and the cost structure of the bank. As such, it is inherent to the business model and strategy chosen by the bank.

Due to the diversification of the business during the past years in Norway, Sweden, Denmark and Finland, the geographical presence of the bank is considered to be completed. Also, through the merger with GE Money Bank, which took place in 2015, the diversification of customer and product portfolio has increased. Focus going forward will be more on increasing the number of products per customer, and consequently build customer loyalty and lasting customer relationships.

14. Compliance risk

The primary role of the Compliance function is to ensure compliance with applicable laws and regulations as well as assess and monitor compliance risk, such as Anti-Money Laundering, terrorist financing and conduct risk etc. The bank is compliant with both internal and external rules and regulations and establishes appropriate policies and procedures to minimize compliance risks. When designing internal rules and procedures, the bank takes into account the nature, scale and complexity, and the nature and scope of its services and business.

The compliance function is also responsible for:

- evaluate the measures taken to remedy any deficiencies in its compliance and control, monitor and evaluate the first line of defense management and internal control structure;
- provide advice and support to the bank's employees and directors so that the business is run according to the statutes governing its licensed business;
- ensure that the employees concerned are informed of new or revised regulations. Training of new regulations is primarily carried out by the legal function;
- verify that new products, services, processes and systems are in compliance with the statutes governing its licensed business. Consideration is also given to the influence of known future changes in laws and regulations (dual ownership with legal function);
- make recommendations on the basis of the work carried out and the findings that the function done;

The compliance function reports its findings and recommendations to the Managing Directors in the countries and the Nordic Chief Executive Officer on a regular basis, monthly or quarterly to local committees and regularly to the Board of Directors.