Sound risk culture generates sustainable profitability

Nordax's business model is based on a restrictive approach to risk taking, and the bank has a low risk appetite and risk tolerance. This approach to risk pervades every part of operations and has helped Nordax over the years to build a sound risk culture.

Simplifying things, it is only in its lending that Nordax consciously takes risk, in the form of credit risk. Nordax tries to limit other risks as far as possible and reasonable. This approach to risk is one reason why Nordax's business model has been profitable during both financial crises and in good times. Credit risk management is also limited by a conservative credit risk appetite and high demands when it comes to our customers' creditworthiness, which has led to stable credit loss levels that have been below the ambition of 2% over an economic cycle. Nordax's overall risk appetite and risk tolerance is determined by the Board of Directors in the risk and capital policy. Special governing documents are in place as well to manage credit risk, market risk, liquidity risk and operational risks.

THREE LINES OF DEFENCE MODEL

To ensure that it effectively manages risk consistent with the risk culture and that good internal governance and control are in place, Nordax has established the three lines of defence model. The three lines of defence are designed to establish robust risk management with clearly delegated responsibility within operations. The three lines of defence are also an effective way to manage the increasing regulatory requirements Nordax faces in practically every part of its business as well as ensure that internal rules are being followed.

- The first line of defence is the risk management performed daily by operations.
- The second line of defence is by the Risk Control and Compliance functions, which monitor, control and report the company's risks and whether they fall within internal and external rules.
- The third line of defence consists of Internal Audit, which serves on behalf of the Board of Directors and, among other things, regularly reviews the Senior Management Team as well as the company's internal controls, the work of the control functions and the company's risk management.

The most important risks that Nordax is exposed to are:

CREDIT RISK

Credit risk is defined as the risk that Nordax will suffer a loss because a counterparty does not fulfil its contractual obligations.

For Nordax, it is primarily the risk that a customer cannot repay a loan, although credit risk also arises when Nordax invests its liquidity.

Nordax was founded by credit risk analysts, and the low risk tolerance that distinguishes its lending is based on many years of experience maintaining low credit losses and sustainable profitability over time.

Nordax's credit risk policy sets out the basic requirements for those who Nordax wants to lend money to – high creditworthiness and low risk. Within the framework of these basic requirements, loan officers have personal lending limits based on the officer's experience with credit assessments. Decisions on the highest amounts that Nordax offers are made by Nordax's most senior credit officers.

Credit risk also means managing customers who, for various reasons, are unable to pay. Nordax's claims department works proactively to take responsibility for customers at risk of default and to help them.

This combination of high creditworthiness requirements and quick and effective responses when a customer incurs problem is an important reason why Nordax has maintained low credit losses over a long period.

OPERATIONAL RISKS

Operational risks are defined as the risk of losses due to inappropriate or faulty internal processes, human error, system deficiencies and external events, including legal and compliance risks.

Every part of Nordax's operations is exposed to operational risks. The complexity of managing operational risks has risen in pace with the increasingly extensive regulatory requirements on banks and because of the fact that Nordax is growing. To manage and minimise operational risks, we use several different tools and processes such as self-assessments, incident management, continuity and crisis management, control testing and the process to approve new products, services and processes.

In 2016 we identified and documented our significant processes, in part to identify operational risks and the key controls in them. The incident reporting process has been made more efficient and system support is now in place that allows all employees to conveniently report incidents.

LIQUIDITY AND MARKET RISK (INTEREST RATE, PRICE AND CURRENCY RISKS)

Liquidity risk is defined as the risk that Nordax will fail to fulfil payment obligations at maturity without a significant increase in the cost of obtaining means of payment. Market risk is defined as the risk that Nordax's results or equity will decrease due to changes in risk factors in the financial markets. Market risk includes interest rate risk, price risk and currency risk.

Liquidity risk is managed through a well-balanced combination of assets and liabilities and distribution of maturities and currencies. Price risk is limited by investing only in stable counterparties with strong credit ratings and for relatively short terms. Interest rate risk is limited by matching the interest fixing periods for assets and liabilities. The impact of changes in foreign exchange rates is limited by matching assets and liabilities in the same currency. Nordax maintains open currency positions to protect its capital adequacy ratio against changes in foreign exchange rates.

GLOBAL FACTORS

2016 was a turbulent year globally with political and economic turmoil: Brexit, terrorist attacks, the failed coup in Turkey, the war in Syria and the presidential election in the US, to name just a few. For Sweden, 2016 was distinguished by a continued focus on household debt. In February the Riksbank cut the repo rate by 0.15 basis points to -0,50%, and since then the repo rate has stayed unchanged. In October the Swedish government introduced measures to achieve a more responsible market for consumer credit. These measures take aim at so-called high-cost credit – loans with an effective interest rate of more than 30 percentage points over the Swedish Interest Act's benchmark rate, which is currently 0 – and include an interest rate cap, special marketing disclosure requirements and tighter rules on credit assessments. Nordax is positive to the initiative and welcomes policy initiatives to eliminate rogue operators and strengthen consumer protection.

Despite the relatively eventful year, Nordax has not seen a significant impact on its credit quality, and during the year the credit loss level was stable at 1.4%. Nordax's strong customer base has historically been shown to be resilient to economic slowdowns and increased unemployment. Nordax's diversified funding structure is also a form of built-in resilience to economic slowdowns that facilitates funding even during difficult times.

CAPITAL AND CAPITAL ADEQUACY

Nordax shall at all times be well-capitalised. The Board of Directors has established a capital target to satisfy the minimum regulatory requirement and buffer requirements and to manage risk exposures in situations of financial stress. Nordax conducts stress tests through a continuing capital evaluation process to ensure that it sets aside sufficient capital for unexpected losses. In addition to these reserves, we maintain capital buffers pursuant to the Basel III regulatory framework. At year-end our total capital ratio was 16.0% (14.6), compared to a capital requirement of 13.1% and a capital target of 14.6%. The Common Equity Tier 1 capital ratio was 14,0% (12.6), compared to capital requirement of 9.1% and the capital target of minimum 12%. *For more information on our capital adequacy, see page 18.*