



NORDIC  
INVESTMENT  
BANK

FINANCING  
THE  
FUTURE



# Risk Management Policy

Adopted by the Board of Directors of the Nordic Investment Bank  
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## Definitions

<b>Counterparty</b>	Entity with whom the Bank enters into business transactions  Refers to a single entity or group of entities which are legally and/or financially consolidated or otherwise interdependent from a risk perspective
<b>Credit exposure<sup>1</sup></b>	Total credit exposure is a sum of credit exposures in Lending and Treasury.  Lending credit exposure is a sum of loans outstanding (less specific impairments but without a deduction of collateral) and commitments (outstanding principal value of committed agreed but not disbursed loans). Exposure from Lending Labelled Bonds is included in the Lending credit exposure.
	Treasury credit exposure consist of <ul style="list-style-type: none"><li>• Bonds, money market instruments (outstanding principal value) and cash (outstanding balance)</li><li>• Repos and reverse repos (market value of the transaction less the collateral amount)</li><li>• Derivatives with CSA (fair value, net of collateral held/post)</li><li>• Derivatives without CSA (fair value + add-on for future fluctuations)</li></ul>
<b>ICAAP</b>	Internal Capital Adequacy Assessment Process
<b>MCC</b>	Mandate, Credit and Compliance Committee
<b>Mid-Cap</b>	Mid-Cap corporate with an annual turnover of EUR 150-500 million
<b>Risk-owner</b>	Entity ultimately responsible for the Bank's claim. May be different from the counterparty if the risk is transferred through a guarantee
<b>RAS</b>	Risk Appetite Statement
<b>SMC</b>	Small Mid-Cap corporate which is not a SME and has an annual turnover of less than EUR 150 million
<b>SME</b>	Small and Medium-sized Enterprise with less than 250 employees and an annual turnover of less than EUR 50 million or a balance sheet less than EUR 43 million

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<sup>1</sup> In addition to the main rule as defined here, there could be model and facility specific credit exposure adjustments both for Lending and/or Treasury related exposures.

# RISK MANAGEMENT POLICY

## 1 SCOPE AND OBJECTIVE

### 1.1 Risk management framework

The Nordic Investment Bank's ("NIB" or the "Bank") risk management framework is designed to manage the Bank's risk-taking in the context of its mission and strategy, and taking into account its risk-bearing capacity, willingness to take risks (risk appetite), and minimum quantitative requirements for capital, leverage and liquidity.

The willingness to take risks is described in the Bank's *Risk Appetite Statement ("RAS")* with the purpose of aligning the Bank's risk-taking with the Statutory<sup>2</sup> requirements, strategic business objectives and capital planning. The RAS provides a clear articulation of the high level principles for the Bank's risk-taking, risk mitigation and risk avoidance. The RAS is reflected in this Risk Management Policy ("Policy") which sets out the overall principles for the management of NIB's financial and non-financial risks as defined and categorised in the Bank's risk taxonomy. The risk taxonomy is based on a set of risk categories that are identified to have the most material impact on NIB's risk profile and solvency. Each risk in the taxonomy is further divided into sub-categories, as seen relevant.

In addition to this Policy, the risk management framework consists of several more detailed risk category-specific policies, guidelines, procedures and internal controls. The framework is supported by an effective risk measurement and limit system as well as risk data and systems. An adequate risk governance structure and competent staff are other key elements of the Bank's risk management framework.



Figure 1. Hierarchical structure of the elements of Risk Management Framework.

<sup>2</sup> For the purposes of this Policy, inclusive of the Board of Governors' *Principles for Capital and Liquidity Management*.

## **1.2 Policy structure**

This Policy is divided into four main sections; scope and objective (Section 1), key risk management principles (Section 2), risk category specific principles (Section 3), and risk limits (Appendices).

Section 2 describes the main aspects of the Bank's mission and mandate framework, risk-bearing capacity, risk appetite and risk limits (see Sections 2.1 - 2.4). It then continues to provide an overview of the capital and liquidity adequacy assessments and stress testing (Section 2.5) and model risk management (Section 2.6). Section 2.7 provides a description of the Bank's risk governance.

Section 3 describes the risk management principles for credit, market, liquidity, and operational risks. Each section is structured as follows: (1) Definition of the risk; (2) Appetite for risk taking; (3) Risk management roles and responsibilities (risk governance); (4) Risk management principles including risk mitigation.

Integrity risks are part of the Bank's risk taxonomy and are categorised under operational risk. NIB has established a Compliance function that has oversight of the management of integrity and compliance risks across organisational units. The Compliance function issues integrity and compliance policies and procedures and has specific reporting lines to the senior management and governing bodies (see more information in Section 2.7 Risk Governance). Therefore, integrity and compliance risk categories are not specified in this Policy but other main principles and rules in Sections 1 and 2 do apply to the management of these risks.

The maximum exposure limits for credit, market and liquidity risks are set in the appendices.

This document is made public on the Bank's website [www.nib.int](http://www.nib.int). The appendices containing, among others, maximum exposure limits are for internal use only.

## 2 KEY RISK MANAGEMENT PRINCIPLES

### 2.1 Mission and strategy

#### 2.1.1 Introduction

NIB is the international financial institution (“IFI”) of the Nordic and Baltic countries. The Bank’s mission is to promote sustainable growth of its member countries by providing financing to projects that promote productivity growth and environmental benefits.

NIB adds value by providing long-term financing in the form of loans and guarantees as a complement to other sources of financing. It may also take equity participations. The Bank’s competitive advantage is its ability to obtain funding at a favourable cost in the international capital markets, which enables longer-term lending on competitive terms to its clients. NIB’s funding advantage builds on its strong shareholder base and sound financial profile, which has enabled the Bank to maintain the highest possible (solicited) credit ratings (AAA/Aaa) from international rating agencies and investor confidence in the Bank as a debt issuer.

#### 2.1.2 Mission fulfilment

The *Statutes* provide that the purpose of the Bank is to make financing available in accordance with sound banking principles and taking into account socio-economic considerations.

Mission fulfilment is a key consideration when determining the Bank’s willingness to take risk. For the purpose of assessing its mission fulfilment, the Bank has translated the mission into operational guidelines and principles and established a methodology for mandate rating. Each project considered for financing from NIB undergoes a mandate rating whereby the expected contribution to promoting productivity growth and environmental benefits is assessed. The assessment covers both the potential impact of the project and the implementation risk, i.e. the probability that the impact will not materialise. The mandate rating methodology and process is described in the *Mandate Rating Framework*.

A sufficient mandate rating is generally a prerequisite for financing from the Bank. In its annual business plan, the Bank sets a target minimal share of loan disbursements achieving mandate ratings of ‘good’ and ‘excellent’<sup>3</sup>.

For assessing how well NIB’s lending projects have been implemented by borrowers and NIB’s mandate criteria have been fulfilled, the Bank has established a *Monitoring and Ex-Post Mandate Assessment Framework*.

#### 2.1.3 Sustainability and climate risk

Sustainability is at the core of NIB’s mission and mandate and retains a high priority throughout the Bank’s operations. The Bank believes that sustainability is fundamental for building prosperous and well-functioning societies, and is inherent to successful businesses. NIB is committed to working alongside its clients in their transformation and expansion of sustainable business models. Taking environmental, social and governance (ESG) aspects into account is not only necessary, but also consistent with sound business practices.

In line with these priorities, the Bank has a *Sustainability Policy* in place to improve the predictability, transparency and accountability of its operations. The *Sustainability Policy* sets out the Bank’s approach to sustainability and provides direction for how the Bank seeks to ensure that its clients and the projects it finances are sustainable from the environmental, social and governance perspectives and in compliance with applicable regulatory requirements and international best practices. In each of its key

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<sup>3</sup> The mandate rating scale is **Excellent/Good/Moderate/Marginal/Neutral** and **Negative**.

(Lending and Treasury) operations, the Bank has implemented and made publicly available its principles and guidelines for integrating environmental, social and governance aspects<sup>4</sup>.

The Bank recognises that adverse environmental and social impacts cannot be avoided in all circumstances. In these cases, the Bank seeks for the negative impacts to be appropriately reduced, mitigated or compensated for. Activities and counterparties that the Bank considers unacceptable from a sustainability perspective – thus not eligible for NIB financing – are specified in the *Exclusion List* as part of the *Sustainability Policy*.

NIB has defined its stance on climate risk management in the *Risk Appetite Statement* (see Section 2.3 below). Climate risk can conceptually be divided into physical risk and transition risk sub-components. Physical risk refers to a financial impact from acute or chronic weather events (such as droughts, floods, and storms, land pollution), while transition risk refers to a financial impact from the process of adjusting to a lower-carbon economy that could be triggered by a change in climate-related policies, technologies, or markets. Climate risk is part of the Bank's overall risk management framework and managed using similar risk management principles as described in this Policy. Climate risk is considered, *inter alia*, during the credit process (with focus on transition risk) and during the annual ICAAP exercise.

Both first line business functions (Lending and Treasury) as well as the second line function (Risk & Compliance department) have their roles in climate risk management in the three-lines-of-defence model applied by NIB (see Section 2.7.2.)

NIB is committed to transparency and open dialogue with its stakeholders on sustainability issues in terms of both risks and opportunities. Information on projects with potential significant adverse social or environmental impacts is made public for comments ([www.nib.int](http://www.nib.int)) in accordance with the *Public Information Policy*.

## 2.2 Risk-bearing capacity

The Bank's ability to take risks is dependent on its risk-bearing capacity. A key factor determining the risk-bearing capacity is stable earnings allowing the build-up of a strong capital base to absorb potential losses. The *Risk Appetite Statement* acknowledges the statutory requirement that the Bank shall aim for a profit allowing for a reasonable return on the subscribed capital.

The *Dividend Policy* sets as a target a dividend pay-out ratio of the annual net profit over the long-term. The annual dividend distribution is approved by the Board of Governors.

NIB's capital consists of capital subscribed by the member countries and reserves accumulated through internal profit generation.

**Equity** comprises the paid-in portion of the capital subscribed by the member countries and the accumulated general and specific reserves;

- The General Credit Risk Fund is established to cover unidentified, exceptional credit losses.
- The Statutory Reserve is a general reserve, which according to the Statutes must equal 10% of the subscribed capital before dividends can be paid.

**Callable capital** is capital subscribed by the member countries but not paid in. Callable capital is made available by the member countries at the request of the Board of Directors if deemed necessary for the fulfilment of the Bank's debt obligations. To date no capital calls have been made.

For capital adequacy assessment purposes NIB uses the concept of **adjusted common equity** to measure its loss-absorbing capacity. The concept builds on banking regulations and is derived by deducting certain items from the accounting equity that are not immediately available to cover losses.

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<sup>4</sup> The Bank has also issued a *Climate Strategy* that contains emission reduction targets for the lending portfolio.

## 2.3 Risk appetite

The foundation for the Bank's financial risk-taking is set in the Constituent Documents. The *Statutes* require that financing is made available in accordance with sound banking principles, that adequate security be obtained, unless sufficient security is considered to exist under the circumstances, and that the Bank protects itself against the risk of exchange rate losses to the extent practicable.

NIB has established its *Risk Appetite Statement* with the goal to align its risk-taking with the statutory requirements, strategic business objectives and capital planning. The RAS provides in written format statements that guide the Bank's risk taking and mitigation on more permanent basis, framing the overall boundaries for risk tolerance and highlighting the need for high risk awareness. The fundamentals of the RAS do not change annually but the RAS is still reviewed at least annually by Risk & Compliance department to ensure that the RAS remains fit-for-purpose and is relevant due to variation in the short-term business circumstances. The RAS is approved by the Board of Directors and implemented through this Policy and other internal policies and procedures, monitoring metrics, limit system and internal controls. The Risk and Audit Committee (RAC) of the BoD may discuss and make recommendations to the BoD on risk appetite related matters.

Given NIB's mission, risk-taking is primarily in its core activity of lending. The Bank strives to be responsive to the financing needs of its customers and the policy objectives of its member countries, thereby maintaining its relevance for key stakeholders. In line with the Bank's risk appetite, it provides long-term financing to its customers through the cycles, and aims to continue financing economically viable investment projects also during economic downturns. The Bank aims to maintain a high quality of the loan portfolio.

The Bank's risk appetite in its treasury operations is driven by the objective of enabling and supporting lending operations, and maintaining a strong liquidity and funding position. Although performance objectives are set for the treasury operations, the Bank applies a conservative risk versus return approach in these activities. This is reflected i.a. in stricter creditworthiness eligibility criteria for treasury counterparties as compared to lending counterparties.

## 2.4 Risk limits

The Bank's risk-taking is operationalised in strategies and business plans as well as day-to-day business activities and decisions. The risk limit framework provides a mechanism to limit the risk-taking to an acceptable level.

NIB has implemented a four-layer risk limit framework where minimum requirements for the amount of economic capital, leverage and liquidity have been set in the *Statutes*. The *Principles for Capital and Liquidity Management* ("Principles") - approved by the Board of Governors - provide further details and calculation principles for the minimum requirements. The third layer cascades down the minimum requirements in the Statutes and Principles, and provides limits in the *Risk Management Policy* for those risk categories which are deemed material by the Board of Directors.<sup>5</sup> *Management Limits for Financial Risks*, approved by the President, are designed to help manage financial risks (credit, market and liquidity risk) and supplement the limit framework and limit monitoring.

This Policy provides limits for credit, market and liquidity risks under the umbrella of the Statutes and Principles (and RAS). It also provides minimum requirements for the statutory metrics; capital ratio, leverage ratio and survival horizon (see Appendix A.3).

The limits are changed from time to time depending on the available financial resources and changes in the risk appetite. The risk limits in this Policy are approved by the Board of Directors. Limit monitoring is conducted on regular basis and breaches are reported to the Board of Directors. The Risk and Audit Committee (RAC) of the BoD may discuss and make recommendations to the BoD on risk limits.

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<sup>5</sup> The Board of Directors has approved limits for market risks, for example.

The risk category specific limits, risk governance structure and reporting is described in more detail in Section 3.

## 2.5 Capital structure and management

### 2.5.1 Capital and liquidity adequacy

The Bank manages capital in accordance with statutory requirements, annual financial and business plans approved by the Board of Directors, its risk position and macroeconomic circumstances. Due to NIB's legal status, national banking legislation does not apply to NIB, nor it is subject to direct supervision of any supervisory authority. Similarly to other IFIs, NIB does not require a banking licence for its operations. Thus, the overall requirement and basis for the Bank's capital and liquidity management originates from the Statutes, and not from legislation or supervisory/regulatory guidance.

The Bank aims to maintain a strong capital and liquidity position in order to support the highest possible credit rating by the rating agencies and to compare well with its peers.

The Bank's internal capital adequacy assessment process ("**ICAAP**") aims to ensure that the Bank holds a sufficient amount of capital and liquidity to withstand its current and potential future risks, including adverse macroeconomic conditions. The framework provides a holistic view on the level of risks, the robustness of risk controls and the amount and quality of capital and liquidity needed to support the strategic objectives of the Bank.<sup>6</sup>

The Bank's ICAAP covers all material risks identified in the risk identification process. Quantitative risk metrics support the risk identification and assessment process.

The Bank monitors its capital and liquidity adequacy on an on-going basis and reports the position to the Board of Directors regularly. In addition, at least annually the Bank conducts a more thorough internal assessment of its capital and liquidity adequacy in line with its ICAAP methodology and provides the outcomes of the assessment to the Board of Directors.

The capital requirement is assessed on a risk-by-risk basis. The assessment and conclusions build on both the use of the Bank's internal models and other available information. The scope and risk coverage of the assessment is reviewed regularly. Capital is reserved for all material risks. The resulting capital requirement is complemented by capital buffers. Capital buffers include macroprudential buffers and additional management buffers (typically in the form of a stress test buffer). The Bank's overall capital requirement is determined by aggregating the risk area specific capital requirements and the capital buffers. The overall capital requirement is measured against the Bank's available financial resources (adjusted common equity) to determine the Bank's capital adequacy.

The assessment of liquidity risk builds on various internal and regulatory metrics complemented by qualitative analysis. The main quantitative metric used in the liquidity risk assessment is the survival horizon, which measures how long the Bank would be able to fulfil its payment obligations in a severe stress scenario. The resulting liquidity requirement is measured against available liquid assets (liquidity buffer) to determine the Bank's liquidity adequacy.

The *ICAAP Guidelines* describe the framework, assessment elements and the internal process in more detail.

### 2.5.2 Stress testing

Stress testing is a forward-looking risk management tool supporting the Bank's risk identification, monitoring and reporting procedures, capital and liquidity adequacy assessments as well as capital and liquidity planning. Stress testing, including sensitivity analysis and reverse stress testing, are used for assessing the resilience of the Bank to different economic scenarios or event-based shocks.

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<sup>6</sup> In addition to the ICAAP framework, the Bank has created a *Capital and Liquidity Recovery Plan* that contains contingency measures for capital and liquidity adequacy to safeguard its viability.

The Bank conducts both solvency stress tests and liquidity stress tests to ensure that it is sufficiently capitalised and holds adequate liquidity buffers to carry out its mission even in severe but plausible scenarios. The design of the stress test methodology and the specification and severity of scenarios test the Bank's business model, risk profile as well as current and assumed future external circumstances.

The stress testing outcomes are utilised in the Bank's capital and liquidity adequacy assessments, capital planning and risk management. Stress tests conducted for ICAAP purposes are conducted concurrently with the ICAAP schedule.

The *Stress Testing Guidelines* provide methodological and practical details for the Bank's stress testing.

## **2.6 Model risk management**

Model risk is defined as the potential for adverse consequences from decisions based on an inappropriate, incorrect, misspecified or misused model. Model risk can lead to financial loss, poor business and strategic decision-making, and/or reputational damage. Model risk can materialise in risk measurement models, in valuation models or in other models that support decision-making. There are also interactions and interdependencies between the models in use, highlighting the need for proper model risk management.

Model risk is managed by careful and adequate model design, development, implementation, documentation and validation practices. As a rule, there shall be adequate separation of duties between those functions/units that develop models and the validation function. An independent model validation function is a cornerstone of a sound model risk management framework and its roles and responsibilities shall be clearly defined.

Model risk management is an important part of the Bank's overall risk management framework. Under the umbrella of this Policy, NIB has issued a separate *Model Risk Management Policy* and the related *Guidelines* that provide detailed principles and governance for model risk management at NIB.

## **2.7 Risk governance**

### **2.7.1 Risk culture**

Risk culture is one of the core elements in the *Risk Appetite Statement*. The Bank is committed to promoting a culture of integrity, high ethical standards and strong risk awareness. All individuals in the Bank are expected to contribute to and promote a sound risk culture which helps to maintain a sound internal control environment and improves the operation of the Bank's risk management framework. A clear governance structure, policies and procedures support the creation of a sound risk culture.

### **2.7.2 Three-lines-of-defence model**

NIB follows the three-lines-of-defence model where the first line of defence consists of risk-taking business functions. The first line business functions are responsible for managing the risks they incur in conducting their activities and are accountable for decisions taken in that regard, and all other decisions, within their business units. They are required to comply with the relevant internal policies, regulations and procedures.

The second line (Risk & Compliance department) is organisationally separate from the business functions. It monitors and provides independent risk monitoring and control activities and conducts independent evaluations and reporting to the senior management on the Bank's risk profile, solvency and liquidity. The second line interacts with the first line functions in risk matters and is involved in decision-making with the objective to ensure that risk considerations are properly taken into account.

The third line (Internal Audit) is an independent, objective assurance function with reporting lines to the Board of Directors and the Control Committee. Internal Audit provides an independent evaluation of the controls, risk management and governance processes.

## 2.7.3 Roles and responsibilities

The **Board of Governors** is the Bank's supreme decision-making body. The Board of Governors is responsible for, among other things, matters concerning NIB's Statutes and subscribed capital. The Board of Governors approves the annual report of the Board of Directors and the audited financial statements of the Bank. The Board of Governors is composed of eight governors. The Minister designated by it as its Governor represents each member country. For further information, please see the *Rules of Procedure for the Board of Governors*.

The **Control Committee and its Chairmanship** is the Bank's monitoring body. It monitors that the operations of the Bank are conducted in accordance with the Statutes. The Committee shall also monitor that NIB's operations are conducted in accordance with the Principles for Capital and Liquidity Management adopted by the BoG. The Chairmanship administers the responsibilities and tasks of the full Committee, monitor the Bank's financial position, risk levels, capital and liquidity positions and oversees the performance of the audit of the Bank's financial statements, carried out by the external auditors. The full Committee focuses on monitoring fulfilment of NIB's purpose and in particular its mandate and mission. For further information, please see the *Rules of Procedure for the Control Committee*.

All the powers that are not exclusively vested in the Board of Governors are entrusted to the **Board of Directors**. The Board of Directors has the overall responsibility of the Bank's risk management and oversees the implementation of the Bank's risk management framework by approving risk management policies, including maximum limits for exposure to the main types of risk, as well as by approving the capital and liquidity adequacy assessment process and its outcomes. The Board of Directors approves projects to be financed by the Bank and adopts policy decisions concerning the operations of the Bank, in particular the general framework for financing, borrowing and treasury operations and their management. The Board of Directors has established its own **Risk and Audit Committee (RAC)** to support and advise the BoD in risk and audit matters, including those related to NIB's financial reporting. For further information, please see the *Rules of Procedure for the Board of Directors*.

The **President** is responsible for implementing the Bank's risk management framework set by the Board of Directors, for management of the Bank's risk exposures, and for ensuring that the Bank's aggregate risk is consistent with its financial resources and willingness to take risk. The Board of Directors has delegated some credit approval authority to the President for execution in the Mandate, Credit and Compliance Committee.

The following committees assist and advise the President:

- The **Executive Committee (ExCo)** comprises the President and other senior management representatives that the President has appointed as members. The Board of Directors confirms the appointments. The committee is a body established to assist and advise the President in general management and decision making concerning NIB, including following up the financial results, business plan and strategy of the Bank. The committee is expected to meet approximately twice a month. For further information, please see the *Rules of Procedure for the Executive Committee*.
- The **Asset, Liability and Risk Committee (ALR)** comprises (selected) members of the ExCo and other senior staff that the President has appointed as members. The ALR is a body established to monitor, analyse, discuss and guide the development and overall management of NIB's balance sheet, its risk and capital, funding and liquidity position, covering both financial and non-financial risks, as well as to maintain and manage risk limits with respect to the Bank's risk appetite and risk bearing capacity. All decisions at the ALR require majority support and, at the same time, the Chief Financial Officer as Chair of ALR and the Chief Risk Officer (or their substitutes) both need to be supportive. The committee meets approximately twelve (12) times a year. For further information, please see the *Rules of Procedure for the Asset, Liability and Risk Committee*.

- The **Mandate, Credit and Compliance Committee (MCC)** comprises (selected) ExCo members. The committee is responsible for management and decision making concerning mandate, credit and related integrity and compliance matters (related to individual counterparties in both Lending and Treasury operations), as well as the overall risk culture of NIB. The committee is chaired by the President who exercises his executive powers regarding lending operations through the MCC. Further, the committee reviews all credit proposals submitted to the Board of Directors for approval. The committee usually meets weekly. For further information, please see the *Rules of Procedure for the Mandate, Credit and Compliance Committee*.
- The **Business and Technology Committee (BTC)** comprises senior staff and management from different departments and units that the President has appointed as members. The committee is chaired by the Head of IT & Business Services. BTC is a body established to facilitate IT's strategic direction and the digital transformation of NIB by prioritising, directing, monitoring and governing NIB's enterprise IT architecture, IT projects and development initiatives. For further information, please see the *Rules of Procedure for the Business and Technology Committee*.

In addition to the above-mentioned advisory bodies to the President, the Bank has the Trust Fund Committee which shall ensure that the purposes of the trust funds managed by NIB are fulfilled in the most efficient way. The committee also approves the activity plan of the trust funds and proposes allocations from a trust fund. The committee gives its recommendations to the respective donor(s) for their final decision.

In the day-to-day operations, the Bank has established a segregation of duties between functions that enter into business transactions with customers or otherwise expose the Bank to risk, and functions in charge of risk assessment, risk measurement, monitoring and control;

- The business functions, **Lending** and **Treasury**, are responsible for implementing the Bank's business strategy and act as the first line of defence for the risks in their operations. Lending is responsible for loan origination and mandate fulfilment in accordance with the Bank's willingness to take risk. Treasury provides support by executing the funding strategy and managing the liquidity as well as balance sheet risks (asset and liability management). The business functions carry out the day-to-day management (identification, assessment, monitoring and internal reporting) of all risks assumed in their operations and ensure that an adequate return is achieved for the risks taken. Both the Head of Lending and the Head of Treasury & Finance report to the President.
- The **Risk & Compliance** department independently controls the risk positions of the Bank. It implements the Bank's risk management related policies, guidelines and frameworks as approved by the Board of Directors and the President. The Risk & Compliance department has the overall responsibility for identifying, measuring, assessing, monitoring and reporting on risks across risk types and organisational units. The department is responsible for the Bank's risk models, tools, and policies, and maintains risk management frameworks (like ICAAP, RAS and risk taxonomy). It also monitors credit, market, liquidity, and operational risks on daily basis. The **Compliance function** belongs to the second line of defence and oversees, coordinates and reports on matters relating to integrity and compliance risks. The function is headed by the Chief Compliance Officer who reports administratively to the Chief Risk Officer (CRO), has a dotted reporting line to the President and shall have unrestricted access to the Chair of the Board of Directors and the Chair of the Control Committee.
- The Chief Risk Officer (CRO) heads the Risk & Compliance department and reports to the President. The CRO is a member of the Executive Committee, the Mandate, Credit and Compliance Committee, and the Asset, Liability and Risk Committee, with the role and purpose to ensure that risk considerations are properly taken into account and is involved in decision-making to influence and, when necessary, challenge decisions that give rise to material risk. The CRO shall have unrestricted access to the Chair of the Board of Directors and the Chair of the Control Committee. An important objective is to engage the senior management, Board of

Directors and the Control Committee (including the Chairmanship) on constructive dialogue on key risk issues. The CRO function acts as a Secretary to the Control Committee Chairmanship and the Risk and Audit Committee of the Board of Directors.

- The **Legal** department supports the business functions carrying the responsibility for minimising and mitigating legal risks in all of the Bank's operational, institutional and administrative activities. The General Counsel reports to the President and is Secretary to the Board of Governors, the Board of Directors and the Control Committee.
- **Internal Audit** provides an independent evaluation of the effectiveness of controls, risk management and governance processes. The Head of Internal Audit reports to the Board of Directors and the Control Committee and works administratively under the auspices of the President.

## **3 RISK CATEGORIES**

### **3.1 General**

The Bank has identified a set of risk categories that cover both financial and non-financial risks and create the basis for the Bank's risk taxonomy. These risks are managed with the overall objective of maintaining financial soundness and avoiding activities that could threaten the Bank's reputation.

NIB operates according to sound banking principles, monitors banking regulations, supervisory standards and industry practices, and takes them into account to the extent relevant for its business model and complexity.

The Bank's risk management framework comprises risk policies and procedures formulated for the identification, measurement, assessment, monitoring and reporting of risks, including several layers of limits set to manage the exposure to quantifiable risks. The Bank recognises that effective risk management is based on a sound risk culture, which is characterised, among others, by a high level of awareness concerning risk and risk management in the organisation. Regular training of staff in risk related matters is part of the Bank's risk management practices.

### **3.2 Credit risk**

#### **3.2.1 Definition**

Credit risk is defined as the risk of loss resulting from the failure of the Bank's borrower or other counterparty to fulfil their contractual obligations and that collateral provided does not cover the Bank's claims.

#### **3.2.2 Appetite for credit risk**

To fulfil its mission, the Bank provides long-term loans and guarantees to customers in the member and non-member countries. Thus, most of the credit risk arises in the Bank's lending operations.

The Bank is also exposed to credit risk in its treasury activities, where credit risk derives from the financial assets that the Bank uses for investing its liquidity, and from derivative instruments that are used to manage foreign exchange and interest rate risks in the Bank's funding and lending transactions.

The Bank is subject to concentration risk due to its regional focus, where majority of the lending is targeted to member countries, and due to its focus on limited range of customers, customer sectors and segments. Yet, the overall target is to avoid excessive risk concentrations and to have an appropriate diversification at the portfolio level.

The Bank aims to maintain a high-quality loan portfolio, while acknowledging that some of its lending involves greater risks. The Bank accepts limited credit risk in its Treasury operations arising from the investments in the liquidity portfolio. The appetite for counterparty credit risk arising from the use of derivatives is low.

#### **3.2.3 Key responsibilities**

The Board of Directors approves the *Credit Risk Policy*, which sets out the key principles of the Bank's credit risk management and control. Based on regular reporting, the Board of Directors oversees the development of the Bank's credit risks, both at the counterparty and portfolio level.

The Board of Directors approves new loans and sets the limits for maximum credit risk exposure at counterparty, business sector, country and business line level. The Board of Directors has authorised the President to approve loans up to a defined amount in the Mandate, Credit and Compliance Committee (MCC) as set out in the *Rules of Procedure for the Mandate, Credit and Compliance Committee*. Treasury counterparties are approved by the MCC within the limits authorised by the Board of Directors. The Board of Directors receives information on credit approvals made in the MCC.

The Lending department is responsible for the loan and counterparty (borrower and/or risk-owner) appraisal process. The Risk Management functions verify compliance with relevant internal policies and guidelines and opine on proposed ratings. The appraisal process for new counterparties in treasury operations is the responsibility of the Treasury function in cooperation with the Risk Management functions. The credit risk monitoring process and related responsibilities are laid out in the *Credit Monitoring Guidelines*.

The MCC decides on watch-listing of credits and on impairment provisioning. The handling of distressed credits is described in the *Guidelines for the Special Credit Operations*.

The Risk & Compliance department provides independent oversight of credit risks at the portfolio level. It monitors the level of credit risks in the Bank and reports on the level and development of credit risk and the respective capital requirement to the Board of Directors regularly.

### **3.2.4 Credit risk management**

NIB's credit risk management aims at preserving the high credit quality of the Bank's portfolios and thereby protecting the Bank's short- and long-term viability. The Bank's credit risk management builds on the principles of (1) appropriate risk diversification within the scope of the mission; (2) thorough risk assessment at the credit appraisal stage; (3) risk-based pricing and risk mitigation; (4) continuous risk monitoring at the individual counterparty level as well as portfolio level; (5) avoidance of undesirable risks to the extent possible.

Risk indicators monitored are, among others, the development in risk class distribution in the lending and treasury portfolios as well as large exposures to individual counterparties, sectors and countries.

#### **3.2.4.1 Risk-sharing and outsourcing of credit risk management**

Within Lending's activities, the Bank provides direct financing to small and medium-sized enterprises (SMEs) and small mid-cap corporates (SMCs) in the member countries. The Bank's direct lending to the SME/SMC segment is carried out in cooperation with a partner bank and includes outsourcing of certain operations, such as the credit assessment process, as well as potential delegation of authority to the partner bank. A thorough due diligence of the partner bank's credit policies, credit analysis, credit reporting and work-out process is undertaken to ensure fulfilment with NIB's credit policies, rating frameworks and other criteria.

Financing to SMEs/SMCs may be provided on the basis of risk-sharing (in the form of a guarantee or other risk-sharing arrangement) or as direct loans originated and administered by the partner bank. In any risk-sharing arrangement, a key principle is to minimize incentives for adverse selection by the partner bank. In case of pro-rata risk sharing arrangement, NIB will generally not assume more risk than the partner bank on any SME/SMC counterparty. In case of non-pro rata risk sharing arrangements, NIB's maximum exposure on a SME/SMC borrower is determined case by case.

Lending to the SME/SMC segment is further outlined in the *Credit Risk Policy* and the *Credit Enhancement Guidelines*.

#### **3.2.4.2 Credit exposure and concentration risk**

The Bank strives to avoid excessive concentration in any single counterparty, industry sector or country outside the member countries. The maximum credit exposure that the Bank is willing to take is expressed in terms of exposure limits set by the Board of Directors (see Appendices). Credit exposure is the aggregate of lending and treasury exposure. The limits are measured by total credit exposure and economic capital consumption against the Bank's equity. The limits are reviewed at least annually.

#### **Counterparty limits**

The Bank defines a single counterparty as a counterparty or group of counterparties that are legally and/or financially consolidated or otherwise interdependent from a risk perspective. For exposure limit

purposes the Bank considers the entity where the risk resides, i.e. the risk-owner, as the counterparty. The risk-owner is the entity that is ultimately responsible for the Bank's claim and may be different from the obligor if there is a risk transfer (see section 3.2.4.4 for eligibility). However, each counterparty (borrower, third-party guarantor, non-payment insurance provider) shall fulfill the minimum conditions for eligible counterparty risk ratings on a stand-alone basis, and as presented in Appendix 1 and Appendix 2 to this Policy.

- **Single counterparty limits:** The maximum risk that the Bank is prepared to take on a single counterparty is defined based on the creditworthiness of the counterparty as expressed by the probability of default (PD). In addition, the exposure is limited based on the expected loss (EL) of the transaction(s) entered into with the counterparty, which factors in the loss given default (LGD). The limits are, respectively, scaled to the counterparty's equity and the Bank's equity.

Counterparty limits in the Bank's lending operations apply to non-sovereign exposures whereas in the treasury operations counterparty limits apply to both sovereign and non-sovereign exposures. Please see the *Counterparty limits, Appendix 1* and *Appendix 2*.

- **Large exposure limits:** The aggregate of large counterparty exposures is managed within limits measured by total credit exposure and economic capital consumption and set in relation to the Bank's equity. Please see the *Limits on large counterparty exposures, Appendix 4*.
- **High-risk exposure limit:** The Bank strives to control risk concentrations in the weaker risk classes. As such, total lending to counterparties in rating category PD14<sup>7</sup> and weaker may not exceed the limit as set in the *Limits on lending to counterparties rated PD14 and weaker, Appendix 5*.

As a rule, the Bank refrains from new lending to borrowers in the risk classes PD17-20.

## Industry sector limits

The Bank aims to maintain a reasonably granular portfolio in terms of industry sector exposure.

Limits have been set on the maximum credit exposure to a single industry sector as well as on the economic capital consumption of a sector. The limits have been set in relation to the Bank's equity. The Bank accepts higher exposure to the public sector, utilities, and the financial sector, the latter in order to accommodate the exposure from the Bank's treasury operations, and the lending to financial intermediaries, please see the *Business sector limits, Appendix 5*.

## Country limits

Country limits apply for lending in non-member countries. These limits are based on the credit risk rating of the sovereign and scaled to the Bank's equity (see *Appendix 3*). Lending in member countries is not subject to country limits. All Treasury exposure (in or outside member countries) is subject to country limits.

### 3.2.4.3 Credit risk assessment

The counterparty's debt servicing capacity is a key consideration for credit approval. The assessment of a counterparty's creditworthiness focuses on identifying the main financial risks and business risks related to the counterparty. Based on the assessment, a risk rating indicating the probability of default (PD) is assigned to the counterparty.

The Bank's PD rating methodologies are laid out in the rating frameworks for corporates, project and structured finance, financial institutions, local and regional governments, treasury counterparties and sovereign counterparties.

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<sup>7</sup> Rating scale: PD1 to PD20 and D1,D2; PD1-10 correspond to investment grade ratings by S&P and Moody's.

A separate expected loss (EL) rating is assigned at the transaction level. The EL rating factors in the loss given default (LGD), i.e. the loss severity in the event of a counterparty default. The LGD assignment process relies on uniform regulatory values and models, based on the type of counterparty and the characteristics of the transaction, such as guarantees, collateral, seniority of the claim and other credit enhancing factors in the transaction. For further information, please see the *Rating Framework for Loss Given Default*.

The Bank's risk rating system comprises 20 classes to differentiate the risk of counterparty default (*Obligor Master Scale, Appendix 11*) and the expected loss on a transaction (*Transaction Master Scale, Appendix 12*). In addition, separate D classes apply for non-performing transactions. For reference to external ratings, the internal scales are mapped to the ratings of Standard & Poor's and Moody's.

The process of assigning PD and LGD ratings to lending counterparties is carried out by the Lending department. The process of assigning PD and LGD ratings to treasury counterparties is carried out by the Treasury function. The credit opinion provided by the Risk Management functions includes an opinion on the PD and LGD. The risk ratings are approved by the Mandate, Credit and Compliance Committee.

The Bank's credit risk assessment includes the use of quantitative risk methodologies and models as well as qualitative assessments based on expert judgement. The development of the analysis tools is made in cooperation between the relevant business functions and the Risk & Compliance department, under the oversight of senior management in steering committees. Periodic validation of the tools is carried out and/or overseen by the Risk & Compliance department. Final approval for production use of credit risk assessment tools is made by the Asset, Liability and Risk Committee.

### **3.2.4.4 Credit risk mitigation**

#### **Lending**

The *Statutes* require that the Bank obtains adequate security for loans (and guarantees) granted, unless sufficient security is considered to exist under the circumstances.

As a rule, the Bank finances maximum 50% of the total costs for a single project. Financing to small and medium-sized enterprises, small mid-cap corporates and mid-cap corporates in the Bank's member countries can be extended up to 75% of the total project or financing need fulfilling NIB's mandate criteria.

The Bank lends and invests on senior unsecured or on secured basis. The level of credit enhancement required in the Bank's lending depends, among others, on the creditworthiness of the counterparty and the tenor and repayment structure of the loan. For further information, please see the *Credit Risk Policy* and the *Credit Enhancement Guidelines*.

The Bank may use third-party guarantees or non-payment insurance as a credit risk mitigation technique. In each case, the eligibility for a risk transfer shall be assessed. Risk transfer refers to a substitution procedure whereby the guarantor or the non-payment insurance provider of a transaction is considered to be the counterparty from a credit risk perspective (risk-owner) instead of the borrower.

The risk transfer to be eligible from a credit risk perspective, as a minimum, the legal conditions between the Bank and the protection provider shall be legally enforceable, unconditional (i.e. the Bank shall have direct control to use the protection), irrevocable during the lifetime of a loan, and the legal conditions of the (guarantee or non-payment insurance) cannot be changed without the Bank's consent.

In third-party guarantees, and for the purposes of risk transfer, the risk coverage shall be complete, i.e. it shall cover the obligations of a borrower in full. In case of a non-payment insurance, the coverage may be a proportion to the initial exposure between the borrower and the Bank.

In all cases, the risk-owner shall be treated in the risk and capital management in proportion to the risk covered. In case the risk-owner doesn't cover the obligations of an obligor in full, the Bank applies risk

transfer only to exposure portions which are covered, so in capital management the effective coverage ratio shall be used.<sup>8</sup>

For transactions where credit risk is mitigated via the non-payment insurance, there shall not be a maturity mismatch nor currency mismatch between the maturity of the underlying transaction and the maturity of the non-payment insurance. Further details are provided in the *Credit Enhancement Guidelines*.

Units responsible for client relationships are responsible in the first place for ensuring that the Bank is protected by sufficient credit enhancement. The Risk Management functions provide an opinion on the proposed credit enhancements. The Mandate, Credit and Compliance Committee makes the final decision on the required credit enhancements.

## Treasury

In its treasury operations, the Bank uses netting and collateralisation to mitigate credit risk related to derivatives and reverse repurchase agreements. The Bank undertakes swap transactions only with counterparties that meet the required minimum counterparty credit rating and have executed an International Swaps and Derivatives Association (ISDA) Master Agreement and signed a Credit Support Annex (CSA). The ISDA master agreement allows for a single net settlement of all transactions covered by the agreement in the event of a counterparty default or early termination of the transactions. Under the CSA, the derivative positions are marked to market daily, and the resulting exposures are collateralised by cash or government securities. Reverse repurchase transactions are conducted on the terms of the Global Master Repurchase Agreement (GMRA).

### 3.2.4.5 Credit risk monitoring and reporting

The Bank continuously monitors the credit risk development in its lending and treasury operations. Credit risk is monitored both at counterparty level, for relevant sectors and at portfolio level. The primary responsibility for credit risk monitoring resides with the unit responsible for the client relationship, i.e. Lending, Treasury and Special Credits. The reference document is *Credit Monitoring Guidelines*. Risk & Compliance department is responsible for regular reporting to the Board of Directors on the Bank's risk position in relation to established limits.

#### 3.2.4.5.1 Counterparty level

##### Lending exposures

All credit exposures are subject to continuous monitoring of contractual compliance and events/signals that could potentially lead to or indicate a material change in risk. In addition, a formalised annual follow-up (AFU) is conducted, in accordance with the *Credit Monitoring Guidelines*, on individual basis for the entire loan portfolio throughout the calendar year. The annual follow-ups are approved in line with the *Rules of Procedure for MCC and Delegation of Authority Concerning Decision Related to Previously Granted Loans*.

Large exposures, defined as the 20 largest non-sovereign exposures and the 20 largest economic capital consumers, are subject to more thorough analysis and are presented to the MCC for approval. The same applies to high-risk counterparties defined as counterparties in risk classes PD14-16<sup>9</sup> and watch-listed counterparties.

Compliance with maximum single-counterparty limits for lending transactions is verified by the Risk Management functions. Compliance with aggregate/portfolio limits in lending operations is also monitored by the Risk Management functions. Exposure in excess of maximum limits may

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<sup>8</sup> If the risk-owner covers only a proportionate share of the principal, or accrued interest payments are not covered, the effective coverage ratio shall be used in the economic capital calculation.

<sup>9</sup> Rating scale: PD1 to PD20 and D1,D2; PD1-10 correspond to investment grade ratings by S&P and Moody's.

occur e.g. due to downgrade of a counterparty rating. Limit breaches are reported to the Board of Directors.

### Treasury exposures

All exposures are subject to continuous monitoring of events/signals that could potentially lead to or indicate a material change in risk. In each calendar year, the Treasury counterparties are analysed and the risk class validated. Counterparties with a risk class weaker than EL6 are prioritised. The annual follow-up is presented to the MCC for approval.

Compliance with maximum individual limits for new treasury counterparties is verified by the Risk Management functions. Compliance with individual counterparty and aggregate/portfolio limits in treasury operations is monitored on daily basis by the Risk Management functions. Exposure in excess of maximum limits may occur e.g. due to downgrade of a counterparty rating. Limit breaches are reported to senior management and the Asset, Liability and Risk Committee, as well as to the Board of Directors if the maximum exposure limit is exceeded.

### Watch-listed exposures

Following the identification of a seriously deteriorated debt repayment capacity and/or a serious deterioration in the financial standing, the counterparty is placed on the watch-list and becomes subject to specific watch-list monitoring. All loans, borrowers and Treasury counterparties in risk class PD17 and/or EL17<sup>5</sup> or below shall be proposed for the watch-list. Please see the *Credit Risk Policy*.

#### 3.2.4.5.2 Portfolio level

Monitoring of the credit risk development at portfolio level is carried out regularly by Risk & Compliance department, which is responsible for analysing and reporting the development to the Asset, Liability and Risk Committee and the Board of Directors. The reporting includes, among others, an analysis of the aggregate credit risk exposure, credit risk concentrations, changes in the risk profile, exposure against portfolio risk limits and development of economic capital.

#### 3.2.4.6 Risk-based pricing

The Statutes stipulate that the Bank shall operate according to sound banking principles and aim for a profit allowing the formation of reserves and reasonable return on capital. Loans and guarantees are priced to cover the Bank's cost of funds, administration costs, the cost of the risk involved in the transaction and the cost of capital employed. For loan pricing purposes the Bank uses a pricing tool that enables calculation of the minimum earnings required on a loan in order to cover all lending related costs and an appropriate return for the level of risk assumed. Internal credit risk ratings and associated risk parameters, as well as the structure of the transaction are key input factors into the pricing tool.

#### 3.2.4.7 Expected credit losses & impairment of financial assets

The Bank makes timely recognition of, and provision for, expected credit losses ("ECL") and the impairment of financial assets and commitments in accordance with the International Financial Reporting Standard (IFRS 9). The estimation of ECL takes into account a broad range of information, including forward-looking macroeconomic factors. The main principles applied for calculating and reporting provisions based on ECL are set out in the *Expected Credit Loss Framework*. ECL are measured by allocating financial assets under scope into three categories (stages) at each reporting date:

- Stage 1: Financial assets which are performing and for which no significant increase in credit risk has been identified since initial recognition;
- Stage 2: Financial assets which are performing but for which a significant increase in credit risk has been identified since initial recognition;

- Stage 3: Non-performing financial assets, as defined in the *Non-Performing Exposures Framework*.

The MCC approves loss provisions from the ECL estimate – based on Macro-Financial scenarios which feed into ECL model calculations and additional management overlay adjustments, if any – and individual impairments. Risk & Compliance is responsible for generating the Macro-Financial scenarios and the maintenance and development of the ECL model.

## **3.3 Market risk**

### **3.3.1 Definition**

The Bank defines market risk as the risk of valuation loss or reduction in expected earnings stemming from adverse fluctuations in exchange rates, interest rates, credit spreads or cross-currency basis spreads.

### **3.3.2 Appetite for market risk**

The Bank's strategy is to obtain cost-efficient funding from diversified sources and provide lending that is tailored to the needs of its customers. This gives rise to foreign exchange risk and structural interest rate risk due to mismatches in the Bank's assets and liabilities in terms of currency composition, maturity profile and interest rate characteristics. Cross-currency basis risk stems from the hedging techniques used by the Bank to mitigate the above risks. This risk is inherent in transactions exchanging foreign currencies at a future point in time and is mainly driven by liquidity supply and demand in those currencies.

The Bank's securities portfolio held for liquidity purposes is exposed to interest rate risk and credit spread risk. Credit spread risk refers to a potential decline in market value due to perceived change in the credit quality of the issuers of the securities held in the portfolio.

The Bank accepts moderate interest rate and credit spread risk arising from the investments in the liquidity portfolio. Interest rate risks arising from funding and lending activities are hedged with the objective of protecting earnings and the economic value of assets and liabilities. Exposure to currency risk is kept low and effectively mitigated by using derivatives to protect the Bank against realised foreign exchange rate losses. The Bank allows exposure to currency basis risk arising from the use of derivatives for hedging purposes. The Bank's appetite for volatility risk is low.

### **3.3.3 Key responsibilities**

The Board of Directors annually reviews and approves maximum limits for exposure to market risks. The Board of Directors receives reports on the Bank's market risk positions at its regular meetings.

The Asset, Liability and Risk (ALR) Committee oversees the activities that give rise to market risk exposure and establishes operating guidelines including various levels of operational limits within the maximum limits set by the Board of Directors. It also oversees market risk exposures as part of the Bank's overall risk picture.

The Bank's day-to-day market risks are managed by Treasury.

The Risk Management functions provide independent oversight of all significant market risks, supporting the ALR and Treasury with risk measurement, analysis, daily monitoring and reporting.

### **3.3.4 Market risk management**

The Bank manages market risks by hedging against foreign exchange risk and interest rate risk with the objective to protect its earnings and the economic value of its assets and liabilities. Foreign exchange risk is practically fully hedged. Interest rate risk deriving from mismatches between funding and lending is kept at a modest level. The Bank's appetite for interest rate risk and credit spread risk pertains to the earnings expectations set for the liquidity portfolio.

As part of its structured funding transactions, the Bank may use financial instruments linked to other market risk factors than the above. A prerequisite is that such transactions are completely hedged with derivatives and that the Bank is able to valuate and measure the risks involved in the derivatives. The instruments that the Bank is authorised to use are laid out in *Authorised Instruments in Treasury Operations, Appendix 10*.

According to the Statutes, the Bank may when specific need arises, acquire shares or other assets, in support of its business or to protect its claims.

### **3.3.4.1 Foreign exchange risk**

The Statutes require that the Bank shall, to the extent practicable, protect itself against the risk of exchange rate losses. The Bank's operating principle is to hedge foreign exchange risk by the use of derivatives to convert its multi-currency borrowings into the primary lending currencies. Investments in assets held for liquidity purposes are made in the primary lending currencies. Generally, the Bank does not hedge its future net interest margin against movements in foreign exchange rates.

In compliance with the statutory requirement and the set risk appetite, limits for acceptable foreign exchange risk are kept low compared to the Bank's equity. Limits have been set to restrict the overnight open positions, i.e. the net nominal value of assets and liabilities in each foreign currency. Please see the *Limits for Exchange Rate Risk, Appendix 8*.

### **3.3.4.2 Cross-currency basis risk**

Cross-currency basis risk is embedded in the currency swaps that the Bank uses to hedge foreign exchange rate risk in future cash flows from its lending and borrowing and for liquidity management purposes. Changes in the currency basis spreads affect the mark-to-market valuations of the swaps, which in turn gives rise to volatility in the Bank's comprehensive income. Cross-currency basis risk is managed within the Bank's economic capital framework, and reflected in the capital requirement for market risk, to ensure that the capital requirement for cross-currency basis risk is aligned with the established risk appetite. Counterparty credit risk inherent in the swaps is mitigated by collateral agreements (CSAs) with the swap counterparties.

### **3.3.4.3 Interest rate risk**

The Bank manages interest rate risk by using derivatives to convert fixed rate funding into floating rate liabilities. Fixed rate lending that is not match-funded, is converted to floating rate receivables. This portfolio hedging approach ensures that interest rate risk between lending and funding in each currency remains low. The majority of the Bank's interest rate risk stems from the portfolio of liquid assets. The Bank does not hedge its future net interest margin against movements in interest rates.

The Bank measures and manages interest rate risk by estimating the sensitivity of the economic value of its balance sheet to an interest rate shock. The sensitivity is measured by means of basis point value (BPV) quantifying the impact of a one basis point parallel increase in interest rates on the present value of interest-bearing assets and liabilities.

The Bank measures its structural net interest income risk by estimating the sensitivity of the accumulated net interest income during the next twelve months to changes in the level of interest rates.

Maximum limit has been set for the acceptable exposure to interest rate risk at an aggregate balance sheet level. Individual BPV limits have been defined for EUR, USD and for the Nordic currencies, whereas a combined limit applies for all other currencies. Please see the *Limits for Interest Rate Risk, Appendix 7*.

### **3.3.4.4 Credit spread risk**

The Bank manages its exposure to credit spread risk by calculating the sensitivity of its marketable securities to credit spread movements. The sensitivity is measured by means of Credit Spread Basis Point Value (Spread BPV) quantifying the impact of one basis point increase in credit spreads on the present value of the assets.

Limits have been defined to restrict the decrease in asset value to acceptable levels in accordance with the Bank's risk appetite for its portfolio of marketable securities. The Bank has set an overall limit for

credit spread risk with specific sub-limits defined for various asset classes and portfolios. Please see the *Limits for Credit Spread Basis Point Value, Appendix 8*

To ensure that the liquidity portfolio maintains its market value and liquidity even under severe market conditions, the Bank has set limits to control the asset quality of the portfolio i.a. by defining minimum requirements for counterparty ratings. Please see the *Limits for the Liquidity Buffer, Appendix 9*.

## **3.4 Liquidity risk**

### **3.4.1 Definition**

The Bank defines liquidity risk as the risk of incurring losses due to an inability to meet payment obligations in a timely manner when they become due. The Bank categorises liquidity risk into *funding liquidity risk*, which occurs when payment obligations cannot be fulfilled because of an inability to obtain new funding, and *market liquidity risk*, which occurs when the Bank is unable to sell or transform assets in the liquidity buffer into cash without significant losses.

### **3.4.2 Appetite for liquidity risk**

The Bank's business model is to obtain cost-efficient funding from the international capital markets (liabilities) and to use these funds to provide long-term lending to its customers and to maintain a liquidity portfolio (assets). Mismatches in the Bank's assets and liabilities in terms of currency composition, maturity profile and interest rate characteristics give rise to liquidity risk.

The Bank accepts funding liquidity risk deriving from maturity mismatches between funding and lending. Liquidity risk is mitigated by maintaining a robust liquidity portfolio where a large majority of the assets are of high quality to support the Bank's operations. Having a strong liquidity position enables the Bank to carry out its core activities even under severely stressed market conditions without access to new funding.

The Bank strives to diversify its borrowing in terms of currencies, maturities, instruments and investor types in order to avoid excessive reliance on individual markets and funding sources. Market liquidity risk tolerance is low and the risk is mitigated by maintaining a high quality and sufficiently short-term liquidity buffer.

### **3.4.3 Key responsibilities**

The Board of Directors approves the *Liquidity Policy*, which outlines the key principles for the Bank's liquidity management. The Board of Directors receives regular reports on the liquidity position and the performance against approved limits and targets.

The President is responsible for ensuring that the *Liquidity Policy* is effectively implemented and for establishing prudent liquidity risk management and control procedures. The President also approves the methodology for liquidity stress testing. Furthermore, it is the President's responsibility to inform the Board of Directors in case the liquidity contingency plan is activated.

The liquidity position and adherence to exposure limits is managed by the Treasury function and monitored by the Risk Management functions on a daily basis.

The Asset, Liability and Risk Committee oversees the development of the Bank's funding and liquidity position and decides on liquidity risk related matters in accordance with their respective mandates.

### **3.4.4 Liquidity risk management**

Key objectives for the Bank's liquidity risk management are to ensure that the liquidity position is strong enough to (1) enable the Bank to carry out its core activities for a defined period of time under stressed market conditions without access to new funding; (2) secure the highest possible credit rating by international rating agencies; (3) fulfil the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) requirements as specified in the Capital Requirements Regulation of the European Union.

## **Measuring the liquidity requirement**

The liquidity requirement for various time horizons is determined based on analysis and stress testing of future contractual cash flows. A key metric applied is the survival horizon, which measures how long the Bank is able to fulfil its payment obligations in a severe stress scenario. The target survival horizon is twelve months, which means that the Bank is able to meet its payment obligations and continue its business operations without disruption for the coming twelve months under stressed conditions. The minimum requirement is that the survival horizon must at all times exceed nine months. The stress scenario includes, among others, the assumption of payment disruptions in the loan portfolio, no access to market funding, early termination of all callable funding transactions and severe decline of asset value in the liquidity buffer as laid out in the *Liquidity Requirements Stress Testing Framework*.

## **Liquidity buffer**

To ensure sufficient liquidity in stressed financial conditions, the Bank holds a liquidity buffer. The buffer comprises unencumbered cash, deposits and securities mainly denominated in EUR, USD and the Nordic currencies. In order to ensure that the market value and liquidity of the buffer is preserved during adverse market conditions, the Bank has set strict rules for the composition of the buffer. As such, the buffer must include a minimum level of High Quality Liquid Assets as defined in the EU capital requirement regulation and a minimum level of assets in the internal rating categories corresponding to at least AA- by S&P and Aa3 by Moody's (please see the [Limits for the Liquidity Buffer, Appendix 9](#)). Furthermore, the buffer must comprise a certain level of assets eligible as repo collateral in central banks. The Bank does not have direct access to central bank repo facilities.

The maturity profile of the liquidity buffer is structured to fulfil the Bank's requirement that the expected net cash outflow during the next three months must be covered by maturing investments in the liquidity buffer.

## **Funding strategy**

Diversification is a key objective of the Bank's funding and liquidity management. The Bank strives to diversify its borrowing in terms of currencies, maturities, instruments and investor types in order to avoid excessive reliance on individual markets and funding sources. Through regular benchmark issues, the Bank aims to secure broad market access. The annual funding plan is based on the projected twelve-month liquidity requirement and the projected size of the liquidity buffer. The funding plan is regularly adjusted to reflect changes in the liquidity requirement.

## **Liquidity recovery plan**

As required by the *Principles for Capital and Liquidity Management* (approved by the Board of Governors), NIB shall have contingency measures for liquidity adequacy to safeguard its viability. Subsequently, the Bank has established *Capital and Liquidity Recovery Plan* that contains internal procedures, predefined contingency measures and trigger levels of key indicators to activate the plan. The *Capital and Liquidity Recovery Plan* is approved by the Board of Directors.

## 3.5 Operational risk

### 3.5.1 Definition

The Bank defines operational risk as the risk of legal / regulatory sanctions, financial loss, reputational harm or adverse impact to NIB's operations that NIB may suffer as a result of inadequate or failed internal processes, people and systems, or external events.

### 3.5.2 Appetite for operational risk

The Bank is exposed to operational risk in all its activities. This includes day-to-day activities of the business functions (Lending and Treasury) as well as activities of the supporting functions (e.g. IT, HR and other support functions). Operational risk is also inherently attached to the Bank's products, services and systems.

The Bank recognises that all its activities expose it to potential operational risk events. The Bank manages operational risk by promoting a culture of integrity and high ethical standards and by maintaining strong risk awareness. Operational risk is further mitigated by implementing a proper risk identification, analysis, reporting and monitoring processes and set of internal control activities.

### 3.5.3 Key responsibilities

The Board of Directors approves the *Operational Risk Policy*, which sets out the key principles of the Bank's operational risk management and control. Based on regular reporting, the Board of Directors oversees the Bank's operational risks.

The President has the ultimate responsibility for ensuring that appropriate operational risk management practices are in place and operating effectively in accordance with the *Operational Risk Policy* and the standards set out in the *Operational Risk Guidelines*.

In the day-to-day operations the three-lines-of-defence model ensures accountability and defines the roles and responsibilities for operational risk management. The first line of defence are the respective Bank functions, who own the risks in their operations. It is the responsibility of line managers to ensure that operational risks are identified, communicated and understood, that appropriate actions are taken to mitigate losses and that incidents are reported. The second line of defence is the Risk & Compliance department, which is responsible for bank-wide monitoring and reporting on events and actual losses to the Asset, Liability and Risk Committee and the Board of Directors. The third line of defence is Internal Audit, which provides an independent evaluation of the controls, risk management and governance processes.

### 3.5.4 Operational risk management

The Bank's operational risk management focuses on proactive measures in order to ensure adequate internal controls, business continuity, the accuracy of information used internally and reported externally, a competent and well-informed staff and its adherence to established rules and procedures as well as on security arrangements to protect the physical and IT infrastructure of the Bank.

- Data on **operational risk events** is collected in order to gain information and to learn from various risk events. Events reported are reviewed and categorised in accordance with a risk taxonomy by Operational Risk & Security Control unit.
- **Operational risk assessments** are conducted for processes, systems and changes in them. This enables the Bank to make informed decision on whether to mitigate risks or accept them. The process owners and key personnel involved in the process, under the stewardship of Risk Management functions, seek to detect potential risk exposures or threats to the efficient functioning of the process and assess the adequacy of risk mitigation techniques used. Potential risks are assessed according to the likelihood of occurrence and impact.

- **New and materially changed products** are managed through a Product Onboarding Process. Prior to launching a new product, all relevant risks are analysed and processes and controls established to manage the risks involved. The *Product Governance Guidelines* shall be followed.
- **Outsourcing and managing risks related to suppliers** requires thorough documentation of the activity to be outsourced and an analysis of risks involved. The Bank seeks to maintain the operational risks related to outsourced activities at the same level as if the activities were performed in-house.
- **Key Risk Indicators** for non-financial risks gauge exposures across different risk types, in order to pre-empt breaches of risk tolerance.
- Operational risk **scenarios** aim to analyse the most severe potential events, quantify their monetary impact and help develop controls against such events.
- The overall purpose of the Bank's *Security Policy* is to ensure that NIB remains resilient and secure by following the described security principles in its operations covering NIB's information security (including cyber and IT security), physical security, and safety (including travel and fire safety).
- NIB maintains a **business continuity and crisis management** capability that limits the impact of incidents and disruptions through an efficient incident response process that ensures prompt recovery. The *Business Continuity Guidelines* sets out the purpose, guiding principles, responsibilities and governance structure for NIB's business continuity and crisis management. The *Crisis Management Plan* is a predefined mechanism for responding to and acting during a crisis or a prolonged disruption.

The Bank's **legal risks** relate to inadequate or inefficient documentation, issues of legal capacity, enforceability and the applicability of national laws and dispute resolution mechanisms in the jurisdictions under which it operates. These risks are mitigated by Legal through e.g. established procedures and legal advice, key clauses and the legal review of all contractual documents and other binding documents of the Bank, irrespective of whether they relate to the operational or the administrative activities of the Bank.

In its documentation of lending operations as well as in procurement contracts for the Bank's own purchases, the Bank uses key clauses developed over the years. For the documentation of treasury transactions, the Bank relies on standardised documentation commonly accepted in the market. Concerning borrowing, the Bank uses its own standard documentation developed based upon the Bank's Statutes and practise that has evolved over time.

The Bank considers **Information Technology (IT)** as one of its key focus areas in order to achieve operational excellence, reduce operational risk and reach a high level of cost efficiency aligned with the Bank's business strategy. The Bank aims at a high-quality IT architecture that ensures performance stability and flexibility and which is adapted to the transaction volumes of the Bank. The Business and Technology Committee is established to facilitate IT's strategic direction and the digital transformation of NIB by prioritising, directing, monitoring and governing NIB's enterprise IT architecture, IT projects and development initiatives.