RISK MANAGEMENT

2019 INTEGRATED ANNUAL REPORT

Prudence, growth and asset quality

Once again, Bankinter grew in terms of loans and receivables above the sector average and maintained the high quality of its assets, its main hallmark. Both asset quality and profitability (RoE) indicators head up the field.

Risk management is one of the cornerstones of Bankinter's competitive strategy. The Bank has a risk management model of proven effectiveness that is in line with regulatory standards and best international practices, in proportion to the scale and complexity of its business activities.

The board of directors is ultimately responsible for risk management. It approves the risk strategy and, in particular, defines the risk appetite framework. This internal governance document defines the type and levels of the different risks that the Group considers reasonable to take on in developing its business strategy. Further, it establishes a set of metrics and key indicators to monitor and manage risks.

The Risk Appetite Framework also establishes the general lines of the Group's risk strategy:

Risk appetite statement. To maximise its long-term value, Bankinter carries out its business activities with a prudent risk profile, pursuing a stable balance sheet and a recurring and sound income statement.

Risk management principles. The risk appetite and tolerance are in line with the following principles:

- Prudent strategies, policies, organisation and management systems adapted adjusted to the size, environment and complexity of the Group's activities, based on quality banking practices.

- The entity's respect for and conformance with established requirements, limits and regulatory restrictions, ensuring proper compliance with prevailing legislation at all times.

- Maintenance of a low or moderate exposure to credit risk with a non-performing loan ratio in the lowest range of the Spanish financial system.

- Appropriate hedging of problem assets.

- Appropriate return on equity to ensure minimum returns over the risk-free rate throughout the cycle.

- Maintenance of a low level of market risk, so that in stress scenarios the losses generated have a reduced impact on the Bank's income statement.

- Growth in the priority strategic SMEs segments.

- Balance of the loans and receivables portfolio between individuals and legal entities.

- Balanced growth in retail funds.

- Diversification of wholesale funding sources by instruments and markets, and maintaining a balanced maturity schedule.

- Optimisation of retail funding costs, maintaining a balance between the return on the loan and market interest rates.

- Use of a risk diversification policy to avoid excessive concentration levels that might translate into difficulties for the Bank.

- Limitation on activities in sensitive industries that might pose a risk to the Group's sustainability, such as industries associated with real estate development or construction, or that might have a negative impact on its reputation and/or respectability.

- Moderate appetite for interest rate risk.

- A very small structural position in foreign currencies.

- Strengthened control of the Bank's reputational positioning (e.g. good corporate governance, systemic risks).

- Willingness to round out the level of services Bankinter offers its Private Banking and Corporate Banking customers with limited-risk Investment Banking services.

- Optimisation of the cost-to-income ratio.

- Maximisation of shareholder value creation throughout cycles through both dividends and increase in share price, all underpinned by a strong capital and liquidity base.

- Maintenance of a Common Equity Tier 1 (CET1) ratio within the fluctuation band set by the Group, above minimum regulatory requirements. Bankinter also has a corporate governance model that is in line with the most demanding supervisory standards. To stimulate and reaffirm its sound risk culture, it has a highly qualified team supported by advanced information systems.

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Regulation and supervision

2019 was another year of extremely intensive activity in regard to adapting to regulations. A large number of rules and regulatory and supervisory directives entered into force. This required a great deal of effort in the area of regulatory compliance in addition to improvements in different risk management standards and procedures. The main developments were as follows:

Internal capital and liquidity adequacy assessment. In January, the new guidelines issued by the European Central Bank (ECB) on the ICAAP (capital adequacy assessment) and ILAAP (liquidity capital assessment) came into force. The aim is to ensure entities have a comprehensive overview of their capital and liquidity needs under harmonised criteria. Meanwhile, the European Banking Authority (EBA) approved guidelines for performing stress tests.

Contagion groups. In January, the new guidelines for connected customers were applied, setting down the conditions under which a group of customers should be treated as a single risk, and introducing contagion as a key factor for establishing risk groups.

ECB guidelines for internal models. In July, the final version of these guidelines was published, including the experiences collected from the TRIM (transversal review of internal models in the industry) carried out by the European Central Bank. In addition to the publication of EBA technical standards and guidelines, which require a great of adaptation work.

EBA guidelines on non-performing and forborne exposures. In June, these guidelines entered into force to improve the management of and reduce non-performing and forborne exposures and establishing additional obligations for companies with NPL ratios of over 5%. In addition to this initiative, the European Parliament has approved the so-called backstops, a prudential coverage requirement (Pillar 1) for non-performing exposures of a certain age.

EBA guidelines for interest rate risk management. These important guidelines, in force since June, establish greater rigour in the management of interest rate risk in the loan book, addressing aspects such as credit spread risk, negative rates scenarios or the inclusion of the explicit or implicit optionality (e.g., prepayments in credit transactions or cancellation of deposits).

CRR II and CRD V: In June, the European Parliament and the Council approved the amendment to regulation (CRR II) and directive on capital requirements (CRD V), in addition to the bank restructuring and resolution directives (BRRD II and SRMR II). With regard to amendments to the CRR, the expected changes in the leverage ratio, calculation of NSFR (the net stable funding ratio), the new treatment of market risk (FRTB), the new standard method for counterparty risk (SA-CCR), extension of the application of the SME factor or the requirement to establish limits on large exposures in terms of TIER 1 capital. Although these rules will be implemented progressively, they oblige entities to make far-reaching changes to adapt to them.

Bankinter earmarks significant resources to complying with these regulatory developments and rigorously applying them in its risk management.

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Credit risk

Reduction of problem assets

Credit risk is the possibility of loss resulting from a debtor's failure to meet their contractual obligations. Trends in credit risk are shaped by the economic and financial environment.

Trade and geopolitical tensions in 2019 (US-China trade dispute, Brexit, the situation in the Middle East) undermined the international economic landscape to some extent. The global economy lost steam and monetary policies were eased further. In Spain, economic growth slowed. Once again, private sector indebtedness decreased for both individuals and businesses, with the growth of new loans to the private sector easing throughout the year.

Against this backdrop, lending at Bankinter continued to show moderate growth. Loans and advances to customers rose by 7.1% and eligible exposures (which include off-balance-sheet exposures) by 8.9% (5% in Spain excluding the acquisition of EVO Banco). As the following table illustrates, asset quality improved further during the year, while problem asset ratios fell again.

Lending at Bankinter once again showed moderate growth.

Asset quality

Thousands of euros	31.12.2019	31.12.2018	Change	%
Eligible exposures	67,008,172	61,508,726	5,499,445	4.56
Non-performing loans (includes contingent exposures)	1,681,590	1,785,160	(103,570)	-12.06
Credit risk allowances and provisions	814,329	881,088	(66,759)	-2.52
NPL ratio (%)	2,51	2,90	- 0,39	-15.94
Coverage ratio (%)	48,43	49,36	-0,93	10.85
Foreclosed assets	290,710	348,201	(57,492)	-15.39
Provision for foreclosed assets	129,231	154,522	(25,291)	-16.98
Foreclosure coverage (%)	44.45	44.38	0.08	-1.88

Decrease in non-performing loans

The non-performing loan ratio ended the year at 2.51%, down 39 basis points or 13% from the year before. The non-performing loan ratio in Spain at the close of the year accounted for 51% of the sector average (5% according to Banco de España data from November 2019). The balance of foreclosed assets decreased by 17% in the year to 291 million euros at 31 December 2019, equal to 0.4% of total credit risk.

A balanced portfolio

Over the years, the Bank has tried to balance the distribution of its loan book between individuals and legal entities. At the end of 2019, eligible exposures to individuals represented 49.9% of the total and exposures to legal entities 50.1%. The key features by segments are described below:

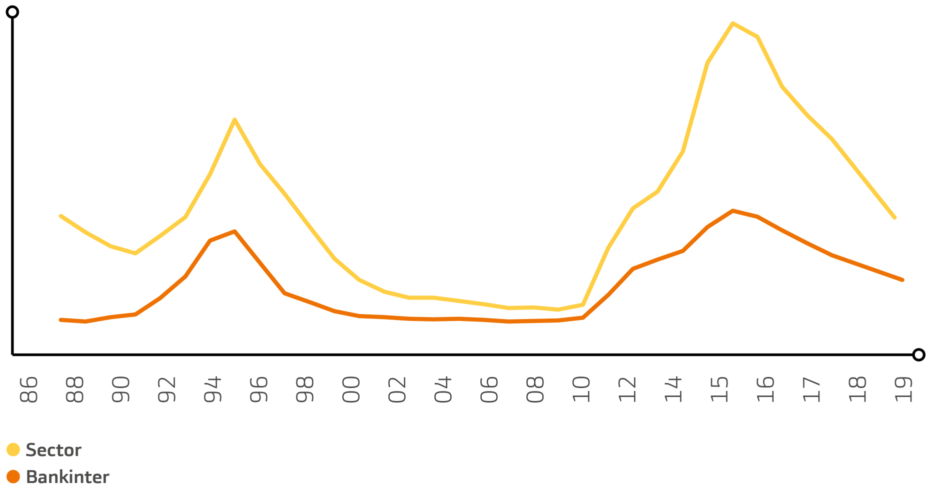
Individuals. Lending to individuals increased by 5.6% in 2019, driven by consumer finance and Private Banking. The individual lending portfolio totalled 28,872 million euros at the close of the year, with an NPL ratio of 2.3%.

The residential mortgage loan book for individuals showed a loan-to-value (the ratio between the loan amount and the value of the mortgaged asset) ratio of 58% at the close of 2019, with 90% of the loans secured by the borrower's primary residence. The non-performing loan ratio of the portfolio was 2.2%. The average effort (the proportion of income that the customer allocates to paying mortgage loan instalments) remained extremely low (23%).

Consumer finance, operated in Spain through Bankinter Consumer Finance, grew by 19.3% to 2,197 million euros at the close of the year, with 3.7% credit risk. Risk-adjusted margins, coverage and NPL ratios remained under control.

Corporate Banking. Credit risk in this area grew by 3.8% to 15,823 million euros with an NPL ratio of 0.8%. In this segment, where the business activities are more international and less exposed to Spain's economy, Bankinter boasts a solid competitive position based on specialisation, KYC, flexibility and quality of service.

Changes in the NPL ratio (%) - Spain



Source: Bankinter and Banco de España (sector)

Decrease in non-performing loans

2.5 %

-39bp

Small and medium-sized enterprises. The portfolio grew by 8.2% to 13,205 million euros with an NPL ratio of 6.3%. The Bank uses automated decision-making models to manage this segment, along with centralised teams of highly-experienced risk analysts.

Portugal. The area contributed risk of 6,523 million euros, with growth of 12.7% and an NPL ratio of 2.41%. The Bank's usual high lending standards are applied in carrying out the business in Portugal, where the NPL ratio is now in line with that of the business in Spain. The business in Portugal is 69% individuals and 31% legal entities.

EVO Banco has a credit risk of 913 million euros, 96% of which is with individuals, while Avantard contributes 451 million euros, 100% with individuals.

Risk calculation models

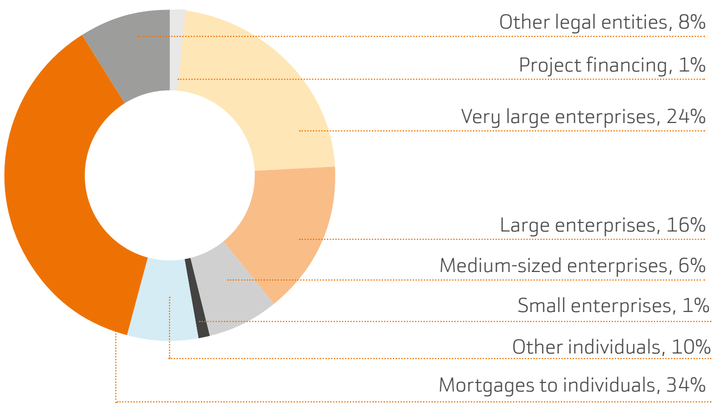
Bankinter has used internal models as a tool for supporting its decisions regarding credit risk since the 90s. These models enable the Bank to assess the credit quality or solvency of transactions and customers, providing quantitative measurements of its credit risk. They are used mainly to support approvals, set prices, quantify impairment allowances or provisions, estimate regulatory capital, monitor loan books and support recovery, all of which facilitates the active management of the loan books' risk profile.

Internal rating models provide standardised classes of solvency that group together customers/transactions with comparable probability of default. They are calibrated to assess expected and unexpected losses. These metrics are essential for managing and monitoring credit risk at Bankinter.

Bankinter has rating models both for retail segments (mortgages, consumer spending, SMEs and so on) and wholesale segments, such as Corporate Banking. These statistical models are developed using customer, operational and macroeconomic information, combined in the wholesale segment with expert analysis. The models are updated and monitored on a regular basis to ensure their power of discrimination, stability and accuracy under a strict governance structure. The models committee and executive risk committee are responsible for their approval. The risk committee also receives information periodically on the status and monitoring of these models.

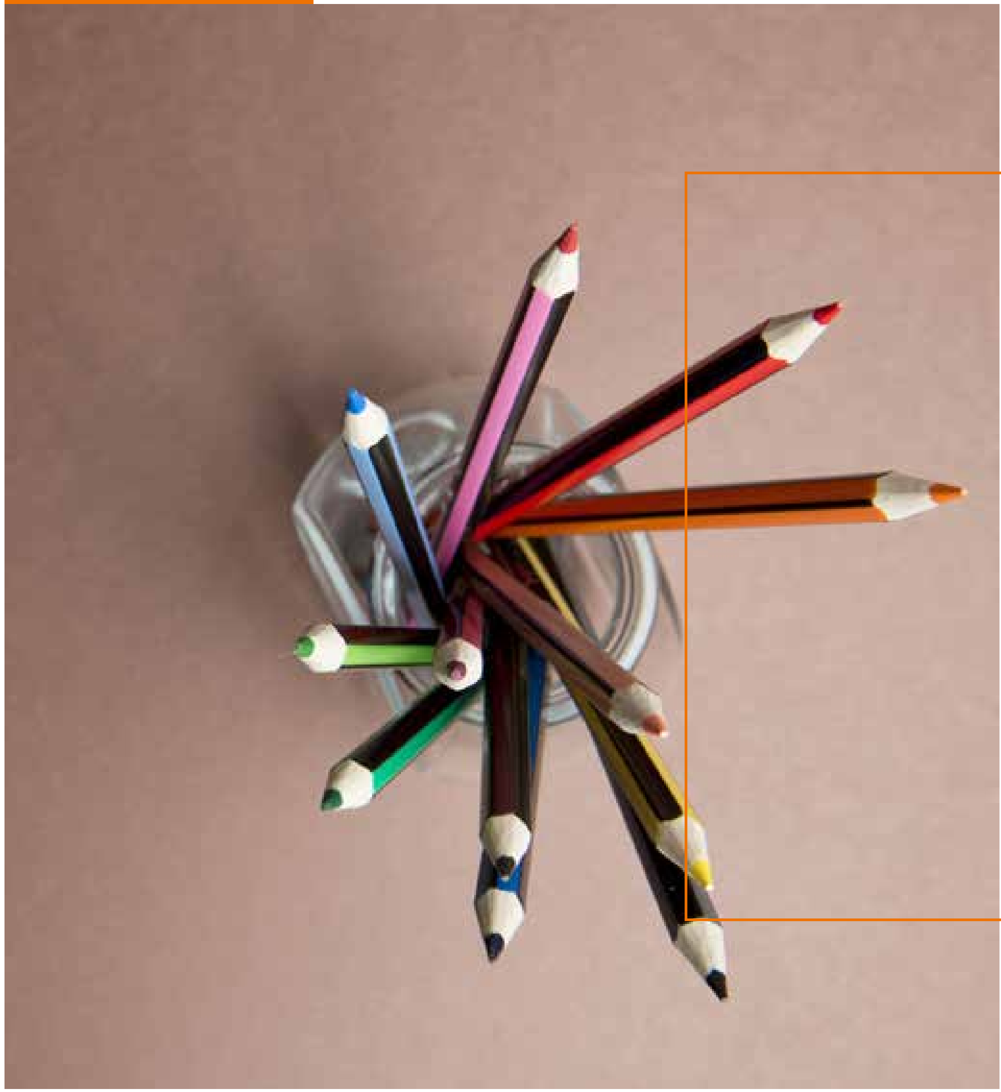
The distribution of exposure at default (EAD) by internal segments or categories is shown below.

Distribution of *Exposure at default* by internal category (Dec. 19)



Structural and market risks

Central bank intervention



From the viewpoint of structural and market risks, 2019, like 2018, was characterised by low inflation in the main economies and by the actions of central banks, which provided liquidity and intervened in the public debt markets. In certain markets, systematic purchases of public debt by central banks triggered a reduction in market depth.

Over the year, the equity markets marked a positive performance as it became clear that no economic recession was at hand. The performance of the US markets stands out, where indices reached historic highs.

Structural interest rate risk

Measures to analyse exposure

Bankinter actively manages structural interest risk, defined as the Bank's exposure to changes in market interest rates arising from timing mismatches and repricing of global balance sheet items. The aim is to safeguard net interest income and preserve the Bank's economic value.

To do this, the exposure of net interest income and economic value to different scenarios of interest rate changes is assessed using two dynamic simulation measures. The main results in 2019 were as follows:

- The interest rate risk exposure of net interest income of parallel shifts of ±100 basis points in market interest rates is 14.7/-4.3%, for a 12-month horizon.

- On a more long-term outlook, the Bank also analyses the sensitivity of economic value to parallel shifts of ±100 basis points. At the close of 2019, this was 2.5%/-5.2% of own funds.

Management assumptions were used to calculate both measures, considering negative interest rates, except for items with a Euribor floor.

Balance between loans and receivables and deposits

The Bank actively monitors liquidity and liquidity forecasts, as well the actions to be taken in both business-as-usual situations and in exceptional circumstances arising due to internal causes or market behaviours. Structural liquidity risk is associated with the Bank's ability to meet its payment obligations and fund its lending activity.

The instruments used to control liquidity risk include monitoring changes in the liquidity gap or map, such as information and specific analysis of balances resulting from trade transactions, wholesale maturities, interbank assets and liabilities and other funding sources. These analyses are performed both under normal market conditions and simulating different scenarios of liquidity needs that could arise from different business conditions or changes in market conditions.

In 2019, the customer funding gap (the difference between loans and receivables and customer deposits) was reduced by 2,451 million euros. The integration of EVO Banco in early June contributed 1,784 million euros of this decrease. The customer funding gap of the banking business in Spain decreased by 1,100 million euros thanks to strong growth in customer funds, which easily outstripped the liquidity requirements generated by the growth of loans and receivables. Conversely, the banking business in Portugal has a positive impact on the customer funding gap, with loans and receivables growing more than customer deposits by 434 million euros. As a result, 98.3% of loans and receivables were financed by customer deposits at the close of the year, compared to 93.8% a year earlier.

In wholesale funding, maturities were replaced with new issuances, maintaining a similar reliance on markets as in the previous year.

The improved liquidity position drove significant growth in the liquidity buffer, leaving the LCR (liquidity coverage ratio) well above both internal and regulatory limits. The LCR stood at 153.7% at the close of 2019, up from 144.2% at the close of 2018.

Market risk

Potential losses on the asset portfolio

Market risk is the possibility of losses as a result of changes in the market prices of on- and off-balance sheet positions of the trading book. Bankinter measures value at risk using the historical VaR methodology with data for one year and a 95% confidence interval.

An asset portfolio's value at risk (VaR) is the estimated maximum potential loss that could be incurred for a specific time horizon with a particular confidence interval. Given the instability experience in recent years, Bankinter kept VaR limits unchanged from the previous year.

The following table sets out the VaR values of trading positions at the close of 2019.

Moreover, the VaR of the portfolio positions of Línea Directa Aseguradora are monitored monthly using the historical simulation methodology. The VaR of the Línea Directa Aseguradora portfolio at 31 December was 1.12 million euros. The same monitoring is performed on the potential risk of the Bankinter Luxembourg subsidiary. Using this same method, the VaR for 2019 was estimated at 0.15 million euros.

2019 VaR trading

Millions of euros	Last
Interest rate VaR	1.35
Equity VaR	0.50
Exchange rate VaR	0.05
Volatility rate VaR	0.38
Total VaR	1.25

Total VaR

1.25

Operational Risk

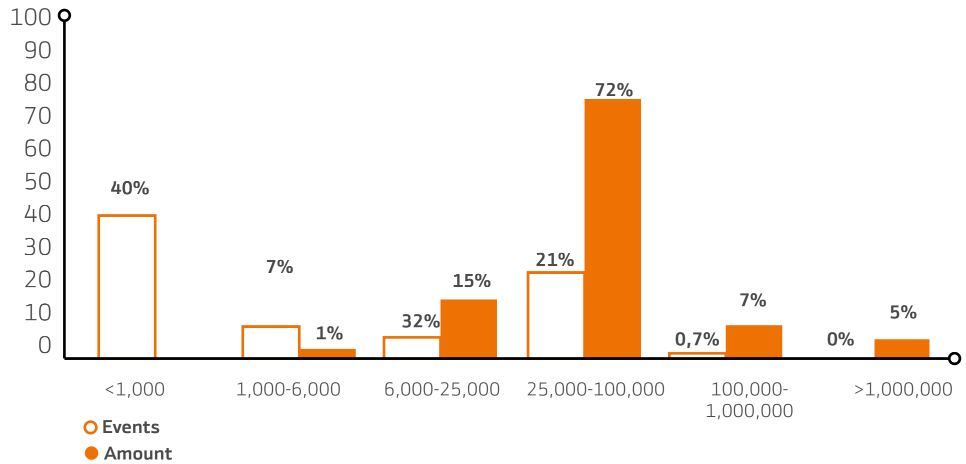
A profile focused on the retail business

Operational risk is the possibility of incurring losses from failed internal processes, people and systems or from external events (e.g. natural disasters), including legal risks.

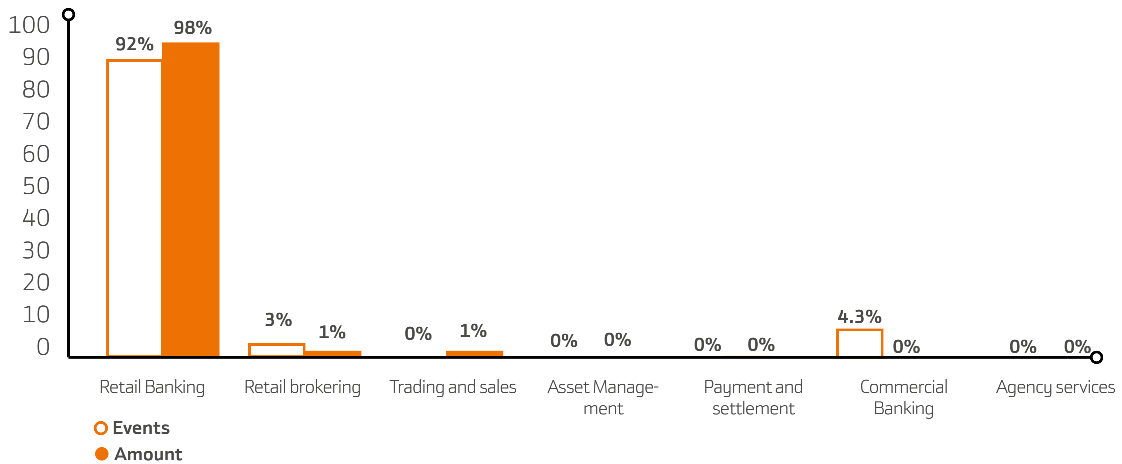
Bankinter's operational risk management model is the "standardised approach" according to prevailing solvency regulations. This method requires the existence of systems for identifying, measuring and managing operational risks with prior authorisation by Banco de España and an annual audit. Bankinter ensures access to best sector management practices by participating in the Spanish Operational Risk Consortium (Consorcio Español de Riesgo de Operacional), a forum of financial institutions for sharing experiences regarding operational risk management.

With regard to loss events in the year, Bankinter's operational risk profile is summarised in the following charts.

Percentage breakdown by amount intervals



Percentage breakdown by line of business



More detailed information on these risks can be found in the Prudential Relevance Report, in the Group's Consolidated Legal Report and the Annual Corporate Governance Report.

Reputational risk

All together to prevent and control

Reputational risk is the risk arising when the expectations of stakeholders (e.g. customers, shareholders, employees, investors) are not met and their reaction can adversely affect existing or future business relationships with them.

The aim of reputational risk management is to prevent the risks, identifying and controlling them pro-actively to reduce their probability of occurrence and mitigate their impact. The entity has various tools at its disposal for this:

- Regular measurement of the perception and expectations of the entity's main stakeholders based on RepTrak®, the international standard for reputation measuring and management.
- Monitoring and analysis of mentions of the entity in conventional and social media, in addition to active listening to gauge trends in the market and environment.
- Assessment of reputational risk before marketing a product or outsourcing a service.
- Monitoring and quarterly reporting to senior management of metrics for each stakeholder.
- Crisis management protocol to preserve reputation and business continuity.

All employees are responsible for safeguarding the entity's reputation, guided by a number of professional conduct and ethics manuals. Therefore, training and awareness of all staff is crucial for creating a strong internal culture of prevention.

As a collective body with a basic remit in this respect, the entity has a cross-cutting brand and reputation committee led by the Chairman.

One of the biggest challenges with this type of risk is financial quantification. Several improvements were made to the economic valuation model over the course of 2019.

Regulatory Compliance

An ethical commitment to adapt the business

The Bank must achieve its business objectives while complying not only with regulations, but also the best practices and standards required of its operations. This issue therefore represents not only a legal obligation for Bankinter, but also an ethical commitment.

This commitment also serves as an opportunity to reflect, for Bankinter to become a leading institution adapted to the new reality of the finance industry, which is subject to the need to change relationships with customers and adjust the Bank's business model in line with new financial consumption habits and multiple reporting requirements.

The growing importance of regulatory compliance has been underlined with the entry into force, as a result of the economic and financial crisis, of several highly complex regulations and the launch of the new supervisory architecture, obliging the Bank to strengthen its available resources.

Purpose

The purpose of the compliance function is to assess and provide guidelines for the lines of business that help define its strategy, ensuring compliance with applicable legislation at all times. With this purpose, all areas in the compliance functions go to great lengths to train commercial staff.

The regulatory compliance function is integrated within Bankinter through an internal institutional framework. The head of the Regulatory Compliance, Regulations and Corporate Governance Division reports to the Audit and Regulatory Compliance Committee of Bankinter's board of directors. It is attached to the office of the General Secretary, through which it is integrated with the rest of the organisation, thereby guaranteeing close cooperation with the rest of the senior management areas, especially the Risks area, and the Legal Counsel department.

In particular, it serves on the following bodies of the Bank:

- **Regulatory Compliance Committee.** This is the senior management body that monitors the Bank's compliance policies according to the bylaws of the Regulatory Compliance function. The committee executes the policies in relation to the regulatory and regulatory compliance matters that are established by the audit and regulatory compliance committee of the board of directors.

- **The products committee.** This committee approves the launch, modification or cancellation of products and services offered to customers. In 2019, new approval and review procedures for the Group's products and services were included in the internal rules and regulations. The objective, in addition to complying with the regulatory requirements, is to ensure that the products and services are directed at the right target audience and that they offer sufficient quality and control guarantees.

- **The internal control body.** Establishes, and ensures compliance with, anti-money laundering and terrorist financing policies, according to Law 10/2010 and its regulatory implementation.

This organisational structure enables the Bank to adequately manage the risk of failing to comply with regulations, which also entails significant reputational risk, with a potentially adverse impact on relations with customers, markets, employees and the authorities. In particular, failure to comply with regulations may lead to sanctions, damages or cancellation of contracts, thereby hurting the Bank's image.

Regulatory map

In 2018, the Bankinter Group assigned the management of regulatory change competencies to the Regulatory Compliance Division through the Regulation area. This decision was ratified throughout 2019, facilitating the early detection of the possible impact of regulatory changes and reducing the corresponding risks. Therefore, the Regulation area drew up a three year regulatory map that serves as the basis for the regulatory strategy. The management of the regulatory change was carried out transversally throughout the year, participating in different projects that required the adaptation of Group activities or processes. These include the new regulation on basic payment accounts, the Real Estate Credit Act, the regulation governing transparency in payment services and cross border payments with foreign exchange, prevention of money laundering, and other changes in the area of insurance, outsourcing and advertising for banking products and services.

The entry into force in 2019 of the rules for transposing the MiFID II directive stands out. This was instrumented as an amendment to Regulation 217/2008 on investment service firms, which required the Group to seek advice on the adaption work, analysis and decisions. The deployment of the PSD2 payment service regulation required changes to be made in processes and technologies to ensure the protection and security of the transactions, and their users.

In another area of activity, Bankinter's adaptation to the new Real Estate Credit Act should be noted, which strengthened customer protection in relation to credits for the acquisition of residential property. Regulatory Compliance also played a direct role in the adaptation to the new obligations, not only with regard to customers but also in the accreditation of personnel directly involved in providing the service.

Another major regulatory change derived from the Regulation of Benchmark Indices, which includes changes to the indices (transition from Eonia to Ester, new Euribor methodology and different IBOR substitutions).

The Regulatory Compliance unit took part in the project to adapt to the new regulations included in the legislative package of the European Commission's Sustainable Finance Action Plan, which aims to strengthen the role of finance to build an economy that allows environmental and social objectives to be achieved.

Beyond purely regulatory changes, the growing supervisory and interpretation activity with regard to recently implemented rules, such as MiFID II and PRIIPS, stands out.

Two main areas

Under this regulatory and institutional framework, the Bank developed the two basic areas of the compliance function in 2019:

- **Control and advisory tasks in the area of regulatory compliance for investment products.** Bankinter has implemented a methodology based on the risk approach that enables the risk of default in each area of activity to be assessed in relation to the provision of investment and banking services.

- **Prevention of money laundering and terrorist financing.** 2019 featured reinforcement of control frameworks in terms of both KYC (know your customer) and controls applying to international financial sanctions and correspondent banking. Preventing these practices is a strategic objective for Bankinter Group and an ethical commitment to society at large, reflected in compliance with international standards and best practices in the area. In line with this objective, in 2019, Bankinter developed the control measures needed to adapt to the regulation and aligned the corresponding risk with its risk appetite framework, in addition to the IT tools for this function.

Another major advance was the implementation of a methodology and culture of compliance common to all Group entities, in the regulatory area and the management of regulatory risk, product governance and the prevention of money laundering.

Outlook

In 2020, the Bank's adaptation to regulations on payment services and advertising for banking services and products will be complete. It must also adapt to the regulatory framework deriving from the transposition of Directive 2017/828 as regards the encouragement of long-term shareholder engagement, and Directive 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.

Further, the adaptation of Royal Decree Law 11/2018, which transposes the 4th European Directive on the prevention of money laundering and terrorist financing and the due diligence measures with customers will be updated, in addition to the continuous monitoring of the business relationship, according to the legally established terms.

Other regulatory requirements for 2020 deriving from the Insurance Distribution Directive (IDD) and European Union Action Plan for Sustainable Finances.

Information Security

Advanced technology against a growing threat

Information security is a great priority at Bankinter. In this sense, in 2019, projects were carried out under the Information Security Director Plan, which has been extended to 2021. The aim is to guarantee high levels of confidentiality, integrity and availability for customers, employees, shareholders and suppliers.

The growing importance of information security highlights the rapid expansion of cybercrime, the activities of which have evolved and become much more dangerous. Initially it involved the actions of individual hackers, who were not only motivated by money. Nowadays, cybercrime has created large and sophisticated business structures that are capable of attacking entire economic sectors.

The theft of confidential big data from companies, the denial-of-service attacks and phishing (using the identity of companies or public bodies in order to obtain confidential information from the victim), access to Swift or ransomware, are the main strategies used by cybercriminals.

Financial institutions are particularly exposed to this kind of manipulation and fraud as a result of their permanent contact with the public and the nature of their business, part of which involves payment systems.

A stronger model

The model for the fight against cybercriminals is based around three lines of defence: the first line is technology, business, operations, etc.; the second line is made up of risk control and Regulatory Compliance bodies; and the third line is the Internal Audit department.

From an organisational viewpoint, a new model was implemented in the first line in 2018 within the Data Security Department consisting of three management areas: technological risk, cybersecurity and security monitoring, and prevention of electronic fraud.

Based on this reinforced risk structure, in 2019, Bankinter embarked on a series of more complex projects, using advanced technology, with a focus on protection for email, browsing, final data for users and above all suppliers.

The activity of the area is completed by the development of awareness plans for users, who are the weakest link in the security chain. The Bank provides online training programmes for employees and carries out simulations to obtain confidential information (passwords, personal details, etc.) through emails, text messages or telephone calls. The aim is to discover their reaction in situations that can be exploited by cybercriminals. The awareness raising exercise also includes external staff.

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