Risk Management

Risk Management

Risk is broadly defined as the possibility that an uncertain event or outcome results in adverse variations of profitability or in losses. Risks might also negatively impact the strength of the Group's balance sheet, its market capitalisation or its brand and reputation. In the process of performing its function as a financial intermediary, the Group exposes itself to various categories of risk, such as credit risk, asset and liability management risk (including market and liquidity risk), operational risk and other risks.

Within its risk appetite and tolerances and in accordance with its strategic objectives, the Group takes and manages risks and controls and monitors them prudently. The Group actively, comprehensively and systematically manages risk and promotes a strong risk and control culture across all business areas. The established risk management process comprises four core elements:

- Identification of risks across all business activities;
- Assessment and measurement of risks, including stress testing;
- Limitation and mitigation of risks; and
- Effective controls, monitoring and reporting.

Risk Governance Structure

The Board of Directors is ultimately responsible for determining the Group's risk strategy, risk appetite and corresponding tolerance levels. It has established an effective internal control system that: (i) ensures that material risks are assessed and controlled; (ii) oversees the Group's risk profile to ensure it is correctly monitored and managed; and (iii) ensures the correct implementation of the risk management framework and strategies.

The Group has set regulations governing the risk management and control processes to ensure that all material risks are recorded and supervised. These processes are supported by a framework of approved policies and directives, which describe the principles guiding the Group's attitude to risk and its appetite for the amount of risk willing to accept.

The Group has established a risk appetite framework including integrated tolerance limits to control overall risk taking. It contains a diverse set of quantitative metrics and qualitative statements across various risk categories and serves as a decision making tool for the Management Board. As part of the Group Risk Policy, it is annually reviewed by the Board of Directors and takes into account strategic objectives and business plans. The risk profile is assessed versus the risk appetite, and risk exposures are monitored versus risk tolerance limits on a regular basis. Summary reports are reviewed by the Audit and Risk Committee and reported to the Board of Directors.

Three working committees have been established. Attendance of the members of the Management Board is required on regular committee meetings:

Committee	Risk category
Credit Committee	Credit Risk
Asset & Liability Management Committee (ALCO)	Asset & Liability Management, Market & Liquidity Risk, Capital Management
Risk & Controllership Committee (RCC)	Risk Framework, Internal Control System, Compliance & Operational Risk Management, Information Security, Data Privacy, Business Continuity Management

The Group's risk and control framework operates along three lines of defence:
- First Line: business functions are responsible for ensuring that a risk and control environment is established and maintained as part of day-to-day operations;
- Second Line: control functions provide independent control and oversight of risks; and
- Third Line: the Internal Audit function evaluates the overall effectiveness of the control environment and provides additional independent assurance.

The Group's adoption of the three lines of defence model ensures the segregation between the direct accountability for risk decisions, the setting and oversight of risk management and the independent assurance on the effectiveness of risk management. Internal policies and directives further detail the expected principles of risk management and control for each risk category.

Credit Risk

Credit risk is the risk to earnings or capital that may arise from the potential that a borrower or counterparty may fail to honour their contractual obligations. The obligations include, for example, principal repayment, interest and fees. A consequent loss may be partial or complete and may arise at any time from a number of isolated or interlinked circumstances. The Group is exposed to credit risk on all its lending products.

The Credit Committee serves as the main decision-making body for credit strategies and exposures and regularly reviews the Group's credit risk performance. The Credit Committee is responsible for making credit decisions on individual counterparties and credit programmes which are not within the authority delegated to the Chief Risk Officer (CRO) or specific subsidiaries, but within the authority determined by the Board of Directors. The Credit Committee is chaired by the CRO.

The guidelines for the approval of credit programmes, as well as the individual counterparty credit approvals are described within the credit risk policy. Delegated credit competency authorities are actively monitored and reviewed regularly.

The Group maintains stringent underwriting processes, which are continually monitored and optimised to ensure that credit risk is adequately managed. Prior to granting credit, the customer's creditworthiness, credit capacity and, where applicable, collateral are assessed. The customer's creditworthiness is evaluated by an automated credit risk rating system, including usage of scorecards, by leveraging available information about the customer. This ensures consistent and systematic decision-making across all lending products.

The credit capacity of consumers is further evaluated according to the legal regulations of the Swiss Consumer Credit Act where applicable. Internal models determine the credit amount based on the risk profile of the customer. Manual underwriting complements the automated system decision in cases where additional information may be required.

The quality of portfolios and specific customer segments are thoroughly and periodically assessed. The quality and performance of new business is monitored to ensure that the credit approval process continues to effectively mitigate credit risk, and underwriting procedures are being correctly followed. Scorecards are regularly monitored and backtested to ensure their performance remains within expected levels and, if required, model changes are implemented. Segmented collection strategies are implemented to tailor activities to customer groups with different payment behaviours and to ensure optimal resource allocation and effective mitigation of credit risk.

For its lending products, the Group uses consumer ratings (CR) to assess overall credit quality. There are five consumer ratings, each having an implied probability of default based on historical default experience, with a default definition of 90 days past due. The Group's financing receivables (before allowance for losses) at 31 December 2018 and 2017 are distributed along the CR as follows:

At 31 December 2018	Personal loans	Auto leases and loans	Credit cards	Total [1]
CR1	51.1%	51.6%	74.2%	56.0%
CR2	29.6%	32.7%	18.8%	28.7%
CR3	16.3%	12.8%	6.3%	12.9%
CR4	2.6%	2.1%	0.6%	2.0%
CR5	0.3%	0.7%	0.0%	0.4%

[1] Does not include eny Credit GmbH, Swissbilling SA and Swiss SME Loans 2018-1 GmbH. There is no material impact on the Group's consumer rating of the total financing receivables.

At 31 December 2017	Personal loans	Auto leases and loans	Credit cards	Total [1]
CR1	47.7%	52.1%	75.8%	54.8%
CR2	29.9%	32.6%	18.2%	28.9%
CR3	17.8%	12.6%	5.5%	13.3%
CR4	4.1%	2.1%	0.5%	2.6%
CR5	0.6%	0.6%	0.0%	0.5%

[1] Does not include eny Credit GmbH and Swissbilling SA. There is no material impact on the Group's consumer rating of the total financing receivables

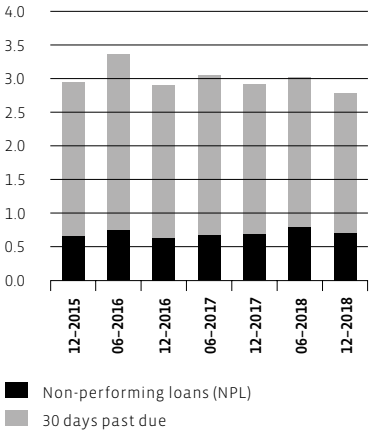
More details on CRs and implied probability of default are described in the Consolidated Financial Statements on page 108.

The Group's customer base comprises primarily of natural persons and small and medium sized enterprises. Concentration risks are regularly assessed and monitored. The large number of borrowers naturally results in a broad credit risk diversification.

Credit risk in specific portfolios is also monitored through asset quality metrics such as delinquency metrics that are further described on page 107. The historic trend is indicated in the below graphs:

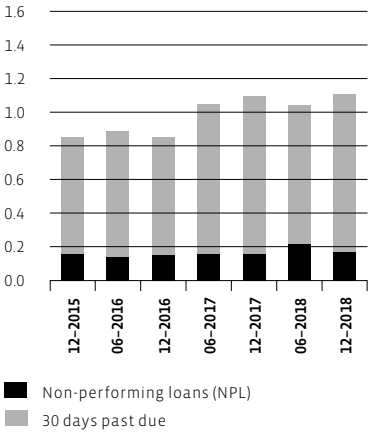
Personal Loans

Delinquencies in %



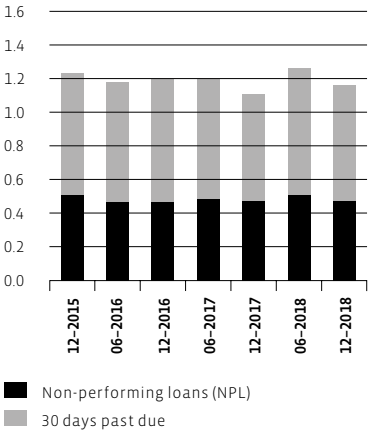
Auto Leases and Loans

Delinquencies in %



Credit Cards

Delinquencies in %



Credit risk metrics, portfolio and collection performance reports, as well as macroeconomic trends, are reviewed on a monthly basis by the Credit Committee. Summary reports of the Group's credit risk profile are reviewed by the Audit and Risk Committee quarterly and reported to the Board of Directors.

ALM, Market and Liquidity Risk

Asset and liability management (ALM) forms part of the Group's risk management framework and can be considered as the coordinated management of various inherent risk types, such as liquidity, funding and market risk, in order to achieve the Group's objectives whilst operating within prudent and predetermined risk limits and concentrations. The ALCO is the decision-making committee for asset and liability management activities and has overall responsibility for the administration of respective policies, their monitoring and reporting. The ALCO is chaired by the CFO.

Liquidity and Funding Risk
Liquidity risk is defined as the risk of the Group not having sufficient funds, or only being able to secure them at excessive costs, to meet contractual obligations when they fall due and support normal business activities. The Group recognises that liquidity risks are often consequential rather than isolated in nature and arise from the materialisation of other risk types such as strategic, reputational, credit, regulatory, or macroeconomic.

The Group's liquidity risk appetite is defined by the Board of Directors and forms the basis for the Group-internal liquidity risk management strategy, the liquidity-related directives and the risk steering and control process.

With a listed entity at the top, the Group aims to maintain a highly conservative liquidity profile; this approach is viewed as an essential safeguard in protecting the reputation of the Group as a stable institution. The Management Board ensures that adequate liquidity levels are maintained to meet operational and regulatory requirements under normal and stressed conditions. Excess liquidity can be invested with two principal objectives in mind: principal preservation and liquidity management.

The Group maintains a robust stable funding structure. In order to withstand an extended period of limited access to the wholesale funding markets, the Group proactively seeks to reduce reliance on short term, potentially volatile sources of funding. The Group actively averts building up concentration risk and strategically diversifies its investor base across different business sectors, by individual counterparty, by maturity buckets and across various categories of debt instruments.

For effective risk controlling, the overall condition of funding markets is regularly monitored and assessed against market-wide and Group-specific early warning indicators to ensure the Group's ability to access funding. This is intended to provide management with timely warning of events that might have a potential unfavourable impact on its access to funding in the near future and, in turn, increase liquidity risk. Consequently, the Group has developed a comprehensive liquidity stress testing process, to ensure it can adequately manage its liquidity during times of market stress of differing, yet plausible, magnitudes. This ensures the Group has sufficient controls and mitigation procedures in place to prevent or alleviate the consequences of stressed market conditions. The Group's contingency funding plan is influenced by the results of stress-testing scenarios and integrated into the Business Continuity Management (BCM) framework. The plan is tested annually, and results are reviewed within ALCO and reported to the RCC. Stress-testing results along with other regulatory liquidity measures, such as minimum reserve, liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) are an essential component to the Group's liquidity management and are reviewed regularly by the ALCO and the Board of Directors. The Group's average LCR for 2018 was 766%, well above the 2018 regulatory requirement of 90% and the 2019 requirement of 100%. The NSFR complements the LCR as part of the liquidity regulations under Basel III. The Group's NSFR as of 31 December 2018 is 112%, above the recommended level of 100%.

Further quantitative information is contained in the separate document "Capital Adequacy and Liquidity Disclosures 2018" published on the Cembra website (www.cembra.ch/en/investor → Reports and Presentations → Financial Reports).

Market Risk
Market risk encompasses the risk of financial losses due to adverse movements in the market prices. The Group's business model leads to a limited exposure to market risk factors. The Group's main source of market risk is interest rate risk in the banking book (IRRBB). IRRBB is the current or prospective risk to the Group's capital and earnings arising from adverse movements in interest rates. Movements in interest rates might change the underlying value of assets, liabilities and off-balance sheet items and hence its economic value. They might also affect net interest income and earnings by altering interest rate sensitive income and expenses. Excessive IRRBB can pose a significant threat to a Group's current capital base and/or future earnings if not managed appropriately. The Group has implemented an effective interest rate risk management framework to limit potential effects on the Group's current capital base or future earnings and to keep interest rate risk at an acceptable level.

Due to the Group's predominately fixed interest rate assets and liabilities, it is mainly exposed to repricing risk. This is the risk of adverse consequence due to increasing or decreasing interest rates because of difference in time of when these rate changes affect the Group's assets and liabilities. The Group faces relatively low option and basis risk. Consequently, the Group focuses IRRBB monitoring on repricing risk.

The Group actively manages and monitors IRRBB performance against internally defined triggers. As per the regulatory requirement, the Group applies different interest rate shock scenarios and reports the impact on the economic value of equity (lifetime) and net interest income (next 12 months) on a weekly basis. As of 31 December 2018, the Group does not employ hedging instruments to manage IRRBB.

Another type of the market risk is the foreign exchange (FX) risk which is defined as the financial risk from adverse movements in the exchange rate on operations denominated in a currency other than the base currency of the institution. The Group operates predominantly in the Swiss consumer lending market, borrows and lends exclusively in Swiss francs. Therefore, the foreign exchange risk exposure of the Group is minimal and is limited to supplier invoices denominated in foreign currencies. FX exposure is monitored closely against internally set triggers, and the Group would take immediate corrective action if limits are exceeded. As of 31 December 2018, the Group does not use hedging instruments to manage its FX risk.

Capital Management

One of the Group's principal management goals is to maintain strong capitalisation by pursuing a prudent approach to balance sheet growth and implementing a balanced dividend payment strategy.

Methodology for Calculating Minimum Required Capital
The Group uses International standard approach ("SA-BIS" approach) as described in the Basel Minimum Standards, which are the standards defined by the Basel Committee on Banking Supervision and relevant for calculating the capital adequacy requirements. The standardised approach is used for Credit Risk, Market Risk and Operational Risk. Thus it also fulfils the qualitative and quantitative requirements of the Ordinance on Capital Adequacy and Risk Diversification for Banks and Securities Dealers (CAO, SR 952.03).

Capital Adequacy Ratio
As of 31 December 2018, the applicable regulatory requirements for a category 4 bank are set by FINMA at 11.2%. The Group aims to consistently operate at a capital base that is well above this mark, defining an internal trigger of a minimum Tier 1 capital ratio of 18% on a Group basis. Compliance with this trigger is monitored at the monthly ALCO meeting. As of 31 December 2018, the Group's Tier 1 capital ratio was 19.2%.

Leverage Ratio
The Basel Leverage standard supplements the Basel III risk-adjusted capital standards and serves as a backstop. The leverage ratio compares the Group's equity against its total asset base (considering off-balance sheet items) without any risk adjustment. As of 31 December 2018, the Group's leverage ratio was 14.7%, well above the recommended 3.0%.

Further quantitative information is contained in the separate document "Capital Adequacy and Liquidity Disclosures 2018" published on the Cembra website (www.cembra.ch/en/investor → Reports and Presentations → Financial Reports).

Capital Planning
The Group prepares a three-year capital plan annually and assesses the impact of several stress scenarios. As per FINMA requirement, the Group assesses its resilience to adverse macroeconomic conditions. In the 2018 stress test, the Group forecasted that it would be in a position to meet the minimum regulatory capital adequacy ratio prescribed by FINMA even under a prolonged severe stress scenario. The capital plan as well as the output of the stress tests are approved by ALCO and presented to the Board of Directors.

Operational Risk and Other Risks

Operational risk is defined as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. The Group recognises the importance of the effective management of operational risks and has implemented a robust framework and appropriate processes to manage them.
Key instruments include:
- Operational Risk Assessments: regular identification and assessment of the likelihood and potential impact of operational risks;
- Control catalogue: execution of a set of documented controls aligned with business processes and their inherent risks;
- Key Risk Indicators: regularly monitored risk metrics that serve as early warning indicators for potentially material operational risks;
- Loss Data Collection: historical dataset of loss events used to identify operational risks deriving from process inefficiencies or control gaps; and
- External Events Analysis: external operational risk events applicable to the Group's risk profile analysed to identify emerging risks and evaluate controls.

The Group is exposed to a wide variety of operational risks, including technology and cybersecurity risk that stem from dependencies on information technology or third-party suppliers. The Group acknowledges the evolving cyber risk landscape and therefore developed a comprehensive framework to effectively manage and control this type of risk. This framework addresses regulatory requirements, is based on international standards and is supported by a cybersecurity strategy that aims for cyber resilience. A set of cyber threats is regularly assessed, and corresponding measures are considered. Specific response plans are maintained for cases where this type of risk materialises. Information security, data confidentiality and integrity are of critical importance, and the Group has implemented a comprehensive framework aiming to ensure the protection of client identifying data and related information technology systems. This includes both the specific training of relevant staff and making use of vulnerability and penetration tests to protect sensitive data and systems.

The Group is aware that severe events beyond its control (such as natural disaster) may result in an inability to fulfil some or all of its business obligations, particularly where its physical, telecommunications or IT infrastructure would be damaged or made inaccessible. In compliance with the Recommendation for Business Continuity Management (BCM) issued by the Swiss Bankers Association, the Group has implemented a BCM programme, including the identification of critical processes and their dependency on systems, applications and external vendors. The Group's BCM framework encompasses planning, testing and other related activities. The framework aims at ensuring that business-critical functions will either continue to operate in spite of a serious incident, or will be recovered to an operational state within a reasonably short period of time after such an incident occurred. Comprehensive crisis management plans are maintained that define processes to be followed in case of a business emergency. This aims to safeguard the continuity of the Group's business critical activities and to control major damages in the event of a significant business interruption. The status of the BCM programme and results of the disaster recovery and business continuity tests are reviewed by the RCC.

The Group has chosen to use external service providers to support its business activities. With the implementation of directives governing this area and an ongoing monitoring process, the Group ensures compliance with relevant regulatory requirements.

Compliance risk is the risk of legal or regulatory sanctions, reputational damage and financial forfeiture or material loss deriving from violations of laws and regulations, internal policies or prescribed best practice, professional and ethical standards. The Group is exposed to this type of risk as a consequence of being a market participant in the financial services industry with its legal and regulatory requirements and their respective evolvement. For operational independence, the Group has a separate Legal & Compliance function. It effectively manages, controls, monitors and reports legal and compliance risks and ensures that the Group's business activities adhere to all relevant legal requirements, regulatory standards and requirements for effective corporate governance. The Group acknowledges the increasing importance of behavioural compliance related to conduct risk in the banking sector and addresses this within the provisions of the Group's Code of Conduct.

Strategic risk is defined as possible losses that arise from uncertainties or untapped opportunities inherent in the Group's strategic intent. Reputational risk is the risk of losses resulting from damages to the Group's reputation. The Management Board directly manages and supervises strategic risk, business risk and reputational risk. Recognising the fact that reputational risk can be difficult to quantify and arises as a consequence of another materialised risk, the Group manages reputational risk jointly with other risks by assessing the inherent reputational impact.