controls. The functions attributed to this line under the control framework are:
— Maintaining effective internal controls and performing risk assessment and control procedures on a daily basis;
— Identifying, assessing, controlling and mitigating risks, following established internal policies and procedures and ensuring that activities are consistent with the bank's targets and objectives;
— Establishing proper management and supervision processes to ensure regulatory compliance and focusing on control errors, inadequate procedures and unexpected events.

Second line of defence, consisting mainly of:
— The risk control function, which is independent from the first line of defence and is responsible for assessing, monitoring and controlling the Group's significant risks and for providing information about such risks.
— The internal validation function, which is responsible for checking that these models work as expected and that their results are appropriate to their uses, both internal and regulatory.
— The Regulatory Compliance, Corporate Social Responsibility and Corporate Governance Department, whose goal is to minimise the possibility of regulatory breaches and ensure that any breaches that occur are diligently identified, reported and resolved and that the appropriate preventive measures are implemented.
— The IT Control Department is responsible for identifying risk situations associated with the use of technology, across all units in the Group, that may give rise to operational or reputational risks for the Group. It also promotes the necessary training and support to enable the Group's units to resolve risk situations within their scope of responsibility and action, and transfer, on an independent basis, any significant risks that have not been covered by the implemented controls to the Group's Operational Risk Department.

In general, the second line of defence ensures that the first line of defence is well designed, fulfils the functions assigned to it and puts forward suggestions for continuous improvement. The essential functions attributed to this line under the control framework are:
— Proposing the risk management framework.
— Guiding and ensuring the application of the risk policies, defining responsibilities and objectives for their effective implementation.
— Verifying compliance with regulations applicable to the Group in conducting its business activities.
— Providing the technological infrastructure for risk management, measurement and control.
— Analysing and cross-checking existing and future incidents by reviewing the information.
— Identifying changes in the organisation's underlying risk appetite.
— Collaborating with the management team to develop risk management processes and controls.

Third line of defence:
— The Internal Audit Department engages in verification and advisory activities on an independent and objective basis, governed by a philosophy of adding value and helping the Group to fulfil its objectives.
— It provides assistance to the Group in meeting its objectives by providing a systematic, disciplined approach to evaluate the sufficiency and effectiveness of the organisation's governance processes and the risk management and internal control activities.

Managing and monitoring the main risks

Credit risk

Definition

Credit risk arises from the possibility of losses arising from defaults on payment obligations by borrowers, as well as losses of value due to impairment of the borrowers' credit rating.

Credit risk management framework

Risk acceptance and monitoring

Credit risk exposure is subjected to rigorous monitoring and control through regular reviews of borrowers' creditworthiness and their ability to meet their obligations to the Group, with exposure limits for each counterparty being adjusted to levels that are deemed to be acceptable. It is also normal practice to mitigate exposure to credit risk by requiring borrowers to provide collateral or other surety to the bank.

The Board of Directors delegates powers to the Executive Committee, which can then sub-delegate authority at each level. The implementation of authority thresholds for credit approval ensures that powers delegated at each level are linked to the expected loss calculated for each business loan or other transaction that is requested.

To optimise the business opportunities that each customer represents and to guarantee an appropriate degree of security, responsibility for monitoring risks is shared between the relationship manager and the risk analyst; effective communication between them provides a comprehensive view of each customer's individual circumstances.

The relationship manager monitors the business aspect through direct contact with customers and by handling their day-to-day banking, while the risk analyst takes a more system-based approach using their specialised knowledge.

The implementation of advanced methodologies for managing risk exposures (adapted to the New Basel Capital Accord - NBCA - and industry best practice) also benefits the process in ensuring that proactive measures can be taken once a risk has been identified. Of vital importance in this process are rating tools such as credit ratings for corporate borrowers and credit scoring for retails customers, as well as early warning indicators for monitoring risk.

By analysing indicators and early warning alerts and reviewing credit ratings, the quality of a risk can be monitored continuously in an integrated way. The establishment of efficient control procedures for outstanding risks also provides benefits in managing past-due risks as it enables a proactive policy to be implemented based on early identification of cases that may default.

The early warnings system allows an integrated measurement to be made of the quality of a given risk and enables it to be transferred to recovery specialists, who will determine the procedures that should be applied. Therefore, based on risks exceeding a certain limit and on the predicted default rates, groups or categories are identified for individual treatment. These warnings are managed by the relationship manager and the risk analyst.

Managing non-performing risks

Debt refinancing and restructuring are generally the main risk management techniques during the weaker stages of the economic cycle. In the case of debtors or borrowers that have, or are expected to have, financial difficulties in meeting their payment obligations in the contractual terms, the Bank's objective is to facilitate repayment of the debt by minimising the likelihood of non-payment. A number of specific policies to achieve this are in place, including procedures for the approval, monitoring and oversight of debt refinancing and restructuring processes, principally:

— Having a sufficiently detailed compliance record for the borrower and evidence of a clear intention to repay the loan, assessing the time-frame of the financial difficulties being experienced by the customer.
— Refinancing and restructuring conditions based on a realistic payment scheme which is in line with the borrower’s current and predicted payment capacity, i.e. not just postponing problems to a later date.
— If new guarantees are provided, these must be regarded as a secondary and exceptional means of recovering the debt, so as to avoid impairing the existing means. All ordinary interest accrued up to the refinancing date must be paid in any event.
— Limitations on grace periods.

The Group continually monitors compliance with current terms and conditions and with these policies.

The Banco Sabadell Group also has an advanced model for managing non-performing exposures. The purpose of managing non-performing exposures is to identify the best solution for the customer as soon as there are any signs of impairment so as to avoid classifying customers in difficulties as being in default by working the problem intensively and avoiding lags between phases.*

Real estate loan risk management

As part of its ongoing risk management and, in particular, its policy on the construction and real estate sectors, the Group has a number of specific policies for mitigating risks.

The main measures that are implemented are continuous risk monitoring and reassessment of the borrower's creditworthiness in their new circumstances. If the borrower is found to be creditworthy, the existing arrangements are continued as originally agreed, and compromise solutions are agreed upon if they offer a better fit to the customer's new circumstances.

The policy varies as a function of the type of asset that is being financed. For completed property developments, sale support actions are carried out through the Group's distribution channels, by setting a competitive price which will attract demand and by offering finance to end buyers provided that they comply with risk requirements. For construction projects in progress, the main objective is to complete the project, provided that short- and medium-term market prospects are sufficient to absorb the resulting supply of dwellings.

In terms of financing for land and plots, the possibility of selling the future homes is also considered before financing their construction.

Where the analysis and scrutiny of a borrower’s position do not indicate a reasonable degree of viability, the solution may take the form of a surrender of assets in settlement of the debt ("dation in payment") and/or the purchase of assets.

Where neither approach is practicable, legal proceedings leading to foreclosure will be taken.

All assets taken into possession by the Group, whether through the dation in payment, purchase, or court-ordered repossession, to ensure collection or to execute other lending enhancements are mainly foreclosed tangible assets received from borrowers and other obligors of the Bank to settle financial assets representing a debt claim held by the bank and are managed actively with the primary purpose of divestment.

Based on the degree of maturity of the real estate assets, three strategic lines of action have been established:

*** For additional quantitative information, see the section of Note 4 dealing with "Credit risk: refinancing and restructuring operations".**

1 Marketing

Various mechanisms are available for the sale of finished products (homes, commercial premises, industrial buildings, parking lots, etc.) through various distribution channels and commercial agents, based on type, status, location and state of conservation. The real estate website www.solvia.es is a fundamental factor in this strategy.

2 Mobilisation

Given the great difficulty of selling plots of building land and unfinished projects, the mobilisation strategy for these assets was adapted to generate liquidity in the case of zoned building land, and a number of asset mobilisation mechanisms have been designed:

— Programme for working with real estate developers: providing building land in areas of high housing demand so that developers can develop and sell properties.
— Investors program: development of third-party real estate projects with the participation of investors.
— Protected housing programme: development of government-sponsored housing for rent and subsequent sale of the rented developments.

3 Zoning management:

For plots of land not yet zoned for construction, it is important to undertake the necessary processes to achieve a zoning status that allows for building, which is an important mechanism for value enhancement and is vital for any subsequent development and sale.

In the case of new lending for construction and real estate development, a series of criteria have been established as a function of the specific type of business, mainly of the different stages of project maturity and the market situation. Additionally, there is a monitoring process for this type of specialised risk, managed by business and risk experts, which covers the established alerts and the customer's behaviour in the various stages of the loan process, so that the funds are released in parallel with progress made on the building.

Due to having previously reached a high level of concentration in this risk, the Group has an RAS tier-1 metric which establishes a maximum level of concentration for real-estate development in Spain. This metric is monitored on a monthly basis, and is reported to the Risk Technical Committee, the Risk Committee and the Board of Directors.

Moreover, the Risk Control Department, together with the Business and Risk Departments, regularly monitors the degree to which new lending conforms to the framework established for property developers, including a review of compliance and of asset allocation. The outcome is reported to the Risk Technical Committee.*

* For additional quantitative information, see the section of Note 4 dealing with "Credit risk: Risk concentration, exposure to construction and real estate sectors".

Risk management models

Credit rating

Credit risks incurred with corporates, developers, specialised funding projects, financial institutions and countries are rated using a rating system based on predictive factors and an internal estimate of the probability of default.

The rating model is reviewed annually based on an analysis of behaviour patterns in defaulted loans. Each internal rating score is assigned to a projected default rate which allows consistent comparisons to be made across segments and with the ratings produced by independent rating agencies, according to a master scale (G5).

Scoring

In general, credit risks undertaken with individual customers are rated using scoring systems based on a quantitative model of historic statistics to identify meaningful predictive factors. In geographies where scoring is used, it is divided into two types:

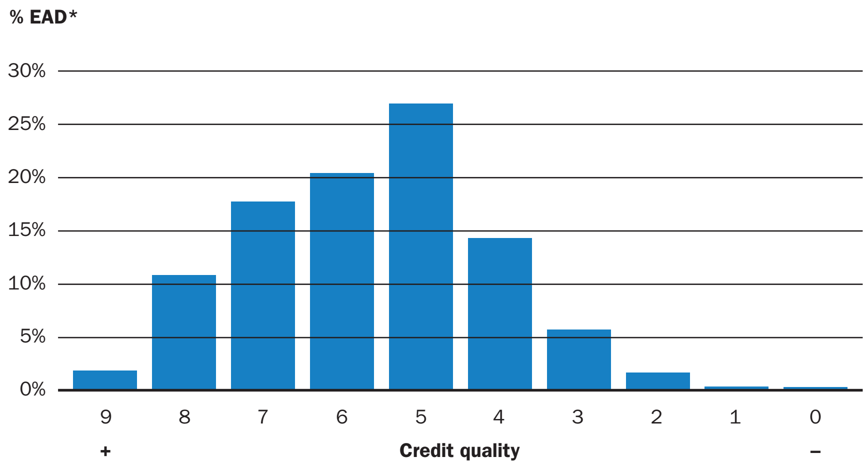
Behavioural scoring: the system automatically classifies customers based on information regarding their activity and each product. It is used primarily for such purposes as granting loans, setting overdraft limits, targeting sales campaigns, and for monitoring and segmenting in claim and/or recovery procedures.

Reactive scoring: this is used to evaluate applications for personal loans, mortgage loans and credit cards. Once all the transaction data has been entered, the system calculates a result based on the estimated creditworthiness and financial profile and any collateral.

If no scoring system exists, it is replaced with individual assessments supplemented with policies (G6).

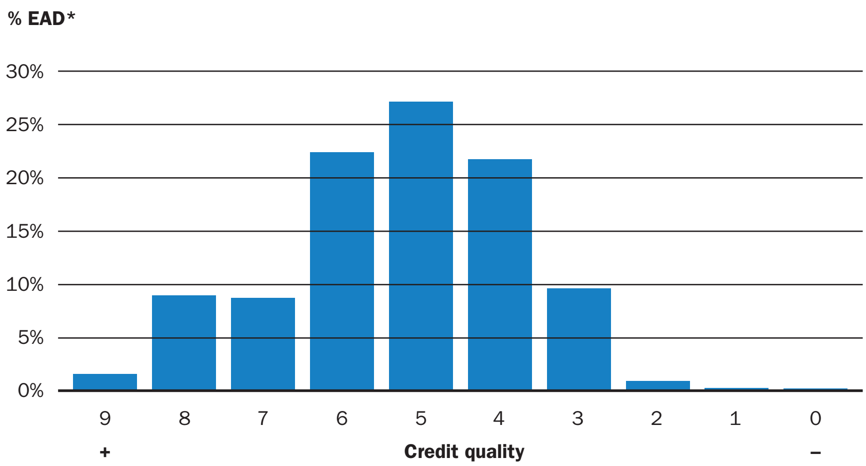
Warning tools

In general, Banco Sabadell Group has a system of early warnings comprised of both individual warnings and advanced early warning models in place for both corporates and private individuals. These early warnings are based on indicators obtained from available sources of information (rating or scoring, customer files, balance sheets, CIRBE — Bank of Spain Central Credit Register, industry and operating performance, etc.). They model the risk posed by a customer on a short-term basis (predicted propensity to default) and have achieved a high level



G5 Company loan rating profile

* EAD (exposure at default)



G6 Individual customer loan portfolio credit score profile

* EAD (exposure at default)

of accuracy in detecting potential cases of default. The score, which is produced automatically, is included in the monitoring process as one of the basic inputs in tracking the risk posed by individuals and companies.
This alert system allows for:

— Improved efficiency when monitoring customers with the lowest score (different cut-off points for each group).
— Early action to manage any negative change in the customer's situation (change in score, severe warnings, etc.).
— Regular oversight of customers whose situation remains unchanged and who have been evaluated by the Basic Management Team.

Credit risk exposure

Performing loans are expanding at Group level and excl. TSB in an increasingly competitive environment.

The volume of problematic assets was reduced faster than projected in the business plan.

€ million

T1

	2016		
Credit risk exposure	**Business in Spain**	**Business in other countries**	**Total**
Cash and cash balances at central banks	**6,698.32**	**4,989.93**	**11,688.25**
Derivatives	**1,642.55**	**191.94**	**1,834.49**
Debt securities	**21.16**	**4.12**	**0.03**
Central banks	—	—	—
General government	19,450.97	3,426.32	22.88
Credit institutions	612.73	319.36	0.93
Other sectors	1,099.86	379.17	1.48
Of which: Non performing loans	9.03	—	0.01
Loans and advances	**106.93**	**47.46**	**0.15**
Central banks	—	66.23	0.07
General government	9,630.50	125.38	9.76
Credit institutions	3,434.76	797.69	4.23
Other sectors	93,864.14	46,475.19	140.34
Of which: Non performing loans	9,411.04	230.85	9.64
Derivatives – Hedge accounting	**413.32**	**121.84**	**0.54**
Guarantees given	**8,314.59**	**214.76**	**8.53**
Contingent liabilities given	**17,762.58**	**7,446.10**	**25.21**
Total	**162,924.34**	**64,553.90**	**227,478.24**

Financial assets exposed to credit risk, broken down by portfolio, type of counterparty and instrument, and the areas in which the risk arose, were as shown below at year-end, indicating the carrying amount as representing the highest level of exposure to the credit risk incurred, inasmuch as they reflect the highest level of debt of the borrower at the reference date (T1).

The Group also maintains contingent risks and commitments with borrowers, materialised by the establishment of guarantees provided or commitments inherent in the credit agreements up to an availability level or limit ensuring financing for the customer when the latter needs it. Such facilities also entail the acceptance of a credit risk and are subject to the same management and monitoring systems as described above.

The collateral or other credit improvements received to ensure compliance, which are standard practice in the type of financial instruments handled by the entity, have not been deducted from the credit risk exposure value referred to above.

Figure G7 shows the distribution of credit risk across the different segments and portfolios of the Group.

Credit risk mitigation

Credit risk exposure is subjected to rigorous monitoring and control through regular reviews of borrowers' creditworthiness and their ability to honour their obligations to the Group, with exposure limits for each counterparty being adjusted to levels that are deemed to be acceptable. It is also normal practice to mitigate exposure to credit risk by requiring borrowers to provide collateral or other sureties to the Bank.

Generally, these take the form of real collateral, mainly mortgages on properties used as housing, whether finished or under construction. The entity also accepts, although to a lesser degree, other types of real collateral, such as mortgages on business premises, industrial warehouses, etc., and financial assets. Another credit risk mitigation technique that is commonly used by the entity is to accept guarantees, in this case subject to the guarantor presenting a valid certificate of solvency.

Legal certainty is secured in all these mitigation techniques, by signing legal agreements that are binding on all parties and can be enforced in all pertinent jurisdictions to ensure, at all times, that the guarantee can be executed. This entire process is subject to internal verification of the legal adequacy of these contracts, and legal opinions of international specialists can be obtained where these contracts are granted under foreign legislation.

Real collateral is formalised before a notary in the form of a public instrument to ensure enforceability vis-à-vis third parties. The public instruments referring to mortgage loans are also registered at the pertinent registry to ensure that they are fully valid and enforceable vis-à-vis third parties. In the case of pledges, the pledged goods are normally deposited with the Bank. Unilateral cancellation by the debtor is not permitted, and the guarantee remains in force until the debt is repaid in full.

Personal guarantees or bonds are established in favour of the Bank and, barring exceptional cases, are also formalised before a notary in the form of a public instrument in order to achieve the utmost legal certainty and be able to claim enforcement via the courts in the event of non-payment. They constitute an irrevocable debt claim against the guarantor that is payable on first demand.

In addition to risk mitigation through the establishment of formal guarantees between the debtors and the Bank, as a result of the acquisition of Banco CAM, the Group has an additional guarantee for a certain asset portfolio, provided by the APS, retroactive from 31 July 2011, and for a period of ten years (for more details, see Note 2 of the 2016 consolidated annual accounts).

The Bank has not received significant guarantees which it is authorised to sell or pledge, irrespective of any non-payment by the owner of such guarantees, except for those intrinsic to the treasury business, which are mostly repos with maturities of no more than three months, as a result of which their fair value does not differ substantially from their carrying amount. The fair value of the assets sold with a repurchase agreement is shown in the "Financial liabilities held for trading", under short securities positions.

Assets transferred under this mechanism amounted to €855,145 thousand and are included under repos, on the basis of their nature, in Notes 19 and 20 to the 2016 consolidated annual accounts.

The main concentration of risk in relation to all these types of real collateral or credit enhancements refers to the use of the mortgages as a credit risk mitigation technique in exposures of loans to fund the construction of homes or other types of real estate. In relative terms, the exposure secured with mortgages represents 66.1% of total customer loans and advances.

In the case of market transactions, in line with general trends, the Banco Sabadell Group also has netting rights and agreements with all financial counterparties with which it arranges derivative instruments and some collateral agreements (CSA), in order to mitigate the exposure to credit risk and avoid excessive concentration.

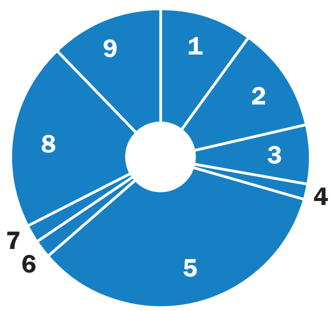
The guarantees deposited at Banco Sabadell as collateral at the end of 2016 amounted to €131 million (€218 million at the end of 2015).

*** For more information, see Note 11 "Loans and advances" in the 2016 consolidated annual accounts and the "Banco Sabadell Groupfinancial information" chapter of the Annual Report.**

Credit quality of financial assets

As stated earlier, in general terms, the Group uses internal models to rate most borrowers (or transactions) giving rise to credit risk. Such models have been designed in line with best practices proposed by the NBCA. Nonetheless, not all portfolios giving rise to credit risk use internal models, partly due to the fact that a minimum level of experience of defaults is required to reasonably design such a model. Therefore, in order to best describe the quality of the portfolio from an overall perspective, the following chart uses the Bank of Spain's rating system to analyse the Group's credit risk exposure and to estimate the requirements for hedging impairment of debt instrument portfolios (G8).

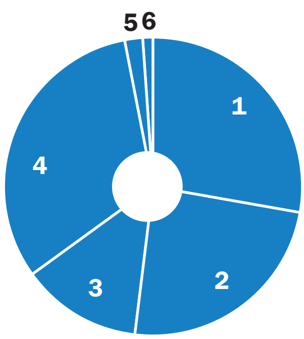
The breakdown of the total exposure, based on internal ratings, is shown in figure G9.



G7

Overall risk profile by customer category (distribution of credit risk exposure) %EAD (exposure at default)

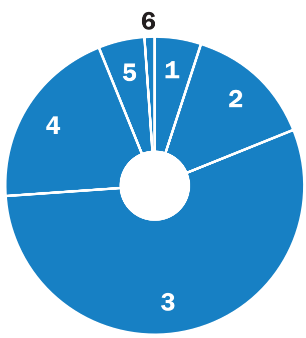
1	Large corporates	10.2
2	Midsize businesses	10.6
3	Small businesses	6.1
4	Retailers and sole proprietors	1.6
5	Mortgage loans	34.3
6	Consumer loans	2.0
7	Banks	2.7
8	Sovereigns	18.7
9	Other	13.9



G8

Credit quality of financial assets (%)

1	No appreciable risk	28
2	Low risk	24
3	Medium-low risk	13
4	Medium risk	32
5	Medium-high risk	2
6	High risk	1



G9

Breakdown of exposure by rating (%)

1	AAA/AA	5
2	A	14
3	BBB	55
4	BB	20
5	B	5
6	Rest	1

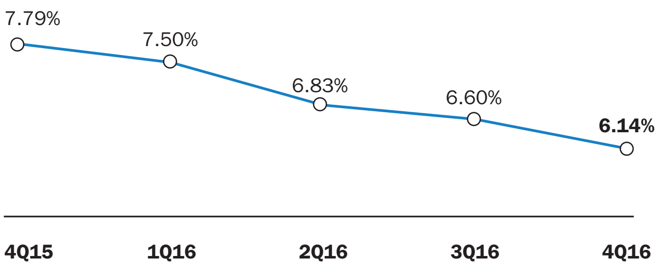
The NPL ratio continues to decline, and stands at 6.1%.

The balance of doubtful and problematic assets continues to decline at a good pace.

Pro-active selling of real estate has proved to be a successful strategy.

G10

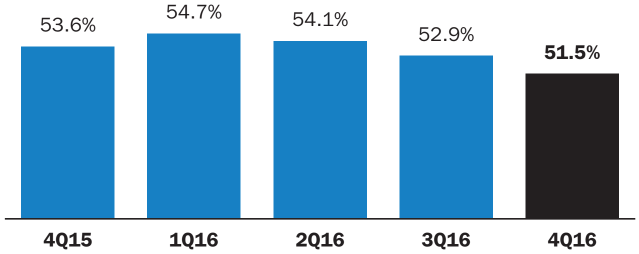
NPL ratio



↓ **6.1%** 2016

↑ **13.6%** 2013

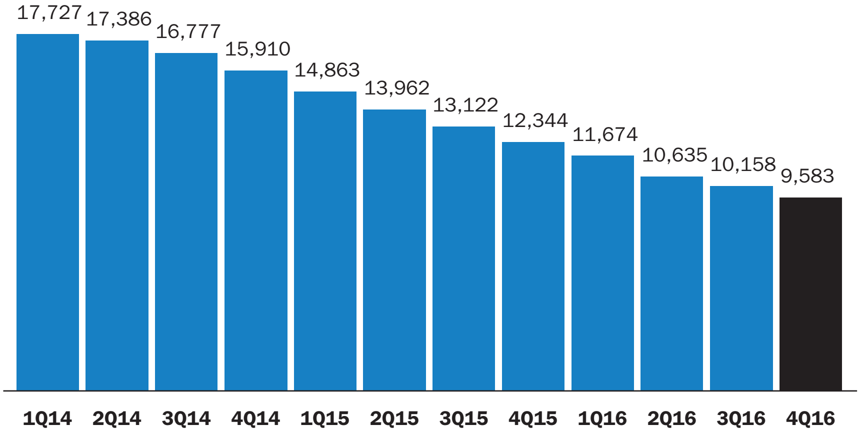
Coverage ratio



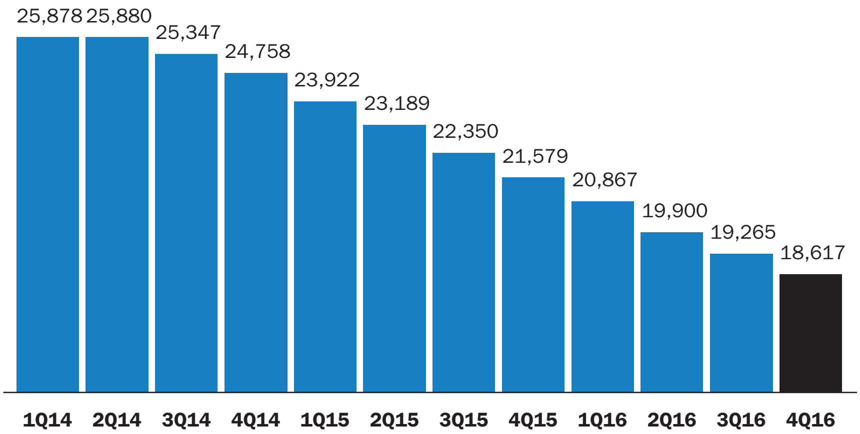
During 2016, an improvement was observed in the volume of doubtful assets, which declined by €2,814 million in 2016, while the NPL ratio reached 6.14% at the end of the year (G10). *

Active management actions by the Bank has achieved a notable reduction in problematic assets since 2013, far exceeding the goals of the business plan (G11 and G12).

* For more information, see Note 11 "Loans and advances" in the 2016 consolidated annual accounts and the "Banco Sabadell Groupfinancial information" chapter of the Annual Report.



G11 Doubtful balances, excl. TSB
(€ million)



G12 Total problematic assets, excl. TSB
(€ million)

-7,411€mn

Concentration risk

Concentration risk refers to exposures that can potentially generate losses large enough to threaten the institution's financial solvency or the viability of its ordinary business activity. This type of risk is divided into two basic subtypes:

— Individual concentration risk: imperfect diversification of the portfolio's idiosyncratic risk due either to its small size or to sizeable exposure to specific customers.
— Sectoral concentration risk: imperfect diversification of the systemic components of portfolio risk, which can be sector-based, geographical, etc.

Banco Sabadell has a series of specific tools and policies to ensure efficient management of concentration risk:

— Quantitative metrics from the Risk Appetite Statement and their subsequent monitoring, such as tier-one metrics.
— Individual limits for risks and customers considered to be significant, which are established by the Executive Committee.
— A structure of delegation which requires that relevant customer transactions be approved by the Credit Operations Committee, or even by the Executive Committee.

For information about exposure to construction and real estate development, see Note 4 in the 2016 consolidated financial statements (section 4.4.1.7.4).

Exposure to customers or significant risks

At 31 December 2016 there were no borrowers with a risk that individually exceeded 10% of the Group's equity.

A total of 32% of performing loans are located outside Spain.

Country risk: geographic exposure to credit risk

Country risk is that applicable to the debts of a country, taken as a whole, as a result of reasons inherent in the country's sovereignty and economic situation, i.e. for circumstances other than the regular credit risk. It manifests itself in a debtor's potential inability to honour their foreign currency payment obligations to external creditors due, among other reasons, to the country preventing access to the foreign currency, the inability to transfer it, the non-enforceability of legal action against borrowers for reasons of sovereignty, war, expropriation or nationalisation.

Country risk affects not only debts contracted with a state or entities guaranteed by it but also all private debtors that belong to such state and who, for reasons outside their control and not at their volition, are generally unable to honour debts.

There are no significant restrictions (e.g. statutory, contractual or regulatory) on the ability to access or use assets and settle liabilities of the Group provided that the entity complies with regulatory requirements established in each country, and there are no other restrictions of the type envisaged in IFRS 12.

An exposure limit is set for each country which is applicable across the whole Banco Sabadell Group. These limits are approved by the Executive Committee and the corresponding decision-making bodies, depending on the level of delegation, and are constantly monitored to ensure that any deterioration in the political, economic or social situation in a country can be detected in good time.

The principal component of the framework for the acceptance of country risk and financial institution risk is the structure of limits on the various metrics; on this basis, the various risks are monitored and Senior Management and the delegated bodies establish the Group's risk appetite on this basis.

The limits structure is based on two tiers: tier 1 metrics in the RAS, and Tier 2 (or "management") limits.

Additionally, a number of indicators and tools are used to manage country risk: ratings, CDS, macroeconomic indicators, etc.

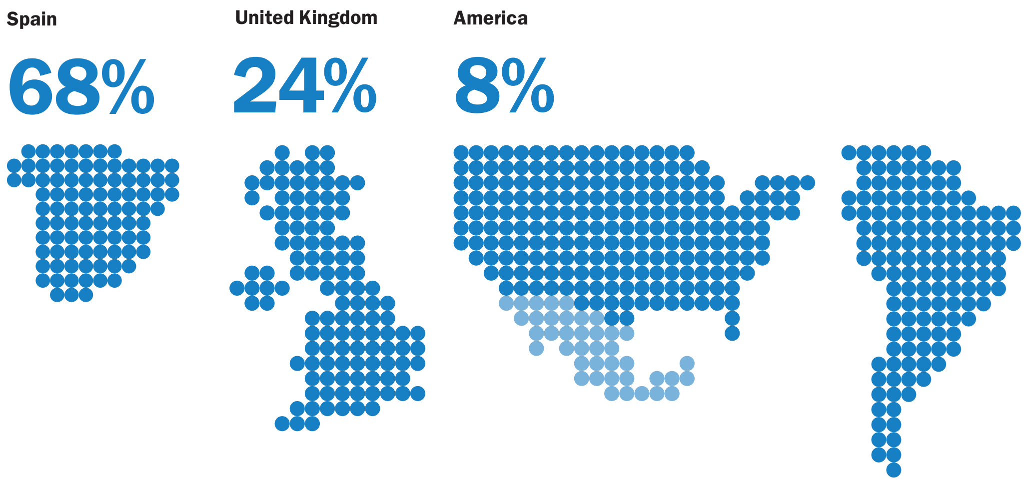
The breakdown, by type of financial instrument, of the exposure to sovereign risk, applying the criteria required by the European Banking Authority (EBA), at 31 December 2016, is shown in Graphic G14.

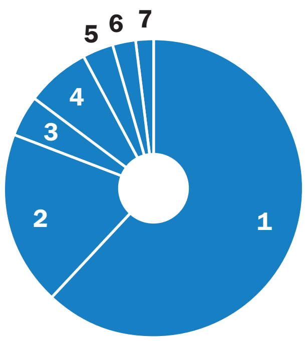
T2 Breakdown of risk concentration by activity worldwide

€ million

	2016				
	TOTAL	**Spain**	**Rest of European Union**	**America**	**Rest of the world**
Credit institutions	**18,269.73**	**8,058.20**	**8,463.92**	**1,208.78**	**538.84**
Public authorities	**32,794.94**	**19,758.60**	**9,533.96**	**3,425.63**	**76.76**
Central government	25,016.11	14,395.30	9,403.08	1,179.13	38.61
Rest	7,778.83	5,363.31	130.88	2,246.50	38.15
Other financial institutions	**3,761.10**	**2,700.96**	**525.92**	**481.11**	**53.11**
Non-financial companies and sole traders	**64,159.25**	**51,874.70**	**3,429.71**	**8,211.14**	**643.70**
Construction and real estate development	7,647.18	7,008.31	87.63	505.74	45.50
Civil engineering work	1,879.04	1,820.93	23.81	22.71	11.59
Other	54,633.03	43,045.46	3,318.27	7,682.69	586.61
Large corporates	24,658.63	16,496.53	2,424.41	5,408.74	328.94
SMEs and sole proprietors	29,974.40	26,548.93	893.86	2,273.95	257.67
Other households and NPISH	**78,609.08**	**39,866.07**	**36,253.46**	**1,614.78**	**874.78**
Home loans	67,015.35	31,112.37	33,598.90	1,579.75	724.34
Consumer loans	7,515.54	5,764.95	1,603.14	17.10	130.35
Other	4,078.19	2,988.75	1,051.41	17.93	20.10
TOTAL	**197,594.10**	**122,258.53**	**58,206.96**	**14,941.43**	**2,187.19**

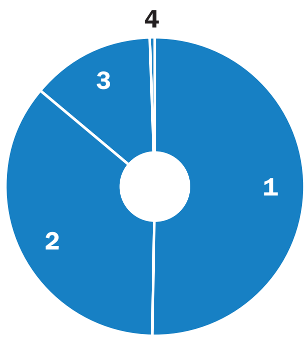
G13 Sabadell Group loan distribution.
%
Data for 4Q2016.





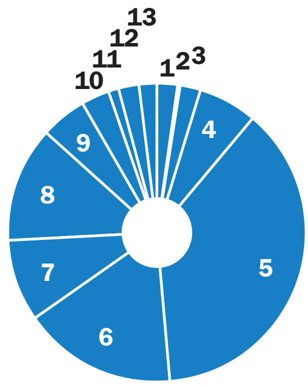
G14 Breakdown of sovereign risk exposure (%)

1	Spain	62.0
2	Italy	18.9
3	United States	4.5
4	United Kingdom	6.9
5	Portugal	3.5
6	Mexico	2.4
7	Rest of the world	1.8



G15 Breakdown of counterparty risk (%) **(by geography)**

1	Euro area	50.4
2	Rest of Europe	35.8
3	USA and Canada	13.3
4	Rest of the world	0.5



G16 Breakdown of counterparty risk, by rating (%)

1	AAA / Aaa	2.3
2	AA+ / Aa1	0.4
3	AA / Aa2	2.2
4	AA- / Aa3	6.4
5	A+ / A1	37.3
6	A / A2	16.7
7	A- / A3	8.9
8	BBB+ / Baa1	12.5
9	BBB / Baa2	5.1
10	BBB- / Baa3	3.0
11	BB+ / Ba1	1.2
12	BB / Ba2	2.2
13	Remainder	1.7

Counterparty risk

This heading refers to credit risk arising from activities in financial markets that are carried out with counterparty risk (derivatives and repos), trades in money markets and fixed-income trades. The exposure resulting from operations in the financial markets is managed and tracked comprehensively.

The exposure resulting from operations in the financial markets under management criteria is mainly concentrated in financial institutions (FI) and Central Counterparties (CCP).

The philosophy behind counterparty risk management is aligned with the business strategy, and seeks at all times to ensure value creation while maintaining a balance between return and risk. For this purpose, criteria have been established for supervising and tracking counterparty risk deriving from activity in the financial markets so as to ensure that the Bank can carry out its business activity within the risk thresholds established by Senior Management.

The Banco Sabadell Group has a system for evaluating and managing those risks that enables it to monitor and oversee compliance with the approved limits on a daily basis. Graphics G15 and G16 show the breakdown of counterparty risk by geographical region and credit rating.

As the table shows, the risk is concentrated among counterparties with a high credit rating: 65% of the counterparty risk is with counterparties rated A or higher.

In June 2016, EMIR (Regulation 648/2012) made it obligatory for the Group to clear and settle certain OTC derivatives through Central Counterparties (CCP). Consequently, the derivatives arranged by the Group that are susceptible to being cleared through a CCP are being cleared in this way. At the same time, the Group has worked to standardise OTC derivatives with a view to increasing the use of CCPs. The exposure to CCPs is equivalent to the amount of the guarantees provided.

Management considers that there is no exposure in derivatives transactions in organised markets (OM), given that the OM acts as counterparty and there is a settlement and guarantee mechanism that ensures transparency and continuity. As in the case of CCPs, the exposure is equivalent to the guarantees provided.

The philosophy behind counterparty risk management is aligned with the business strategy, and seeks at all times to ensure value creation while maintaining a balance between return and risk. For this purpose, criteria have been established for supervising and tracking counterparty risk deriving from activity in the financial markets so as to ensure that the Bank can carry out its business activity within the risk thresholds established by Senior Management.

Exposure is quantified on the basis of Marking to Market (MtM) plus Add-on. MtM represents current exposure, and is defined as the cost of replacing a transaction at market value in the event that a counterparty defaults. The add-on represents the potential future risk, which an operation may attain in a given period of time due to the transactions' characteristics and the market variables on which it depends. In the case of transactions under a collateral agreement, the add-on represents the possible fluctuation of MtM between the time of default and the time the position is unwound in the market. If the transaction is not carried out under a collateral agreement, the add-on represents the possible fluctuation of MtM throughout the term of the operation.

Each day at market close, all exposures are recalculated on the basis of transactions inflows and outflows, changes in market variables and the risk mitigation mechanism established by the Group. In this way, exposures are monitored on a daily basis to ensure that they conform to the limits approved by Senior Management. This information forms part of the risk reports which are escalated to the departments and areas responsible for risk management and monitoring.

With regard to counterparty risk, the Group adopts three different mitigation measures. The main measures are:

— Netting agreements for derivatives (ISDA and CMOF).
— Collateral agreements for derivatives (CSA and Annex III) and repos (GMRA).

Netting agreements allow positive and negative MtM to be aggregated in transactions with the same counterparty in such a way that, in the event of default, a single payment or collection obligation is established in relation to all of the operations arranged with that counterparty.

By default, the Group has netting agreements with all of the counterparties that wish to trade in derivatives.

Collateral agreements provide not just for netting but also for the regular exchange of guarantees that mitigate the exposure to a counterparty in respect of the operations covered by the agreement.

The Group requires that a collateral agreement be in place in order to trade in derivatives or repos with financial institutions. The Group's standard collateral contract is bilateral (i.e., both parties are obliged to post collateral) and provides for daily exchange of guarantees, always in cash and always denominated in euro.

Assets pledged in financing activities

At the end of 2016 and 2015, there are certain financial assets pledged in financing operations, i.e. offered as collateral for certain liabilities. Those assets are mainly loans linked to the issuance of mortgage covered bonds, public sector covered bonds bonds or long-term securitisation bonds (see Note 21 and Schedules III and IV of the 2016 consolidated financial statements). The other pledged assets are debt securities that are delivered in repos, collateral (loans or debt instruments) provided to gain access to certain types of funding from central banks and collateral of all types provided as surety for derivatives transactions.

The Bank has used part of its portfolio of homogeneous loans and advances in fixed-income securities by transferring the assets to securitisation trusts created for this purpose. Under current regulations, securitised assets cannot be derecognised unless the risk has been substantially transferred.

For further information on funding programmes in the capital market, refer to the section below on liquidity risk.

Liquidity risk

Definition

Liquidity risk arises due to the possibility of losses being incurred as a result of the Bank's being unable, albeit temporarily, to honour payment commitments due to a lack of liquid assets, or of its being unable to access the markets to refinance debts at a reasonable cost. This may be associated with factors of a systemic nature or specific to the bank itself.

The Group is exposed to daily demands on its available cash resources to meet contractual obligations related to financial instruments with which it trades, such as maturing deposits, drawdowns of credit facilities, settlements of derivatives, etc. Experience shows, however, that only a minimum amount is ever actually required and this can be predicted with a high degree of confidence.

In this regard, the objective of the Banco Sabadell Group is to maintain liquid assets and a funding structure that, in line with its strategic objectives and based on its risk appetite statement (RAS), allows it to honour its payment commitments normally and at a reasonable cost, under business as usual conditions or under a stress