It should be noted that Banco Sabadell Group applies a decentralised liquidity management model. This model tends to limit the transfer of liquidity between the various subsidiaries involved in liquidity management, thereby limiting intra-group exposures beyond any restrictions imposed by local regulators on each subsidiary. Thus, the subsidiaries involved in liquidity management determine their liquidity position by considering only those assets in their possession which meet the eligibility, availability and liquidity requirements established both internally and in regulations in order to comply with the regulatory minima.

There are no significant amounts of cash and cash equivalents which are not available for use by the Group.

In addition to the first line of liquidity, the bank maintains a buffer of mortgage assets and loans to public authorities that are eligible as collateral for mortgage covered bonds and public sector covered bonds, respectively, which, at the end of 2016, added €4,924 million in terms of the capacity to issue new covered bonds that are eligible as collateral for the ECB facility. At the end of 2016, available liquidity amounted to €31,805 million in cash, corresponding to the amount of the first line of liquidity plus the bank's capacity at year-end to issue mortgage and public sector covered bonds, less the average haircut applicable to covered bonds by the ECB.

Fulfilment of regulatory ratios

As part of its liquidity management approach, the Banco Sabadell Group monitors the short-term liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), and reports the necessary information the regulator on a monthly and quarterly basis, respectively. The measurement of liquidity based on these metrics forms part of the liquidity risk control in the set of the LMUs.

Since 1 January 2016, the regulatory minimum LCR is 70%, a level which is comfortably surpassed by all of the entity's LMUs; in particular, TSB and Banco Sabadell

Spain stand out due to their very high LCRs. At Group level, the bank's LCR was consistently above 100% throughout the year.

The NSFR is still under consideration and the final definition has yet to be adopted. The scheduled date for its implementation is January 2018, and, as with the LCR, it will be phased in. The bank has nonetheless already commenced monitoring this ratio as a liquidity metric at the LMU level.

Given the bank's funding structure, with a preponderance of customer deposits, and as the majority of its market funding is in the medium/long-term, this ratio is consistently over 100%.

Market risk

This risk is defined as arising from the possibility of loss in the market value of financial asset positions due to variations in risk factors with an impact on their market prices, volatility or correlation between them.

Those positions that generate market risk are usually held in trading activities, consisting of hedging transactions arranged by the Bank to provide services to its customers as well as discretionary proprietary positions.

It may also arise simply due to maintaining overall balance sheet positions (also known as structural positions) that in net terms are left open. In the latter case, the entity uses the market risk management and monitoring system to manage the structural market risk position. Other market risks of a structural nature, arising from such factors as interest rates, are addressed in the relevant sections.

The market risk acceptance, management and oversight system is based on setting limits for specifically assigned positions and the approval of transactions of each business unit; in this way, the various management units have the obligation to manage their positions within the established limits and to obtain approval for transactions from the risks department.

Т5

	2016
Cash (*) + Net interbank position	8,002
Available under ECB facility	6,869
Collateral provided under ECB facility (**)	18,687
Balance drawn under Bank of Spain facility (***)	11,818
Assets eligible as collateral for ECB facility not yet used	8,423
Other marketable assets ineligible for central bank facility (****)	3,587
Total available liquid assets	26,881

(*) Excess reserves at central banks.

€ million

(**) Market value after applying ECB haircut for monetary policy transactions.

(***) Of which, in 2016, €10,000 relate to the ECB's 4-year Targeted Longer-Term Refinancing Operation (TLTRO II) on 29 June 2016. In 2015, €11,000 million related to the Bank of Spain TLTRO on 17 December 2014.

(****) Market value after applying the Liquidity Coverage Ratio (LCR) haircut. Includes fixed-income securities classified as high-quality liquid assets (HQLA) for the purposes of the LCR and other marketable securities of Group undertakings.

Main risks in the Risk Appetite Framework / Liquidity risk

Trading activity

The principal risk factors considered by Banco Sabadell in its trading activity are:

- Interest rate risk: risk associated with the possibility of fluctuations in interest rates adversely affecting the value of a financial instrument. This is reflected, for example, in interbank deposit operations, fixed-income and interest rate derivatives.
- Credit spread risk: this risk derives from the fluctuations in the credit spreads at which instruments are quoted with respect to other benchmark instruments, such as interbank interest rates. This risk occurs mainly in fixed-income instruments.
- Exchange rate risk: risk associated with the fluctuation in exchange rates with respect to the reference currency. In the case of Banco Sabadell, the reference currency is the euro. This risk occurs mainly in currency exchange transactions and currency derivatives.
- Equity risk: risk which derives from the fluctuation in the value of capital instruments (shares and indices). This risk is reflected in the market prices of the securities and their derivatives.

Changes in commodities prices did not have an impact in the year, given that the Group's exposure is marginal, both direct and in underlying assets.

Market risk in trading activities is measured using the VaR and stressed VaR methodologies. This allows for a standardisation of risks across different types of financial market transactions.

The VaR provides an estimate of the maximum potential loss posed by a position due to an adverse but normal movement of any of the identified parameters influencing market risk. This estimate is expressed in monetary terms and refers to a specific date, a specified level of confidence and a specific time horizon. A 99% confidence level is used. Due to the low complexity of the instruments and the high liquidity of the positions, a time horizon of 1 day is used.

The methodology used to calculate VaR is historical simulation. The advantages of this methodology are that it is based on the full appreciation of the transactions under recent historic scenarios, and it is not necessary to make assumptions about the distribution of market prices. The main limitation to this methodology is its dependence on historical data, given that, if a potential event did not materialise within the range of historical data used, it will not be reflected in the VaR information.

The reliability of the VaR methodology can be checked using backtesting techniques, which serve to verify that the VaR estimates fall within the contemplated confidence level. Back testing consists of a comparison between daily VaR and daily results. If losses exceed the level of VaR, an exception occurs. In 2016 no exceptions occurred in backtesting due to the low exposure to the year's significant events, such as the Brexit referendum (24 June).

Stressed VaR is calculated in the same way as VaR but with a historical window of variations in the risk

factors in stressed market conditions. This stress situation is determined on the basis of current operations, and it can vary if the risk profile of portfolios changes. The methodology used for this risk metric is the historical simulation.

This is supplemented with additional measures such as sensitivities, which refer to the change produced in the value of a position or portfolio in response to a change in a specific risk factor, and also with the calculation of management results, used to monitor stop-loss limits.

Furthermore, specific simulation exercises are carried out with extreme market scenarios (stress testing), in which the impacts of different past and theoretical scenarios on portfolios are analysed.

Market risks are monitored on a daily basis, and risk levels and compliance with the limits established by the Risk Committee for each management unit (limits based on nominal, VaR and sensitivity, as applicable) are reported to the oversight bodies. This makes it possible to keep track of changes in exposure levels and measure the contribution by each risk factor.

Trading market risk incurred in terms of the 1-day VaR with 99% confidence in 2016 is shown in table T6.

Commodity price changes did not have an impact in the year since the Group's exposure, both direct and to the underlying assets, is negligible.

Structural risks concerning interest rates and exchange rates

Structural interest rate risk

Structural Interest rate risk (also known as Interest Rate Risk in the Banking Book, or IRRBB) is inherent to banking and is defined as the possibility of incurring losses as a result of the impact of interest rate fluctuations on the income statement (revenues and expenses) and on the entity's equity structure (current value of assets, liabilities and off-balance sheet positions that are sensitive to interest rates).

The following types are considered under structural interest rate risk:

- Repricing risk: related to a mismatch between maturity dates and repricing of assets, liabilities and shortand long-term off-balance sheet positions.
- Curve risk: arising from changes in the level or gradient of the yield curve.
- Basis risk: arising from hedging an interest rate exposure using exposure to an interest rate that is repriced in different conditions.
- Optionality risk: arising from options, including implicit options.

The metrics developed to control and monitor the Group's structural interest rate risk are aligned with the market best practices and are implemented consistently across all balance sheet management units (BMUs) and by local asset and liability committees. The effect of diversification between currencies and BMUs is taken into account when presenting overall key figures.

The Group's current interest rate risk management strategy relies particularly on the following principles and pillars, in line with the business model and the defined strategic objectives:

- Each BMU has appropriate tools and processes and robust systems in order to properly identify, measure, manage, control and report on IRRBB. This allows them to obtain information from all of the identified sources of IRRBB, assess their effect on financial margins and the economic value of assets and measure the vulnerability of the Group/BMU to potential losses deriving from IRRBB under different stress scenarios.
- At corporate level, a set of limits is established for overseeing and monitoring the level of IRRBB exposure that are appropriate in the light of internal risk tolerance policies. However, each BMU has the autonomy to set any other additional limits it deems necessary, based on its specific needs and the nature of its activities.
- The existence of a transfer pricing system.
- The set of systems, processes, metrics, limits, reporting and governance covered by the IRRBB strategy must comply with regulatory requirements.

The metrics used to monitor structural interest rate risk include, on one hand, the interest rate gap (G17), which is a static measure that shows the breakdown of maturities and repricing of sensitive items on the balance sheet. For items with no contractual maturity, expected maturities estimated using the bank's past experience are considered to make assumptions as to stability and remuneration on the basis of the product type.

Additionally, the sensitivity of key economic figures (net interest income, economic value) to changes in the yield curve is calculated. Table T7 shows the interest rate risk levels in terms of the sensitivity of the Group's main foreign currencies at the end of 2016.

In addition to the impact on net interest income within one year, presented in the previous table, the Group calculated the impact on net interest income over two years, the result of which is notably more positive for all currencies.

Given the current level of market interest rates, the scenario of a decline in interest rates uses a maximum

shift of 100 basis points in each term, so that the resulting interest rate is always greater than or equal to zero.

Derivatives are arranged in the financial markets to hedge risks, mainly interest rate swaps (IRS), which qualify for hedge accounting. Two different forms of macrohedging are used:

- Interest rate macro hedging of cash flows, whose purpose is to reduce the volatility of net interest income as a result of interest rate fluctuations, for a one-year time horizon.
- Fair value interest rate macro hedges, whose purpose is to maintain the economic value of the hedged items, consisting of assets and liabilities at a fixed interest rate.

Balance sheet items recognised at amortised cost do not present any valuation adjustments associated with interest rate fluctuations. In the case of financial assets classified as available for sale that are measured at fair value, the change in risk premiums had a greater impact than the decline in interest rates during the year.

Structural exchange rate risk

This risk arises from changes in the market exchange rates between currencies, which may generate losses in financial investments or in permanent investments in overseas offices and subsidiaries which use currencies other than the euro.

The purpose of managing structural exchange rate risk is to minimise the impact on the value of the portfolio and the entity's equity of adverse movements in currency markets. The risk appetite defined in the RAS takes precedence and the established levels for the risk metrics must be complied with at all times.

Exchange rate risk is monitored on a daily basis and reports on current risk levels and on compliance with the limits assigned by the Risk Committee are sent to the risk control bodies. The main metric is currency exposure (as a percentage of Tier 1), which measures the sum of the entity's net open position (assets less liabilities) in each currency through any type of financial instrument (FX spot, forward and option transactions), measured in euro and in terms of Tier 1.

Compliance with and the effectiveness of the Group's targets and policies are monitored and reported on a

T6

€.	million	

	2016		
	Mean	High	Low
Interest rate risk	0.90	2.86	0.45
Exchange rate risk in trading position	0.20	0.55	0.04
Equity risk	0.69	1.62	0.30
Credit spread	0.99	3.58	0.32
Aggregated VaR	2.78	7.90	1.23

monthly basis to the Risk Committee and to the Audit and Control Committee, respectively.

The Financial Department, through the ALCO, designs and implements the strategies for hedging the structural position in foreign currency with the priority objective of minimising the negative impact on capital ratios (CET1) of exchange rate fluctuations.

In 2016, in a context of persisting uncertainty about the negotiations in the wake of the Brexit referendum, Banco Sabadell continued to monitor the EUR/GBP exchange rate. During this period, the Group has adopted a hedging policy which aims to mitigate the negative effects on capital ratios, as well as on the earnings generated by its business in GBP, as a result of the evolution of the EUR/GBP exchange rate.

During 2016, capital hedging increased, from 768 million pounds sterling in 2015 to the current 1,368 million pounds sterling, which represents 73% of the total investment.

This currency hedge is monitored continuously based on market movements.

The value in euro of the assets and liabilities denominated in foreign currencies held by the group at 31 December 2015, classified on the basis of their nature, is shown in figure G18. The net position of foreign currency assets and liabilities includes the bank's structural position measured at a historical exchange rate, amounting to €1,685 million, of which €597 million correspond to permanent shareholdings in GBP, €769 million to permanent shareholdings in USD and €279 million to stakes in MXN. Net assets and liabilities valued at the exchange rate are hedged through foreign exchange forward transactions and options, in accordance with the Group's risk management policy.

At the end of 2016, the sensitivity of equity exposure to a 1% devaluation in the exchange rates against the euro of the main currencies to which the bank is exposed amounted to €17 million, of which 35% related to the pound sterling, 46% to the US dollar, 17% to the Mexican peso and the rest to other currencies.

Operational risk

Operational risk is defined as the risk of incurring losses due to inadequate or failed internal processes, people or systems or due to unexpected external events. This definition includes reputation risk (which, in turn, includes behavioural risk), technology, model and outsourcing risks.

T7

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 Instantaneous parallel increase of 100bp			
 Interest rate sensitivity	Impact on net interest income	Impact on economic value	
EUR	0.1	1.3	
 GBP	1.9	(2.2)	
USD	0.2	(0.3)	



Risk management