

The improvement in the Group's fundamentals is reflected in its good credit ratings.

Milestones in 2017

In 2017, the Banco Sabadell group continued to strengthen its risk management framework by making improvements in line with best practices in the financial sector.

The Banco Sabadell Group's risk appetite framework continues to be adapted to the new Group structure

resulting from internationalisation, in order to ensure consistency and effective implementation of the risk appetite statement (RAS) in all geographies (G1).

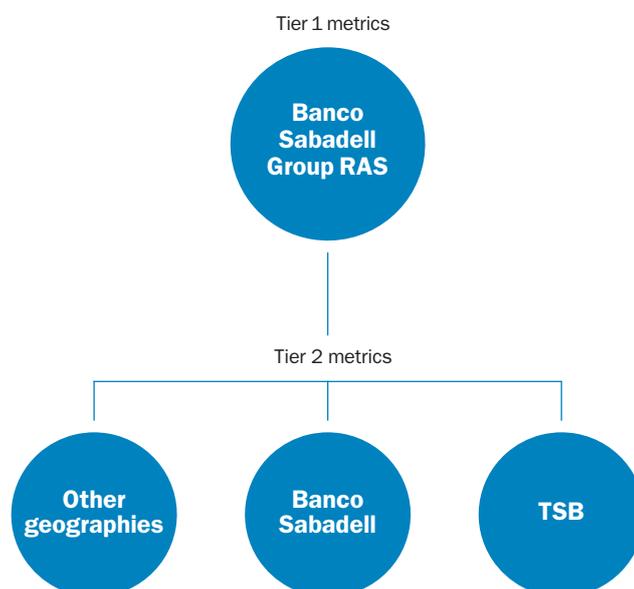
The RAS acts as a first tier in which to set overall limits and targets, while a second tier elaborates on the first-tier targets and limits applied to the various geographies.

Strengthening the Risk Appetite Framework by giving it greater depth in terms of sectors and geographies.

During 2017, work continued to enhance the Group's risk profile and to strengthen the risk management and control environment through the development of management and control frameworks for specific portfolios, sectors and geographies. This powerful tool makes it possible to deploy the Risk Appetite Framework and guide growth in lending while seeking to optimise the risk/return ratio over the long term.

Additionally, the Group's customer risk tracking environment has been updated. The early warning system has been integrated into management approaches through a new tracking environment under which different strategies can be applied depending on the segment (individuals, shops and self-employed workers, businesses and companies).

G1 Risk appetite metrics



Improvement of the Group's risk profile during the year

The Group's risk profile improved during 2017 fundamentally for three reasons: international diversification, concentration and asset quality.

Regarding international diversification, international credit risk (€44,259 million at the end of 2017) represents 30% of the Group's total exposure, having multiplied six-fold since 2014. International diversification is due primarily to the acquisition of TSB, representing exposure of €35,581 million (90% in retail mortgages). Excluding the TSB acquisition, the bank has expanded by 29% internationally since 2014.

As for concentration, real estate exposure has been reduced (to one-third of its 2014 weighting) and exposure in the retail segment has increased following the acquisition of TSB in 2015. The portfolio is well diversified in terms of industries, with rising exposure to sectors with greater credit quality. In terms of individual concentration, the risk metrics relating to concentration of large exposures have also declined. Geographically, the portfolio is positioned in the most dynamic regions, in Spain and worldwide.

As for asset quality, the volume of NPAs has been curtailed sharply in recent years. Non-performing exposures have been reduced by €10,173 million since 2013. In 2017, the Group reduced the volume of NPAs by €3,463 million. All this has led to a reduction in the NPL ratio, from 6.14% to 5.14%.

The improvement in the Group's fundamentals, particularly in terms of risk, is reflected in the stable credit rating granted to the Bank's senior debt during the year, having regained an investment grade rating from all the agencies that rate it.

Strengthening the risk management and control environment

The risk management and control environment continued to be strengthened in 2017 through the development and deployment of management and control frameworks for certain portfolios, sectors and geographies.

In each of these frameworks, the Group's appetite in the sector or portfolio in question, and the requirements to achieve it, are determined by establishing:

- Asset allocation, setting the growth objectives along each basic axis (quality, typology...).
- General principles that should guide the activity in each portfolio, sector or geography.
- Basic policies for accepting and monitoring credit.
- Risk tracking and control metrics (relating to both stock and new production).

The combination of management and control frameworks with planning and continuous management enables us to take early action with regard to portfolios in order to direct growth in a way that is profitable in the long term.

Improved tracking environment

The Group's customer risk tracking environment was updated in 2017. The early warning system was integrated into management approaches through a new tracking environment under which different strategies can be applied depending on the segment (individuals, shops and self-employed workers, businesses and companies).

The main input for the tracking environment is the model of early alerts adapted to each segment. This allows for:

- Improved efficiency by focusing customer tracking on signs of impairment.
- Early action in response to signs of impairment; renewal of the rating for customers that have experienced impairment depends on the Basic Management Team.
- Regular oversight of customers whose situation remains unchanged and who have been evaluated by the Basic Management Team.
- Feedback using the information from the Basic Management Team as a result of actions taken.

Improved management of the risk associated with NPAs

In compliance with the requirements set out in the European Central Bank's "Guidance to banks on non-performing loans", in 2017 the Board of Directors approved a new "Strategic Plan for Managing NPAs" and an "Operational Plan for Managing NPAs". The key points of the Strategic Plan are as follows:

- Principles for managing those assets.
- A governance and management structure that facilitates achievement of those goals.
- Quantitate objectives, with different time horizons, for reducing both non-performing and foreclosed assets.

In order to achieve those results, the ECB has established two strategic priorities with regard to managing NPAs:

- Continuous reduction of NPAs until the balances are normalised.
- Focus on managing NPAs through the specialised services of the Asset Transformation and Industrial and Real Estate Holdings Department, which was one of the first workout units in Spain.

These two strategic priorities are translated into five principles for managing NPAs:

- Early action to manage default and preventive action to avoid default.
- Segmented management of all non-performing and potentially non-performing exposures (potential default).
- Business intelligence and continuous process improvement.
- Funding capacity.
- A clear governance system based on three lines of defence.

Additionally, policies for managing NPAs have been developed in accordance with the requirements set out in the ECB document and in Annex IX of Bank of Spain Circular 4/2016. These policies are aligned with the Strategic Plan for NPAs and the Operational Plan for NPAs. The policies also cover the new risk management model implemented in July 2017.

Main risks in the Risk Appetite Framework

Introduction

The Banco Sabadell Group has a risk appetite framework in place to ensure the proactive control and management of all of the Group's risks. This framework includes a risk appetite statement (RAS), which establishes the amount and diversity of risks that the Group seeks and tolerates in order to achieve its business goals while maintaining a balance between risk and return.

The Banco Sabadell Group Risk Appetite Framework continues to be adapted to the Group's international structure in order to ensure consistency and effective deployment of the RAS in all geographies.

A first tier is established comprising the Group's RAS, setting overall objectives and limits, and a second tier provides details of the first-tier objectives and limits in the various geographies.

The risk appetite statement is comprised of quantitative metrics that allow objective monitoring of risk management, as well as supplementary qualitative aspects.

The risk management and control approach consists of a broad framework of advanced measurement principles, policies, procedures and methodologies integrated into an efficient decision-making structure under a governance framework for the risk function that conforms to Spanish and European law.

The principles, policies, procedures and methodologies framework is reflected in the document entitled "Banco Sabadell Group Risk Policies", which is reviewed regularly and subject to approval by the Board of Directors.

G2 Main risks

