The improvement in the Group's fundamentals enabled it to maintain an investment grade rating from all the agencies that rate its debt.

## Milestones in 2018

In 2018 the Banco Sabadell Group continued to strengthen its risk management framework and to make improvements in line with best practices in the financial sector.

The Banco Sabadell Group's risk appetite framework takes account of the Group's structure resulting from internationalisation in order to ensure consistency and effective implementation of the risk appetite statement (RAS) in all geographies (G1).

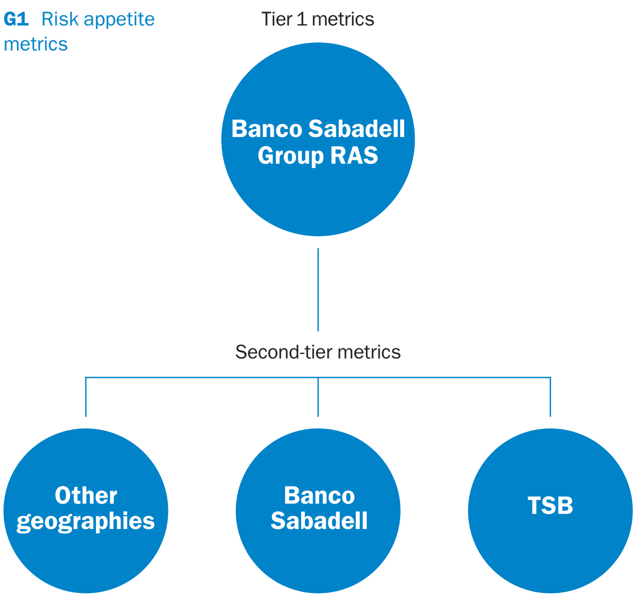
The RAS acts as a first tier in which to set overall limits and targets, while a second tier elaborates on the first-tier targets and limits applied to the various geographies.

The Risk Appetite Framework was strengthened through the development and deployment of risk management and control frameworks on the basis of portfolios, sectors and geographies.

During 2018, the Group's risk profile continued to be strengthened, along with 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 during 2018 improved mainly for three reasons:

Regarding international diversification, international credit risk (€45,225 million) represents 31.0% of the Group's total exposure, having multiplied six-fold since 2014. The increase in the Group's international diversification continues to be largely due to the acquisition of TSB, with an exposure of €34,151 million. The TSB portfolio is in a stable trend and has a remarkably low risk profile (over 90% consists of retail mortgages with an average LTV of 44%), while its composition is improving steadily, as the proportion of interest-only and buy-to-let loans is declining. Excluding the effect of the acquisition of TSB, the Group has expanded overseas by 65% since 2014 (even taking into account the sale of Sabadell United Bank in July 2017), with business growth rates in Mexico being particularly noteworthy.

As for concentration, real estate exposure has been reduced (to one-third of the exposure it represented in 2014) and retail exposure has increased following the acquisition of TSB in 2015. The Group's portfolio is well diversified in terms of sectors, with an upward trend in sectors with higher credit quality. Risk metrics relating to concentration of large exposures have also declined. In geographical terms, the portfolio is positioned in the most dynamic regions, both domestically and internationally.

As for the quality of the loan book, non-performing assets at Group level were reduced by €1,518 million in 2018, not including the impact of the institutional sales of loans announced in the second quarter of 2018. During 2018, the Group completed a number of transactions for the institutional sale of non-performing assets, having disposed of practically all of the problematic exposures on the Group's balance sheet. In parallel, the Group continues to reduce its volume of Stage 3 loans, in line with the trends of recent years. Since 2013, non-performing exposures have been reduced by 63.5%, with the balance falling by €11,401 million. As a result, the Group's NPL ratio fell from 5.14% to 4.22% in 2018.

The improvement in the Group's fundamentals, mainly in terms of risk, enabled it to maintain an investment grade rating from all the agencies that rate its debt. In particular, S&P upgraded its long-term credit rating to BBB, from BBB-, on 6 April 2018, and DBRS Rating Limited changed its outlook to positive (from stable) on 16 July 2018 while affirming its BBB (high) long-term rating.

# Strengthening the risk management and control environment

## Planning and control of stock and new production

The risk management and control environment continued to be strengthened in 2018 through the development and deployment of credit risk 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 targets in each key pillar (quality, type, etc.).
— General principles to guide the activity in each portfolio, sector or geography.
— Basic policies for accepting and monitoring loans and credit.
— Risk tracking and control metrics (relating to both stock and new production).

## Asset Allocation / Sectoral Strategic Debate

The Sectoral Strategic Debate arises in the context of the Risk Appetite Framework (RAF) and the Risk Appetite Statement (RAS), and is one of the key developments since 2014 in the Banco Sabadell Group's sectoral risk management and control model.

As a result of this initial development, the following steps were taken:

— Definition and calculation of key metrics to monitor and manage sectoral concentration risk, and subsequent inclusion as first-tier metrics in the RAS.
— Creation of the Sectoral Analysis Division, reporting to the Chief Economist.
— Generation of a 'correlated sectorisation model' by grouping sectors under a risk management approach so as to enhance the existing expert model.

In this context, a decision was made to create a mechanism to integrate all of the Group's current outlooks in relation to sectoral risk. This determined the need to promote a Sectoral Strategic Debate in order to establish the Group's sectoral asset allocation strategy, integrating to this end the various existing outlooks within the organisation in relation to the various sectors of the economy.

The project pursues the following objectives:

— Obtain the Group's sectoral strategic outlook.
— Detect growth opportunities as well as undesirable scenarios.
— Define mechanisms to achieve the agreed objectives.

### Pricing system that guarantees alignment with credit risk

A pricing process in which prices are assigned on the basis of the cost, risk and allocated capital at transaction level, which is particularly important in the current very competitive pricing environment.

The Group uses Risk adjusted Return on Capital (RaRoC) as a key risk screening factor to ensure the existence of a framework that measures return on the basis of risks and that contributes a coherent vision of returns in the various portfolios.

## Improved tracking environment

In 2018, the Group continued to strengthen its customer credit risk monitoring environment, by factoring in the sectoral strategic outlook and using it on a forward-looking basis in order to anticipate customer needs. The early warning system is incorporated into management procedures through a monitoring environment that allows different strategies to be implemented depending on the segment (individuals, shops and sole traders, businesses and companies).

The main input used in this monitoring environment is taken from the early warning models adapted to the various segments. This allows for:
— Improved efficiency by focusing monitoring activities on customers with 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

During 2018, in compliance with the requirements in the ECB's "Guidance to Banks on Non-Performing Loans", the Board of Directors approved the second version of its "Strategic Plan for Managing NPAs" as well as the corresponding update of the "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.
— Quantitative objectives, with different time horizons, to reduce Stage 3 and foreclosed assets.

In order to achieve these results, the Bank set itself three strategic priorities in relation to managing non-performing assets:
— Continuous reduction of non-performing assets until full de-risking has been achieved.
— 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.
— Maintenance of solid, adequate coverage of non-performing assets.

These three strategic priorities translate into six principles for managing non-performing assets, which are:
— Early action to manage delinquency and preventive action to avoid delinquency.
— Segmented management of all non-performing and potentially non-performing exposures (potential delinquency).
— Large-scale reduction of the non-performing loans and foreclosed assets that have been on the balance sheet the longest.
— Business intelligence and continuous process improvement.
— Funding capacity.
— A clear governance system based on three lines of defence.

The Strategic Plan for Managing NPAs and its objectives are fully integrated into the Bank's risk management and control mechanisms, given that:
— The 2020 Plan and the Budget are fully consistent with them.
— They are integrated into the risk appetite framework (RAF), where the risks relating to NPAs are considered significant and are therefore subject to specific policies and metrics.
— They are taken into account in risk assessment processes, capital planning, stress tests and in quantifying economic capital as part of the ICAAP.
— They are also incorporated into other tools used by the organisation (ILAAP, Recovery Plan, etc.).

Accordingly, the actions relating to NPAs in the Strategic Plan and the Operational Plan are implemented appropriately throughout the entire organisation.