Risks

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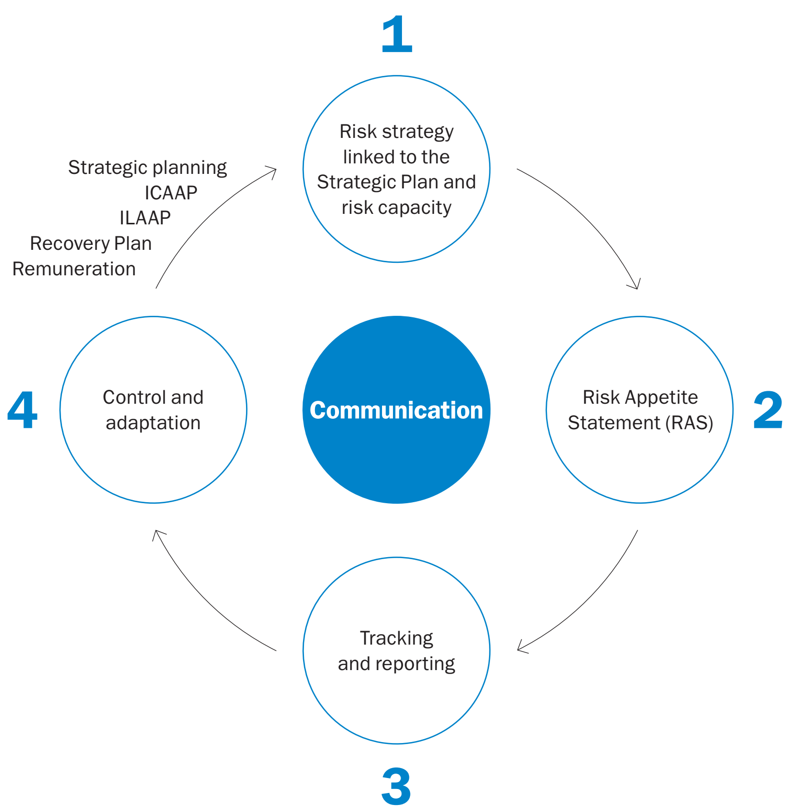
The Group's Global Risk Framework was strengthened with solid governance processes, deployment to the geographies and portfolio-based risk management and control frameworks.

In 2019, Banco Sabadell Group continued to strengthen its risk management framework by making improvements in line with best practices in the financial sector.

The Group maintains a medium-low risk profile, in accordance with the risk appetite defined by the Board of Directors.

The Group's risk strategy is fully implemented and linked to the Strategic Plan and the Group's risk capacity, articulated through the Risk Appetite Statement (RAS), under which all material risks are monitored, tracked and reported, and the necessary control and adaptation systems are established to ensure compliance:

Strategic management and risk control processes



Main 2019 milestones in risk management and control

Risk taxonomy

In March 2019, Banco Sabadell Group approved a new taxonomy of risks that establishes and defines first- and second-tier risks (and sub-risks or risk factors) on the basis of their nature.

This taxonomy lends visibility to the management and control of certain types of risks that would otherwise be diluted due to their lower materiality or the difficulty in quantifying them.

In parallel with the approval of this taxonomy, the first- and second-tier metrics in the RAS were enhanced for the material risks in the taxonomy at Group, company and/or geography level.

With regard to the first-tier risks identified in the Banco Sabadell Group risk taxonomy, the most salient aspects of their management and the steps taken in this connection in 2019 are set out below:

Strategic risk

Definition:

Risk of losses (or negative impacts in general) as a result of strategic decisions or their implementation. It also includes the inability to adapt the Group's business model to changes in the environment in which it operates.

Main milestones in 2019:

(i) Strategy and reputation:

— The Group's guidance indicators for 2019, showing the general level of attainment at year-end.
— Maintenance of the NPS in Spain in 2019, which is one of the Group's competitive advantages, while improving the outcome of the Service Quality Index. At TSB, continuous improvement of the NPS for the Bank overall and for mobile banking; in fact, the latter has practically regained its pre-migration values.
— Deployment of the Group's digital transformation strategy, with significant increases in the main indicators in connection with customers and digital sales.

(ii) TSB:

— Presentation of the new strategy for 2019-2022 in November 2019, the goal being to increase returns and lending, advance in the digital transformation, increase profits and improve the customer experience.

(iii) Improved capital position:

— The CET1 ratio improved to 11.7% in fully-loaded terms at 2019 year-end, driven significantly by organic capital creation. Generalised fulfilment of regulatory capital requirements.
— The total capital ratio was 15.0% at 2019 year-end, while the leverage ratio was 4.75%, vs. 4.54% a year earlier.
— The first asset-backed security was issued in the third quarter of 2019, which released 14bp of capital due to shedding risk.

(iv) Profitability:

— Group net profit amounted to 768 million euros in 2019. ROE was 5.9%. The Group's banking revenues remain strong despite the prevailing interest rate situation. Fees and commissions performed well, rising 7.6% year-on-year on the back of service fees.
— At the same time, the Bank laid the foundations for greater future profitability based on expanding core banking revenues, mainly through digitalisation and divesting non-strategic businesses.

Credit risk

Definition:

the possibility that losses may be incurred as a result of borrowers failing to meet their obligations or through losses in value due simply to deterioration in borrower quality.

Main milestones in 2019:

(i) Reduction in non-performing assets:

— The non-performing assets ratio declined from 5.6% to 4.8% in 2019, and the ratio of net non-performing assets to total assets was 1.7%, while the Group disposed of practically all of its non-performing real estate from the balance sheet.
— The Group's NPL ratio was reduced to 3.83%, from 4.22% at 2018 year-end.

(ii) Concentration:

— The portfolio is well diversified in terms of industries, with rising exposure to sectors that have superior credit quality. Reduction in the exposure to real estate (to one-third of the 2014 level).
— Risk metrics relating to concentration of large exposures have also declined, while the credit rating of the main borrowers improved.
— Geographically, the portfolio is positioned in the most dynamic regions, in Spain and worldwide.
— International exposure continues to represent almost one-third of the loan book, with year-on-year increases in all relevant geographies (Mexico +7.9%, TSB +3.2% and foreign branches and offices +16.2%).

(iii) TSB lending performance:

— TSB expanded lending in the second half of the year, regaining the upward year-on-year trend. Net lending increased, as the high volume of mortgage applications resulted in an increase in mortgage production.
— Lending recovered while maintaining a low risk profile (more than 94% in retail mortgages with average LTV of 44%) and improving the composition of the loan book, as exposure to interest-only and buy-to-let loans was reduced.

Finance risk

Definition:

The possibility of obtaining insufficient returns or having insufficient liquidity such as to prevent compliance with requirements and future expectations.

Main milestones in 2019:

(i) Sound liquidity position:

— The liquidity position was sound, with a Liquidity Coverage Ratio (LCR) of 172% at Group level at the end of 2019 (184% excluding TSB and 231% at TSB), after the early repayment of 7,000 million euros of TLTRO II to the ECB in 2019 and the repayment of GBP 1,995 million of the TFS to the Bank of England.
— The loan-to-deposit ratio was 99% at 2019 year-end, with a balanced retail funding structure. In 2019, Banco Sabadell fulfilled its issuance plan, and strong investor appetite enabled it to optimise the associated costs.
— By year-end, the Bank had exceeded the MREL (Minimum Required Eligible Liabilities).

(ii) Structural interest rate risk:

— The Bank continued to adapt the balance sheet structure to the current and expected environment of negative rates in the Eurozone, showing great resilience to possible future declines. The mortgage book in Spain is exhibiting an increasing preference for fixed rates. On the liabilities side, the customer deposit base makes it possible to pass negative rates on to the wholesale segments, which represent 36% of funds.
— The Bank maintained its programme of adaptation to the new benchmark indices following the entry into force of the European Benchmark Regulation (BMR): the Euro short-term rate was implemented successfully (in October), as was the Euribor hybrid methodology.

Operational risk

Definition:

Operational risk is defined as the risk of loss resulting from failures or inadequacies in people, processes and systems, or from unforeseen external events.

Main milestones in 2019:

(i) Technology function:

— The year 2019 was a transformative one in the Group's technology function, as a new organisation structure was implemented and the control structure and risk management were strengthened in the technology function (new methodologies, procedures and policies). The mainframe configuration was enhanced on the basis of high availability (service quality and resilience).
— TSB's IT platform was stabilised and it regained pre-migration levels of customer service quality.

(iii) PSD2:

— The entry into force of the revised European Payment Services Directive (PSD2) led to a slight change in the risk profile in terms of exposure to fraud and operational risk.

New organisation in the Risk Management Division

The Risk Management Division and the Asset Transformation Division were merged to bring the structure more into line with emerging needs, take advantage of their accumulated experience and know-how, and achieve four fundamental goals:

— Step up the proactive approach to portfolio management and the investment strategy in the loan book by activating the necessary levers to ensure an appropriate return on the loan books.
— Adoption of risk models and the necessary methodologies to market financial products via digital channels that require decision models and fully digitalised processes.
— Accelerate the rotation of real estate assets and holdings in investees within the portfolio of unproductive assets.
— Drive effective, efficient management of unproductive assets.

For more details of the corporate risk culture, the global risk framework and the overall organisation of the risk function as well as the main financial and non-financial risks, see note 4 "Risk management" in the consolidated annual financial statements for 2019.