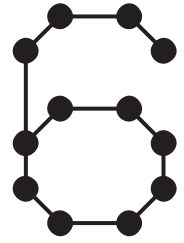


Risks



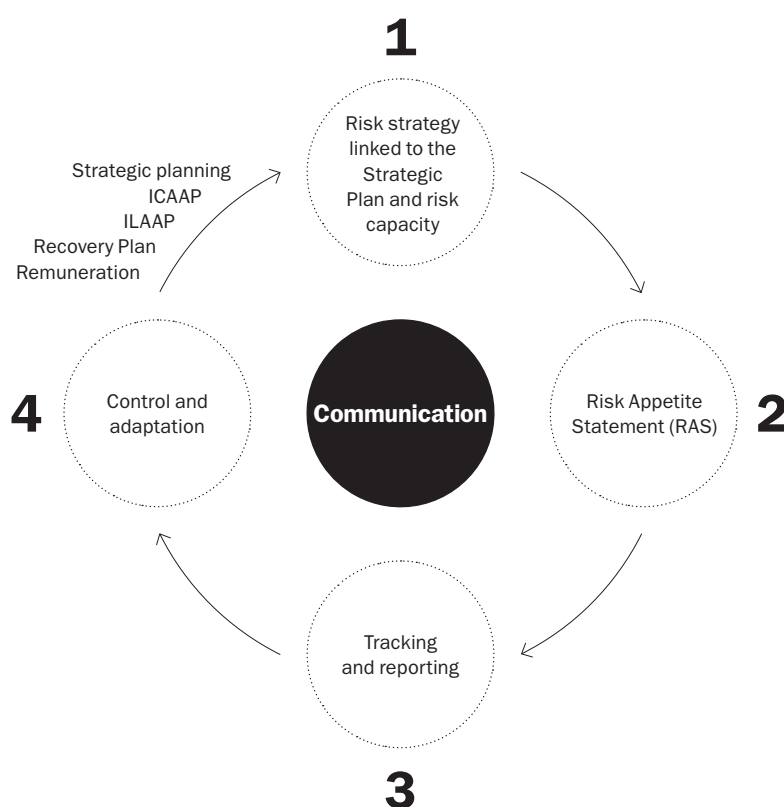
- 113 Strategic risk management and control processes
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In 2020, Banco Sabadell Group continued to strengthen its risk management framework by making improvements in line with best practices in the financial sector.

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 risk management and control processes



Main 2020 milestones in risk management and control

The most salient aspects of managing the first-tier risks identified in the Banco Sabadell Group risk taxonomy, and the steps taken in this connection in 2020, 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 2020:

(i) Strategy and reputation

— An outstanding position supporting customers during the health crisis and in the transition towards a more digital model.

(ii) TSB:

— Presentation in the fourth quarter of 2020 of the project to accelerate the restructuring process with the aim of improving profitability. The project will provide savings on recurring costs, enabling break-even to be achieved ahead of schedule.

(iii) Improved capital position:

— The CET1 ratio improved to 12.0% in fully-loaded terms at 2020 year-end, driven significantly by organic capital creation. The regulatory capital requirements were amply met.
— The total capital ratio was 15.9% at 2020 year-end, while the leverage ratio reached 5.05%, from 4.75% a year ago (in fully-loaded terms).

(iv) Profitability:

— Group net profit amounted to 2 million euros in 2020. The Group's banking revenues remain strong and are close to pre-crisis levels.
— Steps were taken during the year to lay the foundations for greater profitability in the future. A new efficiency programme includes initiatives to increase digitalisation of customer service as well as organisational restructuring and simplification projects.

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 2020:

(i) Reduction in non-performing assets:

— The NPL ratio declined to 3.60%, from 3.83% a year earlier, due to the lower classification of assets as non-performing and to active management of non-performing assets, following a slight upswing in the second quarter, and also to the sale of portfolios in the fourth quarter of 2020.
— The net non-performing assets/total assets ratio ended the year at 1.4% (from 1.7% at 2019 year-end).

(ii) Concentration:

— The portfolio is well diversified in terms of industries, with rising exposure to sectors with greater credit quality. Real estate exposure was reduced and is now one-third of the level at 2014 year-end.
— 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 overseas.
— International exposure continues to represent almost one-third of the loan book, with year-on-year increases in the main geographies (Mexico and TSB).

(iii) Lending performance:

— Outstanding loans continued to grow year-on-year in all geographies: +13.0% in Mexico, +7.1% at TSB and +3.2% in Spain.
— In Spain, ICO loans to large companies, SMEs and self-employed workers catalysed growth in net loans and advances in the second quarter, followed by a gradual recovery and firming of new loan production to individuals in the third quarter. The expiration of a sizeable volume of loan holidays did not have an impact on credit quality.

(iv) TSB lending performance:

— At TSB, all loan categories registered solid growth following the first COVID-19 lockdown. Growth in mortgages benefited from increased mortgage market activity as well as TSB's operational resilience to absorb the increase in demand. Consumer credit and personal loans rebounded once the lockdown was lifted. Companies' demand for credit under the Bounce Back Loans programme surged, particularly in the second quarter of 2020.

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 2020:

(i) Sound liquidity position:

- The liquidity position was sound, with a Liquidity Coverage Ratio (LCR) of 198% at Group level at the end of 2020 (218% excluding TSB and 201% at TSB), after optimising funding sources by obtaining 27,000 million euros under the ECB's new long-term facility (TLTRO III).
- The loan-to-deposit ratio was 98% at 2020 year-end, with a balanced retail funding structure. In 2020, Banco Sabadell fulfilled its issuance plan, and strong investor appetite enabled it to optimise the associated costs.
- At 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.
- The Bank maintained its programme of adaptation to the new benchmark indices following the entry into force of the European Benchmark Regulation (BMR) and it successfully achieved the milestones set for the EUR and other affected currencies (mainly USD and GBP).

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 2020:

(i) Technology function:

- A significant increase in the use of digital/self-service channels in terms of both volume and type of transactions, mainly due to the effects of the COVID-19 pandemic. In general, this increase in transactions was not matched by a proportional increase in the losses associated with this type of channel; accordingly, the control environment is considered to have performed appropriately.
- There was also a change in the risk profile associated with the execution of internal processes, as there was a change in the work methods due to the need to implement telework solutions, and specific controls had to be implemented to protect employees and the information they handle from their homes; consequently, corporate laptops were distributed to enable employees to work from home with appropriate security measures.

(ii) COVID-19 protocols:

- The plans in place for pandemics and contingencies were triggered in the various geographies. Those protocols have been reviewed and updated based on experience and the spread of COVID-19 and its effect on the Group. Triggering the protocols enabled the Group to proactively address potential operational risks that might arise from the situation and prepared the Group companies to adapt their systems, processes and activities as well as their range of products and services so as to minimise exposure to risks and develop and implement new opportunities, such as support measures offered by governments and those provided by the banking industry.

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 2020.