Risks

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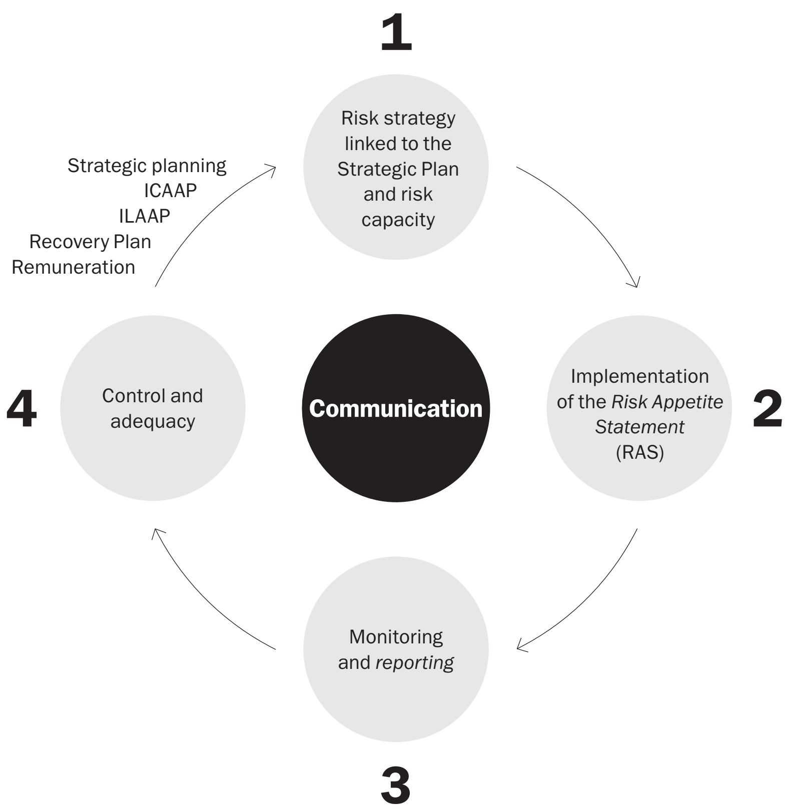
In 2021, Banco Sabadell Group continued to strengthen its Global Risk Framework by making improvements in line with best practices in the financial sector.

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 2021 milestones in risk management and control

Below are the most noteworthy aspects in terms of their management and actions of the first-tier risks identified in Banco Sabadell Group's risk taxonomy in 2021:

Strategic risk

Definition:

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

Main milestones in 2021:

(i) Strategy and reputation

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

(ii) TSB

— Throughout 2021, TSB has been completing the actions of its Master Plan to improve profitability and efficiency.

(iii) Improvement of the capital position

— The CET1 ratio improved to 12.22% in fully-loaded terms at 2021 year-end, driven significantly by organic capital creation. Generalised capital compliance with regulatory requirements.
— Total Capital also improved, ending 2021 at 17.65%, and the Leverage ratio increased from 5.04% to 5.81% year-on-year (in fully-loaded terms).

(iv) Profitability

— Group net profit amounted to 530 million euros in 2021. The Group's banking revenues remain strong and are close to pre-crisis levels.
— During 2021, a series of efficiency initiatives have been launched in Spain, which will help reduce recurrent costs and which include further digitalisation of customer services and process re-engineering.

Credit risk

Definition:

Credit risk refers to the risk of incurring losses as a result of borrowers' failure to comply with payment obligations, as well as experiencing a loss of value due to the impairment of borrowers' creditworthiness.

Main milestones in 2021:

(i) Non-performing assets

— Slight increase in the NPL ratio from 3.6% to 3.7%, mainly due to higher inflows from the regulatory changes in TSB and the repurchase of non-performing Spain portfolios.

(ii) Concentration

— From a sectoral point of view, diversified loan book with limited exposure to sectors with higher sensitivity to COVID-19 and with a downward trend.
— Also, in terms of individual concentration, the downward trend in the concentration risk metrics of large exposures continues, due to both a lower exposure (numerator) and an increase in capital (denominator). The credit rating of the largest exposures is affected, albeit not significantly, by a deterioration of balance sheets, resulting from the health crisis.
— In geographical terms, the portfolio is positioned in the most dynamic regions, both nationally and internationally. International lending continues to account for around a third of the loan book

(iii) Lending performance

— Gross performing loans continued to grow year-on-year in all geographies with growth of +2.3% in Spain, +19.1% at TSB and +5.6% in Mexico per annum.
— In Spain, year-on-year growth was mainly supported by commercial loan to companies, SMEs and the self-employed as well as by the increase in individual mortgages. The project finance portfolio was also dynamic, with particular traction in sustainable projects.

(iv) TSB loan performance

— At TSB, all loan categories showed solid growth, especially in mortgages. Growth in mortgages benefited from increased mortgage market activity, as well as TSB's operational resilience to absorb the increase in demand. Consumer loans and personal loans increased once the lockdown was lifted.

Financial risk

Definition:

Possibility of obtaining insufficient profitability or having insufficient liquidity such as to prevent compliance with requirements and future expectations.

Main milestones in 2021:

(i) Robust liquidity position

— Solid liquidity position, where the LCR (Liquidity Coverage Ratio) stands at 221% at the end of 2021 at Group level (194% at MLU TSB and 254% at Banco Sabadell Spain) and the NSFR (Net Stable Funding Ratio) at 141% at Group level (149% at MLU TSB and 137% at Banco Sabadell Spain) both at the end of 2021, after having optimised funding sources with access to new long-term financing from the ECB (TLTRO III) for a total amount of 32,000 million euros and with the Bank of England (TFSME) for an amount of 6,545 million euros, as well as maintaining a growing generation of commercial gap in 2021.

— The loan to deposits ratio at the closure of September 2021 is 96.3% with a balanced retail funding structure.

— Moreover, as regards capital markets, in 2021, Banco Sabadell fulfilled its issuance plan, and its strong investor appetite enabled it to optimise the associated costs.

(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 portfolio 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 has 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 2021:

(i) Digital transformation

— Sustained increase in the use of digital/assisted channels both in terms of volume and type of transactions, mainly due to the effects of the COVID-19 pandemic and the change in the business model, mainly at the retail level. 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.

— The implementation and adoption of telework, also derived from COVID-19, also caused a change in the risk profile associated with the execution of internal processes and it was necessary to implement specific controls aimed at protecting employees and information, incorporating the massive adoption of secure corporate laptops which have proven to be effective, as no events or incidents related to this new situation and way of working have been detected.

(ii) Business model transformation

— As a result of the changes and adaptations made on the occasion of COVID-19 and within the new Strategic Plan, the process of change and transformation towards a digital business model has been accelerated, in which customer relations have evolved towards greater use of non-face-to-face channels and, consequently, a reduction in the branch network.

— This process of change has driven the adaptation of the entity's systems, processes and activities, ensuring the robustness of the existing control environment, minimising exposure to risks and developing and implementing new opportunities arising from the transformation associated with the new business model.

Compliance risk

Definition:

Compliance risk, which is part of operational risk, is defined as the possibility of incurring legal or administrative sanctions, significant financial losses or reputational losses due to non-compliance with laws, regulations, internal rules and codes of conduct applicable to the banking business, minimising the possibility of non-compliance and ensuring that any non-compliance that may occur is identified, reported and dealt with diligently.

Main milestones in 2021:

(i) Promoting a culture of ethics and compliance among employees

— Designing and approving the new Code of Conduct.
— Strengthening of the Regulatory School to cover the training needs of employees in a user-friendly way in each of its classrooms: Regulators and Supervisors Classroom, Ethics and Conduct Classroom, Sale and Contracting of Products and Services Classroom, Prevention of Money Laundering and Counter-Terrorist Financing Classroom, Data Protection Classroom and Customer Service Space.

(ii) Planning and monitoring

— The Compliance establishes, applying the principle of proportionality in accordance with the nature, volume and complexity of its activities, a Compliance Programme which includes a detailed planning of its activities. This programme covers all services provided and activities carried out by the entity and defines its priorities based on the assessment of compliance risk and in coordination with the Risk Control function.
— In order to guarantee the effectiveness of the Programme, two half-yearly Monitoring Plans have been drawn up, which include two types of information: those that illustrate the activities developed from a quantitative perspective, with KPIs linked to the operational execution of the programme, and those that deal with qualitative variables.
— The action plan required to implement in the Bank the new obligations of Royal Decree-Law 7/21, which transposes the 5th EU directive on the prevention of money laundering and terrorist financing, has been carried out.

(iii) Relationship with supervisors

— Management maintains constant interaction with the main authorities supervising the Bank's activities.
— All requests received from the different supervisors have been dealt with within the established deadlines.

(iv) Incorporation of the Customer Service Department into the Compliance Division

— In May 2021, as a result of the new structure designed and aligned with the new Bank of Spain Banking Guidelines published in July 2021, the Customer Service Department will be incorporated into the Compliance Division, initiating a process of adaptation to its organisation and functioning.

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 Accounts for 2021.