Risks

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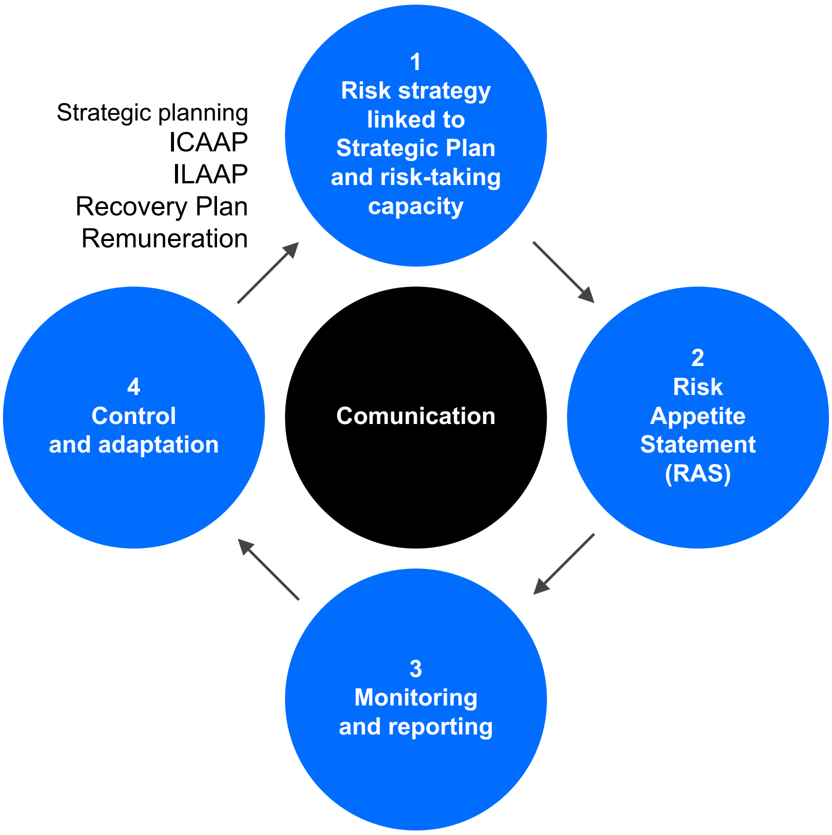
In 2023, Banco Sabadell Group continued to strengthen its Global Risk Framework by making improvements in line with best practices in the financial sector.

During 2023, Banco Sabadell Group has continued to strengthen its Global Risk Framework by making improvements to bring it in line with best practice in the financial sector.

The Group continues to have 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-taking capacity, articulated through the Risk Appetite Statement (RAS), under which all material risks are monitored, tracked and reported, and the necessary control and remediation systems are in place to ensure compliance therewith.

5.1 Strategic risk management and control processes



5.2 Main milestones achieved in 2023 in relation to risk management and control

The most salient aspects concerning the management of the first-tier risks identified in Banco Sabadell Group's risk taxonomy and concerning the actions taken in this regard in 2023 are set out below:

Strategic risk

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

Key milestones in 2023:

(1) Strategy and reputation

— The support of customers in the transition to a more digital model and the adoption of good practices and initiatives to provide greater consumer protection.
— Although certain macroeconomic factors have been at play during 2023 that could have had a negative impact on the Bank's profitability depending on how they developed, that risk ultimately did not materialise as (i) inflation rates in Spain have been falling in recent months and (ii) borrowers have exhibited a good payment capacity, meaning that delinquency has remained contained. Similarly, the good delivery on the Strategic Plan, the stronger credit profile and the delivery of record-breaking results are all reflected in several reputational indicators, for example, (i) the improved outlooks of investors and rating agencies with regard to the Institution and (ii) a solid share price performance, recording a share revaluation of 33% over the year.

(2) Improved capital position

— The CET1 ratio improved to 13.2% in fully-loaded terms as at 2023 year-end, particularly driven by organic capital generation. Regulatory requirements in relation to capital are generally being met.
— The total capital ratio has also improved, ending 2023 at 17.76% in fully-loaded terms.
— During 2023, the leverage ratio rose by 56 basis points compared to the corresponding ratio as at 31 December 2022, ending the year at 5.18%. This development is mainly due to a decrease in the exposure with central banks linked in large part to TLTRO repayments and, to a lesser extent, the decline in lending volumes.

(3) Profitability

— Profit attributable to owners of the parent amounted to 1,332 million euros as at the end of 2023. It is worth calling attention to the good performance of core results (net interest income plus fees and commissions less costs), which improved due to both the increase in net interest income and the efforts made to contain costs. Specifically, net interest income grew by 24.3% year-on-year, mainly due to the credit yield and improved revenue from the fixed-income portfolio, underpinned by higher interest rates, all of which served to offset higher funding and capital market costs and the negative effect of the depreciation of sterling and the Mexican peso.
— It is also worth highlighting the improvement in the Group's credit quality, which has made it possible to reduce provisions and place the total cost of risk substantially below the levels recorded in 2022.
— All these aspects are clearly reflected in the Group's improved profitability, shown by an improvement of its ROTE, which increased from 8.19% as at 31 December 2022 to 11.49% as at 31 December 2023.

Credit risk

Definition: risk of incurring losses as a result of borrowers failing to fulfil their payment obligations, or of losses in value materialising due simply to the deterioration of borrowers' credit quality.

Key milestones in 2023:

(1) Non-performing assets

— During 2023, non-performing assets were reduced by 223 million euros. The NPL ratio for the year stands at 3.52%.

(2) Concentration:

— From a sectoral point of view, the loan portfolio is diversified and has limited exposure to the sectors most sensitive to the current environment.
— Similarly, in terms of individual concentration, the metrics relating to concentration of large exposures show a slight downward trend and remain within the appetite level. The credit rating of the largest exposures has also improved over the year.
— Geographically speaking, the portfolio is positioned in the most dynamic regions, both in Spain and worldwide. International exposures account for 37% of the loan book.

(3) Lending performance:

— Not including the foreign currency effect, performing loans fell by 4.6% in Spain and by 5.9% in TSB but increased by 7.1% year-on-year in Mexico.
— In Spain, the year-on-year decline is mainly due to the reduced volume of the portfolio of business loans and mortgages.

(4) TSB lending performance

— In TSB, at constant exchange rates, gross performing loans fell by 5.9% year-on-year, due to the reduced volume of the mortgage portfolio.

Financial risk

Definition: possibility of obtaining inadequate returns or having insufficient levels of liquidity that prevent an institution from meeting future requirements and expectations.

Key milestones in 2023:

(1) Sound liquidity position

— Sound liquidity position, with the LCR (Liquidity Coverage Ratio) standing at 228% at the Group level (203% in the TSB LMU and 274% in Banco Sabadell Spain) and the NSFR (Net Stable Funding Ratio) standing at 140% at the Group level (152% in the TSB LMU and 134% in Banco Sabadell Spain), both figures as at 2023 year-end, after having optimised the funding sources with access to long-term finance, having borrowed 5 billion euros from the ECB and 4,608 million euros from the Bank of England, as well as generating a funding gap in 2023.

— The loan-to-deposit ratio as at the end of 2023 was 94.0%, with a balanced retail funding structure.

— Moreover, Banco Sabadell has fulfilled the capital markets issuance plan that it had set itself for 2023, with strong investor appetite, allowing it to optimise the associated funding costs.

(2) Structural interest rate risk

— The Institution continued to accommodate higher levels of new fixed-rate lending in an environment of higher interest rates in all relevant currencies. The variable-rate loan book reflected the ongoing revaluation of interest rate benchmarks (mainly the 12-month Euribor). As for liabilities, there was an increase in the balance of interest-bearing demand deposits and term deposits, mostly of wholesale customers, contrasting with the reduction of the balance of non-interest-bearing demand deposits, keeping costs at low levels relative to the upward trend followed by interest rates throughout the year.

Operational risk

Definition: risk of incurring losses due to inadequacies or failures of processes, staff or internal systems or due to external events. This definition includes but is not limited to compliance risk, model risk and information and communications technology (ICT) risk and excludes strategic risk and reputational risk.

Key milestones in 2023:

— Operational risk remains a material risk for the Group, recording impacts that, though acceptable, have gradually increased in recent years due to the problems associated with conduct risk.

— The current situation of high awareness and increased regulatory pressure, aimed especially at providing greater protection for consumers and vulnerable customers, requires conduct risks to be the main focus of attention. The current materiality and the expectation that this situation will likely continue requires the focus to remain fixed on these risks, tracking their evolution and adequately monitoring the planned mitigation measures.

— The focus remains on complaints related to floor clauses, mortgage application and arrangement fees, high rates of interest charged in connection with revolving credit cards and appropriate assistance for

vulnerable customers, especially in the UK, given the demanding regulatory environment.
— The possible creation of the new financial customer protection authority could have an impact on the complaints received, as it facilitates this process. The materialisation of conduct risks involves a potential reputational risk for the Institution, although it remains in line with the sector.

Compliance risk

Definition: risk of incurring legal or regulatory sanctions, material financial loss or loss to reputation as a result of failing to comply with laws, regulations, self-regulating rules and codes of conduct applicable to the Group's activity.

In accordance with Banco Sabadell's Compliance Policy and observing the EBA's Guidelines on Internal Governance, an Annual Programme is drawn up, applying the principle of proportionality according to the nature, volume an complexity of activities, containing a detailed schedule of activities, including the review of policies and procedures, the risk assessment, control plans and staff training in relation to compliance. This programme covers all services provided and activities carried out by Compliance and defines its priorities based on the risk assessment, in coordination with the Risk Control function. Monitoring exercises are conducted and regular reports on them are made to the Group's governing bodies in order to identify any deviations and resolve them quickly and effectively.

In 2023, efforts continued to be made to promote a culture of ethics and compliance among employees, interacting on an ongoing basis with the main supervisory authorities in connection with the Bank's compliance activity.

Main priorities in 2023:

(1) Evolution of supervisory model

— Evolution of the model for supervising subsidiaries and foreign branches.
— Adaptation of the current model to the increasingly demanding levels of supervision carried out by the parent company over the compliance activity of its various subsidiaries and foreign branches, allowing more in-depth knowledge to be obtained about the management of local risks and enabling more uniform compliance risk assessments to be made at the Group level.

(2) Accelerated pace of digitalisation

— Accelerated pace of digitalisation in the Anti-Money Laundering and Counter-Terrorist Financing function.
— A digital transformation agenda was launched with the aim of increasing the effectiveness of preventive assessments, systematising and improving the experience of relationship mangers and customers, and reinforcing the culture of sustainability in relation to compliance.

(3) Management of competition risk

— Incorporation of competition risk management into the annual Compliance Programme.
— Development of the main pillars from which to implement a competition risk management model to reinforce the prevention of possible misconduct in this regard.