# Introduction

## Regulatory environment in 2017

### Legal Context

As a Spanish credit institution, BBVA is subject to Directive 2013/36/EU of the European Parliament and of the Council dated June 26, 2013, on access to the activity of credit institutions and investment firms (“Directive CRD IV”) amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC by means of which the EU began, as of January 1 2014, to implement the capital reforms agreed within the framework of Basel III, thus establishing a period of gradual implementation for certain requirements until January 1 2019. The major regulation governing the solvency of credit institutions is Regulation (EU) No 575/2013 of the European Parliament and of the Council dated June 26, 2013, on prudential requirements for credit institutions and investment firms, amending Regulation (EU) No 648/2012 (“CRR” and, jointly with Directive CRD IV and any other CRD IV implementation measure, “CRD IV”), which is complemented by several binding Regulatory Technical Standards that apply directly to EU member states, there being no need to implement national measures. Directive CRD IV was transposed to Spanish national law by means of Royal Decree-Law 14/2013 dated November 29 (“RD-L 14/2013”), Law 10/2014, Royal Decree 84/2015 dated February 13 (“RD 84/2015”), Bank of Spain Circular 2/2014 dated January 31 and Circular 2/2016 dated February 2 (“Bank of Spain Circular 2/2016”).

In order to strike a balance between risk sensitivity, simplicity and comparability, the Basel Committee has reformed the Basel III framework. The main amendments are focused on internal models, the standard credit risk method, the market risk framework, operational risk and capital floors in the advanced measurement approach based on the standardised approach. The reform has been approved by the Basel Committee meeting on December 8, 2017, with an implementation date of January 1, 2022. In the case of capital floors, its introduction is gradual over a period of 5 years, from a floor of 50% on January 1, 2022 to 72.5% on January 1, 2027. The Committee has also introduced an additional leverage ratio for global systemically important banks (G-SIBs).

In Europe, on November 23, 2016 the European Commission published a new reform package amending both the prudential banking regime (CRR IV) and the resolution regime (Bank Recovery and Resolution Directive, BRRD). This revision includes the implementation of international standards into European legislation (regulation later than 2010 adopted by the Basel Committee and the total loss absorbing capacity (TLAC), the final design of the Minimum Requirement for own funds and Eligible Liabilities (MREL) along with a package of technical improvements. At the same time, a proposal has also been put forward to harmonise the hierarchy of senior debt creditors within the European Union. Publication of this proposal is only the first step in the European legislative process. As of today discussions continue within the European Council and Parliament with the aim of reaching an agreement on the texts that will be the subject of negotiation between the European Commission, the European Council and the European Parliament. However, on December 27, 2017 the Official Journal of the European Union (OJEU) published the agreement reached by the fast-track procedure relating to the following three aspects of the reform:

1) A transitional period of 5 years (2018-2022) during which the banks will be allowed to mitigate partially the negative impact of the increased provisions under the new IFRS 9 accounting standard on their CET1 capital.

2) An additional period of three years (2018-2020) during which exposure with respect to central governments or central banks of the Member States denominated and financed in a currency of another Member State remains exempt from calculation at the limit on large risks.

3) Creation of a new category of subordinated senior debt in the hierarchy of bank creditors that will be eligible for the purposes of TLAC.

With respect to securitisations, the European Commission published a proposal in 2015 designed to facilitate the development of a securitisation market in Europe. The package consisted of 2 draft Regulations:

1) Securitisation Regulation: Combines the rules applicable to all the securitisations including high-quality securitisation (simple, transparent and standardised (STS) securitisation), which is now dispersed across several legal provisions. This rationalises and simplifies the existing rules and establishes a general system for defining STS securitisation.

2) Text modifying the CRR with respect to the capital requirements for securitisation positions. Gives a more risk-sensitive treatment to STS securitisations.

These two regulations were published in the OJEU on December 28, 2017, and are applicable starting January 1, 2019.

At the same time, the Basel Pillar III framework is being revised by the Basel Committee on Banking Supervision (BCBS), which has divided the process into three phases.

The disclosure requirements derived from the first phase of the review were published in January 2015, replacing the disclosure requirements published in 2014 (modified in July 2009).

Subsequently in a second phase, the BCBS reviewed the disclosure requirements included in all the Basel rules currently in force and consolidated in the Pillar III framework in the document "Pillar 3 Disclosure Requirements - Consolidated and Enhanced Framework," which was published in March 2017. This consolidated and enhanced framework includes the following elements:

- Consolidation of all the BCBS disclosure requirements current in Pillar 3.
- Two improvements in the Pillar 3 framework: a dashboard with the key prudential metrics for a bank and a new disclosure requirement for prudent valuation adjustments.
- Reviews and additions to the Pillar 3 rule derived from the reform underway of the regulatory policy framework: disclosure requirements relating to the system of total loss absorption capacity (TLAC) for G-SIB and revised market risk disclosure requirements.

In February 2018, the BCBS has published a consultation on the third phase of the revision of the Pillar III framework, which includes, among others, new information disclosure requirements derived from the conclusion of the Basel III reforms. This consultation ends on May 28, 2018.

The disclosure requirements for the first phase of the review of Pillar 3 entered into force in December 2016, while the disclosure requirements for the second phase have different implementation dates, with the first phase coinciding with the close of 2017.

In order for all European institutions to implement the Basel review in such a way as to meet CRR Part Eight requirements on this matter, in December 2016 the European Banking Authority ("EBA") published its final guidelines on regulatory disclosure ("Guidelines on Revised Pillar 3 Disclosures Requirements"). The implementation date for these guidelines is the close of the financial year 2017. However, it was recommended that global systemically important banks ("G-SIB") should undertake a partial implementation at the close of the financial year 2016.

Annex 5 of this report (see document "Pillar III 2017 Annexes") gathers the correspondence of the articles of CRR Part Eight on information disclosure with the different headings of the document (or other public documents) where the required information is located.

In an exercise of transparency, as of December 31, 2017, BBVA includes all the standard templates on disclosure of information recommended by the different regulators. They can be seen in the following table:

Disclosure requirements

| Template | Guidelines on disclosure requirements EBA/GL/2016/11 | Pillar III Section |
|---|---|---|
| EU-OV1 | Overview of RWAs | 2.4 |
| EU-LI1 | Differences between the accounting and regulatory scopes of consolidation and the mapping of financial statement categories with regulatory risk categories | 1.1.3 |
| EU-LI2 | Main sources of the differences between the regulatory exposure amounts and carrying values in financial statements | 1.1.3 |
| EU-LI3 | Outline of the differences in the scopes of consolidation (entity by entity) | Pillar III Annexes |
| EU-INS1 | Non-deducted participations in insurance undertakings | N/A |
| EU-CR1-A | Credit quality of exposures by exposure class and instrument | 3.2.3.4 |
| EU-CRB-B | Total and average net amount of exposures | 3.2.3.2 |
| EU-CRB-C | Geographical breakdown of exposures | 3.2.3.3 |
| EU-CR1-C | Credit quality of exposures by geography | 3.2.3.3 |
| EU-CRB-D | Concentration of exposures by industry or counterparty types | 3.2.3.5 |
| EU-CR1-B | Credit quality of exposures by industry or counterparty types | 3.2.3.5 |
| EU-CRB-E | Maturity of exposures | 3.2.3.6 |
| EU-CR1-D | Ageing of past-due exposures | 3.2.3.6 |
| EU-CR2-A | Changes in the stock of general and specific credit risk adjustments | 3.2.3.8 |
| EU-CR2-B | Changes in the stock of defaulted and impaired loans and debt securities | 3.2.3.8 |
| EU-CR1-E | Non-performing exposures and forborne exposures | 3.2.3.9 |
| EU-CR4 | Standardised approach: Credit risk exposure and Credit Risk Mitigation effects | 3.2.4.3 |
| EU-CR5 | Standardised approach | 3.2.4.3 |
| EU-CR6 | IRB Approach: Credit risk exposures by exposure class and PD range | 3.2.5.2 |
| EU-CR9 | IRB Approach: Backtesting of PD per exposure class | 3.2.5.2 |
| EU-CR8 | RWA flow statements of credit risk exposures under the IRB approach | 3.2.5.2 |
| EU-CR10 (1) | IRB: Specialised lending | 3.2.5.4 |
| EU-CR10 (2) | IRB: Equity | 3.2.5.5 |
| EU-CCR5-A | Impact of netting and collateral held on exposure values | 3.2.6.2 |
| EU-CCR1 | Analysis of counterparty credit risk exposure by approach | 3.2.6.2 |
| EU-CCR3 | Standardised approach: counterparty credit risk exposures by regulatory portfolio and risk | 3.2.6.2.1 |
| EU-CCR4 | IRB Approach: counterparty credit risk exposure by portfolio and PD scale | 3.2.6.2.2 |
| EU-CCR5-B | Composition of collateral for exposures to counterparty credit risk | 3.2.6.2.3 |
| EU-CCR6 | Credit derivatives exposures | 3.2.6.2.4 |
| EU-CCR2 | Credit valuation adjustment (CVA) capital charge | 3.2.6.3 |
| EU-CCR8 | Exposures to central counterparty clearing houses | 3.2.6.4 |
| EU-CR3 | Credit risk mitigation techniques overview | 3.2.8.3 |
| EU-MR1 | Market risk under the standardised approach | 3.3.3 |
| EU-MR3 | IMA values for trading portfolios | 3.3.4.2.2 |
| EU-MR2-A | Market risk under the internal model approach (IMA) | 3.3.4.2.2 |
| EU-MR2-B | RWA flow statements of market risk exposures under the IMA approach | 3.3.4.2.2 |
| EU-MR4 | Trading Book. Validation of the Market Risk Measurement Model | 3.3.4.2.4 |

| Template | Guidelines on disclosure of liquidity information (EBA/GL/2017/01) | Pillar III Section |
|---|---|---|
| EU-LIQ1 | Guidelines on disclosure of Liquidity information | 3.7.5 |

| Template | Leverage ratio - Commission Implementing Regulation (EU) 2016/200 | Pillar III Section |
|---|---|---|
| LRSum | Summary of the reconciliation of accounting assets and exposure corresponding to the Leverage Ratio | 4.1 |
| LRCom | Common Leverage Ratio disclosure table | Pillar III Annexes |
| LRSpl | Breakdown of balance-sheet exposures | Pillar III Annexes |

| Template | Own Fund requirements - Commission Implementing Regulation (EU) 1423/2013 | Pillar III Section |
|---|---|---|
| Template for presenting the main characteristics of capital instruments | | Pillar III Annexes |
| Template with information on temporary Own Funds | | Pillar III Annexes |

| Template | Anticyclical capital buffer Commission Delegated Regulation (EU) 2015/1555 | Pillar III Section |
|---|---|---|
| Distribution by geographic areas of the credit exposure for calculation of the countercyclical capital buffer. | | Introduction |
| Amount of the countercyclical capital buffer specific to each entity | | Introduction |

| Template | Pillar III disclosure requirements - Basel Supervision Committee | Pillar III Section |
|---|---|---|
| SEC1 | Securitisation exposure in the investment portfolio | 3.2.7.4 |
| SEC4 | Exposure to securitisation in the banking portfolio and associated regulatory capital requirements (bank that acts as investor) | 3.2.7.5 |
| SEC3 | Exposure to securitisation in the banking portfolio and associated regulatory capital requirements (bank that acts as originator or sponsor) | 3.2.7.6.2 |

## Composition of Capital

The regulations require institutions to have a higher and better quality capital level, increase capital deductions and review the requirements associated with certain assets. Unlike the previous framework, the minimum capital requirements are complemented with requirements for capital buffers and others relating to liquidity and leverage. Bank capital under CRD IV mainly comprises of the elements described in section 3.1 herein.

The most relevant aspects affecting the elements making up common equity and risk-weighted assets are detailed in greater depth in section 2.4 of this document.

In this regard, article 92 of the CRR establishes that credit institutions must maintain at all times, at both individual and consolidated level, a total capital ratio of 8% of their risk-weighted assets (commonly referred to as the Pillar 1 requirement). At least 6% of the total capital ratio must comprise Tier 1 capital, of which 4.5% must in any case comprise Common Equity Tier 1 capital (CET1), and the remaining 2% may be completed with Tier 2 capital instruments.

Notwithstanding the application of the Pillar 1 requirement, CRD IV allows for competent authorities to require that credit institutions maintain more shareholders' equity than the Pillar 1 requirements to cover risks other than those already covered by the Pillar 1 requirement (this power of the competent authority is commonly known as Pillar 2).

Furthermore, in accordance with CRD IV, credit institutions must comply with the "combined requirement of capital buffers" as of 2016. The "combined buffer requirement" has incorporated five new capital buffers: (i) the capital conservation buffer; (ii) the buffer for global systemically important banks (the "G-SIB buffer"); (iii) the countercyclical capital buffer specific to each bank; (iv) the buffer for other systemically important financial institutions (the "D-SIB buffer"); and (v) the buffer against systemic risks. The "combined capital buffer requirement" must be met with Common Equity Tier 1 capital ("CET1") in addition to that which is provided to meet the minimum capital required by "Pillar 1" and Pillar 2".

Both the capital conservation buffer as well as the EISM buffer (where appropriate) will apply to credit institutions, as it establishes a percentage over 0%.

The buffer for global systemically important banks applies to those institutions on the list of global systemically important banks ("G-SIBs"), which is updated annually by the Financial Stability Board ("FSB"). Given that BBVA was excluded from the list of global systemically important financial institutions in 2016, as of January 1, 2017, the G-SIB buffer did not apply to BBVA in 2017 (notwithstanding the possibility that the FSB or the supervisor may in the future include BBVA on that list). BBVA was also not on the 2017 list, as of January 1, 2018, so this buffer was not applicable to BBVA in 2018 either.

For more details on the quantitative indicators for assessing the global systemically important banks, see the document "G-SIBs Information" in the section Shareholders and Investors / Financial Information on the BBVA Group website (published in April): https://shareholdersandinvestors.bbva.com/financials/.

The Bank of Spain has extensive discretionary powers as regards the countercyclical capital buffer peculiar to each bank, the buffer for other systemically important financial institutions (which are those institutions considered to be systemically important local financial institutions "D-SIB") and the buffer against systemic risks (to prevent or avoid systemic or macroprudential risks). The European Central Bank (ECB) has the powers to issue recommendations in this respect following the entry into force on November 4 2014 of the Single Supervisory Mechanism (SSM).

In December 2015, the Bank of Spain agreed to set the countercyclical capital buffer that applies to credit exposures in Spain at 0% as of January 1 2016. These percentages will be reviewed every quarter, as the Bank of Spain decided in 2017 to keep the countercyclical capital buffer at 0% for the first quarter of 2018.

As far as BBVA is concerned, after the supervisory review and evaluation process ("SREP") conducted in 2017, the ECB has required that BBVA, as of January 1 2018 maintain (i) a CET1 phased-in ratio of 8.438% at consolidated level and 7.875% at individual level; and (ii) a phased-in total capital adequacy ratio of 11.938% at consolidated level and 11.375% at individual level.

The ECB's decision establishes that the total capital adequacy ratio of 11.938% at consolidated level consists of: (i) the minimum CET1 ratio required by Pillar 1 (4.5%); (ii) the minimum additional Tier 1 capital ratio ("AT1") level required by Pillar 1 (1.5%); (iii) the minimum Tier 2 ratio required by Pillar 1 (2%); (iv) the CET 1 ratio required by Pillar 2 (1.5%); (v) the capital conservation buffer (which is 1.875% in phased-in CET 1 terms); and (vi) the O-SII buffer (which is 0.563% in phased-in CET 1 terms).

As of December 31, 2017, BBVA had a fully-loaded consolidated CET1 ratio of 11.04%, strengthening the Group's capital position, since 2016, with a phased-in ratio of 11.67%.

The following chart presents the distribution by geographic areas of the credit exposure for calculation of the countercyclical capital buffer:

**Table 1.** Geographical breakdown of relevant credit exposures for the calculation of the countercyclical capital buffer (Million Euros. 12-31-17)

| | General credit exposures [1] | | Trading book exposure | | Securitisation exposure | | Own funds requirements | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Exposure value for SA | Exposure value for IRB | Sum of long and short position of trading book | Trading book exposure value for internal models | Exposure value for SA | Exposure value for IRB | of which: General credit exposures | Of which: Trading book exposures | Of which: Securitisation exposures | Total | Own funds requirements weights | Countercyclical capital buffer rate |
| **Geographical breakdown** | | | | | | | | | | | | |
| Sweden | 116 | 100 | - | (16) | - | - | 12 | - | - | 12 | 0.05% | 2.00% |
| Norway | 3 | 17 | - | 4 | - | - | 1 | - | - | 1 | 0.00% | 1.50% |
| Hong Kong | 1 | 659 | - | - | - | - | 16 | - | - | 16 | 0.07% | 1.25% |
| **Total countries with countercyclical capital buffer stablished** | **120** | **776** | **-** | **(11)** | **-** | **-** | **28** | **-** | **-** | **28** | **0.13%** | |
| Spain | 27,472 | 150,317 | 10 | 72 | 0 | 3,147 | 5,969 | 0 | 66 | 6,035 | 28.23% | - |
| USA | 55,127 | 7,011 | 6,790 | (1) | 4,250 | - | 4,027 | 0 | 71 | 4,098 | 19.17% | - |
| Turkey | 51,679 | 670 | 13,432 | 1 | - | - | 3,275 | 3 | - | 3,278 | 15.33% | - |
| Mexico | 33,544 | 23,552 | 82 | 241 | 63 | - | 2,745 | 63 | 3 | 2,811 | 13.15% | - |
| Chile | 15,729 | 440 | 30,776 | 0 | - | - | 901 | 3 | - | 903 | 4.23% | - |
| Peru | 14,908 | 754 | 3,380 | - | - | - | 898 | 2 | - | 900 | 4.21% | - |
| Colombia | 12,520 | 489 | 13,767 | - | - | - | 756 | 10 | - | 766 | 3.58% | - |
| Argentina | 6,378 | 253 | 1,558 | 1 | - | - | 432 | 22 | - | 453 | 2.12% | - |
| Portugal | 4,840 | 1,248 | 30 | (7) | - | - | 279 | 2 | - | 281 | 1.31% | - |
| France | 752 | 4,317 | - | (42) | - | - | 235 | - | - | 235 | 1.10% | - |
| **Total countries without countercyclical capital buffer but with own funds requirements greater than 1%** | **222,950** | **189,050** | **69,823** | **265** | **4,314** | **3,147** | **19,516** | **104** | **140** | **19,761** | **92.43%** | |
| Other areas | 11,104 | 22,856 | 219 | (111) | - | 1 | 1,589 | 1 | 0 | 1,590 | 7.44% | - |
| **Total countries without countercyclical capital buffer but with own funds requirements less than 1%** | **11,104** | **22,856** | **219** | **(111)** | **-** | **1** | **1,589** | **1** | **0** | **1,590** | **7.44%** | |
| **Total** | **234,174** | **212,682** | **70,042** | **143** | **4,314** | **3,148** | **21,133** | **105** | **140** | **21,378** | **100%** | |

[1] Credit exposures exclude exposures to Central Governments or Central Banks, Regional Governments or Local Authorities, Public sector entities, Multilateral Development Banks, International Organizations and Institutions in accordance with art. 140.4 of Directive 2013/36/EU

| | Amount |
|---|---|
| Total risk exposure amount | 362,875 |
| Institution specific countercyclical buffer rate (2) | 0.001% |
| Institution specific countercyclical buffer requirement | 4 |

[2] Countercyclical capital buffer calculated as of December 2017 in accordance with Commission Delegated Regulation (EU) 2015/1555

## Leverage Ratio

In order to provide the financial system with a metric that serves as a backstop to capital levels, irrespective of the credit risk, a measure complementing all the other capital indicators has been incorporated into Basel III and transposed to the solvency regulations. This measure, the leverage ratio, can be used to estimate the percentage of the assets financed with Tier 1 capital.

Although the carrying amount of the assets used in this ratio is adjusted to reflect the bank's current or potential leverage with a given balance-sheet position, the leverage ratio is intended to be an objective measure that may be reconciled with the financial statements.

As of December 31, 2017, BBVA Group had a Leverage Ratio of 6.53% (fully loaded), and a phased-in ratio of 6.62%, above the target set at 3%, and continuing to compare very favorably with the rest of its peer group.