18 April 2019

Financial Institutions

Banco Santander SA
Issuer Rating Report

SCOPE

STABLE

AA-

Overview

Scope Ratings assigns an Issuer Rating of AA- and short-term debt ratings of S-1+ to Banco Santander SA, with Stable Outlook. The agency also rates the institution's senior unsecured debt not eligible for MREL at AA-, and its senior unsecured debt eligible for MREL at A+. These ratings do not apply to the unguaranteed subsidiaries of the rated parent.

The ratings were not solicited by the issuer. Both the ratings and analysis are based solely on publicly available information. The issuer has participated in the process.

Highlights

- The ratings are driven by the bank's strong, seasoned business model in retail and commercial banking, which produces a reliable and well-diversified earnings stream and generates capital at group level. We believe this business model has proven its resilience to shocks, having withstood the global financial crisis, the Spanish real estate market collapse, the euro area sovereign crisis and a recent recession in its key market of Brazil without any damage to capital. Going forward, Santander faces a more challenging outlook in the UK as a result of Brexit-related macro uncertainty, but the outlook for Spain and Brazil is more positive.
- Moreover, good credit demand in emerging markets is compensating for the more muted volume-growth outlook in Europe. This has allowed the group to profitably re-deploy capital from cash-generating European operations to fast-growing emerging-market subsidiaries.
- Due to the group's presence in several developed and emerging markets, we believe the key ongoing challenges for Santander will be the different regulatory requirements and priorities among the various authorities and ensuring that prudential and supervisory requirements are met at both group and local level.

Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- A business model that has withstood crisis challenges
- Globally diversified revenue and earnings streams with strong market positions in several key markets
- Ongoing improvement of capital, liquidity and funding positions in recent years
- The European banking union provides strong regulatory and supervisory framework

Ratings & Outlook

Issuer Rating	AA-
Outlook	Stable
Senior unsecured debt	AA-
Senior unsecured debt (MREL/TLAC eligible)	A+
Tier 2 instruments	A-
Additional Tier 1 instruments	BBB-
Short-term debt rating	S-1+
Short-term debt rating outlook	Stable
Covered bonds ratings	AAA
Covered bonds Outlook	Stable

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Bloomberg: SCOP

Rating-change drivers

Less favourable operating environment in the UK following Brexit. Santander UK is mainly a mortgage bank, with a relatively low average loan-to-value and a very reassuring asset performance in the UK. However, the performance of the UK book may depend on the UK's EU relations and economic performance post Brexit. A material increase in the UK loss rate could have a significant impact on group profitability. Moreover, increased risk for the UK loan book, driven potentially by a material decline in the portfolio's share of residential mortgages, could also have a negative impact on ratings.

Renewed tension on Spanish bank and sovereign debt. Tensions surrounding peripheral European assets were sedated for the past few years by a strongly accommodative monetary policy. As economic recovery takes hold in Europe, the European Central Bank will gradually remove its support. The pace of asset purchases, including public-sector bonds, will gradually reduce over 2018, an initial step towards normalisation of policy, with increases in policy rates likely to follow – albeit gradually. Despite not directly affecting the P&L, rising yields on the bank's Spanish sovereign bond holdings would raise questions on its capital levels. Although these concerns are somewhat allayed by Spain's promising economic performance since the crisis.

Event risk. Santander has been very active in M&A both before and during the crisis, acquiring banking franchises in several countries including the UK, the US, Germany and Poland. This strategy goes beyond the group's more traditional effort to grow in Latin America, where the bank rightly claims to have a cultural-related competitive advantage. So far, most acquisitions and mergers have been effectively and successfully integrated, but the risk remains that potentially unexpected large transactions could have negative consequences on the group's fundamentals, including prudential metrics. However, in recent years Santander has mostly focused on organic growth. Even so, we note the Spanish group's strong record in managing its acquisitions.

Digital investment driving gains in business volume, revenue and market share. We view Santander's efforts in digital innovation as positive, as it somewhat protects the bank's successful business model from technological disruption. Santander's credit profile may also benefit if these efforts led to further consolidation of the group's competitive position in its different markets.

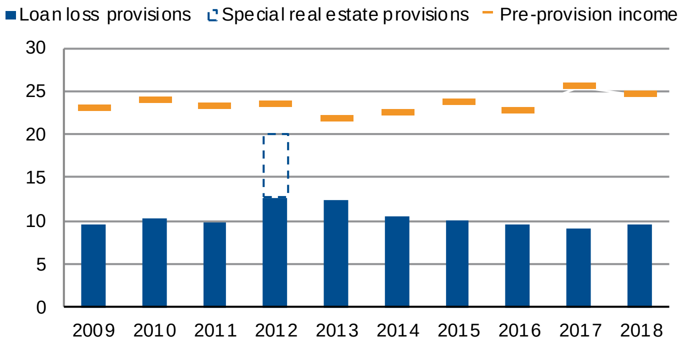
Rating drivers (details)

A business model that has withstood crisis challenges: cost-efficient provision of retail and commercial banking services (high pre-provision income buffer to absorb credit charges) and resilient group profitability

Santander's diversified retail and commercial banking business model has served the bank well in recent years. Despite significant challenges after the collapse of the credit and real estate market and sovereign crisis in Spain, the group survived and emerged thanks to the resilience of its earnings. With a group cost-income ratio of consistently below 50%, Santander averages about EUR 25bn in pre-provision profit annually, which provides a good buffer against a wide range of adverse asset-quality shocks.

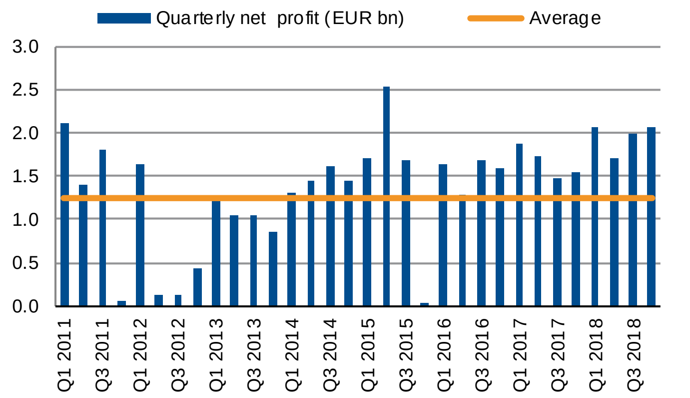
As shown in Figure 1, this pre-provision profit buffer was able to absorb significant losses throughout the crisis, including the extraordinary provision on real estate assets from the 2012 royal decrees. Indeed, Santander has not posted a single quarter of net losses since the global financial crisis began. In addition, profitability shows little volatility when excluding quarters with large one-off provisions (see Figure 2).

Figure 1: Recurring pre-provision profitability vs LLC, 2009-2018



Source: Company data, Scope Ratings

Figure 2: Santander's quarterly net profit, 2011-18



Source: Company data, Scope Ratings

This buffer gives some comfort on protection against future risks: any unforeseen losses, before hitting capital, would be readily absorbed by the group's ordinary profitability.

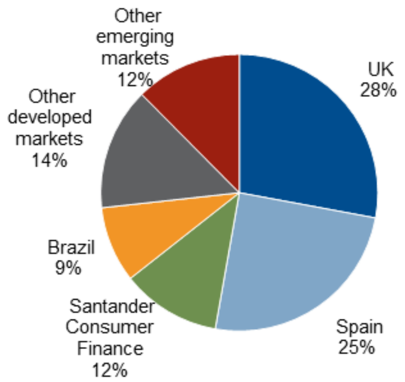
Going forward, Santander is investing heavily in innovation, with EUR 2bn a year earmarked for digital spending. This investment is, in our view, paramount to futureproofing Santander's business model, including from competition from a wide range of non-traditional players such as fintechs and big technology companies.

Santander's approach is two-pronged. On the one hand, it plans to innovate processes and products in the historical group entities – what management refers to as 'supertankers'. On the other hand, it is setting up greenfield digital banks and companies that operate in parallel to the main banks within the group, but that are nimbler and faster at embracing change – the so-called 'speedboats'. While Santander stresses that speedboats can become flywheels for faster growth and customer acquisition, we also see them as potential lifeboats should the supertankers get stranded in low waters in the coming years.

Globally diversified revenue and earnings streams with strong market positions in several key markets including Spain, Portugal, Argentina, Brazil, UK, Mexico, Chile, and Poland.

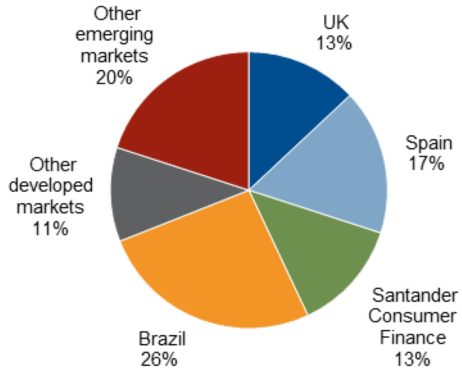
Significant geographical diversification is a key positive driver for Santander's rating. Several of the group's retail and commercial banks are active in the Americas and Europe. As shown in Figures 3 and 4, while mature markets still account for the majority of the loan book, half of Santander's earnings power (as measured by attributable profit) is derived from emerging markets.

Figure 3: Santander loan book split, 2018



Source: Company data, Scope Ratings
Note: 'Other emerging markets' includes Mexico, Chile, Argentina, Poland, and other Latin American countries. 'Other developed markets' includes Consumer Finance, US, Portugal, and other European countries.

Figure 4: Santander attributable profit split, 2018



Source: Company data, Scope Ratings

Going forward, it is likely that faster underlying economic growth, as well as the potential to catch up further in the credit penetration into selected countries and segments (e.g. mortgages in Brazil and Argentina), will lead to a higher share of emerging economies in Santander's loan book. This may be offset, in terms of earnings, by lower margins as the loan mix shifts to lower-risk, lower-margin products.

As such, our positive view of the group's international franchise relates not only to its potential for higher revenue growth but also – and especially – to smoother earnings via diversification. It would take synchronised recessions in the group's different countries of operation for solvency to be seriously threatened.

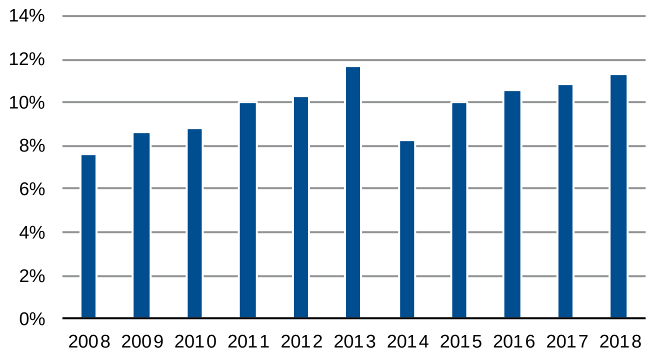
The current multi-country Santander franchise has been built over the last 25 years, mostly through acquisitions. In that respect, we believe the bank's track record in acquisitions and integrations has consistently been very positive. During the crisis years, it acquired several competitors in its core geographies at attractive prices, often benefiting from public backstops to risk, as was the case with the acquisitions of Bradford & Bingley and Alliance & Leicester in the UK. Other recent major acquisitions include ABN AMRO Banco Real in Brazil, Sovereign Bank in the US, Zachodni WBK and Kredyt Bank in Poland, and the SEB retail business in Germany. In 2017, Santander acquired Banco Popular in Spain from the resolution authorities. We also note that, despite a strong appetite for inorganic growth, Santander's franchise has preserved its focus, with top-three positions in most of its core markets.

Ongoing improvement of capital, liquidity and funding positions in recent years

As of December 2018, Banco Santander reported a fully loaded CET1 ratio of 11.3%, lower than the average of both domestic and international peers. The fully loaded total capital ratio and leverage ratio stood at 14.78% and 5.1%, respectively.

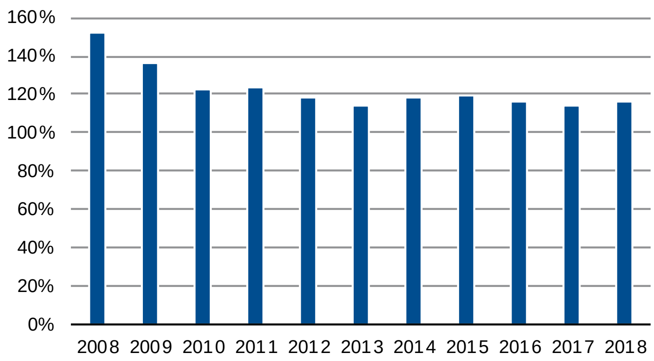
Despite being lower than peers', these levels remain adequate in our view, given the group's strong track record of organic capital generation, low earnings volatility, predominance of retail, and relatively high asset-risk intensity.

Figure 5: Historical CET1 ratio 2008-18



Basel III fully loaded from 2014
Source: Company data, Scope Ratings

Figure 6: Loan-to-deposits ratio 2008-18



Source: Company data, Scope Ratings

At Santander's 2019 Investor Day, management stated that they have quantified future regulatory impacts at 50 bps. This consists of i) 20 bps from the new accounting standard on leases (IFRS 16); and ii) 30bps from other requirements including the ECB's Targeted Review of Internal Models. We view these as manageable given Santander's ability to generate capital.

Santander's capital position has shown resiliency under recent regulatory stress tests. In the EBA 2018 stress test, Santander reported a 9.2% CET1 fully loaded ratio in the adverse scenario.

Funding and liquidity positions have also significantly improved since the beginning of the crisis: the group's loan-to-deposit ratio has materially declined, the result of aggressive deposit acquisition (organic and inorganic) on the one hand and fast asset deleveraging, especially in Spain and Portugal, on the other. Going forward, there is still room to rebalance the funding profiles of some subsidiaries, but we see the group's funding profile as adequate and in line with that of international peers.

The group has a decentralised model in which subsidiaries cover their own funding and liquidity needs. As of December 2018, the liquidity coverage ratio was 160%. The bank is complying with all liquidity requirements and has a high-quality stock of liquid assets (EUR 191bn).

The European banking union provides strong regulatory and supervisory framework

Despite its fundamental strength, the perception of Santander's credit risk has suffered from developments in Spain, including the country's significant macro challenges and concerns over its regulatory and supervisory framework. Going forward, we believe the existence of the European banking union will help address doubts around regulation and supervision in any country, and allow investors – as well as euro area supervisors – to compare banks based on intrinsic credit strength.

The Single Supervisory Mechanism (SSM) – which transfers the supervisory role to a single, supranational and independent actor, the ECB – ensures all large European banks are subject to the same strict standards of supervision. Not only does this help to limit concerns over possible regulatory forbearance or political interference in the supervisory process, but it also materially reduces the risk of inconsistent or incoherent application of rules across the euro area.

As Santander operates in several non-EU jurisdictions, it is also subject to several host country supervisors, increasing the cost (and complexity) of complying with several sets of rules.

The global financial crisis has shown that the mobility of intragroup capital and liquidity across geographies can be significantly constrained during periods of stress, limiting a cross-border banking group's financial flexibility when most needed. Faced with such restrictions, steps ranging from the listing of a minority stake to the disposal of the entire business may be used by some banking groups as an alternative to unlock capital from a subsidiary. The extent to which cross-border banking groups have such options at their disposal mitigates this risk. Against this background, we look favourably upon cross-border banking organisations that display reassuring capital and liquidity metrics, not only at group level but also at subsidiary level.

Santander's additional tier 1 instruments: key features and risks

We have rated the AT1 securities issued by Santander at BBB-/Stable.

In accordance with our rating methodology for capital instruments, the starting point for notching down when rating capital instruments is provided by the senior non preferred rating of A+. The minimum four notches reflect the deeply subordinated status of AT1 capital instruments in the priority of claims, their going-concern loss-absorbing features and investors' exposure to coupon-cancellation risks.

In addition, we add an extra notch for Santander's AT1s due to the double-trigger structure of the notes, which in our view limits the benefits of earnings diversification.

Figure 7: CRD4 compliant AT1 instruments of Santander rated by Scope

ISIN	Currency	Issued amount	Coupon %	Issue date	Next call date	Conversion yype	Trigger %	Scope rating
XS1043535092	EUR	1,500,000,000	6.25	12/03/2014	12/03/2019	Equity conversion	5.125	BBB-
XS1066553329	USD	1,500,000,000	6.375	19/05/2014	19/05/2019	Equity conversion	5.125	BBB-
XS1107291541	EUR	1,500,000,000	6.25	11/09/2014	11/09/2021	Equity conversion	5.125	BBB-
XS1602466424	EUR	750,000,000	6.75	25/04/2017	25/04/2022	Equity conversion	5.125	BBB-
XS1692931121	EUR	1,000,000,000	5.25	29/09/2017	23/09/2023	Equity conversion	5.125	BBB-
XS1793250041	EUR	1,500,000,000	4.75	19/03/2018	19/03/2025	Equity conversion	5.125	BBB-
XS1951093894	USD	1,200,000,000	7.5	08/02/2019	08/02/2024	Equity conversion	5.125	BBB-

Source: Santander, Scope Ratings

As of Q4 2018, Santander's gap to the equity conversion trigger was 6.3%, lower than the average of large European banks (7.7%).

The distance to the MDA trigger (CET1 ratio requirement including CBR) stood at 1.8%, versus an average of 3.4% for the group of large European banks. This is based on the 2018 SREP requirement.

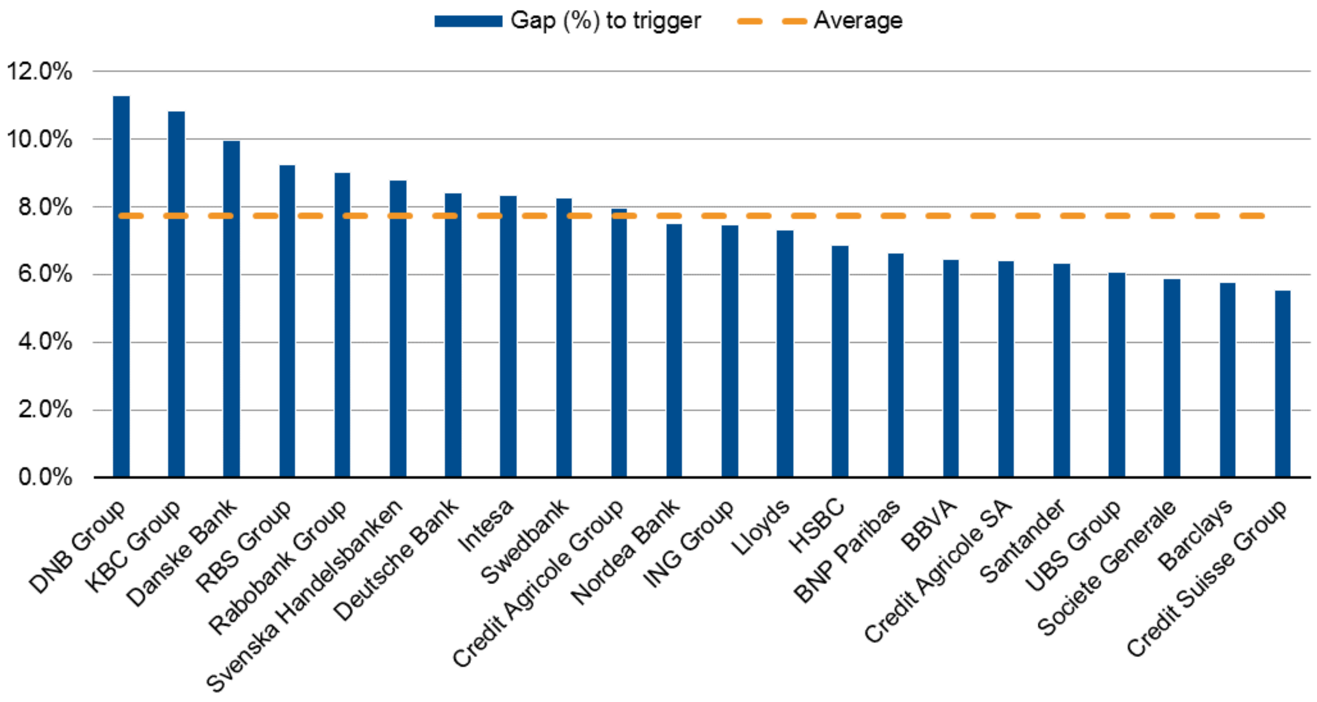
Compared with its 2019 SREP requirement of 9.70%, the bank's current headroom to regulatory requirements is 160 bps.

The bank has communicated clear capital targets in its 2019 Investor Day (fully loaded CET1 ratio of 11%-12% in the medium term), implying a buffer of 130-230 bps to its CET1 requirement, including CBR.

AT1 instruments are perpetual, though they can be called at the discretion of the issuer. So far, most issuers have exercised this option on the first call date.

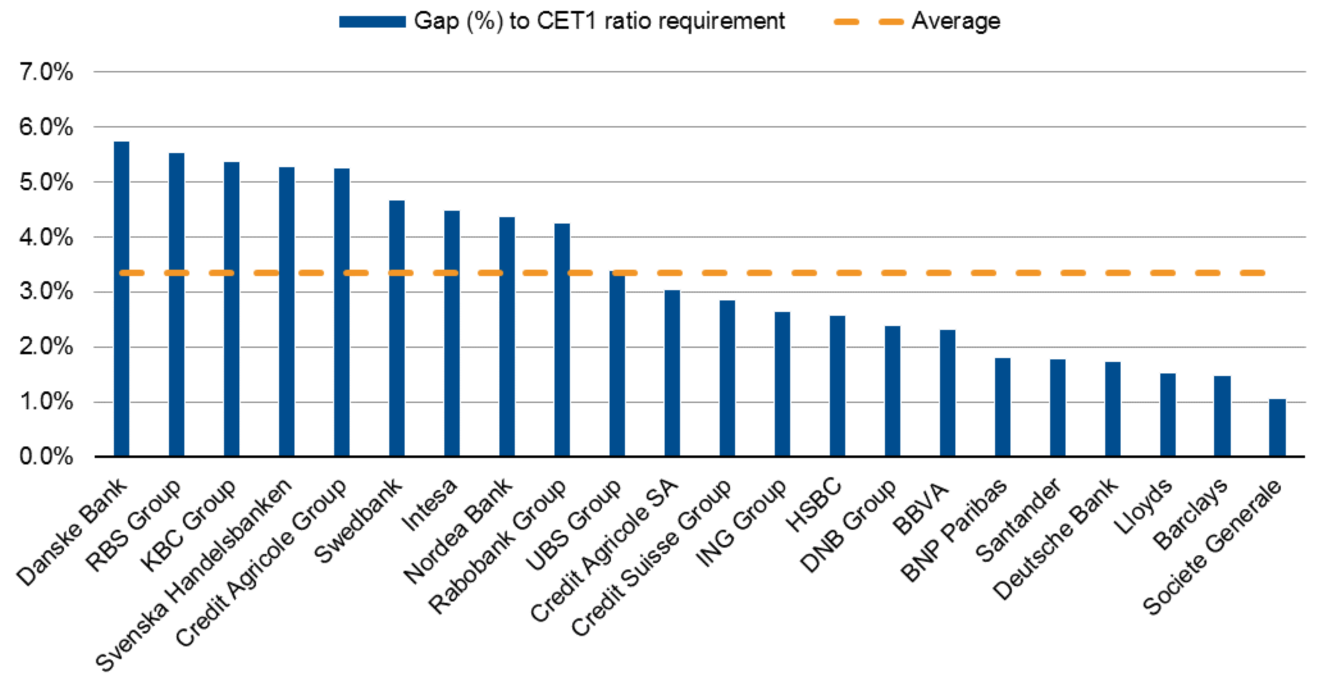
Santander was the first large European issuer not to call a new-style AT1 note on the first call date in March 2019.

Figure 8: Gap to trigger, selected European banks



Source: Banks, Scope Ratings

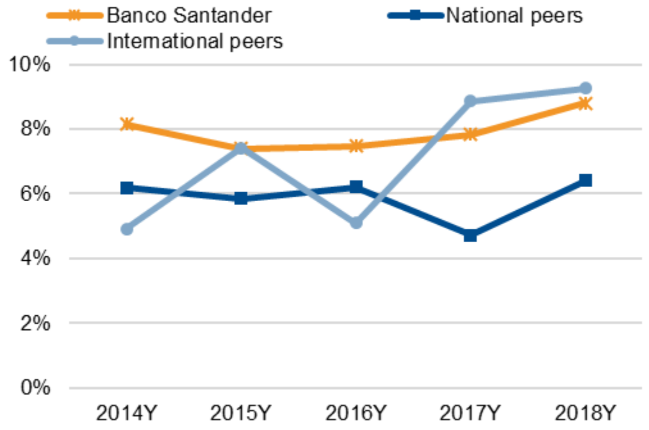
Figure 9: Distance to CBR, selected European banks



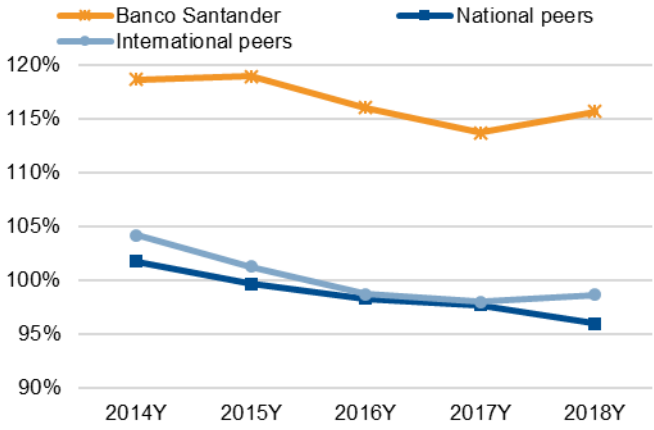
Source: Banks, Scope Ratings

I. Appendix: Peer comparison

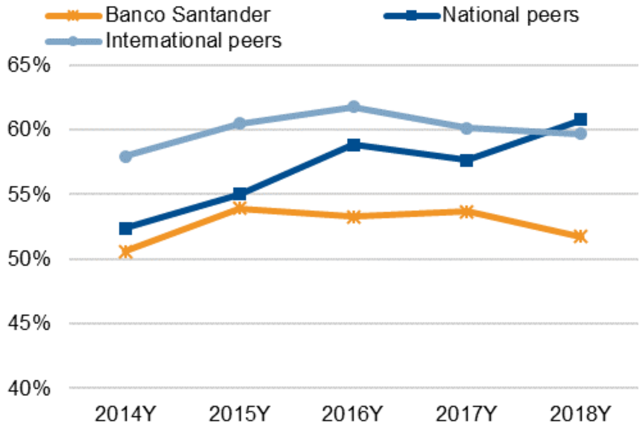
Return on average equity (%)



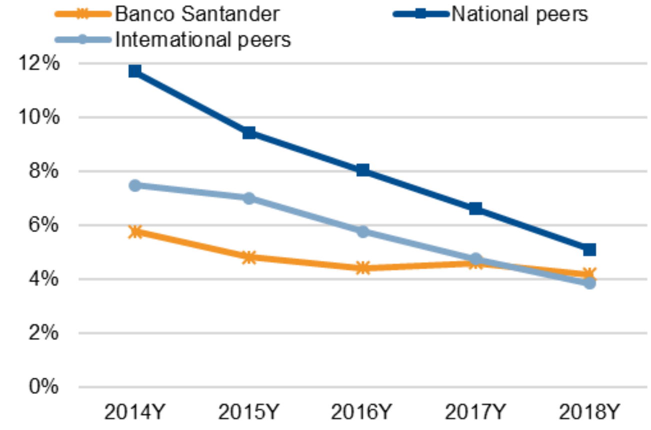
Loan/deposit ratio (%)



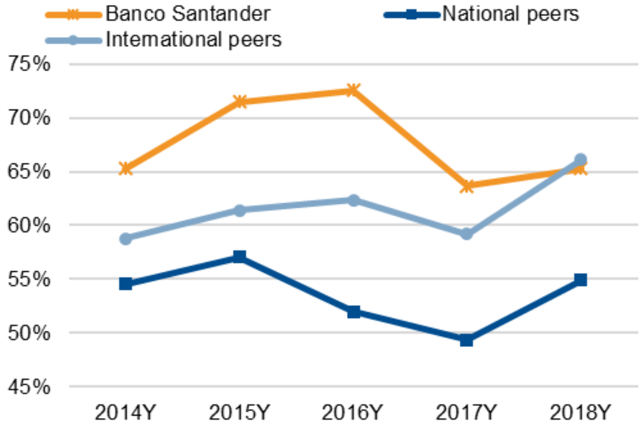
Cost/income ratio (%)



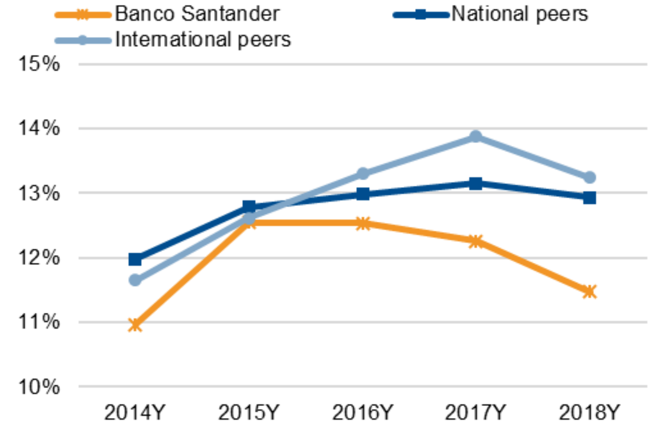
NPLs/net loans (%)



Loan-loss reserves/NPLs (%)



Common equity tier 1 ratio (%, transitional)



Source: SNL, Scope Ratings
*National peers: BBVA, Banco Santander, Caixabank, Bankia, Banco Sabadell, Bankinter, Kutxabank, Ibercaja, Unicaja, Liberbank
International peers: Santander, BBVA, Unicredit, Erste Bank, Nordea, KBC, ING Bank, Raiffeisen Bank International, Standard Chartered, Societe Generale, HSBC

II. Appendix: Selected financial information – Santander group

	2014Y	2015Y	2016Y	2017Y	2018Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	151,141	160,281	153,140	188,426	197,069
Total securities	281,152	289,666	295,743	293,492	271,628
of which, derivatives	85,987	85,830	83,901	67,066	65,633
Net loans to customers	734,711	790,848	790,470	848,914	882,920
Other assets	99,292	99,467	99,771	113,473	107,654
Total assets	**1,266,296**	**1,340,262**	**1,339,125**	**1,444,305**	**1,459,270**
Liabilities					
Interbank liabilities	155,617	175,373	149,398	190,314	187,908
Senior debt	196,563	205,007	208,967	196,456	222,799
Derivatives	86,333	85,525	82,973	66,266	62,008
Deposits from customers	647,706	683,142	691,112	777,730	780,496
Subordinated debt	17,132	21,153	19,902	21,510	23,820
Other liabilities	NA	NA	NA	NA	NA
Total liabilities	**1,176,581**	**1,241,507**	**1,236,425**	**1,337,472**	**1,351,909**
Ordinary equity	80,541	87,828	90,699	93,747	95,674
Equity hybrids	265	214	240	741	799
Minority interests	8,909	10,713	11,761	12,344	10,888
Total liabilities and equity	**1,266,296**	**1,340,262**	**1,339,125**	**1,444,305**	**1,459,270**
Core tier 1/Common equity tier 1 capital	64,250	73,478	73,709	74,173	67,962
Income statement summary (EUR m)					
Net interest income	29,548	32,812	31,089	34,296	34,341
Net fee & commission income	9,696	10,033	10,180	11,597	11,485
Net trading income	2,850	2,386	2,101	1,664	1,797
Other income	3,751	825	962	997	708
Operating income	**45,845**	**46,055**	**44,332**	**48,553**	**48,330**
Operating expense	23,195	24,826	23,609	26,052	25,002
Pre-provision income	**22,650**	**21,229**	**20,722**	**22,502**	**23,328**
Credit and other financial impairments	10,710	10,652	9,625	9,259	8,986
Other impairments	1,277	1,314	352	1,579	208
Non-recurring items	0	0	0	0	0
Pre-tax profit	**10,680**	**9,547**	**10,768**	**12,089**	**14,200**
Discontinued operations	-26	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	3,718	2,213	3,282	3,883	4,886
Net profit attributable to minority interests	1,119	1,368	1,282	1,586	1,504
Net profit attributable to parent	**5,816**	**5,966**	**6,204**	**6,619**	**7,810**

Source: SNL

III. Appendix: Selected financial information – Santander group

	2014Y	2015Y	2016Y	2017Y	2018Y
Funding and liquidity					
Net loans/deposits (%)	118.7%	119.0%	116.1%	113.7%	115.7%
Liquidity coverage ratio (%)	120.0%	146.0%	146.0%	133.0%	160.0%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	58.0%	59.0%	59.0%	58.8%	60.5%
NPLs/net loans (%)	5.8%	4.8%	4.4%	4.6%	4.2%
Loan-loss reserves/NPLs (%)	65.3%	71.5%	72.5%	63.7%	65.3%
Net loan growth (%)	9.8%	7.6%	0.0%	7.4%	4.0%
NPLs/tangible equity and reserves (%)	48.2%	38.7%	34.4%	36.8%	35.0%
Asset growth (%)	13.5%	5.8%	-0.1%	7.9%	1.0%
Earnings and profitability					
Net interest margin (%)	2.7%	2.7%	2.5%	2.6%	2.6%
Net interest income/average RWAs (%)	5.4%	5.5%	5.3%	5.6%	5.8%
Net interest income/operating income (%)	64.5%	71.2%	70.1%	70.6%	71.1%
Net fees & commissions/operating income (%)	21.1%	21.8%	23.0%	23.9%	23.8%
Cost/income ratio (%)	50.6%	53.9%	53.3%	53.7%	51.7%
Operating expenses/average RWAs (%)	4.2%	4.1%	4.1%	4.3%	4.2%
Pre-impairment operating profit/average RWAs (%)	4.1%	3.5%	3.6%	3.7%	3.9%
Impairment on financial assets /pre-impairment income (%)	47.3%	50.2%	46.4%	41.1%	38.5%
Loan-loss provision charges/net loans (%)	1.5%	1.3%	1.3%	1.2%	1.1%
Pre-tax profit/average RWAs (%)	1.9%	1.6%	1.9%	2.0%	2.4%
Return on average assets (%)	0.6%	0.5%	0.6%	0.6%	0.6%
Return on average RWAs (%)	1.3%	1.2%	1.3%	1.3%	1.6%
Return on average equity (%)	8.1%	7.4%	7.5%	7.8%	8.8%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	8.3%	10.1%	10.6%	10.8%	11.3%
Common equity tier 1 ratio (%, transitional)	11.0%	12.5%	12.5%	12.3%	11.5%
Tier 1 capital ratio (%, transitional)	11.0%	12.5%	12.5%	12.8%	13.1%
Total capital ratio (%, transitional)	12.0%	14.4%	14.7%	15.0%	15.0%
Leverage ratio (%)	3.7%	4.7%	5.0%	5.0%	5.1%
Asset risk intensity (RWAs/total assets, %)	46.3%	43.7%	43.9%	41.9%	40.6%
Market indicators					
Price/book (x)	1.8x	1.1x	1.2x	1.4x	1.0x
Price/tangible book (x)	1.2x	0.5x	0.5x	0.6x	NA
Dividend payout ratio (%)	125.0%	49.2%	51.6%	55.0%	NA

Source: SNL

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