FitchRatings

Fitch Affirms Santander at 'A-'; Outlook Stable

Fitch Ratings-Barcelona/London-04 July 2019: Fitch Ratings has affirmed Banco Santander, S.A.'s Long and Short-Term Issuer Default Ratings (IDRs) at 'A-' and 'F2', respectively, and the Viability Rating at 'a-'. The Outlook is Stable. A full list of rating actions is included at the end of this rating action commentary.

KEY RATING DRIVERS

IDRS, VR AND SENIOR NON-PREFERRED DEBT

Santander's IDRs, VR and senior non-preferred debt ratings reflect Fitch's assessment of the group's consolidated risk profile. They also reflect Santander's broad geographic diversification with solid retail banking franchises in several European and Latin American countries and the US, relatively modest risk appetite, asset quality improvement, resilient earnings generation, a large and stable deposit base, and adequate capitalisation.

The relatively low correlation between the performance of its different foreign subsidiaries and the domestic banking business provides the group's asset-quality metrics and earnings generation capacity with a certain degree of resilience. However, Santander's credit profile is correlated with the operating environment in Spain and, therefore, its overall performance and asset quality are sensitive to the domestic economic environment. Furthermore, Santander's funding access, stability and costs are also influenced by perceptions of Spain's sovereign risk.

We expect asset quality indicators to remain stable or to slightly improve in 2019 given reasonably good economic prospects in many of its main markets, particularly in Spain, where a large share of the bank's impaired loans are held. However, Santander's impaired loan ratio is likely to remain higher than at some European peers due to its significant emerging market exposure. At end-March 2019, the group's impaired loan ratio was close to 4% while impaired loan reserve coverage ratio was 68%, which we view as strong relative to international peers considering the significant proportion of residential mortgages in Santander's loan book.

Santander's franchise and business model has resulted in resilient profitability, which is a key rating strength and has allowed the bank to generate capital consistently across the economic cycle. Wide margins in emerging-market operations and a cost control-oriented culture have supported pre-impairment operating profitability. As such, the bank was able to absorb higher impairment charges through the crisis in Spain while maintaining sound operating profitability.

Santander has generated operating profit/risk weighted assets between 1.8% and 2.8% (the latter in 2018) since 2012. We expect pre-impairment operating profit to continue growing modestly, underpinned by growth in net interest income and most notably net fee income, as well as contained operating costs adjusted for inflation. We expect loan impairment charges to grow in line with higher business volumes but not because of asset quality pressures. Geographically, we view the UK as a challenging market amid the Brexit uncertainty. The US business also needs to improve its underlying profitability to group standards.

Santander's adjusted risk weighted capital ratios are adequate for its retail-focused and diversified business profile and well above regulatory minimums, but lagging behind international peers. However, the group's regulatory leverage ratio of about 5.1% at end-March 2019 is in line with international peers. The group reported a fully loaded CET1 ratio (applying IFRS 9 transitional arrangements) of 11.3% at end-March 2019, within its revised 11%-12% target. Additional loss-absorption buffers are in the form of additional Tier 1 instruments and subordinated debt.

Santander's good internal capital generation capacity mitigates its comparatively lower regulatory risk adjusted capital ratios. In our assessment of capital, we also considered the group's well-capitalised foreign subsidiaries.

Santander has a stable funding profile that benefits from solid core deposit franchises in the main markets where it operates. The group's autonomous subsidiary model requires that foreign subsidiaries are locally funded. Santander has also demonstrated good access to wholesale debt markets as a regular issuer in local and international markets. Parent and locally held liquidity portfolios, mostly in the form of government bonds, provide ample liquidity buffers relative to upcoming debt maturities, which are well-spread over time.

Santander's 'F2' Short-Term IDR is the lower of two Short-Term IDRs that map to an 'A-' Long-Term IDR on Fitch's rating scale, reflecting our 'a-' assessment of Santander's funding and liquidity profile.

Santander's senior non-preferred debt, which is the reference liability for the bank's IDRs, is rated in line with the Long-Term IDR.

DERIVATIVE COUNTERPARTY RATING, DEPOSIT RATINGS AND SENIOR PREFERRED DEBT
Santander's DCR and long-term senior preferred debt and deposit ratings are one-notch above the bank's Long-Term IDR because derivatives, deposits and senior unsecured preferred notes have preferential status over the bank's large buffers of qualifying junior debt (QJD) and senior non-preferred debt. They are also one-notch above Spain's sovereign rating (A-/Stable), reflecting our view that Santander benefits from its geographic diversification in highly rated economies.

Santander has a clear multiple point of entry (MPE) resolution strategy. Fitch therefore considers recapitalisation needs, and available QJD and senior non-preferred debt buffers at the parent bank's resolution perimeter, on a basis that deconsolidates the material subsidiaries that will be subject to resolution actions.

Fitch calculates that the buffer of QJD and senior non preferred debt at end-March 2019 was equal to around 12% of the parent bank's resolution perimeter risk-weighted assets. We believe these buffers should be sufficient to recapitalise the bank after a resolution without causing losses to senior preferred creditors. We expect the bank to issue further senior non-preferred debt, which should result in a further increase in the buffers, and which we view as sustainable since it has to meet Minimum Required Eligible Liabilities (MREL) requirements at all times (Santander is already meeting MREL requirements).

SUPPORT RATING AND SUPPORT RATING FLOOR
Santander's Support Ratings (SR) of '5' and Support Rating Floors (SRF) of 'No Floor' reflect Fitch's belief that senior creditors of the bank can no longer rely on receiving full extraordinary support from the sovereign in the event that the bank becomes non-viable. The EU's Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) for eurozone banks provide a framework for resolving banks that is likely to require senior creditors participating in losses, instead of, or ahead of, a bank receiving sovereign support.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
Subordinated debt and other hybrid capital issued by Santander are notched down from its VR, in accordance with Fitch's assessment of each instrument's respective non-performance and relative loss severity risk profiles, which vary considerably.

Subordinated (lower Tier 2) debt is rated one notch below the bank's VR to reflect above average loss severity of this type of debt compared with average recoveries. Upper Tier 2 debt is rated three notches below the bank's VR to reflect above average loss severity of this type of debt compared with average recoveries (one notch) and high risk of non-performance (two notches). This is because there is an option to defer coupons if the issuer reported losses in the last audited accounts.

Preferred shares are rated five notches below the bank's VR to reflect the higher loss severity risk of these securities when compared with average recoveries (two notches from the VR). The rating also reflects the high risk of non-performance (an additional three notches) due to a profit test for legacy issues and a fully discretionary coupon payments for recent issues.

RATING SENSITIVITIES
IDRS, VR AND SENIOR NON-PREFERRED DEBT
[An upgrade of Santander's ratings would likely be contingent on an upgrade of Spain's sovereign rating. This would have to be accompanied by a further material strengthening of capitalisation and better asset quality metrics. Equally important would be to preserve the earnings resilience of the group, which means maintaining the sound earnings performance at the main international subsidiaries.
Downward ratings pressure could arise from a substantial asset-quality or earnings deterioration, resulting in pressure on capital, which we view as unlikely or unexpected event risks in foreign operations.

DERIVATIVE COUNTERPARTY RATING, DEPOSIT RATINGS AND SENIOR PREFERRED DEBT
Santander's DCR and long-term senior preferred debt and deposit ratings are notched up from the bank's IDR and are therefore primarily sensitive to change to the Long-Term IDR. The ratings would no longer be rated one notch above the Long-Term IDR if the buffer of QJD and senior non-preferred debt falls below our assessment of the resolution perimeter's recapitalisation amount. This amount is sensitive to our assessment of the resolution perimeter's capital requirements and the level of investments in subsidiaries outside the resolution perimeter, which we deconsolidate.

We expect Santander's combined QJD and senior non-preferred debt buffers to remain above the recapitalisation amount to the extent Santander has to meet minimum MREL requirements on a sustained basis.

SUPPORT RATING AND SUPPORT RATING FLOOR
Any upgrade of the SRs and upward revision of the SRFs would be contingent on a positive change in the sovereign's propensity to support its banks. While not impossible, this is highly unlikely in Fitch's view.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
Subordinated debt and other hybrid capital issued by Santander are primarily sensitive to any change in the bank's VR. Upper Tier 2 notes and preferred shares are also sensitive to Fitch changing its assessment of the probability of their non-performance relative to the risk captured in the VR.

The rating actions are as follows:

Banco Santander
Long-Term IDR: affirmed at 'A-'; Outlook Stable
Short-Term IDR: affirmed at 'F2'
VR: affirmed at 'a-'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Derivative Counterparty Rating: affirmed at 'A(dcr)'
Long-term deposit rating: affirmed at 'A'
Short-term deposit rating: affirmed at 'F1'

Senior non-preferred debt affirmed at 'A-'
Senior preferred debt long-term rating and certificates of deposit: affirmed at 'A'
Senior preferred debt short-term rating, commercial paper and certificate of deposits: affirmed at 'F1'
Subordinated debt: affirmed at 'BBB+'
Upper Tier 2 debt: affirmed at 'BBB-'
Preference shares: affirmed at 'BB'

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Additional information is available on www.fitchratings.com
Applicable Criteria
Bank Rating Criteria (pub. 12 Oct 2018)
Short-Term Ratings Criteria (pub. 02 May 2019)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

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