22 Jun 2020 | Affirmation

Fitch Affirms Santander at 'A-'; Outlook Negative

Fitch Ratings-Barcelona-22 June 2020:

Fitch Ratings has affirmed Banco Santander S.A.'s Long-Term Issuer Default Rating (IDR) at 'A-' and Viability Rating (VR) at 'a-'. The Outlook on the Long-Term IDR is Negative.

A full list of rating actions is below.

Key Rating Drivers

IDRs, VR AND SENIOR NON-PREFERRED DEBT

Santander's Long-Term IDR and VR are underpinned by its broad and balanced geographic and business diversification, with solid retail banking franchises in several European and Latin American countries, which results in good pricing power and access to large and stable deposit bases. The ratings also reflect a modest risk appetite and sound earnings generation capacity through economic cycles, which offset risk weighted capital ratios that are lower than peers, although these have strengthened in the past few years. Asset quality remains a relative weakness compared with some European peers and we expect it to weaken relative to our previous expectations given the economic fallout from the coronavirus crisis.

To date, the relatively low correlation between the performance of Santander's different foreign subsidiaries and its domestic banking business has provided the group's asset quality metrics and earnings generation with a certain degree of resilience. However, the Negative Outlook highlights that the pandemic represents a major and unprecedented challenge for Santander, in that the group has to manage tougher economic conditions in many of its core markets, albeit presumably to different stages of intensity. Combined with lockdown measures, this has considerably increased downside risks to Santander's operating environment, which will make executing some of its strategic objectives more difficult, at least temporarily (i.e. business growth plans), and will put pressure on the bank's earnings and asset quality in the medium term. The ultimate impact on asset quality will also depend on the effectiveness of the government support programmes in the different countries, the duration of the crisis and the speed and strength of the recovery.

In our view, Santander's franchise and diversified business model results in resilient profitability structurally, which is a key rating strength and has allowed the bank to generate capital consistently across economic cycles. Wide margins in emerging-market operations and a cost control-oriented culture (cost to income ratio consistently below 50% since 2007, which compares with a median average of 70% for large European banks in 2019) have provided an important first line of defence against periods of economic crisis and maintain consistently sound operating profitability. Santander's operating profit/risk weighted assets averaged 2.1% in the last 10 years with limited volatility.

The impact on 1Q20 pre-impairment operating profit from the coronavirus crisis was still low. Net profits declined by around 80% yoy as the bank recorded EUR1.6 billion (around 70bp over gross loans) provisions related to the pandemic, in addition to EUR2.3 billion of recurring LICs (97bp over gross loans). However, the group is not immune to the symmetric nature of the economic shocks from the crisis and hence we expect pressure on earnings will become more visible from 2Q20 onwards as the impact of the crisis unfolds and lower business volumes start to affect revenues. At the same time, the extent to which government support measures can mitigate asset quality deterioration remains to be seen.

The impaired loans ratio was adequate at 3.5% at end-March 2020 after improving slightly in the quarter. Coverage by loan loss allowances also increased to a high 72%. Nevertheless, we expect asset quality to deteriorate over the next two years: more rapidly in cyclical unsecured consumer finance and those core markets worse hit by the pandemic (Spain) or those emerging economies where announced government support measures have to date been more limited (Brazil, Mexico).

Santander manages its capitalisation tightly, although this has improved in recent years. The bank will not pay 2019 dividends following the ECB's recommendation and will adjust its 2020 dividend policy taking into consideration the ultimate impact of the crisis. This decision has helped the fully loaded CET1 ratio (11.6% at end-March 2010) to remain in the high range of 11%-12%, a target Santander recently confirmed. The group's regulatory leverage ratio of about 5% at end-March 2020 is in line with international peers. Our assessment of capital also considers that the group keeps its foreign subsidiaries well capitalised.

Santander has a stable funding profile that benefits from solid core deposit franchises in the main markets where it operates. The group's approach requires foreign subsidiaries to be locally funded. Santander benefits from established access to local and international wholesale debt markets. Liquidity management is conservative and high-quality liquid assets (HQLA) amply cover wholesale and structured funding coming due within a year. HQLAs accounted for 16% of total consolidated assets at end-March 2020.

Santander's 'F2' Short-Term IDR is the lower of two Short-Term IDRs that map to a '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 notes are rated at the same level as the bank's Long-Term IDR, reflecting Fitch's view that the default risk of the notes is equivalent to that of the IDR and that senior non-preferred obligations are viewed as having average recovery prospects.

DERIVATIVE COUNTERPARTY RATING (DCR), DEPOSIT RATINGS AND SENIOR PREFERRED DEBT

Santander's long-term senior preferred debt and that of its issuing vehicle (Santander International Products PLC), deposit ratings and the DCR are rated one notch above Santander's Long-Term IDR to reflect the protection that accrues from buffers of junior and senior non-preferred debt, which exceed 10% of risk-weighted assets (RWA; after deconsolidating subsidiaries that are in different resolution groups, as Santander has a clear multiple point of entry resolution strategy) on a sustained basis. The combination of these buffers was 12.5% of RWAs at end-2019 and we expect Santander to continue issue a significant volume of senior non-preferred and junior debt to continue meeting the group's minimum requirement for own funds and eligible liabilities (MREL) and subordination requirements.

The short-term senior preferred debt and deposit ratings of 'F1' benefit from the fact that equivalent long-term senior debt and deposit ratings have been notched up to reflect lower credit risks.

SUBORDINATED DEBT AND JUNIOR SUBORDINATED DEBT

Subordinated debt issued by Santander is notched down from its VR in accordance with our assessment of each instrument's non-performance and relative loss severity risk profiles. We rate the instruments two notches below the group's VR for loss severity as we expect recoveries to be poor for this type of debt in case of default/non-performance of the bank.

We rate full discretionary coupon payment additional Tier 1 (AT1) debt four notches from the group's VR. This corresponds to two notches for loss-severity and two notches for non-performance risk. Our assessment is based on the bank operating with a CET1 ratio that is above maximum distributable amount thresholds and our expectation that this will continue. Our assessment is also underpinned by the group's track record of strong pre-provision earnings generation throughout the cycle and sound leverage ratio.

Legacy preferred shares are rated five notches below the bank's VR to reflect higher loss severity risk of these securities when compared with average recoveries (two notches from the VR), as well as high risk of non-performance (an additional three notches) due to a profit test.

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.

RATING SENSITIVITIES

IDRs, VR AND SENIOR NON-PREFERRED DEBT

Factors that could, individually or collectively, lead to negative rating action/downgrade:

The Negative Outlook on Santander reflects medium-term risks to its ratings from the coronavirus outbreak.

Triggers for a downgrade would be a CET1 ratio below 11% with no prospect to restore it above this level combined with material and structural deterioration in profitability, which could stem from a further pronounced deterioration in the group's operating environment linked to the pandemic or asset quality. Santander's ratings also remain sensitive to a downgrade of Spain (A-/Stable) or a lower group operating environment score.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The most likely trigger for an upgrade would be contingent on an upgrade of Spain's sovereign rating. This would have to be accompanied by stronger capital ratios and better asset quality. Equally important would be to preserve the group's earnings resilience, which means maintaining the sound earnings performance at the main international subsidiaries.

DCR, DEPOSIT RATINGS AND SENIOR DEBT

Santander's DCR, senior debt and deposit ratings are primarily sensitive to changes in Santander's IDRs. We would downgrade the DCR, long-term senior preferred and non-preferred debt and deposit ratings by a notch if the size of the combined buffer of junior and senior non-preferred debt at resolution perimeter sustainably fall below 10% of RWAs (adjusted by deconsolidating subsidiaries that are in different resolution groups) given the group partly meets its MREL with senior preferred debt.

SUBORDINATED DEBT AND JUNIOR SUBORDINATED DEBT

Subordinated debt is primarily sensitive to a change in Santander's VR. In addition, AT1 and legacy preferred shares ratings could be downgraded if non-performance risk increases relative to the risk captured in the bank's VR, for example if capital buffers over regulatory requirements are eroded.

SUPPORT RATING AND SUPPORT RATING FLOOR

An upward revision of the Support Rating Floor is unlikely given current EU legislation and regulation on recovery and resolution.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations
The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Santander International Products PLC
----Senior preferred; Long Term Rating; Affirmed; A
Banco Santander, S.A.; Long Term Issuer Default Rating; Affirmed; A-; RO:Neg
; Short Term Issuer Default Rating; Affirmed; F2

; Viability Rating; Affirmed; a-
; Support Rating; Affirmed; 5
; Support Rating Floor; Affirmed; NF
; Derivative Counterparty Rating; Affirmed; A(dcr)
----preferred; Long Term Rating; Affirmed; BB
----Senior non-preferred; Long Term Rating; Affirmed; A-
----long-term deposits; Long Term Rating; Affirmed; A
----Senior preferred; Long Term Rating; Affirmed; A
----subordinated; Long Term Rating; Affirmed; BBB
----preferred; Long Term Rating; Affirmed; BB+
----short-term deposits; Short Term Rating; Affirmed; F1
----Senior preferred; Short Term Rating; Affirmed; F1

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Additional information is available on www.fitchratings.com

Applicable Criteria

[Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)]

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Status

Endorsement Policy

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