October 19, 2018

13097

Banco Santander, S.A.

Chief Analyst Toshihiko Naito
Chief Analyst Tomohiro Miyao
Analyst Haruna Saeki

Long-term Rating	A+
Outlook*	Stable
Short-term Rating	-

*Long-term Rating refers to Foreign Long-term Issuer Rating in principle.

1. Company Overview

Banco Santander, S.A. is Spain's largest commercial bank. Since its foundation in 1857, the bank has been expanding its business through the acquisition of local financial institutions in Europe, Central and South America, and North America. Accordingly, the countries where it operates have become well diversified, with a balanced mix of matured and emerging markets. The bank has successfully incorporated the acquired institutions into the group, transforming itself into one of the leading global banking groups with consolidated assets of 1.4 trillion euros at the end of 2017. It has 133 million customers worldwide, with its loans and deposits totaling 790.5 billion euros and 691.1 billion euros, respectively, on a consolidated basis at the end of 2017. International operations account for around 80% of its total loan portfolio. The group focuses on retail banking across the units and the shares of investment banking and corporate banking are small.

The bank runs its overseas operations through its subsidiaries with the Corporate Center, which assumes the group's head office functions, coordinating them. While the group shares the identical corporate philosophy and risk management policy, individual subsidiaries are autonomous in terms of capital and liquidity under the regulations and supervision imposed by the respective local authorities, which in turn helps contain possible risk contagion among the group's different units.

2. Business base

In evolving its business, the bank has pursued critical mass and focused on building up a strong franchise in the selected markets. As a result, it has secured a solid position in each of the markets where it operates, enabling it to hold a pricing power and sticky deposit base there. The core markets defined by the bank are Spain, the UK, the US (including Puerto Rico), Brazil, Chile, Portugal, Mexico, Poland and Argentina plus the consumer finance business in Europe run by Santander Consumer Finance (SCF). In Spain, the bank's market shares for deposits and loans rose from 12-13% to around 20% following its acquisition in June 2017 of Banco Popular which was subject to resolution under the EU's new bank recovery and resolution framework. The acquisition has strengthened the bank's domestic business base as Popular, a leader in SME lending, had a complementary business profile. Outside of Spain, the bank also has extensive operating networks covering wide regions and a broad customer base centering on individuals and SMEs. In the UK, the bulk of the bank's business is mortgages as it took over the foundations of building societies such as Abbey National and Bradford & Bingley. The bank boasts a market share in excess of 10% in that particular field. Santander has reorganized its UK operations in response to the country's ring-fence regulations. However, this is not expected to have a material impact on its business base or financial position because the size of the operations that fall under the restricted activities of a ring-fenced bank is small. In the US, the bank's commercial banking subsidiary Santander Bank, N.A. has a relatively solid franchise in the northeastern region while Santander Consumer USA (SCUSA) has a presence in the auto financing market. In Brazil (Banco Santander Brasil) and other Latin American countries, Portugal (Santander Totta) and Poland (Bank Zachodni WBK), it owns local commercial banks with deposit and loan market shares bigger than 10%. SCF operates in 15 European countries mainly in the area of auto loan, enjoying a leading position in Spain, Germany and the Nordic countries.

3. Asset quality

Risk management is supervised at the group level through the Corporate Center, and each subsidiary strictly and proactively monitors and controls its own risks in accordance with the group's risk control policy. Most of the bank's risk exposure stems from credit risks associated with customer loans. By market, the UK accounts for the largest proportion of the bank's total credit exposure (comprising loans, guarantees and letters of credit) with a share of approximately 30%, followed by Spain with around 20%, the US, Brazil and SCF with around 10% each, and Chile, Mexico and Argentina with less than 5% each (at the end of 2017, excluding Popular). The bank's credit portfolio has a relatively high risk profile due to its exposure to emerging countries and the acquisition of Popular in Spain. Credit costs are particularly high for the loans in Brazil and SCUSA's auto loans which are focused on subprime borrowers. Nevertheless, the bank has been focusing on changing the portfolio mix and stricter risk management in Brazil, while SCUSA has been promoting a shift to borrowers with higher credit scores. Meanwhile, the bank's credit exposure in the UK are mostly mortgage loans and have low risk profile as these mortgage loans are prudently managed in accordance with the strict standards including for LTV, targeted customer segments or purposes of borrowing. The level of concentration on top borrowers is low as most of the bank's loan portfolio is retail business (approximately 89% of the total as of the end of June 2018) with diversified smaller borrowers. As to the bank's corporate banking segment, where the loan amount per borrower tends to be large, no concentration is seen in specific countries or industries and most of its big borrowers are corporations with high credit standing.

The bank's asset quality has been improving in recent years against the background of better macroeconomic conditions and the progress in the reduction of problem assets related to the real estate sector in Spain, and an improved risk profile in Brazil. The bank took over a large volume of problem assets from Popular, but it has already sold 51% of Popular's real estate portfolio that had contained most of those assets to Blackstone. It intends to reduce the rest of the real estate portfolio in the next few years. The bank's nonperforming loan ratio went up from 3.74% at the end of March 2017 to 5.37% at the end of June that year after its integration of Popular. But it declined to 3.92% (3.2% excluding Popular) at the end of June 2018 following the transaction with Blackstone. The ratio including foreclosed assets related to the real estate sector and the forbearance portfolio is also estimated to have improved to the pre-acquisition level. The bank's credit cost ratio has been steadily declining since peaking out in 2012, falling below 100 bps on an annualized basis in the first half of 2018.

Looking at the changes in the bank's loan portfolio in recent years excluding the impact of foreign exchange rate fluctuations, it registered a year-on-year gain for the three consecutive years through 2017, even barring the impact of the acquisition of Popular. While the growth was led by SCF and emerging countries where markets are expanding, there are now signs that the situation is also improving in developed countries where lending has so far been sluggish. In Spain in particular, the pace of decline in the bank's lending has been gradually slowing in line with easing deleveraging in the country's banking sector. In the United States, the bank cleared the Federal Reserve's stress test in 2017 after failing to do so for three consecutive years, creating an environment where it can move to expand its business.

The bank's securities portfolio accounts for less than 20% of its total assets. It is mainly composed of government bonds held by each of the bank's subsidiaries for the purpose of risk management, which were issued in the countries where they operate. Judging from the past records of unrealized gains/losses or the duration of the bonds, credit risks and interest rate risks pertaining to the securities portfolio look to be limited.

4. Earnings and financial structure

While the bank operates in the markets with relatively high risks, its retail-focused operating base geographically diversified among countries whose economic growth is not correlated to each other has enabled it to remain profitable even during the financial crises after the Lehman shock. It has never posted a net loss even on a quarterly basis. The stability of its earnings is high among major global banks. A breakdown of the bank's gross income by markets shows it is well diversified. In 2017, Brazil accounted for around 30% of the total, followed by the US, Spain and the UK with just more that 10% each and SCF with slightly less than 10%.

By product, more than 90% of the bank's gross income comes from net interest income and fee income. Incomes from volatile trading and securities transactions are small. Furthermore, the bank enjoys high solid margins, especially in lending in emerging countries and consumer finance business, thanks to its pricing power backed by the possession of critical mass in each market. Also supported by its contained operating costs, the bank holds high earning power sufficient enough to absorb its high credit costs.

In 2017, the bank expanded its gross income by 10% year-on-year to 48.5 billion euros and reported a better pre-provisioning operating income after absorbing increased costs associated with investment in operational reforms and digitalization being made as part of its business strategy and those related to the integration of Banco Popular. The bank's ROA based on pre-provisioning operating income remained high at around 1.5%. As its credit cost continued shrinking, it made 8.2 billion euros in consolidated profit, up almost 10% over the previous year. With regard to synergy effect from the integration of Popular, the bank aims to achieve an annual cost reduction totaling 500 million euros by 2020.

The bank's consolidated common equity Tier 1 ratio stood at 10.98% on a phase-in basis and 10.8% on a fully-loaded basis at the end of June 2018, sound enough to support its current ratings. The capital ratios fell due to the acquisition of Popular, but they recovered to the pre-acquisition level after following the capital increase of 7 billion euros later on. The implementation of IFRS 9 has an impact of reducing the CET1 ratio by around 25bp due to an increase of loan-loss provisions. However, this is likely to be absorbed within a few years given the pace of capital accumulation through retained earnings in the past. Since the European Commission has set a five-year transition period, only 1bp needs to be absorbed in 2018. JCR holds that the bank will be able to retain the current levels of capital ratios supported by a steady accumulation of retained earnings. Following the finalization of the Basel III reform in December 2017, a set of new regulations that could adversely affect the capital ratios are expected to be introduced in the future. They include a revision of the standardized approaches and the internal rating-based approaches for calculating risk-weighted assets, and an introduction of an output floor based on the standardized approaches for risk-weighted assets generated by internal models. However, their possible impact on the bank's capital position is likely to be minimal, judging from the current application of the internal rating-based approaches.

As regards the TLAC regulation, the bank has opted for the multiple-point-of-entry (MPE) approach under which multiple entities subject to resolution have been defined in the group. The issuance of TLAC-compliant securities has been progressing in preparation for the introduction of the regulation in early 2019. The bank has been gradually ramping up the issuance of senior non-preferred debts that would rank below the unsecured senior debts in resolution procedures.

The bank generally maintains a comfortable liquidity position. The loan-to-deposit ratio exceeds 100% on a group basis. But the balances of loans and deposits are largely matched excluding the consumer finance subsidiaries, as each banking subsidiary holds a local funding base centering on deposits and adequate liquidity. No intragroup funding and liquidity provision are basically carried out with the exception of SCF. The bank mostly covers its wholesale funding with medium-to long-term debts and its reliance on short-term instruments is limited. Maturities of the medium- to long-term debts are diversified, which also contributes to reducing its refinancing risks.

5. Overall assessment and rating outlook

The ratings are mainly supported by the bank's geographically diversified operating base, solid position in each of the markets where it operates, and capacity to generate stable earnings. On the other hand, the ratings are constrained by a relatively high risk profile of its credit portfolio. The rating outlook is Stable. The bank's consolidated profit has been increasing on solid pre-provisioning operating income and contained loan-loss provisioning. Risks involved in the acquisition of Banco Popular in June 2017 stay within manageable limits as its problem assets related to the real estate sector have been mostly sold to Blackstone. JCR holds that the bank will continue to generate stable earnings supported by its solid, geographically diversified operating base and strict risk management.

A further reduction of risks in the bank's credit portfolio could lead up to an improvement of its creditworthiness. On the contrary, any major damage to its earnings base or capital resulting from deterioration of asset quality caused by Brexit or weakening of economic and financial conditions in the emerging countries including Brazil could have a downward pressure on the ratings.

13097 Banco Santander, S.A.

Consolidated Financial Summary

(Million euros,%, bp)

	2013/12	2014/12	2015/12	2016/12	2017/12
Total assets (end-year balance)	1,115,763	1,266,296	1,340,260	1,339,125	1,444,305
Loans and advances to customers (end-year balance)	668,856	734,711	790,848	790,470	848,915
Customer deposits (end-year balance)	608,201	647,705	683,142	691,112	777,730
Total income	39,666	42,612	45,895	44,232	48,355
Pre-provisioning profit from operations	17,378	19,417	21,069	20,623	22,304
Profit from operations	6,151	8,707	10,417	10,997	13,045
Profit for the period	5,329	6,935	7,334	7,486	8,207
ROA (based on pre-provisioning profit from operations)	1.43	1.62	1.57	1.54	1.58
Non-performing balances/Total loans and contingent liabilities	5.64	5.19	4.36	3.93	4.08
Cost of credit	153	143	125	118	107
Total regulatory capital ratio	12.59	12.04	14.40	14.68	14.99
Tier 1 capital ratio	11.13	10.97	12.55	12.53	12.77
Common equity Tier 1 capital ratio	10.67	10.97	12.55	12.53	12.26

* Figures for the most recent period could be indicators based on preliminary figures.

(Notes) Calculation of ROA is based on the average balance of total assets
(Source) Annual Reports, IR materials, etc

Ratings

(Millions of yen)

	Rating	Outlook*	Amount	Rate (%)	Issue Date	Maturity Date	Release
Samurai Senior Non Preferred Bonds - First Series (2017)	A	-	83,700	0.568	2017.12.11	2023.01.11	2018.08.22
Samurai Senior Non Preferred Bonds - Third Series (2017)	A	-	12,200	1.015	2017.12.11	2027.12.10	2018.08.22
Foreign Currency Long-term Issuer Rating	A+	Stable	-	-	-	-	2018.08.22

History of Long-term Issuer Rating (Foreign Long-term Issuer Rating or its equivalent)

Date	Rating	Outlook*	Issuer
2017.05.19	A+	Stable	Banco Santander, S.A.

*Outlook for Foreign long-term issuer rating, or direction in case of Credit Monitor

Japan Credit Rating Agency, Ltd.
Jiji Press Building, 5-15-8 Ginza, Chuo-ku, Tokyo 104-0061, Japan
Tel. +81 3 3544 7013, Fax. +81 3 3544 7026