Banco Santander SA
Issuer Rating Report

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 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 damaging the bank's 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, allowing the group to profitably re-deploy, when needed, 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 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 not only at the group level but also locally.

Rating drivers (summary)

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

- 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
- Globally diversified revenue and earnings streams with strong market positions in several key markets including Spain, Portugal, Argentina, Brazil, UK, Mexico, Chile, and Poland
- Ongoing improvement of capital, liquidity and funding positions in recent years
- European banking union likely to provide a stronger regulatory and supervisory framework

Ratings & Outlook

Issuer Rating	AA-
Outlook	Stable
Senior unsecured debt	AA-
Senior unsecured debt (MREL/TLAC eligible)	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

Lead Analyst

Marco Troiano, CFA
m.troiano@scoperatings.com

Associate Analyst

Alvaro Dominguez Alcalde
a.dominguez@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4577

Headquarters

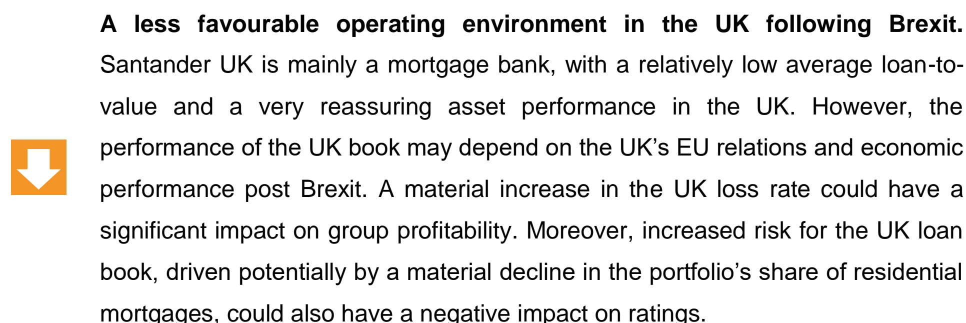
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

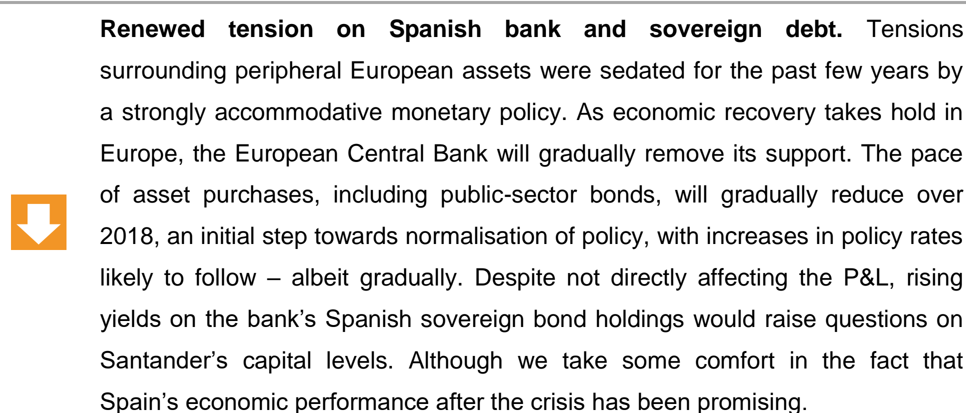
info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

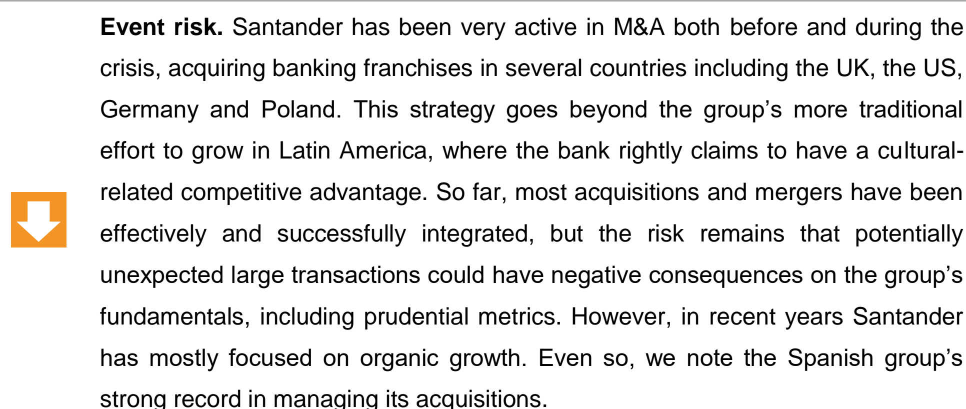
Rating change drivers



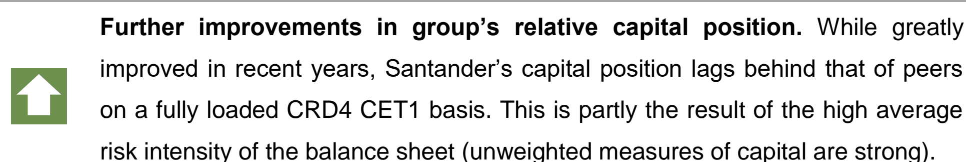
A less favourable operating environment in the UK following Brexit. Santander UK is mainly a mortgage bank, with a relatively low average loan-to-value and a very reassuring asset performance in the UK. However, the performance of the UK book may depend on the UK's EU relations and economic performance 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 Santander's capital levels. Although we take some comfort in the fact that Spain's economic performance after the crisis has been promising.



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.



Further improvements in group's relative capital position. While greatly improved in recent years, Santander's capital position lags behind that of peers on a fully loaded CRD4 CET1 basis. This is partly the result of the high average risk intensity of the balance sheet (unweighted measures of capital are strong).

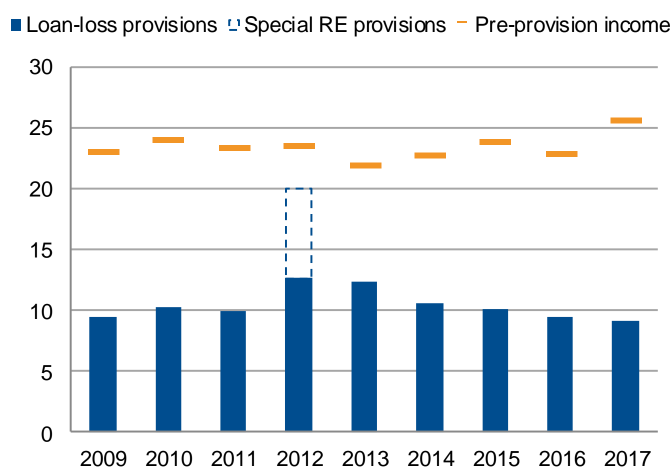
Rating drivers (details)

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 business model has served the bank well in recent years. Despite significant challenges due to the burst of the domestic credit and real estate bubble as well as a sovereign crisis, the group was able to survive and emerge 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.

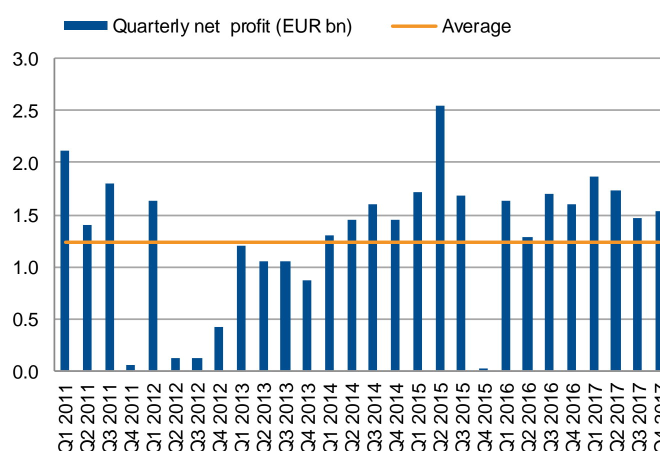
As shown in Figure 1, this pre-provision profit buffer was able to absorb significant losses throughout the crisis, including the extraordinary provision on real estate assets from the 2012 royal decrees. Indeed, Santander has not posted a single quarter of net losses since the global financial crisis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

Figure 1: Recurring pre-provision profitability vs LLC, 2009-2017



Source: Company data, Scope Ratings

Figure 2: Santander's quarterly net profit, 2011-2017



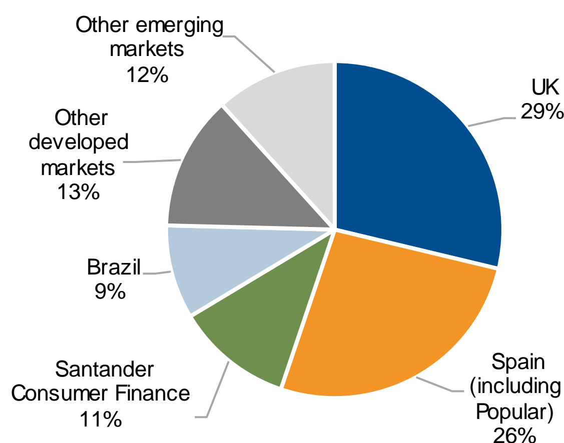
Source: Company data, Scope Ratings

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

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

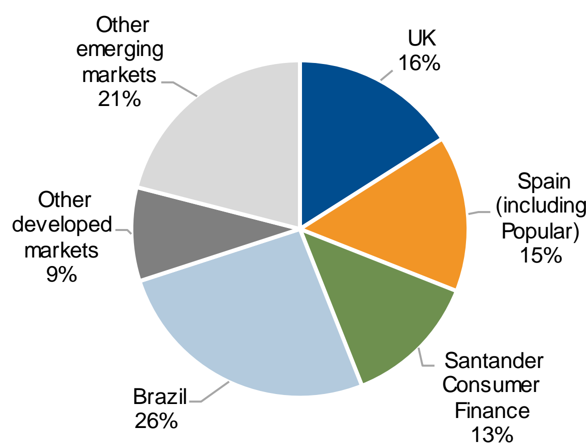
Significant geographical diversification is a key positive driver for Santander's rating. Several of the group's retail and commercial banks are active in both the Americas and Europe. As shown in Figure 3 and 4, while mature markets still account for the majority of the loan book, half of Santander's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

Figure 3: Santander loan book split, 2017



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, 2017



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 likely 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 the earnings smoothing provided by diversification as it would take synchronised recessions in the different countries of operation to seriously threaten group solvency.

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 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.

Following the Popular acquisition in June 2017, Banco Santander became the largest retail and commercial bank in Spain, with a c. 20% market share in loans and a dominant position in domestic SMEs (25%). Excluding the impacts of the Popular acquisition, the underlying profit of the Spanish division increased 15% in 2017, thanks largely to declining provisions.

Santander Brazil is the fifth-largest bank in Brazil with 9% market share. It is also a substantial contributor to group activities: 12% of total group customer funds, and the largest contributor to group pre-provision profits (31% of PPP in 2017). During 2017, underlying net profits of the Brazilian franchise grew by 34%, driven by double-digit revenue growth (18.3% YoY) that materially outpaced cost growth (6% YoY).

The UK is Banco Santander's other large profit centre. Santander UK is the region's sixth-largest bank, with gathering 10% market share, and contributed approximately 10% of group pre-provision profit during 2017. However, the UK franchise also reported a 4.4% decline in underlying net profit that year due to some normalisation in its cost of risk.

Santander Consumer Finance, the group's European consumer finance business, continues to perform strongly, with underlying profit growth of 15% driven by a very low cost of risk (30 bps).

Other relevant countries for Santander Group are Poland, Argentina, Chile, Mexico, Portugal and the US.

Scope expects Santander's geographic diversification to continue to pay off, as a more vibrant environment in Spain and the exit of Brazil from recession provide a counterweight to the uncertain and potentially more challenging outlook for the UK after Brexit.

Ongoing improvement of capital, liquidity and funding positions in recent years
Santander's capital position has improved materially over the years. At the end of 2017, Santander CRD IV CET1 ratio stood at 12.26% on a transitional basis, almost double the 2007 level. On a fully loaded basis, the ratio stood at 10.84%, which in our view is adequate given the group's strong track record of organic capital generation, low earnings volatility, predominance of retail, and relatively high asset-risk intensity.

Both on a transitional and fully loaded basis, Santander is well ahead of its 2018 SREP CET1 requirement of 8.655%. The requirement is set to increase over the coming years as the buffer requirements are phased in. The 2019 SREP CET1 requirement should stand at 9.5%. In our view, Santander is on track to meet both its regulatory requirements and its 11% internal capital target by 2018.

We believe the capitalisation ratio will improve further as Santander manages to organically generate capital on a group basis, thanks to its high risk-adjusted profitability.

The funding and liquidity position has 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.

European banking union provides strong regulatory and supervisory framework
Despite its fundamental strength, the perception of Santander's credit risk has suffered in the past from significant macro challenges in Spain and a degree of market concern regarding the strength of Spain's regulatory and supervisory framework. Going forward, Scope believes the existence of the European banking union will help address doubts around regulation and supervision in any individual country and allow investors – as well as euro area supervisors – to compare banks based on intrinsic credit strength.

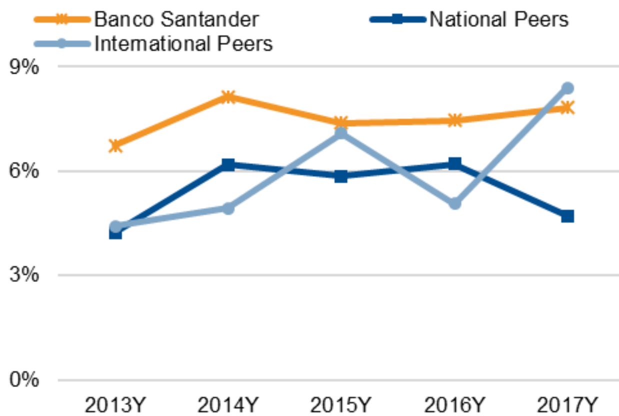
The Single Supervisory Mechanism (SSM) – which transfers the supervisory role to a single, supranational and independent actor, the ECB – ensures all European banks are subject to the same strict standards of supervision. Not only does this help to limit concerns over possible regulatory forbearance 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.

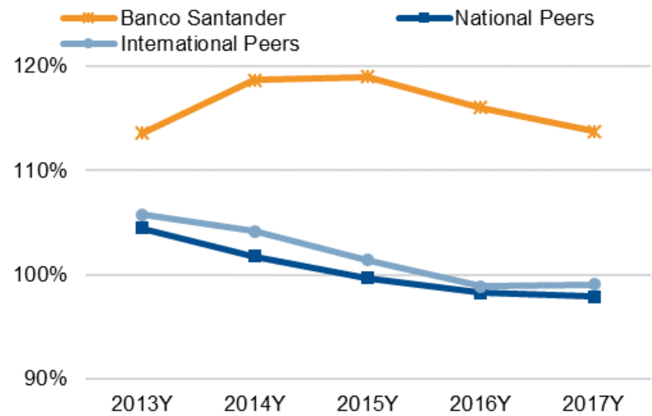
The global financial crisis has shown that intragroup capital and liquidity mobility across geographies can be significantly constrained during periods of stress, limiting a cross-border banking group’s financial flexibility when most needed. Faced with such restrictions, steps ranging from the listing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

I. Appendix: Peer comparison

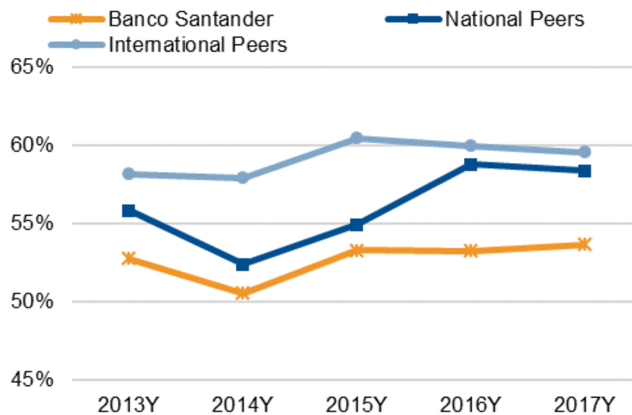
Return on average equity (%)



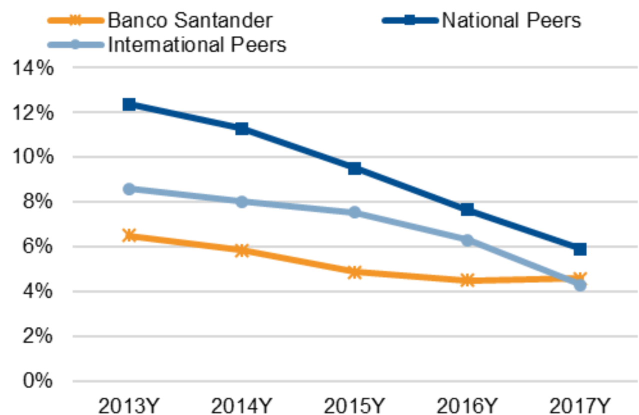
Loan-to-deposit ratio (%)



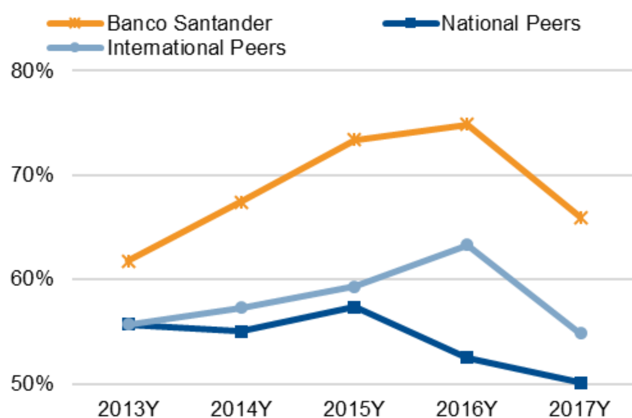
Cost income ratio (%)



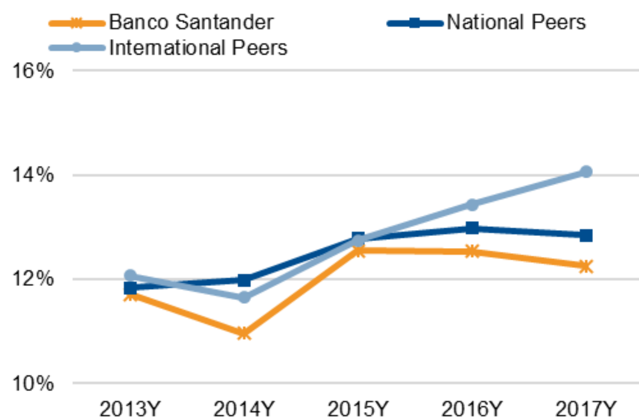
Impaired & Delinquent Loans / Loans (%)



Loan-loss reserves % impaired loans



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

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	2013Y	2014Y	2015Y	2016Y	2017Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	152,067	151,141	160,281	153,140	188,425
Total securities	211,060	281,152	289,666	295,743	293,493
of w hich, derivatives	68,827	85,987	85,830	83,901	67,067
Net loans to customers	668,856	734,711	790,848	790,470	848,915
Other assets	83,654	99,292	99,467	99,771	113,472
Total assets	**1,115,637**	**1,266,296**	**1,340,262**	**1,339,125**	**1,444,305**
Liabilities					
Interbank liabilities	109,397	155,617	175,373	149,398	190,315
Senior debt	175,477	196,563	205,007	208,967	196,456
Derivatives	64,257	86,333	85,525	82,973	66,266
Deposits from customers	607,836	647,706	683,142	691,112	777,730
Subordinated debt	16,139	17,132	21,153	19,902	21,510
Other liabilities	62,630	73,231	71,306	84,074	85,195
Total liabilities	**1,035,736**	**1,176,581**	**1,241,507**	**1,236,425**	**1,337,472**
Ordinary equity	70,395	80,541	87,828	90,699	94,273
Equity hybrids	193	265	214	240	216
Minority interests	9,313	8,909	10,713	11,761	12,344
Total liabilities and equity	**1,115,637**	**1,266,296**	**1,340,262**	**1,339,125**	**1,444,305**
Core tier 1/Common equity tier 1 capital	57,346	64,250	73,478	73,709	74,173
Income statement summary (EUR m)					
Net interest income	25,935	29,548	32,812	31,089	34,296
Net fee & commission income	9,761	9,696	10,033	10,180	11,597
Net trading income	3,394	2,850	2,386	2,101	1,665
Other income	2,652	3,751	825	750	1,116
Operating income	**41,742**	**45,845**	**46,055**	**44,120**	**48,674**
Operating expense	22,026	23,178	24,542	23,587	26,051
Pre-provision income	**19,717**	**22,667**	**21,513**	**20,533**	**22,623**
Credit and other financial impairments	11,227	10,710	10,652	9,625	9,259
Other impairments	838	1,277	1,314	140	1,273
Non-recurring items	0	NA	NA	NA	NA
Pre-tax profit	**7,652**	**10,680**	**9,547**	**10,768**	**12,091**
Discontinued operations	-15	-26	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	2,113	3,718	2,213	3,282	3,884
Net profit attributable to minority interests	1,154	1,119	1,368	1,282	1,588
Net profit attributable to parent	**4,370**	**5,816**	**5,966**	**6,204**	**6,619**

Source: SNL

III. Appendix: Selected Financial Information – Santander group

	2013Y	2014Y	2015Y	2016Y	2017Y
Funding and liquidity					
Net loans/deposits (%)	113.6%	118.7%	119.0%	116.1%	113.7%
Liquidity coverage ratio (%)	NA	120.0%	146.0%	146.0%	133.0%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	60.0%	58.0%	59.0%	59.0%	58.8%
Impaired & delinquent loans/loans (%)	6.5%	5.8%	4.9%	4.5%	NA
Loan-loss reserves/impaired loans (%)	61.8%	67.4%	73.4%	74.6%	71.5%
Net loan growth (%)	-7.0%	9.8%	7.6%	0.0%	7.4%
Impaired loans/tangible equity & reserves (%)	51.3%	46.7%	37.7%	33.5%	27.9%
Asset growth (%)	-12.1%	13.5%	5.8%	-0.1%	7.9%
Earnings and profitability					
Net interest margin (%)	2.3%	2.7%	2.7%	2.5%	2.6%
Net interest income/average RWAs (%)	4.9%	5.4%	5.5%	5.3%	5.6%
Net interest income/operating income (%)	62.1%	64.5%	71.2%	70.5%	70.5%
Net fees & commissions/operating income (%)	23.4%	21.1%	21.8%	23.1%	23.8%
Cost/income ratio (%)	52.8%	50.6%	53.3%	53.5%	53.5%
Operating expenses/average RWAs (%)	4.2%	4.2%	4.1%	4.1%	4.3%
Pre-impairment operating profit/average RWAs (%)	3.7%	4.1%	3.6%	3.5%	3.7%
Impairment on financial assets /pre-impairment income (%)	56.9%	47.2%	49.5%	46.9%	40.9%
Loan-loss provision charges/net loans (%)	1.6%	1.5%	1.3%	1.3%	1.2%
Pre-tax profit/average RWAs (%)	1.4%	1.9%	1.6%	1.9%	2.0%
Return on average assets (%)	0.5%	0.6%	0.5%	0.6%	0.6%
Return on average RWAs (%)	1.0%	1.3%	1.2%	1.3%	1.3%
Return on average equity (%)	6.7%	8.1%	7.4%	7.5%	7.8%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	11.7%	8.3%	10.1%	10.6%	10.8%
Common equity tier 1 ratio (%, transitional)	11.7%	11.0%	12.5%	12.5%	12.3%
Tier 1 capital ratio (%, transitional)	12.6%	11.0%	12.5%	12.5%	12.8%
Total capital ratio (%, transitional)	14.6%	12.0%	14.4%	14.7%	15.0%
Leverage ratio (%)	4.9%	3.7%	4.7%	5.0%	5.0%
Asset risk intensity (RWAs/total assets, %)	43.9%	46.3%	43.7%	43.9%	41.9%
Market indicators					
Price/book (x)	1.0x	1.1x	0.7x	0.8x	0.9x
Price/tangible book (x)	1.7x	1.8x	1.1x	1.2x	1.3x
Dividend payout ratio (%)	150.3%	125.0%	50.0%	51.2%	NA

Source: SNL

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

33 rue La Fayette
F-75009 Paris

Phone +33 1 82885557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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Scope Ratings GmbH, Lennéstrasse 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director(s): Dr. Stefan Bund, Torsten Hinrichs.