FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Santander at 'A-'; Outlook Stable

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Fitch Ratings - Barcelona - 25 May 2022: 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 (VR) at 'a-'. The Outlook is Stable.

A full list of rating actions is below.

Fitch has withdrawn Santander's Support Rating of '5' and Support Rating Floor of 'No Floor' as they are no longer relevant to the agency's coverage following the publication of its updated Bank Rating Criteria on 12 November 2021. In line with the updated criteria, we have assigned Santander a Government Support Rating (GSR) of 'no support' (ns).

KEY RATING DRIVERS

Geographic Diversification: The ratings reflect Santander's international footprint as a key franchise- and business-model strength, despite exposure to higher-risk emerging markets. The ratings also reflect our expectation that the group's rigorous approach to risk control will mitigate asset-quality pressures from the current uncertain operating environment, and that Santander will be able to maintain capital ratios that are commensurate with its ratings, helped by its resilient earnings generation capacity through economic cycles, although ratios are likely to remain at the lower end of European peers'.

Diversified Retail Franchise: Santander benefits from broad and balanced geographic and business diversification, with solid retail-banking franchises in several European and

Latin American countries and, to a lesser extent, in consumer finance in the US. This results in good pricing power and access to large, stable deposit bases. This, combined with Santander's experience over several economic cycles in different markets, has enabled it to manage periods of stress, including the pandemic.

The wide margins in its emerging-market activities and a cost control-oriented culture (cost/income ratio consistently below 50% since 2007) allow Santander to defend its profitability during periods of stress. For this reason, we believe Santander has rating headroom to absorb second-order effects from the economic slowdown and inflationary pressures that are emerging from the Russia/Ukraine conflict.

Asset Quality A Relative Weakness: Asset quality remains a weakness compared with some European peers'. Exposure to emerging markets inherently results in above-European average impaired loan ratios and loan impairment charges, albeit mitigated by Santander's higher net interest margins. Loan performance has proved resilient to date, due to economic recovery and remaining government support measures (particularly in Spain). However, we expect asset quality to modestly weaken over the rating horizon, as higher inflation and interest rates weigh on borrowers.

We expect Santander will operate with an average four-year impaired loan ratio of below 4% (3.4% at end-March 2022), while impaired loan coverage should remain above historical levels (71% at end-March 2022), providing adequate cushion against downside pressures.

Earnings Rebound to be Maintained: We anticipate most of the earnings rebound in 2021 will be maintained over the next two years, despite an uncertain operating environment. Santander stands to see its net interest margin boosted by interest-rate rises in the UK, Poland, the US and, potentially, also in the eurozone later this year. This should offset slower loan growth than initially expected.

Fee income growth should continue to support revenue on higher fee-based business volumes. However, inflation pressures in Europe led Santander to revise downwards its cost-savings guidance to around EUR800 million (from EUR1 billion). This, however, should not prevent Santander from meeting its cost/income target of around 40% in the medium term (45% in 1Q22).

Adequate Capitalisation: We expect Santander will continue to operate with a common equity Tier 1 (CET1) ratio at or above 12% in 2022 (12.05% CET1 at end-March 2022 including a small corporate transaction in the US), including a potential M&A in Mexico and higher capital distribution (current pay-out is 40% of underlying profit). Our assessment of capital also assumes that foreign subsidiaries remain well-capitalised, as well as Santander's strong internal capital generation and proven access to equity markets.

Diversified Funding; Good Liquidity: We believe Santander's funding and liquidity management is good and benefits from large and stable deposit franchises in its core markets. The group has deep global capital-market access both at the parent bank and at subsidiaries. We expect Santander's liquidity coverage ratio to return to more normal levels after an increase during the pandemic (157% at end-March 2022), while its net stable funding ratio should remain high (126% at end-2021). High-quality liquid assets represented about 17% of total assets at end-March 2022.

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.

RATING SENSITIVITIES

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

Santander's ratings would come under pressure if its CET1 ratio declines sustainably below 12% without a credible plan to rebuild it in the short term, including as a result of unexpected events (such as significant acquisitions).

A meaningful erosion of the bank's earnings resilience (ie operating profit/risk weighted assets (RWAs) below 2% on a sustained basis) would also likely result in a negative rating action. Santander's ratings remain sensitive to a downgrade of Spain (A-/Stable) or to the group's current operating environment score ('a-'), the latter being particularly sensitive to the economic and banking prospects of Santander's core markets.

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

An upgrade would be contingent on an upgrade of Spain's sovereign rating, stronger capital ratios (CET1 ratio sustainably above 14%) and better asset-quality metrics (with an impaired loan ratio sustainably below 2%). Equally important would be the ability to preserve the group's earnings resilience, which means maintaining sound earnings performance at its main foreign subsidiaries.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

Government Support Rating (GSR)

Santander's GSR of 'ns' reflects our view that although external extraordinary sovereign support is possible it cannot be relied upon. This is because senior creditors can no longer expect to receive full extraordinary support from the sovereign in the event that the bank becomes non-viable.

Senior Debt, Deposit and Derivative Counterparty (DCR) Ratings

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.

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 RWAs (after deconsolidating subsidiaries that are in different resolution groups, as Santander has a clear multiple-point-of-entry resolution strategy) on a sustained basis. We expect Santander to continue to issue a significant volume of senior non-preferred and junior debt to maintain 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 their equivalent long-term senior debt and deposit ratings being notched up from the Long-Term IDR to reflect lower credit risks.

Subordinated 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 additional Basel III Tier 1 (AT1) debt with fully discretionary coupon payment four notches below 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 record of strong pre-provision earnings generation throughout the cycle and by a 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.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

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

Senior Debt, Deposit Ratings and DCR

Santander's DCR, senior debt and deposit ratings are primarily sensitive to downgrades of Santander's IDRs. We would also downgrade the DCR, long-term senior preferred and non-preferred debt and deposit ratings by one notch to the same level as the IDRs 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 and Junior Subordinated Debt

Subordinated debt is primarily sensitive to a downgrade of 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.

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

Senior Debt, Deposit Ratings and DCR

Santander's DCR, senior debt and deposit ratings would be upgraded if Santander's Long-Term IDR is upgraded.

Subordinated Debt and Junior Subordinated Debt

Santander's subordinated debt and junior subordinated debt ratings would be upgraded if Santander's VR is upgraded.

GSR

An upward revision of the GSR would be contingent on a positive change in the sovereign's propensity to support the bank. In Fitch's view, this is highly unlikely, although not impossible.

VR ADJUSTMENTS

The operating environment score of 'a-' is in line with the 'a' category implied score but above the 'bbb+' score of domestic Spanish banks because of the following adjustment reason: international operations (positive).

The capitalisation & leverage score of 'a-' is above the 'bbb' category implied score because of the following adjustment reasons: Internal capital generation and growth (positive) and capital flexibility and ordinary support (positive).

The funding and liquidity score of 'a-' is above the 'bbb' category implied score because of the following adjustment reasons: deposit structure (positive) and non-deposit funding (positive).

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond 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, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Santander International Products PLC				
Senior preferred	LT	A	Affirmed	A
Banco Santander, S.A.	LT IDR	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Stable
	ST IDR	F2	Affirmed	F2
	Viability	a-	Affirmed	a-
	Support	WD	Withdrawn	5
	Support Floor	WD	Withdrawn	NF
	DCR	A(dcr)	Affirmed	A(dcr)
	Government Support	ns	New Rating	
preferred	LT	BB	Affirmed	BB

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 12 Nov 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Santander International Products PLC	EU Issued, UK Endorsed

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