JCR
ISSUER REPORT
November 11, 2020

13097
Banco Santander

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

Chief Analyst Toshihiko Naito
Chief Analyst Tomohiro Miyao
Analyst Haruna Saeki

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

1. Company Overview

Banco Santander, S.A. is Spain's largest commercial bank, also operating in other European countries, Latin American countries and the United States through many subsidiaries. It is one of the largest leading global banking groups with consolidated assets of 1.5 trillion euros, more than 140 million customers worldwide, and customer loans and deposits totaling 942.2 billion euros and 824.4 billion euros, respectively, at the end of 2019. Geographically, international operations outside of Spain account for more than 80% of its total income. By business segment, retail banking accounts for more than 85% of its total income.

While its subsidiaries are autonomous in terms of capital and liquidity with a view to containing possible risk contagion among the group's different units, corporate philosophy, strategy and risk management policy are shared across the group. The bank has been promoting a new medium-term group strategy since April 2019. Under the strategy, it plans to continue the initiatives to enhance customer loyalty and promote digitalization while also aiming to further enhance profitability through greater emphasis on the more profitable Latin American operations and a cost reduction totaling 1.2 billion euro mainly targeted for European operations.

2. Business base

The bank holds a solid operating base in each of the markets where it operates, both in developed and emerging economies, thanks to its business strategy focused on critical mass and retail banking in selected markets. The core market segments defined by the bank are nine countries consisting of Spain, the UK, the U.S. (including Puerto Rico), Brazil, Chile, Portugal, Mexico, Poland and Argentina, and consumer finance business undertaken in Europe by Santander Consumer Finance (SCF). In Spain, the bank has carved market shares of around 20% for both deposits and loans following the acquisition in 2017 of Banco Popular (Popular) (its integration was completed in July 2019). The acquisition has contributed to strengthening the bank's domestic business base as Popular, the leading lender to SMEs, had a complementary business profile. In the UK, the bulk of the bank's business is mortgages as it took over the foundation of building societies. In this particular field, the bank boasts a market share of around 10%. In the U.S., the bank's subsidiary Santander Bank, N.A. has a solid commercial banking franchise in the northeastern region and another subsidiary Santander Consumer USA (SCUSA) has a strong presence in the auto financing market. In Brazil (Banco Santander Brasil) and other Latin American countries and in Portugal (Santander Totta) and Poland (Santander Bank Polska, former Bank Zachodni WBK), it owns local commercial banks with deposit and loan market shares largely exceeding 10%. SCF primarily offers auto loans in 15 European countries, enjoying a leading position in many countries including Spain, Germany and the Nordic countries. Having a solid franchise in each market, the bank holds a competitive pricing power and sticky deposit base.

The bank's previous medium-term strategy covering the 2015-2018 period had focused on commercial transformation aimed to enhance customer loyalty and promote digitalization, with each unit working on various initiatives including reform of branch models, development of new products and optimization of transaction processes. The new strategy announced in

April 2019 calls for continuing these initiatives and increasing the weight of the more profitable businesses. In line with this, the bank increased its stake in its Mexican subsidiary, Santander Mexico, from 74.96% to 91.65% in 2019. As part of the strategy, the bank reorganized its geographical structure into three regions; "Europe" that covers continental Europe, UK and SCF, "North America" that covers the U.S. and Mexico and "South America" that covers Brazil, Chile and Argentina. At the same time, it created Santander Global Platform (SGP), a new cross-group business segment.

3. Asset quality and risk management

The bank's asset quality continued to improve in most of its core markets in recent years, with its nonperforming loan ratio declining to 3.32% at the end of 2019 from 5.6% at the end of 2013. The bank has made steady progress in divesting its problem assets related to the real estate sector that it took over from Popular. As a result, the ratio of problem loans that also include foreclosed assets related to the real estate sector and the forbearance portfolio declined from 10% at the end of 2017 right after the acquisition of Popular to 5.7% at the end of 2019. The bank's credit cost ratio was contained at around 100 bps in 2018 and 2019, compared with more than 230 bps in 2012.

The impact of the COVID-19 pandemic on its asset quality has been limited so far, with its NPL ratio falling slightly to 3.26% at the end of June 2020. The credit cost ratio rose modestly to 126bp in the first half of 2020 due to an increase of Stage 2 loans based on IFRS 9 and a precautionary overlay of provisions aimed to provide against a weaker economic outlook. Some of the loans put under moratorium may turn nonperforming after the end of the grace period. However, JCR holds that risk of significant additional burdens of provisions is low given that most of them are highly-collateralized housing loans and auto loans.

The bank's securities portfolio accounts for less than 20% of its total assets. It is mainly composed of government bonds issued in the countries where it operates which each of its subsidiaries holds for the purpose of risk management. 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.

The bank's risk management is centralized at the group level and each subsidiary strictly and proactively monitors and controls its own risks in accordance with the group's risk management 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 27%, followed by Spain with around 21%, the U.S. and SCF with approximately 10% each, Brazil with around 9% and others with less than 5% each (at the end of 2019). The bank's credit portfolio has a relatively higher risk profile among the major global financial institutions due partly to its wider exposure to emerging countries. Its credit cost ratio is high, averaging at around 110bp in the five years to 2019. Credit costs are particularly high for the loans made in Latin American countries especially in Brazil and SCUSA's auto loans that are focused on subprime borrowers. It should be noted, however, that the bank ensures ample spreads to absorb credit cost on loans with higher credit risks. In addition, JCR views that risks associated with credit concentration on large borrowers are low given that approximately 90% of the bank's loan portfolio consists of retail business well diversified among smaller borrowers and most of its big borrowers are companies with high internal ratings.

4. Earnings

While the bank operates in the markets with relatively high risks, it makes stable earnings as its earnings sources center on retail banking which is geographically diversified among countries whose economic growth is not correlated to each other. A country-by-country breakdown of its 2019 total income showcases geographical diversification, with Brazil accounting for 28% of the total, followed by the U.S. and Spain with 15% each, and the UK and SCF with 10% each, Mexico with 8%, Chile with 5% and Portugal, Poland and Argentina with 3% each. By business segment, about 85% of the total income comes from retail banking, with invest banking and market-related business, which tend to be susceptible to market conditions, generating only limited income. In addition to such earnings structure, it can absorb relatively high credit costs as its core earning power in terms of pre-provisioning operating income is high thanks to its solid margins ensured by appropriate pricing and restrained operating costs brought by strict cost control.

The business environment in Europe has been challenging in recent years due to prolonged low interest rates and heightened uncertainty associated with the UK's exit from the EU. Even in this situation, the group-wide

initiatives to enhance customer loyalty and promote digitalization have been bearing fruit in capturing more interest and fee incomes and in containing costs. Coupled with a reduction of credit costs, this has been contributing to further stabilizing the bank's capacity to generate earnings.

In 2019, the bank's consolidated profit decreased year-on-year to 8.1 billion euros. But it was higher than the previous year when non-recurring factors such as impairment of goodwill resulting from its UK business and restructuring costs associated with the integration of Popular were excluded. The bank's earnings performance in the first half of 2020 was adversely affected by the pandemic. It ended up with a statutory loss of EUR10.3 billion on consolidated profit driven by an increase of credit costs to EUR7 billion and a recording of impairment losses totaling EUR12.6 billion including goodwill impairment and valuation adjustment of deferred tax assets. On an underlying basis excluding the impact of non-recurring factors such as impairments, however, it made a consolidated profit of EUR2.4 billion by absorbing the increased credit costs. JCR holds that the possibility of the bank incurring large impairment losses again is low as the book value of goodwill related to its UK business, which was the main source of such losses, has already decreased significantly.

5. Financial structure

The bank's consolidated common equity Tier 1 (CET1) ratio stood at 11.8% (after allowing for the IFRS 9 transitional arrangements) on a fully-loaded basis at the end of June 2020, sound enough to support its current rating. The impairment losses in the first half of 2020 did not impact the CET1 ratio, while the easing of the EU's Capital Requirements Regulation (CRR) following the pandemic had a positive impact of around 20bp. Going forward, some regulatory changes may lower the bank's capital ratios. Those include the implementation in 2018 of IFRS 9 (which may lower the CET1 ratio by some 25bp but which can be absorbed in five years according to the European Commission's transition arrangement), the "Targeted Review of Internal Models" being conducted by the ECB and the introduction of an output floor following the finalization of the Basel III reforms. On the other hand, regulatory amendments are in progress in the EU including an exemption from the deduction of intangible assets from CET1 capital for certain software assets. If implemented, this will have a positive impact. All in all, the impacts of the regulatory changes may be negative. Nevertheless, JCR holds that the bank will retain its sound capital levels by absorbing those impacts, judging from the pace of its accumulation of retained earnings in the past years.

As regards the TLAC regulations, 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. In recent years the group's funding has been focused on the issuance of TLAC-compliant securities. Of a total of EUR22 billion worth of debts it issued in the first half of 2020, EUR9.1 billion worth were senior non-preferred (SNP) debts. The TLAC ratio of the resolution group headed by Banco Santander, S.A. was 19.71% based on risk-weighted assets at the end of March 2020. This is higher than an expected year-end requirement of 19.52%. EU's MREL (Minimum Requirement for Own Funds and Eligible Liabilities) applies to the European resolution group that includes Banco Santander, S.A. and Santander Consumer Finance S.A. The bank estimates that this resolution group complies with the MREL requirements (28.6% of risk-weighted assets and 16.81% of total liabilities and own funds).

The bank continues to retain a comfortable liquidity position. Its policy requires each subsidiary to hold a sufficient funding base and liquidity, and no intragroup funding and liquidity support is basically carried out except for SCF. The loan-to-deposit ratio exceeds 100% on a group basis, but the balances of loans and deposits are largely matched except for its consumer finance subsidiaries. In addition, the bank's refinancing risks are mitigated by the fact that its wholesale funding is mostly covered with medium- to long-term debts, its reliance on short-term instruments is limited and that maturities of the medium- to long-term debts are diversified. Both liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) stay at sound levels, respectively standing at 175% at the end of June 2020 and 111% at the end of March 2020.

6. ESG Factors in Credit Rating

As ESG factors in the rating of a bank, JCR primarily focuses on governance of business promotion as to whether it has established an organizational structure to give consideration to the interest of customers and its own asset quality. Putting too much importance on a short-term profitability and making loans which are incompatible with risk and return could impair asset quality and lead to a significant increase in credit costs. Also, an absence of customer-oriented attitude could lead to scandals such as inappropriate solicitation, which in turn may put the bank at reputation risk or litigation

risk. After assessing the bank's control policy and system for the lending and credit cost performance as well as governance of business promotion, JCR holds that the bank’s rating is not affected by those factors. In the case of reputation risk and litigation risk, JCR conducts interviews with regard to business promotion policies.

7. Overall assessment and rating outlook

The rating is mainly supported by the bank’s geographically diversified and retail-focused earning structure, solid operating base in each of the markets where it operates and stable earnings capacity. On the other hand, it is constrained by a relatively high risk profile of its credit portfolio. Amid the COVID-19 pandemic and the resultant economic deterioration in the regions where it operates, the bank managed to make a positive underlying consolidated profit in the first half of 2020 despite increased credit costs, supported by its stable earnings capacity. It is likely to suffer a full-year statutory loss in 2020 due mainly to impairment losses on goodwill. Barring a prolonged impact of the pandemic, the bank will be able to absorb an additional increase in credit costs with its earnings and maintain its capital ratio largely at the current level.

Any major damage to its capital base resulting from deterioration of the quality of credit portfolio or its earnings base due to factors such as a prolonged impact of the pandemic or weakening of economic and financial conditions in the countries where it operates could bring downward pressure on the rating. On the contrary, a further reduction of risks in the bank’s credit portfolio or sounder capitalization could lead up to an improvement of its creditworthiness.

13097 Banco Santander

Consolidated Financial Summary

(Million euros,%, bp)

	2015/12	2016/12	2017/12	2018/12	2019/12
Total assets (end-year balance)	1,340,260	1,339,125	1,444,305	1,459,271	1,522,695
Loans and advances to customers (end-year balance)	790,848	790,470	848,915	882,921	942,218
Customer deposits (end-year balance)	683,142	691,112	777,730	780,496	824,365
Total income	45,895	44,232	48,355	48,424	49,229
Pre-provisioning profit from operations	21,069	20,623	22,304	23,422	22,459
Profit from operations	10,417	10,997	13,045	14,436	12,927
Profit for the period	7,334	7,486	8,207	9,315	8,116
ROA (based on pre-provisioning profit from operations)	1.57	1.54	1.58	1.62	1.49
Non-performing balances/Total loans and contingent liabilities	4.36	3.93	4.08	3.73	3.32
Cost of credit	125	118	107	100	100
Total regulatory capital ratio	14.40	14.68	14.99	14.98	15.05
Tier 1 capital ratio	12.55	12.53	12.77	13.12	13.14
Common equity Tier 1 capital ratio	12.55	12.53	12.26	11.47	11.05

* 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

	Rating	Outlook*	Amount (millions)	Currency	Rate (%)	Issue Date	Maturity Date	Release
Foreign Currency Long-term Issuer Rating	A+	Stable	-	-	-	-	-	2020.10.05
Samurai Senior Non Preferred Bonds - First Series (2017)	A	-	83,700	JPY	0.568	2017.12.11	2023.01.11	2020.10.05
Samurai First Series (2019)	A+	-	50,000	JPY	0.463	2019.12.05	2024.12.05	2020.10.05
Samurai Senior Non Preferred Bonds - Third Series (2017)	A	-	12,200	JPY	1.015	2017.12.11	2027.12.10	2020.10.05

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

Date	Rating	Outlook*	Issuer
2017.05.19	A+	Stable	Banco Santander

*Outlook for Foreign Currency 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

Information herein has been obtained by JCR from the issuers and other sources believed to be accurate and reliable. However, because of the possibility of human or mechanical error as well as other factors, JCR makes no representation or warranty, express or implied, as to accuracy, results, adequacy, timeliness, completeness or merchantability, or fitness for any particular purpose, with respect to any such information, and is not responsible for any errors or omissions, or for results obtained from the use of such information. Under no circumstances will JCR be liable for any special, indirect, incidental or consequential damages of any kind caused by the use of any such information, including but not limited to, lost opportunity or lost money, whether in contract, tort, strict liability or otherwise, and whether such damages are foreseeable or unforeseeable. JCR's ratings and credit assessments are statements of JCR's current and comprehensive opinion regarding redemption possibility, etc. of financial obligations assumed by the issuers or financial products, and not statements of opinion regarding any risk other than credit risk, such as market liquidity risk or price fluctuation risk. JCR's ratings and credit assessments are statements of opinion, and not statements of fact as to credit risk decisions or recommendations regarding decisions to purchase, sell or hold any securities such as individual bonds or commercial paper. The ratings and credit assessments may be changed, suspended or withdrawn as a result of changes in or unavailability of information as well as other factors. JCR retains all rights pertaining to this document, including JCR's rating data. Any reproduction, adaptation, alteration, etc. of this document, including such rating data, is prohibited, whether or not wholly or partly, without prior consent of JCR.

JCR is registered as a "Nationally Recognized Statistical Rating Organization" with the U.S. Securities and Exchange Commission with respect to the following four classes. (1) Financial institutions, brokers and dealers, (2) Insurance Companies, (3) Corporate Issuers, (4) Issuers of government securities, municipal securities and foreign government securities.

Copyright © Japan Credit Rating Agency, Ltd. All rights reserved.