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Banco Santander S.A.

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Banco Santander S.A.

SACP	a		
Anchor	bbb		
Business Position	Very Strong	+2	
Capital and Earnings	Adequate	0	
Risk Position	Strong	+1	
Funding	Average	0	
Liquidity	Adequate		

\+

Support	0
ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating
A/Negative/A-1

Resolution Counterparty Rating
A+/--/A-1

Major Rating Factors

Strengths:	Weaknesses:
• Wide geographic diversification and solid market positions in the markets where it operates. • Focus on stable retail banking business, underpinning the bank's sound and resilient earnings. • Successful strategy and implementation. • Sound capitalization for the risks it faces.	• Exposure to higher-than-average economic risk in some of the countries where it operates. • Challenge posed by the synchronized global recession underway.

Outlook: Negative

The negative outlook indicates that S&P Global Ratings could lower its rating on over the next 18-24 months if the bank's credit strength is materially damaged by the effects of the COVID-19 pandemic. This could happen if the bank's wide geographic diversification proves less effective than we thought, and the bank records massive provisions, or loses substantial earnings power, that impair its profits and could test its capital position. Santander's creditworthiness could also be strained if the 2020 downturn is more profound or the 2021 economic recovery in the countries where the bank has its larger operations is substantially weaker than expected or delayed.

We could revise the outlook to stable if the bank demonstrates resilience through the recession and downside risks to our macroeconomic forecasts ease. Even if Santander's stand-alone creditworthiness remained under pressure, we could consider revising the outlook to stable if Santander continues to build-up its buffer of minimum requirement for own funds and eligible liabilities, and looks likely to reach a cushion of bail-inable debt large enough to protect senior creditors in resolution.

The outlook on the sovereign rating on Spain is negative. Thus, revising the outlook on Santander to stable would also depend on us being confident that our rating on Santander can be above that on Spain, as it was in the past. That would imply concluding that, in the hypothetical stress scenario of the Spanish sovereign defaulting, there will be an appreciable likelihood that Santander would not default.

Rationale

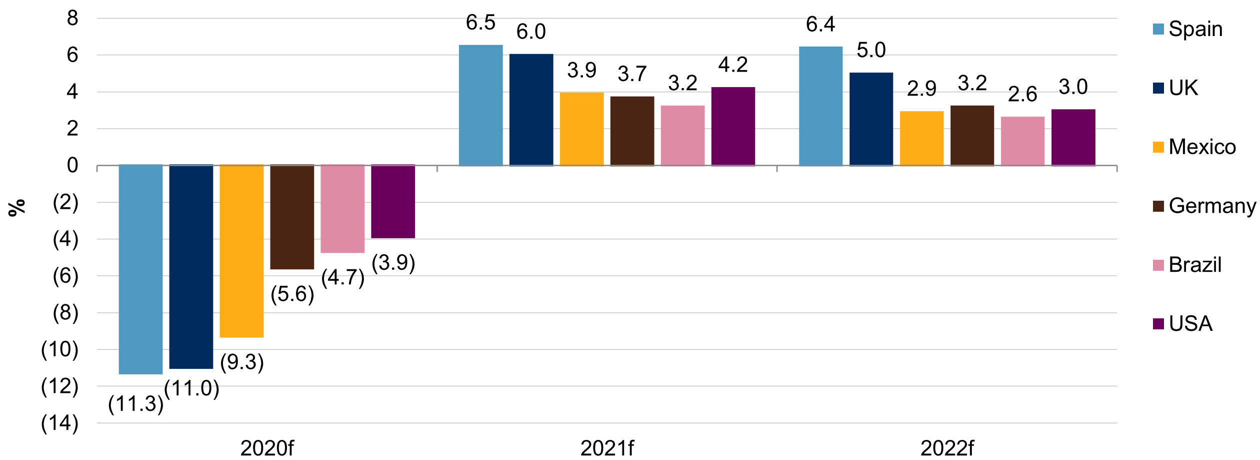
The ratings on Banco Santander S.A. reflect its robust, well-managed business model and sound risk-adjusted capital, while also factoring in the higher-than-average economic risks in the countries where it operates.

Santander enjoys a powerful, geographically diversified retail banking franchise, with a presence in both developed and emerging economies that generates strong, consistent earnings and is fairly efficient. The bank thus faces the pandemic shock from a position of strength, as its ample earnings provide substantial room to accommodate higher credit costs. Furthermore, the diversity of its geographical presence provides it with the opportunity to articulate different responses to try mitigating the financial impact.

That said, this is the first time the group is facing a synchronized downturn in all the markets in which it operates (chart 1). This will test the effectiveness of its geographic diversification and, thus, its resilience. Earnings pressure in developed economies and higher credit costs across the board will cause underlying profits to fall markedly this year. Our estimates suggest that underlying profits could decline by half, and will not recover to pre-pandemic levels until at least 2022. Furthermore, Santander recognized huge goodwill and deferred tax asset (DTA) impairments in the second quarter of 2020, and will probably also recognize some restructuring costs in the fourth quarter. As a result, it will likely report substantial bottom-line losses in 2020.

Chart 1

All Key Markets Where Santander Operates Face A Synchronized Recession



f--Forecast. Source: S&P Global Ratings.

The bank's capital, which has strengthened over recent years, should hold up well, however. We project the bank's risk-adjusted capital (RAC) ratio will be about 7.5% over 2020-2021 (it was 7.7% at end-2019) and it could post modest growth in 2022.

Although asset quality has barely deteriorated at this stage, and thus the scale of the problem remains unknown, we estimate that credit costs will increase to 160-150 basis points (bps) of average loans in 2020 and 2021. In 2017-2019, credit costs stood at 110 bps-120 bps. That said, the bank's guidance suggests a credit cost of around 130 bps this year, and a potentially lower charge in 2021.

We expect asset quality deterioration across the board. That said, given the relative size of the portfolios and the nature of the macroeconomic challenge, we see the small and midsize enterprise (SME) portfolios in Spain and Brazil as potentially more vulnerable. The auto lending portfolios of Santander Consumer Finance S.A. (SCF) and the U.S. consumer finance operations (SCUSA) are also at risk, particularly the latter, which is biased to nonprime borrowers. Conversely, we expect residential mortgages, which account for over a third of Santander's loan book, to remain resilient.

Unlike those on most of its global peers, our ratings on Santander do not benefit from additional loss-absorbing capacity (ALAC) support. The bank's cushion of bail-inable instruments has grown over the recent past, moving closer to the threshold that would make it qualify for a one-notch ratings uplift. But it is not yet strong enough to reduce the default risk of senior debt creditors in a resolution scenario.

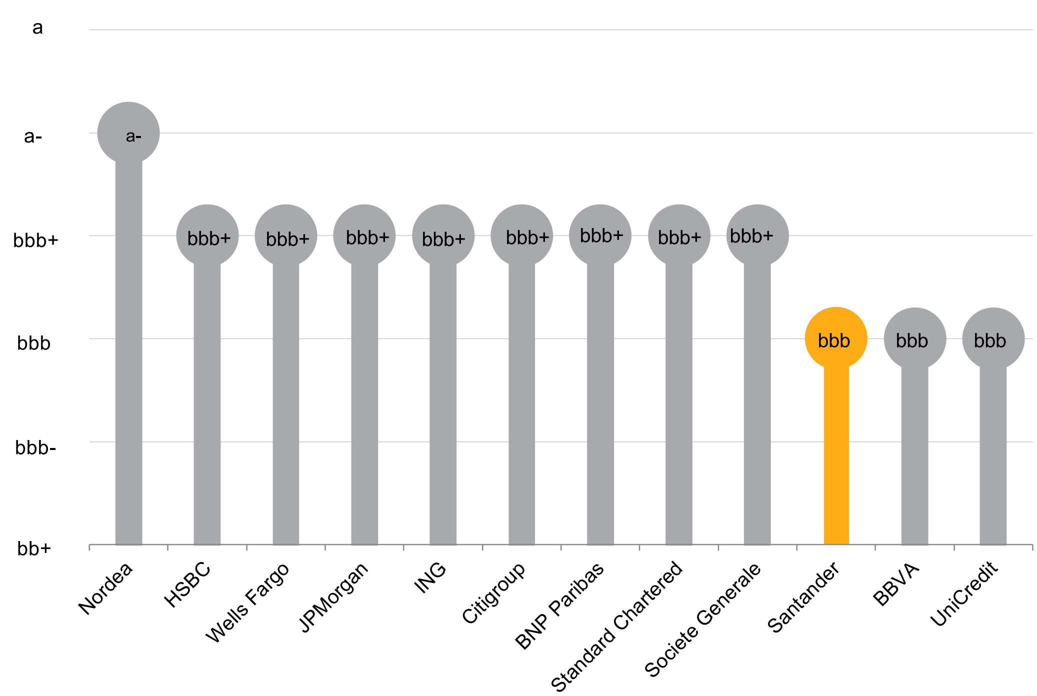
Until recently, our ratings on Santander exceeded those on the sovereign, but now they are at the same level.

Anchor: 'bbb', reflecting the higher-than-average economic risk of the markets where the bank operates

Our anchor for Santander is currently 'bbb', weaker than that of most of its global peers, as chart 2 shows. We generally compare Santander with the following peers: HSBC, BNP, JP Morgan, Citigroup, Standard Chartered, ING, Societe Generale, Wells Fargo, BBVA, Nordea, and Unicredit.

Chart 2

Santander's Lower Than Peers Anchor Reflects Higher Economic Risks Of Its Footprint



Data as of Dec. 7, 2020. Source: S&P Global Ratings.

The weighted-average economic risk to which Santander is exposed is not only higher than that of global peers, but also marginally higher than that faced by institutions operating primarily in Spain. The U.K. and Spain account for the group's largest credit exposures at about one-quarter each in September 2020. Both have an economic risk score of 4. Brazil (economic risk of 7) and the U.S. (economic risk of 3) each account for about 10%. The remaining exposures are split roughly evenly at about 5% each between Mexico (economic risk of 6, revised down in March 2020), Portugal (economic risk of 6), Germany (economic risk of 1), other Latin American countries (economic risk of 7), and the rest of Europe (economic risk of 4). Weightings are rounded to the nearest 5% before averaging.

With regard to industry risk, our assessment of '4' reflects Spanish banks' balanced funding profiles and ample liquidity, as well as the profitability challenges ahead. Customer deposits now fund the bulk of banks' loan books, at historically low costs. Reliance on wholesale market funding is therefore limited and markets remain open. In addition, we expect the European Central Bank will continue to ensure banks' access to funding, if needed, at attractive prices. That said, the pandemic shock will aggravate existing profitability challenges resulting from low rates, limited business growth, and intense competition. The prospect of Spanish banks achieving returns in line with their cost of capital was already remote, particularly for midsize banks, and much more so in the current environment. Banks' profitability will decline substantially in 2020, from the combination of weaker earnings and increased credit costs, and will barely recover in 2021. However, we expect Spanish banks to remain fairly efficient compared with peers.

Table 1

Banco Santander S.A.--Key Figures

	--Fiscal year ended Dec. 31--				
(Mil. €)	**2020***	**2019**	**2018**	**2017**	**2016**
Adjusted assets	1,496,498.1	1,492,966.1	1,429,279.3	1,413,632.0	1,308,249.4
Customer loans (gross)	851,772.9	882,815.2	848,318.7	824,695.0	771,211.6
Adjusted common equity	68,006.6	73,485.8	67,385.1	65,106.0	60,480.7
Operating revenues	34,882.0	51,367.0	50,424.5	49,849.0	45,511.1
Noninterest expenses	17,312.2	24,379.0	23,410.0	23,080.0	21,274.9
Core earnings	N/A	12,291.5	12,277.0	12,600.8	10,513.1

*As of September 2020. N/A--Not applicable.

Business position: A powerful, geographically diversified, and profitable retail banking franchise

Santander benefits from a robust business model focused on a stable retail banking business that generates strong, consistent earnings. Its geographically diversified franchise gives it leading market positions in the countries where it operates. The pandemic, however, has led to a synchronized economic downturn in all the markets where Santander operates, which will test the resilience of the group's earnings.

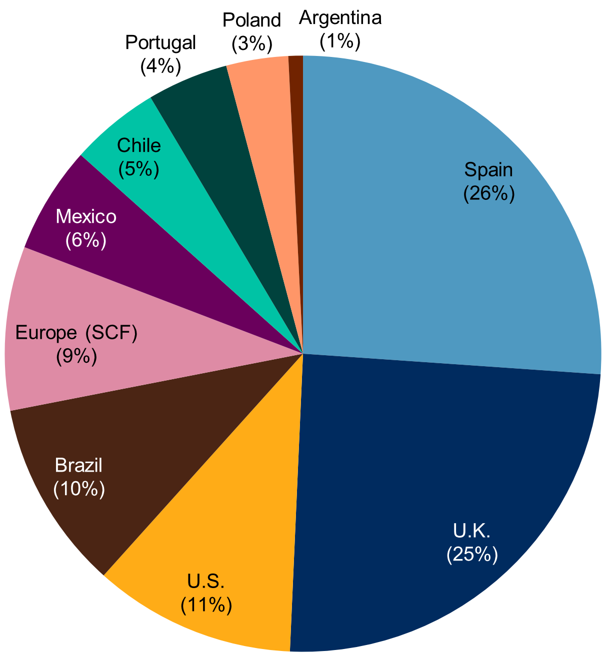
Of the banks' global peers, only the ratings on French bank BNP Paribas and U.S. bank JP Morgan Chase benefit from these business model strengths to the same extent as Santander. Until recently, the ratings on HSBC also reflected these advantages, but that's no longer the case.

As a result of an intensive expansion strategy over the past two decades, Santander is currently one of the most geographically diversified banks in the world. No single country concentrates more than 30% of the group's net profits and credit. Its presence in developed economies outweighs its presence in emerging markets (accounting for 84% and 16% of loans in September 2020, respectively), but it is fairly balanced when measured in terms of profit contribution (48% and 52%, as of September 2020). Historically, the limited economic correlation of the countries in which it operates has allowed Santander to accommodate the ups and down of the different economic cycles and achieve consistent, resilient results over time.

Chart 3

Santander Benefits From Wide Geographic Diversification, Weighted Toward Matured Economies

Geographical distribution of the group's asset base as of the third quarter of 2020

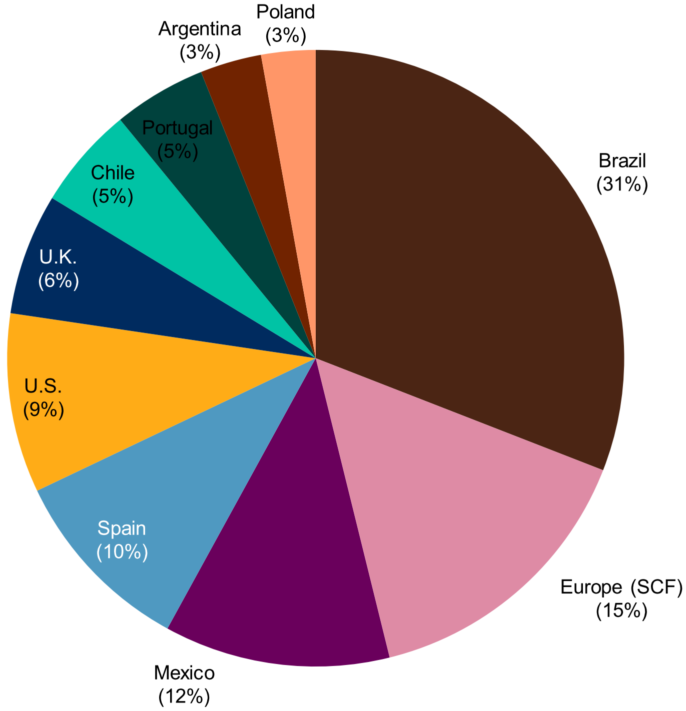


Source: S&P Global Ratings and Banks' Reporting. Excluding Corporate Centre.

Chart 4

Emerging Markets Are Key Contributors To The Group's Profitability

Geographical contribution to net attributable profits as of the third quarter of 2020



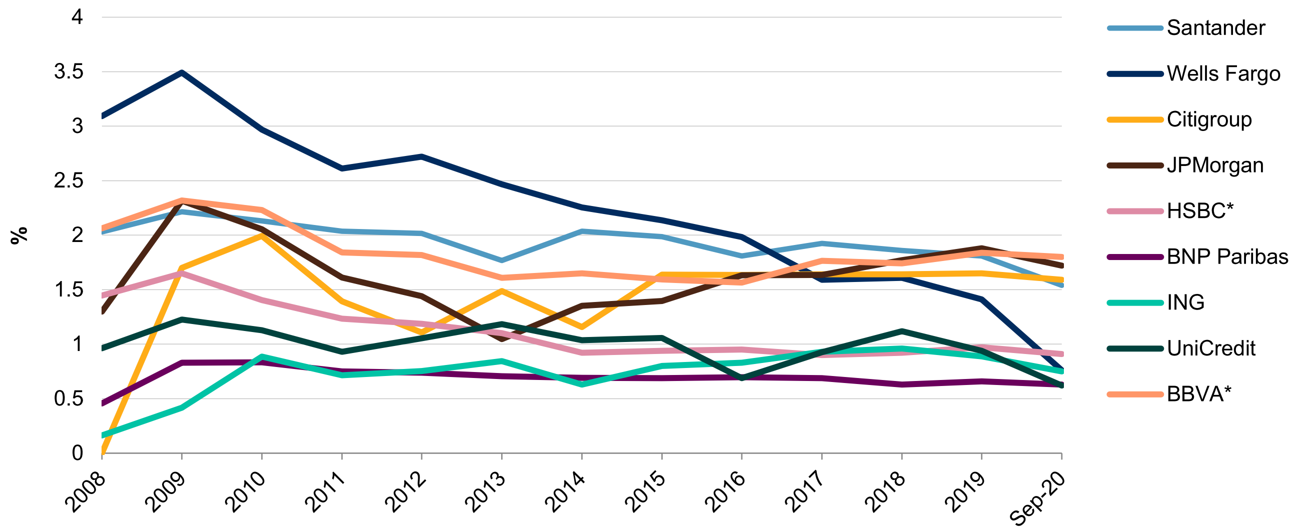
Source: S&P Global Ratings and Banks' Reporting. Excluding Corporate Centre.

Santander also enjoys strong positions and franchises in most of its markets of operation, which provides it with pricing power and a loyal retail customer funding base. In addition to the 18% market share in loans that the bank holds in Spain, Santander is the third-largest mortgage lender in the U.K. (holding about 11% of the market). It owns the second-largest banks in Portugal, Poland, and Chile and the third-largest banks in Mexico and Brazil (excluding public banks). It has also built up a consumer finance business, under SCF, with widespread operations across Europe. Santander is also present in the U.S., where it benefits from decent, though regional and still underperforming, market positions in several strong northeastern markets, and operates a consumer arm specialized in nonprime auto loans (SCUSA).

The group primarily focuses on retail banking activities, which supports the bank's business and earnings stability. Compared with peers, Santander exhibits a track record of stronger, more-resilient earnings, and outstanding efficiency.

Chart 5

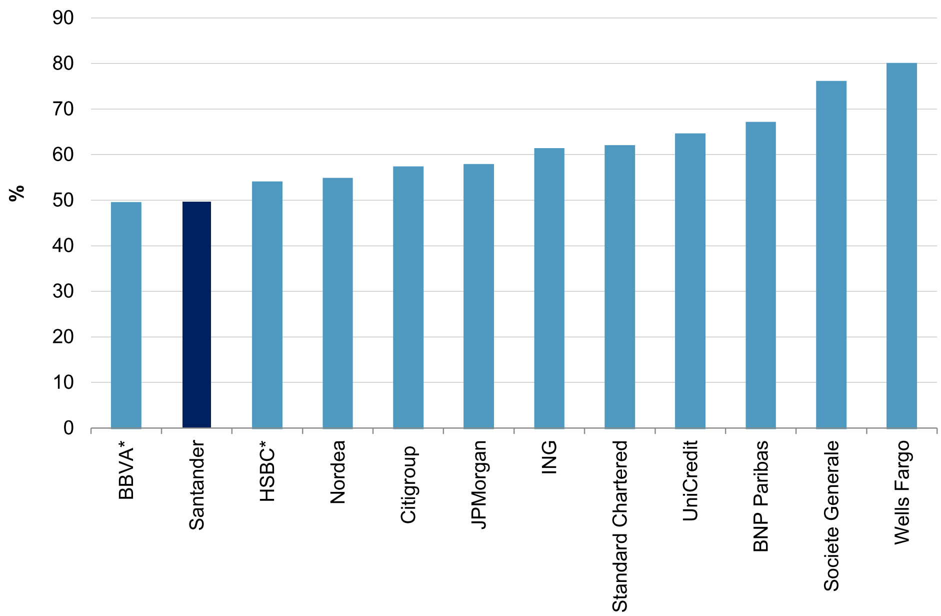
Santander Reports Higher And More Stable Preprovision Income Than Most Global Peers
Preprovision Income To Average Assets



*Data as of June 2020. Source: S&P Global Ratings and Banks' Reporting.

Chart 6

Strong Efficiency Is A Key Attribute Of Santander
Cost to income ratio as of Sept. 2020



*Data as of June 2020. Source: S&P Global Ratings and Banks' Reporting.

Santander benefits from a clear, well-executed strategy, which has led to the transformation of what was once a domestic institution into a strong and well-diversified global banking group. Inorganic growth has been a key enabler of the bank's build-up of a global franchise over the years, although until recently (until the acquisition of Popular in 2017), the bank did not undertake large acquisitions. Still, we think Santander could in principle be willing to consider mergers and acquisitions if opportunities were to arise, most likely to strengthen its business in markets where it already operates. Equally, in the longer term, we would also expect Santander to participate in future consolidation moves in Europe as the Banking Union project progresses.

The COVID-19 pandemic has not altered the strategic priorities the bank set up for the next three years (the strategic plan was announced in April 2019), although achieving some of the financial targets will be tougher in light of the difficult macroeconomic scenario. The focus remains on:

- Improving the bank's operating performance;
- Maintaining a solid capital base, improving the allocation of capital to the more profitable businesses;
- Expanding the business by engaging further existing clients; and
- Accelerating the digitalization of the business.

The group also committed to operate more cohesively across units, fostering collaboration, avoiding duplications, and facilitating synergies. Consistent with that view, the bank recently announced two important strategic initiatives:

- The creation of a single business and operation model for Santander units in Europe, namely Spain, the U.K., Portugal, and Poland, known as One Santander. It aims to simplify the product offer, redefine distribution channels, and automate processes in a common platform.
- The combination of SCF and Openbank, with a view of building up a purely digital consumer finance business leveraging Openbank's technological platform. In addition to operating more efficiently, this move aims to engage SCF's client base further.

The pandemic will certainly make it difficult for the bank to achieve its previous target of improving by 2021-2022 its underlying return on tangible equity to 13%-15% and reducing the cost-to-income ratio to 42%-45%. These indicators stood at 7.1% and 46.8% at September 2020. Furthermore, the units whose performance was already lagging behind the bank's ambitious prepandemic targets (Spain, the U.K., and the U.S.), have also been the ones particularly hit by this shock. Nevertheless, we feel the bank's geographic diversification has still helped to blunt the effect of this crisis on the group's performance. The magnitude of the economic shock in each country has varied, and the bank managed to use different levers in each to mitigate the impact. In Latin America, for example, the bank was able to make revenue grow and continue posting increases in preprovision earnings in 2020, despite the pandemic. Meanwhile, in developed Europe and the U.S., controlling costs became the priority. As of September 2020, operating expenses had declined by 5%-10% in these countries, compared with September 2019. An additional €1 billion in cost savings have also been announced, on top of the €1 billion already envisioned as part of the strategic plan. Details on where these new savings will come from have yet to be disclosed, but we think they will entail further branch closures and staff reductions as part of the One Santander initiative and the combination of Openbank and SCF.

Table 2

Banco Santander S.A.--Business Position

	--Fiscal year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Loan market share in country of domicile	17.8	17.6	17.6	18.3	0.0
Deposit market share in country of domicile	18.4	18.9	18.2	18.9	0.0
Total revenue from business line (currency in millions)	34,970.7	52,657.6	50,453.0	50,541.0	45,720.3
Commercial banking/total revenues from business line	11.8	10.0	10.1	11.0	12.7
Retail banking/total revenue from business line	80.2	82.7	84.9	87.1	85.4
Commercial & retail banking/total revenue from business line	92.0	92.7	95.0	98.1	98.2
Other revenue/total revenue from business line	8.0	7.3	5.0	1.9	1.8
Return on average common equity	(13.4)	6.7	8.2	7.2	6.9

*As of September 2020.

Capital and earnings: Capital has strengthened and we expect it to be resilient

Santander had strengthened its capital position as it faced the pandemic and we believe it will be able to preserve this position as it navigates through the crisis. Its RAC ratio stood at 7.7% at end-2019, having improved from 6.26% in 2016. During these years, the bank issued hybrid instruments; raised capital (including €7 billion in mid-2017, to accommodate the acquisition of Popular); retained earnings; and, more recently, actively managed its risk-weighted assets through securitizations. The easing of economic risks in its home market, as well as the payment in shares of the last dividend distribution of its 2019 results also contributed to the improvement in the RAC ratio.

Capital strengthening has continued through 2020, with the bank reporting a fully loaded common equity (CET1) ratio of 11.98% (at the upper end of its 11%-12% target), up from 11.65% at end-2019. The improvement was largely driven by significantly lower risk-weighted assets (RWAs), which declined by 8.2% up to September, compared with a reduction of just 3.2% of gross loans. Limited migration of credits to Stage 2 has probably also kept pressure on RWAs contained. Both ratios benefit from the IFRS 9 transitional arrangements agreed by regulators at the start of the pandemic. Otherwise, they would have been about 40 bps lower.

As a result, Santander's regulatory capital ratios stand comfortably above the supervisory review and evaluation process (SREP) requirements, especially since requirements got reduced in response to the pandemic-related downturn to 8.86% for the CET1 and 13.02% for the total capital ratio. The bank's CET 1 buffer over requirements has thus increased to 312 bps as of September 2020, from 189 bps prepandemic.

We have a more conservative view of the evolution of Santander's capitalization than the regulatory ratios show so far. We expect the bank's RAC ratio to be barely unchanged through 2020 and 2021, and only mildly improve in 2022. Although regulators just announced that they will allow only a moderate distribution of cash dividends from the 2020 results and asked banks to hold any decision with regards to the 2021 dividends until September 2021, we are assuming in our forecasts the same dividend amount that the bank is accruing for in 2020 and a pay-out of around 40% of underlying profits thereafter, which is what the bank aims to distribute. We also project flat RWAs in 2020, but a growth of 4%-3% thereafter.

Profits will remain subdued this year and next, in our view, only recovering to prepandemic levels by 2022. The massive goodwill and DTAs write down recognized in the second quarter of 2020 will push Santander into sizable losses this year. Equally, underlying profitability could halve compared with 2019 because of:

- Higher credit impairments, which we see as 50% higher than those of 2019 (equivalent to a cost of risk of 160 bps of average loans); and
- Lower revenue (forecast to be down by about 9%), which even tighter cost management will not able to offset.

The bank should, however, be able to maintain comparatively sound efficiency, with the cost-to-income peaking at 50.5%, which is still a much better indicator than that of most other European banks.

Returns could improve in 2021, despite provisioning remaining elevated, on the back of further cost savings and slightly better earnings. That said, we don't see net income returning to its 2019 mark (€6.5 billion) until 2022, which is when credit impairments could decline more meaningfully. Even so, 2019 was not one of the bank's best performing years; it was the year when it undertook the write-off of part of the U.K. business goodwill and some extraordinary restructuring costs. We thus expect Santander's underlying return on equity to be 3.5%-4.5% this year and next, improving to 6.0%-6.5% in 2022.

The bank's earnings buffer (which measures the capacity of the bank's earnings to cover normalized losses) will also weaken, but we expect it to remain at a still-sound 145 bps of S&P Global Ratings' RWAs over 2020-2022, compared with the robust 172 bps average reported in the prior three years.

We forecast hybrid instruments to account for about 10% of Santander's total adjusted capital (TAC) over 2020-2022. Hybrid instruments included in TAC are now largely AT1 instruments--six issued by the parent and two by the U.K. subsidiary. The remaining legacy preference shares included in TAC are minimal--€337 million--and will reduce to less than half following the bank offer to call one of them in December. The recent widening of AT1 and Tier II regulatory buckets, to 1.78% and 2.38%, respectively, has left some room for Santander to issue more AT1 instruments, but not enough to change our capital assessment.

The group's capital is reasonably distributed across subsidiaries, and is only higher than standard group levels in those geographies where host regulators require higher minimum capital requirements, as is the case in Poland, or where regulators have constrained dividend distribution, as has been the case in the U.S. recently. During the pandemic, we could see host authorities restricting or at least recommending a limit on dividend upstreaming to the parent. This could complicate the bank's strategic decision to allocate more capital resources to higher profitable business areas, but limitations will likely be only temporary.

Our capital measure is weaker than the regulator's, reflecting the higher risks that we see in economies where Santander operates, and the still-large balance of DTAs resulting from timing differences outstanding on the bank's balance sheet. Indeed, our calculation of Santander's RWAs is almost 80% higher than the regulatory one.

Table 3

Banco Santander S.A.--Capital And Earnings

	--Fiscal year ended Dec. 31--				
(%)	**2020**	**2019**	**2018**	**2017**	**2016**
Tier 1 capital ratio	13.6	13.1	13.1	12.8	12.5
S&P Global Ratings' RAC ratio before diversification	N/A	7.7	7.0	6.6	6.2
S&P Global Ratings' RAC ratio after diversification	N/A	9.5	9.2	8.7	8.0
Adjusted common equity/total adjusted capital	88.3	89.1	87.7	88.8	90.8
Net interest income/operating revenues	68.7	68.7	68.1	68.8	68.3
Fee income/operating revenues	21.7	22.9	22.8	23.3	22.4
Market-sensitive income/operating revenues	4.9	3.0	3.6	3.3	4.6
Cost to income ratio	49.6	47.5	46.4	46.3	46.7
Preprovision operating income/average assets	1.5	1.8	1.9	1.9	1.8
Core earnings/average managed assets	N/A	0.8	0.8	0.9	0.8

RAC--Risk adjusted capital. N/A--Not applicable.

Table 4

Banco Santander S.A.--Risk-Adjusted Capital Framework Data

(Mil. €)	**Exposure***	**Basel III RWA**	**Average Basel III RW(%)**	**S&P Global Ratings RWA**	**Average S&P Global Ratings RW (%)**
Credit risk					
Government & central banks	279,392.0	15,512.5	5.6	84,749.5	30.3
Of which regional governments and local authorities	18,049.0	312.5	1.7	3,933.2	21.8

Table 4

Banco Santander S.A.--Risk-Adjusted Capital Framework Data (cont.)					
Institutions and CCPs	76,900.0	16,712.5	21.7	28,928.0	37.6
Corporate	267,317.0	173,712.5	65.0	255,981.1	95.8
Retail	613,244.0	221,287.5	36.1	378,940.1	61.8
Of which mortgage	395,246.0	83,725.0	21.2	168,918.9	42.7
Securitization§	43,448.0	6,625.0	15.2	15,907.0	36.6
Other assets†	62,898.0	53,737.5	85.4	89,170.8	141.8
Total credit risk	1,343,199.0	487,587.5	36.3	853,676.5	63.6
Credit valuation adjustment					
Total credit valuation adjustment	--	987.5	--	3,857.0	--
Market Risk					
Equity in the banking book	11,335.0	12,462.5	109.9	96,952.8	855.3
Trading book market risk	--	21,812.5	--	32,532.5	--
Total market risk	--	34,275.0	--	129,485.3	--
Operational risk					
Total operational risk	--	59,662.5	--	86,011.8	--
	Exposure	**Basel III RWA**	**Average Basel II RW (%)**	**S&P Global Ratings RWA**	**% of S&P Global Ratings RWA**
Diversification adjustments					
RWA before diversification	--	605,250.0	--	1,073,030.5	100.0
Total diversification/ concentration adjustments	--	--	--	(208,093.1)	(19.4)
RWA after diversification	--	605,250.0	--	864,937.4	80.6
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		79,536.0	13.1	82,489.6	7.7
Capital ratio after adjustments‡		79,536.0	13.1	82,489.6	9.5

*Exposure at default. §Securitization Exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31 2019, S&P Global Ratings.

Risk position: Wide geographic and risk diversification benefits to be tested by the COVID-19-induced global recession

Despite Santander's capital ratios being lower than peers (both by regulatory and S&P Global Ratings' measure), we consider its capital base solid enough to back the risks that it faces. Because of the countries where it operates, Santander faces higher-than-average risks, but its wide geographic diversification in economies that have historically been uncorrelated provides it with a benefit that our RAC calculation does not fully capture. Equally, the bank enjoys good diversification by risk and client type; and it has a sound track record of better-than-average asset quality in its main markets of operation. It achieved the latter through strong risk management, underwriting standards, and close monitoring of risks.

That said, Santander is facing an unprecedented scenario that will test the benefits of the group's wide geographic footprint, as all its markets of operation faced a downturn at the same time, hence our negative outlook on the bank. The diversification benefit that we calculate for Santander is one of the highest in our sample of rated global banks. We calculate that RWAs after diversification at end 2019 stood 19% below that of RWAs before diversification effects.

After several years of continuous improvement, asset quality metrics are set to deteriorate. So far only credit costs have risen, but nonperforming assets (NPAs) will follow suit in 2021 once government support measures expire. A large number of the payment holidays the group granted have already expired, and most continued to perform according to plan. But about half of those provided to SMEs and corporates are still in place and account for about 3.5% of the corporate and SME lending book. These are the ones more likely to show payment vulnerability. Of those corporate and SMEs loans whose payment holidays expired at September 2020, Santander had classified 25% under Stage 2.

We estimate Santander's credit costs in 2020 at 160 bps of average loans and in 2021 at 147 bps. On aggregate, this is about a third higher than the 110 bps-120 bps recorded in the prior three years. The bank has strong earnings to accommodate this increase, in our view.

Our credit costs estimates are higher than Santander's guideline of 130 bps for this year and a potentially lower charge in 2021. We agree that the credit costs of this crisis will be much lower than those recorded in 2012, when Spain's real estate bubble burst and pushed the country into a deep recession. At that time, mandatory provisioning requirements pushed credit losses to 2.7% of average loans. The short-term nature of this economic shock and the massive support measures undertaken, primarily by governments, to help companies and individuals navigate through the most difficult months of the pandemic, will help contain the damage on banks' balance sheets. That said, Santander's provisioning guideline for 2020 sounds modest to us. It could mean that the bank foresees recognizing losses over a longer period than we expected, rather than materially lower losses overall. For example, migration of credits to the potentially problematic bucket (Stage 2), which should have required higher provisioning, has been limited this year.

We expect to see more clear evidence of the potential scale of problem loans through 2021. In 2020, the stock of NPAs has remained barely unchanged. At September 2020, nonperforming loans (NPLs) stood at 3.6% of the total (4.6% if the remaining Spanish real estate assets are added), while Stage 3 and Stage 2 exposures amounted to 3.25% and 6.3%, respectively. Our estimates point to a peak of NPLs of close to 5% in late 2021-beginning of 2022 (6% NPAs). By geographies, Spain is probably the only country that faced this shock with a still-high (though appropriately provisioned) stock of NPAs, as the divestment of legacy assets from the previous crisis was still ongoing when the pandemic started.

In this crisis, we expect corporate loans, particularly to SMEs, and consumer lending facilities to be the most-vulnerable asset classes, while mortgages should remain resilient. Santander's fairly diversified portfolio should thus help it weather the crisis well. The group's exposure to companies accounted for 39% of the total loan book in September 2020, with large international corporates, midsize companies, and small companies each accounting for 13%. Single-name concentration is limited and does not pose additional risks (exposures to the top 20 private creditors accounted for about 36% of TAC in December 2019). In turn, the group's exposure to consumer lending (25% of the loan book) is higher than that of peers, due to its large auto-lending business in Europe and the U.S. But only the latter has a higher-risk profile, as it is mostly subprime. Furthermore, its performance so far through 2020 has proved more resilient that we expected. The residential mortgage book (36% of total credit) is primarily low risk, especially in the U.K., where most of Santander's mortgages are originated. It will form a source of credit stability.

We expect asset quality deterioration across the board. However, given the relative size of the portfolios and macroeconomic challenges, the following units could be more vulnerable to asset quality deterioration:

- Spain (in particular, the SME lending book and exposures to the most problematic sectors, like hotels, leisure, and CRE);
- SCF and SCUSA (both the stock financing provided to car dealers and the auto loans to companies and individuals, particularly the subprime share in the U.S.); and
- Brazil.

Additional provisioning through 2020 improved the group's reserves coverage to almost 74% of NPLs at September 2020, while it remained stable at 48% for real estate assets, but problem assets have yet to rise. So, the provisioning effort should continue, in our view.

Given the nature of its business, the bank's main risk exposure is to credit risk. That said, Santander is also structurally exposed to foreign currency risks due to its local currency investments in subsidiaries abroad. The bank actively hedges its exposure with a view to minimizing the impact of adverse movement in the group's regulatory capital ratio and subsidiaries' profit contribution to the group. Hedging has historically proved effective when foreign currencies suffered large devaluations. The group also actively manages its structural exposures to interest rate risk, through asset-liability committee portfolios or swaps across geographies. At present, most operations, other than in Brazil, are positioned to benefit from interest rate increases.

Given its large size and operations in multiple jurisdictions, managing the group entails some complexity. However, we consider this to be manageable. We believe that Santander's retail business model, consistently replicated across its network, and its organizational structure, facilitate the bank's management.

Table 5

Banco Santander S.A.--Risk Position

	--Fiscal year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Growth in customer loans	(4.7)	4.1	2.9	6.9	(1.8)
Total diversification adjustment/S&P Global Ratings' RWA before diversification	N/A	(19.4)	(23.4)	(24.3)	(23.1)
Total managed assets/adjusted common equity (x)	22.5	21.0	22.0	22.4	22.4
New loan loss provisions/average customer loans	1.5	1.1	1.1	1.2	1.2
Net charge-offs/average customer loans	0.9	1.3	1.3	1.5	1.4
Gross nonperforming loans/customer loans	3.6	3.8	4.2	4.6	4.2
Loan loss reserves/gross nonperforming loans	73.8	65.8	65.3	63.7	74.9

*As of September 2020. RWA--Risk weighted assets. N/A--not applicable.

Funding and liquidity: A structurally balanced and resilient funding profile.

Santander enjoys a fairly balanced funding profile, weighted toward retail deposits. The group's loan-to-deposit ratio stood at 103% at September 2020. It also holds a manageable amount of wholesale funding, diversified by instrument, market, and investors; is exposed to limited refinancing risk as debt maturities are spread over several years; and has proved able to access market funding in times of market turbulence.

We do not think that the pandemic will pose significant funding risks for the bank. Market sentiment returned to normal rapidly after the shock, supported by the overwhelming response of central banks. Although access to the market remained open, debt issuance was below the original prepandemic plans--instead, the bank resorted to central bank funding under attractive terms.

The bank's stable funding, according to our calculations, which differ from regulators', stood at a solid 105% at September 2020, having improved from 94.5% at end-2011, particularly due to reduced leverage and market-share gains in deposits in matured markets over the past decade.

The bank operates abroad through subsidiaries that are independent from the parent for funding purposes. Only two subsidiaries recurrently receive funding from the parent: SCF and UCI (a joint venture with BNP).

There are no significant differences in the funding profiles of subsidiaries within the group. The group entities/regions that are proportionally more dependent on wholesale financing are SCF, Chile, and SCUSA.

The group's wholesale debt outstanding in the market totaled €174 billion at September 2020, across a wide array of instruments: senior (34%), covered bonds (30%), senior nonpreferred (24%), subordinated debt (7%), and preferred securities (5%). If securitizations are added, total wholesale debt would exceed €200 billion. Banco Santander S.A. and Santander UK are the most active issuers in the group, accounting for about 72% of the group's wholesale debt outstanding. The calendar of debt maturities is well spread and thus manageable.

In recent years, Santander has opportunistically borrowed resources from the European Central Bank (ECB)'s targeted longer-term refinancing operation (TLTRO) programs to take advantage of attractive terms and has done it again under the TLTRO III facility. Similarly, some of Santander's subsidiaries access central bank facilities from host countries, though proportionally to a lower extent.

Santander benefits from sound liquidity, which it will preserve. We do not think the bank will make use of the flexibility provided by regulators to run the bank with tighter liquidity.

We estimate the group's liquidity ratio--by S&P Global Ratings' measure (broad liquid assets to short term wholesale funding)--at 1.43x at September 2020, up from 1.0x at end-2011. Broad liquid assets also amounted to 49% of customer deposits as of the same date. Liquidity is held in cash and liquid securities portfolios. The latter are primarily invested in government securities. The largest portfolios are those of Brazil, U.K., the U.S., and Spain.

Table 6

Banco Santander S.A.--Funding And Liquidity

	--Fiscal year ended Dec. 31--				
(%)	**2020***	**2019**	**2018**	**2017**	**2016**
Core deposits/funding base	62.7	62.0	61.2	60.4	59.7
Customer loans (net)/customer deposits	103.4	109.6	110.3	110.5	115.2
Long-term funding ratio	79.7	80.3	83.5	81.4	81.0
Stable funding ratio	105.2	101.6	106.1	103.5	100.9
Short-term wholesale funding/funding base	21.6	21.0	17.6	19.9	20.4
Broad liquid assets/short-term wholesale funding (x)	1.4	1.4	1.6	1.5	1.4
Net broad liquid assets/short-term customer deposits	15.3	13.1	19.5	16.9	13.9
Short-term wholesale funding/total wholesale funding	56.8	54.3	44.5	49.3	49.8
Narrow liquid assets/3-month wholesale funding (x)	2.3	2.2	2.2	2.1	2.1

*As of September 2020.

Environmental, social, and governance

We see ESG credit factors for Santander as broadly in line with those of industry and domestic peers.

Santander's governance, control standards, and transparency are high, which is very much needed given that its presence in several countries exposes the group to diverse risks. In recent years, it has been under the regulatory scrutiny of the U.S. authorities and was required to make meaningful adjustments to its risk management in the country. Major issues have now been addressed. The bank also has large exposures to markets such as those in Latin America, where governance practices may be weaker than in Spain, Santander's domestic market, and therefore require constant monitoring. So far, the bank has managed those risks well. For instance, the bank was not affected by the ramifications of the "Lava Jato" corruption scandal in Brazil. Santander's board of directors is diverse, fairly international, and includes several independent members. The representation of the Botín family, founder of the bank, looks high compared with the economic interest the family holds. Of the two seats the family holds, however, one belongs to Ana Botín in her role as executive chairman. Recently, the decision-making process at the board level has raised questions from stakeholders. In particular, the board announced a new CEO, only to reconsider three months later. This suggested that the decision was perhaps premature.

Social factors are increasingly relevant for a retail-focused bank like Santander. However, the bank has experienced fewer client claims or conduct issues than several other global banks in the past decade. It was not affected by Spanish customers' claims on mortgage interest rate floors and the bank managed to proactively reduce the risk of claims in other instances (arranging solutions to private banking clients affected by Bernie Madoff's case or to retail clients of Popular who lost their investments when the bank was resolved). In the U.K., misconduct charges largely originated from payment protection insurance cases at the bank that Santander acquired before the financial crisis, but it was also fined in 2018 for failing to effectively process the accounts and investments of deceased customers.

Environmental factors do not overly affect the bank's credit quality, and related risks are very much in line with those faced by peers. Of note, Santander is a large provider of auto loans (15% of the group's loan exposure), so the business and financial challenges that the auto industry faces could indirectly affect its business prospects. A substantial change in consumer preferences, such as favoring renting over ownership, could force the bank to adapt its product offer.

External Support: No notches of uplift for ALAC or government support

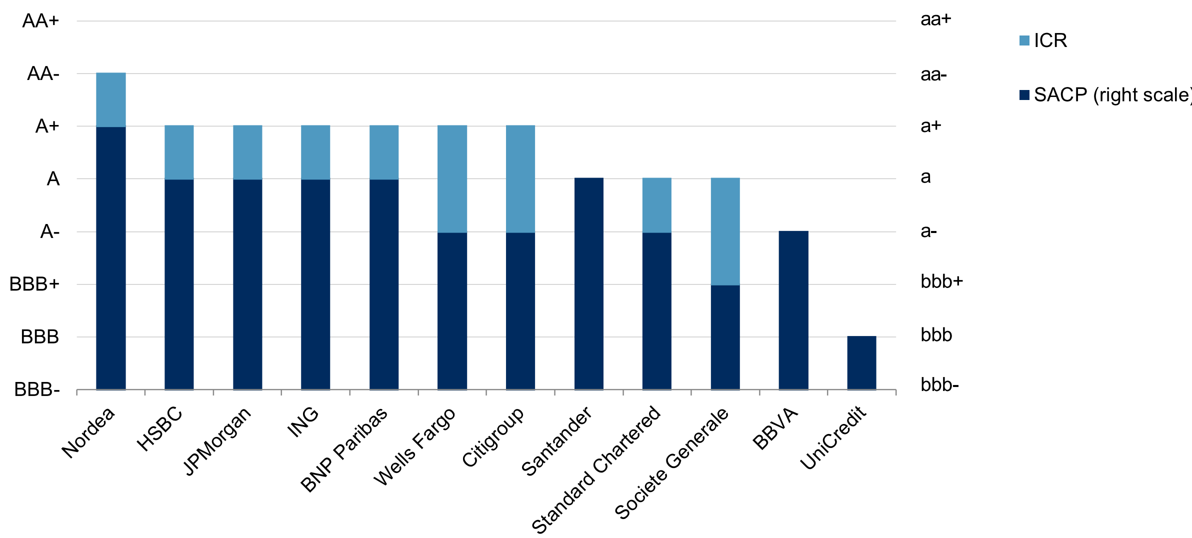
Although we consider Santander to have high systemic importance in the Spanish banking system, the bank is not eligible for ratings uplift based on external government support. Following the implementation of a resolution framework in Spain, we now consider the prospect of support for banks from the Spanish government as uncertain.

Unlike most of its global peers, the ratings on Santander do not benefit from ALAC uplift either (see chart 7). The bank's ALAC buffer has grown over recent years, primarily through the issuance of senior nonpreferred debt--the latter reached a total of almost €23 billion in September 2020. We forecast the ALAC buffer will equal 343 bps of S&P Global Ratings' RWAs by the end of 2020 and will remain at a similar level in 2021 and 2022. Although further issuance of bail-inable instruments is planned for the next two years, it will largely replace maturing instruments, as the bank already complies with both minimum requirement for own funds and eligible liabilities (MREL) and total loss-absorbing capacity (TLAC) requirements. As a result, Santander's buffer of bail-inable instruments will still not be large enough to reduce the default risk of senior debt holders in resolution, as it will fall somewhat short of 400 bps, the minimum threshold to be eligible for a one-notch uplift.

Santander's MREL requirement is €109 billion, equivalent to 28.06% of RWAs and 16.81% of total liabilities and own funds of its resolution group. Of this, €74 billion should take the form of subordinated liabilities. The TLAC requirements are as follows: 19.5% at end 2020 and 21.5% by end 2021. Including the 2.5% allowed share of senior debt, Santander's TLAC of 23.2% at September 2020 was already in compliance with future requirements.

Chart 7

Unlike Most Of Its Global Peers, Santander's Ratings Do Not Benefit From ALAC Uplift



Data as of Dec. 7 2020. HSBC--Hong Kong and Shanghai Banking Corporation. ING--International Netherlands Group. BBVA--Banco Bilbao Vizcaya Argentaria. SACP--Stand-alone credit profile. ICR--Interest coverage ratio. ALAC--Additional loss absorbing capacity. Source: S&P Global Ratings.

The ALAC buffer comprises senior nonpreferred and subordinated debt instruments, and, to a lesser extent, excess capital over the 7% threshold. We have only included bail-inable instruments issued (or to be issued) by Banco Santander S.A., excluding those issued by subsidiaries abroad identified as separate points of entry in resolution (most notably, all instruments--including AT1s--issued out of the U.K. and U.S.). We have also excluded the fidelity bonds granted in 2017 to Popular's retail clients in compensation for the money lost in the bank's resolution.

For Santander, we request a lower-than-standard threshold to benefit from one notch of ALAC uplift (400 bps rather than 500 bps) to reflect the multiple point-of-entry approach for the bank's resolution strategy. The Single Resolution Board identified nine different points of entry for the Santander group, which will be subject to a separate resolution process from that of the parent. Those separate points of entry are:

- Spain, which is the largest as it also includes the European operations of Santander Consumer Finance, as well as all equity holdings in subsidiaries abroad; and
- Portugal, the U.K., Poland, the U.S., Mexico, Brazil, Chile, and Argentina.

Each point of entry would be required to build up its own cushions of bail-inable instruments to face a potential resolution scenario, provided that it is required to do so by host authorities. Indeed, the U.K. and the U.S. operations are already building their own TLAC/MREL cushions, and we understand that the Portuguese operations will also have its own plan soon. We understand that Santander's intention is to downstream ALAC to SCF, which will, in turn, further downstream it to its subsidiaries.

Group structure and rated subsidiaries

We rate six of Santander's operating subsidiaries globally. We consider three of them to be highly strategic for the group: Santander UK PLC, Banco Santander (Brasil) S.A., and Santander Consumer Finance S.A. The other three are considered strategically important: Banco Santander Totta S.A., Santander Bank N.A., and Banco Santander-Chile.

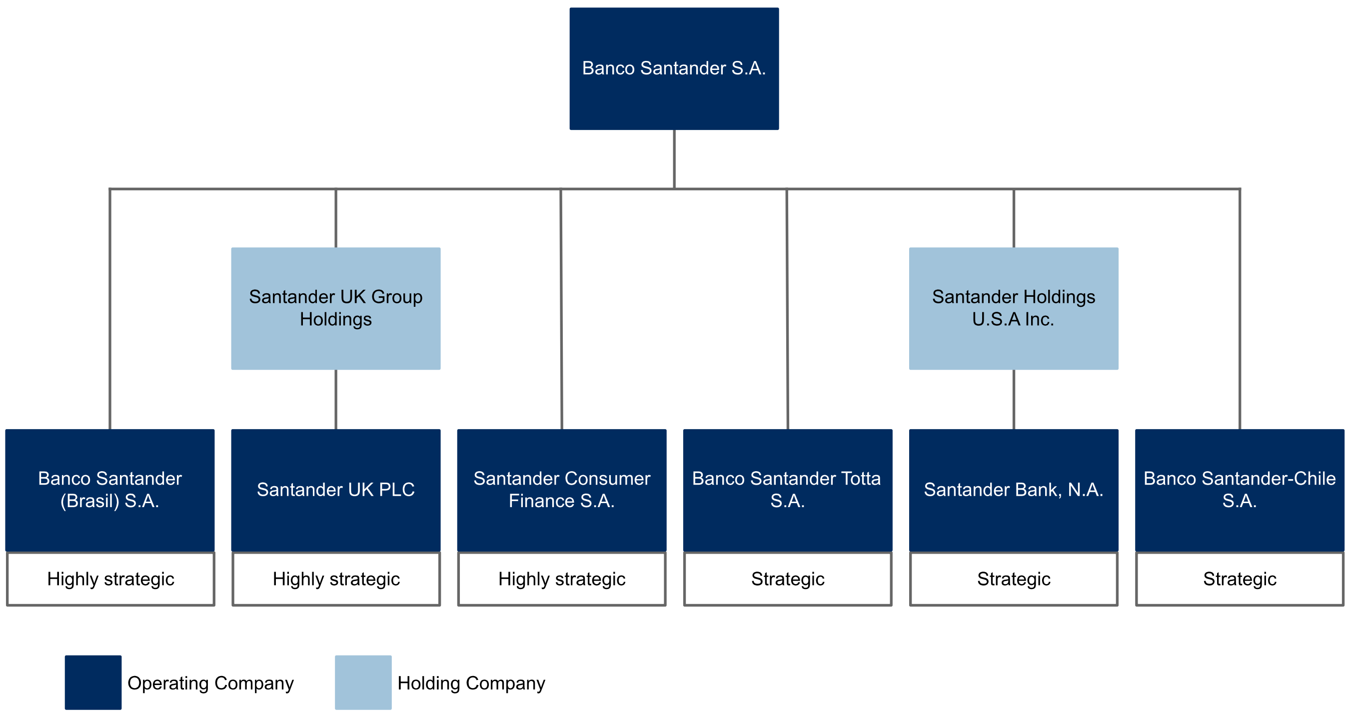
In contrast to most other global banking groups, we do not consider any of Santander's subsidiaries as core, even the more sizable ones such as the U.K. or Brazilian operations. That is because we think it more likely that the group will provide support to those subsidiaries under almost all foreseeable circumstances, rather than under all foreseeable circumstances (see "How We're Refining Our View Of The Strategic Importance Of Certain Spanish Bank Subsidiaries," published on Aug. 2, 2019).

At present, the ratings on only three of Santander's subsidiaries benefit from group support and, as a result, have ratings that are higher than their respective SACPs. Our ratings on Santander Consumer Finance S.A. in Spain benefit from two notches of uplift; those on Banco Santander Totta, S.A. in Portugal benefit from one notch of group support; and those on Banco Santander N.A. in the U.S. benefit from three notches.

We do not incorporate group support into the ratings on the remaining three subsidiaries for various reasons. In the case of Santander's Brazilian subsidiary, the sovereign creditworthiness of the host country limits any upside potential. The ratings on Santander UK PLC benefit instead from ALAC uplift and those on Banco Santander Chile S.A. from government support uplift. The U.K. operations have substantial ALAC cushions to absorb losses and get recapitalized in a resolution scenario, reducing the likelihood of default on senior obligations. Our ratings on the subsidiary in Chile benefit from the likelihood of receiving financial support from the Chilean government, given its high systemic importance and the supportive stance of Chilean authorities toward its banking system.

At present, the stand-alone creditworthiness of all subsidiaries is below the group's credit profile of 'a'. The ratings on the subsidiaries are also generally below the ratings on the parent, except for the U.K. and Chile, whose ratings stand at the same level.

Santander's Simplified Organization Chart Including Rated Subsidiaries Only



Source: Banco Santander S.A., S&P Global Ratings.

Hybrid ratings

We consider senior nonpreferred debt, nondeferrable subordinated debt, and preference shares as hybrid instruments and arrive at these ratings by notching down from the bank's 'a' SACP.

We therefore rate Banco Santander S.A.'s senior nonpreferred debt at 'A-', one notch below the bank's SACP to reflect subordination versus senior obligations.

We rate nondeferrable subordinated debt at 'BBB+', two notches below the bank's SACP. In addition to being subordinated, we believe that these instruments (capital instruments for regulatory purposes), could be written down to absorb losses ahead of resolution, that is, before the institution reaches the point of nonviability.

We rate junior subordinated debt at 'BBB-', four notches below the bank's SACP. In addition to the above, the wider notching compared with nondeferrable subordinated instruments reflects the risk of coupon suspension and these instruments computing as a Tier 2 regulatory capital (one notch), as well as the existence of a mandatory trigger for coupon suspension linked to the availability of enough profits in prior year's reporting--as opposed to enough distributable reserves (an additional notch).

Finally, we rate the remaining two legacy preference shares five notches below the bank's SACP, at 'BB+'. The additional notch difference relates to preference shares computing as Tier I rather than Tier II capital. We have not lowered the rating on these instruments in response to the highly likely possibility of the bank reporting losses, which in turn would trigger the mandatory suspension of the coupon payments on these instruments according to their terms and conditions. The latter, in turn, would prevent the bank from distributing dividends to shareholders, which the bank is keen to resume. For that reason, we expect Santander to find a solution that avoids coupon nonpayment. It could, for example, request that the regulator gives it permission to make the coupon payments (given that this would be allowed if the wider definition of distributable profits were to apply) or it could buy back the instruments before the coupon payment is due.

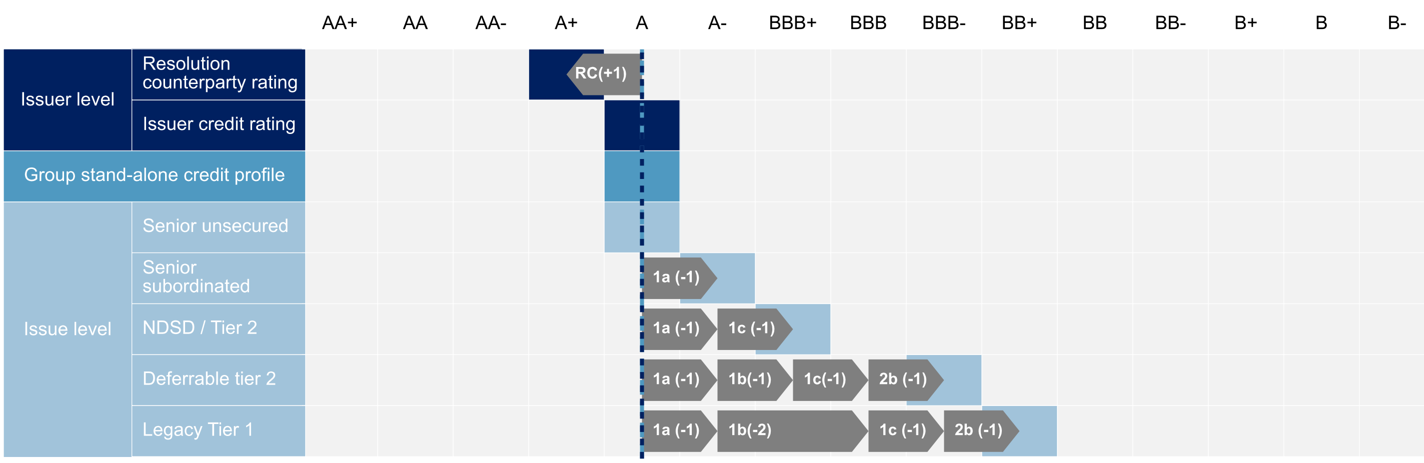
We do not rate the bank's AT1 instruments issued in the past few years.

Resolution Counterparty Ratings (RCRs)

We set the RCR of Banco Santander at 'A+', one notch above the bank's long-term ICR. The RCR applies to certain senior liabilities of the bank that we expect would be excluded from bail-in in a resolution scenario. We therefore rate them at a higher level than traditional senior obligations to show their lower relative default risk. Santander's RCR stands one notch above the long-term sovereign credit rating on Spain, indicating that we see a considerable likelihood that a sovereign default would not immediately trigger a default on the bank's RCR liabilities.

Chart 9

Banco Santander S.A.: Notching



Key to notching

Group stand-alone credit profile
Issuer credit rating

RC	Resolution counterpartyliabilities (senior secured debt)
1a	Contractual subordination
1b	Discretionary or mandatory nonpayment clause and whether the regulator classifies it as regulatory capital
1c	Mandatory contingent capital clause or equivalent
2b	Other nonpayment or default risk not captured already

Note: The number-letter labels in the table above are in reference to the notching steps we apply to hybrid capital instruments, as detailed in table 3 of our "Hybrid Capital: Methodology And Assumptions" criteria, published on July 1, 2019.
NDSD—Non-deferrable subordinated debt.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria | Financial Institutions | Banks: Assessing Bank Branch Creditworthiness, Oct. 14, 2013
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Principles of Credit Ratings. Feb 16, 2011
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- The Eurozone Can Still Rebound In 2021 After Lighter Lockdowns, Dec. 1, 2020
- Bulletin: Extending Depositor Preference To All Depositors Would Not Trigger Rating Changes On Spanish Banks, Nov. 25, 2020
- Global Banks 2021 Outlook Banks Will Face The Next Test Once Support Wanes, Nov. 17, 2020
- Bulletin: Our Negative Outlook Revision On Spain Does Not Trigger Immediate Rating Actions On Spanish Banks, Sept. 21, 2020
- Spain Outlook Revised To Negative From Stable On Mounting Fiscal and Structural Challenges; Affirmed At 'A/A-1', Sept. 18, 2020
- Bulletin: Banco Santander S.A.'s €12 Billion Of Goodwill And DTA Impairments May Signal Weaker Long-Term Profit Expectations, July 30, 2020
- SLIDES: Spanish Banks: COVID-19 Changes Everything, July 24, 2020

- Banking Industry Country Risk Assessment Spain, June 18, 2020
- Spain's Banco Santander Outlook Revised To Negative On Global Economic Downturn; 'A/A-1' Ratings Affirmed, April 29, 2020
- How We're Refining Our View Of The Strategic Importance Of Certain Spanish Bank Subsidiaries, Aug. 2, 2019

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	**4**	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	**bbb**	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of December 22, 2020)*	
Banco Santander S.A.	
Issuer Credit Rating	A/Negative/A-1
Resolution Counterparty Rating	A+/--/A-1
Senior Subordinated	A-
Senior Unsecured	A
Short-Term Debt	A-1
Subordinated	BBB+
Issuer Credit Ratings History	
29-Apr-2020	A/Negative/A-1
06-Apr-2018	A/Stable/A-1
09-Jun-2017	A-/Stable/A-2
09-Feb-2017	A-/Positive/A-2
Sovereign Rating	
Spain	A/Negative/A-1
Related Entities	
Banco Santander (Brasil) S.A.	
Issuer Credit Rating	BB-/Stable/B
Brazil National Scale	brAAA/Stable/brA-1+
Banco Santander-Chile S.A.	
Issuer Credit Rating	A/Negative/A-1

Ratings Detail (As Of December 22, 2020)*(cont.)	
Commercial Paper	
Foreign Currency	A-1
Senior Unsecured	A
Banco Santander SA (London Branch)	
Certificate Of Deposit	
Local Currency	A-1
Banco Santander S.A. (New York Branch)	
Commercial Paper	
Local Currency	A-1
Banco Santander Totta S.A.	
Issuer Credit Rating	BBB/Stable/A-2
Resolution Counterparty Rating	BBB/--/A-2
Senior Unsecured	BBB
PSA Banque France	
Issuer Credit Rating	BBB+/Negative/A-2
Commercial Paper	A-2
Senior Unsecured	BBB+
Santander Bank, N.A.	
Issuer Credit Rating	A-/Negative/A-2
Senior Unsecured	A-
Short-Term Debt	A-2
Subordinated	BBB+
Santander Consumer Bank AG	
Issuer Credit Rating	A-/Negative/A-2
Resolution Counterparty Rating	A/--/A-1
Commercial Paper	A-2
Senior Subordinated	BBB+
Senior Unsecured	A-
Santander Consumer Finance S.A.	
Issuer Credit Rating	A-/Negative/A-2
Resolution Counterparty Rating	A/--/A-1
Commercial Paper	
Local Currency	A-2
Senior Subordinated	BBB+
Senior Unsecured	A-
Short-Term Debt	A-2
Subordinated	BBB
Santander Holdings U.S.A Inc.	
Issuer Credit Rating	BBB+/Negative/A-2
Senior Unsecured	BBB+
Santander Totta SGPS, S.A.	
Senior Unsecured	BBB
Santander UK Group Holdings PLC	
Issuer Credit Rating	BBB/Negative/A-2

Ratings Detail (As Of December 22, 2020)*(cont.)	
Junior Subordinated	B+
Senior Unsecured	BBB
Short-Term Debt	A-2
Subordinated	BB+
Santander UK PLC	
Issuer Credit Rating	A/Negative/A-1
Resolution Counterparty Rating	A+/--/A-1
Junior Subordinated	BB
Junior Subordinated	BB+
Preference Stock	BB
Senior Secured	AAA/Stable
Senior Unsecured	A
Senior Unsecured	A-1
Short-Term Debt	A-1
Subordinated	BBB-

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.