13097

Banco Santander, S.A.

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

*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, its operating base is geographically diversified among various regions including both developed and emerging economies. 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 882.9 billion euros and 780.5 billion euros, respectively, at the end of 2018. International operations outside of Spain account for more than 75% of its loans and more than 80% of its total income. By business segment, retail banking accounts for more than 85% of its total income, with investment banking and corporate banking arms accounting for small proportions.

While corporate philosophy, strategy and risk management policy are shared across the group, its subsidiaries are autonomous in terms of capital and liquidity with a view to containing possible risk contagion among the group's different units. The group's strategy from 2015 through 2018 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. Its new medium-term strategy ongoing since April 2019 calls for continuing those initiatives and further enhancing 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, thanks to its business strategy to focus on critical mass and retail banking in selected markets. The core market segments defined by the bank are nine countries including Spain, the UK, the US (including Puerto Rico), Brazil, Chile, Portugal, Mexico, Poland and Argentina, and consumer finance business 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), which was resolved under the EU's Bank Recovery and Resolution Directive (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 foundations of building societies such as Abbey National. In this particular field, the bank boasts a market share of around 10%. The UK operations have been reorganized to comply with the country's ring-fence regulations since the start of 2019, but this has had no material impact on its business base or financial position because the size of its operations that fall under the restricted activities of a ring-fenced bank is small. In the US, 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 (Bank Zachodni WBK), it owns local commercial banks with deposit and loan market shares

largely exceeding 10%. In Latin America, the bank announced its intention in April 2019 to acquire the minority shares of 25% in Santander Mexico to make it a wholly-owned subsidiary. 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 position in each market, it holds a competitive pricing power and sticky deposit base.

3. Asset quality

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 25%, the US, Brazil and SCF with approximately 9-10% each, and others with less than 5% each (at the end of 2018). 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 120bp in the five years to 2018. 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. The possibility of credit cost surging due to factors attributable to individual borrowers is slim because 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.

The bank's nonperforming loan ratio declined to 3.5% at the end of June 2019 from the peak of 5.6% at the end of 2013 as its asset quality kept improving in most of its core markets in recent years. 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 7% at the end of 2018. The bank's credit cost ratio has been declining from the peak of more than 230 bps in 2012 to around 100 bps in 2018. It remained largely unchanged on an annualized basis in the first half of 2019.

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.

4. Earnings and financial structure

While the bank operates in the markets with relatively high risks, it makes stable profits as its earnings sources center on retail banking which is geographically diversified among countries whose economic growth is not correlated to each other. In addition, it absorbs relatively high credit costs as its core earning power is high in terms of pre-provisioning operating income thanks to its solid margins ensured by appropriate pricing and restrained operating costs brought by strict cost control. A country-by-country breakdown of its 2018 total income showcases geographical diversification, with Brazil accounting for around 30% of the total, followed by the US and Spain with around 15% each, and the UK and SCF with some 10% each. Emerging countries which are growth markets make greater contributions on an income basis than on a credit exposure basis. 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. The stability of its earnings is high among major global banks as indicated by the fact that it remained profitable even during the financial crisis after the Lehman shock and the sovereign debt crisis in Europe.

Looking at the earnings trend during the medium-term period to 2018, the bank's pre-provisioning operating income stayed on an increasing trend, driven by the growth of gross income centering on net interest and fee incomes and cost containment. Thanks to the effects of its commercial transformation, the bank has materialized higher revenues from customer-related businesses and improved cost efficiency in most of its core markets in recent years. Supported also by lower credit costs, its pre-tax profit reached 14 billion euros in 2018, the highest since 2008, with its consolidated profit recovering to 9 billion euros or close to the peak level registered around 2009. Its consolidated profit in the first half of 2019 declined some 10% year-on-year but modestly increased barring the impact of one-off factors

such as the restructuring cost associated with the integration of Popular. By country, profits fell in 2018 and the first half of 2019 in the UK where competitive pressure was strong and in Argentina where the economy turned down, but the setbacks were more than offset by increased profits in other countries such as Spain, Brazil and the US. Especially in Spain, the bank's efforts to reduce deposit cost at Popular has contributed to increasing its net interest income even amid the continued deleveraging in the country's banking sector, leading to a recovery of profits. In addition, creation of synergy effect from the integration of Popular has been steadily progressing, as the bank achieved the initial target of 500 million euros by 2020 in 2018 and raised the target to 750 million euros. The business environment in Europe is expected to remain challenging for some time to come due to prolonged low interest rates and uncertainty over the UK's exit from the EU. Nevertheless, JCR holds that the bank will continue to generate stable earnings supported by the growth of business in the emerging markets and cost reduction initiatives. The bank is set to book some 1.5 billion euros in impairment of goodwill on its UK business in the financial results for the third quarter of 2019. But this is manageable given the current level of annual pre-provisioning income.

The bank's consolidated common equity Tier 1 ratio stood at 11.3% (after allowing for the IFRS 9 transitional arrangements) on a fully-loaded basis at the end of June 2019, sound enough to support its current ratings. Going forward, some regulatory changes may negatively affect the bank's capital ratios. Those include the implementation of IFRS 9 (which may lower the CET1 ratio by some 25bp, 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. 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 and the fact that the application of its internal rating-based approaches has so far been slow by global standard. 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. Toward 2019 it had been ramping up the issuance of TLAC-compliant securities with a focus on senior non-preferred debts. The bank currently complies with the EU's MREL (Minimum Requirement for Own Funds and Eligible Liabilities) that has to be met by January 2020.

The bank generally maintains 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. Liquidity coverage ratios stay higher than the minimum required level of 100% for both the group and each of its subsidiaries.

5. Overall assessment and rating outlook

The ratings are 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 capacity to generate stable earnings. On the other hand, the ratings are constrained by a relatively high risk profile of its credit portfolio. The rating outlook is Stable. The group-wide initiatives to enhance customer loyalty and promote digitalization in recent years have been bearing fruit in capturing more interest and fee incomes, containing costs and contributing to further stabilizing the bank's capacity to generate earnings. The bank plans to continue these efforts and carry out an additional cost reduction totaling EUR1.2 billion mainly in Europe. The bank has also made steady progress in Spain in reducing the problem real estate assets and lowering the cost of deposits it took over when acquiring Banco Popular in 2017. This has been contributing to improving its asset quality and earnings. While attention needs to be paid to possible impacts of the UK's exit from the EU, JCR holds that the bank will continue to generate stable earnings supported by the effects of its various initiatives and the growth of business mainly in the emerging markets.

A further reduction of risks in the bank's credit portfolio could lead up to an improvement of its creditworthiness. On the contrary, any major damage to its earnings base or capital resulting from deterioration of the quality of credit portfolio due to factors such as weakening of economic and financial conditions in the emerging countries or uncertainties related to the UK's exit from the EU could have a downward pressure on the ratings.

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Consolidated Financial Summary

(Million euros,%, bp)

	2014/12	2015/12	2016/12	2017/12	2018/12
Total assets (end-year balance)	1,266,296	1,340,260	1,339,125	1,444,305	1,459,271
Loans and advances to customers (end-year balance)	734,711	790,848	790,470	848,915	882,921
Customer deposits (end-year balance)	647,705	683,142	691,112	777,730	780,496
Total income	42,612	45,895	44,232	48,355	48,424
Pre-provisioning profit from operations	19,417	21,069	20,623	22,304	23,422
Profit from operations	8,707	10,417	10,997	13,045	14,436
Profit for the period	6,935	7,334	7,486	8,207	9,315
ROA (based on pre-provisioning profit from operations)	1.62	1.57	1.54	1.58	1.62
Non-performing balances/Total loans and contingent liabilities	5.19	4.36	3.93	4.08	3.73
Cost of credit	143	125	118	107	100
Total regulatory capital ratio	12.04	14.40	14.68	14.99	14.98
Tier 1 capital ratio	10.97	12.55	12.53	12.77	13.12
Common equity Tier 1 capital ratio	10.97	12.55	12.53	12.26	11.47

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

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

Ratings

(Millions of yen)

	Rating	Outlook*	Amount	Rate (%)	Issue Date	Maturity Date	Release
Samurai Senior Non Preferred Bonds - First Series (2017)	A	-	83,700	0.568	2017.12.11	2023.01.11	2019.09.20
Samurai Senior Non Preferred Bonds - Third Series (2017)	A	-	12,200	1.015	2017.12.11	2027.12.10	2019.09.20
Foreign Currency Long-term Issuer Rating	A+	Stable	-	-	-	-	2019.09.20

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, S.A.

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

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