12 April 2017

Financial Institutions

Banco Santander SA Issuer Rating Report

SCOPE

AA- STABLE OUTLOOK

Overview

Scope Ratings assigns an Issuer Credit-Strength Rating (ICSR) of AA-, senior unsecured debt ratings of A+, and short-term debt ratings of S-1 to Banco Santander SA, all with Stable Outlook. These ratings do not apply to the unguaranteed subsidiaries of the rated parent. The ICSR was upgraded on 2 February 2017, to reflect the increased protection for the most senior part of the capital structure as the bank moves towards MREL and TLAC compliance.

The ratings were not solicited by the issuer. Both the ratings and the analysis are based solely on publicly available information. The issuer has participated in the process. For the full list of ratings see the **ratings list** section at the end of this report.

Highlights

The ratings are driven by the bank's strong and seasoned retail and commercial banking business model, which produces a reliable and well-diversified earnings stream and generates capital at the group level. Having withstood the global financial crisis, the Spanish real estate market collapse, and the euro area sovereign crisis without damage to capital, we believe that the business model of Santander has proven its resilience to shocks.

Good credit demand in emerging markets is making up for the more muted volume-growth outlook in Europe, allowing the group to deploy capital profitably in markets it knows well. Stable profit is flowing from the more developed markets, helping to smooth out emerging markets' higher macro volatility. To some extent, this is the reverse of the situation during the crisis years, when the more robust emerging-market earnings were compensating for developed-market troubles.

Due to the group's presence in several developed and emerging markets, we believe a key challenge for Santander will remain the different regulatory requirements by different authorities – some with different priorities – and ensuring that prudential and supervisory requirements are met not only at the group level, but also locally.

Historically prone to acquisitions, Santander has been more cautious with respect to inorganic growth under Ana Botin's chairmanship, as the strategic focus has shifted from growth to the depth of customer relationships.

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:
1. A business model that has withstood crisis challenges: cost-efficient provision of retail and commercial banking services (high pre-provision income buffer to absorb credit charges) and resilient group profitability
2. Globally diversified revenue and earnings streams with strong market positions in several key markets, including Spain, Brazil, UK, Mexico, Chile and Poland
3. Ongoing improvement of capital, liquidity and funding positions in recent years
4. European banking union likely to provide a stronger regulatory and supervisory framework

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Bloomberg: SCOP

Rating-change drivers

A less favourable operating environment in the UK following Brexit. Santander UK is mainly a mortgage bank, with a relatively low average loan to value, and its asset performance in the UK is, so far, very reassuring. However, the performance of the UK book may depend on how the EU-UK relations shape up post Brexit and how the UK economy performs after the split. A material increase in the UK loss rate could have a significant impact on group profitability. Moreover, an increase in the risk profile of the UK loan book, potentially driven by material portfolio diversification away from residential mortgages, could also have a negative impact on ratings.

Renewed tension on Spanish bank and sovereign debt. Tensions surrounding peripheral European assets were sedated, for the past few years, by a strongly accommodative monetary policy. As economic recovery takes hold in Europe, the European Central Bank will gradually remove its support, starting with a termination of its asset purchase programme in December 2017. Despite not directly affecting the P&L, rising yields on the bank's Spanish sovereign bond holdings would raise questions on the bank's capital levels. To some extent, however, we take comfort in the promising economic performance of Spain after the crisis.

Event risk. Santander has been very active in M&A both before and during the crisis, acquiring banking franchises in several countries, including the UK, the US, Germany and Poland. This strategy goes beyond the group's more traditional effort to grow in Latin America, where the bank rightly claims to have a cultural-related competitive advantage. So far most acquisitions and mergers have been effectively and successfully integrated, but the risk remains that potentially unexpected large transactions could have negative consequences on the group's fundamentals, including prudential metrics. However, in recent years Santander has mostly focused on organic growth. Besides, we note that the Spanish group has historically had a strong record in managing well its acquisitions.

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

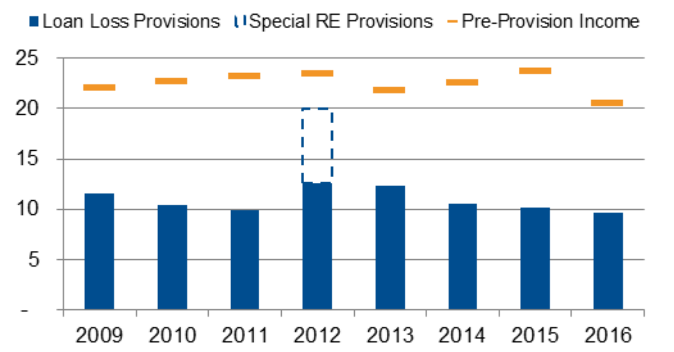
Rating drivers (Details)

A business model that has withstood crisis challenges: cost-efficient provision of retail and commercial banking services (high pre-provision income buffer to absorb credit charges) and resilient group profitability

Santander's diversified retail business model has had a very good track record in recent years. Despite significant challenges due to the burst of a domestic credit and real estate boom, as well as a sovereign crisis, the group was able to survive and emerge in a reassuring shape thanks to its earnings resilience. With a group cost-income ratio consistently below 50%, Santander makes on average about EUR 23bn in pre-provision profit annually. This gives it a buffer that can absorb a wide range of adverse asset quality shocks.

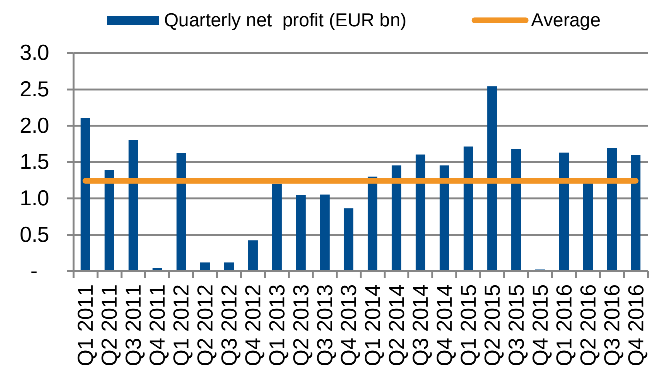
As shown in Figure 1, this pre-provision profit buffer was sufficient to absorb significant losses throughout the crisis, including the extraordinary provision on real estate assets from the royal decrees in 2012. Indeed, we note that Santander has not posted a single quarter of net losses since the beginning of the global financial crisis and that its profitability has shown little volatility if we exclude quarters when large one-off provisions were booked (see Figure 2).

Figure 1: Recurring pre-provision profitability vs LLC, 2009-2016



Source: Company data, Scope Ratings

Figure 2: Santander's quarterly net profit, 2011-2016



Source: Company data, Scope Ratings

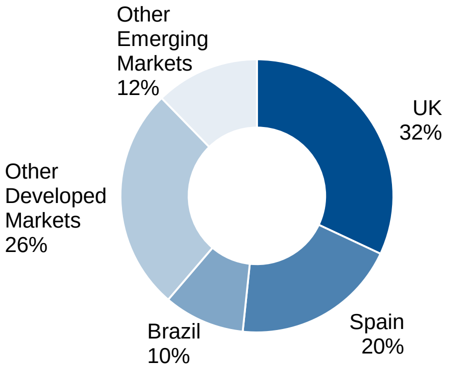
This buffer gives us some comfort on the group's protection against future risks: before hitting capital, any unforeseen loss would indeed be absorbed by the group's ordinary profitability.

We have stressed our group earnings and capital forecasts for Santander under several different, adverse asset-quality shocks to the group's main risk exposures (Spain, Brazil, UK) to test the bank's vulnerability to such shocks and found that there is no single realistic asset-quality shock that, in isolation, would pose a threat to group's solvency. Naturally, should several stresses materialise at once, the group's profits and capital would be more severely impacted.

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

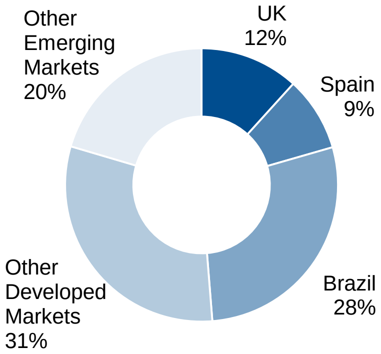
Significant geographical diversification is a key positive driver for Santander's rating. The group comprises several retail and commercial banks in the Americas and Europe. As shown in Figure 3 and 4, mature markets still account for a majority of the loan book, but half of Santander's earnings power (as measured by pre-provision profit) is actually derived from the emerging-market franchises.

Figure 3: Santander loan book split, 2016



Source: Company data, Scope Ratings

Figure 4: Santander pre-provision profit split, 2016



Source: Company data, Scope Ratings

Going forward it is likely that faster underlying economic growth, as well as additional potential for increased catch-up in credit penetration in selected countries and segments (e.g. mortgages in Brazil), will likely lead to an increased contribution of emerging economies to Santander's loan book. This may be offset, in terms of earnings contribution, by lower margins as the loan mix shifts to lower-risk, lower-margin products.

As such, our positive view of the group's international franchise not only relates to its potential for higher revenue growth, but also especially to the earnings smoothing provided by the diversification: it would take synchronised recessions in the different countries of operation to seriously threaten group solvency.

The current multi-country Santander franchise has been built over the last 2.5 decades, mostly through acquisitions. In that respect, we believe Santander's track record in acquisitions and integrations has been all along very positive. During the crisis years, it acquired several competitors in its core geographies at attractive prices, often benefiting from public backstops to risk, as was the case with the acquisition of Bradford & Bingley and Alliance & Leicester in the UK. Other major acquisitions in recent years include ABN AMRO Banco Real in Brazil, Sovereign Bank in the US and Zachodni WBK and Kredyt Bank in Poland, as well as the SEB retail business in Germany. We note that, despite a strong appetite for inorganic growth, Santander's franchise remains fairly focused, with top-three positions in most of its core markets.

Ongoing improvement of capital, liquidity and funding positions in recent years

Santander's capital position has improved materially over the years. At the end of 2016, Santander CRD IV CET1 ratio stood at 12.5% on a transitional basis, almost double the 2007 level (see Figure 5). On a fully loaded basis, the ratio stood at 10.6%, which in our view is adequate given the group's strong track record of organic capital generation, low earnings volatility, predominance of retail, and relatively high asset-risk intensity. Over the next few years, the two ratios will converge, and we expect the organic capital generation of Santander to more than offset the gradual increase of capital deductions.

We believe that the capitalisation ratio should improve further as Santander manages to organically generate capital on a group basis, thanks to high risk-adjusted profitability. In our calculations, the group should generate, before distributions, profits equal to c. 1% of RWA. After accounting for dividend and AT1 distributions, as well as RWA growth financing, this should leave c. 30bps to reinforce the fully loaded CET1 ratio every year.

Both on a transitional and fully loaded basis, Santander is well ahead of its 2017 SREP CET1 requirement of 7.75%. The requirement is set to increase over the coming years as the buffer requirements are phased in. The 2019 SREP CET1 requirement should stand at 9.5%. In our view, Santander is on track to meet both its regulatory requirements and its internal capital target of 11% by 2018.

The funding and liquidity position has also significantly improved since the beginning of the crisis: the group's loan-to-deposit ratio has materially declined, partly the result of aggressive deposit acquisition (organic and inorganic) on the one hand and fast asset deleveraging, especially in Spain and Portugal, on the other. Going forward, there is still scope to rebalance the funding profiles of some subsidiaries, but we see the group's funding profile as adequate and in line with international peers.

European banking union provides strong regulatory and supervisory framework

Despite its fundamental strength, the perception of Santander's credit risk has suffered in the past not only from the significant macro challenges in Spain, but also from a degree of market concern regarding the strength of the regulatory and supervisory framework in Spain. Going forward, Scope believes the existence of the European banking union will help mitigate doubts around the appropriateness of regulation and supervision in any individual country, and will allow investors – as well as euro area supervisors – to compare banks based on their intrinsic credit strength.

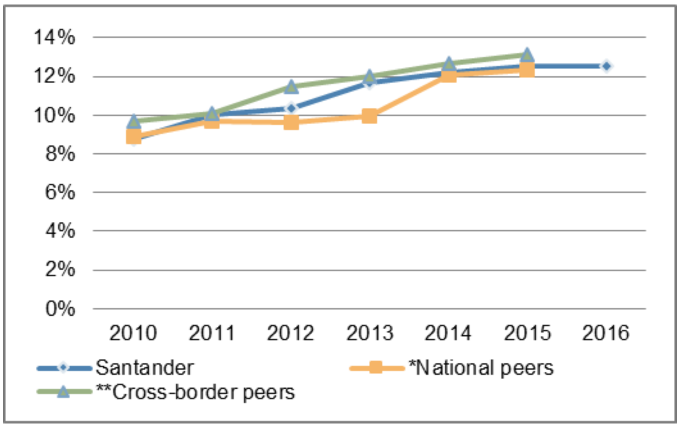
The Single Supervisory Mechanism (SSM) represents a significant reassurance that all European banks are subject to the same strict standards of supervision, limiting concerns relating to possible regulatory forbearance or political interference in the supervisory process. With responsibility for supervision moved to a single, supranational and independent actor such as the ECB, the risk of inconsistent or incoherent application of the rules across the euro area should be materially reduced. Similarly, the risk of political interference from home country politicians is limited within Europe.

As it operates in several non-EU jurisdictions, Santander is also subject to several host country supervisors, increasing the cost (and complexity) of complying with several different sets of rules.

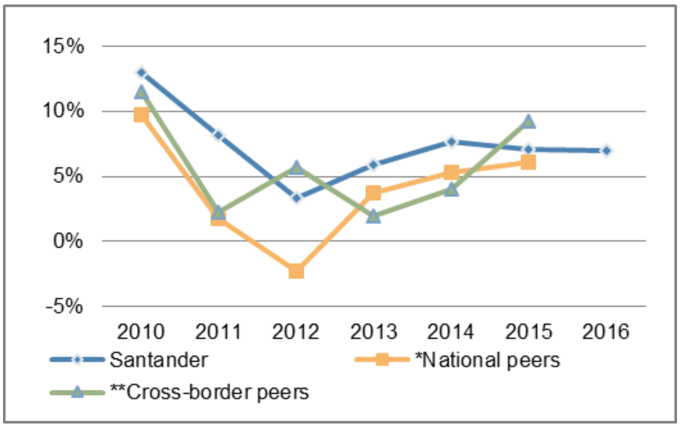
The global financial crisis has shown that, in a period of stress, intragroup capital and liquidity mobility across geographies can be significantly constrained, limiting a cross-border banking group's financial flexibility when it is most needed. Faced with such restrictions, steps ranging from the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

Appendix A: Peer comparison

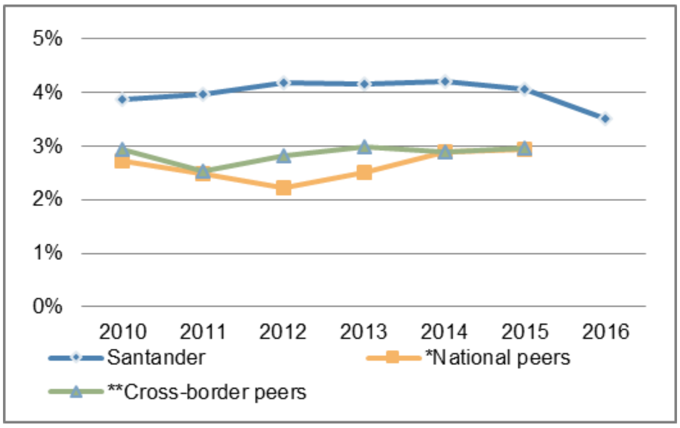
CET1 ratio (%, transitional)



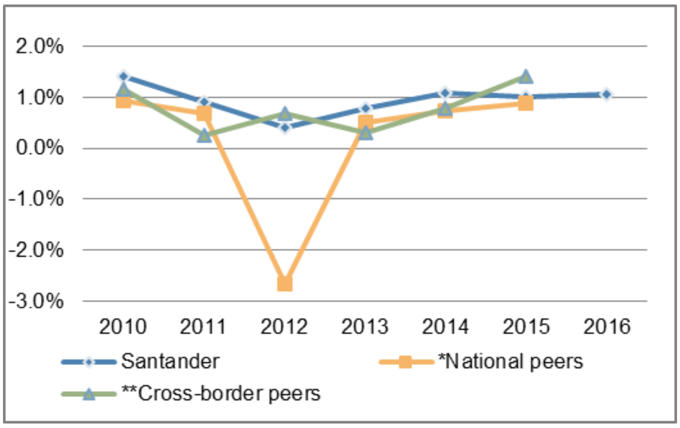
Return on average equity (%)



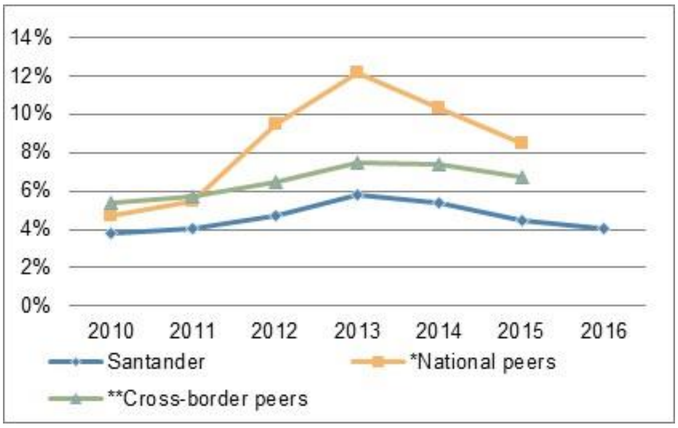
Pre-provision income/RWA (%)



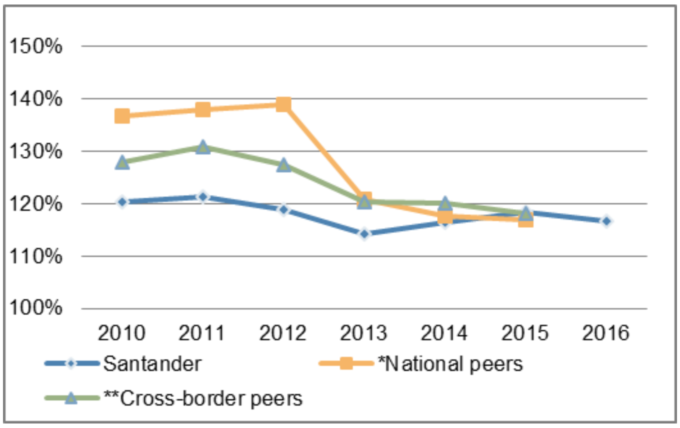
RoRWA (%)



Impaired loans % gross loans



Loan-to-deposit ratio (%)



Source: SNL, Scope Ratings

*National peers: BBVA, Santander, Banco Popular, CaixaBank, Banco Sabadell, Bankia, Bankinter.

**Cross-border peers based on business model: Santander, BBVA, Unicredit, Erste Bank, Nordea, KBC Group, ING Bank.

Appendix B: Selected financial information – Santander group

	2012	2013	2014	2015	2016
Balance sheet summary (EUR bn)					
Assets					
Cash and interbank assets	192.4	152.1	151.1	160.3	153.1
Total securities	152.1	142.2	142.2	142.2	211.8
Derivatives	120.5	68.8	86.0	85.8	83.9
Net loans to customers	719.1	668.9	734.7	790.8	790.5
Other assets	85.5	83.7	152.2	161.1	99.8
Total assets	**1,269.6**	**1,115.6**	**1,266.3**	**1,340.3**	**1,339.1**
Liabilities					
Interbank liabilities	153.0	109.4	147.8	173.1	149.4
Senior debt	206.0	175.5	196.6	205.0	209.0
Derivatives	116.8	64.3	79.0	85.5	83.0
Deposits from customers	626.6	607.8	647.7	683.1	691.1
Subordinated debt + non-equity hybrids	18.2	16.1	17.1	21.2	19.9
Other liabilities	67.7	62.6	73.2	71.3	84.1
Total liabilities	**1,188.3**	**1,035.7**	**1,176.6**	**1,241.5**	**1,236.4**
Ordinary equity	71.6	70.4	80.5	87.8	90.7
Equity hybrids	0.3	0.2	0.3	0.2	0.2
Minority interests	9.4	9.3	8.9	10.7	11.8
Total liabilities and equity	**1,269.6**	**1,115.6**	**1,266.3**	**1,340.3**	**1,339.1**
Core tier 1 / common equity tier 1 capital	57.6	57.3	71.6	73.5	73.7
Income statement summary (EUR bn)					
Net interest income	29.9	28.4	29.5	32.2	31.1
Net fee & commission income	10.3	9.6	9.7	10.0	10.2
Net trading income	2.7	3.5	2.8	2.4	2.1
Other income	0.5	0.4	0.5	0.7	0.8
Operating income	**43.4**	**41.9**	**42.6**	**45.3**	**44.1**
Operating expense	20.0	20.2	20.0	21.6	23.6
Pre-provision income	**23.4**	**21.8**	**22.6**	**23.7**	**20.5**
Loan-loss provision charges	12.6	12.3	10.6	10.1	9.6
Other impairments	0.9	0.5	0.4	0.5	0.1
Non-recurring items	0.0	0.0	0.0	n.a.	n.a.
Pre-tax profit	**5.4**	**7.4**	**9.7**	**10.3**	**10.8**
Discontinued operations	0.1	0.0	0.0	0.0	0.0
Income tax expense	2.3	2.0	2.7	3.1	3.3
Net profit attributable to minority interests	0.9	1.2	1.2	1.3	1.3
Net profit attributable to parent	**2.3**	**4.2**	**5.8**	**6.0**	**6.2**

Source: SNL, Scope Ratings

Appendix C: Ratios – Santander group

	2012	2013	2014	2015	2016
Funding/Liquidity					
Gross loans % total deposits	118.8%	114.1%	116.4%	118.3%	116.6%
Total deposits % total funds	62.4%	66.9%	64.2%	63.1%	64.6%
Wholesale funds % total funds	37.6%	33.1%	35.8%	36.9%	35.4%
Liquidity coverage ratio (%)					
Net stable funding ratio (%)					
Asset mix, quality and growth					
Gross loans % funded assets	64.6%	66.0%	63.5%	64.4%	64.1%
Impaired loans % gross loans	4.7%	5.8%	5.4%	4.5%	4.0%
Loan-loss reserves % impaired loans	72.0%	61.8%	47.9%	48.2%	47.1%
Gross loan growth (%)	-3.0%	-6.8%	8.7%	7.2%	-0.3%
Impaired loan growth (%)	12.9%	14.2%	0.1%	-10.5%	-9.9%
Funded assets growth (%)	1.1%	-8.8%	12.9%	5.7%	0.1%
Earnings					
Net interest income % revenues	68.9%	67.8%	69.3%	71.1%	70.5%
Fees & commissions % revenues	23.6%	23.0%	22.8%	22.2%	23.1%
Trading income % revenues	6.2%	8.3%	6.7%	5.3%	4.8%
Other income % revenues	1.2%	0.9%	1.2%	1.5%	1.7%
Net interest margin (%)	2.9%	2.8%	2.9%	2.9%	2.7%
Pre-provision income % risk-weighted assets (RWAs)	4.2%	4.2%	4.2%	4.1%	3.5%
Loan-loss provision charges % pre-provision income	54.0%	56.7%	46.8%	42.6%	46.9%
Loan-loss provision charges % gross loans (cost of risk)	1.7%	1.7%	1.5%	1.3%	1.2%
Cost income ratio (%)	46.0%	48.1%	47.0%	47.6%	53.5%
Net interest income / loan-loss charges (x)	2.4	2.3	2.8	3.2	3.2
Return on average equity (ROAE) (%)	3.3%	5.9%	7.7%	7.1%	7.0%
Return on average funded assets (%)	0.2%	0.4%	0.5%	0.5%	0.5%
Retained earnings % prior year's book equity	1.7%	4.4%	6.4%	4.2%	7.1%
Pre-tax return on common equity tier 1 capital	9.5%	12.8%	15.1%	14.3%	14.6%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	n.a.	n.a.	9.65%	10.05%	10.55%
Common equity tier 1 ratio (%, transitional)	10.3%	11.7%	12.23%	12.55%	12.53%
Tier 1 capital ratio (%, transitional)	11.2%	12.6%	12.23%	12.55%	12.53%
Total capital ratio (%, transitional)	11.2%	12.6%	13.3%	14.4%	14.7%
Tier 1 leverage ratio (%)	n.a.	n.a.	5.0%	5.4%	5.4%
Total loss coverage (CET1 + loan-loss provisions) % RWAs	14.9%	16.8%	15.6%	15.6%	15.1%
Asset risk intensity (RWAs % total assets)	43.9%	43.9%	46.1%	43.6%	43.9%

Source: SNL, Scope Ratings

Ratings

Issuer Credit-Strength Rating	**AA-**
Outlook	Stable
Senior unsecured debt	AA-
Senior unsecured debt (MREL/TLAC eligible)	A+
Additional Tier 1 instruments	BBB-
Short-term debt rating	S-1
Short-term debt rating outlook	Stable
Covered bond ratings	AAA
Covered bond outlook	Stable

Regulatory Disclosures

Information pursuant to Regulation (EC) No 1060/2009 on credit rating agencies, as amended by Regulations (EU) No. 513/2011 and (EU) No. 462/2013

Responsibility

The party responsible for the dissemination of the financial analysis is Scope Ratings AG, Berlin, District Court for Berlin (Charlottenburg) HRB 161306 B, Executive Board: Torsten Hinrichs (CEO), Dr. Stefan Bund.

The rating analysis has been prepared by Marco Troiano, Director

Responsible for approving the rating: Sam Theodore, Managing Director

Date	Rating action	Rating (ICSR)
01/04/2014	First Assignment	A
12/01/2015	Review for upgrade	A
24/02/2015	Upgrade	A+
2/2/2017	Upgrade	AA-

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

Information on interests and conflicts of interest

The rating was prepared independently by Scope Ratings without a mandate (unsolicited rating) but with participation of the rated issuer.

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Key sources of Information for the rating

Website of the rated entity/issuer, Annual reports/quarterly reports of the rated entity/issuer, Current performance record, Data provided by external data providers, Interview with the rated entity, External market reports, Press reports / other public information.

Scope Ratings considers the quality of the available information on the evaluated company to be satisfactory. Scope ensured as far as possible that the sources are reliable before drawing upon them, but did not verify each item of information specified in the sources independently.

Examination of the rating by the rated entity prior to publication

Prior to publication, the rated entity was given the opportunity to examine the rating and the rating drivers, including the principal grounds on which the credit rating or rating outlook is based. The rated entity was subsequently provided with at least one full working day, to point out any factual errors, or to appeal the rating decision and deliver additional material information. Following that examination, the rating was not modified.

Methodology

The methodologies applicable for this rating “Bank Rating Methodology” (May 2016) & “Bank Capital Instruments Rating Methodology” (May 2016) are available on www.scoperatings.com. The historical default rates of Scope Ratings can be viewed on the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope’s credit rating, definitions of rating symbols and further information on the analysis components of a rating can be found in the documents on methodologies on the rating agency’s website.

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