Santander in the new interest rate cycle

The five things that set our business model apart

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The new year is already presenting challenges for Europe's financial sector. After two years of rising interest rates in the eurozone, the European Central Bank (ECB) started cutting rates last year and will likely continue to do so this year to reach the "neutral" level (around 2% or 2.5%) or even slightly below..

With rates falling, banks' financial income — known as net interest income — faces downward pressure, while greater macroeconomic volatility is expected this year. Despite this, Santander has expressed confidence to the market that it will continue to increase profitability in 2025 (building on the record levels it reached the previous year), keep revenue stable (though it should rise in Private Banking, Business Banking, Consumer and Payments), and reduce costs.

But how is this possible?

The three keys that explain the rise in profitability are:

- the Group's business and geographical diversification, which will protect it against falls in interest rates;
- the Group's transformation to a global business model with shared platforms, which enables us to continue growing our customer numbers, offer them an enhanced experience, and bring down costs; and
- a strong balance sheet that enables us to keep a lid on the cost of risk.

The explanation lies in the group's structural characteristics - geographical and business diversification - and its ability to activate and maximize management levers that provide stability and drive up results.

Businesses benefiting from rate cuts

Geographical and business diversity enable Santander to offer stable results in different economic cycles.

Retail and Commercial (R&C) businesses, i.e., retail and commercial banking, generally have positive sensitivity to rates in most markets, especially in the mortgage segment.

Conversely, the **Auto business** tends to benefit from cheaper money. This is the case with Santander's vehicle financing business in the United States, where it is one of the major players. Lower interest rates enable the bank to strengthen its margins through an appropriate pricing policy. When rates were on an upward trend, the price of new loans, which is set monthly, reflected these rate increases on a lagging basis, putting downward pressure on margins. When rates fall, the opposite situation occurs: the loan prices are cautiously dropped and only partially reflect the decrease, and margins widen.

In fact, in recent months, as the Federal Reserve (FED) has been cutting the cost of money, the profitability of Santander Consumer USA's new credit production is at its highest in the past two years.

"Falling interest rates can create a tailwind for the Consumer business (both Auto and retail) as they tend to boost credit demand – with cheaper loans, families are more willing to borrow,"

said Erik Laney, CFO of Santander US Auto.

At the same time, and no less importantly, the reduction in the cost of money can have positive implications for delinquency, as it helps reduce defaults. However, the macroeconomic context must always be considered: if rates are falling because the economy is weak and consumption needs a boost, this situation may be accompanied by an increase in unemployment, which is never good news for delinquency.

Regarding wholesale banking (Corporate & Investment Banking), the evolution of monetary policy has different and limited impacts, thanks to the geographical and product diversification in the business. For example, rising rates have a positive impact on Global Transaction Banking, especially in the Cash Management area. Conversely, segments linked to debt or equity issuance grow more when the cost of money is falling, which reactivates bond issuances, IPOs and others.

Geographical diversification. Negative sensitivity to interest rate hikes in some regions

Geographical diversification is another one of the most important keys to the stability of Grupo Santander's results. It not only enables the group to offset the different macroeconomic developments of countries and regions but also protects it against interest rate cycles.

In fact, the group has, fundamentally, two types of balance sheets, which broadly correspond to Europe and Latin America (especially Brazil and Chile).

In the eurozone, it has **positive sensitivity** to interest rates, meaning that when the cost of money rises, so does net interest income. This happens because the asset (variable-rate loans, mortgages, etc.) reflects the increase and revalues faster than the liability (term deposits).

In Latin America, sensitivity to rates is mostly **negative,** meaning that when the cost of money rises, net interest income narrows, while it widens when rates fall. This occurs because in Brazil, Chile and other countries, the vast majority of deposits are pegged to the interbank rate, so they depreciate quickly when rates are cut, while the asset takes longer to reflect the change.

In the coming quarters, interest rates are expected to continue falling in the eurozone. Forecasts

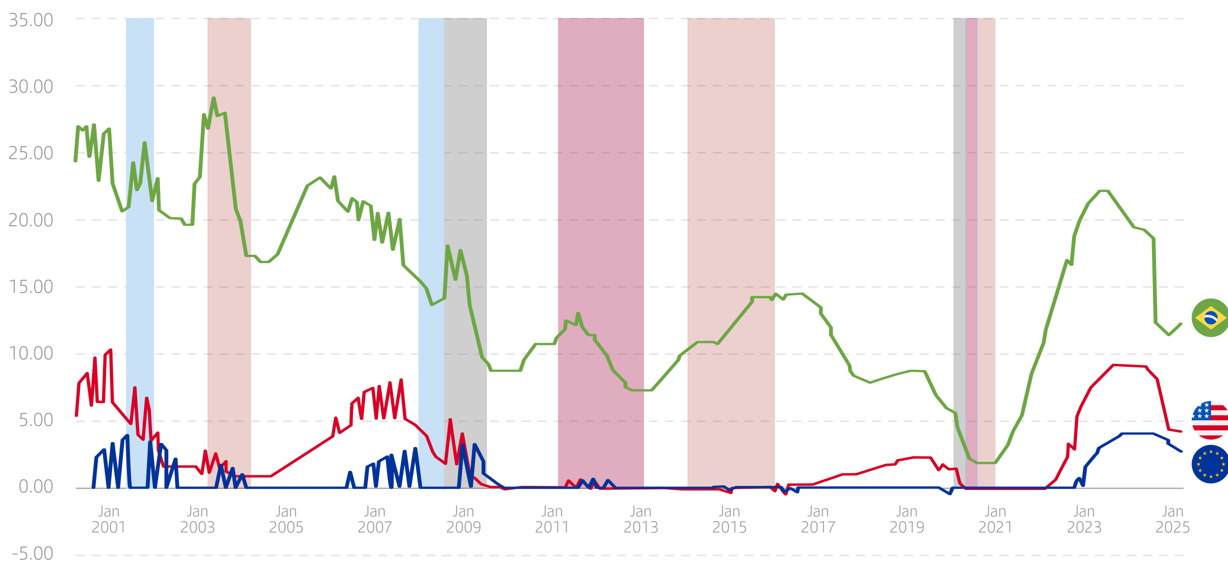
suggest that the ECB will continue cutting the cost of money until it reaches 2%, as inflationary pressures ease. In contrast, the cycle will likely be different in Latin America.

In most countries in Latin America, experts expect widespread rate cuts. Brazil will be an exception in the first half of the year, as rising inflation led its central bank to halt the rate-cutting cycle at the end of last year and start raising rates in recent months, which could continue during H1.

Thus, the pressure on net interest income that European countries and Brazil should experience, which is in any case mitigated by the timely management of other financial levers, such as debt portfolios, will also be offset by the boost from some Latin American markets.

Interest rates evolution

Source: prepared by the author



Prudent financial management. ALCO construction and hedging

Beyond the help provided by geographical and business diversification, the group works proactively to reduce the balance sheet's sensitivity to interest rate variations.

For several quarters, Santander has been preparing its balance sheet for the rate cuts that began in the second half of 2024 and which are expected to continue this year, especially in Europe. Both Europe and Brazil account for most of Santander's interest rate exposure.

The group has been increasing its ALCO portfolio in euros, mainly in Spain, Portugal, and Consumer. The ALCO portfolio is what's called a "countercyclical" instrument, meaning its function is to provide stability to results over time. When interest rates are in an upward cycle, government bonds are bought, whose price becomes cheaper when the cost of money rises. When rates fall, the bond price appreciates, and the value of the ALCO portfolio rises. The group has these bonds mostly recorded at maturity because it keeps them in the portfolio until final payment and does not trade them. Therefore, even if the sale does not materialize, the appreciation of the bonds generates a financial benefit that is reflected in the income statement.

It is important to know when and how much to buy so that the ALCO portfolio provides enough benefits to offset the narrowing of net interest income amid falling rates.

Santander did its homework and currently has about 67 billion euros in sovereign bonds.

The decisions made by the ALCO committee (which includes several areas of the bank, such as the Financial Division, Risks, and the Research service) also serve to limit the impact on profit through exchange rate hedging. This safeguards the profits obtained in each country against variations in local currencies against the euro, which is ultimately the currency in which the group presents its results.

Another stabilization lever that has been implemented in recent months has been to convert part of the bank's market financing to a variable rate, which will enable it to become cheaper in the downward rate cycle. The mortgage portfolio in Spain has also been partially hedged. All this has triggered a reduction in the sensitivity of net interest income to eurozone interest rate variations by about a quarter of a point.

Commercial dynamics. Volume increase and efficiency improvement

The combination of geographical and business diversification also enables Santander to protect itself against interest rate developments because it affects the evolution of commercial dynamics.

An example of this is the mortgage market. It is a business where demand usually rises when interest rates fall. However, experts estimate that in Spain, the rebound in this financing will be limited because the real estate market is suffering from a shortage of new housing and, consequently, there is less need for mortgages, and demand will not increase significantly. Santander's multinational presence, however, will enable it to benefit from this effect in other geographies of its euro balance sheet, as well as in the UK.

The same applies to consumer financing. Not all European economies are at the same point in the macroeconomic cycle, although ECB interest rate decisions affect them all. Thus, in countries like Spain, whose economic growth has been above the European average for several quarters, the rate cut will stimulate consumer credit demand more than in other countries whose economies are growing less or are stagnant.

It's not just the growth in volumes that will enable the Group to protect its revenues in the challenging interest rate landscape that this year promises to bring. Another lever is Santander's ability to increase the profitability of the assets that it adds to the balance sheet. Over the past 10 years, risk-weighted assets (RWAs) that exceed the cost of capital have increased three times to 87% of the balance sheet, compared to just under 30% in 2014, a figure that already exceeds the 85% target set at Investor Day for the end of 2025. Return on tangible capital (ROTE) of new loan production has reached 23%, pushing the Group's total profitability to 16.3% and contributing to the aim of reaching 17% in 2025.

Prudent risk management. Release of provisions

The income statement of any financial institution is conditioned by the quality of the assets on its balance sheet.

Therefore, risk management, through a prudent provisioning policy, is one of the keys that enables Santander to stand out among its competitors.

The group estimated a cost of risk (ratio of provisions to credit) of 1.2% for this year; but finally, at year end this figure was 1,15%. It is worth remembering that approximately each basis point of cost of risk equals 100 million euros in provisions, so five basis points represent a saving of 500 million euros (net of taxes) that reaches the bottom line of the income statement, pushing up profit.

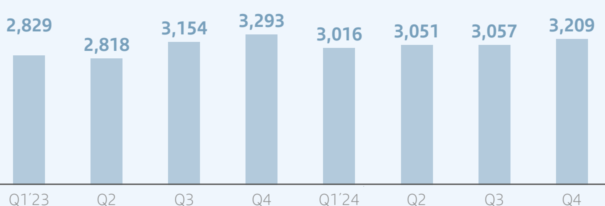
In the coming quarters, rates will probably continue to fall in the eurozone, while employment will continue to show no signs of excessive weakness. The combination of falling rates with solid job markets should favour a further reduction in delinquency from the current low levels. This will help Santander reduce its need for provisions, enabling it to meet its goal of delivering another year of growing income and profits.

Prudent risk and solid credit quality

Source: prepared by the author

CoR
12 month

LLPs
Constant €mn



Other credit quality metrics

	Dec 23	Sep 24	Dec 24
NPL ratio	3.14%	3.06%	3.05%
Coverage ratio	66%	64%	65%
Stage 1	€1,000bn	€1,008bn	€1,002bn
Stage 2	€80bn	€87bn	€88bn
Stage 3	€36bn	€36bn	€35bn

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