Global Banking Trends: going cross border...why globalisation helps

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Grupo Santander
I. **Building** a Global Financial Group: why we go cross border ….

- I thought banking was a *local* business... How can we justify cross-border acquisitions?
- Economics of cross-border mergers
- Value creation

II. **Managing** a Global Financial Group: “second round” value creation opportunities

- Creating value through “globalisation”…
- … and making sure local units do not get “lost”
  - Global scale vs local flavour
  - Are there conflicts between local and parent interests?
  - Role of market discipline

III. **Conclusions**
Why we go cross border?

- One answer explain all other: ... because there are value creation opportunities for shareholders

- Does cross-border consolidation in the financial sector make sense?....

...I thought banking was a local business
Traditional view on mergers… only in-market mergers create significant value

"Retail banking is about culture and knowing and understanding your customers. It is possible to offer your own retail banking services across a border where the cultures are similar. But it is much more difficult to put two different banking organisations together especially where one is from north Europe and the other from the south…."

We have challenged this view…
... our experience is that acquisitions create value... under certain circumstances

**What you need to have**

1. Clear retail business model to export
2. ...operating on exportable IT
3. ...which industrialises your operations
4. Spare management capacity

**What the target needs to have**

1. Good old franchise…
2. Commercially underperforming
3. With low operational efficiency…
4. “Pre –industrial” operating systems

We export our know how in industrialising retail banking
“Darwinism” will keep driving the right acquisitions…
Those not adapting to “the vital necessity” of efficiency are likely to be taken over:

The Abbey example

... SAN opening jaws

... Abbey closing jaws

Capitalism works: Weaker banks (less efficient) are likely to be taken over by efficient ones in an increasingly integrated European financial services market

IT is key
Abbey: the operational “homework”
Significant potential to improve the operational efficiency…

<table>
<thead>
<tr>
<th>Abbey / UK Banks Cost / Income ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abbey</td>
</tr>
<tr>
<td>Nrock</td>
</tr>
<tr>
<td>HBOS</td>
</tr>
<tr>
<td>Lloyds</td>
</tr>
<tr>
<td>A&amp;L</td>
</tr>
<tr>
<td>RBOS</td>
</tr>
<tr>
<td>Barclays</td>
</tr>
</tbody>
</table>

Based on most recent results and management estimates of the PFS components of the peer group

Grupo Santander’s proven track record

<table>
<thead>
<tr>
<th>Year</th>
<th>Abbey</th>
<th>SAN Group best practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>62</td>
<td>39</td>
</tr>
<tr>
<td>1999</td>
<td>58</td>
<td>39</td>
</tr>
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<td>2000</td>
<td>56</td>
<td>32</td>
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<td>2001</td>
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<td>2002</td>
<td>52</td>
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</tr>
<tr>
<td>2003</td>
<td>49</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>47</td>
<td></td>
</tr>
</tbody>
</table>

We run “Abbeys” with a third of the people and generate 20% + revenue per front employee
… by industrialising operations
Integrated IT systems gives us a competitive edge…

... most banks have a “legacy” problem

The “architecture” of the factory becomes very relevant - “Silo” style systems are very inefficient

Operating systems like Partenon represent a key competitive advantage…

... which translates into a strong reduction in unit / transaction costs and revenue productivity

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Transaction costs - Banesto

![Graph showing transaction costs from 0.045 to 0.031 over a period of 0-4 years.](image)

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**Multichannel Architecture**

- **Customer Data Base**
- **Product Catalogue**
- **DGO / DGI**
- **Contract Settlement Model**
- **Risk Systems**
- **Information Systems**
- **Accounting**

- **Branch**
- **ATM / POS**
- **Telephone Banking**
- **Internet**

- **John Smith**

- **Channel integration**
- **Integrated Customer management**
- **Time to Market: short**
- **Coherence and Quality of the information**

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By industrialising operations
Integrated IT systems gives us a competitive edge…

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Integrated Customer Data Base, Product Catalogue, DGO / DGI, Contract Settlement Model, Risk Systems, Information Systems, and Accounting...
Abbey: the commercial “homework”
Abbey has a strong customer franchise and provides a platform to evolve in the long run from a mortgage bank into a universal bank…

Abbey is still an under-exploited franchise in many key areas

Significant potential to increase share of wallet
... and this strategy is already producing results

**Achieving revenues and costs plan.**
Attributable income to the Group of £ 167 MM (EUR 244 MM)

**Change Q1'06 / Q1'05**

- Gross op. income: +11%
- Costs*: -12%
- Net operating income: +63%
- Att. income: +65%

**Net operating income**

<table>
<thead>
<tr>
<th></th>
<th>Q1'05</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Q1'06</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jaws:</td>
<td>180</td>
<td>232</td>
<td>276</td>
<td>275</td>
<td>294</td>
</tr>
</tbody>
</table>

(*) Personnel + general costs + depreciation
Therefore: Why we go cross-border?

Opportunity to create value based on:
- Exporting management
- Exporting a banking model
- Exporting IT & infrastructure
  (This is the new thing vs 10 years ago)

But this does not work with all targets / buyers…
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Creating value through “globalisation”…

... and making sure local units do not get “lost”

- Global scale vs local flavour
- Are there conflicts between local and parent interests?
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III. **Conclusions**
Globalisation generates “second round” value creation opportunities that reinforces the cross-border expansion process…

… economies of scale become Global
The IT / telecom revolution… along with the “available talent” in emerging markets… makes the execution of global models possible.

The value chain is broken…

… with each function being placed in the most efficient location.

- In India…
  - Tax returns are processed for 450,000 US residents
  - … 1m surgeries will be performed on foreigners

- Cahoot (Abbey’s Internet bank) is serviced from Madrid (back office)

Suddenly we start to create economies of scale in IT and operations…
In the medium and long term, the potential for “true” synergies emerges

- Global operations / back office synergies
  - Efficiency leadership / advantage

- Joint development (products, businesses)
  - Best practice
  - Know how transfer

- Global units (corporates, cards, insurance, asset management)
  - Economies of scale in global businesses
The case for global synergies: Global organisations are in a unique position to create value by developing global business units.
“Barbell” structures are developing in all industries … and the banking sector is no exception

Global banks leveraging their scale

Specialist / niche players
I. Building a Global Financial Group: why we go cross border…

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II. Managing a Global Financial Group: “second round” value creation opportunities

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III. Conclusions
Is it possible to combine...

... global skills...

.... with a local flavour?

- Distorted incentives (S-T vs L-T)
- Strategic “straightjackets” (e.g., growth in retail vs SME loans in all markets)
- Capital intensity bias (e.g., dividend payout targets, regardless of investment opportunities)
- ...managing business from 10,000 feet up

We aim to avoid the pitfalls of globalisation
Local market know = exploit local opportunities = adequate Capital allocation + Capital markets check of local businesses

1. We allocate capital across the Group to those areas that offer the most attractive risk / return profile

- No “capital intensity” bias

2. Different strategies in different markets

- **Chile** - exploit dominant position, focus in retail banking; fine-tune risk / return proposition
- **Brazil** - grow consumer lending / credit cards, focus on SMEs, strengthen installed capacity (scalable platform), develop alternative channels
- **Mexico** - develop mortgage strategy / change loan book mix, grow customer funds, exploit potential of customer base

3. The market has full visibility of our strategy in each area
Our strategy and the evolution of our results in each specific is clearly communicated to the market.

Chile. Key aspects of the quarter

**Macro and financial environment**
- Favourable environment with notable banking business growth:
  - Loans: +16%; Savings: +18% (*)
- Improvement in efficiency enables expansion plans to be financed
- Active management of arrears. Ratios improve

**Results**
- Record quarter in revenues due to net interest income (+31%) and fees (+42%).
- Costs growing slightly above inflation with strong efficiency improvement (41%, -600 p.b.).
- “Leap” in net operating income:
  - Favourable environment with notable banking business growth:
    - Loans: +29%; Savings: +17% (*)

**Activity**
- Retail growth: Increase in linkage and in customers
- Market share increase in key products
- Increase in linkage and number of customers: payroll and cards: levers of growth
- Market share increase in key products
- Better composition of loan balances

Solid quarter results with a record attributable income (USD 137 million), underscores the strength of the franchise.

Mexico. Key aspects of the quarter

**Macro and financial environment**
- Favourable macro environment with strong growth in banking business
  - Loans: +26%; Savings: +17% (*)
- Loan-loss provisions increase in retail loan premium
- Loan-loss provisions increase in retail loan premium
- Market share increase in key products
- Loan-loss provision increase: strong loan increase - change of mix
- Increase in taxes (29% to 34%)

**Results**
- Record quarter in revenues due to net interest income and fees
- Strong efficiency improvement. Costs lower than expected
- “Leap” in net operating income

**Activity**
- Increase in customers and linked customers
- Growth in SMEs and businesses
- Stronger increase in volumes than expected: increase in market share in key products
- Technological integration finalised in April: Improvement in future potential

Brazil. Key aspects of the quarter

**Macro and financial environment**
- Favourable environment: solid fundamentals and strong increase in banking business
  - Loans: +20%; Deposits: +20% (*)
- Loan-loss provision increase: strong loan increase - change of mix
- Increase in taxes (29% to 34%)

**Results**
- Record quarter in revenues: in net interest income (+51%) and fees (+57%)
- Lower trading gains: no portfolio sales in Q1'06 (in Q1'05 we sold) and higher unrealised capital gains
- Efficiency improvement. Cost + amortisations are 6% lower in local currency
- “Quality jump” in net operating income

**Activity**
- Increase in customers and linked customers
- Growth in SMEs and businesses
- Stronger increase in volumes than expected: increase in market share in key products
- Technological integration finalised in April: Improvement in future potential

Solid and profitable growth of business increases in net operating income.

(*) Activity growth in local currency

Technological integration and faster business growth make us more optimistic than our previous indications.

(*) Activity growth in local currency
Market discipline: The market does not adopt a “black box” approach to financial analysis
Analysts value each business separately

### Table 3: Santander 2007E Sum of the Parts valuation

<table>
<thead>
<tr>
<th>€m</th>
<th>RWA</th>
<th>Shareholders Capital</th>
<th>Core Tier1 (ex prefs)</th>
<th>Cost of Equity (per SAN)</th>
<th>Net Earnings (per ML)</th>
<th>ROE Adj</th>
<th>P/E (X)</th>
<th>P/NAV (X)</th>
<th>Implied Valuation</th>
<th>% of Total Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continental Europe</td>
<td>273,766</td>
<td>16,353</td>
<td>6.2%</td>
<td>9.4%</td>
<td>4,054</td>
<td>3,726</td>
<td>22.3%</td>
<td>12.4</td>
<td>2.6</td>
<td>46,201</td>
</tr>
<tr>
<td>SCH Spain</td>
<td>103,664</td>
<td>5,701</td>
<td>5.5%</td>
<td>9.0%</td>
<td>1,777</td>
<td>1,533</td>
<td>28.6%</td>
<td>12.5</td>
<td>3.6</td>
<td>20,412</td>
</tr>
<tr>
<td>Banesto</td>
<td>64,656</td>
<td>3,427</td>
<td>6.0%</td>
<td>9.2%</td>
<td>685</td>
<td>630</td>
<td>18.4%</td>
<td>12.5</td>
<td>2.3</td>
<td>7,872</td>
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<tr>
<td>Santander Consumer</td>
<td>39,646</td>
<td>2,379</td>
<td>6.0%</td>
<td>10.0%</td>
<td>707</td>
<td>550</td>
<td>27.3%</td>
<td>13.4</td>
<td>3.7</td>
<td>8,712</td>
</tr>
<tr>
<td>Portugal</td>
<td>27,837</td>
<td>1,809</td>
<td>6.5%</td>
<td>9.5%</td>
<td>422</td>
<td>388</td>
<td>21.4%</td>
<td>12.0</td>
<td>2.6</td>
<td>4,655</td>
</tr>
<tr>
<td>Wholesale and PB&amp;AM</td>
<td>37,962</td>
<td>3,037</td>
<td>8.0%</td>
<td>10.0%</td>
<td>463</td>
<td>425</td>
<td>14.0%</td>
<td>10.7</td>
<td>1.5</td>
<td>4,590</td>
</tr>
<tr>
<td>Abbey</td>
<td>114,021</td>
<td>5,131</td>
<td>4.5%</td>
<td>9.5%</td>
<td>1,226</td>
<td>1,127</td>
<td>22.0%</td>
<td>11.0</td>
<td>2.4</td>
<td>12,394</td>
</tr>
<tr>
<td>Latin America</td>
<td>74,019</td>
<td>9,180</td>
<td>13.9%</td>
<td>13.4%</td>
<td>2,415</td>
<td>2,219</td>
<td>24.2%</td>
<td>10.0</td>
<td>2.4</td>
<td>22,223</td>
</tr>
<tr>
<td>Brazil</td>
<td>20,793</td>
<td>3,119</td>
<td>15.3%</td>
<td>15.0%</td>
<td>853</td>
<td>784</td>
<td>25.1%</td>
<td>9.0</td>
<td>2.3</td>
<td>7,056</td>
</tr>
<tr>
<td>Mexico</td>
<td>16,004</td>
<td>2,281</td>
<td>16.0%</td>
<td>13.0%</td>
<td>504</td>
<td>463</td>
<td>20.3%</td>
<td>10.0</td>
<td>2.0</td>
<td>4,628</td>
</tr>
<tr>
<td>Chile</td>
<td>16,325</td>
<td>1,632</td>
<td>11.5%</td>
<td>10.0%</td>
<td>450</td>
<td>413</td>
<td>25.3%</td>
<td>14.0</td>
<td>3.5</td>
<td>5,786</td>
</tr>
<tr>
<td>Rest of Latam</td>
<td>17,897</td>
<td>2,148</td>
<td>12.2%</td>
<td>14.0%</td>
<td>608</td>
<td>558</td>
<td>26.0%</td>
<td>8.5</td>
<td>2.2</td>
<td>4,753</td>
</tr>
<tr>
<td>Fin Mgmt &amp; Equity Stakes</td>
<td>44,441</td>
<td>4,175</td>
<td>10.0%</td>
<td>623</td>
<td>7,072</td>
<td>7,072</td>
<td>20.3%</td>
<td>12.0</td>
<td>2.4</td>
<td>84,993</td>
</tr>
</tbody>
</table>

Number of shares (million) | 0.254
Implied value, €/sh | 13.5
Acquisition risk discount (5%) | -0.7
Implied value €/sh, net | 12.9

Source: Merrill Lynch estimates
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III. **Conclusions**
Conclusions (I)

1. Cross border consolidation makes sense…
   …but only if you can create value

2. Ignore the “globalisation” opportunity at your peril…
   … technology makes “intragroup synergies” and global business models possible

3. No “black box” approach…
   … and no “tactical bias”…
   … to local market operations
### Conclusions (II)

#### Sensitivity to foreign investment

**What are the appropriate goals and behaviour of foreign banks in host markets?**

<table>
<thead>
<tr>
<th>Possible problems</th>
<th>Solution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distant shareholder might underfund local economy… and distort local market conditions</td>
<td>Maximise shareholders value brings the right incentives:</td>
</tr>
<tr>
<td>Potential different objectives between local – parent (investment opportunities etc)</td>
<td>Ensure rational allocation of capital</td>
</tr>
<tr>
<td></td>
<td>Ensure efficiency, innovation and competition</td>
</tr>
</tbody>
</table>

#### What role can market discipline play in ensuring the interests of all stakeholders are considered …??

<table>
<thead>
<tr>
<th>Possible problems</th>
<th>Solution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Markets do not see local operations dynamics</td>
<td>Transparency: Full disclosure of local operations dynamics</td>
</tr>
<tr>
<td></td>
<td>Valuation of groups as a collection of local markets + global areas</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Different regulation criteria between home and host regulators</td>
<td>Better co-ordination / co-operation between authorities</td>
</tr>
<tr>
<td>Extra cost of double compliance</td>
<td></td>
</tr>
</tbody>
</table>

#### Implication for supervisory policy

<table>
<thead>
<tr>
<th>Possible problems</th>
<th>Solution</th>
</tr>
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<tbody>
<tr>
<td></td>
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</tbody>
</table>