D. Risk Factors

Risks relating to us

Since our loan portfolio is highly concentrated in Spain, adverse changes affecting the Spanish economy could have a material adverse effect on our financial condition.

We historically have developed our lending business in Spain, which continues to be our main place of business. As of December 31, 2008, business activity in Spain accounted for 61.4% of our loan portfolio. See "Item 4. Information on the Company — Selected Statistical Information — Loans and Advances to Customer — Loans by Geographic Area". After rapid economic growth of 3.7% and 3.9% in 2007 and 2006, respectively, the rate of growth in Spanish gross domestic product slowed to 1.2% in 2008 and is expected to contract 2.8% in 2009, according to the Bank of Spain. Because of this, it is expected that economic conditions and employment will continue to deteriorate in 2009, and the rate of growth in gross domestic product, if any, in 2010 will be below that witnessed in 2006 and 2007. Growth forecasts for the Spanish economy are being revised downwards due to lower domestic demand and the impact of the financial crisis. The Spanish economy is affected by the slowdown in global growth, which is especially severe in the most important markets for Spanish goods and services exports, such as the rest of the Euro area. Besides, in these tight international financial market conditions, one of the weaknesses of the Spanish economy is its heightened need for foreign financing, as reflected by the high current account deficit. If the Spanish economy faces difficulties to make the payments associated with this deficit, this will further damage its economic situation.

Our loan portfolio in Spain has been adversely affected by the deterioration of the Spanish economy. For example, substandard loans to other resident sectors in Spain increased in 2008 mainly due to the increase in substandard mortgage loans, which increased sharply to €2,033 million as of December 31, 2008 from €421 million as of December 31, 2007. Substandard loans to real estate and construction customers in Spain increased in 2008 to account for 5.63% of loans in such category. Our total substandard loans to customers in Spain jumped to €5,700 million as of December 31, 2008, compared to €1,590 million as of December 31, 2007, principally due to an increase in substandard loans to customers in Spain generally as a result of the less favorable macroeconomic environment. As a result of the increase in total substandard loans to customers in Spain described above, our total substandard loans to customers in Spain as a percentage of total loans and receivables to customers in Spain increased sharply to 2.73% from 0.78%. Our loan loss reserves to customers in Spain as a percentage of substandard loans to customers in Spain as of December 31, 2008 declined significantly to 66.07% from 213.51% as of December 31, 2007.

Given the concentration of our loan portfolio in Spain, any adverse changes affecting the Spanish economy are likely to have a significant adverse impact on our loan portfolio and, as a result, on our financial condition, results of operations and cash flows.

A substantial percentage of our customer base is particularly sensitive to adverse developments in the economy, which renders our lending activities relatively riskier than if we lent primarily to higher-income customer segments.

Medium- and small-size companies and middle- and lower-middle- income individuals typically have less financial strength than large companies and high-income individuals and accordingly can be expected to be more negatively affected by adverse developments in the economy. As a result, it is generally accepted that lending to these segments of our existing and targeted customer base represents a relatively higher degree of risk than lending to other groups.

A substantial portion of our loan portfolio consists of residential mortgages and consumer loans to middle- and lower-middle-income customers and commercial loans to medium- and small-size companies. Consequently, during periods of slowdown in economic activity we may experience higher levels of past due amounts which could result in higher levels of allowance for loan losses. We cannot assure you that we will not suffer substantial adverse effects on our base loan portfolio to these customer segments in the event of additional adverse developments in the economy.

Increased exposure to real estate in Spain makes us more vulnerable to developments in this market.

In the years prior to 2008 the sound economic growth, the strength of the labor market and a decrease in interest rates in Spain caused an increase in the demand for mortgage loans. This had repercussions in housing prices, which rose significantly. After this buoyant period, demand started adjusting more than two years ago, in mid-2006. In the last quarter of 2008 and first months of 2009, supply of new homes has adjusted more sharply in the residential market in Spain, but a significant excess of unsold homes still exist in the market. In the remainder of 2009, we expect housing supply and demand to adjust further, in particular if the current financial situation continues. In addition, in countries where the housing markets have been booming, the ongoing adjustment may intensify. As residential mortgages are one of our main assets, comprising 25%, 26% and 26% of our loan portfolio as of December 31, 2008, 2007 and 2006, respectively, we are currently highly exposed to developments in residential real estate markets. We expect the worsening financial conditions and the deterioration of the economic activity already underway in Spain to intensify the adjustment process in the Spanish real estate sector. As a result, we expect housing prices to decline in the remainder of 2009. Adverse changes in the Spanish real estate sector could have a significant impact on our loan portfolio and, as a result, on our financial condition and results of operations.

Highly-indebted households and corporations could endanger our asset quality and future revenues.

Spanish households and businesses have reached, in recent years, a high level of indebtedness, which represents increased risk for the Spanish banking system. The high proportion of loans referenced to variable interest rates makes debt service on such loans more vulnerable to changes in interest rates than in the past. In fact, the debt burden of the Spanish households on disposable income has increased substantially from 12.4% in 2003 to 16.3% in 2008. Similarly, the debt burden of Spanish corporations has increased from 16% at the end of 2004 to 29% in 2008, according to the Bank of Spain. Highly indebted households and businesses are more likely to be unable to service debt obligations as a result of adverse economic events, which could have an adverse affect on our financial condition and results of operations. In addition, the increase in households' and businesses' indebtedness also limits their ability to incur additional debt, decreasing the number of new products we may otherwise be able to sell them and limiting our ability to attract new customers in Spain satisfying our credit standards, which could have an adverse effect on our ability to achieve our growth plans.

Current economic conditions may make it more difficult for us to continue funding our business on favorable terms or at all.

Historically, one of our principal sources of funds has been savings and demand deposits. Time deposits represented 35.8%, 26.7% and 23.3% of our total funding as of December 31, 2008, 2007 and 2006, respectively. Large-denomination time deposits may, under some circumstances, such as during periods of significant changes in market interest rates for these types of deposit products and resulting increased competition for such funds, be a less stable source of deposits than savings and demand deposits. The crisis triggered by the U.S. subprime market has turned out to be deeper and more persistent than expected. Central banks' interventions have had a limited effect so far. New issuances in wholesale markets have been scarce, expensive and restricted to a few countries, and the interbank markets have limited liquidity, in particular after the Lehman Brothers collapse. The global economic environment is particularly adverse, with a worsening financial crisis that is spreading to previously-unaffected countries and areas of the economy. Governments around the world are implementing ambitious fiscal expansion programs, trying to boost their economies. Announcements in January 2009 amount to a substantial fiscal stimulus for the global economy. Fiscal policy may offer the best chance to limit economic deterioration, but execution risks are large. In this context, we cannot assure you that we will be able to continue funding our business or, if so, maintain our current levels of funding without incurring higher funding costs or having to liquidate certain of our assets.

We face increasing competition in our business lines.

The markets in which we operate are highly competitive. Financial sector reforms in the markets in which we operate have increased competition among both local and foreign financial institutions, and we believe that this trend will continue. In addition, the trend towards consolidation in the banking industry has created larger and stronger banks with which we must now compete, some of which have recently received public capital.

We also face competition from non-bank competitors, such as:

- department stores (for some credit products);
- automotive finance corporations;
- leasing companies;
- factoring companies;
- mutual funds;
- pension funds; and
- insurance companies.

We cannot assure you that this competition will not adversely affect our business, financial condition, cash flows and results of operations.

Our business is particularly vulnerable to volatility in interest rates.

Our results of operations are substantially dependent upon the level of our net interest income, which is the difference between interest income from interest-earning assets and interest expense on interest-bearing liabilities. Interest rates are highly sensitive to many factors beyond our control, including deregulation of the financial sectors in the markets in which we operate, monetary policies pursued by the EU and national governments, domestic and international economic and political conditions and other factors.

Changes in market interest rates could affect the spread between interest rates charged on interest-earning assets and interest rates paid on interest-bearing liabilities and thereby negatively affect our results of operations. For example, an increase in interest rates could cause our interest expense on deposits to increase more significantly and quickly than our interest income from loans, resulting in a reduction in our net interest income.

Since approximately 69% of our loan portfolio consists of variable interest rate loans maturing in more than one year, our business is particularly vulnerable to volatility in interest rates.

Our financial statements and periodic disclosure under securities laws may not give you the same information as financial statements prepared under U.S. accounting rules and periodic disclosures provided by domestic U.S. issuers.

Publicly available information about public companies in Spain is generally less detailed and not as frequently updated as the information that is regularly published by or about listed companies in the United States. In addition, although we are subject to the periodic reporting requirements of the United States Securities Exchange Act of 1934 (the **"Exchange Act"**), the periodic disclosure required of foreign issuers under the Exchange Act is more limited than the periodic disclosure required of U.S. issuers. Finally, we maintain our financial accounts and records and prepare our financial statements in conformity EU-IFRS required to be applied under the Bank of Spain's Circular 4/2004, which differs in certain respects from U.S. GAAP, the financial reporting standard to which many investors in the United States may be more accustomed. See Note 58 of the Consolidated Financial Statements for the presentation of our stockholders' equity and net income reconciled to U.S. GAAP.

We have a substantial amount of commitments with personnel considered wholly unfunded due to the absence of qualifying plan assets.

Our commitments with personnel which are considered to be wholly unfunded are recognized under the heading "Provisions — Funds for Pensions and Similar Obligations" in the accompanying consolidated balance sheets. These amounts include "Post-employment benefits", "Early Retirements" and "Post-employment welfare benefits", which amounted to €2,638 million, €3,437 million and €284 million, respectively, as of December 31, 2008 (€2,683 million, €2,950 million and €300 million, respectively, as of December 31, 2007). These amounts are considered wholly unfunded due to the absence of qualifying plan assets.

We face liquidity risk in connection with our ability to make payments on these unfunded amounts which we seek to mitigate, with respect to "Post-employment benefits", by maintaining insurance contracts which were contracted with insurance companies owned by the Group. The insurance companies have recorded in their balance sheets specific assets (fixed interest deposit and bonds) assigned to the funding of these commitments. The insurance companies also manage derivatives (primarily swaps) to mitigate the interest rate risk in connection with the payments of these commitments. We seek to mitigate liquidity risk with respect to "Early Retirements" and "Post-employment welfare benefits" through oversight by the Group's Assets and Liabilities Committee (**"ALCO"**). The Group's ALCO manages a specific asset portfolio to mitigate the liquidity risk regarding the payments of these commitments. These assets are government and cover bonds (AAA/AA rated) which are issued at fixed interest rates with maturities matching the aforementioned commitments. The Group's ALCO also manages derivatives (primarily swaps) to mitigate the interest rate risk in connection with the payments of these commitments.

Risks Relating to Latin America

Events in Mexico could adversely affect our operations.

We are substantially dependant on our Mexican operations, with approximately 39% of our net income attributed to parent company in 2008 being generated in Mexico. We face several types of risks in Mexico which could adversely affect our banking operations in Mexico or the Group as a whole. Given the internationalization of the financial crisis, the Mexican economy is feeling the effects of the global crisis and the adjustment process that was underway is accelerating. This process has intensified since the end of the third quarter of 2008 and we expect it to continue at least during the first half of 2009 through a lower growth rate in production and employment. The initial effects are in manufacturing and in those areas with a greater degree of exposure to the international environment, although internal demand is also showing clear signs of moderation. We cannot rule out the possibility that in a more unfavorable environment for the United States or otherwise growth in Mexico would be negative in 2009.

Our mortgage and especially our consumer loan portfolio in Mexico started showing higher delinquency rates and, if there is a persistent increase in unemployment rates, which could arise if there is a more pronounced slowdown in the United States, it is likely that such rates will further increase.

In addition, price regulation and competition could squeeze the profitability of our Mexican subsidiary. For example, in order to increase competition and to deepen credit, Mexican financial regulators could elect to introduce price distortions not linked to the true risk premium. If this were to occur, the market share of our Mexican subsidiary could decrease given its risk management standards.

Finally, political instability or social unrest could weigh on the economic outlook, which could increase economic uncertainty and capital outflows.

Any of these risks or other adverse developments in laws, regulations, public policies or otherwise in Mexico may adversely affect the business, financial condition, operating results and cash flows of our Mexican subsidiary or the Group as a whole.

Our Latin American subsidiaries' growth, asset quality and profitability may be affected by volatile macroeconomic conditions, including government default on public debt, in the Latin American countries where they operate.

The Latin American countries in which we operate have experienced significant economic volatility in recent decades, characterized by slow growth, declining investment and significant inflation. This volatility has resulted in fluctuations in the levels of deposits and in the relative economic strength of various segments of the economies to which we lend. Negative and fluctuating economic conditions, such as a changing interest rate environment, also affect our profitability by causing lending margins to decrease and leading to decreased demand for higher-margin products and services.

Negative and fluctuating economic conditions in some Latin American countries could result in government defaults on public debt. This could affect us in two ways: directly, through portfolio losses, and indirectly, through instabilities that a default in public debt could cause to the banking system as a whole, particularly since commercial banks' exposure to government debt is generally high in several Latin American countries in which we operate.

While we seek to mitigate these risks through what we believe to be conservative risk policies, no assurance can be given that our Latin American subsidiaries' growth, asset quality and profitability will not be further affected by volatile macroeconomic conditions in the Latin American countries in which we operate.

Latin American economies can be directly and negatively affected by adverse developments in other countries.

Financial and securities markets in Latin American countries in which we operate, are to varying degrees, influenced by economic and market conditions in other countries in Latin America and beyond. Negative developments in the economy or securities markets in one country may have a negative impact on other emerging market economies. These developments may adversely affect the business, financial condition, operating results and cash flows of our subsidiaries in Latin America. In particular, the current international financial crisis is starting to have a negative impact on Latin American markets as commodities prices have declined significantly and risk premiums and funding costs have increased. If the global financial crisis continues and, in particular, if the effects on the Chinese and U.S. economies intensify the business, financial condition, operating results and cash flows of our subsidiaries in Latin America are likely to be materially adversely affected.

We are exposed to foreign exchange and, in some instances, political risks as well as other risks in the Latin American countries in which we operate, which could cause an adverse impact on our business, financial condition, results of operations.

We operate commercial banks in nine Latin American countries and our overall success as a global business depends, in part, upon our ability to succeed in differing economic, social and political conditions. We are confronted with different legal and regulatory requirements in many of the jurisdictions in which we operate. These include, but are not limited to, different tax regimes and laws relating to the repatriation of funds or nationalization of assets. Our international operations may also expose us to risks and challenges which our local competitors may not be required to face, such as exchange rate risk, difficulty in managing a local entity from abroad, and political risk which may be particular to foreign investors. Our presence in these markets requires us to respond to rapid changes in market conditions in these countries. We cannot assure you that we will continue to succeed in developing and implementing policies and strategies that are effective in each country in which we operate or that any of the foregoing factors will not have a material adverse effect on our business, financial condition and results of operations.

Regulatory changes in Latin America that are beyond our control may have a material effect on our business, financial condition, results of operations and cash flows.

A number of banking regulations designed to maintain the safety and soundness of banks and limit their exposure to risk are applicable in certain Latin American countries in which we operate. Local regulations differ in a number of material respects from equivalent regulations in Spain and the United States.

Changes in regulations that are beyond our control may have a material effect on our business and operations, particularly in Venezuela. In addition, since some of the banking laws and regulations have been recently adopted, the manner in which those laws and related regulations are applied to the operations of financial institutions is still evolving. No assurance can be given that laws or regulations will be enforced or interpreted in a manner that will not have a material adverse effect on our business, financial condition, results of operations and cash flows.

Risks Relating to Other Countries

Our strategic growth in Asia exposes us to increased regulatory, economic and geopolitical risk relating to emerging markets in the region, particularly in China.

In 2008, we further increased our ownership interest in members of the CITIC Group, a Chinese banking group, by increasing our stake in CITIC International Financial Holdings Ltd (**"CIFH"**) up to 29.7% and China

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CITIC Bank (**"CNCB"**) up to 10.07%. CIFH is a banking entity headquartered in Hong Kong and previously listed on the Hong Kong stock exchange. See "Item 4. Information on the Company — Business Overview — Global Businesses (Wholesale Banking and Asset Management)".

As a result of our expansion into Asia, we are exposed to increased risks relating to emerging markets in the region, particularly in China. The Chinese government has exercised, and continues to exercise, significant influence over the Chinese economy. Chinese governmental actions concerning the economy and state-owned enterprises could have a significant effect on Chinese private sector entities in general, and on CNCB or CIFH in particular.

We also are exposed to regulatory uncertainty and geopolitical risk as a result of our investments in Asia. Changes in laws or regulations or in the interpretation of existing laws or regulations, whether caused by a change in government or otherwise, could adversely affect our investments. Moreover, Asian economies can be directly and negatively affected by adverse developments in other countries in the region and beyond.

Any of these developments could have a material adverse effect on our investments in Asia or the business, financial condition, results of operations and cash flows of the Group.

Our continued expansion in the United States increases our exposure to the U.S. market.

Our expansion in the United States makes us more vulnerable to developments in this market, particularly the real estate market. In the years prior to 2008, the sound economic growth, the strength of the labor market and a decrease in interest rates in the United States caused an increase in the demand for mortgage loans. This had repercussions in housing prices, which also rose significantly. During the summer of 2007, the difficulties experienced by the subprime mortgage market triggered a real estate and financial crisis, which has significant affected the real economy and which has resulted in significant by volatility and uncertainty in markets and economies around the world. As we have acquired entities in the United States, particularly Compass, our exposure to the U.S. market has increased. In addition, adverse changes to the U.S. economy in general, or the U.S. real estate market in particular, has had and could continue to have a material adverse effect on the business, financial condition, results of operations and cash flows of our subsidiary Compass, which could negatively affect to our expected returns on our acquisition of Compass.

Regulatory risks

Governmental responses to recent market disruptions may be inadequate and may have unintended consequences.

In response to recent market disruptions, legislators and financial regulators have taken a number of steps to stabilize the financial markets. These steps have included various fiscal stimulus programs and the provision of direct and indirect assistance to distressed financial institutions, assistance by banking authorities in arranging acquisitions of weakened banks and broker/dealers, implementation of various programs by regulatory authorities to provide liquidity to various credit markets and temporary prohibitions on short sales of certain financial institution securities. Additional legislative and regulatory measures are under consideration in various countries around the world, including, for example in the United States, where measures with respect to modifications of residential mortgages and an overhaul of the financial regulatory framework are under consideration. The overall effects of these and other legislative and regulatory efforts on the financial markets are uncertain and may not have the intended stabilization effects. In addition to these actions, various regulatory authorities in member states of the European Union and the United States have taken regulatory steps to support financial institutions, to guarantee deposits and to seek to stabilize the financial markets. Should these or other legislative or regulatory initiatives fail to stabilize the financial markets, our business, financial condition, results of operations, cash flow and business plans could be adversely affected.

In addition, while these measures have been taken to support the markets, they may have unintended consequences on the global financial system or our businesses, including reducing competition, increasing the general level of uncertainty in the markets or favoring or disfavoring certain lines of business, institutions or depositors. We cannot predict the effect of any regulatory changes resulting from recent market disruptions and any