D. Risk factors.

1. Macro-Economic and Political Risks

1.1 *Our growth, asset quality and profitability may be adversely affected by volatile macroeconomic and political conditions.*

Our loan portfolio is concentrated in Continental Europe (in particular, Spain), the United Kingdom, Latin America and the United States. At December 31, 2016, Continental Europe accounted for 38% of our total loan portfolio (Spain accounted for 19% of our total loan portfolio), the United Kingdom (where the loan portfolio consists primarily of residential mortgages) accounted for 32%, Latin America accounted for 19% (of which Brazil represents 10% of our total loan portfolio) and the United States accounted for 11%. Accordingly, the recoverability of these loan portfolios in particular, and our ability to increase the amount of loans outstanding and our results of operations and financial condition in general, are dependent to a significant extent on the level of economic activity in Continental Europe (in particular, Spain), the United Kingdom, Latin America and the United States. In addition, we are exposed to sovereign debt in these regions. A return to recessionary conditions in the economies of Continental Europe (in particular, Spain), the United Kingdom, some of the Latin American countries in which we operate or the United States, or continued recessionary conditions in Brazil, would likely have a significant adverse impact on our loan portfolio and sovereign debt holdings and, as a result, on our financial condition, cash flows and results of operations. See “Item 4. Information on the Company—B. Business Overview”.

Our revenues are also subject to risk of loss from unfavorable political and diplomatic developments, social instability, and changes in governmental policies, including expropriation, nationalization, international ownership legislation, interest-rate caps and tax policies, some or all of which have occurred in Latin America.

The economies of some of the countries where we operate have been affected in the past twelve months by a series of political events, including the UK’s vote to leave the EU in June 2016, which caused significant volatility (for more information, see the risk factor 1.2 entitled ‘Exposure to UK political developments, including the outcome of the UK referendum on membership of the European Union, could have a material adverse effect on us’) and has given rise to increasing anti-EU sentiment and populist movements in other EU member states. There can be no assurance that the European and global economic environments will not continue to be affected by political developments, including elections in 2017 in key EU member states.

The economies of some of the countries where we operate, particularly in Latin America, have experienced significant volatility in recent decades. This volatility resulted in fluctuations in the levels of deposits and in the relative economic strength of various segments of the economies to which we lend. In addition, some of the countries where we operate are particularly affected by commodities price fluctuations, which in turn may affect financial market conditions through exchange rate fluctuations, interest rate volatility and deposits volatility. Negative and fluctuating economic conditions, such as slowing or negative growth and a changing interest rate environment, impact our profitability by causing lending margins to decrease and credit quality to decline and leading to decreased demand for higher margin products and services. For instance, Brazil’s present high rate of inflation, compounded by high and increasing interest rates, declining consumer spending and increasing unemployment, have had and may continue to have a material adverse impact on the Brazilian economy as a whole as well as on our financial condition and earnings in Brazil, which represented 22% of the profit attributable to the Parent bank’s total operating areas in 2016 and 10% of our total loans as of December 31, 2016. In addition, our business in Brazil will continue to be adversely affected by recessionary conditions and political instability in that country.

There is uncertainty over the long-term effects of the monetary and fiscal policies that have been adopted by the central banks and financial authorities of some of the world’s leading economies, including China. Furthermore, financial turmoil in emerging markets tends to adversely affect stock prices and debt securities prices of other emerging markets as investors move their money to more stable and developed markets. Continued or increased perceived risks associated with investing in emerging economies in general, or the emerging market economies where the Group operates in particular, could further dampen capital flows to such economies and adversely affect such economies, and as a result, could have an adverse impact on the Group’s business and results of operations.

The recent fall and subsequent fluctuation in oil prices may give rise to volatility in the global financial markets and further economic instability in oil-dependent regions, including emerging markets, to which the Group is exposed. In addition, the ability of borrowers in or exposed to the oil sector has been and may be further adversely affected by such price fluctuations.

Our growth, asset quality and profitability may be adversely affected by volatile macroeconomic and political conditions.

1.2 *Exposure to UK political developments, including the outcome of the UK referendum on membership of the European Union, could have a material adverse effect on us.*

On June 23, 2016, the UK held a non-binding referendum (the UK EU Referendum) on its membership in the EU, in which a majority voted for the UK to leave the EU. Immediately following the result, the UK and global stock and foreign exchange markets commenced a period of significant volatility, including a steep devaluation of the pound sterling, in addition to which there is now continuing uncertainty relating to the process, timing and negotiation of the UK’s exit from, and future relationship with, the EU.

On March 29, 2017, the UK gave notice under Article 50(2) of the Treaty on European Union of the UK’s intention to withdraw from the EU. This has triggered a two-year period of negotiation which will determine the new terms of the UK’s relationship with the EU, after which period the UK’s EU membership will cease. These negotiations are expected to run in parallel to standalone bilateral negotiations with the numerous individual countries and multilateral counterparties with which the UK currently has trading arrangements by virtue of its membership of the EU. The timing of, and process for, such negotiations and the resulting terms of the UK’s future economic, trading and legal relationships are uncertain.

While the longer term effects of the UK EU Referendum are difficult to predict, these are likely to include further financial instability and slower economic growth as well as higher unemployment and inflation, in the UK, continental Europe and the global economy, at least in the short to medium term. For instance, the UK could lose access to the single EU market and to the global trade deals negotiated by the EU on behalf of its members and this could affect the attractiveness of the UK as a global investment center and, as a result, could have a detrimental impact on UK growth. Potential further decreases in interest rates by the Bank of England or sustained low or negative interest rates would put further pressure on our interest margins and adversely affect our profitability and prospects.

The UK EU Referendum has also given rise to calls for certain regions within the UK to preserve their place in the EU by separating from the UK, as well as the potential for other EU Member States to consider withdrawal. For example, the outcome of the UK EU Referendum was not supported by the majority of voters in Scotland, who voted in favor of remaining in the EU. This has revived the political debate on a second referendum on Scottish independence. These developments, or the perception that any of them could occur, may have a material adverse effect on economic conditions and the stability of financial markets, and could significantly reduce market liquidity and restrict the ability of key market participants to operate in certain financial markets.

Asset valuations, currency exchange rates and credit ratings may be particularly subject to increased market volatility. The major credit rating agencies have downgraded and changed their outlook to negative on the UK’s sovereign credit rating following the UK EU Referendum. In addition, S&P Global Ratings and Moody’s Investors Service affirmed the long-term credit ratings and changed the ratings outlooks of the operating companies of most major UK banks because of the medium term impact of political and market uncertainty (for more information, see risk factor 2.2.2 “Credit, market and liquidity risk may have an adverse effect on our credit ratings and our cost of funds. Any downgrade in our credit rating would likely increase our cost of funding, require us to post additional collateral or take other actions under some of our derivative contracts and adversely affect our interest margins and results of operations”).

In addition, we are subject to substantial EU-derived regulation and oversight. There is now significant uncertainty as to the respective legal and regulatory environments in which our UK subsidiaries will operate when the UK is no longer a member of the EU, causing potentially divergent national laws and regulations across Europe should EU laws be replaced, in whole or in part, by UK laws on the same (or substantially similar) issues. For example, our UK subsidiaries are in the process of implementing a number of key restructuring and strategic initiatives, such as the ring-fencing of their retail banking activities, all of which will be carried out throughout this period of significant uncertainty. This may impact the prospects for successful execution and impose additional pressure on management. Operationally, our UK subsidiaries and other financial institutions may no longer be able to rely on the European passporting framework for financial services and could be required to apply for authorization in multiple EU jurisdictions, the costs, timing and viability of which is uncertain. This uncertainty, and any actions taken as a result of this uncertainty, as well as new or amended rules, may have a significant impact on our operations, profitability and business. In addition, the lack of clarity of the impact of the UK EU Referendum on foreign nationals’ long term residency permissions in the UK may make it challenging for our UK subsidiaries to retain and recruit adequate staff, which may adversely impact our business.

The UK political developments described above, along with any further changes in government structure and policies, may lead to further market volatility and changes to the fiscal, monetary and regulatory landscape in which we operate and could have a negative adverse effect on our financing availability and terms and, more generally, on our business, financial condition and results of operation.

1.3 *We are vulnerable to disruptions and volatility in the global financial markets.*

In the past nine years, financial systems worldwide have experienced difficult credit and liquidity conditions and disruptions leading to less liquidity and greater volatility (such as volatility in spreads). Global economic conditions deteriorated significantly between 2007 and 2009, and many of the countries in which we operate fell into recession. Although most countries have begun to recover, this recovery may not be sustainable. Many major financial institutions, including some of the world’s largest global commercial banks, investment banks, mortgage lenders, mortgage guarantors and insurance companies experienced, and some continue to experience, significant difficulties. Around the world, there have also been runs on deposits at several financial institutions, numerous institutions have sought additional capital or have been assisted by governments, and many lenders and institutional investors have reduced or ceased providing funding to borrowers (including to other financial institutions).

In particular, we face, among others, the following risks related to the economic downturn:

- Reduced demand for our products and services.
- Increased regulation of our industry. Compliance with such regulation will continue to increase our costs and may affect the pricing for our products and services, increase our conduct and regulatory risks related to non-compliance and limit our ability to pursue business opportunities.

- Inability of our borrowers to timely or fully comply with their existing obligations. Macroeconomic shocks may negatively impact the household income of our retail customers and may adversely affect the recoverability of our retail loans, resulting in increased loan losses.
- The process we use to estimate losses inherent in our credit exposure requires complex judgments, including forecasts of economic conditions and how these economic conditions might impair the ability of our borrowers to repay their loans. The degree of uncertainty concerning economic conditions may adversely affect the accuracy of our estimates, which may, in turn, impact the reliability of the process and the sufficiency of our loan loss allowances.
- The value and liquidity of the portfolio of investment securities that we hold may be adversely affected.
- Any worsening of global economic conditions may delay the recovery of the international financial industry and impact our financial condition and results of operations.

Despite recent improvements in certain segments of the global economy, uncertainty remains concerning the future economic environment. Such economic uncertainty could have a negative impact on our business and results of operations. A slowing or failing of the economic recovery would likely aggravate the adverse effects of these difficult economic and market conditions on us and on others in the financial services industry.

Increased volatility in the global financial markets could have a material adverse effect on us, including on our ability to access capital and liquidity on financial terms acceptable to us, if at all. If capital markets financing ceases to become available, or becomes excessively expensive, we may be forced to raise the rates we pay on deposits to attract more customers and become unable to maintain certain liability maturities. Any such increase in capital markets funding availability or costs or in deposit rates could have a material adverse effect on our interest margins and liquidity.

If all or some of the foregoing risks were to materialize, this could have a material adverse effect on our financing availability and terms and, more generally, on our results, financial condition and prospects.

Additionally, the results of the 2016 United States presidential and congressional elections have generated volatility in the global capital and currency markets and have created uncertainty about the relationship between the United States and Mexico and, to a lesser extent, other Latin American countries in which we have operations. Any continued volatility in the Mexican peso in particular or any material change to United States trade and immigration policy with respect to Mexico or other Latin American countries could have a material adverse effect on the economies of those countries and may materially harm the business, financial condition and results of operations of our subsidiaries, which could in turn materially harm our financial condition and results of operations.

1.4 We may suffer adverse effects as a result of economic and sovereign debt tensions in the eurozone.

Conditions in the capital markets and the economy generally in the eurozone continue to show signs of fragility and volatility, with political tensions in Europe being particularly heightened in the past twelve months. In addition, interest rate differentials among eurozone countries are affecting government finance and borrowing rates in those economies. These factors could have a material adverse effect on our operating results, financial condition and prospects.

The UK EU referendum caused significant volatility in the global stock and foreign exchange markets. It has also encouraged anti-EU and populist parties in other member states, raising the potential for other countries to seek to conduct referenda with respect to their continuing membership of the EU. On December 4, 2016, voters in Italy rejected constitutional reform proposals put forward by the Italian Prime Minister by way of referendum (the Italian referendum), which was generally regarded as portraying an anti-EU sentiment. Following the results of the UK EU referendum and the Italian referendum, the risk of further instability in the eurozone cannot be excluded, particularly in Germany and France, which are due to hold elections in 2017.

In the past, the European Central Bank (ECB) and European Council have taken actions with the aim of reducing the risk of contagion in the eurozone and beyond and improving economic and financial stability. Notwithstanding these measures, a significant number of financial institutions throughout Europe have substantial exposures to sovereign debt issued by eurozone (and other) nations, which may be under financial stress. Should any of those nations default on their debt, or experience a significant widening of credit spreads, major financial institutions and banking systems throughout Europe could be adversely affected, with wider possible adverse consequences for global financial market conditions.

We have direct and indirect exposure to financial and economic conditions throughout the eurozone economies. Concerns relating to sovereign defaults or a partial or complete break-up of the European Monetary Union, including potential accompanying redenomination risks and uncertainties, have significantly increased in light of the political and economic factors mentioned above. A deterioration of the economic and financial environment could have a material adverse impact on the whole financial sector, creating new challenges in sovereign and corporate lending and resulting in significant disruptions in financial activities at both the market and retail levels. This could materially and adversely affect our operating results, financial position and prospects.

2. Risks Relating to Our Business

2.1 *Legal, Regulatory and Compliance Risks*

2.1.1 We are exposed to risk of loss from legal and regulatory proceedings.

We face risk of loss from legal and regulatory proceedings, including tax proceedings, that could subject us to monetary judgments, regulatory enforcement actions, fines and penalties. The current regulatory and tax enforcement environment in the jurisdictions in which we operate reflects an increased supervisory focus on enforcement, combined with uncertainty about the evolution of the regulatory regime, and may lead to material operational and compliance costs.

We are from time to time subject to certain claims and party to certain legal proceedings incidental to the normal course of our business, including in connection with conflicts of interest, lending activities, relationships with our employees and other commercial or tax matters. In view of the inherent difficulty of predicting the outcome of legal matters, particularly where the claimants seek very large or indeterminate damages, or where the cases present novel legal theories, involve a large number of parties or are in the early stages of discovery, we cannot state with confidence what the eventual outcome of these pending matters will be or what the eventual loss, fines or penalties related to each pending matter may be. The amount of our reserves in respect of these matters is substantially less than the total amount of the claims asserted against us, and, in light of the uncertainties involved in such claims and proceedings, there is no assurance that the ultimate resolution of these matters will not significantly exceed the reserves currently accrued by us. As a result, the outcome of a particular matter may be material to our operating results for a particular period.

2.1.2 We are subject to substantial regulation and regulatory and governmental oversight which could adversely affect our business, operations and financial condition.

As a financial institution, we are subject to extensive regulation, which materially affects our businesses. The statutes, regulations and policies to which we are subject may be changed at any time. In addition, the interpretation and the application by regulators of the laws and regulations to which we are subject may also change from time to time. Extensive legislation and implementing regulation affecting the financial services industry has recently been adopted in regions that directly or indirectly affect our business, including Spain, the United States, the European Union, Latin America and other jurisdictions, and further regulations are in the process of being implemented. The manner in which those laws and related regulations are applied to the operations of financial institutions is still evolving. Moreover, to the extent these recently adopted regulations are implemented inconsistently in the various jurisdictions in which we operate, we may face higher compliance costs. Any legislative or regulatory actions and any required changes to our business operations resulting from such legislation and regulations, as well as any deficiencies in our compliance with such legislation and regulation, could result in significant loss of revenue, limit our ability to pursue business opportunities in which we might otherwise consider engaging and provide certain products and services, affect the value of assets that we hold, require us to increase our prices and therefore reduce demand for our products, impose additional compliance and other costs on us or otherwise adversely affect our businesses. In particular, legislative or regulatory actions resulting in enhanced prudential standards, in particular with respect to capital and liquidity, could impose a significant regulatory burden on the Bank or on its bank subsidiaries and could limit the bank subsidiaries' ability to distribute capital and liquidity to the Bank, thereby negatively impacting the Bank. Future liquidity standards could require the Bank to maintain a greater proportion of its assets in highly-liquid but lower-yielding financial instruments, which would negatively affect its net interest margin. Moreover, the Bank's regulatory authorities, as part of their supervisory function, periodically review the Bank's allowance for loan losses. Such regulators may require the Bank to increase its allowance for loan losses or to recognize further losses. Any such additional provisions for loan losses, as required by these regulatory agencies, whose views may differ from those of the Bank's management, could have an adverse effect on the Bank's earnings and financial condition. Accordingly, there can be no assurance that future changes in regulations or in their interpretation or application will not adversely affect us.

The wide range of regulations, actions and proposals which most significantly affect the Bank, or which could most significantly affect the Bank in the future, relate to capital requirements, funding and liquidity, development of a fiscal and banking union in the European Union and regulatory reforms in the United States, and are discussed in further detail below. These and other regulatory reforms adopted or proposed in the wake of the financial crisis have increased and may continue to materially increase our operating costs and negatively impact our business model. Furthermore, regulatory authorities have substantial discretion in how to regulate banks, and this discretion, and the means available to the regulators, have been increasing during recent years. Regulation may be imposed on an ad hoc basis by governments and regulators in response to a crisis, and these may especially affect financial institutions such as the Bank that are deemed to be a global systemically important institution ("G-SII"). In addition, the volume, granularity, frequency and scale of regulatory and other reporting requirements necessitate a clear data strategy to enable consistent data aggregation, reporting and management. Inadequate management information systems or processes, including those relating to risk data aggregation and risk reporting, could lead to a failure to meet regulatory reporting requirements or other internal or external information demands and we may face supervisory measures as a result.

The main regulations and regulatory and governmental oversight that can adversely impact us include but are not limited to the following (see more details on "Item 4. Information on the Company—B. Business Overview—Supervision and Regulation):

Capital requirements, liquidity, funding and structural reform

Increasingly onerous capital requirements constitute one of our main regulatory challenges. Increasing capital requirements may adversely affect our profitability and create regulatory risk associated with the possibility of failure to maintain required capital levels. As a Spanish financial institution, we are subject to the Capital Requirements Regulation (Regulation (EU) No 575/2013) (“CRR”) and the Capital Requirements Directive (Directive 2013/36/EU) (“CRD IV”), through which the EU began implementing the Basel III capital reforms from January 1, 2014, with certain requirements in the process of being phased in until January 1, 2019. While the CRD IV required national transposition, the CRR was directly applicable in all the EU member states. This regulation is complemented by several binding technical standards and guidelines issued by the European Banking Authority (“EBA”), directly applicable in all EU member states, without the need for national implementation measures either. The implementation of the CRD IV into Spanish law has largely taken place through Royal Decree Law 14/2013 and Law 10/2014, Bank of Spain Circular 2/2014 and Bank of Spain Circular 2/2016. Credit institutions, such as us, are required, on a standalone and consolidated basis, to hold a minimum amount of regulatory capital of 8% of risk weighted assets (of which at least 4.5% must be Common Equity Tier 1 (“CET1”) capital and at least 6% must be Tier 1 capital). In addition to the minimum regulatory capital requirements, the CRD IV also introduced capital buffer requirements that must be met with CET1 capital. The CRD IV introduces five new capital buffers: (1) the capital conservation buffer for unexpected losses, requiring additional CET1 of up to 2.5% of total weighted exposures; (2) the institution-specific counter-cyclical capital buffer, requiring additional CET1 of up to 2.5% of total weighted exposures; (3) the G-SIIs buffer of between 1% and 3.5% of CET1; (4) the other systemically important institutions buffer, which may be as much as 2% of CET1; and (5) the CET1 systemic risk buffer. Beginning in 2016, and subject to the applicable phase-in period, entities are required to comply with the “combined buffer requirement” (broadly, the combination of the capital conservation buffer, the institution-specific counter-cyclical buffer and the higher of (depending on the institution) the systemic risk buffer, the global systemically important institutions buffer and the other systemically important financial institutions buffer, in each case as applicable to the institution).

We will be required to maintain a capital conservation buffer of 2.5% and a systemically important institutions buffer of 1%, in each case considered on a fully loaded basis. However, as of the date of this report, due to the application of the phase-in period, we are required to maintain a conservation buffer of 1.25% and a systemically important institutions buffer of 0.5%.

Article 104 of the CRD IV, as implemented by Article 68 of Law 10/2014, and similarly Article 16 of Council Regulation (EU) No 1024/2013 of October 15, 2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions (the “SSM Regulation”), also contemplate that in addition to the minimum “Pillar 1” capital requirements (including, if applicable, any buffer capital as discussed above), supervisory authorities may impose further “Pillar 2” capital requirements to cover other risks, including those not considered to be fully captured by the minimum capital requirements under the CRD IV or to address macro-prudential considerations. This may result in the imposition of additional capital requirements on us pursuant to this “Pillar 2” framework. Any failure by us to maintain our “Pillar 1” minimum regulatory capital ratios and any “Pillar 2” additional capital requirements could result in administrative actions or sanctions, which, in turn, may have a material adverse impact on our results of operations.

The ECB is required to carry out, at least on an annual basis, assessments under the CRD IV of the additional “Pillar 2” capital requirements that may be imposed for each of the European banking institutions subject to the Single Supervisory Mechanism (the “SSM”). Any additional capital requirement that may be imposed on us by the ECB pursuant to these assessments may require us to hold capital levels similar to, or higher than, those required under the full application of the CRD IV. There can be no assurance that we will be able to continue to maintain such capital ratios.

In addition to the above, the EBA published on December 19, 2014 its final guidelines for common procedures and methodologies in respect of its supervisory review and evaluation process (“SREP”). Included in this were the EBA’s proposed guidelines for a common approach to determining the amount and composition of additional capital requirements implemented on January 1, 2016. Under these guidelines, national supervisors must set a composition requirement for the additional capital requirements to cover certain specified risks of at least 56% CET1 capital and at least 75% Tier 1 capital. The guidelines also contemplate that national supervisors should not set additional capital requirements in respect of risks which are already covered by capital buffer requirements and/or additional macro-prudential requirements; and, accordingly, the above “combined buffer requirement” is in addition to the minimum capital requirement and to the additional capital requirement. In this regard, under Article 141 of the CRD IV, Member States of the EU must require that an institution that fails to meet the “combined buffer requirement” or the “Pillar 2” capital requirements described above, will be prohibited from paying any “discretionary payments” (which are defined broadly by the CRD IV as payments relating to CET1, variable remuneration and payments on Additional Tier 1 capital instruments), until it calculates its applicable restrictions and communicates them to the regulator and, once completed, such institution will be subject to restricted “discretionary payments”. The restrictions will be scaled according to the extent of the breach of the “combined buffer requirement” and calculated as a percentage of the profits of the institution since the last distribution of profits or “discretionary payment”. Such calculation will result in a “Maximum Distributable Amount” in each relevant period. As an example, the scaling is such that in the bottom quartile of the “combined buffer requirement”, no “discretionary distributions” will be permitted to be paid. Articles 43 to 49 of Law 10/2014 and Chapter II of Title II of Royal Decree 84/2015 implement the above provisions in Spain. In particular Article 48 of Law 10/2014 and Articles 73 and 74 of Royal Decree 84/2014 deal with restrictions on distributions.

In connection with this, we announced that we had received from the ECB its decision regarding prudential minimum capital phase-in requirements for 2017, following the results of SREP. The ECB decision requires us to maintain a CET1 capital ratio of 7.75% on a consolidated basis. This 7.75% capital requirement includes: the minimum Pillar 1 requirement (4.5%); the Pillar 2 requirement (1.5%); the capital conservation buffer (1.25%); and the requirement from its consideration as a G-SII (0.5%). The ECB decision also requires that Banco Santander, S.A. maintain a CET1 capital ratio of at least 7.25% on an individual basis. This 7.25% capital requirement includes: the minimum Pillar 1 requirement (4.5%), the Pillar 2 requirement (1.5%) and the capital conservation buffer (1.25%). These capital requirements do not result in any limitations referred to in the CRR to distributions in the form of dividends, variable remuneration and coupon payments to holders of AT1 instruments.

In addition to the above, the CRR also includes a requirement for institutions to calculate a leverage ratio ("LR"), report it to their supervisors and to disclose it publicly from January 1, 2015 onwards. More precisely, Article 429 of the CRR requires institutions to calculate their LR in accordance with the methodology laid down in that article. In January 2014, the Basel Committee finalized a definition of how the LR should be prepared and set an indicative benchmark (namely 3% of Tier 1 capital). Such 3% Tier 1 LR has been tested during a monitoring period until 2017 when the Basel Committee will decide on the final calibration. Accordingly, the CRR does not currently contain a requirement for institutions to have a capital requirement based on the LR though prospective investors should note the European Commission's proposal amending the CRR that are mentioned below. The European Commission's proposals contain a binding 3% CET1 LR requirement, which would be added to the CRR and would be applicable (subject to limited exceptions) to all institutions subject to the CRD IV from January 1, 2018. The potential for the introduction of a LR buffer for G-SIIs at some point in the future is also noted in the proposals.

On November 9, 2015, the Financial Stability Board (the "FSB") published its final principles and term sheet containing an international standard to enhance the loss absorbing capacity of G-SIIs such as us. The final standard consists of an elaboration of the principles on loss absorbing and recapitalization capacity of G-SIIs in resolution and a term sheet setting out a proposal for the implementation of these proposals in the form of an internationally agreed standard on total loss absorbing capacity ("TLAC") for G-SIIs. Once implemented in the relevant jurisdictions, these principles and terms will form a new minimum TLAC standard for G-SIIs, and in the case of G-SIIs with more than one resolution group, each resolution group within the G-SII. The FSB will undertake a review of the technical implementation of the TLAC principles and term sheet by the end of 2019. The TLAC principles and term sheet require a minimum TLAC requirement to be determined individually for each G-SII at the greater of (a) 16% of risk weighted assets as of January 1, 2019 and 18% as of January 1, 2022, and (b) 6% of the Basel III Tier 1 leverage ratio exposure measure as of January 1, 2019, and 6.75% as of January 1, 2022.

Furthermore, Article 45 of the European Bank Recovery and Resolution Directive (Directive 2014/59/EU) ("BRRD") provides that member states shall ensure that institutions meet, at all times, a minimum requirement for own funds and eligible liabilities ("MREL"). The MREL shall be calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution. The EBA was in charge of drafting regulatory technical standards on the criteria for determining MREL (the "MREL RTS"). On July 3, 2015, the EBA published the final draft MREL RTS. In application of Article 45(2) of the BRRD, the current version of the MREL RTS is set out in a Commission Delegated Regulation (C(2016) 2976 final) that was adopted by the Commission on May 23, 2016.

The MREL requirement was scheduled to come into force by January 2016. However, the EBA has recognized the impact which this requirement may have on banks' funding structures and costs. Therefore, it has proposed a long phase-in period of 48 months (four years) until 2020.

The European Commission committed to review the existing MREL rules with a view to provide full consistency with the TLAC standard by considering the findings of a report that the EBA is required to provide to the European Commission under Article 45(19) of the BRRD. On July 19, 2016, the EBA published an interim version of the report on implementation and design of the MREL framework where it stated that its provisional view is that the preferred option should be changing the reference base of MREL to risk weighted assets. The final report was published on December 14, 2016.

On November 23, 2016, the European Commission published a proposal for a European Directive amending the BRRD and a proposal for a European Regulation amending Regulation (EU) No. 806/2014 which was passed on July 15, 2014 and became effective from January 1, 2015 (the "SRM Regulation"). The main objective of these proposals is to implement the total loss-absorbing capacity ("TLAC") standard and to integrate the TLAC requirement into the general MREL rules (the "TLAC/MREL Requirements") thereby avoiding duplication from the application of two parallel requirements. As mentioned above, although TLAC and MREL pursue the same regulatory objective, there are, nevertheless, some differences between them in the way they are constructed. The European Commission is proposing to integrate the TLAC standard into the existing MREL rules and to ensure that both requirements are met with largely similar instruments, with the exception of the subordination requirement, which will be institution-specific and determined by the resolution authority. Under these proposals, institutions such as us would continue to be subject to an institution-specific MREL requirement, which may be higher than the requirement of the TLAC standard.

The European Commission's proposals require the introduction of limited adjustments to the existing MREL rules ensuring technical consistency with the structure of any requirements for G-SIIs. In particular, technical amendments to the existing rules on MREL are needed to align them with the TLAC standard regarding inter alia the denominators used for measuring loss-absorbing capacity, the interaction with capital buffer requirements, disclosure of risks to investors, and their application in relation to different resolution strategies. Implementation of the TLAC/MREL Requirements is expected to be phased-in from January 1, 2019 (a 16% minimum TLAC requirement) to January 1, 2022 (an 18% minimum TLAC requirement).

Although there is continued uncertainty regarding the final form of TLAC requirements, we intend to focus our funding plan in 2017 and 2018 on the issuance of TLAC-eligible instruments. Based on our current financial forecast and our expectations for the TLAC requirements, we estimate that we will issue an aggregate of approximately €33-44 billion of qualifying debt in the two year period ending December 31, 2018, €26 - 32 billion of which would be issued at the parent company level, with the remainder issued by our subsidiaries that are expected to be subject to TLAC requirements, Santander Consumer Finance, Santander UK and SHUSA. In addition, we estimate that we will issue an aggregate of approximately €4 billion of Additional Tier 1 instruments and approximately €4 billion of Tier 2 subordinated instruments. We also estimate that our subsidiaries will issue an aggregate of approximately €10-13 billion of senior preferred debt.

While the general goal of these proposals is now well understood, it is too early to confirm the exact amendments that will be introduced and consequently the precise impact on us.

Any failure by an institution to meet the applicable minimum TLAC/MREL Requirements is intended to be treated in the same manner as a failure to meet minimum regulatory capital requirements, where resolution authorities must ensure that they intervene and place an institution into resolution sufficiently early if it is deemed to be failing or likely to fail and there is no reasonable prospect of recovery.

Additionally, the Basel Committee is currently in the process of reviewing and issuing recommendations in relation to risk asset weightings which may lead to increased regulatory scrutiny of risk asset weightings in the jurisdictions who are members of the Basel Committee.

EU fiscal and banking union

The project of achieving a European banking union was launched in the summer of 2012. Its main goal is to resume progress towards the European single market for financial services by restoring confidence in the European banking sector and ensuring the proper functioning of monetary policy in the Eurozone.

The banking union is expected to be achieved through new harmonized banking rules (the single rulebook) and a new institutional framework with stronger systems for both banking supervision and resolution that will be managed at the European level. Its two main pillars are the SSM and the Single Resolution Mechanism (“SRM”).

The SSM (comprised by both the ECB and the national competent authorities) is designed to assist in making the banking sector more transparent, unified and safer. In accordance with the SSM Regulation, the ECB fully assumed its new supervisory responsibilities within the SSM, in particular direct supervision of the 126 largest European banks (including the Bank), on November 4, 2014. In preparation for this step, between November 2013 and October 2014, the ECB conducted, together with national supervisors, a comprehensive assessment of 130 banks, which together hold more than 80% of Eurozone banking assets. The exercise consisted of three elements: (i) a supervisory risk assessment, which assessed the main balance sheet risks including liquidity, funding and leverage; (ii) an asset quality review, which focused on credit and market risks; and (iii) a stress test to examine the need to strengthen capital or take other corrective measures.

The SSM represents a significant change in the approach to bank supervision at a European and global level. The SSM results in the direct supervision of 126 financial institutions, including us, and indirect supervision of around 3,500 financial institutions and is now one of the largest in the world in terms of assets under supervision. In the coming years, the SSM is expected to work to establish a new supervisory culture importing best practices from the 19 national competent authorities that are part of the SSM. Several steps have already been taken in this regard such as the recent publication of the Supervisory Guidelines and the approval of the Regulation (EU) No 468/2014 of the ECB of April 16, 2014, establishing the framework for cooperation within the SSM between the ECB and national competent authorities and with national designated authorities (the SSM Framework Regulation). In addition, this new body represents an extra cost for the financial institutions that funds it through payment of supervisory fees.

The other main pillar of the EU banking union is the SRM, the main purpose of which is to ensure a prompt and coherent resolution of failing banks in Europe at minimum cost for the taxpayers and the real economy. The SRM Regulation establishes uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of the SRM and a Single Resolution Fund (“SRF”). Under the intergovernmental agreement (“IGA”) signed by 26 EU member states on May 21, 2014, contributions by banks raised at national level were transferred to the SRF. The new Single Resolution Board (“SRB”), which is the central decision-making body of the SRM, started operating on January 1, 2015 and has fully assumed its resolution powers on January 1, 2016. The SRB is responsible for managing the SRF and its mission is to ensure that credit institutions and other entities under its remit, which face serious difficulties, are resolved effectively with minimal costs to taxpayers and the real economy. From that date onwards, the SRF is also in place, funded by contributions from European banks in accordance with the methodology approved by the Council of the EU. The SRF is intended to reach a total amount of €55 billion by 2024 and to be used as a separate backstop only after an 8% bail-in of a bank’s liabilities has been applied to cover capital shortfalls (in line with the BRRD).

By allowing for the consistent application of EU banking rules through the SSM and the SRM, the banking union is expected to help resume momentum towards economic and monetary union. In order to complete such union, a single deposit guarantee scheme is still needed which may require a change to the existing European treaties. This is the subject of continued negotiation by European leaders to ensure further progress is made in European fiscal, economic and political integration.

Regulations adopted towards achieving a banking and/or fiscal union in the EU and decisions adopted by the ECB in its capacity as our main supervisory authority may have a material impact on our business, financial condition and results of operations; in particular, the BRRD and Directive 2014/49/EU on deposit guarantee schemes which were published in the Official Journal of the EU on June 12, 2014. The BRRD was required to be implemented on or before January 1, 2015, although the bail-in tool only applies since January 1, 2016. The BRRD was partially implemented in Spain in June 2015 through Law 11/2015 of June 18, on the Recovery and Resolution of Credit Institutions and Investment Firms (“Law 11/2015”) and Royal Decree 1012/2015, of November 6, implementing Law 11/2015 (“Royal Decree 1012/2015”).

In addition, on January 29, 2014, the European Commission released its proposal on the structural reforms of the European banking sector that will impose new constraints on the structure of European banks. The proposal aims at ensuring the harmonization between the divergent national initiatives in Europe. It includes a prohibition on proprietary trading similar to that contained in Section 619 of the Dodd-Frank Act (also known as the Volcker Rule) and a mechanism to potentially require the separation of trading activities (including market making), such as in the Financial Services (Banking Reform) Act 2013, complex securitizations and risky derivatives.

Moreover, regulations adopted on structural measures to improve the resilience of EU credit institutions may have a material impact on our business, financial condition and results of operations. These regulations, if adopted, may also cause us to invest significant management attention and resources to make any necessary changes.

Other regulatory reforms adopted or proposed in the wake of the financial crisis

On August 16, 2012, Regulation (EU) No 648/2012 on over-the-counter (“OTC”) derivatives, central counterparties and trade repositories entered into force (“EMIR”). While a number of the compliance requirements introduced by EMIR already apply, the ESMA is still in the process of finalizing some of the implementing rules mandated by EMIR. EMIR introduced a number of requirements, including clearing obligations for certain classes of OTC derivatives, exchange of initial and variation margin and various reporting and disclosure obligations. Although some of the particular effects brought about by EMIR are not yet fully foreseeable, many of its elements have led and may lead to changes which may negatively impact our profit margins, require it to adjust its business practices or increase its costs (including compliance costs).

The new Markets in Financial Instruments legislation (which comprises Regulation (EU) No 600/2014 (“MiFIR”) and Directive 2014/65/EU (“MiFID II”)), introduces a trading obligation for those OTC derivatives which are subject to mandatory clearing and which are sufficiently standardized. Additionally, it includes other requirements such as enhancing the investor protection’s regime and governance and reporting obligations. It also extends transparency requirements to OTC operations in non-equity instruments. MiFID II was initially intended to enter into effect on January 3, 2017. In order to ensure legal certainty and avoid potential market disruption, the European Commission has delayed the effective date of MiFID II and MiFIR by 12 months, until January 3, 2018.

On February 14, 2013, the European Commission published a proposal (the “Commission's Proposal”) for a Directive for a common Financial Transactions Tax (“FTT”) in Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia (the “participating Member States”). However, the FTT proposal remains subject to negotiation between participating Member States. It may therefore be altered prior to any implementation, the timing of which remains unclear. Additional EU Member States may decide to participate and participating Member States may decide not to participate.

Separately, on September 28, 2011, the European Commission tabled a proposal for a European Council Directive on a common system of financial transaction tax amending Directive 2008/7/EC.

United States significant regulation

The financial services industry continues to experience significant financial regulatory reform in the United States, including from the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) and changes thereto, regulation (including capital, leverage, funding, liquidity and tax requirements), policies (including fiscal and monetary policies established by central banks and financial regulators, and changes to global trade policies), and other legal and regulatory actions. Many of these reforms significantly affected and continue to affect our revenues, costs and organizational structure in the United States and the scope of our permitted activities. We continue to monitor the changing political, tax and regulatory environment in the United States and believe that it is likely that there will be further material changes in the way major financial institutions like us are regulated in the United States. Although it remains difficult to predict the exact impact these changes will have on our business, financial condition, results of operations and cash flows for a particular future period, further reforms could result in loss of revenue, higher compliance costs, additional limits on our activities, constraints on our ability to enter into new businesses and other adverse effects on our businesses.

Specifically, as a large foreign banking organization (“FBO”) with significant U.S. operations, we are subject to enhanced prudential standards that required the Bank to, among other things, establish or designate a U.S. intermediate holding company (an “IHC”) and to transfer its entire ownership interest in substantially all of its U.S. subsidiaries to such IHC by July 1, 2016. The Bank designated its wholly-owned subsidiary, Santander Holdings USA, Inc. (“Santander Holdings USA”), as its U.S. IHC, effective July 1, 2016. As a U.S. IHC, Santander Holdings USA is subject to an enhanced supervision framework that includes, or will include, enhanced risk-based and leverage capital requirements, liquidity requirements, risk management and governance requirements and stress-testing requirements. Collectively, the enhanced prudential standards impose a significant regulatory burden on Santander Holdings USA, in particular with respect to capital and liquidity, which could limit its ability to distribute capital and liquidity to the Bank, thereby negatively affecting the Bank.

We are required under the Dodd-Frank Act to prepare and submit annually to the Federal Reserve Board and the Federal Deposit Insurance Corporation (“FDIC”) a plan (commonly called a “living will”) for the orderly resolution of our subsidiaries and operations that are domiciled in the United States in the event of future material financial distress or failure. In addition, our insured depository institution ("IDI") subsidiary, Santander Bank, N.A., must submit a separate IDI resolution plan annually to the FDIC. These resolution plans require substantial effort, time and cost to prepare and are subject to review by the Federal Reserve Board and the FDIC, in the case of the Bank's plan required under the Dodd-Frank Act, and by the FDIC only, in the case of the IDI plan. If, after reviewing our resolution plan required under the Dodd-Frank Act and any related re-submissions, the Federal Reserve Board and the FDIC jointly determine that we failed to cure identified deficiencies, they are authorized to impose more stringent capital, leverage or liquidity requirements, or restrictions on our growth, activities or operations, or even divestitures, which could have an adverse effect on our business.

In October 2015, the U.S. federal bank regulatory agencies adopted final rules for uncleared swaps that impose variation margin requirements and will phase in initial margin requirements from September 1, 2016 through September 1, 2020, depending on the level of specified derivatives activity of the swap dealer and the relevant counterparty. The final rules of the U.S. federal bank regulatory agencies generally apply to inter-affiliate transactions. We are in the process of implementing the final rule and believe that these rules and similar rules being considered by regulators in other jurisdictions, and the potential conflicts and inconsistencies between them, will likely increase our costs for engaging in swaps and other derivatives activities and present compliance challenges. In addition, the U.S. Securities and Exchange Commission ("SEC") will in the future adopt regulations establishing margin requirements for uncleared security-based swaps.

On May 3, 2016, the Federal Reserve Board proposed a new rule that would impose contractual requirements on certain qualified financial contracts ("QFCs") to which certain covered entities, including the U.S. operations of the Bank, are parties. On August 19, 2016, the Office of the Comptroller of the Currency ("OCC") proposed a substantially similar rule that would apply to Santander Bank, N.A. and its subsidiaries. The QFCs covered by the proposals would include derivatives, securities lending transactions and short-term funding transactions such as repurchase agreements. If adopted as proposed, these rules could adversely affect the rights of our and Santander Bank, N.A.'s creditors or counterparties to these QFCs, which could increase the costs to the Bank of using these contracts.

Each of these aspects of the Dodd-Frank Act, as well as other aspects such as the Volcker Rule, over-the-counter derivatives regulation, changes thereto as well as other changes in U.S. legislation or regulations relating to the financial services industry, may directly or indirectly impact various aspects of our business. The full spectrum of risks that result from the Dodd-Frank Act, changes thereto, or pending or future U.S. financial services, legislation or regulations cannot be fully known; however, such risks could be material and we could be materially and adversely affected by them. See "Item 4 — B.Business overview — Supervision and Regulation" for a summary of certain significant U.S. financial regulations applicable to our business.

United States capital, liquidity and related requirements and supervisory actions

As a U.S. IHC and bank holding company, Santander Holdings USA is subject to the U.S. Basel III capital rules, which implement in the United States the capital components of the Basel Committee's international capital and liquidity standards known as Basel III. In addition, as a U.S. bank holding company with $50 billion or more of total consolidated assets, Santander Holdings USA is subject to a modified version of the quantitative liquidity coverage ratio requirement. The liquidity coverage ratio (" LCR") is one of the liquidity components of the international Basel III framework. These capital and liquidity requirements significantly affect the amount of capital and liquidity that Santander Holdings USA maintains to support its operations, and, if Santander Holdings USA fails to meet these quantitative requirements, it could face increasingly stringent regulatory consequences, including but not limited to restrictions on its ability to distribute capital to the Bank.

In addition to these capital and liquidity requirements, the Federal Reserve Board adopted a final rule on December 15, 2016 that establishes certain TLAC, long-term debt ("LTD") and clean holding company requirements in the United States generally consistent with the FSB's international TLAC standard. U.S. IHCs, including Santander Holdings USA, must comply with all applicable requirements under the final rule by January 1, 2019. Compliance with the final TLAC rule could result in increased funding costs for Santander Holdings USA and, indirectly, the Bank.

In addition, certain of our U.S. subsidiaries, including Santander Holdings USA, are subject to stress testing and capital planning requirements in the United States. In June 2016, the Federal Reserve Board, as part of its Comprehensive Capital Analysis and Review ("CCAR") process, objected for the third time to Santander Holdings USA's capital plan on qualitative grounds. As a result of the CCAR objection, Santander Holdings USA is not permitted to make any capital distributions without the Federal Reserve Board's approval, other than the continued payment of dividends on Santander Holdings USA's outstanding class of preferred stock, until a new capital plan is approved by the Federal Reserve Board. For the 2017 capital planning cycle, the deadline for Santander Holdings USA's capital plan submission is in April 2017. The Federal Reserve Board finalized a rule in February 2017 that will remove, beginning with the 2017 capital planning cycle, the qualitative CCAR assessment for certain bank holding companies and U.S. IHCs of foreign banking organizations, including Santander Holdings USA. Nevertheless, the Federal Reserve Board will continue to assess, and retains the authority to object to, Santander Holdings USA's capital plan on quantitative grounds, and Santander Holdings USA will be subject to regular supervisory assessments that examine its capital planning processes outside the context of CCAR.

Certain of our U.S. subsidiaries, including Santander Holdings USA, are also subject to stress testing and capital planning related policies and supervisory actions. Specifically, on September 15, 2014, Santander Holdings USA and the Federal Reserve Bank of Boston ("FRB Boston") executed a written agreement relating to a subsidiary's declaration and payment of dividends in the second quarter of 2014 without the Federal Reserve Board's approval. Under the written agreement, Santander Holdings USA agreed to submit to the FRB Boston written procedures to strengthen board of directors'oversight of management regarding planned capital distributions by Santander Holdings USA and its subsidiaries.

In addition, Santander Holdings USA agreed to subject future distributions to the prior written approval of the Federal Reserve Board and to take necessary actions to ensure that no such distributions are made.

Other supervisory actions and restrictions on U.S. activities

In addition to the foregoing, U.S. bank regulatory agencies from time to time take supervisory actions under certain circumstances that restrict or limit a financial institution’s activities. In some instances, we are subject to significant legal restrictions on our ability to publicly disclose these actions or the full details of these actions. Furthermore, as part of the regular examination process, U.S. banking regulators may advise our U.S. banking subsidiaries to operate under various restrictions as a prudential matter. Under the U.S. Bank Holding Company Act, the Federal Reserve Board has the authority to disallow us and our U.S. banking subsidiaries from engaging in certain categories of new activities in the United States or acquiring shares or control of other companies in the United States. Such actions and restrictions currently applicable to us or our U.S. banking subsidiaries could adversely affect our costs and revenues. Moreover, efforts to comply with non-public supervisory actions or restrictions could require material investments in additional resources and systems, as well as a significant commitment of managerial time and attention. As a result, such supervisory actions or restrictions could have a material adverse effect on our business and results of operations; and we may be subject to significant legal restrictions on our ability to publicly disclose these matters or the full details of these actions. In addition to such confidential actions and restrictions, in July 2015, Santander Holdings USA entered into a written agreement with the FRB Boston and agreed to make enhancements with respect to, among other matters, board oversight of the consolidated organization, risk management, capital planning and liquidity risk management. In addition, in March 2017, Santander Holdings USA and Santander Consumer USA Inc. (“SCUSA”) entered into a written agreement with the FRB Boston pursuant to which Santander Holdings USA and SCUSA agreed to submit written plans acceptable to the FRB Boston to strengthen board oversight of the management and operations of SCUSA and to strengthen board and senior management oversight of SCUSA’s risk management program, SCUSA agreed to submit a written revised compliance risk management program acceptable to the FRB Boston and Santander Holdings USA agreed to submit written revisions to its firmwide internal audit program of SCUSA’s compliance risk management program.

Banking reform in the UK

On December 18, 2013, the Financial Services (Banking Reform) Act (the Banking Reform Act) was enacted in the UK. The Banking Reform Act implements the recommendations of the Independent Commission on Banking (ICB) and of the Parliamentary Commission on Banking Standards. Among other things, the Banking Reform Act establishes a ring-fencing framework under the Financial Services and Markets Act 2000 (FSMA) pursuant to which UK banking groups that hold significant retail deposits are required to separate their retail banking activities from their wholesale banking activities by January 1, 2019, establishes a new Payment Systems Regulator (the PSR) and amends the Banking Act 2009 (the Banking Act) to include a bail-in stabilization power forming part of the special resolution regime.

On July 7, 2016, the PRA published a policy statement (PS20/16) entitled ‘The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures’ containing final ring-fencing rules ahead of the implementation date for ring-fencing on January 1, 2019. The PRA expects firms to finalize their ring-fencing plans and highlight any changes as a result of the policy statement to the PRA. The PRA will keep the policy under review to assess whether changes may be required as a result of any regulatory change following the UK’s exit from the EU.

Finally, the Banking Reform Act introduced a new form of transfer scheme, the ring-fencing transfer scheme, under Part VII of FSMA to enable UK banks to implement the ring-fencing requirements. This is a court process that requires (i) the PRA to approve the scheme (in consultation with the FCA); (ii) the appropriate regulatory authority in respect of each transferee to provide a certificate of adequate financial resources in relation to that transferee; and (iii) an independent expert (approved by the PRA, after consultation with the FCA) to provide a scheme report stating whether any adverse effect on persons affected by the scheme is likely to be greater than is reasonably necessary to achieve the ring-fencing purposes of the scheme. The PRA published its final statement of policy on its approach to ring-fencing transfer schemes on March 4, 2016.

Our UK subsidiaries are subject to the ring-fencing requirement under the Banking Reform Act and, as a consequence, they will need to separate their core activities from their prohibited activities. Our UK subsidiaries continue to work closely with regulators on developing their business and operating model to comply with the ring-fencing requirements. In light of the changeable macro-environment, the board of Santander UK concluded that we could provide greater certainty for our customers with a ‘wide’ ring-fence structure, rather than the ‘narrow’ ring-fence structure originally envisaged as this will also allow us to maintain longer term flexibility. Under this revised model Santander UK plc, the ring-fenced bank, will serve our retail, commercial and corporate customers. Abbey National Treasury Services plc will no longer constitute the non-ring fenced bank and its activities will be revised as part of the new ring-fenced model. We intend to complete the implementation of our ring-fence plans well in advance of the legislative deadline of January 1, 2019. The ring-fencing model that our UK subsidiaries ultimately implement will depend on a number of factors including economic conditions in the UK and globally and will entail a legal and organizational restructuring of our UK subsidiaries’ businesses and operations, including transfers of customers and transactions through a ring-fencing transfer scheme. In light of the scale and complexity of this process, the operational and execution risks may be material.

This restructuring and migration of customers and transactions could have a material impact on how we conduct our business in the UK. We are unable to predict with certainty the attitudes and reaction of our customers. The restructuring of the UK subsidiaries’ business pursuant to the developing ring-fencing regime will take a substantial amount of time and cost to implement, the separation process and the structural changes which may be required could have a material adverse effect on their business, operating results, financial condition, profitability and prospects.

2.1.3 We are subject to potential intervention by any of our regulators or supervisors, particularly in response to customer complaints.

As noted above, our business and operations are subject to increasingly significant rules and regulations that are required to conduct banking and financial services business. These apply to business operations, affect financial returns, include reserve and reporting requirements, and prudential and conduct of business regulations. These requirements are set by the relevant central banks and regulatory authorities that authorize, regulate and supervise us in the jurisdictions in which we operate.

In their supervisory roles, the regulators seek to maintain the safety and soundness of financial institutions with the aim of strengthening the protection of customers and the financial system. The supervisors' continuing supervision of financial institutions is conducted through a variety of regulatory tools, including the collection of information by way of prudential returns, reports obtained from skilled persons, visits to firms and regular meetings with management to discuss issues such as performance, risk management and strategy. In general, these regulators have a more outcome-focused regulatory approach that involves more proactive enforcement and more punitive penalties for infringement. As a result, we face increased supervisory scrutiny (resulting in increasing internal compliance costs and supervision fees), and in the event of a breach of our regulatory obligations we are likely to face more stringent regulatory fines. Some of the regulators are focusing intently on consumer protection and on conduct risk and will continue to do so. This has included a focus on the design and operation of products, the behavior of customers and the operation of markets. Such a focus could result in usury regulation that could restrict our ability to charge certain levels of interest in credit transactions or in regulation that would prevent us from bundling products that we offer to our customers. Some of the laws in the relevant jurisdictions in which we operate, give the regulators the power to make temporary product intervention rules either to improve a firm's systems and controls in relation to product design, product management and implementation, or to address problems identified with financial products. These problems may potentially cause significant detriment to consumers because of certain product features or governance flaws or distribution strategies. Such rules may prevent institutions from entering into product agreements with customers until such problems have been solved. Some of the regulatory regimes in the relevant jurisdictions in which we operate, require us to be in compliance across all aspects of our business, including the training, authorization and supervision of personnel, systems, processes and documentation. If we fail to comply with the relevant regulations, there would be a risk of an adverse impact on our business from sanctions, fines or other actions imposed by the regulatory authorities. Customers of financial services institutions, including our customers, may seek redress if they consider that they have suffered loss as a result of the mis-selling of a particular product, or through incorrect application of the terms and conditions of a particular product. Given the inherent unpredictability of litigation and the evolution of judgments by the relevant authorities, it is possible that an adverse outcome in some matters could harm our reputation or have a material adverse effect on our operating results, financial condition and prospects arising from any penalties imposed or compensation awarded, together with the costs of defending such an action, thereby reducing our profitability.

2.1.4 We are subject to review by taxing authorities, and an incorrect interpretation by us of tax laws and regulations may have a material adverse effect on us.

The preparation of our tax returns requires the use of estimates and interpretations of complex tax laws and regulations and is subject to review by taxing authorities. We are subject to the income tax laws of Spain and the other jurisdictions in which we operate. These tax laws are complex and subject to different interpretations by the taxpayer and relevant governmental taxing authorities, which are sometimes subject to prolonged evaluation periods until a final resolution is reached. In establishing a provision for income tax expense and filing returns, we must make judgments and interpretations about the application of these inherently complex tax laws. If the judgment, estimates and assumptions we use in preparing our tax returns are subsequently found to be incorrect, there could be a material adverse effect on our results of operations. In some jurisdictions, the interpretations of the taxing authorities are unpredictable and frequently involve litigation, which introduces further uncertainty and risk as to tax expense.

2.1.5 Changes in taxes and other assessments may adversely affect us.

The legislatures and tax authorities in the tax jurisdictions in which we operate regularly enact reforms to the tax and other assessment regimes to which we and our customers are subject. Such reforms include changes in tax rates and, occasionally, enactment of temporary taxes, the proceeds of which are earmarked for designated governmental purposes. The effects of these changes and any other changes that result from enactment of additional tax reforms cannot be quantified and there can be no assurance that any such reforms would not have an adverse effect upon our business.

2.1.6 We may not be able to detect or prevent money laundering and other financial crime activities fully or on a timely basis, which could expose us to additional liability and could have a material adverse effect on us.

We are required to comply with applicable anti-money laundering ("AML"), anti-terrorism, anti-bribery and corruption, sanctions and other laws and regulations applicable to us. These laws and regulations require us, among other things, to conduct full customer due diligence (including sanctions and politically-exposed person screening), keep our customer, account and transaction information up to date and have implemented effective financial crime policies and procedures detailing what is required from those responsible. We are also required to conduct AML training for our employees and to report suspicious transactions and activity to appropriate law enforcement following full investigation by our local AML team.

Financial crime has become the subject of enhanced regulatory scrutiny and supervision by regulators globally. AML, anti-bribery and corruption and sanctions laws and regulations are increasingly complex and detailed and have become the subject of enhanced regulatory supervision, requiring improved systems, sophisticated monitoring and skilled compliance personnel.

We have developed policies and procedures aimed at detecting and preventing the use of our banking network for money laundering and other financial crime related activities. These require implementation and embedding within our business effective controls and monitoring, which in turn requires on-going changes to systems and operational activities. Financial crime is continually evolving and, as noted, is subject to increasingly stringent regulatory oversight and focus. This requires proactive and adaptable responses from us so that we are able to deter threats and criminality effectively. As a global bank, we are particularly exposed to this risk. Even known threats can never be fully eliminated, and there will be instances where we may be used by other parties to engage in money laundering and other illegal or improper activities. In addition, we rely heavily on our employees to assist us by spotting such activities and reporting them, and our employees have varying degrees of experience in recognizing criminal tactics and understanding the level of sophistication of criminal organizations. Where we outsource any of our customer due diligence, customer screening or anti financial crime operations, we remain responsible and accountable for full compliance and any breaches. If we are unable to apply the necessary scrutiny and oversight, there remains a risk of regulatory breach.

If we are unable to fully comply with applicable laws, regulations and expectations, our regulators and relevant law enforcement agencies have the ability and authority to impose significant fines and other penalties on us, including requiring a complete review of our business systems, day-to-day supervision by external consultants and ultimately the revocation of our banking license.

The reputational damage to our business and global brand would be severe if we were found to have breached AML, anti-bribery and corruption or sanctions requirements. Our reputation could also suffer if we are unable to protect our customers' bank products and services from being used by criminals for illegal or improper purposes.

In addition, while we review our relevant counterparties' internal policies and procedures with respect to such matters, we, to a large degree, rely upon our relevant counterparties to maintain and properly apply their own appropriate compliance procedures and internal policies. Such measures, procedures and internal policies may not be completely effective in preventing third parties from using our (and our relevant counterparties') services as a conduit for illicit purposes (including illegal cash operations) without our (and our relevant counterparties') knowledge. If we are associated with, or even accused of having breached AML, anti-terrorism, or sanctions requirements our reputation could suffer and/or we could become subject to fines, sanctions and/or legal enforcement (including being added to any "black lists" that would prohibit certain parties from engaging in transactions with us), any one of which could have a material adverse effect on our operating results, financial condition and prospects.

Any such risks could have a material adverse effect on our operating results, financial condition and prospects.

2.2 *Liquidity and Financing Risks*

2.2.1 Liquidity and funding risks are inherent in our business and could have a material adverse effect on us.

Liquidity risk is the risk that we either do not have available sufficient financial resources to meet our obligations as they fall due or can secure them only at excessive cost. This risk is inherent in any retail and commercial banking business and can be heightened by a number of enterprise-specific factors, including over-reliance on a particular source of funding, changes in credit ratings or market-wide phenomena such as market dislocation. While we implement liquidity management processes to seek to mitigate and control these risks, unforeseen systemic market factors make it difficult to eliminate completely these risks. Continued constraints in the supply of liquidity, including in inter-bank lending, has affected and may materially and adversely affect the cost of funding our business, and extreme liquidity constraints may affect our current operations and our ability to fulfill regulatory liquidity requirements, as well as limit growth possibilities.

Increases in prevailing market interest rates and in our credit spreads can significantly increase the cost of our funding. Changes in our credit spreads may be influenced by market perceptions of our creditworthiness. Changes to interest rates and our credit spreads occur continuously and may be unpredictable and highly volatile.

We rely, and will continue to rely, primarily on commercial deposits to fund lending activities. The ongoing availability of this type of funding is sensitive to a variety of factors outside our control, such as general economic conditions and the confidence of commercial depositors in the economy and in the financial services industry, and the availability and extent of deposit guarantees, as well as competition between banks or with other products, such as mutual funds, for deposits. Any of these factors could significantly increase the amount of commercial deposit withdrawals in a short period of time, thereby reducing our ability to access commercial deposit funding on appropriate terms, or at all, in the future. If these circumstances were to arise, this could have a material adverse effect on our operating results, financial condition and prospects.

Central banks have taken extraordinary measures to increase liquidity in the financial markets as a response to the financial crisis. If current facilities were rapidly removed or significantly reduced, this could have an adverse effect on our ability to access liquidity and on our funding costs.

We cannot assure that in the event of a sudden or unexpected shortage of funds in the banking system, we will be able to maintain levels of funding without incurring high funding costs, a reduction in the term of funding instruments or the liquidation of certain assets. If this were to happen, we could be materially adversely affected.

2.2.2 Credit, market and liquidity risk may have an adverse effect on our credit ratings and our cost of funds. Any downgrade in our credit rating would likely increase our cost of funding, require us to post additional collateral or take other actions under some of our derivative contracts and adversely affect our interest margins and results of operations.

Credit ratings affect the cost and other terms upon which we are able to obtain funding. Rating agencies regularly evaluate us, and their ratings of our debt are based on a number of factors, including our financial strength and conditions affecting the financial services industry generally. In addition, due to the methodology of the main rating agencies, our credit rating is affected by the rating of Spanish sovereign debt. If Spain's sovereign debt is downgraded, our credit rating would also likely be downgraded by an equivalent amount.

Any downgrade in our debt credit ratings would likely increase our borrowing costs and require us to post additional collateral or take other actions under some of our derivative contracts, and could limit our access to capital markets and adversely affect our commercial business. For example, a ratings downgrade could adversely affect our ability to sell or market certain of our products, engage in certain longer-term and derivatives transactions and retain our customers, particularly customers who need a minimum rating threshold in order to invest. In addition, under the terms of certain of our derivative contracts and other financial commitments, we may be required to maintain a minimum credit rating or terminate such contracts or require the posting of collateral. Any of these results of a ratings downgrade could reduce our liquidity and have an adverse effect on us, including our operating results and financial condition.

Banco Santander, S.A.'s long-term debt is currently rated investment grade by the major rating agencies: A3 stable outlook by Moody's Investors Service España, S.A., A- positive outlook by Standard & Poor's Ratings Services and A- stable outlook by Fitch Ratings Ltd. In June 2015, Moody's upgraded Banco Santander, S.A.'s rating from Baa1 to A3 in light of their new banking methodology and in February 2016, they modified our outlook from positive to stable in line with the outlook of the Spanish sovereign debt. In October 2015, Standard & Poor's upgraded Banco Santander, S.A.'s rating from BBB+ to A- following the upgrade of the sovereign credit rating of Spain. In February 2017, Standard & Poor's revised the outlook from stable to positive reflecting the revised funding plans announced by us, which give Standard & Poor's comfort that we will build a substantial additional loss absorbing capacity buffer over the next two years.

Santander UK's long-term debt is currently rated investment grade by the major rating agencies: Aa3 with negative outlook by Moody's Investors Service, A with negative outlook by Standard & Poor's Ratings Services and A with stable outlook by Fitch Ratings.

Banco Santander (Brasil)'s long-term debt in foreign currency is currently rated BB with a negative outlook by Standard & Poor's Ratings Services, BB with negative outlook by Fitch Ratings Ltd. and Ba2 with a negative outlook by Moody's Investors Service. During the course of 2015 and the first half of 2016, the three major agencies lowered the rating as a result of the lowering of Brazil's sovereign credit rating.

We conduct substantially all of our material derivative activities through Banco Santander, S.A. and Santander UK. We estimate that as of December 31, 2016, if all the rating agencies were to downgrade Banco Santander, S.A.'s long-term senior debt ratings by one notch we would be required to post up to €228 million in additional collateral pursuant to derivative and other financial contracts. A hypothetical two notch downgrade would result in a further requirement to post up to €38 million in additional collateral. We estimate that as of December 31, 2016, if all the rating agencies were to downgrade Santander UK's long-term credit ratings by one notch, and thereby trigger a short-term credit rating downgrade, this could result in contractual outflows from Santander UK's total liquid assets of £4.6 billion of cash and additional collateral that Santander UK would be required to post under the terms of secured funding and derivatives contracts. A hypothetical two notch downgrade would result in a further outflow of £0.4 billion of cash and collateral under secured funding and derivatives contracts.

While certain potential impacts of these downgrades are contractual and quantifiable, the full consequences of a credit rating downgrade are inherently uncertain, as they depend upon numerous dynamic, complex and inter-related factors and assumptions, including market conditions at the time of any downgrade, whether any downgrade of our long-term credit rating precipitates downgrades to our short-term credit rating, and assumptions about the potential behaviors of various customers, investors and counterparties. Actual outflows could be higher or lower than the preceding hypothetical examples, depending upon certain factors including which credit rating agency downgrades our credit rating, any management or restructuring actions that could be taken to reduce cash outflows and the potential liquidity impact from loss of unsecured funding (such as from money market funds) or loss of secured funding capacity. Although unsecured and secured funding stresses are included in our stress testing scenarios and a portion of our total liquid assets is held against these risks, a credit rating downgrade could still have a material adverse effect on us.

In addition, if we were required to cancel our derivatives contracts with certain counterparties and were unable to replace such contracts, our market risk profile could be altered.

There can be no assurance that the rating agencies will maintain the current ratings or outlooks. Failure to maintain favorable ratings and outlooks could increase our cost of funding and adversely affect interest margins, which could have a material adverse effect on us.

2.3 ***Credit Risks***

2.3.1 The credit quality of our loan portfolio may deteriorate and our loan loss reserves could be insufficient to cover our actual loan losses, which could have a material adverse effect on us.

Risks arising from changes in credit quality and the recoverability of loans and amounts due from counterparties are inherent in a wide range of our businesses. Non-performing or low credit quality loans have in the past negatively impacted our results of operations and could do so in the future. In particular, the amount of our reported non-performing loans may increase in the future as a result of growth in our total loan portfolio, including as a result of loan portfolios that we may acquire in the future (the credit quality of which may turn out to be worse than we had anticipated), or factors beyond our control, such as adverse changes in the credit quality of our borrowers and counterparties or a general deterioration in economic conditions in the regions where we operate or in global economic and political conditions. If we were unable to control the level of our non-performing or poor credit quality loans, this could have a material adverse effect on us.

Our loan loss reserves are based on our current assessment of and expectations concerning various factors affecting the quality of our loan portfolio. These factors include, among other things, our borrowers' financial condition, repayment abilities and repayment intentions, the realizable value of any collateral, the prospects for support from any guarantor, government macroeconomic policies, interest rates and the legal and regulatory environment. Because many of these factors are beyond our control and there is no precise method for predicting loan and credit losses, we cannot assure that our current or future loan loss reserves will be sufficient to cover actual losses. If our assessment of and expectations concerning the above mentioned factors differ from actual developments, if the quality of our total loan portfolio deteriorates, for any reason, or if the future actual losses exceed our estimates of incurred losses, we may be required to increase our loan loss reserves, which may adversely affect us. Additionally, in calculating our loan loss reserves, we employ qualitative tools and statistical models which may not be reliable in all circumstances and which are dependent upon data that may not be complete. For further details regarding our risk management policies, see "—2.5.1— Failure to successfully implement and continue to improve our risk management policies, procedures and methods, including our credit risk management system, could materially and adversely affect us, and we may be exposed to unidentified or unanticipated risks."

Mortgage loans are one of our principal assets, comprising 46% of our loan portfolio as of December 31, 2016. Our exposure is concentrated in residential mortgage loans, especially in Spain and the United Kingdom. During late 2007, following an earlier period of increased demand, the housing market began to adjust downward in Spain and the United Kingdom as a result of excess supply (particularly in Spain) and higher interest rates. From 2008 to 2013, as economic growth stalled in Spain and the United Kingdom, persistent housing oversupply, decreased housing demand, rising unemployment, subdued earnings growth, greater pressure on disposable income, a decline in the availability of mortgage finance and the continued effect of global market volatility caused home prices to decline, while mortgage delinquencies and forbearances increased.

As a result of these and other factors, our NPL ratio increased from 0.94% at December 31, 2007, to 2.02% at December 31, 2008, to 3.24% at December 31, 2009, to 3.54% at December 31, 2010, to 3.90% at December 31, 2011, to 4.54% at December 31, 2012 and to 5.64% at December 31, 2013. Although the trend changed during the last three years as our NPL ratio decreased to 5.19% at December 31, 2014, to 4.36% at December 31, 2015 and to 3.93% at December 31, 2016, we can provide no assurance that our NPL ratio will not increase again as a result of the aforementioned and other factors. High unemployment rates, coupled with declining real estate prices, could have a material adverse impact on our mortgage payment delinquency rates, which in turn could have a material adverse effect on our business, financial condition and results of operations.

Additionally, financial crisis led to the accumulation of illiquid assets with lower profitability than our current targets. Such assets could negatively affect our ability to reach out current profitability targets.

2.3.2 The value of the collateral securing our loans may not be sufficient, and we may be unable to realize the full value of the collateral securing our loan portfolio.

The value of the collateral securing our loan portfolio may fluctuate or decline due to factors beyond our control, including macroeconomic factors affecting Europe, the United States and Latin American countries. The value of the collateral securing our loan portfolio may be adversely affected by force majeure events, such as natural disasters, particularly in locations where a significant portion of our loan portfolio is composed of real estate loans. We may also not have sufficiently recent information on the value of collateral, which may result in an inaccurate assessment for impairment losses of our loans secured by such collateral. If any of the above were to occur, we may need to make additional provisions to cover actual impairment losses of our loans, which may materially and adversely affect our results of operations and financial condition.

2.3.3 We are subject to counterparty risk in our banking business.

We are exposed to counterparty risk in addition to credit risks associated with lending activities. Counterparty risk may arise from, for example, investing in securities of third parties, entering into derivative contracts under which counterparties have obligations to make payments to us or executing securities, futures, currency or commodity trades from proprietary trading activities that fail to settle at the required time due to non-delivery by the counterparty or systems failure by clearing agents, clearing houses or other financial intermediaries.

We routinely transact with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks, mutual funds, hedge funds and other institutional clients. Defaults by, and even rumors or questions about the solvency of, certain financial institutions and the financial services industry generally have led to market-wide liquidity problems and could lead to losses or defaults by other institutions. Many of the routine transactions we enter into expose us to significant credit risk in the event of default by one of our significant counterparties.

2.4 *Market Risks*

2.4.1 Our financial results are constantly exposed to market risk. We are subject to fluctuations in interest rates and other market risks, which may materially and adversely affect us and our profitability.

Market risk refers to the probability of variations in our interest income/ (charges) or in the market value of our assets and liabilities due to volatility of interest rate, inflation, exchange rate or equity price. Changes in interest rates affect the following areas, among others, of our business:

- interest income/ (charges);
- the volume of loans originated;
- credit spreads;
- the market value of our securities holdings;
- the value of our loans and deposits; and
- the value of our derivatives transactions.

Interest rates are sensitive to many factors beyond our control, including increased regulation of the financial sector, monetary policies and domestic and international economic and political conditions. Variations in interest rates could affect the interest earned on our assets and the interest paid on our borrowings, thereby affecting our interest income/ (charges), which comprises the majority of our revenue, reducing our growth rate and potentially resulting in losses. In addition, costs we incur as we implement strategies to reduce interest rate exposure could increase in the future (which, in turn, will impact our results).

Increases in interest rates may reduce the volume of loans we originate. Sustained high interest rates have historically discouraged customers from borrowing and have resulted in increased delinquencies in outstanding loans and deterioration in the quality of assets. Increases in interest rates may also reduce the propensity of our customers to prepay or refinance fixed-rate loans. Increases in interest rates may reduce the value of our financial assets and may reduce gains or require us to record losses on sales of our loans or securities.

Due to the historically low interest rate environment in the Eurozone, in the UK and in the US in recent years, the rates on many of our interest-bearing deposit products have been priced at or near zero, limiting our ability to further reduce rates and thus negatively impacting our margins. If the current low interest rate environment in the eurozone, in the UK and in the US persists in the long run, it may be difficult to increase our interest income/ (charges), which will impact our results.

We are also exposed to foreign exchange rate risk as a result of mismatches between assets and liabilities denominated in different currencies. Fluctuations in the exchange rate between currencies may negatively affect our earnings and value of our assets and securities. The recent volatility in the value of the pound sterling in the wake of the June 2016 UK referendum (see risk factor 1.2 “Exposure to UK political developments, including the outcome of the UK referendum on membership of the European Union, could have a material adverse effect on us”) may persist as negotiations continue and could adversely impact our UK customers and counterparties, as well as the overall results and prospects of our UK operations. The continued depreciation of the Latin American currencies against the U.S. dollar could make our Latin American subsidiaries’ foreign currency-linked obligations and funding more expensive and have similar consequences for our borrowers in Latin America.

We are also exposed to equity price risk in our investments in equity securities in the banking book and in the trading portfolio. The performance of financial markets may cause changes in the value of our investment and trading portfolios. The volatility of world equity markets due to the continued economic uncertainty and sovereign debt crisis has had a particularly strong impact on the financial sector. Continued volatility may affect the value of our investments in equity securities and, depending on their fair value and future recovery expectations, could become a permanent impairment which would be subject to write-offs against our results. To the extent any of these risks materialize, our interest income/ (charges) or the market value of our assets and liabilities could be materially adversely affected.

2.4.2 Market conditions have resulted and could result in material changes to the estimated fair values of our financial assets. Negative fair value adjustments could have a material adverse effect on our operating results, financial condition and prospects.

In the past nine years, financial markets have been subject to significant stress resulting in steep falls in perceived or actual financial asset values, particularly due to volatility in global financial markets and the resulting widening of credit spreads. We have material exposures to securities, loans and other investments that are recorded at fair value and are therefore exposed to potential negative fair value adjustments. Asset valuations in future periods, reflecting then-prevailing market conditions, may result in negative changes in the fair values of our financial assets and these may also translate into increased impairments. In addition, the value ultimately realized by us on disposal may be lower than the current fair value. Any of these factors could require us to record negative fair value adjustments, which may have a material adverse effect on our operating results, financial condition or prospects.

In addition, to the extent that fair values are determined using financial valuation models, such values may be inaccurate or subject to change, as the data used by such models may not be available or may become unavailable due to changes in market conditions, particularly for illiquid assets, and particularly in times of economic instability. In such circumstances, our valuation methodologies require us to make assumptions, judgments and estimates in order to establish fair value, and reliable assumptions are difficult to make and are inherently uncertain and valuation models are complex, making them inherently imperfect predictors of actual results. Any consequential impairments or write-downs could have a material adverse effect on our operating results, financial condition and prospects.

2.4.3 We are subject to market, operational and other related risks associated with our derivative transactions that could have a material adverse effect on us.

We enter into derivative transactions for trading purposes as well as for hedging purposes. We are subject to market, credit and operational risks associated with these transactions, including basis risk (the risk of loss associated with variations in the spread between the asset yield and the funding and/or hedge cost) and credit or default risk (the risk of insolvency or other inability of the counterparty to a particular transaction to perform its obligations thereunder, including providing sufficient collateral).

Market practices and documentation for derivative transactions differ by country. In addition, the execution and performance of these transactions depend on our ability to maintain adequate control and administration systems. Moreover, our ability to adequately monitor, analyze and report derivative transactions continues to depend, largely, on our information technology systems. These factors further increase the risks associated with these transactions and could have a material adverse effect on us.

2.5 ***Risk Management***

2.5.1 Failure to successfully implement and continue to improve our risk management policies, procedures and methods, including our credit risk management system, could materially and adversely affect us, and we may be exposed to unidentified or unanticipated risks.

The management of risk is an integral part of our activities. We seek to monitor and manage our risk exposure through a variety of separate but complementary financial, credit, market, operational, compliance and legal reporting systems. While we employ a broad and diversified set of risk monitoring and risk mitigation techniques, such techniques and strategies may not be fully effective in mitigating our risk exposure in all economic market environments or against all types of risk, including risks that we fail to identify or anticipate.

Some of our qualitative tools and metrics for managing risk are based upon our use of observed historical market behavior. We apply statistical and other tools to these observations to arrive at quantifications of our risk exposures. These qualitative tools and metrics may fail to predict future risk exposures. These risk exposures could, for example, arise from factors we did not anticipate or correctly evaluate in our statistical models. This would limit our ability to manage our risks. Our losses thus could be significantly greater than the historical measures indicate. In addition, our quantified modeling does not take all risks into account. Our more qualitative approach to managing those risks could prove insufficient, exposing us to material unanticipated losses. We could face adverse consequences as a result of decisions, which may lead to actions by management, based on models that are poorly developed, implemented or used, or as a result of the modelled outcome being misunderstood or the use of such information for purposes for which it was not designed. In addition, if existing or potential customers or counterparties believe our risk management is inadequate, they could take their business elsewhere or seek to limit their transactions with us. This could have a material adverse effect on our reputation, operating results, financial condition and prospects.

As a commercial bank, one of the main types of risks inherent in our business is credit risk. For example, an important feature of our credit risk management system is to employ an internal credit rating system to assess the particular risk profile of a customer. As this process involves detailed analyses of the customer, taking into account both quantitative and qualitative factors, it is subject to human or IT systems errors. In exercising their judgment on current or future credit risk behavior of our customers, our employees may not always be able to assign an accurate credit rating, which may result in our exposure to higher credit risks than indicated by our risk rating system.

Failure to effectively implement, consistently follow or continuously refine our credit risk management system may result in an increase in the level of non-performing loans and a higher risk exposure for us, which could have a material adverse effect on us.

2.6 ***Technology Risks***

2.6.1 Any failure to effectively improve or upgrade our information technology infrastructure and management information systems in a timely manner could have a material adverse effect on us.

Our ability to remain competitive depends in part on our ability to upgrade our information technology on a timely and cost-effective basis. We must continually make significant investments and improvements in our information technology infrastructure in order to remain competitive. We cannot assure that in the future we will be able to maintain the level of capital expenditures necessary to support the improvement or upgrading of our information technology infrastructure. Any failure to effectively improve or upgrade our information technology infrastructure and management information systems in a timely manner could have a material adverse effect on us.

2.6.2 Risks relating to data collection, processing and storage systems and security are inherent in our business.

Like other financial institutions, we manage and hold confidential personal information of customers in the conduct of our banking operations, as well as a large number of assets. Accordingly, our business depends on the ability to process a large number of transactions efficiently and accurately, and on our ability to rely on our digital technologies, computer and email services, software and networks, as well as on the secure processing, storage and transmission of confidential sensitive personal data and other information using our computer systems and networks. The proper functioning of financial control, accounting or other data collection and processing systems is critical to our businesses and to our ability to compete effectively. Losses can result from inadequate personnel, inadequate or failed internal control processes and systems, or from external events that interrupt normal business operations. We also face the risk that the design of our controls and procedures prove to be inadequate or are circumvented such that our data and/or client records are incomplete, not recoverable or not securely stored. Although we work with our clients, vendors, service providers, counterparties and other third parties to develop secure data and information processing, storage and transmission capabilities to prevent against information security risk, we routinely manage personal, confidential and proprietary information by electronic means, and we may be the target of attempted cyber-attack. If we cannot maintain an effective and secure electronic data and information, management and processing system or we fail to maintain complete physical and electronic records, this could result in regulatory sanctions and serious reputational or financial harm to us.

We take protective measures and continuously monitor and develop our systems to protect our technology infrastructure, data and information from misappropriation or corruption, but our systems, software and networks nevertheless may be vulnerable to unauthorized access, misuse, computer viruses or other malicious code and other events that could have a security impact. An interception, misuse or mishandling of personal, confidential or proprietary information sent to or received from a client, vendor, service provider, counterparty or third party could result in legal liability, regulatory action, reputational harm and financial loss. There can be no absolute assurance that we will not suffer material losses from operational risk in the future, including those relating to any security breaches.

We have seen in recent years computer systems of companies and organizations being targeted, not only by cyber criminals, but also by activists and rogue states. We have been and continue to be subject to a range of cyber-attacks, such as denial of service, malware and phishing. Cyber-attacks could give rise to the loss of significant amounts of customer data and other sensitive information, as well as significant levels of liquid assets (including cash). In addition, cyber-attacks could disrupt our electronic systems used to service our customers. As attempted attacks continue to evolve in scope and sophistication, we may incur significant costs in order to modify or enhance our protective measures against such attacks, or to investigate or remediate any vulnerability or resulting breach, or in communicating cyber-attacks to our customers. If we fail to effectively manage our cyber security risk, e.g. by failing to update our systems and processes in response to new threats, this could harm our reputation and adversely affect our operating results, financial condition and prospects through the payment of customer compensation, regulatory penalties and fines and/or through the loss of assets. In addition, we may also be impacted by cyber-attacks against national critical infrastructures of the countries where we operate; for example the telecommunications network. Our information technology systems are dependent on such national critical infrastructure and any cyber-attack against such critical infrastructure could negatively affect our ability to service our customers. As we do not operate such national critical infrastructure, we have limited ability to protect our information technology systems from the adverse effects of such a cyber-attack. For further information see Item 11. Quantitative and Qualitative Disclosures about Market Risk—Part 6. Operational risk—3 Mitigation measures— Cybersecurity and data security plans.

Although we have procedures and controls to safeguard personal information in our possession, unauthorized disclosures could subject us to legal actions and administrative sanctions as well as damages and reputational harm that could materially and adversely affect our operating results, financial condition and prospects. Further, our business is exposed to risk from potential non-compliance with policies, employee misconduct or negligence and fraud, which could result in regulatory sanctions and serious reputational or financial harm. It is not always possible to deter or prevent employee misconduct, and the precautions we take to detect and prevent this activity may not always be effective. In addition, we may be required to report events related to information security issues (including any cyber security issues), events where customer information may be compromised, unauthorized access and other security breaches, to the relevant regulatory authorities. Any material disruption or slowdown of our systems could cause information, including data related to customer requests, to be lost or to be delivered to our clients with delays or errors, which could reduce demand for our services and products, could produce customer claims and could materially and adversely affect us.

2.7 *General Business and Industry Risks*

2.7.1 The financial problems faced by our customers could adversely affect us.

Market turmoil and economic recession could materially and adversely affect the liquidity, credit ratings, businesses and/or financial conditions of our borrowers, which could in turn increase our non-performing loan ratios, impair our loan and other financial assets and result in decreased demand for borrowings in general. In addition, our customers may further significantly decrease their risk tolerance to non-deposit investments such as stocks, bonds and mutual funds, which would adversely affect our fee and commission income. We may also be adversely affected by the negative effects of the heightened regulatory environment on our customers due to the high costs associated with regulatory compliance and proceedings. Any of the conditions described above could have a material adverse effect on our business, financial condition and results of operations.

2.7.2 Changes in our pension liabilities and obligations could have a material adverse effect on us.

We provide retirement benefits for many of our former and current employees through a number of defined benefit pension plans. We calculate the amount of our defined benefit obligations using actuarial techniques and assumptions, including mortality rates, the rate of increase of salaries, discount rates, inflation, the expected rate of return on plan assets, or others. The accounting and disclosures are based on IFRS-IASB and on those other requirements defined by the local supervisors. Given the nature of these obligations, changes in the assumptions that support valuations, including market conditions, can result in actuarial losses which would in turn impact the financial condition of our pension funds. Because pension obligations are generally long term obligations, fluctuations in interest rates have a material impact on the projected costs of our defined benefit obligations and therefore on the amount of pension expense that we accrue.

Any increase in the current size of the deficit in our defined benefit pension plans could result in our having to make increased contributions to reduce or satisfy the deficits, which would divert resources from use in other areas of our business. Any such increase may be due to certain factors over which we have no or limited control. Increases in our pension liabilities and obligations could have a material adverse effect on our business, financial condition and results of operations.

2.7.3 We depend in part upon dividends and other funds from subsidiaries.

The substantial majority of our operations are conducted through our financial services subsidiaries. As a result, our ability to pay dividends, to the extent we decide to do so, depends in significant part on the ability of our subsidiaries to generate earnings and to pay dividends to us. Payment of dividends, distributions and advances by our subsidiaries will be contingent upon our subsidiaries' earnings and business considerations and is or may be limited by legal, regulatory and contractual restrictions. Additionally, our right to receive any assets of any of our subsidiaries as an equity holder of such subsidiaries, upon their liquidation or reorganization, will be effectively subordinated to the claims of our subsidiaries' creditors, including trade creditors.

2.7.4 Increased competition, including from non-traditional providers of banking services such as financial technology providers, and industry consolidation may adversely affect our results of operations.

We face substantial competition in all parts of our business, including in originating loans and in attracting deposits. The competition in originating loans comes principally from other domestic and foreign banks, mortgage banking companies, consumer finance companies, insurance companies and other lenders and purchasers of loans.

In addition, there has been a trend towards consolidation in the banking industry, which has created larger and stronger banks with which we must now compete. There can be no assurance that this increased competition will not adversely affect our growth prospects, and therefore our operations. We also face competition from non-bank competitors, such as brokerage companies, department stores (for some credit products), leasing and factoring companies, mutual fund and pension fund management companies and insurance companies.

Non-traditional providers of banking services, such as internet based e-commerce providers, mobile telephone companies and internet search engines may offer and/or increase their offerings of financial products and services directly to customers. These non-traditional providers of banking services currently have an advantage over traditional providers because they are not subject to banking regulation. Several of these competitors may have long operating histories, large customer bases, strong brand recognition and significant financial, marketing and other resources. They may adopt more aggressive pricing and rates and devote more resources to technology, infrastructure and marketing. New competitors may enter the market or existing competitors may adjust their services with unique product or service offerings or approaches to providing banking services. If we are unable to successfully compete with current and new competitors, or if we are unable to anticipate and adapt our offerings to changing banking industry trends, including technological changes, our business may be adversely affected. In addition, our failure to effectively anticipate or adapt to emerging technologies or changes in customer behavior, including among younger customers, could delay or prevent our access to new digital-based markets, which would in turn have an adverse effect on our competitive position and business.

The rise in customer use of internet and mobile banking platforms in recent years could negatively impact our investments in bank premises, equipment and personnel for our branch network. The persistence or acceleration of this shift in demand towards internet and mobile banking may necessitate changes to our retail distribution strategy, which may include closing and/or selling certain branches and restructuring our remaining branches and work force. These actions could lead to losses on these assets and may lead to increased expenditures to renovate, reconfigure or close a number of our remaining branches or to otherwise reform our retail distribution channel. Furthermore, our failure to swiftly and effectively implement such changes to our distribution strategy could have an adverse effect our competitive position.

Increasing competition could also require that we increase our rates offered on deposits or lower the rates we charge on loans, which could also have a material adverse effect on us, including our profitability. It may also negatively affect our business results and prospects by, among other things, limiting our ability to increase our customer base and expand our operations and increasing competition for investment opportunities.

If our customer service levels were perceived by the market to be materially below those of our competitor financial institutions, we could lose existing and potential business. If we are not successful in retaining and strengthening customer relationships, we may lose market share, incur losses on some or all of our activities or fail to attract new deposits or retain existing deposits, which could have a material adverse effect on our operating results, financial condition and prospects.

2.7.5 Our ability to maintain our competitive position depends, in part, on the success of new products and services we offer our clients and our ability to continue offering products and services from third parties, and we may not be able to manage various risks we face as we expand our range of products and services that could have a material adverse effect on us.

The success of our operations and our profitability depends, in part, on the success of new products and services we offer our clients and our ability to continue offering products and services from third parties. However, we cannot guarantee that our new products and services will be responsive to client demands, or that they will be successful. In addition, our clients' needs or desires may change over time, and such changes may render our products and services obsolete, outdated or unattractive and we may not be able to develop new products that meet our clients' changing needs. Our success is also dependent on our ability to anticipate and leverage new and existing technologies that may have an impact on products and services in the banking industry. Technological changes may further intensify and complicate the competitive landscape and influence client behavior. If we cannot respond in a timely fashion to the changing needs of our clients, we may lose clients, which could in turn materially and adversely affect us.

As we expand the range of our products and services, some of which may be at an early stage of development in the markets of certain regions where we operate, we will be exposed to new and potentially increasingly complex risks and development expenses. Our employees and risk management systems, as well as our experience and that of our partners may not be sufficient to enable us to properly manage such risks. In addition, the cost of developing products that are not launched is likely to affect our results of operations. Any or all of these factors, individually or collectively, could have a material adverse effect on us.

While we have successfully increased our customer service levels in recent years, should these levels ever be perceived by the market to be materially below those of our competitor financial institutions, we could lose existing and potential business. If we are not successful in retaining and strengthening customer relationships, we may lose market share, incur losses on some or all of our activities or fail to attract new deposits or retain existing deposits, which could have a material adverse effect on our operating results, financial condition and prospects.

2.7.6 If we are unable to manage the growth of our operations, this could have an adverse impact on our profitability.

We allocate management and planning resources to develop strategic plans for organic growth, and to identify possible acquisitions and disposals and areas for restructuring our businesses. From time to time, we evaluate acquisition and partnership opportunities that we believe offer additional value to our shareholders and are consistent with our business strategy. However, we may not be able to identify suitable acquisition or partnership candidates, and our ability to benefit from any such acquisitions and partnerships will depend in part on our successful integration of those businesses. Any such integration entails significant risks such as unforeseen difficulties in integrating operations and systems and unexpected liabilities or contingencies relating to the acquired businesses, including legal claims. We can give no assurances that our expectations with regards to integration and synergies will materialize. We also cannot provide assurance that we will, in all cases, be able to manage our growth effectively or deliver our strategic growth objectives. Challenges that may result from our strategic growth decisions include our ability to:

- manage efficiently the operations and employees of expanding businesses;
- maintain or grow our existing customer base;
- assess the value, strengths and weaknesses of investment or acquisition candidates, including local regulation that can reduce or eliminate expected synergies;
- finance strategic investments or acquisitions;
- align our current information technology systems adequately with those of an enlarged group;
- apply our risk management policy effectively to an enlarged group; and
- manage a growing number of entities without over-committing management or losing key personnel.

Any failure to manage growth effectively could have a material adverse effect on our operating results, financial condition and prospects.

In addition, any acquisition or venture could result in the loss of key employees and inconsistencies in standards, controls, procedures and policies.

Moreover, the success of the acquisition or venture will at least in part be subject to a number of political, economic and other factors that are beyond our control. Any of these factors, individually or collectively, could have a material adverse effect on us.

2.7.7 Goodwill impairments may be required in relation to acquired businesses.

We have made business acquisitions in recent years and may make further acquisitions in the future. It is possible that the goodwill which has been attributed, or may be attributed, to these businesses may have to be written-down if our valuation assumptions are required to be reassessed as a result of any deterioration in their underlying profitability, asset quality and other relevant matters. Impairment testing in respect of goodwill is performed annually, or more frequently if there are impairment indicators present, and comprises a comparison of the carrying amount of the cash-generating unit with its recoverable amount. Goodwill impairment does not, however, affect our regulatory capital. While no material impairment of goodwill was recognized at Group level in 2014, 2015, or 2016, there can be no assurances that we will not have to write down the value attributed to goodwill in the future, which would adversely affect our results and net assets.

2.7.8 We rely on recruiting, retaining and developing appropriate senior management and skilled personnel.

Our continued success depends in part on the continued service of key members of our senior executive team and other key employees. The ability to continue to attract, train, motivate and retain highly qualified and talented professionals is a key element of our strategy. The successful implementation of our strategy and culture depends on the availability of skilled and appropriate management, both at our head office and in each of our business units. If we or one of our business units or other functions fails to staff its operations appropriately, or loses one or more of its key senior executives or other key employees and fails to replace them in a satisfactory and timely manner, our business, financial condition and results of operations, including control and operational risks, may be adversely affected.

In addition, the financial industry has and may continue to experience more stringent regulation of employee compensation, which could have an adverse effect on our ability to hire or retain the most qualified employees. If we fail or are unable to attract and appropriately train, motivate and retain qualified professionals, our business may also be adversely affected.

2.7.9 We rely on third parties and affiliates for important products and services.

Third party vendors and certain affiliated companies provide key components of our business infrastructure such as loan and deposit servicing systems, back office and business process support, information technology production and support, internet connections and network access. Relying on these third parties and affiliated companies can be a source of operational and regulatory risk to us, including with respect to security breaches affecting such parties. We are also subject to risk with respect to security breaches affecting the vendors and other parties that interact with these service providers. As our interconnectivity with these third parties and affiliated companies increases, we increasingly face the risk of operational failure with respect to their systems. We may be required to take steps to protect the integrity of our operational systems, thereby increasing our operational costs and potentially decreasing customer satisfaction. In addition, any problems caused by these third parties or affiliated companies, including as a result of them not providing us their services for any reason, or performing their services poorly, could adversely affect our ability to deliver products and services to customers and otherwise conduct our business, which could lead to reputational damage and regulatory investigations and intervention. Replacing these third party vendors could also entail significant delays and expense. Further, the operational and regulatory risk we face as a result of these arrangements may be increased to the extent that we restructure such arrangements. Any restructuring could involve significant expense to us and entail significant delivery and execution risk which could have a material adverse effect on our business, operations and financial condition.

2.7.10 Damage to our reputation could cause harm to our business prospects.

Maintaining a positive reputation is critical to protect our brand, attract and retain customers, investors and employees and conduct business transactions with counterparties. Damage to our reputation can therefore cause significant harm to our business and prospects. Harm to our reputation can arise from numerous sources, including, among others, employee misconduct, including the possibility of fraud perpetrated by our employees, litigation or regulatory enforcement, failure to deliver minimum standards of service and quality, compliance failures, unethical behavior, and the activities of customers and counterparties. Further, negative publicity regarding us may result in harm to our prospects.

Actions by the financial services industry generally or by certain members of, or individuals in, the industry can also affect our reputation. For example, the role played by financial services firms in the financial crisis and the seeming shift toward increasing regulatory supervision and enforcement has caused public perception of us and others in the financial services industry to decline.

We could suffer significant reputational harm if we fail to identify and manage potential conflicts of interest properly. The failure, or perceived failure, to adequately address conflicts of interest could affect the willingness of clients to deal with us, or give rise to litigation or enforcement actions against us. Therefore, there can be no assurance that conflicts of interest will not arise in the future that could cause material harm to us.

2.7.11 We engage in transactions with our subsidiaries or affiliates that others may not consider to be on an arm's-length basis.

We and our affiliates have entered into a number of services agreements pursuant to which we render services, such as administrative, accounting, finance, treasury, legal services and others.

Spanish law provides for several procedures designed to ensure that the transactions entered into with or among our financial subsidiaries and/or affiliates do not deviate from prevailing market conditions for those types of transactions.

We are likely to continue to engage in transactions with our affiliates. Future conflicts of interests between us and any of affiliates, or among our affiliates, may arise, which conflicts may not be resolved in our favor.

2.8 *Financial Reporting and Control Risks*

2.8.1 Changes in accounting standards could impact reported earnings.

The accounting standard setters and other regulatory bodies periodically change the financial accounting and reporting standards that govern the preparation of our consolidated financial statements. These changes can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in the restatement of prior period financial statements. For further information about developments in financial accounting and reporting standards, see Note 1 to our consolidated financial statements.

2.8.2 Our financial statements are based in part on assumptions and estimates which, if inaccurate, could cause material misstatement of the results of our operations and financial position.

The preparation of financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgments and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognized in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to our results and financial position, based upon materiality and significant judgments and estimates, include impairment of loans and advances, goodwill impairment, valuation of financial instruments, impairment of available-for-sale financial assets, deferred tax assets provision and pension obligation for liabilities.

If the judgment, estimates and assumptions we use in preparing our consolidated financial statements are subsequently found to be incorrect, there could be a material effect on our results of operations and a corresponding effect on our funding requirements and capital ratios.

2.8.3 Disclosure controls and procedures over financial reporting may not prevent or detect all errors or acts of fraud.

Disclosure controls and procedures over financial reporting are designed to provide reasonable assurance that information required to be disclosed by the company in reports filed or submitted under the U.S. Securities Exchange Act of 1934 (the “Exchange Act”) is accumulated and communicated to management, and recorded, processed, summarized and reported within the time periods specified in the US Securities and Exchange Commission’s rules and forms.

These disclosure controls and procedures have inherent limitations which include the possibility that judgments in decision-making can be faulty and that breakdowns occur because of errors or mistakes. Additionally, controls can be circumvented by any unauthorized override of the controls. Consequently, our businesses are exposed to risk from potential non-compliance with policies, employee misconduct or negligence and fraud, which could result in regulatory sanctions, civil claims and serious reputational or financial harm. In recent years, a number of multinational financial institutions have suffered material losses due to the actions of ‘rogue traders’ or other employees. It is not always possible to deter employee misconduct and the precautions we take to prevent and detect this activity may not always be effective. Accordingly, because of the inherent limitations in the control system, misstatements due to error or fraud may occur and not be detected.

2.9 *Foreign Private Issuer and Other Risks*

2.9.1 Our corporate disclosure may differ from disclosure regularly published by issuers of securities in other countries, including the United States.

Issuers of securities in Spain are required to make public disclosures that are different from, and that may be reported under presentations that are not consistent with, disclosures required in other countries, including the United States. In particular, for regulatory purposes, we currently prepare and will continue to prepare and make available to our shareholders statutory financial statements in accordance with IFRS-IASB, which differs from U.S. Generally Accepted Accounting Principles in a number of respects. In addition, as a foreign private issuer, we are not subject to the same disclosure requirements in the United States as a domestic U.S. registrant under the Exchange Act, including the requirements to prepare and issue quarterly reports, the proxy rules applicable to domestic U.S. registrants under Section 14 of the Exchange Act or the insider reporting and short-swing profit rules under Section 16 of the Exchange Act. Accordingly, the information about us available to you will not be the same as the information available to shareholders of a U.S. company and may be reported in a manner that you are not familiar with.

2.9.2 Investors may find it difficult to enforce civil liabilities against us or our directors and officers.

The majority of our directors and officers reside outside of the United States. In addition, all or a substantial portion of our assets and the assets of our directors and officers are located outside of the United States. Although we have appointed an agent for service of process in any action against us in the United States with respect to our ADSs, none of our directors or officers has consented to service of process in the United