D. Risk factors

Risks Relating to Our Operations

Since our loan portfolio is concentrated in Continental Europe, the United Kingdom and Latin America, adverse changes affecting the Continental European, the United Kingdom or certain Latin American economies could adversely affect our financial condition.

Our loan portfolio is concentrated in Continental Europe (in particular, Spain), the United Kingdom and Latin America. At December 31, 2009, Continental Europe accounted for approximately 47% of our total loan portfolio (Spain accounted for 33% of our total loan portfolio), while the United Kingdom and Latin America accounted for 33% and 14%, respectively. Therefore, adverse changes affecting the economies of Continental Europe (in particular, Spain), the United Kingdom or the Latin American countries where we operate would likely have a significant adverse impact on our loan portfolio and, as a result, on our financial condition, cash flows and results of operations. See "Item 4. Information on the Company—B. Business Overview."

Some of our business is cyclical and our income may decrease when demand for certain products or services is in a down cycle.

The level of income we derive from certain of our products and services depends on the strength of the economies in the regions where we operate and certain market trends prevailing in those areas. Therefore, negative cycles may adversely affect our income in the future.

Our business could be affected if our capital is not managed effectively.

Effective management of our capital position is important to our ability to operate our business, to continue to grow organically and to pursue our strategy. Any future change that limits our ability to manage our balance sheet and capital resources effectively or to access funding on commercially acceptable terms could have a material adverse effect on our financial condition and regulatory capital position.

A sudden shortage of funds could increase our cost of funding and have an adverse effect on our liquidity and funding.

Historically, our principal source of funds has been customer deposits (demand, time and notice deposits). At December 31, 2009, 21.4% of these customer deposits were time deposits in amounts greater than $100,000. Total time deposits represented 46.8%, 48.8% and 48.9% of total customer deposits at the end of 2009, 2008 and 2007, respectively. Large-denomination time deposits may be a less stable source of deposits than other type of deposits. The loss of market liquidity, triggered by the deterioration of the US sub-prime credit market, affected the supply and cost of liquidity and funding. The effects of the downturn spread to the global economy, in particular to issuances in wholesale markets (principally asset-backed securities) and to availability of liquid resources via the interbank markets. Although recent months have seen an improvement in market conditions, there can be no assurance that we will not incur materially higher funding costs or be required to liquidate certain assets.

We are vulnerable to disruptions and volatility in the global financial markets as well as to government action intended to alleviate the effects of the financial crisis.

Commencing in August 2007, the global financial system experienced difficult credit and liquidity conditions and disruptions leading to less liquidity, greater volatility, general widening of spreads and, in some cases, lack of price transparency on interbank lending rates. In September 2008, global financial markets deteriorated sharply following the bankruptcy filing by Lehman Brothers Holdings Inc. In the days that followed, it became apparent that a number of other major financial institutions, including some of the largest global commercial banks, investment banks, mortgage lenders, mortgage guarantors and insurance companies, were experiencing significant difficulties.

Following the bankruptcy filing by Lehman Brothers Holdings Inc., there were runs on deposits at several financial institutions and numerous institutions sought additional capital. Central banks around the world coordinated efforts to increase liquidity in the financial markets by taking measures such as increasing the amounts they lend directly to financial institutions, lowering interest rates and significantly increasing temporary reciprocal currency arrangements (or "swap lines").

In an attempt to prevent the failure of the financial system, the United States and European governments intervened on an unprecedented scale. In the United States, the federal government took equity stakes in several financial institutions, implemented a program to guarantee the short-term and certain medium-term debt of financial institutions, increased consumer deposit guarantees, and brokered the acquisitions of certain struggling financial institutions, among other measures. In the United Kingdom, the government effectively nationalized some of the country’s largest banks, provided a preferred equity program open to all financial institutions and a program to guarantee short-term and certain medium-term debt of financial institutions, among other measures. In Spain, the government increased consumer deposit guarantees, made available a program to guarantee the debt of certain financial institutions, created a fund to purchase assets from financial institutions and the Spanish Ministry of Economy and Finance was authorized, on an exceptional basis and until December 31, 2009, to acquire, at the request of credit institutions resident in Spain, shares and other capital instruments (including preferred shares) issued by such institutions.

Despite the extent of the aforementioned intervention, global investor confidence remains cautious. In addition, the world’s largest developed economies, including the United States and United Kingdom, although improving in recent months, ended 2009 under economic recessions. In addition, recent downgrades of the sovereign debt of Greece, Portugal and Spain have caused volatility in the capital markets. Continued or worsening disruption and volatility in the global financial markets could have a material adverse effect 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. Any such increase in capital markets funding costs or deposit rates would entail a repricing of loans, which would result in a reduction of volumes, and may also have an adverse effect on our interest margins. A further economic downturn, especially in Spain, the United Kingdom, other European countries, the United States and certain Latin American countries, could also result in a further reduction in business activity and a consequent loss of income for us.

Risks concerning borrower credit quality and general economic conditions are inherent in our business.

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. Adverse changes in the credit quality of our borrowers and counterparties or a general deterioration in Spanish, United Kingdom, Latin American, United States or global economic conditions, or arising from systemic risks in the financial systems, could reduce the recoverability and value of our assets and require an increase in our level of allowances for credit losses. Deterioration in the economies in which we operate could reduce the profit margins for our banking and financial services businesses.

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

Market turmoil and economic recession, especially in Spain, the United Kingdom, the United States and certain Latin American countries, could materially and adversely affect the liquidity, 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 the context of continued market turmoil, economic recession and increasing unemployment coupled with declining consumer spending, the value of assets collateralizing our secured loans, including homes and other real estate, could decline significantly, which could result in the impairment of the value of our loan assets. Moreover, in 2009 we experienced an increase in our non-performing ratios and a deterioration in asset quality as compared to 2008. 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. Any of the conditions described above could have a material adverse effect on our business, financial condition and results of operations.

We are exposed to risks faced by other financial institutions.

We routinely transact with counterparties in the financial services industry, including brokers and dealers, commercial banks, investment banks, mutual and 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. These liquidity concerns have had, and may continue to have, a chilling effect on inter-institutional financial transactions in general. 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. A default by a significant financial counterparty, or liquidity problems in the financial services industry in general, could have a material adverse effect on our business, financial condition and results of operations.

Our exposure to Spanish and UK real estate markets makes us more vulnerable to adverse developments in these markets.

As mortgage loans are one of our principal assets, comprising 53% of our loan portfolio as of December 31, 2009, we are currently highly exposed to developments in real estate markets, especially in Spain and the United Kingdom. In addition, we currently have exposure to certain real estate developers in Spain. From 2002 to 2007, demand for housing and mortgage financing in Spain increased significantly driven by, among other things, economic growth, declining unemployment rates, demographic and social trends, the desirability of Spain as a vacation destination and historically low interest rates in the Eurozone. The United Kingdom experienced a similar increase in housing and mortgage demand, driven by, among other things, economic growth, declining unemployment rates, demographic trends and the increasing prominence of London as an international financial center. During late 2007, the housing market began to adjust in Spain and the United Kingdom as a result of excess supply (particularly in Spain) and higher interest rates. Since 2008, as economic growth came to a halt in Spain and the United Kingdom, housing oversupply has persisted, unemployment has continued to increase, housing demand has continued to decrease and home prices have declined while mortgage delinquencies increased. As a result, our non-performing loan ratio increased from 0.94% at December 31, 2007, to 2.02% at December 31, 2008 and to 3.24% at December 31, 2009. These trends, especially higher 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.

Portions of our loan portfolio are subject to risks relating to force majeure and any such event could materially adversely affect our operating results.

Our financial and operating performance may be adversely affected by force majeure, such as natural disasters, particularly in locations where a significant portion of our loan portfolio is composed of real estate loans. Natural disasters such as earthquakes and floods may cause widespread damage which could impair the asset quality of our loan portfolio or could have an adverse impact on the economy of the affected region.

In particular, our operations in Chile were adversely affected by the 8.8 magnitude earthquake that struck central Chile on February 27, 2010. Certain government officials have stated publicly that the Chilean gross domestic product may decline by approximately 1.5% in 2010 as a result of the earthquake. In addition, the earthquake has adversely affected many of our corporate and retail customers. Although it is premature to assess the extent of the adverse effect of the recent earthquake on the Chilean economy, our customers and our loan portfolio, it is likely that these events will adversely affect the asset quality of our Chilean loan portfolio and our results of operations in Chile.

We may generate lower revenues from brokerage and other commission- and fee-based businesses.

Market downturns are likely to lead to declines in the volume of transactions that we execute for our customers and, therefore, to declines in our non-interest revenues. In addition, because the fees that we charge for managing our clients' portfolios are in many cases based on the value or performance of those portfolios, a market downturn that reduces the value of the our clients' portfolios or increases the amount of withdrawals would reduce the revenues we receive from our asset management and private banking and custody businesses.

Even in the absence of a market downturn, below-market performance by our mutual funds may result in increased withdrawals and reduced inflows, which would reduce the revenue we receive from our asset management business.

Market risks associated with fluctuations in bond and equity prices and other market factors are inherent in our business. Protracted market declines can reduce liquidity in the markets, making it harder to sell assets and leading to material losses.

The performance of financial markets may cause changes in the value of our investment and trading portfolios. In some of our business, protracted adverse market movements, particularly asset price decline, can reduce the level of activity in the market or reduce market liquidity. These developments can lead to material losses if we cannot close out deteriorating positions in a timely way. This may especially be the case for assets of the Group for which there are less liquid markets to begin with. Assets that are not traded on stock exchanges or other public trading markets, such as derivative contracts between banks, may have values that we calculate using models other than publicly quoted prices. Monitoring the deterioration of prices of assets like these is difficult and could lead to losses that we did not anticipate.

The increasing volatility of world equity markets due to the recent economic uncertainty is having a particular impact on the financial sector. This may affect the value of our investments in entities in this sector 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.

Volatility in interest rates may negatively affect our net interest income and increase our non-performing loan portfolio.

Changes in market interest rates could affect the interest rates charged on interest-earning assets differently than the interest rates paid on interest-bearing liabilities. This difference could result in an increase in interest expense relative to interest income leading to a reduction in our net interest income. Income from treasury operations is particularly vulnerable to interest rate volatility. Since the majority of our loan portfolio reprices in less than one year, rising interest rates may also bring about an increasing non-performing loan portfolio. Interest rates are highly sensitive to many factors beyond our control, including deregulation of the financial sector, monetary policies, domestic and international economic and political conditions and other factors.

As of December 31, 2009, our interest rate risk measured in daily Value at Risk (“VaRD”) terms amounted to €211.4 million.

Foreign exchange rate fluctuations may negatively affect our earnings and the value of our assets and shares.

Fluctuations in the exchange rate between the euro and the US dollar will affect the US dollar equivalent of the price of our securities on the stock exchanges in which our shares and ADSs are traded. These fluctuations will also affect the conversion to US dollars of cash dividends paid in euros on our ADSs.

In the ordinary course of our business, we have a percentage of our assets and liabilities denominated in currencies other than the euro. Fluctuations in the value of the euro against other currencies may adversely affect our profitability. For example, the appreciation of the euro against some Latin American currencies and the US dollar will depress earnings from our Latin American and US operations, and the appreciation of the euro against the sterling will depress earnings from our UK operations. Additionally, while most of the governments of the countries in which we operate have not imposed prohibitions on the repatriation of dividends, capital investment or other distributions, no assurance can be given that these governments will not institute restrictive exchange control policies in the future. Moreover, fluctuations among the currencies in which our shares and ADSs trade could reduce the value of your investment.

As of December 31, 2009, our largest exposures on temporary positions (with a potential impact on the income statement) were concentrated, in descending order, on the pound sterling and the Chilean peso. On that day, our largest exposures on permanent positions (with a potential impact on equity) were concentrated, in descending order, on the Brazilian real, the pound sterling, the Mexican peso and the Chilean peso.

Despite our risk management policies, procedures and methods, we may nonetheless be exposed to unidentified or unanticipated risks.

Our risk management 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. If existing or potential customers believe our risk management is inadequate, they could take their business elsewhere. This could harm our reputation as well as our revenues and profits.

Our recent and future acquisitions may not be successful and may be disruptive to our business.

We have acquired controlling interests in various companies and have engaged in other strategic partnerships. See “Item 4. Information on the Company — A. History and development of the Company.” Additionally, we may consider other strategic acquisitions and partnerships from time to time. While we are optimistic about the acquisitions we have made, there can be no assurances that we will be successful in our plans regarding the operation of these or other acquisitions and strategic partnerships.

We can give no assurance that our recent and any future acquisition and partnership activities will perform in accordance with our expectations. We base our assessment of potential acquisitions and partnerships on limited and potentially inexact information and on assumptions with respect to operations, profitability and other matters that may prove to be incorrect. We can give no assurances that our expectations with regards to integration and synergies will materialize.

Increased competition in the countries where we operate may adversely affect our growth prospects and operations.

Most of the financial systems in which we operate are highly competitive. Financial sector reforms in the markets in which we operate have increased competition among both local and foreign financial institutions, and we believe that this trend will continue. In particular, price competition in Europe, Latin America and the US has increased recently. Our success in the European, Latin American and US markets will depend on our ability to remain competitive with other financial institutions. 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.

Changes in the regulatory framework in the jurisdictions where we operate could adversely affect our business.

As a result of the current financial crisis and ensuing government intervention, it is widely anticipated that there will be a substantial increase in government regulation of the financial services industry, including the imposition of higher capital requirements, heightened disclosure standards and restrictions on certain types of transaction structures. In addition, novel proposals for new regulatory initiatives, abound in the current environment. If enacted, new regulations could require us to inject further capital into our business as well as in businesses we acquire, restrict the type or volume of transactions we enter into, or set limits on or require the modification of rates or fees that we charge on certain loan or other products, any of which could lower the return on our investments, assets and equity. We may also face increased compliance costs and limitations on our ability to pursue certain business opportunities. Changes in regulations, which are beyond our control, may have a material effect on our business and operations. As some of the banking laws and regulations have been recently adopted, the manner in which those laws and related regulations are applied to the operations of financial institutions is still evolving. Moreover, no assurance can be given generally that laws or regulations will be adopted, enforced or interpreted in a manner that will not have material adverse affect on our business.

Operational risks are inherent in our business.

Our businesses depend on the ability to process a large number of transactions efficiently and accurately. 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. We have suffered losses from operational risk in the past and there can be no assurance that we will not suffer material losses from operational risk in the future.

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 management team. The ability to continue to attract, train, motivate and retain highly qualified professionals is a key element of our strategy. The successful implementation of our growth strategy depends on the availability of skilled management, both at our head office and at each of our business units. If we or one of our business units or other functions fails to staff our operations appropriately or loses one or more of our key senior executives 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. Likewise, if we fail to attract and appropriately train, motivate and retain qualified professionals, our business may also be affected.

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

Maintaining a positive reputation is critical to our attracting and maintaining customers, investors and employees. 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, litigation or regulatory outcomes, failing to deliver minimum standards of service and quality, compliance failures, unethical behavior, and the activities of customers and counterparties. Further, negative publicity regarding us, whether or not true, 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 has damaged the reputation of the industry as a whole.

We could suffer significant reputational harm if we fail to properly identify and manage potential conflicts of interest. Management of potential conflicts of interest has become increasingly complex as we expand our business activities through more numerous transactions, obligations and interests with and among our clients. The failure to adequately address, or the 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. Therefore, there can be no assurance that conflicts of interest will not arise in the future that could cause material harm to us.

Different disclosure and accounting principles between Spain and the US may provide you with different or less information about us than you expect.

There may be less publicly available information about us than is regularly published about companies in the United States. While we are subject to the periodic reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), the disclosure required from foreign private issuers under the Exchange Act is more limited than the disclosure required from US issuers. Additionally, we present our financial statements under IFRS-IASB which differs from U.S. GAAP.

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

We face various issues that may give rise to risk of loss from legal and regulatory proceedings. These issues include appropriately dealing with potential conflicts of interest, legal and regulatory requirements, ethical issues, and conduct by companies in which we hold strategic investments or joint venture partners, could increase the number of litigation claims and the amount of damages asserted against the Group or subject the Group to regulatory enforcement actions, fines and penalties. Currently, the Bank and its subsidiaries are the subject of a number of legal proceedings and regulatory actions. An adverse result in one or more of these proceedings could have a material adverse effect on our operating results for any particular period. For information relating to the legal proceedings involving our businesses, see "Item 8. Financial Information—A. Consolidated statements and other financial information—Legal proceedings".

Credit, market and liquidity risks may have an adverse effect on our credit ratings and our cost of funds. Any reduction in our credit rating could increase our cost of funding and adversely affect our interest margins.

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 long-term debt are based on a number of factors, including our financial strength as well as conditions affecting the financial services industry generally.

Any downgrade in our ratings could increase our borrowing costs, limit our access to capital markets and adversely affect the ability of our business to sell or market their products, engage in business transactions—particularly longer-term and derivatives transactions—and retain our customers. This, in turn, could reduce our liquidity and have an adverse effect on our operating results and financial condition.

The Group's long-term debt is currently rated investment grade by the major rating agencies (Aa2 by Moody's Investors Service España, S.A. and AA by each of Standard & Poor's Ratings Services and Fitch Ratings Ltd., respectively). Standard & Poor's maintains our outlook at negative reflecting continued and increased credit deterioration in most economies in which we are present. The downgrade of our rating by Moody's expresses their concerns about the broad deterioration of the Spanish economy, to which we remain heavily exposed, as well as our recently increased exposure to the UK and the US, which both also faced severe economic disruptions, including decreased economic activity and increased unemployment. Moody's expects that we will continue to face further asset quality pressures both from Sovereign and Alliance & Leicester as well as from our home market, and believes that this will lead to significant future provisioning requirements, which in turn would affect our earning power and ability to strengthen our capital levels internally. In light of the difficulties in the financial services industry and the financial markets, there can be no assurance that the rating agencies will maintain their current ratings or outlooks, or with regard to those rating agencies who have a negative outlook on the Group, there can be no assurances that such agencies will revise such outlooks upward. The Group's failure to maintain favorable ratings and outlooks could increase the cost of its funding and adversely affect the Group's interest margins.

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

The economies of the eight Latin American countries where we operate have experienced significant volatility in recent decades, characterized, in some cases, by slow or regressive growth, declining investment and hyperinflation. This volatility has resulted in fluctuations in the levels of deposits and in the relative economic strength of various segments of the economies to which we lend. Latin American banking activities (including Retail Banking, Global Wholesale Banking, Asset Management and Private Banking) accounted for €3,834 million of our profit attributable to the Parent for the year ended December 31, 2009 (an increase of 6% from €3,609 million for the year ended December 31, 2008). Negative and fluctuating economic conditions, such as a changing interest rate environment, impact our profitability by causing lending margins to decrease and leading to decreased demand for higher margin products and services. Negative and fluctuating economic conditions in some Latin American countries could also result in government defaults on public debt. This could affect us in two ways: directly, through portfolio losses, and indirectly, through instabilities that a default in public debt could cause to the banking system as a whole, particularly since commercial banks' exposure to government debt is high in several Latin American countries in which we operate.

In addition, revenues from our Latin American subsidiaries are 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.

No assurance can be given that our growth, asset quality and profitability will not be affected by volatile macroeconomic and political conditions in the Latin American countries in which we operate.

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

Financial and securities markets in the Latin American countries where we operate are, to varying degrees, influenced by economic and market conditions in other countries in Latin America and beyond. Negative developments in the economy or securities markets in one country, particularly in an emerging market, may have a negative impact on other emerging market economies. These developments may adversely affect the business, financial condition and operating results of our subsidiaries in Latin America.