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The international economic context as a factor for business strategy: Low-interest rates influence on The Santander Group

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The international economic context as a factor for business strategy: Low-interest rates influence on The Santander Group

El contexto económico internacional como factor para la estrategia de negocios: la influencia de los bajos tipos de interés en el Grupo Santander

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ABSTRACT: The main purpose of this dissertation is to understand how low interest rates have influenced the economy and the financial sector. This paper includes an analysis of interest rates and how they have impacted in the economy, especially in advanced economies and in the financial sector. It is also going to be studied how business strategies have been changing due to this low-interest rates environment. These concepts are going to be implemented in an empirical case, which is the Santander Group, with a focus on how low-interest rates have affected its business model and its business strategies. The findings of this study support the need to consider interest rates' influence in companies' business strategies.

RESUMEN: El principal propósito de este trabajo se centra en explicar cómo los tipos de interés han influido en la economía y en el sector financiero. Este proyecto incluye un análisis de los tipos de interés y de cómo han impactado en la economía; en concreto en las economías avanzadas y en el sector financiero. También se estudiará cómo las estrategias de negocio han cambiado debido a ese entorno de bajos tipos de interés. Dichos conceptos se van a aplicar en un caso práctico para su demostración, en el Grupo Santander. Se estudiará cómo los bajos tipos de interés han afectado a su modelo de negocio y a sus estrategias. Los resultados de este estudio apoyan la necesidad de tener en cuenta la influencia de los tipos de interés en las estrategias de negocio de las empresas.

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1. INTRODUCTION

"The future is not expected, but is built".

- Maurice Blondel

The economic environment in the last decade has become a trending topic for analysis and discussions. Growth decreased in 2008 turning financial setbacks into a full- scale crisis which synchronized advanced economies and emerging economies due to a reduction of global growth by more than 85%[1]. From the beginning of the financial crisis, benefits from European companies have diminished by 30%[2].

The financial sector has been the most damaged since the crisis began in this sector and it then expanded to the real economy.

The action of central banks has been very influential in the current situation, as they have designed monetary policies with a double objective: to provide liquidity against market collapse, and to fight against deep recession in the economy. Policy rates have been decreasing due to the financial crisis, turning even to negative rates.

In Mario Draghi's words; *"behind the fall in nominal yields, lies a fall in real yields; which is driven by three main factors: a secular slowdown in productivity growth across advanced economies, a global imbalance of saving and investment and debt overhang in the private and public sectors bequeathed by the financial crisis"*.

Historically, zero has been considered as the effective limit of nominal interest rates (*zero lower bound*), based in the concept that it does not exist an investor with the idea of acquiring an asset with a yield lower than zero, which means receiving a smaller capital than the initial investment. But experience has shown that nominal interest rates can be below zero.

This situation has affected especially banks, because negative interest rates mean that their profitability decreases, and there is higher risk of going bankrupt.

Nowadays banks in advanced economies have stronger balance sheets than ten years ago; but they are still fighting for a sustainable profitability. Even if markets recover, there are

[1] INTERNATIONAL MONETARY FUND (2016). Financial stability challenges in a low-growth, low-rate era.
[2] AND BANK (2016). Weekly market report 29th August 2016.

flatter yield curves, disinflationary pressures, structural challenges to their businesses model and regulatory uncertainty.

Due to these circumstances, the aim of this work is to focus on understanding how the low-interest rates environment has affected the economy, and specially banks. It is important to understand this situation together with the fact that banks must design their business strategies in an international context. As a specific example of the challenges a bank has to face, the project will present a practical case involving a Spanish bank, the Santander Group, and will study which strategies have been promoted due to the low-interest rates environment.

The present dissertation can be useful to show that a macroeconomic variable like interest rates can affect the global economy, forcing changes in business strategies for private and public companies; how central banks have decided to decrease them as part of a global solution to the financial crisis, and finally, to make the reader think about the magnitude of the challenges that some companies have to face to improve its weaknesses as a consequence of changes in just one macroeconomic variable.

This project is divided into five sections. Chapter two reviews the basic concepts of interest rates and their determinants. Chapter three discusses the recent evolution of interest rates in the global economy. Chapter four explains some business strategies that can be applied in the current economic environment. In chapter five the Santander Group is presented, and some hypotheses about interest rates influence in its business are developed. Chapter six discusses the main conclusions.

2. BASIC CONCEPTS ON INTEREST RATES

Fluctuations in interest rates affect directly or indirectly every economic agent, such as financial entities, institutional and individual investors or companies. But what could be defined as an interest rate?

2.1. WHAT IS AN INTEREST RATE?

An interest rate can be broadly defined as the cost of credit. It is generally understood to mean the price that must be paid to borrow money for a period; but it can also be described as the return on savings, what a person pays to a credit entity in exchange for a quantity of money, and what a credit entity pays to a customer for lending a quantity of money.

To be more specific, it is an interest corresponding to a capital, which is also called principal. It can be expressed as a percentage over the capital and it is referred to a specific period (normally a one-year-period).

The level of interest rates for a given asset or loan will depend on the combination of determinants such as liquidity, the length of the period or the perception of risk. This means that the more liquid the asset, the shorter the period and the lower the risk, the lower will be the interest rate. In a crisis like the current one, monetary authorities add money to markets to decrease interest rates, improve liquidity and to facilitate the access to credit for customers.

Depending on the period that an investment takes, interest rates can be higher or lower. To understand the relationship between a period of time and a rate, the term structure of interest rates (TSIR) is key.

As spot rates are defined depending on a specific period, it is possible to establish a speculative functional relationship between spot rates and each period. This functional relation is known as the Term Structure of Interest Rates (TSIR) or the Yield Curve. If interest rates are equal for every period, then the yield curve is flat. If interest rates in the short-term are higher than in the long-term, then the TSIR diminishes, and if short-term rates are lower than long-term rates, then it increases.

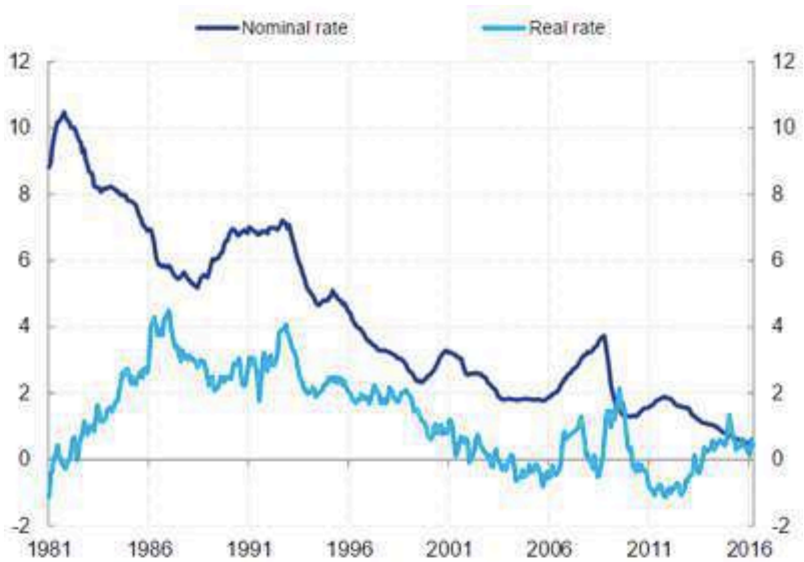
Part of the recent interest rates fall has come from a fall in the term-premium (Adrian et al, 2013), which is the compensation that investors ask for as a result of assuming the risk of short-interest rates not evolve in accordance with projections. In any investment, there is a risk that its value could change due to a change in the interest rates level or in the yield curve shape. If the investment needs external finance and interest rates may rise, this affects the value negatively. Risk may be divided into two types, economic and financial.

Economic types of risk are related to product, operations, fixed costs, dependence, logistics or law. Financial types of risk can be classified into credit to suppliers, inflation, insolvency, country risk, tax risk and exchange rates risk.

Risk is correlated with the rest of determinants, but its relationship with profitability is more relevant. A higher level of profitability does not mean that there is a financial security to obtain higher yields. Higher profitability means higher level of risk

There are three main types of interest rates, which are the nominal interest rate, the effective interest rate and the real interest rate. The nominal interest rate is defined by the European Central Bank (2015) as "*the rate that is agreed and paid*". What customers must pay on their loans or on their mortgages; it is not adjusted for inflation. The effective interest rate is the interest rate on a loan minus the nominal interest rate that can be applied when the liquidity interest period does not coincide with the period used for its calculation. Real interest rate is adjusted for inflation (nominal interest rate minus inflation).

Chart 1. Nominal and real interest rates on short-term bank deposits in euro area countries (European Central Bank)



As Chart 1 shows, nominal rates were higher than real rates in most of the period, due to inflation, as one of the macro variables that influence interest rates most. Therefore, nominal rates are higher when inflation is positive.

2.2. HOW ARE INTEREST RATES FORMED IN THE MARKET?

In every monetary system, there is an official interest rate for money: central banks fix the official rates, using them as a tool for monetary policies.

Central banks are responsible for managing the total amount of money in circulation and their main objective is price stability in terms of the general level of prices in the economy. It implies avoiding prolonged inflation or deflation.

To make this possible, they set interest rates as one of the most important parts of their monetary policies. Central banks are not commercial banks; that means that profit does not motivate them, only the good development of the economy. Official interest rates should be understood as the base for the rest of the interest rates in the economy.

The following description focuses on the European Central Bank (ECB), which is the central bank for the euro-zone, including Spain. Its direct aim is to guarantee price stability as it has been said before, with the purpose of helping economic growth and implementing job creation.

But price stability is not guaranteed, prices for services and goods are constantly changing; inflation happens when there is a steady rise in the general level of goods and services prices. It can be measured as an annual percentage change.

Inflation is a factor that is influenced by interest rates in a country during a specific period because they are correlated; therefore, monetary authorities pay attention to its evolution to decide which policies to develop in order to fight inflation. The most common means to reduce inflation is to increase interest rates.

An oversupply of money causes inflation, but there are two more causes of inflation:

a. <u>Demand-pull inflation</u>: when economic growth is above the growth long-run trend rate (which is determined by growth in productivity).

b. <u>Cost-push inflation</u>: when there is an increase in costs and businesses increase their prices to maintain their profit margins.

As shown in Chart 2, there are important differences in inflation in Europe between periods; from the seventies until the eighties inflation was significantly high with historical peaks. Owing to this situation, interest rates were very high to fight inflation. During the early change inflation was in a "normalisation period" with a stable movement, and it is observable that from 2009 inflation slumped and interest rates have been reduced to solve this situation.

Chart 2. Inflation in Europe from 1961 to 2007 (European Central Bank)

2.2.1. MONETARY POLICIES

Monetary policy can be defined in the words of "The Economic Times" as:

> *The macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity*. (The Economic Times, 2016).

In the European Monetary Union (EMU) mechanism to develop monetary policies starts with the liquidity distribution to the euro system banks and the interest rates control. These measures affect banking interest rates and the financial assets prices, it determines investment and credit decisions and affects wages and prices[3].

Chart 3. Monetary measures in the European Central Bank in 2014 (Source: Own, based on the European Central Bank)

[3] According to the European Central Bank

The European Central Bank sets some interest rates that are called *intervention rates*, which are paid by European banks influence directly interest rates in the market in exchange for European Central Bank's financing, defining the EURIBOR. They can be separated into three types:

a. The interest rate on the main refinancing operation (MRO). It provides most liquidity to the banking sector. It refers to one-week periods.

b. The rate on the deposit facility. Banks use it to make overnight deposits with the Euro system; and it is applied the EONIA rate as one determinant for.

c. The rate on the marginal lending facility. It offers overnight credits to those banks that belong to the Euro system.

The European Central Bank reduced interest rates during the first years of the financial crisis to incentive investment and consumer spending of households and companies, reducing their borrowing costs. Later, it has been developed a *quantitative easing policy*; an unconventional policy where central banks purchase bonds from banks or non-financial companies to increase money supply and decrease interest rates.

2.2.2. EURIBOR and EONIA. European market interest rates

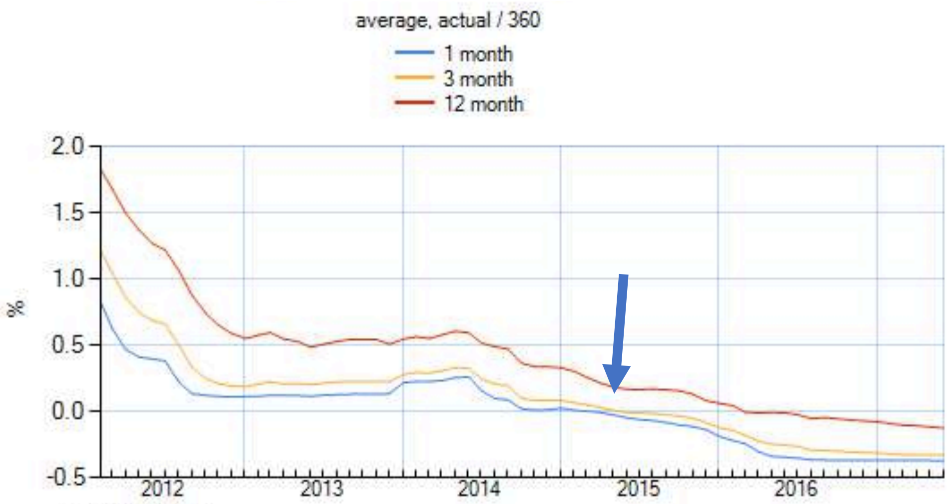
Euribor are public short-term rates that are calculated every day at 11:00 am (CET)[4]. They are based on the interest rates at which a group of European banks (the most relevant currently) borrow funds one from another.

For its calculation, the highest 15% of every quote that has been collected and the lowest 15% are eliminated. There are eight different Euribor interest rates and they provide the basis for the interest rate of every financial product.

As shown in Chart 4, its development during the last years follows a similar structure to interest rates in general terms, as it has been said before. It is observable that from 2015 the Euribor rate has been negative; as an example of the consequences of the quantitative easing.

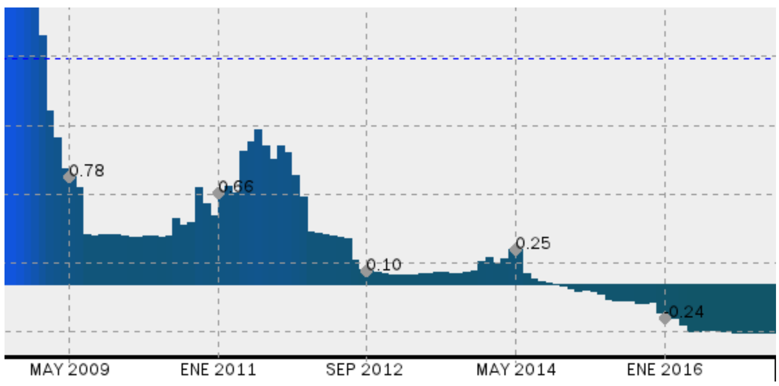
[4] EURIBOR-RATES.EU (2017). What is Euribor?

Chart 4. Euribor monthly evolution from 2011 to 2017 (Suomen Pankki Bank)



The Eonia rate is the one-day interbank interest rate in the Eurozone, and this means that is the rate at which European banks provide loans to each other every day.

Chart 5. EONIA and European Central Bank policy rates (European Money Markets Institute)



In Chart 5, the same evolution as in the previous charts can be observed, the low-interest rate environment is bringing down every rate in Europe, with an important drop in 2009 and another one in 2014. It can also be observed, as in the Euribor chart, that nowadays the Eonia rate is lower than zero.

Interest rates are one of the main macroeconomic variables that affect markets, banks and the whole economy. Once the main concepts have been laid down, the evolution of interest rates in the recent years and the consequences in the real economy, and specially for banks, are developed in the next section.

3. THE LOW INTEREST RATES CONTEXT

Since the last financial crisis in 2008 the economy has been suffering its consequences, with a reduction of economic growth over 85%[5] and a reduction by 30% in European companies benefits[6]. The action of central banks has been determinant for the current situation, as they designed monetary policies with a double objective; to provide liquidity against bank market collapse, and to fight against a deep recession in the economy. Monetary policies have fought against an inflation rate at historically low levels in advanced economies, to promote public and private investment and to reduce economic uncertainty[7].

Advanced economies have suffered the worst consequences from the financial crisis because they were at the epicentre of the global financial crisis. Continuous deceleration in global growth made financial markets suffer an extensive period of low interest rates, turning zero or even negative[8] during the last years. Interest rates were previously low but with the last financial crisis they have steadily turned negative.

In Chart 4 the evolution of interest rates in the last years shows a cyclical move, increasing and decreasing; but the most important fact is that from 2015, there are negative nominal interest rates in Europe and it is seems that the trend is not reversing.

The low-interest rates environment has been the source of difficulties for financial companies and banks. They have been significantly damaged by this scenario, which has reduced their profitability, as well as their shareholders' opinion, as can be observed in the stock market, owing to the economic uncertainty and the financial situation.

Some determinants of this financial context are selected in this dissertation because of their importance in the current economy situation in the last years.

<u>Low inflation</u>

Inflation has declined across developed markets. Economists have called this "the missing inflation". As it has been observed in Chart 2, inflation decreased significantly in Europe in 2013, and the same trend has continued.

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[5] INTERNATIONAL MONETARY FUND (2016). Financial stability challenges in a low-growth, low-rate era.
[6] AND BANK (2016). Weekly market report 29th August 2016.
[7] BANCO DE LA REPÚBLICA- COLOMBIA (2013). ¿Por qué es importante tener una inflación baja y estable?
[8] GARCÍA, A. and NEUT, A. (2016). How long can the low interest rate environment last?

This has impacted decreasing interest rates charged by banks on borrowings, loans or interest rates demanded by depositors.

Low interest rates

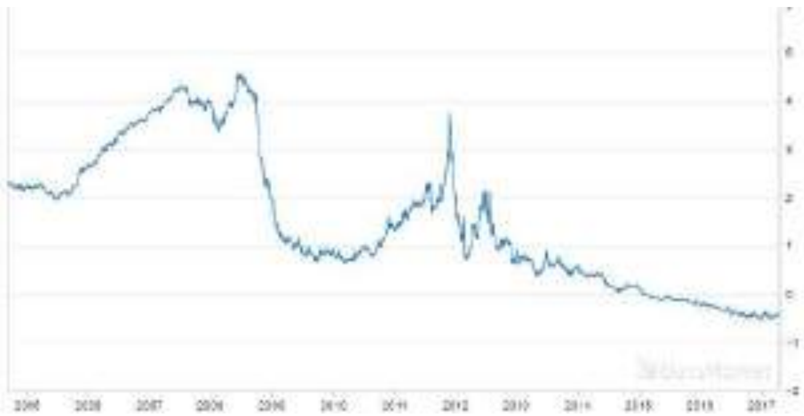
The plunge in interest rates during the last decade has been caused by an expansionary monetary policy to improve demand and consumption.

Central banks decided to take measures to fight the crisis environment and help the recovery of aggregated demand, as it has been explained in the previous chapter. For example, the Federal Reserve (Fed) provided liquidity to banks and financial institutions in the short-term at the beginning of the crisis. It also provided liquidity directly to borrowers and investors, and decreased long- term interest rates to improve open market operations[9].

The European Central Bank has decreased interest rates to incentive investment and consumer spending, through the reduction of borrowing costs that could increase the borrowing demand. To do this, there has been lately a quantitative easing, where central banks purchase bonds from banks and non-financial companies to increase the money supply and decrease interest rates.

The low-interest rates environment has made the euro area yield curve low and flat, as can be seen in Chart 7. The negative interest rates situation has made the European Central bank estimate zero-coupon yield curves; which means that bonds pay no coupon from 2015. This tendency seems to have levelled out.

Chart 6. Euro yield par curve; 1-year maturity (Data Market)



[9]BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (2017): Credit and liquidity programs and the balance sheet.

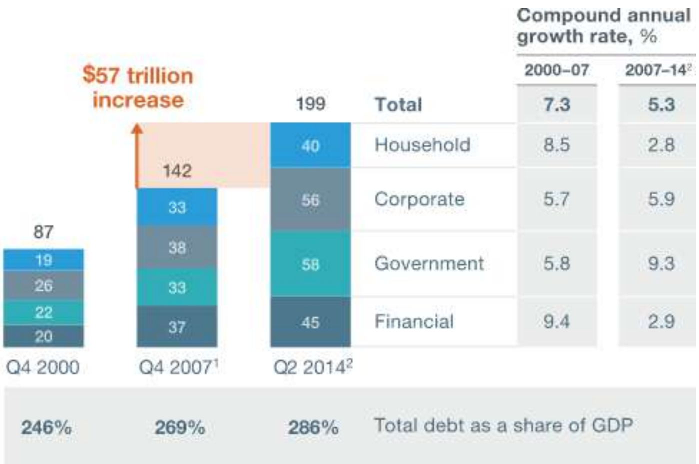
High global debt levels

Variations in interest rates have more effect in the economy when the debt stock is high, and this has been the case in the last years.

"Global debt has grown by $57 trillion and no major economy has decreased its debt-to-GDP ratio since 2007" (McKinsey, 2015). This global debt is an evidence of the increase in government debt because of the recession, a weak recovery since the financial crisis plus a deceleration in household debt due to lending difficulties from banks.

Chart 6 shows that in seven years (from 2007 to 2014) there was a drop in the compounded annual growth rate of the debt stock for financial companies and households. Meanwhile, the annual growth rate for government debt has significantly increased from 5.8% to 9.3%. But it is also important to remark that total debt as a share of GDP was increasing well before the financial crisis and it has continued to growth.

Chart 7. Global stock of outstanding debt (McKinsey Global Institute Analysis)



To better understand the current economic structural and cyclical situation, it is very important to explain those factors that have pressed real interest rates down.

3.1. FACTORS THAT HAVE PRESSED INTEREST RATES DOWN

During the last decade, different forces have driven real interest rates down, with factors such as credit supply expansion, credit demand contraction, and some variations in the credit market.

a. The credit supply expansion has been encouraged by three factors:

Table 1. Credit supply expansion factors (Source: Own, based on BBVA Research except where indicated)

External surplus	It results in an increase in reserves, which are invested in "safe assets" mainly in advanced economies and this provokes an important fall in free-risk interest rates.
Demographical change in advanced economies	Life-expectancy is longer than in the past, and it has expanded the global saving curve during last decades.
Inequality in the largest developed countries	Inequality in the income distribution has been rising during the last decade in those countries with higher purchasing power, provoking an inverse sensibility to interest rates (reducing consumption in those countries with higher purchasing power as a reaction to low interest rates).

b. The credit demand contraction has been increased by three factors:

Table 2. Credit demand contraction factors (Source: Own, based on BBVA Research except where indicated)

Fall in productivity and growth expectations	Ageing population, and the deficit in advanced economies have contributed to a structural fall of productivity (*see Appendix 1).*
Drop in capital goods investment	Investment has been reduced in nominal terms and it has pushed interest rates down. This effect can continue in the future (Ali et al, 2014).
Public investment in advanced economies has fallen	There has been progressive reduction since 1980, from a 4.5% of GDPto around 3%GDPnowadays. This situation has made private investment and productivity growth to fall down, reinforcing the fall in demand.

c. The variations in the credit market were increased due to two factors:

Table 3. Variations in credit market factors (Source: Own, based on BBVA Research except where indicated)

Answers to financial repression	A response to the financial crisis and debt has resulted from a quantitative easing made by central banks as a large-scale program to promote a rise in lending.
Predictability of the monetary policy	Part of the interest rates fall has come from a fall in the term premium (Adrian et al, 2013), which is the compensation that investors ask as a result of assuming the risk that short-interest rates do not evolve in accordance with projections.

3.2. CONSEQUENCES OF CURRENT INTEREST RATES LEVELS

Every move from monetary authorities has direct consequences for customers and companies in prices, credits, loans, savings… As it has been explained before, the fall in policy interest rates has been intended to stimulate the economy. There are two types of consequences in the euro area, positive and negative. Positive consequences are the following.

- A reduction in Euribor is translated into a drop in mortgages quotes. In Spain, more than the 80% of mortgages are directly related to the Euribor and variable interest rates (BBVA Research, 2015).
- The cost of loans goes down and companies and citizens can have a cheaper and easier access to credit. A reduction in the rate that central banks use to lend money will automatically contract interest rates.
- Families have higher amounts of money for daily consumption due to lower interest payments. This can be translated into a national demand improvement; and this into companies' sales increase.
- Exports grow due to the euro depreciation because of lower interest rates and this makes companies with internationalization strategies more competitive.

Negative consequences are the following.

- Lower profitability in saving products. Profitability in bank deposits is contracted, and it could be possible that savers will invest in risky equity in search of higher profits.
- The euro depreciation could have bad consequences for citizens; if they travel abroad their money will have a lower value.

Banks have suffered significantly owing to the financial crisis and to those changes that came from monetary policies, as the next section explains.

3.3. FEATURES IN THE FINANCIAL SYSTEM

The last financial crisis and the measures that central banks have applied to the financial system to fight against it have affected and damaged banks' activity and their businesses models. This process has had some negative effects for their balance sheets and their activities[10]. Low interest rates are one of the factors that have determined significant changes in the financial system during the last years. But there was also an increase in market regulation with higher capital and liquidity requirements affecting the structure of balance sheets; not only in liabilities, but also on the asset side.

<u>Increase in regulation</u>

Some examples of the new measures include higher capital requirements, liquidity coverage ratios, loss absorbing capacity requirements and leverage ratios[11].

The increase in regulation has had an impact on three levels.

Table 4. Levels of impact in the financial system (Source: Own, based on Santander, profitability and growth)

Credit growth	Capital requirements are more stringent; therefore, banks are becoming more selective with lenders and their lending activity.
Business model	Increasing banks' funding costs owing to investors' concerns over bank profitability.
Profitability	Low margins under pressure, higher capital requirements and increase pricing competition put profitability under pressure.

[10] FAIBISHENKO, A. and OCAÑA, C. (2016). "Challenges ahead for the banking industry".
[11] FAIBISHENKO, A. and OCAÑA, C. (2016). "Challenges ahead for the banking industry".

As Ocaña has pointed out:

> *These objectives* [unique macro environment, stricter regulation and technology-related disruptive change] *are not entirely compatible. New measures do not come free costs, bringing with them consequences for the financial sector, and depending on bank's answers in credit supply terms, potential impact on real economy and outweigh costs benefits". (OCAÑA, C. 2016).*

Lack of profitability

Lack of profitability is the main problem for every financial institution. The prolonged exposition to the low-interest rates environment, which some specialists have denominated the *New Normal*[12] (*see Appendix 1*), has mixed with a low nominal GDP growth, making bank's profitability fall.

As the ECB highlighted in its Financial Stability Review (2016): "*since the start of the crisis, many European banks have diversified their sources of income to maintain profitability".* On the whole, what banks need to do to improve this situation can imply changing business strategies, rise revenue growth and decrease costs.

Changes in the business model and in the income structures

The low-interest rates environment, regulatory requirements, an increasing competition and deleveraging has forced banks to adapt their businesses models harder to maintain their profitability. Changes have involved the balance sheet composition and their income structure.

Balance sheet composition has been affected in its whole structure. On the liability side, there has been a growing weight in bank's own resources; and on the asset side, there has been a decline in those activities that need a larger consumption of capital (*see Appendix 2).*

The income structure has suffered changes due to low interest rates pressure, which has a negative impact on net interest margin, and also because of the drop in lending growth[13].

[12] Initially it was defined as a time of low, but predictable growth.
[13] Negative in some countries like Spain.

These two factors have forced banks to look for alternative sources of income, such as commissions or trading income.

Next, the case of the Spanish financial sector will be presented in terms of how it has been affected by the low-interest rate environment and how it has assumed the consequences as a mature market. It will be useful to understand how the general concepts previously explained have been applied in a well-known situation.

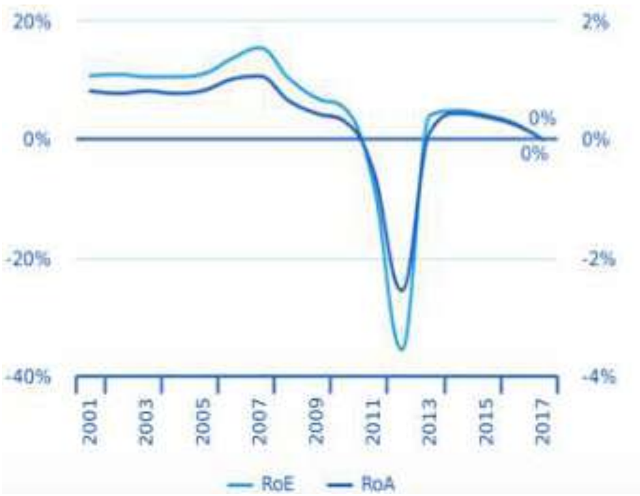
3.3.1. THE SPANISH CASE

The Spanish financial market has the same characteristics of every mature economy: low interest rates, low inflation, high private and public debt levels, a flat yield curve... But it is a fact that every country has its specific features. The specific characteristics for Spain in the recent years are the following:

- The housing bubble was a determinant for economic growth from 2007 to 2013. In 2008, house prices were dramatically high and the real estate market started to decline and consequently house prices began to fall. Between 2007 and 2013, they had fallen by 37%[14]. One of its main effects was household debt growth.
- During the crisis unemployment went significantly high, and wages went down, entering in a recession; which means the economy contracted for a long period.
- There was a liquidity problem for the banking system during the financial crisis, Spain financed itself with a huge amount of external funding. During the economic expansion, growth was supported basically by external funding, been one of the most dependent economies in Europe[15].
- We can see in Chart 8 that the Spanish banking system had some solvency and profitability problems from 2010 on, as a result of excess lending to customers who were not able to return the money back after the financial crisis. Some banks and specially saving banks entered in bankruptcy needed to be saved by other banks or by public intervention.

[14] KARAIAN, J. (2013). The Pain in Spain.
[15] VEGA, J. (2015). “A España le cuesta reducir su dependencia financiera externa”.

Chart 8. RoE and RoA banks' evolution in the Spanish financial system (BBVA Research)



These factors have affected considerably the Spanish financial system, because it is bank-based[16]. But it is also a fact, that the measures that Spain has undertaken during the last years have had positive effects, with better results than in other countries with a similar economic situation.

There has been a restructuration of the Spanish banking system since the beginning of the crisis. Financial entities have took over several problems like decapitalization, doubtful loans increase, difficulties to reach international financing or business diminution due to the decline in economic growth. All these changes have taken place in a low-interest rates environment.

As it has been discussed in the previous section, balance sheets and net income in banks have suffered several changes during the last decade in the whole euro area, increasing deposits of euro area residents from 51.3% to 54.8% or capital and reserves from 5.7% to 8.0%. And decreasing debt securities issued from 15.7% to 12.1% or from 4.4% to 3.8% in holdings of shares (*see Appendix 2*). In Spain, the change adopting new measures took longer. Between 2008 and 2015, Spanish authorities adopted several measures to provide liquidity to entities, promoting consolidation and restructuring the most fragile ones. But they did not reach the expected results due to a persistent uncertainty about asset quality.

[16] FERNANDEZ DE GUEVARA, J. and MAUDAS, J. (2012): El sector bancario español en el contexto internacional.

4. MAIN BUSINESS STRATEGIES TO FIGHT AGAINST LOW-INTEREST RATES ENVIRONMENT

There are many business strategies that can be very useful to fight against this new era of low interest rates. In this study, the two main business strategies that have been chosen are internationalization and diversification, because they can be better suited for the empirical work, where the international context is dealt with. Every company should start by analysing its internal and external environment in order to choose the most appropriate strategy (*see Appendix 3 for an explanation of the study of the environment)*.

4.1. INTERNATIONALIZATION

Internationalization can be defined as a total or partial operation displacement from a company. The operations to be internationalized are those where the company looks for a competitive advantage for the product, the business model or the country (economies of scale, cost reduction, new markets …).

To start the internationalization process, several reasons to motivate the company to cross the borders of its country of origin must exist. The main ones could be to exploit new commercial opportunities in other countries or to seize the foreign countries opportunities. The knowledge and engagement a company can afford in its internationalization process could be divided into two types of strategies: defensive and offensive (Durán, J. 1995).

Defensive strategies are meant to help the company survive. They are focused on gaining competitiveness, fighting against foreign competition that is entering or established in the local market. These strategies can be developed through cooperation arrangements and direct foreign investment.

Offensive strategies are related to an internationalization strategy; without the survivor sense that defensive strategies have. This type of strategy can be applied through direct investment for a transnational competitive advantage or to take advantage of markets with new opportunities.

4.2. DIVERSIFICATION

Companies normally use this type of strategy to manage risk, minimizing potential damages during economic downfalls. It can also be used as a growth strategy. Diversification can be defined as the action that a company takes to develop a new product or to expand into a new market.

This can be understood as an example of why some companies move part of their businesses to another country or to different segments of the market; an example could be a company that moves part of it to an emergent country. If part of the company has any damage or enters into bankruptcy, this strategy will make the company more viable.

There are different types of diversification depending on which direction the company decides to follow.

Table 5. Types of diversification (Source: Own, based on Business strategy's classwork)

Horizontal	Acquiring or developing new products or offering new services that could appeal to the company´s current customer groups.
Vertical	The company goes back to previous stages of its production cycle or moves forward to subsequent stages of the same cycle, production of raw materials or distribution of the final product.
Concentric	Enlarging the production portfolio by adding new products with the aim of fully using the potential of the existing technologies and the marketing system. The concentric diversification can be more financially efficient as a strategy, since the business may benefit from some synergies in this diversification model.
Heterogeneous	Moving to new products or services that have no technological or commercial relationship with current products, equipment or distribution channels, but which may appeal to new groups of customers. The main reason behind this kind of diversification is the high return on investments in the new industry.
Corporate	Involves production of unrelated but profitable goods. It is often tied to large investments where there may be high returns.

It is going to be explained how some companies from advanced economies have decided to work in emergent countries because of the low-interest rates environment and the difficult economic situation suffered in developed countries, looking for new markets and new strategies to improve their financial situation. It can be understood as a sum of the internationalization strategy and the diversification strategy, mixing both strategies in new markets with many opportunities.

4.3. EMERGING MARKETS AS A BUSINESS STRATEGY

Many companies from mature markets have decided to invest in these countries, looking for better growth and profitability perspectives. The financial system was not an exception and many banks established their entities and merged with local banks, making these transactions as part of their business strategies, considering them as a strong competitive advantage.

During the last decade, emergent countries have also suffered the consequences of the financial crisis and they faced some cyclical adjustments. Those adjustments were weaker than in mature markets, because they had a different economic context, with a more solid growth and a higher yield curve.

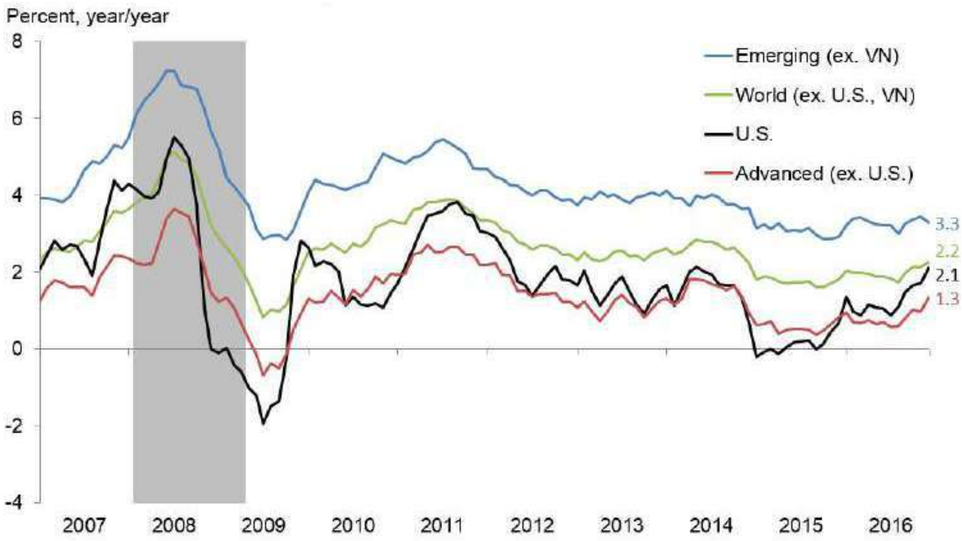
Here are some reasons to invest in emergent countries.

- They have different demographic trends, with younger population and massive migration from rural areas to cities.
- There is a macro evidence: their economic weight is increasing, more than 50% world GDP[17].
- In the long-term economic outlook, the present is promising, but the future looks better, based on models of capital productivity and demographic trends; even if interest rates were to decrease, perspectives are better than in developed countries.
- Developed markets have the potential to take advantage from emerging markets, improving also imports and exports. These investments represent new capital sources and higher capital levels to finance private companies' growth. Therefore, many banks have decided to internationalize and solve their lack of capital and profitability and improve their balance sheets.

[17] EUROPEAN CENTRAL BANK (2017). Emerging economies.

- Inflation is higher in emerging countries, especially in Latin America according to Chart 9; therefore, their interest rates environment is higher than in the G7[18], trying to fight against this. A traditional slope of yield curves can be found.

Chart 9. Headline inflation in advanced economies (Federal Reserve Bank of Dallas)



It is a fact that emerging economies are starting to have some similarities with developed economies, and the differences between them are becoming smaller. But there is still a high margin for business.

In the next section, all these theoretical aspects are going to be applied to understand how a real financial company and its business strategies are influenced by the low-interest rates environment and how its business model has succeeded in this context. The financial company is Santander Group, one of the biggest banks in the world.

[18] G7 is formed by Germany, Canada, United States, France, Italy, Japan and United Kingdom.

5. THE SANTANDER GROUP

How interest rates have affected decisions that had to be taken in the company and how they have been implemented will be in focus. The Santander Group is not only a Spanish bank but also a multinational and one of the most relevant banks in the world. Nowadays it is the sixth most valuable brand in the world, the fourth bank in Europe[19] and the thirty-third world's company in the stock market[20].

The main objective in this section is describing the evolutive process of the company along its history, with emphasis in its links to the international context. The Santander Group is a Spanish bank which was established in 1857 in Santander (Cantabria). Its headquarters are established in the Financial City in Boadilla del Monte (Madrid), and the president is Ana Patricia Botín-Sanz de Sautuola.

The main mission for this international financial group is to "*contribute to people and companies' progress*" as her president has said; and its vision as a group is to "*focus on being the best commercial bank, earning their workers, shareholder customers and society's trust*". As its slogan says; "*Simple, Personal and Fair*".

To reach these objectives, the group has been present in several markets, it works with business strategies at a global level. This enormous multinational has autonomous entities in capital and liquidity in every country. The Santander Group did not have a high position in bank rankings in the eighties, but from that moment, it started a complex and deep transformation that has taken it to beat their competitors at a worldwide level and to place itself as one of the biggest ones.

It is important to remember that in that period, the world was less globalised and Spain had just left a dictatorship behind. That was the moment when the Santander Group started to expand. It was a social and economic opening encouraged by a growth necessity: increasing its international relationships through a new idea of expansion. Its first movements were focused on Latin America countries, and later on Europe. But previously, it decided to have a strong position in the national market.

[19] EUROPA PRESS (2017). Santander, la sexta marca más valiosa entre las entidades financieras.
[20] FORBES MAGAZINE (2017). The world's biggest public companies.

In a thirty-year period, the Spanish company has grown to be one of the best national and international banks, improving its net margin from 2009 to 2016 up to 22 thousand million euros thanks to its business model[21].

In the recent years, there have been some changes in the economy, as it has been said in past sections. These changes have also affected Santander Group in the following ways:

5.1. INTEREST RATES INFLUENCE IN SANTANDER GROUP

During the last decade, the Santander group has been involved in a deep process of change, improving its market and working hard to fight against the low-interest rates environment consequences. Even in that environment, the Santander Group was one of the three international banks that was more profitable throughout the financial crisis. The European Banking Authority's stress test in 2016 showed that the Santander Group was the most resilient bank in the financial sector[22].

In order to improve profitability, the main problems faced were margins under pressure (due to low or negative interest rates), higher capital requirements, the need to balance out the losses from the lack of lending and an increase in pricing competition. But at the end of this decade there has been also a moderate improvement in credit demand, the regulatory agenda has come to an end and revenues pressure has gone down.

The low-interest rates environment forced the Santander Group to adapt to the new era. Its main challenge was, as it has been said, the low profitability in mature markets. There has been a development of its strategy to improve revenues by a commercial transformation to improve revenue growth and reduce costs. These changes were made to improve its *RoTE* (Return on Tangible Equity), which is used to evaluate the tangible assets from a company.

The presence of big companies in emergent countries as Latin America (Latam) is a strong competitive advantage for the Spanish bank. Santander Group has been working with Latin America markets and this has enhanced long term value to the bank. As shown in Chart 10, the differences between advanced economies and emerging ones are huge. It can be observed, for example, that the yield curves are higher in Latin America or that nominal GDP growth is expected to be twice that of Europe and that credit demand will be sustainably high compared with advanced economies. This context yields a high

[21] SANTANDER (2016): Análisis Estratégico y Financiero. División Financiera.
[22] SANTANDER (2017). Message from Ana Botín. Annual Report 2016.

potential for increasing operations and profits, amplified by the much lower levels of banking penetration.

Chart 10. Comparative situation in the Santander Group markets (Santander Group)

	Latam	Europe & US
Yield curves	Steeper and higher	Low / negative
Low levels of banking penetration	c.40%	c.95%
Low leverage Debt/ GDP	<100%	>200%
Credit demand (2015-2020)	Sustainable high double-digit growth	Low single-digit growth
Nominal GDP growth (2015-2020)	+6-8%	+2-3%
Growing population (2015-2020)	+2%	+0.5%
Middle class (2009-2030)	+73%	-4%

As J.A. Alvarez, the CEO from the Santander Group, has recently said in a presentation for *J.P. Morgan*.

> *The Santander Group is best placed for profitable growth because the bank has balanced between markets with high growth potential and capital generating markets. It had lower exposure to negative interest rates environment during the last decade, and a proven track record of shareholders' value creation in matured investments*. (ALVAREZ, J. 2017).

There have been two stages that have made the Santander Group profitable with a continuous growth trend during this decade:

<u>From 2008 to 2014: Balance sheet cycle completed</u>

In this period the Santander Group worked to improve the main weaknesses to have a stronger market position, through:

- Capital accumulation.
- Liquidity improvement.
- Restructuring costs.
- Absorption of regulatory impacts in capital, liquidity and other costs.

From 2014 to 2016: ROE and growth improvement

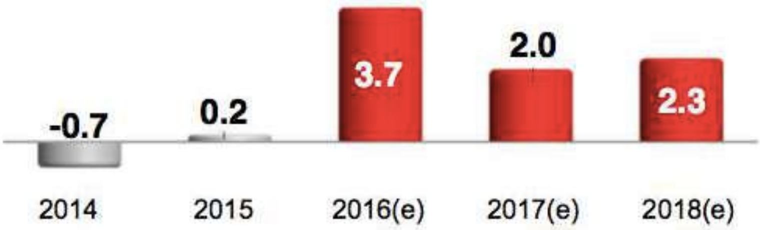
In these two years, there was a rise in its business model and in its balance sheet results.

- Progressive normalisation of provisions.
- Pickup of credit demand.
- Low-interest rates continue to put its profitability under pressure.
- Capital optimization.

As revealed by Chart 11 and Chart 12, the Santander Group has improved the annual rate of growth not only in loans to the private sector but also in their customer deposits during the last years, and it is expected to follow the same direction in the future.

Chart 11. Loans to private sector in the Santander Group [annual growth, %] (The Santander Group)

Chart 12. Customer deposits in the Santander Group [annual growth, %] (The Santander Group)



Finally, the business strategies that the Santander Group has chosen during the last years and how they have been influenced by the low-interest rates environment will be shown.

5.2. BUSINESS STRATEGIES

The Santander Group pursues different business strategies, but this project focuses on the two most relevant: internationalization and diversification. It is true that both strategies are correlated because nowadays it is almost impossible to think about one without the other.

5.2.1. INTERNATIONALIZATION

Due to the low-interest rates environment many companies, including banks, have to look for other markets with better financial conditions to improve their profits and their net incomes. The Santander Group decided to expand its operations to other countries thirty years ago. Nowadays this decision has proven to be one of the best strategies that the bank could take.

To have a better understanding of the process, the starting point will be 1986. This period can be divided into two stages. The first one is necessary to understand the second one and how it has been useful for the following years.

<u>A new era and new strategies (1986-2007)</u>

During these twenty years, growth and good results were a normal situation. There were several events that made Banco Santander start a change in its strategy and in its mentality. In 1989 its new idea was focused on "*value for shareholders*", in a context of new economic policies and interest rates liberalization. The "*Supercuenta*" was created (with high profitability) and this was a determinant factor for the improvement in its market share.

In 1994 it acquired *Banesto*, one of the most important Spanish banks in that moment, reinforcing its groundwork in the national context. This was a stimulus to start its projection for internationalization; mainly in Latin America as an emergent market with many possibilities.

<u>Financial crisis (2008- nowadays)</u>

As it has been previously described, this period was mainly marked by the financial crisis and by negative interest rates that are still present. Some factors that affected Santander Group were the bursting of the housing bubble that was set up in Spain and the subsequent increase in defaulting loans.

The Santander Group did not choose a defensive strategy based in its market consolidation after the housing bubble burst. To fight against this situation, it started an offensive strategy focused on the acquisition and franchising of international banks with the aim of strengthening its market position and compensating its losses caused by low interest rates, low inflation and stricter regulation.

The most relevant operations during the financial crisis were the acquisition of Banco Real in Brazil, the acquisition of Alliance & Leicester and Bradford & Bingley in United Kingdom (2008), the acquisition of Sovereign in United States (2010) and the entry in the Polish market and in the German market from 2010[23].

5.2.2. GEOGRAPHICAL DIVERSIFICATION

As Ana Botín (2017) pointed out, "*geographic diversification leads to more predictable earnings and means we require a less capital intensive model than our global peers*". This statement means that diversification is its main business strategy.

The economic scenario in the Eurozone and in the United States has brought interest rates to a minimum and increased volatility. Because of this, the Santander Group has also focused its strategies on diversification; establishing itself in different countries, and remaining in emergent economies, owing to their economic potential. Its geographic diversification is clear: 97% of its general profit is generated in nine different countries and this has been thanks to a strategy of credit risk distribution: 72% of it lies in Europe, but 15% is in the United States and another 13% in South America (*see Appendix 4*).

This strategy can be analysed by continent:

Latin America and North America

The Santander Group decided to start this expansion through the American continent due to the following factors:

- **Leverage of the Spanish banking system**: In the eighties, the bank opted for expanding its business model to those countries where the banking sector was not developed and interest rates were higher than in advanced economies; therefore, the potential market was large.
- **Fast growth option**: Through acquisitions, alliances and cooperation agreements.
- **Low competition and high profitability in operations**: Latin America banking systems were underdeveloped at that moment, a fact that Santander Group took as an advantage to grow and become stronger at a global level.
- **Similarities through culture and language**: Sharing the same language and habits was appealing for the Santander Group to made work easier.

[23] SANTANDER (2017): History- Banco Santander.

Nowadays it is well positioned in these countries, especially in Brazil. Santander Group has made some strong investments in its commercial model. The bank expects a payoff from investments in terms of higher profit growth and an improvement in efficiency in the country.

Europe

The strategy that Santander Group has followed in the European continent can be described as "defensive" and "selective".

- Selective, because it was focused on closer countries, to reach presence and influence in important markets with growth possibilities.
- Defensive, because it made mergers and acquisitions that were necessary to improve Santander Group's situation in the Spanish economy.

The expansion in Europe has been concentrated in the following countries.

a. Spain and Portugal

The bank is well positioned with a dominant market position, thanks to a strong balance sheet in both countries, where there has been an improvement in efficiency. Because of the economic crisis, it had a remarkable level of provisions, a low level of solvent demand and some liquidity tensions. Interest rates are in negative levels, making deposit margins negative. Both countries are starting to come out of the crisis.

b. United Kingdom

The group is well positioned in the country with strong local presence, because there has been an important investment during the last years in its commercial franchise with new products.

In this market, profitability is improving since 2013, but below the 2007 peak[24]. There is a small increase in credit demand and a drop in funding costs supporting revenue growth. Due to the recent interest rates normalisation ("The *New Normal*", *see Appendix 1*), there has been an expansion in deposit margins.

c. Poland

The bank is well positioned in the market because it has made a big effort to raise efficiency. It is a market with strong growth, but it has been slower during the last years.

[24] MARIN, J. (2014): Santander: delivering growth.

Santander Group chose this country because of its economic growth potential and to improve its bancarisation.

The Santander Group has better potential growth than other banks in its main markets, which is reflected in market share gains, as can be seen in Chart 13. This has allowed more stable profits than in other top banks in United Kingdom, United States, Portugal or in Chile based on much lower efficient ratios than competitors. It is also remarkable that there has been a significantly increase in loans in the emerging countries (Chart 13).

Chart 13. Business portfolio geared for growth from Santander Group (Santander Group)

Thanks to this double strategy (internationalization and diversification), the Santander Group has been strengthened after the financial crisis and the low-interest rates environment. Profits increased since 2013 as can be seen in Chart 14, and this line has been improving through time. It has also allowed the bank to have better results than other institutions from the financial sector, especially in Spain, as revealed by Chart 15, beating other banks like CaixaBank or Banco Popular with remarkable results. It can be concluded that Santander Group has applied its business strategies successfully and has become stronger in hard times.

Chart 14. Profit evolution from Santander Group; thousand € (La Nueva España)

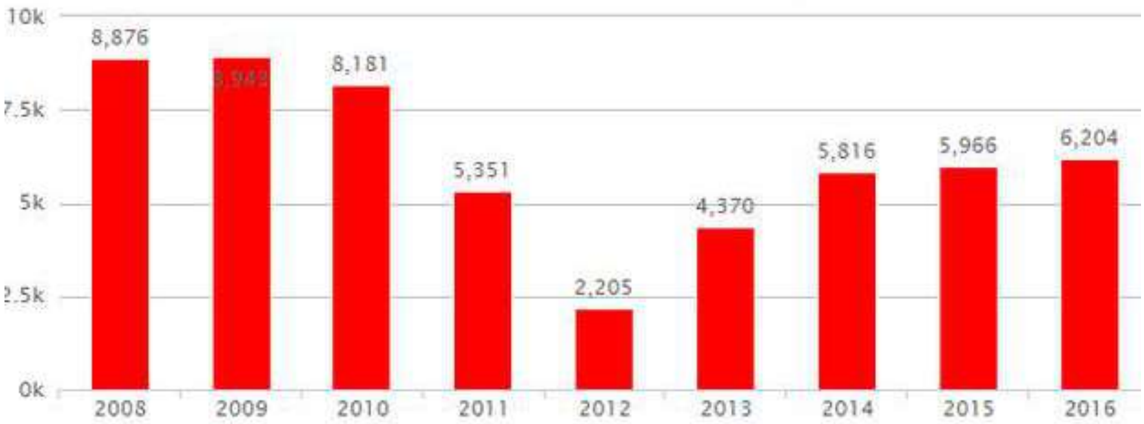
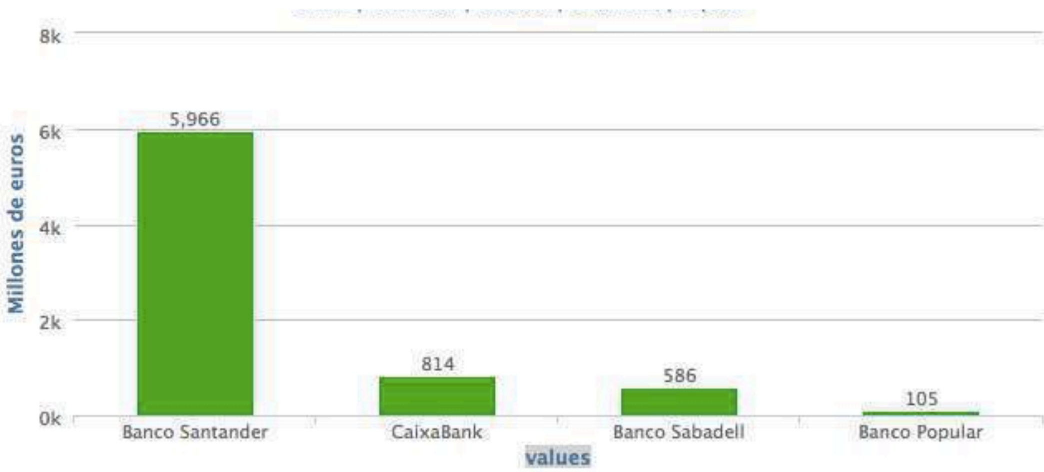


Chart 15. Profit evolution from the Spanish Financial System in 2015; thousand € (La Nueva España)



6. DISCUSSION AND CONCLUSION

The purpose of this dissertation is searching for a better understanding about how interest rates developments have influenced the economy along time and especially the financial sector.

Through this study, the determinants for the low-interest rates environment in the international economy have been explained. In this report, these determinants have been applied to a real company, the Santander Group, studying how it has developed its own business strategies in this environment. However, the findings do not imply the same consequences and business direction in every company.

The most relevant conclusions to consider are the following:

Central banks are responsible for managing the money in circulation and their main objective is usually price stability in the economy. This implies avoiding prolonged inflation or deflation. Central banks set interest rates as one of the most important parts of their monetary policies, which vary according to the phases of economic growth.

Advanced economies have been sharply damaged during the financial crisis and have suffered some of the worst consequences of it, facing a continuous deceleration in their economic growth during a long period of low interest rates, which turned zero or even negative during the last years.

The financial crisis has damaged companies, making them lose part of their profitability and liquidity, or even entering in bankruptcy, and the result has been increasing unemployment. Interest rates have been reduced by central banks as an attempt to normalize low inflation and recover growth in the global economy, trying to increase credit and consumption. Furthermore, central banks decided to manage this situation with a quantitative easing that has decreased interest rates even more, turning into negative levels.

Spain has suffered the consequences of the low-interest rates environment. The measures that Spain has undertaken during the last years have had positive effects in this environment, with good results from companies.

The banking system has been one of the most damaged sectors in advanced economies, affecting specially bank's profitability, decreasing their balance sheets and increasing pressures to improve both factors. These issues have forced banks to look for alternative sources of income like commissions or trading income.

To improve their situation from the low-interest rates environment, one of the options that some international companies have decided to use is to expand their business strategies, and to increase their business market; considering emergent countries as a tool to improve their weaknesses, due to their better market health, and higher future profitability.

The most relevant strategies in an international context according to this study are diversification and internationalization. Internationalization looks for a competitive advantage and it could be offensive or defensive. Companies normally use diversification to manage risk or minimize potential damages during economic downfalls. The aim of every company is to improve its profitability and to expand its businesses to different areas in order to build a solid structure.

The Santander Group made a bet by expanding through Europe and America, and after several years of work and effort, it is established as one of the most important companies in the financial sector.

Low interest rates forced the Santander Group to adapt its business model, developing its strategy to improve revenues and reduce costs. The presence in emergent countries has been a strong competitive advantage, enhancing long term value for the bank.

Both strategies developed in this work have been applied by the Santander Group. It has applied internationalization, making mergers and acquisitions in Europe and in America with foreign banks. Geographical diversification is its main business strategy, focusing in strong and potential profitable markets in more than ten countries.

The Santander Group has better potential growth than other banks in its main markets, which is reflected in market share gains. This has allowed more stable profits based on much lower efficient ratios than competitors. It has been strengthened after the financial crisis and the low-interest rates environment.

To conclude, interest rates affect significantly every strategy from a company around the world, it is a macroeconomic aspect that must be kept in mind to decide the strategy to follow, in order to improve future profits.

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APPENDICES

Appendix 1: The New Normal

Larry Summers, director of the National Economic Council for President Obama stated:

> *"The economies of the industrial world, in this view, suffer from an imbalance resulting from an increasing propensity to save and a decreasing propensity to invest. The result is that excessive saving acts as a drag on demand, reducing growth and inflation, and the imbalance between savings and investment pulls down real interest rates". (SUMMERS, L. 2016).*

This low-growth situation will persist in the future due to a low productivity growth and maintaining a period of secular stagnation, which was defined by Summers as a condition for no economic growth; it is a long period of slow economic growth measured in terms of GDP growth accompanied by high unemployment. There will be some consequences:

Table 6. Consequences from the "New Normal" (Source: Own, based on Summers, L. 2016)

People who save or lend money will realize lower returns. However, while low interest rates hurt savers and lenders, people who borrow money to purchase have lower monthly payments.
Lower interest rates reduce the Fed's ability to fight severe recessions. If average interest rates are 2%, then the Fed can cut rates by only 2% before running into the "zero lower bound". When interest rates hit the zero bound, the Fed loses its most powerful tool for stimulating the economy.
A prolonged period of low growth, particularly if secular stagnation is the cause, will lead to low inflation. Lower inflation helps people who receive fixed monthly payments and hurts people making the payments.
Slower economic growth reduces tax revenues and because employment also grows slower, finding a job becomes more difficult, which also increases government spending on social programs. The result is a larger budget deficit than there would be higher economic growth. Larger deficits lead to pressure to raise taxes.
If interest rates are low, the risk of creating financial bubbles increases, as investors "search for yield" causes them to take excessive risks.

Appendix 2: Changes in the Balance Sheet and in the Net Income of the euro area

Chart 16. Balance sheet of the euro area Monetary Financial Institutions. Spain and Euro Area (Spanish Economic and Financial Outlook)

(Percentages)

1. ASSETS	2007			2016			2016-2007	
	Spain	Euro area	Spain-Euro area	Spain	Euro area	Spain-Euro area	Spain	Euro area
1.1. Loans to euro area residents	72.7	57.3	15.4	60.0	56.7	3.4	-12.6	-0.6
1.1.1. Monetary financial institutions	12.0	19.7	-7.7	9.8	18.6	-8.8	-2.2	-1.1
1.1.2. General government	1.4	3.3	-1.8	3.3	3.5	-0.2	1.8	0.2
1.1.3. Other euro area residents	59.2	34.4	24.9	47.0	34.6	12.4	-12.3	0.2
1.1.3.1. Non-financial corporations	30.2	14.8	15.4	18.7	13.8	4.9	-11.5	-1.1
1.1.3.2. Households	28.1	16.3	11.8	25.9	17.4	8.5	-2.2	1.1
1.1.3.2.1. Consumer credit	3.4	2.1	1.3	2.5	2.0	0.6	-0.9	-0.1
1.1.3.2.2. Lending for house purchase	20.8	11.6	9.2	19.7	13.0	6.7	-1.1	1.4
1.1.3.2.3. Other lending	3.8	2.5	1.2	3.6	2.4	1.2	-0.2	-0.1
1.1.3.3. Non-monetary financial intermediaries other than insurance corporations and pension funds	0.8	2.9	-2.1	2.0	3.1	-1.1	1.2	0.2
1.1.3.4. Insurance corporations and pension funds	0.1	0.3	-0.2	0.4	0.3	0.0	0.2	0.0
1.2. Holdings of securities other than shares issued by euro area residents	9.8	13.4	-3.6	17.5	13.1	4.3	7.6	-0.3
1.2.1. Monetary financial institutions	1.7	5.9	-4.2	0.7	3.9	-3.1	-1.0	-2.0
1.2.1.1. Up to 1 year	0.3	1.3	-1.0	0.1	0.8	-0.7	-0.1	-0.5
1.2.1.2. Over 1 year and up to 2 years	0.2	0.5	-0.3	0.1	0.1	-0.1	-0.1	-0.3
1.2.1.3. Over 2 years	1.3	4.1	-2.9	0.6	2.9	-2.3	-0.7	-1.3
1.2.2. General government	3.1	4.0	-0.9	9.4	5.4	4.1	6.3	1.3
1.2.3. Other euro area residents	5.0	3.4	1.5	7.3	3.9	3.4	2.4	0.5
1.3. Money market fund shares/units	0.0	0.3	-0.3	0.0	0.2	-0.2	0.0	-0.1
1.4. Holdings of shares/other equity issued by euro area residents	4.5	4.4	0.1	4.2	3.8	0.4	-0.3	-0.6
1.4.1. Monetary financial institutions	0.6	1.4	-0.8	0.7	1.3	-0.5	0.1	-0.1
1.4.2. Other euro area residents	3.9	3.0	0.9	3.5	2.5	1.0	-0.4	-0.5
1.5. External assets	6.6	16.5	-9.9	6.9	13.9	-7.0	0.3	-2.6
1.6. Fixed assets	1.0	0.7	0.3	1.6	0.6	1.0	0.6	-0.1
1.7. Remaining assets	5.3	7.4	-2.1	9.7	11.6	-1.9	4.4	4.2
1.8. Total	100.0	100.0	0.0	100.0	100.0	0.0	0.0	0.0

Chart 17. Balance sheet of the euro area Monetary Financial Institutions. Spain and Euro Area (Spanish Economic and Financial Outlook)

	2007			2016			2016-2007	
2. LIABILITIES	Spain	Euro area	Spain-Euro area	Spain	Euro area	Spain-Euro area	Spain	Euro area
2.1. Currency in circulation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2.2. Deposits of euro area residents	65.1	51.3	13.8	69.1	54.8	14.3	4.0	3.5
2.2.1. Monetary financial institutions	15.5	20.6	-5.1	15.4	16.4	-1.0	-0.1	-4.2
2.2.2. Central government	0.9	0.4	0.5	0.5	0.4	0.1	-0.4	0.0
2.2.3. Other general government/other euro area residents	48.7	30.3	18.4	53.2	38.0	15.2	4.5	7.7
2.2.3.1. Overnight	16.1	10.7	5.5	29.2	19.1	10.2	13.1	8.4
2.2.3.2. With agreed maturity	29.6	13.1	16.5	22.4	10.8	11.5	-7.2	-2.3
2.2.3.2.1. Up to 1 year	11.0	6.1	4.9	7.4	3.1	4.2	-3.6	-2.9
2.2.3.2.2. Over 1 year and up to 2 years	1.8	0.7	1.1	4.7	1.0	3.7	3.0	0.3
2.2.3.2.3. Over 2 years	16.9	6.4	10.5	10.3	6.7	3.6	-6.6	0.3
2.2.3.3. Redeemable at notice	0.0	5.5	-5.5	0.0	7.2	-7.2	0.0	1.7
2.2.3.3.1. Up to 3 months	0.0	5.1	-5.1	0.0	7.0	-7.0	0.0	1.9
2.2.3.3.2. Over 3 months	0.0	0.4	-0.4	0.0	0.2	-0.2	0.0	-0.2
2.2.3.4. Repurchase agreements	2.9	1.0	2.0	1.6	0.9	0.7	-1.3	-0.1
2.3. Money market fund shares/units	0.0	2.6	-2.6	0.4	1.8	-1.5	0.4	-0.7
2.4. Debt securities issued	14.1	15.7	-1.6	7.6	12.1	-4.6	-6.5	-3.5
2.4.1. Up to 1 year	3.1	2.0	1.1	0.7	1.0	-0.3	-2.5	-1.0
2.4.2. Over 1 year and up to 2 years	0.7	0.8	-0.1	0.3	0.3	0.1	-0.3	-0.5
2.4.3. Over 2 years	10.3	12.9	-2.5	6.6	10.9	-4.3	-3.7	-2.0
2.5. Capital and reserves	6.9	5.7	1.2	11.0	8.0	3.0	4.1	2.3
2.6. External liabilities	7.1	15.4	-8.3	4.1	11.9	-7.8	-3.0	-3.5
2.6. External liabilities	7.1	15.4	-8.3	4.1	11.9	-7.8	-3.0	-3.5
2.7. Remaining liabilities	6.8	9.3	-2.5	7.8	11.3	-3.5	1.0	2.0
2.8. Total	100.0	100.0	0.0	100.0	100.0	0.0	0.0	0.0

Appendix 3: Study of a company environment

To make the correct decision about what direction a company should follow, the first step is knowing what is the best for the company and what it is going to focus on. It is going to be developed the internal and the external environment of the company.

a. Internal environment

The main base in which a company should hold up the decision, is deciding if it is going to follow a strategy based on cost savings or in a local adaptation.

Cost savings is a measure focused on alternative searches to obtain an end. There are several ways to reach the point, and they have relationship with the geographical production localization and the company's technical facilities in those territories where the essential productive factors (labour costs, raw materials, technology…) are more economic and accessible.

Local adaptation is based on adapting those services and products that the company offers to the local demand of the country in which it is present or where it is focus. It is important to consider the different customers' needs[25], the costs that can be generated, the company' capacity of adaptation or the acceptance of the products by the population.

b. External environment

Beforehand, it is important to describe the environment where any company works and develops its strategy. It is important to find a business opportunity by an analysis of the general environment.

PESTLE Analysis (general environment)

The best way to study the general environment is by the PESTLE Analysis (P for Political, E for Economic, S for Social, T for Technological, L for Legal and E for Environmental). It is like a bird's eye view from the whole environment of a company, it estimates the possible impact of each factor that it is analysed.

[25] They vary depending on the country or the territory

Table 7. Characteristics of PESTLE Analysis (Source: Own)

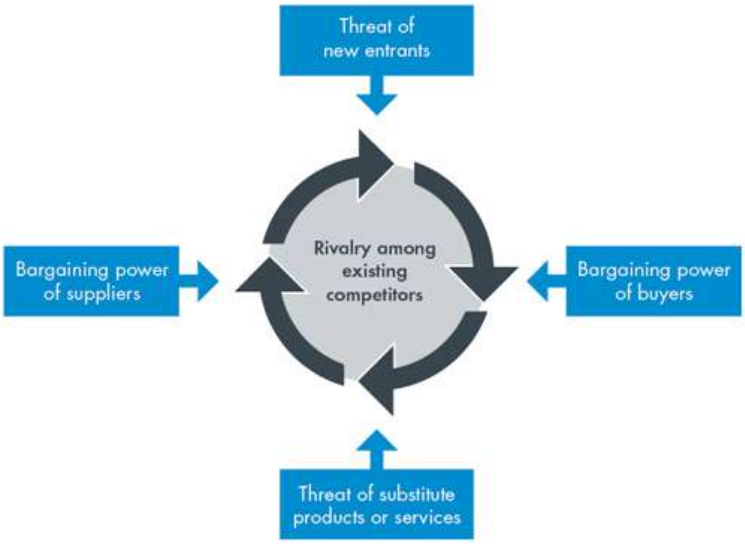
FACTORS	DESCRIPTION	VARIABLES TO BE CONSIDERED
ECONOMIC	Macro-economic variables that evaluate the current and future situation of the economy	- Current growth and expected GDP from internal consumption - Inflation - Interest rates evolution - Unemployment rate
SOCIAL	Demographical variables about social and cultural changes in the population	- Population pyramid's evolution - Birth and death rates - Emigration and migration evolution
TECHNOLOGICAL	Scientific level and technological infrastructure for a specific context	- Technological development level - %GDP for research and development - Number of patents
POLITICAL	Institutional framework that exits in a determined economic context	- Type and characteristics of the current political system - Robustness, transparency and maturity - Level of stability in the government - Monetary and financial policy
LEGAL	Legislative development that can affect the sector	- Laws and regulations - Intellectual property rights
ENVIRONMENTAL	Degree of green and the sustainability trend of the agents involved in our context	- Renewable energy - Existence of environmental taxation - Environmental laws

Once the general environment that affects is defined, it is time to study the specific environment, that can affect the profitability of operating in a specific place.

Michael Porter's analysis (specific environment)

Michael Porter's analysis studies the five parts of a company that determine its competitive level[26].

Chart 18. Analysis of Porter's five forces of competitive position (Chartered Global Management Accountant)



The five forces are:

1. **Supplier power**: it consists in evaluating the possibility that suppliers can fix the rules in the relationship with the company that exists when there is a high negotiation power with the suppliers.
2. **Buyer power***:* it exists when buyers can modify the conditions of buying from companies; like price or quality, and as a result, profits can be reduced.
3. **Competitive rivalry***:* it is an evaluation of the current rivals. When rivalry is high; companies see an opportunity to improve their position saving costs and increasing their product or service differentiation.
4. **Threat of substitution***:* it consists in evaluating the threat that alternative technologies could to cover the same needs. When the threat is high; profits can be reduced, because the substitute product limits the selling price and reduces the attractiveness of the market.
5. **Threat of new entry***:* it consists in evaluating the possibility that new companies can join and compete in the sector. When this situation takes place; profits could decrease.

[26] DEPPERU, D. (2016): "Business Strategy's classwork".

c. Types of strategies

In an international context, we can define three types of international competitive strategies following the ideas of Porter, which are global strategy, multicountry strategy and transnational strategy.

Choosing the right strategy to follow will depend on the grade of concentration (concentrated configuration or dispersed configuration) and on the grade of coordination (low coordination or high coordination) of the company.

i. Global strategy

Companies that follow this strategy normally make emphasis in cost savings, focusing specially in economies of scale. The main objective is to focus on total activities' concentration in the chosen country and, later on, to provide the rest of territories.

Table 8. Advantages and disadvantages of a Global Strategy (Source: Own)

Advantages	Disadvantages
High efficiency and profitability	Reduced adaptation to customers' needs
Cost reduction	Highadministrative and bureaucratic costs of coordination
Easiness to stablish contracts with suppliers	Loss of capacity of reaction against demand changes and customer's tastes
Competitive prices	Higher access costs to local markets
Logisticnetworks for a more efficient distribution	Commercialization activities in a few geographical areas
Obtain cost advantages	Standardized product

ii. Multicountry strategy

It gives importance to adaptation; the opposite to costs savings. It focuses on the differentiation of their products and services and their post adaptation to local markets.

The main organization and the rest of the business units are linked through the transfer of dividends and profits.

Table 9. Advantages and disadvantages of a Multicountry Strategy (Source: Own)

Advantages	Disadvantages
Differentiation against their competitors	Bigeffort to adapt to laws, culture, language and religion of every country
Higher capacity of answering to changes in local demand	Products and services adapted to local tastes and needs require an important dedication and time
	Obtaining long-term results
	Low global learning
	Higher costs are associated to the chosen country

iii. Transnational strategy

This strategy has as main objective to absorb and to exploit the advantages of the two strategies, it focuses on efficiency to reach an optimum level of global competitiveness, offering a local answer in every moment.

Table 10. Advantages and disadvantages of a Transnational Strategy (Source: Own)

Advantages	Disadvantages
Very complete and competitive strategy at every level	Difficultyfor setting up structures and control system effective
Room for improvement strategy with huge growth potential	Hard optimal choice of an economically geographic area
Many advantages in just one strategy	Long-term strategy with a high investment required, coordination and a proper function and development of the company
Communication between the parent company and subsidiaries	Risk of engaging in disadvantages from both strategies in which it is based without obtaining the desired results
	Difficultyto obtain saving costs and local adaptation advantages at the same time

The main purpose that companies who develop this strategy follow; according to Guerra and Navas (2007), is that every individual business should think globally and act locally.

Appendix 4: Santander Group geographical diversification

Chart 19. Santander Group geographical diversification (Annual Report 2015 Santander Group)