14 Sep 2020 | Affirmation

Fitch Affirms Santander UK Group Holdings at 'A'; Outlook Negative

Fitch Ratings-London-14 September 2020:

Fitch Ratings has affirmed Santander UK Group Holdings plc's (SGH) Long-Term Issuer Default Rating (IDR) at 'A' with a Negative Outlook and Santander UK plc's (San UK) Long-Term IDR at 'A+' with a Negative Outlook.

The Negative Outlooks, which have been in place since 1 April 2020, reflect the potential implications of the economic and financial market fallout from the coronavirus outbreak. These will likely result in pressure on our management and strategy assessment, due to challenges in implementing the group's strategy, as well as on asset quality metrics. In the baseline forecast, Fitch expects the UK economy to contract by 11.5% in 2020 followed by a recovery over 2021 and 2022. There are downside risks to these economic forecasts, including the risk that further lockdowns are implemented, causing further shocks to the economy.

Key Rating Drivers

VRS, IDRS, SENIOR DEBT RATINGS AND DERIVATIVE COUNTERPARTY RATINGS (DCR) - SGH AND SAN UK

SGH's Long-Term IDR is driven by its Viability Rating (VR), which is assessed on a consolidated basis. SGH acts as the holding company for the Santander group's UK entities, and its VR is equalised with that of the main operating subsidiary, San UK, reflecting SGH's role in the group and low holding company double leverage, which remains comfortably below 120%.

The VR is based on the group's conservative risk appetite, low levels of impaired loans though recent credit cycles, adequate capitalisation and stable funding and liquidity profile. The VR also reflects a less diversified business mix than larger UK peers, which weakens the group's profitability.

SGH's profitability is lower than some of its similarly rated high-street peers, which reflects its focus on lower-risk residential mortgage lending, and we expect it to remain under pressure over the next 12-18 months. Loan impairment charges (LICs) increased in 1H20, to GBP376 million, mostly related to the pandemic, from previously unsustainably low levels. We expect them to remain high over the next couple of quarters at least. Net interest margins are also under pressure from the low base rates, although these are expected to stabilise as the bank has been able to reduce funding costs and grow business volumes in the months following the removal of lockdown measures. SGH also has some levers in terms of its ability to continue to reduce costs in order to protect profitability.

Asset quality has remained healthy, with only small rises in Stage 2 and Stage 3 loans so far. Current support measures, in particular payment holidays on residential mortgage loans and the government job-retention scheme, have resulted in most mortgage loans remaining in Stage 1, per regulatory guidance. We expect the Stage 3 ratio (1.2% of end-1H20 gross loans) to increase as government measures to support borrowers roll off over 4Q20.

We do not expect SGH's Stage 3 ratio to increase as much as peers, given SGH's lower exposure to more vulnerable lending segments, including commercial and consumer lending. Nevertheless, there is risk of a material and sustained deterioration in asset quality in a downside scenario.

SGH's 14.5% common equity Tier 1 (CET1) ratio at end-1H20 benefited from the cancellation of dividends. Capital headroom has also benefited from a reduction in the UK countercyclical buffer to 0% until at least March 2022. The UK leverage ratio, 4.7% at end-1H20, has less headroom over its 3.6% minimum requirement, although it has been slowly increasing through retained profits, additional AT1 issuance and management of the total leverage exposure amount. We expect the CET1 ratio to be more resilient than peers as a result of sound internal capital generation and more stable risk-weighted assets (RWAs). Capital retention in order to maintain sufficient headroom over the minimum UK leverage ratio will also result benefit the CET1 ratio.

Funding is supported by SGH's solid and granular retail deposit base, and pandemic-driven retail deposit inflows reduced the loans/deposits ratio slightly to 114% at end-1H20. Like other UK banking groups, SGH will be able to refinance its Term Funding Scheme (TFS) drawings under the new TFS with Additional SME Incentives (TFSME), providing it with low-cost funding until 2024. Liquidity is prudently managed with liquidity coverage ratio-eligible assets of 16% of total assets (GBP47 billion) at end-1H20, mainly cash placed at the Bank of England.

Fitch assigns a one-notch uplift to the 'A+' Long-Term IDR of San UK due to the group's large buffer of qualifying junior debt (QJD) plus internally subordinated senior debt, which together accounted for 19% of end-1H20 RWAs. Fitch considers these buffers to be sufficient and sustainable and expects them to be made available to protect senior obligations from default in case of the group's failure.

SGH is required to issue additional senior holding company debt in order to meet its January 2022 indicative minimum requirement for own funds and eligible liabilities (MREL) of 26.9% of RWAs, including buffers. The final requirement has not yet been confirmed. SGH has made good progress in issuing senior holding company debt to date, which is down-streamed in a subordinated manner to San UK and SFS, and so we expect SGH to have sufficient capacity to issue additional debt by the deadline.

San UK's DCR is at the same level as its Long-Term IDR because derivative counterparties have no preferential status over other senior obligations in a resolution scenario under UK legislation. The senior unsecured debt instruments of all entities are rated in line with the Long-Term IDRs of the respective entities.

The Short-Term IDRs of 'F1' for all entities is the lower option mapping to the Long-Term IDRs, in line with our assessment of the group's funding and liquidity profile.

SUPPORT RATINGS (SR)

SGH and San UK's SRs of '2' reflect Fitch's view that their ultimate parent, Banco Santander SA (A-/Negative), has a strong propensity to support both entities. However, Banco Santander's ability to provide support is constrained by the subsidiaries' large size relative to its own equity and by possible regulatory restrictions. The SR indicates a 'BBB+' rating floor based on institutional support. Our view of the parent's strong propensity to support is primarily based on the strategic importance of the UK business to Banco Santander. It is also based on the high reputational risk the parent would face in the case of a default by its UK subsidiaries.

SUBSIDIARIES AND AFFILIATES

SFS was previously known as Abbey National Treasury Services plc. SFS's IDRs are based on support, and the Long-Term IDR is one notch above SGH's VR due to the group's large buffer of QJD, which we expect to be made available to protect senior obligations from default in case of the group's failure.

We believe SGH would have a strong ability and propensity to support SFS. This is based on the entity's role within the group and our expectation that support would be manageable for SGH given the small relative size of SFS. SFS became a direct subsidiary of SGH on 31 October 2018 as part of ring-fencing restructuring. Under the revised structure, San UK is SGH's ring-fenced group, while SFS is outside the ring-fence and operates branches in the Crown Dependencies (Isle of Man and Jersey). It also holds a small portfolio of post-restructuring residual assets that will be held until maturity.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The ratings of all subordinated debt and hybrid securities issued by SGH and San UK are notched down from their VRs.

SGH's AT1 capital securities are rated four notches below SGH's VR to reflect above-average loss severity risk (two notches) and higher risk of non-performance as coupon payments are fully discretionary (two notches). Dated Lower Tier 2 instruments are notched down twice from the VR for loss severity.

Legacy Tier 1 securities issued by San UK are rated four notches below San UK's VR to reflect higher loss severity risk (two notches) and higher risk of non-performance due to discretionary coupon payments (two notches).

Legacy upper Tier 2 securities are rated three notches below San UK's VR (two for loss severity and one for non-performance). Legacy dated Lower Tier 2 instruments are notched down twice from the VR for loss severity.

RATING SENSITIVITIES

VRS, IDRS, SENIOR DEBT RATINGS AND DCRS - SGH AND SAN UK

Factors that could, individually or collectively, lead to negative rating action/downgrade:

The most immediate downside rating sensitivity for SGH's and San UK's ratings now relates to the economic and financial market fallout arising from the pandemic as this represents a clear risk to our assessment of asset quality and to the group's ability to execute on its strategy. The ratings would be downgraded if there is sustained pressure on asset quality from a material increase in loan impairments, particularly in the group's mortgage loan book, which represents the bulk of lending, or on SGH's ability to execute on strategic targets, including reducing its cost base. Profitability may also come under pressure, but our current assessment of earnings and profitability incorporates sufficient headroom to absorb potential downside scenarios.

SGH's ratings are not directly sensitive to a change in the UK's (AA-/Negative) ratings, and the group has headroom to emerge from the current crisis with its ratings intact. However, SGH's operating environment score is at the same level as and constrained by the UK sovereign rating. If the UK sovereign rating was downgraded we would therefore lower the operating environment assessment for UK domestic banks to the 'a' range'. This would not necessarily result in a downgrade of SGH's ratings but rating headroom would reduce.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The Outlook on the Long-Term IDR could be revised to Stable if the negative impacts of the pandemic and of UK-EU trade negotiations on the UK economy are short and the recovery relatively fast.

In the event SGH is able to withstand rating pressure arising from the pandemic, the most likely trigger for an upgrade would be a significant increase in the diversity of its business model, such as through growth in commercial banking, without significantly increasing its risk appetite and while maintaining solid capitalisation and funding.

SR

The SRs of SGH and San UK are sensitive to both a change in the strategic importance of the UK entities to their ultimate parent, Banco Santander, which we currently do not expect, and in Banco Santander's ability to provide extraordinary support.

SUBSIDIARIES AND AFFILIATES

SFS's ratings are primarily sensitive to changes in SGH's IDRs or a change in the propensity of SGH to support SFS, which we do not expect.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES

The ratings are primarily sensitive to changes in the VRs from which they are notched. Additional Tier 1 and other discretionary Tier 1 instruments are also sensitive to Fitch changing its assessment of the probability of their non-performance relative to the risk captured in the VR. This could occur if there was a change in capital management or flexibility, or an unexpected shift in regulatory buffers. Tier 2 subordinated debt ratings are also sensitive to a change in Fitch's assessment of loss severity in default.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

Public Ratings with Credit Linkage to other ratings

SGH's and San UK's Support Ratings are driven by our view of the support propensity of ultimate parent Banco Santander S.A. The ratings of SFS are ultimately driven by support from SGH.

ESG Considerations

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

Santander Financial Services plc; Long Term Issuer Default Rating; Affirmed; A+; RO:Neg
; Short Term Issuer Default Rating; Affirmed; F1
; Support Rating; Affirmed; 1
----senior unsecured; Short Term Rating; Affirmed; F1
Santander UK plc; Long Term Issuer Default Rating; Affirmed; A+; RO:Neg
; Short Term Issuer Default Rating; Affirmed; F1
; Viability Rating; Affirmed; a
; Support Rating; Affirmed; 2
; Derivative Counterparty Rating; Affirmed; A+(dcr)
----subordinated; Long Term Rating; Affirmed; BBB
----preferred; Long Term Rating; Affirmed; BBB-
----senior unsecured; Long Term Rating; Affirmed; A+
----subordinated; Long Term Rating; Affirmed; BBB+
----senior unsecured; Short Term Rating; Affirmed; F1
Santander UK Group Holdings plc; Long Term Issuer Default Rating; Affirmed; A; RO:Neg
; Short Term Issuer Default Rating; Affirmed; F1
; Viability Rating; Affirmed; a
; Support Rating; Affirmed; 2
----senior unsecured; Long Term Rating; Affirmed; A

----subordinated; Long Term Rating; Affirmed; BBB+
----subordinated; Long Term Rating; Affirmed; BBB-
----senior unsecured; Short Term Rating; Affirmed; F1

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Additional information is available on www.fitchratings.com

Applicable Criteria

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

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