01 Apr 2020 | Rating Changed Outlook to Negative

Fitch Revises Santander UK Group's Outlook to Negative on Coronavirus Outbreak

Fitch Ratings-London-01 April 2020:

Fitch Ratings has revised Santander UK Group Holdings' (SGH) and Santander UK plc's (San UK) Outlooks to Negative from Stable. The action reflects the economic disruption driven by the coronavirus pandemic. A full list of rating actions is detailed below.

Unless noted below, the key rating drivers are those outlined in our RAC published on 26 September 2019 (Fitch Maintains Santander UK Group's 'A' IDR on RWN; Affirms VR).

Fitch expects global economic growth to decline sharply in 2020 and now estimates that the UK's GDP could fall by close to 4% in 2020 in its baseline forecast, followed by a sharp recovery in 2021. This expectation is based on containment measures being unwound in 2H20, with material downside risk to these economic forecasts.

The UK authorities have taken monetary and fiscal support measures for the private sector, which should be positive for the banking sector. Nonetheless, we expect asset quality to weaken compared with previous expectations and earnings to come under pressure from lower business volumes, higher loan impairment charges and pressure on net interest margins.

The rating actions today include upgrades, downgrades and affirmations of a number of issuer and issue ratings, which were placed on Under Criteria Observation (UCO) following the publication of Fitch's new rating criteria on 28 February 2020. The affected ratings have been removed from UCO.

Santander Financial Services plc; Long Term Issuer Default Rating; Upgrade; 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; Downgrade; BBB+
----subordinated; Long Term Rating; Affirmed; BBB
----preferred; Long Term Rating; Affirmed; BBB-
----senior unsecured; Long Term Rating; Affirmed; A+
----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; Downgrade; BBB+
----subordinated; Long Term Rating; Upgrade; BBB-
----senior unsecured; Short Term Rating; Affirmed; F1

Key Rating Drivers

SGH, SAN UK AND SANTANDER FINANCIAL SERVICES PLC

The Negative Outlook reflects our belief that the economic fallout from the pandemic poses risks to the bank's ratings in the medium-term. SGH enters the economic downturn from a relative position of strength, reflecting its conservative risk appetite, a solid retail banking franchise, low levels of impaired loans, adequate capitalisation and a stable funding and liquidity profile. However, we see material risks to profitability as the bank's business is not highly diversified, and profitability is weaker than similarly rated peers'. This is driven by intense competition in the UK mortgage lending market and increased costs associated with the bank's IT and digital strategy. We believe SGH's profitability provides a more limited buffer to absorb higher loan impairment charges than peers'.

Asset quality is likely to deteriorate given the bank's exposure to the SME and corporate sectors, but also indirectly, for example, through higher unemployment. We believe the economic and financial market fallout from the pandemic creates additional downside risks to our assessment of strategic execution, asset quality and capitalisation relative to when we last reviewed the bank's ratings.

The Long-Term IDR of Santander Financial Services plc (SFS) has been upgraded to 'A+', removed from UCO and assigned a Negative Outlook. This is because Fitch considers that its bank holding company parent, SGH, has a clearly defined and credible role in protecting SFS's external senior creditors in a resolution. The upgrade reflects our expectation under our new criteria that external senior creditors will benefit from resolution funds ultimately raised by SGH and designed to protect the subsidiaries' senior creditors in a group failure.

The Tier 2 debt of SGH and San UK has been downgraded by one notch to 'BBB+' and removed from UCO to reflect the change in baseline notching for loss-severity to two notches (from one previously) from SGH's Viability Rating (VR) since these banks do not meet the specific conditions under our new criteria for applying one notch.

SGH's AT1 debt has been upgraded by one notch to 'BBB-' and removed from UCO to reflect a change in baseline notching to four notches (from the previous five) from the VR, reflecting a reduction in incremental non-performance risk relative to our previous assumptions. Our assessment is based on the bank operating with a CET1 ratio that is comfortably above maximum distributable amount (MDA) thresholds and our expectation that this will continue.

RATING SENSITIVITIES

The most immediate downside risk to SGH's and San UK's ratings is the depth and duration of the coronavirus shock to the UK economy. Extended economic contraction would put pressure on asset quality and capitalisation, and on management's ability to achieve expected cost efficiencies, jeopardising the ability to build up capital organically.

In the event SGH is able to withstand rating pressure arising from the pandemic, the most likely trigger for an upgrade would be a sustained improvement in earnings combined with greater diversification of its business model, namely through an expansion of its retail, commercial and larger corporate franchise while maintaining its modest risk appetite. We believe this will take time to achieve.

The Long-Term IDR of SFS is sensitive to Fitch's view of the probability of external senior creditors benefitting from resolution funds. This could result from e.g. a change in resolution legislation, a change in the role of SFS for the group in a resolution, or a change in the amount of debt/equity buffers available to it in a resolution.

Subordinated debt ratings are primarily sensitive to changes in the issuers' respective VRs. The ratings of AT1 securities are also sensitive to a change in Fitch's assessment of the probability of their non-performance relative to the risk captured in the respective VRs.

Best/Worst Case Rating Scenario

Ratings of financial institutions 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 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
ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or 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.

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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)

Additional Disclosures

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