

Rating Action: Moody's changes outlook to positive on Santander UK's senior unsecured and deposit ratings

08 Jan 2019

Upgrades rating of the Additional Tier 1 issued by Santander UK Group Holdings to Ba1 (hyb) from Ba2 (hyb)

Paris, January 08, 2019 -- Moody's Investors Service (Moody's) today affirmed the baseline credit assessment (BCA) and adjusted BCA of Santander UK plc (Santander UK) at a3, as well as the notional BCA and adjusted BCA of the holding company Santander UK Group Holdings plc (Santander UK Group Holdings). The rating agency also affirmed Santander UK's long-term deposit and senior unsecured debt ratings at Aa3, long-term counterparty risk ratings (CRR) at Aa2, short-term CRR at Prime-1, long-term counterparty risk assessment (CR Assessment) at Aa2(cr), and short-term CR Assessment at Prime-1(cr). The short-term deposit ratings were affirmed at Prime-1. Furthermore, Moody's affirmed Santander UK Group Holdings' Baa1 senior unsecured debt ratings, and upgraded the Additional Tier 1 (AT1) High Trigger Contingent Convertible Perpetual Preferred Securities issued in June 2015 by Santander UK Group Holdings to Ba1 (hyb) from Ba2 (hyb).

The outlook on Santander UK's long-term deposit and senior unsecured ratings, and Santander UK Group Holdings' long-term senior unsecured debt ratings has been changed to positive from stable.

A full list of affected entities and their ratings can be found at the end of this press release

RATINGS RATIONALE

RATIONALE FOR THE BCAs

The affirmation of Santander UK's a3 BCA reflects (1) its strong franchise in UK mortgage and saving products; (2) its solid earnings generation capacity and low earnings volatility; and (3) its robust capital levels. The BCA also incorporates the bank's (1) rising asset risk through increasing exposure to small and medium-sized corporates; (2) expected pressures on revenues and asset risk due to the weakening UK operating environment and (3) ongoing reliance on wholesale funding, although somewhat mitigated by a sizeable liquid assets buffer.

The a3 notional BCA of Santander UK Group Holdings is aligned with the a3 BCA of Santander UK and reflects the predominance of Santander UK within the UK sub-group (with customer loans expected to be about GBP199 billion under Santander UK compared to GBP0.3 billion under its sole sister company Abbey National Treasury Services plc at year-end 2018).

RATIONALE FOR THE LONG-TERM RATINGS

Santander UK is subject to the UK implementation of the EU Bank Recovery and Resolution Directive (BRRD), which Moody's considers to be an Operational Resolution Regime. Therefore, Moody's applies its Advanced Loss Given Failure (LGF) analysis to the issuer and its liability structure.

Moody's Advanced LGF analysis indicates that Santander UK's deposits are likely to face very low loss-given-failure, due to the loss absorption provided by subordinated debt and, potentially, by senior unsecured debt should deposits be treated preferentially in a resolution, as well as the substantial volume of deposits themselves. This results in a preliminary rating assessment (PRA) of a1, two notches above the BCA.

Santander UK's senior unsecured debt, issued by the bank, is also likely to face very low loss-given-failure, due to the loss absorption provided by its own volume and the amount of debt subordinated to it. This results again in a PRA of a1, two notches above the BCA.

The senior unsecured debt issued by Santander UK Group Holdings is likely to face high loss-given-failure due to the small amount of debt subordinated to it. Moody's assumes that EU senior holding company obligations benefit from the subordination of both holding company and bank-issued subordinated instruments. However,

Moody's believes that EU holding company senior unsecured debt is economically junior to bank senior unsecured debt, based on the agency's forward-looking view that EU holding company senior unsecured debt, although legally pari passu to bank debt, will through down-streaming eventually fund bank senior unsecured debt which is contractually, structurally or statutorily subordinated to operating company external senior debt. This results in a PRA of baa1 for the senior unsecured debt issued by Santander UK Group Holdings, one notch below the BCA.

Moody's believes there is a moderate probability of government support for Santander UK's deposits and senior debt, resulting in a one-notch uplift to the PRAs, and long-term deposit and issuer ratings of Aa3. Moody's considers the probability of government support for holding company liabilities to be low, leading to long-term issuer and senior unsecured ratings of Baa1 for Santander UK Group Holdings.

RATIONALE FOR THE OUTLOOKS

The positive outlooks on Santander UK's long-term deposit and senior unsecured debt ratings and Santander UK Group Holdings' senior unsecured debt rating reflect Santander UK's expected issuance plans given its informative MREL target of 27.2% of RWAs. When confirmed, this would provide additional protection for the bank's senior unsecured debt and deposits, and for the holding company's senior unsecured debt, and could lead to higher ratings over the outlook horizon.

RATIONALE FOR THE ADDITIONAL TIER 1

The upgrade of the Additional Tier 1 (AT1) High Trigger Contingent Convertible Perpetual Preferred Securities issued in June 2015 by Santander UK Group Holdings to Ba1 (hyb) from Ba2 (hyb) reflects Moody's approach to the rating of high trigger contingent capital securities, where Moody's rates to the lower of a model-based outcome and the bank's non-viability security rating, which is positioned based on Moody's advanced Loss Given Failure analysis.

This method captures the credit risk associated with the distance to trigger breach and the credit risk of these securities' non-viability component, which also captures the risk of coupon suspension on a non-cumulative basis. The model based outcome suggested a rating of Ba1 (hyb). This is one notch below the bank's non-viability security rating of Baa3 (hyb).

The principal of the security would be fully and permanently written-down if Santander UK Group Holdings' fully loaded consolidated Basel III Common Equity Tier 1 (CET1) capital ratio fell below 7%. Santander UK Group Holdings had a CET1 capital ratio of 13.1% at end-September 2018.

Moody's had historically reflected the risk that Santander UK might be more willing to allow the trigger breach to occur, than had it issued a security that converted to equity which would have diluted the parent's control, by applying an additional negative notch to the model outcome. Today's upgrade is driven by the removal of this additional notch, given Moody's view that the bank has a strong incentive to avoid triggering of any breach and that the regulatory environment for UK banks is in practice unlikely to facilitate such differentiation. The notching applied to this instrument is consistent with the approach applied to instruments with similar features, and comparable distance to the conversion trigger, issued by other UK banks.

WHAT COULD CHANGE THE RATINGS UP/DOWN

Santander UK's BCA could be upgraded if the bank: (1) shows a structural reduction in its reliance on market funding; (2) maintains its strong asset quality despite growth in its SME and corporate lending portfolio; and (3) continues to maintain its strong solvency profile through internal capital generation. A positive change in Santander UK's BCA would likely affect all ratings.

Santander UK's deposit and senior debt ratings could also be upgraded if its holding company were to issue or confirmed plans to issue significant amounts of long-term debt in line with its interim and final MREL requirements.

Santander UK's BCA could be downgraded due to: (1) an unexpected significant deterioration in its asset quality metrics; (2) a material weakening in profitability, which would reduce the bank's going-concern loss-absorption capacity; or (3) a deterioration in the bank's funding and liquidity position, including a further reduction in the quantity or quality of its liquidity buffer. A downward movement in Santander UK's BCA would likely result in downgrades of all ratings.

Santander UK's long-term senior unsecured debt and deposit ratings could also be downgraded in case of a

reduction in the volume of debt that could be bailed in, which would increase loss-given-failure for these instruments.

LIST OF AFFECTED RATINGS

..Issuer: Santander UK plc

Affirmations:

- Adjusted Baseline Credit Assessment, Affirmed a3
- Baseline Credit Assessment, Affirmed a3
-Counterparty Risk Assessment, Affirmed Aa2(cr)
-Counterparty Risk Assessment, Affirmed P-1(cr)
-Counterparty Risk Rating, Affirmed Aa2
-Counterparty Risk Rating, Affirmed P-1
-Issuer Rating, Affirmed Aa3 , Changed to Positive from Stable
-Bank Deposit Rating, Affirmed Aa3 , Changed to Positive from Stable
-Bank Deposit Rating, Affirmed P-1
-Senior Unsecured Regular Bond/Debenture, Affirmed Aa3 , Changed to Positive from Stable
-Junior Subordinated Regular Bond/Debenture, Affirmed Baa2 (hyb)
-Subordinate Regular Bond/Debenture, Affirmed Baa1
-Pref. Stock Preferred Stock, Affirmed Baa2 (hyb)
-Pref. Stock Non-cumulative Preferred Stock, Affirmed Baa3 (hyb)
-Senior Unsecured Medium-Term Note Program, Affirmed (P)Aa3
-Senior Unsecured Medium-Term Note Program, Affirmed (P)P-1
-Subordinate Medium-Term Note Program, Affirmed (P)Baa1
-Senior Unsecured Commercial Paper, Affirmed P-1
-Junior Subordinate Shelf, Affirmed (P)Baa2
-Senior Unsecured Shelf, Affirmed (P)Aa3
-Subordinate Shelf, Affirmed (P)Baa1

Outlook Actions:

-Outlook, Changed To Positive From Stable

..Issuer: Santander UK Group Holdings plc

Affirmations:

- Adjusted Baseline Credit Assessment, Affirmed a3
- Baseline Credit Assessment, Affirmed a3
- Issuer Rating, Affirmed Baa1 , Changed to Positive from Stable
-Senior Unsecured Regular Bond/Debenture, Affirmed Baa1 , Changed to Positive from Stable

...Subordinate Regular Bond/Debenture, Affirmed Baa1
...Senior Unsecured Medium-Term Note Program, Affirmed (P)Baa1
...Subordinate Medium-Term Note Program, Affirmed (P)Baa1
...Multiple Seniority Medium-Term Note Program, Affirmed (P)P-2
...Pref. Shelf Non-cumulative, Affirmed (P)Ba2
...Senior Unsecured Shelf, Affirmed (P)Baa1
...Subordinate Shelf, Affirmed (P)Baa1

Upgrades:

...Pref. Stock Non-cumulative Preferred Stock, Upgraded to Ba1 (hyb) from Ba2 (hyb)

Outlook Actions:

...Outlook, Changed To Positive From Stable

The principal methodology used in these ratings was Banks published in August 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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