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Santander UK Group Holdings PLC

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Santander UK Group Holdings PLC

Group SACP	bbb+	
Anchor	bbb+	
Business Position	Adequate	0
Capital and Earnings	Adequate	0
Risk Position	Adequate	0
Funding	Average	0
Liquidity	Adequate	

+

Support	+2
ALAC Support	+2
GRE Support	0
Group Support	0
Sovereign Support	0

+

Additional Factors	0

Issuer Credit Rating
A/Negative/A-1
Resolution Counterparty Rating
A+/--/A-1
Holding Company ICR
BBB/Negative/A-2

ALAC--Additional loss absorbing capacity. ICR--Issuer credit rating. SACP--Stand-alone credit profile. The bank holding company ICR shown applies to Santander UK Group Holdings PLC, and is one notch below the group SACP. The ICR and the resolution counterparty rating shown apply to Santander UK Group Holdings PLC's core bank operating subsidiary, Santander UK PLC.

Major Rating Factors

Issuer Credit Rating
BBB/Negative/A-2

Strengths:	Weaknesses:
• Good position in U.K. retail banking. • Conservative loan book profile compared to peers. • Solid capitalization by our measures.	• U.K. recession and interest rate cuts owing to the COVID-19 pandemic are weakening asset quality and weighing on profitability. • Cost-to-income ratio is weakening, in part due to net interest margin pressure and ongoing investment in the bank. • Lower revenue and business diversification than its larger U.K. competitors.

Outlook

Santander UK Group Holdings PLC

The negative outlook reflects our expectation that, despite its good market position, the bank will endure weakened asset quality and earnings over our two-year outlook horizon as a result of the economic and market impact of the COVID-19 pandemic. It also reflects our expectation that the bank will steadily expand its market position in U.K. retail banking, while maintaining its supportive risk appetite and capitalization. We assume Banco Santander will continue to provide ongoing group support, despite the uncertainty for extraordinary group support in a severe stress scenario given its multiple point of entry approach to resolution.

We could lower the ratings if a significant deterioration in the operating environment occurred such that material weakness in underlying performance was anticipated. If clear signs that the 2020 systemwide domestic loan loss rate is likely to exceed 100 basis points (bps), with no offset from prospective economic recovery, we would likely lower the Banking Industry Country Risk Assessment (BICRA) for the U.K. to 'bbb' from 'bbb+'. In that scenario, we would consider managements' ability to leverage balance sheet strength and flexibility to further conserve capital and weather an adverse economic environment.

We could revise the outlook to stable if our view of U.K. economic risk were to improve, or if the bank were to outperform both domestic and international peers.

Santander UK PLC

The negative outlook on the main operating subsidiary reflects our view of the group SACP as described above. It also assumes that its additional loss-absorbing capacity (ALAC) buffer will remain supportive of the issuer credit rating by remaining above our 8% threshold.

We would most likely raise or lower the ratings if the group SACP strengthened or deteriorated, or if we expected the ALAC ratio to fall below 8%, which would most likely be due to material risk-weighted asset (RWA) inflation beyond our current expectations.

Rationale

As Santander UK is one of the six largest financial institutions focused on the U.K. banking market, we believe the bank's good position in U.K. retail banking, and conservative risk profile underpin its creditworthiness at the current rating level. However, the bank's franchise and market shares in business and commercial banking will continue to lag behind some of Santander UK's closest peers, which leads to higher revenue concentrations.

We believe the bank will face a particularly challenging operating environment in 2020 given the combination of COVID-19- related credit provisioning increases, the lower rate environment extending the period of net interest margin pressure, and ongoing competitive pressure to maintain digital transition investment costs. We revised the outlook to negative in April 2020 due to the economic and market impact of COVID-19 (see "Santander UK Group

Holdings Outlook Revised To Negative On Economic Impact Of COVID-19; Ratings Affirmed," published on April 23, 2020). The bank previously lowered its stated medium-term return on tangible equity (RoTE) target to 9%-11% (from a reported 10%-12% in 2019) and has seen its adjusted cost-to-income ratio increase from around the 50%-55% mark to a reported 63% as at March 31, 2020. Santander UK is not alone in this respect owing to the prolonged low-interest-rate environment, increasing competitive dynamics, and a series of regulatory and associated cost initiatives. We believe that balance sheet metrics--specifically capitalization, the funding and liquidity profiles, and asset quality--are broadly in line with those of domestic U.K. peers and we expect Santander UK will maintain its healthy balance sheet profile.

Our 'A' rating on Santander UK PLC includes two notches of uplift for its ALAC. The bank's ALAC buffers do not positively affect the rating on Santander UK Group Holdings PLC. The 'BBB' rating on the nonoperating holding company (NOHC) is one notch lower than the 'bbb+' group SACP, reflecting the structural subordination of holding company creditors.

We consider Santander UK a highly strategic subsidiary of Banco Santander due to its material contribution to group earnings and relative medium-term earnings stability. However, we capture the benefits of being part of a large, diversified global bank within the group SACP, rather than potential group support notches, owing to the broader group's multiple point of entry approach to bank resolution.

Anchor:'bbb+' for banks operating in the U.K.

We view the economic risk trend for the U.K., as it affects its domestic banking sector, as negative. This principally reflects the possibility that, in light of the evolving impact of COVID-19, domestic loan losses could rise to around 100bp of outstanding balances in 2020. This loan loss rate would be around five times the level of each of the previous six years, and would challenge the current economic risk assessment, allied with our existing view of the U.K.'s relatively high household leverage. We would also factor in the likely pace and strength of the economic recovery that we assume will occur in 2021.

We see the trend for U.K. banking industry risk as stable. The firm actions of the Bank of England, and government measures, have supported the banking system during the COVID-19 crisis. Moreover, the banking sector entered this period with a robust balance sheet profile, confirmed by the results of the latest Bank of England stress tests in both December 2019 and May 2020. However, pre-provision earnings will be further squeezed by the even lower rate environment than we had previously assumed, as well as reduced economic activity. The weaker profitability outlook for the industry may offset our growing views of the robustness of the system's balance sheet profile and its institutional strengths.

All else being equal, a lowering of the economic risk score, as implied by the negative economic risk trend, would result in a bank anchor of 'bbb' compared to the current 'bbb+'.

Table 1

Santander UK Group Holdings PLC Key Figures

	--Year-ended Dec. 31--				
(Mil. £)	**2019**	**2018**	**2017**	**2016**	**2015**
Adjusted assets	286,712	287,567	313,018	300,825	279,178

Table 1

Santander UK Group Holdings PLC Key Figures (cont.)					
	--Year-ended Dec. 31--				
(Mil. £)	**2019**	**2018**	**2017**	**2016**	**2015**
Customer loans (gross)	208,879	202,952	208,838	204,821	202,699
Adjusted common equity	11,055	11,027	11,456	11,058	10,866
Operating revenues	4,170	4,543	4,864	4,676	4,577
Noninterest expenses	2,613	2,632	2,595	2,558	2,580
Core earnings	794	1,073	1,256	1,270	1,257

Business position: Ongoing investment in the franchise

Our assessment of Santander UK's business position as adequate reflects the strength of its retail banking franchise, offset by its lower business and revenue diversification compared with its closest domestic peers.

We think that Santander UK's relatively high earnings concentration and exposure to the leveraged U.K. household sector make it harder to achieve a higher business position assessment, notwithstanding the benefits of being part of a large, diversified global bank. Moreover, unlike for some peers Santander UK's inherent franchise strengths do not appear to be manifesting in improving earnings metrics. For example, its cost-to-income ratio is deteriorating. Much improved efficiency could be one indication that Santander UK's business position is more favorable, and a credit strength under most operating conditions. This fact would complement the inherent stability of Santander UK's retail franchise and its bias toward the typically stable performance of U.K. residential property lending.

Key peers are Lloyds Banking Group PLC (Lloyds; group SACP: 'a-'), Nationwide Building Society (NBS; 'a-'), Royal Bank of Scotland Group PLC (RBS; 'bbb+') and the U.K. ring-fenced banks, principally, of Barclays PLC ('bbb+') and HSBC Holdings PLC ('a'), Barclays Bank UK PLC and HSBC UK Bank PLC, respectively. A lower rated, and less diverse U.K. peer is Virgin Money UK PLC ('bbb'). Outside of the U.K., other retail-focused peers are ABN AMRO Bank N.V.('a-'), Credit Mutuel Group ('a-'), Danske Bank A/S ('a-') and Nykredit Realkredit A/S ('a-').

Santander UK is one of the U.K.'s leading banks by deposits and mortgage loan balances. Indicative of its scale, Santander UK states that it has 14 million active customers. We estimate that Santander UK's share of the U.K. residential mortgage stock at end-2019 stood at about 11%. We note that Santander UK's share of the U.K. retail current account market continues to steadily increase, such that it now ranks close to HSBC.

Effective Jan. 1, 2019, Santander UK had completed the relevant business transfers in order to comply with the ring-fencing requirements in the U.K. During 2018, it transferred £1.4 billion of customer loans, £21.5 billion of other assets, and £20.7 billion of liabilities, mainly related to derivatives business, principally to Banco Santander's London branch.

Santander UK is managed via three main divisions (at Dec. 31, 2019):

- Retail Banking, including business banking with turnover up to £6.5 million; 67% of regulatory RWAs, up from 59% the year before, led by a £7.4 billion increase in mortgage lending.
- Corporate & Commercial Banking, which covers businesses with annual turnover of £6.5 million to £500 million; 17% of regulatory RWA, down from 22% the year before.

- Corporate & Investment Banking (CIB), which covers corporate clients with an annual turnover of over £500 million; 7% of regulatory RWA, down from 9% the year before.
- The balance of RWA (9%) is held in the corporate centre.

While ring-fencing developments altered some of the comparative metrics, the following is indicative of Santander UK's more limited diversification (though it is more diverse than NBS):

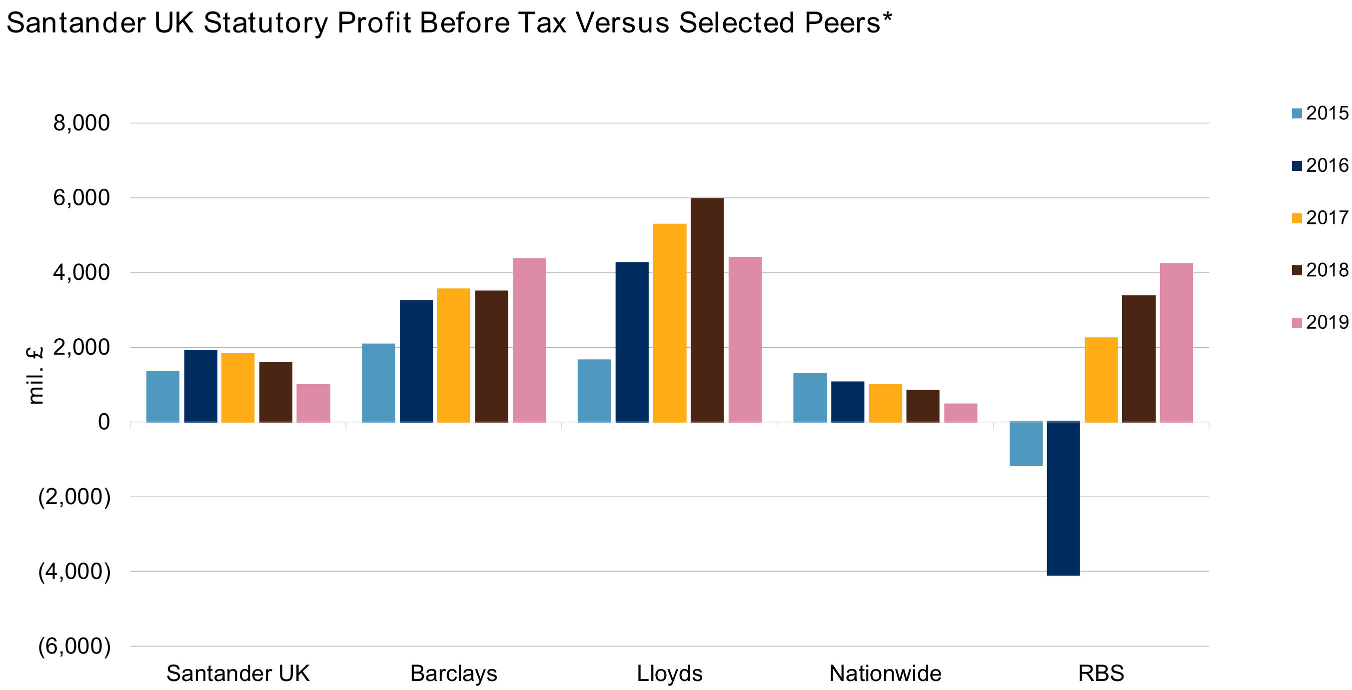
- At Dec. 31, 2019, retail banking was a reported 86% (2018: 83%) of total income; for Lloyds and RBS this metric is typically in the 50%-60% range.
- At Dec. 31, 2019, net interest income was a reported 79% (2018: 79%) of total income; for Lloyds and RBS this metric is typically in the 60%-70% range.

2019 saw another year of development of Santander UK's core retail franchise and represented the strongest year for net mortgage lending in a decade. The commercial banking franchise is evolving, with the focus on commercial real estate (CRE) lending having significantly reduced in recent years (another £1.1 billion reduction in 2019). In particular, we see evidence of Santander UK leveraging the group's international franchises by targeting more internationally focused U.K. companies. We expect this strategic shift will continue even though the related income expansion may lag the investment.

The combined impact of Santander UK's business banking and corporate banking strategies, and ring-fencing, means that total business line and income diversity has not fundamentally altered in recent years; mortgages, savings and other retail products will therefore continue to be the key driver of earnings performance.

Relative to the larger U.K. banking groups, we acknowledge that Santander UK has generally demonstrated greater earnings and business stability over the past several years (chart 1). This mainly reflects its more modest conduct and litigation charges and its lesser need to restructure. That said, 2019 saw a material decline in profit before tax of 37%, which is likely to be indicative of performance in future years as the COVID-19 pandemic reduces economic activity and interest rates remain exceptionally low. U.K. mortgage market competition has increased in recent years, which has pressured income growth. Moreover, we believe that Santander UK's larger peers are now better positioned to compete than they have been, especially in light of recent ring-fencing requirements that have increased funding available for the larger U.K. banks' retail operations, and the resolution of their key legacy litigation matters.

Chart 1



*Year end Dec. except for Nationwide whose financial year end is April 4 (i.e 2019=April 4, 2020).
Source: Company accounts.

The management team is relatively stable and we don't consider its overall strategy or return targets to be overly aggressive. Indeed, consistent with the public statements of its parent and the parent's reticence to allocate more capital toward the U.K., we believe that management's conservative stance first adopted post the 2016 EU Referendum may prove relatively supportive of asset quality during the current economic downturn.

Key elements of management's updated strategic transformation program include improving returns in its corporate and commercial division, achieving enhanced efficiency and capital discipline. Management has prioritized digital transition as Santander UK announced the closure of 140 branches through 2019. Like peers, Santander UK is investing heavily in its digital capability; while this investment may constrain earnings growth in the short term, we view this as necessary to compete, satisfy customer demands, and deliver simpler and more resilient technology platforms, in an increasingly demanding U.K. competitive and regulatory environment.

Table 2

Santander UK Group Holdings PLC Business Position

	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Total revenues from business line (currency in millions)	4,170	4,543	4,912	4,795	4,577
Commercial banking/total revenues from business line	14.7	18.2	9.5	10.2	12.4

Table 2

Santander UK Group Holdings PLC Business Position (cont.)					
	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Retail banking/total revenues from business line	85.7	82.9	79.7	77.9	76.6
Commercial & retail banking/total revenues from business line	100.4	101.0	89.3	88.1	89.0
Trading and sales income/total revenues from business line	N/A	N/A	8.9	8.4	8.3
Other revenues/total revenues from business line	(0.4)	(1.0)	1.8	3.6	2.7
Investment banking/total revenues from business line	N/A	N/A	8.9	8.4	8.3
Return on average common equity	3.6	6.5	7.5	8.1	5.9

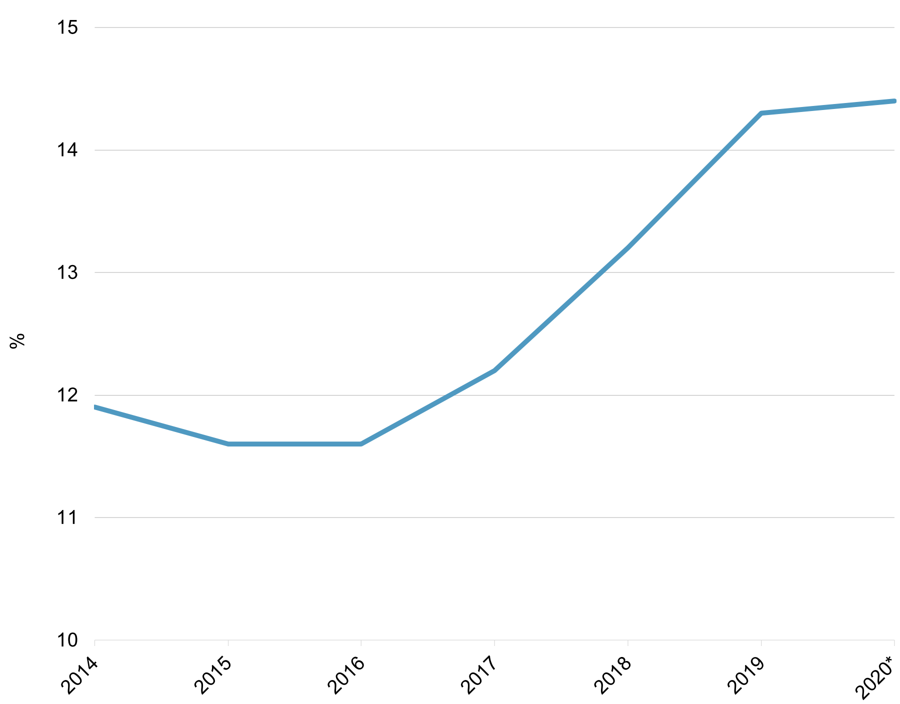
N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Capital and earnings: A higher assessment might require reduced distributions to the parent

Santander UK's regulatory capitalization has gradually strengthened over recent years, and today is broadly in line with that of its domestic peers (see chart 2). Santander UK reported a regulatory Common Equity Tier 1 (CET1) ratio of 14.4% at March 31, 2020 and a U.K. leverage ratio of 4.7%. In the short term, we expect weaker earnings capacity to likely constrain any upside to the score.

Chart 2

Santander UK CET1 Ratio Continues To Strengthen



*As of March 31, 2020. CET--Common Equity Tier. Source: Full Year Company Accounts.

By our measures, we calculate Santander UK's risk-adjusted capital (RAC) ratio to be 9.5% as of Dec. 31, 2019, and we project that it will typically remain at 8.5%-9% through end-2022. We expect the COVID-19 pandemic to result in both higher credit losses and lower earnings, as such further increases in RAC via organic capital generation are likely to be delayed. While Santander UK may be reasonably close to the 10% threshold that could lead to a stronger assessment, we are not confident the ratio will be maintained comfortably and consistently above that level, not least given its status as a subsidiary of a larger banking group. We estimate the pro forma impact of U.K. economic risk to be 58bps.

The base-case RAC ratio projection incorporates our expectations of:

- Pre-provision operating income to decline in 2020, and to a lesser extent in 2021, reflecting net interest margin pressure from retail banking competition and standard variable rate mortgage product attrition (SVR), and higher operating costs from investments to deliver strategic priorities and improve efficiency. We assume that pre-provision operating income growth will begin to improve in 2021 as the benefits of management actions and economic recovery are realized.
- We assume a decline of around 2% total loan growth in 2020 before a return to growth of 2% as the economy recovers in 2021 and 2022.
- The loan loss rate to rise to over 50 basis points (bps) in 2020 before recovering somewhat to 34bps in 2021 (it was a reported 11 bps in 2019). Nevertheless, we have tailored these levels to be better than our base-case loan loss rate for the U.K. industry.
- We think that restructuring costs and additional conduct-related provisions may continue to weigh on statutory earnings in both 2020 and 2021.
- A dividend policy to distribute one-half of earnings will resume in 2021, and possible additional distributions if Santander UK makes strong progress in managing regulatory RWA moves.
- S&P Global Ratings' RWAs expected to remain stable in 2020, helped by a reduction in higher risk-weighted CRE and other corporate loans, before increasing in 2021.

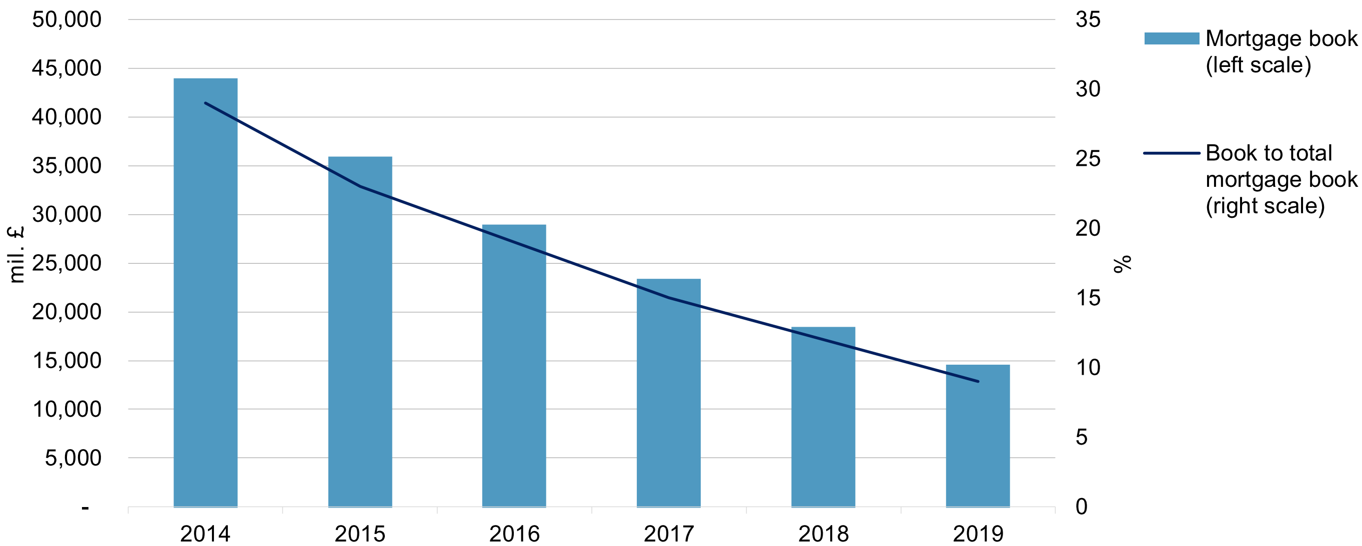
We expect the quality of capital will remain a neutral credit factor. Adjusted common equity was 83% of total adjusted capital (TAC) at end-2019, similar to that of many peers.

At Dec. 31, 2019, Santander UK reported adjusted profit before tax of £1.300 billion, a 24% reduction compared to the Dec. 31, 2018. Within this,the reported banking net interest margin fell by 16 bps to 1.64%, the reported cost-to-income ratio was 59% and transformation charges booked were £155 million. Santander UK stated that SVR balances reduced by a further £3.9 billion as at Dec. 31, 2019 (Dec. 31, 2018: £4.9 billion), which is a continuation of the longer-term trend as customers refinance to lower rate fixed rate products (see chart 3), and contributed to the 9% fall in net interest income for the period.

First-quarter 2020 has seen a continuation of these negative trends that are likely to be exaggerated by the COVID-19 pandemic over the remainder of the year. Adjusted profit before tax of £152 million represented a 57% fall compared to first-quarter 2019. Credit impairment losses increased to £165 million (Q1 2019: £53 million), £122 million of which related to a COVID-19 charge.

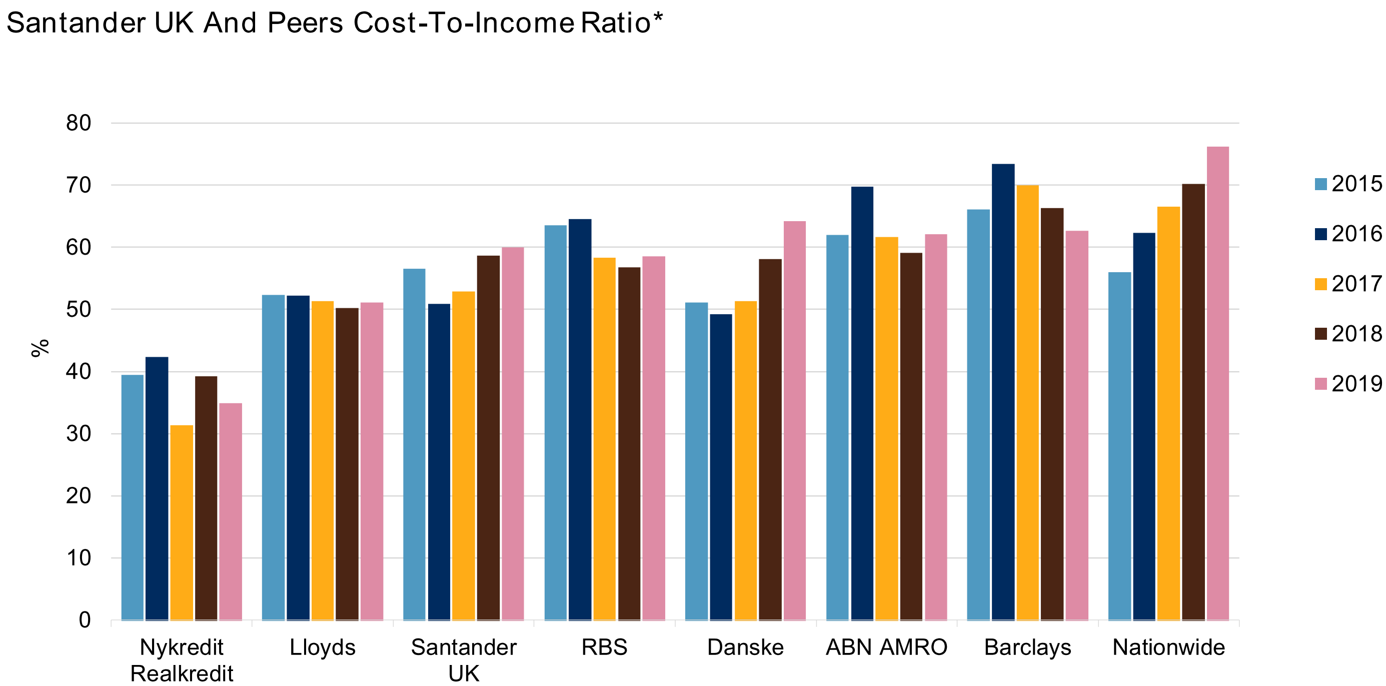
Chart 3

SVR Mortgage Book Declining As A Proportion Of Total Mortgage Book



Source: Full Year Company Accounts.

Chart 4



*Year end Dec. except for Nationwide whose financial year end is April 4 (i.e 2019=April 4, 2020).

Source: S&P Global Ratings database.

Table 3

Santander UK Group Holdings PLC Capital And Earnings

	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Tier 1 capital ratio	17.9	16.2	15.0	14.0	14.1
S&P Global Ratings' RAC ratio before diversification	9.5	9.4	9.3	8.6	8.9
S&P Global Ratings' RAC ratio after diversification	8.8	8.9	8.9	8.2	9.4
Adjusted common equity/total adjusted capital	83.1	84.3	84.8	87.6	87.5
Double leverage	100.3	100.7	100.0	100.0	100.0
Net interest income/operating revenues	79.0	79.4	78.2	76.6	78.1
Fee income/operating revenues	16.5	16.5	16.6	16.5	15.6
Market-sensitive income/operating revenues	0.6	2.8	3.6	4.6	5.4
Noninterest expenses/operating revenues	62.7	57.9	53.4	54.7	56.4
Preprovision operating income/average assets	0.5	0.6	0.7	0.7	0.7
Core earnings/average managed assets	0.3	0.4	0.4	0.4	0.5

Table 4

Santander UK Group Holdings PLC--Risk-Adjusted Capital Framework Data					
(mil. £)	**Exposure***	**Basel III RWA**	**Average Basel III RW(%)**	**S&P Global Ratings RWA**	**Average S&P Global Ratings RW (%)**
Credit risk					
Government & central banks	40,500.0	--	--	503.6	1.2
Institutions and CCPs	4,743.8	838.0	17.7	872.6	18.4
Corporate	30,200.0	18,800.0	62.3	35,663.5	118.1
Retail	193,500.0	40,100.0	20.7	82,698.1	42.7
Of which mortgage	175,300.0	28,600.0	16.3	64,037.1	36.5
Securitization	5,914.0	1,250.0	21.1	1,526.7	25.8
Other assets	6,600.0	3,800.0	57.6	8,627.1	130.7
Total credit risk	281,457.8	64,788.0	23.0	129,891.7	46.1
Credit valuation adjustment					
Total credit valuation adjustment	--	300.0	--	--	--
Market Risk					
Equity in the banking book	200.0	700.0	350.0	1,500.0	750.0
Trading book market risk	--	300.0	--	450.0	--
Total market risk	--	1,000.0	--	1,950.0	--
Operational risk					
Total operational risk	--	7,299.0	--	8,566.9	--
	Exposure	**Basel III RWA**	**Average Basel II RW (%)**	**S&P Global Ratings RWA**	**% of S&P Global Ratings RWA**
Diversification adjustments					
RWA before diversification	--	73,387.0	--	140,408.5	100.0
Total Diversification/ Concentration Adjustments	--	--	--	10,054.5	7.2
RWA after diversification	--	73,387.0	--	150,463.0	107.2
		Tier 1 capital	**Tier 1 ratio (%)**	**Total adjusted capital**	**S&P Global Ratings RAC ratio (%)**
Capital ratio					
Capital ratio before adjustments		13,083.0	17.8	13,296.0	9.5
Capital ratio after adjustments		13,083.0	17.9	13,296.0	8.8

*Exposure at default. Securitization Exposure includes the securitization tranches deducted from capital in the regulatory framework. Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). CCP--Central counterparty clearing house. RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of 'Dec. 31, 2019', S&P Global Ratings.

Risk position: Solid mortgage book and controlled growth in other segments

Table 5

Santander UK Group Holdings PLC Risk Position					
	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Growth in customer loans	2.9	(2.8)	2.0	1.0	5.0

Table 5

Santander UK Group Holdings PLC Risk Position (cont.)

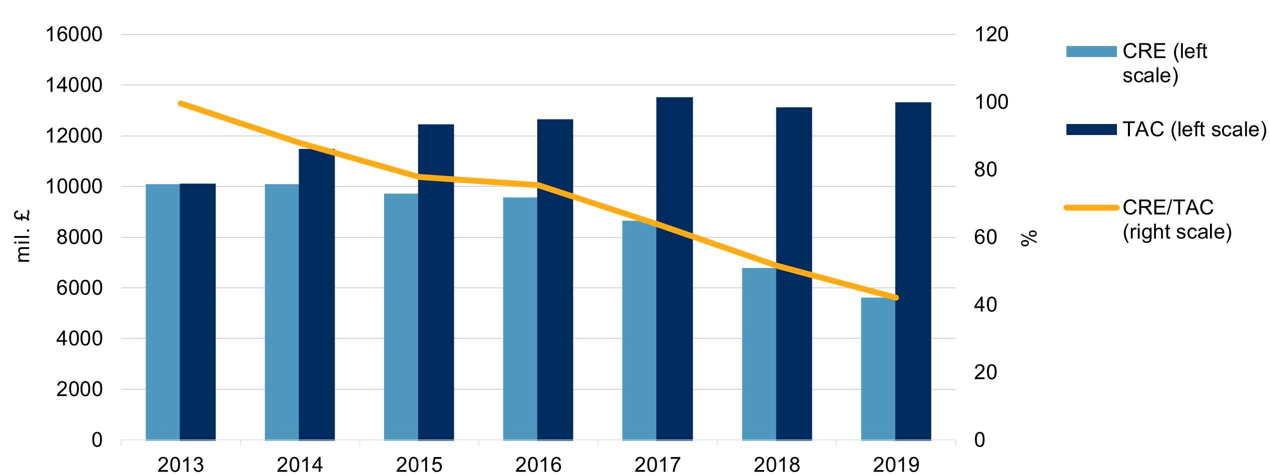
	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Total diversification adjustment/S&P Global Ratings' RWA before diversification	7.2	4.8	4.5	4.7	(4.9)
Total managed assets/adjusted common equity (x)	26.1	26.2	27.5	27.4	25.9
New loan loss provisions/average customer loans	0.1	0.1	0.1	0.0	0.0
Net charge-offs/average customer loans	0.2	0.2	0.1	0.1	0.2
Gross nonperforming assets/customer loans + other real estate owned	1.7	1.8	1.9	2.1	3.2
Loan loss reserves/gross nonperforming assets	21.8	20.7	23.6	22.5	17.6

Our assessment of Santander UK's risk position reflects our view that the bank's capital and earnings adequately capture the bank's exposure to, and capacity to absorb, unexpected losses. Risk is primarily of a credit nature, with minimal market risk, reflecting the small scale of Santander UK's financial market operations. Overall, we consider that the profile and credit quality of Santander UK's loan book is broadly in line with that of peers. We would need to observe a greater differential in asset quality measures to consider a stronger assessment.

We note Santander UK's relatively cautious approach to credit growth. In particular, total retail loan growth has been slower than the market in recent times and we are not expecting a large shift in this respect. Further evidence of recent caution is the reduction in the absolute size of the bank's CRE exposure, which had been a negative outlier (see chart 5). One of the side effects of expanding a commercial banking franchise is that it tends to be biased toward property, and not all clients will have primary relationships with the bank (which affects returns). The weighting of CRE to TAC was 42% at Dec. 31, 2019, having been at a high level of 100% at end-2013. Santander UK states that CRE loans further reduced by £1.1 billion in 2019.

Chart 5

Santander UK's Commercial Real Estate Exposure To Total Adjusted Capital

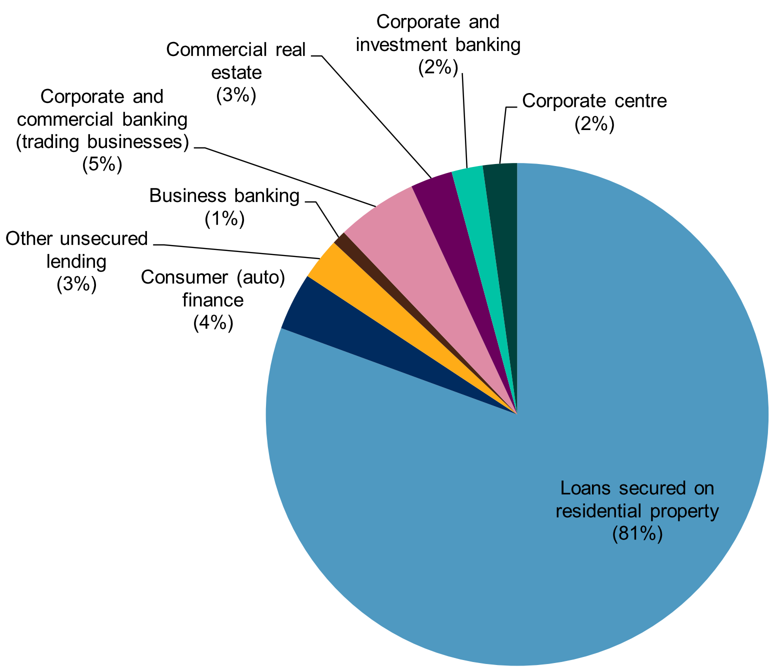


Source: As reported and S&P Global Ratings database.

Santander UK's total loan book remains heavily biased toward residential mortgages, which constituted a reported 81% of the gross customer loan book at Dec. 31, 2019. Conversely, relative to U.K. peers, Santander UK's loan book exposure to consumer credit is relatively modest (see chart 6). A material part (around £8 billion) of Santander UK's consumer credit book is auto finance, which can be particularly volatile during periods of recession--that said, we note that around 90% of such customer loans are secured.

Chart 6

Santander UK's Gross Customer Loans By Sector At December 31, 2019*



*Excludes amounts due from fellow Banco Santander subsidiaries and joint ventures. Source: Company Accounts.

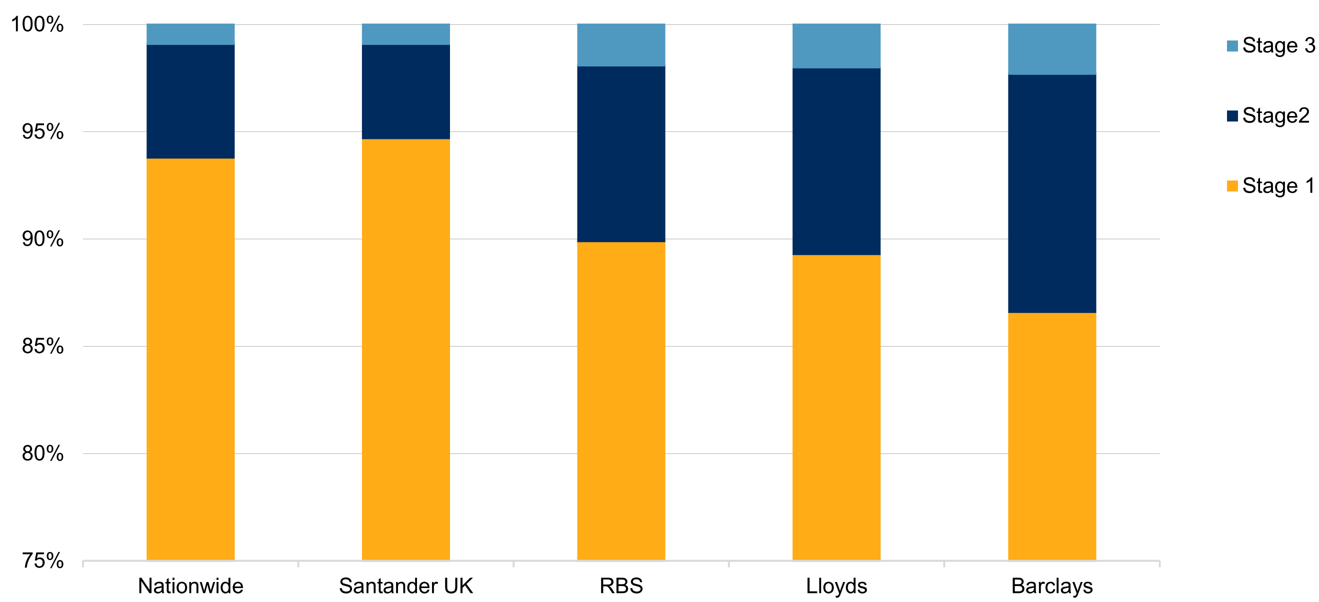
We believe that Santander UK's mortgage underwriting record compares satisfactorily with its U.K. peers'. We also note that buy-to-let mortgages, although increasing in terms of new lending, still represent only 6% of the mortgage stock, well below the industry stock figure of about 16%.

Santander UK reports that less than 1% of the mortgage book showed negative equity at Dec. 31, 2019, with a further 5% having an indexed loan-to-value ratio of 85%-100%. We consider these figures to be fairly typical for U.K. mortgage lenders. Furthermore, the proportion of interest only mortgages continues to reduce.

The stock of nonperforming and problematic loans remains low. Santander UK reported that Stage 3 loans were £1.9 billion or 0.9% of gross loans at Dec. 31, 2019. A broader analysis of asset quality also captures Stage 2 loans. For Santander UK, total Stage 2 loans are relatively low, partly owing to its mortgage book bias. Only 0.5% of total loans were defined as Stage 2 and past 30 days due, which supports our view that Santander UK's credit risk compares well. Total Stage 2 and Stage 3 loans to total loans was 5.3% at Dec. 31, 2019 which is lower than many U.K. peers (see chart 7).

Chart 7

Santander UK And Peers Loan Breakdown By Stage*



*As of Dec. 31, 2019. Data for Nationwide is as of April 4, 2020. Source: Company accounts and S&P Global Ratings.

The 7% RAC adjustment after diversification mainly reflects the concentration on the U.K. market. We note, for example, that London and the South East regions represented a reported 56% of the mortgage stock, which compares to just under 30% of the U.K. population (though the average LTV profile is favorable and loans above £1 million are limited).

The RAC framework does not capture the nontrading market risk of Santander UK's large defined-benefit pension fund exposure. The fair value of postretirement scheme assets was £12.5 billion at year end-2019.

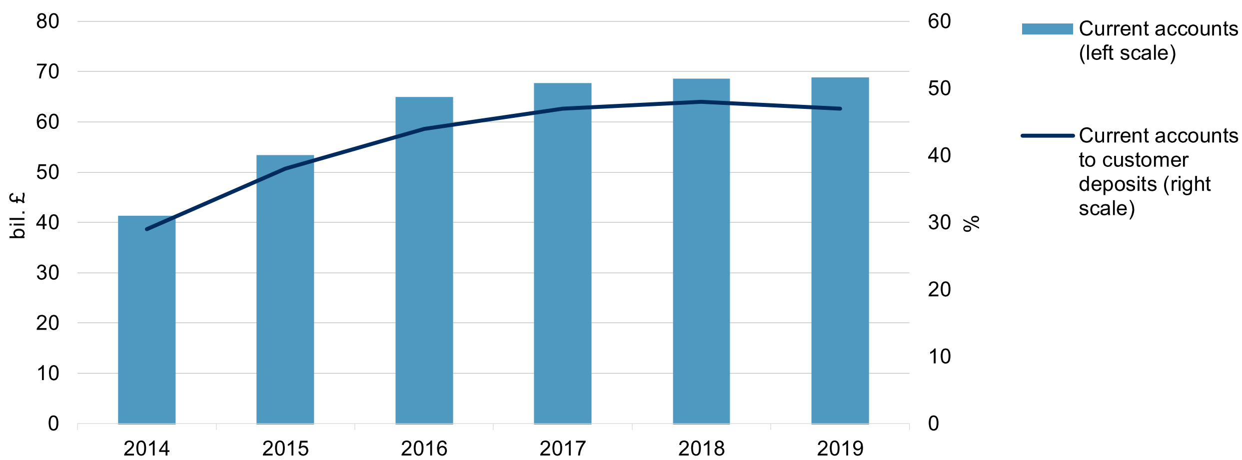
Funding and liquidity: Granular deposit franchise and access to diversified funding sources

Santander UK's large deposit base is supported by a suite of well-managed and diverse wholesale funding activities, and we believe that our key funding metrics are broadly in line with the U.K. bank averages. The bank adequately manages its liquidity position and is able to withstand an extended period of market or idiosyncratic stress. Santander UK has no structural reliance on group funding and is self-supporting from a liquidity standpoint.

At year-end 2019, and post the impact of ring-fencing, Santander UK stated that its loan-to-deposit ratio was 116%. To put this into context, the median for the top-25 U.K. banks (by revenues) was 111% at end-2019. We don't expect Santander UK's metric will weaken, unlike some smaller U.K. lenders. Indicative of the quality of its deposit franchise, current accounts now represent a reported 47% of customer deposits (see chart 8).

Chart 8

Important And Stable Role Of Current Accounts In The Funding Base (Retail Banking Division)



Source: Full Year Company Accounts.

Our stable funding ratio of 103% at Dec. 31, 2019 is also broadly in line with the average of 112% for the top-25 U.K. banks.

The bank remains one of the larger issuers of residential mortgage-backed securities and covered bonds in the U.K, representing 8.5% of its funding (£22.8 billion as of end-2019). It also means that asset encumbrance tends to be higher at Santander UK than at other U.K. banks. However, we observe that the encumbrance remained stable at £47 billion in 2018 and 2019, having reduced significantly in prior years (e.g. £74 billion back in 2014).

The liquidity position is satisfactory given the bank's restrained use of short-term wholesale funding, its stock of liquid assets, and its ability to further monetize its mortgage book. We believe that the continued strong capacity of the unencumbered mortgage book could generate additional liquidity if needed. Our measure of broad liquid assets to short-term wholesale funding was a comfortable 1.6x at year-end 2018. The bank states that its liquidity coverage ratio (LCR) ratio as of Dec. 31, 2019 was 142% (end-2018: 164%), with the decrease being a result of the new ring-fence structure (liquidity is managed separately for the ring-fenced bank, and the small non-ring-fenced bank with effect from Jan. 1, 2019).

Table 6

Santander UK Group Holdings PLC Funding And Liquidity

	--Year-ended Dec. 31--				
(%)	**2019**	**2018**	**2017**	**2016**	**2015**
Core deposits/funding base	66.5	64.7	63.8	66.5	67.8
Customer loans (net)/customer deposits	116.2	116.4	117.5	118.0	123.4
Long-term funding ratio	84.0	87.7	82.2	87.0	87.9
Stable funding ratio	102.6	108.2	105.9	106.3	102.0
Short-term wholesale funding/funding base	16.9	13.0	18.7	13.7	12.8
Broad liquid assets/short-term wholesale funding (x)	1.2	1.6	1.3	1.5	1.3
Net broad liquid assets/short-term customer deposits	4.6	12.2	9.8	10.4	6.3
Short-term wholesale funding/total wholesale funding	49.2	35.9	50.5	40.0	39.0
Narrow liquid assets/3-month wholesale funding (x)	N/A	N/A	1.7	2.0	1.7

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Environmental. Social, and Governance Factors

Although Santander UK has experienced more modest conduct and litigation charges than peers in recent times, the group's core businesses remain exposed to conduct and compliance risk. We consider the PPI misselling episode to be largely an issue of the past and do not expect further provision going forward. That said, as the digital transformation of the banking industry accelerates so too do risks relating to cybersecurity, operational resilience, and financial crime. The group has outlined a four pillar-based sustainability strategy that covers social and environmental aspects. We see ESG credit factors for the Santander UK group as being consistent with domestic peers. The ring-fenced and non-ring-fenced bank and Santander Financial Services all have strong governance arrangements including independent board members.

Support: Two notches of ALAC support

In our view, Santander UK has high systemic importance in the U.K., primarily due to its very strong position in the U.K. retail banking market. We regard the prospect of extraordinary government support for U.K. banks as uncertain in view of the country's well-advanced and effective resolution regime. As a result, systemic banks are not eligible for notching uplift for possible future U.K. government support.

However, we view the U.K. resolution regime as effective under our ALAC criteria because, among other factors, we believe it contains a well-defined bail-in process under which authorities would permit nonviable systemically important banks to continue critical functions as going concerns following a bail-in of eligible liabilities. Therefore, we factor in two notches of uplift to the long-term rating on Santander UK PLC, based on our view that its ALAC ratio is likely to be consistently above our 8% threshold.

We include all of the consolidated Santander UK group's junior instruments in our ALAC assessment because we believe they have the capacity to absorb losses without triggering a default on Santander UK PLC's senior obligations. We also include senior unsecured issuance by the NOHC. On this basis, we calculate that ALAC was 9.9% of S&P Global Ratings RWAs at year-end 2019 (see table 7). We expect our ALAC measure will remain above our 8% threshold on an ongoing basis.

Santander UK states that its minimum requirement for own funds and eligible liabilities (MREL) position was 33.6% at Sept. 30, 2019, including eligible operating company instruments. The Bank of England has now communicated to all relevant U.K. banks their non-binding indicative MREL requirements. Firms become subject to final requirements from Jan. 1, 2022. In Santander UK's case, this indicative figure is 27.0%, and the gross issuance required to achieve this target appears to be both manageable and supportive of our ALAC assessment.

Table 7

Summary Of ALAC Calculation As Of Dec. 31, 2019

		Bil. £	% of S&P Global Ratings' RWAs
A	Adjusted common equity	11,055	--
B	Hybrids in TAC	2,241	--
C (A+B)	Total adjusted common equity	13,296	9.5
D	TAC in excess of our 7% threshold	3,467	--
E	ALAC-eligible instruments	10,418	8.3
	of which NOHC senior	7,945	--
	of which dated subordinated	2,306	--
	of which minimal equity content hybrids	1,044	--
	of which other*	(877)	--
F (=D+E)	ALAC buffer	13,885	9.9
	S&P Global Ratings RWA	140,409	--

ALAC--Additional loss-absorbing capacity. TAC--Total adjusted capital. NOHC--Nonoperating holding company. RWAs--Risk-weighted assets. *Principally instruments maturing within 12-24 months in excess of 0.5% of S&P Global Ratings' RWAs. Source: S&P Global Ratings' database.

Additional rating factors:

No additional factors affect the ratings.

Group status: Highly strategic subsidiary of Banco Santander

We consider Santander UK a highly strategic subsidiary of Banco Santander. Despite the Spanish parent being rated at the same level as Santander UK PLC, we continue to incorporate ALAC support into the ratings on the U.K. subgroup where applicable, rather than group support. This is because of the broader group's multiple point of entry approach to bank resolution, which means that we view the UK subgroup as more likely to self-support through bailing in its subordinated debt instruments for loss absorption and recapitalization, rather than relying on group support. While we understand that Banco Santander may provide support to Santander UK in certain circumstances, we do not envisage this to be the case in all scenarios--it is especially uncertain in the extreme scenario whereby the U.K. subgroup needs to be resolved, given the severity of the associated stress.

Holding company rating

We regard Santander UK Group Holdings as an intermediate NOHC. The ratings on Santander UK Group Holdings PLC are based on our view of the group SACP. We do not include notches of uplift for ALAC support in the ratings on NOHCs because we do not believe that their senior obligations would continue to receive full and timely payment in a resolution scenario.

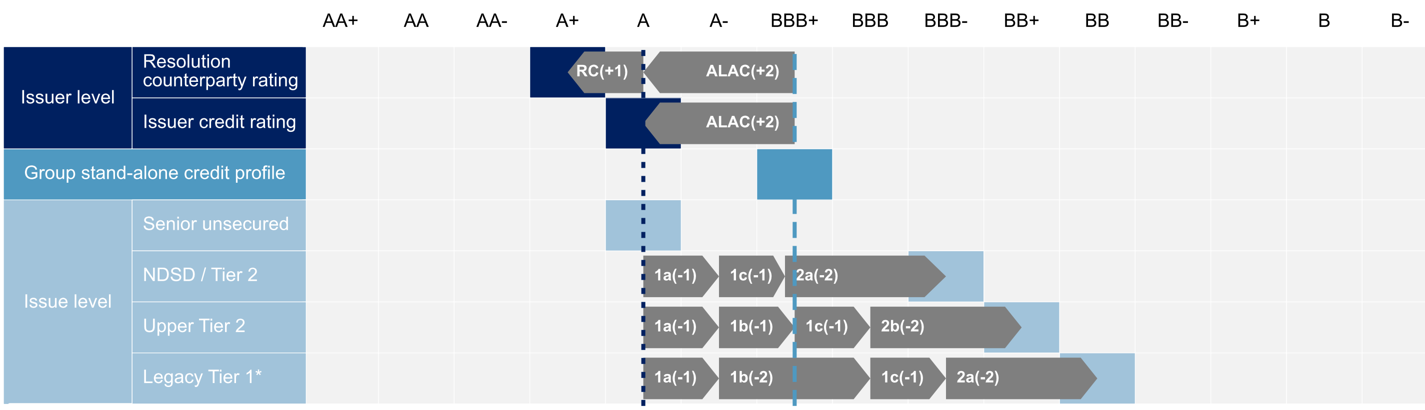
We rate the NOHC one notch below the group SACP to reflect our view that NOHC creditors are structurally subordinated to those of operating company creditors.

The group structure is relatively straightforward, mainly comprising the ring-fenced bank. In 2018, Abbey National Treasury Services PLC (ANTS) become a subsidiary of the NOHC (having previously been a subsidiary of Santander UK plc). ANTS has been renamed Santander Financial Services PLC (SFS). SFS holds a small number of legacy business positions and the business of the Jersey and Isle of Man branches.

Hybrid issue ratings

We rate hybrid instruments according to their respective features (see charts 9 and 10).

Santander UK PLC: Notching



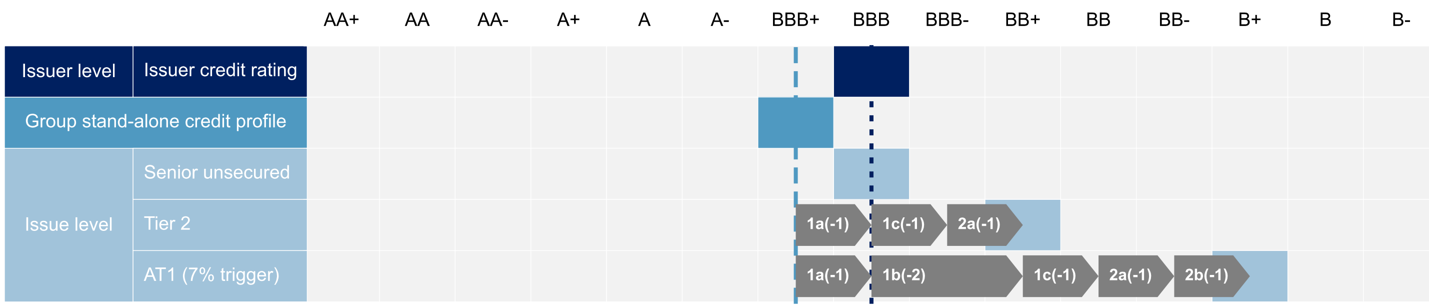
Key to notching

- - - Group stand-alone credit profile
····· Issuer credit rating

RC	Resolution counterpartyliabilities (senior secured debt)
ALAC	Additional loss-absorbing capacity buffer
1a	Contractual subordination
1b	Discretionary or mandatory nonpayment clause and whether the regulator classifies it as regulatory capital
1c	Mandatory contingent capital clause or equivalent
2a	Mandatory going-concern, regulatory capital-based trigger (either statutory or contractual)
2b	Other nonpayment or default risk not captured already
2c	Rating-sensitive or exceptionally sensitive contingent capital trigger leading to common equity conversion and/or principal write-down

Note: The number-letter labels in the table above are in reference to the notching steps we apply to hybrid capital instruments, as detailed in table 3 of our "Hybrid Capital: Methodology And Assumptions" criteria, published on July 1, 2019.
NDSD--Non-deferrable subordinated debt.

Santander UK Group Holdings PLC: NOHC Notching



Key to notching

- - - Group stand-alone credit profile
..... Issuer credit rating

1a	Contractual subordination
1b	Discretionary or mandatory nonpayment clause and whether the regulator classifies it as regulatory capital
1c	Mandatory contingent capital clause or equivalent
2a	Mandatory going-concern, regulatory capital-based trigger (either statutory or contractual)
2b	Other nonpayment or default risk not captured already

Note: The number-letter labels in the table above are in reference to the notching steps we apply to hybrid capital instruments, as detailed in table 3 of our "Hybrid Capital: Methodology And Assumptions" criteria, published on July 1, 2019.
The nonoperating holding company (NOHC) issuer credit rating and senior unsecured debt ratings are notched down from the group stand-alone credit profile (SACP) under our criteria to reflect structural subordination (see "Group Rating Methodology," published July 1, 2019).
AT1--Additional Tier 1.

Resolution Counterparty Ratings

We set 'A+/A-1' resolution counterparty ratings (RCsR) on Santander UK PLC one notch above its long-term issuer credit rating. The RCRs also reflect our jurisdiction assessment for the U.K.

An RCR is a forward-looking opinion of the relative default risk of certain senior liabilities that may be protected from default through an effective bail-in resolution process for the issuing financial institutions. RCRs apply to issuers in jurisdictions where we assess the resolution regime to be effective and we consider the issuer likely to be subject to a resolution that entails a bail-in if it reaches nonviability.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing

Capacity, April 27, 2015

- Criteria | Financial Institutions | Banks: Assessing Bank Branch Creditworthiness, Oct. 14, 2013
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- COVID-19 Effects Might Quadruple U.K. Bank Credit Losses In 2020, May 4, 2020
- Spain's Banco Santander Outlook Revised To Negative On Global Economic Downturn; 'A/A-1' Ratings Affirmed, April 29, 2020
- Santander UK Group Holdings Outlook Revised To Negative On Economic Impact Of COVID-19; Ratings Affirmed, April 23, 2020
- Outlooks Revised On Six U.K. Banks On Deepening COVID-19 Downside Risks, April 23, 2020
- Europe's AT1 Market Faces The COVID-19 Test: Bend, Not Break, April 22, 2020
- COVID-19 Deals A Larger, Longer Hit To Global GDP, April 16, 2020
- Banco Santander S.A., Dec. 20, 2019
- Santander UK Group Holdings PLC, Dec. 6, 2019

Ratings Detail (As Of June 30, 2020)*	
Santander UK Group Holdings PLC	
Issuer Credit Rating	BBB/Negative/A-2
Junior Subordinated	B+
Senior Unsecured	BBB
Short-Term Debt	A-2
Subordinated	BB+
Issuer Credit Ratings History	
23-Apr-2020	BBB/Negative/A-2
10-Apr-2015	BBB/Stable/A-2
Sovereign Rating	
United Kingdom	AA/Stable/A-1+

Ratings Detail (As Of June 30, 2020)*(cont.)	
Related Entities	
Banco Ole Bonsucesso Consignado S.A.	
Issuer Credit Rating	
Brazil National Scale	brAAA/Stable/brA-1+
Banco Santander (Brasil) S.A.	
Issuer Credit Rating	BB-/Stable/B
Brazil National Scale	brAAA/Stable/brA-1+
Banco Santander-Chile S.A.	
Issuer Credit Rating	A/Negative/A-1
Commercial Paper	
Foreign Currency	A-1
Senior Unsecured	A
Subordinated	A-
Banco Santander S.A.	
Issuer Credit Rating	A/Negative/A-1
Resolution Counterparty Rating	A+/--/A-1
Senior Subordinated	A-
Senior Unsecured	A
Short-Term Debt	A-1
Subordinated	BBB+
Banco Santander SA (London Branch)	
Certificate Of Deposit	
Local Currency	A-1
Banco Santander S.A. (New York Branch)	
Commercial Paper	
Local Currency	A-1
Banco Santander Totta S.A.	
Issuer Credit Rating	BBB/Stable/A-2
Resolution Counterparty Rating	BBB/--/A-2
Senior Unsecured	BBB
PSA Banque France	
Issuer Credit Rating	BBB+/Negative/A-2
Commercial Paper	A-2
Senior Unsecured	BBB+
Santander Bank, N.A.	
Issuer Credit Rating	A-/Negative/A-2
Senior Unsecured	A-
Short-Term Debt	A-2
Subordinated	BBB+
Santander Consumer Bank AG	
Issuer Credit Rating	A-/Negative/A-2
Resolution Counterparty Rating	A/--/A-1
Commercial Paper	A-2
Senior Subordinated	BBB+

Ratings Detail (As Of June 30, 2020)*(cont.)	
Senior Unsecured	A-
Santander Consumer Finance S.A.	
Issuer Credit Rating	A-/Negative/A-2
Resolution Counterparty Rating	A/--/A-1
Commercial Paper	
Local Currency	A-2
Senior Subordinated	BBB+
Senior Unsecured	A-
Short-Term Debt	A-2
Subordinated	BBB
Santander Holdings U.S.A Inc.	
Issuer Credit Rating	BBB+/Negative/A-2
Senior Unsecured	BBB+
Santander Totta SGPS, S.A.	
Senior Unsecured	BBB
Santander UK PLC	
Issuer Credit Rating	A/Negative/A-1
Resolution Counterparty Rating	A+/--/A-1
Junior Subordinated	BB
Junior Subordinated	BB+
Preference Stock	BB
Senior Secured	AAA/Stable
Senior Unsecured	A
Senior Unsecured	A-1
Short-Term Debt	A-1
Subordinated	BBB-
Sovereign Real Estate Investment Trust	
Preferred Stock	BB+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.