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# Santander UK Group Holdings PLC

**Primary Credit Analyst:**
Nigel Greenwood, London (44) 20-7176-1066; nigel.greenwood@spglobal.com

**Secondary Contact:**
Pierre Gautier, Paris (33) 1-4420-6711; pierre.gautier@spglobal.com

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# Santander UK Group Holdings PLC

| UGCP | 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/Stable/A-1 |

| Resolution Counterparty Rating |
|---|
| A+/--/A-1 |

| Holding Company ICR |
|---|
| BBB/Stable/A-2 |

ALAC--Additional loss absorbing capacity. ICR--Issuer credit rating. UGCP--The unsupported group credit profile of the Santander UK group. The bank holding company ICR shown applies to Santander UK Group Holdings PLC, and is one notch below the UGCP. 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/Stable/A-2 |

| Strengths: | Weaknesses: |
|---|---|
| • Good position in U.K. retail banking.<br>• Long track record of stable earnings.<br>• Conservative risk profile, including a relatively cautious pace of credit growth. | • Lower revenue diversification than its larger U.K. competitors.<br>• Market shares and franchise in business and commercial banking lag behind direct peers.<br>• Concentrated exposure to the leveraged U.K. household sector. |

**Outlook**

### Santander UK Group Holdings PLC

The stable outlook reflects our view that the bank will continue to steadily grow its market position in both U.K. retail banking and U.K. business and commercial banking over our two-year outlook horizon, while maintaining its stable earnings, supportive risk appetite, and adequate capitalization. It also reflects our view that 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 would most likely only raise the ratings if we revised upward the unsupported group credit profile (UGCP). This could occur if we considered that Santander UK was making sustainable progress to materially improve the diversification of its revenue streams while maintaining predictable earnings performance, or if we believed Santander UK's risk-adjusted capital (RAC) ratio were to remain comfortably and consistently above our 10% threshold.

We could lower the ratings if we revised downward the UGCP. At this time, we see limited downward pressures on Santander UK's credit characteristics. However, we could lower the ratings if asset quality significantly deteriorated due to a weakening in the external environment, or if we perceived a step change in risk appetite.

### Santander UK PLC

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

We would most likely raise or lower the ratings if the UGCP strengthened or deteriorated, or if we expected the ALAC ratio to fall below 8%, which would most likely be due to material credit growth or capital distributions 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, stable earnings, 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 lag behind some of Santander UK's closest peers, which leads to higher revenue concentrations. The demanding operating environment for U.K. banks, including the prolonged low-interest-rate environment, increasing competitive dynamics, and a series of regulatory and associated cost initiatives, also currently constrains Santander UK's creditworthiness. We believe that balance sheet metrics--specifically capitalization, the funding profile, and asset quality--are broadly in line with those of domestic U.K. peers.

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

We consider Santander UK to be a core subsidiary of Banco Santander due to its material contribution to group earnings and relative earnings stability. However, we capture the benefits of being part of a large, diversified global bank within the UGCP, 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 stable. While economic growth will remain lackluster, and may well decline in a disruptive Brexit scenario, the steady strengthening of U.K. banks' balance sheets over the past decade, and the reduction of pockets of risks/legacy assets at the large and diversified banks, means that the sector as a whole is now much more resilient to a tougher operating environment. An orderly Brexit with a transitional arrangement is still our base case. However, the risk of a disorderly Brexit has increased. If such a scenario materializes, or becomes likely, we would consider a negative action on the BICRA economic risk trend or score if we saw a severe economic shock looming.

We view the U.K. banking industry risk trend as stable. The domestic reform agenda is well advanced and banks have clarity on their future regulatory environment. Banks are also ready for the ring-fencing of retail and SME deposits, which takes legal effect from January 2019. We assume that past changes in regulatory structures will now continue to support market discipline, constrain risk appetites, curb adventurous management strategies, encourage a better conduct and compliance agenda and still enable the banking industry to yield adequate profitability. We see limited downside to our industry risk assessment in our base case, though implicit in our assessment is the expectation that the industry continue on its path towards consistent statutory profitability and a return to earnings above the cost of capital.

**Table 1**

| Santander UK Group Holdings PLC Key Figures | | | | | |
|---|---|---|---|---|---|
| | | --Year-ended Dec. 31-- | | | |
| **(Mil. £)** | **2018*** | **2017** | **2016** | **2015** | **2014** |
| Adjusted assets | 314,842 | 313,018 | 300,825 | 279,178 | 273,790 |
| Customer loans (gross) | 211,307 | 208,838 | 204,821 | 202,699 | 193,046 |
| Adjusted common equity | 11,526 | 11,442 | 11,058 | 10,866 | 10,603 |
| Operating revenues | 2,312 | 4,864 | 4,676 | 4,577 | 4,468 |
| Noninterest expenses | 1,285 | 2,595 | 2,558 | 2,580 | 2,574 |
| Core earnings | 556 | 1,256 | 1,270 | 1,257 | 1,300 |

*Data as of June 30. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

### Business position: Steady expansion of franchise

Our assessment of Santander UK's business position reflects the strength of its retail banking franchise and earnings stability, 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. Key peers are Lloyds Banking Group PLC, Nationwide Building Society, Royal Bank of Scotland Group PLC, and the U.K. ring-fenced banks, principally, of Barclays PLC and HSBC Holdings PLC (Barclays Bank UK PLC and HSBC UK Bank PLC, respectively).

In the third quarter of 2018, Santander UK largely completed the relevant business transfers in order to comply with the ring-fencing requirements in the U.K., which have to be met by Jan. 1, 2019. Rather than create a non-ring-fenced bank, like the four largest U.K. banking groups, the existing Santander UK PLC legal entity will be the ring-fenced bank. Santander UK has stated that it has transferred £1.4 billion of customer loans to Banco Santander London branch. It has also transferred £21.5 billion of other assets and £20.7 billion of liabilities, mainly related to its derivatives business. We believe that the impact of these transfers on the diversity of Santander UK's revenues and customer base are not material to our business position assessment.

Santanger UK is principally managed via three main divisions:

- Retail Banking, including business banking with turnover up to £6.5 million; 57% of regulatory risk-weighted assets (RWA) at Sept. 30, 2018;
- Corporate & Commercial Banking, which covers businesses with annual turnover of £6.5 million to £500 million; 22% of regulatory RWA; and
- Corporate & Investment Banking, which covers corporate clients with an annual turnover of £500 million and above; 10% of regulatory RWA;
- The balance of RWA (11%) is held in the corporate centre.

While ring-fencing developments this year alter some of the comparative metrics, the following is indicative of Santander UK's more limited diversification:

- In the first nine months of 2018, retail banking was a reported 82% of total income; for Lloyds and RBS this metric is typically in the 50%-60% range, and lower still at Barclays group and HSBC group.
- In the first nine months of 2018, net interest income was a reported 79% of total income; for Lloyds and RBS this metric is typically in the 60%-70% range, and lower still at Barclays group and HSBC group.

Relative to the larger U.K. banking groups we acknowledge that Santander UK has demonstrated superior earnings and business stability over the past decade. This mainly reflects its more modest conduct and litigation charges and its lesser need to restructure post the financial crisis. That said, U.K. mortgage market competition has increased in recent years, which is gradually pressuring the scope for 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 new ring-fencing requirements that have increased funding available for the larger U.K. banks' retail operations.

We believe that Santander UK's management is taking a creditor-friendly strategic approach, including a focus on organic growth and below-system-average credit growth. The bank's focus on attracting retail customers deemed to be loyal--with a particular focus on its current account franchise--appears to be progressing well. Similarly, the growth in the commercial bank (where the scope for market share growth is greater) is being sensibly managed, in our view.

Santander UK is one of the U.K.'s leading banks by deposits and mortgage loan balances. We estimate that Santander UK's share of the U.K. residential mortgage stock at end-2017 stood at about 11%. We note that Santander UK's share of the U.K. retail current account market continues to increase steadily, such that it now ranks close to HSBC in fourth position.

Nonetheless, the bank has remained underweight in its business, commercial, and corporate banking franchises relative to peers. Reported corporate lending balances were £24.3 billion or a relatively modest 12% of total customer loans at Sept. 30, 2018. This metric does not truly capture the overall growth in Santander UK's commercial banking franchise over the past several years, owing to the impact of ring-fencing and the reduced emphasis placed upon commercial real estate lending. It also reflects the fact that franchise growth in U.K. commercial banking is a long-term process. Over time, our central scenario is that its commercial banking franchise will offer greater revenue diversification and resilience, including a higher net interest margin (NIM).

A key opportunity, which could accelerate this strategy, could arise in the coming months if Santander UK were to be successful in its bid for a pool of the Alternative Remedies Package, which is the September 2017 agreement between the Royal Bank of Scotland and the European Commission to dispose of Williams & Glyn. We understand that the related incentivised switching scheme has recently commenced and that the award of the largest available capability and innovation fund pool will be announced in February 2019.

**Table 2**

**Santander UK Group Holdings PLC Business Position**

| | | --Year-ended Dec. 31-- | | | |
|---|---|---|---|---|---|
| **(%)** | **2018*** | **2017** | **2016** | **2015** | **2014** |
| Total revenues from business line (currency in millions) | 2,312 | 4,912 | 4,795 | 4,577 | 4,470 |
| Commercial banking/total revenues from business line | 10.6 | 9.5 | 10.2 | 12.4 | 10.9 |
| Retail banking/total revenues from business line | 81.8 | 79.7 | 77.9 | 76.6 | 81.7 |
| Commercial & retail banking/total revenues from business line | 92.4 | 89.3 | 88.1 | 89.0 | 92.6 |
| Trading and sales income/total revenues from business line | 8.8 | 8.9 | 8.4 | 8.3 | 7.9 |
| Other revenues/total revenues from business line | (1.2) | 1.8 | 3.6 | 2.7 | (0.4) |
| Investment banking/total revenues from business line | 8.8 | 8.9 | 8.4 | 8.3 | 7.9 |
| Return on average common equity | 7.6 | 7.5 | 8.1 | 5.9 | 8.2 |

*Data as of June 30. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

### Capital and earnings: Continued strengthening of capitalization

Santander UK's capitalization has gradually strengthened over recent years, and is broadly in line with its domestic peers. We calculate Santander UK's risk-adjusted capital (RAC) ratio to be 9.3% as of Dec. 31, 2017, and we project that it will be in the 9.25%-9.75% range by end-2020. This implies that Santander UK may be reasonably close to pushing up against the 10% threshold that could lead to a stronger assessment. However, we are not yet confident that the ratio will be maintained comfortably and consistently above that level.

The base-case RAC ratio projection over the next two years incorporates our expectations of:

- Pre-provision operating income to decline in 2018 by 5%-10%, reflecting pressure on the NIM from competition and standard variable rate product attrition, and higher operating costs from various different regulatory initiatives and the continued need to invest in the business. We assume more stable performance in 2019-2020 as a result of management actions. We also assume only 2% loan growth in both 2019 and 2020, slightly below our forecast for systemwide credit growth.

- The loan loss rate to rise in 2019 to about 16 basis points (bps) and a little higher in 2020 (it was a reported 6 bps in the first nine months of 2018, broadly similar to the prior three years). We have tailored these levels to be better than our base-case loan loss rate for the U.K. industry.
- Additional conduct-related provisions to be relatively modest.
- A dividend policy to distribute one-half of earnings.
- A reduction in S&P Global Ratings' risk-weighted assets (RWAs) to capture the movement of certain commercial and corporate banking activities to Banco Santander London branch, in the third quarter of 2018; Santander UK stated that it paid an associated dividend of £668 million and so the net effect on our RAC ratio appears to be broadly credit neutral. That aside, underlying credit growth means that we forecast RWAs to increase henceforth at a moderate pace.

We expect the quality of capital will remain a neutral credit factor. Adjusted common equity was 85% of total adjusted capital (TAC) at end-2017, similar to that of many peers.

Santander UK reported a regulatory Common Equity Tier 1 (CET1) ratio of 13.1% at Sept. 30, 2018, which is now more in line with U.K. peers; this ratio was 12.2% at end-2017 and 11.6% at end-2016.

The bank last revised its financial targets in the second half of 2016. It targets a cost-to-income ratio of 50%-52% in 2018, up from a previous target of less than 50%, reflecting a lower NIM and lower loan growth assumptions. This target is not on track owing to the tougher than expected competitive dynamics and increased regulatory and other costs. It also targets an adjusted return on tangible equity in 2018 of 9%-10%; it was a reported 9.8% in the first nine months of 2018. In terms of efficiency and returns we view Santander UK as being broadly in line with its peer group. We note that its parent has stated it will present a strategy update in early 2019 and we assume an update from Santander UK at that time.

**Table 3**

**Santander UK Group Holdings PLC Capital And Earnings**

| | | --Year-ended Dec. 31-- | | | |
|---|---|---|---|---|---|
| **(%)** | **2018*** | **2017** | **2016** | **2015** | **2014** |
| Criteria reflected in RAC ratios | 2017 | 2017 | 2017 | 2010 | N/A |
| Tier 1 capital ratio | 15.5 | 15.0 | 14.0 | 14.1 | 14.0 |
| S&P Global Ratings' RAC ratio before diversification | N/A | 9.3 | 8.6 | 8.9 | N/A |
| S&P Global Ratings' RAC ratio after diversification | N/A | 8.9 | 8.2 | 9.4 | N/A |
| Adjusted common equity/total adjusted capital | 84.9 | 84.8 | 87.6 | 87.5 | 92.7 |
| Net interest income/operating revenues | 78.3 | 78.2 | 76.6 | 78.1 | 76.9 |
| Fee income/operating revenues | 16.4 | 16.6 | 16.5 | 15.6 | 16.5 |
| Market-sensitive income/operating revenues | 5.2 | 3.6 | 4.6 | 5.4 | 5.7 |
| Noninterest expenses/operating revenues | 55.6 | 53.4 | 54.7 | 56.4 | 57.6 |
| Preprovision operating income/average assets | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 |

**Table 3**

| Santander UK Group Holdings PLC Capital And Earnings (cont.) | | | | | |
|---|---|---|---|---|---|
| | | --Year-ended Dec. 31-- | | | |
| (%) | 2018* | 2017 | 2016 | 2015 | 2014 |
| Core earnings/average managed assets | 0.4 | 0.4 | 0.4 | 0.5 | 0.5 |

*Data as of June 30. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

**Table 4**

| Santander UK Group Holdings PLC RACF [Risk-Adjusted Capital Framework] Data | | | | | |
|---|---|---|---|---|---|
| (Mil. £) | Exposure* | Basel III RWA | Average Basel III RW (%) | S&P Global RWA | Average S&P Global RW (%) |
| **Credit risk** | | | | | |
| Government and central banks | 45,059 | 0 | 0 | 412 | 1 |
| Of which regional governments and local authorities | 19 | 0 | 0 | 1 | 4 |
| Institutions and CCPs | 4,676 | 479 | 10 | 583 | 12 |
| Corporate | 39,226 | 27,788 | 71 | 34,938 | 89 |
| Retail | 180,860 | 37,028 | 20 | 75,507 | 42 |
| Of which mortgage | 163,511 | 25,750 | 16 | 59,731 | 37 |
| Securitization§ | 5,626 | 950 | 17 | 1,329 | 24 |
| Other assets† | 16,846 | 7,175 | 43 | 13,799 | 82 |
| Total credit risk | 292,312 | 73,419 | 25 | 126,568 | 43 |
| **Credit valuation adjustment** | | | | | |
| Total credit valuation adjustment | -- | 2,200 | -- | 4,633 | -- |
| **Market risk** | | | | | |
| Equity in the banking book | 97 | 313 | 322 | 728 | 750 |
| Trading book market risk | -- | 2,550 | -- | 5,031 | -- |
| Total market risk | -- | 2,863 | -- | 5,759 | -- |
| **Operational risk** | | | | | |
| Total operational risk | -- | 7,513 | -- | 8,634 | -- |
| **(Mil. £)** | | **Basel III RWA** | | **S&P Global RWA** | **% of S&P Global RWA** |
| **Diversification adjustments** | | | | | |
| RWA before diversification | | 86,203 | | 145,594 | 100 |
| Total Diversification/Concentration Adjustments | | -- | | 6,511 | 4 |
| RWA after diversification | | 86,203 | | 152,105 | 104 |
| **(Mil. £)** | | **Tier 1 capital** | **Tier 1 ratio (%)** | **Total adjusted capital** | **S&P Global RAC ratio (%)** |
| **Capital ratio** | | | | | |
| Capital ratio before adjustments | | 13,067 | 15.2 | 13,497 | 9.3 |
| Capital ratio after adjustments‡ | | 13,067 | 15.0 | 13,497 | 8.9 |

**Table 4**

**Santander UK Group Holdings PLC RACF [Risk-Adjusted Capital Framework] Data (cont.)**

*Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Other assets includes Deferred Tax Assets (DTAs) not deducted from ACE. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31, 2017, S&P Global.

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

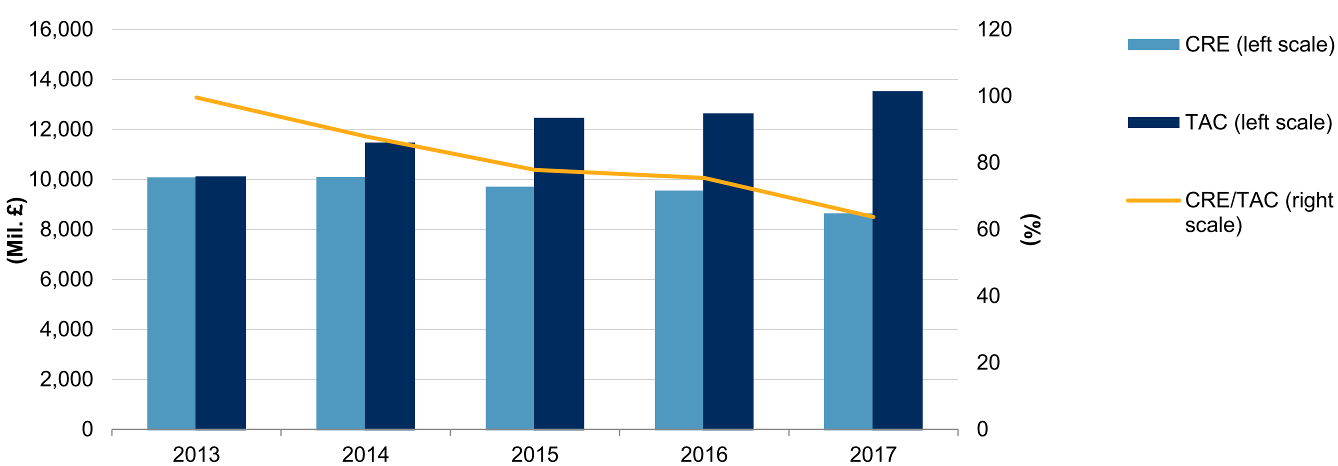
Our assessment of Santander UK's risk position reflects our view that the bank's capital and earnings adequately capture the bank's exposure to, and capacity to absorb, unexpected losses. Risk is primarily of a credit nature, with minimal market risk, reflecting the small scale of Santander UK's financial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

We take some comfort from Santander UK's relatively cautious approach to credit growth. In particular, 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 commercial real estate (CRE) exposure (see chart 1). One of the side effects of growing 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 of 64% at Dec. 31, 2017, was higher than that of U.K. peers.

We note that CRE exposure has further reduced during 2018. For example, Santander UK states that CRE loans within its Corporate & Commercial Banking division reduced to £6.5 billion at Sept. 30, 2018 from £7.9 billion at Dec. 31, 2017.

**Chart 1**

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




CRE--Commercial real estate. TAC--Total adjusted capital.



Santander UK's credit exposures remain heavily biased toward residential mortgages, which constituted a reported 79% of the gross customer loan book at Sept. 30, 2018. Conversely, Santander UK's loan book exposure to consumer credit is relatively modest.

We believe that Santander UK's underwriting record compares satisfactorily with its U.K. peers'. For instance, buy-to-let mortgages, although growing in terms of new lending, still represent only 5% of the mortgage book, well below the industry stock figure of about 16%. This partly explains why mortgage asset quality appears to be worse than that reported by some peers, because current buy-to-let industry arrears are less than one-half owner-occupier mortgages.

Santander UK reports that only 1% of the mortgage book showed negative equity at Dec. 31, 2017, with a further 4% 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 standard variable-rate and variable-rate mortgages continued to reduce to 30% of the mortgage portfolio, compared with 46% as of 2015.

The stock of nonperforming and problematic loans remains low. Santander UK reported that Stage 3 loans were £2.6 billion or 1.3% of gross loans at June 30, 2018. 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 0.6% 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 6.8% at June 30, 2018 which is lower than many U.K. peers: (Barclays 17.1% and HSBC 8.9% at Sept. 30, 2018 respectively; Lloyds 12.4% and RBS 10.5% at June 30, 2018 respectively). Santander UK's coverage metrics appear to be lower than peers as the expected credit loss (ECL) allowance represents 14.7% of Stage 3 loans, or 4.7% coverage of Stage 2 and Stage 3 loans.

The 5% RAC diversification benefit is relatively modest compared with that of peers. That said, the U.K. is a large economy and Santander UK's exposures are well diversified geographically. 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 £11.7 billion at year end-2017.

**Table 5**

| Santander UK Group Holdings PLC Risk Position | | | | | |
|---|---|---|---|---|---|
| | | --Year-ended Dec. 31-- | | | |
| **(%)** | **2018*** | **2017** | **2016** | **2015** | **2014** |
| Growth in customer loans | 2.4 | 2.0 | 1.0 | 5.0 | 2.4 |
| Total diversification adjustment/S&P Global Ratings' RWA before diversification | N/A | 4.5 | 4.7 | (4.9) | N/A |
| Total managed assets/adjusted common equity (x) | 27.5 | 27.5 | 27.4 | 25.9 | 26.0 |
| New loan loss provisions/average customer loans | 0.1 | 0.1 | 0.0 | 0.0 | 0.1 |
| Net charge-offs/average customer loans | 0.4 | 0.1 | 0.1 | 0.2 | 0.2 |
| Gross nonperforming assets/customer loans + other real estate owned | N.M. | 1.9 | 2.1 | 3.2 | 4.0 |
| Loan loss reserves/gross nonperforming assets | N.M. | 23.6 | 22.5 | 17.6 | 18.7 |

*Data as of June 30. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

### 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 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 Sept. 30, 2018, and post the impact of ring-fencing, Santander UK states that its loan-to-deposit ratio was 116%. We expect that this metric will continue to be at the upper end of the range for the main U.K. peers, reflecting Santander UK's proportionately greater use of securitized funding. Santander UK remains one of the largest issuers of residential mortgage-backed securities and covered bonds in the U.K. The median for the top 25 U.K. banks was 110% at end-2017. 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 has reduced significantly in recent years, and the bank has stated it expects a further reduction in 2018. Its stable funding ratio of 103% (at Dec. 31, 2017) is also broadly in line with the average of 107% for the top 25 U.K. banks. We believe that the continued strong capacity of the unencumbered mortgage book could generate additional liquidity if needed.

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. Our measure of broad liquid assets to short-term wholesale funding was a comfortable 1.3x at year-end 2017. The bank states that its liquidity coverage ratio (LCR) ratio was 146% at Sept. 30, 2018, and that its LCR for its eligible liquidity pool covers short-term wholesale funding by about 3.0x.

**Table 6**

| Santander UK Group Holdings PLC Funding And Liquidity | | | | | |
|---|---|---|---|---|---|
| | | --Year-ended Dec. 31-- | | | |
| **(%)** | **2018*** | **2017** | **2016** | **2015** | **2014** |
| Core deposits/funding base | 63.2 | 63.8 | 66.5 | 67.8 | 65.2 |
| Customer loans (net)/customer deposits | 121.4 | 117.5 | 118.0 | 123.4 | 124.4 |
| Long-term funding ratio | 80.7 | 82.2 | 87.0 | 87.9 | 87.5 |
| Stable funding ratio | N.M. | 105.9 | 106.3 | 102.0 | 103.1 |
| Short-term wholesale funding/funding base | 20.4 | 18.7 | 13.7 | 12.8 | 13.1 |
| Broad liquid assets/short-term wholesale funding (x) | N.M. | 1.3 | 1.5 | 1.3 | 1.3 |
| Net broad liquid assets/short-term customer deposits | N.M. | 9.8 | 10.4 | 6.3 | 7.0 |
| Short-term wholesale funding/total wholesale funding | 54.3 | 50.5 | 40.0 | 39.0 | 37.4 |
| Narrow liquid assets/3-month wholesale funding (x) | N/A | 1.7 | 2.0 | 1.7 | 1.9 |

*Data as of June 30. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

## 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. Since June 2015, we have regarded 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 8.9% of S&P Global Ratings RWAs at year-end 2017 (see table 7). Year-to-date Santander UK has issued over £2 billion sterling equivalent of NOHC senior obligations, which supports our expectation that our ALAC measure will likely be above 9% on an ongoing basis.

**Table 7**

**Summary Of ALAC Calculation As Of Dec. 31, 2017**

| | | Bil. £ | % of S&P Global Ratings' RWAs |
|---|---|---|---|
| A | Adjusted common equity | 11,442 | |
| B | Hybrids in TAC | 2,055 | |
| C (A+B) | Total adjusted common equity | 13,497 | 9.3% |
| D | TAC in excess of our 7% threshold | 3,305 | 2.3% |
| E | ALAC-eligible instruments | 9,647 | 6.6% |
| | of which NOHC senior | 6,000 | |
| | of which dated subordinated | 2,382 | |
| | of which minimal equity content hybrids | 811 | |
| | of which other | 247 | |
| F (=D+E) | ALAC buffer | 12,952 | 8.9% |
| | S&P RWA | 145,594 | |

ALAC--Additional loss-absorbing capacity. TAC--Total adjusted capital. NOHC--Nonoperating holding company. RWAs--Risk-weighted assets. Source: S&P Global Ratings' database.

We could potentially rate Santander UK PLC above its parent Banco Santander (they are currently both rated at the same level) as a result of ALAC because we believe that:

- The subsidiary is clearly subject to a separate resolution process;
- The subsidiary will be able to continue operating without defaulting on its senior unsecured obligations in the event of a resolution of the parent; and
- Santander UK's ALAC cannot be used to recapitalize another part of the Banco Santander group.

## Additional rating factors: None

No additional factors affect the ratings.

## Group status: Core subsidiary of Banco Santander

We consider Santander UK to be a core 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 U.K. subgroup's ratings 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 U.K. 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 UGCP. 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 UGCP 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. Santander UK has stated that Abbey National Treasury Services PLC (ANTS) has recently become a subsidiary of the NOHC (it was a subsidiary of Santander UK PLC); reported customer loans are £0.3 billion. Further, the business of the Jersey and Isle of Man branches of Santander UK are expected to transfer to ANTS.

### Rating on hybrid instruments

We rate the nondeferrable subordinated debt issued by Santander UK PLC two notches below the UGCP, reflecting the debt's contractual subordination as a Tier 2 instrument and our view that the Bank Recovery and Resolution Directive (BRRD) creates the equivalent of a contractual write-down clause. We rate similar issuance by the NOHC a notch lower, reflecting our view of structural subordination.

We rate all legacy Additional Tier 1 (AT1) instruments four notches below the UGCP, reflecting:

- One notch because the notes are contractually subordinated;
- Two notches because the notes have AT1 regulatory capital status; and
- One notch because we consider that the BRRD creates the equivalent of a contractual write-down clause.

We rate the AT1 securities issued by the NOHC 'B+', six notches below the UGCP, reflecting:

- One notch because the notes are contractually subordinated;
- Two notches because the notes have regulatory capital status;
- One notch because we consider the notes have a contractual write-down clause;
- One notch because the instrument contains a going-concern write-down trigger (defined as CET1 falling below 7%), and we expect that the distance to the trigger will remain within a range of 301 bps-700 bps; and
- One notch because the NOHC issues the notes.

### Resolution Counterparty Ratings

We set the 'A+/A-1' resolution counterparty ratings (RCRs) 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: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- 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
- Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Banks: Assessing Bank Branch Creditworthiness, Oct. 14, 2013
- Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Banks: Commercial Paper I: Banks, March 23, 2004

## Related Research

- Banking Industry Country Risk Assessment: United Kingdom, Nov. 5, 2018
- Countdown To Brexit: Financial Institutions Are Past The Point Of No Return, Oct. 11, 2018
- Rearranged And Ready: U.K. Banks Are On Track For Ring-Fencing, Aug. 15, 2018
- Industry Report Card: U.K. Banks Keep Calm And Carry On Amid Brexit Uncertainty, Aug. 13, 2018
- How The Smaller U.K. Lenders Fare Against The Big Six In An Increasingly Competitive Environment, June 27, 2018
- Our Credit Loss Estimates For U.K. Banks: 2018-2020, June 7, 2018
- Santander UK Group Holdings PLC And Santander UK PLC Ratings Affirmed; Outlook Stable, May 25, 2018

| Ratings Detail (As Of November 16, 2018) | |
|---|---|
| **Santander UK Group Holdings PLC** | |
| Issuer Credit Rating | BBB/Stable/A-2 |
| Junior Subordinated | B+ |

| Ratings Detail (As Of November 16, 2018) (cont.) | |
|---|---|
| Senior Unsecured | BBB |
| Short-Term Debt | A-2 |
| Subordinated | BB+ |
| **Issuer Credit Ratings History** | |
| 10-Apr-2015 | BBB/Stable/A-2 |
| **Sovereign Rating** | |
| United Kingdom | AA/Negative/A-1+ |
| **Related Entities** | |
| **Abbey National Capital Trust I** | |
| Preferred Stock | BB |
| **Banco Santander (Brasil) S.A.** | |
| Issuer Credit Rating | BB-/Stable/B |
| *Brazil National Scale* | brAAA/Stable/brA-1+ |
| Junior Subordinated | CCC |
| Subordinated | B- |
| **Banco Santander-Chile S.A.** | |
| Issuer Credit Rating | A/Stable/A-1 |
| Commercial Paper | |
| *Foreign Currency* | A-1 |
| Senior Unsecured | A |
| Subordinated | A- |
| **Banco Santander S.A.** | |
| Issuer Credit Rating | A/Stable/A-1 |
| Resolution Counterparty Rating | A+/--/A-1 |
| Certificate Of Deposit | |
| *Local Currency* | A-1 |
| Senior Subordinated | A- |
| Senior Unsecured | A |
| Short-Term Debt | A-1 |
| Subordinated | BBB+ |
| **Banco Santander S.A. (New York Branch)** | |
| Commercial Paper | |
| *Foreign Currency* | A-1 |
| **Banco Santander Totta S.A.** | |
| Issuer Credit Rating | BBB-/Positive/A-3 |
| Resolution Counterparty Rating | BBB-/--/A-3 |
| Senior Unsecured | BBB- |
| **PSA Banque France** | |
| Issuer Credit Rating | BBB/Stable/A-2 |
| Commercial Paper | A-2 |
| Senior Unsecured | BBB |
| **Santander Bank, N.A.** | |
| Issuer Credit Rating | A-/Stable/A-2 |

| Ratings Detail (As Of November 16, 2018) (cont.) | |
|---|---|
| Senior Unsecured | A- |
| Short-Term Debt | A-2 |
| Subordinated | BBB+ |
| **Santander Consumer Bank AG** | |
| Issuer Credit Rating | A-/Stable/A-2 |
| Resolution Counterparty Rating | A/--/A-1 |
| Commercial Paper | A-2 |
| Senior Subordinated | BBB+ |
| **Santander Consumer Finance S.A.** | |
| Issuer Credit Rating | A-/Stable/A-2 |
| Resolution Counterparty Rating | A/--/A-1 |
| Commercial Paper | |
| *Local Currency* | A-2 |
| Senior Subordinated | 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+/Stable/A-2 |
| Preferred Stock | BB+ |
| Senior Unsecured | BBB+ |
| **Santander UK PLC** | |
| Issuer Credit Rating | A/Stable/A-1 |
| Resolution Counterparty Rating | A+/--/A-1 |
| Junior Subordinated | BB |
| Junior Subordinated | BB+ |
| Preference Stock | BB |
| Senior Unsecured | A |
| 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.