Rating Action Release

18 Sept 2019

Scope affirms Banco Santander SA's mortgage and public sector covered bonds at AAA/Stable

The issuer's rating of AA- combined with fundamental credit support for the covered bonds supports the highest achievable ratings for both covered bond programmes.

Rating action

Scope Ratings has today affirmed the AAA ratings[1] of the Spanish mortgage and public sector covered bonds issued by Banco Santander SA (Santander). All ratings have a Stable Outlook. The ratings reflect Santander's issuer rating of AA- enhanced by fundamental credit support of up to six notches for the cédulas hipotecarias (mortgage covered bonds) and five notches for the cédulas territoriales (public sector covered bonds).

Rating rationale

The affirmation of the senior secured covered bonds reflects the solid issuer rating of AA- (the analytical anchor for the covered bonds issued by Santander) enhanced by the stable fundamental credit support available to the covered bonds. This results in the highest achievable rating. As such, cover pool support is not a rating driver.

Scope monitors the development of the covered bond programmes' risk profiles and performed a limited cover pool analysis. The analysis identified whether cover pool support could further stabilise the ratings – if needed. The agency used publicly available information and applied conservative assumptions, concluding that additional rating stability is likely for the mortgage covered bond programme but unlikely for the public sector programme.

Key rating drivers

Issuer rating (positive). Santander's issuer rating reflects: i) a business model that has withstood crisis challenges, with cost-efficient provision of retail and commercial banking services and resilient group profitability; ii) globally diversified revenue and earnings streams with strong market positions in several key markets including Spain, Portugal, Argentina, Brazil, the UK, Mexico, Chile, and Poland; iii) ongoing improvement of capital, liquidity and funding positions in recent years; and iv) the high likelihood that the European Banking Union will strengthen the regulatory and supervisory framework. The Stable Outlook for the rating is supported by evidence that Santander's digital investments can drive material business and revenue growth and market share gains.

Fundamental credit support (positive). The legal covered bond framework in Spain just meets Scope's criteria for a two-notch rating uplift.

Four additional notches are granted for the Spanish mortgage covered bonds specifically. This reflects: i) their exclusion from bail-in upon a potential regulatory intervention in the issuer; ii) the very high likelihood of regulators maintaining the

1 The credit rating and outlook(s) provided in this document are deemed inside information and may not be shared with any unauthorised third party.

issuer as a going concern; iii) the high ongoing systemic importance of mortgage covered bonds in Spain and the high visibility of Santander; and iv) the cohesion of Spain's covered bond stakeholders and their willingness to preserve and enhance the bonds as an attractive funding instrument. This equates to a total fundamental credit support-based uplift of six notches above issuer rating for these covered bonds.

The Spanish public sector covered bonds were granted three notches for fundamental credit support in addition to the two notches from the Spanish legal framework (five-notch uplift in total). This reflects the bonds' lower systemic importance as they fund the domestic public sector, their lower visibility on the capital markets, and that only a few Spanish banks use this instrument opportunistically.

Rating-change drivers

The covered bond ratings may be downgraded upon: i) an issuer rating downgrade by at least four and three notches for the mortgage and public sector covered bonds, respectively; ii) a deterioration in Scope's view on fundamental support factors relevant to the issuer and Spanish covered bonds in general; and/or iii) the loss of the cover pools' ability to sustain the current ratings, if needed.

Transaction overview

For the mortgage programme, EUR 74.2bn of cover assets provided 89.9% of overcollateralisation for the EUR 39bn of covered bonds as of 30 June 2019. The cover pool is fully domestic and comprises mortgage loans in Madrid (26%), Catalonia (18%), Andalusia (12%) and the rest of the autonomous communities in Spain. Of the total loans, 76% are secured by residential and 24% by commercial properties. The indexed weighted average loan-to-value ratio is 65.4%, with the Spanish act stipulating a limit of 80%. Scope assesses the credit risk for the mortgage loans as medium.

The collateral supporting the outstanding mortgage covered bonds can provide additional rating stability. The regularly available level of overcollateralisation is sufficient to mitigate credit and cash flow risks. Scope calculated this level based on public information and its limited cover pool analysis.

For the public sector programme, EUR 9.7bn of cover assets provided 68.5% of overcollateralisation for the EUR 5.8bn of covered bonds as of 30 June 2019. The cover pool is fully domestic and consists of loans in Madrid (28%), Castile and León (12%), Aragon-Navarre (11%) and the rest of the autonomous communities in Spain. Scope assesses the credit risk for the Spanish public sector loans as high, particularly in an international context.

Collateral supporting the outstanding public sector covered bonds is currently insufficient to provide additional rating stability. The regularly available level of overcollateralisation is lower than the conservatively established support needed to ensure a very high likelihood of full repayment on the covered bonds. The level needed to provide additional rating stability and to mitigate credit and cash flow risks was calculated based on public information and Scope's limited cover pool analysis.

Research on the issuers as well as performance updates on the rated covered bonds can be found on ScopeOne.

Stress testing and cash flow analysis

No stress testing and no cash flow analysis was performed. For fundamental credit support-based covered bond ratings, a simplified cash flow risk assessment is performed, however. The assessment identifies whether the cover pool, including available overcollateralisation, would be very likely to provide rating stability in the event of an issuer downgrade.

Methodology

The methodology used for the ratings and rating outlooks is Scope's Covered bond Rating Methodology which is available on www.scoperatings.com.

Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definitions of default and rating notations can be found at https://www.scoperatings.com/#governance-and-policies/rating-scale.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Solicitation, key sources and quality of information

The rating was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the rating process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following substantially material sources of information were used to prepare the credit rating: public domain, third parties and Scope internal sources. Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.

Prior to the issuance of the rating or outlook action, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was <amended/not amended> before being issued.

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings GmbH.

Lead analyst Mathias Pleissner, Director

Person responsible for approval of the rating: Karlo Fuchs, Managing Director

The ratings/outlooks were first released as a public rating by Scope on 22 Sept. 2015. The ratings/outlooks were last updated on 22 Sept. 2015 and regularly monitored since. Ratings and outlooks were converted from public to subscription ratings on 29 August 2019.

Potential conflicts

Please see www.scoperatings.com. for a list of potential conflicts of interest related to the issuance of credit ratings.

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