MOODY'S
INVESTORS SERVICE

Rating Action: Moody's assigns Aa1 rating to covered bonds transferred to Banco Santander

01 Oct 2018

Action follows the merger by absorption of Banco Popular by Banco Santander

Madrid, October 01, 2018 -- Moody's Investors Service ("Moody's") has today taken the following rating actions on the ratings of the covered bonds transferred from Banco Popular Espanol, S.A. (Banco Popular) (deposits A2; adjusted baseline credit assessment baa1; counterparty risk (CR) assessment A3(cr)) to Banco Santander S.A. (Spain) (Banco Santander or the issuer) (deposits A2; adjusted baseline credit assessment baa1; counterparty risk (CR) assessment A3(cr)):

- Mortgage covered bonds (Cédulas Hipotecarias or CHs) issued by Banco Popular: withdrawn for reorganisation; previously Aa1.

- Public-sector covered bonds (Cédulas Territoriales or CTs) issued by Banco Popular: withdrawn for reorganisation; previously Aa1.

- CHs assumed by Banco Santander and transferred from the former Banco Popular: Aa1, new rating assigned.

- CTs assumed by Banco Santander and transferred from the former Banco Popular: Aa1, new rating assigned.

Today's rating action follows the merger by absorption of Banco Popular by Banco Santander.

Please refer to the Moody's Investors Service's Policy for Withdrawal of Credit Ratings, available on www.moodys.com

RATINGS RATIONALE

Today's rating actions follow the merger by absorption, effective as of 28 September 2018, of Banco Popular by its parent Banco Santander. Banco Santander will also absorb Banco Pastor S.A.U. (Banco Pastor) (not rated), which is a subsidiary of Banco Popular. Following the merger, Banco Santander will assume all the assets and liabilities of Banco Popular and Banco Pastor including the covered bonds. As a result, Moody's understands that the new cover pool backing Banco Santander's CHs represents the addition of Banco Popular's, Banco Pastor's and Banco Santander's former total mortgage pools. Moody's also understands that the new cover pool backing Banco Santander's CTs represents the addition of Banco Popular's, Banco Pastor's (if any) and Banco Santander's former total public-sector pools.

A covered bond benefits from (1) the issuer's promise to pay interest and principal on the bonds; and (2) if the issuer defaults, the economic benefit of a collateral pool (the cover pool). The ratings therefore take into account the following factors:

(1) The credit strength of Banco Santander (deposits A2; adjusted baseline credit assessment baa1; counterparty risk (CR) assessment A3(cr)) and a CB anchor of CR assessment plus 1 notch.

(2) Following a CB anchor event the value of the cover pool. The stressed level of losses on the cover pool assets following a CB anchor event (cover pool losses) for the CHs is 32.1%. The cover pool losses for CTs is 50%.

The analysis of the value of the cover pool considered:

a) The credit quality of the assets backing the covered bonds. The mortgage covered bonds are backed by Spanish commercial and residential mortgage loans. The collateral score for the mortgage cover pool is 16.4%. The public-sector covered bonds are backed by claims against Spanish public-sector entities or claims guaranteed by such entities. The collateral score for the public-sector cover pool is 21.2%. These figures are based on the amalgamated cover pool of the Banco Santander and Banco Popular and excludes Banco Pastor's cover pool assets.

b) The robust Spanish legal framework for CHs. CHs are issued by Spanish financial institutions, secured by the issuer's entire mortgage book and regulated mainly by the Spanish Mortgage Market Law and the Insolvency Law. The Spanish legal framework for CHs is characterised by (1) the fact that CH holders have a priority security claim over the bank's whole mortgage pool (the total cover pool); (2) the restriction on issuing CHs to a maximum of 80% of the portion of loans regarded as eligible mortgages (the eligible cover pool), which provides for a minimum 25% over-collateralisation (OC) for the purposes of issuance; and (3) the fact that CHs do not have to be accelerated because of insolvency proceedings.

c) The robust Spanish legal framework for CTs. CTs are governed mainly by the Law 44/2002, of 23 November, on the reform of the Financial System and the Insolvency Law, and are full-recourse direct corporate obligations of the issuing entity. Legal framework strengths include (1) that CT holders have a priority security claim over all the issuer's public-sector loans made in the European Economic Area (the cover pool); (2) the restriction on issuing CTs to a maximum of 70% of the cover pool, which provides for a minimum 43% OC; and (3) if the issuer becomes insolvent, the CTs do not have to be terminated or accelerated.

d) The exposure to market risk. The market risk for the mortgage cover pool is 21.1%.The market risk for the public-sector cover pool is 39.4%. These figures are based on the amalgamated cover pool of Banco Santander and Banco Popular.

e) As of 30 June 2018, the OC in the mortgage cover pool based on the three merged entities is 135.3%, of which Banco Santander provides 25% on a "committed" basis (see Key Rating Assumptions/Factors, below). The OC in the public-sector cover pool based on Banco Santander and Banco Popular is 70.8% of which Banco Santander provides 42.9% on a "committed" basis (see Key Rating Assumptions/Factors, below).

The timely payment indicator (TPI) assigned to these transactions is "Probable". This TPI constrains the rating of the covered bonds at its current level.

KEY RATING ASSUMPTIONS/FACTORS

Covered bond ratings are determined after applying a two-step process: an expected loss analysis and a TPI framework analysis.

EXPECTED LOSS: Moody's uses its Covered Bond Model (COBOL) to determine a rating based on the expected loss on the bond. COBOL determines expected loss as (1) a function of the probability that the issuer will cease making payments under the covered bonds (a CB anchor event); and (2) the stressed losses on the cover pool assets following a CB anchor event.

The CB anchor for these programmes is the CR assessment plus 1 notch. The CR assessment reflects an issuer's ability to avoid defaulting on certain senior bank operating obligations and contractual commitments, including covered bonds. Moody's may use a CB anchor of CR assessment plus one notch in the European Union or elsewhere, where an operational resolution regime is particularly likely to ensure continuity of covered bond payments.

-Banco Santander CHs:

The cover pool losses of Banco Santander CHs are 32.1% with market risk of 21.1% and collateral risk of 11%. Collateral risk is derived from the collateral score, which for this programme is currently 16.4%. These figures are Moody's estimates based on weighted cover pool data from Banco Santander and Banco Popular. As of June 2018, the OC in this cover pool is 135.3%, of which Banco Santander provides 25% on a "committed" basis. Under Moody's COBOL model, the minimum OC level that is consistent with the Aa1 rating target is 21.5%. These numbers show that Moody's is not relying on "uncommitted" OC in its expected loss analysis.

-Banco Santander CTs:

The cover pool losses of Banco Santander CTs are 50%, with market risk of 39.4% and collateral risk of 10.6%. Collateral risk is derived from the collateral score, which for this programme is currently 21.2%. These figures are Moody's estimates based on weighted cover pool data from Banco Santander and Banco Popular. As of June 2018, the OC in this cover pool is 70.8%, of Banco Santander provides 42.9% on a "committed" basis. Under Moody's COBOL model, the minimum OC level that is consistent with the Aa1 rating target is 57%. These numbers show that Moody's is relying on "uncommitted" OC in its expected loss analysis.

For further details on cover pool losses, collateral risk, market risk, collateral score and TPI Leeway across covered bond programmes rated by Moody's please refer to "Moody's Global Covered Bonds Monitoring Overview", published quarterly. All numbers unless otherwise stated are based on the most recent modelling (based on data, as of end March 2018 for Banco Popular CHs and Banco Santander CTs and as of June 2018 for Banco Santander CHs and Banco Popular CTs).

TPI FRAMEWORK: Moody's assigns a "timely payment indicator" (TPI), which measures the likelihood of timely payments to covered bondholders following a CB anchor event. The TPI framework limits the covered bond rating to a certain number of notches above the CB anchor.

Factors that would lead to an upgrade or downgrade of the ratings:

The CB anchor is the main determinant of a covered bond programme's rating robustness. A change in the level of the CB anchor could lead to an upgrade or downgrade of the covered bonds. The TPI Leeway measures the number of notches by which Moody's might lower the CB anchor before the rating agency downgrades the covered bonds because of TPI framework constraints.

Based on the current TPI of "Probable", the TPI Leeway for these programmes is two notches. This implies that Moody's might downgrade the covered bonds because of a TPI cap if it lowers the CB anchor by three notches, all other variables being equal.

A multiple-notch downgrade of the covered bonds might occur in certain circumstances, such as (1) a country ceiling or sovereign downgrade capping a covered bond rating or negatively affecting the CB Anchor and the TPI; (2) a multiple-notch downgrade of the CB Anchor; or (3) a material reduction of the value of the cover pool.

RATING METHODOLOGY

The principal methodology used in these ratings was "Moody's Approach to Rating Covered Bonds" published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions of the disclosure form.

Moody's did not use any stress scenario simulations in its analysis.

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