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Santander UK

Santander UK is regulated on a standalone basis by the United Kingdom Financial Services Authority. The bank is UK focused with more than 95% of assets UK based. In the UK, the bank has a market share of over 10% across mortgages, savings, banking and branches. It is one of the largest banking groups and the second-largest UK mortgage lender. It holds 14% of UK mortgages and 10% of customer deposits.

The ratings of Santander UK are based on its position in the Banco Santander Group, and its position as one of the leading providers of domestic financial services.

Please see below for the current credit ratings of Santander UK:

Fitch's Ratings applicable are:

Long Term: AA-, Stable Outlook

Short Term: F1+

Individual: B

Support: 1

- 20th January 2011 Fitch Ratings has affirmed Santander UK's Long Term and Short Term Rating, which together with the bank's Individual Rating reflects Santander UK's strong profitability, low risk mortgage portfolio, solid funding and sound capital base. They also reflect the bank's growing franchise in the UK mortgage and savings market.
- 20th July 2011, Fitch Ratings introduced Viability Ratings, representing Fitch's primary assessment of the intrinsic creditworthiness of financial institutions around the globe. These ratings will eventually replace Individual ratings. Santander UK received a rating of "aa-". As defined by Fitch, "aa" ratings denote very strong prospects of ongoing viability.

Moody's Ratings applicable are:

Long Term: Aa3, Under Review for Possible Downgrade

Short Term: P-1,

BFS: C-, Stable Outlook

- 7th April 2011 Moody's announced a review of their treatment of systemic support in UK bank ratings. Systematic support is defined as the uplift given to banks' ratings in respect of the likely support they would receive from the UK government.
- 24th April 2011 Moody's announced that after an initial review of systemic support the ratings of 14 UK banks have been put under review for a possible downgrade.
- 19th May 2011 Moody's upgrades the Financial Strength rating and junior debt ratings for Santander UK. The standalone rating upgrade reflects Moody's view that Santander UK's underlying financial strength has improved.

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S&P's Ratings applicable are:

Long Term: AA, Negative Outlook

Short Term: A-1+

- Standard & Poor's give Santander UK one of the highest ratings amongst its UK peers. It considers the bank to be of high systemic importance in the UK, although its business diversity and market position will remain more limited than the top tier of UK banking peers. While Santander UK has not been immune from the adverse economic and market environment in the U.K., Standard & Poor's consider that the bank will continue to demonstrate resilient earnings performance. In Standard & Poor's view, the weakest element of the bank's financial profile is capitalization, although we expect sustained improvement through 2011.
- The negative outlook on Santander UK mirrors that on Banco Santander, reflecting Standard & Poor's expectation that Santander UK will remain a core subsidiary. While Standard & Poor's expect the loan impairment charge to remain elevated, we consider that Santander UK remains relatively well positioned to withstand the adverse economic environment, and therefore expect its resilient performance to continue.
- Due to its core status, Standard & Poor's expect the ratings on Santander UK to move in line with those on Banco Santander. However, a negative rating action on Santander UK could result if, in Standard & Poor's opinion, it becomes less strategically or operationally integrated with the parent.

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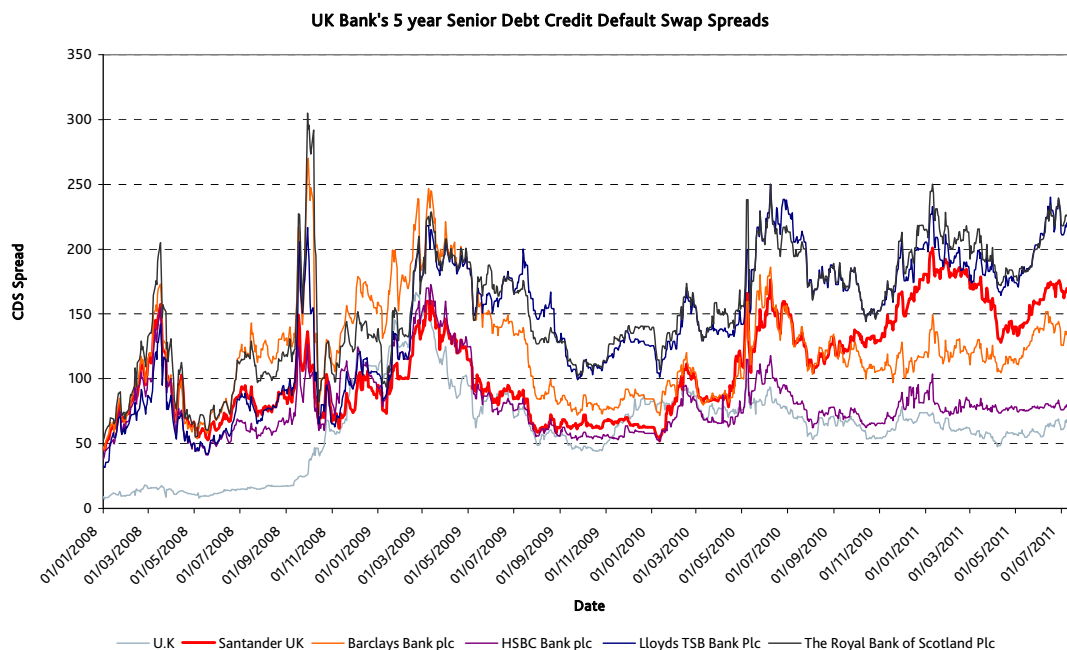
How does Santander UK's credit quality compares to its UK peers?

Overall, there is still a lot of uncertainty in the UK banking sector. Banks are facing long roads to normalised returns with tail risk in UK banks' credit portfolios remaining a particular concern.

Santander UK is considered to be in a relatively strong position when compared to its UK peers. Moody's latest ratings for Santander UK and its main peers are outlined below:

Bank	Long Term Rating	Short Term Rating	BFSR	Current LT Outlook
Barclays Bank Plc	Aa3	P-1	C	Negative
HSBC Bank Plc	Aa2	P-1	C+	Negative
Lloyds TSB Bank Plc	Aa3	P-1	C-	RUR-down
Royal Bank of Scotland Plc	Aa3	P-1	C-	RUR-down
Santander UK	Aa3	P-1	C-	RUR-down

In addition, although stigmatized for their role in the financial crisis, credit default swaps (CDS) have played a pivotal role in the global financial system over the last couple of years. Credit default products provide the market's view on a company's default prospects. CDS spreads react instantly to new information and market news. Institutions that are rated AA, for example, should have the same credit risk, thus, their CDS spreads should trade broadly in line with each other. However, this is not always the case. Sometimes, the market perceives a particular institution to be more risky than its peer AA rated institutions and Sector is able to inform clients of this disparity. Our research has shown that credit rating agencies downgrade institutions far after the CDS market has reacted to the new data. By using the CDS spreads, Sector is able to inform clients earlier of any expected credit rating downgrades. The graph below compares the CDS spread of Santander UK against its UK peers.



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Relationship between Santander UK and its parent Banco Santander

Banco Santander does not guarantee the deposits of its 100% owned UK subsidiary Santander UK Plc. Instead of an explicit parental guarantee, Banco Santander chose to inject capital directly into Santander UK Plc, meaning Santander UK has its own capital to protect deposits and, therefore, does not need to rely on the parent for support. This "subsidiary model" applies across all Santander subsidiaries whereby the local entities are provided with local capital to support local deposits.

Fitch has noted that:-

'Banco Santander would, if required, support Abbey (Santander UK), given the UK bank's significance in the group. If the parent were unable to provide support, Fitch considers that Abbey's inclusion in 2008 among systemically significant UK banks means there is an extremely high probability that ultimate support would be forthcoming from the UK authorities.'

Banco Santander runs a subsidiary model which mitigates the systematic risk within Group. This is achieved by the creation of autonomous local divisions where each unit is accountable for their own liquidity and capital management, which gives Santander's businesses local autonomy. In essence, each unit essentially operated as a separate business with one controlling shareholder. At least in theory, the parent cannot raid the Santander UK for capital, liquidity or cash because it has no direct access. This is particularly important when the parent company is abroad. In September 2008, UK operations of Lehman Brothers were raided by its American parent before it went bust.

In addition, Banco Santander group, as a result of its clear and transparent structure, has become the first global bank to submit to regulators a 'living will', detailing how it can be wound down in the event of failure without jeopardising financial stability.

In principle, should the Spanish arm fail, the UK bank would be unaffected. It even has its own credit ratings (Fitch: F1+, AA-, B, 1; Moody's: P-1, Aa3, C-; S&P: A-1+, AA).

From a business perspective this subsidiary model neutralises the risk of contagion among different entities of the Group, it reinforces supervision, it brings market discipline in local issuances and demands accountability for local risk management. This model also offers a few additional advantages as corporate policies are implemented globally.

Overall, Santander UK is considered to have a strong capital and liquidity position, which is reflected in evolution of Core Tier 1 Capital. In 2010, Core Tier 1 Capital stood at 12%, which is a significant increase from the 2007 position of 5%. In 2007, the loan to deposit ratio of Santander UK was 173%, but this has been reduced to 123% in the first quarter of 2011. On 3 August 2010, Banco Santander S.A., through a wholly-owned Spanish-based subsidiary Santusa Holding, S.L., injected £4.4bn of equity capital into Santander UK plc, to support organic and inorganic growth, as well as a planned reorganisation of Banco Santander, S.A. group companies in the UK.

Despite Banco Santander being a Spanish bank, only a small proportion of Santander's profits (around 25%) actually come from Spain, the remainder come from the UK, the rest of Continental Europe, and Central and South America. This is a global bank and extremely

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well diversified with the major part of the business focused on the retail and commercial banking sectors - over 70% of total deposits and 87% of income comes from these sectors. The fact that Santander has 14,000 branches worldwide is further testament to the main focus of the bank being on the retail side. This approach is very different to a lot of other banks who have a greater reliance on the wholesale markets for their funding.

Santander UK's parent, Banco Santander, was one of the 91 banks that was put under "stress test" by the Committee of European Banking Supervision, the result of which were published on 23 July 2010. Under the assumed "adverse scenario" banks capital levels were tested against a 35% drop in commercial properties prices and an 8.8% drop in residential properties prices in 2010, followed by a further fall of 30% for commercial properties and 15.2% for residential properties in 2011. In this scenario, Banco Santander's tier 1 capital ratio would have dropped to 10.2%. If sovereign risk shock were included, that would affect the value of sovereign bond holdings on the bank's trading books, then the tier 1 capital ratio would drop to 10%. Under both adverse scenarios put forward by the regulator and Committee of European Banking Supervision, the bank's tier 1 capital is well above the Committee of European Banking Supervision's threshold at the time of 6%.

Banco Santander also passed the second stress test in July 2011. This showed that under the "stress scenario" that Banco Santander would end 2012 with a Core Tier 1 ratio of 8.4%, well above the 5% minimum set out by the European Banking Authority for the purpose of the tests. The Core Tier 1 ratio would stand at 8.9% including generic provisions. The stress test has been carried out using a static balance sheet assumption as at 31 December, 2010 and a constant business model in terms of geographies and products.

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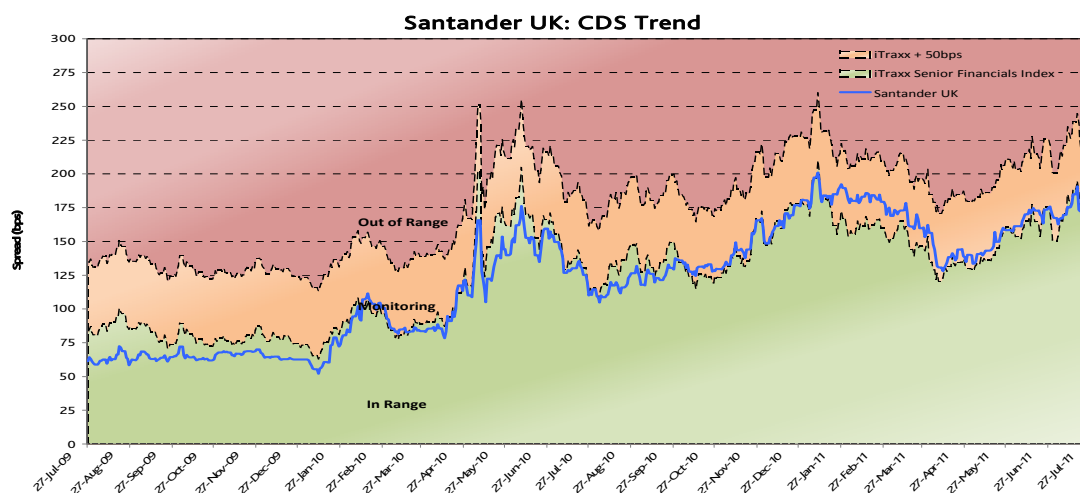
Investing with Santander UK

Sector's suggested duration for Santander UK, as at end of July 2011, is up to three months. As part of our creditworthiness methodology, we have implemented an overlaying system incorporating CDS spreads that are actively traded in the market. This means that we can base our duration suggestions on the opinions of the credit rating agencies AND the market.

	Fitch				Moody's				S&P			Suggested Duration	Suggested Duration (Watch/Outlook Adjusted)	Suggested Duration (CDS Adjusted)
	Long Term Status	Short Term Status	Individual Status	Support Status	Long Term Status	Short Term Status	Individual Status	Long Term Status	Short Term Status					
Santander UK plc	AA- SB	F1+ -	B -	1 -	A&3 RD	P-1 -	C- SB	AA NO	A-1+ -	O - 12mths	R - 6mths	G - 3mths		

Sector uses a credit rating system that incorporates all of the credit ratings from all three major rating agencies to produce a mathematically calculated, risk-weighted score that is then compared to pre-determined credit scoring bands. In addition, our approach is based on comparing the CDS spread of a subject institution with the benchmark level based on a CDS market index. This cut-off point is capped at 50 basis points above the benchmark level. If an institution's CDS spread is below the benchmark level, the suggested duration is equal to the credit rating suggested duration. If the CDS spread is above the benchmark, but below the cut-off point, then the suggested duration drops one colour band from the credit rating suggested colour. This is the case with Santander UK (as of July 2011 data), where the bank's CDS spread is above the benchmark but below the cut-off point. Suggested duration of up to 6 months (colour code 'red') is therefore reduced to 3 months (colour code 'green').

As the graph below illustrates, over the last 18 months the CDS spread for Santander UK was hovering over the benchmark level. This had an impact on Sector's suggested duration for the bank because on many occasions during the same period, the suggested duration for Santander UK was changing from three months to six months and vice versa.



In accordance with investment guidance, the final decision on investment remains with the Local Authority.

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