18 August 2017

Public Finance

United Kingdom Rating Report

SCOPE | AA | NEGATIVE OUTLOOK

Credit strengths

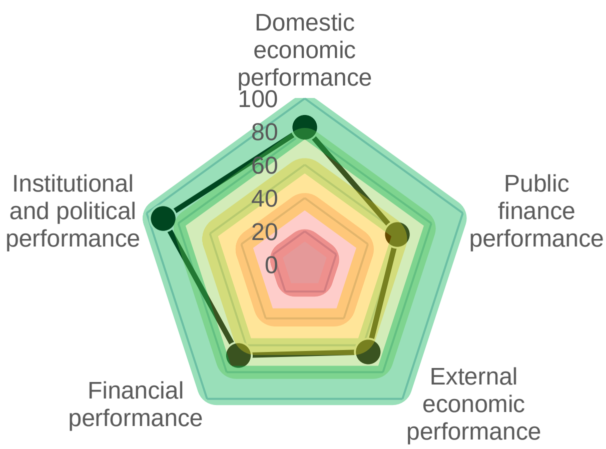
- Sterling reserve currency status
- Historic institutional strengths
- Large, resilient economy

Credit weaknesses

- Brexit-related uncertainty
- Weakening economic/fiscal outlook
- Uncertainty in policy framework

Rating rationale and Outlook: The UK's AA rating is underpinned by its large, diversified economy, monetary policy and exchange rate flexibility and reserve currency status. In addition, the UK benefits from having deep capital markets, a favourable public debt maturity structure, and historical institutional strengths. We consider a 'soft Brexit' outcome to negotiations with the European Union (EU) to be the most probable. Next to this, a 'no Brexit' scenario and a 'hard Brexit' are alternatives. Debt remains at elevated levels, and the economic and fiscal policy outlook has weakened owing to uncertainty around and consequences of the exit from the EU. While the UK maintains significant credit strengths – including London's role as one of the world's premier financial centres, we consider the current constellation of risks to signal an overall adverse trajectory. The Negative Outlook reflects this assessment. Conversely, if a more benign outcome of exit negotiations appears probable, or the economy shows material resilience, we could consider a stabilisation of the Outlook.

Figure 1: Sovereign rating categories summary



Positive rating-change drivers

- A soft Brexit, ensuring full single market access and materially reducing Brexit uncertainty
- A reversal in Brexit: a no Brexit scenario
- Improvement in the policy environment, enhancing debt sustainability

Negative rating-change drivers

- An increase in the probability of a hard Brexit
- A rise in uncertainty that materially weakens the economic and/or fiscal outlook
- Weakening of fiscal targets
- Any long-term threat to sterling's reserve currency status

Ratings & Outlook

Foreign currency

Long-term issuer rating	AA/Negative
Senior unsecured debt	AA/Negative
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AA/Negative
Senior unsecured debt	AA/Negative
Short-term issuer rating	S-1+/Stable

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Bloomberg: SCOP

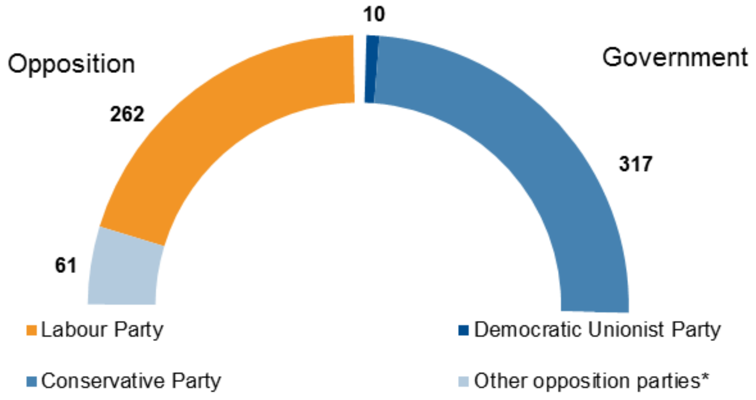
Brexit and institutional/political risk

Unexpected result in election

Prime Minister Theresa May activated Article 50 of the Treaty of Lisbon in March, officially launching the UK's exit proceedings from the European Union. Shortly thereafter, to bolster her government's negotiating position, fresh elections were called for June 8. Despite a large advantage in opinion polls at the time the vote was called, Mrs May's government was materially weakened – with the shock result costing her government its slim majority in the House of Commons.

The formation of a minority Tory government on 26 June by means of a 'confidence and supply' agreement with the small Democratic Unionist Party has increased political uncertainty. It could also limit the May government's effectiveness in Brexit negotiations, as well as hinder policy implementation in a range of other economic and fiscal arenas. In Scope's view, the result of the June election heightens the risk of political instability, with reports of internal cabinet tensions, and the prospect of future challenges to Mrs May's leadership of the Conservative Party. The weakened government also reduces the likelihood of a successful resolution to Brexit negotiations by 29 March 2019.

Figure 2: Composition of the House of Commons, June 2017 election



Source: House of Commons

*Other opposition parties: Scottish National Party, Liberal Democrats, Sinn Féin, Plaid Cymru, Green Party, Independent Unionists

In June, the UK and EU launched formal talks on the form Brexit will take. The issue is that talks have been restricted until 'sufficient progress' has been made on several opening areas of contention, delaying deliberation on the most critical issues including a new free-trade agreement with the EU and immigration. The earliest consideration on whether such minimum progress has been made will come at a European summit in mid-October. The opening topics that must be resolved include the rights of European nationals in the UK, the jurisdiction of the European Court of Justice after Brexit, a 'soft' border between Northern Ireland and the Republic of Ireland, and the size of the so-called 'Brexit Bill' – the UK's payment of dues to the EU budget. The resolution of these thorny issues may well prove problematic. The possibility of delays in the early months of Brexit negotiations would restrict the government's room to manoeuver.

Due to the UK's constraints and the potentially significant costs of a hard Brexit, Scope's view is that the most likely scenario remains some form of eventual soft Brexit. Such a soft Brexit scenario could last significantly past the two year window given under Article

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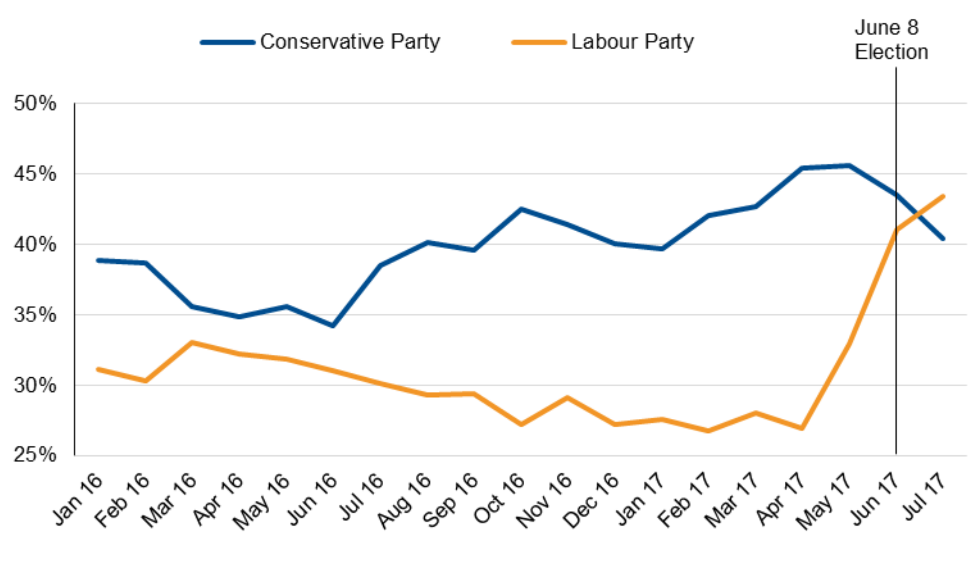
50, potentially requiring an extension of Article 50 negotiations (which an EU 28 consensus decision would make possible) and/or post-Brexit transitional arrangements. The June election pushed the next scheduled parliamentary election from 2020 to 2022, allowing the government more time to extend negotiations past 2019 if needed. Recently, there have been some signs of movement in this direction, with the Chancellor indicating greater willingness within the Cabinet for such a transition (of two to three years, ending before a 2022 election). The government, in August, issued a position paper suggesting a transitional association with the EU customs union after departure.[1]

In light of the difficulty of talks and the unlikelihood of material near-term concessions from the EU, we believe such a 'phasing in' of negotiations considering transition relationships would be advisable in order to avoid any 'cliff edge' changes in trading conditions. This could at least temporarily include the arrangement that Norway has with the EU, in which the UK would exit the EU but remain transitionally in the single market. Due to the complicated interconnections at play, research has noted the process for a full Brexit could last a decade, lending weight to the expediency of such a phased process.

A no Brexit scenario is not off the table

With the multi-year horizons relevant to Brexit in mind, we note that there is potential for shifts in public opinion. In April, a YouGov/Times survey found that 45% of respondents considered Brexit to be the wrong decision in hindsight, while 43% considered it right for the country.[2] This was the first survey to show a majority against Brexit since last June's referendum. In July, a Survation survey also found 54% of respondents in favour of Remain, while 46% back Brexit. While polling data vacillates, the relatively even split during the 2016 referendum and opinion surveys since then underscore the tenuous state of the public majority that initially propelled Brexit. In addition, the lead that Labour has taken in polls since June place further pressure on Mrs May to soften the Brexit approach, and may cause instability within the Conservative leadership.

Figure 3: Labour versus Conservative Party voting intentions, poll of polls



Source: Various polling companies, Scope Ratings AG calculations

In view of the above, we do not consider an eventual no Brexit scenario to be off the table. Obviously, any such scenario would require a confluence of factors: difficulty in extended negotiations, increasing headwinds in the economy due to resulting uncertainty,

[1] HM Government. (2017) 'Future customs arrangements: a future partnership paper'. 15 August 2017.
[2] Bloomberg

and/or a material and sustained change in public opinion in favour of Remain. Such a scenario would likely involve fresh elections and/or a second referendum.

But concerns surrounding a hard Brexit will remain

We consider a no Brexit scenario to be the second most probable scenario after soft Brexit, and more feasible than a hard Brexit. However, given the limited foresight shown in current negotiations, the present government's intention of achieving a hard Brexit, and the unlikelihood of any conclusion for a transitional arrangement in the near term, concerns surrounding a hard Brexit are likely to remain central to the Brexit discourse and could grow in scale if no deal pervades as we approach 2019. This constellation of outcomes is reflected in the AA rating for the UK.

Complications from devolved legislatures

Moreover, the vote for Remain in Scotland, Northern Ireland and Gibraltar in last year's referendum create complications. Mrs May, who emphasised her commitment to the union between the nations of the United Kingdom, faces possible challenges from any future second independence referendum in Scotland – even if this has been momentarily shelved[3]. The potential for constitutional crisis if devolved legislatures veto UK parliament acts was illustrated in warnings from the national legislatures of Scotland and Wales that they could reject the proposed Great Repeal Bill to transfer EU legislation into British law after Brexit.[4]

Institutional strength, but weakened policy framework

While the decision to exit the EU presents obvious challenges, the UK's AA rating is underpinned by the nation's historical institutional strengths. These include as a highly advanced economy (with per capita income of USD 42,609 in 2016), the rule of law under the nation's parliamentary democracy, a strong fiscal framework, a highly credible central bank and elevated human development. Nevertheless, the deep divisions which the debate on Europe opened up within both of the major parties and society at large may prove difficult to heal, and, combined with the government's weakened state post-election, may impede government stability and complicate economic policymaking in the near to medium term. This, in turn, weakens our institutional assessment, informing our Negative Outlook.

Domestic economic risk

Large, diversified and competitive economy

The UK is a large, diversified and competitive economy (ranked seventh in the 2016-17 Global Competitiveness Index[5]), with flexible labour and product markets.

Dip in recent growth

In 2016, UK growth stood at 1.8%, down from 2.2% in 2015. This dip was partly due to a drop-off in investment, though household consumption growth remained robust. Personal consumption has been supported by rising disposable income, growth in unsecured credit and a decline in the savings ratio (to the lowest level on record at 1.7% in Q1 2017).

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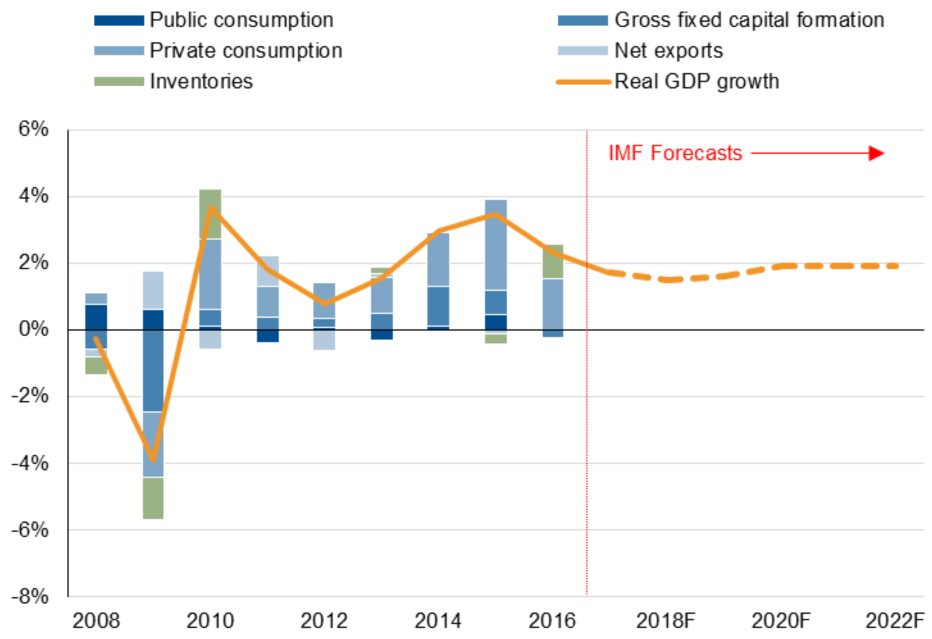
[3] CNN
[4] Bloomberg
[5] World Economic Forum. (2016) 'The Global Competitiveness Report 2016-2017'.

Figure 4: Percentage point contribution to annual real gross domestic product (GDP) growth



Source: IMF, Scope Ratings AG calculations

Forecasts for 2017 growth have been revised downwards recently, owing to a weaker-than-expected first half. The International Monetary Fund (IMF), in its July update to the World Economic Outlook, cut 2017 growth to 1.7% from 2.0%, while keeping 2018 at 1.5%. In August, the Bank of England (BoE) cut the 2017 growth forecast to 1.7% from 1.9% while reducing the 2018 forecast to 1.6%.

Second quarter GDP was in line with consensus at 0.3% quarter on quarter, confirming a slowdown. Production and construction were a drag, while services contributed 0.4%.

High frequency data has shown some resilience. Surveys show that consumer confidence has ebbed, but industrial confidence (a component of the European Commission's Economic Sentiment Indicator) has remained buoyant. In line with the latter, a Confederation of British Industry survey showed that UK factory production in the previous quarter reached its highest level since 1995 as optimism regarding export orders increased. Unemployment has continued to decline, down to 4.4% in the three months to June – the lowest rate since 1975. Unemployment is low even with labour force participation at an elevated 78.7%.

Effects of Brexit may be more gradual than supposed

Uncertainty around the conclusion of Brexit has and will continue to weigh on the UK economy. However, the effects may be more complex/gradual than initially supposed – compared with forecasts directly after the referendum from the IMF, the BoE, etc. for a sharp correction in growth. While investment and private consumption will continue to be adversely impacted, net exports will be an important automatic stabilising element, in Scope's view. That said, some negative Brexit effects on investment have accelerated since Article 50 was formally initiated in Q1.

The support from net exports reflects the more than 10% depreciation of sterling (in trade-weighted terms) since the referendum, lower private demand growth and still-robust economic growth among trading partners – including the euro area and the United States. The movement of trading and investment banking operations to continental locations, in anticipation of risks to 'passporting', will be negative for services exports in the medium term. Any adverse scenario in which the UK regresses to WTO most-favoured-nation rules would have major implications, although we do not anticipate this scenario.

Inflation will affect private consumption

Against a positive contribution from trade, private consumption is likely to be dampened in the near term by inflation, which stood at 2.6% in July – exceeding the BoE's 2.0% target. Core inflation stands at 2.5%. This transitory boost in inflation is rooted in the sterling devaluation. Along with low wage growth (2.1% year on year as of June), this has meant negative rates of real earnings growth, which weighs on consumers. However, given bottoming of the sterling since last October, the impact of rising inflation on consumption should gradually recede.

Investments on hold, as exits in financial sector to hit economy

During the next several years, heightened uncertainty will result in investment decisions being placed on hold. Structurally low investment as a share of GDP (of around 16%) has been an issue since the global financial crisis, contributing to only modest expansion in factor productivity. This problem could be exacerbated by Brexit.

Research from Bruegel indicates that about 35% of London wholesale banking is related to EU27-based clients.[6] Extrapolating this, they estimated that EUR 1.8trn of banking assets (or 17% of the total) could be relocated to Europe in the scenario of no access to the single market, placing as many as 30,000 domestic jobs at risk. Even if such a scenario is not fully realised, Bloomberg has to date tallied more than 12,500 jobs under consideration to be moved, related to contingency planning.[7] Deutsche Bank was recently reported to shift about EUR 300bn from its UK balance sheet to Frankfurt.[8] Furthermore, uncertainty prevails on the future of euro clearing, predominantly located in London at present. In June, the European Commission recommended that clearinghouses deemed systematic to European markets should face direct oversight from EU institutions. The European Parliament and member states will assess the EC's proposals after the summer holidays. Finance and related professional services contribute GBP 190bn per annum, representing 11% of the UK economy.

Monetary conditions to support outlook

Downside risks are likely to be cushioned by accommodative monetary conditions. In addition to the weaker sterling, the BoE is expected to maintain a supportive policy stance. Even if the Bank Rate begins in time to rise from historic lows of 0.25%, such increases are anticipated to be gradual and limited. Loans are expanding to households and businesses (by 3.9% and 3.1% year on year respectively in June 2017). However, there have been indications of a near-term downturn in this credit availability to households from the BoE's Q2 Credit Conditions Survey.

Medium-term growth of 1.5% to 2.0%

Over the medium term, we assume a baseline UK growth estimate of 1.5% to 2.0%. This compares with 2.0% average growth rates from 2010-2016 post-crisis, and a medium-term growth forecast from the IMF of 1.9%[9]. Our medium-term baseline acknowledges annual working-age population growth of around 0.2% per UN forecasts for 2017-2022. In addition, we assume small pro-cyclical contributions from rising labour force participation and employment. Implicitly, we assume labour productivity growth of around 0.5%-1.0% (compared with 0.7% over 2010-16).

Scope acknowledges significant uncertainty around medium- to long-run growth due to inherent dependence on the path of Brexit, what trade agreement the UK reaches with the EU and other trading partners, and the nation's overall policy framework. Due to the demands of Brexit, we note the potential adverse impact on macroeconomic policymaking vis-à-vis other significant policy areas, including long-run growth and the

[6] Sapir, André, Dirk Schoenmaker and Nicolas Véron. (2017) 'Making the best of Brexit for the EU27 financial system'. Bruegel Policy Brief, Issue 1, February 2017.
[7] https://www.bloomberg.com/graphics/2017-brexit-bankers/
[8] Bloomberg
[9] IMF World Economic Outlook, April 2017, projection for UK growth in 2022

consolidation of public finances. The strength of the Labour Party since the election and party leader Jeremy Corbyn's anti-market policy prescriptions also create some uncertainty for the medium term.

Brexit weakens the medium-term economic outlook

Though the economic impact of a softer exit could be more tenable in the long run, the implications of a hard Brexit are more severe. In a 2016 analysis, the UK Treasury concluded that trading on WTO terms could reduce UK GDP by 5.4% to 9.5% after 15 years relative to a baseline of remaining in the EU.[10] At the same time, Treasury concluded that a Norwegian model in which the UK exits the EU but remains in the European Economic Area would reduce GDP by 3.4% to 4.3% after 15 years relative to the baseline of remaining in the EU. MIT's John Van Reenen has noted that a Swiss model, in which the UK joins the European Free Trade Association post-exit, would reduce UK incomes by between 6.3% and 9.5% based on a dynamic model.[11]

Public finance risk

Higher near-term budget deficit

The government deficit fell in 2016-17 to 2.4% of GDP, down from 3.8% of GDP in 2015-16. The deficit will rise temporarily in 2017-18 to 2.9% of GDP, considerably higher than expectations as of 2015-16. This is partly because of policy measures announced in the 2016 Autumn Statement and 2017 Spring Budget, which increased the 2017-18 deficit by around 0.3% of GDP. Moreover, the government recently scrapped 17 measures designed to yield GBP 3.5bn (0.2% of GDP) of savings for Treasury.

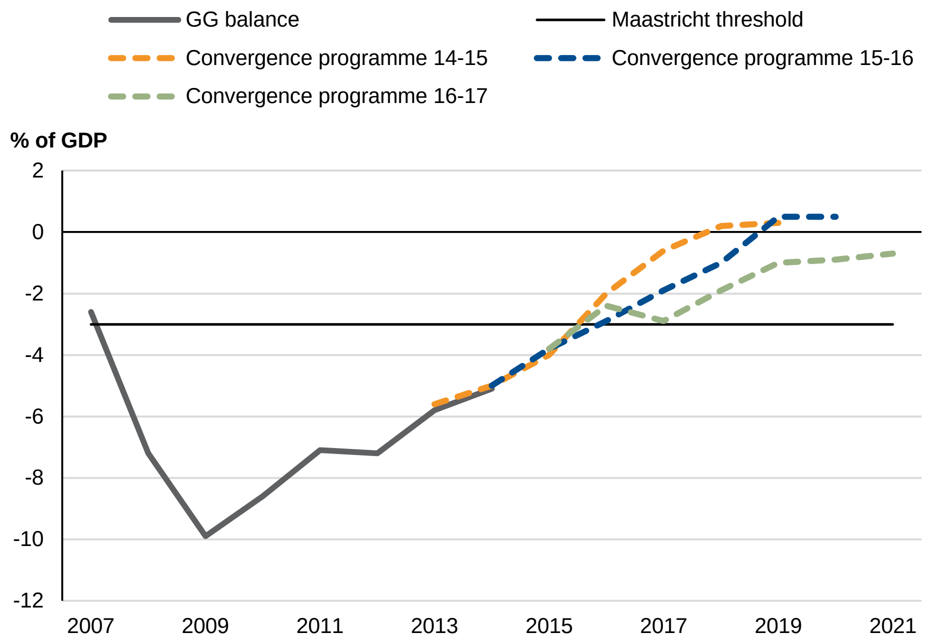
In order to bolster the economy during the Brexit transition, the overall budgetary adjustment has been substantively gradualised. According to EU Convergence Programme forecasts, the headline deficit should initially rise in 2017-18, then fall to 1.9% of GDP in 2018-19 before reaching 0.9% in 2020-21. We note, however, that some of the budgetary proposals – including the GBP 23bn National Productivity Investment Fund, increases in tax rate thresholds and a cut to the corporate tax rate (to 17%) – will have positive impacts on economic growth.

More gradualised consolidation

In the most recent Autumn Statement, the Chancellor of the Exchequer laid out a vision of new fiscal objectives aimed at a 2% structural deficit (compared to 2.4% in 2016-17) and a fall in net debt-to-GDP by fiscal year 2020-21, with a balanced budget by the mid-2020s. This has replaced previous goals for a budget surplus by the end of 2019-20. The updated objectives also include the supplementary goal of keeping total spending on some welfare benefits below a target nominal level (a 'welfare cap') by 2021-22.

[10] HM Treasury. (2016) 'HM Treasury Analysis: the long-term economic impact of EU membership and the alternatives'. Cm 9250, April 2016.
[11] John Van Reenen. (2016) 'Brexit's Long-Run Effects on the U.K. Economy'. Brookings Institution.

Figure 5: General government balance, UK 2016-17 Convergence Programme forecasts vs. earlier programme expectations



Source: Eurostat, Office for Budget Responsibility

Risks to fiscal outlook

In Scope's view, the government's need to sustain public support for tough Brexit negotiations poses risks to fiscal consolidation plans slated for 2018 and beyond and, as such, there are material risks to medium-term fiscal targets. This is credit negative. The government has agreed a confidence and supply arrangement that increases public spending significantly in Northern Ireland. Fiscal risks are also reinforced by pressure against public spending cuts from the opposition Labour Party alongside general 'austerity fatigue'. But, given economic bottlenecks and the present risks to long-term growth, a fiscal programme that emphasises public investment, e.g. in infrastructure, research and housing, should be advocated within an overall programme of fiscal prudence. Risks to the budget balance also emanate from higher inflation vis-à-vis higher interest payments on inflation-linked debt and greater current expenditure, alongside costs from higher UK gilt yields.

The UK remains subject to the corrective arm of the Excessive Deficit Procedure, opened in December 2009. In addition, as debt exceeds the 60% Maastricht threshold, the United Kingdom will also be subject to a transitional debt rule emphasising brakes during the three years following exit from the Excessive Deficit Procedure. In Scope's view, the divorce from the EU will reduce the resilience of the UK's fiscal framework due to the removal of such EU fiscal oversight institutions.

Debt levels remain high, though composition strong

Government debt stands at 88% of GDP as of Q1, and, under an IMF baseline scenario, should edge lower in 2017 and 2018 before beginning a more gentle descent starting in 2019. An annual decline in general government debt-to-GDP in 2017 would represent the first such drop since 2001. The IMF baseline sees public debt dipping to 83% by 2022. This is driven by an anticipated small primary surplus by 2019, to be sustained going forward, as well as favourable debt dynamics. The ongoing sale of government holdings in the financial sector is also expected to reduce public debt. In Scope's view, the UK's high public debt (at the upper end of an 'aa' peer analysis) remains a material credit weakness. However, the long average maturity of the debt (of more than 14 years in 2016), its sterling denomination and low interest rates suggest a strong debt composition.

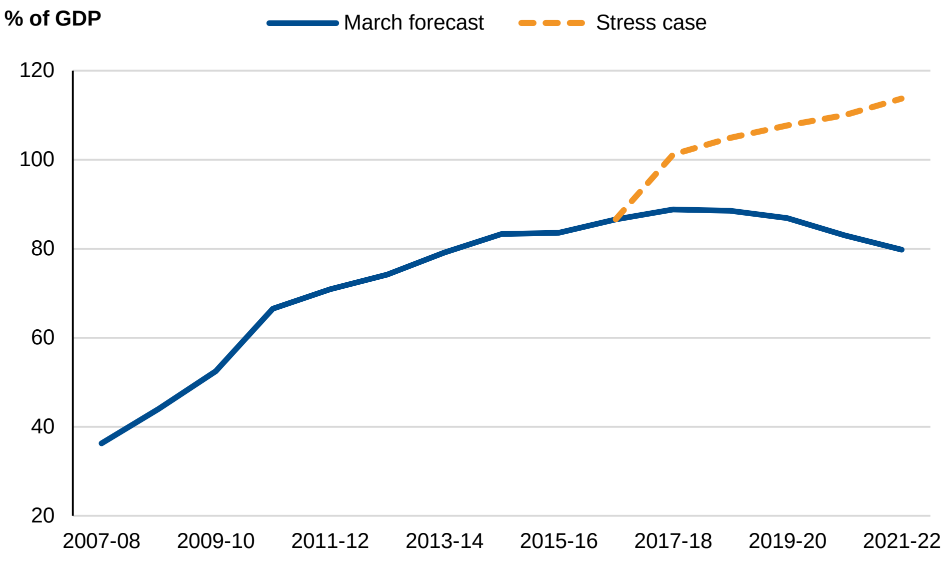
Moreover, the budget deficit has been increasingly funded by the local financial sector, enhancing resilience.

Brexit challenges outlook

Brexit presents material challenges to public finances. In the near term, the debate may centre on the Brexit Bill. Bruegel places the net payment in the EUR 25bn to EUR 65bn range[12], possibly with a large upfront payment (up to EUR 109bn), followed by subsequent EU reimbursements. A net payment in the EUR 25bn to EUR 65bn range would constitute a 1-3 pp boost to the debt/GDP ratio, potentially spread over multiple years. This could be counterbalanced by any reduction/cessation of annual payments to the EU budget after Brexit (GBP 16-17bn gross per year[13]), though exact savings from this depend on which payments are required to continue to maintain single market access.

In a July 2017 report[14], the Office for Budget Responsibility (the UK's independent fiscal watchdog) noted that the greatest risk to the long-term fiscal outlook would stem from an economic shock, including any impacts of Brexit on long-run growth. The report pointed out the weakened state of Britain's public sector balance sheet, making the UK more vulnerable to adverse shocks than in 2007, before the global financial crisis. To illustrate this, the authors implemented a stress case akin in severity to the financial crisis: in the scenario, public sector net debt ended the forecast horizon (2021-22) at 114% of GDP, compared with 80% by 2021-22 in a baseline scenario. We believe this demonstrates the vulnerabilities of the fiscal position to shocks of either domestic or external origin.

Figure 6: Net public debt, OBR baseline versus stress case



Source: Office for Budget Responsibility

Long-term sustainability risks

The UK's ageing population poses challenges to fiscal sustainability. Based on the Ageing Report 2015, the European Commission noted that an adjustment effort equal to 3.1 percentage points of GDP[15] would be needed to place debt on a sustainable path, mainly correcting risks stemming from healthcare and pension costs.

[12] Darvas, Zsolt, Konstantinos Efstathiou and Inês Goncalves Raposo. (2017) 'Divorce settlement or leaving the club? A breakdown of the Brexit bill'. Bruegel Working Paper, Issue 03, 2017.
[13] Keep, Matthew. (2017) 'The UK's contribution to the EU budget'. House of Commons Library, Briefing Paper, Number CBP 7886, 31 July 2017. Gross contributions to the EU/EC budget, after rebate and refunds, 2019-2021 forecasts.
[14] Office for Budget Responsibility. (2017) 'Fiscal risks report'. Cm 9459, July 2017.
[15] European Commission. (2017) 'Assessment of the 2016-17 convergence programme for the United Kingdom'. Directorate General, Economic and Financial Affairs, 23 May 2017.

UK maintains strong historical record

The UK maintains a strong record of prudent fiscal policy, and has paid all debts in full and on time in the post-war era. Since 2008, fiscal consolidation has been substantial, primarily consisting of cuts to expenditure. The AA rating reflects these institutional strengths. However, a weakened fiscal framework, lower policy effectiveness and weakened growth surrounding Brexit weigh on the Outlook.

External economic risk

Reductions in the current account deficit

The UK has posted an annual current account deficit since 1984, and currently holds the world's second largest deficit in absolute terms. A process of correction has begun: the European Commission forecasts a current account balance of -3.9% of GDP for 2017 and -3.2% for 2018, down from -4.4% in 2016. In the April World Economic Outlook, the IMF forecasted a long-run current account balance of -2.1% by 2022. This correction will come, in part, due to a reversion in the investment income balance, which has turned negative, and recorded deficits of over 1% of GDP since 2014 owing to lower returns on UK overseas investments and an increase in investment income outflows on inward investment. The attribution of strong foreign investment in UK private non-financial corporations, and resulting investment income outflows, to increased current account deficits since 2011 suggests that some of the headline risk of a rising current account deficit may have been exaggerated. In addition, we expect the trade balance to improve thanks to higher exports and import substitution after sterling devaluation, alongside lower domestic demand. There is material uncertainty regarding the medium-term outlook, which depends on the new trading relationship with the EU and other major trading partners.

Risks to FDI and portfolio flows

The UK's credit strength has been supported by the strong composition of the financing of its external deficit through net foreign direct investment (FDI). Annual net FDI flows averaged GBP 130bn in 2014-16, more than compensating for the deficit in the current account. However, there are uncertainties and challenges to these flows: the financial sector attracts more FDI to the UK than any other sector – with London as the financial gateway to Europe – and 48% of the FDI stock in the UK originated from the EU (as of 2014). Consequently, a downturn in EU/foreign inflows due to uncertainty and flux in the European financial industry could materially lessen this resilience. In addition, other important sources of external financing could be placed at risk, including the wholesale funding of the UK's commercial banks, half of which is denominated in foreign currency. An Invesco report in June[16] found that sovereign wealth funds and central banks may reduce UK holdings owing to Brexit.

Net international investment position flipped due to currency revaluations

Currency revaluations turned the net international investment position positive, to +24% of GDP in 2016 from -5% in 2015. While the EU divorce process may dampen FDI inflows, the existing stock of FDI will remain more durable and less prone to reversal relative to other types of financing.

Monetary and FX (foreign exchange) regime a major strength

In Scope's view, the flexibility of the UK's monetary and exchange rate regime is a major strength, acting as an automatic stabiliser during crises. The pound's more than 10% trade-weighted depreciation since the referendum has reversed some of the earlier strengthening from 2013-2015, helping support the competitiveness of the UK's manufacturing export sector.

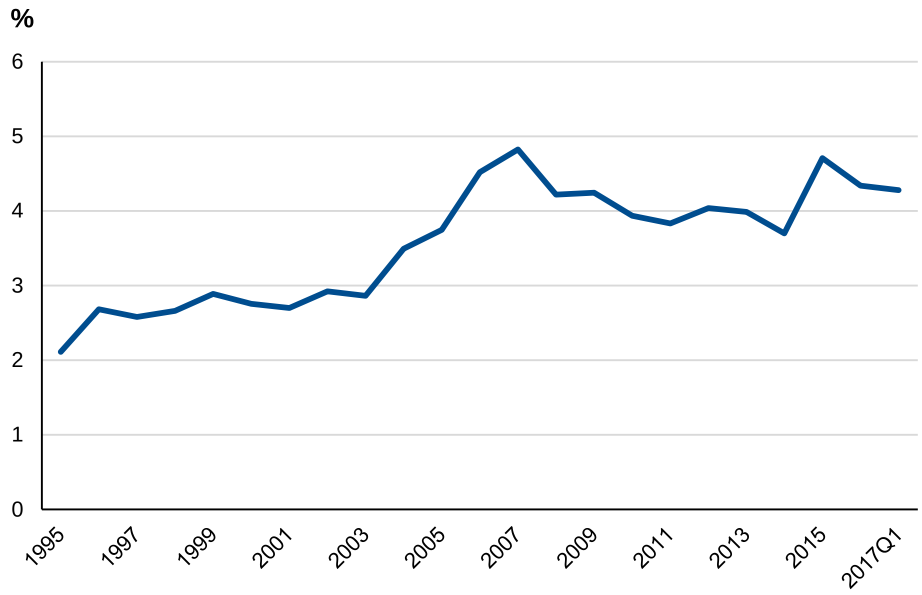
Pound's reserve currency status an area to watch

As noted, Scope views the pound's status as a global reserve currency as a major credit strength – stemming risks of 'sudden stop' balance of payment crises and bolstering sterling markets including government debt during global shocks. This status is supported by the UK's EU membership and London's status as one of the world's premier financial

[16] Invesco. (2017) 'Invesco Global Sovereign Asset Management Study 2017'.

centres. 4.3% of global reserves were held in sterling as of Q1 2017 – slightly lower than the 4.7% in Q4 2015 (based on IMF data), reflecting effects from pound depreciation, although 12.8% of global forex transactions involved sterling in 2016, up from 11.8% in 2013[17]. In the adverse scenario that sterling's global reserve status is challenged in the long run, we'd consider this to be a material credit negative development. Without this status, the UK's high external deficits would represent a significant vulnerability, with gross external financing needs as a share of current account receipts and official FX reserves among the highest in the advanced world.

Figure 7: Percentage of global allocated reserves held in pound sterling



Source: IMF COFER

Financial stability risk

Deep capital markets a plus

The United Kingdom benefits from deep capital markets and its position as one of the world's leading financial centres. UK financial system assets amount to around 4.5 times GDP and foreign banks make up half of UK banking assets on a residency basis.

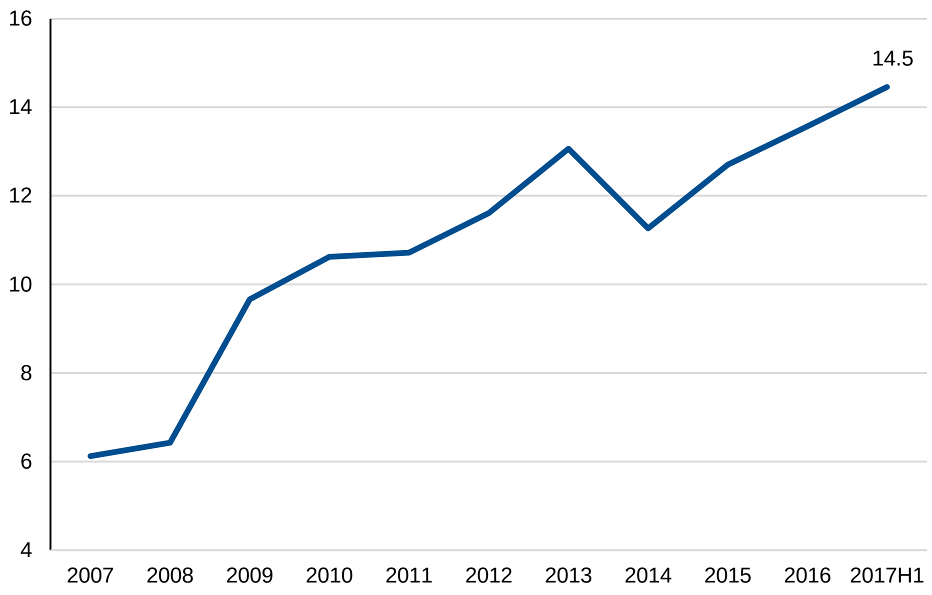
Major banks well capitalised

The soundness of the UK's financial system is supported by the nation's sophisticated financial regulation network – including the Bank of England, its Financial Policy Committee (FPC), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). In its June Financial Stability Report, the FPC noted that it expects to raise the counter-cyclical capital buffer (CCyB) to 1.0% this November[18], absent any material change in the outlook. The 1.0% rate would correspond to a 'standard risk environment'. The alignment of the CCyB at 1.0% in a standard environment is higher than that of international peers, and represents a proactive approach to financial supervision, in Scope's view. Banks' aggregate Tier 1 capital ratio stood at 15.7% as of March, higher than the Bank of England's view on steady state capital requirements of around 11%. In the BoE's 2016 annual cyclical stress test, Common Equity Tier 1 (CET1) ratios across the seven participating banks declined from 12.6% (end-2015) to a low point of 8.8% in the scenario – remaining well above a 6.5% weighted average hurdle rate and a 7.3% weighted average systemic reference point. While the PRA Board found some capital inadequacies at three institutions (the Royal Bank of Scotland group, Barclays and

[17] Bank for International Settlements, Monetary and Economic Department. 'Triennial Central Bank Survey: Foreign exchange turnover in April 2016'. September 2016.
[18] In June 2017, the CCyB was raised by the FPC to 0.5% from 0%

Standard Chartered), the BoE determined the system as a whole to be well capitalised to support the real economy in the referenced stress scenario of "a synchronised UK and global recession with associated shocks to financial market prices, and an independent stress of misconduct costs". In 2017, the BoE will release results from the annual cyclical stress scenario and a biennial exploratory scenario in November.

Figure 8: Major banks' aggregate core Tier 1 capital ratio, % of total assets



Source: Individual banks' financial statements, Scope Ratings AG calculations

Pockets of risk in domestic sector

The high level of private sector indebtedness remains a concern, though private sector debt-servicing costs have declined due to low interest rates. Consumer credit has increased rapidly (10% year on year to June). The short maturity of consumer credit is worrying as the credit quality of such loans could deteriorate sharply in a downturn. In July, the PRA and FCA published opinions on the consumer credit market, responding to perceived weaknesses in some aspects of underwriting.

Measures of market uncertainty remain low, implying potential for some future repricing of risk. This could affect markets including corporate bonds and UK commercial real estate – in which the FPC noted valuations do not appear to fully reflect downside risks. Furthermore, the residential housing market has entered a slowdown/correction – with the Nationwide house price index down to 2.9% annual growth in July, led by a sluggish London market.

Contingency planning in progress on Brexit

The effect of Brexit on financial stability could be very significant. However, Scope believes that the UK financial system is presently well positioned to deal with a shock, based on the results of the 2016 stress test, continued improvements in capital adequacy, and stronger asset quality. Nevertheless, the form Brexit takes may present unexpected challenges. Around GBP 40bn of UK financial service revenues relate to EU clients and markets[19], underscoring the potential for disruption in the event of a hard Brexit. Without contingency plans, financial stability may be interrupted by dislocations in services provided, higher costs and impacts on market liquidity, in addition to spillover from any macroeconomic shock. In a recent report, Oliver Wyman concluded that banks

[19] Oliver Wyman. (2016) 'The impact of the UK's exit from the EU on the UK-based financial services sector'.

may need USD 30bn to USD 50bn in new capital to support European units after a hard Brexit, and operating costs could rise by USD 1bn as functions are duplicated.[20] The effect could be most pronounced in markets that have recently had greater reliance on access to overseas capital, such as commercial real estate. Since 2015, about half of the investment in UK commercial real estate has been financed by overseas investors. Moreover, banking and insurance services provided to UK-based clients by firms in the European Economic Area could be adversely impacted.

The BoE, FCA and PRA are working with regulated institutions to ensure that comprehensive contingency plans are made. In April, the Prudential Regulation Authority asked financial institutions to summarise such contingency preparations. Any shock to the UK's financial sector would be highly significant, owing to the sector's intrinsic importance to employment and public receipts, and connectivity to the real economy.

Methodology

The methodology applicable for this rating and/or rating outlook "Public Finance Sovereign Ratings" is available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/governance-and-policies/regulatory/esma-registration.
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 definition of default, definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

[20] Austen, Matt, Lindsey Naylor, James Davis, Nick Darbyshire, Chris Allchin and Patrick Hunt. (2017) 'One year on from the Brexit vote: a briefing for wholesale banks'. Oliver Wyman.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative "AA" ("aa") rating range for the United Kingdom. This indicative rating range can be adjusted by the Qualitative Scorecard (QS) by up to three notches depending on the size of relative credit strengths or weaknesses versus peers based on analysts' qualitative analysis.

For the United Kingdom, the following relative credit strengths are identified: 1) market access and funding sources, 2) low vulnerability to short-term shocks, 3) financial sector performance and 4) financial sector oversight and governance. Relative credit weaknesses are signalled for: 1) growth potential of the economy, 2) fiscal performance, 3) recent events and policy decisions and 4) macro-financial vulnerabilities and fragility. Combined relative credit strengths and weaknesses generate no adjustment and signal a sovereign rating at AA for the UK. A rating committee discussed and confirmed these results.

Rating overview	
CVS category rating range	aa
QS adjustment	AA
Final rating	AA

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower-case.

Within the QS assessment, the analyst conducts a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, review of debt sustainability, fiscal and financial performance and policy implementation assessments.

There are three assessments per category for a total of fifteen. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analyst recommendation to the rating committee.

Foreign versus local currency ratings

The UK's debt is predominantly issued in local currency. Because of its history of repayment, reserve currency status and material institutional strengths, Scope sees no evidence that the UK would differentiate among any of its contractual debt obligations based on currency denomination.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	**30%**
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	**15%**
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	**10%**
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	**10%**
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**aa**
QS adjustment	**AA**
Final rating	**AA**

QS

Maximum adjustment = 3 notches

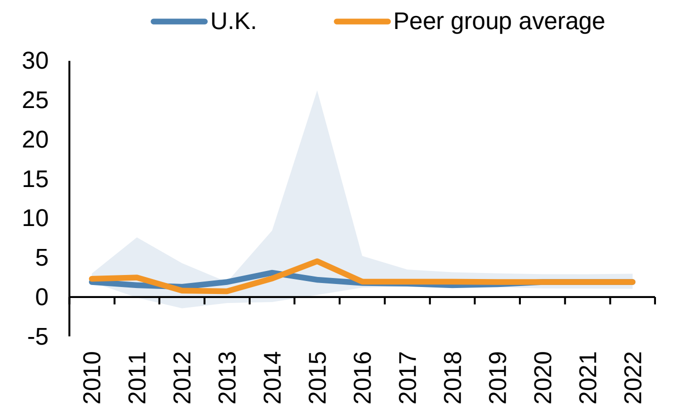
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	○ Neutral	● Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negative
Economic policy framework	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Macroeconomic stability and imbalances	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Fiscal performance	○ Exceptionally strong performance	○ Strong performance	○ Neutral	● Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	● Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	● Very good access	○ Neutral	○ Poor access	○ Very weak access
Current-account vulnerabilities	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Vulnerability to short-term shocks	○ Excellent resilience	● Good resilience	○ Neutral	○ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Geo-political risk	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	● Good	○ Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	● Good	○ Neutral	○ Poor	○ Inadequate
Macro-financial vulnerabilities and fragility	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings AG

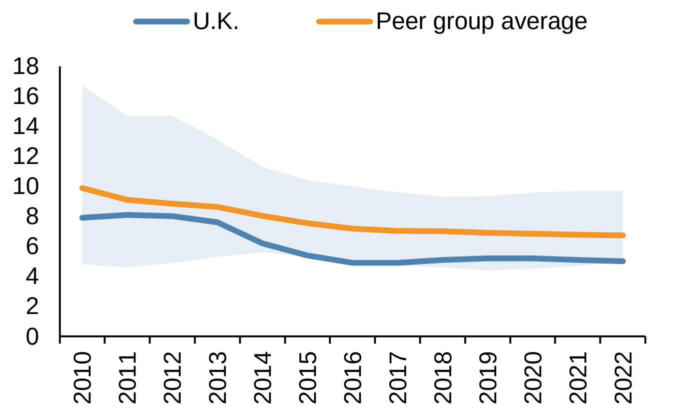
III. Appendix: Peer comparison

Figure 10: Real GDP growth



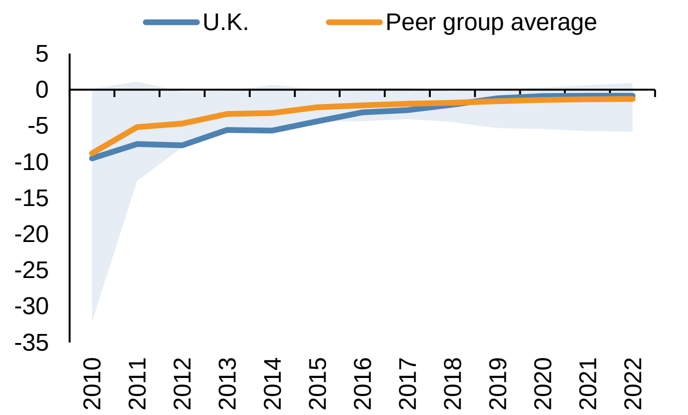
Source: IMF, Calculations Scope Ratings AG

Figure 11: Unemployment rate, % of total labour force



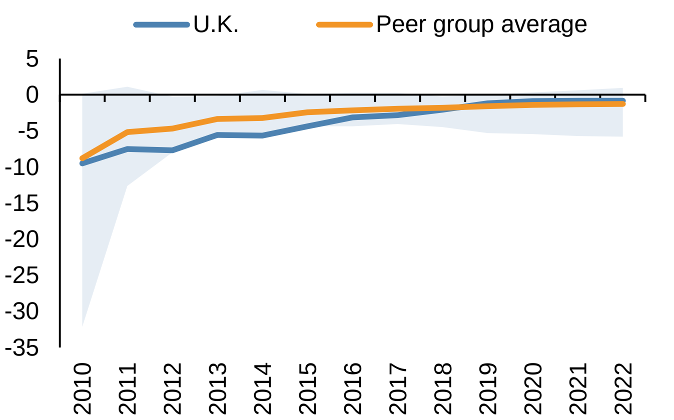
Source: IMF, Calculations Scope Ratings AG

Figure 12: General government balance, % of GDP



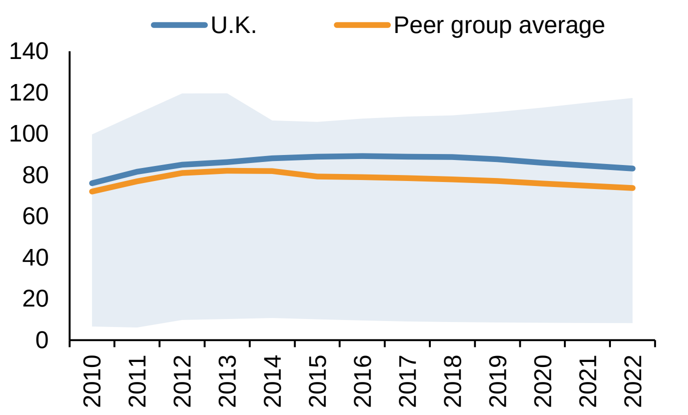
Source: IMF, Calculations Scope Ratings AG

Figure 13: General government primary balance, % of GDP



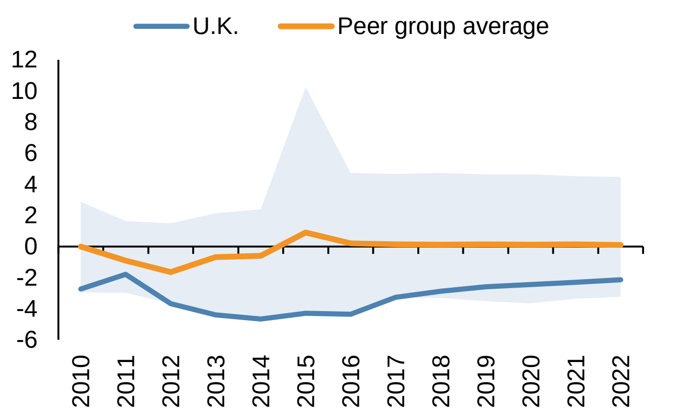
Source: IMF, Calculations Scope Ratings AG

Figure 14: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 15: Current account balance, % of GDP



Source: IMF, Calculations Scope Ratings AG

IV. Appendix: Statistical tables

	2012	2013	2014	2015	2016	2017E	2018F
Economic performance							
Nominal GDP (GBP bn)	1,675.0	1,739.6	1,822.5	1,872.7	1,939.6	2,014.3	2,084.4
Population (thous)	64,250.3	64,641.1	65,015.7	65,397.1	65,788.6	66,181.6	66,573.5
GDP-per-capita PPP (USD)	37,477.8	39,016.8	40,709.2	41,767.3	42,608.9	-	-
GDP per capita (GBP)	26,293.8	27,135.7	28,213.1	28,762.3	29,580.1	30,506.3	31,350.0
Real GDP growth, % change	1.3	1.9	3.1	2.2	1.8	1.7	1.5
GDP growth volatility (10-year rolling SD)	2.3	2.2	2.2	2.2	2.2	2.1	2.0
CPI, % change	2.8	2.6	1.5	0.1	0.6	2.5	2.6
Unemployment rate (%)	8.0	7.6	6.2	5.4	4.9	4.9	5.1
Investment (% of GDP)	16.1	16.7	17.4	17.2	17.0	16.7	16.6
Gross national savings (% of GDP)	12.4	12.0	12.7	13.0	12.6	13.4	13.7
Public finances							
Net lending/borrowing (% of GDP)	-7.7	-5.6	-5.7	-4.4	-3.1	-2.8	-2.1
Primary net lending/borrowing (% of GDP)	-5.4	-4.2	-3.8	-2.9	-1.4	-1.0	-0.4
Revenue (% of GDP)	36.0	36.4	35.4	35.8	36.3	36.4	36.7
Expenditure (% of GDP)	43.7	42.0	41.1	40.1	39.4	39.2	38.8
Net interest payments (% of GDP)	2.3	1.4	1.8	1.5	1.7	1.8	1.7
Net interest payments (% of revenue)	6.5	3.8	5.2	4.2	4.6	5.0	4.6
Gross debt (% of GDP)	85.1	86.2	88.1	89.0	89.2	89.0	88.7
Net debt (% of GDP)	76.4	77.8	79.7	80.4	80.7	80.4	80.2
Gross debt (% of revenue)	236.1	236.7	248.6	248.7	245.7	244.3	241.9
External vulnerability							
Gross external debt (% of GDP)	374.1	340.8	325.5	295.0	313.7	-	-
Net external debt (% of GDP)	-	-	-	-	-	-	-
Current account balance (% of GDP)	-3.7	-4.4	-4.7	-4.3	-4.4	-3.3	-2.9
Trade balance [FOB] (% of GDP)	-	-6.9	-6.7	-6.4	-6.9	-7.4	-7.3
Net direct investment (% of GDP)	-1.3	-0.4	-6.3	-3.9	-	-	-
Official forex reserves (EOP, Bil. USD)	66.7	77.7	82.2	106.0	112.0	-	-
REER, % change	4.3%	-1.4%	7.1%	5.4%	-10.4%	-	-
Nominal exchange rate (EOP, USD/GBP)	1.58	1.65	1.56	1.48	1.23	-	-
Financial stability							
Non-performing loans (% of total loans)	3.6	3.1	1.7	1.0	0.9	-	-
Tier 1 ratio (%)	12.3	14.4	-	15.6	16.9	-	-
Consolidated private debt (% of GDP)	174.0	167.8	160.0	157.7	160.7	-	-
Domestic credit-to-GDP gap (%)	-7.6	-22.7	-7.3	-19.7	-15.4	-	-

Source: IMF, European Commission, European Central Bank, World Bank, United Nations, Scope Ratings AG

V. Regulatory disclosures

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

Rating prepared by Dennis Shen, Lead Analyst

Person responsible for approval of the rating: Dr Stefan Bund, Chief Analytical Officer

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003. The subscription ratings/outlooks were last updated on 05.05.2017.

The senior unsecured debt ratings as well as the short term issuer ratings were assigned by Scope for the first time.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on the United Kingdom are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Sovereign Ratings Calendar of 2017" published on 21.07.2017 on www.scoperatings.com). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the deviation was due to the recent revision of Scope's Sovereign Rating Methodology and the subsequent placement of ratings under review, in order to conclude the review and disclose ratings in a timely manner, as required by Article 10(1) of the CRA Regulation.

Rating Committee: The main points discussed were: (1) latest political developments and negotiations regarding Brexit, (2) economic growth potential and outlook, (3) public finance performance and outlook, (4) external economic position and developments linked to Brexit, (5) financial and banking sector performance and regulatory framework, (6) Brexit potential scenarios analysis and impact on rating outcome, (7) peers consideration.

Solicitation, key sources and quality of information

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

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: (UK) Office for National Statistics, Bank of England, European Commission, Statistical Office of the European Communities, IMF, OECD, and Haver Analytics.

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 publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Conditions of use / exclusion of liability