Rating Update:

Creditreform Rating affirms the United Kingdom's credit ratings at "AA", outlook "negative"

Rating Action

Neuss, 19 March 2021

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "AA" for the United Kingdom. Creditreform Rating has also affirmed the UK's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "AA". The outlook is negative.

Reasons for the Rating Decision and Latest Developments

Macroeconomic Performance

Its large, wealthy and competitive economy as well as its very flexible labor market, which at the onset of the corona crisis was virtually operating at full employment, continue to underpin the United Kingdom's (UK) strong macroeconomic profile which is somewhat balanced by stretched household balance sheets. Although uncertainty is still unusually high, impressive progress made in the vaccination process, together with continued significant monetary and fiscal stimulus should lay the ground for a rebound coming mainly on the back of household spending. Notwithstanding the therefore more benign economic outlook in the near term, Brexit and scarring effects entailed by the pandemic weigh on medium-term prospects, while exceptional policy support should subside. Major downside risks have been averted by concluding the Trade and Cooperation Agreement (TCA) with the EU. Still, the introduction of non-tariff barriers in services trade, the lack of clarity as regards financial services, with possibly diverging regulatory standards further down the road, are likely to drag on growth and already lackluster productivity. Whilst the jury is still out on future spending behavior of the private sector and the eventual extent of inevitable redundancies and insolvencies, we would rather take a conservative approach, which leads us to expect some scarring effects on medium-term growth, also in view of the comparatively stronger role played by consumer-facing services in the UK.

Following moderate real GDP growth burdened by Brexit uncertainty over the last few years (average 2015-19: 1.7%), the Covid-19 pandemic drove total output down by 9.9% in 2020, corresponding to the largest decline in the G7, largely driven by relatively strict and longer lockdown phases as suggested by Blavatnik's stringency index, and the comparatively stronger role played by consumer-facing services in the UK. Domestic demand contributed negatively with strong falls in household consumption (-11.0%) and business investment (-10.7%), while exports and imports contracted by 16.7% and 18.1% respectively.

Thanks to decisive policy action taken by the authorities, even greater damage to the UK economy and its population has been averted. Including the latest measures, the government has provided a sizeable fiscal response to protect lives and support the health sector, vulnerable groups, workers and businesses, amounting to about GBP 344bn since the outbreak of the corona crisis. Numerous measures have been extended to further support the economic recovery, which is held back by a new wave of infections and re-imposed restrictions. Despite a setback in the last quarter of 2020, the UK's economy was still able to expand by 1.0% q-o-q, contrary to developments in the euro area (Q4-20: -0.7%). Having said this, the better-than-expected outturn in Q4 was also due to the ONS' attempt to provide more accurate volume estimates of the health sector. Thus, adjustments to better capture public healthcare and education services have been made, including an adjustment to capture new Covid-19-related services such as the coronavirus TTT scheme.

Although this factor is likely to provide an uplift at the beginning of the current year as well, we expect Q1 to see GDP shrink again, amid a third comparatively strict lockdown, although negative effects seem considerably less deep than last spring. According to ONS, GDP contracted by 2.9% in January. However, in the face of fast progressing inoculations, waning frictions in merchandise trade which will presumably drag on growth in the first quarter, and ongoing substantial government support, we expect a recovery to take hold from Q2-21.

At this stage, we would tentatively expect restrictions to have gradually phased out by Q3-21, albeit subject to still very high uncertainty, not least against the backdrop of the spread of new strains of the virus. On 22 February, the government presented its roadmap out of the lockdown which foresees a four-staged approach to returning to normality by 21 June, conditional on the evolution of vaccination success and infection numbers. Education has been given priority, with children and students returning to face-to-face education from 8 March. Non-essential retail is to open on 12 April at the earliest, while the hospitality sector will be allowed to serve customers outdoors from then. Restrictions on social gatherings will be incrementally eased along the way.

The UK is far ahead of EU countries in the vaccination process, thus enabling restrictions to be lifted relatively soon. The number of first vaccination doses administered has climbed to 38.4 per 100 people in the total population as of 14 March, one of the highest readings worldwide, and well ahead of e.g. 11.2 in Germany and 10.9 in France. Recent sentiment indicators would back expectations of our baseline scenario. Consumer confidence (GfK) in February climbed to its highest level since the outbreak of the corona crisis, and the manufacturing and services PMI in February posted increases, although sentiment among service providers still hints at contracting activity. For 2021 as a whole, we expect real GDP growth to rebound to about 5.0%, followed by a further increase to 6.0%, with downside risks primarily relating to the coronavirus and the adjustment to the post-Brexit environment (also see below).

Real GDP growth in 2021/22 should mainly be buttressed by private consumption. The UK's labor market entered the Covid-19 crisis on a strong footing in light of an unemployment rate well below EU and euro area levels and a high participation rate. However, over the course of last year, unemployment rose from 3.8% in Q4-19 to 5.2% in Q4-20 (ONS, LFS, 16-64y). We expect weakening labor market conditions to translate into moderate wage growth. At the same time, spending power will be aided by moderate CPI, and in particular, by continued extensive government support. The vital Coronavirus Job Retention Scheme (CJRS), under which 11.2mn jobs had been furloughed by 15-Feb-21, has thus been extended to September 2021 and there will be a fourth and fifth round of grants under the Self Employment Income Support Scheme (SEISS). Moreover, households command over substantial savings as illustrated by a saving rate of 16.5% in Q3-20 (1963-2019 average: 9.4%). Hence, households appear to have plenty of room to maneuver, representing both an upside and downside risk to spending growth, as it is not clear as to which extent households will be inclined to consume at this juncture. Stretched household balance sheets as mirrored by household debt-to-disposable income at 128.7% (Q3-20, ONS), may restrain consumption dynamics.

Gross fixed capital formation should pick up, assuming that uncertainty will subside, aided by government measures such as the extended business rates holiday and the reduced VAT rate for heavy-hit sectors. As of April, the three loan schemes (CBILS, CLBILS, BBLS) which lent valuable support to businesses, will be replaced by the new Recovery Loan scheme, geared towards making available loans as well as asset and invoice financing. Furthermore, investment will remain supported by favorable funding costs entailed by the Bank of England's (BOE) very accommodative monetary policy. In the near term, there remains some uncertainty especially over services trade with the EU and initial obstacles in implementing the new customs regime some businesses may be hesitant to invest. We will monitor whether such obstacles can be overcome quickly. Drawing on February data from the Decision Maker Panel, the share of companies citing Brexit as one of their top three sources of uncertainty has fallen compared to autumn 2020, but remains slightly higher than the share of companies referring to Covid-19 as one of their main sources of uncertainty. Investment growth should be fostered by the so called 'super deduction' announced with the March Budget as well, and increasingly so in 2022. The 130% capital allowance will be in full effect for two years, beginning in April 2021, and aims to incentivize businesses to bring forward investment in plants and machinery.

With economic activity resuming in the UK and elsewhere as vaccination progresses, trade dynamics should generally gain traction going forward. Amid a likely stronger increase of imports, we would expect net trade to exert a negative impact on growth in 2021/22. Against the backdrop of non-tariff barriers concerning trade with the EU, as well as the uncertainty over services trade, we caution that the UK's competitiveness may come under pressure in the near term and likely with a view to the more medium term. To be sure, zero-tariffs on merchandise trade are ensured, even concerning agricultural goods, thanks to the TCA reached with the EU on 24 December 2020 and which entered into force on 1 January 2021.

While negotiations between the two jurisdictions are ongoing, not least with regard to a memorandum of understanding on financial services, envisaged to be reached by the end of March 2021, we reckon that the UK's decision to leave the EU will entail a longer-lasting trade shock, adversely affecting the UK's medium-term growth performance. Drawing on 2019 Eurostat BOP data, services exports make up for roughly 46% of total exports, with the EU accounting for 38% of total services exports. As of now, we would be rather skeptical whether the strains emanating from Brexit on UK trade will be compensated by more favorable terms under FTAs with non-EU countries. In addition, it will take several years to work out further details regarding the FTA with the EU. Past experience shows that comprehensive agreements with the EU took between five and ten years. That said, we observe that there has been good progress regarding further trade agreements with non-EU countries. According to the Department of International Trade, trade agreements with 62 countries took effect from 1 January 2021, corresponding to 13.4% of total trade in 2019 (also see below).

Looking beyond Brexit, prospects related to investment and productivity had generally been remote before the pandemic hit. The corona crisis should result in rising unemployment and corporate insolvencies, albeit from low levels, and induce some sectoral shifts leading to more structural effects on the labor market as well as resource allocation going forward, thereby strengthening our view of a subdued medium-term outlook at this stage. Growth will also likely be constrained by the government's indicated steps towards reining in public finances further afield, as household expenditure could be dampened by the announced freeze to the income tax personal allowance and to the higher rate threshold between April 2022 and April 2026. On the other hand, business investment should be hampered by the higher corporate tax rate from 2023. Also, we believe that investment will taper off beyond 2022, due to the time-limited super deduction. The fiscal measure is likely to result in a temporal shift in investment decisions by the corporate sector, implying lower investment growth in the outer years at the expense of larger investment activity in the near term.

Further risks to business investment may be harbored by stretched corporate balance sheets. Even though the UK's NFC debt has remained at more moderate levels by European comparison more recently, we would continue to monitor developments in this respect, as a considerable share of the corporate sector, in particular SMEs, may face liquidity or solvency problems going forward, having only avoided bankruptcy by tapping one of the abovementioned schemes. By 21 February, GBP 74.05bn in loans have been approved across all loan schemes, with GBP 45.61bn or 62% of the total having been formed under the Bounce Back Loan Scheme which has been predominantly taken up by SMEs (see below).

On a more positive note, as part of the plans to spend GBP 600bn in gross public investment over the next five years, the government announced GBP 100bn of capital investment in FY 21/22 in its Spending Review 2020 last autumn, corresponding to a GBP 30bn cash increase compared to FY 19/20. Alongside the Budget, the government presented 'Build Back Better', its plan for significant investment in the three main pillars 'skills, infrastructure and innovation' over coming years to help enhance productivity growth. The latter remains a structural challenge that is shared among a number of advanced countries. Given persistent challenges concerning basic skills and technical skills in particular, the government is taking action, e.g. via the Plan for Jobs and new approved higher technical qualifications, to support employment and improve skills in order to help tackle productivity issues. Planned infrastructure investment would e.g. include green industrial projects, investment in broadband, flood defenses, roads, rail and cities, as well as various Funds to strengthen the prosperity of towns and high streets. The Union Connectivity Review, to be delivered in summer 2021 is to give guidance over improving transport connectivity across the UK in the long-term. Moreover, the government announced the establishment of a new UK Investment Bank (UKIB), which will replace some activities of the European Investment Bank (EIB) and is to have an annual budget of about GBP 1.5bn.

Institutional Structure

The UK's high-quality institutional framework constitutes a key rating driver for affirming the sovereign's credit rating, with its sound monetary policy (BOE), fiscal policy (OBR) and financial sector policy (BOE, FCA, PRA) frameworks adding to this strength. Political volatility following the referendum on EU-membership, and perceived quality of communication as well as predictability of policies since then balance this to some extent. The UK's unilateral extending of a grace period regarding some procedures for Northern Ireland may be seen as another case in point. However, we ultimately view the TCA between the UK and the EU, which remains to be ratified by the European parliament by 30 April, as a positive signal for greater political stability and the continuation of important cooperation between the two jurisdictions. Whilst public support for Scottish independence appears to have decreased recently, we generally deem this as a tail risk, attaching a very low probability to a disintegration of the UK.

Despite the very cumbersome and arduous negotiations, we view the TCA deal struck at the end of 2020 as a positive signal, reflecting flexibility and readiness to compromise, laying the ground for greater political stability and constructive cooperation going forward. The post-Brexit deal comprises three major pillars of cooperation: A free trade agreement including close cooperation on economic, social, and environmental aspects, citizens' security, and a new governance framework that establishes how the TCA will be operated and controlled.

The deal neither covers foreign policy, external security and defense cooperation, nor does it cover decisions concerning equivalence rules for financial services, the adequacy of the UK data protection regime (though including a temporary bridging mechanism), or the assessment of the UK's sanitary and phytosanitary regime for the purpose of listing it as a third country allowed to export food products to the EU. These decisions hence remain unilateral on the part of the EU, bearing the potential for controversy on various issues.

Furthermore, handling of the new EU border between Northern Ireland and the Republic of Ireland in practice might cause some tension as recently evidenced by the European Commission's (EC) move to launch another infringement procedure against the UK by sending a letter of formal notice for breaking substantive provisions of the Protocol on Ireland and Northern Ireland on 15 March. The EC was responding to the UK's unilateral extension of transitional provisions on trade with Northern Ireland in the withdrawal agreement earlier this month.

Meanwhile, we assess as positive the UK's continuing efforts to establish trade agreements with non-EU countries, with a more recent example including its formal application to join the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP). We understand that formal negotiations are to start this year. More recent trade deals with non-EU countries include a trade agreement with Turkey, signed in December 2020, which is to form the basis for a more comprising trade relationship between the two countries in the future. The UK-Japan Comprehensive Economic Partnership Agreement (CEPA) was signed on 23 October 2020.

As regards domestic issues, we would continue to follow developments concerning internal political and social cohesion, given intentions by the Scottish National Party (SNP), which according to current polls could win a majority in the upcoming Scottish parliamentary election on 6 May, to prepare for a second referendum on Scotland's independence. Having said this, the polls also suggest that the population's backing of a second referendum has faded somewhat, indicating that a majority in favor of another vote might not be obtained.

While pre-dating the recent major developments around the turn of the year, we would highlight that the latest vintage of the World Bank´s Worldwide Governance Indicators (WGIs), our preferred measure of institutional quality, buttress our view of a very sound institutional framework of the sovereign. With regard to the WGIs we assess, the sovereign compares favorably with the respective median ranks of our AA rated peers and the euro area. It seems worth mentioning that latest data points to an improvement concerning the perceived quality of government effectiveness, with the UK edging up to a relative rank 21 out of 209 economies (euro area median: 35), following a marked deterioration from 2016. When it comes to the WGIs control of corruption and rule of law, the UK is also attested a persistently high quality (ranks 14/209 and 19/209 respectively), though having slipped somewhat with regard to the latter.

Fiscal Sustainability

Due to the pandemic and the required support to cushion the fallout and assist a recovery, fiscal metrics have deteriorated substantially, pushing the public debt ratio significantly higher from an already elevated level. Although the existence of a post-Brexit agreement with the EU gives more confidence over a more stable macroeconomic context and despite a first glimpse on the Chancellor's *plans to repair public finances, we continue to view fiscal sustainability risks as the sovereign's main credit weakness. Whilst the public debt ratio is likely to edge up over the medium term, ongoing sound debt management as evidenced by a favorable debt composition and maturity profile, benign refinancing conditions, as well as ongoing commitment on necessary medium-term fiscal consolidation remain mitigating factors. Contingent liability risks stemming from the banking sector are cushioned by sound banking metrics at this stage, but have to be monitored in view of a possible deterioration of private sector balance sheets against the pandemic backdrop and the strong demand for mortgages.*

On the back of lower revenues amid restrictions to public life as well as a large rise in expenditure to bolster the health sector, protect vulnerable groups, employment and businesses, the UK's headline deficit (Maastricht Treaty aggregate) in the financial year (FY) 2020/21 looks set to soar to approx. GBP 358bn or 16.9% of 2020 GDP (quarterly national accounts data, ONS), up from a deficit of 2.8% of GDP in FY 19/20 (OBR).

The March Budget presented on 3 March 2021 includes a number of extended or additional measures, e.g. extension of the CJRS to Sep21, two further SEISS grants, business rates holidays, and the extension of the reduced VAT rate for sectors particularly hard-hit by restrictions. Moreover, the government announced a two-year temporary capital allowances 'super deduction' of 130% of investment spending on eligible plant and machinery against profits. The effect of government measures would amount to roughly GBP 59bn in FY 21-22 (total effect approx. GBP 53.5bn, OBR data), of which GBP 43.2bn would be virus-related, and the remainder deployed for economic recovery measures. As further measures or extensions may become necessary, and with the profile of the economic recovery still challenging to predict, despite the expected faster recovery as vaccination progresses, we cautiously estimate that the general government balance will see a deficit of about 10.0% in FY 21-22.

While the March Budget provides another significant fiscal stimulus (roughly 2.7% of projected GDP), we note that it also envisages reining in public finances in the medium term. Notwithstanding considerably uncertainty in the current context, we would thus positively highlight commitment to fiscal consolidation, as mirrored in the provided medium-term strategy that envisages to balance the current budget by FY 25/26. The main channels for achieving this would be the increase in the corporation tax rate, which would rise to a main rate of 25% for profits over GBP 250,000 from April 2023, and maintaining the personal allowance and higher rate threshold at FY 21/22 levels through FY 25/26.

However, we think that fiscal risks remain firmly skewed to the downside for now. Firstly, whether these policies can be delivered as planned will have to be seen. Raising the corporation tax rate without additional concessions to the corporate sector may prove challenging. By the same token, we are not overly confident regarding the feasibility of the implied spending cuts amounting to roughly GBP 4bn per year. Secondly, we see spending pressure as mounting against the backdrop of the pandemic, since the costs incurred by the various departments will not fall, in particular regarding unprotected services other than health or defense. Thirdly and interrelated, we are not aware of Covid-19 related spending plans beyond the commencing fiscal year. We believe that public services will still be in need of additional funding in the time beyond the most acute phase, essentially in the health and education realm. Fourthly, the macroeconomic context for the proposed medium-term fiscal outlook is highly uncertain, i.e. the fiscal forecast may turn out to rest on shaky assumptions, entailing significant top-ups if economic recovery is slower than expected. Finally, acknowledging the burden of particularly high uncertainty at this juncture, we are aware that a follow-up on the fiscal mandate that expires this month and other fiscal targets in the existing Charter has not yet been decided.

Against the backdrop of the skyrocketing headline deficit and collapsing GDP, public debt should leap to about 107.6% of GDP in FY 20/21 (Maastricht debt), from 84.4% in FY 19/20, thus reversing a moderate downward movement over the last few years. For the upcoming financial year (21/22), we would expect the ratio to tick up to approx. 109% of GDP, and further drift upwards before beginning to stabilize over the medium-term, contingent on the fiscal measures envisaged by the government. Although subject to substantial uncertainty for the reasons mentioned above, we would expect the public debt ratio to remain above the level of 110% of GDP in the medium term.

We observe that interest rate payments measured against revenue, at 5.2% in Q3-20 (Eurostat data, Q3-19: 5.8%), remained somewhat elevated as compared to EU member states and higher than those of our AA-rated sovereigns. Moreover, the higher stock of debt entails higher vulnerability to increasing interest rates. The OBR gauges that a rise of interest rates by one percentage point could lift the debt interest burden by about GBP 20.8bn in FY 25-26. This being said, we expect the BoE's monetary policy to further contribute to benign refinancing conditions, making debt increasingly affordable. The Monetary Policy Committee (MPC) signaled continued accommodative monetary policy at its meeting in February and voted unanimously to maintain the Bank Rate at 0.1%, to maintain the stock of sterling non-financial investment-grade corporate bond purchases at GBP 20bn and to continue its UK government bond purchase program, with the target for the stock of government bonds remaining at GBP 875bn. Moreover, while not intending to signal lowering the Bank Rate into negative territory, the MPC suggested that the Prudential Regulation Authority (PRA) should engage with PRA-regulated firms over starting preparations that would enable implementation of a negative Bank Rate at any point from August 2021.

Sustained debt affordability, along with the sovereign's sound and transparent debt management – to which the very favorable debt maturity profile and debt composition pay testament – can be regarded as risk mitigating factors. The Ways and Means facility provided by the Bank of England may serve as a backstop. The average maturity of the total stock of UK government bonds was 15.3 years as of Dec-20 (DMO). We also expect sterling's status as reserve currency to remain unscathed by recent political/institutional changes, thus continuing to generate ample demand for gilts. In addition, we recall that almost a third of government bonds is held by the Bank of England (30.5% as of end-Sep-20, HM Treasury), although the latter does come with a downside. Via the Asset Purchase Facility, the average maturity of public sector (net) debt has been shortened, which increases the sensitivity of debt interest payments to changes in short-term interest rates.

In light of contingent risks relating to the relatively large banking sector, displaying total assets of 384.4% of GDP as of Dec-20 (BoE data), we assess as positive that the NPL ratio has so far remained stable at its rather low level (Sep-20: 1.3%, EU incl. UK: 2.8%, EBA data). In addition, a CET 1 ratio of 15.8% (Sep-20, EU incl. UK: 15.4%) hints at sizeable buffers, and profitability held up relatively well as of Sep-20 (RoA 0.2%, EU incl. UK: 0.2%). We would reiterate that, based on a reverse stress test conducted in August, major UK banks hold sufficient buffers to show resilience to a wide array of adverse scenarios for the UK economy. Against this backdrop, potential negative knock-on effects on banks' balance sheets, due to struggles in parts of the private sector if government support phases out, seem by and large manageable. We gather that an updated solvency test is due in 2021, based on end-2020 balance sheets and subject to a scenario similar to the one created for the reverse stress test, with results to be published possibly in June. Furthermore, the Financial Policy Committee (FPC) gave updated guidance pertaining to countercyclical capital buffer, with increases not to be expected before Q4-22.

Private households find themselves confronted with a debt level reaching 128.7% of their disposable income (Q3-20; Q3-19: 127.4%, ONS) and may face difficulties servicing their debt if unemployment continues to rise. While (secured) lending to individuals eased to 3.1% y-o-y in Dec-20 (from 3.8% y-o-y in Dec-19, BoE), with the annual rate of change in mortgage lending in positive territory, we would continue to watch house price dynamics, which have risen markedly over 2020, judging by the House Price Index of HM Land Registry. According to this indicator, house prices exceeded their level of the preceding year by 8.5% in Dec-20 (Dec-19: 0.9%), corresponding to the strongest increase since Oct-14. We note that other indicators signal a tamer expansion (OECD: 1.5% y-o-y, Q3-20). With regard to the extension of the temporary cut in Stamp Duty Land Tax (England, Northern Ireland) and a new mortgage guarantee scheme, house prices may continue to go up.

In terms of lending to NFCs, we note that the SME loan volume has risen strongly by 25.2% y-o-y in Dec-20 (Dec-19: 1.0%), hinting at possibly rising insolvencies once support to these companies is withdrawn. We gather that most of the funds raised by companies via banks and the financial market since March 2020 came on the back of government guaranteed loan schemes, with SMEs borrowing the most. Having said that, NFC debt overall remains comparatively moderate (78.1% of GDP, Q3-20, ONS).

We would still flag somewhat higher vigilance over potential risks to financial stability beyond the banking sector, with pockets of vulnerability regarding market-based finance clearly illustrated by the 'dash for cash' episode in March 2020. Work to enhance resilience of the non-bank financial system appears to be ongoing; the FPC intends to publish an update on this in the first half of this year. While the FPC mentioned GBP 16tn of uncleared derivative contracts between the EU and UK, of which GBP 13tn was due to mature after 31 December 2020, actions have been taken to ensure that lifecycle events can be performed on such contracts.

Foreign Exposure

While risks pertaining to the external position seem overall manageable, we continue to flag some vulnerabilities as regards the UK's position as an international financial hub, amid pending longer-term agreements on services trade and in particular on financial services between the UK and the EU. Generally, we believe that risks pertaining to volatile capital flows are mitigated by the solid financial supervision framework and robust financial soundness metrics.

Given the UK's position as a large international financial hub, we continue to expect a phase of higher volatility as regards portfolio investment and direct investment, as long as service trade agreements with the EU are a work in progress, and as currently the case, mainly based on equivalence rules with regard to financial services. Agreements with third countries may have to be fleshed out in detail as well. The country's negative NIIP, which in 2019 became somewhat larger, amounting to -28.7% of GDP, narrowed slightly to -24.5% of GDP in Q3-20 (ONS data), mainly on account of a less negative portfolio investment position, as UK residents benefitted from positive valuation effects.

In view of the large current account deficit (in absolute terms) that needs to be refinanced, sensitivity to investor sentiment remains pronounced, and longer-term effects on foreign direct investment from Brexit seem unclear at this stage. As a share of GDP, the UK's current account deficit narrowed to -2.1% of GDP in Q3-20 (four-quarter-moving-sum, ONS data), from -3.1% of GDP in Q4-19. Slumping domestic demand contributed to a smaller deficit in goods trade as well as to a higher surplus in services trade, the effects of which offset a widening deficit in the primary income balance. Looking ahead, we would assume these developments to reverse over the course of 2021, leading to some widening of the current account deficit.

Rating Outlook and Sensitivity

Our rating outlook on the United Kingdom is negative. Downside risks pertaining to fiscal sustainability persist in an environment still subject to macroeconomic uncertainty regarding the pandemic and, further out, relating to medium-term growth prospects in a context of yet uncertain scarring effects brought by Covid-19 and of new trade relationships with the EU and third countries, which may not be without some political challenges.

We could consider a downgrade of the UK's credit ratings if the macroeconomic recovery falls short of our expectations, and key fiscal metrics fail to stabilize in the medium term, despite commitment to consolidating public finances. Repeated controversy over watering down issues as laid out in the Withdrawal Agreement might have a bearing on considerations over downgrades as well, as this could affect our perception of the otherwise very strong institutional quality. The impression of possibly increasing domestic political challenges with regard to Scotland and/or the Irish border could have a similar effect.

Conversely, upward pressure on the ratings or the outlook could arise, if fiscal metrics start improve on a sustainable basis amid a credible path to reining in public finances, and economic growth evolves in line with our baseline scenario or even more robust that currently envisaged. Successful implementation of agreed trade deals would seem beneficial to such a scenario, as would enhanced productivity growth amid targeted investment in upskilling and infrastructure which is among the priorities in terms of tackling structural challenges going forward.

Analysts

Primary Analyst
Fabienne Riefer
Sovereign Credit Analyst
f.riefer@creditreform-rating.de
+49 2131 109 1462

Chairperson
Dr Benjamin Mohr
Head of Sovereign Ratings
b.mohr@creditreform-rating.de
+49 2131 109 5172

Ratings*

Long-term sovereign rating	AA /negative
Foreign currency senior unsecured long-term debt	AA /negative
Local currency senior unsecured long-term debt	AA /negative

*) Unsolicited

Economic Data

[in %, otherwise noted]	2015	2016	2017	2018	2019	2020e	2021e
Real GDP growth	2.4	1.7	1.7	1.3	1.4	-9.9	5.0
GDP per capita (PPP, USD)	42,522	44,138	45,988	47,439	48,727	44,288	47,693
HICP inflation rate, y-o-y change	0.0	0.7	2.7	2.5	1.8	0.9	1.5
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	81.0	81.2	81.3	81.3	n.a.	n.a.	n.a.
Fiscal balance/GDP	-4.3	-2.7	-2.7	-1.9	-2.8	-17.1	-10.0
Current account balance/GDP	-5.0	-5.4	-3.8	-3.7	-3.1	n.a.	n.a.
External debt/GDP	288.9	308.7	312.6	312.9	303.8	n.a.	n.a.

Source: International Monetary Fund, Eurostat, ONS, OBR, own estimates

*) Treaty deficit, financial years, i.e. calendar year 2015 ⇔ FY15/16, etc.

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In what follows, we explain how and to which degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

ESG Factor Box

Environ-mental Quality	Ecological Risks	Ressource Management	Education	Health	Demo-graphic
Labor	Equality	Technology & Infrastructure	**Safety & Security**	**Judicial system**	**Quality of Public Services**
Integrity of Public Officials	Quality and Efficacy of Regulations	**Civil Liber-ties/ Political Participation**	Market Access	**Business Environ-ment**	Data Transparency

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank's Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating's assessment of the sovereign's institutional set-up, which we regard as a key rating driver, we consider the ESG factors 'Judicial System and Property Rights', 'Quality of Public Services and Policies', 'Civil Liberties and Political Participation', and 'Integrity of Public Officials' as highly significant to the credit rating.

Since indicators relating to the competitive stance of the sovereign such as the World Bank's Ease of Doing Business index and the World Economic Forum's Global Competitiveness Indicator add further input to our rating or adjustments thereof, we judge the ESG factor 'Business Environment' as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Labor market metrics constitute crucial goalposts in Creditreform Rating's considerations on macroeconomic performance of the sovereign, and we regard the ESG factor 'Labor' as significant to the credit rating or adjustments thereof. What is more, risks pertaining to social cohesion with a view to the Irish border and the Scottish independence movement touch upon the social dimension in our ESG framework as well. This is reflected, among other things, by the WGI "Political Stability", and would ultimately affect institutional performance. Therefore, the ESG factor 'Safety and Security' is of importance.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	02.06.2017	AA /stable
Monitoring	30.03.2018	AA /stable
Monitoring	29.03.2019	AA /stable
Monitoring	27.03.2020	AA /negative
Monitoring	25.09.2020	AA /negative
Monitoring	19.03.2021	AA /negative

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The HM Treasury participated in the credit rating process as it commented on a draft version of the rating report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of HM Treasury during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's "Sovereign Ratings" methodology (v1.2, July 2016) in conjunction with its basic document "Rating Criteria and Definitions" (v1.3, January 2018). CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on our website.

To prepare this credit rating, CRAG used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World

Economic Forum, European Centre for Disease Prevention and Control, Blavatnik School of Government, Bank of England, HM Treasury, Debt Management Office, Office for Budget Responsibility (OBR), Office for National Statistics (ONS), UK Government – Department of International Trade, National Institute of Economic and Social Research (NIESR).

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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Creditreform Rating AG

Creditreform Rating AG
Europadamm 2-6
D - 41460 Neuss

Phone +49 (0) 2131 / 109-626
Fax +49 (0) 2131 / 109-627
E-Mail info@creditreform-rating.de
Internet www.creditreform-rating.de

CEO: Dr. Michael Munsch
Chairman of the Board: Dr. Hartmut Bechtold
HRB 10522, Amtsgericht Neuss