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Rating Action

Neuss, 27 March 2020

Creditreform Rating has revised the outlook on the United Kingdom to "negative" from "stable" and affirmed the unsolicited long-term sovereign rating of "AA" for the United Kingdom. Creditreform Rating has also affirmed the United Kingdom's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "AA".

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Key Rating Drivers

1. Very large-sized and wealthy economy boasting a strong and innovative business environment as well as a dynamic labor market; low productivity represents an ongoing challenge, restraining the medium-term growth outlook along with weak private investment and a high household debt level
2. Near-term outlook seriously dampened by the Covid-19 fallout, with possibly disruptive effects on domestic demand and production; while our baseline scenario assumes a more or less U-shaped pattern of economic development, the forecast is materially clouded by uncertainty and heavily dependent on the success of containing the pandemic; short-to-medium-term growth perspectives additionally subject to risks owing to the need to establish new economic and finance relations following the exit from the European Union
3. Very high quality of institutional framework somewhat balanced by recent prolonged period of heightened political volatility which has tended to jeopardize policy predictability; while risk of a 'hard Brexit' is not entirely erased, we assume that the UK will request an extension of the transition period
4. With fiscal metrics still underperforming, fiscal sustainability risks continue to represent the sovereign's main credit weakness; elevated public debt ratio to rise a consequence of necessary countermeasures to the corona crisis, as well as of fiscal stimulus aimed at tackling structural shortcomings – and not expected to decline significantly; sound debt management and benign debt profile expected to remain a mitigating factor

5. Continued high current account deficit poses risks of sudden reversal of capital flows, which is somewhat balanced by large external assets and currency composition of liabilities

Reasons for the Rating Decision

Creditreform Rating has affirmed the United Kingdom's AA ratings, indicating a continued very high creditworthiness, and overall mirroring a very strong underlying macro-institutional setting, underperforming fiscal metrics and generally robust external finances.

The outlook on the United Kingdom was lowered to negative in light of our expectation that (i) the UK will see a significant deterioration in its public finances, reflected by an increase in the debt-to-GDP ratio from an already elevated debt level in the short term and no significant decline thereafter; (ii) political uncertainty will remain heightened given the need to negotiate new arrangements with the EU and third parties, potentially further undermining broad policy predictability, increasing macro-financial volatility and causing supply chain disruptions, and/or having detrimental effects on potential growth via anemic business investment.

Macroeconomic Performance

A strong macroeconomic performance, buttressed by the large size of the economy, a high level of wealth, as well as a competitive business environment and tight labor market generally continue to underpin our credit assessment of the United Kingdom. This assessment is somewhat balanced by an uncertain outlook for the economy in the short-to-medium-term, not only owing to the corona virus outbreak, but also to the UK's negotiations with the EU over a trade arrangement from January 2021 which are to follow a very ambitious schedule over the remainder of this year. What impact the corona crisis will have on the envisaged schedule is unclear at the time of writing. If negotiations were to be terminated prematurely – a risk that we cannot rule out entirely but consider rather unlikely under the extraordinary circumstances – trade frictions could occur beyond assumed temporary ones caused by corona, potentially disrupting supply chains. Adding to this uncertainty is the fact that the UK will have to agree separate trade deals with major third parties, too, with no guaranteed success in the short term. Persistently elevated private sector debt continues to represent another factor balancing the otherwise strong assessment with regard to the macroeconomic picture.

The UK's real GDP growth has slowed down from a cycle high of 2.6% in 2014 to 1.4% in 2019 (2018: 1.3%), according to preliminary data from the Office for National Statistics (ONS). Brexit-related uncertainty has been weighing in particular on domestic demand over the last two years. Latest available quarterly data point to a further decrease in annual growth to 1.1% in Q3-19 and to 1.0% in Q4-19. Total output thus broadly stagnated in the fourth quarter compared to Q3, with government and private consumption as well as net trade contributing positively, according to ONS.

The expansion of private consumption, which had reached a peak of 3.6% in 2016, decelerated further to 1.3% last year (2018: 1.6%) despite increasing real wage growth and expansionary fiscal policy, but against the backdrop of the uncertain political course of the country in relation to the EU. Households' saving rate remained relatively stable, although limited increases in Q4-18 and Q2-19 seem to point to more cautious behavior in the context of several assumed dates on which the country was to exit the EU before ultimately leaving in January 2020. In light of a tight labor market and resulting upward pressure on wages, nominal wage growth is at its highest level since the financial crisis, with average regular weekly earnings rising by 3.2% in December 2019 compared to December 2018. In real terms, weekly earnings increased by 1.9%, reflecting relatively moderate inflation. Under normal circumstances all this should have provided for a more vivid expansion of household spending.

Above all, political uncertainty has had a bearing on gross fixed capital formation (GFCF) since the UK's decision to leave the EU. In 2019, investment seemed to stabilize (0.4%) after falling slightly in 2018 (-0.2%). Significantly dragged down by domestic political turmoil and unclear prospects as to whether the UK would leave the EU in an orderly way, i.e. on the basis of an agreement, businesses' willingness to invest was subdued over much of 2019, despite ongoing favorable financing conditions. In Q4-19, investment activity declined by 0.9% against Q4-18, although mainly driven by falling private sector investment in dwellings, which saw a decrease to 2.5%, amid a cooling housing market. Business investment, which accounts for over 50% of GFCF, was up 0.9% by comparison, notwithstanding a decline of 1.0% against Q3-19.

With an increase in exports by 3.7% and import growth of 3.6%, net trade seems to have had a broadly neutral effect on GDP growth in 2019. However, in the course of 2019, trade data was volatile, and according to ONS, the trade surplus recorded for Q4-19, at 1.1% of GDP, was driven by precious metals. Excluding this position, the UK would have seen a trade deficit to the tune of 1.2% of GDP in Q4. Sterling has been on a relatively steep rollercoaster over 2019, depreciating by August to its lowest level against the euro since the financial crisis amid Brexit uncertainty and appreciating thereafter as it transpired that the UK would be heading for an agreement-based exit from the EU after all. As per December 2019, the currency (effective exchange rate) appreciated by about 5% versus other currencies compared to December 2018, still weaker than in the pre-referendum phase. Overall, it remains the case that the depreciation since the 2016 decision to leave the EU has done little to boost the UK's total exports, as evidenced by a decline of the export market share since 2016 (2018: 3.52%).

While the UK left the EU on 31 January 2020, the initially envisaged departure date on 29 March 2019 and, although to a lesser extent, a postponed date on 31 October 2019 added to quarterly GDP volatility, since it appears that stockpiling boosted growth performance ahead of the respective assumed exit date, with a partial reversal thereafter.

Looking ahead, while the effects of Covid-19 seriously dampen our short-term outlook, it is not yet possible to say how deep the near-term impact of the corona virus will be from the current perspective. This will depend on the full range of measures eventually taken to

combat the virus, and ultimately the duration of the shock contingent on the development of effective medicines.

While infected or sick employees will certainly not contribute to an economy's gross value added, the economic impact of public and private containment measures, e.g. closed schools/childcare facilities and factories, travel restrictions, and quarantines, is difficult to gauge.

In a coordinated response with the Bank of England (BoE), the UK government announced support measures unprecedented in scope to cushion the impact from the supply and demand shock caused to the economy by the spread of the virus. Measures which initially (11 March) featured an emergency response fund for the National Health Service (NHS) and other public services (GBP 5bn), along with support to businesses, self-employed and vulnerable people (GBP 7bn), were topped up and complemented in quick succession with further direct and indirect support, including deferring tax payments, loans and guarantees. Mentioned in this context was, among other things, an initial GBP 330bn or 15% of GDP government-backed loan scheme. Employers will be able to receive grants to cover 80% of the wages (up to a total of GBP 2,500 a month) of people who are not working but are furloughed and kept on payroll. Further support will be added as deemed necessary.

BoE lowered the monetary policy rate by a total of 65 basis points to 0.10% and decided to increase its holdings of UK government bonds and sterling non-financial investment-grade corporate bonds by GBP 200bn, mainly through timely purchases of government bonds, to GBP 645bn. Furthermore, BoE introduced a Term Funding Scheme for SMEs to ensure transmission of the rate reduction to the real economy. The Bank also decided to enhance liquidity provision by activating a facility enabling participants to borrow central bank reserves in exchange for less liquid assets to help alleviate observed frictions in the money market. In addition, the Financial Policy Committee reduced the counter-cyclical buffer rate of banks' exposures to UK borrowers from 1% to 0% to support banks' lending ability. Further supporting measures by the BoE, to our understanding, include cancellation of the 2020 bank stress test in order to ensure that lenders can focus on meeting their clients' needs, to adapt accounting standards so as to enable a pragmatic approach in view of difficulties to make forecasts at the current stage, and to adjust regulatory and prudential requirements to alleviate the operational burden on all parties involved.

At present, a sharp decline in the first half of the year now appears almost inevitable. The course of the economy in H2-20 hinges on whether the restrictions continue or are eased or lifted towards the summer. The pandemic is set to curb external demand and final demand for imported goods and services. Production is hit by direct supply disruptions and subsequent supply-chain contagion via Asia and other key industrial economies such as Germany, Italy, and the US. Moreover, it may be reasonable to assume disruptions to domestic demand, driven by a fall in aggregate demand as well as by postponed corporate investment decisions and purchase delays by consumers.

Our baseline scenario assumes a more or less U-shaped pattern of economic development. Still, the forecast is materially clouded by uncertainty and heavily dependent on the success of containing the pandemic.

Before the latter struck, conditions seemed to be in place for private consumption to be a main pillar of growth in 2020. Amid wage increases on the back of continued tightness in the labor market, moderate inflation rates, and a more expansionary fiscal stance, including a 6.2% increase of the National Living Wage to GBP 8.72 per hour from April as well as tax cuts (increased primary threshold), household expenditure should have continued to benefit. Consumer confidence, according to the GfK indicator, had risen this February to its highest level since August 2018, improving for the third month in a row. Notwithstanding some hoarding purchases, private consumption now looks likely to experience a dent, as people are advised to stay at home and many shops and restaurants are closed. As described above, if these conditions are eventually lifted, there should be a rebound later this year.

Business surveys had brightened up at the beginning of the year, with the manufacturing PMI pointing to rising activity for the first time in ten months in February and the PMI for the service sector remaining in expansionary territory for the second consecutive month. However, we think a rebound of business investment is unlikely given the unclear prospects regarding the future relationship between the EU and the UK as well as regarding pending trade deals with third parties, not to mention the economic fallout caused by the novel corona virus. Government expenditure, on the other hand, should add favorably to economic output in 2020, on the back of combined emergency measures to support the economy against Covid-19 and planned fiscal loosening. Net trade appears set to exert a negative effect on GDP growth in 2020. Initially, we expected only subdued or even negative export growth in a difficult global trading environment and higher import growth in the light of growing private and public consumption. This view has now come under scrutiny, as both imports and exports should see declines, with the latter presumably seeing a more pronounced decrease. Both the short-term and the medium-term growth outlook are subject to high uncertainty at this stage, and while it seems somewhat premature to come up with a forecast as regards the magnitude of this economic shock, we would tentatively put a tag of about -1.0% to real GDP growth in 2020, followed by a rebound in 2021.

Irrespective of the abovementioned sizeable risks, and in light of the UK economy's size as well as of the strong business environment combined with the presence of a well-educated workforce, we remain of the view that its economy is generally equipped to show a good degree of resilience to shocks. According to IMF estimates, the UK is the sixth-largest economy in the world (USD 2.74tr, 2019) and has an estimated per-capita GDP of about USD 46,827 (PPP terms, 2019). Compared to other countries in our AA-rated universe, this leaves the UK roughly on par with Finland and France, while there remains a noticeable gap to Belgium and Austria.

The country's high level of competitiveness and its business-friendly conditions are confirmed by the World Bank's latest Ease of Doing Business Report, in which the UK is ranked 8th (out of 190 economies), although slipping from rank 7. Among the remaining EU countries, only Denmark can boast a higher rank. To name a few examples, the World Bank's report underscores the UK's strength when it comes to starting a business (rank 18) as well as insolvency procedures (14th), and also with regard to the ease of getting building permits (23rd).

The World Economic Forum's (WEF) latest edition of the Global Competitiveness Index (GCI) underscores the UK's status as a very competitive economy, although the country has slipped one rank to 9th position out of 141 (8 out of 140 previously). Within the former EU-28, the Netherlands, Germany and Sweden are ranked higher. It is worth mentioning that the UK features among the top ten in 6 out of 12 pillars considered for the GCI, among them the financial system, innovation capability, and business dynamism, once more highlighting long-standing strengths of the country.

Being a largely service-oriented economy, the gap to the remaining EU-27, as far as the industry's share in gross-value-added is concerned, remains striking. While the UK's industry (excluding construction) accounted for 13.3% of total GVA in Q3-19, the EU-27's was at 19.7% (Eurostat). The gap is even larger when considering the manufacturing sector alone, where in the UK the contribution to total GVA only amounted to 9.6%, versus 16.7% in the EU-27. Given the current challenges arising from tensions over trade practices, one might argue that a lower exposure to goods manufacturing may shield the UK to some extent from the negative effects that other countries are experiencing. At the same time, business services, ICT and financial services accounted for 13.3%, 7.4% and 6.6% of total GVA in the UK in Q3-19, thus comparing favorably with the EU-27 (11.3%, 4.9% and 4.4%).

The UK's labor market has continued to show strength recently, as mirrored in a persistently low unemployment rate which was stable at 3.8% in the first three quarters of 2019, the lowest rate for decades and considerably below the rate in the remaining EU-27 economies (Q3-19: 6.7%). Annual employment growth turned out to be at a still relatively strong 1.0% in Q3-19. Furthermore, we observe that the labor participation rate reached a record of 78.1% (Eurostat), well above the EU-27 average of 73.4%. Supply constraints on the labor market seem possible at this stage, if not counteracted by net migration, both of which, however, might drive wage increases further. Compared to the pre-referendum phase, when net migration exceeded an annual rate of 300,000 persons, the number has come down to 241,000 in the year to September 2019, with net migration from the EU declining to 64,000 whilst net migration from non-EU countries increased to 250,000. The intended new point-based immigration regime presented by the UK government in February, which is to start from January 2021, will align treatment of EU and non-EU migrants and aims at attracting highly skilled workers to enhance productivity, while reducing overall migration numbers.

In view of already tight labor market conditions, raising labor productivity seems essential, for GDP growth appears to have been driven by rising employment lately, rather than by increases in productivity. Labor productivity in the UK has remained below that of most other developed countries, and it is also hardly higher than before the financial crisis. Labor market duality, a lower industry share in the economy, an increase of zero-hour contracts in most UK regions, and the wider spread of platform work seem to have contributed to low productivity. We also note that the share of under-employed part-time workers, referring to those in part-time employment who wish to work more, remained above the remaining EU-27 average as per Q3-19 (4.2 vs. 3.0%), which seems to suggest mismatches.

What is more, the UK economy has been suffering from decades of under-investment, with a low level of investment in equipment, infrastructure and R&D as well as existing skills

gaps (basic and technical skills) contributing to this. Private investment accounted for 14.1% of GDP in 2019, compared to an investment-to-GDP ratio of 18.7% in the remaining EU-27 (AMECO data). This gap has been widening over the last few years, the UK's share declining against the backdrop of Brexit, whereas in the EU-27 the ratio has risen. Public GFCF (in % of GDP) stayed below the level seen in most other AA-rated sovereigns in our rating universe.

With the March 2020 Budget the government announced a large fiscal stimulus, among other things with the purpose of boosting investment in infrastructure. Against the backdrop of about GBP 640bn of gross capital investment intended to be directed towards transport, communication, education and energy infrastructure by 2024-25, we assess positively the government's commitment to tackling existing deficiencies in this regard. We understand that a National Infrastructure Strategy that will give more detail on this will be published further out, after having been postponed.

As for negotiations on free trade agreements with third countries, the government published negotiation objectives with the United States on 02 March. While talks were expected to begin shortly thereafter, current global health concerns and related precautions may cause serious delays. This may also apply to intended talks with Australia, Japan and New Zealand, for which the UK government aims to set out negotiating objectives in due course. Moreover, we understand that mutual recognition agreements have been signed with Australia, New Zealand and the US, and are expected to take effect from January 2021. In addition, we are aware of the expressed ambition of having 80% of total UK external trade covered by FTAs by 2022. Trade agreements already signed with third countries, including Switzerland and expected to take effect from 2021, would affect a trade volume of about 8% of the UK's combined exports and imports in 2018 (UK Department of Int. Trade). Progress will thus have to be monitored in this respect.

Institutional Structure

The UK's very strong institutional set-up, including a sound monetary policy framework, continues to constitute an important pillar of our assessment of the sovereign's creditworthiness. The assessment is somewhat balanced by heightened political volatility in the aftermath of the referendum on EU membership in 2016, due to significant domestic controversy over the exit from the EU, which has also led to two snap elections since the decision to leave the EU. However, given that the Conservative party won a majority of 80 seats in the December 2019 snap election, ultimately enabling the country to execute the exit from the EU on the basis of an agreement at the end of January, there is reason to believe that at least domestic policymaking and implementation should be facilitated and become more predictable again. However, given the current extraordinary circumstances, UK public perception of how the Covid-19 crisis is being handled seems worth following as regards domestic political consensus. It may also serve as a guide to the quality of communication and political predictability in a wider sense.

The turbulent political developments since the referendum have partly left their mark in our preferred measure of the institutional set-up, the World Bank's Worldwide Governance Indicators (WGIs). A particularly striking case in point is the WGI political stability, on which

the UK fell from rank 86 to 110 in the 2019 edition, its lowest rank on record. The WGI pertaining to government effectiveness also experienced a pronounced slide in the ranking since 2015 and the sovereign currently occupies the 26th position out of 209 economies, down from rank 20. Nevertheless, the UK still compares well with other countries of our AA-rated universe in this regard – outperformed only by France (rank 18). The positive comparison also holds with regard to other perception-based WGIs we consider, such as voice and accountability (rank 14), and rule of law (rank 18).

As mentioned further above, we would raise some concern over the uncertain outlook on the country's trading relations not only with the EU but also with third countries beyond 2020. Not only in the face of the immensely disruptive corona crisis the schedule for the negotiations with the EU – which are to be finished by the end of the year with an extension of the transition period ruled out by law – appears very ambitious. To our knowledge, what would become of services trade if the UK were to fall back to trade based on WTO rules with respect to goods remains very vague. We thus consider the current strategy as a rather risky one that might lead to a 'hard Brexit' after all, with detrimental consequences to the UK economy in particular, but also to the economies of close trading partners. Although postponing the end date of the transition period has been ruled out, we would concur with the view that ultimately an extension of the transition period - or actions to the same effect - is becoming more likely given the current adverse circumstances. Moreover, walking out on negotiations with the EU may shed a rather bad light on the UK as a reliable negotiating partner.

An additional risk in terms of political stability that we are aware of in this context is the Scottish leadership's expressed opposition towards Brexit and the suggestion that the possibility of another Scottish referendum on independence after 2014 will be explored. While arguably not acute at this point in time and certainly cast aside by the need to tackle Covid-19, we will monitor developments very closely in this regard, as well as potential tensions over how the new EU border between Northern Ireland and the Republic of Ireland will be handled in practice.

Fiscal Sustainability

In our view, fiscal sustainability risks continue to represent the sovereign's main credit weakness, with general government gross debt and its interest-to-revenue ratio remaining elevated.

There is little doubt that the measures to tackle the corona crisis will put a strain on the UK's public finances. Other than that, while Brexit results in the benefit of contributions no longer paid from 2021, which to our understanding amounts to about GBP 42.3bn (including customs duties retained) over the parliamentary term (HM Treasury data), we continue to think that having to establish new structures and know-how previously shared by or fully provided by the EU could pose challenges to budget consolidation.

Over the last ten years, public finances have improved considerably, with the budget deficit (Maastricht definition) falling from a peak of 10.0% of GDP in the aftermath of the global financial crisis (financial year 09/10) to 1.8% of GDP in FY18/19, mainly thanks to reined-in

spending. The government's total managed expenditure-to-GDP ratio fell by 7.0 p.p. to 39.3% in that period. In the current financial year (FY19/20), the deficit should have reversed and risen to about 2.2%, with receipts expected to rise by 3.3% year-on-year, after 4.4% in the previous financial year (OBR data). Income tax receipts (pay-as-you-earn and self-assessed) should climb by 1.3% (FY18/19: 6.4%), while national insurance contributions are forecast to grow by 5.9%. VAT is estimated to post a relatively tame increase of 2.6%, whereas corporation tax (onsshore) may record a decline of 1.4%, both positions thus mirroring moderating economic developments. Central government debt interest, which declined in FY18/19, is forecast to rise by 2.0% in FY19/20, leaving it essentially stable at about 1.7% of GDP. As for the spending side, total managed expenditure is expected to increase by 4.2% (total public sector current expenditure: 3.9%), marking the highest increase in spending since the global financial crisis and to a great extent reflecting higher spending on Brexit preparations.

With a view to the financial year 2020/2021 starting from April, the headline deficit is set to come in significantly higher than the currently expected GBP 54.8bn or 2.5% of GDP (OBR estimate), which does not consider the support measures to counter the corona crisis. Authorities' initial emergency envelope of GBP 12bn (11 March) in response to the pandemic was quickly topped up, among other things with guarantees and loans to the tune of GBP 330bn that would amount to about 15% of GDP. To what extent guarantees will ultimately be called on is hardly predictable. The emergency measures will only be reflected in the Autumn Budget 2020. At this stage, an estimate for the deficit in FY20/21 might be something closer to 4.5% of GDP. However, this does not include drawn guarantees, so risks to the estimate are clearly tilted to the downside.

Apart from ad-hoc corona measures, the Budget presented on 11 March focuses on a substantial fiscal stimulus. Noteworthy seems also that the planned CIT cut from 19% to 17% has been omitted. Taken together, the respective policy decisions should cost about GBP 17.9bn in FY20/21. Total managed expenditure is forecast to amount to about GBP 928bn, which would represent an increase of roughly 4.6% compared with the previous financial year. Looking at the departmental budgets, health & social care as well as education saw their resource budgets markedly ramped up by GBP 6.5bn and 4bn respectively, while in particular housing and transport saw capital budgets increased by GBP 4.7 and 3bn respectively. The NHS also remains a priority over the parliamentary term, as compared to FY18/19, receiving a cash increase of GBP 34bn per year by 2024. In addition to this, the Budget commits over GBP 6bn of new funding over the parliamentary term.

Existing budgetary rules, including public sector net investment not exceeding 3% of GDP and the debt-to-interest ratio remaining below 6%, are anticipated to be met, although this will be revisited later in the year. Furthermore, we understand that the Comprehensive Spending Review 2020, launched with the Budget, which will give detailed spending plans for public services and investment, as well as cover resource and capital budgets for the coming years, is to conclude in July.

Against the backdrop of a potentially steep, albeit presumably temporary fall in growth, increased spending, and loss of revenues, government debt should not only remain ele-

vated, but looks set to soar in the short term. After reaching a peak of 85.7% of GDP (Maas-tricht definition) in the FY14/15, general government gross debt to GDP declined to 84.1% in FY18/19 and is expected to decline further to 83.2% in the present concluding financial year. A further decrease to 82.9% in FY20/21, as is forecast in the Budget, is now highly unlikely in the face of the support packages provided to counter the corona pandemic. While difficult to gauge at the current juncture, we would tentatively envisage the debt ratio rising closer towards 90% of GDP in FY20/21 and remain more or less stable thereafter.

Debt affordability measures could thus remain less beneficial compared to AA-rated peers in our rating universe. In the year to Q3-19, the debt-to-revenue ratio stood at 215.9% and the interest-to-revenue ratio at 5.9% (Eurostat), representing a decrease on both counts compared to a year earlier, but still at levels above those of countries such as Austria or Belgium. However, the sovereign's sound debt management and favorable debt maturity profile (average weighted maturity at 15.2 years as per Dec-19) should continue to act as mitigating factors to risks associated with an elevated debt ratio, as should an ongoing accommodative stance of global monetary policy contributing to keeping bond yields at low levels.

The yield on 10-year UK government bonds continued its general downward trend over the last twelve months, although having briefly reversed amidst heightened uncertainty over the course of Brexit between September and the December 2019 snap election. After the resulting majority for the Conservative party, yields resumed their decline, reinforced by the deteriorating outlook for the global economy in the light of the corona virus outbreak. As per 20 March 2020, the 10-year bond yield was at 0.56%, after reaching an all-time low at 0.16% on 09 March.

Concerning developments in the banking sector, we observe that MFI assets increased to 457.4% of GDP as of Q3-19 (ECB data), constituting a notable contingent liability given the large size. Having said this, banks appear relatively well-capitalized, with the CET-1 ratio broadly stable at 15.1% in Q3-19, although standing below the EU-28 median (16.6%). What is more, the ratio of non-performing loans (Q3-19: 1.3%, EBA) is very low compared to remaining EU countries, adding to the overall impression of a by and large sound banking sector.

While the BoE's latest stress test from December 2019 confirmed that the system was in good shape and resilient to deep UK and global recessions, the actual magnitude of the economic shock caused by the corona virus and subsequent defaults may turn out to be severe. However, BoE points out that the stress scenario is based on a prolonged global and UK downturn, whereas there is reason to believe that current disruptions, although rather sharp and broad-based, should be transitory. We would cautiously concur with this view. Moreover, BoE with its three policy committees has provided a substantial first response to the outbreak, as described further above, to reassure markets, provide necessary liquidity, allow for some flexibility, and free resources, and stands ready to add to this if necessary. The reduction of the countercyclical capital buffer back to 0% will release up to GBP 190bn for lending purposes, according to the BoE, equivalent to 13 times banks' net lending to businesses last year.

Lending to the private sector accelerated to 7.9% y-o-y in Dec-19 (Dec-18: 2.1%), with the annual growth rate of both loans to households and non-financial corporations gaining traction, to 8.1% and 7.3% respectively; housing loan growth rose to 8.8%; however, house price growth has decelerated over the past few years, mainly driven by a slowdown in the South and East of England. Drawing on Eurostat data, the 3-year-growth rate, which had peaked at 22.9% in 2016, dropped to 1.4% in Q3-19. Brexit-related uncertainty and a generally less benign economic outlook on the back of a more challenging international trading environment have acted as main factors behind this. Housing affordability indicators such as price-to-income and price-to-rent-ratios have been broadly stable over the last two years, and while they are below 2007 peaks, they remain well above their historical averages. According to latest data provided by HM Land Registry, UK house prices increased by 2.2% in the year to December 2019, representing a slight pickup in annual growth since July 2019. Bearing in mind still rather stretched household balance sheets (compared to most EU-27 countries, high debt-to-income ratio of 124.13% in Q3-19), which may well worsen as a consequence of the corona pandemic, we follow these developments closely. That being said, envisaged limits to immigration and enhancements of building activity would, if realized, point to further abating pressure on house prices.

Foreign Exposure

Overall, we assess the United Kingdom's external position as robust. Since the global financial crisis, the UK displayed a generally larger current account deficit, highlighting the dependence on external funding needs. To a considerable extent, the larger deficit appears to be attributed to a weaker income balance, with the latter partly reflecting lower returns on the UK's foreign direct investments (FDI) abroad. In 2018, the deficit widened from 3.5% to 3.9% of GDP, as the surplus in services trade measured against GDP declined somewhat and as the deficit in the income balance increased, whereas the goods deficit shrank slightly. In the first three quarters of 2019, the current account deficit widened further to 4.7% of GDP, with all main components contributing. The trade in services surplus narrowed as imports rose more strongly than exports over this period, with exports of financial services even posting a decline of 1.5%. A Brexit effect also seems to be visible to the extent that the goods deficit increased noticeably in Q1-19 and later narrowed, suggesting efforts to mitigate assumed disruptions regarding the initial exit date by stockpiling and thus higher imports, followed by some unwinding effects as the Brexit date was postponed.

On the back of an increasing current account deficit, the net international investment position (NIIP) widened from -10.0% to -12.8% of GDP in 2018. Driving forces behind this were an increasingly negative net position in portfolio investment in the wake of repatriation of assets, as well as recovering net direct investment inflows. As of Q3-19, the NIIP has increased to -19.0% of GDP.

Owing to its role as one of the world's key international financial hubs, the UK remains exposed to risks of potentially large fluctuations in capital flows. Portfolio investment and other investment account for most of the financial account. Having said this, we continue to view these risks as somewhat tempered by a large amount of external assets (as of Q3-19 about GBP 6.4tr, excl. MFIs) and the currency composition of the external liabilities. To

this end, the IMF points out that external liabilities have a larger share denominated in sterling than assets, with the effect that a sterling depreciation would ceteris paribus contribute to a narrowing of the NIIP. In addition, sound financial regulation and supervision can play their part in mitigating vulnerabilities stemming from erratic capital movements.

Notwithstanding this, we would flag that high uncertainty over future trade arrangements both with the EU and third countries could lead to stronger outflows of portfolio investments as well as direct investments. Going forward, the current account thus remains susceptible to potentially rather drastic and volatile movements, also dependent on how the country will be faring in combating the corona crisis and its economic and financial market consequences. In a corona scenario entailing a rebound of the economic development in the second half of the year, flanked by the fiscal boost, recovering domestic demand should lift imports thus nurturing an increasing deficit.

Rating Outlook and Sensitivity

Our Rating outlook on the United Kingdom's long-term sovereign ratings is lowered from "stable" to "negative", as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to deteriorate over the next 12 to 24 months.

Given the current substantial economic and financial market uncertainty and the very dynamic development of Covid-19, the assessment and interpretation of economic developments is materially more difficult than under normal circumstances for the near future, as is the case for other indicators.

We could downgrade the UK's credit ratings if key fiscal metrics fail to show signs of improvement beyond the current acute crisis phase and in the absence of a credible longer-term commitment towards consolidating public finances. A downgrade could also be triggered by prolonged or intensified political uncertainty that could further undermine broad policy predictability, increase macro-financial volatility and cause supply chain disruptions, and/or result in adverse effects on potential growth. This could be the case if no new agreement with its European partners is reached.

Downward pressure could also arise if the corona pandemic has a stronger and longer lasting impact on the United Kingdom's economy than we expect and we observe significant adverse effects on the United Kingdom's medium-term potential growth. This could be the case if the consequences of the pandemic and the impact on demand and production are more pronounced than assumed, implying that the disruption of value-chains extends well into the second half of the year and beyond, and if policy-makers fail to minimize the economic fallout.

While the negative outlook indicates that an upgrade is rather unlikely at this stage, we could raise the outlook or the rating if key fiscal metrics improve, which could be the case if, in a benign scenario, medium-term growth proves substantially higher than in our baseline scenario, thus supporting fiscal consolidation. Credible commitment to consolidate

public finances would also seem beneficial in such a scenario. Targeted structural improvements leading to higher productivity growth, thus enhancing medium-term growth prospects, may also lead us to consider an uplift.

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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] | 2014 | 2015 | 2016 | 2017 | 2018 | 2019e | 2020e |
|---------------------------------------|--------|--------|--------|--------|--------|--------|--------|
| Real GDP growth | 2.6 | 2.4 | 1.9 | 1.9 | 1.3 | 1.4 | -1.0 |
| GDP per capita (PPP, USD) | 41,049 | 42,117 | 42,959 | 44,301 | 45,741 | 46,827 | 48,169 |
| HICP inflation rate, y-o-y change | 1.5 | 0.0 | 0.7 | 2.7 | 2.5 | 1.8 | 1.0 |
| Default history (years since default) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Life expectancy at birth (years) | 81.4 | 81.0 | 81.2 | 81.3 | 81.3 | n.a. | n.a. |
| Fiscal balance/GDP* | 5.1 | 4.3 | 2.8 | 2.7 | 1.8 | 2.2 | -4.5 |
| Current account balance/GDP | -4.7 | -4.9 | -5.2 | -3.5 | -3.9 | n.a. | n.a. |
| External debt/GDP | 308.7 | 286.8 | 306.4 | 308.9 | 309.5 | n.a. | n.a. |

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

*) Fiscal years, i.e. calendar year 2014 ⇔ FY14/15, etc.

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 |

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.

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

The rating was conducted on the basis of CRAG´s "Sovereign Ratings" methodology in conjunction with its basic document "Rating Criteria and Definitions". 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 the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

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, Bank of England, HM Treasury, Office for Budgetary Responsibility (OBR), Office for National Statistics (ONS), IHS Markit, UK Government – Department of International Trade.

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".

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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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