Creditreform Sovereign Rating

Rating Object	Rating Information	
UNITED KINGDOM	Assigned Ratings/Outlook: **AA /stable**	Type: Monitoring, unsolicited with participation
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	02-06-2017 18-03-2022 “Sovereign Ratings” “Rating Criteria and Definitions”

Contents

Rating Action

Neuss, 18 March 2022

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

The outlook revision on the United Kingdom reflects

(i) its economic resilience mirrored by the robust economic recovery from the Covid-19 shock, implying faster-than-expected growth, a more resilient labor market, and presumably lower scarring effects;

(ii) the improved situation of public finances, as the more positive macro backdrop, i.e. fast economic growth and well-performing labor markets, provides for a stronger revenue intake and a more favorable starting point to bring down the elevated debt level; and

(iii) the authorities’ transition to a medium-term fiscal consolidation in a bid to repair public finances in the wake of the corona crisis, buttressed by new fiscal rules which we view as a credible anchor.

Key Rating Drivers

1. Large, prosperous and diversified economy featuring a flexible labor market and boasting a welcoming business environment attracting capital and talent, not least in its very competitive financial sector; with Omicron representing less of a threat, we expect a continued recovery, but events in Ukraine and associated reactions are likely to weigh on economic activity in the short-to-medium term, essentially via disruptive energy price developments which will drag down real incomes

2. Remaining challenges associated with adjusting to new trade and regulatory regimes post-Brexit, partly still in flux, pose constraints to growth prospects in the medium term, added to by high household indebtedness and stalling labor productivity; efforts to address gaps in infrastructure, skills, and innovation will be made through the government’s Build Back Better program, which could contribute meaningfully to lifting productivity and to putting economic growth on a broader base, thus strengthening resilience

3. High-quality institutional set-up, building on strong policy frameworks, including highly credible and accountable institutions with regard to monetary policy and financial sector governance as well as a strong fiscal framework; persisting challenges to implementing the Northern Ireland protocol; finding sustainable solutions concerning post-Brexit regulation around financial services, and potential domestic political volatility over the question of a new Scottish referendum on independence remain issues we follow closely
4. Significant improvement of public finances reflecting ongoing economic recovery and the scaled back fiscal measures related to the pandemic should help to stabilize and gradually reverse the sovereign's public debt ratio, which has soared to elevated levels; the new fiscal rules and announced consolidation efforts, especially via net tax rises, should feature prominently in reducing public debt over the next few years, although some uncertainty remains over timing and extent in light of the Ukraine war; while having become more sensitive to inflation and interest rate risks over the years, a favorable debt portfolio structure resulting from very sound debt management mitigates fiscal risks to some extent
5. Persistently high current account deficits leave the sovereign susceptible to a reversal of capital flows, with current time-limited solutions in the financial services realm adding to our reservations; risks remain somewhat mitigated by large external assets and the currency sensitivity of the NIIP

Reasons for the Rating Decision and Latest Developments[1]

Macroeconomic Performance

The UK's macroeconomic profile is buttressed by the huge size and wealth of the economy and a highly competitive business environment including a strong financial services sector. A flexible labor market adds to these strengths. High household debt may limit risk-bearing capacities, constituting some balancing factor with regard to medium-term growth expectations, alongside downside risks stemming from adjustments to the post-Brexit trade regime. Non-tariff barriers in services trade and ongoing impaired visibility with regard to regulatory standards of financial services may hold back growth to some extent, whereas the government's Build Back Better plan is meant to address long-standing issues around regional disparity and productivity growth, among other things. Apart from still lingering pandemic-related uncertainty, downside risks to growth have, at least in the short term, been increased by the events in Ukraine, firstly via high commodity prices and penalizing reactions to Russia's aggression against Ukraine. Adverse repercussions on economic activity via important European trading partners with closer Russian ties and restraint household spending due to a higher energy bill are very likely, and it is not entirely inconceivable that the global economy enters a recession, particularly if geopolitical events witness further escalation.

After a steep fall in real GDP in light of the Covid-19 pandemic in 2020 (-9.4%) and amid some struggles to adapt to the post-Brexit trade regime in particular, the UK economy has recovered strongly and faster than expected since our last review. Buttressed by the extensive government support to protect jobs and income as well as by rapidly-progressing vaccinations, total output expanded by 7.5% in 2021 overall. On a monthly basis, the pre-pandemic real GDP level was

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[1] This rating update takes into account information available until 11 March 2022.

regained in November 2021. While full details for growth composition in 2021 are not yet available, the recovery was likely driven chiefly by private consumption, with government consumption and gross fixed capital formation also contributing positively. Net exports likely acted as a drag.

Despite soaring infection rates due to the Omicron variant around the turn of the year 2021/2022, the government imposed relatively moderate restrictions compared to many other European countries. Real GDP should continue to grow in Q1-22, with the monthly GDP indicator pointing to an expansion of 0.8% m-o-m for Jan-22 (ONS), driven by strong contributions of the wholesale and retail sector. The VAT rate is to revert back to 20% from 1 April 2022, likely leading to some private consumption being brought forward.

Generally, economic growth should be backed by private consumption in the face of the tight labor market and upward pressure on wages. Unemployment has fallen to 4.1% in the three months to Dec-21, posting only slightly higher than prior to the pandemic (Oct-Dec-19: 3.8%) and notwithstanding the closure of the UK's furlough scheme (CJRS) at the end of Sep-21. The impression of a significantly tightening labor market is also backed by continued increases in employment, record-high vacancies, and comparatively strong underlying earnings growth, with the latter averaging 4.2% in the three months to Nov-21 (Bank of England, BoE).

That said, prospects for household expenditure have clouded. Inflation rates at 30-year highs in light of surging prices for energy and food and a tighter fiscal policy, including the Health and Social Care Levy from April (+1.25 p.p.) and a freezing of personal allowance thresholds, are set to drag down real disposable income and prompt household to cut back on consumption. Moreover, a new default price cap 54% higher than the current one on household energy bills comes into effect in April. Consumer confidence (GfK) thus fell for a third consecutive month in Feb-22 to the lowest level since Jan-21.

Even though direct dependency on Russian oil and gas is smaller than in many European countries, UK consumers will still feel the pain of higher commodity prices, especially energy prices, driving inflation and eating into disposable income. In order to bring some relief to households, the Chancellor announced measures to alleviate the effect of higher energy bills (3-Feb-22), amounting to GBP 9.1bn in the fiscal year 2022/23, including a GBP 150 non-repayable rebate for tax-paying households this April and a repayable GBP200 reduction on energy bills this autumn.

Given Russia's war in Ukraine and increasingly likely larger negative economic repercussions on European trading partners and the global economy, business indicators are likely to worsen in the short term as well. We would thus remain cautious of recent marked improvements in the services PMI and the respective indicator for the manufacturing sector in Feb-22 (to 60.5 and 58.0 points) on the back of the subsiding Omicron wave. While UK companies in car manufacturing recently reported some improvements around shortages of semi-conductors, the geopolitical tensions are also set to intensify supply-chain issues on a broader scale over the course of 2022, also adding to price pressures, with a large degree of uncertainty as to the duration and widening scope of the eastern European conflict.

Near-term prospects for investment otherwise appear rather constructive, although company insolvencies have been trending upward over the twelve months to Jan-22, approx. doubling to 1,560 in this month (Jan-21: 758), but roughly matching average figures in Q1-19 (1,508), suggesting some normalization. The three main schemes providing business loans to companies of all sizes closed at the end of Mar-21, disbursing roughly GBP 79.3bn by May-21. The schemes were replaced by the Recovery Loan Scheme in Apr-21, expected to run until 30-Jun-22. The government's latest pandemic support package for businesses, announced in December 2021, alongside fiscal plans elaborated in the Autumn Budget and Spending Review in October 2021 (see below), should generally act as stabilizing elements to GDP growth this year.

In any case, business investment should benefit from the super-deduction this year, which incentivizes companies to bring forward capital spending, as the deduction rate (130% for main rate assets) is set to expire at the end of Q1-23. However, in combination with the announced increase in corporation tax from April 2023, business investment will likely decline in the further course of 2023.

We expect net exports to remain a drag on GDP growth this year and next, with domestic demand-driven import growth set to exceed export growth. Possible frictions in trade with the EU (see below) could weigh somewhat on the external outlook. In this context, we are aware of a report published by the Committee of Public Accounts this February, raising concerns over new border arrangements having driven up costs to UK businesses. From the beginning of this year, full customs controls have become effective, whilst some extra checks on agricultural and food imports from the EU are being postponed until 1 July 2022. At the same time, on a more positive note, the European Commission's (EC) extension of time-limited equivalence for UK central counterparties until the end of June 2025 supports benign prospects for financial services trade.

At present, we tentatively expect UK real GDP to expand by 3.6% in 2022 and by 1.8% in 2023, flagging extremely high uncertainty as well as downside risks to this, as the projection of the scale of collateral damage created by Russia's aggression is significantly obstructed by the constantly evolving situation in Ukraine. Remaining uncertainty over possible coronavirus mutations escaping immunization will have to be borne in mind as well.

Total trade between the UK and Russia came to GBP 15.9bn in 2021. Imports, primarily oil and metals, accounted for the bulk thereof (GBP 11.6bn). To be sure, the government has taken the decision to phase out Russian oil imports by the end of 2022 and considers ending gas imports prospectively. Other ties with Russia which are difficult to trace, however, relate to Russian investment in the UK, which according to information by the House of Commons comes to 'tens of billions' of GBP. Drawing on IMF data, total inward direct investment from Russia to the UK stood at about USD 32.8bn as of Dec-20 (Coordinated Direct Investment Survey). UK investment in Russia seems as if it is about to be pulled back, judging by reports over e.g. the British energy company BP divesting its 19.75% stake in Russian Rosneft.

Prospects with a view to medium and longer-term growth could brighten markedly with the implementation of the government's comprehensive 'Build Back Better: Our Plan for Growth' program aiming to materially enhance the UK's infrastructure, invest in workforce skills, and unleash innovation. It is the authorities' intention to significantly reduce regional disparities in the UK by 2030 ('Levelling up') and to enhance the economic growth potential across the country, given the dominance of London and the south east of England in terms of growth and productivity, while the UK overall displays low productivity growth compared to peers.

The UK's strategic plan foresees massive investment in digitalization, transport infrastructure, education and skills, as well as into the National Health System (NHS). This includes, inter alia, GBP 5bn for broader coverage of gigabit-capable broadband, aiming at 85% of the UK by 2025, as well as a GBP 1bn Shared Rural Network deal with mobile operators aiming for 95% of 4G coverage in the UK by the end of 2025. About GBP 5.7bn is allocated for transport enhancements in eight city regions outside of London over a five-year-horizon, alongside GBP 96bn for improvements and expansion on rail transport across the country. The NHS is to receive additional funding of about GBP 23bn, and several billions are earmarked to update and maintain skills. The government aims to increase public R&D investment to GBP 20bn by 2024 to 2025, with a target for total UK R&D investment to reach 2.4% of GDP by 2027. At least 55% of total domestic R&D funding is to go outside the greater south east by 2024 to 2025. Total R&D expenditure was at 1.7% of GDP in 2019, up only slightly from 1.6% in 2008 (ONS). All this would come alongside planned investment to support the transition to a net-zero-carbon-emitting economy, for which GBP 30bn funding is foreseen over the period 2021-25.

In our view, a timely and effective implementation of these plans should substantially bolster the UK's position as the currently fifth-largest economy in the world (2021, IMF data), and its prosperity in terms of GDP per capita (2021e: USD 48,693, our AA median: USD 50,876, IMF). Furthermore, its already very welcoming business environment is likely to be improved, thereby dampening adverse effects from having to come to terms with new trade and regulatory regimes in the aftermath of its exit from the EU.

The UK performed well in the 2020 vintage of the EC's Digital Economy and Society Index (DESI), occupying rank 8 among the then 28 EU countries, underscoring a strong basis on which to build in the pursuit of the sovereign's digital agenda. Highlighting a further strongpoint of the UK as an international services hub, the 2022 OECD Services Trade Restrictiveness Index attests the UK to be one of the leading reformers among the 50 countries considered in this assessment (2021: 5th rank).

However, we also continue so see downside risks from having to adjust to the post-Brexit regime as concerns the medium term. While authorities forge ahead to agree trade deals with third parties, fleshing these out takes time. Moreover, shortages of qualified labor in various areas may not turn out to be so easy to plug following Brexit, given a more targeted, but also more restrictive, immigration system. Although exacerbated by Covid-19, difficulties in recruiting lorry drivers as experienced last autumn may be only one case in point. The government envisages launching new visa schemes this spring, among them Scale-Up, which requires a salary of at least GBP 33,000 and a certain level of English language skills. Further visa routes (High Potential Individual, Global Business Mobility) are to add to this.

Vulnerabilities associated with stretched private sector balance sheets have not increased significantly over the course of the global health crisis, but private debt could pose some constraints to the medium-term growth outlook. Household debt-to-disposable income was at 132.2% as of Q3-21 (Q3-20: 131.3%), comparing relatively high against many European peers. However, the share of households with high mortgage debt servicing ratios (>40%) has remained in line with average levels seen shortly before the outbreak of the pandemic and well below levels experienced at the onset of the global financial crisis, and the share of high-LTV loans seems to remain low (BoE data). At 73.7% (Q3-21), non-financial corporate debt-to-GDP moves in the middle range compared to EU countries, having increased somewhat over the pandemic, but largely driven by declining total output.

Institutional Structure

We continue to view the sovereign's high-quality institutional set-up, including sound monetary policy, fiscal policy, and financial sector frameworks, as a major pillar underpinning the UK's creditworthiness. Implementation of arrangements following the UK's exit from the EU continues to pose some challenges, with controversy over the Northern Ireland Protocol and the UK's suggestion to renegotiate this being recent examples, constituting some balancing factor to the mentioned institutional strengths. We vigilantly monitor intentions of the Scottish regional government to prepare for a second referendum, although we continue to consider Scotland becoming an independent country an unlikely scenario over the next few years.

Our preferred measure of institutional quality, the World Bank´s Worldwide Governance Indicators (WGIs), continue to underpin the UK's very sound institutional framework, comparing slightly more favorably with the respective median rank of our AA-rated sovereigns. Having said this, we observe some deterioration in three of the four indicators we consider the most relevant. When it comes to the perception of free media, association, and speech (i.e. voice and accountability), the sovereign slipped one place from relative rank 22 to 23 out of 209 economies. Meanwhile, the sovereign's performance in terms of government effectiveness as well as rule of law is seen as having deteriorated somewhat more noticeably (from rank 20 to 23 and from rank 18 to 22, respectively). By contrast, the sovereign has edged up from relative rank 14 to 13 with regard to the perception of control of corruption.

We will monitor developments around the controversial handling of 'de-facto customs border' checks for incoming goods from Great Britain into Northern Ireland (NI) following the UK's exit from the EU. The resignation of NI's First Minister in February 2022 amid his party's (DUP) protests against the NI protocol has once more highlighted sensitivities around this subject. While not a main scenario, a conceivable unilateral breach of the protocol on a larger scale than seen so far would complicate relations with the EU and may even jeopardize the existing TCA. In the meantime, there are continuous efforts on trade agreements with non-EU countries. In December 2021, the UK reached agreement in principle over a FTA with Australia, as well as over a digital trade deal with Singapore. In January 2022, negotiations on a FTA with India were launched.

Another politically sensitive issue remains on the agenda of the regional government in Scotland, where the power-sharing Scottish National Party and the Scottish Greens following the May-21 election have committed to hold a second referendum on Scottish independence, possibly as early as 2023. The UK government has repeatedly ruled out a second referendum on this matter. We believe that a Scottish split from the UK is rather unlikely, but will follow developments on this matter. According to opinion polls, opponents of Scotland becoming an independent country seem slightly ahead of supporters at present, while polls painted the opposite picture over much of 2020. Further to domestic politics, despite recent public criticism and a police inquiry of PM Johnson in relation to the Covid-19 lockdown, which has further strengthened support of the Labour party currently in the lead in opinion polls, we do not consider a snap election ahead of the UK's scheduled parliamentary election in May 2024 a likely scenario.

In terms of greening the economy, the UK has been among the stronger performers of the (former) EU with regard to the level and the reduction of greenhouse gas (GHG) emissions per head over the years to 2019, for which latest data is available (Eurostat). Compared to 2010, the UK lowered its GHG emission per capita by 2.8 tons to 7.3 tons of CO_2 equivalent in 2019, vis-a-vis a reduction of 1.6 tons to a level of 8.2 tons per capita of the then EU-28. We understand that the Prudential Regulation Authority (BoE) will incorporate supervision of climate-related financial risks into its core supervisory approach from 2022 on. In a bid to achieve a net zero carbon emission goal by 2050, the government aims to produce all electricity in the UK from renewable energy sources by 2035 – including nuclear energy. Judging by Eurostat data until 2019, the UK's share of energy from renewable sources in gross electricity consumption was at 34.8%, roughly in line with the share in the EU-27 at the time (2019: 34.1%). Regarding the overall share of energy from renewables, the UK was lagging behind the EU-27 in 2019, displaying a share of 12.3% versus a share of 19.9% in the EU-27.

Fiscal Sustainability

Risks to fiscal sustainability pose a burden on the sovereign's creditworthiness in our view, underscored by the significantly elevated debt-to-GDP ratio in the wake of the pandemic. However, the robust economic recovery and the scaling back of support measures have resulted in a stronger-than-expected outcome in public finances, providing some firmer ground for the envisaged consolidation path over the medium term, which is to be supported by net tax rises. We expect the public debt ratio to gradually decline on an elevated level over the medium term, with sterling's reserve currency status, benign maturity profile and persistently sound debt management representing ongoing risk-mitigating factors in an environment characterized by slowly increasing debt servicing costs. Contingent liability risks in relation to the banking sector appear limited in light of sound banking metrics, whilst a possible deterioration of private sector balance sheets against the backdrop of some monetary policy tightening and squeezed income due to higher energy costs have to be monitored. Conceivable larger asset price corrections, as well as adverse developments in the large non-bank financial sector, represent pockets of vulnerability. Generally, we believe that downside risks to the envisaged fiscal consolidation have gone up more recently, since a softer growth backdrop originating from the geopolitical tensions may lead to lower revenue intake or necessitate additional support measures.

Following a phase of fiscal consolidation resulting in a comparatively moderate general government deficit averaging 2.3% of GDP in the fiscal years (FY) 2017/18 to 2019/20 (Maastricht terms), the pandemic had the UK's general government deficit soar to 15.3% of GDP in FY 20/21. The outturn for FY 20/21constitutes the highest headline deficit among our AA-rated sovereigns and one of the highest among advanced economies.

Thanks to robust economic recovery since then, public finances are rapidly improving. In fact, public sector net borrowing is well on course for a better turnout than forecast in Oct-21, at GBP 138.5bn being 11.4% below the expected level with regard to FY21/22 up to Jan-22 (OBR data). Central government receipts (excl. Asset Purchase Facility) in the current fiscal year (FY 21/22) exceed the forecast by about 4.5% (GBP 29.1bn), driven by strong income tax, corporation tax, and VAT performance in light of the ongoing economic recovery and wound down fiscal support linked to the corona crisis. Compared to the outturn of the same period in the previous fiscal year, receipts have increased by 15.6%. At the same time, current central government expenditure in the ten months up to Jan-22 fell by 5.4%, albeit being higher than anticipated last October (+1.3%), on account of higher interest outlays associated with a sharp rise in RPI inflation, higher rail subsidies, and higher spending on public services.

Including measures announced with the Oct-21 Budget, the overall expansionary fiscal impact of government decisions since the Mar-21 Budget could peak in FY 22/23 and decrease thereafter. Total cost of pandemic-related measures since the outbreak of the corona crisis are estimated to come to about GBP 378bn (OBR).

In its first multi-year Spending Review since 2015, provided with the new Budget in Oct-21, the government announced increases in departmental resource spending, which will be partly financed by net tax rises, mainly the Health and Social Care Levy, for which an average GBP 17.3bn per year is expected from FY 22/23 to FY 26/27. The net tax rises come on top of those announced in the Mar-21 Budget, i.e. primarily an increase in the main corporate tax rate and the freezing of personal income thresholds. It also seems worth reiterating that the anticipated spending profile over the coming years is higher than before, partly due to higher debt interest and the cost effect from persistent inflation when benefits and public service pensions are increased as foreseen.

Overall, we expect the public deficit to decrease markedly to about 7.8% of GDP in FY 21/22, thus better than expected in our last review, and further to roughly 4.0% of GDP in FY 22/23, though highlighting that this forecast is subject to very high uncertainty due to the geopolitical situation. The current dramatic developments in Eastern Europe and associated wider consequences for the global community thus add to downside risks for the fiscal outlook, i.e. further coronavirus mutations and adapting to the post-Brexit world. Economic growth and respective revenues might fall short of current expectations, and spending policies may have to be reprioritized to some extent and/or generally be increased.

We highlight changes to the fiscal objective and targets with effect from Jan-22. The Treasury's fiscal objective is now centered around 'sustainable public finances' alongside a number of further objectives, rather than for public finances 'to balance at the earliest date in the next parliament', suggesting some shift in priorities has already taken place. This said, the current budget is to be balanced by the third year of the OBR's forecast, and there are spending caps on welfare and public sector net investment, in our view pointing to ongoing commitment to sound public finances. In addition, the government now targets a decline in public sector net debt excluding debt held by the BoE, as a percentage of GDP, required to be falling by the third year of the OBR's forecast. Further innovative elements of the new fiscal rules relate to ensuring affordability of public debt as well as to strengthening measures of the public sector balance sheet.

With a view to the upcoming Spring Statement (23-Mar-22), spending on defense could reportedly see some increase in reaction to the Russian aggression against Ukraine and potential further escalation of this conflict. Given the increasing pressure on households via soaring energy prices, some further relief measures might be included. It seems conceivable that authorities could contemplate delaying the rise in national insurance contributions or other consolidation measures.

Following the corona-induced leap in the debt ratio to 103.7% of GDP in FY 20/21 (FY 19/20: 83.0% of GDP, Maastricht terms), we expect the debt-to-GDP ratio to shrink to about 101.6% in the current FY 21/22, against the backdrop of the narrowing deficit and higher nominal GDP. At the current juncture, we would pencil in a further decline to just under 100% of GDP in FY 22/23.

Amid persisting price pressures and expectations of inflation remaining well above its 2% target over the medium term, BoE's Monetary Policy Committee (MPC) increased its policy rate by 0.15 p.p. to 0.25% in Dec-21 and by 0.25 p.p. to 0.50% this February. On the latter occasion, a minority of 4 to 5 committee members had preferred to raise the rate by 50 basis points. In February, the MPC also voted unanimously to begin reducing the stock of gilt purchases by ceasing to reinvest maturing assets. In the same vein, the stock of sterling non-financial investment-grade corporate bond purchases is to be run down by ending reinvestment of maturing assets and by a program of corporate bond sales to be completed no earlier than towards the end of 2023 in order to fully unwind the stock of corporate bond purchases. The MPC also stressed that it would not consider actively shrinking the stock of UK government bonds until the Bank Rate has risen to at least 1.0%, also depending on the economic conditions at that point in time.

We currently still expect the MPC to increase its policy rate to at least 1.00% this year, although uncertainty has increased around such forecasts. In any case, we expect the BoE to signal readiness to contribute to bridging any potential disruptions and to adjust its stance as seen fit in light of the dramatic developments amidst the Russian invasion into Ukraine, and potential spill-over effects to the UK economy.

Debt affordability thus looks set to evolve somewhat less favorable, also given a 23.9% share of index-linked gilts in the debt portfolio (Dec-21, net uplifted values, DMO), which has increased sensitivity of the debt portfolio to higher inflation rates as currently witnessed. The yield on 10y government bonds has trended up over the past year, by now catching up with levels last seen in autumn 2018, standing at 1.49% as of 11-March-22 (weekly quote). Nevertheless, we continue to view sound debt management and the benign debt profile as mitigating risks to fiscal sustainability. An average maturity of the gilt portfolio of 15.07y as of Dec-21 (net uplifted value, DMO) corresponds to one of the highest readings among advanced economies. We further note that a share of 33.3% of outstanding gilts was held by the BoE as of Q3-21 (DMO).

The UK's relatively large banking sector has shown resilience to the risks linked to the pandemic. The sector's total assets amounted to 362.7% of GDP as of Dec-21 (Dec-20: 377.3% of GDP, BoE). Judging by the BoE's solvency stress test 2021, the sector appears well-positioned to withstand an economic shock on top of the one experienced in 2020, alleviating some concern over potential risks from current events around the Russian invasion in Ukraine.

We observe that capitalization ratios are at relatively comfortable levels, with the aggregate ratio standing at 16.5% as of Q3-21 (BoE), 1.7 p.p. above the pre-crisis level. In this context, upcoming regulatory changes concerning measurement of capital and risk-weighted assets are expected to contribute to lowering capital ratios from the second half of 2022. This notwithstanding, banks can be expected to meet capital requirements following the announced increase of the CCyB from 0% to 1% from 13 Dec-22, as was decided in Nov-21. Asset quality remains relatively high, judging by an NPL ratio of 1.2% as of Q4-20 (Q4-19: 1.1%, IMF).

As to financial stability regarding other sectors, we will monitor the outcome of the insurance stress test announced for May-22. Against the backdrop of the increasing significance of cryptoassets, risks related to this realm, whilst currently appearing limited, may have knock-on effects to the wider financial system.

Given the abovementioned stretched balance sheets of private households in particular, we will continue to monitor lending dynamics, as potential difficulties in servicing debt in light of income squeezed by higher energy and food prices might have some adverse effects on the banking sector. The annual growth rate of outstanding (secured) MFI loans to individuals has decreased somewhat from a peak in Sep-21, but at 4.7% stands well above levels observed prior to the pandemic (avg 2017-19: 3.4%).

House prices have shown vivid growth lately, displaying an annual average increase of 9.9% in 2021 (Dec-21: 10.8% y-o-y), drawing on the HM Land Registry's UK house price index for all types of property. The pandemic-related higher demand for more space seems to have remained an important driver. The OECD house price indicator adds to the impression of rising dynamics, reflecting a rise of 9.1% y-o-y as of Q2-21. Moreover, OECD data points to increasingly stretched valuations, approaching highs last seen prior to the global financial crisis. This said, we would expect house price growth to calm somewhat if monetary policy is further tightened.

Foreign Exposure

The UK continues to display external vulnerabilities, in particular related to its position as a large international financial hub and a persistent current account deficit. Whilst these appear to be overall manageable, there remains uncertainty with the still limited visibility over future financial services trade between the UK and the EU. The solid financial supervision framework remains a risk-mitigating factor. Due to high sensitivity to financial market developments, events in Ukraine and associated market reactions could add to volatility in the external position going forward.

As a large international financial hub, the UK is exposed to downside risks to global financial markets emanating from the events in Ukraine, adding to remaining uncertainty over the future relationship between the UK and the EU in terms of financial services in the absence of equivalence and of a functioning framework for regulatory cooperation. To be sure, as mentioned above, the EC has extended time-limited equivalence for UK central counterparties until end of June 2025, and efforts are ongoing to find sustainable solutions. We would reiterate expectations of a phase of higher volatility regarding portfolio investment and direct investment under these circumstances, also recalling present intentions to further reduce or cut any financial links to Russia assumed to be limited.

The current account deficit, which had narrowed to 2.6% of GDP in 2020 (average 2015-19: 4.1% of GDP) amid plunging domestic demand, widened in the course of last year. On the back of the economic recovery reviving private consumption, the current account deficit rose to 3.3% of GDP in Q3-21, measured as four-quarter moving sum. Looking ahead, we would generally expect the current account balance to deteriorate further this year and next, mainly due to our assumption of domestic demand being the key driver of the UK's economic expansion. That said, the negative position could narrow somewhat if downside risks pertaining to the Russian-Ukraine conflict and related counteractions by Western allies materialize.

In the meantime, the country's negative NIIP widened somewhat from -21.1% of GDP in 2020 to -23.0% as of Q3-21. To some extent, the flexible exchange rate acts as a risk buffer for external vulnerabilities, and valuation effects mitigate risks emanating from the current account deficit on the NIIP to some degree as well. Any longer-term effects on foreign direct investment from Brexit may have to be monitored, difficult though they may be to pinpoint.

Rating Outlook and Sensitivity

Our rating outlook for the United Kingdom is stable. Positive factors underpinning this assessment encompass the robust economic recovery including that of the tight labor market, despite a challenging environment, and better-than-expected fiscal revenue leaving some space for improving on structural economic challenges, along with ongoing commitment to sound public finances amid a new fiscal strategy. These factors are balanced by uncertainties regarding coronavirus mutations, outstanding issues between EU and UK post Brexit, and acute downside risks in light of the current geopolitical context. While links to Russia and Ukraine appear somewhat more limited compared to European peers, we have to emphasize that the assessment and interpretation of economic developments remains considerably more challenging than under normal circumstances, as is the case for other indicators, in particular from the fiscal realm.

We could lower the sovereign's credit ratings or outlook, if the economic cycle proves significantly more lackluster than we currently expected, and efforts to implement the Build Back Better program fall substantially short of expectations. Failure of fiscal metrics to revert to a consolidation path could also prompt us to consider a downgrade of the rating or outlook, as could repeated controversy over aspects of the TCA including the NI Protocol. Our perception of an otherwise very strong institutional quality could also be affected by possibly increasing domestic political challenges with regard to the Scottish independence movement.

Conversely, we could consider a positive rating action if we gain further confidence that economic growth remains robust and potential output increases, as adverse effects following Brexit can be kept low and reform initiatives presented under the 'Build Back Better' flag are being implemented, enhancing the outlook for broader-based growth and revived productivity. Upward pressure on the rating and/or the outlook could also arise if the public debt ratio embarks on a firmer-than-expected downward path, possibly on the back of the abovementioned circumstances.

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Ratings*

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

*) Unsolicited

ESG Factors

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

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

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 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.

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, e.g. the World Bank's, the World Economic Forum's, and the OECD's assessments of the business environment, 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.

Economic Data

[in %, otherwise noted]	2016	2017	2018	2019	2020	2021e	2022e
Macroeconomic Performance							
Real GDP growth	2.3	2.1	1.7	1.7	-9.4	7.5	3.6
GDP per capita (PPP, USD)	44,121	45,923	47,326	48,599	44,154	48,693	52,252
Credit to the private sector/GDP	86.8	85.4	86.0	85.3	92.3	n/a	n/a
Unemployment rate	4.9	4.4	4.1	3.8	4.6	4.5	n/a
Unit labor costs (index 2019=100)	93.1	95.2	97.4	100.0	107.6	n/a	n/a
Ease of doing business (score)	83.3	83.2	83.6	83.5	n/a	n/a	n/a
Life expectancy at birth (years)	81.2	81.3	81.3	81.2	n/a	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	1.7	1.7	1.6	1.6	1.5	n/a	n/a
WGI Control of Corruption (score)	1.9	1.9	1.8	1.8	1.7	n/a	n/a
WGI Voice and Accountability (score)	1.3	1.4	1.4	1.3	1.2	n/a	n/a
WGI Government Effectiveness (score)	1.6	1.5	1.4	1.5	1.4	n/a	n/a
HICP inflation rate, y-o-y change	0.7	2.7	2.5	1.8	0.9	2.6	6.0
GHG emissions (tons of CO2 equivalent p.c.)	7.8	7.7	7.5	7.3	n/a	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP*	-2.7	-2.6	-1.8	-2.6	-15.3	-7.8	-4.0
General government gross debt/GDP*	84.3	83.5	82.8	83.0	103.7	101.6	99.9
Interest/revenue	6.3	6.9	6.3	5.5	4.8	n/a	n/a
Debt/revenue	227.1	221.9	220.8	219.8	264.4	n/a	n/a
Average maturity all gilts (years)	15.6	15.8	15.8	15.9	15.3	15.1	n/a
Foreign exposure							
Current account balance/GDP	-5.3	-3.6	-3.9	-2.7	-2.6	n/a	n/a
International reserves/imports	0.2	0.2	0.3	0.3	0.3	n/a	n/a
NIIP/GDP	-2.2	-12.8	-13.1	-25.5	-21.1	n/a	n/a
External debt/GDP	305.5	308.7	304.9	298.4	336.9	n/a	n/a

Sources: IMF, World Bank, BIS, ONS, DMO, Eurostat, own estimates

*) Maastricht terms, fiscal years, i.e. calendar year 2016 ⇔ FY 16/17, 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
Monitoring	25.09.2020	AA /negative
Monitoring	19.03.2021	AA /negative
Monitoring	18.03.2022	AA /stable

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. HM Treasury participated in the credit rating process, as it provided additional information and commented on a draft version of the report. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

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 has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Bank for International Settlement, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, European Investment Bank, Blavatnik School of Government, ECDC, 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.

Disclaimer

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When assessing the creditworthiness of sovereign issuers, Creditreform Rating AG relies on publicly available data and information from international data sources, governments and national statistics. Creditreform Rating AG assumes no responsibility for the true and fair representation of the original information.

Future events are uncertain, and forecasts are necessarily based on assessments and assumptions. Hence, this rating is no statement of fact but an opinion. Neither should these ratings be construed as recommendations for investors, buyers or sellers. They should only be used by market participants (entrepreneurs, bankers, investors etc.) as one factor among others when arriving at investment decisions. Ratings are not meant to be used as substitutes for one's own research, inquiries and assessments. Thus, no express or implied warranty as to the accuracy, timeliness or completeness for any purpose of any such rating, opinion or information is given by Creditreform Rating AG in any form or manner whatsoever. Furthermore, Creditreform Rating AG cannot be held liable for the consequences of decisions made on the basis of any of their ratings.

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