# United Kingdom
## Rating Report

SCOPE AA STABLE OUTLOOK

### Credit strengths

- Large, wealthy and diversified economy
- Strong institutional framework
- Robust debt profile and market access

### Credit challenges

- High stock of public debt
- Weak external position with persistent current account deficit
- Prolonged uncertainties surrounding the implementation of the post-Brexit UK-EU trade agreement

## Rating rationale:

**Large, wealthy and diversified economy:** The UK's economy has proved resilient during the Covid-19 crisis, with output near its pre-pandemic level by late 2021. Rising inflationary pressures have since dampened the economic outlook.

**Strong institutional framework**: The country benefits from robust financial supervisory, economic, and monetary governance frameworks. This includes the independent Bank of England, which reacted promptly to the Covid-19 crisis and appropriately to the subsequent rising inflationary pressures.

**Robust debt profile and market access**: The UK benefits from strong market access conditions and a high average debt maturity, while the central bank holds a large share of government debt. Around a fifth of government debt is indexed to retail-price inflation, which may lead to significant increases in interest payments in the medium run.

**Rating challenges include**: i) the country's high public debt; ii) a weak external position with persistent current account deficits; and iii) prolonged uncertainties surrounding the implementation of the post-Brexit UK-EU trade agreement.

**United Kingdom's sovereign rating drivers**

| Risk pillars | | Quantitative scorecard | | Reserve currency adjustment (notches) | Qualitative scorecard | Final rating |
|---|---|---|---|---|---|---|
| | | Weight | Indicative rating | | Notches | |
| Domestic Economic Risk | | 35% | aaa | | +1/3 | |
| Public Finance Risk | | 25% | a+ | | -1/3 | |
| External Economic Risk | | 10% | ccc | | -2/3 | |
| Financial Stability Risk | | 10% | aaa | | +1/3 | AA |
| ESG Risk | Environmental Risk | 5% | aa+ | | 0 | |
| | Social Risk | 5% | bbb+ | | -1/3 | |
| | Governance Risk | 10% | aaa | | 0 | |
| Overall outcome | | aa | | +1 | -1 | |

Note: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

## Outlook and rating triggers

The Stable Outlook reflects Scope's view that risks to the ratings are balanced over the next 12 to 18 months.

### Positive rating-change drivers

- Economic and fiscal policy frameworks maintain the debt-to-GDP ratio on a stable downward trajectory in the medium term
- Reduction of external vulnerabilities

### Negative rating-change drivers

- Weakening in economic and fiscal outlooks lead to higher debt-to-GDP
- Larger attrition of UK services sector than anticipated due to Brexit and/or risks to the UK's constitutional integrity
- Increase in external vulnerabilities or challenge to sterling's status as a reserve currency

### Ratings and Outlook

**Foreign currency**

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

**Local currency**

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


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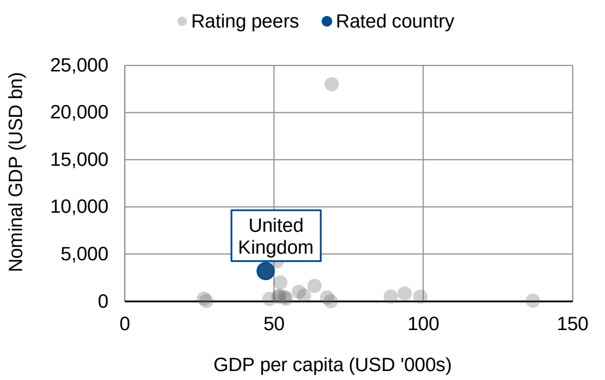
## Domestic Economic Risks

- **Growth outlook:** After one of the sharpest contractions among advanced economies during the Covid-19 crisis (-9.3%), the UK economy grew by 7.4% in 2021 on the back of a strong recovery in private demand. Despite its moderate direct ties to Russia and Ukraine, the UK is negatively impacted by the fallout from the war. The spike in energy and raw material prices and supply chain disruptions intensified and are fuelling already strong inflationary pressures. While growth remained robust in Q1 2022 (+0.8% QoQ), household consumption is likely to slow sharply over the next few months. As the economy continues to recover from the pandemic shock, we expect GDP growth of 3.5% in 2023, supported by a temporary boost in business investment related to the government's 'super-deduction' tax allowance. Growth is then expected to moderate towards the medium-run potential of around 1.5%. Longer-term challenges to the growth outlook relate to low productivity growth as well as continued uncertainty concerning the lasting impact of the UK-EU Trade and Co-operation Agreement.
- **Inflation and monetary policy:** The fallout from the Ukraine conflict added to pre-existing price pressures and pushed consumer price index inflation to 9% in April 2022, driven by higher electricity, gas and fuel prices as well as higher transport costs. Core inflation also increased markedly, up 6.2%, pointing to the broadening of price pressures across the consumer basket. A weakening sterling and tight labour markets also contribute to inflationary pressures. The Bank of England started a process of monetary tightening in the autumn of 2021, raising its Bank rate by a cumulated 90bps since December to 1%, and will consider starting the process of selling UK government bonds held in the Asset Purchase Facility.
- **Labour market:** The labour market rebounded quickly, in parallel with the economic recovery, bringing the unemployment rate down to 3.7% in Q1 2022. Record high vacancies point to a tight labour market, in part owing to a lower participation rate following the Covid-19 crisis. We expect unemployment to stabilise at this very low level in the medium term, which should support nominal wage growth, albeit at a slower rate than inflation.

**Overview of Scope's qualitative assessments for the United Kingdom's *Domestic Economic Risks***

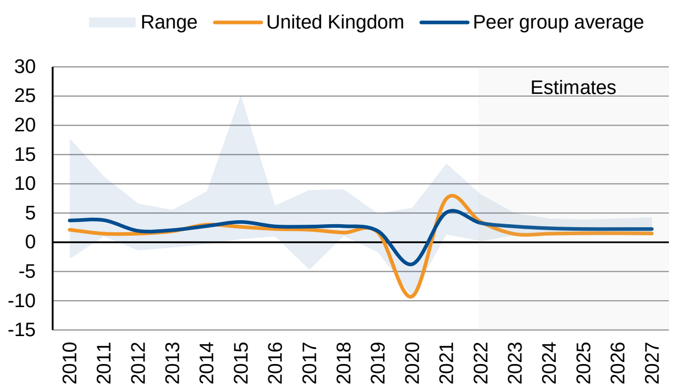
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| aaa | Growth potential of the economy | Neutral | 0 | Moderate growth potential, has weakened since 2016 referendum |
| | Monetary policy framework | Strong | +1/3 | Highly credible and effective central bank; independent monetary policy |
| | Macro-economic stability and sustainability | Neutral | 0 | Diversified economy and flexible labour market; ongoing economic costs following the Brexit process |

**Nominal GDP and GDP per capita**, USD '000s




Source: IMF World Economic Outlook (WEO), Scope Ratings

**Real GDP growth**, %




Source: IMF WEO, Scope Ratings forecasts

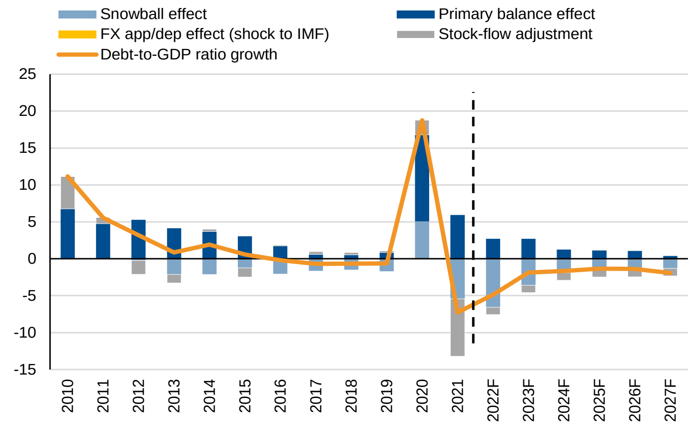
## Public Finance Risks

- **Fiscal outlook:** After rising to 12.8% of GDP in 2020 to finance large-scale support measures, the government deficit receded faster than anticipated to 8% in 2021 due to increased tax receipts. The government announced fiscal measures to cushion the impact of rising inflation on households. Total fiscal support announced to date amounts to approximately GBP 37bn over the fiscal year 2022/23 (1.7% of GDP in 2021). However, these measures are partially counterbalanced by policies announced in 2021, which are expected to improve public finances in the medium-to-long run. This included a revamp of the higher education funding system and an increase in the overall tax burden to 36.3% of GDP by fiscal year 2026/27, which would be its highest level since the 1940s. We expect a continued headline budget deficit as the worsening cost of living crisis results in further government support measures over the coming year.
- **Debt trajectory:** The recovery in economic output and in fiscal performance allowed for a 7.3pp improvement in the debt-to-GDP ratio in 2021 to 95.3%, albeit still well above its 2019 level of 83.9%. The Office for Budget Responsibility expects the government to meet its fiscal targets, including a decline in public debt, by the third year of the rolling forecast period. While the headroom against these targets has increased since October 2021, it would be eroded by slightly slower growth or higher interest rates. We expect debt levels to decline gradually in the coming years, falling below the pre-pandemic level by the end of our forecast horizon at 82.3% in 2027. Downside risk to the debt trajectory relates to the fallout from the Russia-Ukraine war and significant contingent liabilities related to pension and healthcare expenditure.
- **Market access:** The UK benefits from strong market access conditions, with an exceptionally long average debt maturity (14.7 years as of end-2021) compared to its peers. The Bank of England holds a large share of government debt and is the largest single holder of outstanding gilts and treasury bills. Similarly to peers, higher inflation and tightening monetary policy have increased financing costs in recent months with the 10-year government bond yield at 2.1%, up from 0.8% last year. Around a fifth of government debt is indexed to retail-price inflation, which may lead to significant increases in interest payments in the medium run.

**Overview of Scope's qualitative assessments for the United Kingdom's *Public Finance Risks***

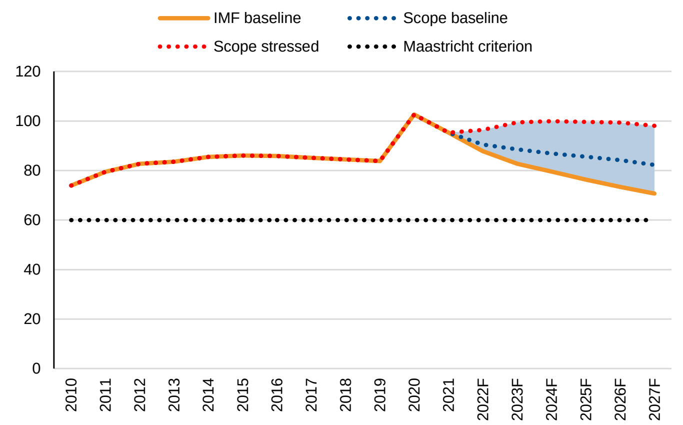
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| a+ | Fiscal policy framework | Weak | -1/3 | Revised fiscal framework includes ambitious targets for public debt levels, but there are frequent revisions to the framework |
| | Debt sustainability | Neutral | 0 | Debt expected to gradually decrease, in line with some peers |
| | Debt profile and market access | Neutral | 0 | Excellent government market access, long average debt maturity, significant debt held by central bank, high share of index-linked government debt |

**Contributions to changes in debt levels**, pps of GDP




Source: IMF WEO, Scope Ratings forecasts

**Debt-to-GDP forecasts**, % of GDP




Source: IMF WEO, Scope Ratings forecasts

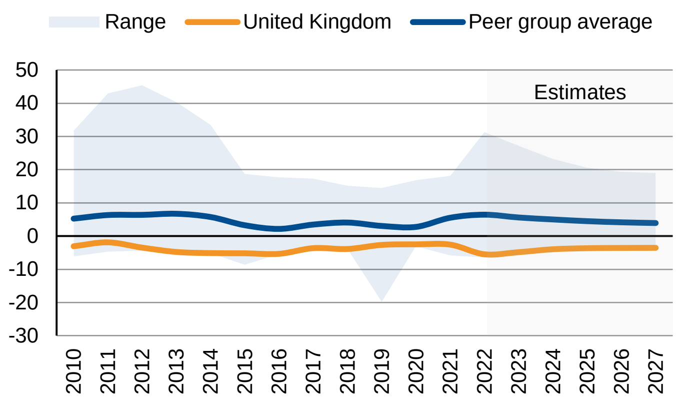
## External Economic Risks

- **Current account:** The UK has been running a current account deficit for several decades, at 3.4% on average over 2017-19, significantly larger than the peer country average. It receded somewhat during the pandemic, to 2.6% in 2021, on the back of lower nominal energy imports and strong services and pharmaceutical exports. We expect the current account deficit to widen significantly in the medium term, primarily due to the spike in global energy prices, which will weigh on the trade balance, before gradually converging to its pre-crisis level. In the longer term, the UK's departure from the EU will have an ambiguous effect on the current account deficit as it will reduce both import and export intensity. The full impact will only become evident once the UK-EU agreement is fully implemented, pandemic-related trade disruptions dissipate, and businesses have adjusted to the new norm.
- **External position:** The external debt-to-GDP ratio stood at 317% of GDP in 2021, below its 2020 high (339%) but still 19pp above its pre-crisis level and close to historical highs in absolute terms. Short-term liabilities make up around two-thirds of the external debt stock and more than half of external liabilities are owed by financial institutions. The net international investment position is negative, at 32% of GDP, and on a notably worsening trend over the past five years, having widened from 2% of GDP in 2016. This partially relates to the impact of Brexit, which caused a downturn in foreign direct investment inflows, thus significantly lessening the UK's external financing resilience.
- **Resilience to shocks:** International reserves held by the UK are typically low. Holdings of gross reserves increased in 2009 and 2021, with the allocation of Special Drawing Rights by the IMF, a rise in the value of gold and a government provision of GBP 72bn of additional financing that ended in March 2020. The sterling's status as a reserve currency largely shields the country from external short-term shocks. The share of global reserves held in GBP has moderately increased in recent decades, from 2.8% in 2000 to 4.8% in 2021, supporting our view that it will retain its status in the foreseeable future.

**Overview of Scope's qualitative assessments for the United Kingdom's *External Economic Risks***

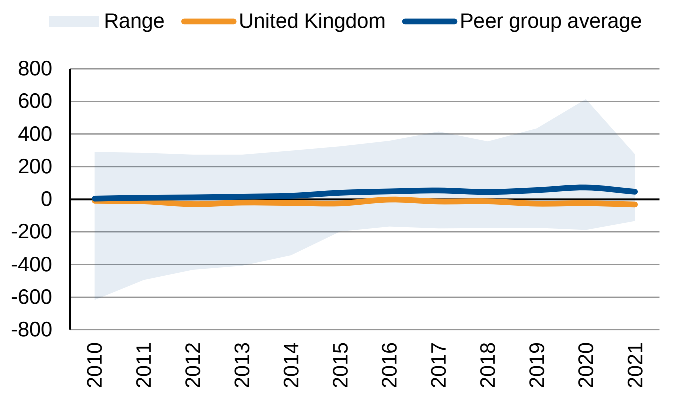
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| ccc | Current account resilience | Weak | -1/3 | Weaker services exports may exacerbate external weaknesses, weakened net foreign direct investment inflows |
| | External debt structure | Weak | -1/3 | Elevated external debt, with high foreign-currency composition |
| | Resilience to short-term shocks | Neutral | 0 | Sterling as a reserve currency shields against short-term external shocks |

**Current account balance**, % of GDP




Source: IMF WEO, Scope Ratings GmbH

**Net international investment position**, % of GDP




Source: IMF WEO, Scope Ratings GmbH

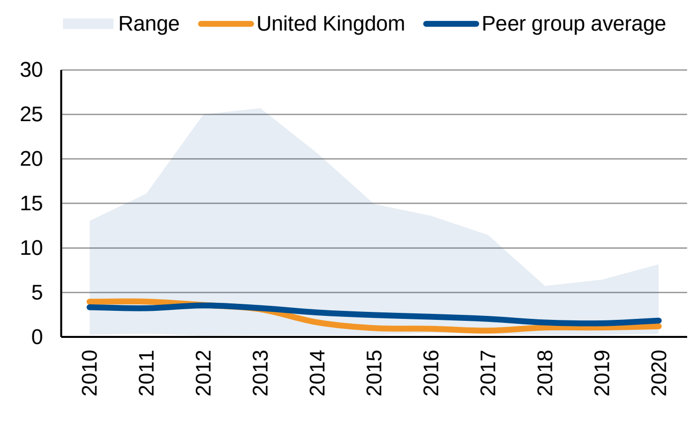
## Financial Stability Risks

- **Banking sector:** The UK banking sector is resilient and well-capitalised, with a stable aggregate CET-1 ratio of 16.8% as of end-2021. Robust liquidity positions and strong asset quality, as reflected in very low non-performing loan (NPL) ratios, underpin the sector's resilience. We expect NPLs to increase moderately in the medium term, following the phase out of government support measures and the deterioration of the economic outlook. Profitability recovered well from the Covid-19 shock, as reflected in the return-on-equity ratio for major UK banks increasing to 8% in 2021 (up from 2% in 2020). Looking forward, we expect interest margins to improve from their currently low level in line with the gradual rise in interest rates. Exposure to Russia and Ukraine is low, comprising less than 1% of CET-1 capital for the sector. In view of the economic recovery, the Financial Policy Committee enacted an increase in the counter-cyclical capital buffer rate from 0% to 1% at the end of last year, effective in December 2022.
- **Private debt:** Private-sector debt is elevated overall, at 210% of GDP as of end-2020, especially for households (96% of GDP). Household finances remained resilient throughout the crisis, however, in part owing to strong government support measures. The share of households with high debt-servicing burdens as of Q3 2021 remained broadly in line with its pre-pandemic levels and stood well below its pre-2008 levels. Business insolvencies have increased in the recent period following the phase out of government support, albeit remaining aligned with pre-crisis averages. We expect financial vulnerabilities to increase moderately in the medium term, following from the expected dip in real earnings in parallel with rising costs of debt, especially for households with variable-rate mortgage loans (around 20% of total).
- **Financial imbalances:** The residential real estate market was particularly active throughout 2021, supported by a stamp duty holiday and the availability of low-cost mortgages. House prices rose by about 10% over the year, boosted by a 43% increase in property transactions. We expect demand to moderate in the medium term in line with the dip in real incomes and the rise in interest rates.

**Overview of Scope's qualitative assessments for the United Kingdom's *Financial Stability Risks***

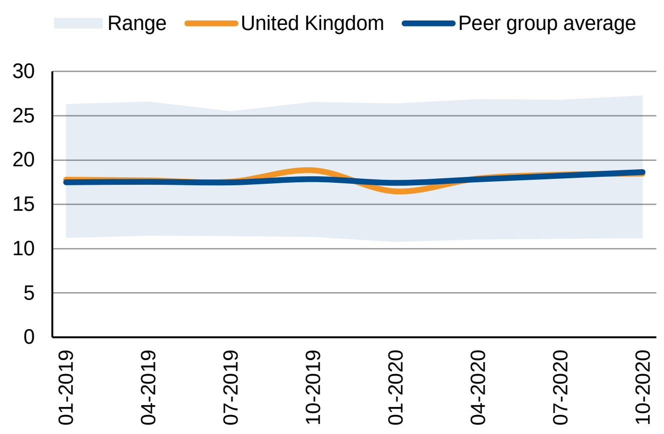
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| aaa | Banking sector performance | Neutral | 0 | Banking-system capitalisation remains sound, low NPLs, good profitability |
| | Banking sector oversight | Strong | +1/3 | Sophisticated financial regulatory system and strong macro-prudential governance framework |
| | Financial imbalances | Neutral | 0 | High private debt levels, high asset valuations and evidence of increased risk-taking in financial markets |

**Non-performing loans**, % of total loans




Source: IMF WEO, Scope Ratings GmbH

**Tier 1 ratio**, % of risk-weighted assets




Source: IMF WEO, Scope Ratings GmbH

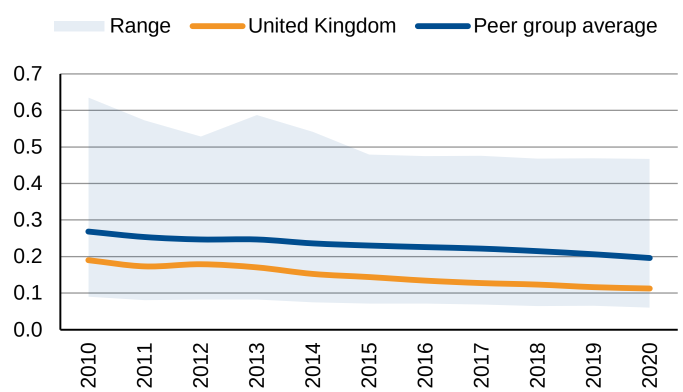
## ESG Risks

- **Environment:** The UK is committed to reaching net zero carbon emissions by 2050. According to the independent Climate Change Committee, the Net Zero Strategy is an ambitious but achievable vision towards carbon neutrality. The UK has a strong record in reducing carbon emissions, down 40% from 1990 to 2019, and the sixth Carbon Budget requires an emissions reduction of 63% from 2019 to 2035. Further investments are needed in the electrification of the railway system to reduce transport-sector emissions, as well as in the renewal of the UK housing stock with a view to improving energy-efficiency. The UK is vulnerable to the effects of climate change, specifically flooding, water-supply shortages and risks to health from high temperatures. While some estimates suggest a moderate impact on the UK's economic output in the long run, there remains a high degree of uncertainty.
- **Social:** Employment rates are broadly in line with peers and have reached pre-crisis levels. Challenges relate to comparatively high income inequality, reflected in a higher Gini coefficient compared with peer countries and elevated poverty rates. We expect the worsening cost of living crisis to aggravate income inequality levels due to a drop in real incomes, thereby raising the risk of social exclusion and increasing the need for government support to households.
- **Governance:** The UK benefits from mature institutions under parliamentary democracy, although its institutional strength has weakened since the 2016 EU referendum, with regulatory policies being subject to increased uncertainty outside the EU. International and domestic political tensions related to Brexit are likely to persist, especially surrounding the Northern Ireland protocol.

**Overview of Scope's qualitative assessments for the United Kingdom's *ESG Risks***

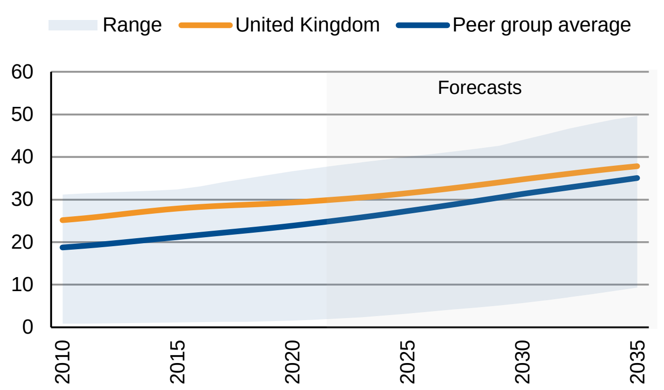
| CVS indicative rating | Analytical component | Assessment | Notch adjustment | Rationale |
|---|---|---|---|---|
| aa | Environmental risks | Neutral | 0 | Ambitious commitment to carbon neutrality by 2050 |
| | Social risks | Weak | -1/3 | Challenges include high income inequality, elevated poverty rates compared with peers and the risk of social exclusion |
| | Institutional and political risks | Neutral | 0 | Resilient institutional framework, but ongoing domestic and international Brexit-related challenges |

**$CO_2$ emissions per GDP**, $mtCO_2e$



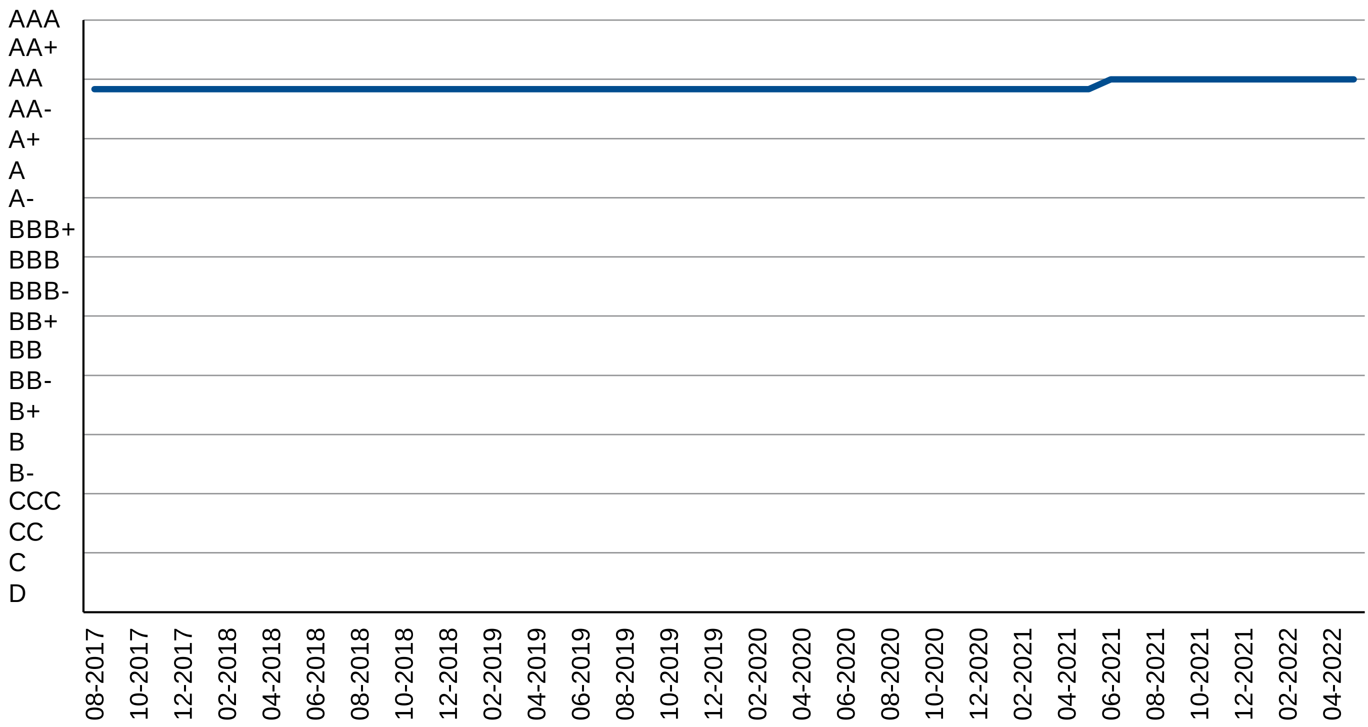

Source: European Commission, Scope Ratings GmbH

**Old age dependency ratio**, %




Source: United Nations, Scope Ratings GmbH

## Appendix I. Rating history




## Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard embedding a methodological reserve-currency adjustment.

| Peer group* |
|---|
| Austria |
| Belgium |
| Czech Republic |
| Denmark |
| Estonia |
| Finland |
| Germany |
| Ireland |
| Luxembourg |
| Netherlands |
| Norway |
| Sweden |
| Switzerland |
| United States |

Publicly rated sovereigns only; the full sample may be larger.

## Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022E | 2023F |
|---|---|---|---|---|---|---|---|---|
| **Domestic Economic Risk** | | | | | | | | |
| **GDP per capita, USD '000s** | 41.6 | 40.9 | 43.7 | 43.1 | 41.1 | 47.2 | 49.8 | 54.1 |
| **Nominal GDP, USD bn** | 2733.0 | 2701.3 | 2904.5 | 2880.4 | 2758.9 | 3187.6 | 3376.0 | 3686.9 |
| **Real growth, %[1]** | 2.3 | 2.1 | 1.7 | 1.7 | -9.3 | 7.4 | 3.5 | 1.1 |
| **CPI inflation, %** | 0.7 | 2.7 | 2.5 | 1.8 | 0.9 | 2.6 | 7.4 | 5.3 |
| **Unemployment rate, %[1]** | 4.9 | 4.4 | 4.1 | 3.8 | 4.5 | 4.5 | 3.8 | 4.1 |
| **Public Finance Risk** | | | | | | | | |
| **Public debt, % of GDP[1]** | 85.8 | 85.1 | 84.5 | 83.9 | 102.6 | 95.3 | 90.5 | 88.6 |
| **Interest payment, % of government revenue** | 4.4 | 4.9 | 4.5 | 3.8 | 2.9 | 5.5 | 7.0 | 4.3 |
| **Primary balance, % of GDP[1]** | -1.7 | -0.6 | -0.5 | -0.8 | -11.7 | -5.9 | -2.7 | -2.7 |
| **External Economic Risk** | | | | | | | | |
| **Current account balance, % of GDP** | -5.3 | -3.6 | -3.9 | -2.7 | -2.5 | -2.6 | -5.5 | -4.8 |
| **Total reserves, months of imports** | 1.5 | 1.6 | 1.7 | 1.7 | 2.2 | - | - | - |
| **NIIP, % of GDP** | -2.0 | -13.5 | -12.5 | -26.2 | -23.6 | -31.2 | - | - |
| **Financial Stability Risk** | | | | | | | | |
| **NPL ratio, % of total loans** | 0.9 | 0.7 | 1.1 | 1.1 | 1.2 | - | - | - |
| **Tier 1 ratio, % of risk-weighted assets** | 16.9 | 17.1 | 17.9 | 18.9 | 18.5 | - | - | - |
| **Credit to private sector, % of GDP** | 130.7 | 132.3 | 132.6 | 131.3 | 143.7 | - | - | - |
| **ESG Risk** | | | | | | | | |
| **$CO_2$ per EUR 1,000 of GDP, $mtCO_2e$** | 133.9 | 127.1 | 123.0 | 115.9 | 112.1 | - | - | - |
| **Income quintile share ratio (S80/S20), x** | 5.9 | 6.2 | - | - | - | - | - | - |
| **Labour-force participation rate, %** | 77.2 | 77.4 | 77.7 | 78.0 | - | - | - | - |
| **Old-age dependency ratio, %** | 28.3 | 28.5 | 28.8 | 29.0 | 29.3 | 29.7 | 30.0 | 30.5 |
| **Composite governance indicator[2]** | 1.4 | 1.4 | 1.4 | 1.4 | 1.3 | - | - | - |

[1] Forecasted values are produced by Scope
[2] Average of the six World Bank Worldwide Governance Indicators
Source: European Commission, IMF WEO, World Bank, Scope Ratings GmbH

## Appendix IV. Economic development and default indicators

| | |
|---|---|
| IMF Development Classification | Advanced economy |
| 5y USD CDS spread (bps) as of 3 June 2022 | 10.9 |

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