United Kingdom
Rating Report

AA STABLE OUTLOOK

Credit strengths

- Strong institutional framework
- Large, wealthy and diversified economy
- High degree of financing flexibility
- Robust debt profile

Credit challenges

- Weakening fiscal and economic outlooks
- Weak external position with persistent current account deficit
- Prolonged uncertainties surrounding the implementation of the post-Brexit UK-EU trade agreement

Rating rationale

Strong institutional framework: The UK benefits from robust financial supervisory, economic and monetary governance frameworks. This includes the Office for Budget Responsibility and the Bank of England which reacted promptly to the recent market turmoil involving pension funds.

Large, wealthy and diversified economy: The UK economy proved broadly resilient to the Covid-19 shock, with output edging close to pre-pandemic level by late 2021. While the economic outlook has weakened materially in recent months, comparatively high wealth levels and a very diversified economic base remain significant resilience factors.

High degree of financing flexibility: Despite the recent volatility in gilt markets, the country still benefits from its access to deep capital markets and sterling's status as a reserve currency.

Robust debt profile: The UK benefits from high average debt maturity of 14.8 years. Around a fifth of government debt is indexed to inflation, leading to a temporary increase in debt interest payments.

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

United Kingdom's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	aaa	GBP [+1]	+1/3	AA
Public Finance Risk		20%	bbb+		0	
External Economic Risk		10%	ccc		-2/3	
Financial Stability Risk		10%	aaa		+1/3	
ESG Risk	Environmental Factors	5%	aa-		0	
	Social Factors	7.5%	bbb-		-1/3	
	Governance Factors	12.5%	aaa		0	
Indicative outcome		**aa**			**0**	
Additional considerations					**0**	

* 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 Rating 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

- Significant improvement of the fiscal outlook including a stable downward trajectory of public debt in the medium term
- Reduction of external vulnerabilities

Negative rating-change drivers

- Further weakening in economic and fiscal outlooks lead to higher debt-to-GDP
- More severe weakening of UK-EU trade, attrition of the UK's services sector and/or risks to the constitutional integrity
- Increase in external vulnerabilities or challenge to sterling's reserve currency status

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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Bloomberg: RESP SCOP

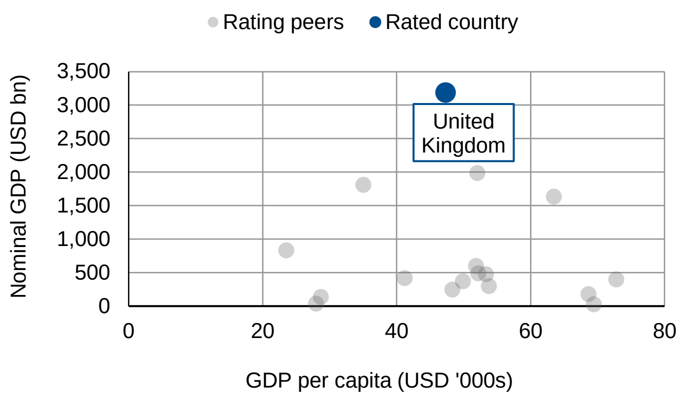
Domestic Economic Risks

- **Growth outlook**: Despite a strong rebound in 2021, with GDP growth of 7.4%, the UK has been trailing peers in its post-pandemic recovery, with quarterly GDP still below its Q4 2019 level at the end of H1 2022. The growth momentum remained robust in the first half of the year, with real growth of 0.7% and 0.2% in the first two quarters as resilient consumption and investment offset the dip in net exports resulting from soaring global energy and commodity prices. The UK economy contracted by 0.2% in Q3 2022 primarily due to weakening private demand, with negative contributions from household consumption and inventories, and despite improvements in the external balance. Rising consumer and producer prices are weakening private consumption despite government support measures, while tight funding conditions and high uncertainty are affecting investment decisions. We expect these headwinds to weigh on economic activity over the medium term. While real growth will remain comparatively high in 2022 at 4.4% thanks to significant carryover effects, we expect a contraction of 0.6% in 2023, followed by a small rebound of 1.1% in 2024.
- **Inflation and monetary policy**: CPI inflation continued to rise in recent months, reaching a new multi-decade high in October at 11.1% YoY, in part reflecting a record high spike in food prices (+16.5%). The increase occurred despite the implementation of the government's energy price guarantee which limits electricity and gas price increases for households. Core inflation remained high but stable at 6.5%. A weak sterling and tight labour markets contribute to inflationary pressures. The Bank of England (BoE) has rapidly tightened monetary policy since the autumn of 2021, raising the Bank rate by a cumulated 290 bps since December 2021 to 3.00%. The Bank also continued its planned quantitative tightening by stopping re-investments in February 2022 and actively selling bonds in November – the first major central bank to do so.
- **Labour market**: The UK labour market remains tight, with a high employment rate of 75.5% as of Q3 2022. Labour shortages still constitute a significant challenge as 83% of firms reported hiring difficulties in October, although there has been a slight decline in the total number of unfilled vacancies in recent months, signalling some easing in labour demand. The tightness in the labour market has supported robust nominal wage growth, at +6% YoY in September, though it has so far remained below CPI inflation, causing a sharp dip in real incomes for workers.

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

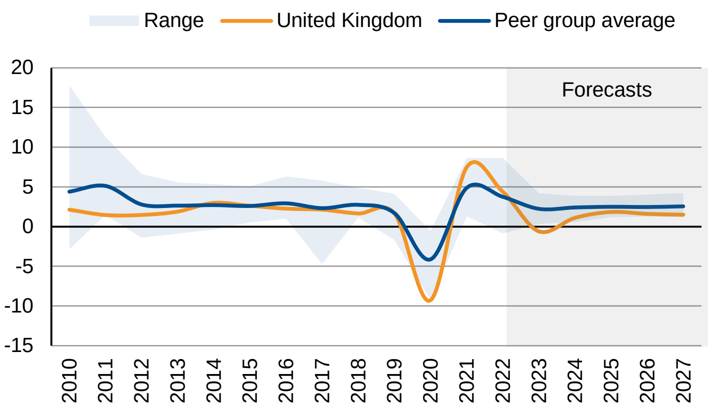
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Growth potential of the economy	Neutral	0	Moderate growth potential, has weakened since 2016 referendum
	Monetary policy framework	Strong	+1/3	Highly credible and effective central bank; independent monetary policy
	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



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

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

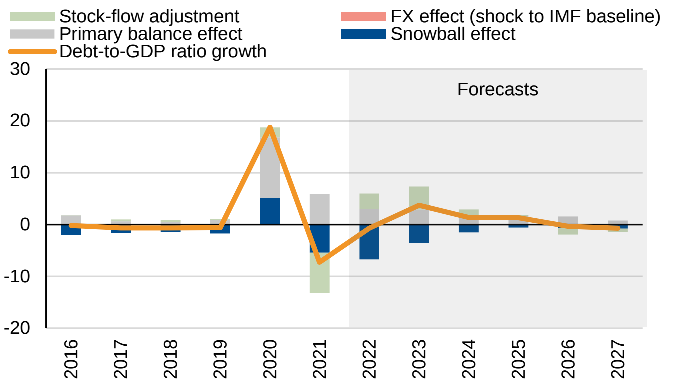
Public Finance Risks

- **Fiscal outlook**: After a decrease in the general government deficit in 2021 (8% of GDP, down 4.8 pp from 2020), we estimate the budget balance will remain elevated this year at around 5.7% of GDP and only fall gradually over subsequent years. Total funds allocated to measures aimed at shielding households and corporates from high energy prices amounted to EUR 97bn (3.5% of GDP) between September 2021 and October 2022. The government's Autumn Statement set out several additional support measures, particularly focussed on lower-income households, and has revised the fiscal framework which could reduce fiscal discipline in future. The weakening of the economic outlook will materially weigh on the fiscal recovery over the medium term from the combined impacts of spending pressures related to energy support measures, higher debt service payments and rising social and pension costs. We expect the general government deficit to rise to 6.6% in 2023, before declining in subsequent years, to around 3.5% by 2027.
- **Debt trajectory**: After declining to 95.3% in 2021, we estimate that the debt-to-GDP ratio will remain stable this year on the back of robust nominal growth. However, slowing economic growth and rising interest payments are then expected to raise debt levels above 100% of GDP by 2025. According to OBR forecasts, the government would miss its legislated fiscal targets of a current budget surplus and falling public sector net debt by 2025-26. In the Autumn Statement, the government therefore proposed to amend the fiscal framework to extend the period by when the targets must be met from three years to five years. Long term challenges to the debt trajectory relate to significant contingent liabilities related to pension and healthcare expenditures.
- **Market access**: The UK benefits from strong market access, with an exceptionally long average debt maturity (14.8 years as of June 2022) compared to peers. The Bank of England is the largest holder of gilt and treasury bills (around a third of total), though quantitative tightening is expected to reduce this share. Similarly to peers, funding costs have been increasing steadily since H2 2021 due to rising inflation and tightening monetary policy. After experiencing a sharp jump in September following the 'mini-budget' announcement, yields have moderated in recent weeks on expectations of a reversal of fiscal policy, although remaining elevated, with the yield on 10-year government bonds averaging 3.6% in the first half of November (up 2.6 pp from the same period last year). Over a quarter of government gilts are indexed to retail-price inflation, accelerating the rise in interest payments.

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

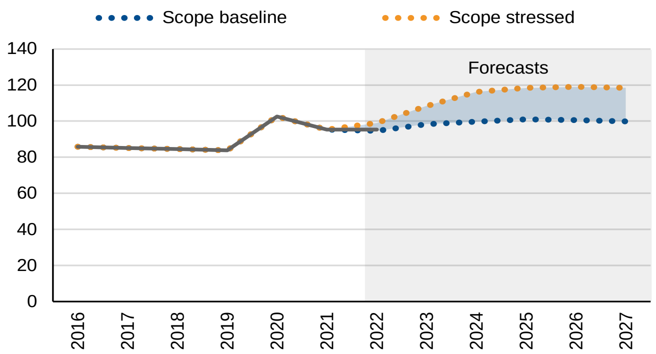
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Fiscal policy framework	Neutral	0	Renewed commitment to budgetary discipline, but revised fiscal framework could weaken future fiscal discipline
	Debt sustainability	Neutral	0	Debt expected to gradually increase, but still 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, pp of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

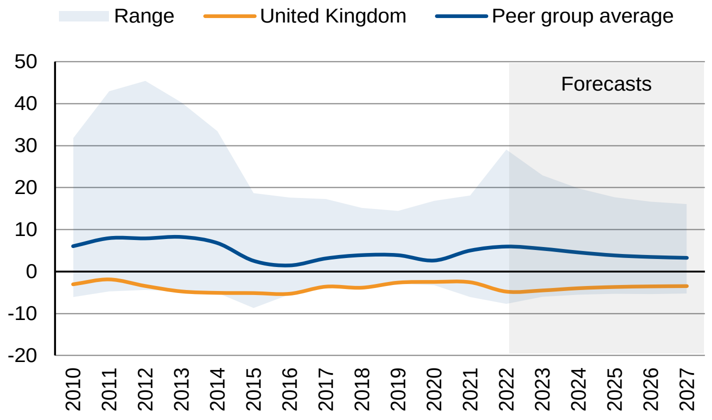
External Economic Risks

- **Current account**: The UK has a track record of running sizable current account deficits, averaging at 3.4% of GDP over 2017-19, well above peer countries. The deficit declined during the pandemic to 2.5% and 2.6% of GDP in 2020 and 2021, respectively, on the back of robust services exports. However, it widened to 7.2% of GDP in the first quarter of 2022 from the record high deficit in the trade of goods balance (11.1% of GDP) due to rising nominal imports in light of very high global energy and raw material prices. The current account deficit moderated to 5.5% of GDP in Q2 2022, thanks to slightly more benign deficits in the goods and primary income balances. We expect the external balance to remain near pre-pandemic levels, in line with IMF forecasts, which estimate the current account deficit to average 4.0% of GDP over 2022-27.
- **External position**: The external debt-to-GDP ratio stood at about 299% of GDP as of Q2 2022, below pandemic-era highs of above 330% but still around 9 pp above its end-2019 level, as well as close to historical highs in absolute terms. Short-term liabilities make up 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 moderately sized, at minus 7% of GDP in the year to Q2 2022, up from a negative 22% in Q2 2021. This shift has been supported by a favourable currency-denomination structure of the UK's external position, with sterling's depreciation improving the net international investment position (NIIP) as UK liabilities tend to be denominated in sterling and UK assets tend to be denominated in foreign currencies.
- **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 for additional financing that ended in April 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 4.9% as of Q2 2022, 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*

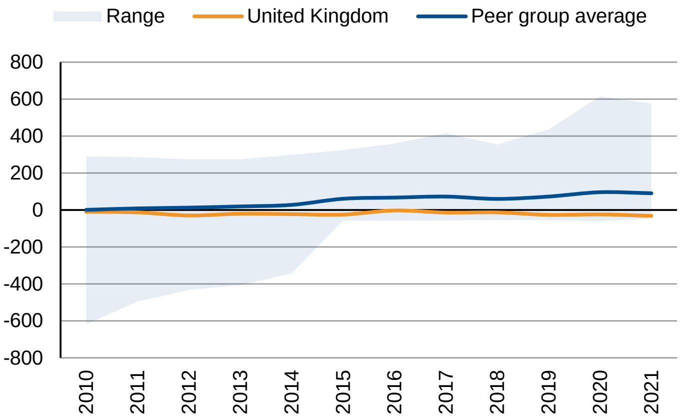
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Current account resilience	Weak	-1/3	Weaker services exports may exacerbate external weaknesses, weakened net foreign direct investment inflows
	External debt structure	Weak	-1/3	Elevated external debt, with high foreign-currency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

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

Financial Stability Risks

- **Banking sector**: The aggregate capital and liquidity positions of the UK banking sector remain strong. The Tier 1 ratio increased by 0.3 pp to 17.6% in Q2 2022 compared with the previous quarter, remaining below its historic peak of 19.1% in Q4 2021, but with headroom above regulatory buffers. 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 in the medium term, following the sharp rise in interest rates, rising cost pressures and the deterioration of the economic outlook. While asset quality is likely to deteriorate, we expect higher interest rates to support banks' profitability. So far, profitability recovered well from the Covid-19 shock, as reflected in the return-on-equity ratio for major UK banks increasing to 11.9% in Q1 2022, up from around 4% in mid-2020. To further build bank resilience in light of the more challenging economic outlook, the Financial Policy Committee maintained the counter-cyclical capital buffer rate in its September meeting at 2%, effective from July 2023.

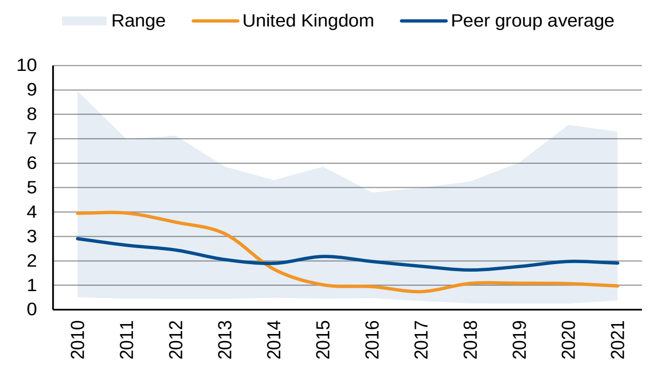
- **Private debt**: Private-sector debt is elevated but fell back to pre-pandemic levels with aggregate household debt at 87% of GDP as of Q1 2022 and debt to non-financial corporations at 66%. Household finances remained resilient throughout the pandemic thanks to government support measures. However, rising inflationary pressures and interest rates will strain finances and increase households' vulnerability to future shocks. While the aggregate debt service ratio decreased in recent years, it still stood at 8.5% of income in Q1 2022, remaining above French (6.6%) and German (6.2%) household levels. Average mortgage rates on five-year fixed contracts with a loan-to-value ratio of 75% have increased more than fourfold from 1.3% in October 2021 to 5.6% in October 2022. Since around 85% of mortgage balances are on fixed rates, the sharp rise in interest rates will only gradually impact average mortgage costs. Small and medium-sized businesses will be impacted significantly faster as most of their loans tend to be on variable rates.

- **Financial imbalances**: While house prices fell by 0.9% in October 2022 compared with the previous month, they are still 7.2% higher than in October 2021. The rapid increases in financing costs will increasingly stretch UK household and business finances in the coming months, leading to a correction in the housing market. While there is significant uncertainty about the extent of the price correction, it is unlikely to rival the global financial crisis as household finances are on a stronger footing and mortgage contracts since 2008 better reflect borrower risk profiles.

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

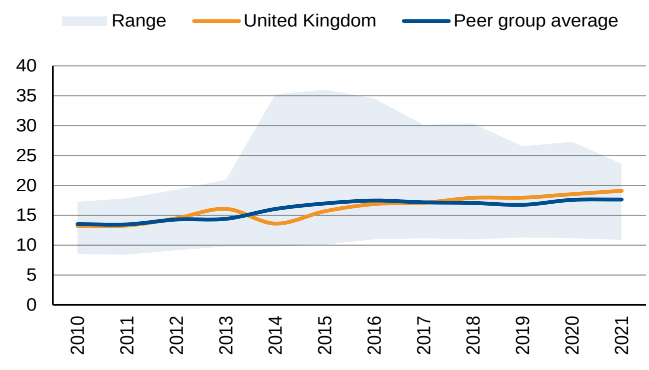
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Banking-system capitalisation remains sound, low NPLs, good profitability
	Banking sector oversight	Strong	+1/3	Sophisticated financial regulatory system and strong macro-prudential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

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

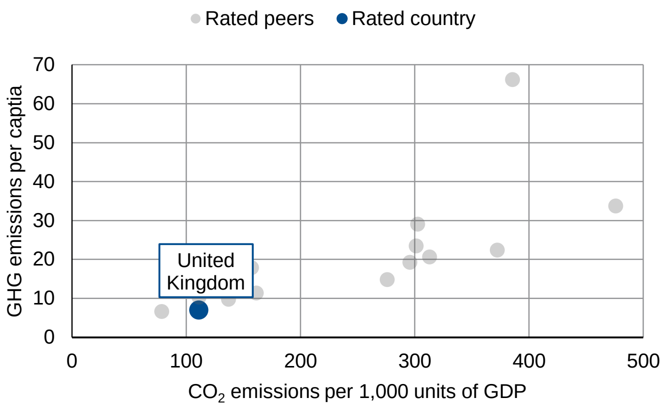
ESG Risks

- **Environment**: The UK is committed to reaching net zero carbon emissions by 2050. According to the independent Climate Change Committee (CCC), the Net Zero Strategy is an ambitious but achievable vision towards carbon neutrality. The UK has a strong record in reducing carbon emissions, down 47% from 1990 to 2021, and the sixth Carbon Budget requires an emissions reduction of 78% from 1990 to 2035. The CCC noted in its latest progress report that there are either significant risks or a policy gap for 38% of the required emissions reduction specified in the sixth Carbon Budget. Policy areas identified which require further attention include the introduction of a market-based mechanism for low-carbon heat in homes, peatland restoration, increased CO_2 storage and removal, support for low-carbon farming practices and industrial electrification. 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 in the three months to September 2022 remained 1.1 pp below pre-pandemic levels while the level of economic inactivity stood at 21.6%, remaining 1.4 pp higher than in February 2020. 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 been tested since the 2016 EU referendum, with regulatory policies being subject to increased uncertainty. International and domestic political tensions related to Brexit are likely to persist, especially surrounding the Northern Ireland protocol. With Rishi Sunak being the third prime minister within one year, political instability is weighing on policy certainty and business investment.

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

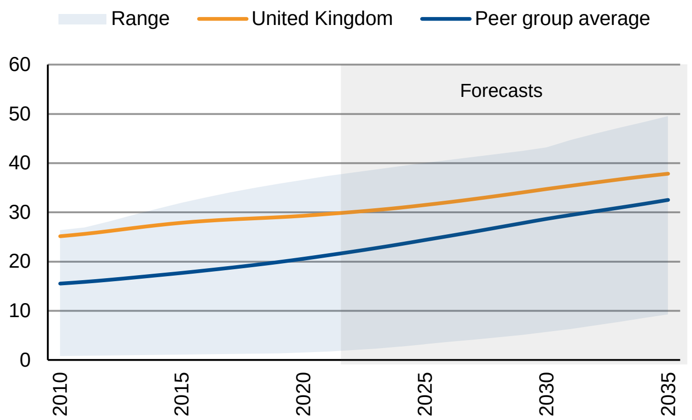
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa	Environmental factors	Neutral	0	Ambitious commitment to carbon neutrality by 2050
	Social factors	Weak	-1/3	Challenges include high income inequality, elevated poverty rates compared with peers and the risk of social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

Emissions per GDP and per capita, $mtCO_2e$



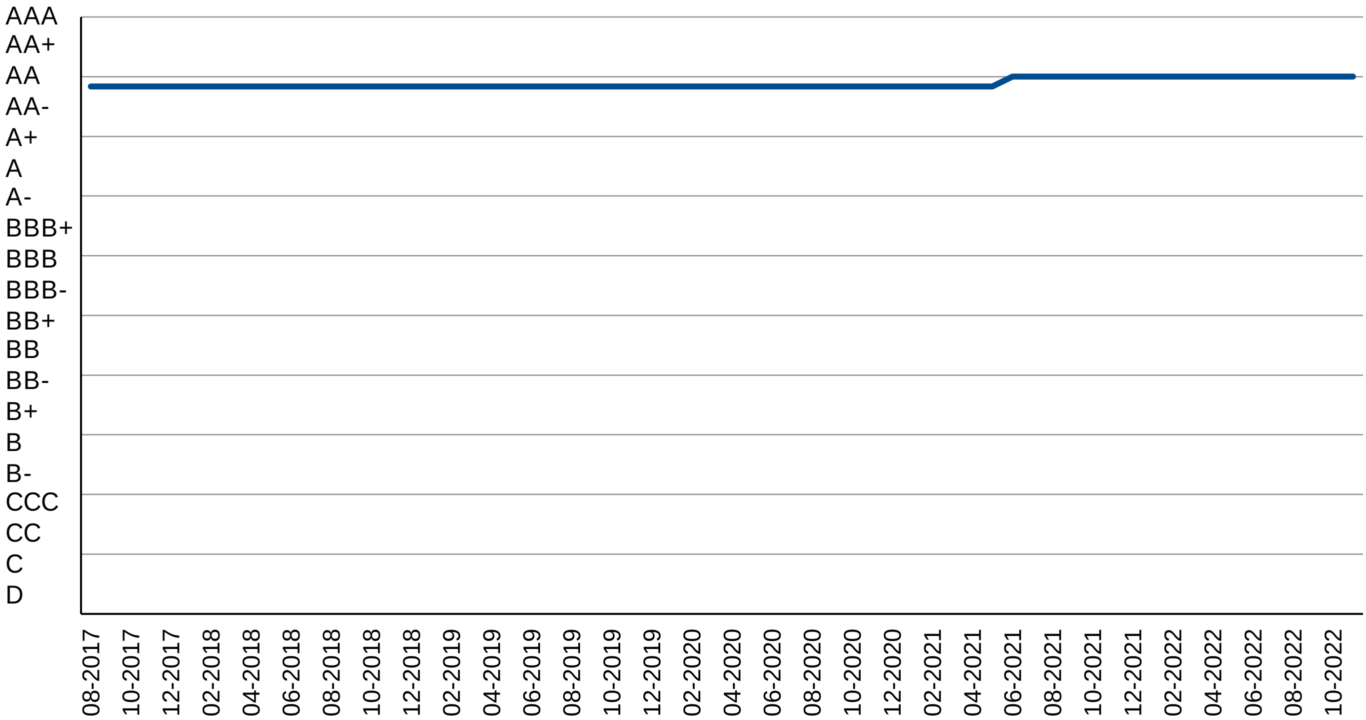
Source: European Commission, Scope Ratings

Old-age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

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, including a methodological reserve-currency adjustment.

Peer group*
Austria
Belgium
Estonia
Finland

*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 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	**GDP per capita, USD '000s**	IMF	40,904	43,719	43,121	41,127	47,329
	Nominal GDP, USD bn	IMF	2,701.3	2,904.5	2,880.4	2,758.9	3,187.6
	Real growth, %	IMF	2.1	1.7	1.7	-9.3	7.4
	CPI inflation, %	IMF	2.7	2.5	1.8	0.9	2.6
	Unemployment rate, %	WB	4.3	4.0	3.7	4.5	4.5
Public Finance	**Public debt, % of GDP**	IMF	85.1	84.5	83.9	102.6	95.3
	Interest payment, % of revenue	IMF	4.9	4.5	3.8	2.9	5.5
	Primary balance, % of GDP	IMF	-0.6	-0.5	-0.8	-11.7	-5.9
External Economic	**Current account balance, % of GDP**	IMF	-3.6	-3.9	-2.7	-2.5	-2.6
	Total reserves, months of imports	IMF	1.6	1.7	1.7	2.2	2.0
	NIIP, % of GDP	IMF	-13.5	-12.5	-26.2	-23.6	-31.2
Financial Stability	**NPL ratio, % of total loans**	IMF	0.7	1.1	1.1	1.1	1.0
	Tier 1 ratio, % of RWA	IMF	16.5	17.0	17.8	17.2	18.4
	Credit to private sector, % of GDP	WB	132.3	132.6	131.3	143.8	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	125.7	121.8	116.1	111.0	108.7
	Income share of bottom 50%, %	WID	20.4	20.3	20.4	20.4	20.4
	Labour-force participation rate, %	WB	77.4	77.7	78.0	-	-
	Old-age dependency ratio, %	UN	28.5	28.8	29.0	29.3	29.7
	Composite governance indicators*	WB	1.4	1.4	1.4	1.3	-

* Average of the six World Bank Worldwide Governance Indicators

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 25 November 2022	6.8

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