Rating Update:

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

Rating Action

Neuss, 25 September 2020

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "AA" for the United Kingdom. Creditreform Rating has also affirmed the United Kingdom's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "AA". The outlook is negative.[1]

Reasons for the Rating Decision and Latest Developments

With a view to the macroeconomic performance profile, the United Kingdom's credit ratings rest on its large, wealthy economy that also features a very competitive business environment and flexible labor market. Apart from corona-related risks, the assessment remains balanced by the uncertain outlook on the short-to-medium-term economic development in light of apparently stalling trade negotiations with the EU, which may also hamper capital accumulation and possibly labor supply. To some extent, stretched household balance sheets limit risk-bearing capacities.

Since our last review, negative effects on the economy from the corona crisis and the related lockdown have become more palpable, suggesting that the UK's economic output will record a very steep, albeit presumably temporary, decline this year. While implemented macroeconomic policies in response to the crisis - along with the flexible labor market and the business-friendly environment - should support a recovery in 2021, we remain wary over recent news on the lack of progress in negotiating the future relationship with the EU beyond the transition period. Trade frictions in a scenario without a follow-up agreement (see below) would likely hamper GDP growth going forward. Moreover, faced with possible disruption to supply chains, consumers and businesses might want to bring some purchases or activity forward into the second half of 2020 at the expense of developments in 2021. The pandemic hit at a time when the economy had already been grappling with Brexit-related uncertainty and associated political controversy for several years. Real GDP in 2019 was slightly revised upward to 1.5%, remaining below the average of 1.8% over the last five years and the average 2.1% real GDP growth achieved in the EU-27 over that period.

Prompted by a somewhat late and drastic shift in strategy in the corona crisis, the eventual strict lockdown took a toll on the economy. While in Q1-20, real GDP growth decreased by 2.2% q-o-q and thus to a lesser extent than in many European peers, economic output in Q2-20 saw the strongest fall within the former EU-28, plunging by 20.4% q-o-q (EU-27: -11.4%). Monthly estimates point to GDP having risen by 6.6% in July, corresponding to a third consecutive

[1] This rating update takes into account information available until 22 September.

monthly increase after 2.4% and 8.7% in May and June, emphasizing that a bounce-back is underway. We currently expect real GDP to contract by about 10.2% this year due to a dismal first half, and to see growth rebound by about 6.6% in 2021.

Since our last review, the UK has been hit by a relatively high number of coronavirus infections and related fatalities. Judging by the stringency index compiled by the Blavatnik School of Government, the UK government had decided to implement strict lockdown measures at a relatively late stage. Containment measures have shown the desired effect and have helped to significantly bring down infection numbers over the summer months, enabling the sovereign to embark on a gradual reopening strategy accompanied by comprehensive testing activity. While the 14-day cumulative number of COVID-19 cases (per 100k persons) dwindled to as low as 12.8 (1 August), it has begun to climb since then, and has been gaining traction from mid-September, reaching 78.8 as of 22 September (ECDC data).

As a reaction to latest dynamic developments, authorities announced further Covid-19 measures on 22 September, mostly affecting gastronomy and gatherings, while people are advised to work from home. At the current juncture, we would not expect measures to become as restrictive as seen in the second quarter. Having said that, we acknowledge that there remains enormous uncertainty around such assumptions, and certainly for as long as there is no or an insufficient amount of vaccine and/or medication available to tackle Covid-19. More generally, we observe that the UK scores comparatively well as regards our Pandemic Vulnerability Index (rank 5 out of 28 European economies), suggesting that the country is structurally less vulnerable to a pandemic and tends to be better prepared to cope with it.

Consumer expenditure fell sharply over the lockdown period but has been experiencing a recovery since the restrictions have been eased, also backed by the Coronavirus Job Retention Scheme (CJRS), which has been extended through to October, and the Self-Employment Income Support Scheme (SEISS), as well as the kicking-in of automatic stabilizers. Until 30 June, 9.6 million employments were at least temporarily furloughed through CJRS between March and June, corresponding to about a third (32%) of eligible employments (HMRC data). As to SEISS, 3.4mn self-employed were identified as potentially eligible of which, in a first round between 13 May and 31 July 2020, 2.6mn claims totaled GBP 7.6bn. By 31 August, 2mn had claimed a second grant, with the value of the second-round claims amounting to GBP 5.1bn.

We note that spending centered around social interaction has suffered the most and has only partly recovered so far. Typically, the proportion of this type of spending is somewhat higher in the UK compared to some other countries. Going forward, consumers may exert more caution as employment may be hampered by a number of insolvencies in the wake of the corona crisis and as support measures phase out. Spending patterns may also be influenced by adapted consumer behavior as far as 'social consumption' is concerned, as well as by concern over possible post-Brexit-related trade disruptions. Nevertheless, private consumption should constitute the main engine of the prospective recovery.

Business investment activity should be affected more severely by the elevated level of uncertainty over the near-term course of the pandemic, as well as in light of unclear future relations with the EU, and might thus take longer to recover as projects may be postponed or cancelled altogether. Respondents to the Decision Maker Panel (DMP) survey in August indicated that capital expenditure would be on average 31.6% and 25.5% lower in Q3 and Q4 respectively due to Covid-19. Reportedly, business loan schemes could be extended for applications until the end of November, providing for continued aid for the business sector.

While resuming growth among main trading partners is backing expectations for recovering import and export activity, prospects for global trade remain somewhat dampened by the ongoing pandemic worldwide. Any delay or even breakdown of the negotiations between the UK and the EU, as well as slow progress on agreements with third parties, would potentially weigh more heavily on the near-term prospects. While in the absence of a follow-up deal with the EU, WTO rules for goods would need to kick in, frictions may occur after all despite preparations towards this scenario having advanced. As regards trade in services, we gather that there remain uncertainties over whether or to what extent equivalence agreements concerning financial services can/will be established. What is more, a number of trade agreements with third countries will take time to be concluded or fleshed out. While there is a Mutual Recognition Agreement (MRA) in place with e.g. the US, Australia, and New Zealand, further decisive steps towards comprehensive trade deals have yet to be taken. By comparison, we gather that negotiations with Japan are more advanced, as a UK-Japan Comprehensive Economic Partnership Agreement was agreed in principle on 11 September.

We continue to view the very strong institutional set-up, which also encompasses a sound monetary policy framework, as a credit strength of the sovereign. This assessment is to some extent balanced by the heightened political volatility in the aftermath of the UK's EU referendum, which has partly left its mark on the World Bank's Worldwide Governance Indicators, and by some reservations over the quality of communication and political predictability. The current public debate over whether the signed Withdrawal Agreement from the EU will be adhered to represents the latest case in point.

Recent developments in the post-Brexit process have thus added to our concerns. We recall that UK authorities stick to their position ruling out an extension of the transition period in the Withdrawal Agreement which will end on 31 December. Progress on negotiating the future trade relationship has been feeble, with fishing rights and state subsidies seemingly being the main points of disagreement. More recently, the Internal Market Bill which was put forward on 10 September and which sets out rules concerning market access principles between England, Scotland, Wales and Northern Ireland relevant after the end of the Brexit transition period has sparked serious controversy with the EU over whether this bill would modify the Withdrawal Agreement signed with the EU in 2019 and breach international law. Against this backdrop we would flag potentially significant reputational damage as regards the UK's qualities as a reliable negotiation partner, possibly eroding policy credibility. Moreover, possibly resurfacing tensions over the handling of the EU border between Northern Ireland and the Republic of Ireland in the affected region would present a concern. In the same vein, we note that the Scottish government has expressed the intention to prepare for another referendum on Scottish independence, serving as a reminder that political and social cohesion within the country might be further put to the test.

The economic downturn caused by the corona crisis and the necessary measures to rein in the spread of the virus will have the general government budget deficit soar and push the elevated debt level further up, thus adding to the sovereign's main credit weakness. However, persistently sound debt management results in a favorable debt composition and maturity profile. Together with historically low interest rates, these factors continue to alleviate risks to fiscal sustainability. Contingent liability risks via the large banking sector as a consequence of the corona crisis, bearing in mind already stretched household balance sheets, will have to be monitored.

The UK's headline deficit (Maastricht aggregate, OBR) has risen to 2.7% of GDP in the financial year 2019/20 (FY 19/20), up from 1.9% in the preceding FY, thus putting an end to years of falling

debt-to-GDP ratio since a peak in 2010. Already pre-corona, the Kingdom's fiscal stance was set to become more expansionary in a bid to boost investment and infrastructure. Amid foregone tax revenue and increased spending to cushion the economic blow caused by this pandemic, we expect a budget deficit of approx. 13.7% of GDP for FY 20/21, which would be the highest in any post-World War II recession. In the following year, the deficit should shrink significantly, reflecting our assumption of resuming GDP growth and scaled-back or withdrawn support measures.

Direct effects of government decisions taken in response to corona, to our understanding, would amount to GBP 192.3bn (OBR data) - which would correspond to about 9.4% of our estimated 2020 GDP - with employment support measures (CJRS and SEISS) and business support in the form of grants and business rates relief accounting for the majority thereof. To soften the expiry of the furloughing scheme in October, HM Treasury has announced payment of GBP 1,000 to firms for every employee kept on for three months following the end of the scheme, which is part of a package of up to roughly GBP 50bn (Plan for Jobs, other measures), presented on 8 July. In September it was announced that businesses in England that are required to shut down because of local interventions would be able to claim up to GBP 1,500 per property every three weeks, underscoring that uncertainty pertaining to the overall fiscal outcome remains unusually high.

We expect general government debt to leap from an already elevated level (84.7% of GDP in FY 19/20) to about 106% of GDP in FY 20/21 before stabilizing in the following financial year, exceeding 100% of GDP for the first time since the 1960s. Despite the elevated debt level, we continue to deem the sovereign's persistently sound and transparent debt management, which translates into a favorable debt maturity profile boasting a very long average maturity of the debt portfolio of 15.2y at the end of March-20, as a key strength mitigating fiscal sustainability risks to some extent. The fact that the Bank of England (BoE) held about a quarter of the general government debt at the end of 2019 (Q4-19: 26%, IMF data), and the foreign official sector another 18%, will have to be factored in here as well. Moreover, sterling's status as reserve currency continues to generate demand for government bonds.

While central government interest payments have fallen to 1.6% of GDP in the FY 19/20, the interest-to-revenue ratio (Eurostat data) relative to other European economies remains comparatively high at 5.6% in Q1-20 (Q4-19: 5.5%) and above that of AA-rated peers in our rating universe. UK 10y government bond yields hit a new all-time low on 4 August (0.079%), and we expect that the government will be able to borrow at historically low interest rates going forward, implying that interest costs will remain low despite rising debt levels. This being said, the BoE's monetary policy should continue to contribute to ongoing low bond yields, thus benefiting debt affordability. We recall the sovereign's positive track record in bringing down the deficit in the aftermath of the global financial crisis and will monitor in how far fiscal consolidation will be addressed going forward, possibly with an Autumn Budget. As far as demographic developments are concerned, the UK displays somewhat more benign prospects than many European peers, notwithstanding reduced mobility between the UK and the European continent.

Given the banking sector's large size (423% of GDP in Q4-19, ECB data), contingent liabilities remain in place although indicators such as CET1 and NPL ratios point to a relatively sound situation of the banking sector at present. What is more, based on recent Covid-19 stress tests, the BoE's Financial Policy Committee (FPC) in August judged that banks would be resilient to a wide range of possible outcomes, not least due to substantial buffers. Among other things, the

FPC suggested that for capital ratios to shrink by more than 5p.p. banks would have to face credit impairments to the tune of about GBP 120bn. While risks to financial stability beyond the banking sector which could arise from disruption to cross-border financial services following the end of the Brexit transition period were deemed widely mitigated, we note that the FPC points to necessary action to minimize risks related to disruption of derivatives markets. We understand that the end of September would be an important deadline in this respect. Developments will have to be closely monitored, not least as lack of clarity could cause wider financial market distress after all.

Against the backdrop of a relatively high household debt-to-income ratio and a likely rising number of insolvencies that should come with job losses, we would also stay vigilant regarding potential negative spillover on banks' balance sheets as companies and households may struggle to service their debt. To this end, we would also observe the development of house price dynamics, which have been more muted recently.

Some external vulnerabilities related to the United Kingdom's being a large international financial hub remain

While the UK's external position seems robust by and large, heightened uncertainty over future trade arrangements with the EU and third parties might lead to somewhat higher volatility as regards portfolio investment and direct investment. The current controversy over adherence to international law seems to add to the uncertainty in this respect. With regard to the current account balance, whose deficit was broadly stable at 4.0% of GDP in 2019, the narrowing observed in Q1-20, mainly due to a shrinking goods deficit as imports saw a stronger decline than exports, could reverse in the second half of the year as the economic recovery progresses. The country's net international investment position closed 2019 with a larger negative stance, at -25.2% compared to -12.8% in Q4-18, albeit to a broad extent owing to sterling's appreciation, but saw some reversal in Q1-20. Excluding non-defaultable instruments (NENDI), the position saw a similar development and came to -8.6% of GDP in Q1-20.

Rating Outlook and Sensitivity

Our rating outlook on the United Kingdom's long-term sovereign ratings is negative, as we perceive downside risks stemming from the fiscal outlook in an environment coined by macroeconomic uncertainty due to coronavirus and from eroding political predictability as outweighing otherwise prevalent macroeconomic and institutional strengths at this stage.

A downgrade of the United Kingdom's credit ratings could be triggered if key fiscal metrics fail to improve over the medium term and in the absence of a credible longer-term commitment to consolidate public finances. Protracted and/or intensified political uncertainty that might further impair broad policy predictability, increase macro-financial volatility, cause supply chain disruptions and/or result in adverse effects on potential growth could also give rise to downward pressure on the credit ratings. This might be the case if no new agreement with the European Union is reached and controversy over the issue escalates further. Furthermore, the loss of trust and jeopardized policy credibility entailed by unilaterally watering down parts of the Withdrawal Agreement between the UK and the EU would weigh on our perception of the sovereign's institutional quality.

Upward pressure on the rating could arise if key fiscal metrics improve quickly in a more benign economic scenario than currently envisaged, buttressed by a credible commitment to rein in

debt. We could consider a positive rating action if a prolonged phase of political uncertainty over trade relations, including those with the EU, can be avoided as timely agreements can be struck.

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Ratings*

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

*) Unsolicited

Economic Data

[in %, otherwise noted]	2014	2015	2016	2017	2018	2019	2020e
Real GDP growth	2.6	2.4	1.9	1.9	1.3	1.5	-10.2
GDP per capita (PPP, USD)	41,049	42,117	42,959	44,301	45,741	46,827	n.a.
CPI, y-o-y change	1.5	0.0	0.7	2.7	2.5	1.8	0.5
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	81.4	81.0	81.2	81.3	81.3	n.a.	n.a.
Fiscal balance/GDP*	-5.6	-4.6	-3.3	-2.5	-2.2	-2.1	-13.7
Current account balance/GDP	-4.7	-4.9	-5.2	-3.5	-3.9	-4.0	n.a.
External debt/GDP	308.7	286.8	306.4	308.9	309.5	299.9	n.a.

Source: International Monetary Fund, Eurostat, own estimates

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

ESG Factors

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

outlook is associated with what we understand to be an ESG factor and outline why these ESG factors were material to the credit rating or rating outlook.

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

ESG Factor Box

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

Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

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

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

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

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

Appendix

Rating History

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

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

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

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

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

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

Treasury, Office for Budgetary Responsibility (OBR), Office for National Statistics (ONS), UK Government – Department of International Trade, National Institute of Economic and Social Research

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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