UK banks quarterly

Credit fundamentals remain solid but asset quality expected to weaken

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The credit fundamentals of UK banks remain robust. We expect profitability to remain elevated throughout 2025, supported by strong net interest income, high interest rates and structural hedges. The impact from car finance exposures within our bank sample (Barclays, HSBC, Lloyds, NatWest, Santander UK) is manageable.

Asset quality remains sound but we expect a mild weakening. Our outlook reflects persistent geopolitical tensions and a challenging domestic economic environment: our UK growth forecasts are 1.4% for this year and 1.5% for 2026.

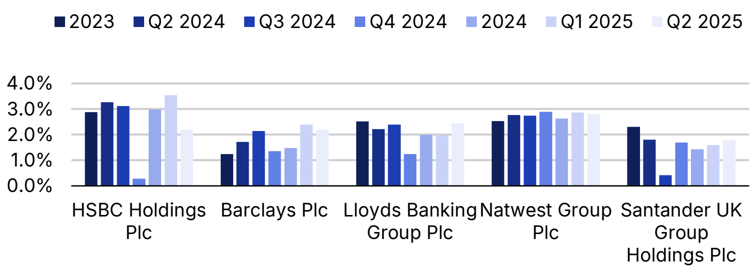
Capital levels are robust; organic capital generation offsets shareholder payouts. Principal liquidity metrics remain broadly stable; customer deposits are seeing modest growth, gradually normalising after past outflows.

The consolidation of the financial sector continues. Santander UK's acquisition of TSB is the latest in a series of UK bank M&A. We believe the consolidation trend will support banks' credit profiles through more diversified business models, stronger market positions and improved efficiency. The bolt-on nature of most deals announced so far limits execution risks.

Leeds Reforms will be positive for the banking sector but also entail risks. We believe the new financial sector reforms will support growth, resilience and competitiveness, and will unlock capital for lending and investment. However, a relaxation of loan-to-income metrics for consumers could encourage riskier lending and weaker underwriting standards.

Rating Outlook broadly balanced. The stable outlooks assigned to the subscription ratings on our sample of UK banks indicate that risks are broadly balanced in 2025.

Figure 1: Return on risk-weighted assets (RoRWA)



Source: Company data, Scope Ratings.

Table 1: Q2 2025 Trend overview and outlook

Our expectations of 2025 trends by key area for UK Banks		
Profitability	↗	**Mildly positive. Supported by structural hedges, gradual loan growth and higher-for-longer interest rates.**
Asset quality	↘	**Mildly negative. Expected weakening in 2025 driven by geopolitical risks and challenging UK economic outlook.**
Capital position	→	**Stable. Capital levels to remain robust, supported by solid organic capital generation offsetting shareholder distributions.**
Funding and liquidity	→	**Stable. Deposit outflows have stabilised, with a recovery expected through 2025.**

Consolidation in the domestic banking sector continues

Santander UK's acquisition of TSB Banking Group from Banco de Sabadell strengthens its market position, expanding its customer base and lending capacity. The transaction expands Santander's loan book by roughly 18% (using December 2024 numbers) making it the UK's third largest bank by personal current accounts and the fourth largest in mortgages. Santander UK gains approximately five million customers, GBP 34bn in mortgages (increasing its market share by 2%), and GBP 35bn in deposits.

Although the UK banking sector is relatively concentrated, we expect further consolidation to continue for the large players if potential bolt-on deals present strong financial rationales, an improvement in efficiency, operational synergies and greater scale and controlled growth.

In their respective earnings presentations, NatWest and Lloyds emphasised that although their strategies focus on organic growth, they do not rule out inorganic growth opportunities, provided such potential transactions create operational synergies and shareholder value and pose low risk.

We see private equity-owned challenger banks and neobanks as potential targets. Some of these players have developed an interesting presence in specific market niches, though their financial performance may suffer from lack of breadth. We also do not rule out further M&A among building societies. The driver here is geographic reach and scale.

Leeds Reforms simplify regulation for smaller banks but may entail risks

The government's drive to accelerate domestic economic growth spawned the Leeds Reforms as part of the Financial Services Growth and Competitiveness Strategy. The key initiatives include:

1) Increasing the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) threshold for transfer or bail-in resolution strategies from GBP 15bn-25bn to GBP 25bn-40bn from January 2026, adjusted every three years for nominal growth.
2) Doubling the Resolution Assessment Threshold for reporting and disclosures to GBP 100bn.
3) Delaying implementation of the Fundamental Review of the Trading Book – Internal Model Approach (FRTB-IMA) by a year to 1 January 2028, giving banks more time while helping regulators co-ordinate more effectively with other jurisdictions. Other Basel III finalisation rules covering roughly 90% of RWA will be implemented on 1 January 2027.
4) Implementing the Strong and Simple capital regime from 1 January 2027, a simplified regime for Small Domestic Deposit Takers (SDDTs), where a Single Capital Buffer (SCB) will be introduced to replace the current multiple buffers.
5) Review of Loan to Income (LTI) ratio requirements to allow lenders to increase their mortgage lending at high LTIs (over 4.5 times buyers' income) while ensuring the total flow remains within the 15% cap.
6) Reform of the ring-fencing regime targeting a balance between growth and stability.
7) Unlock and accelerate retail investment. The Financial Conduct Authority (FCA) will introduce Targeted Support from April 2026 allowing banks to make customers aware of specific investment opportunities.

Banks and insurers welcomed the reforms as they support long-term economic growth, streamline regulation, accelerate financial resilience and facilitate investment and innovation. While the reforms are the most comprehensive in over a decade, they do not radically alter the UK's highly regulated operating environment. They do provide an important update that simplifies financial regulation and reduces the regulatory burden on smaller financial institutions, helping them to compete more effectively with larger high street banks.

We believe the new measures will be positive although we are cautious about the potential risks of relaxing strict loan-to-income ratio limits, as this could weaken underwriting standards and increase household debt levels. We also caution that more relaxed rules from the review and update of the ring-fencing regime may pose risks to financial stability.

Profitability remains high, supported by loan growth and structural hedging income

Solid NII and increasing income from structural interest-rate hedges will underpin healthy profitability

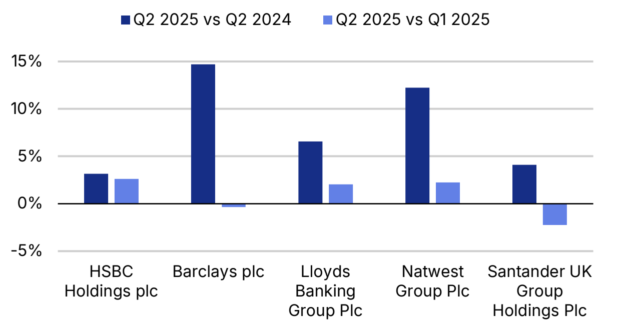
UK bank's maintained strong profitability. The average return on risk-weighted assets (RoRWA) was 2.3% in Q2 2025, and average return on equity (RoE) was 11% – both marginally higher than the 2023-2024 average. However, both metrics declined slightly compared to Q1 2025, because of weaker results from HSBC due to the recognition of dilution and impairment losses of approximately USD 2 billion related to its associate, China's Bank of Communications.

Robust sector performance was primarily driven by solid net interest income (NII) supported by persistently high interest rates, and favourable effects from structural hedges, which helped maintain stable revenues. Net interest margins (NIM) remained elevated in the second quarter due to the growing contribution of structural hedges (as balances were reinvested in a higher rate environment) and wider deposit margins. Higher loan volumes will continue to bolster net interest income, as observed in recent quarters.

In Q2 2025, income from structural hedges accounted for 41% of net interest income and 25% of total revenue at Barclays and Lloyds on average, underscoring its significant contribution to overall earnings. Barclays, Lloyds, and NatWest have indicated that their structural hedge income will increase year-on-year in the medium term.

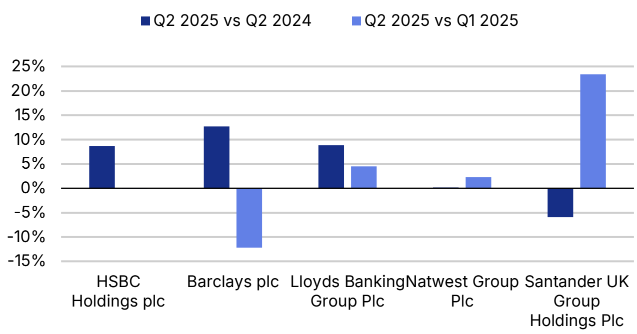
Although our base case scenario is for UK banks' profitability to remain elevated, we cannot rule out the impacts of a worsening geopolitical scenario, which would slow global trade, worsen the UK's economic situation, significantly increase market volatility, and lead to a deterioration in consumer confidence, all of which could consequently impact credit.

Figure 2: Net interest income, QoQ and YoY comparison



Source: Company data, Scope Ratings

Figure 3: Net fee and commission income, QoQ and YoY comparison



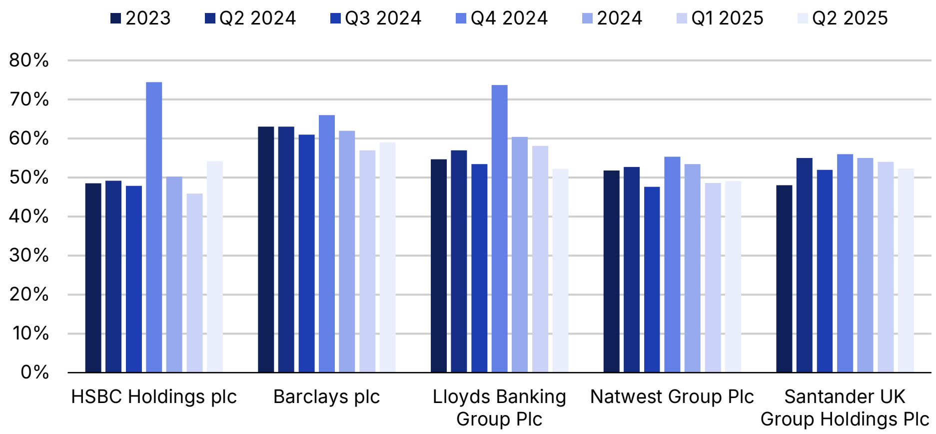
Source: Company data, Scope Ratings

Despite a slight improvement in efficiency ratios in the second quarter of 2025 year on year, they have remained stable on a quarterly basis. Cost-income ratios were 53% in Q2 2025 and Q1 2025 on average vs 55% in Q2 2024 as robust revenues outmatched elevated operating expenses driven by higher salaries due to inflationary pressures and strategic investments.

UK banks will continue with their policy and objectives of controlled costs in the short and medium term to stabilise and improve efficiency ratios. We expect recent strategic cost-reduction initiatives to alleviate the pressure of high personnel expenses, thereby improving operational efficiency and profitability.

Examples of these initiatives include: headcount reduction over the last 12 months (Santander UK and NatWest); further business model simplification exiting some countries (NatWest); and strategic reorganisations to deliver cost efficiency savings (HSBC and Barclays).

Figure 2: Cost-to income ratios



Source: Company data, Scope Ratings

In August 2025, the UK Supreme Court judgment partially reversing the Court of Appeal ruling on car finance led to widespread relief among the banks affected (Lloyds and Santander UK in our sample) as it will materially reduce compensation payouts as well as planned provisions against potential liabilities.

The FCA redress scheme (on which it has launched a consultation) will cover agreements dating back to 2007 that align with the UK Financial Ombudsman's complaints, and will include discretionary commission arrangements (DCAs), with the possibility of including non-discretionary commission arrangements. The scheme is likely to be launched in 2026.

The cost to the banks will not exceed GBP 18bn, according to FCA estimates, but will not be materially lower than GBP 9bn either. Most individuals will receive less than GBP 950 in compensation plus proposed interest per year of 1% over the base rate. For further details see related research on page 9 for links.

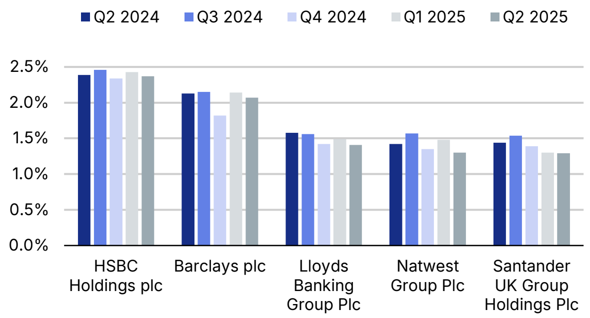
Asset quality steady but downside pressures emerging

Resilient asset quality skewed to the downside due to challenging operating environment

The stage 3 ratios of the UK banks in our sample improved marginally in Q2 2025 compared to Q1, averaging 1.7%. However, we are cautious about this mild improvement as it was mainly reflective of increased lending in the wake of interest-rate cuts. Although Stage 3 ratios are within the 2021-2024 range, high geopolitical risks and worsening trade due to US tariff policy puts pressure on asset quality.

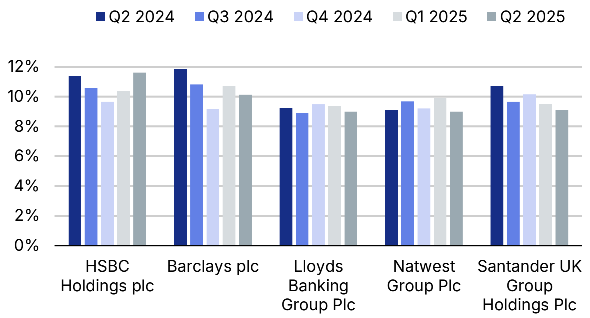
The possible relaxation of loan-to-income ratios by banks to increase their mortgage lending as a result of the Leeds Reforms could lead to a deterioration in underwriting standards hence to riskier lending, with the potential risk of higher default rates.

Figure 5: Stage 3 ratios



Source: SNL, Scope Ratings

Figure 6: Stage 2 ratios



Source: SNL, Scope Ratings

Cost of risk (CoR) for most banks in our sample decreased due to the release of provisions owing to lower than anticipated impacts of US tariffs and was line in with banks' short and medium-term targets. The only exception to the CoR improvement was HSBC because of an increase in guidance for impairment charges to around 40bp in 2025 from 35bp-40bp related to Hong Kong commercial real estate. But despite these releases of provisions, banks continue to maintain specific provisions to hedge against economic and geopolitical uncertainty.

We expect CoR to remain elevated but to remain within 2025 targets, ranging from below 20bp (NatWest) to 50bp-60bp (Barclays) However, some banks could exceed their current guidance and cost of risk targets in the short and medium term if tariff policy becomes more aggressive, as this would lead to a slowdown in global trade and worsen the UK economic situation.

Mortgages in arrears representing over 2.5% of outstanding homeowners' balances, continued their sustained decrease, declining by 3% and 9% on a quarterly and annual basis, respectively. This positive development was more pronounced in the buy-to-let sector, with a quarterly decline of 5% and an annual decline of 17%.

Arrears remained at just 1% of total household mortgages (0.6% in the buy-to-let segment) according to UK Finance data for Q2 2025. Despite the continuous rise in mortgage possessions since Q1 2024, the actual number remains limited and poses no credit threats.

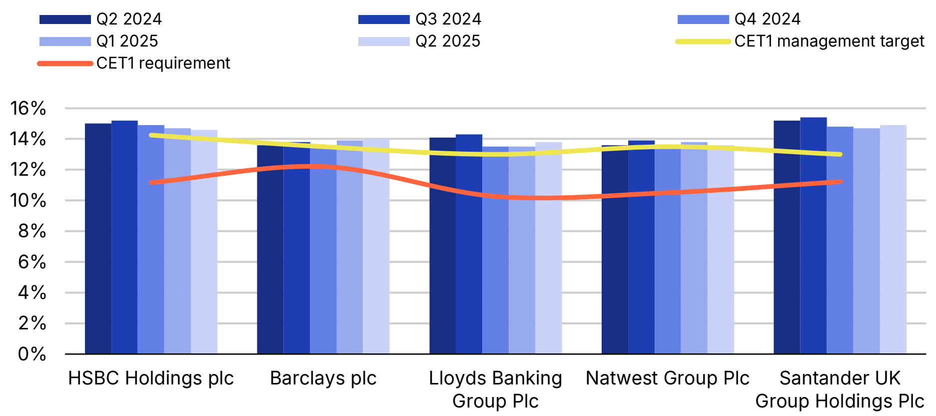
Company insolvencies showed an encouraging improvement in Q2 2025, decreasing by 16% YoY to the lowest since March 2025, mainly driven by a material decline in Creditor Voluntary Liquidations. Construction, wholesale and retail trade, and accommodation and food services were the sectors most materially affected as of May 2025.

Despite this decline and the fact that insolvency rates in H1 2025 are moderately lower than in H1 2024 and materially lower than those observed at the peak of the global financial crisis, we view this improvement with caution due to higher-for-longer interest rates, higher employer national insurance contributions, a challenging economic outlook, and uncertainty in global trade.

Stable capital levels with buffers that remain adequate

Despite dividends payouts and share buybacks, UK banks' capital levels saw a marginal increase in the second quarter of 2025, due to strong organic generation. As of Q2 2025, the average CET1 ratio among the banks in our sample stood at 14.2%, with all banks reporting levels above their capital targets. Capital buffers above regulatory requirements ranged between 1.8% and 3.7% across the sample. We expect capital levels to remain broadly stable due to solid organic capital generation that will offset expected returns to shareholders and the future increase in RWAs. Regulatory headwinds to remain manageable.

Figure 7: CET1 ratios, management targets and requirements



Source: Company data, Scope Ratings.

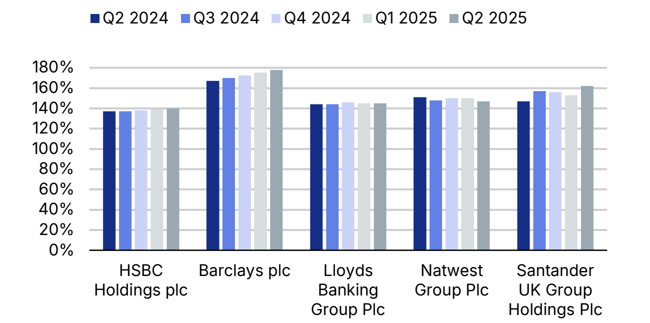
Deposits continued to show modest growth, with liquidity levels remaining stable

Deposits grew modestly in Q2, with most banks fully rebounding from previous poor performance

Most UK banks saw a minor uptick in deposits in Q2 2025, continuing their recovery from the declines seen in the first half of 2024. The recovery was prompted by customers shifting funds into higher-yielding savings accounts and alternative financial products in the high-interest rate environment. We anticipate a continuation of the recovery in the second half, supported by expected interest-rate cuts and customers' preference to preserve liquidity amid geopolitical and market uncertainties.

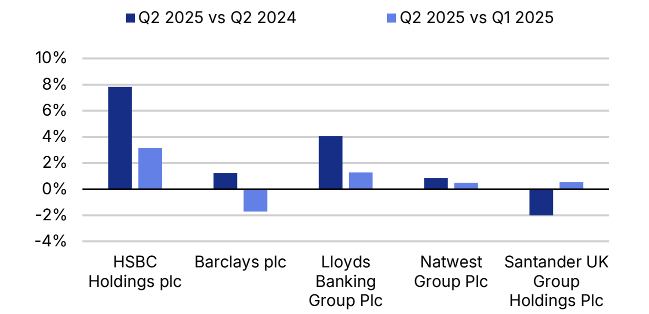
Key liquidity metrics (LCR and NSFR) showed a mixed performance in Q2 2025. While the average LCR increased marginally in Q2 2025 compared to Q1 2025 levels, as well as compared to levels in the period 2022-2024, the NSFR declined slightly compared to previous periods.

Figure 8: Liquidity Coverage Ratio



Source: Company data, Scope Ratings

Figure 9: Customer deposits, QoQ and YoY comparison



Source: Company data, Scope Ratings

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