Brexit: UK Banks Remain Well Positioned

The debate and politics concerning Brexit is ongoing, with clarity only likely to emerge nearer the March 2019 deadline. The health of the UK economy is the factor most likely to impact the future credit quality of UK banks. Scope continues to monitor the situation, but at this time the large UK banks appear relatively well positioned. Since the financial crisis, business models have been refocused, balance sheets have been strengthened and legacy conduct issues have mostly been dealt with. In addition, materially bolstered supervisory practices and regulatory requirements reassure.

Scope publicly rates Barclays plc (A+), HSBC Holdings plc (AA), Lloyds Banking Group plc (A+), and RBS Group plc (A); all with Stable Outlooks. The UK is an important market for each of these groups, with Lloyds and RBS being primarily domestic banks while Barclays and HSBC are more geographically diversified. Regardless the extent of their businesses in Europe, each has taken steps to prepare for a severe Brexit scenario.

Structural and operational changes being made

Barclays has been expanding the capabilities of Barclays Bank Ireland to support the corporate, investment and private banking activities of European clients and intends to operate a branch network across Europe. EEA-domiciled clients account for about 15% of group assets and less than 10% of group revenues.

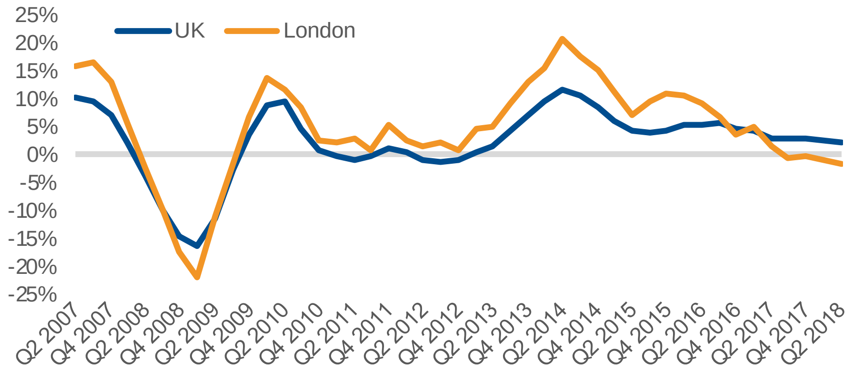
HSBC has started to reorganise its subsidiary, HSBC France, to become the hub for its European operations. The transfer of subsidiaries and operations are taking place with HSBC France expected to acquire another seven European branches (Belgium, Czech Republic, Ireland, Italy, Luxembourg, Netherlands and Spain) during 1Q 2019.

UK economy slowing

Scope estimates that Brexit has already cost the UK economy at least 1.2% of GDP since the referendum. This conclusion comes from comparing the UK's quarterly growth against the performance of the UK's 10 largest trading partners between 3Q 2016 and 2Q 2018.[1]

Nevertheless, the UK economy continues to grow at a slow pace. For 2019, GDP growth forecasts range from 0.8% to 2.0%.[2] Supportive factors include unemployment at historically low levels and low interest rates. At the same time, house price growth remains subdued, particularly in the south of England. Businesses have also shown some reluctance to invest given the uncertainty.

Figure 1: House prices (Y/Y change)



Source: Nationwide Building Society, Scope Ratings

[1] https://www.scoperatings.com/#search/research/detail/157674EN
[2] Independent forecasts compiled by UK HMT, September 2018.

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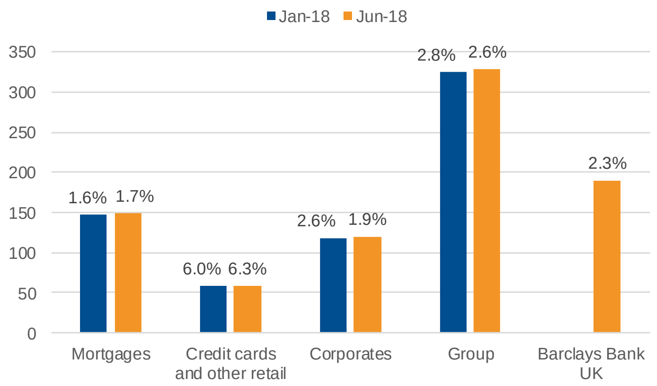
Bank fundamentals remain resilient

The large UK banks have largely completed the restructuring necessitated by the financial crisis. This is evidenced by significant improvement in solvency, liquidity, funding and asset quality metrics. Earnings are returning to more stable levels as restructuring costs decline and legacy conduct costs are being dealt with. Management teams are focused on the future, making investments to address the challenges from changing customer behaviour and new competitors.

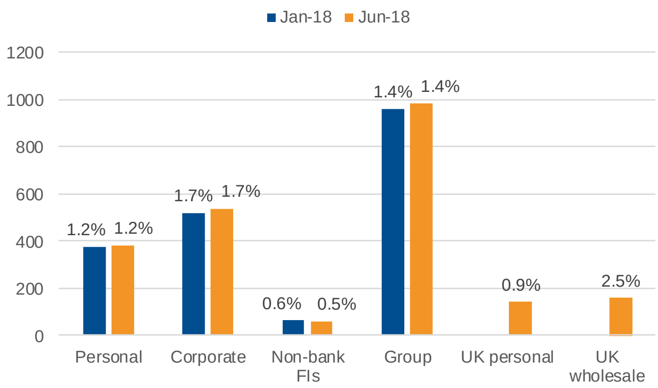
The slowing UK economy is so far not evident in banks' loan portfolios. Asset quality metrics are stable overall and in some cases are improving. Management teams continue to monitor for potential risks and reiterate that asset quality remains broadly stable with no areas of particular concern.

Figure 2: Barclays (Stage 3 % Loans – GBP bn)



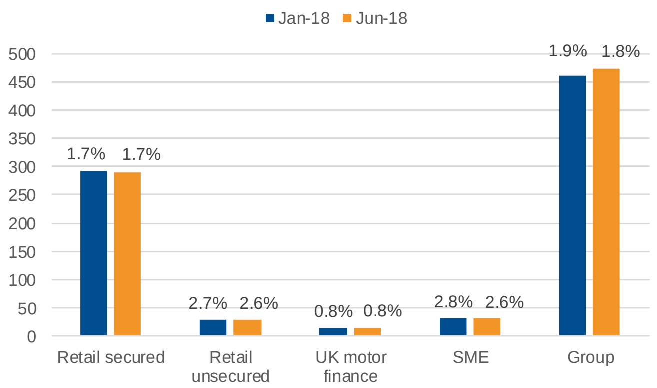
Source: Company data, Scope Ratings

Figure 3: HSBC (Stage 3 % Loans - USD bn)



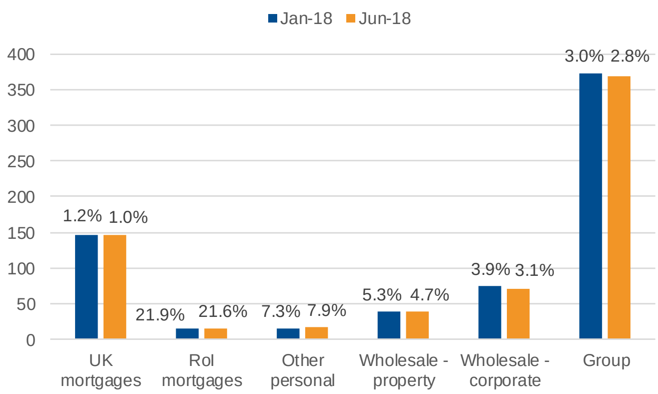
Source: Company data, Scope Ratings

Figure 4: Lloyds (Stage 3 % Loans – GBP bn)



Source: Company data, Scope Ratings

Figure 5: RBS (Stage 3 % Loans – GBP bn)



Source: Company data, Scope Ratings

Meanwhile, the banks acknowledge the uncertainty and continue to refine their strategies. For example, Barclays has said that their preference is to grow secured lending in the UK rather than unsecured and that for the last two years they have been reducing the duration and proportion of long-dated balance transfers in their credit card business. RBS has said that they plan for loan growth in line with subdued GDP growth. The CEO has made comments to the effect that the economy is ten years into a positive cycle and he urges the management team to be cautious when extending credit.

Supervisory and prudential environment reassures

Since the financial crisis, the supervision and regulation of banks has been greatly tightened. This is certainly the case in the UK and we regard the UK regulator as being relatively proactive and stringent. For example, the Bank of England (BoE) has put in place leverage and MREL requirements and performs regular stress testing on an annual cyclical scenario as well as on a biennial exploratory scenario. The exploratory scenario was conducted for the first time in 2017 and looked at how UK banks would meet regulatory requirements and build sustainable business models in an environment where headwinds to bank profitability persist or intensify (e.g. persistently low interest rates, increased competition from smaller banks and non-banks and a continuation of costs related to conduct).

The BoE has been vocal in flagging concerns (e.g. rapid growth in consumer credit, resilience of financial market infrastructure such as central clearing systems) and actively uses Pillar 2 requirements to mitigate bank specific risks such as unfunded pension liabilities. The BoE has also been at the forefront of focusing on issues like the financial risks of climate change and operational risks, setting expectations for banks regarding how they withstand, absorb and recover from disruptions.

No matter the Brexit outcome, we do not foresee a return of supervisory practices and expectations to pre-crisis norms. Further, based on the good reputation and respect that the UK regulator has established with other supervisory authorities globally, we expect supervisory collaboration and cooperation to continue.

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