UK Bank Outlook 2021

Profitability challenges remain but banks will remain resilient in face of Brexit and Covid-19

Financial Institutions, Scope Ratings GmbH, Scope Ratings UK Limited, 29 January 2021

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Executive summary

UK banks have proven to be resilient in the face of Covid-19 and Brexit. We expect this to remain the case. Banks entered the current crisis with largely reshaped business models, cautious risk appetites, and healthy balance sheets. At the same time, supportive fiscal, monetary and supervisory policies continue to offset credit, funding and solvency risks.

- UK banks prepared for a hard Brexit. Government efforts to boost the attractiveness of the UK as a financial centre may eventually partially offset economic repercussions, but this will increase the competitive dynamics for banks.
- Regulatory activity to remain high as the UK considers how best to utilise the flexibility afforded by no longer being strictly bound by EU rules. Stress testing, including for climate risks, ensuring resolvability and operational resilience, and the implementation of remaining Basel 3 standards are on the agenda.
- Improving profitability was a priority before the pandemic and still is but is now more challenging considering the low-rate environment and muted revenue outlook. Material conduct and restructuring costs should no longer be an issue, although investments are still needed to improve efficiency and better meet customer needs. Diversifying income streams and managing costs will be key.

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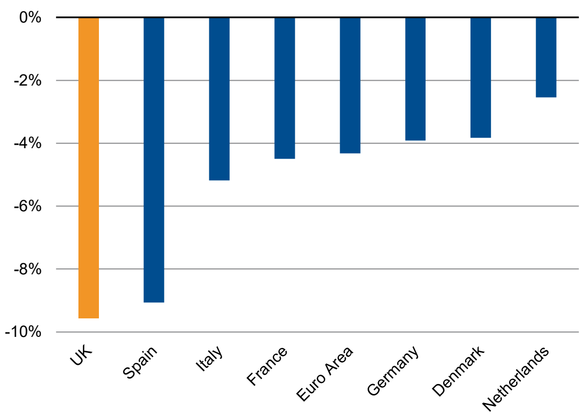
Key trends for 2021

UK economic prospects clouded by pandemic and Brexit

The UK economy has been among the most impacted in Europe by Covid-19. The second wave of infections and the reintroduction of restrictions have placed further pressure on the economy, with GDP estimated to have fallen by more than 11% in 2020[1]. A return to pre-pandemic levels is not expected until 2022/2023.

Figure 1: GDP decline YoY (1Q-3Q)



Source: IMF, Scope Ratings.

While the pandemic is having a sharp and deep impact, the implications of Brexit will be gradual and long-lasting. The trade deal agreed with the EU in December 2020 avoided a hard Brexit but the new trading arrangements and their associated costs will weigh on the economy.

Hard Brexit for financial services

The trade deal contained little clarity on financial services. By March 2021, the UK and the EU aim to agree on a memorandum of understanding; a framework for regulatory dialogue and co-operation. This is likely to cover how changes in regulations will be dealt with, the protocols surrounding equivalence decisions, and enhanced co-operation at the global level on international regulatory standards.

The memorandum is not expected to cover issues regarding market access and equivalence, which would enable firms to sell services into the EU single market from the UK. To date, the EU has not made any permanent equivalence decisions and has made clear that these decisions are unilateral.

There are numerous and specific equivalence decisions to be made. The scope of equivalence does not cover the full range of financial services. Core banking services such as lending, payments and deposit taking are excluded. Ultimately, no agreements on equivalence would replicate the passporting that was in place before Brexit.

Given the importance of the financial services industry, the UK has signalled that equivalence may not be worth achieving if it means being controlled by EU decisions. There are also strong indications that the UK intends to diverge from EU rules to bolster the competitiveness of its financial services sector.

The longer it takes to arrive at equivalence decisions, the less value they are likely to have. Many firms have already made arrangements to address the current situation and there may be little incentive to revert to the way things were before Brexit. The UK banks had prepared for a hard Brexit, putting in place the necessary infrastructure to continue operating in the EU and to serve clients.

To date, there has not been the mass exodus of financial services activity some had feared. At the same time, efforts are being made to support and enhance the attractiveness of the UK as a financial centre, with talk of re-examining listing regimes for new firms, promoting sustainable finance initiatives, and further innovation in financial technology such as privately issued digital currencies.

Nevertheless, some attrition in the level of financial activity is likely, with consequences for the economy. Around 20% of financial services business in the UK is related to its role as a gateway to the EU[2].

Material fiscal and monetary support expected to continue

Like elsewhere, UK authorities have acted to support individuals and businesses impacted by the pandemic. Support measures such as the furlough scheme, payment holidays on mortgages and personal loans, business grants, and various government guaranteed lending schemes have been extended more than once. There are already calls for the Chancellor to review the government's pandemic response before the budget is presented on 3 March.

Credit risk to remain a supervisory priority

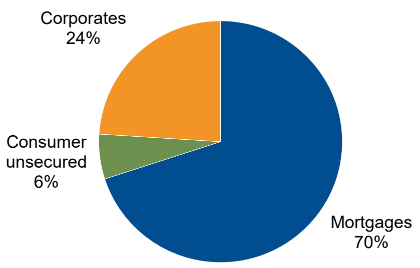
With the anticipated increase in customers facing financial difficulties in 2021, banking supervisors have stated that they will continue to assess credit risk through thematic and firm-specific reviews. Three thematic reviews are currently underway: buy-to-let, SME, and retail collections. Thematic reviews of wholesale portfolios in potentially pandemic vulnerable sectors as well as some international portfolios subject to challenging economic and credit risk conditions are also expected.

[1] Average of HM Treasury compilation of independent forecasts

[2] The Economist Intelligence Unit

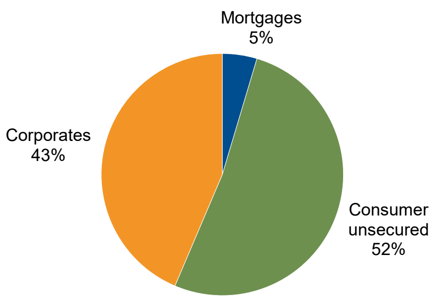
When considering how UK how banks might be impacted by the weaker macroeconomic environment, we see the high proportion of mortgage lending to be supportive. The historic loss-rate on mortgages is much lower than on other types of lending such as unsecured consumer and corporate loans.

Figure 2: Breakdown of lending



Note: Data as of 30 November 2020.
Source: Bank of England, Scope Ratings.

Figure 3: Cumulative write-offs since 2000



Note: Last data point as of 30 Sep 2020.
Source: Bank of England, Scope Ratings.

A key support measure for the mortgage market has been the temporary stamp duty holiday which is scheduled to expire 31 March 2021. Since July 2020, buyers of homes valued up to GBP 500K do not pay stamp duty on their purchase.

There are calls for the programme to be extended but it is uncertain whether it will. According to the real estate agency website Rightmove, 100,000 pending home sales may not complete before the 31 March deadline. Home sales are taking just over four months to complete, from when an offer is accepted until legal completion. Prior to the pandemic, just under 100,000 transactions were completed monthly[3].

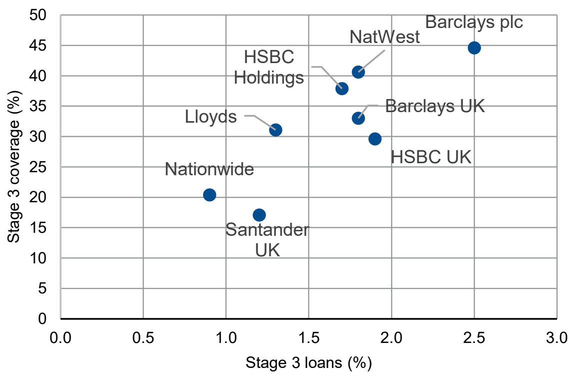
On the commercial lending side, some of the most vulnerable are likely to be smaller businesses. Here, it is worth noting that the largest uptake under the government-guaranteed lending schemes has been under the Bounce Back Loan Scheme targeting smaller businesses, with 100% guaranteed loans up to GBP 50K. As of 24 January, nearly GBP 45bn had been approved under the scheme, accounting for over 60% of all lending under the various programmes.

Another GBP 20.8bn and GBP 5.1bn have been approved under the Coronavirus Business Interruption Loan Scheme (CBILS) and Coronavirus Large Business Interruption Loan Scheme (CLBILS), respectively. These loans benefit from 80% government guarantees.

The open question is whether banks will be responsible for collecting on these loans and when. There are also concerns about potential fraudulent use of the programmes and the quality of underwriting.

We expect UK banks to absorb credit losses largely through earnings. With the numerous support measures in place, the realisation of credit losses will likely be further delayed. As of 30 September 2020, the proportion of Stage 3 loans remained relatively low.

Figure 4: Stage 3 loans and coverage (%)



Notes: Data as of 30 Sep 2020 except for Barclays UK and HSBC UK which are as of 30 Jun 2020.
Source: Company data, Scope Ratings.

Developments in payment deferrals also look encouraging. Since early October 2020, the estimated number of outstanding mortgage payment deferrals has been below 200,000, from a peak of 1.8m in June 2020. Industry analysis also suggests that 89% of customers whose mortgage payment deferrals have ended have returned to making payments[4]. While the deadline for requesting a payment deferral has been extended to 31 March, the maximum duration for deferrals remains six months.

For 9M 2020, the cost of risk for the four large universal banks ranged from around 100bp to 160bp. For this year, the banks have guided to lower credit impairments, with caveats on large single-name exposures in commercial books and material changes in macroeconomic assumptions.

Commitment to rigorous prudential regulation

The pace of regulatory activity should remain high as the UK considers how best to utilise the flexibility afforded by no longer being bound by EU rules. At the same time, there has been a reassuring and consistent

[3] HM Revenue & Customs. Transactions completed in UK with value of GBP 40,000 or above.

[4] UK Finance, data as of end November 2020.

message that the UK will maintain standards above those required by international standards and that there will be no weakening of prudential regulation.

In October 2020, the UK government launched a review of the future regulatory framework for financial services, with the first phase focused on the division of responsibilities and co-ordination between regulatory authorities.

The second phase, open for consultation until 19 February 2021, builds on the model of regulation within the Financial Services and Markets Act 2000 (FSMA). This model delegates the setting of regulatory standards to independent regulators working within an overall policy framework set by the government.

The approach is in contrast with the EU model where technical rules are established in primary legislation rather than via the rule-making powers of the prudential authority. A second consultation containing a final package of proposals is expected this year.

The UK government has also launched reviews of the payments and fintech industries to support further growth in these sectors. Both the government and regulators appear keen to ensure that regulations keep pace with advances in financial services rather than hinder them, with the view that regulations should not create unnecessary barriers to entry and impede healthy competition.

Sam Woods, the Bank of England (BoE) Deputy Governor for Prudential Regulation, has spoken of regulation becoming more dynamic and responsive as well as proportionate.

A full regulatory agenda

Regular stress testing

In January 2021, the BoE disclosed further details on this year's regular annual stress test to be performed on end-2020 balance sheets. In addition to the usual seven large banks and building societies, Virgin Money UK (now incorporating Clydesdale Bank and Yorkshire Bank) will be included for the first time.

The scenario for the stress test contains a "double dip" that sees UK GDP falling by another 9% in the first quarter of 2021 and implies 2020-2022 cumulative UK GDP losses of 37%. Unemployment rises by 5.6% beyond Q4 2020, peaking at 11.9% and averages a little under 9% between 2020 and 2022. Meanwhile, UK residential property and commercial real estate prices fall by one-third.

Each bank's capital low point will be benchmarked against a reference point equal to its minimum CET1 requirement (sum of 4.5% Pillar 1 minimum, Pillar 2A and any systemic buffers). The results will be published in Q4 2021. As usual, there is no pass or fail and no mechanical regulatory response. However, the PRA will use the outcomes as an input into its decisions about shareholder distributions for 2021.

In relation to 2020 results, the PRA has put in place a temporary framework where shareholder dividends should not exceed the higher of 20bp of risk-weighted assets as of end-2020 or 25% of cumulative eight-quarter profits in 2019 and 2020 after deducting prior shareholder distributions over the period.

Climate stress test

After being postponed last year, the climate biennial exploratory scenario is moving ahead. The objective is to test the resilience of large UK banks' and insurers' current business models and the financial system to the physical and transition risks from climate change.

In June 2021, scenarios will be published and by the end of September 2021, participants must make their submissions. In December 2021, the BoE will announce whether it will perform a second round of the exercise.

Results will be published in Q1 2022, or at the end of that quarter if there is a second exercise. While the BoE has stated that the aim is to determine the magnitude of the risks rather than testing individual firms' capital adequacy or setting capital requirements, we envision that if the risks are found to be material this could eventually influence prudential requirements.

Implementing Basel 3.1 standards

In March 2020, the UK government published its approach for updating the prudential regime for banks to enable the implementation of finalised Basel III reforms (Basel 3.1) agreed in December 2017. These still need to be implemented as few of these revisions are included in CRR II and CRD V. The UK has stated that it remains committed to the full, timely and consistent implementation of Basel 3.1 standards in line with the new deadline of January 2023.

In November 2020, the UK announced a target implementation date of January 2022 for outstanding elements of CRR II while in the EU this is due to take effect from June 2021. The six-month delay follows industry concerns about the general volume of regulatory reform in 2021.

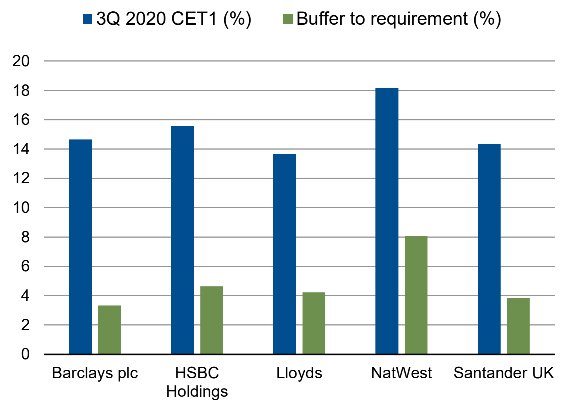
During the transition period and pursuant to the terms of the withdrawal agreement, the UK implemented EU legislation requiring transposition before the end of 2020, including CRD V and BRRD II. At the same time, the UK exercised its discretion by not transposing certain aspects with an application date beyond end-2020 and the use of sunset clauses. The clauses meant that certain transposed provisions no longer applied from 1 January 2021 in the UK.

Shift towards capital buffers

The UK has modified the balance between minimum capital requirements that are always meant to be met and capital buffers that can be drawn down or increased as needed. In December 2019, the BoE raised the structural level of the UK countercyclical buffer rate to 2% in a standard risk environment, from 1%.

Subsequently, the PRA implemented a policy to reduce Pillar 2 requirements to reflect the additional resilience from having a countercyclical capital buffer (CCyB) rate of 2% in a standard risk environment. At the same time, the reduction aims to keep total loss-absorbing capacity (MREL plus buffers) broadly constant when the UK CCyB rate is 2%.

Figure 5: CET1 capital position and buffer to requirements



Note: CET1 figures on transitional basis.
Source: Company data, Scope Ratings

Increasing the useability of buffers

Further, the UK has made changes related to the Maximum Distributable Amount (MDA). When the combined buffer is breached, CRD IV restricts distributions to a percentage of profits made since the last distribution. CRD V redefines the calculation of the MDA to allow for the distribution of interim and year-end profits (net of distributions) not included in CET1 capital resources, irrespective of the timing of the last distribution. In line with CRD V, this modification has been implemented by the UK.

Some changes implemented differ from CRD IV/V. Namely, the restriction on making distributions that cause CET1 levels to fall into the combined buffer no longer applies.

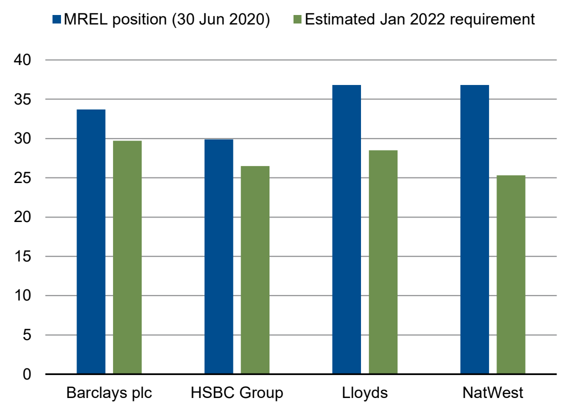
Further, the MDA definition has been amended to include certain profits already recognised as CET1 capital with the aim of balancing the useability of buffers with capital conservation. To limit the amount of historically recognised CET1 capital included in the MDA, profits from the past four calendar quarters, net of distributions, can be included.

These changes follow earlier amendments allowing firms to fix their Pillar 2A requirement as a nominal amount in the 2020 and 2021 Supervisory Review and Evaluation Processes (SREPs). This avoids absolute increases in Pillar 2A requirements in the current stress caused by the pandemic and potentially reduces Pillar 2A requirements and thus the threshold where MDA restrictions apply.

Ensuring resolvability

In December 2020, the BoE released the first part of its MREL review focused on mid-tier banks. The deadline for these banks to meet their end-state MRELs has been extended to January 2023 while the deadline for large banks remains January 2022. The large banks have been steadily refinancing maturing debt to meet MREL requirements and are well positioned against future expected requirements.

Figure 6: MREL positioning (% of RWA)



Note: Figures as of 30 June 2020.
Source: Company data, Scope Ratings estimates.

The BoE intends to publish a consultation paper on any proposed changes to its MREL framework this summer, with any policy changes to be made by the end of the year. The remainder of the review will consider resolution strategy thresholds, the calibration of MREL, instrument eligibility and the application of MREL within banking groups.

In January 2021, the BoE announced interim and end-state requirements for all UK-headquartered firms with an MREL above minimum capital requirements[5]. The UK's MREL framework which is aligned with international TLAC standards has been in place since 2016.

Meanwhile, the BoE has decided not to implement the MREL-MDA provisions contained in BRRD II. These would have provided the power to prohibit firms from making distributions if neither the combined buffer requirement nor MREL are met.

Under the Resolvability Assessment Framework published in 2019, the largest UK banks and building societies with more than GBP 50bn in retail deposits are required to submit assessments of their resolvability every two years. A summary report should also be disclosed to the public. The first submissions are due in October 2021, with the first public disclosures to be made in June 2022. The BoE also intends to make a public statement on each bank's resolvability, although the initial deadline has been postponed by one year due to the pandemic.

[5] https://www.bankofengland.co.uk/financial-stability/resolution/mrels

By January 2022, banks must demonstrate that they would be able to achieve the following outcomes in resolution: (1) have adequate financial resources to support resolution, (2) continue to operate through resolution and restructuring, and (3) communicate effectively with authorities and the markets to ensure orderly resolution and restructuring.

Strengthening operational resilience

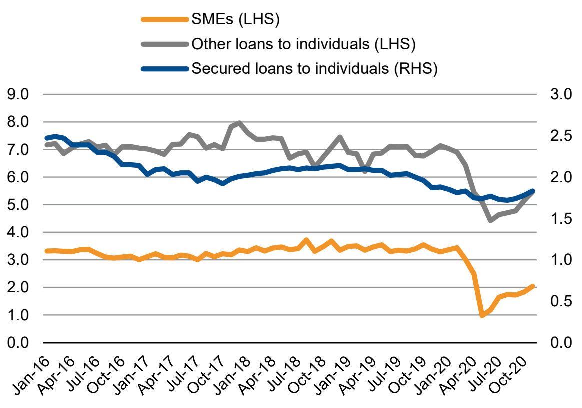
A policy statement on operational resilience is planned for April 2021, with firms expected to meet requirements from the beginning of 2022. This follows publication by the PRA in December 2019 of policy proposals for impact tolerances for important business services. The new aspects of the policy proposals will require firms to identify important business services; set impact tolerances for these services; and act so they are able to deliver them within their impact tolerances during severe but plausible disruptions.

The proposed approach to operational resilience assumes that, from time to time, disruptions will occur which may prevent firms from operating as usual and see them unable to provide services for a time.

UK banks to muddle through

Since the cut in the bank rate to 0.1% from 0.75% in March 2020, there has been some recovery in loan pricing, but the outlook is mixed. In the latest credit conditions survey, lenders reported that overall spreads on secured lending to households widened in Q4 2020 but were expected to narrow in Q1 2021. For SMEs and large firms, lending spreads were expected to widen slightly and to widen, respectively.

Figure 7: Development of lending rates (%)

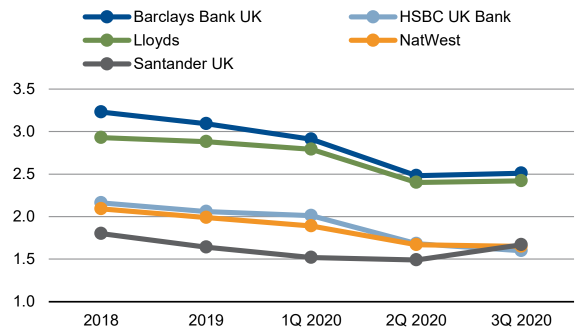


Note: Last data point as of 30 Nov 2020. Source: Bank of England, Scope Ratings.

Pressure on net interest margins remains. Customer support measures, elevated levels of liquidity, and changes in lending mix continue to have an impact. In October 2020, the BoE began a review of the operational considerations of a negative policy rate. The review is ongoing, with no overriding opinion one way or another among members of the Monetary Policy Committee.

Following adjustments to deposit rates, UK banks are guiding to some stabilisation in net interest margins. Management teams are also focused on growing sources of non-interest income. For example, NatWest has invested in merchant acquiring platforms and developing its wealth management business. HSBC has plans to move to a revenue model that is less reliant on interest rates, with its earnings also being impacted by the cut in US rates.

Figure 8: Net interest margins (%)



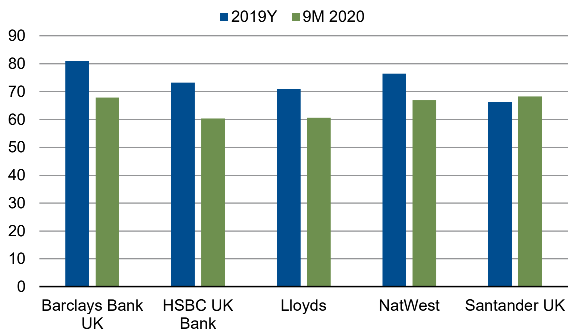
Note: Lloyds NIM is banking NIM; NatWest NIM excludes NatWest Markets. Source: Company data, Scope Ratings.

Managing costs remains key considering the muted revenue outlook and economic headwinds. For example, Barclays has aimed for full year 2020 costs to be broadly flat versus full year 2019 and is evaluating ways to structurally reduce its cost base. HSBC is looking to achieve a multi-year reduction in its nominal cost base and has indicated the group will be targeting more than the original USD 4.5bn in cost savings planned for 2020-2022.

Restructuring plans have restarted following the pause in the early part of the pandemic, with staff reductions and branch closures ensuing. For example, Lloyds will be closing 56 branches from March which had been originally planned for last year.

The pandemic is also accelerating the pace of closures as customers increasingly switch to digital banking. Barclays is closing 63 branches this quarter and TSB is closing 164 branches as part of a three-year strategic plan announced in November 2019.

Figure 9: Cost-income ratios (%)



Note: Latest figures for Barclays Bank UK and HSBC UK Bank are for 1H 2020. Source: SNL, Scope Ratings

Annex I: Related research

Brexit trade agreement avoids no-deal but disruptions and persistent uncertainty weaken UK outlook, published Jan 2021, available here.

The Wide Angle: European banks: the context ahead of the Q4 reporting season, published Jan 2021, available here.

2021 European Banking Outlook: first real-life stress test since post-GFC sector de-risking, published Dec 2020, available here.

When cash is no longer king: from mobile payments to central bank digital currencies, published Dec 2020, available here.

The regulatory outlook for European banks in 2021 and beyond, published Dec 2020, available here.

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