UK banks: asset quality outlook improves
Vaccination success lifts prospects after Brexit preparedness shows sector's resilience

The UK economy suffered one of the worst declines last year due to the pandemic, with GDP down nearly 10%. As banks had been planning for some time for the economic uncertainty related to Brexit, they were in some ways prepared. Some potential risks remain, particularly for wholesale exposures, but we do not expect a material deterioration in the asset quality of UK banks this year.

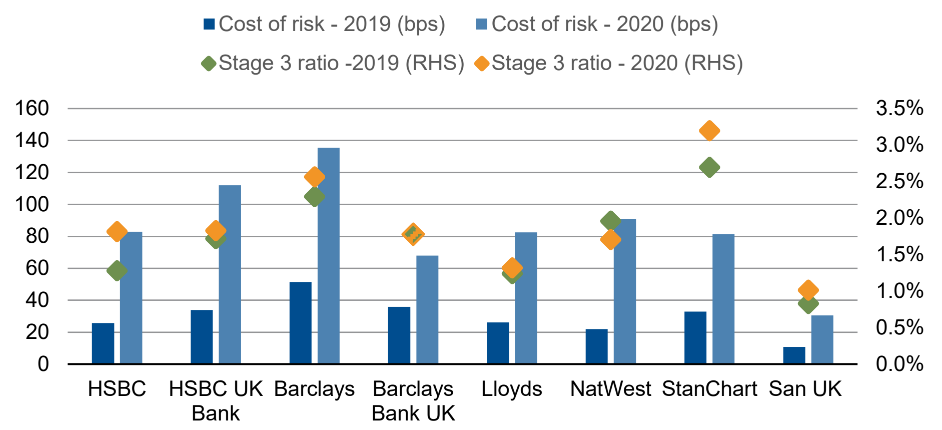
Banks' cost of risk rose significantly in 2020 compared to 2019 but remained at relatively moderate levels. To a large degree, charges were taken for performing exposures and stemmed from changes in macroeconomic assumptions. In contrast to the aggregate decline in NPL ratios seen in the EU, Stage 3 ratios increased for UK banks – although not to levels that are unmanageable.

The outlook for asset quality is encouraging. Numerous support measures have remained in place for individuals and businesses and there no indications that these will be abruptly ended. The pace of vaccination in the UK should also support a re-opening of the economy. Banks have guided to a materially lower cost of risk this year, with an eventual convergence to pre-pandemic levels in 2022/2023.

The magnitude of loans subject to payment holidays has greatly reduced with most personal customers returning to normal payments. The important weight of residential mortgage lending in loan books continues to be supportive for banks' asset quality.

As the first repayments under government lending schemes come due next month, this will provide more colour on the health of businesses, particularly smaller ones. Banks in the latest Credit Conditions Survey indicate that they expect the default rate to increase in the second quarter for small and medium-sized businesses, with the default rate expected to remain unchanged for large businesses.

Figure 1: Change in cost of risk (bps) and Stage 3 ratio (%)



Note: Cost of risk = Loan loss provisions % Average gross customer loans.
Source: SNL, Banks, Scope Ratings.

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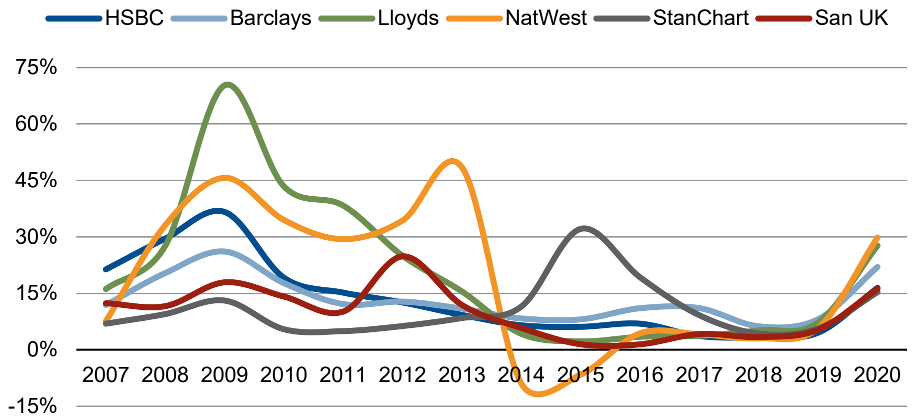
Banks have been able to absorb elevated levels of impairments

In 2020, the large UK banks incurred elevated levels of credit impairments equivalent to 15% to 30% of operating income (Figure 2). Compared to previous periods of economic stress, the impact on earnings was largely manageable. Credit costs, however, still absorbed from 45% to 110% of pre-impairment operating profit.

Figure 2: Impairments % Operating income



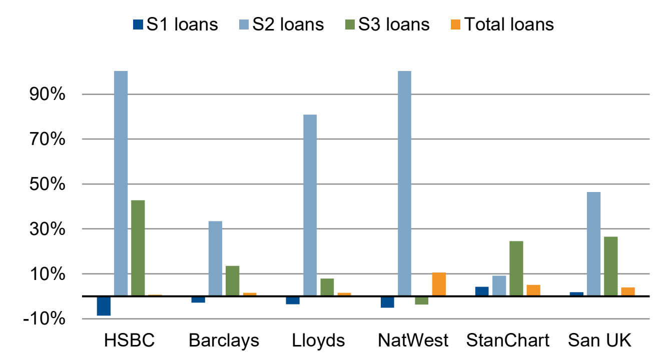
Source: SNL, Banks, Scope Ratings.

The increase in credit costs was driven by changes to macroeconomic assumptions under IFRS 9 and accompanied by a significant increase in Stage 2 loans, with the proportion being higher for commercial than personal exposures. As seen across the rest of Europe, the use of Stage 2 classification varied across UK banks (Figure 3). Between 6% and 21% of loans have been classified as Stage 2 as of year-end 2020, compared to a range of 4% to 11% as of year-end 2019 (Figure 4).

A closer look at Stage 2 exposures encouragingly shows that 90% or more of Stage 2 exposures were performing and not past due at year-end 2020 (Figure 5). As shown by the impairments taken, a large proportion were related to macroeconomic assumptions, management overlays and Stage 1 and 2 exposures rather than specific losses (Figure 7). Banks' base case assumptions for UK GDP growth this year range from 3% to 6% with the unemployment rate above 6%.

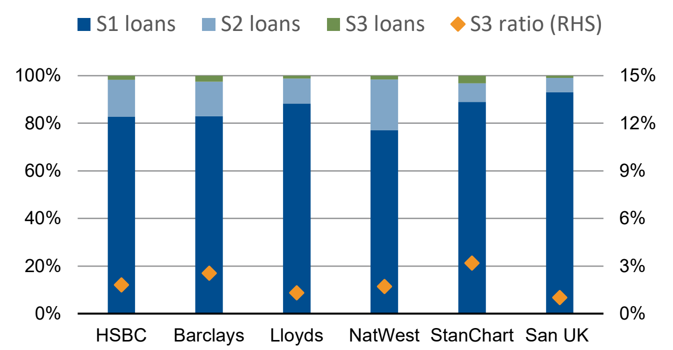
Meanwhile, the increase in Stage 3 loans was relatively modest, with the Stage 3 ratio remaining generally below 3% as coverage increased (Figure 6).

Figure 3: Change in loan staging (2020 vs 2019)



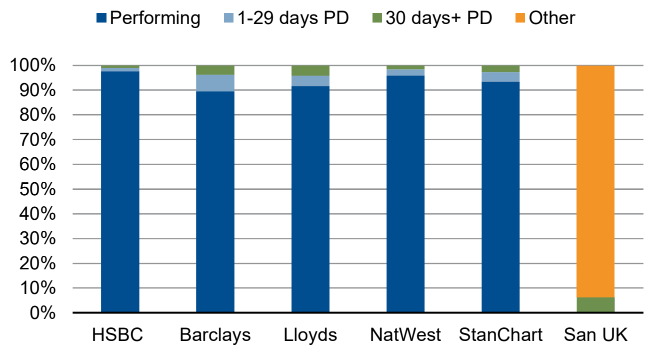
Source: SNL, Banks, Scope Ratings.

Figure 4: Loan staging (YE 2020)



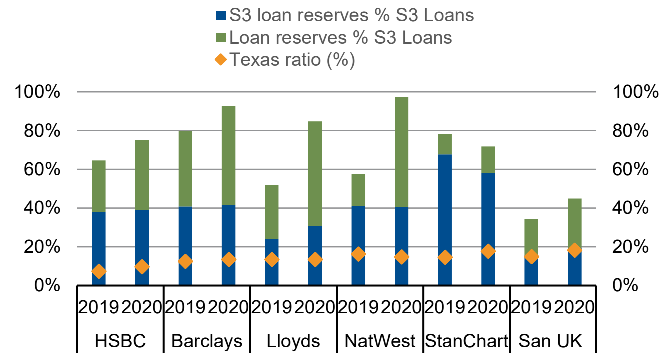
Source: SNL, Banks, Scope Ratings.

Figure 5: Stage 2 analysis (performing and past due)



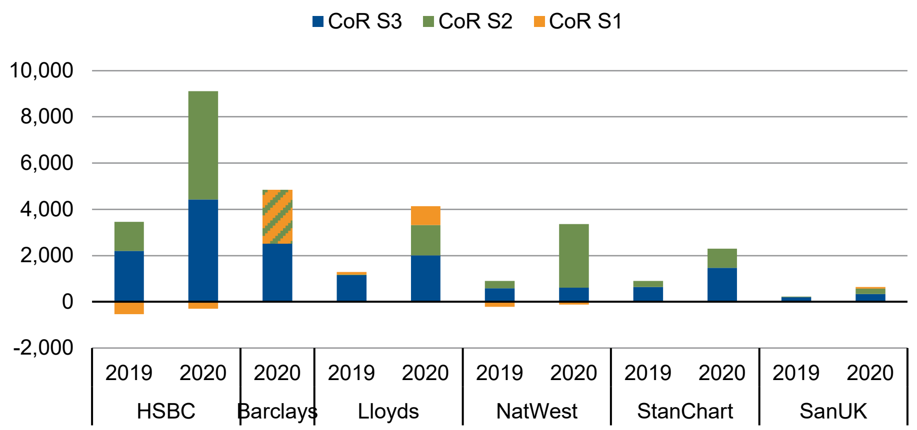
Note: For San UK, "Other" includes probability of default deterioration and high-risk corporates.
Source: SNL, Banks, Scope Ratings.

Figure 6: Stage 3 exposures and provisions



Note: Texas ratio = Stage 3 exposures % (Tangible equity and loan loss reserves).
Source: SNL, Banks, Scope Ratings.

Figure 7: Distribution of credit impairments by loan staging (bn in reporting currency)



Note: Reporting currency is GBP except for HSBC and StanChart which is USD.
Source: SNL, Banks, Scope Ratings.

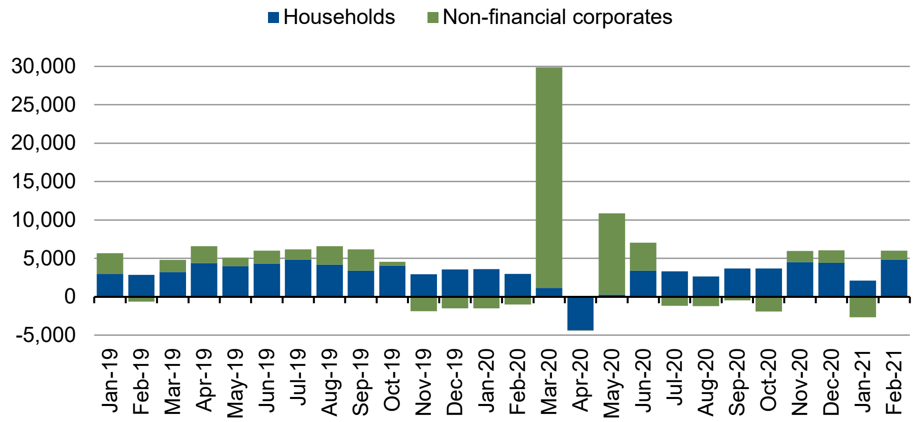
Government schemes provide critical support for clients

The UK loan market is typically skewed towards households and residential mortgage lending. In 2019, the volume of lending to households was 3.6x the volume of lending to non-financial corporations. This was not the case in 2020 however as lending to corporates was more than 1.3x the lending to households (Figure 8).

Under the government's three support schemes, more than GBP 75bn has been disbursed to businesses as of 31 March when the application deadlines for the programmes ended. For the large UK banks, these loans accounted for less than 5% of their loan books as of year-end 2020.

Over 60% of loans granted were through the Bounce Back Loan Scheme. Under the scheme, loans of up to GBP 50,000 for a maximum period of six years were available, with interest charged at 2.5% and the government paying fees and interest for the first 12 months.

Figure 8: Monthly lending volume (GBP m)



Source: Bank of England, Scope Ratings.

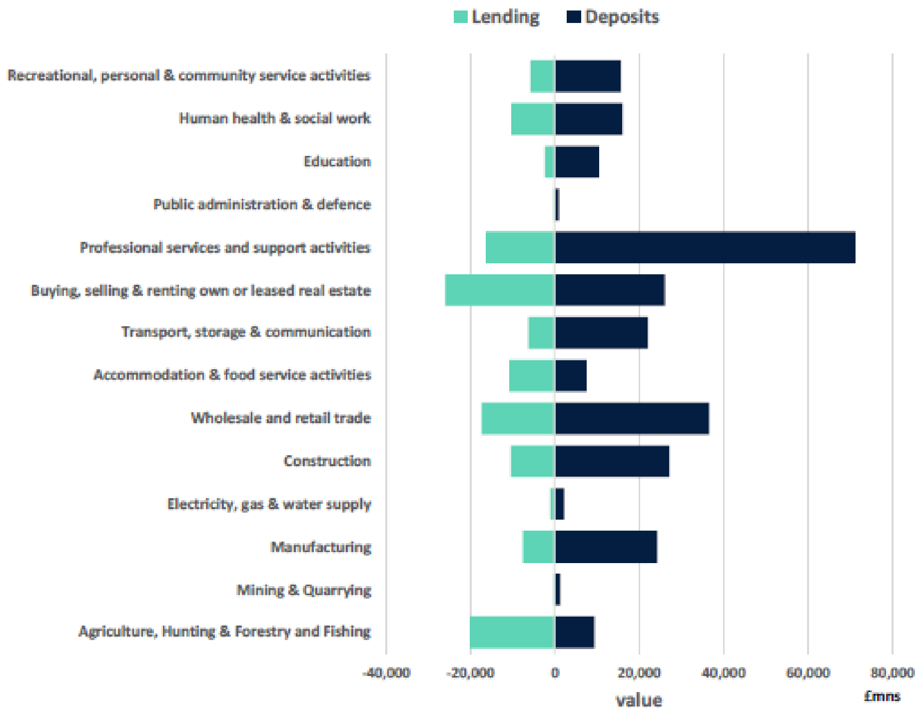
No capital repayments are required for the first 12 months, with the first repayments due to start next month. Before the first payment is due, customers can extend the term of the loan to 10 years, move to interest-only repayments for a period of six months (option can be used three times) and/or pause repayments for a period of six months (option can be used once). The scheme benefits from a 100% government guarantee.

Another 30% of lending was provided under the Coronavirus Business Interruption Loan Scheme (CBILS). SMEs with turnover of less than GBP 45m were eligible for loans up to GBP 5m for a maximum term of six years, with interest charged between 3.49% and 3.99% above the UK base rate. This scheme benefits from an 80% government guarantee.

From 6 April, a new GBP 75bn Recovery Loan Scheme has been in place and will run until year-end. The loans benefit from an 80% government guarantee. Loans between GBP 25,000 and GBP 10m, with a term of up to six years are available. Including fees, the maximum interest rate which can be charged is 14.99%.

Data from UK Finance suggests that many businesses which obtained financing through the government loan schemes had not used the funds. At the end of last year, SME deposits were almost GBP 260bn, representing a 29% or GBP 58bn increase from 2019. In most sectors, there was a surplus of deposits over borrowing (Figure 9).

Figure 9: SME lending and deposit balances at year-end 2020



Source: UK Finance.

Asset quality looks set to improve although risks remain

With the publication of year-end 2020 results, management teams indicated that they expect credit impairments to be lower this year, with a convergence to more normal in levels in 2022/2023. Cost of risk guidance included the following: NatWest: 30-40bps vs 88bps in 2020 and Lloyds: less than 40bps vs 96bps in 2020.

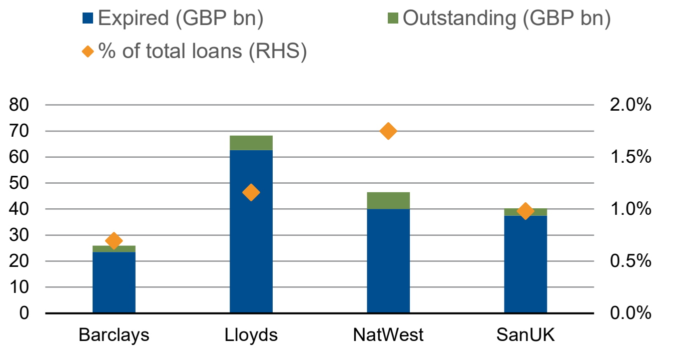
As of 1Q 2021, HSBC has guided to a 2021 cost of risk below its three-to-four-year planning range of 30-40bps, down from 81bps last year. A large proportion of the ECL release in the quarter was related to the UK ring-fenced bank.

The experience from expired payment holidays has been encouraging with most customers returning to making normal payments. For example, upon maturity, 89% of Lloyds' mortgage customers and 85% of its card customers resumed payments. As of year-end 2020, only a small proportion of loan books remain subject to payment holidays (Figure 10).

The important weight of residential mortgage lending continues to be supportive of UK banks' asset quality. On household loans, customers were able to receive payment holidays of up to six-months. The deadline for deferral requests was 31 March, with the deferral period ending 31 July at the latest.

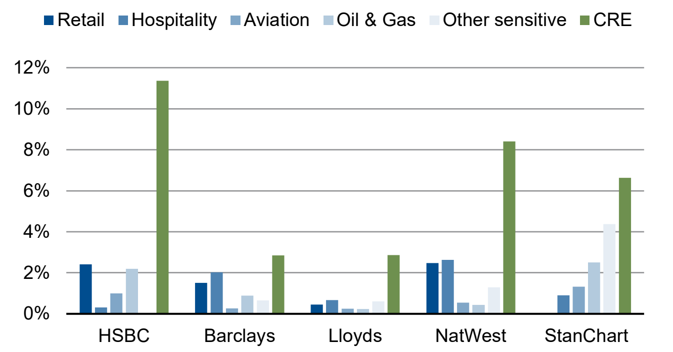
As disclosed by the banks, the exposure to more Covid-sensitive industry sectors such as retail and aviation is relatively contained. Meanwhile, the exposure to commercial real estate is typically more prominent (Figure 11). There remains some uncertainty for this sector as we have yet to see the implications from changes in the demand for and the use of commercial space stemming from the pandemic.

Figure 10: Selected outstanding payment holidays



Notes: Barclays figures include UK and US exposures only. Lloyds figures includes retail exposures only. NatWest figures include retail and commercial banking exposures only. Source: Banks, Scope Ratings.

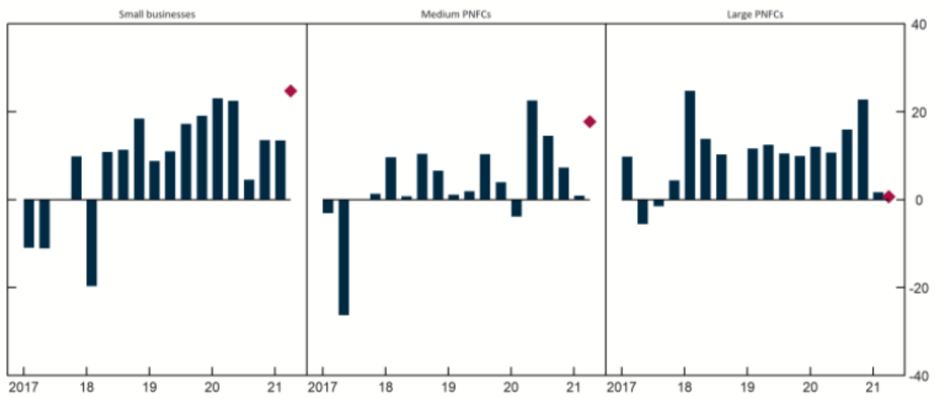
Figure 11: Exposure to Covid-sensitive sectors (% of loan books)



Note: For Barclays, CRE exposure is for the UK only. Source: Banks, Scope Ratings.

Responses from the latest Credit Conditions Survey show that banks expect default rates on loans to small and medium-sized businesses to increase in Q2 while remaining unchanged for large businesses over the same period. In Q1, default rates for small businesses increased but were unchanged for medium and large-sized businesses.

Figure 12: Net percentage balance for changes in default rates on loans to businesses by size



Notes: Question – How has the default rate on loans to small/medium/large businesses changed? A positive balance indicates an increase in the default rate. Source: Bank of England.

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