Brexit and UK Banks:
Cautious Optimism

In this report, Scope assesses the possible impact of Brexit uncertainty on the UK banking system. The first data releases following the referendum point to a material decline in confidence. This alone warrants a cautious approach to the economic outlook in the UK. Most estimates point to a slowdown in growth, ranging from a mild to a sharp downturn, with a smaller possibility of a more severe recession.

Retail and commercial banking activity volumes are likely to be affected to the extent that the economic cycle deteriorates, but asset quality is likely to only be marginally impacted in a mild downturn. This is largely because banks' loan books are significantly more conservatively positioned than they were before the financial crisis. Also, ultra-low interest rates are helping borrowers' repayment capacity.

Mortgage portfolios are largely skewed towards mainstream residential loans with relatively low average loan-to-values (LTVs). One concerning location with respect to mortgages is London, where prices have risen by double digits since the crisis trough. However, the large UK banks seem to have maintained a relatively prudent approach to mortgage lending in recent years. Buy-to-let lending could be an area of concern if employment and income growth were to weaken. On the other hand, since June 2014, underwriting standards in buy-to-let lending have been strengthened by a mortgage-interest-rate stress test and a loan-to-income-flow limit.

Another concern is commercial real estate (CRE) lending, which has benefited in recent years from significant foreign capital inflows. However, in CRE as well, banks have de-risked since the peak of the crisis, and exposures look manageable. Scope believes it will take time for any lowering in confidence to translate into a more difficult operating environment that would lead to credit losses.

At this time, the Scope-rated UK banks (see Figure 1) report that the referendum result has had a limited impact on customer behaviour, and we expect no material changes to bank strategies, at least until more clarity emerges. During the Q2 reporting season, management teams conveyed a message of cautious optimism. Based on the analysis highlighted in this report, we subscribe to this view.

Figure 1: Scope ratings on UK banks

Bank	Issuer Credit-Strength Rating	Senior unsecured MREL/TLAC eligible debt	Outlook	Short-Term Rating	Short-Term Rating Outlook
Barclays Bank PLC	A+	A	Stable	S-1	Stable
HSBC Holdings PLC	AA	AA-	Stable	S-1+	Stable
Lloyds Bank PLC	A+	A	Stable	S-1	Stable
Royal Bank of Scotland PLC[1]	A-	BBB+	Stable	S-2	Stable

[1] RBS benefits from a one-notch rating uplift due to the UK government's majority ownership.
Source: Scope Ratings

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Increased macro uncertainty but no material change to strategies or regulatory environment

The Q2 results season allowed a comparison of what the different bank management teams were reporting with respect to Brexit.

Overall, the main messages were:

i) The Leave vote has materially raised uncertainty on the outlook for the UK economy. However, most banks have stressed the strong starting point of the UK economy.

ii) So far, the impact on customer behaviour seems limited, with some withholding of business investment and indications of a slowdown in mortgages. The cards business has not suffered so far.

Scope does not expect banks to drastically change their strategies as a result of Brexit.

In retail and commercial banking, any economic slowdown may exert some pressure on asset quality and profitability, but not unlike with any other fluctuation in the business cycle. Resolving legacy issues and completing restructuring plans initiated during the crisis should remain the strategic priority for Barclays, Lloyds Banking Group and Royal Bank of Scotland.

Cross-border investment banking activities into the EU may suffer more disruption, including in the transition period, as the future of EU 'passporting' remains unclear. However, UK banks seem confident that the impact will be manageable.

For example, in the Q2 results call, Barclays played down the risks to its investment banking franchise, stressing that about half of its investment business is US-centric, with UK and other non-EU-centric business also being relevant. With respect to passporting-dependent business, management signalled that several options are available, including the development of one of their EU-based subsidiaries or the licensing of branches in different countries. Similarly, HSBC signalled that, if needed, it could transfer some activities to its French subsidiary.

Meanwhile, we do not expect any material change to the regulatory environment. Depending on the final outcome of negotiations, EU legislation (including CRD IV and BRRD) may or may not apply. In any case, UK banks remain subject to the Basel III and Financial Stability Board rules on global systemically important banks. Moreover, we note that the current UK regulatory framework is stricter than EU norms, for example, implementing the Basel III fully loaded regime ahead of the mandated timeline and requiring banks to ring-fence domestic retail activities.

One area of particular concern is the real estate exposure of banks, given the unusually strong performance of certain segments in recent years, such as the London residential property market and commercial real estate (see Appendix I).

Lloyds Banking Group

Given Lloyds' almost entirely domestically focused franchise, the impact Brexit may have lies squarely with the performance of the domestic economy over the coming years.

In terms of immediate direct impact, Lloyds reported the following:

- A negative 30bps impact on the group's capital position due to foreign exchange movement in the wake of the referendum. This was driven by risk-weighted asset inflation due to the depreciation of the pound vis-a-vis the dollar and the euro.
- A strong deposit intake, ascribed to a safe-haven effect as uncertainty rose with the referendum.

According to management, retail customer behaviour was little changed (apart from the increase in deposits) in the weeks following the referendum, with stable activity in cards and current accounts. On the corporate side, Lloyds reports that businesses have held back new investment both before the vote and after.

In the analyst call accompanying the release of Q2 results, the CEO acknowledged that uncertainty has increased following the UK's vote to leave the EU. However, he also stressed that the UK enters this period of uncertainty with good fundamentals, including low unemployment and a deleveraged economy.

In our view, economic performance and the resilience of the UK property market will be key factors in determining how the group performs in the coming years.

Lloyds is the leading mortgage provider in the UK and, as such, is likely to suffer more from any slowdown in the residential real estate segment.

The large mortgage book (GBP 297.4bn as of June 2016) has an average LTV of 43% and has been declining in recent years as collateral values have increased, while the average LTV at origination is now at 64.3%, having been essentially stable over time. Lloyds has been growing below market average in both buy-to-let mortgages and London, which points to a relatively prudent approach.

At the end of June 2016, it had circa GBP 20bn in UK CRE lending exposures, or 69% of its Common Equity Tier 1 (CET1) capital, still a material exposure. However, the exposure is much lower than in the past and is focused on Lloyds' core clients.

Royal Bank of Scotland (RBS)

In terms of customer activity after the referendum result, RBS reported a slowdown in mortgage applications, while consumer spending and corporate lending seemed resilient. RBS also sees the higher market volatility as creating the potential for more CIB business in foreign currencies and rates due to the increased volatility.

RBS reported strong growth in retail mortgages (13% annualised, clearly gaining market share). It continues to target growth in this segment and has been investing in distribution capacity in the past few years. The average LTV of the mortgage book is 59% (68% at origination in Q2)

Exposure to CRE lending in the UK stood at GBP 24.8bn, 69% of its CET1 capital as of June, with an average LTV of 53%.

Barclays

Management has communicated that they are not "unduly pessimistic" and that Barclays is well prepared to deal with potential ramifications from Brexit. Excluding Africa, during H1 2016 nearly half of group income was generated outside of the UK, with almost a third coming from the US. Barclays remains committed to the strategy detailed in March this year and is confident that it will continue to accelerate the disposal of non-core assets and meet its target of closing the non-core unit in 2017.

While Brexit may pose some headwinds, in our view, Barclays' credit profile remains driven by the group's progress on executing strategic plans to grow its core businesses, dispose of non-core assets and reduce costs in order to improve returns.

Management clarified that the majority of its commercial and investment banking businesses are not highly dependent on passporting – around half of the business is US-centric while UK-onshore and non-EU businesses are also significant. Mentioned alternatives to passporting include developing the group's Irish subsidiary or another EU subsidiary, licensing existing branches in the EU for particular operations on a country-by-country basis, and relying on third-country access arrangements that are part of the MiFID II legislation.

As of end-June 2016, the UK loan portfolio of GBP 273bn accounted for over 55% of the group total, with the largest component being residential mortgage loans (GBP 127bn). Cards and other personal lending accounted for another GBP 29bn. The UK mortgage loan portfolio has an average LTV of 47%, and the average LTV on new mortgage lending is 63%. The average LTV for London is 36% and for the South East it is 45%. Buy-to-let accounts for 9% of the portfolio. UK CRE exposure, which is backed by collateral of GBP 26bn, amounted to GBP 12bn, equivalent to 29% of CET1 capital.

HSBC

While activities in Asia drive the group's earnings, the UK remains one of HSBC's two home markets. Management considers that it is too early to see the impact from Brexit. Since early June 2016, the group has seen a slowdown in mass business and SME activity, but expects this to recover in September this year as this financing is often short-term and for operating expenses.

As of end-June 2016, the UK loan book of USD 285bn accounted for over 30% of the group total, with 55% of the exposure being wholesale and 45% being personal. Nearly 85% of the personal portfolio is comprised of residential mortgage lending, with the remainder split between credit cards, personal loans and overdrafts. Within mortgages, 28% of the exposure is to London, where 86% have a LTV of less than 60%, and another 13% is to the rest of the South East, where 80% have a LTV of less than 60%. Mortgages continue to be a priority, with the group increasing the number of intermediary partners it works with. The mortgage book is up 3% year on year, and HSBC has a 24% share of direct approvals. The LTV ratio on new mortgages is 59% compared with the average of 41% for the total mortgage portfolio. UK CRE exposure amounted to USD 17bn, equivalent to 13% of CET1 capital.

Concerning its global banking and markets activities, management has said that if necessary up to 1,000 jobs could move to Paris where the group already has a major subsidiary with about 10,000 employees.

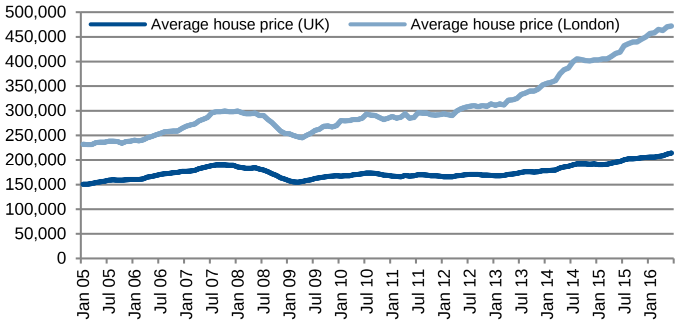
I. Appendix: Exposures to real estate risk

Since the crisis trough, house prices have recovered. The average house price in the UK in June 2016 was 39% higher than in February 2009 – a mid-single-digit average annualised increase.

As is often the case, however, the average paints a broad picture that may not accurately reflect different regional realities. In particular, while real prices have stagnated in the Midlands and in the North, the London housing market has been booming in recent years.

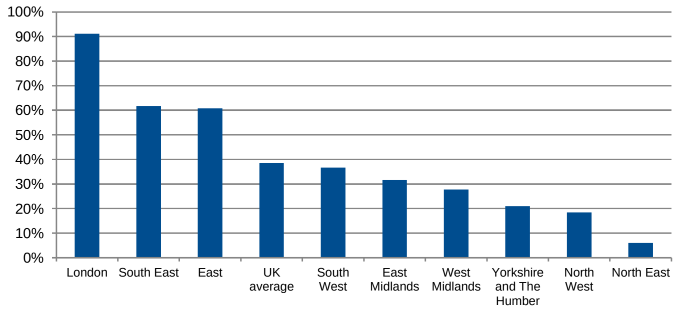
In nominal terms, the average house price has increased by 90% in London in a little over seven years, justifying a cautious approach.

Figure 2: UK house prices have recovered, driven by London



Source: ONS, Scope Ratings

Figure 3: Change in house prices since the Feb 2009 trough

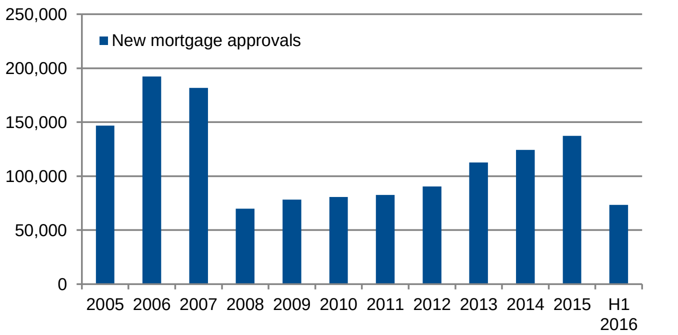


Source: ONS, Scope Ratings

The recovery in house prices has gone hand in hand with a recovery in mortgage credit. Mortgage approvals, which had collapsed in 2008, started accelerating again in 2013 and are currently running at an average of 12,000 per month.

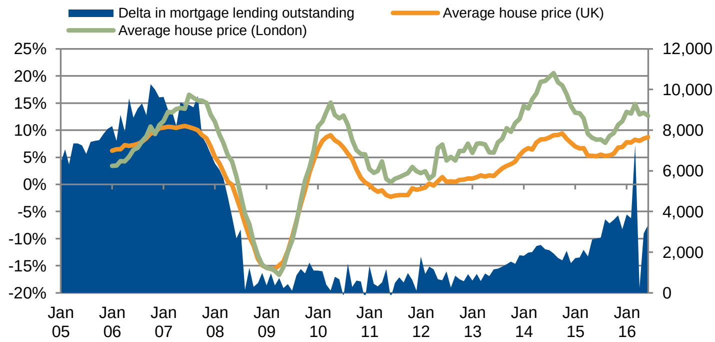
The Bank of England has for some time warned of the vulnerability of highly leveraged households, with a particular focus on the London mortgage market.

Figure 4: Mortgage approvals have accelerated since 2013



Source: Bank of England, Scope Ratings

Figure 5: Growth in mortgage finance correlated with prices



Source: Bank of England, ONS, Scope Ratings

Similarly, the Bank of England has expressed concerns with respect to the CRE market, due to the material inflows of foreign capital in recent years[1]. The following table summarises the exposure of the four rated banks to these two segments.

[1] Financial Stability Report (June 2016)

Figure 6: Overview of UK banks' exposure to selected credit risk segments

	Lloyds GBP bn	RBS GBP bn	HSBC USD bn	Barclays GBP bn
UK CRE lending exposure	19.8	24.6	17.0	12.3
CET1 capital	28.9	35.7	130.7	42.4
CRE exposure as % CET1 capital	68.6%	69.0%	13.0%	29.0%
LTV	n.a.	53.0%	n.a.	n.a.
UK mortgages	297.4	131.2	106.7	127.0
LTV (average)	43.0%	56.0%	41.0%	47.0%
LTV (new business)	64.3%	68.0%	59.0%	63.0%
London mortgages	n.a.	21.3	29.9	n.a.
% of total mortgages	n.a.	16.2%	28.0%	n.a.
% of CET1 capital	n.a.	59.7%	22.9%	n.a.
LTV (average)	n.a.	45.0%	n.a.	36.0%

Source: Company data, SNL, Scope Ratings

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