UK banks quarterly

Credit fundamentals still resilient but moderating

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UK bank profitability will remain sound throughout 2025. A strong performance in Q1 was driven by solid net interest income (NII) owing to persistently high interest rates and tailwinds from structural hedges, which helped stabilise revenue generation amid interest-rate fluctuations. A continued recovery in lending and stronger customer and market activity also contributed to earnings growth.

Limited impact from car finance exposures, but legal risks persist. To date, exposures have only had a moderate impact on UK banks rated by Scope. However, potential additional provisions related to UK historical car finance commission payments could weigh on the profitability of Lloyds and Santander UK depending on the outcome of the appeal in the UK Supreme Court, which is expected to conclude in summer 2025.

Asset quality resilient but softening. Scope's base case comprises a mild deterioration in asset quality in 2025, driven by rising unemployment and a weaker economic outlook, with GDP growth expected to be 1% in 2025 and 1.3% in 2026. Geopolitical tensions and trade-related risks skew the balance of risk to the downside.

Capital levels remain adequate. UK banks continue to report stable capital levels, as strong organic generation offsets dividends and buybacks, enabling the banks to maintain adequate capital buffers in Q1. We expect this trend to continue for the remainder of 2025.

Liquidity remains stable as deposits start to recover. Deposit outflows have recovered and grew growing modestly in Q1 2025. Key liquidity metrics remained stable in Q1 2025.

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.

Table 1: Trend overview and outlook

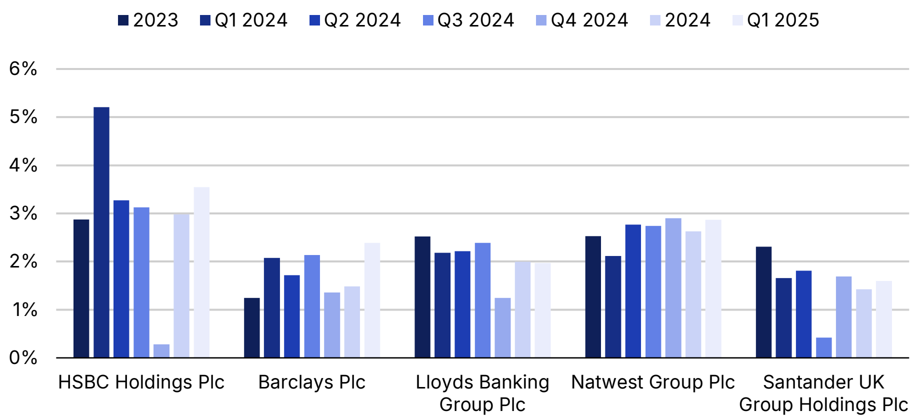
Our expectations of 2025 trends by key area for UK Banks		
Profitability	↗	Positive. Robust profitability driven by solid net interest income due to still high interest rates and income from structural hedges
Asset quality	↘	Moderately negative. A mild deterioration in asset quality in 2025, driven by rising unemployment and a weaker economic outlook.
Capital position	→	Stable. Capital levels to remain sound as strong organic generation offsets dividends and buybacks.
Funding and liquidity	→	Stable. Deposit outflows seen in past quarters have normalised. We expect a steady recovery through 2025 due to more prudent customer behaviour in the tighter economic environment

Q1 results set the stage for a strong performance in 2025

Robust NII and income from structural interest-rate hedges will support profitability

Q1 performance was broadly in line – if not stronger – than 2025 guidance. The average return on risk-weighted assets (RoRWA) in Q1 was approximately 2.5% for the UK banks in our sample (Barclays, HSBC, Lloyds, NatWest, Santander UK), and the average return on equity (ROE) was around 11%, both marginally higher than 2024. The main drivers of this strong performance were solid net interest income (NII) owing to still-high interest rates and tailwinds from structural hedges, which help stabilise revenue generation against interest-rate fluctuations. NII increased by 1% on average in Q1 2025 compared to Q4 2024. Net interest margins (NIMs) also improved, driven by an expansion in deposit margins and a growing contribution from the rollover of structural hedges into higher yields.

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



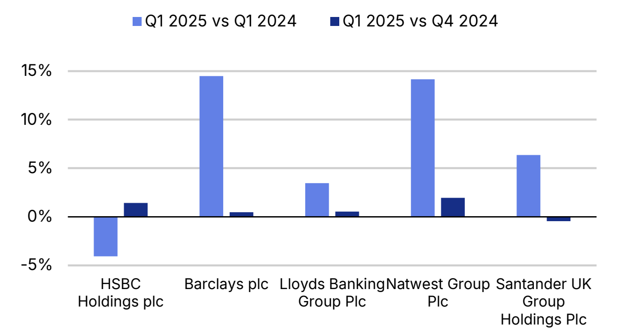
Source: Company data, Scope Ratings

Structural hedging income represented an average of 37% of NII and 21% of total income at Barclays and Lloyds in Q1 2025. UK banks expect structural hedges to continue to support revenues in the medium term. Barclays, Lloyds, and NatWest confirmed their structural hedging income in 2025 will be larger than in 2024. The typical duration of this hedging is 2.5 to 3.5 years, with NatWest and HSBC guiding for positive impacts out to 2027.

Higher loan volumes will also support NII, as has been the case in recent quarters. Fee and commission income increased by 8% in Q1 2025 across our sample (excluding Santander UK). Strong customer and market activity were key drivers for the strong performance, which we anticipate will persist throughout the year. Wealth management – a key focus area for some UK banks – also recorded positive growth.

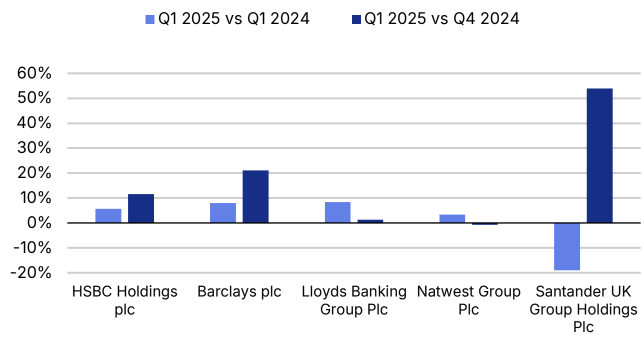
Key risks to this relatively benign revenue outlook include rising geopolitical tensions and market volatility, which could dampen customer sentiment and weigh on capital markets and trading income.

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

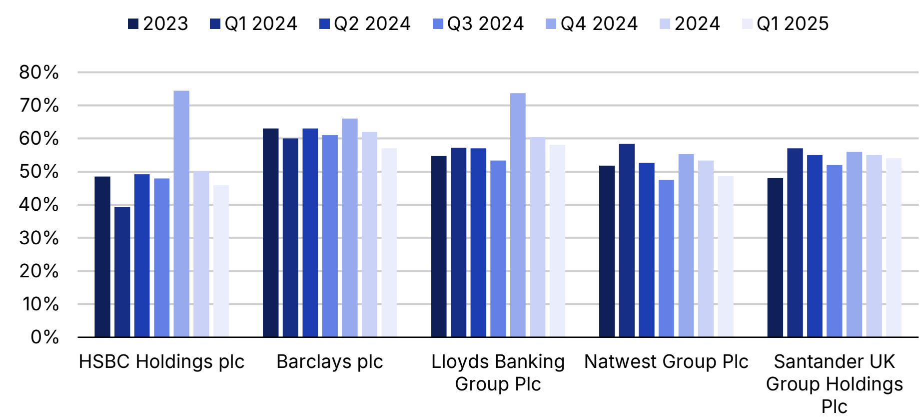


Source: Company data, Scope Ratings

Efficiency ratios improved modestly both quarter-on-quarter and year-on-year, reaching an average of 53% in Q1 2025 vs 56% in 2024 and 54% in Q1 2024, as strong revenues outperformed wage increases caused by sustained high inflation over the past three years and ongoing strategic investments.

Tight cost control, alongside a stable revenue outlook, help stabilise banks' efficiency ratios. Cost-cutting initiatives such as HSBC's announced strategic reorganisation, will help offset the long tail of elevated staff costs. Barclays confirmed it had delivered approximately GBP 150m in gross cost efficiencies in Q1 out of GBP 500m planned for the year as part of a multi-year strategic plan for GBP 1bn of efficiency savings by end 2026.

Figure 2: Cost-to-income ratios



Source: Company data, Scope Ratings

The need to provision against potential liabilities related to historical UK car finance commission payments could weigh on the outlook for Lloyds and Santander UK, which booked significant provisions in 2023 and 2024 for this. Exposure of other rated banks is contained.

UK Supreme Court hearings in the first week of April included submissions from the Financial Conduct Authority (FCA) and the National Franchised Dealers Association (NFDA), which were granted permission to intervene. A verdict is expected by July.

The FCA noted in March that it will confirm within six weeks of the UK's Supreme Court ruling if it will propose a redress scheme and how it will be implemented. The FCA's next steps regarding complaints related to Discretionary Commission Arrangements on auto loans will be informed by the UK's Supreme Court decision.

Lloyds has cumulatively booked GBP 1.15bn in provisions for operational/legal costs and customer redress since Q4 2023, including GBP 700m in 2024, equivalent to 16% of its annual profits. No new provisions related to this were taken in Q1 2025.

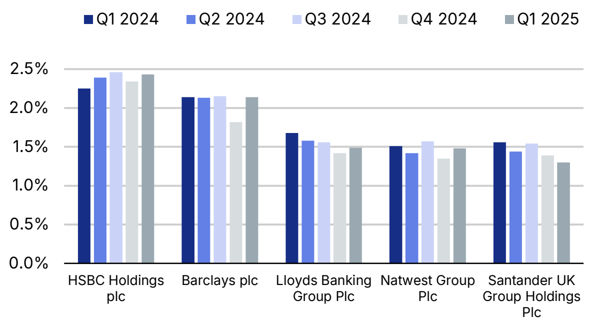
Santander UK booked a provision of GBP 295m related to historical motor finance commission payments in its Q3 2024 results, equivalent to 31% of its total net profit for 2024. Its final provision for UK car finance was within the range we estimated in November 2024 (Car finance exposures will have moderate impact on UK banks rated by Scope). The bank did not book any additional provisions in its Q4 2024 or Q1 2025 results.

Asset quality remains resilient but early signs of deterioration are emerging

Asset-quality indicators expected to worsen in 2025

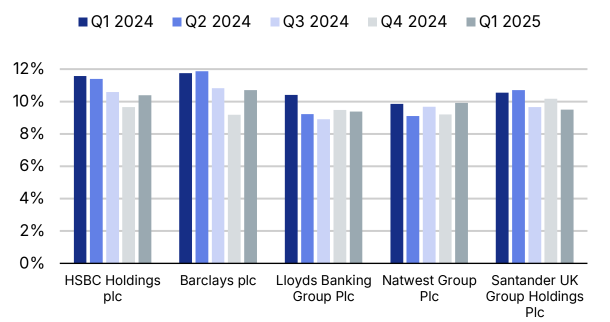
Geopolitical and trade-related risks skew the balance of risk for asset quality to the downside. At the end of March 2025, banks showed minor increases in Stage 3 loans relative to Q4 2024, but stage 3 ratios were below 2% for three out of the five UK banks in our sample. Drivers of the deterioration include higher charges for US consumer banking (Barclays), heightened uncertainty and a deterioration in the economic outlook due to geopolitical tensions and higher trade tariffs (HSBC), and less debt sales activity in the retail banking portfolio (NatWest)

Figure 5: Stage 3 ratios



Source: SNL, Scope Ratings

Figure 6: Stage 2 ratios

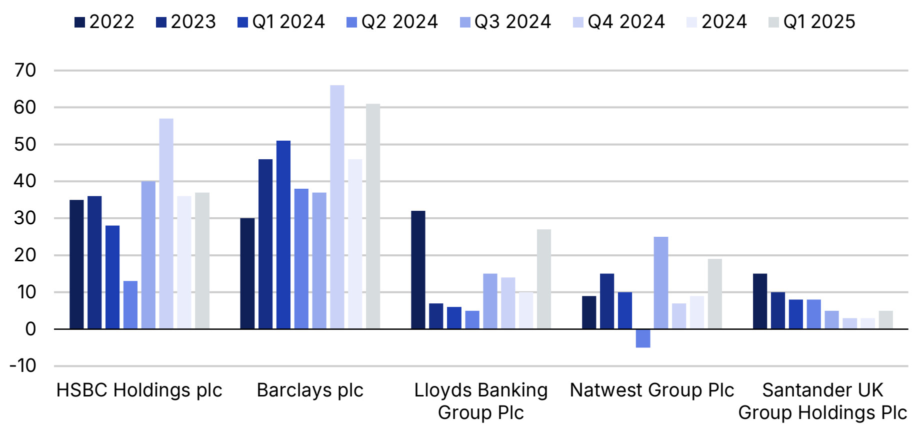


Source: SNL, Scope Ratings

Cost of risk increased on a yearly basis for most banks in our sample due to higher loan-loss provisions driven by post-model adjustments for heightened US macroeconomic uncertainty and a deterioration in the economic outlook due to higher trade tariffs and geopolitical tensions. Exceptional provisions caused cost of risk at Barclays and Lloyds to slightly exceed 2025 targets. We expect UK banks' cost of risk continue increasing for the remainder of the year, but it should remain close to guidance and targets for 2025, ranging from below 20bp (NatWest) to 50bp-60bp (Barclays).

The wide range of cost-of-risk guidance reflects significant business-model heterogeneity, from global diversified banking groups exposed to multiple geographies and more corporate exposures (HSBC), banks with large consumer banking businesses (Barclays) and banks with a domestic focus (Lloyds Banking Group, NatWest Group, Santander UK).

Figure 3: Cost of risk (bp)



Source: Company data, Scope Ratings.

Mortgage arrears continued to increase in Q1 albeit at a very controlled pace. Arrears stood at just 1% of total household mortgages (0.6% in the buy-to-let segment) according to UK finance data for Q1 2025.This is not a cause for concern. House repossessions also remain very low.

Company insolvencies increased by 9% year-over-year to Q1, primarily driven by an increase in Creditor Voluntary Liquidations (CVLs). The construction, wholesale, and retail trade sectors were most significantly affected. Despite this rise, insolvency rates remain notably lower than the peak observed during the Global Financial Crisis, largely attributable to an increase in the number of companies. We anticipate this trend to persist due to sustained higher interest rates, persistent inflation, and uncertainty in global trade.

Capital levels remain adequate while buffers continue to optimise

Capital levels remained stable in Q1 as strong capital generation offset capital distributions

Despite generous capital distributions, UK banks in our sample reported stable capital levels in Q1, as strong organic generation offset dividends and buybacks. The average CET1 ratio amounted to 14.1% as of Q1 2025 and all banks reported CET1 ratios above their respective capital management targets. Buffers to requirements were in the range of 1.7%-3.5%, against average requirements that are that of EU peers. The UK countercyclical buffer stands at 2% and Pillar 2 requirements for our sample range from 2.6% to 4.7% against an EU average of 2.1%[1].

For the remainder of 2025, we expect underlying capital trends to remain intact. Steady earnings generation will be sufficient to finance both RWA growth and high levels of shareholder remuneration. Regulatory headwinds look manageable, with the initial rollout of Basel 3 final rules delayed until January 2027, with full implementation still set for January 2030.

We expect capital to remain at a safe distance from requirements and sufficient for management's risk appetite. Our UK banks sample had an average MREL ratio of 33.9% as of Q1 2025, a comfortable 5.2pp buffer to minimum requirements. The UK government's focus on increasing economic growth could pressure the regulatory environment. Recent regulatory initiatives include:

1. A consultation on scrapping the Building Societies Sourcebook (BSOCS);
2. A proposal for a simplified prudential framework for less systemically important banks and building societies (the Small Domestic Deposit Takers (SDDT) regime);
3. Abolition of the UK Payment Systems Regulator (PSR) and its consolidation into the Financial Conduct Authority (FCA);
4. No additional measures in Diversity; Equity and Inclusion;
5. A plan to strip outdated or duplicated requirements from the domestic insurance rulebook.

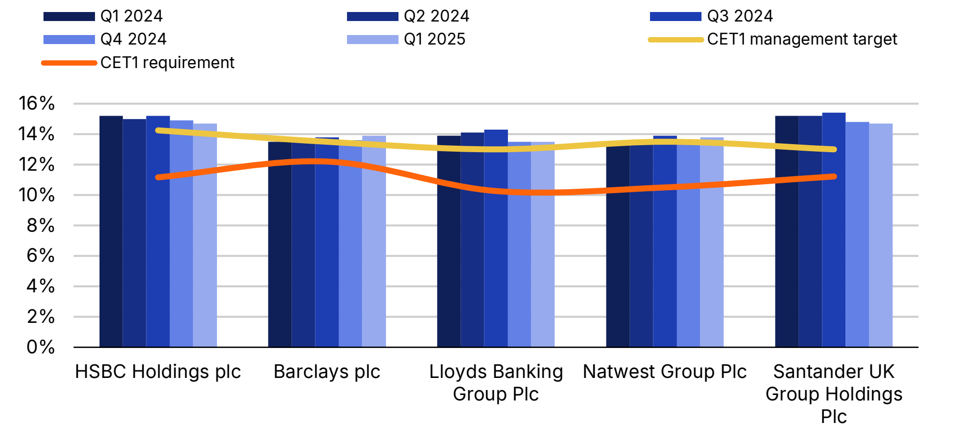
[1] ECB keeps capital requirements broadly steady for 2025, reflecting strong bank performance amid heightened geopolitical risks

These measures do not significantly change the highly regulated operating environment for UK banks, with the Prudential Regulation Authority firmly committed to its mandate of maintaining the resilience and stability of the UK financial system.

Another key regulatory debate revolves around the ringfencing regime. Earlier this year, the regime was reformed to restrict its application to banks with over GBP 35bn in deposits (up from GBP 25bn) and to introduce further flexibility for banks with limited trading activities. It also relaxed the restrictions on certain activities, including cross border.

HSBC, Lloyds and NatWest emphasised in their Q1 results presentations the increased costs that they were incurring because of ringfencing and called for further reform. By contrast, Barclays is opposing any change or relaxation of the current regime, which it considers a strong and secure form of domestic depositor protection. We consider the ringfencing regime as a helpful feature enhancing financial stability, in particular by lowering banks' deposit funding risks.

Figure 4: CET1 ratios, management targets and requirements



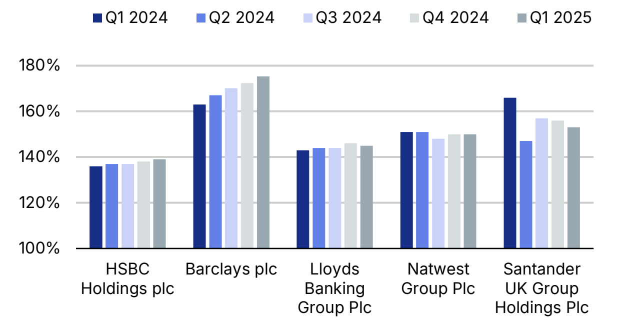
Source: Company data, Scope Ratings.

Recovery and moderate growth in deposits, stable liquidity levels

Most UK banks saw a slight increase in deposits in Q1 2025, recovering from the weakness of the first half of 2024 when customers switched deposits into higher-yielding savings accounts and into other financial products in the higher-for-longer rate environment. We expect a steady recovery in deposits for the remainder of 2025 given the current expected trend of moderate interest-rate cuts and customers deciding to retain sufficient liquidity given the challenging operating environment of geopolitical uncertainty. Key liquidity metrics (LCR and NSFR) remained stable in Q1 2025, at similar levels to those in Q4 2024 as well as the period 2023-2024.

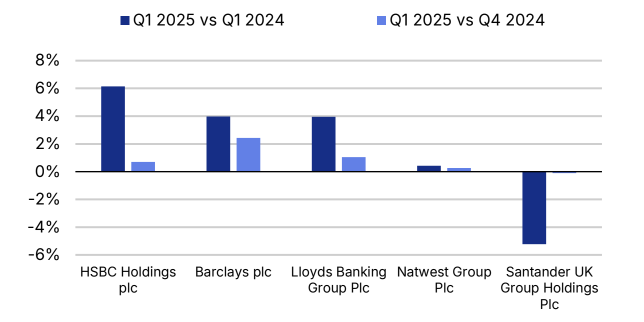
Mild deposit growth in Q1 2025 fully recovering from weak performance

Figure 9: Liquidity Coverage Ratio



Source: Company data, Scope Ratings

Figure 10: Customer deposits, QoQ and YoY comparison



Source: Company data, Scope Ratings

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