Global Research & Analytics

CRISIL
An S&P Global Company

UK Banks – Portfolio review 2018

Date of assessment: Oct-2018

Banking Sector Overview

- **Overview:** The UK banking sector benefits from high capital cushion and solid liquidity buffers, driven by a regulatory regime that is not just well-aligned with the EU's CRD IV regulations, but also more stringent. The banks have significantly de-leveraged and de-risked their business models over the last decade and in more recent years, have also made good progress in resolving litigation and conduct-related issues.
- The large banks have already completed their ring-fencing requirements by separating their traditional P&C operations from their wholesale divisions. Furthermore, they have also migrated their provisioning standards to IFRS 9 with limited impact on capital metrics.
- The key risks to the banking system stem from the economic uncertainty related to the Brexit negotiations and the high exposure to domestic households, with the latter being both, highly leveraged and also vulnerable to interest rate increases. However, the strong capital buffers and improving profitability should provide a moderate cushion against the impact, should these risks materialize. Banks with relatively lower exposure to the UK such as HSBC and Standard Chartered would be relatively better-positioned to cope with a 'hard' Brexit.
- **Rating Agency Views**: All the three major rating agencies believe that UK and EU would reach an orderly agreement on Brexit ahead of the Mar-2019 deadline, and that banks are adequately capitalized to deal with uncertainties. However, they also agree that banks may be challenged in case of a 'no deal', with S&P warning of rating downgrades, Moody's warning of potential asset quality deterioration and Fitch cautioning that wholesale funding markets may be disrupted for a pro-longed period.

Support Risk Assessment

Support Risk Assessment:

- The UK government has historically been very supportive of the banking system. This was clearly demonstrated in multiple instances of bailouts in 2008, including for big banks such as Lloyds and RBS. However, following the implementation of the Banking Recovery & Resolution Directive (BRRD) in the UK effective 1-Jan-2015, we expect the likelihood of government support to be 'low'.
- The UK's BRRD implementation was a strict adoption of the EBA's guidelines on the framework. It clearly respects the principle of no creditor worse off (NCWO) and has a stated preference for structural subordination of senior holding company issuers. This differs from the French legislation, which introduced a new 'non-preferred senior' layer, and the German legislation, which ranks senior unsecured debt below other senior claims (such as depositors and counterparties) in insolvency. Separately, as an added layer of support for retail depositors, the UK government maintains a deposit guarantee scheme, with the guarantee per deposit holder being limited to GBP 85,000. The regulators are also looking to further strengthen the resolution framework and increase transparency. In this regard, from FY19, the BoE plans to publish summaries of the resolutions plans of all UK banks, along with its own assessment.

Figure 1: Banks Under Review (7 Banks):

	Market Cap*** (EUR mn)	Total Assets (EUR mn)	Net Income (EUR mn)	Credit Rating		
				Moody's	S&P	Fitch
HSBC Holdings Plc (HSBC)	140,290.9	2,100,131	10,535	A2/Stable	A/Stable	AA-/Stable
Standard Chartered Plc (STAN)	20,479.2	552,564	1,125	A2/Stable	BBB+/Stable	A/Stable
RBS Group Plc (RBS)	32,159.1	830,780	1,615	Baa2/Positive	BBB-/Positive	A/Stable
Lloyds Banking Group Plc (LBG)	45,294.3	914,137	4,048	A3/Stable	BBB+/Stable	A+/Stable
Barclays Plc (BARC)	31,746.8	1,275,621	(1,021)	Baa3/Stable	BBB/Stable	A/Stable
Investec Bank Plc (IBP)*	NA	22,896	110	A1/Stable	NR	BBB+/Stable
Clydesdale Bank Plc (CLY)**	NA	43,314	(294)	Baa1/positive	BBB+/Stable	BBB+/Stable

Source: Company filings, S&P GMI;

Year ended 31-Mar-2018; ** Year ended 30-Sep-2017; * as on 19-Oct-2018; NA = Not Available; NR = Not Rated*

Bank's Assessment

HSBC

Capital (Good; 1H18 CET1 14.2%)

- HSBC's regulatory capital metrics have steadily improved during the period FY14-FY17, largely due to RWA optimization partly offset by high shareholder payouts. The CET1 ratio declined to 14.2% at end-1H18 (FY17: 14.5%), while it was above the management target of 14.0% and the fully loaded requirement of 11.7%. The leverage ratio declined to 5.3% at end-1H18 (FY17: 5.6%). Its estimated MREL ratio was 25.9% as of 1H18.

Asset quality (Sound)

- Well-diversified loan book (both industry and geography wise) and declining impaired loans underpin HSBC's asset quality. Stage 3 loans (impaired) declined 11bps y-t-d at 1.4% at end-1H18, aided by the run-down of its US consumer and mortgage lending portfolio to zero. Near-term risks to credit quality arise from trade protectionism globally, Brexit and a consequent weakening of global GDP.

Management (Good)

- John Flint took over as the CEO effective 21-Feb-2018, following the retirement of Stuart Gulliver. The group continues to face headwinds arising from various litigations but in Oct-2018 HSBC settled with DoJ over RMBS for USD765mm. HSBC's FY18-20 strategic priorities include growing its Asia and UK franchises, turning around its US business and improving capital efficiency. It targets RoTE of >11% by FY20, underpinned by positive jaws.

Earnings (1H18 Net profit USD8.4bn)

- Net income improved 4.6% y-o-y in 1H18 to USD 8.4bn, aided by higher NII, better fee income, and lower provisions, partly offset by lower trading income and higher operating expenses. NIM improved 5bps y-o-y to 1.4% reflecting higher yields in Asia driven by rate rises. The cost/income ratio weakened to 57.2% in 1H18 (1H17: 54.2%), affected by investments in productivity programmes and technology. RoAE was 8.7% in 1H18.

Liquidity (Strong; 1H18 LtD 72%)

- NSFR for all the principal operating entities ranged between 112% and 176% at end-1H18. The LtD ratio, albeit increasing marginally, was sound at 72.4% (FY17: 68.5%). Its LCR improved further to 158% at end-1H18 (FY17: 142%) and was well above the minimum requirement of 100%.

Standard Chartered

Capital (1H18 CET1 14.2%; outlook stable)

- STAN's end-point CET1 ratio remained largely unchanged y-o-y at 13.6% at end-FY17 (vs. minimum regulatory requirement of 10.1%), and improved to 14.2% at end-1H18, from better earnings generation, coupled with lower RWAs. At end-1H18, STAN's MREL ratio was 26.4% (vs. minimum requirement of 16% by FY19), whereas its UK leverage ratio was 5.8% (vs. 3.73%).

Asset quality (liquidation portfolio deleveraging may continue)

- The NPL ratio has been declining since FY15 and was 3.4% at end-FY17 (3.0% at end-1H18). At end-1H18, USD1.6bn of gross loans remained in the liquidation portfolio (90% is covered, including collateral). At end-1H18, top 20 corporate exposures accounted for 53% of Tier 1 capital (FY17: 50%), and the proportion of its IG corporate exposures improved to 61% (FY17: 57%). Underwriting standards have tightened, probably to mitigate geopolitical uncertainties in largely emerging markets.

Management (Experienced, proven ability to turnaround the business)

- Bill Winters, having three decades of banking experience, turned around STAN by achieving profits in FY17 and resumed shareholder dividend payouts. Moreover, the cost reduction targets were achieved six months ahead of schedule. If legal fines related to violation of Iran sanctions (around USD1.5bn or ~4% of 1H18 CET1 capital) materialise, shareholder returns could be lowered, thus affecting investor confidence in the management.

Earnings (Returned to profit in FY17)

- Following two consecutive years of losses, STAN reported a net profit of USD1.3bn in FY17 and USD1.6bn in 1H18 (up 32.1% y-o-y). Improvement was largely driven by lower impairment charges which we believe are in line with declining NPL formation and higher recoveries. Operating efficiency ratio increased to 67.1% in 1H18 (1H17: 66.2%), in spite of strict cost discipline. We expect further cost reduction coupled with lower provisioning to result in a sustainable earnings generation.

Liquidity (1H18 LtD 67.1%)

- STAN's LCR was robust at 151% at end-1H18 (FY17: 146%), while the NSFR ratio remained above 100%. The bank's LtD ratio fell to 67.1% at end-1H18, from 67.7% at end-FY17.

RBS

Capital (1H18 FL CET1 best-in-class at 16.1%)

- RBS' FL CET1 ratio improved by 250bps y-o-y to 15.9% at end-FY17, and further to 16.1% at end-1H18. RBS has gone from being the least to the most capitalized over the last 5 years, driven by material progress in reduction of legacy assets (to ~11% of RWA). We expect future volatility of capital ratios to reduce, owing to the resolution of the US DOJ claims, improved funding profile of its pension fund (GBP2bn already transferred) and improving profitability. Management targets a long-term CET1 ratio of 13%, as it would face pressures from RWA inflation on mortgage loans, IFRS 16 and Basel III final rules (longer-term). The CRR and PRA FL leverage ratios were 5.2% and 6.0%, respectively.

Asset Quality (Improving)

- The impaired loan ratio improved by 32bps y-o-y to 1.8% at end-FY17. Upon migration to IFRS 9, the 'Stage 3' category stood at 2.1% of credit exposure at end-1H18, which improved from 2.4% as on 1-Jan-2018. Unlike key peers, RBS has been focused on expanding its mortgage loan market share with marginally weaker underwriting standards, and it now also intends to expand its unsecured consumer loans, albeit at a cautious, measured pace.

Management (Good)

- RBS has made material progress on restructuring its business model and resolving legacy issues since the appointment of Ross McEwan as CEO in 2013. While concerns have arisen over the unexpected and sudden resignation of Ewen Stevenson as CFO and growing speculation of McEwan's departure, we note that it does have a seasoned management team that can takeover internally.

Earnings (Turnaround in sight; first annual profits in 10 years)

- The bank's FY17 net income was GBP752mn, its first annual profit in 10 years. 1H18 attributable earnings fell 5.4% y-o-y to GBP888mn on higher litigation charges and lower NIM, but core segments continue to perform well. For FY20, management targets C/I of 50% (FY17: 75.5%) and ROE of 12% (FY17: 1.8%).

Liquidity (1H18 LtD ratio of 87.9%)

- Over the last decade, the bank's funding profile has transformed from one of the most reliant on wholesale sources to a deposit-funded franchise. LtD ratio improved to 89% at end-FY17 (FY16: 93.6%), and further to 87.9% at end-1H18. At end-1H18, the bank reported solid LCR and NSFR ratios of 167% and 140%, respectively.

Lloyds Banking Group

Capital (Sound; 1H18 FL CET1 ratio of 14.1%)

- LBG's regulatory capital metrics have improved over the last few years, aided by core earnings generation and run-off of its non-core legacy assets. The pro-forma CET1 ratio improved 50bps y-o-y to 14.1% at-end FY17 and remained stable y-t-d at end-1H18. In Jul-2018, the PRA reduced LBG's Pillar 2A requirement starting Jan-2019 to 2.7% from 3%. However, LBG is likely to maintain its CET1 ratio above the internal target of 14% (includes 1% management buffer). The UK leverage ratio declined 10bps y-t-d to 5.3% at end-1H18.

Asset Quality (Adequate; impaired loan ratio improved to 1.8%)

- Stage 3 loans (impaired loans) to total loans improved to 1.8% at end-1H18 (1.9%, as of 1-Jan-2018). Reported ECL allowances to total impaired loans was 48.9% at end-1H18. We see limited credit risks arising from its loan book given low LTV of the group's mortgages, diversified and high quality commercial loan book and a prime credit card book.

Management (Good)

- LBG has an experienced management team (CEO in place since 2011), which has helped restructure and turnaround the business. Management's priorities are improving customer experience through digitisation, and maximising capabilities as an integrated financial services provider. The FY20 strategic goals on cost efficiencies, CET1 capital and RoTE (14-15%) look achievable. The potential wealth JV with Schroders could improve fee income.

Earnings (Net income of GBP2.3bn with RoAE of 9.6% in 1H18)

- LBG's net income grew 38% y-o-y to GBP2.3bn in 1H18 driven by better NII, positive operating jaws and lower PPI charges (-52% y-o-y), partly offset by higher provisions. NIM rose 20bps y-o-y to 1.6%, aided by lower funding costs and higher yields supported by a changing loan mix. The cost/income ratio fell to 63.9% (1H17: 71.6%). RoAE improved to 9.6% (1H17: 6.7%). Headwinds could arise from no-deal Brexit as well as higher PPI charges.

Liquidity (1H18 LtD ratio of 112.3%)

- LBG's LtD ratio improved to 112.3% at end-1H18 (FY17: 113.5%). However, wholesale funding grew to GBP185.5bn (up 8.1% y-t-d), following an increase in term funding to replace the FLS and higher reliance on short-term funding. The LCR ratio improved marginally to 129% at end-1H18 (FY17: 125%).

Barclays

Capital (1H18 FL CET1 ratio of 12.6%)

- BARC's FL CET1 ratio improved by 92bps y-o-y to 13.3% at end-FY17, primarily on deconsolidation of the African operations. However, the CET1 ratio declined to 12.6% at end-1H18, primarily on balance sheet growth and methodology updates. The FL UK leverage ratio stood at 4.9% at end-1H18.

Asset Quality (Sound, with further reducing impaired loans)

- Upon adoption of IFRS 9 standards, BARC's problem loans ratio has gone from being the lowest to among the highest (save for RBS) among key peers. Underwriting standards remain prudent, with average LTV (stock) on mortgage loans being <50% and buy-to-let accounting for just 12%. At end-1H18, the share of 'Stage 3' loans accounted for 2.6% (from 2.8% on 1-Jan-2018).

Management (Experienced, but challenged)

- Jes Staley (at the helm since 2015) has steered the bank well over the last couple of years and his vision is to grow and challenge the US IBs in capital markets. It is worth noting that Staley himself faced investor criticism for two gaffes – a) responding to a phishing mail; and b) attempting to identify a whistle-blower.

Earnings (FY17 net loss of GBP1.7 bn)

- BARC reported a GBP1.7bn loss in FY17, primarily on the sell down of African Operations. In 1H18, the bank recorded a profit of GBP561mn, a significant improvement from a loss of GBP1.2bn, owing to the GBP1.4bn penalty paid to the DoJ, which marked the conclusion of one of the last major legacy conduct issues for the bank. In May-2018, the bank also announced the dismissal of charges brought by the Serious Fraud Office (SFO) against BARC relating to its capital raisings in 2008. The cost base has reduced to GBP15.4bn in FY17 and the management plans to further reduce this to GBP13.6bn by FY19.

Liquidity (1H18 LtD ratio of ~83%)

- LtD ratio improved to 85.4% at end-FY17 (FY16: 92.8%) and further to ~83% at end-1H18. LCR was robust, having improved from 131% at end-FY16 to 154% at end-FY17 (unchanged at end-1H18). The group has also significantly improved the term structure of its wholesale funding, with the share of funds <1 year reducing to 27% at end-1H18 (FY13: 44%). The MREL ratio was 26.5% at end-1H18, making steady progress towards the potential Jan-2022 target of 29.1%, and has issued GBP6.2bn in long-term debt y-t-d.

Investec

Capital (FY3/18 CET1 ratio of 11.8%, trails peers)

- IBP's Basel III FL CET1 ratio declined ~40bps y-o-y to 11.8% at end-FY3/18. The bank's CET1 trails peers, as its standardized approach leads to high RWA density (68.4%). However, balance sheet gearing is better. We expect regulatory capital metrics to remain stable, as benefits from sustainable earnings generation would be offset by its high risk asset base.

Asset Quality (FY3/18 NPL ratio 3.5%, legacy remains a weakness)

- Asset quality metrics trail domestic peers on exposure to legacy assets (3.1% of gross loans at end-FY3/18) and high concentration toward mid and large-sized corporates (60% share of gross core loans). However, loan quality is likely to improve from current levels, as the bank continues to pare down its legacy portfolio, albeit at a gradual pace.

Management (Stable and experienced)

- Despite significant leadership changes at ultimate parent (Investec Group), IBP's CEO remains unchanged, which we view positively given his long tenure with the bank. The bank's on-going strategy is to invest more in capital-light businesses (such as wealth management), improve operating efficiency (aided by investment in technology) and de-lever legacy portfolios.

Earnings (FY3/18 Net profit of GBP96.2mn; outlook 'stable')

- IBP reported a net profit of GBP96.2mn (down 18.2% y-o-y) mainly on higher impairments against the legacy portfolio. Consequently, the ROAE fell to 4.9% in FY3/18 from 6.2% a year ago. The bank has a well-diversified revenue stream, and revenue growth has been benefitting from fees realized in the Wealth & Investment segment. We expect revenue growth to be only partially offset by higher legacy-related impairment charges.

Liquidity (Solid liquidity and sticky deposit base)

- Despite a steep decline on a y-o-y basis, standalone LCR remained solid at 301% at end-FY13/18. Driven by a sticky client base, customer deposits have grown at a CAGR of 8.6% over the last decade. The LtD ratio of 85.5% at end-FY17 (FY16: 82.3%) trails the peer average.

Clydesdale

Capital (1H3/18 Transitional CET1 ratio of 11.3%)

- CLY's CRD IV Transitional CET1 ratio declined 40bps y-o-y to 12.2% at end-FY9/17, and fell further to 11.3% at end-1H3/18. The CET1 ratio was ahead of the minimum regulatory requirement of 8.9%, but below management's mid-term guidance of 12-13%. Capital metrics are likely to improve from mortgage RWA reduction (management estimates ~GBP5bn), as CLY migrates to the IRB risk-weighting approach - to materialise by end-FY18.

Asset Quality (Negligible NPLs; adequate loan book coverage)

- CLY benefits from its prudent underwriting practices, evident from the sound loan quality and adequate coverage ratio. The bank's NPL ratio has been declining steadily over the years and improved to 0.5% at end-1H18 (FY17: 0.6%), while the coverage ratio improved to 130% at end-1H18 (FY17: 120%). Mortgage loans had an average LTV of ~70% on new originations, while SME loans are well-diversified (by sector) and 68% of it is either fully or partially collateralised.

Management (Stable and experienced)

- The management team has been attempting to restructure the business model, largely affected by legacy issues. However, CLY has been reporting losses since FY12. Following a demerger from National Australia Bank, and an IPO, the bank announced its FY20 targets in Dec-2015, later revised in Sep-2016. CLY could revisit its targets again, following the takeover of Virgin Money Bank in Oct-2018, thus implying volatility in strategic planning.

Earnings (Six consecutive years of losses)

- CLY reported a net loss (GBP294mn in FY17), largely affected by ongoing conduct-related issues. CLY's margins benefit from stronger mortgage loan origination (vs. the market), which more than offsets low yields. The bank's cost reduction programme which is progressing well, and settlement of PPI-related issues should aid profitability in the medium term.

Liquidity (1H18 LtD ratio of 115.3%)

- Customer deposits form about three-fourths of CLY's funding base. The LtD ratio remained largely unchanged y-t-d at 115.3% at end-1H18, and was within the management guidance of <120%. CYBG reported an LCR of 164% at end-FY17 (up from 140% a year ago), while the NSFR was 118% (FY16: 124%).

Peer Comparison

Figure 2: Peer Analysis (EUR mn)	Barclays Plc	Lloyds Banking Group Plc	Royal Bank of Scotland Group Plc	Standard Chartered Plc	HSBC Holdings Plc	Clydesdale Bank Plc	Investec Bank Plc
Fiscal period	2017	2017	2017	2017	2017	2017	2017
Fiscal period end	31-Dec-17	31-Dec-17	31-Dec-17	31-Dec-17	31-Dec-17	30-Sep-17	31-Mar-18
Country	UK	UK	UK	UK	UK	UK	UK
Ratings:							
Moody's Rating	Baa3/ Stable	A3/ Stable	Baa2/ Positive	A2/ Stable	A2/ Stable	Baa1/ Negative	A2/ Positive
S&P Rating	BBB/ Stable	BBB+/ Stable	BBB-/ Positive	BBB+/ Stable	A/ Stable	BBB+/ Stable	NR
Fitch Rating	A/ Stable	A+/ Stable	BBB+/ Positive	A/ Stable	AA-/ Stable	BBB+/ Stable	BBB+/ Stable
Balance Sheet and P&L (EUR mn)							
Total Assets	1,275,621	914,137	830,780	552,564	2,100,131	43,314	22,896
Total Equity	74,310	55,317	55,261	43,145	164,787	3,464	2,516
Net Income	(1,021)	4,048	1,615	1,125	10,535	(294)	110
Profitability (%):							
Net Interest Margin (NIM)	1.2	1.5	1.6	1.5	1.4	2.1	1.8
Efficiency Ratio	72.7	68.5	75.5	71.3	58.4	104.4	78.1
ROAE	(3.1)	7.3	1.8	1.8	6.0	(8.8)	4.9
Asset Quality (%):							
NPL Ratio	3.1	1.7	1.8	3.4	1.6	0.6	3.5
Reserves / NPLs	41.2	28.1	61.5	65.7	48.4	120.0	42.4
Capital Adequacy (%):							
CET1 Ratio (Fully-loaded)	13.3	14.1	15.9	13.6	14.5	12.2*	11.8
Basel III Leverage Ratio (Fully-loaded)	4.5	4.9	5.3	5.7	5.6	6.3	8.5
UK Leverage Ratio (Fully-loaded)	5.1	5.3	6.1	6.0	6.1	7.4	10.2
Tangible Common Equity (TCE) Ratio	4.2	4.8	4.8	6.1	5.7	7.3	8.3
Liquidity (%):							
Loans / Customer Deposits	85.4	113.5	88.9	67.7	68.5	115.3	85.5
Customer Deposits / Total Funding	53.1	70.9	77.0	72.1	73.3	76.3	73.9
Basel III Liquidity Coverage Ratio	153.6	124.9	140.3	148.1	142.4	164.0	NA

*Source: Company filings, S&P GMI, * on a transitional basis*

INDUSTRY PEER ANALYSIS

- **Business profiles & market positions:** The UK banking sector landscape has changed significantly over the last decade. Prior to 2008, the UK banks significantly expanded their global operations but at the onset of the global financial crisis, several of them were troubled. RBS and LBG were bailed out with taxpayer funds while BARC managed to source private capital injections from SPVs owned by the Qatari royals. As part of the EU bailout norms, RBS and LBG had to significantly downsize their overseas operations and were gradually transformed into domestic operating entities. HSBC and Standard Chartered, on the other hand were relatively less affected by the crisis, owing to their diversified operations across several emerging markets. Among these five banks, HSBC alone maintains a strong global presence, albeit we acknowledge that it has also exited operations from quite a few countries. Since the crisis, the UK banks have negotiated several challenges – restructuring operations, strengthening capital and liquidity resources, reducing non-core operations and improving asset quality, and have recently also undergone separation of the retail banking activities under the ring-fencing requirements. However, profitability for the UK banks remains a challenge, as they have been grappling with low margins on tightened competition and high conduct-related charges, especially over items such as mis-selling of payment protection insurance (PPI) and interest rate hedging products (IRHP) in the UK, while some have also suffered from heavy fines by US regulators on mis-selling of mortgage-backed securities. Competition remains tight in the mortgage lending space, as all the large banks are both well capitalized and flush with liquidity.
- **Systemic importance:** With an aggregate asset-base of GBP8 trn, the UK is the world's fourth-largest and Europe's largest banking system. Four UK banks (BARC, HSBC, RBS and Standard Chartered) are ranked among the world's 30 G-SIBs (2017) and each of their prescribed buckets have remain unchanged since the previous year. HSBC has been assigned bucket 3, which translates into an additional capital buffer of 2.0%. BARC has been assigned bucket 2 which requires 1.5%. Both Standard Chartered and RBS have been assigned bucket 1 which requires 1.0%. Overall, the credit institutions operating in the UK employed 353,299 personnel at the end of 2017, down 4.5% y-o-y, the steepest decline since 2012.
- **Credit assessment**
  - *Capitalization:* The capital position at UK banks have improved over the last few years, driven by regulatory mandates and increased pressure from investors. BoE data indicates that the UK banking system tripled its CET1 ratio since 2007 to 15% as of 2Q18. While some of the challenger banks are yet to report the fully-loaded capital ratios and are not subject to the UK leverage ratio framework, we note that both CLY and IBP have sound capital metrics which are ahead of regulatory requirements. HSBC and STAN benefit from a less leveraged balance sheet, while RBS has the highest CET1 ratio in our peer set, aided by active balance sheet de-risking. While RBS benefits from lower mortgage risk-weighting, its management claims this is offset by higher Pillar 2A charges.
  - *Asset Quality:* The UK banking system has been improving its asset quality metrics, largely owing to the considerable progress in paring down legacy exposures, and disposing/writing off NPLs. RBS, owing to the weakest starting point a decade ago, has had the most work to do in this regard, while HSBC and STAN have also made some progress. Following the adoption of IFRS 9, UK banks (excluding challenger banks) have been mandated to classify their financial assets differently, under which credit impaired loans are specifically termed stage 3 loans. STAN has the highest share of Stage 3 loans, which we attribute to its large exposure to troubled economies in emerging markets.
  - *Profitability:* Profitability has remained a challenge for UK banks, and though they have a wide gap to cover with global peers, some progress has been observed. For example, both RBS and STAN reported annual profits in FY17 after a gap of several years. LBG was the most profitable in FY17, owing to its primarily domestic operations and lack of any major pending legacy issues.
  - *Funding/Liquidity:* Apart from BARC (high capital markets exposure) and CLY (challenger), all banks have loan books that are well-funded by deposits. All these banks also maintain solid liquidity ratios, and it has been observed that most of them have significantly improved the term structures of their long-term debt.

Country Risk Analysis

The UK is the fifth largest economy in the world with a GDP (at current prices) of ~GBP2.0 trillion (2017). The UK is a diverse, and wealthy country, with GDP per capita around GBP30.9k (2017). The sterling currency's reserve status, strong governance indicators and its access to capital markets support its credit profile. Further, the UK is also a highly competitive economy, with a flexible labour market and business-friendly regulatory environment. However, the key risks to its credit profile are: Brexit, high public debt and wide current account deficit.

- **Economy:** UK's economic growth has somewhat moderated since the EU referendum in Jun-2016. The economic growth accelerated in 2Q18 but remained moderate (0.4% q-o-q and 1.3% y-o-y). We do note that 1Q18 (0.2% q-o-q) was impacted by the adverse weather conditions. The UK economy grew by 0.6% y-o-y in 1H18, continuing the decelerating trend seen since 2H14. Both the IMF and the BoE have projected the 2018 and 2019 real GDP growth to be 1.4% and 1.9%, respectively.
- **External and Public Finance:** On a q-o-q basis, UK's current account deficit rose to 3.9% of GDP in 2Q18 (unchanged from FY17) from 3.0% of GDP in 1Q18, mainly due to a high trade deficit during the quarter primarily attributed to an increase in oil prices. At end Sep-2018, public debt (excluding public sector banks) stood at 84.3% of GDP, down from 86.7% at end Sep-2017 however, significantly higher than the Maastricht Treaty reference value (60.0% of GDP). Further, we note that the net public debt of £19.9bn y-t-d at end Sep-2018 was less than £30.6bn y-t-d at end Sep-2017 and the lowest since 2002.
- **Brexit:** In Jun-2016, the UK voted to leave the European Union, popularly known as the BREXIT. The exit process began in Mar-2017, and the country has been allowed two years to negotiate with the EU to ensure a seamless exit from the union. As per the ongoing negotiations, Theresa May requested for i) an extension of this transition period, and ii) introduction of a new referendum to create a temporary UK-EU joint customs territory, until border issues are resolved between Republic of Ireland and Northern Ireland. While negotiations are underway and the deadline is nearing, uncertainties on the outcome would have a negative impact on the UK - lower economic growth and reduced demand for credit and FDI. Thus, we expect a mild deterioration in the country's banks' credit quality and subdued profitability, partly mitigated by their sound solvency and liquidity buffers.
- **World Bank Indicators:** According to the World Bank Indicators, the percentile rank for all indicators scored well except 'political stability and absence of violence/terrorism'. The percentile rank for 'political stability and absence of violence/terrorism' declined to 56.7 in 2017 (vs. 58.6 in 2016).

Figure 3: United Kingdom

Government	Conservative	**Currency**	GBP
Next Elections	2022	**GDP per head**	€ 30,900
Population	66.0 mn	**GDP total**	€ 2,041 bn (2017)

Source: ONS, IMF, World Bank

Figure 4: Sovereign Ratings

Credit Rating Agency	Moody's	S&P	Fitch
Sovereign Ratings	Aa2 (Stable)	AA (Negative)	AA (Negative)

Source: S&P GMI

Figure 5: Economic and Fiscal Indicators

	2016	2017	2018e	2019e	2020e
Nominal GDP ($bn)	2,669	2,628	2,808	2,810	2,913
Real GDP Growth %	1.8	1.7	1.4	1.5	1.5
Investment/GDP %	17.3	17.4	17.2	17.2	17.5
Savings/GDP %	12.0	13.6	13.7	14.0	14.4
Unemployment Rate %	4.9	4.4	4.1	4.2	4.5
Debt/GDP %	87.9	87.5	87.4	87.2	86.5

Source: S&P UK report Oct 2017; e = estimate

BANKING SECTOR ASSESSMENT

As of Aug-2018, the UK banking system comprised 344 banks and 45 building societies. In 2017, apart from Sweden, the UK was the only major country to report an increase in number of operational banks, primarily driven by the large entry of technology-powered challenger banks.

- **Concentration and main banks:** Asset concentration in the UK banking system is somewhat high, with the seven largest banks accounting for over 75% of total system assets. BARC was the largest bank in the UK, with a 14% share of system assets, followed by Lloyds Bank Plc and HSBC Bank Plc, at 10.4% and 10.3% respectively.
- **Loan book composition:** UK banks are highly exposed to the household sector, which accounted for 51.7% of total loans (including 46.5% secured and 5.2% unsecured), as of end-Aug 2018. The UK resident banking sector reported total assets of £8,029bn at end-Aug 2018. Between Aug-2010 and Aug-2018, total assets decreased by 0.3%, reflecting the deleveraging that the sector has undergone during this period.
- **Funding and Liquidity profile:** UK banks benefit from the combination of a large deposit base and a solid capital markets centre. At end-Aug 2018, deposits accounted for 61.7% of total system liabilities. The banks have also benefitted from strong capital market access, but over the last few years, they have consciously been focusing on improving the term structure of the funding, driven in part by the mandate to comply with the LCR and NSFR requirements. Reliance on short-term and interbank funding has also declined over the years, indicating an improvement in the funding structure. UK banks benefit from sound liquidity buffers, where liquid assets (cash, balances with central banks and government bonds) at large lenders accounted for 17.2% of total assets in 2017, more than double the levels seen in the pre-crisis era.

  As part of contingency planning for Brexit, UK-based banks (and also central clearing counterparties) have access to £300bn of borrowing capacity at the BoE through collateral pre-positioned in its facilities. This broadly equates to the funding provided during the peak of the global financial crisis.

  To mitigate the low interest rate environment and promote lending, the BoE launched the Term Funding Scheme (TFS) and the Funding for Lending scheme (FLS), which came to an end in early-2018. This has resulted in banks searching for alternative funding sources such as tapping wholesale capital markets for debt, or instead issue capital or subordinated debt instruments in order to comply with total loss-absorbing capacity (TLAC) and minimum requirement for own funds and eligible liabilities (MREL) requirements which are more stringent.

Supervision & Regulation

- We assess the UK's institutional framework as 'strong'. Regulatory oversight has strengthened considerably since the start of the global financial crisis. In Apr-2013, the UK's supervisory structure was overhauled with the cessation of the then Financial Services Authority (FSA) and the establishment of two new agencies, in what became commonly referred to as the 'twin peaks' model. The Prudential Regulatory Authority (PRA) was assigned the responsibility of regulating banks, credit unions, insurers, while the Financial Conduct Authority (FCA) was to look into market conduct. Separately, a third authority, the Financial Policy Committee (FPC, a macro prudential authority) closely monitors systemic risks and prescribes rules around capital buffers and sectoral curbs as deemed appropriate. Key regulatory measures include: a) strict implementation of Basel III norms (including high capital and liquidity requirements); b) annual stress tests with severely adverse macroeconomic scenarios; c) implementation of ring-fencing of core retail activities; and d) implementation of a strong, well-defined resolution framework. The FCA has driven a cultural shift towards stringent compliance norms by levying heavy penalties on several large banks for operational misconduct. However, we note that uncertainty over policy measures is likely to increase, due to the unknown outcome of a long-drawn process of Brexit negotiations with the EU.

2017 Stress Tests – Results:

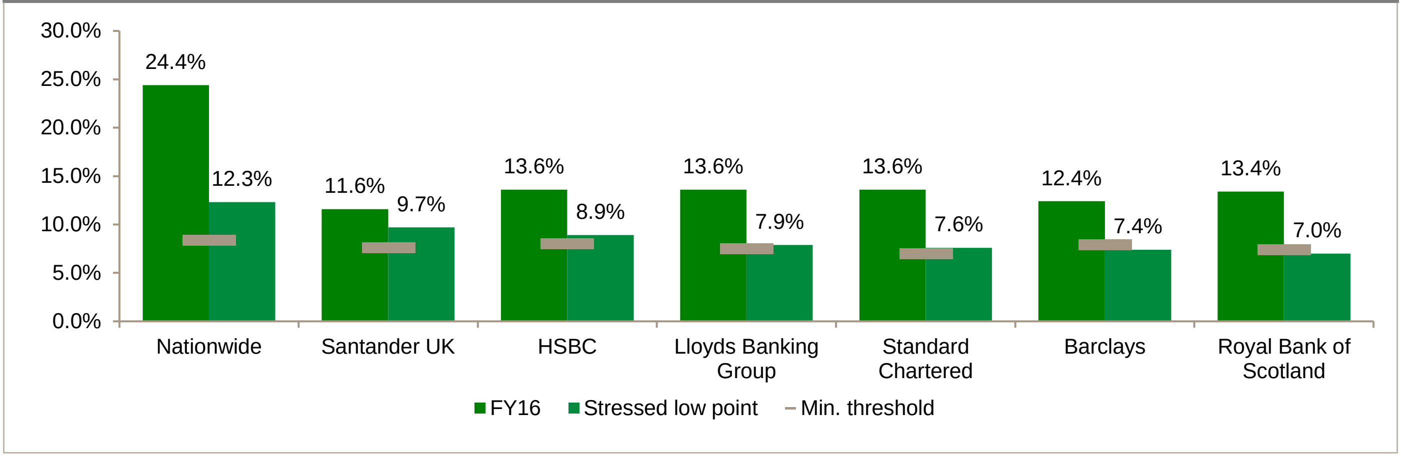
- For the first time since the tests were introduced in 2014, all participant banks passed the stress tests
- RBS and BARC did not meet their minimum CET1 ratio requirements while BARC also failed to meet the minimum Tier 1 leverage ratio. However, the PRA decided to exempt both banks from any capital actions, acknowledging that the banks' capital strengthening measures in 2017 y-t-d were adequate.
- Results under the biennial scenario were not broken down by bank, but on aggregate indicated that profitability metrics may be reduced significantly

2017 Stress Tests- Assumptions:

The Annual Cyclical Scenarios and exploratory scenarios

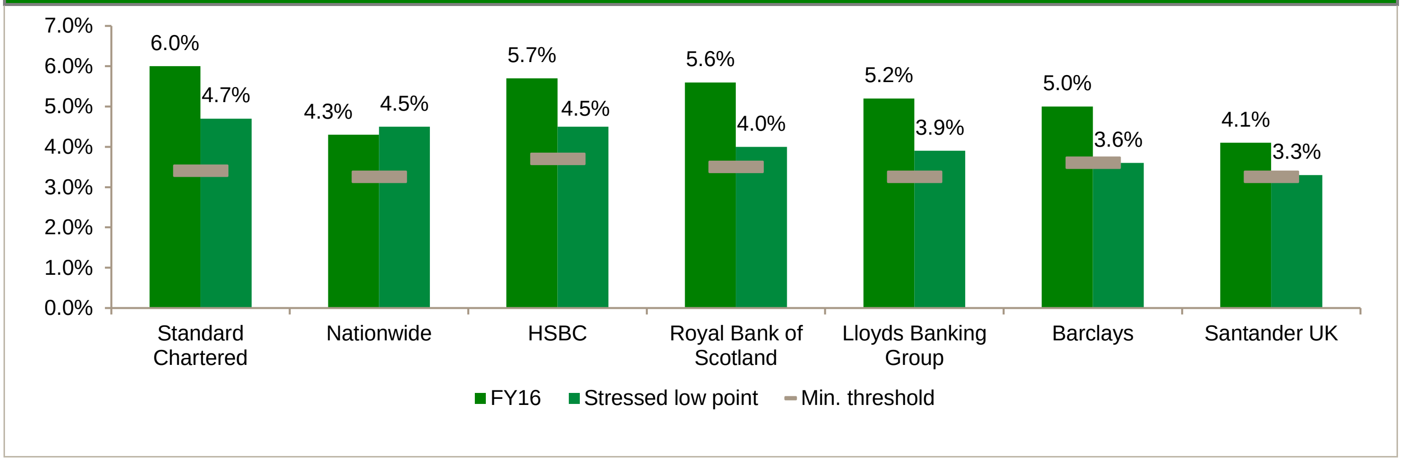
- World GDP falls by 2.4%
- UK, EU and US GDP falls by 4.7%, 3.6% and 3.5%, respectively
- UK, US unemployment rates increase to 9.5%, 9.1%, respectively
- UK residential and commercial property prices fall by 33% and 40%, respectively
- UK Bank Rate rises and peaks at 4%, GBP/USD drops to 68.20

Figure 6: 2017 Stress Test Results: Comparison of CET1 Ratios (after impact of strategic management actions) *



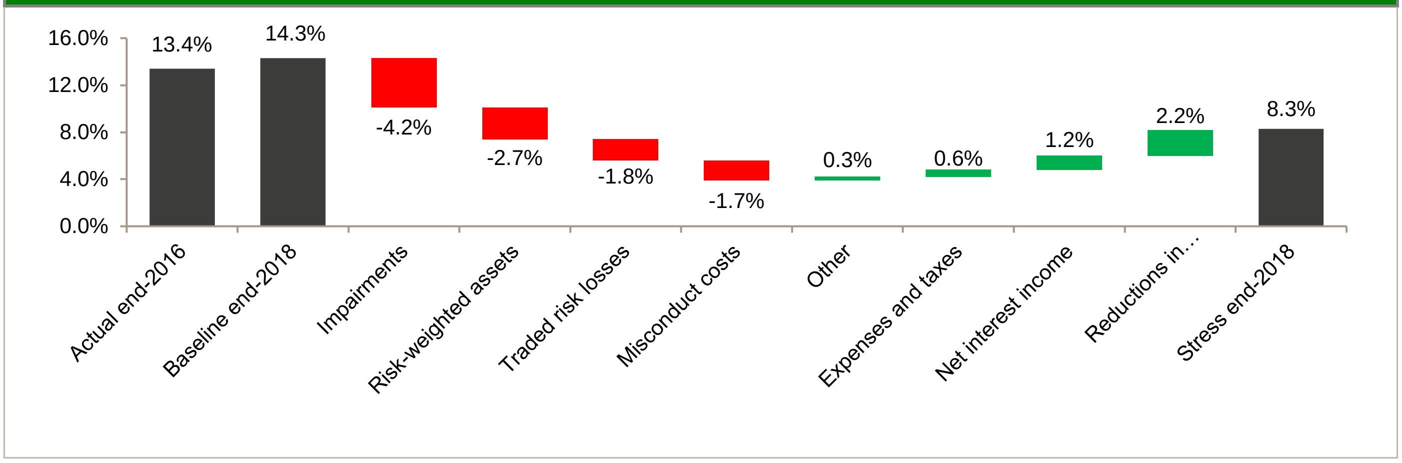
*Source: Bank of England, * AT1 conversion did not occur in the current stress test as all banks' CET1 ratios were above the 7.0% trigger threshold*

Figure 7: 2017 Stress Test Results: Comparison of Tier 1 Leverage Ratios (after impact of strategic management actions)



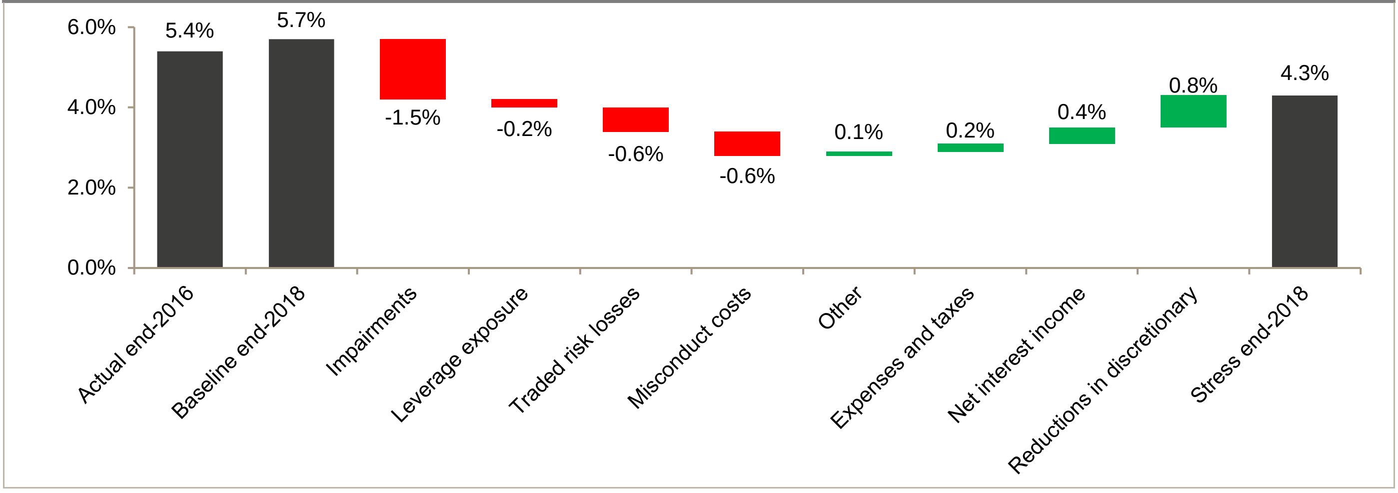
Source: Bank of England

Figure 8: 2017 Stress Test Results: Movement in CET1 ratio since end-2016 (after impact of strategic management actions) *



*Source: Bank of England, * AT1 conversion did not occur in the current stress test as all banks' CET1 ratios were above the 7.0% trigger threshold*

Figure 9: 2017 Stress Test Results: Movement in Tier 1 Leverage ratio since end-2016, (after impact of strategic management actions)



Source: Bank of England

The 2018 stress test would be based on the same scenarios that were incorporated in 2017. However, a few key differences are worth noting for the upcoming tests: - a) systemically important banks will be treated at par the other banks and hence may need to take intensive capital raising measures if they fail to achieve the minimum hurdle; b) domestic systemic importance risk buffers will also be included in the hurdle rate for capital computation; c) Pillar 2A requirement to shift from fixed proportion of RWA to a dynamic one; d) adjustments to reflect higher loss absorbency from IFRS 9 implementation.

RINGFENCING

As part of the measures to strengthen the UK banking system and with a view to protect retail depositors' rights, the UK government passed the ring-fencing legislation wherein all UK banks with a deposit base exceeding GBP25bn would need to firewall their traditional personal and commercial banking operations from their wholesale banking operations

Bank-specific actions on ring-fencing:

Figure 10: Credit Ratings of UK Banks and Key Subsidiaries

Group	Entity	S&P	Moody's	Fitch
HSBC	HSBC Holdings plc (HoldCo)	A	A2	AA-
	HSBC Bank plc (NRF)	AA-	Aa3	AA-
	HSBC UK Bank plc (RF)	N/R	N/R	N/R
RBS	RBS Group plc	BBB-	Baa2	BBB+
	NatWest Markets Plc (NRF)	BBB+	Baa2	BBB+
	Natwest Bank Plc (RF)	A-	A2	A-
	Royal Bank of Scotland plc (RF)	A-	A2	A-
Barclays	Barclays plc (HoldCo)	BBB	Baa3	A
	Barclays Bank plc (NRF)	A	A2	A
	Barclays Bank UK plc (RF)	A	A1	A
Lloyds	Lloyds Bank Group plc	BBB+	A3	A+
	LBCM (NRF)	A	A1	A
	Lloyds Bank and Bank of Scotland (RFs)	A+	Aa3	A+

Barclays: Barclays was the first bank to complete ring-fencing of its UK retail banking unit - Barclays Bank UK Plc (BBUK) in Apr-2018; nine months ahead of the deadline. Around GBP250bn or 22% of the bank's FY17 assets were transferred to BBUK. Proforma BBUK mainly includes Barclays UK division of Barclays Bank Plc which caters to retail and SME customers in the UK (including Barclaycard UK). The RFB is serving close to 24mn customers and one million businesses in UK.

The ring-fenced bank has already completed one full quarter of operations (April-Jun 2018). Total assets declined marginally to GBP247bn at end-1H17. The CET1 ratio of the ring-fenced bank was 14.1% at end-1H18. Pro-forma 1H18 earnings of the ring-fenced entity was GBP569mm (accounting for about 28.5% of the group's earnings in 1H18).

Lloyds: Following the court approval in April 2018 for its Ring-Fencing Transfer Scheme (RFTS), the group set up a new non-ring-fenced bank, Lloyds Bank Corporate Markets plc (LBCM). According to the unaudited pro-forma financial information of LBCM, around GBP32bn assets (or 3.9% of the LBG's assets) will be transferred to LBCM as part of RFTS as a Day 1 (28-May-2018). Lloyds Bank plc and Bank of Scotland plc would operate as ring-fenced banks. The group anticipates LBCM's assets to increase to

GBP54bn as the ring-fenced banks could transfer businesses outside RFTS scheme by end-FY18. However, given that Lloyds operating a very modest capital markets franchise, management estimated that ~97% of group loans and 100% of deposits will remain within the ring-fenced bank.

RBS: RBS Plc has a more complex ring-fence restructuring /transfers as compared with its peers. Natwest Holdings Ltd (which is the holding company of ring-fenced banks) has five licensed subsidiaries (directly and indirectly). The Royal Bank of Scotland Plc (previously Adam and Co), National Westminster Bank Plc (which also owns Coutts and Ulster Bank Ltd) and Ulster Bank Ireland DAC. Majority of the UK and Western European banking businesses are transferred to the ring-fenced banking entities.

The group used RFTS twice; once in Apr-2018 when it transferred some of its customers from non-ring fenced bank- The Royal Bank of Scotland plc (renamed as NatWest Markets plc)- to Adam & Company plc (renamed to the Royal Bank of Scotland Plc). In addition, certain advisory products and a covered bond programme were transferred from NatWest Markets plc to National Westminster Bank Plc (NatWest Bank Plc).

As part of RFTS-2 (concluded in Aug-2018), the group transferred certain products from NatWest Bank Plc to NatWest Markets Plc. The group is yet to quantify the asset transfers and consolidated assets under ring-fenced unit.

HSBC: HSBC UK Bank plc (HSBC UK), which is the HSBC Holdings' UK ring-fenced bank, was incorporated in Dec-2015 and was set up to hold qualifying components of HSBC Bank Plc's UK Retail Banking and Wealth Management segment, Commercial Banking and Global Private Banking businesses and relevant retail banking subsidiaries. On 21-May-2018, the high court approved the UK ring-fenced transfer scheme. Consequently, the group completed the ring-fencing of its UK retail banking activities on 1 July 2018.

HSBC UK is headquartered in Birmingham and the migration of roles from London stands completed. Unlike its peers RBS and Lloyds Banking Group, only a small portion of HSBC Bank Plc's assets are transferred to its ring-fenced bank- HSBC UK. At end-FY17, pro-forma assets of HSBC UK (GBP233bn) accounted for 28.5% and 12.5% of the erstwhile HSBC Bank plc and HSBC Holdings Plc's assets respectively. HSBC Bank Plc transferred ~14.5mn customers to HSBC UK.

Standard Chartered: Owing to its relatively modest presence in UK retail banking, Standard Chartered has been exempted from the requirement of setting up a ring-fenced entity.