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Research Update:

Ratings On The United Kingdom Lowered To 'AA' On Brexit Vote; Outlook Remains Negative On Continued Uncertainty

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Overview

- In the nationwide referendum on the U.K.'s membership of the European Union (EU), the majority of the electorate voted to leave the EU. In our opinion, this outcome is a seminal event, and will lead to a less predictable, stable, and effective policy framework in the U.K. We have reassessed our view of the U.K.'s institutional assessment and now no longer consider it a strength in our assessment of the rating.
- The downgrade also reflects the risks of a marked deterioration of external financing conditions in light of the U.K.'s extremely elevated level of gross external financing requirements.
- The vote for "remain" in Scotland and Northern Ireland also creates wider constitutional issues for the country as a whole.
- Consequently, we are lowering our long-term sovereign credit ratings on the U.K. by two notches to 'AA' from 'AAA'.
- The negative outlook reflects the risk to economic prospects, fiscal and external performance, and the role of sterling as a reserve currency, as well as risks to the constitutional and economic integrity of the U.K. if there is another referendum on Scottish independence.

Rating Action

On June 27, 2016, S&P Global Ratings lowered its unsolicited long-term foreign and local currency sovereign credit ratings on the United Kingdom to 'AA' from 'AAA'. The outlook on the long-term rating is negative. We affirmed the unsolicited short-term foreign and local currency sovereign credit ratings on the U.K. at 'A-1+'.

We also lowered to 'AA' from 'AAA' our long-term issuer credit rating on the Bank of England (BoE) and the ratings on the debt programs of Network Rail Infrastructure Finance PLC. We affirmed the short-term ratings on the BoE and Network Rail Infrastructure Finance debt programs at 'A-1+'. The outlook on the long-term rating on the BoE is negative.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on the United Kingdom, are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Calendar Of 2016 EMEA Sovereign, Regional, And Local Government Rating Publication Dates," published Dec. 22, 2015, on RatingsDirect). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the reason for the deviation is the U.K.'s referendum vote to leave the EU. The next scheduled rating publication on United Kingdom will be on Oct. 28, 2016.

Rationale

The downgrade reflects our view that the “leave” result in the U.K.’s referendum on the country’s EU membership ("Brexit") will weaken the predictability, stability, and effectiveness of policymaking in the U.K. and affect its economy, GDP growth, and fiscal and external balances. We have revised our view of the U.K.'s institutional assessment and we no longer consider it to be a strength in our assessment of the U.K.'s key rating factors. The downgrade also reflects what we consider enhanced risks of a marked deterioration of external financing conditions in light of the U.K.’s extremely elevated level of gross external financing requirements (as a share of current account receipts and usable reserves). The Brexit result could lead to a deterioration of the U.K.’s economic performance, including its large financial services sector, which is a major contributor to employment and public receipts. The result could also trigger a constitutional crisis if it leads to a second referendum on Scottish independence from the U.K.

We believe that the lack of clarity on these key issues will hurt confidence, investment, GDP growth, and public finances in the U.K., and put at risk important external financing sources vital to the financing of the U.K.’s large current account deficits (in absolute terms, the second-largest globally behind the U.S.). This includes the wholesale financing of the U.K.’s commercial banks, about half of which is denominated in foreign currency. Brexit could also, over time, diminish sterling's role as a global reserve currency. Uncertainty surrounding possibly long-lasting negotiations around what form the U.K.’s new relationship with the EU will look like will also pose risks, possibly leading to delays on capital expenditure in an economy that already stands out for its low investment/GDP ratio.

Detailed negotiations are set to begin, with a great deal of uncertainty around what shape the U.K.'s exit will take and when Article 50 of the Lisbon Treaty will be triggered. While two years may suffice to negotiate a departure from the EU, it could in our view take much longer to negotiate a successor treaty that will have to be approved by all 27 national parliaments and the European parliament and could face referendums in one or more member states. While some believe the U.K. government can arrive at a beneficial arrangement with the EU, others take the view that the remaining EU members will have no incentive to accommodate the U.K. so as to deter other potential departures and contain the rise of their own national eurosceptic movements.

In particular, it is not clear if the EU--the destination of 44% of the U.K.'s exports--will permit the U.K. access to the EU’s common market on existing (tariff-free) terms, or impose tariffs on U.K. products. Future arrangements regarding the export of services, including by the U.K.’s important financial services industry, are even more uncertain, in our view. Given that high immigration was a major motivating issue for Brexit voters, it is also uncertain whether the U.K. would agree to a trade deal that requires the country to accept the free movement of labor from the EU. The negotiation process is therefore fraught with potential challenges and vetoes, making the outcome unpredictable.

We take the view that the deep divisions both within the ruling Conservative Party and society as a whole over the European question may not heal quickly and may hamper government stability and complicate policymaking on economic and other matters. In addition, we believe that Brexit makes it likely that the Scottish National Party will demand another referendum on Scottish independence as the Scottish population was overwhelmingly in favor of remaining within the EU. This would have consequences for the constitutional and economic integrity of the U.K. There may be also be similar constitutional issues around Northern Ireland.

These multiple and significant challenges will likely be very demanding and we expect them to take precedence over macroeconomic goals, such as maintaining growth, consolidating public finances, and the importance of finding a solution to worsening supply bottlenecks in the U.K. economy. Lack of clarity while negotiations ensue will also significantly deter private investment.

The U.K. benefits from its flexible open economy and, in our view, prospered as an EU member. We believe that the U.K. economy was able to attract higher inflows of low-cost capital and skilled labor than it would have without the preferential access that EU membership delivers. We consider that significant net immigration into the U.K. over the past decade helped its economic performance. EU membership also helped enhance London's position as a global financial center.

We believe that the U.K.'s EU membership, alongside London's importance as a global financial center, bolstered sterling as a reserve currency. When we assess the U.K.'s external picture, we incorporate our view that the U.K. benefits from its reserve currency status. This leads us to make a supportive external assessment, despite the U.K.'s very large external position in terms of external liabilities and external debt, on both a net and gross basis. Under our methodology, were sterling's share of allocated global central bank foreign currency reserve holdings to decline below 3%, we would no longer classify it as a reserve currency, and this would negatively affect our external assessment. Sterling's share was 4.9% in the fourth quarter of 2015, according to International Monetary Fund data.

Furthermore, since having joined the European Community 43 years ago, the U.K. has attracted substantial foreign direct investment (FDI), which has helped to solidify its role as a global financial center. High FDI inflows increased the capital stock in an economy that is notable for its low investment levels; FDI was an estimated 18% of GDP in 2015. This underscores the high importance of FDI inflows for the growth prospects of the U.K. economy.

About two-thirds of all FDI into the U.K. represents investment in the financial services sector. Most investment into the financial services sector is channeled into London. The U.K. financial system, measured by total assets, stands at about 4.5x GDP and foreign banks make up about half of U.K. banking assets on a residency basis. Foreign branches account for about 30% of total U.K. resident banking assets.

Brexit could lead financial firms, especially foreign ones, to favor other destinations when making investment decisions.

Net FDI is also a major source of financing for the U.K.'s current account deficit, which has persisted without interruption since 1984. The current account deficit exceeded 5% of GDP in both 2014 and 2015. We believe the “leave” vote will put pressure on sterling and could improve net exports, in particular by weakening imports as growth decelerates, leading to a faster narrowing of the current account than if the U.K. had stayed in the EU. For this reason, we forecast the current account deficit to average 3.4% in 2016-2019 compared to our April forecast of 4.5%, though we would add that past episodes of sterling weakness largely did not necessarily improve the U.K.’s merchandise deficit, which last year was 6.7% of GDP. The U.K.’s services sector ran a net surplus of almost 5% of GDP last year, but to the extent that financial services may face more difficult access to EU markets (subject to the outcome of negotiations with the EU), that position may also worsen.

Nevertheless, we see the U.K.'s high external deficits as a vulnerability, and we view an EU departure as a risk to financing sources. The U.K.’s gross external financing needs (as a share of current account receipts and usable official foreign exchange reserves) is the highest among all 131 sovereigns rated by S&P Global Ratings. At over 800%, this ratio stands at over twice the level of the G7 runners-up (U.S. and France are under 320%).

The U.K. economy had been recovering robustly since 2007. Over the past two years, it has grown faster than any economy in the G7, and faster than almost all the large European economies, including Germany. However, given the uncertainty and fall in investment tied to the “leave” vote, we are forecasting a significant slowdown in 2016-2019, with GDP growth averaging 1.1% per year (compared to our April forecast of 2.1% per year). A fall in investment will affect growth, job creation, private sector wage growth, and consumer spending.

At 84% of GDP (2016 estimate), the U.K.'s net general government debt ratio remains high. Since the 2008 financial shock, fiscal consolidation has been substantial--primarily in the form of cuts to general government expenditure. Fiscal consolidation will become harder to achieve given the slower growth, as well as in the face of rising risks of discretionary fiscal easing to arrest the economic slowdown. In our opinion, the decision to leave the EU raises further the fiscal challenges of meeting already ambitious targets, as weaker consumption and investment, possibly via a correction in the U.K.’s highly valued housing market, would take a toll on tax receipts. Over the medium term, a reduction in employment and earnings in the financial services sector could further undermine public finances. Since Brexit, plans to start the sale of shares in government-owned banks may have to be postponed owing to economic uncertainty.

We view the U.K.'s monetary and exchange rate flexibility as a key credit strength. During the financial crisis, it enabled wages and prices to adjust rapidly, relative to trading partners, we expect it to provide as rapid an adjustment again. Exchange rate adjustments can help to broadly maintain competitiveness. The U.K. authorities have drawn on the flexibility afforded by its reserve currency, and this has benefited GDP growth and public debt sustainability, in our view. As mentioned earlier, if the U.K. were to lose its reserve currency status, we would view this as a significant negative.

Despite the uncertainty around Brexit, we believe that the U.K. will continue to benefit from its large, diversified, and open economy, which exhibits high labor- and product-market flexibility, and enjoys credible monetary policy. Additionally, the U.K. benefits from deep capital markets and a globally competitive financial sector.

WEBCAST DETAILS

S&P Global Ratings will hold a webcast on Tuesday June 28, 2016, at 2:00 p.m. GMT / 9:00 a.m. EST, during which senior analysts will discuss the impact of the referendum vote.

You can register for this webcast by clicking on the link below:
http://event.on24.com/wcc/r/1217054/50797011DA9088CFBDE74625D73D9253

Outlook

The negative outlook reflects the multiple risks emanating from the decision to leave the EU, exacerbated by what we consider to be reduced capacity to respond to those risks given what we view as the U.K.'s weaker institutional capacity for effective, predictable, and stable policymaking.

We could lower the rating should we conclude that sterling will lose its status as a leading world reserve currency; that public finances will deteriorate; or that GDP per capita will weaken markedly beyond our current expectations (see "GDP Per Capita Thresholds For Sovereign Rating Criteria," published on Dec. 21, 2015). In addition, we could lower the rating if another referendum on Scottish independence takes place, or other significant constitutional issues arise and create further institutional, financial, and economic uncertainty.

We would revise the outlook to stable if none of the aforementioned negative developments occur.

Key Statistics

Table 1

United Kingdom Selected Indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. £)	1,556	1,619	1,665	1,735	1,817	1,865	1,909	1,958	2,010	2,068
Nominal GDP (bil. $)	2,404	2,595	2,630	2,712	2,990	2,849	2,531	2,522	2,676	2,753
GDP per capita (000s $)	38.3	41.0	41.3	42.3	46.3	43.8	38.7	38.3	40.4	41.4

Table 1

United Kingdom Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Real GDP growth	1.5	2.0	1.2	2.2	2.9	2.3	1.5	0.9	1.0	0.9
Real GDP per capita growth	0.7	1.1	0.5	1.5	2.1	1.7	0.9	0.3	0.4	0.3
Real investment growth	5.0	2.0	1.5	2.6	7.3	4.1	0.2	(1.7)	(0.1)	(0.2)
Investment/GDP	16.4	16.2	16.2	16.9	17.5	17.7	17.7	17.2	17.0	16.4
Savings/GDP	13.6	14.5	13.0	12.4	12.4	12.6	13.0	13.8	13.9	13.7
Exports/GDP	28.6	30.7	30.1	30.0	28.3	27.4	27.8	29.1	30.2	31.2
Real exports growth	5.8	5.8	0.7	1.2	1.2	5.1	2.0	4.6	3.6	3.5
Unemployment rate	7.9	8.1	8.0	7.6	6.2	5.4	5.1	5.7	6.4	6.4
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(2.8)	(1.7)	(3.3)	(4.5)	(5.1)	(5.2)	(4.7)	(3.4)	(3.0)	(2.7)
Current account balance/CARs	(6.8)	(3.8)	(7.9)	(11.3)	(13.7)	(14.5)	(12.4)	(8.8)	(7.8)	(6.9)
Trade balance/GDP	(6.3)	(5.8)	(6.4)	(6.6)	(6.8)	(6.7)	(7.0)	(6.4)	(6.1)	(5.0)
Net FDI/GDP	0.4	(2.1)	1.3	2.4	4.5	3.5	4.0	1.5	1.5	1.5
Net portfolio equity inflow/GDP	(2.3)	0.6	(3.4)	3.1	2.9	4.8	1.0	1.0	1.0	1.0
Gross external financing needs/CARs plus usable reserves	909.8	841.2	922.8	898.0	835.5	894.2	805.7	787.8	783.3	788.2
Narrow net external debt/CARs	457.7	419.2	451.4	483.5	486.6	449.9	469.7	496.4	424.5	394.5
Net external liabilities/CARs	20.1	16.4	50.1	37.1	60.5	9.5	(2.4)	46.1	69.2	92.8
Short-term external debt by remaining maturity/CARs	864.6	797.8	895.1	874.0	800.2	874.6	803.7	787.2	765.1	760.7
Reserves/CAPs (months)	0.8	0.8	1.0	1.0	1.0	1.1	1.5	1.5	1.3	1.1
FISCAL INDICATORS (%, General government)										
Balance/GDP	(9.6)	(7.7)	(8.3)	(5.6)	(5.6)	(4.4)	(3.3)	(3.0)	(2.7)	(2.5)
Change in debt/GDP	13.8	8.2	5.8	4.3	5.8	3.3	3.0	2.8	2.5	2.3
Primary balance/GDP	(6.8)	(4.6)	(5.4)	(2.8)	(2.9)	(2.1)	(0.7)	(0.4)	0.0	0.3
Revenue/GDP	39.1	39.3	38.5	39.3	38.3	38.8	38.6	38.7	38.7	38.7
Expenditures/GDP	48.8	46.9	46.8	45.0	43.9	43.2	41.9	41.7	41.4	41.3
Interest /revenues	7.2	7.9	7.3	7.1	7.0	6.0	6.8	6.8	7.1	7.3
Debt/GDP	76.6	81.8	85.3	86.2	88.2	89.2	90.2	90.7	90.8	90.5
Debt/Revenue	195.6	208.3	221.6	219.2	230.3	229.7	233.6	234.3	234.6	233.6
Net debt/GDP	71.0	74.9	78.7	79.5	81.7	83.5	84.4	84.9	85.0	84.7
Liquid assets/GDP	5.6	6.8	6.6	6.7	6.5	5.7	5.7	5.8	5.8	5.8
MONETARY INDICATORS (%)										
CPI growth	3.2	4.5	2.9	2.5	1.5	0.0	0.9	2.2	1.7	1.9
GDP deflator growth	3.1	2.1	1.6	2.0	1.8	0.3	0.9	1.6	1.7	1.9
Exchange rate, year-end (LC/$)	0.6	0.6	0.6	0.6	0.6	0.7	0.8	0.8	0.7	0.7
Banks' claims on resident non-gov't sector growth	(0.4)	(4.7)	(2.7)	(3.3)	(5.2)	(0.6)	2.0	3.0	3.0	3.0

Table 1

United Kingdom Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Banks' claims on resident non-gov't sector/GDP	191.6	175.4	165.9	154.0	139.3	134.9	134.4	135.0	135.4	135.6
Foreign currency share of claims by banks on residents	27.4	27.0	26.1	25.9	24.6	23.8	25.0	25.0	25.0	25.0
Foreign currency share of residents' bank deposits	55.6	57.2	54.5	51.8	54.0	52.6	54.0	54.0	54.0	54.0
Real effective exchange rate growth	7.1	0.7	4.0	(3.4)	5.6	7.0	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

United Kingdom Ratings Score Snapshot

Key rating factors	
Institutional assessment	Neutral
Economic assessment	Strong
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Weakness
Monetary assessment	Strong

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014

- General Criteria: Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings - October 24, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- Criteria - Governments - Sovereigns: Methodology: Rating Partially Guaranteed Sovereign Debt - May 06, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009
- General Criteria: Rating Sovereign-Guaranteed Debt - April 06, 2009

Related Research

- Sovereign Risk Indicators - April 12, 2016. An interactive version is also available at http://www.spratings.com/sri.
- Default, Transition, and Recovery: 2014 Annual Sovereign Default Study And Rating Transitions - May 18, 2015
- Brexit Would Spell The End Of The U.K.'s 'AAA' Rating - May 20, 2016

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee decided that the institutional and external assessments had weakened, and that all other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Rating	
	To	From
United Kingdom		
Sovereign Credit Rating		
Foreign and Local Currency |U~	AA/Negative/A-1+	AAA/Negative/A-1+
Transfer & Convertibility Assessment |U~	AAA	AAA
Senior Secured		
Local Currency [#1]	AA	AAA
Local Currency [#2]	AA	AAA
Senior Unsecured		
Foreign and Local Currency [#3]	AA	AAA
Foreign and Local Currency [#4]	AA	AAA
Local Currency [#5]	AA	AAA
Bank of England		
Sovereign Credit Rating		
Foreign and Local Currency	AA/Negative/A-1+	AAA/Negative/A-1+
Senior Unsecured		
Foreign and Local Currency	AA	AAA
Short-Term Debt		
Foreign and Local Currency	A-1+	A-1+
CTRL Section 1 Finance PLC		
Senior Secured		
Local Currency[1]	AA	AAA
LCR Finance PLC		
Senior Unsecured		
Local Currency[1]	AA	AAA
Network Rail Infrastructure Finance PLC		
Senior Secured		

Ratings List Continued...

Foreign and Local Currency[1]	AA	AAA
Commercial Paper		
Local Currency[1]	A-1+	A-1+

|U~ Unsolicited ratings with no issuer participation and/or no access to internal documents.

[1] Dependent Participant(s): United Kingdom

[#1] Issuer: Affordable Housing Finance PLC, OBLIGOR: United Kingdom

[#2] Issuer: Affordable Housing Finance PLC, BANKACCT: Barclays Bank PLC, Guarantor: United Kingdom

[#3] Issuer: Barclays Bank PLC, Issuer: Barclays PLC, Guarantor: United Kingdom

[#4] Issuer: Lloyds Bank PLC, Guarantor: United Kingdom

[#5] Issuer: Barclays Bank PLC, Guarantor: United Kingdom

Samuel Tilleray and Ekta Bhayani contributed research assistance to this report.

This unsolicited rating(s) was initiated by a party other than the Issuer (as defined in S&P Global Ratings' policies). It may be based solely on publicly available information and may or may not involve the participation of the Issuer and/or access to the Issuer's internal documents. S&P Global Ratings has used information from sources believed to be reliable based on standards established in our policies and procedures, but does not guarantee the accuracy, adequacy, or completeness of any information used.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.