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Rating Action

Neuss, 02 June 2017

Creditreform Rating has published the unsolicited long-term sovereign rating of "AA" for the United Kingdom. Creditreform Rating has also published the United Kingdom's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "AA". The outlook is stable.

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Key Rating Drivers

1. Wealthy economy, characterized by robust growth in 2013-16 and a track record of predictable and effective institutions which is conducive to the country's business environment
2. Low gross refinancing needs and recent progress with regard to budget consolidation are balanced against elevated debt-to-GDP ratio and emerging housing price risks
3. Sustained current account deficits and a still large external liability position leave the UK with some vulnerability to sudden reversals of capital flows
4. Medium-term perspectives for growth, investment and trade are heavily clouded with uncertainty, as the final outcome of prospective UK-EU-negotiations will have a major impact on the UK's macroeconomic aggregates

Reasons for the Rating Decision

Our assessment of the United Kingdom's very high creditworthiness balances the country's strong macroeconomic performance and very high quality of its political and monetary institutions against elevated levels of sovereign and external debt and substantial uncertainties related to the outcome of ongoing negotiations on the future UK-EU-relationship.

Above all, our "AA" credit rating for the UK is supported by the very high quality of the country's institutional set-up, indicated by high rankings on most dimensions of the World Bank's World Governance Indicators. The UK achieves very high scores with regard to the quality of law and contract enforcement and public services – ranking 14th in terms of rule of law and government effectiveness, respectively. Moreover, the World Bank is high-

lighting the government's demonstrated ability to formulate and implement sound policies and regulations that promote private sector development. Thus, the UK is ranked 4th out of 209 countries when it comes to regulatory quality – well above all other EU-28 members. In addition, the UK's business environment benefits from a proven institutional track record. Favorable business conditions are mirrored by the World Bank's Doing Business report, which ranks the UK 7th out of 190 economies (5th/32 OECD high-income). In particular, the UK's lean tax framework, characterized by comparatively low rates, provides a competitive edge. Profits are taxed on average by 30.9%, which is 10 p.p. lower than the average of OECD high-income countries (40.9%). At the same time, it only takes a total of 110 hours per year for businesses in the UK to comply with tax regulations, which compares favorably to an average 163.4 hours in OECD high-income countries. Another strength is the UK's deep and broad domestic capital market, making the country a front-runner in terms of financing conditions for SMEs. According to the EU 2016 SME performance review, the UK is among the top three EU countries regarding the financing environment for SMEs, with UK-residing firms having better access to venture capital, equity funding, and public financial support as compared with their EU-28 counterparts.

Having said this, it has to be mentioned that these business climate indicators do not yet reflect uncertainties related to the UK's vote to leave the EU. On 23 June 2016, a majority of the British electoral (51.9%) voted in favor of leaving the European Union. Subsequently, the British government submitted a formal request to withdraw from the EU in accordance with Article 50(3) of the Treaty of the European Union on 29 March 2017. After having informed the European Council of its intention to leave, the UK has two years to reach an agreement with the EU clarifying the terms of its withdrawal as well as the future UK-EU-relationship. Against this background, we believe that the predictability and reliability of the institutional framework, which are essential for attracting foreign direct investment and promoting entrepreneurship, have been impaired by the outcome of last year's referendum.

By contrast, we believe that the UK economy benefits from the Bank of England's (BoE) prudent and effective monetary policy-making, which we expect to remain in place. During the financial crisis and in particular since the vote to leave the EU, the BoE has demonstrated its capacity and determination to respond to adverse events. Following the Brexit decision, the Monetary Policy Committee further eased its already expansive monetary policy stance at its meeting ending on 03 August 2016. To support the British economy in light of the vote, the BoE introduced a set of monetary policy measures, including a cut of the Bank Rate from 0.5 to 0.25% and a Term Funding Scheme to support the transmission of the lowered Bank Rate. Furthermore, the BoE decided to ramp up its existing asset purchase program by GBP 70bn, with treasury gilts and corporate bonds accounting for 60 and 10bn of the additional volume, respectively. Despite CPI inflation having picked up and inflation expectations gradually approaching the central bank's 2%-target, the executive board decided to continue with its current policy stance at its latest meeting ending on 10 May 2017. In view of the prospects for decelerating q-o-q growth and the very high uncertainty surrounding macroeconomic perspectives of a post-Brexit-

UK going forward, we expect monetary policy to remain accommodative. Forward market interest rates point to a very gradual increase of the Bank Rate to 0.5% by 2020.

British GDP expanded steadily over the course of 2016 and growth did not show immediate signs of weakness in the aftermath of the EU-referendum. After GDP had increased by 0.6% q-o-q in Q2-16, growth held up well in the second half of the year, posting at 0.5 (Q3) and 0.7% (Q4) q-o-q. As a result, the UK's total output expanded by a solid 1.8% last year – broadly in line with Germany (1.9%) and well above France (1.2%) and Italy (0.9%). However, the UK's robust growth performance in 2016 was not balanced, but entirely driven by vibrant private consumption, which contributed 1.7 p.p. to GDP growth. Household spending growth accelerated to 2.8% (2015: 2.5%). Private consumption was buttressed by the growing real disposable income of British households (+1.5%) on the back of strong employment growth and low inflation. While the unemployment rate fell from 5.3 (2015) to a low 4.8% last year, consumer prices as measured by the CPI inflation rate increased by a moderate 0.7%, up from 0.0% in 2015. On the other hand, neither investment nor net exports fueled growth last year. Gross fixed capital formation was essentially flat y-o-y (+0.5%), with a 1.5% drop in business investment, reflecting Brexit-related uncertainty over economic prospects. At the same time, net exports subtracted 0.4 p.p. from GDP growth. Despite the depreciation of the sterling against the UK's main trading partners in the second half of 2016, export growth remained sluggish (+1.8%) and lagged behind that of imports (+2.8%) by one percentage point. In general, the UK's credit profile reflects the country's strong macroeconomic performance, which is also indicated by high levels of wealth (2016: USD 42,481 in PPP terms) and a well-developed service sector (80.0% of GVA in Q4-16).

With regard to this year, British growth should lose some momentum, coming in at 1.6%. Our expectation is underpinned by the latest ONS data, according to which q-o-q growth has decelerated to 0.2% in Q1-17. Although private consumption should remain the key driver of growth, we expect growth of household expenditures to moderate in 2017. Firstly, British households have only limited room to expand spending by a further reduction of their savings. The savings rate of British households has followed a downward trajectory since Q1-10, when it stood at 11.5%, and recorded a historic low of 3.3% in Q4-16. Secondly, growth of real disposable household income should slow down, as inflation has picked up significantly. According to latest data, CPI inflation stood at 2.1% (Q1-17), up from 0.3% a year before, as the effect of declining energy prices is fading out. The BoE projects that inflation should hit 2.8% in 2017 (four-quarter inflation rate in Q4), mainly driven by the pass-through of rising import costs due to the weakening of the pound sterling. Between Aug-15 and the end of Oct-16, the sterling effective exchange rate (EER) experienced a sharp depreciation by some 20%. Although the EER has appreciated by 6.8% (02-05-17) from its lows in Nov-16 and we expect it to stabilize on current levels in 2017, net exports should benefit from improved terms of trade in 2017. Thus, we expect net export growth to accelerate notably and to have a positive impact on growth for the first time since 2011. At the same time, a lower sterling exchange rate may also lead to an export-driven stimulus to business investment. However, we believe that a significant

increase in business investment is unlikely for the time being against the backdrop of high uncertainty surrounding the negotiations on the agreement to withdraw from the EU.

That said, medium-term growth perspectives of the UK are exceptionally difficult to assess at the moment. The eventual terms of a future UK-EU-agreement will have a significant impact on trade, migration, and foreign direct investment inflows, and thus on GDP growth. Notwithstanding these issues, sluggish productivity growth in recent years has been weighing on the country's growth potential – a challenge faced by most advanced economies. Despite labor productivity in the UK being significantly below the levels in France and Germany, no improvements have been recorded in 2007-16. Labor productivity per hour worked increased by a meager +0.6% since 2007, against +5.7% in France and Germany, respectively. Weak productivity growth can be explained in part by the shift in the economy towards sectors with lower productivity. Moreover, subdued investment activity after the financial crisis hampered productivity gains. The UK's private as well as its public investment stood structurally below EU-28 levels in the recent past. While private investment accounted for 14.0% of 2016 GDP in the UK, the private sector in the EU-28 as a whole exhibited an investment-to-GDP ratio of 17.0%. However, the gap in government investment has continuously narrowed, almost disappearing in 2016 (UK: 2.6%; EU-28: 2.7%). Going forward, the British government intends to boost productivity growth by increasing public investment. In its autumn statement 2016, the UK government announced it would set up a National Productivity Investment Fund (NPIF) with a total volume of GBP 23.7bn, of which GBP 8.9bn are envisaged for upgrading the country's transport infrastructure and supporting housing construction. Furthermore, the NPIF will make funds available to encourage corporate R&D expenditures. In general, we believe that these measures should be conducive to productivity growth.

Turning to the UK's budget performance, we acknowledge that the sovereign has recently made progress in containing a further increase of its elevated debt ratio. In 2016, the UK's debt-to-GDP ratio, which has more than doubled over the last decade (2007: 42.0% of GDP) stabilized and posted at 89.3% of GDP. What is more, government debt exhibits a favorable maturity profile with an average maturity of 14.9 years (end Dec-16) and comparatively low refinancing needs amounting to 5.2 and 3.6% of 2016 GDP in 2017 and 2018, respectively.

Robust GDP growth and lower net borrowing contributed positively to the stabilization of the government debt ratio. Standing at 4.3% of GDP in 2015, the budget deficit significantly narrowed to 3.0% of GDP last year. According to preliminary data published by the Office for Budget Responsibility (OBR) in Apr-17, the actual budget deficit in FY16/17 came in at GBP 52bn, significantly lower than projected in the government's autumn statement (Nov-16: GBP 68.2bn). Nevertheless, it has to be noted that one-offs contributed about half to this reduction. The revenue side of the budget benefitted from changes to the timing of CIT receipts (18.3% above projections from Nov-16) and dividend income, which was realized ahead of higher dividend taxation effective from Apr-2018. At the same time, underspending by departments as well as the shift of some EU-payments into FY17/18 resulted in lower than anticipated spending.

In its spring budget 2017, the government announced an increase in public sector investment by GBP 5.2bn. Additionally, some tax relief became effective in Apr-17, such as lower property taxes (“business rates”) for small businesses (GBP 1.4bn), a reduction of the CIT-rate to 19% (GBP 2.3bn), and a higher PIT-allowance. On the revenue side, an initially-planned national insurance hike for the self-employed was suspended. On the whole, we believe that the budget deficit should remain broadly stable and stand at around 3% of GDP in the current year.

As regards the UK’s fiscal framework, the picture is mixed. The British government sets fiscal targets which include a cap on welfare spending as well as targets for the budget balance and debt reduction. Compliance with these rules is regularly monitored by the OBR. According to the IMF, the OBR serves as best practice for developed economies regarding transparency and frequency of data provision. Notwithstanding, it has to be noted that fiscal rules have been subject to multiple changes since 2010. In the light of lower growth forecasts after the Brexit vote, the British parliament eased fiscal rules somewhat in Jan-17, following the government’s decision in the Autumn Statement 2016. The achievement of a budgetary surplus, which was envisaged for FY19/20 under the previous framework, has been postponed to a least 2020. Furthermore, the debt rule, which called for a continuous debt reduction until FY19/20, has been weakened. The new target allows the government to postpone debt reductions to FY20/21.

We regard the significant size of the UK’s banking sector, indicated by an asset-to-GDP ratio of 374.2% (Dec-16), as a contingent liability risk for the state budget. At the moment, the country is home to four systemically important financial institutions (HSBC, Barclays, Royal Bank of Scotland and Standard Chartered). To be sure, we consider the asset quality of British banks to be high and their capital buffers to be sufficient to weather adverse economic shocks. Regulatory tier 1 capital to RWA saw a further increase to 15.7% in Q2-16 and non-performing loans have been in continuous decline since Q4-11 (4.0%), recently the UK reported an NPL-ratio of only 1.0% (Q2-16) – one of the lowest ratios in the EU-28. Also, the banking sector’s liquidity profile further strengthened. The loan-to-deposit ratio continued on its downward trajectory in 2016, standing at 94.7% in Mar-17 down from a high 124.8% (Mar-08). Furthermore, lending turned a corner in 2016. After the volume of outstanding loans to NFCs had declined for more than six consecutive years, a positive y-o-y growth rate of +0.2% was recorded again in Jan-16. Loan growth further accelerated in the following months, recently posting at 4.3% (Mar-17). Meanwhile, secured lending to individuals (i.e. mortgages) continued to grow vividly in the 4-5% range, despite some deceleration over the last months. Hence, mortgage growth is mirroring the recent slow-down in house prices. After house prices recorded y-o-y growth of 8.7 and 7.1% in Q2-16 and Q3-16, growth fell to a still high 5.7% by the end of the year. Still, residential real estate prices in the UK have sharply increased since 2013. Driven by a growing population and low mortgage rates, house prices in Q4-16 stood 28.3% above the levels seen in Q1-13. More importantly, growth of real estate prices outpaced that of household income and rents. At the end of 2016, the price-to-income and the price-to-rent ratio stood 8.0 and 7.5% above their respective 10y-averages and both affordability indicators reached their highest levels since Q2-08. These develop-

ments should be vigilantly monitored against the backdrop of high household indebtedness (Q4-16: 94.1% of GDP).

Nevertheless, we believe that vulnerabilities related to residential real estate are somewhat tempered, taking into account the households' sizeable assets, which exceed liabilities by far. The private households' net asset position amounted to 243.4% of GDP in Q4-16, with only Belgium (251.0% of GDP) reporting higher figures in the EU-28. Moreover, British authorities are aware of growing risks pertaining to the housing market and have taken action to mitigate related financial stability risks. To prevent the housing market from overheating, several macroprudential policy changes have been introduced in the recent past. First regulatory actions were taken in 2014, when the Financial Conduct Authority (FCA) introduced obligatory affordability assessments for mortgage lenders and tightened criteria to qualify for zero-principal mortgages (Apr-14). Later that year, the BoE decided to tighten mortgage lending standards. Effective from Oct-14, mortgage lenders are prevented from extending more than 15% of new mortgages at LTIs at or greater than 4.5 times. Most recently in Sep-16, the BoE issued supervisory guidelines regarding minimum underwriting standards for buy-to-let mortgages. The guidelines, which should be gradually phased in until Sep-17, instruct mortgage lenders to conduct interest rate stress testing.

Assessing the UK's external position, we believe that the UK's flexible exchange rate regime may mitigate risks to some extent, which are linked to the still large stock of gross external liabilities and persistent current account deficit. Over the last decade, the country's current account deficit averaged at a relatively high 3.5% of GDP. What is more, current account deficits have become more entrenched in the recent past. While the current account stabilized on its 2015 level last year (-4.4% of GDP), 2016 was the fourth consecutive year with a current account deficit of more than 4% of GDP. The deterioration was mainly driven by the primary income balance, which contributed positively to the current account before it turned negative in the years since 2012. This development is mirroring lower returns on British assets abroad, but also the UK's capability to attract large FDI inflows, which subsequently increase income transfers to investors abroad. In the medium term, the current account is likely to narrow somewhat, as the weaker sterling should dampen import demand while improved price competitiveness should be conducive to British exports.

So far, sustained high current account deficits are not reflected by a significant deterioration of the country's negative net international investment position (NIIP), which is mainly a result of valuation effects. As of 2015, the UK's NIIP posted at a modest -4.6% of GDP before it soared to 24.2% of GDP in 2016 on the back of the sharp sterling devaluation in 2016. Although external liabilities have been trending downward since the end of 2010 (379.6% of GDP), the UK's external debt remains at an elevated level, leaving the country susceptible to changes in investor sentiment and financing conditions. As of Q4-16, the UK's external liabilities stood at 284.7% of GDP – exceeding the external indebtedness of all other G7 members by far. In particular, this was a result of the country's large deposit-taking sector, to which can be attributed more than half (160.8% of GDP) of the economy's total external debt.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of “AA” is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged in the near term.

We could consider a downgrade if the UK’s medium-term growth falls significantly short of our expectations. Besides external risks, such as a sustained period of sluggish growth in world GDP, we believe that prolonged uncertainty concerning the timeline and content of a prospective EU-UK-trade agreement is an important downside risk to the UK’s medium-term growth prospects. Should we observe increasing signs that a trade arrangement is not within reach by the end of the negotiation timetable in Mar-19 and no transitional arrangement can be agreed on, we expect that British GDP would take a serious hit, as the failure of the negotiations would imply a reversion to WTO-rules. In this case, financial market volatility may promptly increase and the sterling exchange rate should experience another sharp depreciation. A substantial weakening of the sterling, reflected by rising import prices, could exert further upward pressure on inflation with negative repercussions on private consumption, which is by far the most important driver of British growth.

Our baseline scenario assumes that an arrangement can be achieved, though it appears unlikely that this will be feasible by end of March 2019, so that the parties may agree on a two- or three-year transitional arrangement before reaching a free trade agreement – thus, a disorderly EU-exit by the UK should not materialize. Regarding the final terms and conditions of a new EU-UK-treaty, it seems premature to make assumptions at this time. Given that negotiations are in an early stage and there is a broad range of possible arrangements, we have no indications as yet which point to a specific outcome. However, we believe that any agreement will imply a lower degree of economic integration with the EU as compared to the status quo (Single Market membership). Thus, the terms of any potential EU-UK-contract should be at best neutral to the UK’s economic perspectives, as the free movement of labor and capital will likely be restricted to some degree, possibly denting potential GDP growth. While PM May recently affirmed her government’s determination to cut net migration, which includes EU citizens, to below 100,000 per year, EU officials have made clear that British banks cannot keep their passporting rights after the UK has left the EU.

Prevailing uncertainties in the institutional sphere are amplified by the snap election (08 June 2017), which was announced by PM May in April 2017. Recent polls have signaled that the Conservatives’ lead over the Labour Party has narrowed sharply. We assume that PM May and her government will stay in office beyond June 2017, but not with the significant majority polls predicted a few weeks ago.

A downgrade of our rating could also occur, if fiscal metrics show signs of a material deterioration. Fiscal policies, which might be adopted to cushion a potential “post-Brexit” slump in domestic demand by additional government expenditure, may lead to some fiscal backtracking. Furthermore, the government’s ongoing consolidation efforts could also be impeded by a mix of higher risk premia on debt securities coupled with rising

inflation. Given that 23.6% of outstanding central government debt is linked to inflation (end Dec 2016) this would negatively affect debt affordability. Regarding the interest-to-revenue ratio in 2016, the UK (6.4%) was yet spending a higher share of government revenues on debt service than France (3.6%), despite exhibiting comparable debt levels (UK: 89.3; FR: 96.0% of GDP).

On the other hand, we may raise our rating if the British economy achieves higher-than-expected and sustainable growth, or if budget consolidation is progressing faster than we currently assume, resulting in a steeper decline of the government's debt-to-GDP ratio beyond 2017.

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Ratings*

Long-term sovereign rating	AA /stable
Foreign currency senior unsecured long-term debt	AA /stable
Local currency senior unsecured long-term debt	AA /stable

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017e
Real GDP growth	1.5	1.3	1.9	3.1	2.2	1.8	1.6
GDP per capita (PPP, USD)	36,853	37,774	38,873	40,474	41,478	42,481	44,001
Inflation rate, y-o-y change (CPI)	4.5	2.8	2.6	1.5	0.0	0.7	2.8
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	81.0	80.9	81.0	81.3	81.6	n.a.	n.a.
Fiscal balance/GDP	-7.5	-8.2	-5.6	-5.7	-4.3	-3.0	-3.0
Current account balance/GDP	-1.8	-3.7	-4.4	-4.7	-4.3	-4.4	n.a.
External debt/GDP	370.2	366.3	345.8	305.4	285.9	284.7	n.a.

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. HM Treasury participated in the credit rating process as the authorities commented on a draft version of this report. Thus, the report represents an updated version which was augmented in response to the factual remarks of HM Treasury. The rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of Creditreform Rating's "Sovereign Ratings" methodology. Creditreform Rating AG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of Creditreform Rating's rating methodologies is published on the following internet page: www.creditreform-rating.de.

A Rating Committee was called consisting of highly qualified analysts of Creditreform Rating AG. The quality of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in Creditreform Rating's "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

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