

Rating Object	Rating Information	
UNITED KINGDOM Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Assigned Ratings/Outlook: AA /negative	Type: Monitoring, Unsolicited with participation
	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	02-06-2017 03-03-2023 "Sovereign Ratings" "Rating Criteria and Definitions"

Rating Action

Neuss, 3 March 2023

Creditreform Rating has revised its outlook on the United Kingdom to negative from stable and affirmed the unsolicited long-term sovereign rating of "AA". Creditreform Rating has also affirmed the UK's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "AA".

The outlook revision on the United Kingdom reflects

- (i) a deteriorating fiscal outlook on the back of weaker economic growth prospects due to persistent price pressure, higher borrowing and rising costs thereof, which are set to worsen debt affordability and pose challenges to envisaged fiscal consolidation over the medium term; and
- (ii) repeated episodes of domestic political volatility which carries the risk of lessening policy predictability and of negative implications for investor confidence, in a context of remaining uncertainty related to having to complete post-Brexit trade agreements with third countries and regulatory regimes.

Key Rating Drivers

1. Being among the largest economies in the world, the UK boasts a wealthy and diversified economy with a flexible labor market and a very competitive financial services sector, as well as strong business and educational clusters enabling innovation outperformance
2. High energy and food prices, alongside increasingly tighter monetary policy and imminent tax changes are set to curb business investment and household spending, weighing on near- to medium-term growth prospects; comparatively high private sector indebtedness poses some constraints to the medium-term growth outlook alongside ongoing pressure to complete post-Brexit trade and regulatory regimes
3. Very high standard of the institutional framework, including highly credible and accountable institutions in charge of monetary policy and financial sector governance; domestic political volatility has been elevated lately, adding to a recent track record of some challenges to policy predictability, in particular related to fiscal policymaking; repeated issues over the Northern Ireland protocol may be brought to an end by the EU and UK government's agreement on the 'Windsor framework'; progress on defining a new regulatory regime regarding financial services is underway, with a more sustainable agreement on this matter with the

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EU not yet in sight; the possibility of an imminent Scottish referendum seems to have receded of late

4. A short succession of crises requiring fiscal support, alongside the weaker economic outlook and impaired debt affordability, have led to a deteriorating outlook for fiscal metrics; we expect public debt to stabilize at elevated levels over the near to medium term, rather than pursuing a firm downward path, whilst interest outlays have ballooned and should remain elevated over the next years
5. While commitment to fiscal consolidation has been reaffirmed, fiscal rules have been amended again, allowing for backloaded fiscal consolidation over the medium term, which is not without risks in the uncertain and volatile environment; the UK's favorable debt portfolio structure and very sound debt management remain mitigating factors to some extent
6. Persistent and recently more pronounced current account deficits illustrate risks of sudden reversals of capital flows and related vulnerabilities of the UK as a significant international hub for financial services; the currency composition and a large stock of external assets balance risks around foreign exposure to some degree

Reasons for the Rating Decision and Latest Developments¹

Macroeconomic Performance

The large scale and wealth of its economy continue to underpin the UK's macroeconomic profile, which also features a flexible labor market and a highly competitive business environment, supported by its strong financial services sector. High energy and food prices have proved more persistent and have led to broadening price pressure, eating into private households' disposable income and weighing on the near- to medium-term growth outlook. Persistently lackluster business investment and productivity tend to act as a drag on the UK economy's underlying growth. Apart from dampening effects from a more aggressive tightening monetary policy cycle in a bid to rein in inflation, the relatively high level of household indebtedness and the ongoing adjustment to the post-Brexit regime also restrain medium-term growth prospects.

In light of the repercussions for commodity prices and the global economy from the ongoing war in Ukraine, the UK economy's post-pandemic recovery virtually came to a halt in the course of 2022, although partly due to some exceptional effects. Ultimately, fiscal measures to cushion the adverse effects from the pandemic, and subsequently the energy price crisis have likely prevented worse. Following an expansion of 0.5% in Q1-22 (q-o-q), total output by and large stagnated in the following three quarters, with economic activity in the third quarter negatively affected by an exceptional bank holiday for the state funeral of Queen Elizabeth II in Sep-22.

Moreover, according to ONS data, the equivalent of more than 560 thousand workdays was lost due to strike action across industries in connection with higher wage demands in August and September 2022 combined, the highest fallout in over ten years. In Dec-22, real GDP fell by 0.5% against the preceding month, again partly against the backdrop of industrial action. Measured in quarterly terms, real output has not yet caught up with its pre-pandemic level (Q4-19), missing

¹ This rating update takes into account information available until 27 February 2023.

it by 0.8% as of Q4-22 and trailing the three largest euro area economies in this respect. Likewise, the increase in UK GDP per capita between 2016 and 2021 has remained somewhat behind that of its peers. The latter is estimated to have climbed to USD 55,862 in 2022 (IMF data, PPP terms).

Drawing on preliminary ONS data, real GDP growth slowed to 4.0% last year (2021: 7.6%), on the back of decreasing growth in private and government consumption as well as a slowing pace of investment expansion. This notwithstanding, imports expanded strongly, leaving net exports to exert a drag on GDP growth.

Sentiment indicators such as the monthly PMIs have hinted at very subdued economic activity around the turn of the year, with the services, construction and manufacturing PMIs all in slightly contractionary territory in Dec-22 and Jan-23. That said, the service PMI recovered into expansionary territory in February. Consumer confidence as captured by the GfK indicator fell in Jan-23, posting close to its record low reached in Sep-22, but recovered somewhat in February, overall still boding ill for the near-term outlook on private consumption.

However, to alleviate the burden placed on consumers and businesses due to high energy prices since last March, successive support packages were announced by the government, including the May-2022 cost-of-living package, the Sep-2022 energy package, as well as measures announced with the growth plan after the Oct-2022 reversal and the Nov-2022 Autumn Statement. Overall, the packages are estimated to come to a combined GBP 58.4bn in the current fiscal year 2022/2023 (FY 22/23). First indications for the following fiscal year point to about GBP 28bn (OBR intelligence).

Alongside the still tight UK labor market, considerable government support could thus still enable gentle growth of household expenditure in 2023 as a whole, although there remain downside risks, as the cost of living remains high and the freeze in personal tax allowance thresholds announced some time ago is going ahead, eating into disposable income. While consumer price inflation (CPI) eased slightly in Jan-23, it remained in double digits, posting at 10.1%, having averaged 9.1% over 2022.

Wholesale gas and oil prices have fallen over the last few months, and energy prices should moderate further over the course of the year. That said, the CPIH for all services has trended upward (Jan-23: 5.2%), suggesting broadening price pressure. Despite increasing wage growth, including a 9.2% increase in the national living wage from April 2023, real wages are thus likely to remain negative in 2023. Average regular pay growth for the private sector was 7.3% y-o-y in Oct-Dec-22 and 4.2% y-o-y for the public sector, corresponding to the largest growth rate for the private sector outside of the acute pandemic phase.

Meanwhile, the unemployment rate has remained near long-term lows, posting at 3.7% in the three months to Nov-22 (persons aged 16 to 64, ONS), comparing low in a European context. Employment has still trended upward over the year to Q3-22, moving roughly at the high pre-pandemic level. A relatively high share of vacancies continues to point at difficulties to find staff, adding to upward pressure on wages. Decelerating economic activity should put the labor market under pressure, but unemployment is likely to rise only modestly in the near term, as we assume businesses to decrease vacancies and hoard labor. We will continue to monitor developments around the rate of labor market activity, which at 78.5% (Sep-Nov-22) remains 1p.p. below its pre-pandemic level.

Prospects for gross fixed capital formation have clouded in view of the imminent expiry of investment incentives (super-deduction) and an increase in the corporation tax rate from 19% to

25% from this April, adding to existing cost pressure and struggles to find skilled labor. Moreover, while shortages of materials have eased somewhat lately, higher market interest rates have pushed up rates for new mortgages and business loans, likely weighing on housing and business investment. According to the most recent Decision Maker Panel data published in Feb-23, average expected annual investment growth could be negative over the next year. We will also monitor any potential changes to insolvency dynamics as government support is partly withdrawn from this April. From Feb-22 to Jan-23, the cumulative number of insolvencies was by almost a third higher than in the respective period in 2019 (+31.1%, Insolvency Service). More positive aspects include envisaged relief for businesses e.g. in the form of a GBP 13.6bn package over the next five years for business rate payers.

Acknowledging recent statistical changes around trade data collection and coverage, we note that analysis by the Bank of England (BoE, Feb-23) following adjustments to these issues points to a weaker profile of trade in goods than initially exhibited vis-à-vis the EU over the last two years following the Brexit-related regime change. Drawing on IMF data on global goods exports, the UK's share in the global market has shrunk to 2.1% in 2021 (2016: 2.6%), a longer-term low, although pandemic-related distortions may have had a bearing here, too. Trade in services with the EU appears negatively impacted by the post-Brexit trade regime to some extent as well.

Looking ahead, alongside persisting Brexit-related effects, export performance is likely to continue to feel the consequences of weakened global economic activity following Russia's military attack on Ukraine. Amid muted and only gradually accelerating domestic demand, real imports will presumably post negative growth this year and next, ultimately leading to a positive contribution from net trade.

In view of the constraints on both the domestic economy and the external environment, we expect UK real GDP to decrease slightly in 2023, by -0.4%. Even though we assume energy prices will moderate further over the course of the year, likewise entailing improving prospects for trade partners, adverse effects from tighter monetary policy on economic activity should further unfold, likely restricting growth dynamics in 2024. At this stage, we expect total output to increase moderately by 0.9% next year.

With regard to the medium term, growth prospects have worsened since our last review (Mar-22), in light of persistent price pressure and the associated – more aggressive than initially assumed – monetary policy tightening, as well as regarding the higher level of labor market inactivity compared to the pre-pandemic phase. Adding to this, we would flag ongoing challenges to adapting to the post-Brexit environment. While progress was made on replacing former EU trade deals with new ones, there remains work to do. We gather that as of Sep-22, trade agreements with 71 countries plus the Trade and Cooperation Agreement with the EU were in force, in total accounting for 63% (GBP 808bn) of UK bilateral trade in 2021.

We see a risk of this combination of factors leading to some deeper scarring to the economy than previously expected, in particular if the likely imminent phase of weaker business investment extends a trend of already lackluster capital spending since 2016, potentially with negative consequences for productivity and, ultimately, potential growth. Indeed, private investment-to-GDP was persistently among the lowest in Europe over the last decade.

Related to that, UK productivity growth has remained relatively low compared to its main peers. Looking through the acute pandemic phase and its likely distortionary effects on these concepts, potential growth is estimated to reach 1.0% in 2024 (AMECO, Nov-22), which would be slightly

below the average over the years 2015-19 (1.3%). OBR estimates of potential output put it somewhat higher, at 1.4% for 2024, and foresee an increase to 1.7% by 2027, with the capital component delivering the smallest contribution (Nov-22).

Vulnerabilities linked to stretched household balance sheets remain in place as well, but have not displayed any significant changes since our last review. Household debt-to-disposable-income counts among the higher levels in Europe. Both total household debt and the debt-to-income ratio rose during the acute Covid-19 phase, driven by mounting mortgage debt, although tempered by consumers repaying unsecured debt. As of Q3-22, the household debt-to-income ratio decreased somewhat, to 133.8% (Q3-21: 135.6%, ONS). In light of monetary policy tightening being more aggressive than initially expected, we would monitor households' debt servicing ability, as we see some risk that, compounded by the exceptional drop in disposable income and a possibly stronger-than-expected increase in precautionary saving, private consumption may remain more subdued for a protracted period.

On a more positive note, and emphasizing the underlying resilience of the economy, the sovereign can build on existing strengths when it comes to its highly competitive and welcoming business environment, as e.g. underscored by the latest OECD Services Trade Restrictiveness Index (2023). According to the latter, the UK continues to be one of the countries displaying the lowest regulatory barriers to service trade across sectors. Moreover, the UK has scored persistently high in terms of its innovation performance over the last 15 years, as suggested by the World Intellectual Property Organization, which in its 2022 Global Innovation Index (GII) ranks the UK fourth among 132 economies worldwide, boosted by thriving science and technology clusters. Regarding the IMD's World Competitiveness Ranking, the UK continues to count among the stronger European countries considered in the assessment comprising 65 countries overall, despite having slipped a few places to 23rd in the reference year 2022.

As regards efforts to ensure the prosperity of British society over the coming years, the 2022 Autumn Statement reiterates a commitment to raising the R&D budget to GBP 20bn per year by FY 24/25, as well as broadly to major (envisaged) infrastructure projects such as the nuclear plant Sizewell C, High Speed 2 and the Northern Powerhouse Rail. Concerning the Levelling Up Fund, aiming to reduce disparities in the UK by 2030, plans for the second round prioritize local infrastructure projects. Moreover, authorities aim to further advance the UK's digital strategy, inter alia, by increasing gigabit broadband coverage through the Project Gigabit program.

Institutional Structure

The sovereign's credit rating remains buttressed by the high quality of its institutional framework, as also broadly corroborated by the latest set of the World Bank's Worldwide Governance Indicators (WGIs). The UK's sound monetary policy, fiscal policy and financial sector frameworks constitute major pillars of its strong governance set-up. A phase of heightened domestic political volatility following the referendum on ending EU membership and associated challenges to predictability of policymaking balance these strengths to some extent, with last year's quick succession of prime ministers and diverging fiscal policies adding emphasis to this assessment. Chances for an end to the protracted controversy with the EU over implementation of the Northern Ireland seem to have improved in light of the Windsor framework agreed with the EU. We continue to view developments around the possibility of another Scottish referendum on independence as a tail risk. The recent ruling by the UK Supreme Court on required UK parliament consent to such a referendum, and the announced change in leadership of the Scottish National Party, in our view point to slowing dynamics regarding this matter.

Judging by the latest edition of our preferred measure of institutional quality, the World Bank's WGI, the UK continues to compare somewhat more favorably against the respective median ranks of our AA-rated sovereigns when focusing on the four pillars we consider the most relevant. However, and tying in with the abovementioned challenges to predictability of policymaking, we observe that the perceived quality of policy formation and implementation, i.e. government effectiveness, has markedly deteriorated over recent years, and in particular, in the most recent set of indicators referring to the year 2021. With the UK slipping by six places to a relative rank 29 out of 209 sovereigns considered, it matches the median rank of our AA-rated sovereigns, but the outcome represents the weakest assessment of the UK government's capacity to effectively formulate and implement sound policies since inception of the WGIs in 1996.

The sovereign's relative ranks regarding the WGIs 'control of corruption' and 'rule of law' only saw minor changes compared to the preceding year. A rank of 23 out of 209 when it comes to the WGI 'rule of law', which gauges the extent to which agents have confidence in and abide by the rules of society, also represents the weakest reading since 1996, having displayed a worsening trend over recent years. By contrast, perceptions in terms of 'voice and accountability' have improved, lifting the sovereign to relative rank 16 versus a median rank of 21 regarding our 'AA'-rated sovereigns.

The turbulent domestic political phase since our last review, featuring three prime ministers within the space of only a few months, has accentuated challenges to political predictability, although we ultimately see political credibility as preserved. After less than two months in office, Liz Truss, Boris Johnson's successor as prime minister following his resignation in July, stepped down as well. With Rishi Sunak taking over as head of the Conservative government in October, the new leadership reversed a large part of the policies announced under the Truss government, which had contributed to rising concerns about waning policy credibility and a marked repricing of UK government debt on financial markets. The latter, in turn, caused swift communication and counteraction on the part of the Bank of England to alleviate financial market developments deemed unfounded.

The next general election will have to be held no later than January 2025. We continue to monitor political developments in view of the perception of a higher level of dissatisfaction among society as expressed in widespread strike activity recently, which appears to go beyond the surging cost of living, as well as in view of fading public support for the Conservative party in polls. Long-standing challenges regarding the National Health System (NHS) seem to have also intensified following the pandemic.

As one consequence, the Health and Care Bill, enacted into law in April 2022 and coming with a budget of GBP 36bn over the following three years, to be financed via the Health and Care Levy, aims to reduce the backlogs accumulated during the pandemic and reform health and social care services. According to the Autumn Statement, access to funding for the NHS and social care will be increased by up to GDP 8bn in the FY 24/25, allocated to efforts to reduce waiting times and improve urgent and emergency care. The statement also allocates additional funding of GBP 2.3bn each to education in both FY 23/24 and FY 24/25.

With regard to the post-Brexit environment, we will also pay attention to the implementation of the recently agreed 'Windsor framework' (27 February 2023), which could finally put an end to repeated issues over the Northern Ireland protocol. The framework inter alia is to ensure a smooth flow of trade within the UK internal market, while also addressing EU concerns. As men-

tioned above, a considerable share of former trade agreements via the EU remains to be replaced with new ones, despite progress. Likewise, a more robust form of cooperation on financial services trade and regulation with the EU, rather than an equivalence regime that can be changed unilaterally, remains an open issue.

In the meantime, the Financial Services and Markets Bill 2022-23, introduced to parliament in July 2022 and repealing a large number of pieces of EU retained law in a bid to set up a regime strengthening the UK's position as an international financial services hub, is still in the parliamentary process. As part of the so-called 'Edinburgh reforms' (Dec-22), which build on the bill, a separation of retail banking from investment banking ('ring-fencing') as introduced following the global financial crisis (GFC) is to be reformed alongside other post-GFC regulatory decisions.

Looking at regulatory aspects within the financial services sector, a larger degree of diversion between the UK and the EU may thus emerge, in particular when it comes to newer developments such as green finance and crypto assets, which are considered growth areas. An updated Green Finance Strategy is to be published in early 2023. Amid the pursuit of their ambitious digital agenda, UK authorities have announced placing high emphasis on any regulatory frameworks to follow an innovation and competition-friendly approach.

Whilst we view the UK as a stronghold in terms of effective regimes on anti-money laundering (AML) and countering the financing of terrorism (CFT), concrete implementation and potential effects on AML, CFT and combat against tax evasion may have to be monitored more closely in light of the envisaged changes and the establishing of initial regulatory frameworks, e.g. with a view to crypto asset regulation. More recently, the latest FATF assessment of the UK's AML/CFT measures (May-22) has acknowledged further progress the country has made in strengthening its respective frameworks, leading to a positive re-rating on one FATF recommendation.

With the envisaged construction of Sizewell C, authorities aim to enhance low-carbon power supply amid the green transformation, remaining committed to achieving net zero carbon emissions by 2050. It is worth recalling that, measured by capacity, the UK is home to the world's largest offshore windfarm as of 2022 (Hornsea 2), with more large-sized windfarms under construction (Dogger Bank A and B), foreseen to be completed this year and next, underscoring its current leading position in this field. Offshore wind power was the second-most important source for electricity generation in 2021. Compared to the EU-27 as a whole, the UK was ahead in terms of use of renewables for electricity consumption in 2021, with 41.0% of gross final electricity consumption obtained via renewables (Department for Business, Energy & Industrial Strategy; EU-27: 37.5%, Eurostat).

That said, the UK's overall share of renewable energy sources in gross final energy consumption amounted to 13.0% in 2021, remaining markedly lower than in the EU-27 (2021: 21.8%, Eurostat), with the largest gap exhibited regarding use of renewables for heating/cooling. Nevertheless, the overall share has continued to increase rapidly, more than doubling since 2013. In a bid to further increase transparency on climate issues and help to devise efficient strategies, the UK introduced mandatory environmental disclosure for over 1,300 of the largest UK-registered companies.

Fiscal Sustainability

Risks to fiscal sustainability remain a factor weighing on our assessment of the sovereign's creditworthiness. The medium-term outlook for public finances has clouded in view of the recent succession of

global crises, as well as due to rising debt interest outlays amid increased borrowing and a more aggressive monetary policy tightening cycle than expected during our last review, weighing on debt affordability. The elevated debt-to-GDP ratio is likely to stabilize around current levels in the upcoming fiscal year, with a relatively high price deflator partly making up for a significant slowdown in economic growth, and the expected headline deficit likely to see only a small decrease. Ongoing sound debt management and the sterling's status as reserve currency remain risk-mitigating factors, as is the UK's reasserted commitment to fiscal consolidation, although fiscal rules have been relaxed somewhat. Contingent liability risks linked to the large and complex financial sector appear contained in light of sound banking metrics, while debt-servicing capacities of the private sector may become increasingly stretched in light of the monetary policy backdrop. Conceivable larger asset price corrections, as well as adverse developments in fintech and the large non-bank financial sector, represent pockets of vulnerability.

Following a pandemic-induced general government deficit of 15.3% of GDP in the FY 20/21 (Maastricht terms), the economic recovery and expiry of some of the Covid-19 support had the headline deficit shrink to 6.1% in the following fiscal year (FY 21/22; calendar year 2021: 8.1% of GDP). With this, the outcome was better than envisaged in our last review (Mar-22: 7.8% of GDP), but still compares as high versus our AA-rated sovereigns.

In the face of soaring energy and food prices, the government's efforts to alleviate adverse effects on private households and businesses will likely result in another pronounced deficit in FY 22/23. While a growth plan announced during the brief term of the previous prime minister in September 2022, including a number of tax cuts, was almost fully reversed by the current leadership, net borrowing will rise significantly in the short term. That said, the current government also presented envisaged measures to restrain spending and increase taxes over the medium term in a bid to rein in public finances.

The total effect of government decisions since our last review (March 2022), including the May 2022 cost-of-living package, the September 2022 energy package, the growth plan after the October 2022 reversals and new measures introduced with the Autumn Statement in November 2022 is estimated to amount to GBP 41.9bn in the FY 22/23 and to about GBP 27.1bn in FY 23/24 (OBR intelligence). Measures include an energy price guarantee for private households and an energy bill relief scheme for enterprises, both involving caps to energy prices and intended to be effective from Oct-22 to end of Mar-23. From Apr-23, the cap for the energy price guarantee will be increased, remaining in force to Mar-24.

Public sector net borrowing in the first ten months of FY 22/23 came to GBP 116.9bn, corresponding to an increase of 6.3% on the same period of the preceding fiscal year, while remaining 15.8% below OBR's November forecast profile. On the revenue side, in particular income tax receipts, VAT revenue and national insurance contributions showed a more favorable outcome. With regard to the expenditure side, a lower level of subsidies and grants, as well as lower interest payments than estimated, seems to emerge.

At this stage, we expect a general government deficit of about -5.3% of GDP in the FY 22/23 (Maastricht terms). For the next fiscal year, we expect the headline deficit to come in only slightly lower (FY 23/24e: -5.1% of GDP), given that we expect real economic output to slightly decrease while some government support is set to be withdrawn.

With a view to the medium-term outlook, fiscal policy is envisaged to exert a tightening effect as support measures are tapered and as spending restraint across departments except for health,

social care and schools, as well as announced tax increases, are to provide for a consolidation path for public finances. We note that fiscal effort is backloaded towards the end of the Autumn Statement's forecasting horizon. The main tightening effect would thus kick in after the next parliamentary election, adding to considerable uncertainty around any estimates in light of the unpredictability of the war in Ukraine and its repercussions for the global economy. In the longer run, a less favorable demographic situation could place a higher burden on public finances.

From a more institutional angle, it seems worth stressing that the fiscal rules guiding fiscal policy have been adjusted several times since its introduction back in 2011. The Charter for Budget Responsibility was revised again with the latest Autumn Statement, now implying that public sector net debt (excluding the BoE) measured against GDP has to fall and public sector net borrowing has to be below 3% of GDP by the fifth year of the rolling forecast. As the updated framework may thus allow more time to recover from the recession, it could be described as overall less ambitious, in our view adding further to a more uncertain fiscal outlook as regards the medium-to-longer term.

We expect general government debt to decrease to 99.3% of GDP in FY 22/23, from 102.1% of GDP in FY 21/22 (Maastricht terms), aided by an inflation-driven increase in nominal GDP. As of Q3-22, the debt level stood at 100.2% of GDP. Against the backdrop of the expected weak economic activity and assumed moderation of inflationary pressure, we expect the public debt ratio roughly stabilize in the coming fiscal year (FY 23/24e: 99.6% of GDP) and the year after, remaining well above its pre-pandemic level.

Debt affordability has deteriorated since our last review. On the back of increased borrowing and higher borrowing costs on the capital markets, and amid a more aggressive monetary policy tightening cycle than previously anticipated, debt interest spending could be on course for the highest share versus GDP and total revenue since the late 1940s. That said, as mentioned above, interest payments have come in slightly more favorable than envisaged in the OBR November 2022 forecast in the first ten months of the fiscal year ending in March 2023, amounting to GBP 95.6bn. For the full fiscal year, the government had expected debt interest payment to reach GBP 120.4bn in its Autumn Statement. Nevertheless, at 9.4% of total revenue (Maastricht terms), measured as four-quarter average as of Q3-22, interest-to-revenue was higher than in any of the EU members, and is likely to decline only gradually over the next few years.

Drawing on OBR estimates (Nov-22), the impact of an increase in short-term interest rates by one percentage point would lift debt interest spending by about GBP 7.9bn in FY 26/27, suggesting that fiscal pressure via cost of debt could remain elevated over the medium term, also as a higher debt stock affects sensitivity to increases in long-term rates.

Uncertainty around our forecasts remains considerable. At least with a view to domestic monetary policy, we expect the interest rate hiking cycle to approach his peak, with a possibly last hike of the Bank Rate by 25bp to 4.25% to occur in March 2023. Moreover, we expect the policy of unwinding the accumulated asset purchases under the Asset Purchase Facility to continue. The sale of the portfolio of long-dated UK government bonds purchased by the MPC between 28 September and 14 October 2022 (GBP 19.3bn) during an episode of asset price turbulence, partly in reaction to the mini-budget of the previous finance minister in September 2022, has been fully sold as of January 2023.

At its meeting ending on 1 February 2023, the MPC raised its policy rate by 50bp to 4.0%, with two of the nine-member committee preferring to maintain the rate at 3.5%. While headline CPI

inflation was judged as likely to experience a sharp decline over the rest of the year, mostly due to energy and goods prices, the committee perceives in particular underlying inflationary risks ultimately as skewed towards greater persistence. Against this backdrop, we would view a first rate cut in 2023 as a rather remote possibility at this stage.

Generally, CET1 capitalization levels in the UK banking sector point to still comfortable risk buffers, judging by the aggregate ratio, which stood at 15.6% as of Q3-22 (Q3-21: 16.5%, BoE). Asset quality remains high, given a non-performing loan ratio of 0.95% as of Q3-22 (IMF data), moving slightly below pre-pandemic levels. However, following the acute phase of Covid-19, monthly company insolvencies have displayed a rising trend, with the abovementioned loan scheme to cushion the blow from high energy prices likely contributing to flatten developments more recently.

We will closely follow the private sector's credit quality, as difficulties in servicing household and/or corporate debt could have negative repercussions on the otherwise relatively stable banking sector. Corporate insolvencies, which have increased compared to pre-pandemic levels, deserve attention in this regard, as do an increased volume of consumer loans (Dec-22: 5.0% y-o-y; Dec-21: 1.4%, BoE data) and mortgage loans to households (Dec-22: 4.1% y-o-y, Dec-21: 4.7%).

To be sure, according to the BoE's latest Financial Stability Report (Dec-22), there were no reports of materially increased default values pertaining to corporate lending among major UK banks at the time. A significantly higher share of SME debt in arrears is likely of limited risk to the banking sector, insofar as this debt is largely subject to government guarantees. Contributing to mitigating any concern on this issue, the countercyclical capital buffer (CCyB) applied to the banking sector is to rise to 2.0% with effect from 05 July 2023, from currently 1.0%. Moreover, increases to contingent liabilities of the government would occur from low levels (0.1% of GDP in FY 21/22, ONS), thus appearing manageable at this stage. That said, we note that, according to the recently established Contingent Liability Central Capability, maximum quantified contingent liabilities of the government amounted to about 9% of GDP in 2021.

Various metrics and surveys linked to the housing market, including property transactions statistics, RICS UK Residential Market Survey and mortgage approvals for house purchases point to some softening of the housing market lately, which may eventually start to show in house price dynamics as well. However, in the year to December, house prices still exhibited an increase by 9.8% y-o-y (Dec-21: 8.1% y-o-y), drawing on the HM Land Registry's UK house price index for all types of property. OECD data on housing affordability, such as the price-to-income ratio, continue to hint at stretched valuations, exceeding highs last seen prior to the global financial crisis. In light of weakening economic activity and tighter monetary policy, we would still expect house price growth to calm somewhat.

While the BoE judges risks in connection with crypto as currently limited to financial stability, it stresses the need for enhanced regulatory and enforcement frameworks in this field, also bearing recent prominent cases of failure in the industry. More generally, due to the large scale and significance of the UK's overall financial sector, materializing risks to financial stability weigh particularly heavy on fiscal sustainability. Concerning the episode of long-dated government bond repricing in September 2022 and negative implications to LDI funds in which defined benefit schemes often engage, the Pensions Regulator, FCA, as well as overseas regulators, would be in the driver's seat to design any measures potentially enhancing resilience of LDI funds.

Foreign Exposure

External exposure remains subject to vulnerabilities. Overall, we continue to assess risks around the sovereign's foreign exposure as manageable at the current juncture, partly due to the currency composition of external liabilities (mainly GBP) and the UK's flexible exchange rate regime. Further moderation of energy prices should give way to some improvements regarding the trade in goods deficit following its recent widening. For a more sustainable improvement in the external balance over the medium and longer term, successful replacement of former EU trade agreements alongside robust frameworks for services trade seems key.

The UK's current account deficit as a percentage of GDP and measured as four-quarter moving average has deteriorated since our last review, coming to -4.2% as of Q3-22 (Q4-21: -1.5%) amid the widening deficit in the goods balance (Q3-22: -9.4% of GDP) and largely owing to higher costs of importing energy. The surplus in services trade remained relatively solid (Q3-22: 6.1% of GDP), masking a peak in the positive position registered in last year's third quarter.

Looking ahead, we would generally expect the current account balance to remain close to current levels in the near term, with the presumable further moderation of energy prices partly offset by weaker domestic demand. With regard to the medium term, the outlook remains even more vague, as it is largely dependent on the completion of beneficial trade deals and a successful implementation of pending legislation on financial services and markets.

The ongoing post-Brexit adjustments and updated financial services regulation will also affect the UK's attractiveness in terms of foreign direct investment as well as portfolio investment. Visibility on these issues may well remain impaired for some time, as negotiations with various jurisdictions, as well as with the EU over financial services regulatory cooperation on financial services, drag on. Having stood at -15.3% of GDP in 2021 (2019: -10.7% of GDP), the UK's net international investment position has become less negative of late, amounting to -6.2% of GDP as of Q3-22.

Rating Outlook and Sensitivity

Our rating outlook on the United Kingdom is negative, as we assume that the risk situation underlying the key factors affecting sovereign credit risk is likely to deteriorate over the next 12 to 24 months, due to deteriorating prospects for fiscal performance, the impression of a higher level of political volatility with related bearings on predictability of policymaking, as well as the more subdued outlook for economic growth.

We could lower the sovereign's credit ratings if fiscal metrics continue to deteriorate. A protracted phase of political volatility and potentially entrenched dissatisfaction in society, possibly amid substantial delays in further adjusting to the post-Brexit environment, could jeopardize political credibility, with the risk of reputational damage as seen from investors' point of view. A longer phase of very subdued economic activity than currently expected and possibly requiring additional and/or extended support measures, with associated negative fiscal effects, could also have us consider a negative rating action.

Conversely, we could raise the sovereign's credit rating or outlook, if economic activity bounces back stronger than we expect, lifting confidence over robustness of the cycle and improving prospects for fiscal performance. Upward pressure on the rating and/or the outlook could also

arise if the public debt ratio returns to a firm downward path, possibly on the back of the above-mentioned circumstances. Clear manifestations of strengthening productivity and underlying growth would also be conducive to a positive rating action, potentially amid tangible signs that frictions following Brexit are rapidly overcome.

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Ratings*

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

*) Unsolicited

ESG Factors

Creditreform Rating has signed the ESG in credit risk and ratings statement formulated within the framework of the UN Principles for Responsible Investment (UN PRI). The rating agency is thus committed to taking environmental and social factors as well as aspects of corporate governance into account in a targeted manner when assessing creditworthiness.

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook.

For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down [key principles of the impact of ESG factors on credit ratings](#).

ESG Factor Box



The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank’s Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating’s assessment of the sovereign’s institutional set-up, which we regard as a key rating driver, we consider the ESG factors ‘Judicial System and Property Rights’, ‘Quality of Public Services and Policies’, ‘Civil Liberties and Political Participation’, and ‘Integrity of Public Officials’ as highly significant to the credit rating.

Since indicators relating to the assessment of a economy’s competitive stance by e.g. the World Bank, the World Economic Forum, the European Commission, IMD Business School and the World Intellectual Property Organization (UN) add further input to our rating or adjustments thereof, we judge the ESG factor ‘Business Environment’ as significant.

The social dimension plays an important role in forming our opinion on the creditworthiness of the sovereign. Labor market metrics constitute crucial goalposts in Creditreform Rating’s considerations on macroeconomic performance of the sovereign, and we regard the ESG factor ‘Labor’ as significant to the credit rating or adjustments thereof. What is more, risks pertaining to social cohesion with a view to the Irish border and the Scottish independence movement touch upon the social dimension in our ESG framework as well. This is reflected, among other things, by the WGI “Political Stability”, and would ultimately affect institutional performance. Therefore, the ESG factor ‘Safety and Security’ is of importance.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2017	2018	2019	2020	2021	2022e	2023e
Macroeconomic Performance							
Real GDP growth	2.4	1.7	1.6	-11.0	7.6	4.0	-0.4
GDP per capita (PPP, USD)	46,553	48,164	49,576	45,329	50,523	55,862	57,822
Credit to the private sector/GDP	85.9	86.7	85.9	94.3	89.6	n/a	n/a
Unemployment rate	4.4	4.0	3.8	5.2	4.0	3.7	n/a
Unit labor costs (index 2019=100)	94.8	97.3	100.0	106.2	107.6	n/a	n/a
World Competitiveness Ranking (rank)	19	20	23	19	18	23	n/a
Life expectancy at birth (years)	81.3	81.3	81.2	80.9	n/a	n/a	n/a
Institutional Structure							
WGI Rule of Law (score)	1.7	1.6	1.6	1.5	1.4	n/a	n/a
WGI Control of Corruption (score)	1.9	1.8	1.8	1.7	1.7	n/a	n/a
WGI Voice and Accountability (score)	1.4	1.4	1.3	1.2	1.3	n/a	n/a
WGI Government Effectiveness (score)	1.5	1.4	1.5	1.4	1.3	n/a	n/a
CPI inflation rate, y-o-y change	2.7	2.5	1.8	0.9	2.6	9.0	6.9
GHG emissions (tons of CO2 equivalent p.c.)	7.1	7.0	6.7	6.0	6.3	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP*	-2.8	-1.8	-2.9	-15.3	-6.1	-5.3	-5.1
General government gross debt/GDP*	84.8	84.6	84.4	107.7	102.1	99.3	99.6
Interest/revenue	7.0	6.5	5.7	5.1	6.9	n/a	n/a
Debt/revenue	224.3	223.4	222.9	269.9	261.5	n/a	n/a
Average maturity all gilts (years)	15.8	15.8	15.9	15.3	15.1	n/a	n/a
Foreign exposure							
Current account balance/GDP	-3.6	-4.1	-2.8	-3.2	-1.5	n/a	n/a
International reserves/imports	0.2	0.3	0.3	0.3	0.3	n/a	n/a
NIIP/GDP	-3.3	-3.1	-10.7	-18.2	-15.3	n/a	n/a
External debt/GDP	299.5	299.6	289.6	334.4	320.7	n/a	n/a

Sources: IMF, World Bank, BIS, IMD, ONS, DMO, own estimates

*) Maastricht terms, fiscal years, i.e. calendar year 2017 ⇔ FY 17/18, etc.

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	02.06.2017	AA /stable
Monitoring	30.03.2018	AA /stable
Monitoring	29.03.2019	AA /stable
Monitoring	27.03.2020	AA /negative
Monitoring	25.09.2020	AA /negative
Monitoring	19.03.2021	AA /negative
Monitoring	18.03.2022	AA /stable
Monitoring	03.03.2023	AA /negative

Regulatory Requirements

In 2011 Creditreform Rating AG (CRA) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. HM Treasury participated in the credit rating process, as it provided additional information and commented on a draft version of the report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of HM Treasury during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's ["Sovereign Ratings" methodology](#) (v1.2, July 2016) in conjunction with its basic document ["Rating Criteria and Definitions"](#) (v1.3, January 2018). CRAG 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 CRAG's rating methodologies and basic document "Rating Criteria and Definitions" is published on our [website](#).

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, IMD Business School, European Center for Disease Prevention and Control (ECDC), Blavatnik School of Government, Bank of England, HM Treasury, Debt Management Office, Office for Budget Responsibility (OBR), Office for National Statistics (ONS), UK Government – Department of International Trade, National Institute of Economic and Social Research (NIESR), World Intellectual Property Organization (WIPO).

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent 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. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. 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 CRAG's "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the

CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as “initial rating”; other updates are indicated as an “update”, “upgrade or downgrade”, “not rated”, “affirmed”, “selective default” or “default”.

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: <https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml>.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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