Giles Edwards
Senior Director, FI Ratings

Countdown to Brexit:
Key Bank Rating Considerations

Dec. 3, 2018

Agenda

1 **Brexit in context**

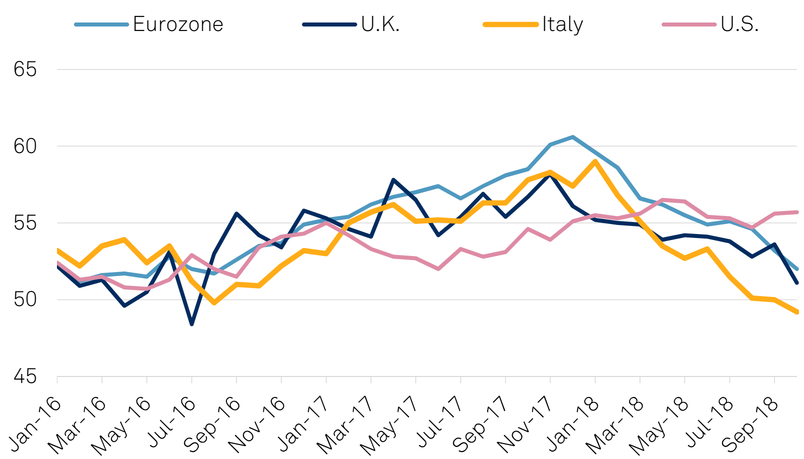
2 **S&P Global Ratings base case**

3 **Implications of a no deal / disruptive Brexit**

Credit Conditions: Europe

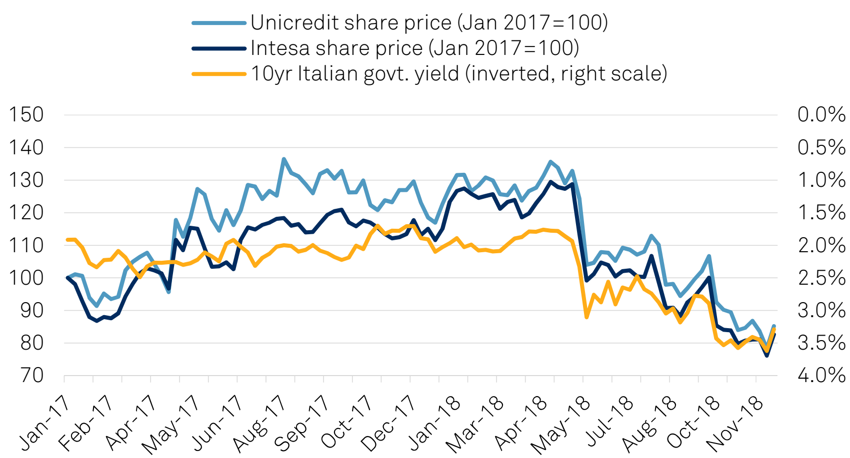
- The **Eurozone economy has shifted down a gear** since the start of the year, but capacity pressures remain high. Against this backdrop, we expect the European Central Bank (ECB) to start with the **gradual normalization of monetary policy**, with two rate rises per year from 2020. We expect the euro to remain at its current level until mid-2019 in a context of political uncertainty and rising monetary policy divergence with the U.S.
- Credit conditions are tightening somewhat in the U.K. **The risk of a disruptive Brexit remains significant**, despite the U.K. and the EU having reached a draft withdrawal agreement. In addition, the Italian government maintained its expansionary budget in a clear challenge to the European Commission, which is feeding market volatility.
- Eurozone **private-sector credit conditions remain benign**, encouraging reasonable loan demand.
- **Mainstream political parties continue to be challenged** from all sides. With their sights set firmly on the European parliamentary elections in May 2019, a sizable vote for nationalist parties could put the brakes on any remaining momentum toward a closer union.

EU Manufacturing PMIs Diverging From U.S. Recently



PMIs--Purchasing manager indices. Sources: Markit, Thomson Reuters Datastream.

Italian Banks Shares Remain Sensitive BTP Bond Yields



Source: Thomson Reuters Datastream.

Top European Cross-Sector Risks

Global trade

Risk level*	Very low	Moderate	Elevated	**High**	Very high	Risk trend**	Improving	Unchanged	**Worsening**

The risk of a further escalation in trade tensions remains high as the U.S. administration deliberates over whether wide-ranging trade discussions with the EU are proceeding satisfactorily. In the first instance, any tariffs would likely center on the auto industry, provoking a tit-for-tat response, forcing global supply chains to restructure.

Disruptive Brexit

Risk level*	Very low	Moderate	Elevated	**High**	Very high	Risk trend**	Improving	Unchanged	**Worsening**

Unless the U.K. Parliament approves the government's Withdrawal Agreement or agrees an alternative, the legal position is that the U.K. will leave the EU on March 30, 2019, with no-deal. While not our base case, a no-deal Brexit remains a meaningful likelihood, given the current lack of consensus in Parliament for the Withdrawal Agreement or an alternative.

Tighter credit conditions

Risk level*	Very low	Moderate	**Elevated**	High	Very high	Risk trend**	Improving	**Unchanged**	Worsening

As global financing conditions head in a restrictive direction and the credit cycle starts to turn in Europe, riskier, credit-sensitive asset classes, such as real estate, leveraged finance, direct lending, and emerging markets, will likely experience greater price volatility, a deterioration in underlying credit quality, and bouts of market illiquidity.

Weakening European political cohesion

Risk level*	Very low	Moderate	**Elevated**	High	Very high	Risk trend**	Improving	Unchanged	**Worsening**

2019 will see a major overhaul in political leadership in Europe with Angela Merkel stepping down, European parliamentary elections, and a new European Commission. This will challenge European mainstream political parties seeking to strengthen social cohesion, complete economic and monetary union, and address security and migration.

European Banks: Base Case

Key Expectations

- We expect a more balanced mix of upgrades/downgrades in 2019. We anticipate relatively stable balance sheets, modest new lending, benign asset quality with some progress in nonperforming assets' reduction in the periphery, stable capitalization, and subpar profitability.
- Authorities will continue working to enhance bank resolvability and systemic banks will continue to build their buffers.
- Potential divestments of government stakes in banks rescued during the crisis and some domestic consolidation, but not yet cross-border mergers.
- Potential for episodes of market turbulence, which could lead to increased funding costs for some banks.

Key Assumptions

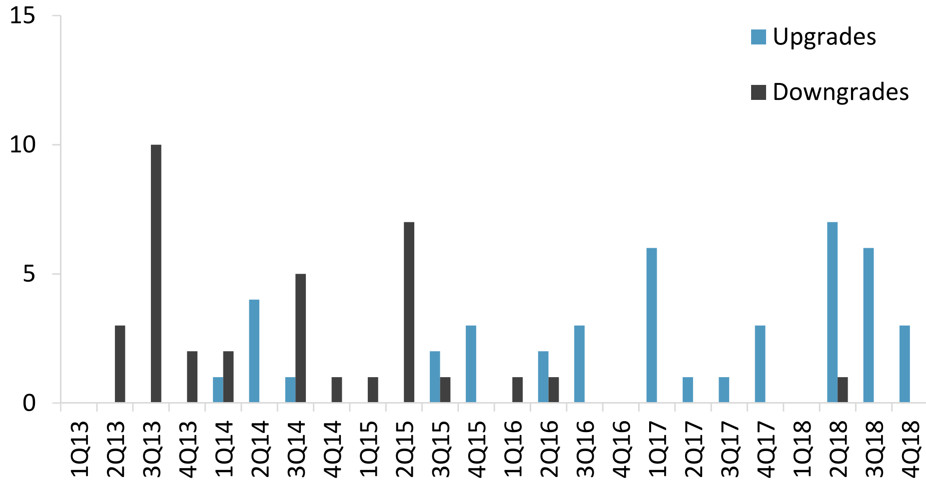
- Brexit will not be disruptive.
- Economic growth will converge to its potential rate, but will remain generally supportive of banking activity.
- The ECB monetary policy shift will be gradual, allowing banks time to adjust.

Key risks

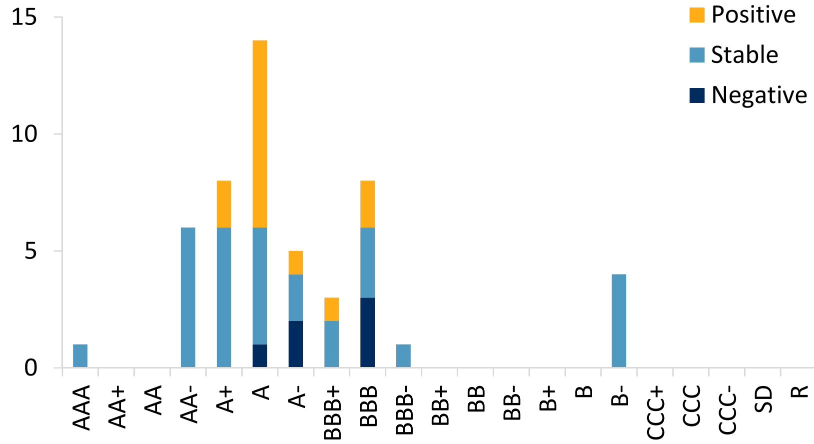
- A disorderly Brexit with a likely negative impact on the economy.
- An ongoing turmoil in Italy, which could result in higher funding costs for the private sector (including banks), slow economic growth, and constrain banks' progress in their recovery, which is just half-way through.
- A reversal of economic momentum that would challenge our expectations of benign asset quality and slow the ongoing reduction of legacy problematic assets in the periphery, complicate the repositioning of banks' business models, and stagnate banks' profitability at low levels.
- An abrupt correction of the fixed-income markets, hitting capital through the mark-to-market of securities portfolios, reducing lending, and increasing funding costs for banks.

Top European Banks: Positive Bias

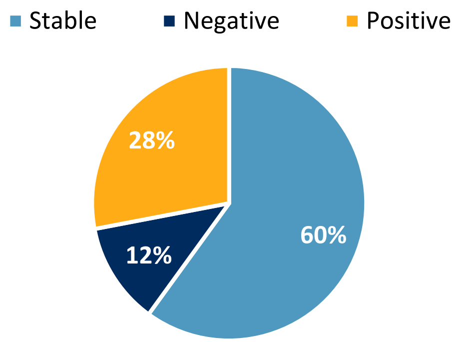
Downgrades & upgrades of top 50 European banks



Rating distribution of top 50 European banks



Outlook distribution top 50 European banks

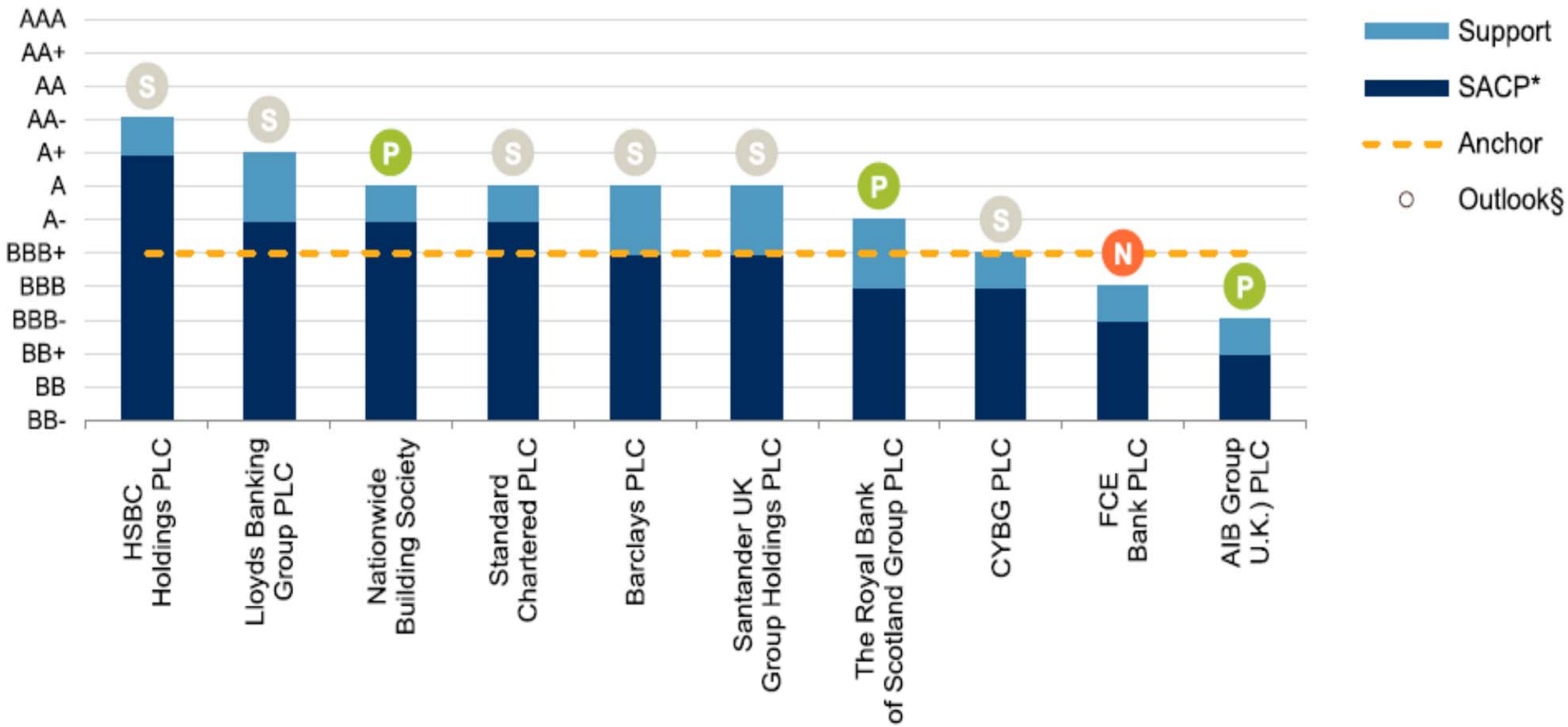


1. Since end-2015, 32 upgrades vs. 3 downgrades.
2. 14 banks on positive outlooks, 6 negative.
3. Potential rating actions could be driven by SACP improvement (mainly BICRA related) or other factors, eg ALAC.

Source: S&P Global Ratings. All data as at: Oct. 31, 2018. SACP—standalone credit profile, ALAC—additional loss absorbing capacity

S&P Global Ratings

UK Banks: Ratings Broadly Stable



*Standalone credit profile or unsupported group credit profile for rated groups. §P=Positive, S=Stable, N=Negative. All ratings relate to the main operating company as Oct. 17, 2018. Source: S&P Global Ratings.

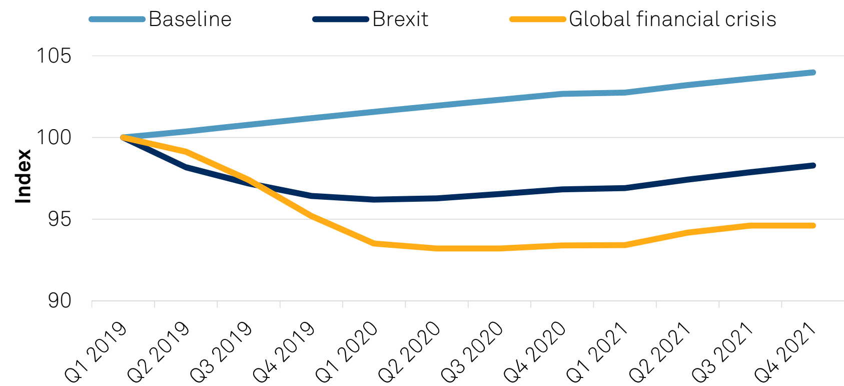
Impact Of A No-Deal Brexit

- While the EU and the U.K. have reached an agreement on the terms of the U.K.'s withdrawal from the EU and on a framework for their future relationship, there remains a significant risk that the U.K. parliament will not approve the deal.
- In that scenario, unless other avenues toward an agreement opened up, the U.K. would leave the EU with no deal in place.
- Our no-deal scenario posits a moderate U.K. recession, with GDP falling by 2.7% over two years, and a partial recovery thereafter.
- U.K. banks will likely be the most vulnerable in a no-deal Brexit, but their earnings and balance sheets would provide a material cushion.
- Other open economies like Ireland, Belgium, or Netherlands could also feel the impact of no deal, but we expect those countries' banks to better accommodate its adverse consequences.
- A no-deal Brexit that leads to a severe economic downturn in the U.K. would likely result in a deterioration of U.K. banks' asset quality and earnings. More immediately, U.K. banks could face constrained and/or more expensive access to wholesale funding.

Key Figures From The No-Deal Scenario

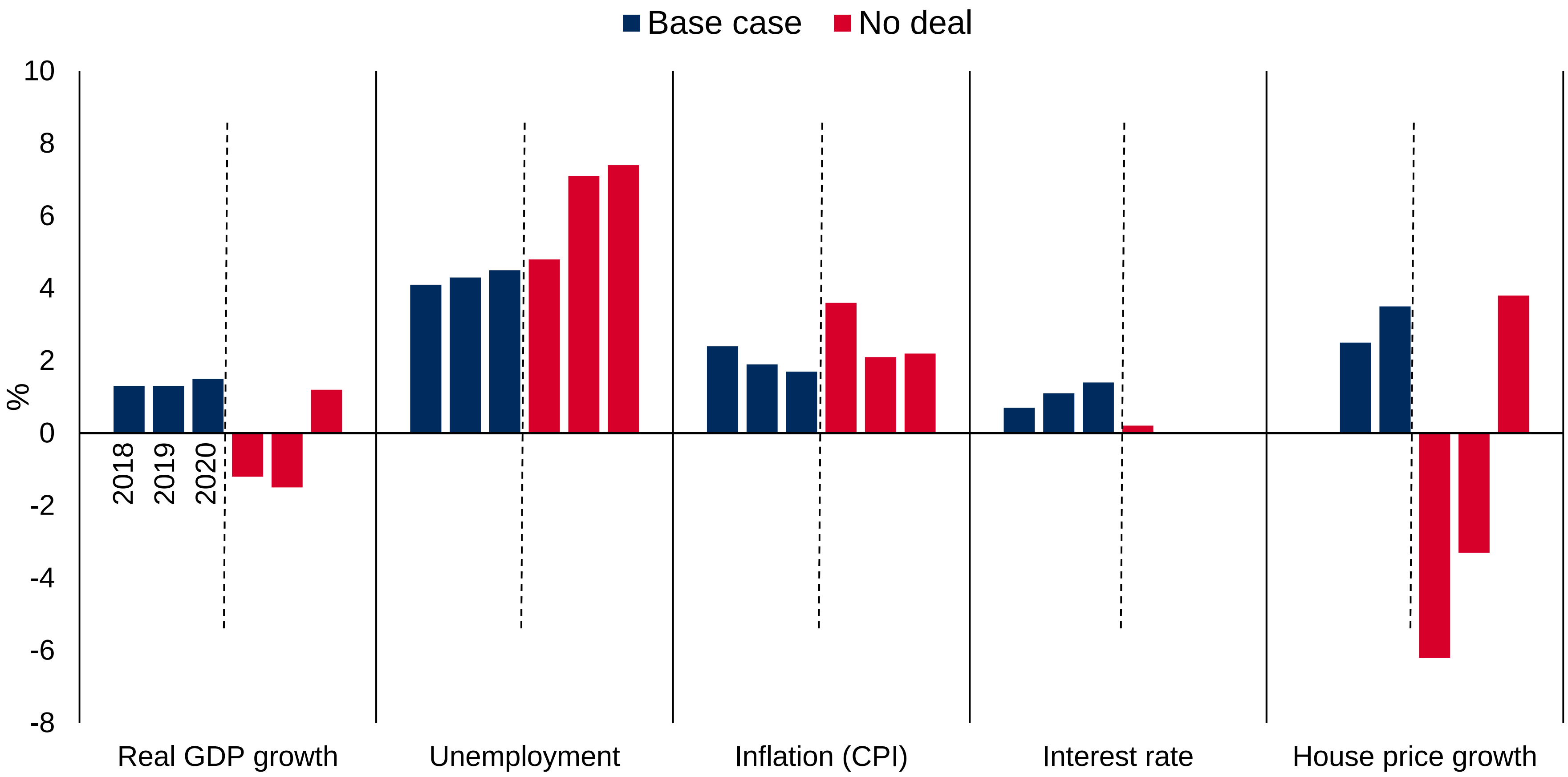
GDP	Unemployment	Households lose	Inflation peaks at	House prices down
5.5%	**7.4%**	**£2,700**	**4.7%**	**10%**
below our baseline forecast by 2021	by 2021	in income per year 2019-2021	in mid-2019	by 2020

A No-Deal Brexit Would Be 60% As Damaging To The U.K. Economy As The Global Financial Crisis



Note: Index=100 in quarter before the shock. GDP index has been transformed for the global financial crisis so that is consistent and can be compared with our baseline forecast. Sources: ONS, S&P Global Economics & Research.

Our Base Case vs Our No-Deal Brexit Scenario - 2018-2020



Source: *Countdown to Brexit: No Deal Moving Into Sight*, 30 October 2018. The bars represent our forecasts or projections for each of the three years from 2018 to 2020

S&P Global Ratings

Brexit Considerations: UK Sovereign

AA/Neg/A-1+

- The **passage of the withdrawal agreement** in its current form through the U.K. parliament **is uncertain** and could culminate in both sides having to return to the negotiating table, putting further pressures on meeting the March deadline.
- In our **base case**, we continue to anticipate an orderly withdrawal of the U.K. from the EU and the implementation of a transition period until at least December 2020.
- Our **current negative outlook** reflects our view of the risk of sustained economic weakness and a deterioration in government finances if merchandise and services exports from the U.K. lose access to key European markets, external financing diminishes, or sterling's status as a reserve currency comes under pressure due to a loss of confidence in the U.K. economy.
- We **could lower the ratings** under a scenario in which the likelihood of a "disorderly" Brexit appears more apparent. We define a "disorderly" Brexit as one which would either significantly limit U.K. manufacturing and services access to key European markets, or subject them to tariffs and nontariff barriers high enough to reduce their ability to compete.
- We **could revise the outlook to stable** if negotiations with the EU provide greater certainty for the U.K. economy, and if key sectors retain their access to European markets without penalizing tariffs or significant nontariff barriers.

Source: "*United Kingdom 'AA/A-1+' Ratings And Negative Outlook Not Immediately Affected By Agreement With EU*", Nov. 15, 2018

Financial Institutions: Past The Point Of No Return

- Four months before the UK leaves the EU, in March 2019
- Yet there is still limited clarity on the future EU-UK relationship, or even whether there will be a transition period to end-2020
- Broadly, FIs are past the point of no return in carrying out their contingency plans
- They will continue to position themselves for the worst-case scenario, i.e. a disorderly Brexit in March 2019 with no transition period

Brexit Considerations: Non-EU Banks

London has historically been the European HQ for international banks	• Typically via a blend of a London branch of the parent bank and UK subsidiaries (e.g. bank sub and broker sub), using passporting rights to carry out business across the EU. • Larger banks will also have smaller subsidiaries elsewhere in the EU
They have been discussing with regulators with regulators what must move, and when it must move	• Booking model • Risk management functions • Personnel • Licences • Repapering
Ratings impact expected to be very limited	• Creation of additional subsidiaries → inefficiencies in capital, liquidity, expense • Existing UK subsidiaries expected to remain integral to their banking group's provision of services in EMEA and/or to non-EMEA clients • Assumes broadly smooth execution of plans

Brexit Considerations: EU-27 Banks

Licensing / client service	• Similar to non-EU banks London • But potentially easier to address, given the UK's approach of a temporary permissions regime
Macroeconomics	• Ireland, or other largely open EU economies (Netherlands, Belgium) relatively more sensitive to negative macroeconomic effects from Brexit, particularly if disorderly • Currently, we don't expect a significant impact for these countries' banks or economies
MREL (bail-in buffers)	• Some EU banks have issued a meaningful proportion of their MREL instruments under New York or English law → as the UK becomes a 3rd country, legacy MREL-eligible instruments that don't contain a contractual acknowledgement of EU bail-in power would become ineligible, although some grandfathering is possible. • We do not expect banks to be materially affected

Brexit Considerations: UK Banks

Licensing / client service	• Similar considerations as for non-EU banks, international banks – but UK banks leveraging already-licensed EU27 subsidiaries • Well-advanced plans but with significant work to complete planned migrations
Macroeconomics (base case)	• A steady strengthening of U.K. banks' balance sheets over the past decade, the reduction of pockets of risks/legacy assets, and low unemployment, means that the UK domestic banking sector as a whole is in a more resilient position to face tougher operating conditions • No substantial ratings changes expected.
Macroeconomics (disorderly Brexit)	• UK banks could likely ride out a sustained period of market turbulence • But current UK bank ratings are unlikely to be consistent with a disruptive Brexit accompanied by a severe economic shock; we could therefore lower outlooks and/or ratings if we thought a materially adverse scenario were becoming increasingly certain.

Related Research

- Credit Conditions EMEA: Bracing For Turbulence, Nov. 29, 2018
- The ECB's New Normal And How We Might Get There, Nov. 29, 2018
- Everyone Passed: Stress Tests Highlight Growing Resilience Of U.K. Banks, Nov. 29, 2018
- Bulletin: United Kingdom 'AA/A-1+' Ratings And Negative Outlook Not Immediately Affected By Agreement With EU, Nov. 29, 2018
- Banking Industry Country Risk Assessment: United Kingdom, Nov. 5, 2018
- 2018 EU Bank Stress Test: Harsher Macro Assumptions And IFRS 9 Will Raise The Bar For Some Banks, Oct. 31, 2018
- Countdown to Brexit: No Deal Moving Into Sight, Oct. 30, 2018
- Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative, Oct. 26, 2018
- EMEA Financial Institutions Monitor 4Q2018, Oct. 18, 2018
- Countdown To Brexit: Financial Institutions Are Past The Point Of No Return, Oct. 11, 2018
- Countdown To Brexit: A Disruptive Brexit Would Mean Increased Losses In U.K. ABS And RMBS Transactions But 'AAA' Ratings Will Be Stable, Sept. 5, 2018
- Industry Report Card: U.K. Banks Keep Calm And Carry On Amid Brexit Uncertainty, Aug. 13, 2018
- Resolution Regimes And Financial Institutions: Research By S&P Global Ratings, Aug. 6, 2018
- European Bank M&A: More Talk Than Action, Aug. 6, 2018

Base Case UK Economic Projections

Orderly Brexit Transition And Moderate Growth

(%)	2015	2016	2017	2018f	2019f	2020f
Real GDP growth	2.3	1.8	1.7	1.3	1.3	1.5
Real private consumption growth	2.7	3.2	1.9	1.1	1.1	1.4
Real fixed investment growth	3.4	2.3	3.4	0.8	2.1	3.6
Real government consumption growth	1.4	0.8	-0.1	1.2	0.8	0.9
Real export growth	4.4	1	5.4	-0.1	2.7	2.6
Real import growth	5.5	3.3	3.2	0.2	2.6	2.9
CPI inflation	0.1	0.6	2.7	2.4	1.9	1.7
Unemployment rate	5.4	4.9	4.4	4.1	4.3	4.5
Short-term interest rate	0.50	0.40	0.29	0.70	1.10	1.40
Long-term interest rate	1.90	1.30	1.24	1.46	1.97	2.72

Source: European Economic Snapshots: October 2018, 11 October 2018

Our No-Deal Scenario: A Moderate Recession

	2019	2020	2021
GDP (% year)	-1.2	-1.5	1.2
Unemployment rate	4.8	7.1	7.4
CPI (% year)	3.6	2.1	2.2
USD per GBP	1.18	1.31	1.32
BoE policy rate	0.21	0	0
House prices (% year)*	-6.2	-3.3	3.8
Share prices (% year)	-13.1	6.4	8.9
Expenditure components (% year):			
Private consumption	-1.8	-2.7	1.4
Government consumption	3.3	0.4	-0.1
Fixed investment	-1.4	-2.5	2.5
Exports	-3.3	0.4	2.1
Imports	-1.9	-1.9	2.5

Source: Countdown to Brexit: No Deal Moving Into Sight, 30 October 2018