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U.K. BICRA Revised To Group 2 From Group 1 On Deteriorating Credit Conditions

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Standard & Poor's Ratings Services has revised downwards its Banking Industry Country Risk Assessment (BICRA) on the United Kingdom (AAA/Stable/A-1+) to Group 2 from Group 1.

Our BICRA rankings evaluate the strengths and weaknesses of a country's banking system compared with those of other countries. The scale ranges from Group 1 (strongest) to Group 10 (weakest). Banking systems ranking similarly to the U.K. include the U.S., Germany, Italy, Spain, and Ireland.

The BICRA change primarily reflects the deteriorating credit conditions and the high level of household indebtedness in the U.K., and the resulting deterioration that we expect to see in the banking system's financial profile. The change also reflects the pressure on many of the banks to rebalance their funding profiles, which may delay economic recovery and, in our view, is likely to constrain asset and revenue growth. Despite these challenges, the system boasts generally strong preprovision earnings and benefits from quite stable client relationships, as well as the good-quality infrastructure and flexible labor markets in the U.K. The larger banks typically also benefit from decent geographic and business line diversification, large market shares, and good economies of scale.

We believe that the banks' intermediation of the country's savings and credit has helped support the U.K.'s 16 straight years of annual average economic growth and a decade of good profits for the banks, despite rising competition. However, this strong credit growth also fuelled a property boom, which led U.K. households to become among the most indebted in the world, while competition led the banks to weaken their lending criteria, particularly in the past few years. As a result, we believe that, when compared with their peers in certain European countries, U.K. consumers and banks are relatively poorly positioned to ride out the bursting of the property bubble and the impending economic downturn.

We believe that the U.K. economy is now on the verge of recession. Standard & Poor's expects the economy to contract by 1.0% in 2009, with only modest economic growth of 0.5% expected for 2010. In our view, unemployment, which has been consistently better than the EU average, but is now rising quite sharply, will be the main determinant of banks' credit losses. Under a reasonable worst-case economic scenario, we currently estimate the U.K. banking system's level of gross problematic assets (GPAs) as a percentage of private sector credit to be in the range of 5%-15%, the strongest category. (For more information, see "S&P's Banking Industry Country Risk Assessments: Global Annual Roundup," published on Aug. 9, 2007, on Ratings Direct.)

Most U.K. banks have grown their loan books faster than their deposit bases for many years, leading to a structural reliance on wholesale funding. The U.K. authorities' actions, through the special liquidity and credit guarantee schemes (see "U.K. Government Financial Support Will Not Affect Bank Counterparty Credit Ratings," published on Oct. 8, 2008), have resolved immediate questions around bank liquidity. However, with the supply of wholesale funding likely to remain constrained for some time, the banks are seeking to reduce their reliance on this funding source. We expect this trend to be supported by weak credit growth, a rising retail savings rate, and the banks' strong customer relationships. If managed correctly, deleveraging could occur over an extended period. However, even in this scenario, it will slow the growth rate of bank revenues once the economy rebounds and, compared with recent years, restrict the availability of credit to households and businesses. By contrast, rapid deleveraging by the banks provides the most likely driver of a deep, sustained recession.

We expect the deteriorating credit conditions to lead to a sharp rise in banks' credit losses through 2009, and for losses to remain at a sustained high level into 2010. The banks' typically good efficiency, strong revenue bases, and supportive interest margin trends should provide a cushion against these credit losses, as should further consolidation within the sector. However, bank earnings seem likely to be highly pressured during this time. The U.K. authorities' bank recapitalization scheme, which has led to capital injections for many institutions, has addressed the previously weak capitalization of the U.K. system when compared with global peers, and, in our view, improved the ability of the system to withstand a severe and sustained economic downturn.

Under our criteria, we consider the U.K. authorities to be "supportive" of the banking system. This means that our credit ratings on the country's financial institutions factor in ongoing implicit external support, including advantages derived from bank status--in the form of preferential access to liquidity, prudential regulation, and proactive supervision. In cases of financial stress, when we expect the state to provide extraordinary support to a particular bank, we may elevate the long-term counterparty credit rating above a bank's stand-alone creditworthiness, particularly if we consider the bank to be systemically important to the sector.

Table 1

Banking Industry Country Risk Assessments

Group 1	Group 2	Group 3	Group 4	Group 5
Australia	Denmark	Austria	Czech Republic	Bahrain
Belgium	Germany	Chile	Greece	Brazil
Canada	Hong Kong	Japan	Israel	Malta
Finland	Ireland	Portugal	Korea	Oman
France	Italy	Saudi Arabia	Kuwait	Poland
Luxembourg	New Zealand		Malaysia	South Africa
The Netherlands	Norway		Mexico	
Sweden	Singapore		Qatar	
Switzerland	Spain		Slovak Republic	
	U.K.		Slovenia	
	U.S.		Taiwan	
			United Arab Emirates	
Group 6	**Group 7**	**Group 8**	**Group 9**	**Group 10**
Bulgaria	El Salvador	Argentina	Belarus	Bolivia
China	Lithuania	Colombia	Bosnia and Herzegovina	Cambodia
Croatia	Romania	Egypt	Costa Rica	Dominican Republic
Cyprus	Russia	Iceland	Georgia	Ecuador
Estonia	Turkey	Indonesia	Guatemala	Jamaica
Hungary		Jordan	Lebanon	Surinam
India		Kazakhstan	Nigeria	Ukraine
Panama		Latvia	Vietnam	Venezuela
Peru		Montenegro		
Thailand		Morocco		
Trinidad and Tobago		Pakistan		
		Philippines		
		Serbia		

Table 1

Banking Industry Country Risk Assessments (cont.)
Tunisia
Uruguay

As of Dec. 17, 2008.

Table 2

Gross Problematic Asset Ranges

5%-15%	10%-20%	15%-30%	25%-40%	35%-50%	50%-75%
Australia	Austria	Bahrain (onshore)	Croatia	Argentina	Dominican Republic
Belgium	Chile	Brazil	Bulgaria	Belarus	Ecuador
Canada	Greece	Colombia	Cyprus	Bolivia	Egypt
Denmark	Italy	Czech Republic	El Salvador	Bosnia and Herzegovina	Georgia
Finland	Japan	Israel	Estonia	Cambodia	
France	Korea	Kuwait	Hungary	China	
Germany	New Zealand	Malaysia	India	Costa Rica	
Hong Kong	Portugal	Malta	Jordan	Guatemala	
Ireland	Singapore	Mexico	Lebanon	Iceland	
Luxembourg	South Africa	Oman	Lithuania	Indonesia	
The Netherlands		Panama	Morocco	Jamaica	
Norway		Peru	Philippines	Kazakhstan	
Spain		Qatar	Poland	Latvia	
Sweden		Saudi Arabia	Romania	Montenegro	
Switzerland		Slovak Republic	Trinidad and Tobago	Nigeria	
U.K.		Slovenia	Turkey	Pakistan	
U.S.		Taiwan	Uruguay	Russia	
		United Arab Emirates		Serbia	
				Surinam	
				Thailand	
				Tunisia	
				Ukraine	
				Venezuela	
				Vietnam	

As of Dec. 17, 2008.

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