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

Primary Credit Analysts:

Giles Edwards, London (44) 20-7176-7014; giles_edwards@standardandpoors.com
Richard Barnes, London (44) 20-7176-7227; richard_barnes@standardandpoors.com

Secondary Credit Analysts:

Nick Hill, London (44) 20-7176-7216; nick_hill@standardandpoors.com
Nigel Greenwood, London (44) 20-7176-7211; nigel_greenwood@standardandpoors.com
Trevor Cullinan, London (44) 20-7176-7110; trevor_cullinan@standardandpoors.com

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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.

Additional Contact:

Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com

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