



## Despite inflation risks, UK banks' credit outlook remains stable due to improving capital positions and asset quality

by [Valerie Kok](#)

- The credit profile of UK banks has improved since the start of 2021, on the back of improving asset quality amidst the rapid economic recovery in Q2 2021, as shown by the NUS-CRI Agg PD
- The NUS-CRI Agg Forward PD demonstrates that the credit risk for UK banks eventually stabilizes in the long term due to improving capitalization structure and tightening underwriting criteria amidst strict regulations

Following a rapid rebound in the recovery of the UK's economy in Q2 2021, recent soaring inflation levels have driven the Bank of England (BOE) to raise interest rates from its record low of 0.1% to [0.25%](#) last Thursday. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) (See Figure 1a) shows the improving credit quality of UK-domiciled banks (UK banks) in H1 2021, primarily due to improved asset quality and boosted earnings as a result of [releases of credit provision expenses for loan losses](#). However, with the recent spread of the Omicron variant in the UK and the recent rate hike threatening economic growth, UK banks are set to witness a slight increase in credit risk in the short term before stabilizing in the long term, as shown by the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD) (See Figure 1b). In the long term, the well-capitalized structure of UK banks, as well as strict regulations in the financial sector, ensures that UK banks' credit profile stabilizes.

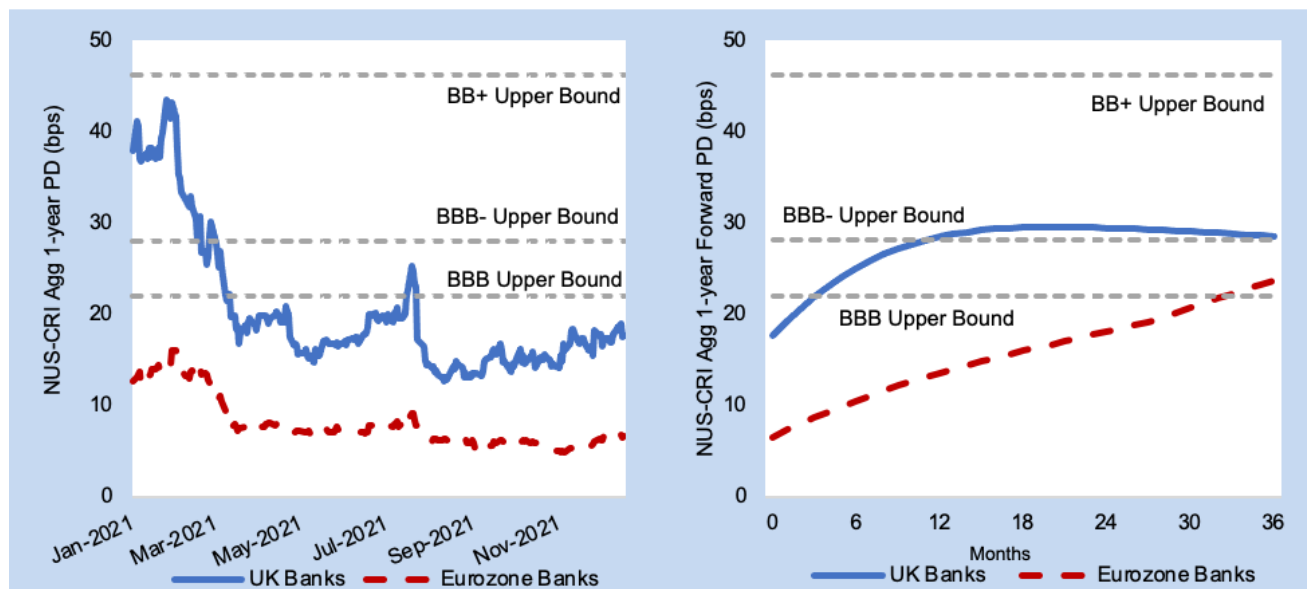


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for UK banks and Eurozone banks from Jan-2021 to Dec-2021 with reference to PDiR2.0<sup>1</sup> bounds. Figure 1b (RHS): NUS-CRI Agg (Median) Forward 1-year PD for UK banks and Eurozone banks as of Dec-2021 with reference to PDiR2.0 bounds. Source: NUS-CRI

Amidst government support, UK banks saw their credit quality recover in H1 2021, largely driven by an improvement in asset quality and a strong rebound in earnings. The decreasing trend in the proportion of loans classified as Stage 2 (heightened risk of default) and Stage 3<sup>2</sup> (credit impaired) since 2020 Q4 highlighted the improvement in UK banks' asset quality (Figure 2a). To guard against risks stemming from household debt, as

<sup>1</sup> The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

<sup>2</sup> [Stage 2 Assets](#), in the context of IFRS 9 are financial instruments that have deteriorated significantly in credit quality since initial recognition but offer no objective evidence of a credit loss event. [Stage 3 Assets](#), in the context of IFRS 9 are financial instruments that offer objective evidence of a credit loss event.

well as relieve financing pressures and mitigate the risk of defaults by corporates, the UK government has implemented several measures<sup>3</sup>. At the start of the pandemic, UK banks had been [more proactive](#) than their Eurozone counterparts in recognizing IFRS 9 Stage 2 loans, and thus saw profits weighed down by the surge in impairment charges, which became a drag on their credit quality as compared to their Eurozone counterparts. With the [rapid rollout](#) of the UK’s vaccination program and the easing of lockdown restrictions in 2021, the UK’s economy quickly recovered in Q2, with QoQ growth of [5.5%](#), a [23.6%](#) YoY improvement. A fast recovery prompted UK banks to reduce and even release provision expenses for loan losses (Figure 2b). The release of part of UK banks’ large credit provision expenses for loan losses became the main [factor](#) for the rebound in earnings. As shown in Figure 2b, the profit margins of UK banks have seen an uptrend from 2020 Q4 to 2021 Q2, in tandem with a decreasing trend in the percentage of provision expenses for loan losses to total loans.

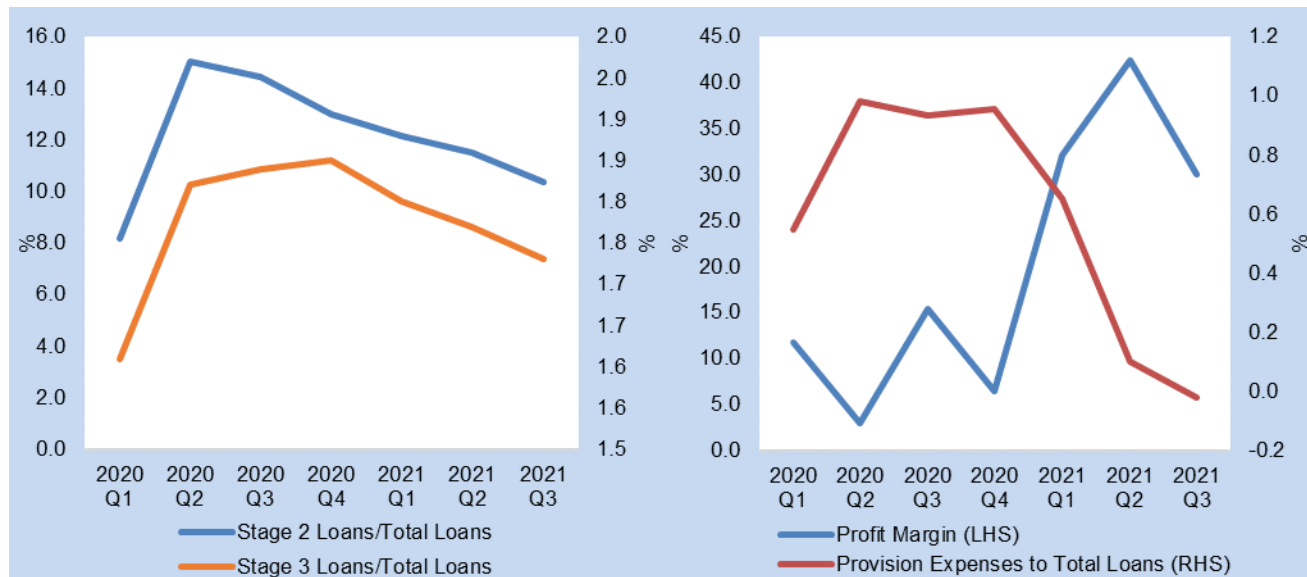


Figure 2a (LHS): Percent of Stage 2 Loans to Total Loans (primary axis) and Stage 3 Loans to Total Loans (secondary axis) from 2021 Q1 to 2021 Q3 for UK banks. Figure 2b (RHS): Profit Margin (primary axis) and Provision Expenses for Loan Losses to Total Loans (secondary axis) for UK banks. Source: Bank of England, Bloomberg

As the government started to wind down its pandemic-era support and other fiscal measures in H2 2021, economic recovery slowed down, with the economy experiencing a mere [0.1%](#) expansion in Oct-2021. Despite this, UK banks’ Agg PD largely remained below the levels of BBB Upper Bound in H2 2021 (Figure 1a) due to their well-capitalized structure. UK banks’ regulatory capital ratios were [strengthened](#) during the pandemic (See Table 1), aided by the expanded [IFRS 9 transitional arrangement](#), low risk-weight on government-guaranteed loans, as well as regulatory constraints on shareholder distributions. Even with the [lifting of restrictions](#) on distributions in Jul-2021, which saw banks responding by raising dividends and buybacks, UK banks’ CET1 continued to increase in Q3, demonstrating their strong capital sources.

	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3
<b>Total capital (%)</b>	20.4	21.3	21.7	21.6	21.3	21.6	21.8
<b>Tier1 (%)</b>	17.2	17.9	18.4	18.5	18.4	18.6	18.8
<b>CET1 (%)</b>	15.0	15.7	16.1	16.2	16.1	16.4	16.5

Table 1: Total capital, Tier 1 capital, and CET1 ratios (%) of UK banks from 2021 Q1 to 2021 Q3. Source: Bank of England

In Dec-2021, the BOE revised down its expectations for UK GDP for Q4 2021 by around [0.5%](#) and expects GDP growth to continue to slow down in Q1 2022. Meanwhile, inflation hit a 10-year high in Nov-2021 with the CPI rising to [5.1%](#) and is expected to peak at [6%](#) in Apr-2022. As concerns about rising inflation outweigh the uncertainty surrounding the economic impacts of the [rapidly spreading](#) Omicron variant, the BOE unexpectedly raised interest rates from 0.1% to [0.25%](#) in Dec-2021. The rise in interest rates, amidst a deterioration in economic outlook and rising inflation rates, threatens to worsen the asset quality of UK banks by raising borrowing costs and the risk of default for lenders, potentially worsening UK banks’ asset quality in the short term (See Figure 1b).

<sup>3</sup> For households, measures include the [Coronavirus Job Retention Scheme](#), the Financial Conduct Authority’s guidance for lenders to offer [temporary deferrals](#) of debt payments, and [mortgage market recommendations](#) by the Financial Policy Committee. For corporates, the [Coronavirus Business Interruption Loan Scheme](#) provides small and medium businesses loans of up to GBP 5mn, while the BOE’s [Covid Corporate Financing Facility](#) provides a quick and cost-effective way to raise working capital for large firms.

However, UK banks' credit risk stabilizes in the long term, with all eight major banks passing the Bank of England's latest [stress test](#), indicating that the sector is well-positioned to manage any severe deterioration in credit conditions. UK banks have [improved their capital positions](#) since the start of the pandemic (See Table 1) and are holding far more capital than required, allowing the BOE to re-introduce the [countercyclical capital buffer](#). By Dec-2022, banks will have to build up this buffer, worth 1% of all their loans, to guard against future shocks. This figure will rise to [2%](#) the following year, further enhancing their capital positions. As such, the Forward PD only slightly increases and is set to stabilize in the long term (See Figure 1b). Comparatively, Eurozone banks hold [lower Tier 1 Capital](#), with lower capabilities to absorb losses. Their [low profitability](#), with profit margin standing at 23.16%<sup>4</sup> at the end of Q3 2021, also poses a risk in credit quality, [especially](#) during a weakening economic environment due to Omicron variant uncertainty. On top of this, [structural challenges](#), such as low cost-efficiency, limited revenue diversification and compressed margins remain.

From a regulatory standpoint, ahead of Brexit and at the onset of the pandemic, UK banks had tightened their underwriting criteria, with the BOE stating that it [would not loosen standards](#) for mortgage lending any time soon. In contrast, as the EU housing markets expand rapidly, there is still [little indication](#) that Eurozone banks have tightened their lending standards in response. Additionally, the UK has adopted a relatively conservative interpretation of the EU's prudential rules, such as the [ring-fencing](#) of its retail banks, which has reduced systemic risks and improved resolvability. Higher pillar 2 capital requirements, countercyclical capital buffers, and the application of capital requirements at an entity level and a consolidated level, have also contributed to a generally [high level of capital adequacy](#) of UK banks as compared to Eurozone banks (Figure 1b).

With the [full effect](#) of Brexit in place in Jan-2021, financial regulators in the UK are planning for [regulatory reforms](#) to boost growth and international competitiveness in the financial sector, for example, by ensuring UK regulation is [more responsive](#) to international standards and structural changes in the industry such as the adoption of digital technologies. Although the uncertainties in economic outlook and rising inflation continue to threaten the credit profile of UK banks, they appear well-positioned to navigate through these economic challenges given their strong capital positions and [stricter regulations](#) which have ensured that banks' asset quality and capital positions remain strong to withstand deterioration in economic outlook.

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<sup>4</sup> Median profit margin of all Eurozone banks, data retrieved from Bloomberg.

## Credit News

### Asian junk bonds set for stronger 2022 after property turmoil

**Dec 17.** After a major selloff in Asian junk bonds driven by turmoil in the Chinese property market, the Asian high-yield market is likely to ease in 2022. According to JPMorgan Chase & Co, the market prices of Chinese junk property bonds implied a default rate of nearly 37%, which analysts deem to be overshoot. Analysts say that Asian high-yield bonds could return 12% by next year as opposed to a total return of -18% this year, with a majority likely coming from a rebound in bond prices. However, it could take some time before the Chinese property sector could fully recover, with the domino effect of defaults likely to be felt until the first quarter of next year before easing off. ([WSJ](#))

### Unigroup rescue plan opposed by chipmaker's co-owner

**Dec 17.** Unigroup was once at the forefront of China's chip industry, but after the investment failed to bear fruit, this technology group defaulted on debt. The administrator appointed by the court approved the Jianguang-Wise Road restructuring plan on Dec 10, which involves an injection of CNY 60bn from the strategic investors. However, the co-owners of China's Tsinghua Unigroup are fighting against their rescue plan. Beijing Jiankun Investment Group, which owns 49% of Unigroup, has objected to the restructuring plan, highlighting the potential outflow of state-owned assets if these two funds take over Unigroup as private investors ultimately own the entirety of Wise Road Capital and 49% of Beijing Jianguang AMC. Tsinghua Holdings, which holds the other 51% of Unigroup, defended the proposed deal. It criticized Jiankun's remarks as erroneous, unauthorized and containing "untrue information." Unigroup creditors are expected to make a final decision later this month. ([Nikkei Asia](#))

### Treasury yields rise after Fed signals turn to tighter monetary policy

**Dec 15.** After Fed announced its plan to tighter monetary policy, US government bond yields rose on Wednesday. Consistent with investors' expectations, the Fed will double its pace in winding down the pandemic bond-purchase program. Most officials also indicated that they would raise short-term interest rates at least three times next year. The bond market's reaction was mild, with investors selling both short- and long-term Treasuries but showing little surprise. The yield on 10-year Treasury note was 1.460% at the end of Wednesday, down from 1.437% Tuesday. The yield on the two-year note, usually more sensitive to monetary policy moves, increased to 0.683% from 0.657% the day before. Despite selling short-term Treasuries in expectation of rate hikes next year, investors have mostly continued to purchase longer-term bonds, believing the central bank will be unable to raise rates very high as the economy will slow and force the Fed to stop. ([WSJ](#))

### Global bond funds see biggest outflow since early April 2020 - Lipper

**Dec 17.** Investors pulled USD 6.91bn out of global bond funds in the week ended Dec 15 amidst concerns that major central banks would shift their monetary policy driven by surging inflation. The Fed has doubled the pace of tapering its monthly bond-purchases program and planned three rate hikes next year as the US CPI increased 6.8% in the 12 months through November. Furthermore, global government bond funds saw outflows of USD 809mn, investors sold USD 13.14bn of equity funds, global money market funds saw an outflow of USD 20.46bn, and commodity funds saw net selling of USD 498mn. Similarly, emerging market bond funds also saw outflows of USD 4.49bn, while equity funds witnessed USD 1.51bn of outflows. ([Reuters](#))

### Investors pour billions of dollars into inflation-linked assets

**Dec 15.** More than three-quarters of the countries have higher inflation rates in the third quarter of 2021 than in the same period in 2019, as supply chain bottlenecks, rising energy costs, heavy government spending, and strong consumer demand have contributed to rising global inflation in 2021. Therefore, investors are pouring into inflation-linked assets, betting that consumer prices will continue to soar even as the central bank is preparing to tighten monetary policy. For example, a record USD 66.8bn flowed into funds holding inflation-protected Treasury bonds this year. Meanwhile, "Real assets" such as commodities or property have received a second look from investors. Bets on rising energy costs have pushed the inflow of energy-

related equity funds to a record high this year. Real estate investment trusts have been popular in the US because they mainly generate income through rent, which tends to rise with inflation. ([FT](#))

**Kaisa group appoints financial adviser; shares to resume trading** ([Bloomberg](#))

**Investors bargain hunt in Evergrande bonds amid default** ([WSJ](#))

**Bond ETF inflows slump to lowest level since start of pandemic** ([FT](#))

### Regulatory Updates

#### **BOJ dials back pandemic funding as global central banks eye post-COVID era**

**Dec 9.** The Bank of Japan (BOJ) decided to slow purchases of corporate bonds and commercial paper to pre-pandemic levels from April, but also extended by six months a Mar-2022 deadline for its pandemic-relief loan scheme to ensure commercial banks keep channeling funds to small firms. Borrowing costs will remain low in Japan even as other central banks hike interest rates. In a week where other central banks signaled several rate hikes, the BOJ sounded strikingly dovish. Core consumer inflation just rose slightly, as firms remain cautious about passing on costs to consumers on concerns households may hold back on spending. As a result, Japan's inflation is around 0% and remains well below the 2% target, indicating that BOJ will maintain massive monetary stimulus. Therefore, the BOJ will ease monetary policy much longer than its major counterparts. ([Reuters](#))

#### **Hawkish Fed, dovish PBOC diverge in new phase of pandemic policy**

**Dec 20.** The Fed is preparing to raise interest rates from near zero to fight record inflation levels in 20 years, while the People's Bank of China (PBOC) lowered borrowing costs for the first time in 20 months on Monday, potentially causing the growth of the two economies to converge. One immediate implication of the policy divergence would be the depreciation of the yuan relative to the dollar, as less capital is likely to flow into China. Chinese authorities have begun tapering stimulus on the property market this year, which triggered defaults and slowed down economic growth, but growth is expected to stabilize next year amidst recovering demand. In contrast, the growth of the US economy is projected to slow next year as the Fed ends its asset-purchase program and carry through its three planned rate hikes next year. ([Bloomberg](#))

**ECB to act if upside inflation risks materialize, Holzmann says** ([Bloomberg](#))

**Turkey's Erdogan pledges more rate cuts, triggering Lira losses** ([Bloomberg](#))