Appendix B

Update on UK Sovereign Rating

The recent downgrade of the UK sovereign rating by Moody's from Aa2 to Aa3 came as no surprise considering that the rating was put on Negative Outlook last November. Back then, the agency emphasised two core reasons for this view: the weakening of the UK institutions (governmental, rather than financial) and anticipation that the economic and fiscal strength would be dimmer and more vulnerable to shocks than the agency previously assumed. Moody's also noted it was likely to downgrade the rating if policy makers failed to develop a credible debt reduction strategy.

The agency's decision to downgrade the UK rating on 16th October was driven by a reduction in the UK's economic strength, weakening of the country's fiscal capacity and a further erosion of the UK's institutions and governance. On the flip side, the UK's rating is now on Stable Outlook as, in Moody's view, "the upside and downside risks are balanced, at least over the coming 12-18 months. The UK's intrinsic economic and institutional strengths, as well as the likely level where debt will stabilise, compare well to peers at the Aa3 rating level".

Subsequently, Moody's took a decision to downgrade the long-term ratings of six large UK banks. This is something that was anticipated as most of the UK banks rated by Moody's were on Negative Outlook at the time. In addition, the agency had also previously highlighted that one trigger for a potential downgrade of these banks' ratings was a change in the sovereign rating. It is important to stress that these changes were solely because of the action on the UK sovereign rating, NOT a reflection of deteriorating conditions at the banks themselves. The reason why only some banks were affected is that not all UK institutions benefit from the uplift for government support in their long-term ratings – i.e. there was no direct linkage between the sovereign and bank ratings. As part of the rating action, the long-term ratings of these banks were placed on Stable Outlook, balancing the risk that banks' credit strength declines on the back of the current economic events, with the potential notch of government support that Moody's could assign should the long-term ratings of these banks fall further.

It is also worth noting that on 23rd October S&P Global Ratings affirmed the sovereign rating on the UK and left the rating on Stable Outlook. The agency said in its report that the rating "could come under downward pressure if the economic recovery is significantly weaker than they anticipate, making fiscal consolidation more challenging. Ratings downside could also emerge if foreign financing for the UK's large external deficit diminishes and sterling's status as a reserve currency comes under pressure".

Appendix B

Looking at the UK banking sector and noting that this is where most local authorities have exposure to, it is important to be mindful of certain negative scenarios that could unfold in the coming months and quarters. This is to ensure that treasury investment strategies remain both risk averse and flexible to accommodate these scenarios. UK banks have several credit strengths such as strong levels of capitalisation and stable funding channels, combined with robust liquidity. They also operate under an enhanced regulatory framework which has been subject to a material test over the last six months. At the same time, UK banks and building societies face a range of challenges to their profitability and likely asset quality deterioration because of the COVID 19 pandemic-induced shock.

Over the next 12-18 months, further rating downgrades of the UK banks and building societies by the three main rating agencies of the UK banks cannot be discounted. After all, where rated by Fitch, they are all on Negative Outlook, and many of them have Negative Outlooks assigned to their long-term ratings by the other two agencies. If changes do occur, then these could potentially have an impact not only in relation to our suggested durations but could limit investment options, including monetary limits, dependent on individual client strategies.

Whilst some indicators point to benign credit conditions, the key advice from us is not to be complacent. Frequent credit analysis and active monitoring of credit factors should remain a priority as credit risks remain volatile. This includes a possibility of a stumbling economic recovery, Brexit (deal or no deal) a dramatic re-widening of credit spreads and no notable deceleration in debt growth after this year. All, or just some of these could lead to more insolvencies and defaults than are currently being projected by banks and rating agencies alike. To date, the bulk of bank earnings' reports has been focussed on provisions being built up to offset future expected credit losses. However, details on actual credit losses are limited, and these may yet take many years to fully emerge. In addition, as Fitch Ratings noted recently, it will also take some time for banks' underlying asset quality to become clear given the extent of governments' and central banks' support for markets since March this year.

While the extent of rating changes has been somewhat limited, for both UK financial institutions and those overseas, this does not mean that they will not occur. Investors need to remain aware and prepare for a range of different potential scenarios, both good and bad. At a time when clients will be looking ahead to preparing their 2021/22 TMSS, we believe it is important that considerations of different outcomes should be factored into thinking – simply restating / rolling over credit criteria that has been used in the past may not be the most appropriate approach.

Appendix B

Source: City Watch October 2020 - Link Asset Services

This page is intentionally left blank