Rating Action: Moody's downgrades the UK's ratings to Aa3, outlook stable

16 Oct 2020

Paris, October 16, 2020 -- Moody's Investors Service ("Moodys") has today downgraded the government of the United Kingdom's long-term issuer and senior unsecured ratings to Aa3 from Aa2. Concurrently, the outlook has changed to stable from negative.

Moody's has also downgraded the Bank of England's long-term issuer and senior unsecured bond ratings to Aa3 (from Aa2) and (P)Aa3 (from (P)Aa2) for the senior unsecured MTN programme. The P-1 short-term issuer rating is affirmed. The outlook on these ratings has also changed to stable from negative.

The three key drivers for this action are closely related and mutually reinforcing.

First, the UK's economic strength has diminished since we downgraded the rating to Aa2 in September 2017. Growth has been meaningfully weaker than expected and is likely to remain so in the future. Negative long-term structural dynamics have been exacerbated by the decision to leave the EU and by the UK's subsequent inability to reach a trade deal with the EU that meaningfully replicates the benefits of EU membership. Growth will also be damaged by the scarring that is likely to be the legacy of the coronavirus pandemic, which has severely impacted the UK economy.

Second, the UK's fiscal strength has eroded. General government debt, already high and sticky prior to the crisis, has risen further as a result of the pandemic. While the UK's reserve currency status provides a high capacity to carry debt, the material increase in debt poses risks to debt affordability in future years, particularly in the absence of a clear plan to reduce government indebtedness. Notwithstanding recent statements of intent by the government, it is in Moody's view unlikely that the government will be able meaningfully to rebuild the UK's fiscal strength in the coming years given the low growth environment and the likely political obstacles to doing so.

The third driver relates to the weakening in the UK's institutions and governance that Moody's has observed in recent years, which underlies the previous two drivers. While still high, the quality of the UK's legislative and executive institutions has diminished in recent years. Policymaking, particularly with respect to fiscal policy, has become less predictable and effective. Looking forward, the self-reinforcing combination of low potential growth and high debt in a fractious policy environment will create additional headwinds to addressing the economic, fiscal and social challenges that the UK faces.

The stable outlook reflects the UK's intrinsic economic and institutional strengths as well as Moody's expectations that the debt will stabilise at its current level.

The foreign and local currency bond ceilings and the local-currency deposit ceiling remain unchanged at Aaa. The foreign-currency long-term deposit ceiling has been lowered to Aa3 from Aa2, and the short-term foreign-currency bond and bank deposit country ceilings remain at P-1.

Please click on this link https://www.moodys.com/viewresearchdoc.aspx?docid=PBC_ARFTL434583 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and identifies each affected issuer.

RATINGS RATIONALE

RATIONALE FOR DOWNGRADE TO Aa3 FROM Aa2

FIRST DRIVER: ECONOMIC GROWTH IS LIKELY TO BE MEANINGFULLY WEAKER GOING FORWARD THAN ASSUMED IN THE Aa2 RATING

The first driver of Moody's decision to downgrade the UK's government bond rating to Aa3 is the rating agency's view that economic growth will remain meaningfully weaker going forward than was expected when the rating was downgraded to Aa2 in September 2017, presenting an obstacle to a material reversal in the UK's debt burden. Even before the coronavirus-induced shock, a combination of persistently low productivity growth since the global financial crisis, tepid business investment since the June 2016 EU referendum, and prolonged uncertainty over the eventual future trading relationship with the EU were weighing on the UK's growth performance. Even if there is a trade deal between the UK and EU by the end of 2020, it will likely be narrow in scope and therefore the UK's exit from the EU will, in Moody's view, continue to put downward pressure on private investment and economic growth.

The coronavirus-induced shock has brought new and considerable pressures on the UK economy. Despite the projected recovery, we estimate a sharper peak-to-trough contraction for the UK than for any other G-20 economy because of the relatively greater severity of the coronavirus outbreak, the reliance of the UK economy on service activities which involve greater levels of human interaction, and the continued risk of further outbreaks and localized restrictions. Moody's forecasts also reflect the view that lingering Brexit uncertainty will hold back the recovery in the second half of the year. The structural impact of the coronavirus-induced shock will be uncertain for some time, but in view of the impact on investment and the labour market to-date, some permanent scarring on the economy appears likely.

SECOND DRIVER: DETERIORATION IN THE UK'S FISCAL STRENGTH WILL BE CHALLENGING TO UNWIND, POSING RISKS TO DEBT AFFORDABILITY

The second driver of the downgrade is Moody's expectation that the UK's public finances will remain weaker going forward than we expected when we downgraded the rating to Aa2 in September 2017. That reflects not just the significant increase in government debt related to the coronavirus-induced shock, but the more expansionary fiscal policy stance underway even before the pandemic. Spending pressures and Brexit uncertainty present additional risks to fiscal outcomes.

One mitigant is high debt affordability; despite the much higher issuance of government debt, the UK's funding environment and interest costs are likely to remain benign. Moody's base case is that interest rates will remain low for longer. That said, the UK's debt affordability is not immune to shocks and the structure of the UK's debt stock is less robust to increases in funding costs than it once was due to the issuance of an unusually large proportion of short-dated gilts.

Moody's expectation is that the broad deterioration in the UK's fiscal position will not be rapidly reversed. Relative to peers, the UK's fiscal policy effectiveness and the predictability and cohesion of policymaking have weakened, reducing the likelihood that the fiscal loosening stemming from the pandemic will be corrected in a timely manner. Spending pressures are unusually large and -- importantly - predate the coronavirus-induced shock. The government is running out of space to cut spending in areas of discretionary spending that are not protected. This implies that the government will have limited ability to cut in areas that are not ring-fenced without instituting some revenue-raising measures or coming up against some very significant political obstacles. Higher expenditure could be financed through higher taxation, though the timing and magnitude of any such changes will difficult to manage given that they will likely balance the need for fiscal consolidation against an equally important desire to not choke off a nascent economic recovery.

THIRD DRIVER: WEAKER INSTITUTIONS UNDERLY BOTH OF THE AFOREMENTIONED TRENDS

The third factor informing today's rating action is Moody's view that the UK's weakened institutional policy effectiveness, an element that the rating agency considers a governance factor under its ESG framework, makes these credit challenges more difficult to tackle.

This reduced institutional capacity to manage change in a predictable and confidence-building manner is evident with respect to the UK's approach to Brexit, in its inability to achieve an outcome which meaningfully replicates the benefits of EU membership and in its approach to implementing the agreement reached with the EU to date. However, the erosion in the predictability of policymaking and respect for rules and norms is perhaps most clearly reflected in the conduct of fiscal policy. Some fiscal institutions, such as the Office for Budget Responsibility, remain very strong relative to global peers. However, the UK's broad fiscal framework, characterized by features such as multi-year budget plans and more detailed revenue and spending decisions announced for the outer years of the planning period, has weakened. This deterioration in the quality of institutions has made policy planning more unpredictable.

The UK effectively has no fiscal policy anchor. Before the pandemic, Moody's saw an increasing willingness to move the goalposts, with changes to the longer-term fiscal anchor and the definition of fiscal targets and a revealed preference to shift the fiscal tightening to outer years of a five-year horizon. While the economic and public health uncertainties are undeniable at the current juncture, there is no indication that this trend—which has transcended electoral cycles—is likely to reverse.

RATIONALE FOR STABLE OUTLOOK

The stable outlook reflects Moody's view that 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 stabilize, compare well to peers at the Aa3 rating level.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE CONSIDERATIONS

Moody's takes account of the impact of environmental (E), social (S), and governance (G) factors when assessing sovereign issuers' economic, institutional, and fiscal strength and their susceptibility to event risk. In the case of the UK, the materiality of ESG to the credit profile is as follows.

Environmental considerations are not currently material to the rating.

Social factors are material in determining the UK's credit profile. The most relevant social factors relate to spending pressures on healthcare and pensions due to an ageing population. Over the longer term, demographic pressures will (as in many peers) negatively influence potential growth in the absence of increases in productivity, in participation rates or in immigration. Moody's also regard the coronavirus outbreak as a social risk under our ESG framework, which will have a significant negative impact on the UK's growth and fiscal metrics.

Governance factors are a material driver of the rating. On a global basis, the UK's governance institutions are strong, supporting the Aa3 rating for now. However, the deterioration observed in recent years is a key driver for the rating downgrade.

GDP per capita (PPP basis, US$): 48,727 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 1.3% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.3% (2019 Actual)

Gen. Gov. Financial Balance/GDP: -2.1% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -4.3% (2019 Actual) (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: a1

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 13 October 2020, a rating committee was called to discuss the rating of the United Kingdom, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially decreased. The issuer's institutions and governance strength, have materially decreased. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer's susceptibility to event risks has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

The UK's outlook, and ultimately its rating could improve if there were indications that the apparent erosion in institutional strength is reversing. In particular, indications that British institutions are reverting to the capability and predictability that has traditionally characterised the UK's institutional framework would be positive. Such an outcome would most likely be characterised by the development of a credible strategy to achieve medium-term fiscal objectives that rebuild the UK's fiscal strength. Passage of economic policies that could sustainably boost growth potential would also be credit positive.

The UK's rating would likely come under downward pressure if Moody's were to conclude that the UK's fiscal strength was likely to deteriorate due to growth pressures, higher-than-expected deficits, or higher funding costs. A further structural weakening in economic fundamentals would also undermine the UK's credit profile. While it is unlikely at this stage, indications that sterling's status as a reserve currency was in question would also exert downward pressure on the outlook and eventually the rating.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 .

Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

The List of Affected Credit Ratings announced here are a mix of solicited and unsolicited credit ratings. Additionally, the List of Affected Credit Ratings includes additional disclosures that vary with regard to some of the ratings. Please click on this link https://www.moodys.com/viewresearchdoc.aspx?docid=PBC_ARFTL434583 for the List of Affected Credit Ratings. This list is an integral part of this Press Release and provides, for each of the credit ratings covered, Moody's disclosures on the following items:

• Rating Solicitation

• Issuer Participation

• Participation: Access to Management

• Participation: Access to Internal Documents

• Disclosure to Rated Entity

• Endorsement

• Lead Analyst

• Releasing Office

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

For ratings issued on a program, series, category/class of debt or security this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series, category/class of debt, security or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this credit rating action, and whose ratings may change as a result of this credit rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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Sarah Carlson, CFA
Senior Vice President
Sovereign Risk Group
Moody's France SAS
96 Boulevard Haussmann
Paris 75008
France
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Yves Lemay
MD-Sovereign/Sub Sovereign
Sovereign Risk Group
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Releasing Office:
Moody's France SAS
96 Boulevard Haussmann
Paris 75008
France
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

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