

What does S&P's re-classification of the UK banking system mean?

A report last week from ratings agency Standard & Poor's (S&P) provided some further detail around its decision last December to move UK banks down in its classification system. S&P's statement that the UK was 'no longer amongst the most stable and low-risk banking systems' led to some eye-catching headlines, but the muted market reaction reflected the fact that the agency's assessment was old news. Sterling did fall after the report, but only by around one cent against both the dollar and the euro.

Much of the detail of the report was probably already discounted by investors. S&P classifies national banking systems into 10 categories from Group 1 (strongest) to Group 10 (weakest). The announcement that the UK was being demoted to Group 3 from Group 2 had already been made on 21 December 2009, using the same language that the UK was no longer 'among the most stable and low-risk banking systems globally.' On the same day S&P also re-classified the US banking system to Group 3 from Group 2.

report issued on the reasons for the UK demotion. S&P noted the relatively high leverage in the UK economy, particularly in households and in the property and construction sectors, which would lead to 'an elevated rate of loan losses for the next two years.' In addition, S&P felt that deleveraging would weigh on the growth prospects for the UK, leading to 'weak-to-moderate earnings for banks.'

Given that regulatory change in the UK banking system is ongoing, S&P also said it could raise its BICRA classification for UK banks if further changes rendered the industry 'less prone to excessive credit expansion and more resilient to economic shocks.' Conversely, the ranking could be lowered further, S&P warned, 'if the UK economy fails to strengthen due to persistent budget deficits and continued imbalances.'

In summary, the re-classification was effectively a statement of what we already know - the UK banking system has been through a tremendous shock that will impair profitability for some years, but could over time lead to a more stable banking environment with the right regulatory changes. Indeed, on a more positive note, S&P also said it had a high opinion of the infrastructure, IT capabilities and robust payment systems of UK banks. The demotion could also be a warning shot from S&P in an attempt to influence UK banking regulatory reform.

Still, the alarming headlines greeting the S&P announcement did highlight important questions in investors' minds about the rating agencies' view of the UK economy. In particular, there has been considerable discussion in recent months about the potential for UK government debt to lose its top-quality AAA rating, and what this would mean for sterling and UK bond markets. We will examine this issue in a separate daily next week.

Top 5 S&P BICRA* Groups

Group 1	Group 2	Group 3	Group 4	Group 5
Australia	Belgium	Austria	Czech Rep.	Bahrain
Canada	Denmark	Chile	Greece	Brazil
Finland	Germany	Ireland	Israel	Kuwait
France	Hong Kong	Portugal	Korea	Malta
NethInds.	Italy	Saudi Arabia	Malaysia	Oman
Sweden	Japan	UK	Mexico	Poland
Switz.	Luxemb.	US	Qatar	S. Africa
	NZ		Slovak Rep.	
	Norway		Slovenia	
	Singapore		Taiwan	
	Spain		UAE	

Source: S&P *Banking Industry Country Risk Assessment (BICRA)

Last week's announcement was simply confirmation of the December decision, with a more detailed

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