S&P Global Ratings

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Countdown to Brexit: No Deal Moving Into Sight

October 30, 2018

Key Takeaways

The risk of a no-deal Brexit on March 30, 2019, while still not our base case, has increased sufficiently to become a relevant rating consideration. Our view reflects the inability thus far of the U.K. and EU to reach agreement on the Northern Irish border issue, the critical outstanding component of the proposed Withdrawal Treaty.

Economics: A no-deal Brexit could push the U.K. economy into a moderate recession and lower the economy's long-term growth potential. Most of the economic loss of about 5.5% GDP over three years compared to our base case would likely be permanent.

Sovereign: Our economic, fiscal and debt, and external assessments would come under pressure in the event of no-deal and the U.K. sovereign ratings are likely to be lowered.

Corporate: Contingency plans are unlikely to insulate companies fully from market volatility, legal and regulatory uncertainty, border delays, rising input costs and tariffs, and weakening competitiveness and operating performance in many sectors. In real estate, London office prices could fall by 20% over two-to-three years, and result in negative rating pressure for severely affected issuers.

Financial institutions: U.K. banks will likely be the most vulnerable banks in a no-deal Brexit, but even severe macroeconomic weakness leading to rising corporate insolvencies and weaker collateral values would only play through to bank asset quality and undermine bank earnings and capital over time.

Structured finance: Potential operational and counterparty risks from a no-deal Brexit may be significantly higher than the credit risk of the securitized assets if counterparties can no longer perform on existing contractual arrangements, in particular if this leads to the termination of derivative agreements.

Insurance: While insurers have been planning for post-Brexit business continuity, negative rating pressure would likely result from any downward revision to the U.K. sovereign rating, economic downturn, financial market volatility, or material operational challenges.

U.K. public sector: About half of social housing providers would likely suffer negative rating pressure if real estate prices declined consistent with our no-deal Brexit scenario.

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Key Figures From The No-Deal Brexit Scenario

GDP	Unemployment	Households lose	Inflation peaks at	House prices down
5.5%	**7.4%**	**£2,700**	**4.7%**	**10%**
below our baseline forecast by 2021	by 2021	in income per year 2019-2021	in mid-2019	by 2020

When it voted to leave the EU in the June 2016 referendum, the United Kingdom decided against "business as usual" with the EU. As a result, the U.K.'s business model will change, but at this point, it is still uncertain when this change will happen and how significant it will be.

Our base-case economic forecasts assume that the U.K. and the EU will agree and ratify a Brexit deal, leading to a transition phase lasting through 2020, followed by a Free Trade Agreement (FTA). But given our increasing doubts that the U.K. and EU will agree to the terms of a Withdrawal Treaty required to facilitate a 21-month status-quo transition, we see an increasing risk that the U.K. will secede from the EU and, importantly, the EU single market, without any deal at the end of March 2019 (for further details see "Credit Conditions EMEA: Looking Over The Edge On Trade And Brexit," published Sept. 27, 2018, on RatingsDirect). This would constitute an abrupt and very significant change to the U.K.'s business model overnight, although policy measures might soften the short-term blow to the U.K. economy.

In a no-deal Brexit, the U.K. would become a third country from the EU's perspective, reverting to World Trade Organization (WTO) rules for goods trade not only with the EU, but also with third countries currently covered by EU Free Trade Agreements (FTA), such as Canada, together affecting around 65% of U.K. goods exports. A no-deal Brexit would also mean a lapse of EU regulatory recognition of U.K. rules in many areas, including financial services. Even U.K.-issued credit ratings might not be usable in the EU absent a deal. The U.K. might also be required to create regulatory supervisory procedures to substitute for those currently conducted by the EU.

This report analyzes various economic and credit-related implications of such a no-deal Brexit scenario for entities we rate in various sectors from a U.K. perspective, even though we would expect also some negative, albeit lesser, impact for other exposed EU economies and companies.

What No Deal Could Mean To The U.K. Economy

Primary contacts: Sylvain Broyer, Boris Glass

Key Takeaways

- A no-deal Brexit could push the U.K. economy into a moderate recession, representing a cumulative loss of about 5.5% GDP compared with our baseline forecast over 2020-2021. Although severe, this projected loss is still only about 60% of that caused by the 2008 financial crisis.
- The U.K.'s direct loss of trade globally could amount to 1.9% of U.K. GDP over the scenario horizon.
- Regulatory and infrastructure challenges, lack of investment, trade bottlenecks, and lower immigration would push down the U.K. economy's long-term growth potential.
- As a result, we believe it likely that the U.K. economy would have limited scope to emerge from this moderate recession and regain pre-Brexit output levels over the next three years.

Table 1

U.K. Economic Indicators In The No-Deal Scenario Versus Our Base-Case Forecast

	No-deal scenario			Base-case forecast			
	2019	2020	2021	2018	2019	2020	2021
GDP (% year)	-1.2	-1.5	1.2	1.3	1.3	1.5	1.2
Unemployment rate	4.8	7.1	7.4	4.1	4.3	4.5	4.6
CPI (% year)	3.6	2.1	2.2	2.4	1.9	1.7	2.6
USD per GBP	1.18	1.31	1.32	1.34	1.35	1.46	1.47
BoE policy rate	0.21	0.00	0.00	0.60	0.84	1.31	1.59
House prices (% year)*	-6.2	-3.3	3.8	0.0	2.5	3.5	4.5
Share prices (% year)	-13.1	6.4	8.9	-	-	-	-
Expenditure components (% year)							
Private consumption	-1.8	-2.7	1.4	1.1	1.1	1.4	1.2
Government consumption	3.3	0.4	-0.1	1.2	0.8	0.9	1.2
Fixed investment	-1.4	-2.5	2.5	0.8	2.1	3.6	3.1
Exports	-3.3	0.4	2.1	-0.1	2.7	2.6	1.9
Imports	-1.9	-1.9	2.5	0.2	2.6	2.9	2.7

Note: Oxford Economics' Global Economic Model was used as part of the scenario exercise.*House price inflation is reported year on year for the fourth quarter in each year. Sources: Oxford Economics, Office for National Statistics, Bank of England, S&P Global Economics & Research.

In our no-deal scenario, the U.K. would experience a moderate recession lasting four to five quarters, with GDP contracting by a cumulative 2.7% over two years, after which the economy would return to growth, although the pace of growth would be moderate. By 2021, economic output would still be 5.5% less than what would have been achieved had a deal been struck and a transition occurred. Unemployment would rise from current all-time lows of 4% to above 7% by 2020 (a rate last seen in the aftermath of the financial crisis). House prices would likely fall by 10% over two years.

How A No-Deal Brexit Could Unfold

In our scenario, the short-term impact would start with a fall in share prices, a rise in corporate borrowing costs, and a further substantive weakening of sterling in the first quarter of 2019, even before the end of March 2019 as markets start to discount a no-deal Brexit. Significant disruption and further market volatility could then ensue, following the no-deal Brexit. In a set of technical notes, the U.K. government has identified key stress points, including transport, customs, financial and insurance contracts, and medicine supply. However, the economic consequences of these disruptions is uncertain. These consequences will also depend in part on the effectiveness of preventative measures taken by the U.K. and EU. We expect both the U.K. and the EU will try to limit disruption, at least in critical areas, such as customs and transportation. We do, however consider it almost certain that most goods shipments would be delayed. This would in particular affect U.K. sectors with supply chains that are heavily integrated with the EU.

Moreover, in a no-deal Brexit the U.K.'s financial sector would immediately lose financial passporting rights, which we estimate would directly cost the U.K. economy, without considering second- and third-round effects, about 0.4% of GDP per year. These direct costs are relatively moderate, partly because financial institutions have already been preparing for this case (see "Countdown To Brexit: Financial Institutions Are Past The Point Of No Return," published Oct. 11, 2018). The most immediate concern for the financial sector would be the serviceability of certain derivatives and insurance contracts. If required, the Bank of England (BoE) and the European Central Bank (ECB) would likely also introduce measures to mitigate financial stability risks.

Given our expectation that sterling will depreciate by 15% initially and that WTO import tariffs will apply to imports from the EU and countries covered by EU FTAs, inflation would likely rise: we see it peaking at 4.7% in mid-2019. Similarly, the EU would impose tariffs. As a result, goods exports from the U.K. could be an estimated 1.9% of U.K. GDP less than in our baseline forecast, although the weaker sterling exchange rate would offset the impact somewhat by making U.K. goods cheaper to import abroad.

We also expect that the BoE would likely see through temporarily higher inflation by cutting its policy rate to zero. It might not be necessary to relaunch a full-fledged quantitative easing (QE) program, in our view. The share of foreign investors in U.K. Gilts (treasury securities) is relatively low (28%) and, more importantly, it has not declined following the referendum. U.K. sovereign debt also has much longer average maturity than that of many peer countries. Rather than a full QE we believe the BoE might deploy a form of QE that specifically targets corporate bonds. As businesses adapt to the new and weaker business environment, many would need to cut costs, including by letting workers go. We expect that the U.K.'s unemployment rate could rise to above 7% by early 2020. The weaker business environment will also likely mean weaker wage growth and, along with higher inflation, real wages could fall for at least a two-year period, weighing substantially on consumer spending. We estimate that household income could decline by £2,700 per year on average over 2019-2021. Declining household spending and weaker demand would also, by 2021, lead to significant house price declines, ending up 15% below the levels that we expect in our base-case forecasts. We expect a moderate decline in fixed investment spending as the government would need, in our view, to increase its own investment spending to cope with a no-deal Brexit. Businesses will also need to spend on Brexit-related investment. Public sector recruitment levels would also likely need to rise, which would offset some decline in household incomes.

Regarding the assumption of certain regulatory responsibilities by the U.K. authorities, we expect that these authorities' capabilities and efficiencies will develop over time. We expect that certain physical and digital infrastructure will need to be developed rapidly to cope with the new post-Brexit reality. Some of the current supply chains would likely be impaired and require reorganization. These factors, in conjunction with lower net immigration and contraction of investment spending, would translate not only into lower economic potential of the U.K. economy, but also lower trend growth. This latter feature is important, as it is key in determining how much and how quickly the economy might be able to recover from a no-deal Brexit. In our scenario, we project that the effects of a no-deal Brexit will likely extend at least to our three-year forecast horizon. Incidentally, a slowdown in trend growth was a key reason why the U.K. economy was thrown onto a lower growth trajectory following the global financial crisis: the impairment of the financial system, which is a crucial part of market infrastructure, had negatively affected the economy's operating capacity.

An Overview Of Our No-Deal Assumptions

Lack of political agreement: We assume that the U.K. and EU are unable to agree the terms of, or achieve parliamentary ratification of, a Withdrawal Agreement before the Article 50 period ends on March 29, 2019, so that the U.K. leaves the EU at 12pm CET March 29, 2019. Moreover, we assume there won't be any substitute deal until the end of our forecast horizon in 2021.

Tariffs: U.K. external goods trade reverts to WTO most-favored nation rules, not just with the EU but also with third parties currently covered by EU FTAs, altogether affecting around 65% of U.K. goods exports. Corresponding tariffs are introduced. The loss of single-market access also creates some new non-tariff barriers to trade. Total costs of importing from the U.K. into the EU would increase by 7.5%; from the EU into the U.K. by 8.8%; U.K. imports from the rest of the world by 5.3% (including non-tariff barriers to former FTA partners). Differences in the rates are due to differences in the goods mix.

Financial services: U.K. financial services would lose rights to "passport" into the EU immediately, rather than only in 2021, as in our base case. Accounting for substantial rebooking of revenues and profits to the U.K., we estimate the direct loss would amount to 0.4% of GDP per year.

Exchange rates: We assume that sterling would depreciate by around 15% in the first year compared to the baseline, with a small recovery thereafter.

Fiscal: Our scenario does not assume any explicit fiscal stimulus. However, we assume both government consumption and investment will increase. This higher spending softens the impact on the economy cumulatively by about 0.7% over 2019-2020.

Corporate financing: Corporate borrowing spreads over sovereign bonds increase by 130 basis points before gradually falling. Despite the BoE cutting policy rates to zero, sovereign bond yields stay approximately the same as in our baseline forecast.

An Overview Of Our No-Deal Assumptions (cont'd)

Immigration: Total net immigration falls to 150,000 a year, about half the number the U.K. has seen in the past few years. This would be due to tighter rules on immigration from the EU, but also to the weakness of the U.K. economy, exchange rate depreciation, and an improving economic environment in origin countries that makes the U.K. less attractive for immigration.

Potential output and growth: To the extent that a no-deal Brexit, especially the loss of single-market access, implies an abrupt change to the U.K.'s business model, potential growth suffers. This comes from a mix of factors: diminished regulatory efficiency, both IT and physical infrastructure challenges (customs, VAT), as well as supply-chain interruption and loss.

Weaker Sterling Unlikely To Offset The Negative Impact Of Tariffs On Trade

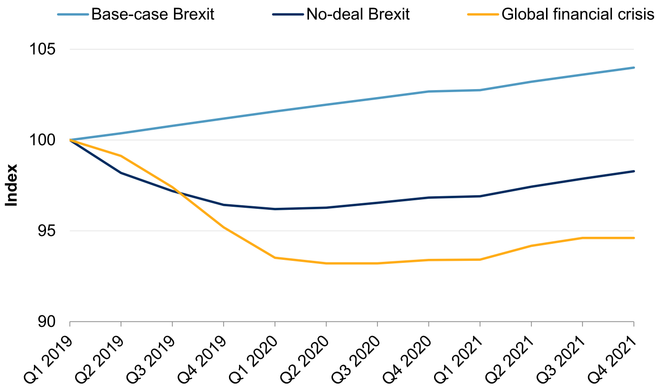
Far from offsetting the negative impact, the weaker currency would only mitigate the impact somewhat. First, in addition to tariffs, U.K. exporters and EU importers would face non-tariff barriers (for example, U.K. exporters proving at the border that the goods were indeed produced in the U.K.). This would make importing from the U.K. more cumbersome and costly. More importantly, the effect of a weaker pound would in many cases wash out, as the U.K. uses many inputs to manufacture goods for export and those inputs would become more costly and will have to be paid for with a weaker pound. Overall, little help could be expected from the weaker currency, and the economy would end up worse off as a result. This is illustrated by the U.K.'s export performance since the Brexit referendum in June 2016, when the pound depreciated by around 18% and similar mechanisms were at work. Despite the substantial depreciation, the share of GDP growth due to net exports hardly improved, and some of the small improvement reflected a coinciding revival in external demand.

How A No-Deal Brexit Scenario Compares With The Financial Crisis

Unlike the 2008 financial crisis, the consequences of which were felt globally, the impact of the no-deal Brexit scenario is concentrated in the U.K. While global asset prices may move somewhat, and while there may be a very moderate slowdown in the EU, the external environment should remain broadly supportive. We find, however, that the U.K.'s external trade would nevertheless suffer. Under our scenario, the impact of a no-deal Brexit on GDP is about 60% as severe as in the financial crisis (see chart 1). One feature common to both crises over the same horizon is that there is no strong catch-up to pre-crisis levels. Shocks like these are of a more lasting nature.

Chart 1

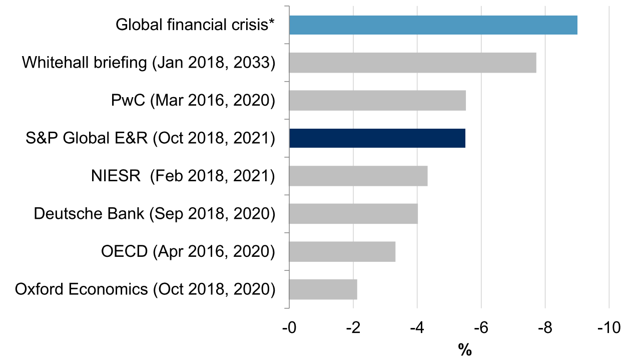
A No-Deal Brexit Would Be 60% As Damaging To The U.K. Economy As The Global Financial Crisis



Note: GDP rebased to 100 in quarter prior to first contraction. GDP index has been transformed for the global financial crisis so that is consistent and can be compared with our baseline forecast. Sources: ONS, S&P Global Economics & Research.

Chart 2

No-Deal Brexit Scenario Studies Compared
Cumulative GDP decline versus baseline



Note: The first date in brackets shows the publication date, the second is the end of the scenario horizon. Units are in % deviation from baseline or cumulative % difference of GDP growth. *Imputed. E&R--Economic & Research. NIESR--National Institute of Economic and Social Research. Source: S&P Global Economics & Research.

Scenario Caveats

While we have confidence in our assumptions, our no-deal Brexit scenario still comes with more caveats than normal because of its complexity and the number of its variables. These variables include the effectiveness of the U.K.'s and the EU's safeguarding measures against initial post-Brexit economic disruption, the nature and extent of fiscal responses, and market sentiment. Of course, study outcomes differ according to the assumptions made and the approaches taken (see chart 2).

In determining the scenario outcomes, we also assume some initial trade disruptions, which ripple through the economy but these are not substantial enough to significantly alter scenario numbers for the first year as a whole. This is helped by both the U.K. and EU putting at least some safeguarding measures in place. More severe or longer-lasting disruption, or the absence of safeguarding measures, would make the impact considerably worse.

Moreover, our analysis is based upon the current structure of the U.K. economy. We account for changes to the U.K.'s business model via assumptions on key drivers of potential growth and output, but not in terms of the sectoral set-up. Should the economy be able to adjust more quickly to the loss of single-market access, we could see more of a recovery towards the end of our horizon. Finally, even though our scenario does not see much of a catch-up in 2021, this does not mean there will not by any catch-up at all in the subsequent year, although we would not expect it to advance at a rapid pace.

Frequently Asked Questions On A No-Deal Brexit

In the context of our views on the possible consequences of a no-deal Brexit, we now answer some of the common credit and rating-related questions our ratings practices have received.

Contract Continuity: A Cross-Sector Issue

Primary contacts: Matthew Mitchell, Dennis Sugrue

If issuers are not able to perform their contracts because of a no-deal Brexit, what would this do to their ratings?

We understand that contracts entered into between U.K. and EU counterparties pre-Brexit will generally remain performable in a no-deal scenario. However, we also understand that counterparties performing regulated activities in the insurance, banking, and derivative sectors, might, in a no-deal scenario, lack authorization to continue performing those activities on a cross-border basis.

The U.K. has proposed legislation that would allow EU counterparties to perform activities in the U.K. However, while the sentiment from the EU has recently shifted towards establishing a temporary solution for recognition of clearing houses, legislation is yet to be proposed and it remains unclear whether insurance activities, uncleared derivatives, or any other regulated activity, would be included in any temporary solution.

Without a deal or similar temporary legislation or permission from the EU addressing performance risk, we believe this issue could have market-disruptive consequences. In particular, EU27 policyholders and counterparties doing business with U.K.-based institutions could well face delays in payment, or significant expenses to restructure existing agreements.

For bank, insurance, corporate, and infrastructure obligors, we do not anticipate direct rating implications arising from delays or discontinuation in their ability to perform. However, we view performance risk as high in the structured finance sector, particularly for EU-domiciled structured finance issuers having U.K.-based swap counterparties. We currently assume that in a no-deal scenario, counterparties will be able to perform their obligations under existing contracts entered into pre-Brexit. However, if this assumption does not hold and existing agreements are terminated, it is possible that highly rated structured finance securities could default. In addition, there will likely be second-order effects to issuers' capital, liquidity, or earnings that could impact their ratings in the immediate aftermath of a no-deal Brexit, as well as in the longer-term. We are monitoring the situation, and evaluating these potential second-order effects.

Sovereigns: A No-Deal Brexit Would Weaken U.K. Government Finances

Primary contact: Aarti Sakhuja

How would key aspects of your sovereign analysis be impacted in no-deal?

In the wake of the 2016 referendum and despite considerable uncertainty surrounding Brexit negotiations, the U.K. economy has shown resilience. It is important to recognize that operational aspects of the U.K.-EU relationship have not yet changed. U.K. businesses continue to have full access to the single trade area for goods and services. Despite this, since the referendum, U.K. economic growth has slowed to below that of the eurozone, and to near the bottom of the G7.

In the no-deal scenario described above, the U.K. economy would be faced with a structural shift, adversely affecting key metrics in our economic, fiscal, debt, and external assessments to varying degrees. This could result in downward pressure on our sovereign ratings on the U.K. We expand below on how each of these assessments could be affected under our scenario. By way of background, our 'AA/A-1+' sovereign credit ratings on the U.K. already take into account a less predictable policy framework following the 2016 referendum. The outlook on the ratings is negative, reflecting the risk of sustained economic weakness and deterioration in government finances in a no-deal Brexit (see "Research Update: Ratings On The United Kingdom Affirmed At 'AA/A-1+'; Outlook Remains Negative," published Oct 26, 2018).

Economic: We anticipate that the U.K.'s GDP per capita (measured in US$) would initially fall sharply, by 14%, from its 2018 level (which we estimate at about $42,300) reflecting sterling depreciation and the subsequent real economic contraction. We anticipate that this metric would start to recover in 2020 as sterling regains some of its lost value, and further recover as the economy expands in 2021 after two years of negative growth. Even so, by 2021, the U.K.'s GDP per capita would still be considerably lower than in our base case assessment, in which the U.K. economy could adjust during a 21-month transition period.

Fiscal and debt: We anticipate that the consequences of a no-deal outcome will also be reflected in wider general government deficits through 2021 relative to 2018 and our base case scenario. Government spending would increase, in part due to the costs of customs excise administration and other checks as a result of the U.K. leaving the customs union. Public sector employment and procurement expenses are also likely to rise through 2021. Consistent with rising unemployment, benefit payouts would increase. Central government interest costs would rise given that about one-quarter of U.K. government debt is inflation-linked and that we project inflation will rise well above our base-case scenario. Any savings related to EU budgetary contributions are likely to be channeled into expenditure, particularly to those areas that are currently net recipients of EU funds. At the same time, tax revenues are likely to be lower, reflecting higher unemployment, lower corporate profitability, and a fall in intake from consumption-related taxes (such as value-added tax, excise duties). The financial services sector, one of the sectors most likely to be heavily exposed to a no-deal Brexit, contributes about 10% of government revenues through direct taxes, taxes on employee incomes, and value-added taxes.

We believe the government would find it difficult to fully offset the impact of higher spending and lower tax intake. It might choose to defer investment in some areas, raise certain taxes, while putting on hold planned cuts to tax rates or raise certain taxes. Cuts in other areas, such as welfare benefits, after a decade of fiscal consolidation led primarily by expenditure-side measures would be politically less palatable, in our view. As a result, in a no-deal Brexit, we project general government debt-to-GDP will rise toward 100% of GDP by 2021, compared to our base case scenario where we project it will stay relatively flat at about 85% of GDP through 2021.

External: We view the U.K.'s external liabilities and financing needs more favorably because of sterling's reserve currency status. Under our methodology, were sterling's share of allocated global central bank currency reserve holdings to decline below 3.0% (from about 4.5% currently), we would no longer classify sterling as a reserve currency. This is not implied by our scenario, but could happen if the rest of the world's confidence in the U.K. economy were to decrease, or if London's importance as an international financial center were to decrease significantly beyond that suggested in our scenario.

Corporates: There Are Limits To Contingency Planning For Businesses

Primary contacts: Alex Herbert, Eric Tanguy

What are the key credit risks of a no-deal for corporate issuers?

The main credit risks arising from a no-deal Brexit fall into one of three categories: operations, finance, and liquidity.

- Operations: Reverting to WTO rules in March 2019 without coordinated safeguarding measures would result in disruption for many sectors, ranging from manageable to severe. Large and midsize corporates domiciled in the U.K., or those with significant U.K. business activities are starting to implement contingency plans to mitigate business disruption, a process which we expect to accelerate before Brexit. These plans can come at significant cost for companies needing to build up additional inventory, for instance to ensure security of supply.
- However, even after implementing their contingency plans, we anticipate that a no-deal Brexit will raise many issues outside individual companies' control. These issues could range from disruption in the supply chain arising, for instance, from logistical and border delays, and delays in performing regulated activities due to loss of regulatory recognition after Brexit. For the moment, regulatory or licensing restrictions appear to be more a risk for U.K. entities operating in the EU rather than vice versa. This is because the U.K. has prioritized stability through the establishment of temporary permissions regimes to cover critical areas, such as aviation, financial services, and data transfer among others, while the EU has not.
- Financial risks could initially arise for companies dependent on EU trade, or for companies with limited financial flexibility whose margins may be squeezed by higher costs or lower revenues. The competitiveness of EU exports, including intermediate goods and consumer products, may be challenged depending on the overall impact of tariffs and sterling's depreciation, also taking account of border frictions that will be introduced. Increased working capital requirements could also reduce free cash flow and translate into higher borrowing and weaker credit metrics. Additionally, the medium-term macroeconomic implications would feed through to sectors to varying degrees over time, as discussed below.
- Liquidity is always an important rating consideration, especially for speculative-grade and other smaller companies that may have only limited access to non-bank or overseas financing. The risk here is that Brexit-induced volatility in sterling and U.K. financial markets could lead to tightening in U.K. credit conditions for some time, to the detriment of U.K. companies needing to refinance or raise additional debt finance. Some U.K. corporates are taking steps to improve liquidity by extending or increasing undrawn committed bank lines, or prefunding 2019 bond maturities well ahead of time.

What are the credit implications for the U.K. commercial real estate market?

For the London office market, we already incorporate in our base case scenario a fall in valuations of 10% over a two-year period starting in 2018.

A no-deal Brexit will, we believe, first result in longer times for sales to complete. It would also likely further depress real estate values, with declines of up to as much as 20% for London offices over two-to-three years, in line with the trough of the 2008-2009 recession for the U.K. However, to put things in perspective, we do not believe, given the depth of the economy, international investors' appetite for this asset class, and supportive demographics, that a no-deal Brexit will result in anything nearly as severe as that suffered by the Spanish market during the aftermath of the 2008 great recession.

For retail property owners, pressure on appraised values could be as important as for the London office segment. Retail landlords face the additional challenges of ecommerce development, operational difficulties of some of their retail tenants, and tough competition for physical store locations chosen by prime international retailers.

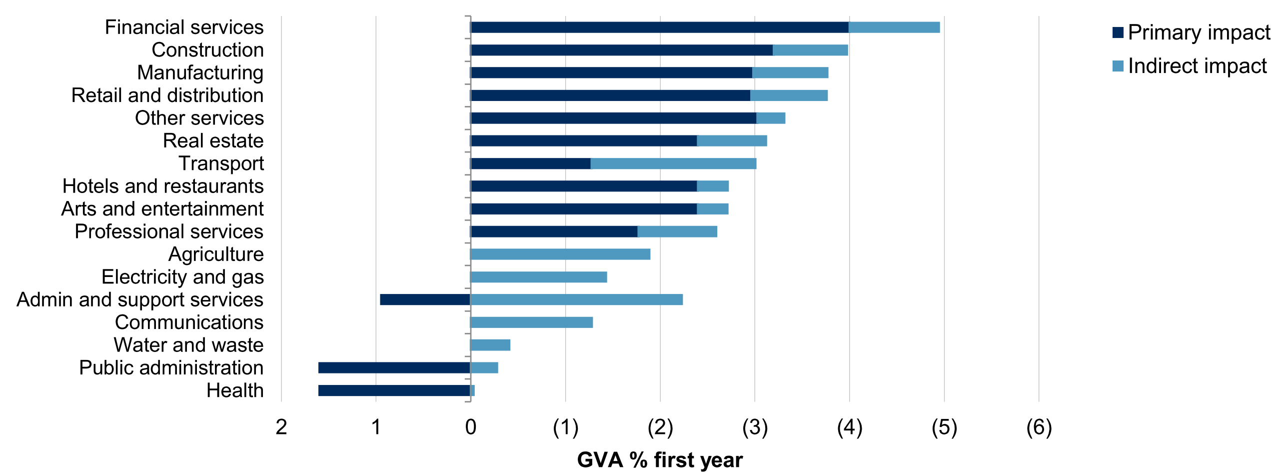
Across our rated universe of U.K. REITs, an average 20% drop in asset values would likely result in downgrades, probably by a notch. The full effects, however, are likely to unfold over a period of a few years; they may not be fully visible before the end of 2019. Other regions and asset classes in the U.K.--residential but also industrial, hotels and specialty--should prove more resilient, with values likely to fall in the mid- to-high single digits even in case of a no-deal Brexit. Conversely, some locations, such as Frankfurt or Dublin, or to a lesser degree Paris, may be beneficiaries from the separation process.

What sectors would be impacted the most?

We anticipate a no-deal Brexit would cause a 5.5% drop in GDP over the period 2019-2021 against our baseline. At the sectoral level we see a substantial variation between sectors looking at the first full year impact in terms of gross value added (GVA) (see chart 3). This comprises the primary impact and the indirect impact that estimates the domestic knock on demand for other sectors' goods and services, excluding some other offsetting factors such as weaker imports. Aggregating sector output growth based on GVA is a good proxy for GDP growth in an economy.

Chart 3

Service Sector, Manufacturing, Retail, And Real Estate Are The Worst Affected In A No-Deal Brexit Scenario



GVA--Gross value added. Sources: ONS, S&P Global Economics & Research.

In terms of sectors, our observations include:

- U.K. manufacturing goods trade with the EU is heavily reliant on a frictionless border. Any imposition of tariff or non-tariff barriers at the border would disrupt complex, well established, and just-in-time cross-border supply chains and distribution channels. This applies notably for manufacturers in the capital-intensive auto and aerospace sectors. Under this no-deal scenario, we expect capital investment in the U.K.to be weak, in part because these capital-intensive sectors would likely diversify their manufacturing footprint where they have been using U.K. production to supply the EU market.
- More domestic consumer-facing industries, including retail, hotels, distribution, and arts and recreation, would experience operational challenges on the back of weaker sterling, higher input costs, and weaker consumption expenditure. Many U.K. rated companies in these sectors, particularly in the non-food retail sector, have seen credit quality slide in recent years. A no-deal Brexit would likely accentuate what is already a weak operating environment with the risk of further defaults.
- Transportation covers various modes including road, rail, and air. As a service industry, transportation is sensitive, not only to the strength of the underlying economy under a no-deal, but also by any restrictions on cross-border travel or trade. For instance, U.K. and EU-licensed airlines would lose authorizations to provide air services between the U.K. and EU and without permission from national governments there would likely be some disruption for U.K. flights to EU countries. Similarly, while bilateral agreements pre-dating Brexit, such as the Treaty of Canterbury between U.K. and France, could mitigate partly the effect on the business model for Eurotunnel, any need to levy custom duties could have an impact on its smooth and effective operations.
- Business and financial services that generate almost 20% of the U.K.'s output GVA are expected to experience the biggest slowdown as loss of passporting and regulatory authorizations will act as a disincentive for banks and professional advisers to provide cross-border services between the U.K. and EU. While not a credit issue for larger firms established in both jurisdictions, it implies a potential loss of revenue and earnings for U.K. firms with only a more local footprint.
- More positively, we see little direct economic impact for the utility sector. Moreover, given that their business operations are substantially U.K. based, with several benefitting from local monopoly positions, this translates into a stable credit outlook for rated companies in this sector. Perhaps the bigger concern would be a scenario in which a no-deal leads to a prolonged period of market volatility with reduced levels of market liquidity. Significant curtailment of attractive European Investment Bank (EIB) funding in the U.K. would likely cause some upward pressure on funding costs for the sector. The increasing risk of political interference in the sector might also undermine investor confidence due to the government's focus on affordability of power bills and the discussion of nationalizing key utility companies by the opposition party.

Financial Institutions: Past The Point Of No Return

Primary contacts: Osman Sattar, Giles Edwards

Are banks ready for a no-deal Brexit?

In many respects, we see financial institutions (FIs) as well prepared. Due to the sector's worst-case planning, few, if any, in the industry had assumed that financial services passporting would remain post Brexit. Now, with less than five months remaining until Brexit day, the sector is past the point of no return. Most FIs are implementing their Brexit contingency plans to establish themselves in the EU through cross-border legal entity mergers and the establishment of additional licensed entities (see "Countdown To Brexit: Financial Institutions Are Past The Point Of No Return," published Oct. 11, 2018).

Will U.K. banks be the FIs worst affected?

Yes, in our view, U.K. banks would be the most vulnerable banks under a no-deal Brexit. Although other similarly open European economies like Ireland, Belgium, or The Netherlands could also feel the impact of a no-deal, we would expect those countries' banks to better accommodate its adverse consequences.

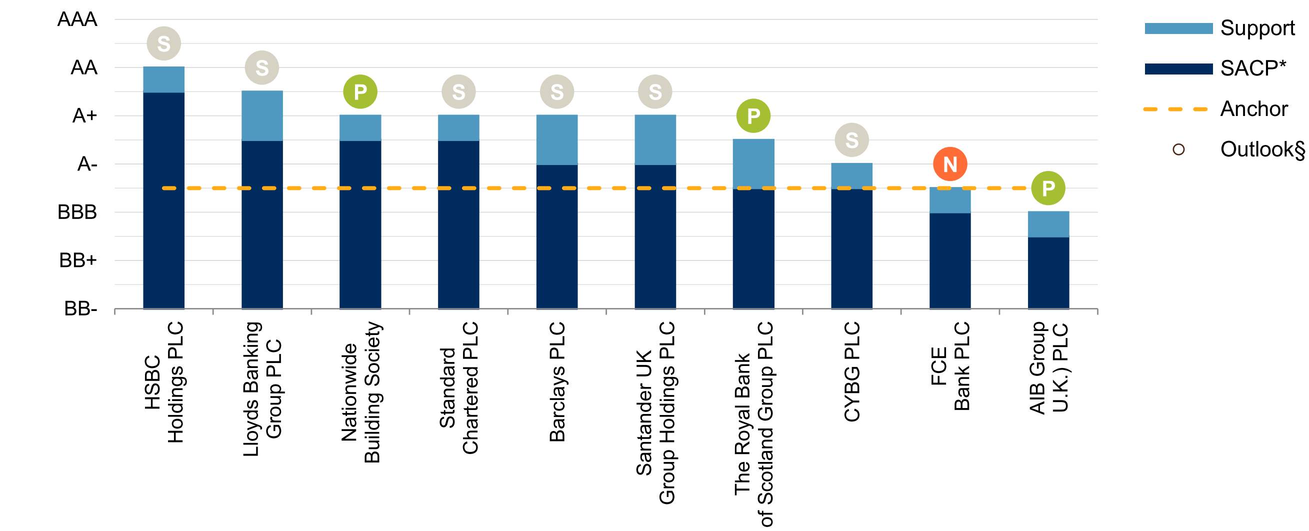
A no-deal Brexit resulting in severe macroeconomic weakness could lead to rising personal and corporate U.K. insolvencies and weaker collateral values. In time, this would likely play through to bank asset quality and activity, undermining earnings and, possibly, capitalization to a modest degree. In our view, these factors would be relatively greater for smaller lenders given their business focus on U.K. retail banking or property-related lending.

Wholesale market disruption would be unhelpful for the sector as a whole--not least because the larger U.K. banks use the U.S. and other non-U.K. debt markets. Spread widening or funding disruption for the banks and other U.K. corporates could be more acute if the market perceived the U.K. sovereign to have weakened. The BoE explored major U.K. banks' potential resilience to a similar but potentially more severe macroeconomic downturn scenario in the sector stress test in late 2017--a scenario that it has re-run for its 2018 exercise. Under this scenario, the banks appeared resilient in 2017, and we expect a similar result this time also.

Nevertheless, despite the implications for U.K. banks under our no-deal scenario, we believe on the whole that U.K. banks' earnings and balance sheets are solid and provide a substantial cushion to withstand potential turbulence from political and economic events. Indeed these strengths contribute to our current stable view of the sector (see chart 4). Ultimately, banks are a function of the economy they serve. Investment-grade bank ratings take a long-term view of creditworthiness and imply that a highly rated bank can withstand a moderate recession--and the no-deal Brexit scenario presented in this article is a moderate recession--perhaps with a one-notch downgrade during the period, absent bank-specific problems. Our generally supportive view of U.K. bank capitalization, asset quality, and funding and liquidity profiles, and the BoE's stress test data, also support this view.

Chart 4

U.K. Bank Ratings Are Broadly Stable Or Positive Given Their Balance Sheet Strengths



*Standalone credit profile or unsupported group credit profile for rated groups. §P=Positive, S=Stable, N=Negative. All ratings relate to the main operating company as Oct. 17, 2018. Source: S&P Global Ratings.

We also believe that the larger U.K. banks will also feel the effects of Brexit from a licensing and client service perspective, although we see this as a lesser concern than the macroeconomic implications described above. The most affected U.K. banks are leveraging their existing EU27 subsidiaries for this purpose, and appear relatively well advanced in their execution.

What are the implications for international banks that currently use London as their European base?

Until now, London has been the principal EU base for non-EU banking groups, notably from the U.S., Canada, Switzerland, and Japan. These groups have sought to minimize the upheaval to their existing operations, at least on day one post Brexit. Discussions with EU27 regulators have typically explored the minimum substantive presence that they would permit, the thorniest topics being the booking model, risk management, and personnel. Nevertheless, their related Brexit projects remain multifaceted, complex, and resource-sapping (notably in terms of management time, but also cost). Aside from gaining the necessary licenses, live workstreams include information systems and financial reporting, ensuring connectivity to financial market infrastructures (FMIs), re-papering of contracts with some clients, expanding or securing physical facilities, managing the redeployment of personnel, and gaining court approval for legal mergers or business transfers.

While all these workstreams continue apace, we see it as positive that the larger banks at least appear relatively well placed to ensure operational continuity even in a no-deal Brexit in March 2019--at least for the aspects that are within their control. Locations have been identified, typically Frankfurt, Paris, Dublin, and Amsterdam. Licensing discussions appear relatively well advanced in many cases, now focusing on granular issues such as finalizing the extent to which any back-to-back risk management arrangements will be permitted between the U.K. and EU27 entities, and the pace at which the ramp-up of the EU27 operation will need to take place. (The ECB has reportedly accepted that this could continue until well after March 2019.) Where banks are relying on cross-border mergers to effect the necessary transfer of business, for example as planned by Bank of America Merrill Lynch, they appear to be well on track towards successful execution.

Clearly, the creation of additional subsidiaries adds capital, liquidity, and expense inefficiencies. However, assuming that these groups execute well, we see very limited rating implications for them and their rated entities. They will continue to rely heavily on their London operations for capital markets and other banking activities, and we expect London to remain the most important financial center in Europe and one of the most important globally.

Structured Finance: Potential Termination Event Poses The Largest Risk

Primary contacts: Matthew Mitchell, Andrew O'Neill

How would a no-deal Brexit impact the performance of collateral backing U.K. structured finance transactions?

We believe that increased unemployment, a decline in household income, and reduced housing prices resulting from a no-deal Brexit could lead to increased defaults in consumer receivables, including auto loans, credit cards, and residential mortgages. To test the stability of our ratings if a no-deal Brexit were to occur, we conducted a scenario analysis for U.K. ABS and RMBS transactions using the macroeconomic assumptions from the BoE 2018 annual cyclical scenario stress tests. These are generally more conservative than our forecast no-deal Brexit scenario that serves as the basis for this paper (see "Countdown To Brexit: A Disruptive Brexit Would Mean Increased Losses In U.K. ABS And RMBS Transactions But 'AAA' Ratings Will Be Stable," published Sept. 5, 2018). We continue to believe that 'AAA', 'AA', and 'A' rated ABS and RMBS tranches have a cushion to withstand potential deterioration in credit losses in a no-deal scenario. Under our no-deal scenario, we expect 'AAA' to 'A' ratings generally to remain unchanged, although 'BBB' and lower ratings may be vulnerable to a downgrade.

For U.K. mortgage-backed covered bond issuers, in light of their typical overcollateralization levels, we believe the ratings would be more vulnerable to downgrades if we lowered our ratings on U.K. sovereign debt or on the covered bond issuing bank than if credit quality of the cover pools were to moderately deteriorate. We believe that mortgage-backed programs could currently withstand a potential downgrade of the sovereign and the issuing bank of one notch or more, depending on the program, without resulting in negative rating actions. By contrast, in our view, public sector-backed programs would be more exposed, both to deterioration in the creditworthiness of the sovereign (through the sovereign ratings cap), and the credit quality of the cover pool.

What operational and counterparty risks could a no-deal scenario introduce?

In our view, the largest risk to structured finance transactions in a no-deal Brexit is the potential termination of derivative agreements were it to become illegal for counterparties to perform their obligations in rated transactions. While the U.K. has proposed legislation that would allow EU counterparties to continue to perform on their contractual obligations in the U.K., a reciprocal agreement that would apply to U.K. banks in the EU has not yet been announced. Failing such an agreement, U.K. banks may lose the passport necessary to conduct regulated business in EU member states. We understand that many market participants are considering novating their swaps to EU affiliates as part of their Brexit planning, which would help to alleviate this risk.

Absent any mitigating actions, in our view, the largest potential for disruption risk would apply to EU-based issuers that have a U.K.-based swap counterparty. Our current assumption is that existing agreements would remain in force and would not be affected by a no deal-Brexit. If this assumption does not hold, structured finance issuers may be exposed to liquidity risks resulting from the termination of derivative contracts (which support the rating on many structured finance transactions). Derivative contracts typically contain a provision allowing for termination of the derivative in the event that performance becomes illegal. If an illegality termination event were to occur under applicable swap documentation due to a counterparty losing its passporting rights, the issuer may owe senior termination payments to the counterparty, depending on the mark-to-market value of the swap (i.e. if the issuer is out-of-the- money when the swap is terminated). This could present substantial liquidity risks to issuers and result in significant ratings volatility; it is possible that if issuers owe large mark-to-market payments to counterparties, highly rated structured finance securities could default. For covered bonds, we would expect less impact given the dual recourse nature of the obligations, which would mitigate the liquidity risk. We intend to publish a further commentary on the potential impact of no-deal Brexit on derivatives and contract continuity.

We continue to monitor potential disruption risk to other transaction roles held by U.K. financial institutions in structured finance transactions with EU domiciled issuers, such as paying agents, cash managers, bank account providers, liquidity providers, and trustees. But we do not currently believe these roles pose the same level of disruption risk as derivatives. To the extent that such other roles currently require passporting rights in the issuer's location, and any interruption to services due to loss of passporting were to result in disruption or delays to transaction cash flows, this could have a rating impact. However, although there may be some uncertainty as to the extent to which these roles may be considered regulated activities in the EU, we understand that issuers would in any event generally have the ability to novate these agreements to other counterparties without significant costs.

Insurance: Contingency Plans Are Effective So Far

Primary contacts: Dennis Sugrue, Robert Greensted

How prepared are U.K. insurers for a no-deal Brexit?

Similar to FIs and other financial services providers, U.K. insurers have been preparing to ensure that they can continue to serve their EU27 clients. Many U.K. insurers have existing EU27 operations, but others are looking to establish an EU27 presence in preparation for a no-deal Brexit. Many U.K. insurers have been developing their plans on the assumption that passporting will not continue, and that a legal entity presence on the continent will be required. Rated insurance companies are at varying stages in their discussions with regulators, plans for relocating operations and staff, the process with Part VII transfers (the legal transfer of insurance liabilities between entities), and plans for communication to the market and their organizations.

Among the rated U.K. insurers that write EU business, we are not aware of any that have decided to exit that market. The EU is an important market for these firms, and all have taken steps to ensure their ability to continue doing business there.

What would be the rating impact for insurers of no deal?

We see a no-deal Brexit potentially affecting ratings on insurers in three ways.

- The first, and most immediate impact would be negative rating implications if the U.K. sovereign rating were to be downgraded by more than one notch. Based on our most recent research update on the U.K. and insurers' relative exposures to the U.K. sovereign rating, were the long-term U.K. sovereign rating to be lowered by one notch, then we would need to review whether the ratings on Prudential PLC and Legal & General Group PLC were resilient to a sovereign stress scenario.
- We estimate that the adverse macroeconomic and financial market impact of a no-deal Brexit could put the ratings of four U.K. insurance groups at risk of deteriorating by at least one notch (See text box "Insurance Stress Test"). The financial market volatility and adverse economic implications of a no-deal Brexit could have negative implications for insurers' balance sheets and capital models in the near term. The no-deal scenario outlined above envisages adverse effects on the U.K. economy that could have implications for insurers' ratings that would be felt over the medium to long term as well. For example, economic contraction would have a dampening effect on top lines for insurers, and the depreciation of sterling could also increase claims costs, particularly for motor insurers in the U.K. as the cost of sourcing replacement parts would increase.
- Finally, the financial implications of operational challenges could have negative implications for U.K. and EU insurers' ratings. These would include additional capital requirements for U.K. insurers setting up operating subsidiaries in the EU, or vice versa for EU insurers operating in the U.K.

The issue of contract continuity for insurers does not, in our view, present a direct risk of default for insurer ratings. Our insurer financial strength ratings (FSRs) are forward-looking opinions about an insurer's ability to pay under its insurance policies and contracts in accordance with their terms. The FSR is not specific to any particular policy or contract, nor does it address timeliness of payment (see: S&P Global Ratings Definitions). Thus, a delay in an insurer's ability to pay claims due to a lack of authorization would not be deemed an event of default for the insurer's FSR, as long as we were confident that the insurer would ultimately be able to honor any valid claims. Similarly, such a delay in paying claims would not be an event of default for an insurer's ICR.

Contract discontinuity issues would likely present second-order challenges for ratings on insurers. For U.K. insurers forced to delay paying claims to EU policyholders, there could be reputational risks that could erode an insurer's position in the EU market. EU27 insurers are not off the hook either. Many engage in derivative transactions with U.K. banks to hedge their interest rate, foreign exchange, or asset risk, and the termination or transfer of these derivative contracts in a no-deal scenario would likely lead to significant expense as well as possible liquidity or capital constraints. We are monitoring these potential second-order effects on U.K. and EU27 insurers' ratings.

Insurance Stress Test

Using the economic assumptions from the no-deal scenario above, we stressed the ratings of 15 U.K. insurance groups that we felt were most exposed to the scenario. The no-deal scenario approximately equates to a 'BB' stress scenario, which we applied to these groups' capital models and earnings forecasts.

The results of the test indicated that four of the 15 groups could see their standalone credit profiles (SACP) deteriorate by at least one notch. The impact on insurers' capital adequacy was the most significant, with six insurers likely to experience a change in their capital adequacy score. Financial flexibility was an area of concern for six insurers, as in some cases leverage increased due to increased reported liabilities due to FX impacts on foreign currency-denominated bonds, or fixed charge coverage deteriorated as a result of weakened earnings.

Finally, should a no-deal Brexit lead us to revise our insurance industry county risk assessments (IICRA) down by one category for the U.K. sector (both P/C and life) this would have an adverse impact on the ratings of one insurer in our sample. Our stress test does not account for potential management actions that would follow in such a scenario, including cancelling dividends, de-risking investment portfolios, or capital raises. We expect that management teams could use tools like these to mitigate the economic impact of a no-deal Brexit, and thus the ratings impact would likely be lower than our initial test indicates.

Public Sector: Social Housing Ratings Are Exposed To A No-Deal

Primary contact: Felix Ejgel

Could ratings on housing associations sustain volatility in the housing market from no deal?

We anticipate that in a no-deal Brexit scenario we might lower ratings on about half of 35 U.K. social housing providers we rate, most likely if housing prices dropped by about 10% over 2019-2020, but also from a possible downgrade of the U.K. sovereign rating.

The U.K. government is encouraging social housing providers to boost social housing construction, leading these entities to increase their investments. Housing associations are increasingly dependent on proceeds from market sales to fund social housing development. Together with borrowings, these revenues will make up for reductions in grants and constrained social housing rents until the financial year ending in March 2020. The development of sizable housing projects for sale to private individuals is now becoming a core business for many social housing providers, whereas previously only large London-based entities pursued this strategy in an effort to offset temporary funding gaps. A price correction and delays in transactions in case of real estate market stress may erode their social housing providers' liquidity positions and raise their debt burdens. We understand that the providers might reduce their capital programs should the need arise. However, rising unemployment in a no-deal Brexit scenario might increase demand for social housing, so adjustments in their investment programs are likely to be only marginal and temporary. Scottish and Welsh social housing providers are less exposed to volatility in the real estate and capital market because most of their investments are covered by grants from devolved administrations. Nevertheless, a no-deal Brexit may weaken the devolved administrations' capacity to provide support to their social housing providers.

Would you lower ratings on other public sector entities in a no-deal scenario?

Ratings on Greater London Authority (GLA) and Transport for London (TfL) might come under pressure, mainly because of the link with the sovereign rating and dependence on central government funding. The rating on GLA is currently at the sovereign level, and we believe that U.K. local and regional governments should not be rated above the sovereign. The rating on TfL is very much supported by our expectation that the Department of Transport will continue to cover cost overruns generated by TfL's flagship investment project, Crossrail. We also anticipate that the credit standing of other U.K. local governments could weaken because their revenues will likely decline as a result of subdued economic activity and potential further grant cuts, while demand for welfare services may increase with rising unemployment. Nevertheless, local governments across the sector still maintain large, albeit decreasing, reserves, which should be sufficient to cover potentially widening deficits in the few years after Brexit. We still view any substantial mismatches of revenues and expenditures, as in the case of Northamptonshire, as isolated and driven by occasional weaknesses in financial management.

We don't believe a no-deal Brexit will affect the creditworthiness of U.K. universities more than an orderly Brexit. Whatever the exit scenario, Brexit may impact the U.K.'s attractiveness to international students and academics, primarily from the EU, especially if combined with stricter immigration measures. It also will also herald uncertainty over fee structures for EU students, as well as availability of EU research and capital funding. Nevertheless, a weaker sterling in a no-deal scenario may make a U.K. education more attractive for oversees students and boost competitiveness.

This report does not constitute a rating action.

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