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Asset Management

UK Banks: Cautiously Optimistic

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The major UK banks — Barclays, Lloyds, Nationwide Building Society and NatWest — are an investor focus, given COVID- and Brexit-related risks. How well are these banks prepared for these challenges? Are credit concerns justified?

UK regulators have implemented tough stress tests, which have been conservative on Brexit risks. All of these banks passed the late 2019 stress test with no capital actions required — a plus. Further, the new IFRS 9 accounting rule tends to cause the front-loading of credit loss allowances. What this means is that any capital or profit diminution caused by building such loss allowances shows up sooner, and thus remaining capital levels are more representative of appropriate risk estimates. In addition, all-important housing prices have been holding up. Nevertheless, a rough Brexit would be a particular challenge for London and the major cities – especially the important financial sector. Combined with COVID risks, which have more deeply affected the rest of the UK (more people working from home in cities), a 'Double Whammy' is a possibility. But there have been any number of Brexit deadlines that seem to get managed, and no one is interested in a reckless break. Moreover, the UK government has been focused on supporting people and businesses affected by COVID. ***This is good news for loan quality***. UK banks have also made good progress in shifting to digital systems, another plus that will become clearer.

- Barclays has a diverse mix of investment banking (a large profit contributor in 2Q20), corporate, mortgage and card businesses that provide earnings balance. Though the CET1 capital ratio of 14.2% is below UK peers, it rose over 100bps vs. 1Q20, nearly doubling its capital cushion. Loss provisions for 2H20 should be below those of 1H20. Deposit funding is ample.

- Lloyds is a UK-focused market leader with substantial retail operations, especially mortgage, but also cards and unsecured personal loans. The 2Q20 loss reflects reserve strengthening and interest margin pressure, though lower costs helped given Lloyds' reputation for efficiency. The bank's 14.6% CET1 capital ratio represents a 300+bps cushion over its minimums.

- NatWest has a CET1 capital ratio of 17.2%, with an ample 800+bps cushion. The 2Q20 loss reflects conservative loss reserve strengthening — easily afforded by its strong capital. Its business has been right-sized after years of restructuring, and is now more competitively positioned. NatWest also has a leading small/medium-sized (SME) segment which is COVID-vulnerable.

- Nationwide Building Society is a mutual focused on single-family mortgages and deposits. Its CET1 capital ratio at 2Q20 quarter end was a massive 32.8%, though overstated due to low risk weights assigned to mortgages. Still, capital is very strong. Also, mortgages under moratoria have been dropping.

Spectrum acknowledges the risks of COVID and Brexit. However, while UK bank earnings will be pressured, and some banks could post negative earnings in the coming quarters from loss allowance strengthening, the challenges are still more an income, rather than capital, issue. The UK banks should be able to manage these risks reasonably well. **Spectrum is cautiously optimistic on the major UK banks, based on their leading franchises, and overall healthy capital and core earnings levels — strengths that will help them meet revenue and loan quality challenges.**

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