UK banks

Sound credit fundamentals, but profitability, asset quality set to decline

Analyst

Alvaro Dominguez Alcalde
a.dominguez@scoperatings.com

Team leader

Marco Troiano, CFA
m.troiano@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

UK bank profitability will remain elevated in 2025 but will likely decline from previous highs. Strong 2024 performance was driven by solid net interest income due to higher-for-longer interest rates, positive contributions from structural hedging programmes, and a recovery in lending. Profitability will likely decline slightly this year as rates continue to fall, but it will continue to be supported by a recovery in loan growth and income from structural interest-rate hedges.

Car finance exposures have had only moderate impact so far on UK banks rated by Scope. Additional provisions related to UK historical car finance commission payments will pressure Lloyds and Santander UK's bottom lines depending on the outcome of the appeal in the UK Supreme Court.

Asset quality remains resilient but is also expected to deteriorate slightly in 2025. Positive UK economic growth, albeit revised down, low unemployment and loan arrears, strong underwriting standards and lower borrowing costs due to expected interest-rate cuts should support asset quality. However, the recent increase in the employers' National Insurance Contributions (NICs) could lead to potential hiring freezes and layoffs, potentially weakening asset quality. Current global geopolitical instability may also be a future factor for banks if it has a significant negative impact on the domestic economy and other countries where banks have relevant exposure.

Capital levels remain adequate and aligned to management targets. UK banks continue to maintain adequate capital buffers. However, they are optimising excess capital towards target levels through dividends and share buybacks. We expect this trend to continue in 2025.

Recovery in deposit growth and stable liquidity levels. Deposit outflows have stabilised and returned to normal levels. Key liquidity metrics remained stable in 2024.

Rating Outlook. The stable outlooks assigned to subscription ratings on our sample of UK banks indicate that risks are broadly balanced in 2025.

Table 1: 2025 Trends overview

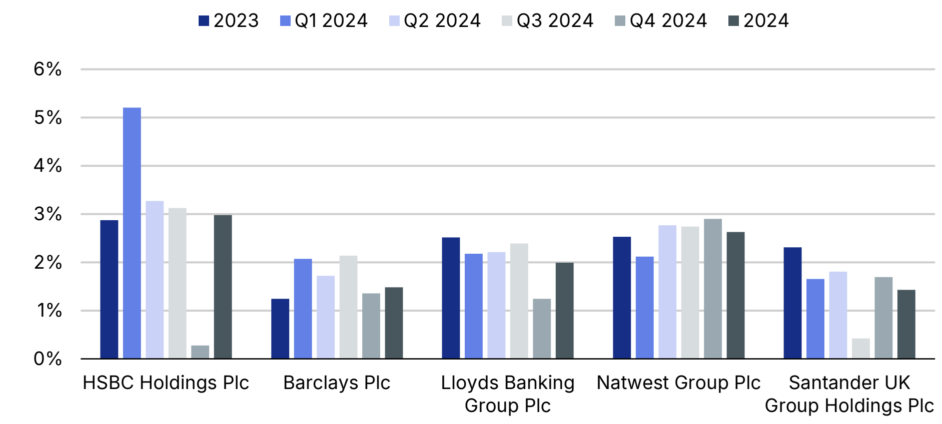
Expected 2025 trends for UK banks		
Profitability	Mildly negative, with a slight decline compared to 2024 due to lower interest rates.	↘
Asset quality	Stable, resilient asset quality underpinned by strong employment and very low levels of arrears.	→
Funding & liquidity	Stable. Deposit outflows seen in H1 2024 stabilising and returning to normal levels. Sound liquidity levels.	→
Capital	Stable, in line with banks' CET1 targets. Excess capital likely to be distributed to shareholders via dividends and/or share buy-backs.	→

Profitability will remain sound in 2025

Solid NII and income from structural interest-rate hedges will support elevated profitability

Most banks in our sample (HSBC, Barclays, Lloyds, NatWest, Santander UK) reported returns in 2024 in line with guidance. But they are targeting higher returns for this year. The average return on risk-weighted assets (RoRWA) was approximately 2% in 2024, and average return on equity (ROE) was around 10%, both broadly unchanged from 2023. The main drivers of this solid performance were robust net interest income (NII) due to higher-for-longer interest rates; and tailwinds from structural hedges, which have stable, medium-term impacts on income.

Figure 1: Return on risk-weighted assets (RoRWA)



Source: Company data, Scope Ratings.

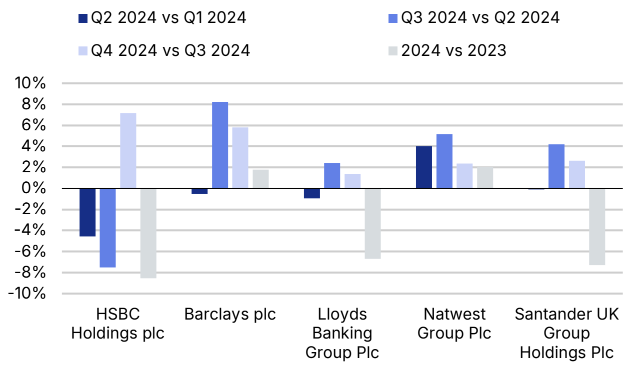
NII declined by 4% on average in 2024 compared to 2023 for the UK banks in our sample, and net interest margins (NIMs) were lower because of rate cuts and higher deposit costs due to strong competition between banks, neobanks and fintechs.

We expect NII to remain elevated in 2025 due to continued recovery in loan growth, a trend already seen in recent quarters. Anticipated interest-rate cuts will partially provide relief to borrowers, easing financial conditions on households and borrowers. UK banks will also continue to benefit from structural hedging programmes.

All banks in our sample highlighted the increasing tailwinds from structural hedges i.e. interest-rate swaps, which will support top lines until at least 2026. NatWest and HSBC referenced positive impacts out to 2027. Most banks of our sample reported an average duration across structural hedging programmes of 2.5 to 3.5 years. Structural hedging income represented an average of 32% of NII and 17% of total income at Barclays, Lloyds, and NatWest. All three confirmed their structural hedging income in 2025 will be larger than in 2024.

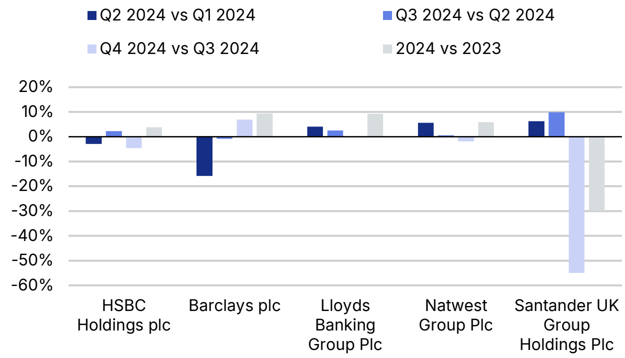
Average fee and commission income across our sample (excluding Santander UK) increased by 7% in 2024 due to strengthening customer and market activity. We expect this positive trend to remain for 2025 as some banks are focusing on growing on their wealth management businesses as well as continued strong customer activity. However, geopolitical risk and market volatility could have an impact on customer sentiment as well as capital markets and trading income.

Figure 2: Net interest income, QoQ and YoY comparison



Source: Company data, Scope Ratings

Figure 3: Net fee and commission income, QoQ and YoY comparison



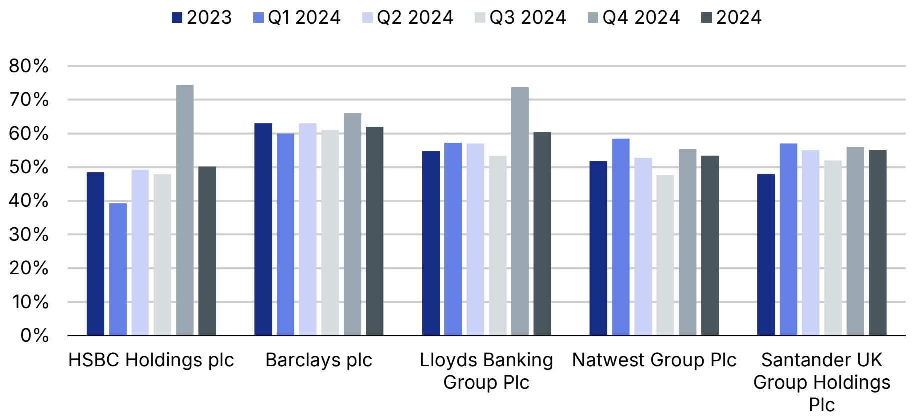
Source: Company data, Scope Ratings

Higher employer NICs will adversely affect UK companies

Efficiency ratios remained stable quarter-on-quarter, reaching an average of 56% in 2024 vs 54% and 53% in 9M 2024 and 2023, as strong revenues absorbed wage increases caused by two years of high inflation and strategic investments.

We expect banks to maintain tight cost control in 2025 and efficiency levels to remain stable as lower revenues on the back of lower interest rates will be offset by a stabilisation of employee costs as high inflation fades. HSBC plans to partly offset higher costs from inflation and investments by simplifying and reorganising the group, achieving annual savings of about USD 1.5bn by YE 2026). Barclays' strategic plan aims to increase returns by reducing costs by GBP 1bn by 2026.

Figure 2: Cost-to income ratios



Source: Company data, Scope Ratings

UK car finance already having a negative impact on some UK banks

Additional provisions related to UK historical car finance commission payments will pressure Lloyds and Santander UK, although the impact so far has been moderate. The next important development will be the outcome of the appeal in the UK Supreme Court, which is expected between 1 and 3 April.

Lloyds Banking Group recognised a GBP 450m provision for operational and legal costs and potential customer redress in its Q4 2023 results. The group booked an additional GBP 700m in its Q4 2024 results, equivalent to 16% of total net profit for 2024. This provision includes an estimate for operational costs and potential redress, based on multiple scenarios.

Santander UK booked a provision of GBP 295m related to historical motor finance commission payments in its Q3 2024 results, equivalent to 31% of its total net profit for 2024, after the court decision in October 2024 forced the bank to delay its Q3 2024 results to further assess the potential impact. Santander UK's final provision for UK car finance is within the range we estimated in our November 2024 commentary (Car finance exposures will have moderate impact on UK banks rated by Scope). The bank did not book any provision in its Q4 2024 results. Barclays exited the motor finance market in 2019 but booked a GBP 90m provision in its Q4 2024 results related to the historical operations Clydesdale Financial Services, a Barclays subsidiary.

The past year was very active in mergers and acquisitions in the UK banking sector with 10 transactions[1]. The main transactions of the banks included in our sample were: Barclays' acquisition of Tesco's retail banking business; NatWest's purchase of Sainsbury's Bank assets and liabilities; and NatWest's acquisition of GBP 2.3bn of Metro Bank's prime residential mortgages.

These transactions are expected to drive a significant increase in the number of customers at the acquiring banks, leading to growth in mortgages, credit cards, unsecured personal loans and savings accounts, which will lead to higher revenues and improve already strong profitability.

Future M&A operations cannot be ruled out, although the CEO of NatWest confirmed on the bank's last results call that future inorganic growth would be very high-bar and would need to be compelling financially from a shareholder perspective as well as aligned to the group's strategy.

Asset quality resilient, mild deterioration expected

Asset-quality indicators expected to worsen in 2025

We expect UK high-street banks to continue displaying strong asset quality in 2025 underpinned by healthy mortgage portfolios, strong underwriting standards and low UK unemployment (albeit mildly increasing).

Despite the negative impacts of higher-for-longer interest rates on loan demand and even though high inflation squeezed customer's personal finances, stronger GDP growth in 2024 and stable unemployment will support asset quality, a pattern also seen in many European countries. However, the recent increase in UK employers' National Insurance Contribution (NIC) will drive up employment costs potentially hindering future recruitment and is already contributing to job redundancies in retail and hospitality sectors, putting downward pressure on current stable employment levels.

While mortgage arrears have been rising since 2022, they remain at very low levels, accounting for 1.1% of all homeowner mortgages outstanding and 0.7% of all buy-to-let mortgages, according to Q4 2024 UK Finance data. House repossessions also remain very low.

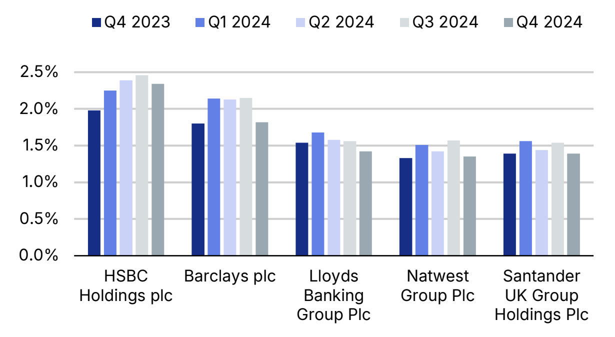
UK banks' strong customer loan portfolios contrast with the 14% year-on-year increase in individual insolvencies in the UK in 2024 and the highest annual level of Debt Relief Orders (DROs) since their introduction in 2009, following the abolition of the upfront fee in April 2024 and expansion of DRO eligibility criteria in June 2024.

Company insolvencies are also high, mostly driven by Creditors' Voluntary Liquidations (CVLs). Construction, wholesale and retail trade are the most affected industries. However, insolvency rates are materially lower than the peak seen during the Global Financial Crisis, due to the increase in the number of companies. We expect the current trend to continue due to the impact of higher-for-longer interest rates, sticky inflation as well as global trade uncertainty.

Stage 3 ratios were below 2% for four out of the five UK banks in our sample, as of December 2024. Banks have shown very mild increases in stage 3 relative to December 2023. Reasons include higher charges for US consumer banking (Barclays), mainland China commercial real estate (HSBC) and a smaller mortgage book and some single-name cases in Corporate and Commercial Banking (Santander UK).

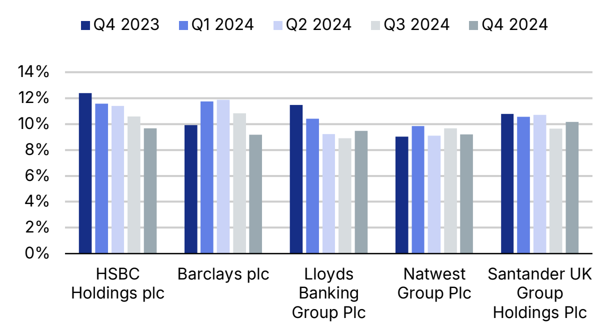
[1] Source: SNL. Banking sector includes banks, building societies, credit unions and mutuals and development banks. Transactions apply to acquisitions of full companies, acquisition of majority and minority stakes, acquisition of assets or branches and spinoff or splitoffs.

Figure 5: Stage 3 ratios



Source: SNL, Scope Ratings

Figure 6: Stage 2 ratios

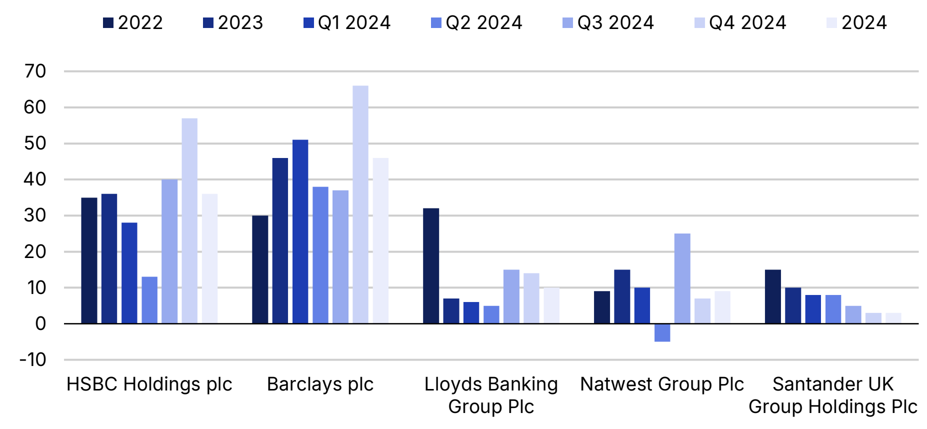


Source: SNL, Scope Ratings

Cost of risk (CoR) is contained, with a maximum of 46bp for our bank sample. But there is clear differentiation between global diversified banking groups exposed to multiple geographies and more corporate exposures (HSBC), banks with material consumer banking businesses (Barclays) and the domestically focused banks (Lloyds Banking Group, NatWest Group, Santander UK).

CoR decreased or was flat year over year for most banks due to lower loan-loss provisions driven by the improved economic outlook. We expect UK banks' cost of risk to increase in 2025, but it should remain close to banks' guidance and targets for 2025, ranging from below 15bp (NatWest) to 50-60bp (Barclays)

Figure 3: Cost of risk (bp)



Source: Company data, Scope Ratings.

Optimising capital buffers via distributions

Capital levels continue to decline, driven by a steady increase in distributions

Our sample of UK banks continues to maintain adequate capital levels, with an average CET1 ratio of 14.1% as of Q4 2024. There was a mild decline compared to Q3 2024 as earnings were distributed to shareholders via dividends and share buybacks. Most banks reported CET1 ratios close to management targets. The buffer to requirements is in the range of 1.5%-4.0%. UK banks have higher requirements than EU peers as the UK countercyclical buffer stands at 2% and Pillar 2 requirements for our sample ranges from 2.6% to 4.6% against an EU average of 2.1%[2].

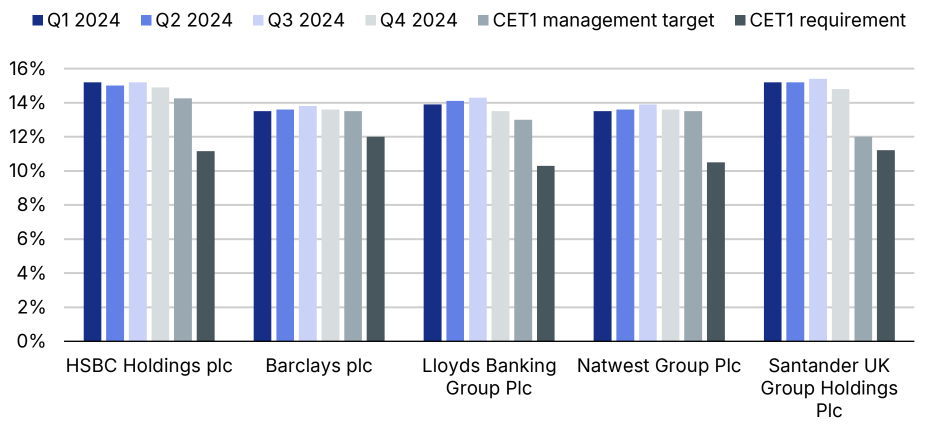
We do not expect material changes in UK banks' capital levels in 2025. Banks will operate close to their management targets, distributing profits to shareholders via dividends and/or share buybacks which will be partially offset by continued capital generation and expected lending growth leading to higher risk-weighted assets. NatWest has continued to buy back shares to reduce the UK government's stake (to less than 9%) and is expected to return to full private ownership this year.

We believe that regulatory headwinds will be manageable, especially given the delay in Basel 3.1 implementation to January 2027 (full implementation remains January 2030).

UK regulators have been under the spotlight as the UK government pursues policies aimed at stimulating economic growth. While the Prudential Regulation Authority is taking action to advance competitiveness and growth, it remains committed to its primary objective of ensuring the resilience and soundness of the firms it regulates. The measures taken and being proposed do not in our view materially change the highly regulated operating environment for UK banks. These measures include simplifying the prudential regime for small banks, further changes to remuneration requirements, and simplifying regulatory data reporting.

Our sample of UK banks displayed an average MREL ratio of 33.6% as of Q4 2024, holding a comfortable average 5.3pp buffer to minimum requirements.

Figure 4: CET1 ratios, management targets and requirements



Source: Company data, Scope Ratings.

[2] ECB keeps capital requirements broadly steady for 2025, reflecting strong bank performance amid heightened geopolitical risks

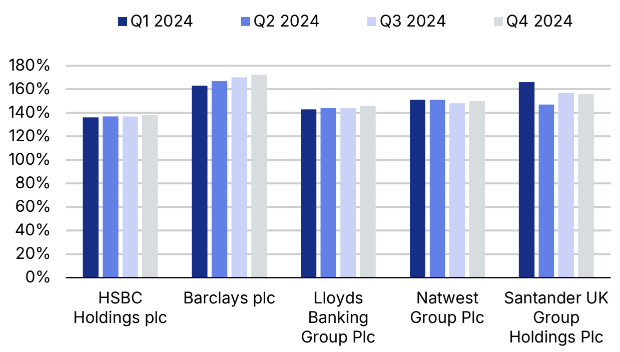
Stable liquidity levels and recovery of deposit growth

Continued recovery in deposits in 2025

Customer deposits started to bounce back in Q4 2024 after a weak performance in previous quarters as customers switched deposits into higher-yielding savings accounts and other financial products in the higher-for-longer rate environment.

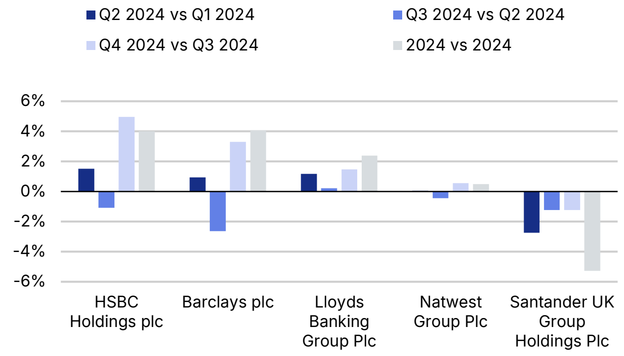
We expect a continued recovery in banks deposits for 2025 given more stable economic growth and the potential for further interest-rate cuts. UK banks' key liquidity metrics (Liquidity Coverage Ratio, Net Stable Funding Ratio) remained stable in Q4 2024, at roughly similar levels to those in 2023.

Figure 9: Liquidity Coverage Ratio



Source: Company data, Scope Ratings

Figure 10: Customer deposits, QoQ comparison



Source: Company data, Scope Ratings

Related research

Deutsche Bank: Improved profitability outlook on non-operating cost normalisation, February 2025

Italian Bank Quarterly: Amid surging M&A, banks project another record year but caution is warranted, Feb 2025

BPER's new bid a defensive move to create a stronger group, February 2025

Georgia: microbank law to enhance financial-sector competitiveness and support growth, February 2025

Digital euro: a wake-up call for banks to adapt and innovate, February 2025

ING, Goldman Sachs set to exit Russia; RBI faces legal provision related to failed asset swap, February 2025

MPS bid for Mediobanca could reshape Italy's financial landscape but faces hurdles, January 2025

BPCE's joint venture with Generali supports business diversification and profitability, January 2025

European Bank Capital Quarterly: Capital positions remain sound, requirements manageable, January 2025

Bank Outlook 2025: Sound fundamentals in less benign rate environment amid geopolitical uncertainty, January 2025

EU banks' NPL Heatmaps: marginal increase in non-performing loan ratio, January 2025

Covered Bond Outlook 2025: Credit stability in times of increasing uncertainty, January 2025

Stress-testing European banks: significant climate-related credit losses likely, January 2025

Car finance exposures will have moderate impact on UK banks rated by Scope, November 2024

UK car financing review not material for large UK banks, February 2024

Applied methodology

Financial Institutions Rating Methodology, January 2025

Scope Ratings GmbH

Lennéstraße 5, D-10785 Berlin
Phone: +49 30 27891-0
Fax: +49 30 27891-100
info@scoperatings.com

Scope Ratings UK Limited

52 Grosvenor Gardens
London SW1W 0AU
Phone: +44 20 7824 5180
info@scoperatings.com

Bloomberg: RESP SCOP
Scope contacts
scoperatings.com

Disclaimer