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UK banks, base rate, bad debts and borrowing … what does it all mean?

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- **After a sustained period of quantitative easing, and with more deposits than loans, UK high street banks have huge liquidity**
- **If the unemployment picture turns negative, we are likely to see rising bad debt, despite increased levels of savings**
- **We think the additional earnings from charging higher rates on loans relative to deposits will outweigh the drag from rising bad debts**

The UK is facing numerous headwinds: soaring energy bills, falling house prices, high and persistent inflation, rising interest rates, country-wide strikes across multiple sectors and weaker economic performance than the eurozone. It's natural as an analyst team that, in the midst of such turmoil, our thoughts turn to how the high street banking sector might fare.

Base rate effects

When the Bank of England (BoE) raises the base interest rate, high street banks quickly increase the interest rate at which loans are offered. With the base rate having risen from 0.25% at the start of 2022 to 4% as of 15 March 2023[1], a household rolling its two-year fixed mortgage this year will find that the interest rate on the loan will likely have moved from somewhere less than 2% to more than 4%.

Calculating how much a bank pays out as interest to depositors, however, is less straightforward. This is much more dependent on competition and consumer behaviour. Currently, UK banks are awash with liquidity. The BoE has been pumping money into the system through quantitative easing[2] and for the first time in decades there are now more deposits in the UK than loans[3]. Moreover, unlike SVB and Credit Suisse, the UK high street

[1] https://www.bankofengland.co.uk/monetary-policy/the-interest-rate-bank-rate

[2] https://www.bankofengland.co.uk/monetary-policy/quantitative-easing

[3] Bank of England, March 2023

banks have a high proportion of stable household deposits. Since the banks have sufficient deposits, they aren't competing for them as keenly as they have in the past, which they would do by offering higher rates of return. When a UK bank increases the cost of borrowing by 1% it will generally only increase the return it pays on deposits by less than 0.5%[4]. It holds on to the remining 0.5% as increased revenues.

The effects of bad debts

However, as the cost-of-living crisis continues to bite, bad debts are sure to rise among consumers. UK households in aggregate built up savings buffers throughout the Covid crisis when they were unable to go out and spend money how they normally might[5]. In addition, year-ahead wage growth averaged at a high pace of 5.7% in February[6]. Our research suggests that while this is a hard time for UK households, most have enough wiggle room in their budgets to make them stretch – provided the breadwinners in the family remain employed. Once unemployment kicks in, however, it becomes much more difficult to pay the bills. Unemployment is therefore the primary input into banks' forward-looking assessments of credit losses.

We examined what the impact might be of these two opposing forces – improving earnings and rising bad debt – on bank profits and capital. Our data science team took our analyst models and aggregated them up to the system level. We predicted how much net interest income could grow as rates rise and how much the bad debt charge (cost of risk) could increase as unemployment rises. We were then able to calculate what sector level profitability (ROE: return on equity) and capitalisation (Core Tier 1) would be at each interest rate and unemployment rate (Figures 1 and 2 respectively).

Figure 1: UK banks' sector level profitability (%)

UK Bank ROE	Bank of England Base Rate								
UK Unemployment	1.00%	1.50%	2.00%	2.50%	3.00%	3.50%	4.00%	4.50%	5%
4%	6.5%	7.3%	8.2%	9.1%	9.9%	10.2%	10.5%	10.8%	11.1%
5%	4.9%	5.7%	6.7%	7.6%	8.5%	8.7%	9.0%	9.3%	9.6%
6%	3.4%	4.2%	5.1%	6.1%	6.9%	7.2%	7.5%	7.8%	8.1%
7%	1.8%	2.6%	3.5%	4.5%	5.4%	5.7%	6.0%	6.3%	6.6%
8%	0.1%	1.0%	1.4%	3.0%	3.8%	4.1%	4.4%	4.7%	5.0%
9%	-1.5%	-0.7%	0.3%	1.3%	2.2%	2.5%	2.8%	3.1%	3.5%
10%	-3.2%	-2.4%	-1.4%	-0.3%	0.6%	0.9%	1.2%	1.5%	1.8%

[4] UK bank company reports, 2023

[5] The Guardian, Covid savings: Britain built up second highest level on record in early 2021, 30 June 2021

[6] FT.com, UK businesses expect inflation and costs to ease but wages to stay high, 2 March 2023

Figure 2: UK banks' capitalisation

UK Core Tier 1 Ratio	Bank of England Base Rate								
UK Unemployment	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%	4.50%	5%
4%	13.9%	14.0%	14.1%	14.2%	14.3%	14.4%	14.4%	14.4%	14.5%
5%	13.7%	13.8%	13.9%	14.0%	14.1%	14.2%	14.2%	14.2%	14.3%
6%	13.5%	13.6%	13.7%	13.8%	13.9%	13.9%	14.0%	14.0%	14.0%
7%	13.3%	13.4%	13.5%	13.6%	13.7%	13.7%	13.8%	13.8%	13.8%
8%	13.1%	13.2%	13.3%	13.4%	13.5%	13.5%	13.6%	13.6%	13.6%
9%	12.9%	13.0%	13.1%	13.2%	13.3%	13.3%	13.4%	13.4%	13.4%
10%	12.7%	12.8%	12.9%	13.0%	13.1%	13.1%	13.1%	13.2%	13.2%

Source: UK bank company reports and Bloomberg. As at 15 March 2023 the market is pricing base rates to peak at 4.25% and unemployment to remain below 5%.

As can be seen in Figure 1, the UK is in a sweet spot of low unemployment and higher rates. Higher interest rates have pushed return on equity (ROE) to around 10%, indicated by the green zone. Even if unemployment rises and ROE tips into the orange zones we expect the sector to remain profitable. Therefore, we expect capital (Figure 2) to remain above 13%, which is considered healthy.

Our conclusion from this analysis is that the tailwind from rising interest rates is so powerful for the UK banking sector that it would need a significant move towards higher unemployment to dent profitability, and capital would remain at healthy levels. We are comfortable with the UK banking sector as a whole and given the fundamentals are happy to take exposure to some of the smaller, risker UK banks to benefit from fundamental improvement as earnings grow.

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