MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades UK's government bond rating to Aa1 from Aaa; outlook is now stable

Global Credit Research - 22 Feb 2013

London, 22 February 2013 -- Moody's Investors Service has today downgraded the domestic- and foreign-currency government bond ratings of the United Kingdom by one notch to Aa1 from Aaa. The outlook on the ratings is now stable.

The key interrelated drivers of today's action are:

1. The continuing weakness in the UK's medium-term growth outlook, with a period of sluggish growth which Moody's now expects will extend into the second half of the decade;

2. The challenges that subdued medium-term growth prospects pose to the government's fiscal consolidation programme, which will now extend well into the next parliament;

3. And, as a consequence of the UK's high and rising debt burden, a deterioration in the shock-absorption capacity of the government's balance sheet, which is unlikely to reverse before 2016.

At the same time, Moody's explains that the UK's creditworthiness remains extremely high, rated at Aa1, because of the country's significant credit strengths. These include (i) a highly competitive, well-diversified economy; (ii) a strong track record of fiscal consolidation and a robust institutional structure; and (iii) a favourable debt structure, with supportive domestic demand for government debt, the longest average maturity structure (15 years) among all highly rated sovereigns globally and the resulting reduced interest rate risk on UK debt.

The stable outlook on the UK's Aa1 sovereign rating reflects Moody's expectation that a combination of political will and medium-term fundamental underlying economic strengths will, in time, allow the government to implement its fiscal consolidation plan and reverse the UK's debt trajectory. Moreover, although the UK's economy has considerable risk exposure through trade and financial linkages to a potential escalation in the euro area sovereign debt crisis, its contagion risk is mitigated by the flexibility afforded by the UK's independent monetary policy framework and sterling's global reserve currency status.

In a related rating action, Moody's has today also downgraded the ratings of the Bank of England to Aa1 from Aaa. The issuer's P-1 rating is unaffected by this rating action. The rating outlook for this entity is now also stable.

RATINGS RATIONALE

The main driver underpinning Moody's decision to downgrade the UK's government bond rating to Aa1 is the increasing clarity that, despite considerable structural economic strengths, the UK's economic growth will remain sluggish over the next few years due to the anticipated slow growth of the global economy and the drag on the UK economy from the ongoing domestic public- and private-sector deleveraging process. Moody's says that the country's current economic recovery has already proven to be significantly slower -- and believes that it will likely remain so -- compared with the recovery observed after previous recessions, such as those of the 1970s, early 1980s and early 1990s. Moreover, while the government's recent Funding for Lending Scheme has the potential to support a surge in growth, Moody's believes the risks to the growth outlook remain skewed to the downside.

The sluggish growth environment in turn poses an increasing challenge to the government's fiscal consolidation efforts, which represents the second driver informing Moody's one-notch downgrade of the UK's sovereign rating. When Moody's changed the outlook on the UK's rating to negative in February 2012, the rating agency cited concerns over the increased uncertainty regarding the pace of fiscal consolidation due to materially weaker growth prospects, which contributed to higher than previously expected projections for the deficit, and consequently also an expected rise in the debt burden. Moody's now expects that the UK's gross general government debt level will peak at just over 96% of GDP in 2016. The rating agency says that it would have expected it to peak at a higher level if the government had not reduced its debt stock by transferring funds from the Asset Purchase Facility -- which will equal to roughly 3.7% of GDP in total -- as announced in November 2012.

More specifically, projected tax revenue increases have been difficult to achieve in the UK due to the challenging economic environment. As a result, the weaker economic outturn has substantially slowed the anticipated pace of deficit and debt-to-GDP reduction, and is likely to continue to do so over the medium term. After it was elected in 2010, the government outlined a fiscal consolidation programme that would run through this parliament's five-year term and place the net public-sector debt-to-GDP ratio on a declining trajectory by the 2015-16 financial year. (Although it was not one of the government's targets, Moody's had expected the UK's gross general government debt -- a key debt metric in the rating agency's analysis -- to start declining in the 2014-15 financial year.) Now, however, the government has announced that fiscal consolidation will extend into the next parliament, which necessarily makes their implementation less certain.

Taken together, the slower-than-expected recovery, the higher debt load and the policy uncertainties combine to form the third driver of today's rating action -- namely, the erosion of the shock-absorption capacity of the UK's balance sheet. Moody's believes that the mounting debt levels in a low-growth environment have impaired the sovereign's ability to contain and quickly reverse the impact of adverse economic or financial shocks. For example, given the pace of deficit and debt reduction that Moody's has observed since 2010, there is a risk that the UK government may not be able to reverse the debt trajectory before the next economic shock or cyclical downturn in the economy.

In summary, although the UK's debt-servicing capacity remains very strong and very capable of withstanding further adverse economic and financial shocks, it does not at present possess the extraordinary resilience common to other Aaa-rated issuers.

RATIONALE FOR STABLE OUTLOOK

The stable outlook on the UK's Aa1 sovereign rating partly reflects the strengths that underpin the Aa1 rating itself -- the underlying economic strength and fiscal policy commitment which Moody's expects will ultimately allow the UK government to reverse the debt trajectory. The stable outlook is also an indication of the fact that Moody's does not expect further additional material deterioration in the UK's economic prospects or additional material difficulties in implementing fiscal consolidation. It also reflects the greater capacity of the UK government compared with its euro area peers to absorb shocks resulting from any further escalation in the euro area sovereign debt crisis, given (1) the absence of the contingent liabilities from mutual support mechanisms that euro area members face; (2) the UK's more limited trade dependence on the euro area; and (3) the policy flexibility that the UK derives from having its own national currency, which is a global reserve currency. Lastly, the UK also benefits from a considerably longer-than-average debt-maturity schedule, making the country's debt-servicing costs less vulnerable to swings in interest rates.

WHAT COULD MOVE THE RATING UP/DOWN

As reflected by the stable rating outlook, Moody's does not anticipate any movement in the rating over the next 12-18 months. However, downward pressure on the rating could arise if government policies were unable to stabilise and begin to ease the UK's debt burden during the multi-year fiscal consolidation programme. Moody's could also downgrade the UK's government debt rating further in the event of an additional material deterioration in the country's economic prospects or reduced political commitment to fiscal consolidation.

Conversely, Moody's would consider changing the outlook on the UK's rating to positive, and ultimately upgrading the rating back to Aaa, in the event of much more rapid economic growth and debt-to-GDP reduction than Moody's is currently anticipating.

COUNTRY CEILINGS

The UK's foreign- and local-currency bond and deposit ceilings remain unchanged at Aaa. The short-term foreign-currency bond and deposit ceilings remain Prime-1.

IMPACT ON OTHER RATINGS

Moody's will assess the implications of this action for the debt obligations of other issuers which benefit from a guarantee from the UK sovereign, and will announce its conclusions shortly in accordance with EU regulatory requirements. Moody's does not consider that the one-notch downgrade of the UK sovereign has any implications for the standalone strength of UK financial institutions, or for the systemic support uplift factored into certain UK financial institutions' unguaranteed debt ratings.

PREVIOUS RATING ACTION

Moody's previous action on the UK's sovereign rating and the Bank of England was implemented on 13 February 2012, when the rating agency changed the outlook on both Aaa ratings to negative from stable. For the UK sovereign, the actions prior to that were Moody's assignment of a Aaa rating to the UK's government bonds in March 1978 and the assignment of a stable outlook in March 1997. For the Bank of England, the action prior to the one from February 2012 was the assignment of a Aaa rating and stable outlook in March 2010.

The principal methodology used in these ratings was Sovereign Bond Ratings published in September 2008. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this rating action, and whose ratings may change as a result of this rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

The ratings of rated entity United Kingdom, Government of were initiated by Moody's and were not requested by the rated entity

All rated entities or their agents participated in the rating process. The rated entities or their agents provided Moody's access to the books, records and other relevant internal documents of the rated entity.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Sarah Carlson
VP - Senior Credit Officer
Sovereign Risk Group
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

Bart Jan Sebastian Oosterveld
MD - Sovereign Risk
Sovereign Risk Group
JOURNALISTS: 212-553-0376
SUBSCRIBERS: 212-553-1653

Releasing Office:
Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London E14 5FA

United Kingdom
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. ("MIS") AND ITS AFFILIATES ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

 All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources Moody's considers to be reliable, including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling. NO WARRANTY, EXPRESS