Credit Benchmark®

Last Year's COVID Waves May Lead to This Year's Default Tsunami for UK Corporates

January 2021

- **Government support for UK businesses is due to end in early 2021, leaving many at-risk companies in debt.**

- **UK lenders have expected to see a significant rise in defaults since Q2 2020 but actual increases have so far been mild, likely due to large boost in credit availability from government packages.**

- **A significant increase in default rates may be observed as credit becomes less available.**

- **Credit Benchmark data shows that UK companies have an almost 20% higher chance of defaulting in 2021 compared to a year ago.**

- **This data suggests that 1 in 150 UK companies will default this year.**

- **Consumer Services and Oil & Gas are the worst affected industries, with a 27% and 23% increase in default risk compared to a year ago, respectively.**

- **The average monthly drop-out rate (companies disappearing from lenders' portfolios) has doubled in the last year, particularly in the non-investment grade credit categories, suggesting these companies are no longer considered creditworthy by their lenders and thus signalling rising credit risk.**

- **The rate of credit downgrades also increased compared to the rate of credit upgrades across the last year.**

As the clock struck midnight and 2020 came to a close, the words of 'Auld Lang Syne' may have rung hollow for the millions living through another lockdown in the United Kingdom. The tradition of bidding farewell to the old year and welcoming new beginnings seemed like wishful thinking amidst a fresh surge of COVID infection rates and the prolonged economic strangulation of many British businesses.

With the vaccination program picking up pace, Brits may look forward to the prospect of a European summer break or at the least, a drink in the local pub. However, the prospects of that package holiday firm or the favourite 'local' staying afloat long enough to meet post-pandemic demand remains in question. The government's furlough scheme is due to wrap up at the end of April, and the Bank of England's Covid Corporate Financing Facility (CCFF) closes in late March, leaving the future of many British businesses uncertain as they grapple with a year's worth of debt and minimal incomings.

The Bank of England has been monitoring trends in the demand for and the supply of credit for a long time. The Bank's discussions with major UK bank and building society lenders were formalized as the Credit Conditions Survey in 2007, which is since updated on quarterly basis. The 2020 numbers clearly show the impact of the current crisis. The default rates have been in general increasing since early 2018, and UK lenders expected to see a significant rise in the pace of increase in defaults in Q2 2020 but the bleak scenario has not yet been realised. The increase in actual default rates stayed comparable to previous quarters for small and large corporates and only grew slightly for medium corporates. Q3 2020 rates of increase were again lower than expected although large corporates saw a 16% increase in actualised default rates, up from an average increase of 11% in the previous five quarters.

The limited impact on default rates was most likely driven by the large increase of credit availability supplied by various government support packages, which allowed lenders to provide credit even to corporates with lower credit quality. **However, these support packages do not resolve underlying fundamental challenges and may have simply deferred the inevitable. A significant increase in default rates may be observed as credit become less available.**

Credit Benchmark collects internal credit risk estimates from global financial institutions providing a valuable and more granular complement to the outlook survey by the Bank of England. The Credit Benchmark consensus data provides forward looking tracking of changes in the credit risk of existing borrowers and of the impact on the portfolios of the contributing financial institutions.

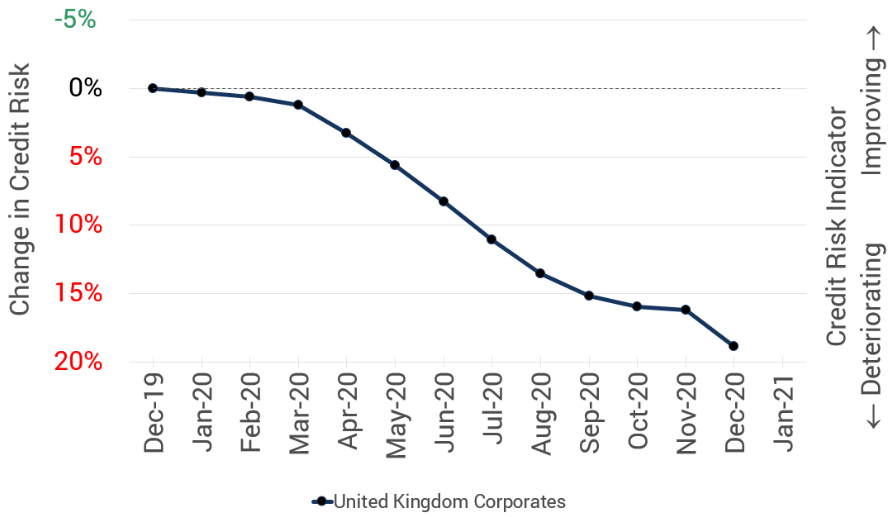

Figure 1: Credit Trend for UK Corporates, December 2019 – December 2020

The data, covering more than 5,000 UK Corporates, show that the average one-year default probability of UK Corporate has risen to 0.67%. In effect, financial institutions expect 1 in 150 corporates to default over the next year. As shown in Figure 1, this represents a 19% higher chance of defaulting compared to a year ago, with Consumer Services and Oil & Gas the most impacted industries (see Figure 2). The steepest increase in credit risk was observed between April and August with an average monthly growth rate of 2.4%. The latter months of the year show a stabilization, with credit risk growing only by 0.2% in November. But the third COVID wave brought another steep increase in credit risk in December.

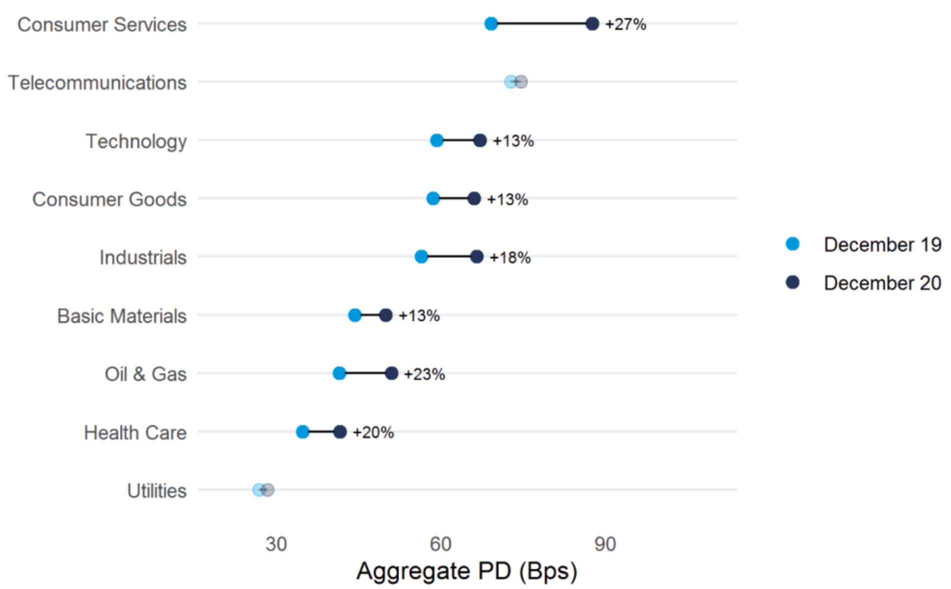

Figure 2: Changes in Average Probability of Default for UK Corporates by Industry, December 2019 - December 2020

As shown in Figure 3, the granularity of the Credit Benchmark data demonstrates that not all sectors have fared equally, with some industries including Telecommunication and Basic Materials even having started to improve in November, but this trend was halted by the impact of the current third wave.

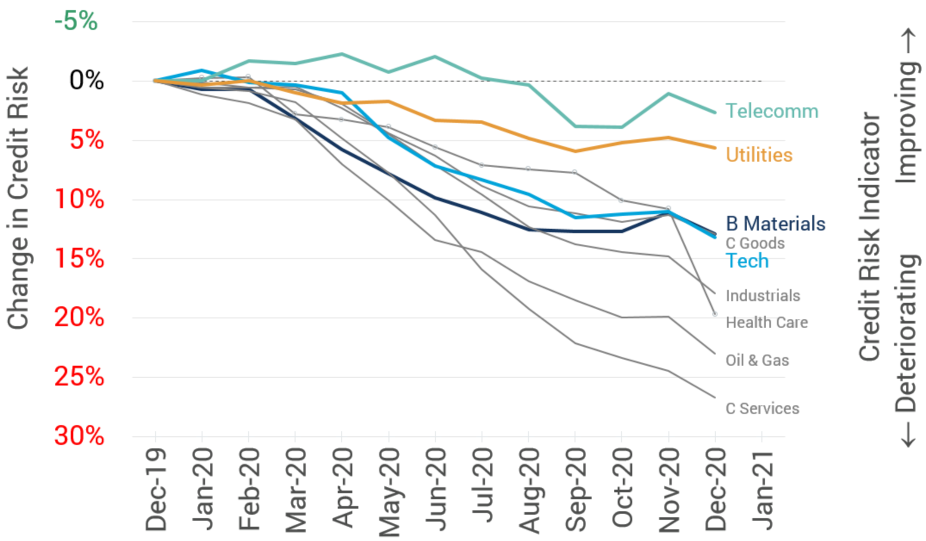

Figure 3: Changes in Credit Risk Trend for UK Corporates by Industry, December 2019 - December 2020

Looking at the universe of UK Corporates with a direct credit risk consensus, we can observe a significant drop in the number of covered entities over the last year, from 6,300 in Dec-19 to 5,300 in Dec-20. This signals that banks have adjusted their portfolios and dropped a number of their exposures, which is interesting in the context of the Bank of England survey showing an increased availability of credit. It is possible that the availability of credit has been selective and not all borrowers have access to it. On average, 2.4% of entities dropped from Credit Consensus Rating coverage every month in 2019 (see Figure 4). This proportion of dropouts almost doubled in 2020 to 4.2%, and all months in 2020 starting with April showed values above the 2019 average with marked spikes in April and June. An entity dropping out of Credit Consensus Rating coverage means at least one financial institution removed them from their portfolio, suggesting that the entity is no longer considered creditworthy. This drop-out is a potential indicator of deteriorating credit quality.

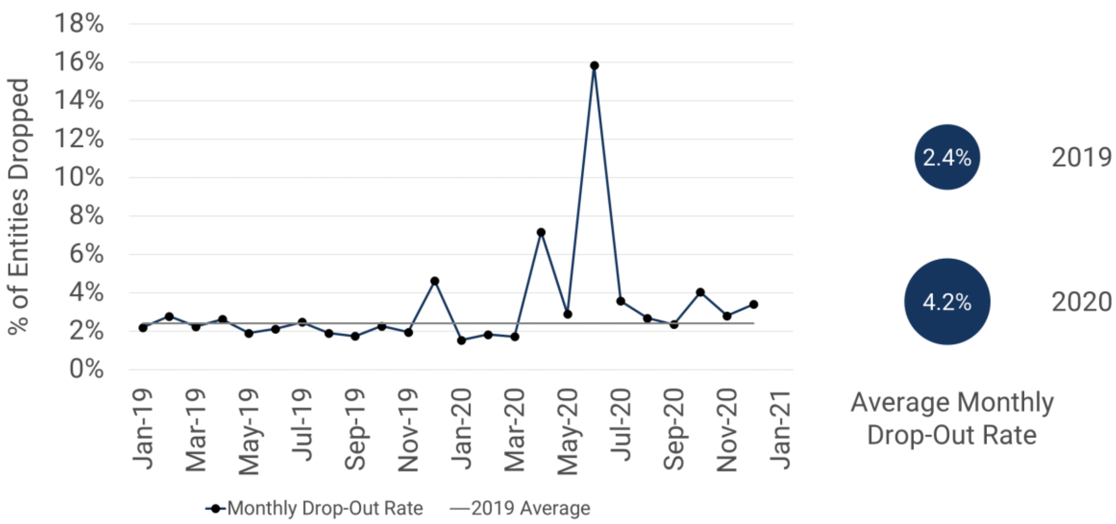

Figure 4: Monthly Drop-Out Rate of Entities with Consensus Coverage, January 2019 – December 2020

Some of the government support programs have been limited to entities with an investment grade rating (see [Bank of England's CCFF page]) so in Figure 5 we investigate the drop-out rates by rating. Figure 5 shows that the financial institutions dropped a larger percentage of entities in more risky categories, which signals that corporates with lower credit quality might have had more difficult access to funding.

Figure 5: Annual Drop-Out Rate of Entities with Consensus Coverage by Credit Category, December 2019 - December 2020

The Credit Benchmark data allow us to observe not only changes in the portfolio structure but also the credit dynamic of individual entities. Figure 6 shows that the average upgrade rate decreased from the 2017-2019 average of 20% to 16% in 2020, while the downgrade rate increased from 25% to 34%, and the growth can be observed across all rating categories.

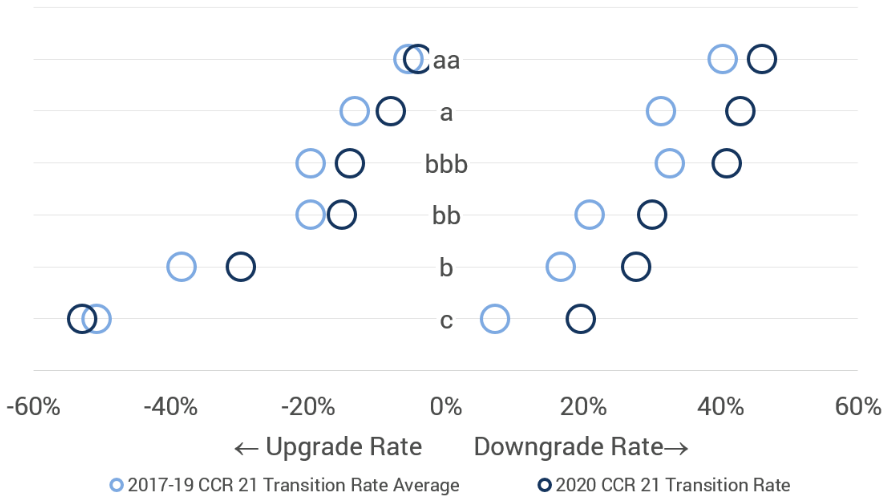

Figure 6: Average Upgrade & Downgrade Rates by Credit Category, 2017-2019 vs 2020

In conclusion, the expectation from the broader market as evidenced by the Bank of England survey is for continued deterioration in market conditions which has not yet taken effect. The Credit Benchmark consensus view from financial banks is consistent with this general outlook but highlights that not all obligors are equal, and that more sophisticated monitoring using forward looking market views could help better navigate what is expected to be a challenging 2021.

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