

Schroders Quickview



Banks remain centre stage 2 March 2009



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- **New Asset Protection Scheme means the UK is moving closer to a 'good bank / bad bank' type of solution to ring-fence bad assets**
- **Some fairly drastic assumptions about the pace of future decline (extrapolating the sharp downturn in recent months) may be reflected in latest writedowns.**
- **This could ultimately draw a line under the market's capital adequacy concerns**

A busy banking week

The banking sector continues to dominate market news in the UK. Last week Royal Bank of Scotland (RBS) and Lloyds Banking Group (Lloyds plus HBOS) unveiled sharp losses. Yesterday HBOS announced plans for a rights issue to raise £12 billion and cut its dividend on falling profits.

Asset Protection Scheme

The UK government announced further details of its Asset Protection Scheme, expected to insure more than £500 billion of banks' vulnerable assets. Commercial loans or mortgages which have declined rapidly in value over the last year will be ring-fenced, and the participating banks will be insured from losses above a certain level should these assets not recover. In the very worst case scenario, the UK taxpayer might be called on to pick up the rest of the tab. RBS's participation has already been confirmed and the extent of Lloyds' participation is still unclear. Investors will be watching to see whether Barclays participates, and on what terms.

We believe that in the creation of this scheme, the UK is moving closer to a 'good bank/bad bank' type of solution, with the new plan providing an opportunity to free up risk-weighted assets in order to stimulate credit creation. The government clearly has no desire to nationalise the banking sector.

Royal Bank of Scotland (RBS) announced 2008 losses of over £24 billion, and said it would put £325 billion assets into the UK government's Asset Protection Scheme. The government is also injecting a further £25.5 billion in return for shares. However, the government has deliberately stopped short of fully nationalising RBS.

Our view: RBS had clearly flagged losses in advance, and its results were not the main focus. In its participation in the government's Asset Protection Scheme, the bank has attracted relatively favourable terms. However, while RBS will be paying lower fees than some had feared, this is clearly no gift from the taxpayer. Overall, with the shares at a significant discount to net asset value (NAV), we continue to hold the stock and will add at distressed levels.

On Friday **Lloyds** announced a 75% fall in profits over 2008, but remained profitable, while the recently acquired HBOS (Halifax/Bank of Scotland) lost £7.5 billion for the year. The group has not yet finalised a plan to put assets into the government-backed scheme.

Our view: The market was clearly disgruntled that there were no details in terms of its involvement in the government's scheme, and the bank is still in negotiations. Lloyds is now 43.5% owned by the taxpayer and

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maintains that it does not want the government's shareholding to rise above 50%. It is difficult to comment without further details.

The results were worse than expected – in particular the impact on HBOS's book value from bad loans. In the long term, however, provided shareholder equity isn't diluted significantly through further capital raisings, investors should make good returns from this huge UK banking conglomerate. Shares are currently trading at a significant discount to NAV. We await more details on the asset protection scheme and we continue to hold.

HSBC has announced plans to raise more than £12 billion through a share issue in order to shore itself up against the global economic downturn. The company this morning issued pre-tax profits for 2008 of £6.5 billion, down 62% on the previous year, cutting its dividend.

Our view: We are currently underweight HSBC in our UK equity portfolios. However, we think this capital raising is sensible and we believe the bank is being cautious, and realistic in terms of tough times to come. Its retreat from its disastrous acquisition of Household in the US should also help restore its competitive position: it is writing off most of the value of this sub-prime consumer finance business which it bought six years ago.

Even at this reduced dividend level, the ex-rights shares yield a very attractive 5%+. We may look for an opportunity to add.

The HSBC news is throwing a spotlight on **Standard Chartered** as investors compare the scale of its Asian write-downs to HSBC – and the fear is that Standard Chartered's write-offs are still on the light side. It also went through a capital raising late last year, but its capital ratios now look less robust when compared with HSBC's. Standard Chartered has been one of the better performing bank shares over the last two years and for the last twelve months we have been reducing exposure.

Drawing the line

The UK government is trying to draw the line. Its Asset Protection Scheme and latest capital injections are aimed at preventing the need for further capital raisings or, indeed, the nationalisation of the banks.

The scale of the deterioration in the loan books over the past few months reflects the sharp downturn in the global economic climate over this time. The speed of the downturn has surprised everyone and, in our opinion, means some fairly drastic assumptions about the future are reflected in the degree of write-downs.

While there could be further poor newsflow in the near term, and market sentiment is clearly against banks, we believe the latest news should ultimately draw the line under the market's capital adequacy concerns.

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