

Schroders Quickview

UK government moves support senior debt

8 October 2008



Roger Doig
Credit Analyst

- **The UK government measures are a significant positive step from a credit perspective**
- **We would expect other European governments to look for similar measures over the coming days**
- **Senior bank creditors are beneficiaries. Our focus on maintaining exposure at senior levels in the highest quality names is being supported**
- **In the US, banks' net interest margins should expand over the coming quarters and, with funding secured, in our view the major banks look well-positioned to trade through the downturn.**

The UK government's support package for the UK banks is the latest and boldest of a series of recent government interventions to support banking systems. As we have seen with other recent government interventions, senior bank creditors have been beneficiaries, with the government extending a guarantee to short and medium term debt issuance for eligible institutions. This is entirely understandable – while the governments are ostensibly protecting depositors, many European banks are highly dependent on wholesale markets, and unfreezing these markets is as important a step in securing the banking system as maintaining depositor confidence.

From a credit perspective, therefore, we believe the UK government measures are a significant positive step. We would expect other European governments to look at similar measures for their domestic banks over the coming days. For our investment strategy, we are reassured that our focus on maintaining exposures at the senior level in the highest quality names is being supported, and we do not need to rush into government bonds which offer significantly lower spreads. With governments taking action, we believe there is no need to eschew credit risk altogether.

This is also the case in the US, where the moves to support the commercial paper market and guarantee money market funds, the steep yield curve, and the nationalisation of Fannie Mae and Freddie Mac all combine to underpin bank credit. Certainly, the banks face the prospect of a recession, but net interest margins should expand significantly over the coming quarters, and funding has been secured, which in our view means the major banks look well-positioned to trade through the downturn.

Hybrid debt

If we are comfortable with senior, bank level risk, would we also consider investing in junior debt securities? After all, the government is injecting equity or preference capital into the banks, which provides additional support for these issues.

In principle, we accept the argument that junior securities could in theory benefit from the injection of capital. However, we have seen in several instances that capital injections do not in practice provide much support. A number of European banks issue senior debt at an operating company level, while junior debt securities are issued at holding company level. This means that support for senior debt may benefit more junior securities. In addition, while governments are stepping in to support banks, we think it unlikely they will be comfortable to allow banks to call junior securities, which count towards bank capital ratios.

Furthermore, many of the buyers of hybrid debt, particularly Tier 1, have been life insurers, who have focused on the rating of the debt, rather than the risk. Rating agencies typically automatically rated the junior

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securities one or two notches lower than their senior debt ratings. Recent events have shown the methodology to be rather simplistic – the default risk of Tier 1 debt is clearly much higher than senior debt. At some point we expect rating agencies to reassess their ratings on these bonds, which will trigger forced selling. We would rather wait for this to happen before buying into the asset class.

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