

Schroders Quickview



Banks update 30 September 2008



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- **The failure of the US bailout package is a short-term negative, and we are likely to see more ad-hoc moves by local regulators**
- **These actions are designed to reassure depositors and the money markets; the cost inevitably rests with shareholders**
- **Interest rates need to fall significantly, plus fixing some issues in the banking sector will be a long haul**
- **But there are winners – for some banks net interest margins and market share are likely to increase**

The rejection of the US bail-out package is clearly a near-term negative for the European banks sector as it delays any stabilisation in money markets. Until banks become confident enough to lend to each other we are likely to see continued ad-hoc reactions by local regulators and governments to 'prop up' those banks with a high dependence on wholesale funding and 'question marks' over capitalisation. Unfortunately, there is quite a long list of European names in this position.

Thus far this week (it is only Tuesday morning as I write this!) we have seen:

- Bradford & Bingley nationalised in the UK (with deposits and branches sold to Santander)
- Fortis forced to sell over 50% of its banking earnings to governments in Belgium, Holland and Luxembourg
- the Irish government guaranteeing 100% of deposits of Irish banks (including interbank, covered bonds, senior debt and dated subordinated debt)
- Hypo Real Estate in Germany supplied with a government organised €35 billion emergency credit line
- Dexia injected with €6.4 billion of new capital from the governments of Belgium, France and Luxembourg as well as core shareholders.

Clearly, all these actions are designed to reassure depositors and the money markets. However, the cost of this inevitably rests with shareholders. Further actions seem likely in the coming days meaning that we have to tread extremely carefully as investors. In many cases value is there, but in some it is illusory.

In my view interest rates need to fall significantly in the UK and Europe. The banks are likely to 'swallow' initial cuts as they look to rebuild profits and capital; hence significant cuts need to be made to have an impact on the real economy. This will help restore confidence. However, it does not detract from the fact that many banks are light on capital and deposits and heavy on 'toxic assets' and wholesale funding. Fixing these issues will be a very long haul. However, for the 'winners' net interest margins and market share are likely to structurally increase, preserving the overall level of returns in the face of tighter capital and liquidity constraints.

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