

# Schroders Quickview



UK Equities  
29 June 2009



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- **Banks seem to be in a position to withstand the difficult economic and bad debt environment**
- **Regulatory changes may require further capital raising over time, but the process should be gradual to avoid any market shocks**
- **A 'normal' banking environment remains some way off, but we expect to see our names generating good margins and trading at premiums to book value on a two- to three-year view**

## UK banks – safe again?

With all the major UK domestic banks' shares up between two- and five-fold from their lows of the spring, how safe is it investing in the sector again? Have the banks raised sufficient capital for the waves of bad debts which they continue to face or is this merely a relief rally likely to be unwound in the coming months?

Clearly at this stage of the downturn, it is impossible to say with complete certainty that sufficient capital has been raised. Gloomy forecasts of a multi-year recession or a further significant lurch down in global activity could frighten regulators into demanding further capital-raising. However, it is clear that we have come a long way from the panic lows of February and March.

## Lloyds and RBS underpinned by APS

Crucially, Lloyds and Royal Bank of Scotland have participated in the government's Asset Protection Scheme (APS), whereby in exchange for a substantial fee they have been able to limit losses on their worst loans, with the government shouldering any further impairment. Whilst the cost of this has been massive dilution to shareholders, we can take comfort that the assumptions underpinning the APS have been pretty cautious. Bad debts are assumed to be substantial, with the economic backdrop anticipated to be every bit as bad in 2010 as in 2009. Given the degree of monetary and fiscal stimulus being applied, this looks quite conservative.

## Barclays making its own way

Barclays has sought to avoid government support throughout the crisis. Whilst dilutive to shareholders, last year's capital raising with Middle Eastern investors enabled it to pass the FSA's stress test earlier in the year – a test clearly intended to reassure investors that the bank could weather the storm without the need to participate in the APS. This accomplishment came with the proviso that the bank raised some additional capital, which it chose to do initially via the sale of its iShares business but eventually through the sale of its entire investment arm, BGI.

This sale does, of course, change the mix of Barclays' business – effectively increasing the exposure to the investment banking arm BarCap. At present, however, the strength of the investment banking environment, courtesy of booming bond and equity issuance, renders this a positive for Barclays. Furthermore, its purchase of the US Lehman business at the nadir of its fortunes looks very astute.

## Never say never

Clearly, it is a brave call to suggest that there will not be further shocks to the global economy or the banking system which ultimately may require additional capital to be raised. But given the events of the last few months, including the substantial rights issue by HSBC, it looks increasingly likely

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that sufficient has been done to render the sector strong enough to withstand the current difficult environment. Talk of outright nationalisation has died. Appetite for investing in UK banks has returned to the extent that one of Barclays' Middle Eastern investors has been able to sell their stake back to investors for a substantial profit.

### **Regulatory change**

One source of uncertainty for the banks remains the degree to which regulators change the rules post-crisis, requiring greater amounts of capital to support their business going forward or new liquidity tests. Encouragingly, it looks likely also that there will be a move towards some form of counter-cyclical provisioning. In other words, rules that enable the banks to make prudent reserves during the good years for use during the bad times – a common-sense approach which has in recent years been prevented by accountancy rules.

It is perfectly possible that regulatory change may require further capital raising in time, but we believe any changes by the authorities are likely to be gradual rather than risk shocking the market with a plan that requires further immediate calls for capital.

### **An artificial normal?**

Finally it is worth bearing in mind that whilst the rally in bank shares, together with the re-opening of the bond and equity markets for capital raising, suggests a degree of 'business as usual', we are still a long way away from a 'normalised' banking environment. Critically, the banks are continuing to fund their activities via the central banks as the wholesale money market remains essentially closed for business. This situation will need to correct at some point and it is highly likely that the sector will remain volatile as the regulators and central banks strive to re-open the wholesale market and draw investors back to some form of securitised issuance.

So the sector is likely to remain volatile – and one cannot rule out further need for capital. But we continue to invest with a long-term view. Two to three years down the line, even if more capital is required to support their businesses, a much more concentrated competitive landscape should see our favoured banks achieving good margins and generating good returns on equity once more. Most importantly, this should enable them to trade at a premium to book value once again, so given today's starting valuations we continue to believe they represent attractive investments.

Given moves from the lows of up to five-fold, clearly the 'easy money' has been made during the upswing of the past few months. However, we still believe there is an attractive opportunity to be gained from investing in the UK's banks.

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