

Market View – UK Banks

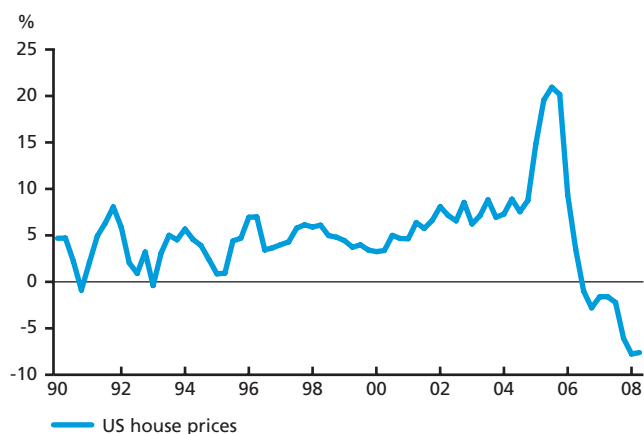
August 2008

With several banks reporting that trading conditions in the first half of this year were the most difficult they have faced for decades, Alliance Trust Global Financials Analyst Tim Gibbens looks at what the punishing effects of the credit crunch mean for the outlook of the UK banking sector. The recent sharp decline in the US housing market led to more than \$500bn (around £260bn) of write-offs for financial sector companies worldwide by early August. Uncertainty remains about whether all the bad news is out yet. Looking ahead, the key areas to monitor are the strength of banks' capital and liquidity positions and their exposure to commercial property and to specialist mortgage markets. Even though valuations now look attractive on a long-term basis, the UK banking sector still has to prove that its relatively weak capital ratios will be sufficiently robust.

Effects of the crunch – capital strain, pressure on loans and questions over property

The credit crunch and its effects have their roots in an era of low interest rates. Seeking higher returns, financial companies around the world purchased high yielding structured finance products such as RMBSs (residential mortgage backed securities) and CDOs (collateralised debt obligations) which had US mortgage assets as their underlying collateral. These securities, that were typically AAA rated, which implied a very low probability of default by the underlying borrower, appeared to be an attractive use for some of their surplus capital. However, when US housing prices tumbled, banks had to cover the losses. This has led to RBS, Barclays, HBOS and Bradford & Bingley collectively raising over £20bn of capital.

US house prices



Source: Ecwin, National Association of Realtors

	Cumulative writedowns to end H1 08 (£bn)	Capital raised to end H1 08 (£bn)
Alliance & Leicester	0.9	-
Barclays	7.5	4.5
Bradford & Bingley	0.3	0.4
HSBC	3.2	-
HBOS	4.8	4.0
Lloyds TSB	2.0	-
RBS	8.7	12.0
Standard Chartered	0.3	-

Source: Citigroup, Merrill Lynch

Despite the efforts to bolster their balance sheets, it remains debatable whether UK banks' balance sheets will be sufficiently strong going forward. In many cases their capital ratios still appear low compared with those of their European, North American and Asian peers. Alternative means of repairing balance sheets include slower loan growth, selective disposals, reduced share buybacks or dividend cuts. Further capital raising certainly cannot be ruled out.

A lack of disclosure has also led to banks being reluctant to lend to each other due to uncertainty over which banks own which structured products. Loans tend to be priced off base rate with funding costs based on three month LIBOR so the increased differential between these two interest rates has put pressure on banks' margins. In order to pass on higher funding costs, the banks have increased their loan pricing, further exacerbating already slowing demand.

The effect of this credit crunch (i.e. a reduction in loan supply) and increased loan pricing can be seen most markedly in the UK housing market where the price fall is starting to mirror what occurred in the US (see graph on next page).

Apart from the housing market, another area of concern for the banks has been their exposure to commercial property. Prices have fallen sharply here too, due largely to lower capital returns, though concern is now shifting to lower expected rental demand for retail and office property. Some banks, such as Lloyds TSB and HBOS, have been aggressive in increasing their property exposure, though their focus has been on well let investment property rather than more risky developments.

No rate relief yet for banks with Asian focused banks best placed

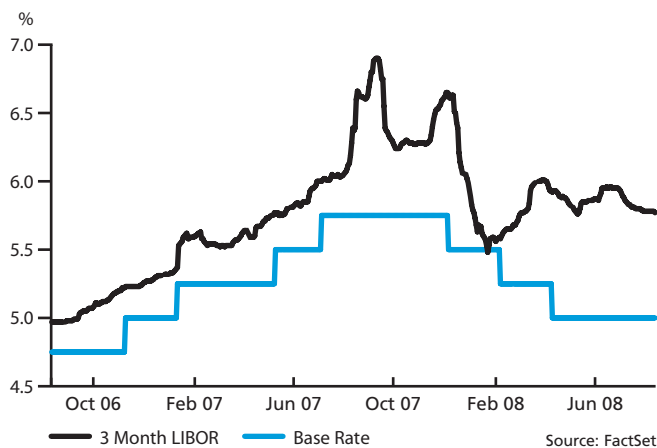
There is still uncertainty over the extent of banks' future write-downs and whether they will need to raise further capital. Loan growth has been restrained and the price of these loans has increased. The resultant macro slowdown is expected to lead to credit quality deterioration but the question is how bad will things get? While the Bank of England has taken various measures to increase liquidity in the markets, further interest rate cuts that would help borrowers may be off the agenda as long as inflation, especially in food and energy, remains at current elevated levels.

The banks that seem best positioned are those with strong capital and liquidity positions, such as HSBC. By contrast, banks with high loan/deposit ratios such as Bradford & Bingley are relatively more dependent on expensive wholesale funding. The more domestically oriented banks are more exposed to the slowing UK economy than HSBC and Standard Chartered, both of which have a strong presence in Asia, a region relatively unaffected by the credit crunch thus far. However, if the US slowdown was to be particularly sharp or prolonged, Asia would certainly not be immune because of its reliance on the US as an export market, and because rising inflation has become a key issue in many Asian countries. Negative real interest rates there are likely to lead to further monetary and fiscal policy tightening going forward.

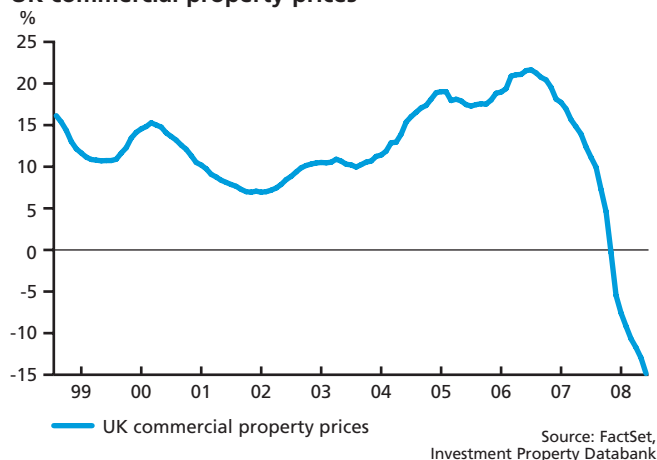
Outlook – economic doubts but attractive long-term valuations

The outlook for the UK banks remains challenging with interest rate cuts unlikely if inflation does not moderate but there

3 month LIBOR v.s base rate



UK commercial property prices



are distinctions within the sector. The key to an improvement in current conditions is undoubtedly a stabilisation of the US housing market. This is not likely to arise until some time in 2009, once prices have reached a clearing level, correcting the present imbalance between supply and demand.

While credit quality may continue to deteriorate, defaults are not expected to rise to the levels experienced in the early '90s because of a relatively high level of employment and relatively low, stable interest rates. The business areas of most risk would appear to be specialist mortgage markets such as buy-to-let and self-certified lending as well as some areas of the corporate loan market, including commercial property and unsecured retail lending such as consumer credit and credit cards. To determine how banks will fare, we need to monitor the course of UK house prices because there is a higher correlation between house price inflation and consumer spending in the UK than in other economies.

Another effect of the crunch could be an increase in consolidation within the sector. Potential buyers, though, are probably more inclined to see how the credit crunch unwinds rather than pursue deals in what is still a very uncertain environment. The smaller mortgage banks, such as Alliance & Leicester (presently subject to a bid from Spanish bank Santander) and Bradford & Bingley, would seem to be the most likely targets given their valuations, their digestible size and lack of strategic options. In general, though, the UK banking sector is relatively mature and concentrated so consolidation is unlikely to be as important a driver as in the far more overbanked US sector.

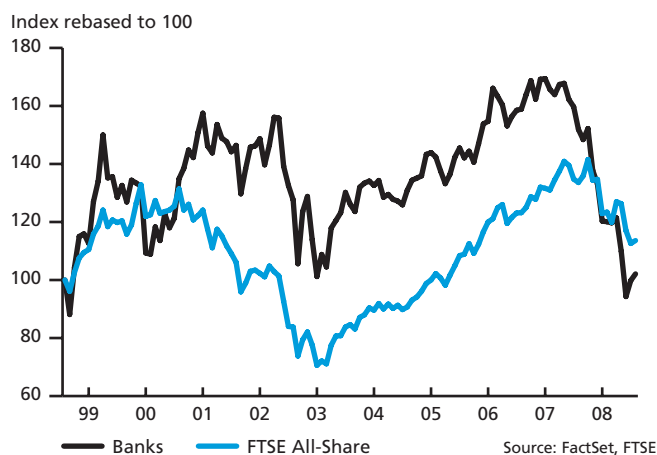
Although the crisis has not yet ended, valuations among the UK banks are now compelling, especially on a long term basis. Most banks are trading on single digit P/E multiples and at or near book value. Returns on equity are expected to be lower going forward dropping to the mid teens from the high teens and low twenties they enjoyed before the crunch. This is because of the banks' need to deleverage, but this fall in returns is arguably discounted in valuations. Banks' dividend yields are at historic highs although, in some cases, this may simply reflect market expectations of future dividend cuts.

When conditions eventually stabilise, banking stocks are likely to experience a sharp bounce but it may be short-lived. Tough fundamentals such as a relative lack of growth options, pressure on margins from increased competition and still-stretched capital positions will soon reassert themselves.

UK house prices



Banking sector stock performance v.s stockmarket



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