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INVESTMENT NOTE **30 OCTOBER 2014**

Hermes: Solid Q3, but Barclays awaits UK leverage ratio rules says Senior Credit Analyst Filippo Alloatti

Third quarter recap

Headline profit before tax of £1.59bn was ahead of consensus expectations of £1.2bn. Core revenues are in line, with the investment bank down quarter-on-quarter and year-on-year, but in line with consensus. Non-core losses are a bit lower. It seems it may outperform the 2014 risk-weighted asset (RWA) reductions.

Barclays did rather well in the third quarter, with statutory pre-tax profit rising to £3.7bn, up £1.2bn year-on-year. However, the adjusted after tax number is flat year-on-year, at £2.6bn. Group return on equity was 6.3%, with core return on equity at 10.5%.

One-offs: Barclays booked £170m in new PPI, which takes it to £910m for the year. It also booked a £360m loss on the sale of Spanish operations, and a £500m provision for FX fines. This was offset by Lehman Brothers acquisition gains.

Fully-loaded common equity tier 1 was 10.2%, up 30bp, and leverage is 3.5% - which is fine for the moment. Obviously the market is waiting for tomorrow's Prudential Regulation Authority (PRA) announcement.

Sensible investment bank restructuring

With the new regulatory environment and the subsequent retrenchment of competitors, Barclays' investment bank is one of the few global players with a strength in fixed income, currency and commodity (FICC) trading - and leading positions in the two largest investment banking markets, North America and the UK. Barclays maintains the business aims to minimise earnings volatility.

In 2013, the investment bank generated £2.5bn in profit before tax, about half of total group profit. Within the investment bank, FICC activities accounted for just over half of total revenues. Barclays continues to invest in its equity business and is aiming to increase the contribution of revenues from equities and investment banking. In the first half of 2014, its equity value at risk (VaR) had become the largest contributor to total VaR, overtaking credit risk VaR for the first time.

Barclays has identified £79bn of legacy RWA within the investment bank and aims to reduce this to £36bn by 2015. The largest remaining component is a £19bn portfolio of interest rate derivatives. Within European retail, there is £9bn of legacy RWA, of which half is in Italy and a third in Spain.

Awaiting the PRA's leverage ratio decision

On Friday, we should get the final calibration of the UK leverage ratio by the PRA. Expectation is for a 5% target. Previously we had a minimum of 3%, to be met by June 14. The regulator may consider excluding additional tier 1 (AT1) instruments from the calculation of the leverage ratio, or to cap the amount of AT1 eligible for inclusion in the leverage ratio calculation. This would require a bank such as Barclays to reduce its leverage exposure further than currently planned.

On the plus side, the bank's RWAs already reflect prudent valuation adjustments on its derivative portfolio, which has not yet been the case for other EU banks and is likely to increase RWA at some of its peers. Deutsche Bank is a case in point here, which as of the end of September has yet to take this €2.5bn-€3bn hit.

As of June 2014, Barclays had an estimated PRA leverage ratio of 3.4%. The target is for a ratio above 4% by 2016.

In terms of supply of debt from Barclays, we should have more clarity after Friday, as well as the G20 summit in Australia on 15 November.

ECB stress tests

At 7.1%, Barclays was well above the common equity tier 1 threshold under the EBA's adverse scenario, giving it a 160bp capital buffer.

Probably a limited catalyst for most investors, except perhaps for the AT1 with a 7% trigger, with the trigger being very close to the stress test outcome (10bps buffer). The main reason for the smaller buffer is a £5.3bn loss on the trading book, which would seem a very remote risk compared to the credit risk.

-ENDS-

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Notes to Editors:

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