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INVESTMENT NOTE **27 FEBRUARY 2015**

HERMES: BANK REVIEW – NEW STANDARD CHARTERED CHIEF FACES CAPITAL CHALLENGE

Filippo Alloatti, Senior Analyst, Hermes Credit, reviews this week's news from Standard Chartered, Lloyds and RBS.

"Standard Chartered this week announced Bill Winters will take over as group CEO in June 2015, replacing Peter Sands, who has been in charge for the last 8 years. Chairman Sir John Peace will also step down during the course of 2016.

Given the recent spread, as well as share price and earnings weakness, we think these management changes are positive. We look forward to hearing the new team's strategy later this year.

Various past press articles have highlighted a number of initiatives the bank may consider to help boost its capital position. Firstly, Standard Chartered could sell its stakes in the likes of Agricultural Bank of China, PT Bank Permata and Asia Commercial Joint Stock Bank. The current market values of these are a combined $1.4bn. This is likely to be helpful in reducing its risk weighted assets. It could also sell its leasing business Pembroke, a portfolio worth about $4.9bn, to free up capital. There are also reports it could exit some principal investments, such as its private equity stakes.

There is more evidence, following the recent closure of the equities division, that Standard Chartered is streamlining its business and looking to incrementally increase capital. However, the bank either needs a more concrete de-leveraging plan or a capital raising large enough to withstand the continued uncertain emerging market and commodity environment. This will be the number one priority for Bill Winters.

Standard Chartered will need to raise $5bn-6bn to get to a common equity tier 1 ratio of 12%. This is required for loan write-offs, risk weighted assets inflation and restructuring initiatives.

Is Lloyds' restructuring over?

The Lloyds Banking Group has reduced its non-core risk weighted assets by more than 75% over the past seven years, to £51bn as of end of September 2014. This is a significant reduction and beats estimates. This has propelled the bank's fully loaded common equity tier 1 ratio to 12% and the total capital ratio to almost 20%.

Lloyds' liquidity position has improved substantially, with an ample liquidity pool as its wholesale funding continues to decline as it de-levers. The short-term funding dependence in particular – which was a key weakness of the former HBOS – has been reduced by over 75% to less than £20bn. The loan-to-deposit ratio has been cut by almost 50 percentage points to 109% over the last five years.

Such progress was initially helped by the Bank of England's QE programme and reflects the current UK environment of bank deleveraging and scarce lending opportunities.

Lloyds' asset quality has improved and there could be more to come. Loan impairments have been falling consistently since the peak in 2009 and have normalised in 2013, where it fell from £1bn in Q1 to £0.5bn in Q4. If historical bank numbers in the UK are anything to go by, provisions tend to stay a third below the normalised level for a protracted period of time. A simple regression analysis would suggest there is much further scope to reduce impairments from here.

Lloyds received approval from the Prudential Regulation Authority to resume dividend payments – albeit a token one of 0.75p announced this morning. In terms of below-the-line items, £2.5bn of unutilised provisions will help absorb additional PPI charges.

The challenge for Lloyds is translating its strong franchise into solid income growth. Its prospects will also be influenced by the outcome of the general election in May. Proposals aiming to cap the market share of the top four retail banks, additional bank levies and cap on deferred tax utilisation are to be watched.

Usual RBS challenges

RBS' full year 2014 results were affected by a usual long list of one-off items – £563m in restructuring costs, £1.16bn of conduct charges, a £250m UK bank levy, as well as a £1.5bn deferred tax write-off and the £3.9bn Citizens writedown. The last two exceptional items are an accounting loss, but importantly, are capital neutral. The bank's £4.1bn of cumulative litigation provision seems an adequate buffer to us.

The underlying result was relatively good, with improving net interest margins, manageable costs and returns below the 12% long-term target. The group's credit profile is now much more normalised and the bank is targeting a 13% common equity tier 1 ratio by the end of 2015, mostly by further reducing non-core risk weighted assets. The sale of its remaining stake in Citizens is a large part of this.

Management confirmed its intention to issue £2bn of additional tier 1 capital in 2015, as promised to the Prudential Regulation Authority after scraping through its stress test in December."

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Notes to Editors:

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