

The equity analyst view of A&LM

Presentation to ALMA

Mark Thomas

11th October 2005



KEEFE, BRUYETTE & WOODS
Specialists in Financial Services

Agenda

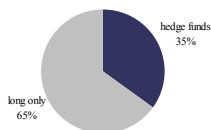
- 2 minutes on K.B.W.
- 2 minutes on investors' views of the UK banks
- Analysts' views of A&LM
 - ◆ Where analysts come from
 - ◆ Focus on accounting results as well as cash
 - ◆ Acquisition issues
 - ◆ Hedging techniques
 - ◆ What risks should the bank run
 - ◆ Liquidity management
 - ◆ IAS / Basel
 - ◆ Definition of successful A&LM

Largest specialist global sales team

– bigger on Nasdaq trading than UBS, CS, Morgan Stanley



Accounts: 800

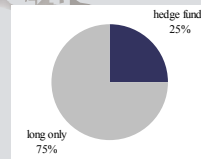


Sales team*: 62

including 5 for European product

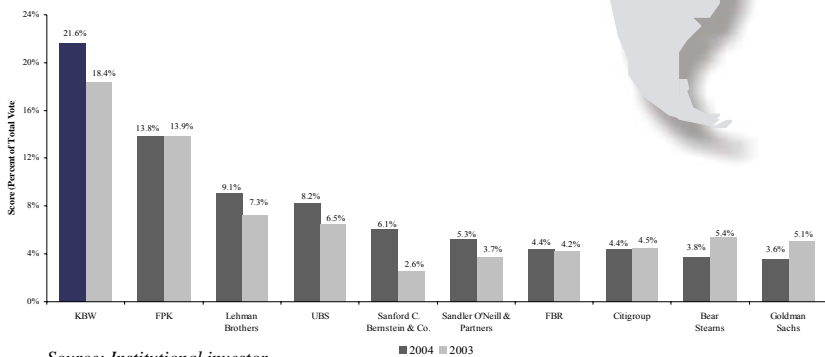


Accounts: 167



Sales team*: 12

2004 “Best Financial Institutions Sales Team”



Source: Institutional investor

*Includes sales traders and excludes market makers

2005YTD Leading NASDAQ 100 Financial Trading

Rank	Broker	Trading Vol 1/1 - 8/22 (000)	% Of Total	Securities Traded
1	Merrill Lynch	591,575	11.35	101
2	Citigroup	493,017	7.88	100
3	Lehman Brothers, Inc.	432,500	7.22	86
4	Keefe, Bruyette & Woods	396,551	6.56	101
5	UBS	382,471	6.46	101
6	Credit Suisse First Boston	380,665	5.19	101
7	Morgan Stanley	307,668	4.84	101
8	Prudential Securities	292,300	4.57	85
9	Knight Equity Markets	270,450	3.67	100
10	RBC Capital Markets	267,734	3.65	79

Source: BlockData as of 8/22/05 – Industry Rankings of Investment Banking & Trading Firms NASDAQ 100 Financial Index



2005 leading M&A advisor to financial institutions

KBW is the leading M&A adviser to financial institutions as ranked by number of transactions, extending its record of the past seven consecutive years.

Historical Rankings		
Year	# of Deals	Deal Value
2004	1	9
2003	1	9
2002	1	3
2001	1	8
2000	1	7
1999	1	9
1998	1	8



Deal Value Rank	Volume Rank	Advisor	2005 YTD	
			Deal Value	Number of Deals
1	1	Keefe Bruyette & Woods Inc.	38,227	23
2	11	UBS Securities LLC	37,824	6
3	3	Goldman Sachs & Co.	27,294	11
4	7	Credit Suisse First Boston USA	15,260	7
5	9	Citigroup Global Markets	13,885	6
6	5	Morgan Stanley	11,983	9
7	51	Banc of America Secs	11,500	1
8	10	Lehman Brothers Inc.	9,892	6
9	19	First Annapolis Capital Inc	8,559	4
10	28	J.P. Morgan Securities Inc.	7,140	3
11	54	Bear Stearns & Co.	5,351	1
12	15	Merrill Lynch & Co.	3,288	5
13	61	Deutsche Bank Securities Inc.	2,650	1
14	2	Sandler O'Neill & Partners LP	2,453	17
15	48	Thomas Weisel Partners LLC	1,350	2


 Acquisition of:

 \$35 billion
 Current


 Acquisition of 31%
 stake in

 \$86.8 million
 November 2004


 Acquisition of
 51% stake by:

 \$3.8 billion
 August 2004

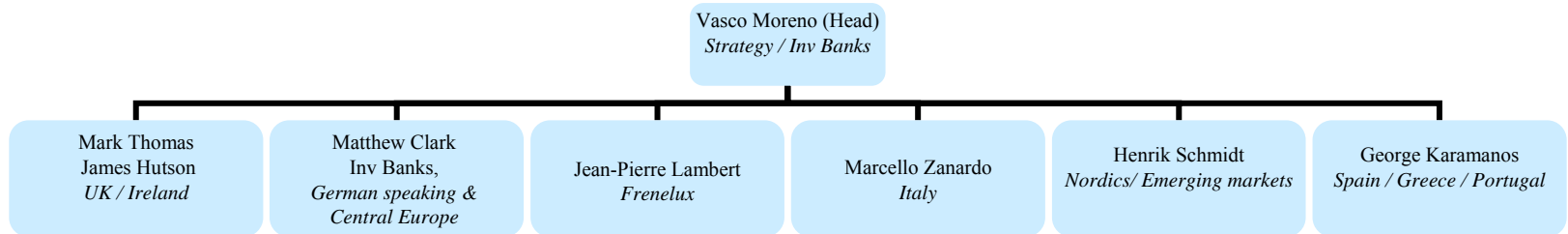

 Helping everyday people. Everyday.
 Acquisition by:

 \$15.3 billion
 November 2002


 Acquisition by:

 \$494.5 million
 September 2002

Comprehensive European coverage across geographies & market cap



	UK	Eire	Germany	France	Italy	Nordics	Spain	Greece	Other
>€5.0 bn	RBS	Allied Irish	Deutsche Bank	BNP Paribas	Unicredito	Danske Bank	BBVA	Alpha Bank	Millennium bcp
	Barclays	Anglo Irish	Commerzbank	Société Générale	Banca Intesa	DNB NOR	Banesto	EFG Eurobank	Sberbank
	HBOS	Bank of Ireland	HypoVereinsbank	Crédit Agricole	Sanpaolo IMI	Nordea	Popular	NBG	ISCTR
	Lloyds TSB				Mediobanca	SEB	Sabadell		Akbank
	HSBC		Austria	Bnlx	MPS	SHB	SAN		OTP
	Standard Chartered		Bank Austria	Dexia	Capitalia	Swedbank			PKO
	Alliance & Leicester		Erste Bank	KBC	BNL				Garanti
	Northern Rock		Raiffeisen International	ABN Amro	BPU				
					BPVN				
						Carige		Bankinter	Piraeus Bank
€1.5bn > €5.0bn	Bradford & Bingley				BPM				BPI
	Provident Financial				Carifirenze				Finansbank
	Cattles				Credem				
<€1.5 bn	Egg							Marfin	
	Paragon								
	London Scottish								



Investors' views on UK banks

- UK profitability high and must come down
- Credit problems in housing... personal unsecured... retailers... leveraged deal...
- Boring growth given economic gearing levels especially for consumer
- No consolidation theme
- Falling rate environment deferred
- No upgrades such as we have seen every quarter for European banks this year

The Analyst views of A&LM issues



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Analysts Hate Surprises

- Makes us look stupid – bad for our egos!
- Means we may extrapolate near-term trends to longer-term value of the company – normally to downside
- Introduces greater uncertainty and consequently higher cost of capital
- Dents management credibility and rating

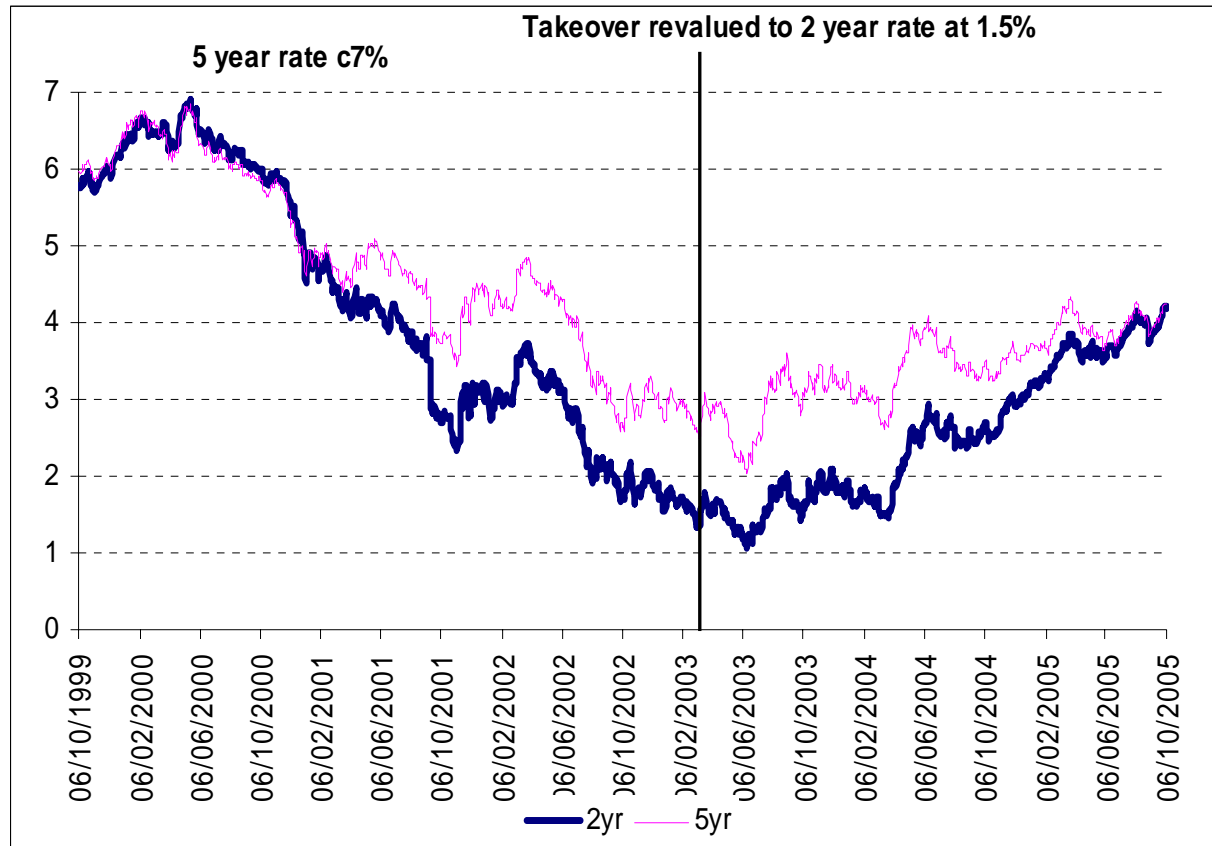
Analysts base knowledge is base

- Relatively few have worked in banks
- Most will cover up to 10 companies where A&LM will primarily be:
 - ◆ part of the NII calculation
 - ◆ which is part of one revenue line
 - ◆ which is part of the overall P/L
- Unless they are surprised by bad news the time spent on A&LM will be limited

Accounting not just cash

- A&LM will focus on cash flows
- May well differ from accounting – which is what the analysts will focus on
- Obvious example with HSBC and Household where fair value adjustment on takeover means accounting recognises completely different interest rate than the real cash movements

HSBC and Household



Acquisition - regulatory treatments

- **Tangible equity-to-assets ratios**
 - ◆ US banks are typically required to hold tangible equity of at least 4% of assets
 - ◆ Different capital requirement on mortgages
 - ◆ Different approach to credit enhancement in the major corporate end
 - ◆ At LTSB, the ratio is 2.4% (reported equity to assets 3%, less £2.5bn of goodwill) meaning that £5bn extra tangible equity would be required to support the balance sheet
 - ◆ Resolution via securitisation, sale of assets, change in wholesale books
- **Treatment of pensions**
 - ◆ Accounting deficits will crystallise rather than FSAs cash flow approach
- **Life businesses.**
 - ◆ In-force highly unlikely to be accepted
- **We believe US buyer needs \$16bn extra equity to buy LTSB**

Hedging techniques

- Understanding is quite low
- Tools used may distort message - LTSB below interest rate sensitivity below excludes IR options to hedge exposure

£mn	<3mn	3-6mn	6-12mth	1-5 yr	5yr +
Assets	127,236	8,843	7,861	39,239	8,813
Liabilities	160,542	6,033	2,412	5,750	9,914
Off bal Sheet	13,254	-3,902	-2,424	-9,468	2,540
Gap	-20,052	-1,092	3,025	24,021	1,439
Cumulative	-20,052	-21,144	-18,119	5,902	7,341

What risk should banks run ?

- Over-lent banks may be more exposed to:
 - ◆ Basis risk (Libor to Base rate)
 - ◆ Market pricing
 - ◆ Duration mis-matching / flexibility
- Can analysts really tell what is real business margin erosion (and sustained drag to earnings) and what is due to the temporary structural issues

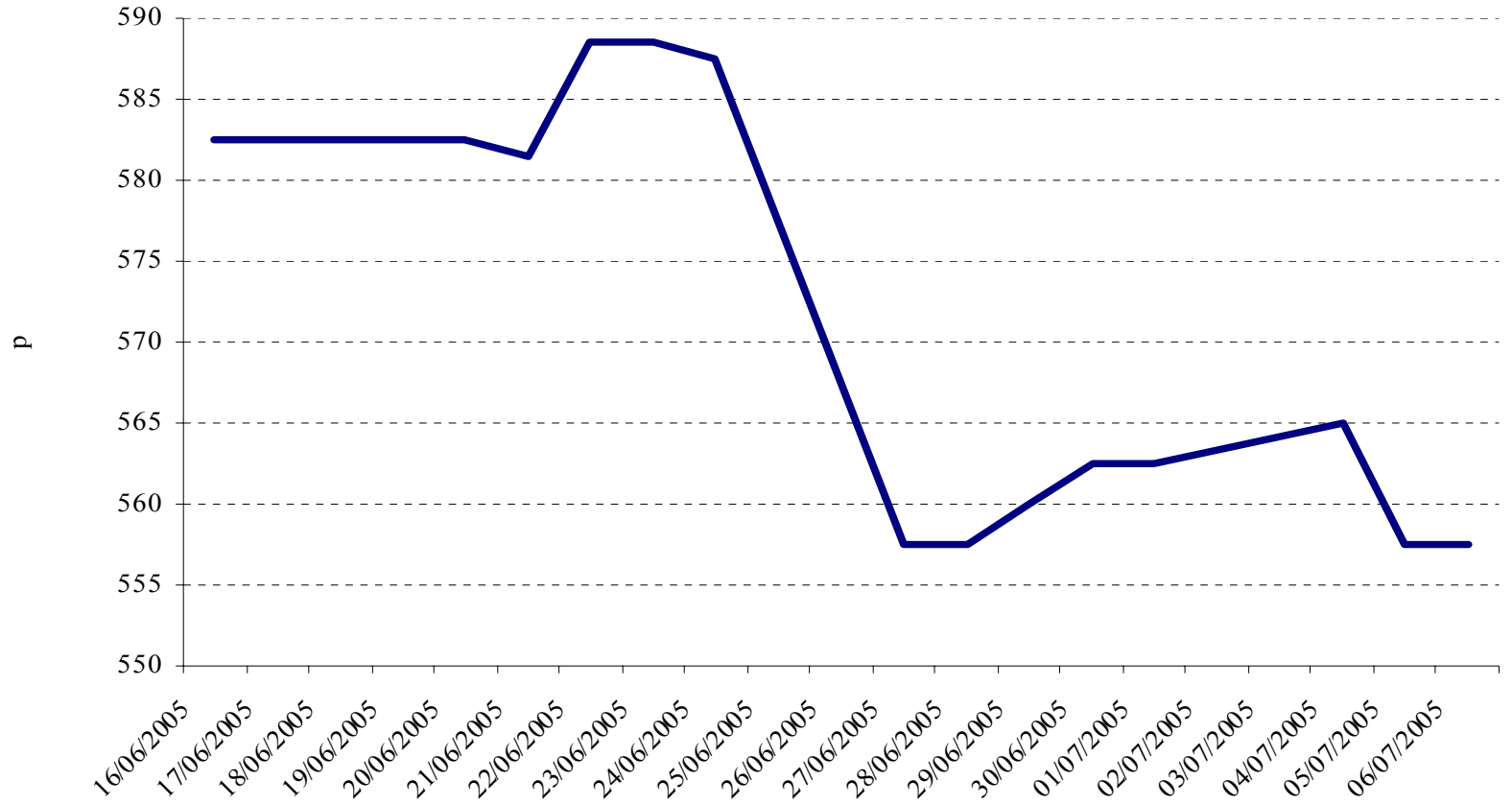
HBOS / NRK

- 1H04 NRK and HBOS highlight that basis risk is an issue with rising funding costs ahead of re-pricing variable mortgages
- New news to many investors where it had not been stated as an issue before. Degree of over-lending meant problem increased with time
- HBOS extended duration of funding
- Not seen same benefit when rates fell
- Why wasn't position hedged when possible to do so at a reasonable spread?
- How can we forecast the constant dynamic?

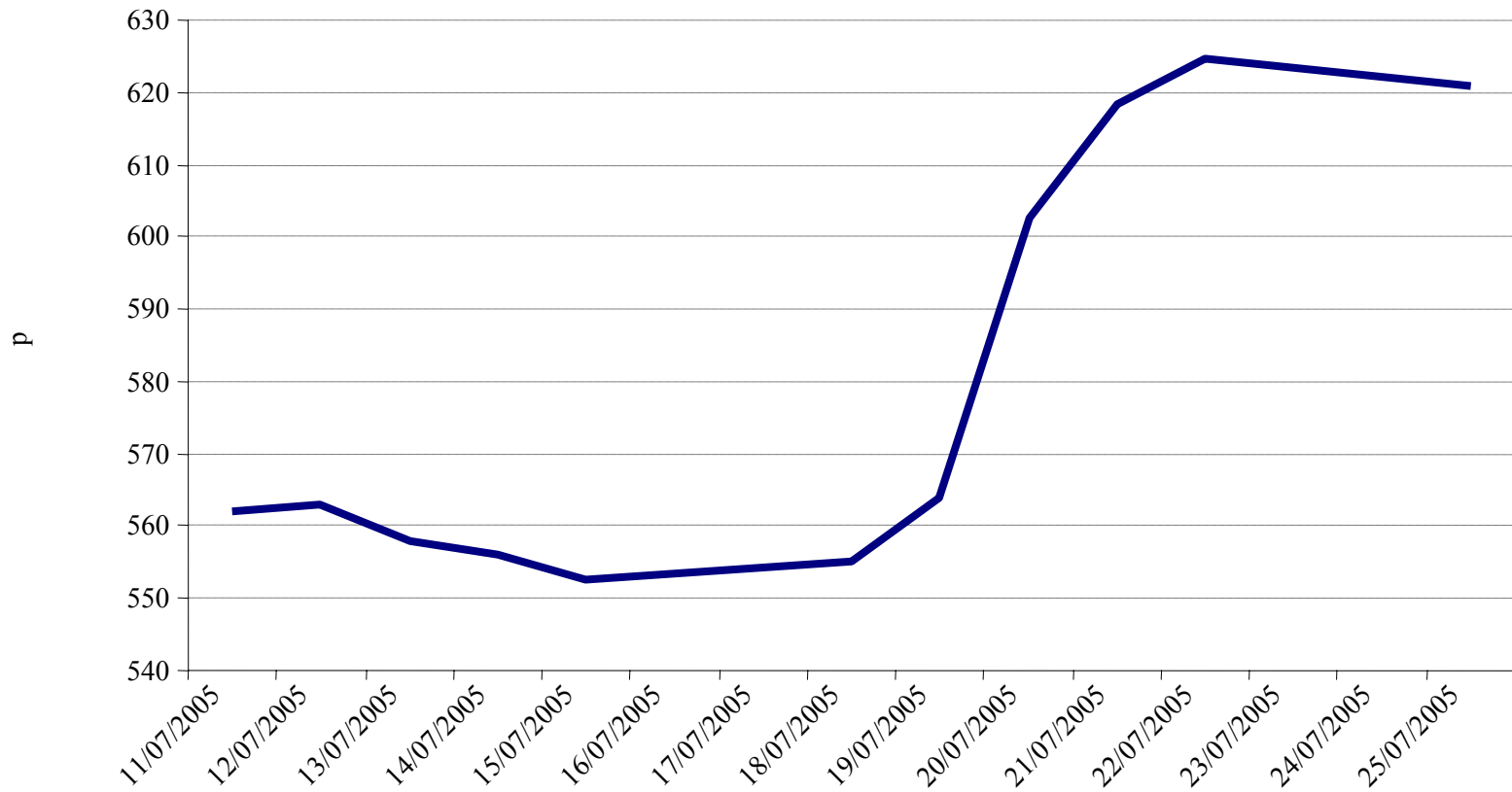
Liquidity management

- Disaster scenario – Household in US, most UK market funded mortgage suppliers in early 90s. Squeezed on risk and funding cost
- But also nature of funding:
 - ◆ Basis and duration risk covered before
 - ◆ Structure of securitisations – master trust v separate SPVs

Kensington price – RMS15/16 problem



Kensington price – with more clarity



IAS

- Understanding is quite low
- Primary objective of the analyst is to strip out volatility to get to underlying
 - ◆ Size of this volatility is less important than being able to identify it
 - ◆ Perception of good management if data is readily to hand and known and volatility managed
 - ◆ Out of line behaviour would be investigated
 - ◆ Assumption is it will change again at end 2006

Basel II - Overview

- Understanding remains low
- 2007 is only just coming on radar screens and transition arrangements make implementation a 2010 event?
- Credit savings been primary focus to date
- Sceptics say no change overall and will be managed by regulator and rating agencies with operational risk the swing factor

Basel II – Pillar III

- Most analysts want to be “kissed”
- Most analysts do not have the technical training to understand detailed disclosure of derivatives now let alone in the future
- Netting treatment under IAS drew a blank
- We need to know that you know rather than wanting to know ourselves
- Biggest users may be credit departments of banks

Definition of success (1)

- Stable predictable earnings streams driven by operational management of the business not by changes in external factors
- Boring is good

Definition of success (2)

- You keep your job
- I keep mine

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Reg AC

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