The Banking Monitor

Shock and Aw(ful): Bank equities imply poor ROEs, not insolvent institutions

Equities

United Kingdom
Banks

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A poor start to the year, with cross-asset weakness driving anxiety

European banks are down 25% YTD, underperforming wider equity markets by 8-14%, and with less differentiation amongst stocks than we would expect. Part of the sell-off is driven by broader anxiety around falling high yield, credit default swap and bank additional tier 1 debt markets. Macro and liquidity concerns are front and centre amongst the investors we have seen since our UK re-launch, leaving few, if any, willing to commit additional capital to the space until the stocks begin to rally.

The base case, and a fall-back option for the ECB

The Eurobanks sector appears to be discounting a ~20% EPS downgrade. For markets-related firms this kind of cut is easy to envisage given a deteriorating revenue outlook and inflexible costs. For retail & commercial banks, a weaker NIM and energy-related loan loss outlook is more manageable (energy loans are ~3% of exposures). If the AT1 market doesn't reopen – unlikely, we think – then the capital gap to be made up by retained equity or deleveraging is <10% of sector market cap. A controversial option would be for the ECB to buy bank paper. As regulator it would know what it is buying. Deutsche Bank's debt buyback projects confidence around its liquidity but reduces the firm's ability to lend and grow. This is not an example we want the sector to follow.

Meanwhile, in the UK housing and loan markets, things are looking up

This note is also our first monthly covering trends in the UK housing and credit markets. House prices are rising (7% YoY, 0.7% MoM), loans outstanding accelerating (mortgages +3% YoY, corporates +1% YoY) and margins are stable in the most recent data. RICS data, a good steer on near term trends, suggests a decent housing market for 1Q16. The NIM outlook will be key for LBG in particular with FY15 results on 25 February, though we think that the share discounts a disappointing outlook.

Take the gap. Buy quality retail & commercial banks here

We expect our top picks to recover their lost market caps as fears around earnings power and, for some banks, solvency, recedes. Low growth but reasonable underlying profitability should see firms service their debt and pay good dividends. We have LBG trading at 7.8x 2016E EPS and yielding 9.8% in the current year. LBG is our top pick, with the forecast return of 55% of market cap in dividends to end 2020.

Figure 1: UK large bank valuations

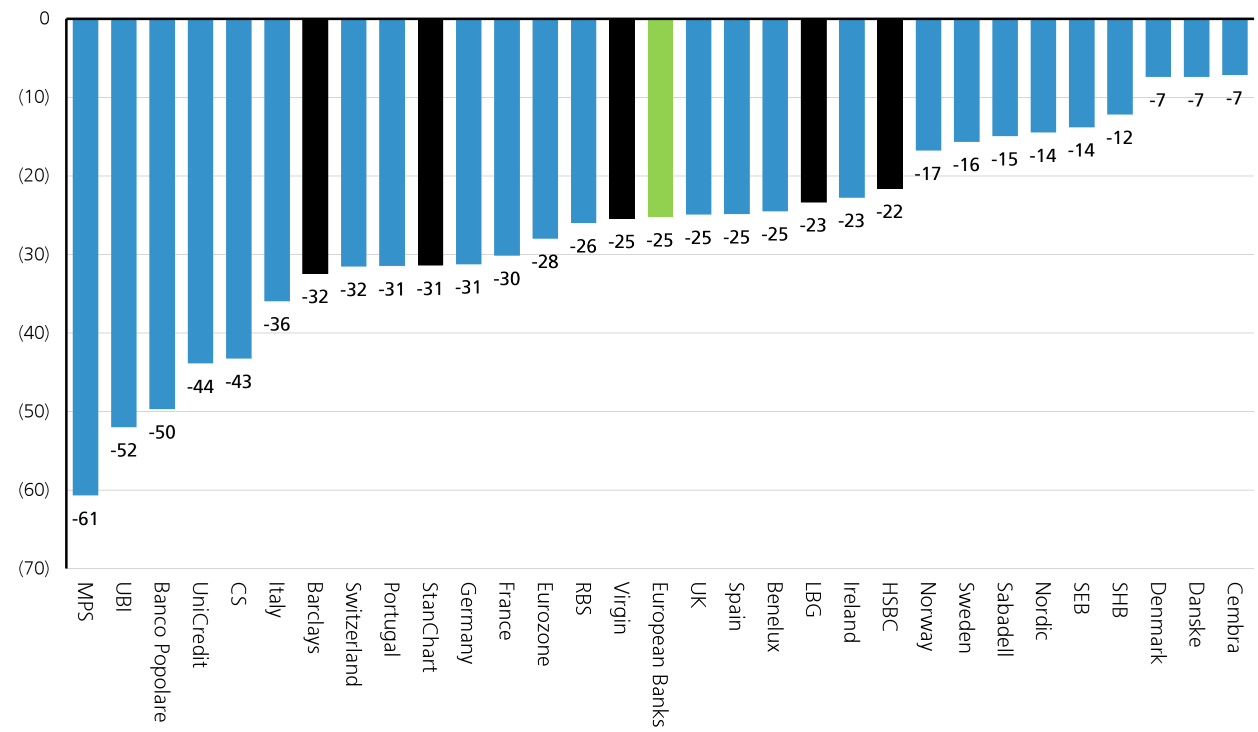
						P/E (x)			DY		P/TNAV (x)		ROTE		
	Price (p)	PT (p)	Est. Capital upside	16e DY	Est. Total return	2016e	2017e	2018e	2016e	2017e	2016e	2017e	2016e	2017e	2018e
Barclays	157	215	37%	4.8%	42%	7.3	6.4	6.2	4.8%	5.1%	0.56	0.6	7.7%	8.5%	8.9%
HSBC	440	520	18%	7.8%	26%	9.5	8.7	7.8	7.8%	7.8%	0.82	0.81	8.7%	9.4%	10.4%
LBG	58	88	50%	9.8%	60%	7.8	7.6	7.3	9.8%	9.8%	1.08	1.1	14.3%	14.2%	14.9%
RBS	240	340	42%	2.1%	44%	11.0	10.5	10.5	2.1%	12.5%	0.72	0.8	6.4%	7.2%	7.6%
StanChart	429	510	19%	1.6%	20%	66.9	9.7	6.3	1.6%	3.2%	0.50	0.49	0.7%	5.2%	8.0%

Source: UBS estimates

Shock and Aw(ful) – Poor ROEs, not failures

Capital markets have had a poor start to 2016 with the FTSE 100, Eurostoxx 600 and S&P500 down 11%, 17% and 11% respectively. Eurobanks have fared worse, down 25% YTD, with the UK names each falling over 20%. Europe's best bank performers are down around 7% (Figure 2).

Figure 2: European banks down an average 25% YTD in local currency, with less differentiation than we'd expect



Source: Datastream

Violent moves in the high yield and CDS markets have us back in a world in which debt holders are asking equity analysts what the equity market is saying, just as we are looking to them for guidance as to the drivers of the sharp shifts in their space.

Figure 3: US high yield spreads are back to 2012 levels…

Source: Federal Reserve Bank of St. Louis, Bank of America Merrill Lynch; Note: BofA Merrill Lynch US High Yield Master II Option-Adjusted Spread

Figure 4: …as are, almost, European bank defaults swaps

	Jan-12	Jan-15	28-Dec-15	11-Feb-16
DB	399	103	126	359
StanChart	264	114	194	344
Intesa	851	123	132	265
RBS	806	94	96	225
HSBC	223	73	99	224
Barclays	434	79	89	227
SG	671	130	110	215
BNP	584	96	99	198
LBG	703	82	85	194
UniCredit	553	123	149	172
CS	205	81	80	156

Source: Datastream

Low valuations are about returns, not solvency

What it would take for equity market valuations to be justified? At a sector level, **the low forward P/B multiples we are seeing are more an indicator of poor expected future returns than about solvency we think.** If we assume that the market will pay, say, 0.8x book for a 9% forecast ROE, then Figure 5 shows an implied earnings downgrade for the sector of about 18%.

Figure 5: The market appears to be discounting a c.18% earnings downgrade

	P/TNAV (2016e)	ROTE (2016e)	Provisions / Op profit (%)	Implied return upgrade / (downgrade)
Austria	0.80	10.8	30	(23%)
Benelux	0.85	11.6	16	(26%)
Germany	0.34	2.9	36	43%
Ireland	0.96	10.0	20	7%
Nordic	1.19	13.0	8	1%
Switzerland	0.83	10.3	9	(13%)
United Kingdom	0.72	8.9	22	(11%)
Europe	0.76	10.0	18	(18%)

Source: UBS estimates; Note: UBS bank research coverage presently limited to the above European markets

Given market conditions a downgrade of this magnitude is feasible for some banks. Importantly, with turmoil in debt and capital markets almost no investors met after our re-launch appear willing to commit more capital to the sector until share prices at least stabilise (with several saying that prices must start rising first). **Supply of shares is meeting little active demand that we can see.**

We expect the sector risk premium to fall, we believe best played via retail and commercial banks like LBG and ING. We think low book multiples reflect poor ROTEs in a banking market in which there is no lower bound to official interest rates – hurting net interest margins – where loan growth is modest, impairments around energy exposures lumpy and potentially large, but where debt instruments will be serviced and capital built.

Commerzbank is a decent example of this, trading at 0.4x book value. Results reported last week showed fully loaded common equity tier 1 at 12% and tier 1 leverage at 4.5%. This puts the bank E3.3bn or 36% of market cap beyond its current 10.25% SREP requirement. There are risks, and domestic buffer needs, but the main explanation for the 0.4x historic book value at which the bank trades is low prospective profitability, not questionable solvency, in our view.

Figure 6 shows the SREP numbers for the mainland European banks and UBS target ratios for the balance.

Figure 6: Current CET1 ratios vs fully-loaded SREP (if disclosed) or UBS targets

				Gap to SREP or UBS target		
	Latest	FL SREP	UBSe min.	% RWA	€'bn	% market cap
DBK	11.1%	12.3%		(1.2%)	(4.6)	**(22%)**
CS	11.4%		13.0%	(1.6%)	(4.8)	**(20%)**
BNPP	10.9%	11.5%		(0.6%)	(4.0)	**(8%)**
ING Bank	11.6%	12.5%		(0.9%)	(2.9)	**(8%)**
SAN	10.1%	10.5%		(0.4%)	(2.6)	**(5%)**
Barclays	11.1%		11.1%	0.0%	0.0	**0%**
CASA	10.3%	10.3%		0.1%	0.2	**1%**
HSBC	11.8%		11.5%	0.3%	3.4	**3%**
UCG	10.9%	10.8%		0.2%	0.7	**4%**
BBVA	10.3%	10.0%		0.3%	1.3	**4%**
LBG	13.7%		12.6%	1.1%	3.1	**6%**
CBK	12.0%	11.8%		0.3%	0.6	**6%**
SocGen	10.9%	10.3%		0.7%	2.3	**10%**
KBC	14.0%	10.8%		3.2%	2.8	**14%**
ABN	14.8%	12.5%		2.3%	2.6	**16%**
CABK	11.6%	9.5%		2.1%	3.0	**21%**
ISP	13.1%	9.5%		3.6%	9.9	**25%**
RBS	16.2%		12.0%	4.2%	13.4	**38%**
StanChart	13.6%		9.4%	4.2%	11.6	**64%**

Source: Company reporting, UBS estimates; Priced on 13 February 2016; Note: FL SREP is fully loaded

The core / non-core trade isn't working

The Commerzbank case suggests that **investors have lost** – if they ever possessed it – **confidence in valuing banks on the basis of core profitability**. We believe Commerzbank is clearly not being valued solely on the basis of its 8% 4Q15 Core Bank ROE. This is important for **Barclays** into its 1 March results announcement. Low returns in the IB in the past and – given current conditions and the need to prepare for ring-fencing – in the future too, require action.

But assigning a chunk more of the IB's £120bn in RWAs to non-core would see consensus earnings fall further, in our view, putting forward group ROTEs under pressure, justifying a lower valuation for the stock.

Figure 7: We are 11-13% below consensus for 2016e and 2017e despite being more optimistic around cost reduction

Consensus comparisons	2015e			2016e					2017e				
Core Bank	UBSe	Cons.	% diff	UBSe	Cons.	UBSe YoY	Cons. YoY	% diff	UBSe	Cons.	UBSe YoY	Cons. YoY	% diff
Income net of claims	**24,818**	**25,087**	**-1%**	**24,495**	**25,576**	**-1%**	**2%**	**-4%**	**25,262**	**26,370**	**3%**	**3%**	**-4%**
Impairments	-1,964	-1,938	1%	-2,281	-2,132	16%	10%	7%	-2,726	-2,360	20%	11%	16%
Operating profit	**22,854**	**23,149**	**-1%**	**22,215**	**23,444**	**-3%**	**1%**	**-5%**	**22,535**	**24,010**	**1%**	**2%**	**-6%**
Expenses ex restructuring	-14,463	-14,641	-1%	-13,915	-14,151	-4%	-3%	-2%	-13,884	-14,079	0%	-1%	-1%
Bank levy	-520	-525	-1%	-469	-460	-10%	-12%	2%	-424	-432	-10%	-6%	-2%
Adjusted PBT	**7,871**	**7,983**	**-1%**	**7,831**	**8,833**	**-1%**	**11%**	**-11%**	**8,228**	**9,499**	**5%**	**8%**	**-13%**

Source: UBS estimates

Better to get on with the task of cutting costs and reassigning capital on a day to day basis rather than announcing another big-bang restructuring exercise, we think. For investment banks in particular, significant action on costs will be needed, a tough ask given sticky non-comp expenses and high fixed costs within the comp base – only 5-10% of IB costs are in cash bonuses, the rest are fixed. We

are 13% below consensus for 2016e Core Bank PBT – a larger restructuring programme would see these earnings estimates fall further.

Figure 8: A 10% IB income miss for Barclays in 2016 would require 5% Core cost cuts or 15% cuts within the IB: Too much in the near term

A miss in the IB requires a considerable effort on costs	2013	2014	2015e	2016e	2017e	2018e	2019e	2020e
Core Bank Revenues (£'bn)	25.9	24.7	24.8	24.8	25.7	26.5	27.5	28.8
IB revenues (£'bn)	8.9	7.6	7.6	7.4	7.6	7.8	8.0	8.3
IB as % of Core Bank income	34%	31%	31%	30%	29%	29%	29%	29%
10% delta in IB is % delta for group	3%	3%	3%	3%	3%	3%	3%	3%
IB costs (£'bn)	6.2	5.5	5.3	4.9	4.9	5.0	5.1	5.2
Core Bank costs ex PCB, Barclaycard (£'bn)	8.7	7.8	7.7	7.2	7.2	7.3	7.4	7.6
Core Bank costs (ex levy) (£'bn)	15.9	14.5	14.4	13.8	13.8	14.0	14.3	14.7
Offsetting a 10% miss in IB revenues means a cut of x% of:								
IB costs (£'bn)	14%	14%	15%	15%	15%	16%	16%	16%
Core Bank costs ex PCB, Barclaycard (£'bn)	10%	10%	10%	10%	10%	11%	11%	11%
Core Bank costs (ex levy) (£'bn)	6%	5%	5%	5%	5%	6%	6%	6%

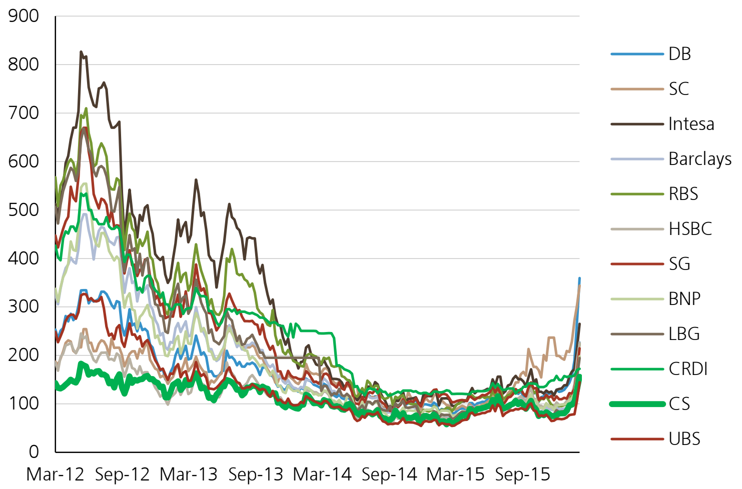
Source: Company data, UBS estimates

For some banks - particularly those involved in capital markets activities - a 20% downgrade to earnings is not that big a stretch. For sure, as we showed in our recent benchmarking exercise of 19 European bank strategic plans, current bank results are much weaker than was assumed in the plans themselves. We retain a preference for retail and commercial banks in Europe, like LBG and RBS in the UK and ING and ABN Amro in Europe.

The AT1 market isn't dead. But if it were, it wouldn't be the end of the world for bank equities

One of the reasons bank equities have been so weak this year, we think, is the reintroduction of fears around the CDS market and the viability of the AT1 market. Anecdotal evidence suggests that some holders of AT1 securities – which have sold off amidst concerns around near term coupon payments and concerns that issuers will not call these at the 5 year call dates – may be hedging their now less tradeable investments by shorting equities or CDS.

Figure 9: CDS markets as hedge for a falling AT1 market?



Source: Datastream

A debt market sell off is no good thing, clearly. Funds raised today would cost more than just a short while ago. But here also the macroeconomic concerns we are hearing from investors around required future AT1 issuance feel overdone to us. Figure 10 provides current and target/required AT1 volumes for a number of key banks. We express the remaining issuance as a proportion of market cap to get a sense of how large an equity top up would need to be. We think the **numbers overall are manageable** – and that **in the event that this market remained shut, that deleveraging rather than cap raises would result.**

Figure 10: AT1 outstanding and issuance requirements

Bank	Currency	Issued	% of RWAs	Required/ Targeted	% of RWAs	Gap	% of mcap
Unicredit	EURbn	1.8	0.5%	5.4	1.5%	3.6	**19.3%**
Sabadell	EURbn	--	0%	1.3	1.5%	1.3	**16.2%**
RBS	GBPbn	2.0	0.8%	6.3	2.2%	4.3	**16.0%**
Caixabank	EURbn	--	0%	2.1	1.5%	2.1	**14.1%**
Bankia	EURbn	--	0%	1.2	1.5%	1.2	**13.3%**
Santander	EURbn	4.3	0.7%	8.8	1.5%	4.5	**8.8%**
Barclays	GBPbn	5.5	1.4%	7.8	2.0%	2.3	**8.6%**
Bankinter	EURbn	--	0%	0.4	1.5%	0.4	**7.4%**
ING	EURbn	2.1	0.7%	4.8	1.5%	2.7	**7.1%**
HSBC	USDbn	6.2	0.8%	14.2	1.9%	8.0	**6.4%**
Deutsche	EURbn	4.6	1.2%	5.8	1.5%	1.2	**6.0%**
StanChart	USDbn	1.3	0.6%	2.4	1.8%	1.1	**5.7%**
BBVA	EURbn	4.4	1.1%	6.0	1.5%	1.6	**4.5%**
ABN	EURbn	1.0	0.9%	1.7	1.5%	0.7	**4.2%**
ISP	EURbn	2.1	0.8%	3.0	1.5%	0.9	**2.2%**
Nordea	EURbn	2.1	1.4%	2.1	1.5%	0.0	**0.1%**
Popular	EURbn	1.2	1.6%	1.1	1.5%	--	--
CS	CHFbn	14.2	4.9%	12.5	4.3%	--	--
Lloyds	GBPbn	5.4	2.4%	5.0	2.2%	--	--
KBC	EURbn	1.4	1.6%	1.3	1.5%	--	--
SEB	USDbn	1.1	1.6%	1.0	1.5%	--	--
Danske	EURbn	1.5	1.5%	1.5	1.5%	--	--
Swedbank	USDbn	0.6	1.6%	0.5	1.5%	--	--
SHB	USDbn	1.2	2.1%	0.9	1.5%	--	--

Source: Company data, UBS estimates. Market cap as of 11 Feb 2016
Spain and Italy: we assume 1.5% of RWAs for required AT1 capital
Nordic and Benelux: we assume 1.5% of RWAs for required AT1 capital
UK: We assume 19% of Pillar 2 requirements met with AT1 capital
CS: Swiss capital metrics used (inc high trigger T2) – Eligible AT1 according to BIS metrics: CHF11.5bn
DBK: we expect that part of the capital gap to 4.5% Tier 1 leverage ratio may be met with AT1

Deleveraging? What other options?

No one wants more deleveraging (unless from investment banking, that is). But if solvency concerns continue and sub- and senior-debt issues in the banking sector prove problematic, what then?

The ECB should consider bank debt purchases in the market.

As unlikely as that sounds at first, it **has logic on its side**. After all, if the ECB, as regulator to the systemically important Eurozone banks, is not well placed to adjudicate as to the safety of banks it would be reinforcing, then who is? And if the banks are not solvent - an argument against the ECB buying this paper - then surely ECB-as-regulator should have precipitated capital strengthening for those

under its charge. Does the ECB know as much about the corporates whose bonds it is buying under its expanded marketable securities plan as it does about the banks? **Can Europe really afford to have the monetary transmission mechanism impaired?** It's not as though credit expansion was contributing a great deal to growth before (Figure 11).

Figure 11: Poor credit growth is being blamed for lacklustre GDP expansion. Can we really afford for it to be worse?

		Austria	France	Germany	Greece	Ireland	Italy	Netherlands	Portugal	Spain	UK
Mortgage	MoM	0.8%	0.4%	0.2%	0.0%	0.0%	0.1%	0.0%	-1.4%	-0.5%	0.3%
	QoQ	1.6%	-0.1%	0.9%	-0.8%	0.7%	0.4%	3.4%	-1.8%	-0.9%	1.0%
	YoY	4.3%	3.1%	3.5%	-3.5%	-1.2%	0.4%	5.4%	-3.8%	-4.2%	3.1%
Other HH	MoM	-0.7%	0.1%	-0.1%	-0.2%	-1.3%	-0.1%	-1.8%	1.1%	-3.6%	0.3%
	QoQ	-1.4%	0.8%	-0.1%	-0.4%	-1.4%	0.2%	-2.1%	1.0%	1.0%	1.4%
	YoY	-2.3%	1.4%	1.1%	-1.7%	-8.0%	3.4%	-2.6%	0.4%	1.1%	5.2%
Corporate	MoM	-0.4%	0.1%	-0.5%	0.2%	-1.8%	-1.1%	-4.7%	-0.3%	0.0%	-0.3%
	QoQ	-0.1%	1.2%	0.5%	0.0%	-2.0%	-1.0%	-4.8%	-0.5%	0.5%	0.2%
	YoY	0.7%	3.1%	1.6%	-6.2%	-9.7%	-1.4%	-4.7%	-1.8%	-1.3%	1.0%

Source: Haver

Another ECB deposit rate cut - which we expect in March - will hurt bank margins and perhaps underline fears that the toolkit for supporting growth (weakening the Euro) has but one tool in it, and one damaging to banks at that. Reinforcing investor fears that official rates will push ever more negative will force more investors out of bank stocks. Most importantly, from a policy prescription perspective, the poor market environment means that even lower returns on cash are unlikely to see banks and other market players rush to buy riskier assets.

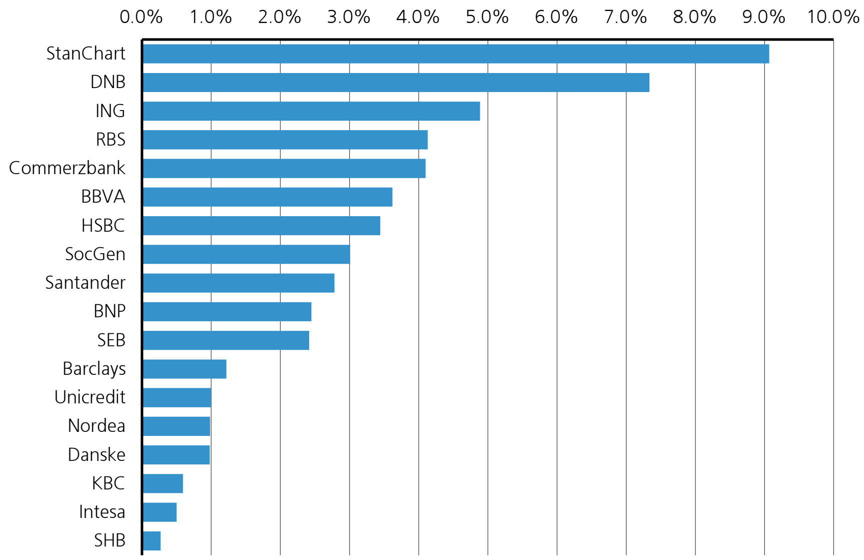
Events last week showed that Deutsche Bank believes the best use for some of its liquidity is to reduce its funding base, proving that it has excess. Ultimately, this reduces its capacity to lend or grow and is not a road we want to encourage banks to travel. Not if we're keen on European economic growth, that is.

Perhaps as was half-jokingly suggested the ECB should starting buying oil. Better asset quality, higher prospective inflation and eventually higher interests rates. Not a bad outcome, though not a likely one either.

Speaking of oil…

Cheaper energy is, in the longer term, an obviously good thing for the economy. But, those hurt by the collapse in commodity prices react faster by cutting capex, laying off staff and, in some cases, ceasing to operate. In the near term therefore, a negative price shock will see increased loan losses for this sector, with the potential for the odd negative surprise as to who is holding how much exposure. Overall, though, with average exposure at around 3% of loans this is not a crucial issue at a sector level (Figure 12).

Figure 12: Energy-related lending exposure as a % of total, by bank (latest reported). Average in sample comes to c3%



Source: Company reports, UBS estimates

Within the UK, StanChart is most in the frame, mostly driven by its trade business. When the bank reports results on 23 February, expect credit quality and the length of this cycle's elevated charges to be the largest area of interest. Income generation will naturally be a close second. We remain fairly cautious on the name.

Use the opportunity

Unless global recession and widespread deflation is really in our future, **we expect our top picks to recover their lost market caps** as fears around earnings power and, for some banks, solvency, recedes. Stable, if low, growth, and underlying profitability should see firms service their debt and pay good dividends.

Clarity on capital requirements and the start of material returns to shareholders, generated by capital generative UK retail and corporate banking businesses are the basis for our **enthusiasm for LBG and RBS**. We see cost cutting upside for these too. In the current environment **we think the market will remain sceptical as to the sustainability of the HSBC dividend** - where we assume a Nordic-like payout ratio but without a Nordic-like capital ratio - **and Barclays' ability to improve returns in its investment bank**. The figure below shows the forecast dividend returns over the coming five years for the five large UK banks.

Figure 13: More than half of market cap back in divs at LBG and RBS

	Dividend declared						
£m	**2016e**	**2017e**	**2018e**	**2019e**	**2020e**	**Total**	*% mcap*
Barclays	1,259	1,342	1,510	1,678	2,181	**7,971**	*30%*
HSBC	6,727	6,722	6,991	7,260	7,529	**35,229**	*41%*
LBG	4,104	4,104	4,282	4,996	5,353	**22,838**	*55%*
RBS	575	3,450	4,600	4,830	2,875	**16,330**	*59%*
SCB	226	451	564	677	903	**2,821**	*20%*
Total	**12,890**	**16,069**	**17,947**	**19,441**	**18,840**	**85,188**	***44%***

Source: UBS estimates, priced on 13 February 2016

LBG and RBS are our top picks, trading on low multiples and on our estimates due to return over half of market cap in dividends to end 2020.

Meanwhile, in the UK housing market

This publication, the first in the series, reviews in brief current trends in the UK housing and credit markets. Where helpful, this review will be preceded by thematic or sector work such as that above. First, house prices. Values continued to grow in 2016, rising 7% YoY and 0.7% MoM in January surveys currently available (Figure 14).

Figure 14: The housing market continues to demonstrate stability and growth

			Avg. value		YoY			QoQ			MoM	
	Nov-15	Dec-15	Jan-16	Nov-15	Dec-15	Jan-16	Nov-15	Dec-15	Jan-16	Nov-15	Dec-15	Jan-16
Halifax	204,830	208,943	212,430	8.9%	10.3%	10.4%	0.0%	3.0%	3.6%	0.0%	2.0%	1.7%
Nationwide	196,305	196,999	196,829	3.7%	4.5%	4.4%	0.5%	0.7%	0.0%	-0.3%	0.4%	-0.1%
Rightmove	292,572	289,452	290,963	6.2%	7.4%	6.5%	0.1%	-1.8%	-1.9%	-1.3%	-1.1%	0.5%
LSL/Acadametrics	290,428	292,077		5.9%	6.6%		1.9%	1.9%		0.4%	0.6%	
ONS	288,454			7.7%			1.1%			0.6%		
Average	**231,236**	**231,798**	**233,407**	**6.3%**	**7.4%**	**7.1%**	**0.2%**	**0.6%**	**0.6%**	**-0.5%**	**0.4%**	**0.7%**

Source: Halifax, Nationwide, LSL, ONS, Haver, UBS estimates. Note: Average uses a consistent sample (Halifax, Nationwide, Rightmove)

Industry participants expect house price inflation of 4-5%, in line with their estimates of sustainable HPI of 2.5 - 4% (Figure 15).

Figure 15: Industry participants expect house prices to keep growing

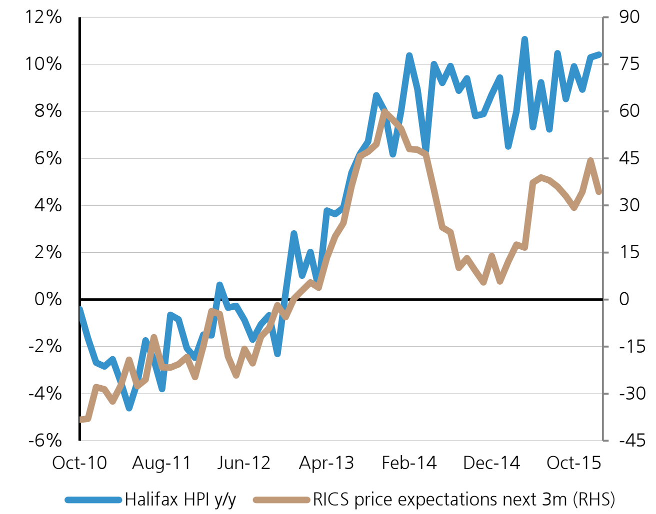
YoY %	Jan-16	2016	2017	2018	2019	2020
History	7.1%					
Savills		5.0%	3.0%	3.0%	2.5%	2.5%
RICS		6%				
NAEA/ARLA		4.4%	4.4%	4.3%	4.1%	4.1%

Source: Savills, RICS, NAEA, UBS estimates

The important RICS[1] survey data has improved with a net 45% of surveyors expecting house prices to continue rising over the next quarter. Liquidity in the market has tightened to pre-MMR levels – measured by sales/stocks ratio – which is supportive of house prices. The sales to stocks ratio shows that at current sales volumes, properties currently advertised for sale would take a little under five months to sell. Over the longer term, surveyor sentiment and supply measures have correlated well with outcomes in house prices (Figure 16 and Figure 17).

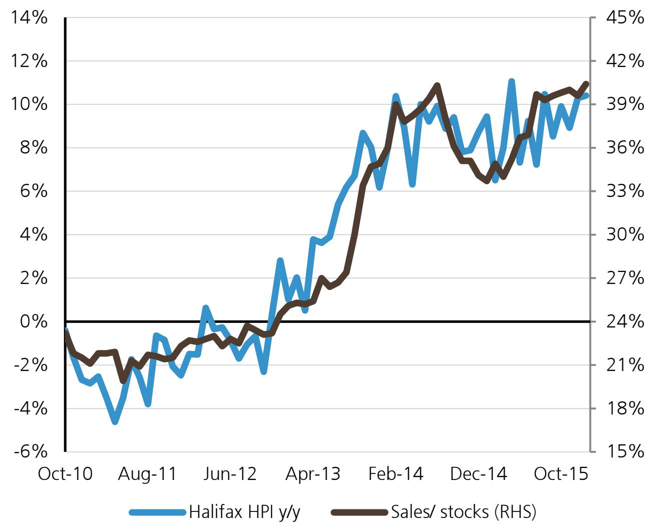
[1] Royal Institute of Chartered Surveyors

Figure 16: Surveyors expect house prices to rise in the coming three months…



Source: LBG, RICS, UBS estimates

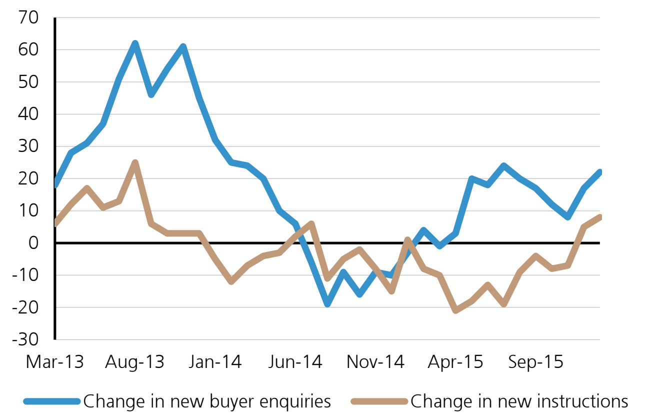
Figure 17: …while market liquidity remains tight



Source: LBG, RICS, UBS estimates

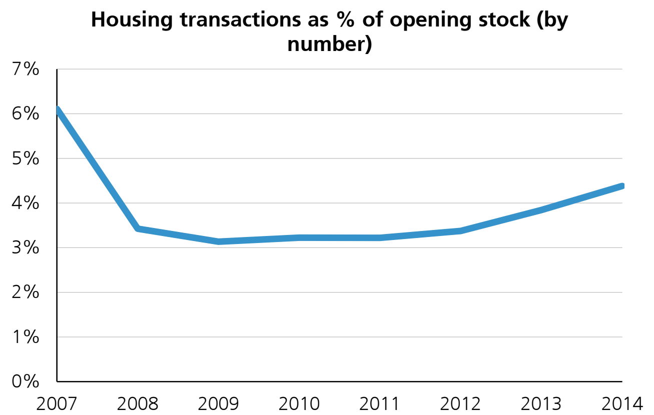
We will be watching the sales to stocks measure closely, particularly in light of the upcoming changes in stamp duty and interest deductibility for buy-to-let properties (Figure 18). While near term we may see an increase in properties bought ahead of the April increase in stamp duty, investors should also be alert for signs that landlords are realising profits ahead of the start of the phase out of interest deductibility in 2017. With only 4% of the 28m UK homes being sold a year, a material shift in supply of properties for sale could clearly cause some volatility (Figure 19).

Figure 18: An uptick in supply of properties to market is worth monitoring closely



Source: RICS

Figure 19: UK property is an illiquid market: just 4% of properties change hands each year



Source: Haver

We remain generally constructive on the outlook for UK house prices. If rates remain how – an outcome the debt market is increasingly discounting – and new build supply remains around historic levels we do not think a material sell-off is likely. A **plausible but low probability risk case** in our view is that Sterling weakens materially around an 'out' Brexit vote, causing high end property price expectations to fall as international investors take fright. Sterling weakness here, if any, would be driven by concerns around the financing of the UK's high current account deficit (-4.3% over the last twelve months, worse than South Africa) and

budget gap (-4.4% in 2015, weaker than all countries listed in the back of The Economist this week other than Japan, Pakistan, Venezuela, Egypt and Saudi Arabia).

Volumes are improving

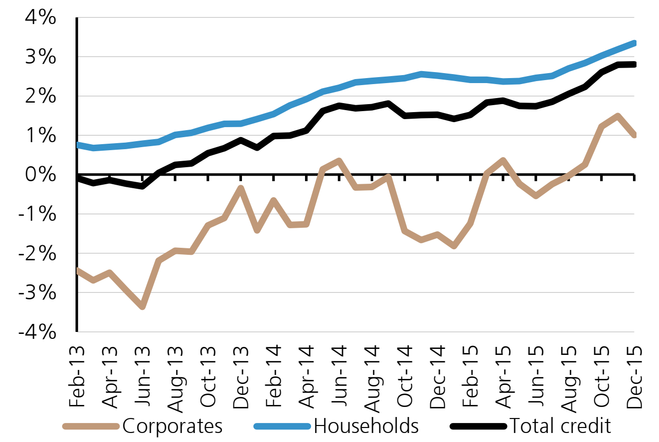
Household credit was up 3% YoY and 0.3% MoM in December supported by mortgages (+3.1%) and consumer credit (+7.2%). Corporate credit was up 1% YoY. Deposit are growing faster than loans in both markets in percentage and in £'m terms (Figure 20). The returns to deposit holders will continue to fall, we think. Challenger banks are most at risk from rate hikes and should benefit from falling liquidity costs.

Figure 20: Credit growing across the board, with deposits still expanding faster

£m	Corporates	Mortgages	Cons. Credit	Total Household	Total Credit	Corporate deposits	Household deposits	Total Deposits
Dec 2015	368,900	1,109,904	119,807	1,260,759	1,629,659	413,780	1,278,729	1,692,509
Nov 2015	368,225	1,103,822	119,254	1,254,158	1,622,383	408,810	1,269,097	1,677,907
Dec 2014	372,577	1,074,614	114,708	1,221,242	1,593,819	375,359	1,229,671	1,605,030
YoY %	1.0%	3.1%	7.2%	3.3%	2.8%	10.4%	3.8%	5.4%
MoM%	-0.3%	0.3%	0.4%	0.3%	0.2%	0.6%	0.8%	0.7%

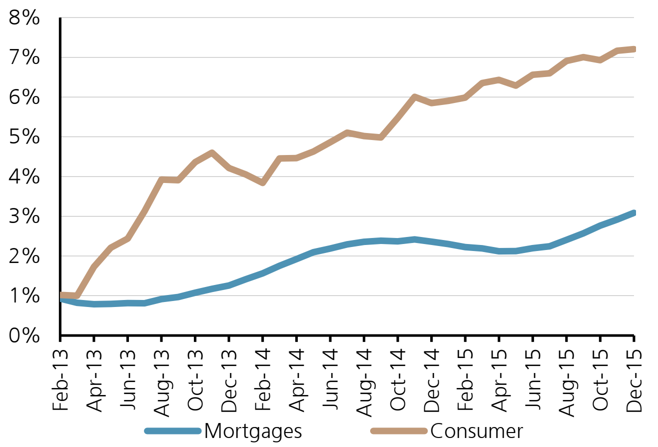
Source: BoE, Haver, UBS estimates. Note: Based on M4 lending adjusted for sales/securitisations

Figure 21: System credit growth continues to improve



Source: BoE, Haver, UBS estimates

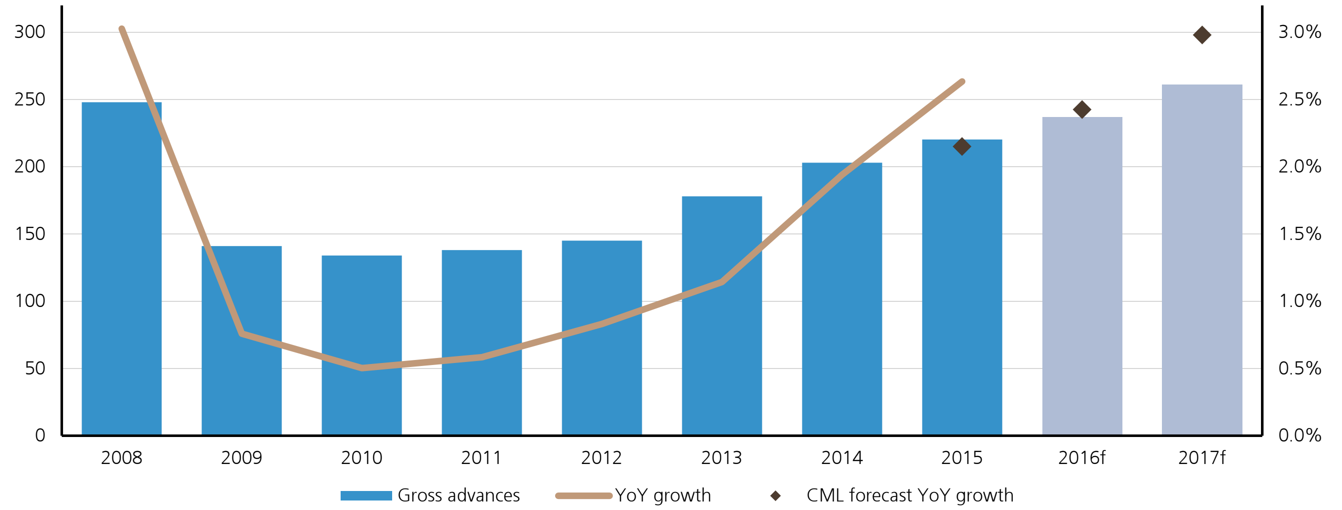
Figure 22: Household credit growth breakdown



Source: BoE, Haver, UBS estimates

The Council for Mortgage Lenders (and other industry forecasters) expect mortgage market growth of 2.5%-3.0% for 2016 and beyond (Figure 23).

Figure 23: Healthy growth expected in the mortgage market



Source: CML inc. CML forecasts, UBS estimates

We expect 3-5% over the next ten years, driven by a 3% structural fall in interest rates (Figure 24) and expectations for growing leverage to be applied to the £7 trillion UK property market. The basis for this forecast was laid out in our recent sector note. A similar perspective was shared in a recent speech by Sir Jon Cunliffe of the Bank of England, entitled "Credit: Can trees grow to the sky?".

Figure 24: The UK mortgage market continued to grow through the cycle

Outstanding loans (£ bn)	3Q07	3Q08	3Q09	3Q10	3Q11	3Q12	3Q13	3Q14	4Q14	1Q15	2Q15	3Q15
Fixed	606	609	482	394	348	336	379	494	520	537	561	597
Variable	532	588	721	820	870	891	855	762	739	724	711	685
Total	1,138	1,196	1,203	1,213	1,218	1,227	1,234	1,256	1,260	1,261	1,272	1,282
% fixed rate loans (outstanding)	53	51	40	32	29	27	31	39	41	43	44	47
% fixed rate loans (flow)	67	53	67	44	52	56	77	83	82	78	79	81
Outstanding int rate (%)												
Fixed	5.3	5.7	5.6	5.3	5.0	4.6	4.0	3.5	3.5	3.4	3.3	3.2
Variable	6.6	6.0	2.5	2.8	2.9	3.0	3.1	3.1	3.1	3.1	3.0	3.0
Market average	5.9	5.9	3.8	3.6	3.5	3.4	3.4	3.3	3.2	3.2	3.2	3.1
Flow interest rate (%)												
Fixed	5.8	6.1	4.9	4.6	4.2	4.3	3.4	3.4	3.4	3.1	2.9	2.8
Variable	6.3	6.1	3.0	3.2	2.9	3.3	3.1	2.8	2.7	2.6	2.5	2.6
Market average	5.9	6.1	4.2	3.8	3.6	3.9	3.3	3.3	3.3	3.0	2.8	2.8
Pool interest cost (£ bn)												
Fixed	32	35	27	21	17	15	15	17	18	18	19	19
Variable	35	35	18	23	25	27	27	24	23	22	22	21
Total	67	70	45	44	42	42	42	41	41	41	40	40
% of GDP	4.6	4.7	3.1	2.8	2.6	2.5	2.4	2.3	2.2	2.2	2.1	2.1

Source: Financial Conduct Authority

Figure 25: Mortgage market could triple on re-leveraging of the housing stock – the market will continue to grow steadily, supporting bank revenues

	Owner occupied		Private rental		Total	
£ billion	Mortgaged	Unlevered	Mortgaged	Unlevered	Mortgaged	Unlevered
Debt	1,150	0	383	0	1,533	0
Collateral	2,300	2,045	766	681	3,066	2,725
LTV	50%	0%	50%	0%	50%	0%
Mortgage upside to 70% LTV	460	1,431	153	476	613	1,908
% of current mortgage market	37%	114%	12%	38%	49%	152%
Housing stock (m)	9.1	8.1	3.0	2.7	12	11

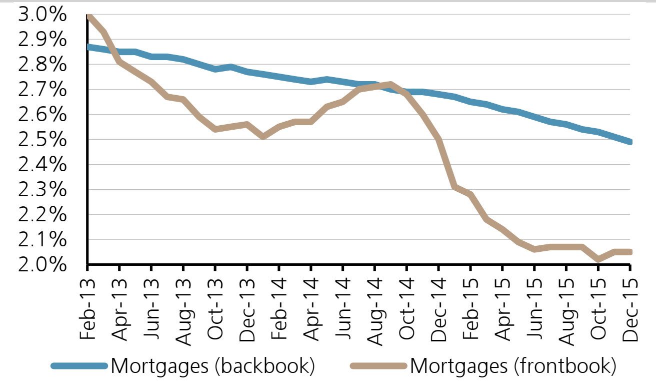
Source: ONS, Council of Mortgage Lenders, UBS estimates

Margins are *the* key market concern

For the UK bank domestic businesses, the outlook for net interest margin will be of key importance within the upcoming results. This is most important for LBG, though with the share below 60p we are not as sensitive as we were before. We analysed the key drivers of the LBG NIM, including potential for material hedge decay in 2017, in our recent detailed stock piece. 2016 looks fine to us – we have net interest income flat and margins slightly lower – with 2017 the period of higher risk, with additional work on costs required if spreads don't increase.

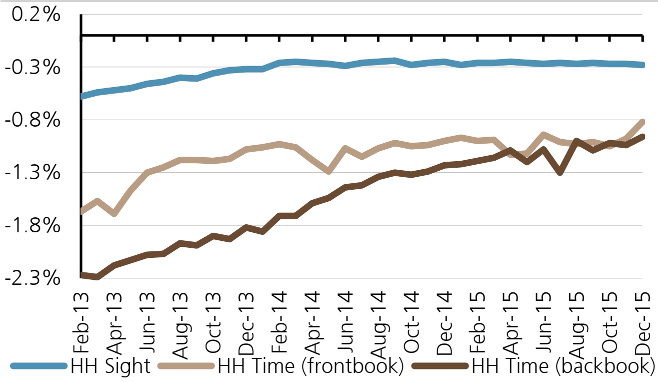
Most recent front book industry spread numbers are broadly stable (Figure 26, Figure 27), as are those in the corporate market (Figure 28, Figure 29).

Figure 26: Mortgage front book spreads stabilising…



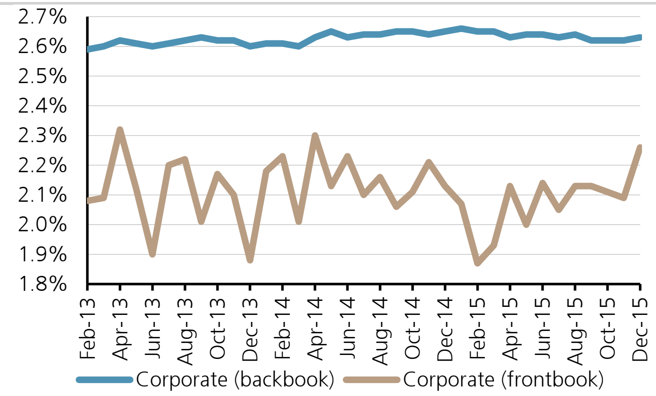
Source: BoE, Haver. Note: Spreads vs UK base rate (currently 0.50%)

Figure 27: …while time deposits are selling off



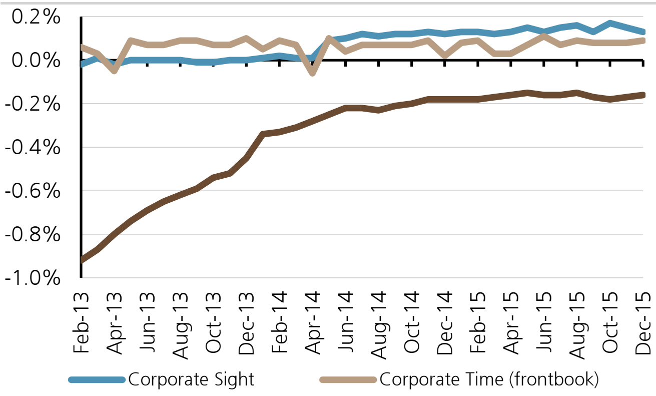
Source: BoE, Haver. Note: Spreads vs UK base rate (currently 0.50%)

Figure 28: Corporate loan spreads narrowed last month, in a volatile series



Source: BoE, Haver. Note: Spreads vs UK base rate (currently 0.50%)

Figure 29: Corporate deposits – no obvious change



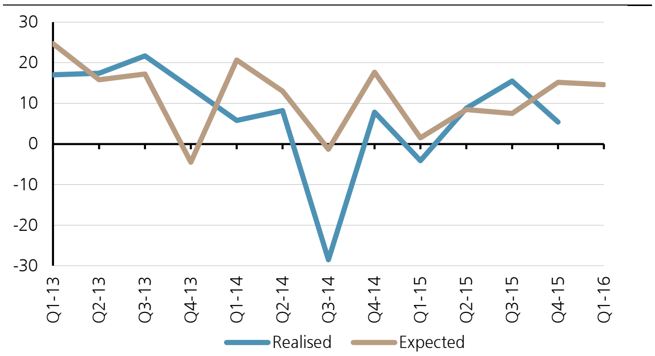
Source: BoE, Haver. Note: Spreads vs UK base rate (currently 0.50%)

Credit Conditions Survey summary – Q4 2015

Mortgage conditions have continued easing, with a higher net balance of respondents expecting easing in Q1 too. Demand for remortgaging increased in line with expectations, but demand overall is now expected to remain flat. Lenders expressed particular optimism regarding house prices.

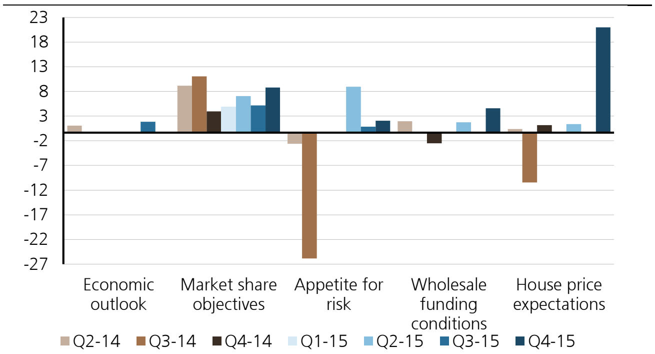
On the **corporate side**, conditions have remained unchanged, although a small net balance of respondents expects easing in Q1, which would spur the current recovery in corporate lending.

Figure 30: Mortgage credit availability (net %)



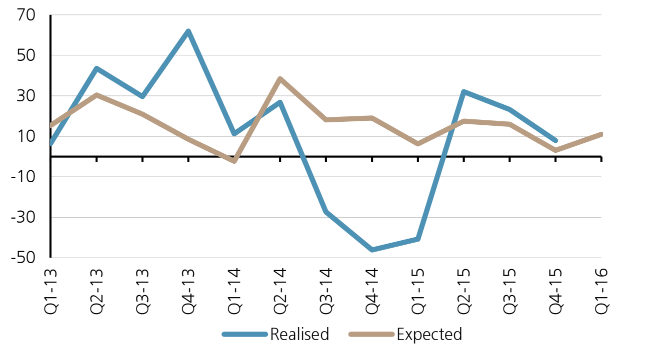
Source: Haver, Bank of England, UBS

Figure 31: Factors affecting mortgage availability (net %)



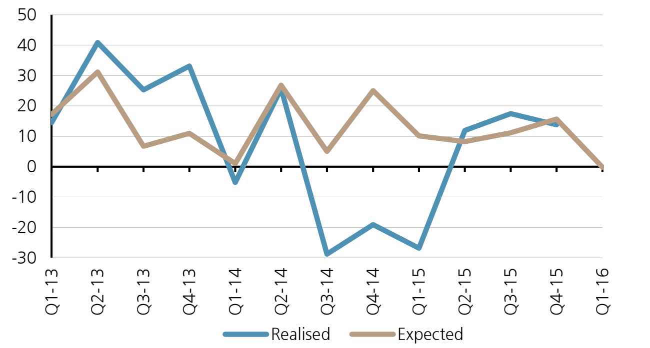
Source: Haver, Bank of England, UBS

Figure 32: Demand for loans for house purchase (net %)



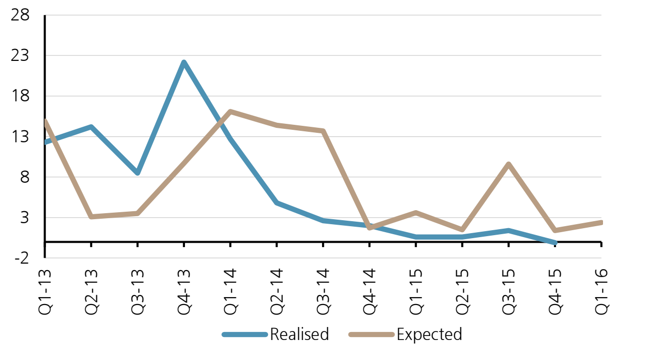
Source: Haver, Bank of England, UBS

Figure 33: Demand for loans for remortgaging (net %)



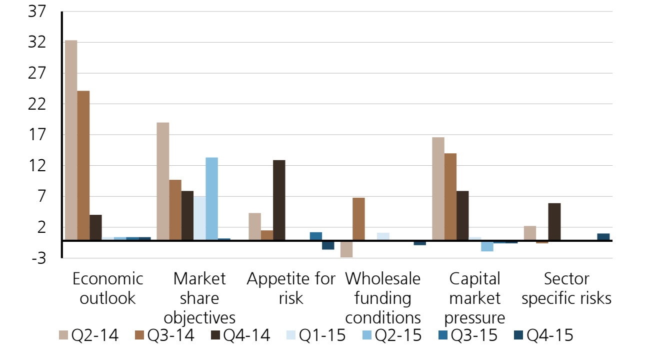
Source: Haver, Bank of England, UBS

Figure 34: Overall corporate credit availability (net %)



Source: Haver, Bank of England, UBS

Figure 35: Factors affecting corp. credit supply (net %)



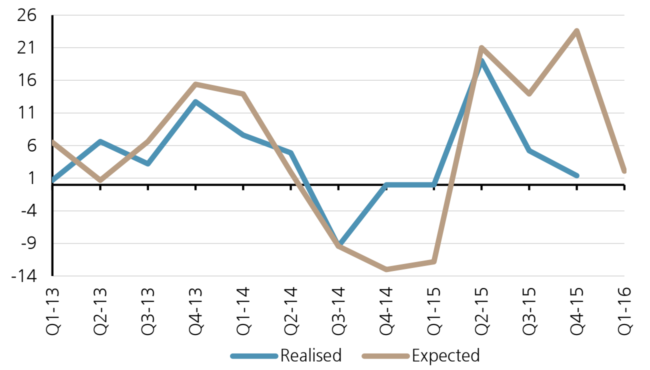
Source: Haver, Bank of England, UBS

Note: The CCS survey sends a questionnaire to UK lenders. The result is a weighted net percentage balance of positive responses e.g. net easing.

Credit Conditions Survey – corporate credit breakdown

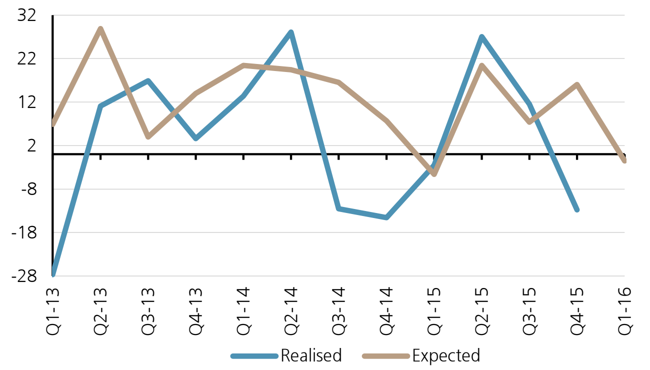
Looking at the breakdown of corporate credit, availability remained largely unchanged across the board in Q4 (despite high expectations for small business credit), with this expected to continue. Credit demand from small businesses fell, while it increased for medium and large corporates. On average, lenders expect flat demand from small businesses in Q1, and increased demand from medium and especially large corporates.

Figure 36: Small business credit availability (net %)



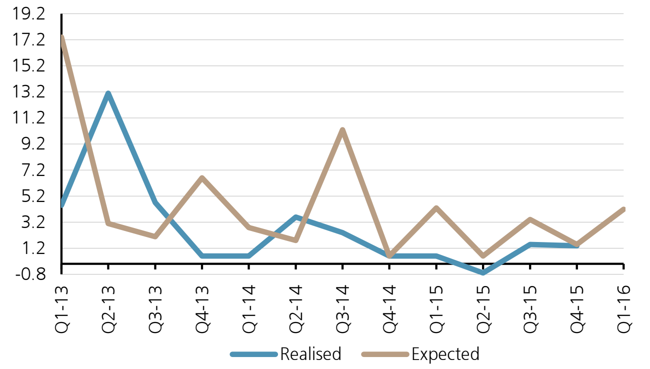
Source: Haver, Bank of England, UBS
Note: Small business classified as <£1m annual turnover

Figure 37: Small business credit demand (net %)



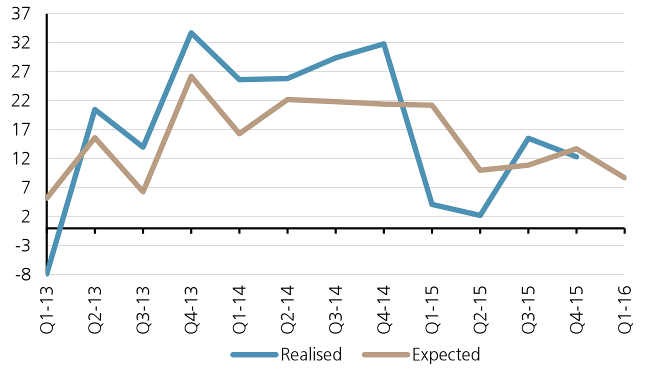
Source: Haver, Bank of England, UBS

Figure 38: Medium corporate credit availability (net %)



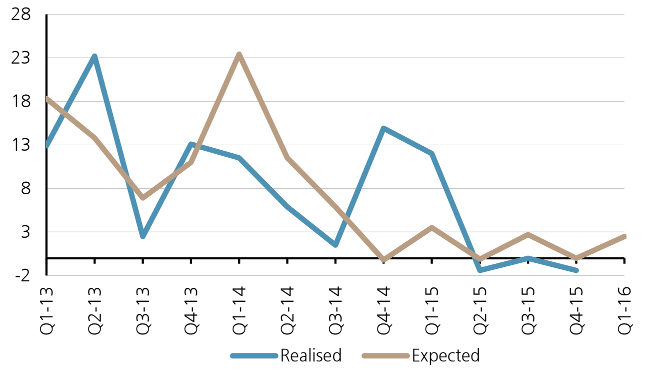
Source: Haver, Bank of England, UBS
Note: Medium business classified as >£1m and <£25m annual turnover

Figure 39: Medium corporate credit demand (net %)



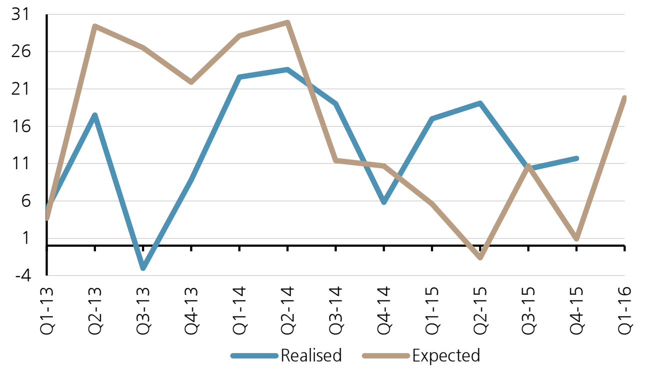
Source: Haver, Bank of England, UBS

Figure 40: Large corporate credit availability (net %)



Source: Haver, Bank of England, UBS
Note: Large business classified as >£25m annual turnover

Figure 41: Large corporate credit demand (net %)



Source: Haver, Bank of England, UBS

Valuation Method and Risk Statement

UK banks are exposed to a wide range of risks, including credit and interest rate risk, and exchange rate volatility. They are also regulated and in recent years, regulatory changes have generally led to higher operating costs and capital demands.
Price targets for Barclays, HSBC, LBG, RBS and Standard Chartered are derived by applying fair P/E multiples to our forecast adjusted divisional profit for 2017. The gap to an assumed 13% common equity tier 1 requirement is added to or deducted from our fair value, before discounting using a 10-12% assumed cost of equity.

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12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	48%	36%
Neutral	FSR is between -6% and 6% of the MRA.	39%	28%
Sell	FSR is > 6% below the MRA.	12%	22%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 December 2015.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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UBS Limited: Jason Napier, CFA; Ivan Jevremovic.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
ABN AMRO[4, 5, 7]	ABNd.AS	Buy	N/A	€16.61	12 Feb 2016
Barclays[7, 16b, 18a]	BARC.L	Buy	N/A	157p	12 Feb 2016
Commerzbank[1, 2, 4, 5, 7, 14]	CBKG.DE	Neutral	N/A	€7.54	12 Feb 2016
Deutsche Bank[2, 4, 5, 7, 16b]	DBKGn.DE	Neutral	N/A	€15.30	12 Feb 2016
HSBC[2, 4, 6, 7, 16a, 16b, 22]	HSBA.L	Buy	N/A	440p	12 Feb 2016
HSBC Holdings[2, 4, 6, 7, 16a, 16b, 22]	0005.HK	Buy	N/A	HK$48.10	12 Feb 2016
ING[2, 4, 5, 6, 7, 16b]	ING.AS	Buy	N/A	€9.77	12 Feb 2016
Lloyds Banking Group[2, 4, 5, 7, 14, 16b, 18b]	LLOY.L	Buy	N/A	58p	12 Feb 2016
RBS Group[2, 4, 16b]	RBS.L	Buy	N/A	240p	12 Feb 2016
Standard Chartered[2, 4, 5, 6, 7, 16a]	STAN.L	Neutral	N/A	429p	12 Feb 2016
Standard Chartered[2, 4, 5, 6, 7, 16a, 20]	2888.HK	Neutral (CBE)	N/A	HK$44.65	12 Feb 2016

Source: UBS. All prices as of local market close.
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