

**Financial stocks: worth an investment despite the subprime crisis?
Bank Sarasin identifies some potential winners**

Basel, 19 June 2008

Booming real estate markets, lax lending practices and credit rating processes, inadequate risk control mechanisms on the part of banks, and failure to anticipate macroeconomic impacts in time: these are the main reasons for the subprime crisis. Since then, the world of banking is not the same, and is now on the brink of a sea change. A new report published by the Research team at Bank Sarasin & Co. Ltd entitled "Banking in the wake of the subprime crisis" concludes that future prospects for banking shares are still subdued. At the moment the only financial stocks recommended for investment are those which are just marginally affected (if at all) by the fallout of the subprime crisis and still enjoy broadly supported earnings potential. These include BNP Paribas, BBVA (Banco Bilbao), JP Morgan Chase, Allianz, AXA and Zurich FS.

The subprime crisis was caused by offering artificially low or 'teaser' interest rates on mortgages to low-income American borrowers with poor credit histories (or none at all). Losses are now predicted to exceed 4% of US GDP. A report published recently by the International Organization of Securities Commissions (IOSCO) criticises banks and institutional investors: it says there were inadequate risk models and internal controls in place for detecting the risks associated with structured financial products.

Banks desperately looking for a way out of the crisis

In order to restore their capital ratios to the legally required levels, many of the banks affected by the crisis have been forced to raise new capital. This was done either through direct shareholdings of large public investors such as sovereign wealth funds, or through capital rights issues. Both courses of action dilute the value of the bank's shares for investors quite significantly. In addition, financial institutions are actively striving to remove the toxic loans from their balance sheets by selling receivables to interested third-party investors, or try to minimise their risks by restructuring their balance sheets.

Spillover effects now being felt in the real economy

With US house prices continuing to plummet and a sharply increased need for value adjustments at banks, the much feared spillover effects on the real economy have now become reality. Consumer confidence has slumped to its lowest level in the past 28 years and America is experiencing a de facto recession. In the meantime other countries with overheated housing markets, such as the UK, Ireland and Spain, have also been hit by falling house prices. In Europe and Asia we expect this to result in a sharp slowdown of economic growth, coupled with mounting inflation and rising unemployment.

Gloomy outlook for banking stocks

Basically Bank Sarasin's analysts expect the prices of banking shares to remain depressed for the foreseeable future. Banks will need to rethink their future business activity due to the likelihood of higher capital costs and weaker demand for credit. According to comments made by the representatives of various regulators, central banks and financial institutions, the capital requirements for banks generally need to be tightened up.

In future banks will certainly have to be more cautious in their lending practices (property, cars, consumer goods, business loans, credit cards) and set the credit costs for borrowers at a level that more closely reflects the actual risk. Demand for credit and overall lending volumes are therefore likely to rise far less in future years. For some banks this means, depending on their positioning and business model, having to tap into new sources of revenue or having to be content with a slower rate of earnings growth.

Still some beneficiaries of the crisis

At present Bank Sarasin advises investing exclusively in financial stocks only marginally affected (if at all) by the subprime crisis and which enjoy an intact and more broadly supported revenue stream. Concrete recommendations include three banks: BNP Paribas as a well diversified company with a solid balance sheet, BBVA (Banco Bilbao) as a rapidly growing, exceptionally profitable bank and JP Morgan Chase as a bank with a better than average equity ratio and winner of market shares. In the case of insurance companies, Bank Sarasin also identifies three particularly attractive stocks: Allianz, which has significant savings potential in its insurance business and benefits from increased demand for private pension policies, the financially strong AXA, and Zurich FS, which has an attractive business portfolio and is well on track to achieve its ambitious targets.

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Copies of the full report on banking in the wake of the subprime crisis, both in German and English, are available for clients and the media from:

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