UNITED KINGDOM

Rating Analysis - 11/3/10
Debt: GBP1,069.3B, Cash: GBP74.0M

EJR Sen Rating(Curr/Prj) AA/ N/A
EJR CP Rating: A1+
EJR's 1 yr. Default Probability: 1.0%

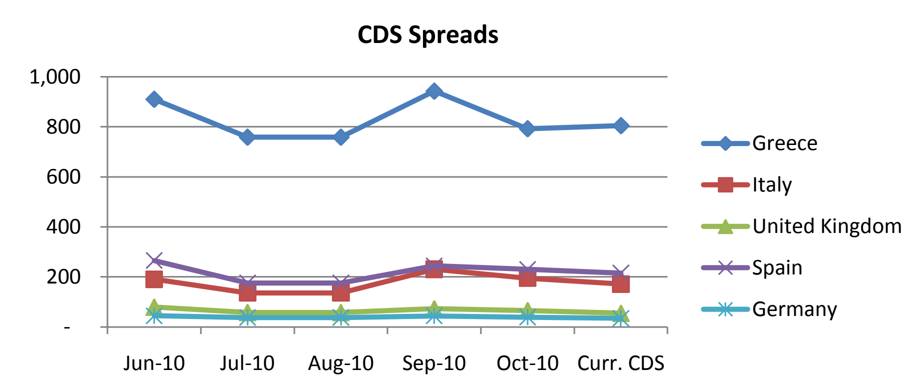
GDP in Q2 2010 increased by 1.2% over Q1 2010 and 1.7% YoY. Manufacturing output increased by 1.6% while utilities output decreased by 1.3%. Meanwhile, construction output rose by 9.5% and output in the services industries was revised downward to 0.6% (after 0.2% growth in Q1 2010). Household expenditure rose 0.7% in Q2 2010 following flat growth in Q1 2010. Employee compensation rose by 0.1% at current prices in the quarter, remaining 2.4% higher than Q2 2009. CPI was 3.1% in September, unchanged from August. Though unchanged, shifting forces included downward pressures from various transport costs and upward pressures from clothing & footwear and food categories (namely meat and fruit). September retail sales increased 0.5% YoY while decreasing 0.2% from the month prior. Total sales volume in the three months to September was up 0.9 %YoY. The UK's current account deficit fell to £7.4 billion in Q2 2010 from £11.3 billion in Q1 2010. Trade in goods recorded a deficit of £23.2 billion while trade in services recorded a surplus of £10.5 billion. Mortgage lending was down 7% in September and is now at a 10 year low.

Spreads on the UK's 5-year credit default swaps are currently trading at levels slightly above those of comparable peers including the US and Germany. Spreads have remained relatively stable in recent months though we expect some upset as austerity measures kick in.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
Debt/ GDP (%)	47.8	79.1	86.9	95.3	104.6	114.8
Govt. Sur/Def to GDP (%)	-5.0	-11.4	-12.0	-12.1	-12.1	-12.1
Adjusted Debt/GDP (%)	63.7	98.6	108.1	118.5	130.0	142.5
Interest/ Taxes %	7.4	6.9	8.8	9.3	9.3	9.3
GDP Growth (%)	-0.1	-5.0	0.9	0.9	0.9	0.9
Foreign Reserves/Debt (%)	3.7	2.8	2.6	2.5	2.5	2.5
Implied Sen. Rating	AA-	AA	A	BBB	BBB-	BB+

INDICATIVE CREDIT RATIOS	B	BB	BBB	A	AA	AAA
Debt/ GDP (%)	120.0	80.0	60.0	50.0	40.0	30.0
Govt. Sur/Def to GDP (%)	-5.0	-2.0	0.5	3.0	5.0	9.0
Adjusted Debt/GDP (%)	125.0	85.0	65.0	55.0	45.0	35.0
Interest/ Taxes %	22.0	15.0	12.0	9.0	7.0	5.0
GDP Growth (%)	-1.0	1.0	2.0	4.0	5.0	6.0
Foreign Reserves/Debt (%)	9.0	12.0	15.0	20.0	25.0	30.0

PEER RATIOS	S&P Sen.	Debt as a % GDP	Govt. Surp. Def to GDP (%)	Adjusted Debt/ GDP	Interest/ Taxes %	GDP Growth (%)	Ratio-Implied Rating*
Greece	BB+	117.0	-3.0	120.4	25.8	-2.5	B
Italy	A+	117.9	-5.3	123.8	15.9	-2.8	B
Spain	AA	54.2	-11.1	58.9	9.6	-3.0	BB
United Kingdom	AAA	79.1	-11.4	98.6	6.9	-5.0	BB
Germany	AAA	74.3	-3.0	81.3	10.7	-2.0	BBB



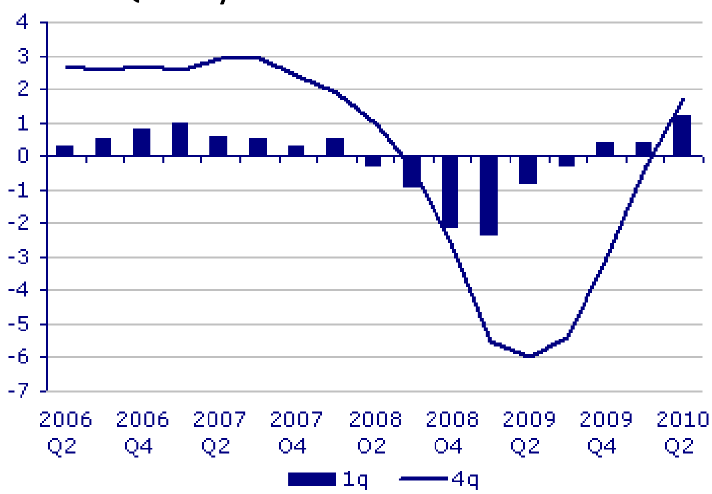
Country (EJR Rtg)	Current CDS	Targeted CDS
Greece(BB)	805	350
Italy(BBB+)	171	158
United Kingdom(A+)	55	60
Spain(A+)	215	60
Germany(A+)	34	60

Macroeconomic Indicators

The UK is one of the world's most developed economies. The country's GDP ranks among the highest in the world with US$2.18 trillion, or 3.76% of the global economy (2009). In terms of purchasing power parity, GDP ranks slightly lower at US$2.07 trillion (2009).

The economy grew by 1.2% in Q2 2010 (1.7% YoY). Overall production output remained flat. Specifically, manufacturing output increased by 1.6% while utilites output fell by 1.3%. Meanwhile, construction output rose by 9.5%. Finally, output in the service industry *fell* 0.6% after growth of 0.2% in Q1 2010. The decline was due mainly to a decline of 1.5% in transport, storage and communication services having offset a rise of 1.0% in business services and finance.

Real GDP Quarterly Growth in the UK



Source: UK Office for National Statistics

Gross Domestic Product 2010		
Seasonally Adjusted; Constant Prices		
	Amount (£B)	**Quarterly % Change**
Q1	358.65	0.3
Q2	364.88	1.2
Source: IMF		

Consumer Prices (% Change)		
	Monthly	**Annual**
April 2010	0.6	3.7
May 2010	0.2	3.4
June 2010	0.1	3.2
July 2010	-0.2	3.1
Aug. 2010	0.5	3.1
Sep. 2010	0.0	3.1
Source: Bloomberg		

Preliminary estimates for Q3 2010 indicate a surprising and encouraging 0.8% rise in GDP from the previous quarter (3.2% SA YoY). The rate is double the previously expected 0.4% Q3 2010 growth rate. The positive figures are due in large part to the UK's services sector which, while accounting for more than 75% of GDP, expanded 0.6% during the quarter. Meanwhile, total production output rose 0.6% in Q3 2010 compared with an increase of 1.0% in Q2 2010. Construction output rose 4.0% compared with an increase of 9.5% in Q2 2010.

Government Finances

In 2009, the UK ran a budget deficit of 11% of GDP as expenditures of $1.129 trillion exceeded revenues of $880 billion. Meanwhile, the US ran a deficit of 9.9% and the OECD average was below 8%. To date, the UK has recorded general government net borrowing for the most recent fiscal year of £159.8 billion, or 11.4% of GDP. Meanwhile, general government debt was £1,000.4 billion, or 71.3% of GDP, by the end of March 2010. Government spending has increased steadily over the past two decades. In the most recent year, total government expenditures remained high at 44% of GDP. Welfare benefits (the largest component of government spending) continue to rise.

Inflation

CPI annual inflation remained unchanged from the month prior at 3.1% in September. Although unchanged, significant upward and downward pressures fluxuated during the period. The largest upward pressures came from clothing & footwear (up 6.4% during the month) and food with meat prices up 0.3% (down 1.2% YoY). Meanwhile, the largest downward pressures were accounted for in transportation costs. Air transport fares fell 27.8% while fuel and lubricant prices were down 0.8%. Second-hand car prices also recorded a decline in prices after recording an increase in 2009.

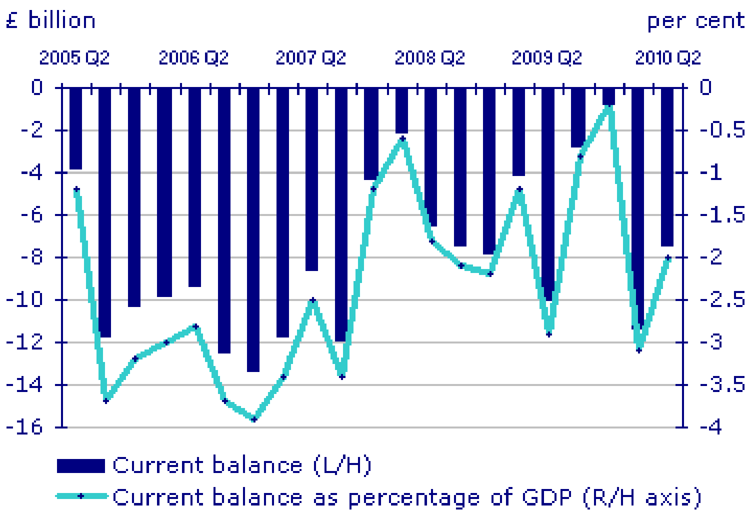
Employment

The unemployment rate for the three months to August 2010 was 7.7% (down 0.1% on the quarter). Meanwhile, the employment rate for individuals aged 16 to 64 years was 70.7% (up 0.2% on the quarter). Overall, the number of individuals unemployed fell by 20,000 in the three months to August to a total of 2.45 million. Male unemployment decreased by 56,000 on the quarter to total 1.44 million. Female unemployment increased by 36,000 on the quarter to total 1.01 million. Meanwhie, the 16-nation euro zone average rate is 10% and the US rate is 9.6%.

Balance of Payments

The UK's current account deficit fell 30% from the £11.3 billion deficit in Q1 2010 to a recorded £7.4 billion deficit in Q2 2010. The deficit on trade in goods increased by £1.2 billion to £23.2 billion. Finished manufactured goods, semi-manufactured goods and oil drove the increase. Meanwhile, the *surplus* on trade in services fell by £1.4 billion to £10.5 billion as imports of government & travel services increased and business & insurance services decreased.

UK current account balance: seasonally adjusted



Source: UK Office for National Statistics

Q2 2010 Current Account		
Billions of Euros (€)		
	Trade in Goods	**Trade in Services**
Exports	**+3.2**	**-0.4**
Imports	**+4.4**	**+1.0**

UK earnings on investment abroad increased 10% during the second quarter to £45.2 billion due to higher earnings on direct investment abroad. Foreign earnings on investment in the UK fell 6% to £35.7 billion due to lower foreign earnings on investment in the UK.

Economic Freedom

The 2010 Index of Economic Freedom as measured by the Heritage Foundation indicates that the UK's freedom score has fallen 2.5 points from the year prior as financial and monetary freedoms have declined in the nation. Still, the UK remains open to global trade and investment. Foreign investors receive the same treatment as domestic businesses and the regulatory environment provides strong protection in starting, operating and closing businesses in the UK. Meanwihle, the UK's labor rights are flexible and property rights remain strict.

The recent downgrade in the UK's measured economic freedom results mainly from decreases in financial and monetary freedom. The government has intervened in some of the UK's major banks, expanding state ownership of the institutions. The government nationalized Northern Rock Bank, the mortgage lender which became one of the UK's main casualties of the financial crisis, in 2008. The government also took majority and minority stakes, respectively, in the Royal Bank of Scotland and Lloyds Banking Group.

Finally, fiscal freedom is limited in light of the UK's high income tax rate and moderate corporate tax rate. The top income tax rate is 40 percent, while the top corporate tax rate is 28 percent. Other taxes include a value-added tax (VAT), an inheritance tax, and capital gains taxes on business and personal assets.

Heritage Foundation 2010 Index of Economic Freedom - United Kingdom				
World Rank: 11; Regional Rank: 4 of 43*				
	2010 Rank	**2009 Rank**	**Change in Rank**	**World Average**
Business Freedom	**94.9**	89.8	+5.1	64.6
Trade Freedom	**87.5**	85.8	+1.7	74.2
Fiscal Freedom	**61.8**	61.0	+0.8	75.4
Government Spending	**41.9**	40.3	+1.6	65.0
Monetary Freedom	**73.7**	80.4	-6.7	70.6
Investment Freedom	**90.0**	90.0	0.0	49.0
Financial Freedom	**80.0**	90.0	-10.0	48.5
Property Rights	**85.0**	90.0	-5.0	43.8
Freedom from Corruption	**77.0**	84.0	-7.0	40.5
Labor Freedom	**72.8**	78.5	-5.7	62.1

*The ten economic freedoms are based on a scale of 0 (least free) to 100 (most free).

**Based on a scale of 1-183 with 1 being the highest ranking.

Source: The Heritage Foundation & Wall Street Journal

"Unavoidable" Austerity Measures

At roughly 11% of GDP, the UK's budget deficit is currently the largest among advanced economies. As a result, the government is currently setting out on its biggest fiscal squeeze since WWII in an effort to reduce the deficit. A planned £81 billion (US$128 billion) in spending cuts will be implemented over the next four years. This is set to equate to 4.5% of projected 2014/15 GDP. The government will also effectively raise the value-added sales tax in 2011. Chancellor George Osborne's plan will lead to 500,000 public sector job losses, higher pension contributions and an increase in the retirement age. Furthermore, a two year freeze on civil service salaries is expected to save more than £3 billion per year by 2015. The plan aims to reduce the deficit to 2.1% in the 2014/15 fiscal year. In light of the measures the IMF predicts the UK economy will grow by 1.3% this year and by 2.5% in 2011. Meanwhile, global GDP growth is expected to measure 4% in 2011.

Assumptions for Projections

	Peer	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	(4.8)	(11.5)	**(4.8)**	**0.5**
Social Contributions Growth %	(1.8)	(1.8)	**0.5**	**0.5**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	0.1	1.7	**2.0**	**2.0**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	(6.4)	(8.4)	**(8)**	**(8.4)**
Compensation of Employees Growth%	5.2	5.2	**5.2**	**5.2**
Use of Goods & Services Growth%	5.4	4.2	**4.2**	**4.2**
Social Benefits Growth%	8.7	10.8	**10.8**	**10.8**
Subsidies Growth%	2.3	4.9		
Other Expenses Growth%	(2.0)	(2.0)	**(2.0)**	**(2.0)**
Special Items (millions GBP)	0.0	0.0		
Balance Sheet				
Currency and Deposits Growth%	0.4	0.4	**(4.8)**	**(4.8)**
Securities other than Shares LT Growth%	7.8	(24.8)	**2.0**	**2.0**
Loans Growth%	2.4	13.9	**3.0**	**3.0**
Shares and Other Equity Growth%	14.8	22.2	**22.2**	**20.0**
Insurance Technical Reserves Growth%	2.8	(3.2)	**2.0**	**2.0**
Financial Derivatives Growth%	0.0	(60.8)	**2.0**	**2.0**
Other Accounts Receivable LT Growth%	8.0	4.9	**(4.8)**	**(4.8)**
Monetary Gold and SDR's Growth %	0.0	150.2	**12.0**	**12.0**
Other Accounts Payable Growth%	9.2	NMF		
Currency & Deposits Growth%	4.5	6.3	**6.3**	**6.3**
Securities Other than Shares Growth%	16.3	31.5	**5.0**	**5.0**
Growth%	0.0	0.0		
Loans Growth%	0.8	(49.1)	**0.5**	**0.5**
Insurance Technical Reserves Growth(%)	0.0	0.0		
Financial Derivatives Growth%	0.0	0.0		
		0.0		
Addl debt. (1st Year) million GBP	0.0	0.0		

Base Case

ANNUAL REVENUE AND EXPENSE STATEMENT (MILLIONS GBP)

	Dec-07	Dec-08	Dec-09	PDec-10	PDec-11	PDec-12
Taxes	412,258	438,474	387,914	369,294	351,568	353,326
Social Contributions	115,660	121,561	119,383	119,980	120,580	121,183
Grant Revenue	0	0	0	0	0	0
Other Revenue	52,206	55,061	56,001	57,121	58,263	59,429
Other Operating Income	0	0	0	0	0	0
Total Revenue	580,124	615,096	563,298	515,862	472,421	432,637
Compensation of Employees	153,571	160,008	168,286	176,992	186,149	195,779
Use of Goods & Services	164,113	178,625	186,134	193,959	202,112	210,609
Social Benefits	178,379	189,958	210,443	233,137	258,279	286,131
Subsidies	9,280	8,987	9,425	9,426	9,427	9,428
Other Expenses	56,951	83,776	82,115	-4,809	-5,308	-5,860
Grant Expense	0	0	0	0	0	0
Depreciation	12,833	13,528	14,269	14,269	14,269	14,269
Total Expenses	575,127	634,882	670,672	622,974	664,928	710,356
Operating Surplus/Shortfall	4,997	-19,786	-107,374	-107,112	-192,507	-277,719
Interest Expense	31,217	32,578	26,956	32,509	32,671	32,835
Net Operating Balance	-26,220	-52,364	-134,330	-139,621	-225,179	-310,553

ANNUAL BALANCE SHEETS (MILLIONS GBP)

ASSETS	Dec-07	Dec-08	Dec-09	PDec-10	PDec-11	PDec-12
Currency and Deposits	44,274	73,707	73,980	70,429	67,048	63,830
Securities other than Shares LT	26,846	39,368	29,586	30,178	30,781	31,397
Loans	37,122	41,082	46,795	48,199	49,645	51,134
Shares and Other Equity	134,430	157,104	191,995	234,635	286,745	344,059
Insurance Technical Reserves	854	875	847	864	881	899
Financial Derivatives	(423)	(3,504)	(1,374)	(1,401)	(1,430)	(1,458)
Other Accounts Receivable LT	46,893	63,514	66,602	63,405	60,362	57,464
Monetary Gold and SDR's	4,344	6,276	15,701	17,585	19,695	22,059
Additional Assets	0	0	0	0	0	0
Total Financial Assets	294,340	378,422	424,132	463,893	513,728	569,384

LIABILITIES	Dec-07	Dec-08	Dec-09	PDec-10	PDec-11	PDec-12
Other Accounts Payable	32,848	31,976	30,443	30,443	30,443	30,443
Currency & Deposits	101,570	120,877	128,551	266,674	496,758	815,791
Securities Other than Shares	511,822	650,593	855,803	898,593	943,523	990,699
Loans	49,742	51,969	26,455	26,455	26,455	26,455
Insurance Technical Reserves						
Financial Derivatives						
Other Liabilities			(2)	(1,531)	(1,531)	(1,531)
Liabilities	695,982	855,415	1,041,250	1,220,634	1,495,647	1,861,857
Net Financial Worth	(401,642)	(476,993)	(617,120)	(756,741)	(981,919)	(1,292,473)
Total Liabilities & Equity	294,340	378,422	424,130	463,893	513,728	569,384

Sovereign Rating Methodology

Egan-Jones takes the perspective of the investor as its primary point of view when developing the ratings it issues for sovereigns. Therefore, in the case of sovereign ratings, we attempt to take a more holistic view of credit quality to include not only analytic comparisons of various sovereign issuers but also the impact on our quantitative and qualitative analyses by current global, sovereign, governmental and market events, including the effects of government investments in speculative, volatile or other high risk investment products. For example, many sovereign issuers have taken on significant exposures of major financial institutions over the past several years. Hence, we calculate the under-funding of financial institutions and include this amount in the total indebtedness of sovereigns. (We use a base assumption that no country can afford to allow its major banks to fail and therefore we believe that there will almost always be an intervention by either a host or allied nation should financial institutions or markets require support at some measurable level.)

Generally we devise modeling calculators and do an analysis that examines the debt load of a country with respect to its GDP and other economic indicators. The analysis is then adjusted to reflect the outlook on a myriad of factors that reflect the firm’s overall view of the sovereign debt and the quality of the country’s ability to meet and thrive under such load. Some of the qualitative factors that impact our ultimate assessment of credit quality such as the flexibility, stability and overall strength of the economy, ease of tax collection, acceptance of contract law, ease of doing business, and prospects for future growth and health. The non quant issues are generally subjective and a moving target, so each rating of a sovereign may differ because of the non-quantitative nuances being addressed.

Nota Bene

History has proven that defaults on domestic public debt do occur. In fact, seventy out of three hundred twenty defaults since 1800 have been on domestic public debt (1). Egan-Jones does not view a country's ability to print its own currency as a guarantee against default. Additionally, Egan-Jones generally views cases of excessive currency devaluation as a de facto default.

1. "This Time Is Different: Eight Centuries of Financial Folly", Reinhart & Rogoff, p.111, 126