UNITED KINGDOM

Rating Analysis - 6/4/12
Debt: GBP1,505.4B, Cash: GBP0.0M

EJR Sen Rating(Curr/Prj) AA-/ A+
EJR CP Rating: A1+
EJR's 1 yr. Default Probability: 1.3%

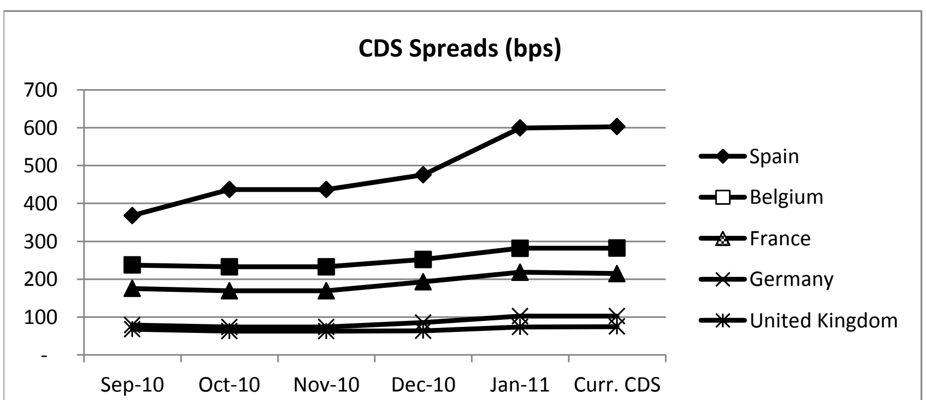
Worse than it appears - per the IMF's IFS, the UK's debt to GDP has rocketed from 49% as of 2007 to 99.7% as of 2011 and for 2014 we believe it is likely to be in excess of 110%. Since 2007, debt grew a total of 119% while GDP rose only 7.4%. The services, particularly banking, is critical to the UK's economy and the industry is requiring taxpayer support to address problem credits.

On the balance of payment side, imports have exceeded exports by an average of approximately 500B pounds annually over the past several years. The major problems for the UK is that Europe's banking crisis does not appear to be abating as evidenced by the miserable results of most EU banks. On the fiscal side, the deficit to GDP has declined over the past three years from 11.5% to 8.3%, which is a respectable decline, but the bulk of the reduction was the result of increased taxes since GDP growth was weak. The over-riding concern is whether the country will be able to continue to cut its deficit in the face of weaker economic conditions and a possible deterioration in the country's financial sector. Unfortunately, we expect that the UK's debt/GDP will continue to rise and the country will remain pressed.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	2009	2010	2011	P2012	P2013	P2014
Debt/ GDP (%)	74.4	83.9	99.7	103.9	110.1	116.3
Govt. Sur/Def to GDP (%)	-11.5	-10.2	-8.3	-6.9	-6.0	-6.3
Adjusted Debt/GDP (%)	150.5	154.2	160.8	165.2	172.2	179.3
Interest Expense/ Taxes (%)	6.9	10.2	11.0	7.4	7.4	7.6
GDP Growth (%)	-4.4	2.1	0.7	-1.5	-1.5	-1.4
Foreign Reserves/Debt (%)	2.9	2.0	2.2	2.1	2.1	2.0
Implied Sen. Rating	AA-	BBB	BBB+	BBB	BBB	BBB

INDICATIVE CREDIT RATIOS	AA	A	BBB	BB	B	CCC
Debt/ GDP (%)	45.0	55.0	75.0	85.0	95.0	145.0
Govt. Sur/Def to GDP (%)	4.0	1.0	-2.0	-5.0	-8.0	-10.0
Adjusted Debt/GDP (%)	40.0	50.0	60.0	80.0	120.0	150.0
Interest Expense/ Taxes (%)	7.0	9.0	12.0	15.0	22.0	26.0
GDP Growth (%)	4.0	3.0	2.0	1.0	-1.0	-5.0
Foreign Reserves/Debt (%)	25.0	20.0	15.0	12.0	9.0	7.0

PEER RATIOS	S&P Sen.	Debt as a % GDP	Govt. Surp. Def to GDP (%)	Adjusted Debt/ GDP	Interest Expense/ Taxes %	GDP Growth (%)	Ratio-Implied Rating*
Government Of Canada	AAA	32.3	-5.0	54.5	14.1	1.9	A
Federal Republic Of Germany	AAA	79.5	-5.2	79.5	11.2	2.0	BB+
French Republic	AA+	83.8	-5.2	83.8	9.5	1.2	BB
Kingdom Of Belgium	AA	96.3	-3.7	96.3	11.9	1.2	BB-
Kingdom Of Spain	BBB+	65.2	-8.5	65.6	9.5	0.3	BB+



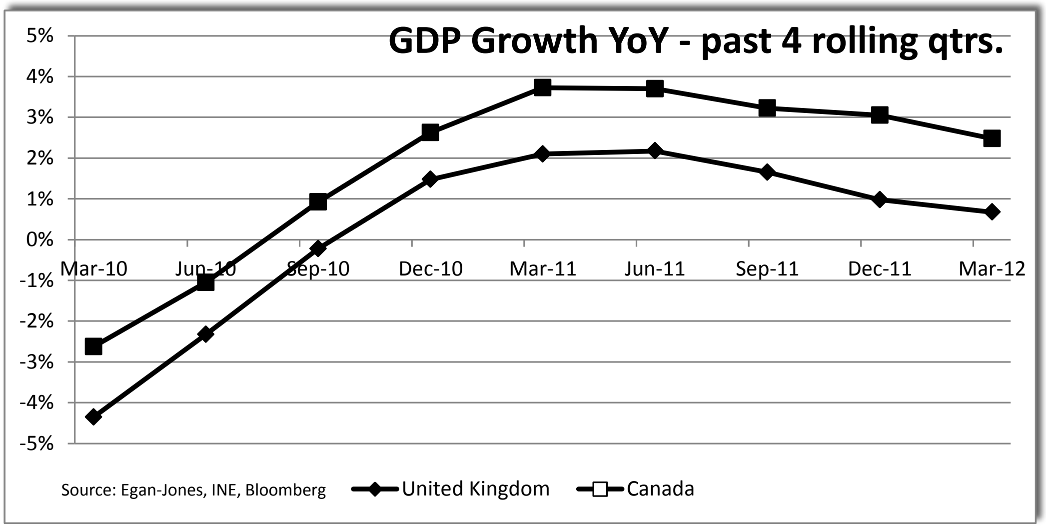
Country (EJR Rtg*)	Current CDS	Targeted CDS
Spain (CCC)	603	2,000
Belgium (BBB-)	282	400
France (A-)	215	120
Germany (A+)	102	80
United Kingdom (A+)	75	80

* Projected Rating
* EJR's targeted CDS based on rating

Economic Growth

The country was hobbled by the global financial crisis of 2007, harming the nation's GDP and causing the economy to enter into a recession during the third quarter of 2008. As seen below, growth has been tepid at 1% or less over the last couple of quarters. We expect GDP to continue to slip over the next couple of quarters.

As can be seen from the below chart, the UK's rolling four quarter GDP growth has been less than stellar over the past year; the UK is barely growing while Canada has recorded growth near 3%. A large portion of England's economy is geared to the services industry, particularly financial services. The continued weakness in the EU limit's growth in the UK's service economy.



Fiscal Policy

The United Kingdom's deficit to GDP of 8.3% is high and is likely to grow over the next couple of years. From FYE 2009 through 2011, because of increased taxes, total sovereign revenues rose 9.9% while expenses excluding interest rose 0.8% The major problem for the UK is its high debt Debt to GDP and support needed for its banks. As can be seen from the chart to the right, only Spain has a worse deficit to GDP than the UK. As the UK implements austerity measures and provides further support for its banks, debt to GDP will rise.

	Deficit-to-GDP	Debt-to-GDP (%)	5 Yr CDS Spreads
U.K.	8.3	85.5	74
Canada	5.0	30.1	#N/A
Germany	5.2	78.3	102
France	5.2	77.8	219
Belgium	3.7	90.6	282
Spain	8.5	57.1	599

Source: Bloomberg using yr end data other than CDS data

Unemployment

The UK's unemployment rate of 8.4% is near the middle of the pack as indicated in the chart at right. However, as of the March 2012 quarter, the rate declined slightly to 8.2%. The weak level of employment will impede the government's attempts to reduce the budget deficit. We expect unemployment to remain high because of the soft conditions in financial services although the London olympics will help.

Unemployment (%)	2010	2011
U.K.	7.9	8.4
Canada	7.6	7.5
Germany	7.4	6.8
France	9.7	9.8
Belgium	7.6	7.2
Spain	20.3	22.9

Source: Intl. Finance Statistics

Banking Sector

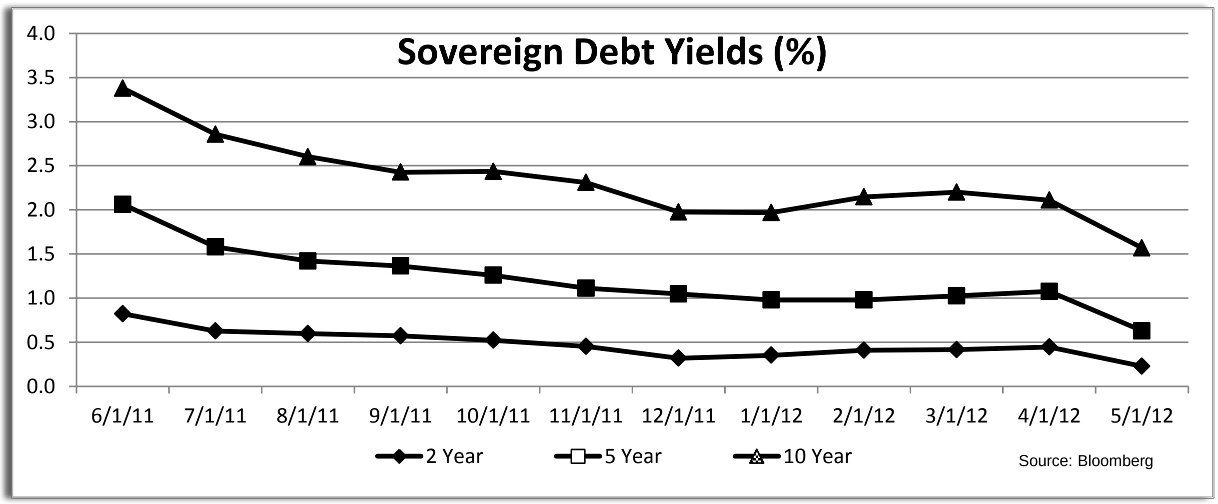
History has shown that country and bank obligations are linked during times of economic distress. The UK has significantly exposure to its banking because the bank's large aggregate size measured in assets The top five banks have assets equal to 477% of GDP versus 125% for Germany. The UK will probably be expected to provide financial support to its banks over the next couple of years quarters to ameliorate asset quality problems.

Bank Assets (billions of local currency)

	Assets	Cap/ Assets %
HSBC HLDGS PLC	2,556	6.5
ROYAL BK SCOTLAN	1,564	4.2
BARCLAYS PLC	1,507	5.0
LLOYDS BANKING	971	4.8
STANDARD CHARTE	599	6.9
Total	7,196	
EJR's est. of cap shortfall at 10% of assets less market cap		536
United Kingdom's GDP		1,510

Funding Costs

A Flight to Quality - with the waning of the ECB's LTRO and weakening of EU credit metrics, the UK's funding costs have plunged over the past several months. As can be seen in the below graph, the bond yields have plunged since Nov. 2011. A major issue is whether the UK belongs in the top-tier of credit quality.



Ease of Doing Business

A major factor for growing the economy is the ease of doing business and the economic freedom; although not the sole factor for determining economic growth, a country which makes it easy for businesses to operate and provides a reasonably free environment to conduct business has a good chance for growth. The chart on the right indicates that with an overall rank of 7 (1 is best) is weak.

The World Bank's Doing Business Survey*

	2012 Rank	2011 Rank	Change in Rank
Overall Country Rank:	**7**	**6**	**-1**
Scores:			
Starting a Business	19	17	-2
Construction Permits	22	20	-2
Getting Electricity	60	54	-6
Registering Property	68	62	-6
Getting Credit	1	1	0
Protecting Investors	10	10	0
Paying Taxes	24	21	-3
Trading Across Borders	13	14	1
Enforcing Contracts	21	22	1
Resolving Insolvency	6	7	1

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

Economic Freedom

As can be seen below, United Kingdom is above average in its overall rank of 74 for Economic Freedom with 100 being best.

Heritage Foundation 2012 Index of Economic Freedom

World Rank 74*

	Rank**	2011 Rank	Change in Rank	World Avg.
Business Freedom	**94.7**	94.6	0.1	64.3
Trade Freedom	**87.1**	87.6	-0.5	74.8
Fiscal Freedom	**56.4**	52.0	4.4	76.3
Government Spending	**21.5**	32.9	-11.4	63.9
Monetary Freedom	**73.9**	74.9	-1.0	73.4
Investment Freedom	**90.0**	90.0	0.0	50.2
Financial Freedom	**80.0**	80.0	0.0	48.5
Property Rights	**90.0**	85.0	5.0	43.5
Freedom from Corruption	**76.0**	77.0	-1.0	40.5
Labor Freedom	**71.5**	71.2	0.3	61.5

*Based on a scale of 1-100 with 100 being the highest ranking.

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

Source: The Heritage Foundation & Wall Street Journal

Assumptions for Projections

	Peer	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	4.2	5.4	**2.0**	**2.0**
Social Contributions Growth %	2.0	4.0	**1.0**	**1.0**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	2.3	(1.6)	**1.0**	**1.0**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	3.1	4.6	**(2)**	**(1.4)**
Compensation of Employees Growth%	2.5	0.6	**0.6**	**0.6**
Use of Goods & Services Growth%	4.5	(0.5)	**(0.5)**	**(0.5)**
Social Benefits Growth%	3.2	4.0	**2.0**	**2.0**
Subsidies Growth%	2.9	(12.5)		
Other Expenses Growth%	(10.7)	(10.7)	**(1.0)**	**(1.0)**
Interest Expense	0.0	3.2	**2**	
Balance Sheet				
Currency and Deposits (asset) Growth%	(20.6)	0.0		
Securities other than Shares LT (asset) Growth%	7.0	20.5	**2.0**	**2.0**
Loans (asset) Growth%	17.6	7.0	**2.0**	**2.0**
Shares and Other Equity (asset) Growth%	2.1	1.1	**1.1**	**1.1**
Insurance Technical Reserves (asset) Growth%	3.0	0.1	**0.1**	**0.1**
Financial Derivatives (asset) Growth%	0.0	61.5	**2.0**	**2.0**
Other Accounts Receivable LT Growth%	0.8	7.7	**1.0**	**1.0**
Monetary Gold and SDR's Growth %	0.0	6.0	**1.0**	**1.0**
Other Accounts Payable Growth%	2.4			
Currency & Deposits (liability) Growth%	2.5	7.1	**7.1**	**7.1**
Securities Other than Shares (liability) Growth%	7.3	25.4	**3.0**	**3.0**
Loans (liability) Growth%	7.2	5.9	**2.0**	**2.0**
Insurance Technical Reserves (liability) Growth%	0.0	0.0		
Financial Derivatives (liability) Growth%	8.2	16.5	**2.0**	**2.0**
Addl debt. (1st Year) million GBP	0.0	0.0		

Base Case
ANNUAL REVENUE AND EXPENSE STATEMENT (MILLIONS GBP)

	Dec-09	Dec-10	Dec-11	PNov-12	PDec-13	PDec-14
Taxes	386,745	417,234	439,823	448,619	457,592	466,744
Social Contributions	119,293	123,079	128,025	129,305	130,598	131,904
Grant Revenue	0	0	0	0	0	0
Other Revenue	53,049	47,449	46,683	47,150	47,621	48,098
Other Operating Income	0	0	0	0	0	0
Total Revenue	559,087	587,762	614,531	625,075	635,811	646,746
Compensation of Employees	162,307	167,289	168,265	169,247	170,234	171,227
Use of Goods & Services	190,267	191,249	190,244	189,244	188,250	187,261
Social Benefits	210,806	220,714	229,588	234,180	238,863	243,641
Subsidies	9,251	9,440	8,256	8,257	8,258	8,258
Other Expenses	91,067	78,340	69,943	77,557	69,244	76,781
Grant Expense	0	0	0	0	0	0
Depreciation	13,946	15,129	15,398	15,398	15,398	15,398
Total Expenses excluding interest	668,393	672,721	673,438	693,882	690,247	702,566
Operating Surplus/Shortfall	-109,306	-84,959	-58,907	-68,808	-54,435	-55,820
Interest Expense	26,708	42,350	48,383	33,119	33,989	35,689
Net Operating Balance	-136,014	-127,309	-107,290	-101,927	-88,424	-91,509

Base Case
ANNUAL BALANCE SHEETS (MILLIONS GBP)

ASSETS	Dec-09	Dec-10	Dec-11	PNov-12	PDec-13	PDec-14
Currency and Deposits (asset)	86,207	83,231				
Securities other than Shares LT (asset)	29,586	36,860	44,417	45,305	46,211	47,136
Loans (asset)	47,134	52,983	56,698	57,832	58,989	60,168
Shares and Other Equity (asset)	189,891	191,633	193,788	195,967	198,171	200,399
Insurance Technical Reserves (asset)	851	702	703	704	705	706
Other Accounts Receivable LT	66,136	69,414	74,728	75,475	76,230	76,992
Monetary Gold and SDR's	15,701	18,159	19,250	19,443	19,637	19,833
Additional Assets			96,283			
Total Financial Assets	434,132	454,260	487,931	396,832	402,090	407,426
LIABILITIES						
Other Accounts Payable						
Currency & Deposits (liability)	127,872	122,786	131,500	131,500	131,500	131,500
Securities Other than Shares (liability)	855,803	1,051,463	1,318,477	1,358,031	1,398,772	1,440,735
Loans (liability)	26,167	24,776	26,247	26,247	52,494	78,741
Insurance Technical Reserves (liability)						
Financial Derivatives (liability)		1,850	2,155	2,198	2,242	2,287
Other Liabilities	26,517	28,428	29,189	419	419	419
Liabilities	1,036,359	1,229,303	1,507,568	1,518,395	1,612,078	1,708,923
Net Financial Worth	(602,227)	(775,043)	(1,019,637)	(1,121,564)	(1,209,988)	(1,301,497)
Total Liabilities & Equity	434,132	454,260	487,931	396,832	402,090	407,426

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. Note, debt levels for many sovereign issuers have increased over the past decade and has accelerated recently, effecting the implied ratings.

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