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February 22, 2012

Industry View
In-Line

Banks/Economics/Rates

The next LTRO: What to expect and what next?

We think there is another leg to the LTRO trade, but with a large recovery trade already done, what's next and how to assess next week's LTRO? Our base case is €0.2-0.5tr of new liquidity to support sovereign & bank funding. This will ease credit flows but won't stop the Great Deleveraging.

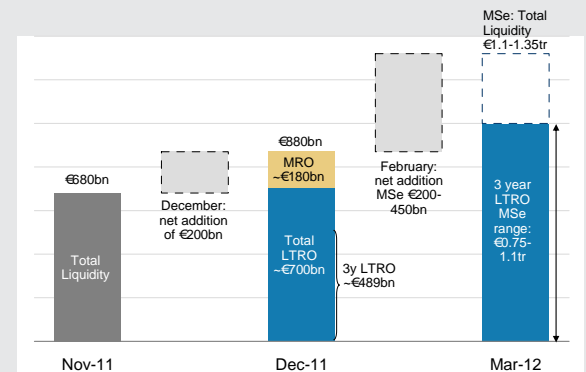
LTRO is important but not a panacea. We think LTRO could add a further €0.2-0.5tr of new liquidity *plus* €0.1tr rolling in. We think Spanish and Italian banks will be the biggest users and that much of the proceeds will be "parked" or invested in government securities. Indeed our discussions with Italian banks make us think they may draw more than December, in part due to easing of EBA sovereign buffer rules.

Funding easing: By reducing the risk of a systemic bank failure, funding markets re-opened and broadening out, e.g., €46bn of senior unsecured issued YTD, more than during the prior 6.5 months. Market has notably eased for some Spanish, Italian and French banks in recent sessions with longer unsecured tenor.

The key challenge will be to ease evident credit constraints: While the LTRO should materially ease the Eurozone deleveraging process, credit conditions appear likely to remain fairly tight in Spain, Italy, CEE and a headwind to several assets (shipping, CRE, parts of trade finance) – and could require further targeted policy action, e.g., for SMEs, Vienna 2.0, and, our economists argue, 50bps rate cuts & later broader QE.

X-asset recommendations: In Equities, LTRO supports a basket of national champions and we still like those at big discount to NAV (BARC, DBK, BNP, KBC, ING – and UBS, SBER, Aberdeen). In Credit, we moderate our overweight in financials and recommend reducing risk by upgrading exposure: selling T1s outright or switching into LT2, out of senior and into covereds, and buying CDS against existing positions. In Rates, we continue to recommend Italy and Spain flatteners. In FX, we recommend selling EURs and buying defensive currencies, namely USD and JPY.

Our base case is for a €250-600bn increase in the 3y LTRO in February. This equates to a possible 8-16% increase in the ECB balance sheet



Source: Morgan Stanley Research

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Agenda

Summary and Key Recommendations

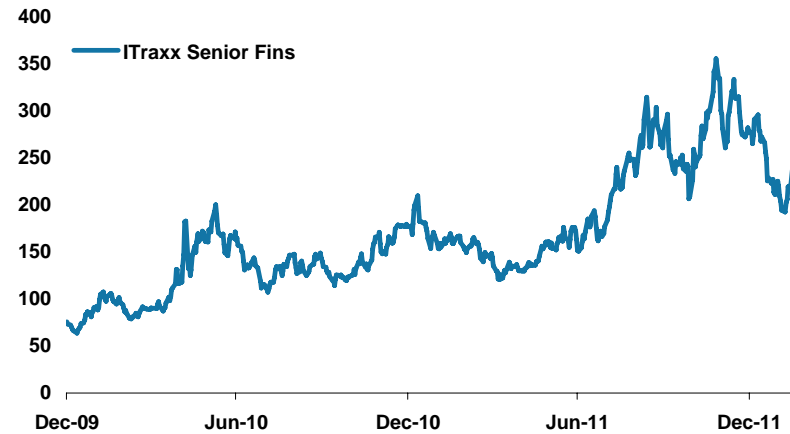
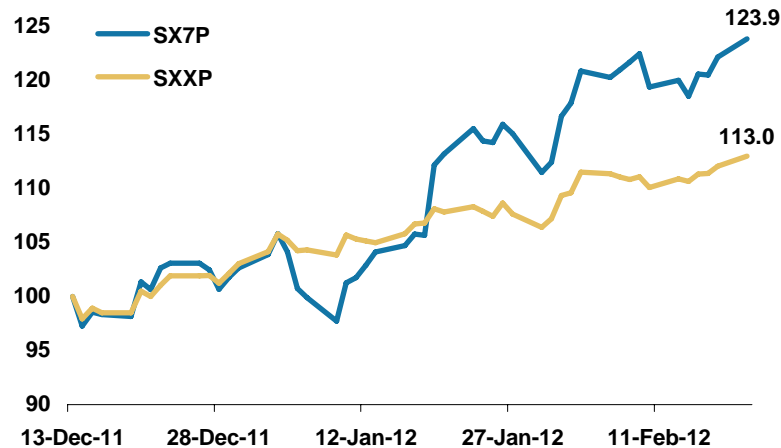
How the LTRO will ease a crunch but not stop the Great Deleveraging

Valuation, Trade Ideas & Eligibility Rules

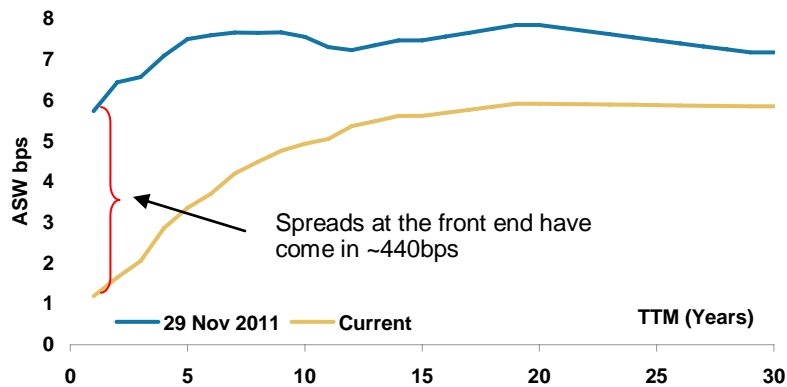
The first leg of “Don’t underestimate the LTRO” thesis has played out– the key issue now is how much more of the liquidity injection and recovery trade still to run – we think there is another leg to this trade although with shifting investment opportunities - but dependent on Greek resolution

European banks up 24% and have outperformed index by 11%, with greatest moves in stocks well below book.

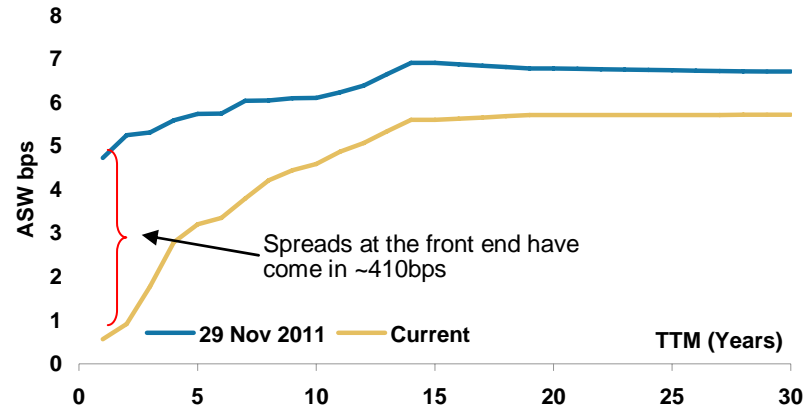
Bank funding markets are normalising as we hoped – e.g. SenFin from 323 to ~220bps since we first made our call



Italian curve has steepened dramatically



As has the Spanish curve as domestic banks bought



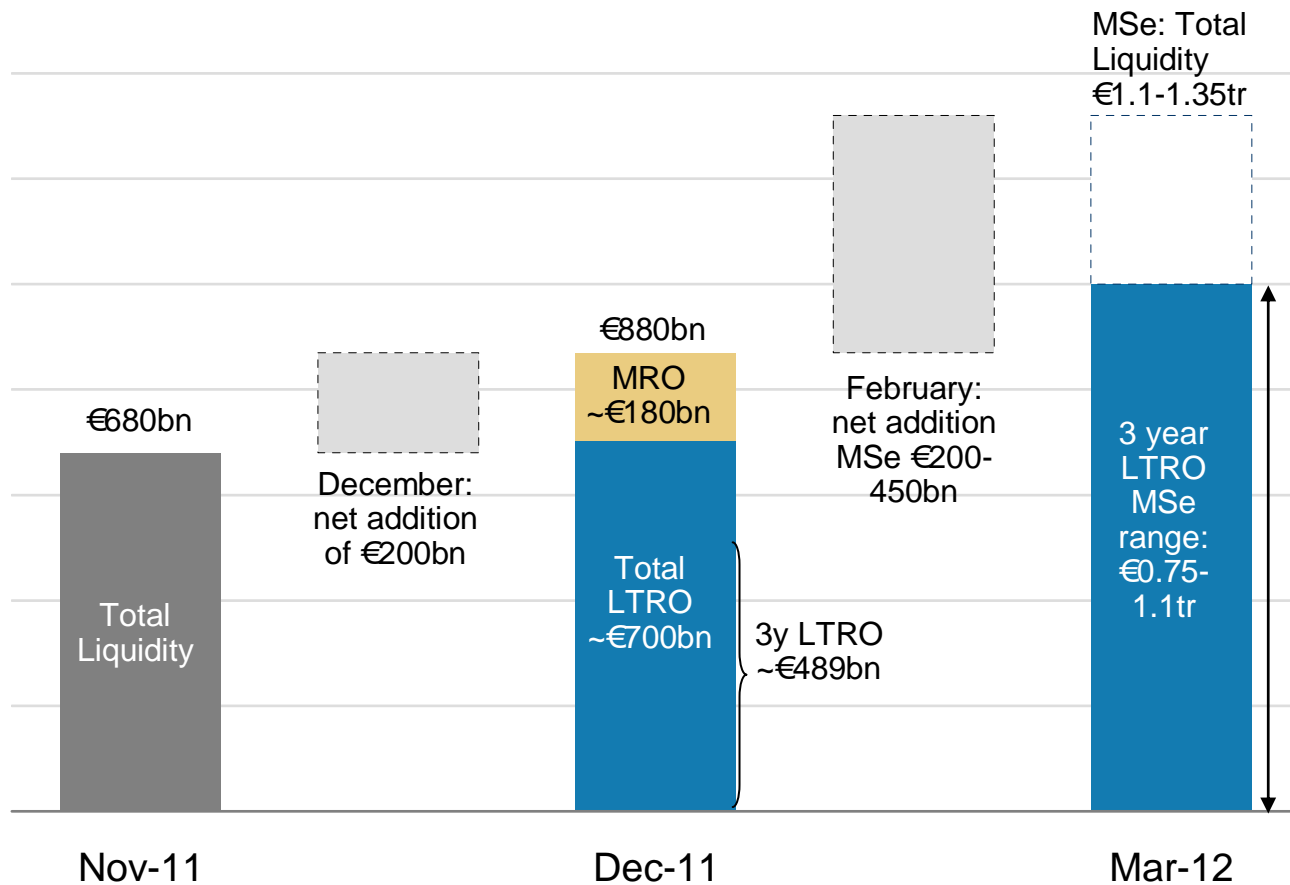
Source: Bloomberg, data as at February 20th

Our “Crib-sheet” of key dimensions and our base case into the next LTRO

Dimension	MS Base Case outcome
Overall Size?	We still expect €200-450bn of additional new funding to the system and approximately €100bn of existing LTROs could roll into 3 year scheme (last time €290bn moved across) yielding a possible €300-550bn gross increase in LTRO. Reuters suggest consensus has come down to €470bn. Meaningfully higher outcome is most likely to suggest Spanish and Italian banks are not only pre-funding 2 years but taking significant incremental carry trades, or far broader range of banks have participated. Meaningfully below €400bn will be viewed more negatively.
Country Composition?	We're expecting Spanish and Italian banks will be well over half of the incremental new funds (ie excludes shifts in LTRO) similar to our estimate of the first time. This should provide further material support for government funding. Well below this level would suggest Northern Europeans taking advantage of cheap funding and unlikely to be put to work in the South
By Bank?	We expect banks to be in several tiers. Midcap banks in Italy, Spain and periphery likely to take the most as % B/S and be most open to longer-dated carry trades. National champions in Spain, Italy, France, Austria likely to be more limited in using LTRO as a cheap source of finance and build liquidity buffers but not wish to become perceived as overly dependent or risk concerns on subordination/exit strategy. On the whole, large cap North European banks likely to use LTRO more sparingly, save a handful of obvious banks with asset quality /high funding costs
Use of proceeds?	Primarily to buy or be “parked” in domestic bills/bonds First use is to prefund the next 1-3 years of wholesale maturities. We previously argued the proceeds likely to end up in 6 month to 3 year government securities. Clearly the 2nd LTRO will be more focused on 2-3 year maturity in Spain and Italy as our survey showed many banks already covered 2012 needs. Second, is explicitly for carry trades, focusing on 2-5 years out on the yield curve. Again Spain and Italy to dominate. The third is to buyback hybrids, asset backed securities and covered bonds. This has already started, and mostly a focus in Spain and periphery so far. Last, a handful of banks (eg French) may also use to increase liquidity buffer into an uncertain period and in this case may either re-deposit some at the ECB or short dated government bills.
Ease in lending standards?	We think the LTRO will ease credit conditions vs what would have otherwise happened, but we think that this will have a lag in to the real data and deleveraging will continue. We still expect very tight credit conditions in Spain and Italy in Q1 and not really material in data until Q2. We think ECB will be open minded to further more targeted intervention should the 3 year LTROs not prove successful enough in getting SME credit to flow.

Our base case is for a €250-600bn increase in the 3y LTRO. This equates to a possible 8-16% increase in the ECB balance sheet

How we think about incremental ECB support evolving over the coming weeks



- We think that the next LTRO could add €200-450bn of additional new funding to the system. The way we built this estimate was to assume 2 years of wholesale redemption pre-funding for banks in Spain/Italy/periphery, and 6 months in France/Austria/Belgium etc with a extra dollop for non Eurozone players.
- In addition some €100bn of existing LTROs could roll into 3 year scheme (last time €290bn moved across) yielding a possible €300-550bn gross increase in LTRO.
- Policy makers have repeatedly said they expect the LTRO to be similar order of magnitude to the first one although slightly smaller. The remarks on collateral reinforce this.
- We think the users will have similar proportions to the first LTRO where we estimate 60% of funds were taken by Spain and Italy.
- Upside and downside risks revolve not only around the banks but the strong perceived indirect QE trade. A larger expansion of liquidity would clearly be preferred by markets, although the exit strategy would be more challenging
- We also think further follow-on policy support for lending plausible (could be more targeted SME support) or more LTROs

Source: ECB, Central Banks data, Morgan Stanley Research estimates/interpretation.

Our LTRO scenarios

	Scenario Outlines	Trade Recommendations
Bull Case:	<p>Higher than expected LTRO then take up used to fund carry trades led by Spanish and Italian banks, which should broaden liquidity to the market. This should improve profitability as well as allow for pre-financing of 2013+ funding needs, but could leave longer term concerns.</p> <p>Rates: Carry trade opportunities and stable funding outlook for the banking system could encourage further buying of government bonds, which helps to keep lower yield for short-end Spain and Italy.</p> <p>Credit flows/ Bank Deleveraging: In the short term, higher than expected LTRO take up should abate sovereign and credit volatility, and ease banks funding stress. This makes it plausible that credit conditions, especially in Spain and Italy, could be materially eased further. We believe that Spain and Italian lending could be ~1-3% better than base case. In the longer term, lower systemic risks from a 'successful' round of LTRO would likely facilitate orderly bank deleveraging, and we may be left with a positive secular credit story with striking similarities to Japan, which moved from a debt super-cycle to a savings super-cycle.</p>	<p>Bank Equity: In this scenario sovereign risk reduced and bank see EPS upgrades. Helps recovery trades banks more</p> <p>Rates: long 5yr Italy and Spain</p> <p>FX: 3M EUR put option with knock-in (KI) at higher levels</p>
Base Case:	<p>€300-600bn net increase in LTRO (of which up to €450bn new money). Usage led by Italy and Spain where banks use to buy a mix of 1/2/3 and 5 year bonds and pre-finance 2012/13 funding needs.</p> <p>Rates: carry trade momentum has also helped the sovereigns' funding; in particular Spain has already completed 35% of issuance for 2012, compared to usual path of 15%. Italy has followed its usual path, but front end yields remains to be supported, where both short-end 2s5s sovereign curve could remain at steep levels. In addition, it is unlikely to be more than 30% for the portion coming from the banks directly. Our economics team expects the ECB to cut interest rates by a further 50bp in H1 2012. Not all of the rate reduction might come in before the end of 1Q though. The outcome of the LTRO and its impact on the euro area financial system could introduce risks to their call for the ECB to embark on outright QE before the summer.</p> <p>Credit flows/ Bank Deleveraging: risks of credit crunch materially reduced but lending remains weak in 2012 as banks repair balance sheets and expect higher provisions. We expect lending to be particularly weak in Spain and Italy, but also subdued in France. ECB/EU to remain open to further more targeted actions on SMEs.</p>	<p>Bank Equity: Favour a basket of national champions. Alongside some capital market financials for EPS upgrades.</p> <p>Bank Credit: sell T1s outright or switch into LT2, sell senior and into covered and buy CDS against existing positions.</p> <p>Rates: Italy 2s10s flattener vs long 2yr Belgium; 5s10s Spain flattener vs Germany</p> <p>FX: Sell EURUSD as weak growth fundamentals and political risk continue to loom</p>
Bear Case:	<p>A much lower LTRO – below €400bn - is likely to be viewed negatively principally as less indirect QE to support Spain and Italy and aggregate liquidity,. Also it may signal much tighter credit conditions as banks delever in uncertain period, more consistent with our Economics bear cases giving downside to economic outcomes.</p> <p>Rates: Curves could bear flatten and cost of borrowing for Spain and Italy subject to upward pressures.</p> <p>Credit flows/ Bank Deleveraging : growing risks of accelerated and disorderly deleveraging, with much tighter credit conditions, especially within Southern Europe. European banks will remain very focused on speedy reduction in cross border flows of capital, with risks not only to CEE but also Asia.</p>	<p>Bank Equity: Focus more on defensives again & less on recovery trades</p> <p>Credit: Going into the LTRO , buy protection on 22-100%; short HY as financing more at risk from disorderly deleveraging</p> <p>Rates: Italy and Spain 2s5s or 2s10s flattener, outright or vs Germany</p> <p>FX: Sell high-beta currencies, including AUD, NZD, EM, and EUR.</p>

Our recommendations into & after the 2nd 3 year LTRO founded on our Base Case

Economics (Bartsch et al)

- We expect the ECB to cut interest rates by a further 50bp in H1 2012. Not all of the rate reduction might come in before the end of 1Q though
- The outcome of the LTRO and its impact on the euro area financial system could introduce risks to our call for the ECB to embark on outright QE before the summer.
- For the ECB to take such action it would need to get more concerned again about the availability of credit to the non-financial private sector than it currently seems to be.

Rates (Mutkin et al)/FX (Redeker et al)

- We think steepening has gone beyond what is justified by the level of spreads – only Spain has seen a material increase in the government bonds held.
- We recommend Italy 2s10s flattener vs long Belgium, and 5s10s Spain flattener (outright or vs Germany).
- Hans Redeker believes EUR will be the weakest developed market currency this year; we recommend selling EURs and buying defensive currencies, namely USD and JPY.

LTRO cuts off tail risks and supports banks and sovereign funding markets

Bank Equity (van Steenis et al)

- We think the relief trade in bank equity has not fully played out yet. We favour a basket of national champions, mostly trading well below book value: BNP, DBK, ING, BARC, KBC, & UBS & SBER, ABER
- We see greatest potential for earnings upgrades from wholesale/investment banks given January being best month for credit in 2 years. Focus: BARC, BNP, UBS, DB
- Our least preferred list includes Southern Europeans/restructuring stories where challenges are high: POP, MPS, BP and CBK, RBS, LLOY.
- LTRO helps US bank equity de-correlate to Europe, supporting JPMorgan and Wells Fargo (both OW by Betsy Graseck).

Credit Strategy/Banks (Sheets/Ineke et al)

- We remain constructive on financial credit and think deleveraging and bank recapitalisation should be positive for euro bank credit over time.
- However, given the recent rally, we have moderated our overweight in financials. We recommend reducing risk by upgrading exposure: selling T1s outright, or switching into LT2, out of senior and into covereds, and buying CDS against existing positions.

Event risk calendar to assess the impact and effectiveness of the LTROs

Upcoming key dates :

Key Policy Making Decisions			
Date	Region	Event	MS Comments
01-Mar	EMU	EU Summit (two days)	EU Summit to sign new treaty, approve Greek package
08-Mar	EMU	ECB Council meeting & press conference	ECB Council Meeting & press conference
12-Mar	EMU	Euro group Meeting (2 days)	Euro zone and EU finance ministers to meet
04-Apr	EMU	ECB Meeting	ECB Council Meeting & press conference
22-Apr	FRA	French Presidential Election	If no clear conclusion is reached, a secondary run-off election may be held on May 6th
Aggregated bank and monetary statistics			
Date	Region	Event	MS Comments
07-Mar	ITA	Bank of Italy - monthly balance sheet released (Feb)	Monthly update of ECB reliance, which will provide guidance regarding February LTRO uptake
Early Mar	SPA	Bank of Spain - monthly balance sheet released (Feb)	Monthly update of ECB reliance, which will provide some guidance regarding February LTRO uptake. Although given balance sheet is prepared as a daily average, then the full impact of LTRO will not be evident until April.
Mid Mar	FRA	Bank of France - monthly balance sheet released (to mid March)	Monthly update of ECB reliance, which will provide guidance regarding February LTRO uptake
28-Mar	EMU	EMU M3 (Feb)	Key report showing credit flows to the private and the public sector as well as asset purchases by banks
28-Mar	EMU	National balance sheets of the Euro system (Feb)	Update on lending/deposits conditions in member states
06-Apr	ITA	Bank of Italy - monthly balance sheet released (Mar)	Monthly update of ECB reliance. Update of LTRO/MRO reliance of the banking system.
Early Apr	SPA	Bank of Spain - monthly balance sheet released (Mar)	Combination of February and March balance sheets should give a clearer idea of February LTRO uptake, given numbers reflect average daily outstanding rather than end of period observations like other NCB's
Mid Apr	FRA	Bank of France - monthly balance sheet released (to mid April)	Monthly update of ECB reliance. Update of LTRO/MRO reliance of the banking system.
25-Apr	EMU	Q2 Bank Lending Survey	First read on bank lending conditions in the euro area post the two LTROs
30-Apr	EMU	EMU M3 (Mar)	Key report showing credit flows to the private and the public sector as well as asset purchases by banks
30-Apr	EMU	National balance sheets of the Euro system (Mar)	Update on lending/deposits conditions in member states
Key bank by bank releases			
Date	Region	Event	MS Comments
March		Bank by bank disclosure of what they took & commentary on uses	In addition to ad hoc announcements, MS will once again survey the banks
March		Tracking bank funding costs & term issuance by French, Italian, Spanish	We expect French to issue further unsecured debt post LTRO. We expect funding markets to continue to improve in tenor and pricing.
12 Mar-28 Mar	ITA	Italian FY11 results viz BPM, Intesa, BP, UCG, UBI & MPS	MS expects further colour on LTRO usage to come from full year results
27-29 Mar		Morgan Stanley European Financials Conference (3 days)	First event conference post LTRO with major European banks attending
April/May		Q1 bank results	Will outline expectations on lending and how much LTRO has impacted

Source: ECB, Morgan Stanley Research

Agenda

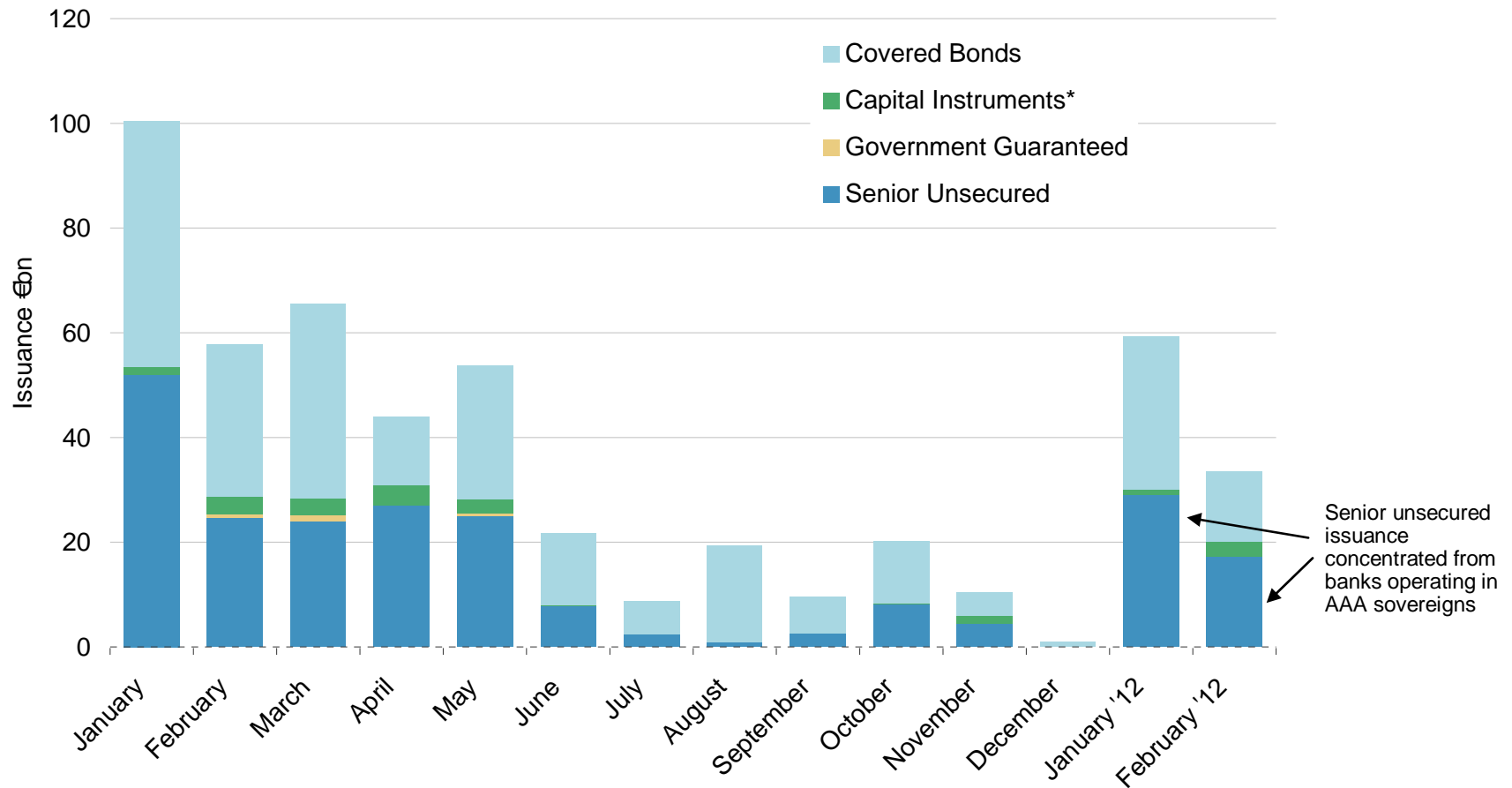
Summary and Key Recommendations

How the LTRO will ease a crunch but not stop the Great Deleveraging

Valuation and Trade Ideas

The LTRO has opened up trading flows: in response to reduced systemic risk, we have seen more senior unsecured issuance YTD than all of 2H 11. We're also seeing broadening appetite for Spanish and Italian bank paper and longer tenor too

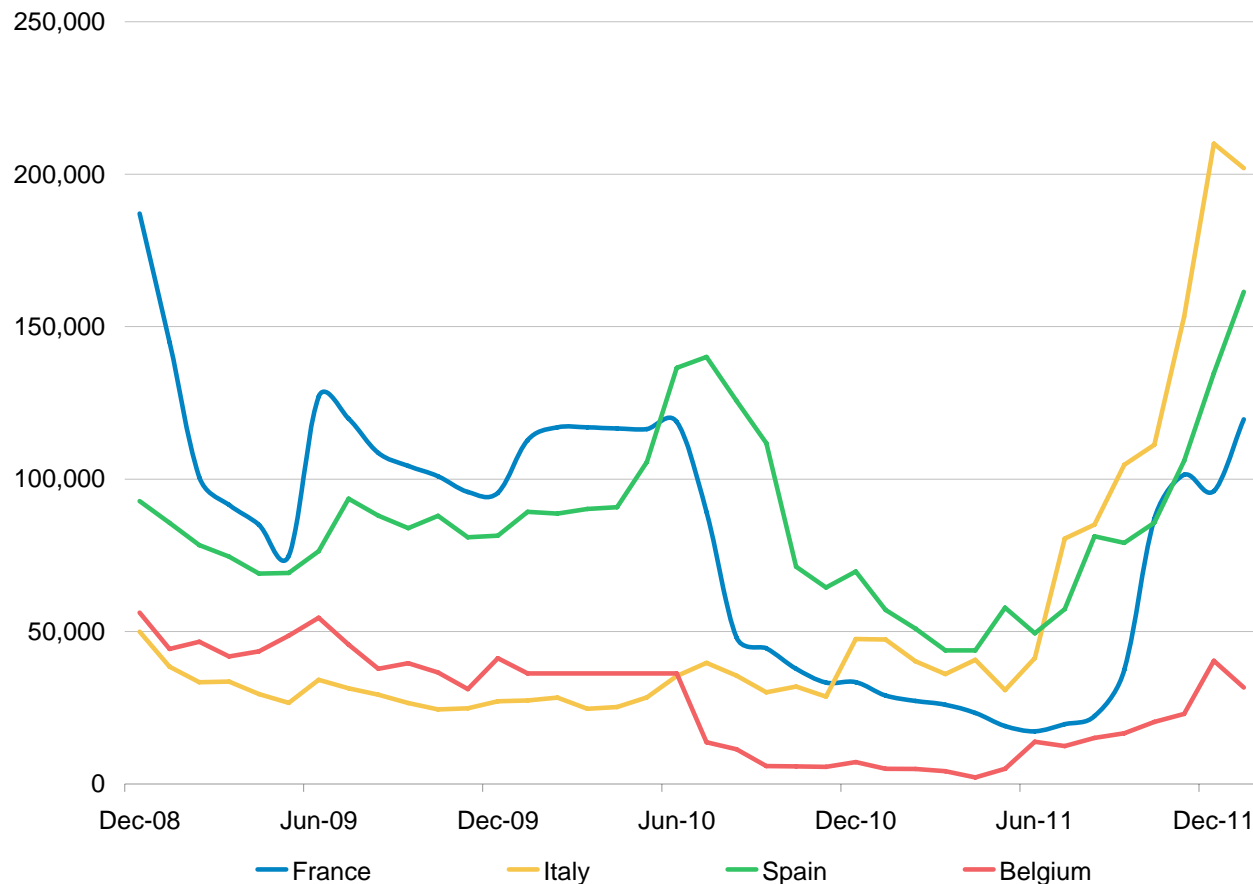
European banks have raised €3bn in the senior markets YTD, with the bulk of this concentrated in banks operating in AAA rated sovereigns. We have seen encouraging signs of broadening with senior unsecured deals by Intesa, BBVA plus covered bonds by 4 Spanish. Also longer tenor senior unsecured issues have come from Intesa, BNP/Soc Gen: 5 year and ING: 10 year



Source: Bloomberg. *NOTE: Capital instruments include insurance. Data as at February 20th, 2012

Since the December LTRO, banking systems reliance on ECB has stabilised as deposit trends have stabilised and bank funding markets reopen – after a very challenging 6 months

January data from ECB suggests Portuguese and Italian systems have stabilised in January whilst our conversations with banks also suggest Q1 deposit and funding trends have shown a material improvement

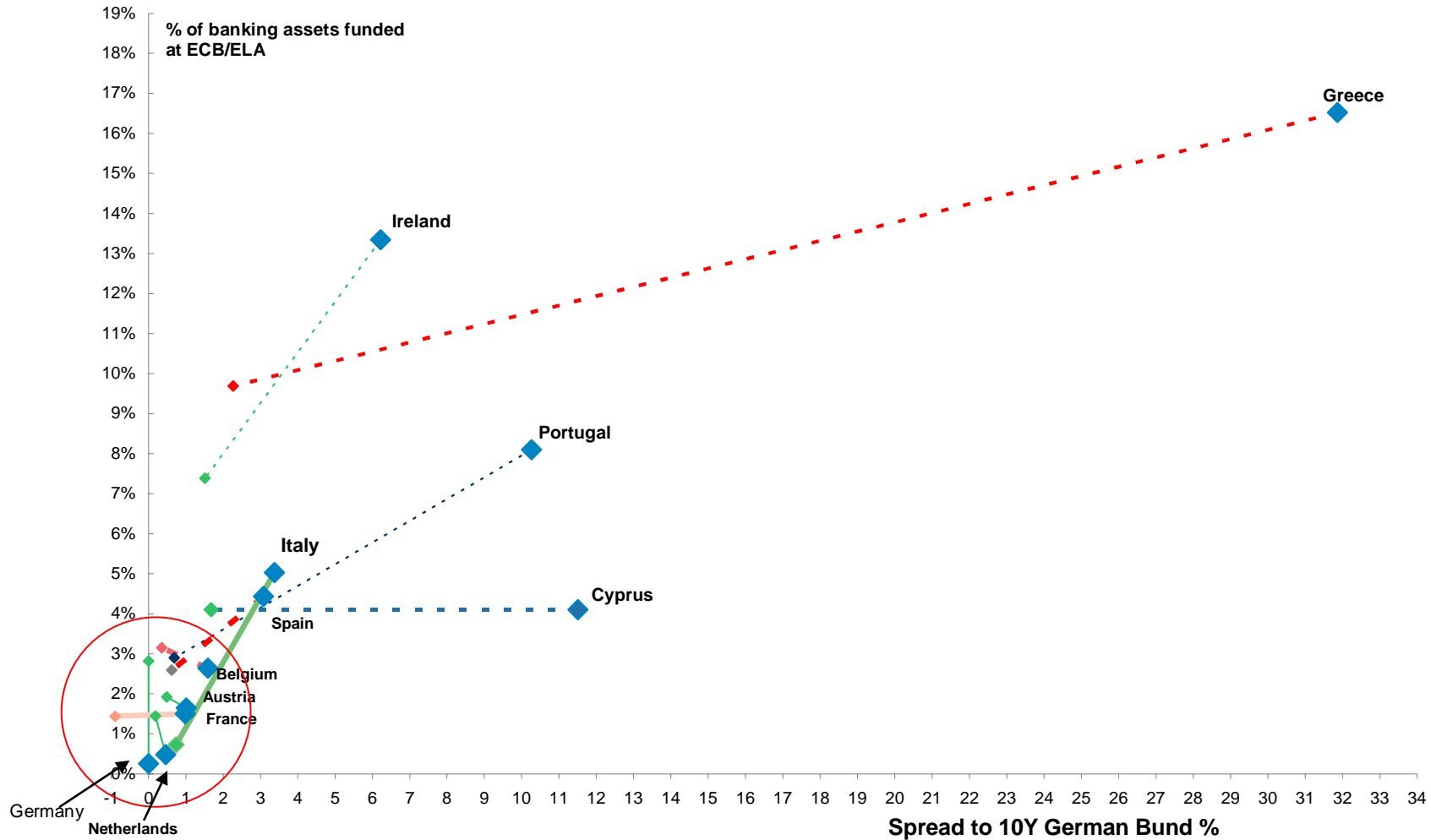


Italy: Usage has tripled since mid 2011 but flattened off in January; €202bn or 5% of bank assets now funded at ECB

- **Spain*:** Retraced back to peak usage levels over the H2 2011 as a result of LTRO; €154bn or 4.4% of assets funded.
- **Belgium:** Usage fell in January to €31bn or 2.6% of bank assets.
- **France**:** Mid February reported usage reflected higher take up of LTRO to €125bn or 1.5% of banking assets.

Source: Central Bank Data, ECB. Data as at February (France) January (Italy, Spain & Belgium) 2012. * Spanish data based on average daily usage and thus January numbers reflect the late December LTRO usage. **French data is mid month, so current mid January data release reflects late December usage. We would expect February data points for both to moderate as we have seen in Italy, Portugal and Belgium.

But many European banking systems now having significant support from ECB – mirroring markets with sovereign funding stress, with greatest rise in Spain and Italy in recent months

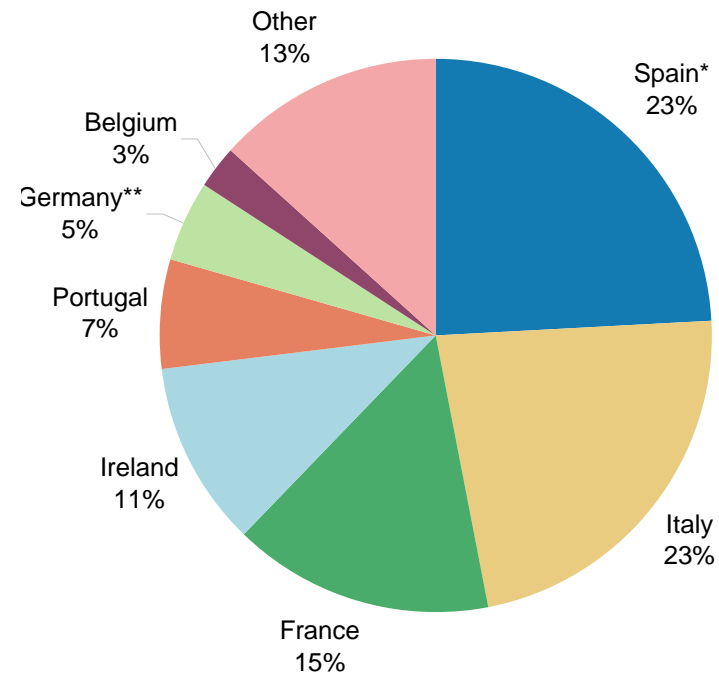
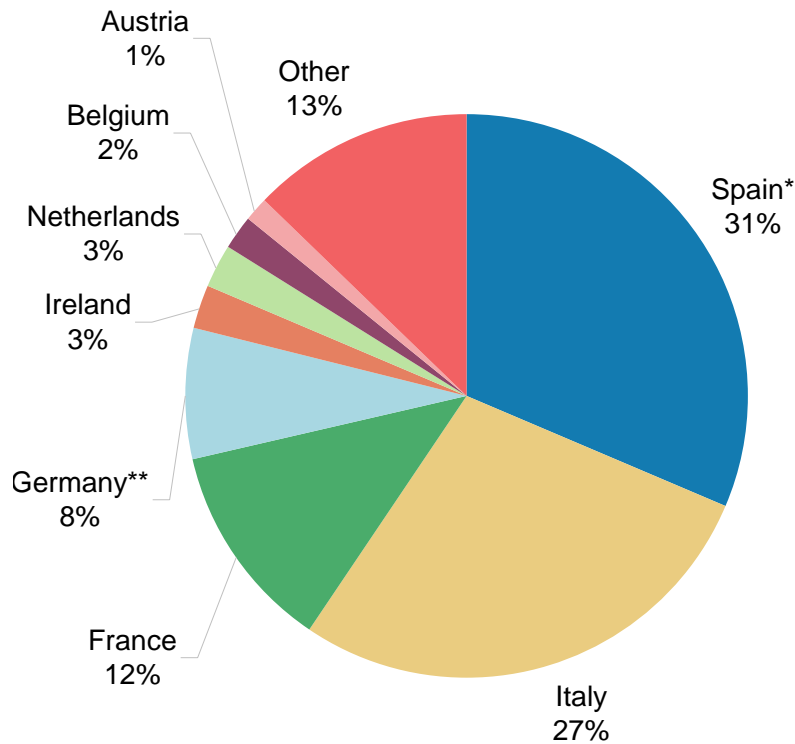


Source: Bloomberg, ECB and Central Bank of Ireland, Morgan Stanley Research estimates. Prices as at 21st February 2012
Latest ECB reliance figures released for February (France) January (Portugal, Italy, Belgium, Spain, Ireland) November (Greece) October (Austria, Germany, Netherlands, Cyprus)

We think the 2nd LTRO will also show Italian and Spanish banks as the biggest *incremental* users with much of the proceeds finding their way into government securities

Of the €200bn of incremental LTRO funding taken in December, we think Italy and Spain represented nearly 60% of the total

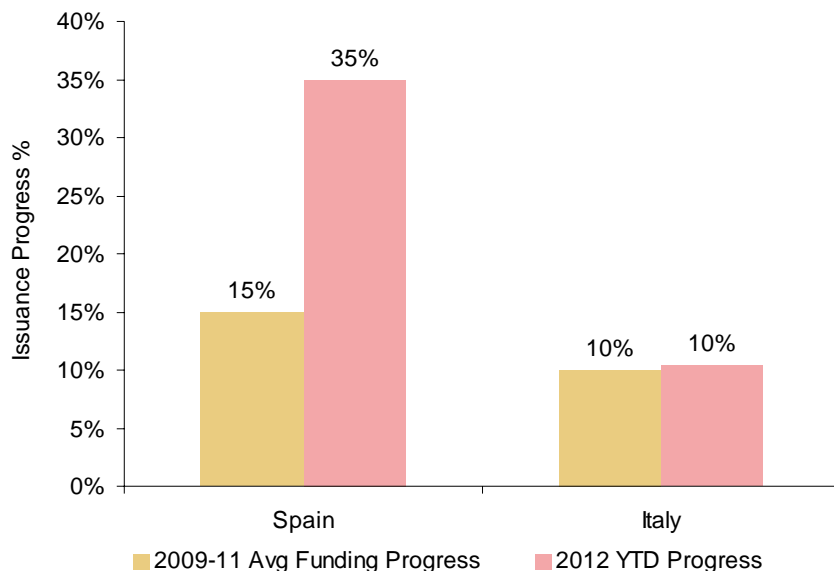
On a gross basis, of the €704bn total outstanding LTRO, which includes the €489bn of 3y funding, Spain, France and Italy we estimate represent ~60%



Source: Company data, Central Banks data, Morgan Stanley Research estimates/interpretation. *NOTE Spanish figures are based on daily average data from Bank of Spain. ** German LTRO net usage is Morgan Stanley Research estimate

Carry trade has already helped to absorb government bond supply, take-up at the 2nd LTRO will likely further assist the issuance, especially in Spain

The buying support from banks has already helped Spain's government bond issuance to be well ahead of schedule

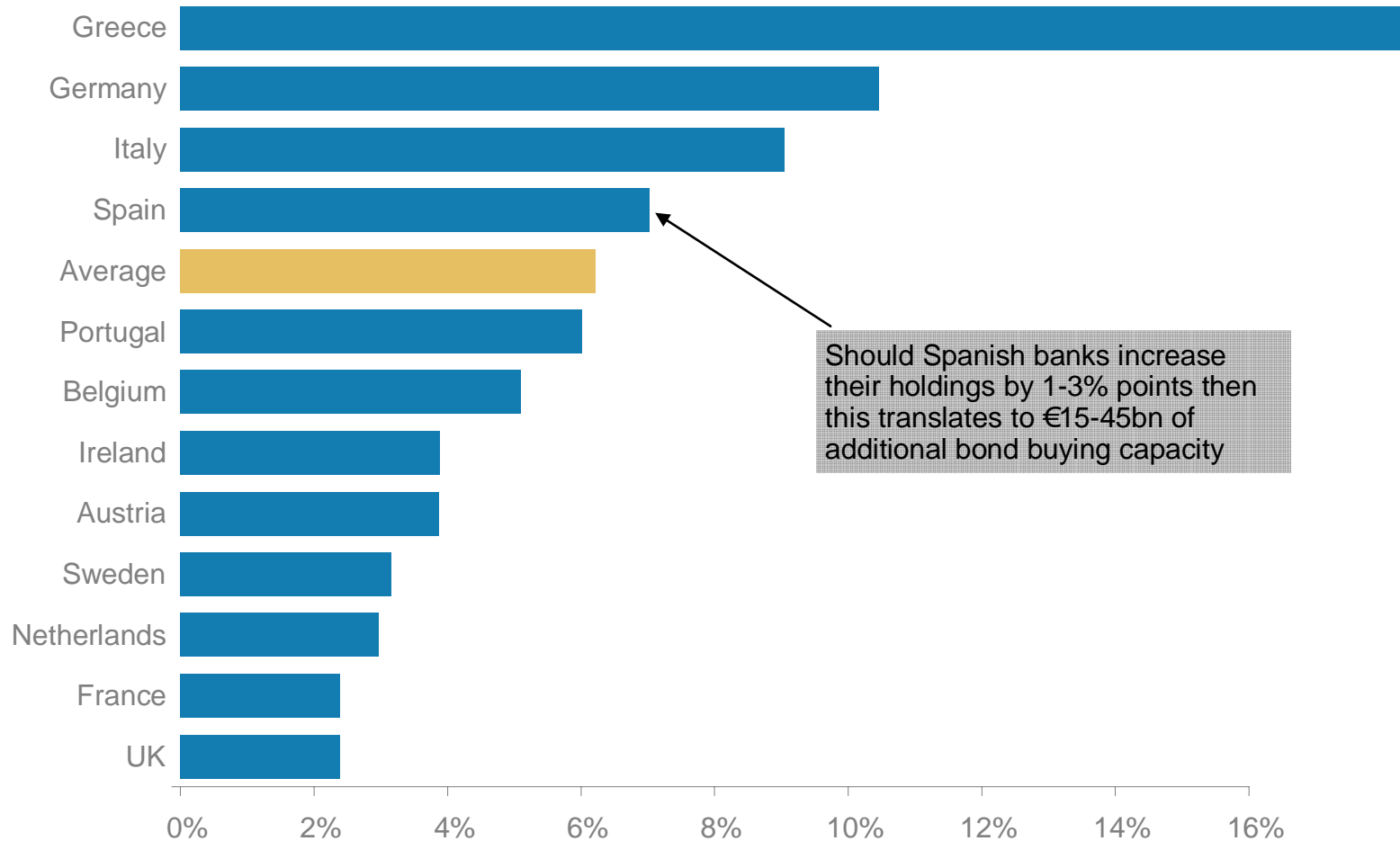


So how much incremental sovereign bond buying could there be?

- In our note ahead of the first 3 year LTRO (December 13), we estimated Spanish banks may buy €20-60bn of government bonds from the two LTROs put together vs. €36bn of government refinancing needs. So far we believe they have bought €27bn from the first 3 year LTRO. Meanwhile we argued in Italy the number could be similar, which would be a much smaller % of Italian sovereign roll of €247bn in 2012. We also thought the EBA rules - which we argued would be relaxed but not in time for the first LTRO - would mean the Italians didn't participate materially in the first LTRO into sovereign paper. So far we think Italian banks may have only about €4bn of paper.
- So where are we now? If we assume our base case LTRO range and the same % taken down by Spanish banks and the same % put to work in government bonds, we may see a further €25-60bn of buying off government bonds in Spain. This could mean Spanish banks alone could help Spain fully fund for 2012. However, if we assumed the same dimensions for Italy, we would only see €7-15bn of demand. But we argued in a prior note that we thought that the relaxation/refinement of EBA rules means that Italian banks would be far more open to buy bonds in the 2nd LTRO then one could see demand for up to €60bn of bonds. However, this is still substantially below the Italian funding need of €247bn. This supports our rates call on Italy flatteners.

Given the economics, we think the LTRO will encourage some mid cap Spanish & Italian banks to buy government bonds, although with average duration inside 3 years

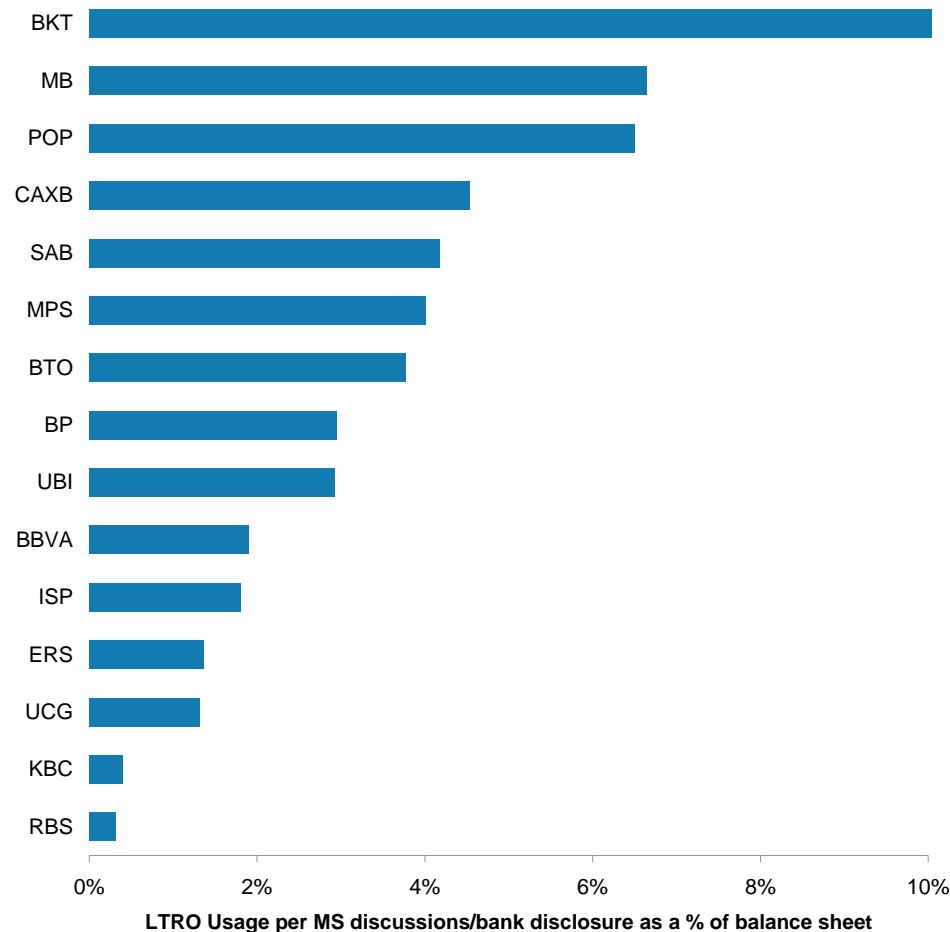
Eurozone banks have on average ~6% of their total assets in domestic sovereign bonds/loans. We think that this ratio will increase especially in the case of Italian and Spanish banks.



Source: EBA, Morgan Stanley Research

We think that Italian and Spanish banks will take the rump of the February LTRO and utilise the incremental funding to engage in carry trades

In the first LTRO Italian and Spanish banks uptake represented on average 4% of the total balance sheet



- Turning our thoughts to the February LTRO then we think that Spanish and Italians will take the rump of the pie but we still do not know to what extent – our view is that given structurally low profitability within these sectors may encourage high usage. Although banks are keen to demonstrate an exit strategy.

- Our conversations with “National Champion” banks, who previously used the LTRO eg UCG, BNP, BBVA, KBC have led us to believe that they may utilise the February facility to a similar range again.

- From our meetings with banks and policy makers, we understand that banks are being actively discouraged from liquefying their loan books. We hear that policy makers in several countries are encouraging banks to pursue alternative sources of funding unless the bank makes a very strong case, as the loan books would become contingent liabilities of the NCB not the ECB.

Source: Company Data, Morgan Stanley Research.

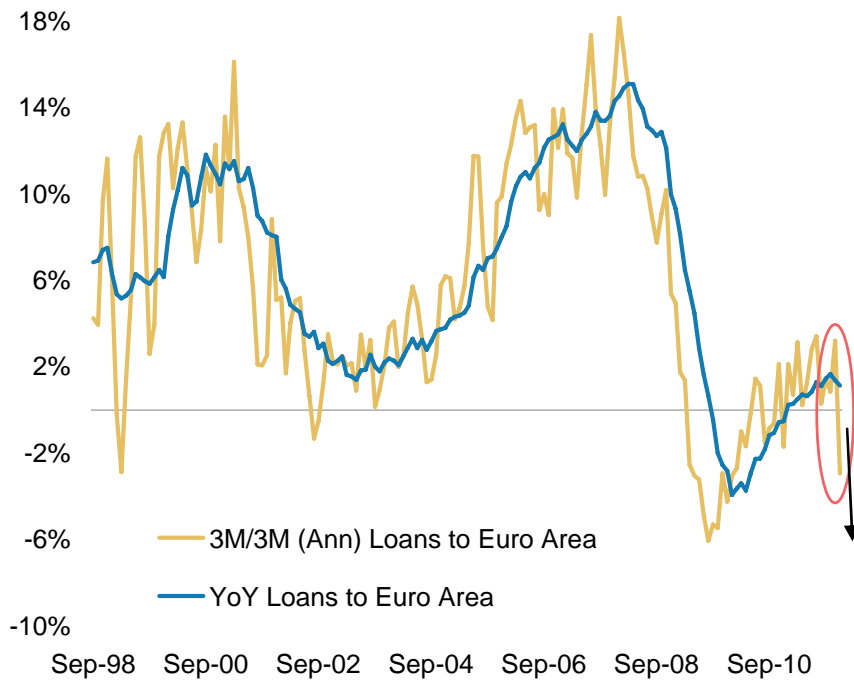
How some of the major banks approached the first LTRO and how we think will approach the second

European Banks LTRO Usage and Funding Progress 2012								December LTRO	February LTRO
Bank	CCY	Target	LTRO	% LTRO	Issued	% Done	To raise	Commentary	Commentary
BNP	EUR	28.0	10.0	36%	9.0	68%	9.0	Have participated; but amount not disclosed. MS estimates €10bn usage, based on Q4 results	Q4 Results - said they are considering option of February LTRO
Societe Generale	EUR	12.0	10.0	83%	5.0	125%	-	Have participated but amount not disclosed. MS estimates €10bn usage based on BNP read-	Q4 Results - said they are considering option of February LTRO
Credit Agricole	EUR	17.0	ND	ND	6.4	38%	10.6	Have participated but amount not disclosed.	MS believes that they will consider the option of participating, given past participation
BPCE	EUR	21.0	ND	ND	7.1	34%	14.0	Have participated but amount not disclosed.	MS believes that they will consider the option of participating, given past participation. Peugeot reportedly considering €1bn uptake in February (FT 17 Feb).
French Corporates									
France						61%	33.5		
KBC	EUR	4.0	3.3	83%	4.0	183%	-	Participated in LTRO via Irish sub to reduce funding gap in Ireland.	From company conversations, MS expects participation via Belgium sub. MS estimates €3-5bn.
Belgium						183%	0.0		
RBS	GBP	20.0	5.0	25%	1.0	30%	16.8	Participated in LTRO via RBS NV subsidiary.	MS expects that they will participate, taking a similar amount to December.
Barclays	GBP	15.0	-	-	5.4	36%	11.4	Confirmed that they did not participate.	FY11 results - did not comment on participation.
Lloyds	GBP	25.0	-	-	11.1	45%	16.6	Confirmed that they did not participate.	MS does not expect February participation.
HSBC	USD	5.0	ND	ND	0.0	0%	-	Not Disclosed. MS believes that they have participated via German sub.	MS expects that they will participate, taking a similar amount to December.
UK						38%	44.8		
Intesa	EUR	12.0	12.0	100%	2.5	121%	-	LTRO taken up is equivalent to 100% of "wholesale" funding requirement. They still need to issue €10bn of retail bonds, which they still plan to issue.	MS expects that they will participate, taking a similar amount to December.
MPS	EUR	5.2	10.0	192%	1.0	212%	-	More than covered wholesale funding requirements in 2012	No comment from company, but MS expects that they will participate, given past participation.
Mediobanca	EUR	4.2	4.0	95%	-	95%	0.2	Participated and covered 95% wholesale funding requirements in 2012	Planning to take a further €5bn (retail & wholesale) in February to fulfill additional 2012/2013 requirements. Not using to buy government.
Banco Popolare di Milano	EUR	1.4	ND	ND	-	0%	1.4	Confirmed that they did participate, but only on a small scale.	Likely to use February LTRO to fund 2012+ maturities. MS expects higher take up than in December, given small scale participation in December.
Unicredit	EUR	25.4	12-15	47-59%	-	47-59%	10.4-13.5	LTRO taken so far (UCG has not given precise disclosure) has been the result of, largely, the lengthening of shorter ECB funding (the actual increase in ECB line is likely half that in our view).	No comment from company, but MS expects that they will participate, given past participation.
UBI	EUR	4.1	4.5	111%	0.8	130%	3.0	Estimate - rolled funding into LTRO, likely to fund 2012 and part of 2013 wholesale maturities in February, will not replace retail funding with ECB money	Likely to continue to fund 2012 and part of 2013 wholesale maturities in February, will not replace retail funding with ECB money.
Banco Popolare	EUR	5.5	10.0	182%	3.9	253%	1.6	Estimate - prefunded most of 2012 in 2011, rolled ECB funding into LTRO.	MS thinks likely to participate in February to fund 2013 wholesale maturities, given past
Other Italian Banks	EUR		7.9					Data obtained from discussions with Italian banks.	
Italy						84%	6.2		
Deutsche Bank	EUR	20.0	-	-	0.6	3%	19.4	Confirmed that they did not participate.	MS does not expect February participation.
Commerzbank	EUR	10.0	ND	ND	5.0	50%	5.0	Not disclosed. MS believes that they did participate.	No comment from company, but MS expects that they will participate.
Other German Banks								Discussions between HSH Nordbank and Heleba and our credit colleagues indicate that they have been involved in some uptake though didn't disclose.	
German Corporates									VW - reportedly considering participating (FT Feb 17)
Germany						19%	24.4		
ING	EUR	18.0	-	-	16.8	93%	1.2	Q4 Results - Confirmed that they did not participate.	Q4 results - commented they are still debating whether to use February LTRO on an opportunistic basis.
Netherlands						47%	56.2		
Danske	DKK	55.0	11.2	20%	5.0	29%	5.2	Q4 results - Confirmed that they did take LTRO money in Dec	Q4 results - said they may take LTRO at the end of Feb
Swedbank	SEK	130.0	-	-	80.0	62%	5.6	Q4 Results - Confirmed that they did not participate.	Q4- Results - Confirmed that they will not participate.
SHB	SEK	133.8	-	-	117.0	87%	1.9	Q4 Results - Confirmed that they did not participate.	Q4- Results - Confirmed that they will not participate.
SEB	SEK	100.0	-	-	25.0	25%	8.5	Q4 Results - Confirmed that they did not participate.	Q4- Results - Confirmed that they will not participate.
DNB	NOK	120.0	15.7	13%	9.6	21%	12.3	Q4 results - confirmed that they did participate.	MS thinks it is likely that they will participate in February, given past participation.
Nordea	EUR	16.7	-	-	9.3	56%	7.4	Q4 Results - Confirmed that they did not participate.	Q4 results - commented they are still debating February take-up. MS believes that it is unlikely
Nordics						49%	40.9		
Sabadell	EUR	4.0	4.4	110%	1.2	139%	-	Q4 Results - LTRO taken up for 2012+ funding requirement	MS expects further LTRO take-up although not confirmed by company
Santander	EUR	32.0	ND	ND	2.0	6%	30.0	Company has taken LTRO funds but didn't disclose how much.	MS expects further LTRO take-up although not confirmed by company
BBVA	EUR	11.0	11.0	100%	1.5	114%	-	Q4 Results - LTRO taken up to fulfill 2012 funding requirement.	MS thinks likely the company will take up a similar amount to the 1st (which was E11bn).
Bankinter	EUR	3.6	7.0	194%	-	194%	-	Q4 Results - LTRO taken up for 2012+ funding requirement	MS expects further LTRO take-up and company commented that it expects to roll €1bn of ST facilities into February LTRO
Banesto	EUR	5.2	5.0	96%	0.5	106%	-	Q4 Results - LTRO taken up to fulfill 2012 funding requirement.	MS expects further LTRO take-up although not confirmed by company
Caixabank	EUR	2.3	12.4	539%	1.0	583%	-	Q4 Results - LTRO taken up for 2012+ funding requirement	MS expects further LTRO take-up although not confirmed by company
Bankia	EUR	17.2	ND	ND	-	0%	17.2	Expects to cover most of 2012 issuance requirements	Expects to cover remaining 2012 issuance requirements
Popular	EUR	6.0	8.5	142%	-	142%	-	Q4 Results - LTRO taken up to fulfill 2012 funding requirement.	MS expects further LTRO take-up although not confirmed by company
Spain						67%	47.2		
Raiffeisen	EUR	2.5	-	-	-	0%	2.5	Confirmed that they did not participate	MS thinks unlikely given they state they will not use ECB facilities.
Erste	EUR	3.0	2.8	93%	1.0	127%	-	Used to meet most of 2012 funding requirements	No disclosure as yet if they will participate.
Austria						69%	2.5		

Source: Morgan Stanley Research estimates, Company data, Bloomberg.

Banks' restriction in capital is unlikely to change overnight, but LTRO cuts off tail risks. We still see credit channels in Spain, Italy, Denmark, SEE having large challenges and headwinds to Asia too, given banks challenged to access \$. We think ECB will keep hawk eye on these trends and open to more intervention

Euro area lending has fallen materially in the last month: down 1.8% on an annualised basis



Corporate lending has fallen or stagnated among the core European countries

- According to ECB data out last week, corporate lending across the eurozone fell by 0.5% MoM and 0.6% QoQ – although some seasonality.
- The key drivers of this deterioration were found in Italy and Spain, where lending to companies fell by 2.1% and 0.3% MoM respectively, reflecting funding squeezes.

Data from BIS show 9%QoQ decrease in eurozone bank claims on Asia non-Japan

- Claims fell US\$47 billion during the quarter.
- First decrease in claims since Q2 2010 and sharpest decrease in eurozone bank claims on AxJ since Q4 2008.
- \$ funding constraints clearly the big issue.

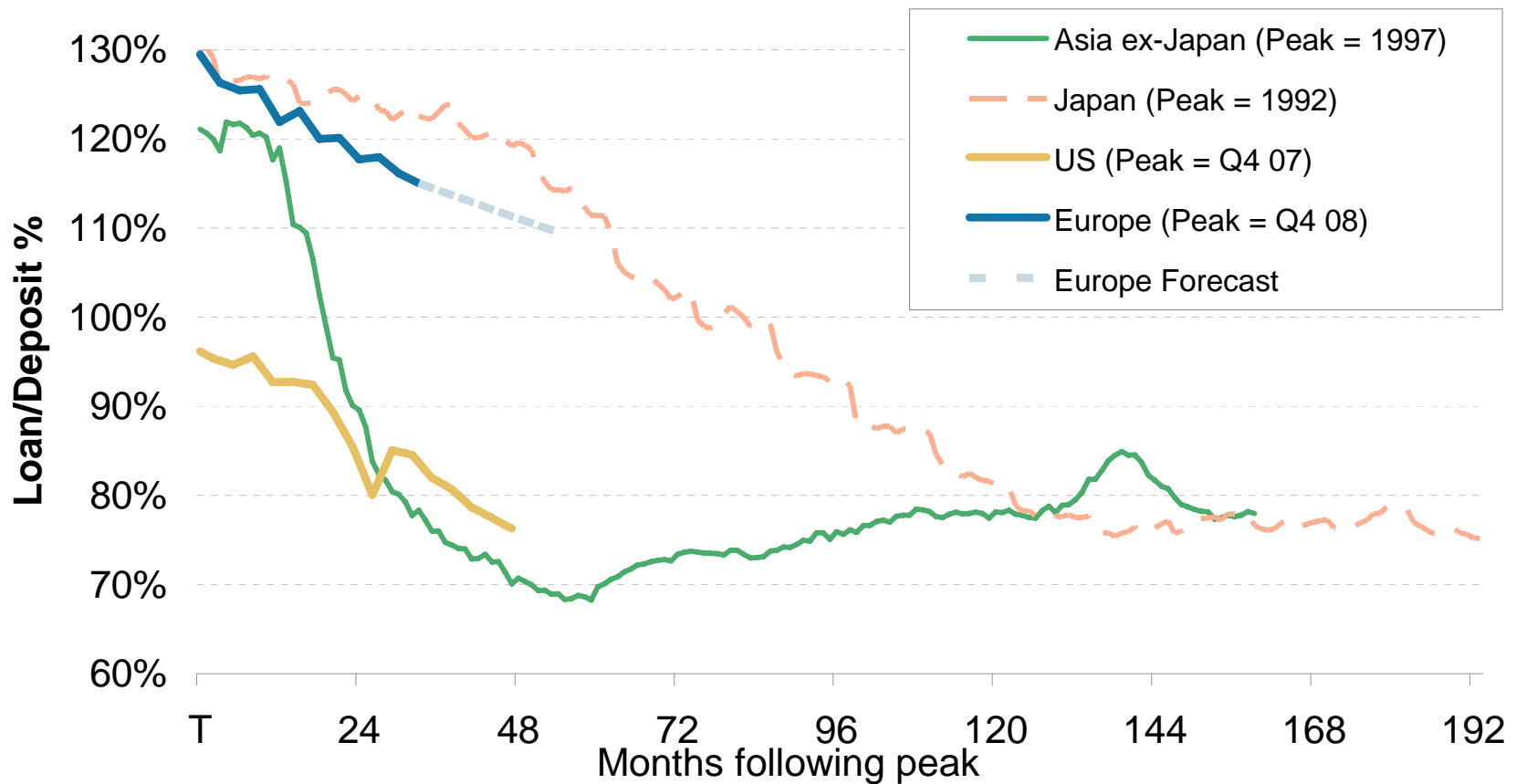
Claims fell across AxJ, Korea, Taiwan and Malaysia most impacted in Q3 2011

For more on trends in lending and outlook see our note: [“Banks/Economics/Rates: LTROs underestimated, but Great Deleveraging ongoing” February 2, 2012](#)

Source: ECB. Data as at Q4 2011

While we may have avoided a broad credit crunch, the ‘Great Deleveraging’ in Europe seems far from over; history suggests that European banks have a long way to go and the LTRO will slow but not stop the process. European banks will have to conserve more equity too

We think that European banks could delever €1.5-2.5tr over the next 18 months, but history suggests that over a longer timeframe – say, 5-6 years – this could reach €4.5tr assuming zero deposit growth



Source: SNL, Company Data, Morgan Stanley Research. For further detail please see: "2012 Credit Outlook: Yielding to credit", Andrew Sheets et al, December 7th

Where we see the greatest risks from European banks deleveraging

Assets in focus	Risk	Comments
Emerging Markets – we see greatest risks to CEE	High in SEE/CEE	We see major risks in Central and Eastern Europe (CEE)/Southern and Eastern Europe (SEE) where European banks represent ¾ of the banking system. 12 of the 16 major European banks in CEE (representing ~78% of these banking assets) either had a capital shortfall in the recent 9% test or are TARP recipients. We expect the greatest strain in SEE although note EBRD's important stabilising role. <i>New BIS, IIF and bank data support the risks.</i>
EM – Asia/Latam	Lower than CEE but still meaningful in parts, shift to global/locals	We see growing risks to global trade finance – French banks looking to reduce dollar dependency represent 25% of outstanding trade finance – but in an orderly scenario we think this much will be passed to local banks or selected global banks (HSBC, STAN, JPM, C) and some Australians/Japanese. In 2008-09 European banks reduced their exposures by 20%. Within this STAN and HSBC – which today are over ½ of the European banks lending to the region – were far more stable: (7)% vs (31)% for non-UK banks. <i>Latest BIS data support this with eurozone shrinking (9)% in Q3 vs UK only (1.5)%</i>
Southern and Peripheral Europe	High	We are concerned that stresses in bank and sovereign funding as well as capital challenges will impact Spanish and Italian banking markets. Funding and capital stresses are evident, but on our estimates, Spanish and Italian banks were the biggest users of the LTROS, helping cut off the tail of the credit crunch. Constraints on SMEs remain.
\$ lending such as commodity finance and parts of syndicated lending	Likely to be passed to US/global banks	Continental European banks, notably the French, are looking to reduce their need for \$ funding by not renewing or not entering some new loans. French banks have been major players in global trade finance and have been major players in commodity finance too. Our deal by deal analysis suggests some are being picked up by leading US large cap banks (such as JPM, C, USB, WFC) as well as some Asian and international banks.
Structured credit and securitised assets	High on overhang	~€0.5tr of existing structured credit assets (about 2/3 in \$) held by European banks will continue to act as an overhang in the market, impacting asset prices. We also think European investment banks may look to shed 1/4-1/2 of their Basel 3 RWAs in fixed income and legacy assets over the coming years - e.g we forecast CS to shrink theirs by 48% and UBS by 55%.
Commercial Real Estate	Some weak spots	We see a large number of lenders constraining CRE lending given requires long dated unsecured funds. Asset quality and large concentrations in portfolios, particularly in UK banks to Ireland and within Spanish banks, remain a focus.
Leasing (aircraft, car)	May be sold to Japanese/Asian banks?	Over 25% of outstanding aircraft leasing is reportedly for sale. We think Japanese banks could be buyers and beneficiaries given their funding profiles. Asian & some US banks could find opportunities too. Private equity should be rarer given funding. Latest data supports our call.
Non-core Units (various)	Mixed	Those assets that can be sold to private equity & are non-funding heavy (private banking, custody, asset management, and some parts of insurance) look reasonably supported, but those that require heavy bank funding – including EM bank units – may not see such compelling pricing – impacting those banks dependent on large asset sales

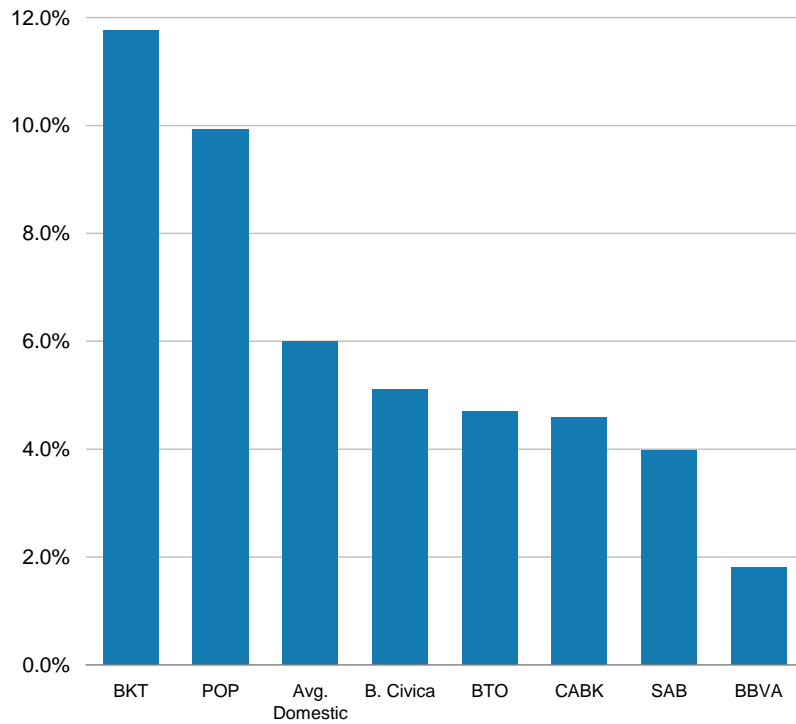
For more on trends in lending and outlook see our note: [“Banks/Economics/Rates: LTROs underestimated, but Great Deleveraging ongoing”](#) February 2, 2012

Source: Morgan Stanley Research.

ECB to alleviate funding, but more capital needed short term against real estate

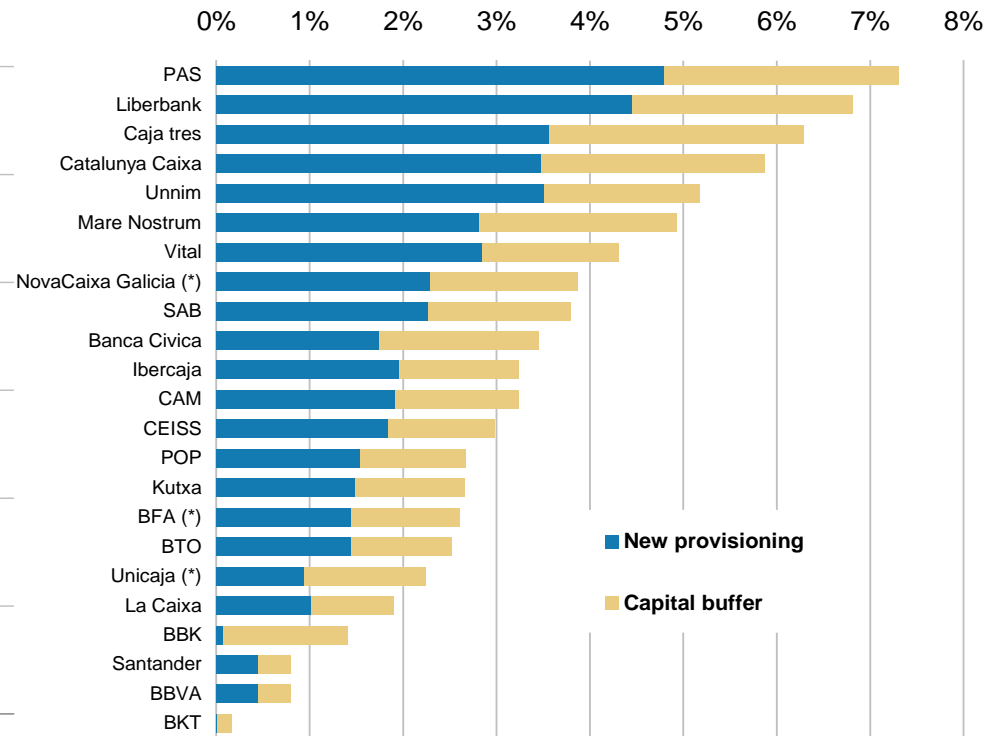
ECB funding as % of group Balance sheet

December 2011 figures



Source: Source: Company Data, Morgan Stanley Research

New capital and provisioning requirements as % of RWAs



Source: Company Data, Morgan Stanley Research (*) Based on 2010 figures (**) Liberbank losses likely covered by APS

Spanish Banks: LTRO may add 8-12% to pre-provision profits to be offset by higher provisions in 2012.

We upgraded our PPP estimates by ~4% for 2012 driven by the ECB LTRO.

- We are forecasting a 3.5% NII 2012 growth vs. -2% before. We expect a direct positive effect from the take up, and we also believe the improved liquidity will make wholesale funds more affordable, and lower competition for deposits.
- 5 Spanish banks have issued 6.7bn YTD with an average 236bp spread on covered bonds.
- Improved funding conditions are mitigated by higher deposit insurance premiums and more than offset at the net profit level driven by new regulation on real estate provisions.

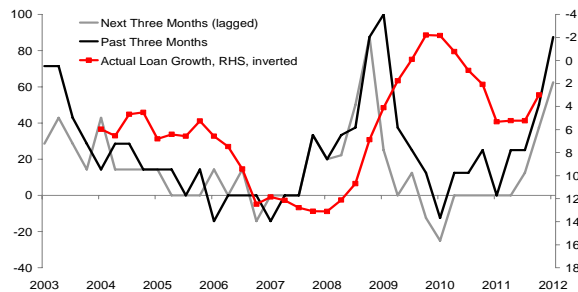
Potential impact of LTRO as % of 2011A NII

Bank	2012 Maturities	250bp assuming take up		% 2011A NII	
		50%	100%	50%	100%
SAN	15,500	194	388	0.6%	1.3%
BBVA	11,000	138	275	1.0%	2.1%
CABK	2,560	32	64	1.0%	2.0%
POP	6,508	81	163	3.9%	7.8%
BTO	4,606	58	115	4.0%	7.9%
SAB	4,068	131	261	8.5%	17.0%
BKT	3,600	45	90	8.3%	16.6%
Average				3.9%	7.8%

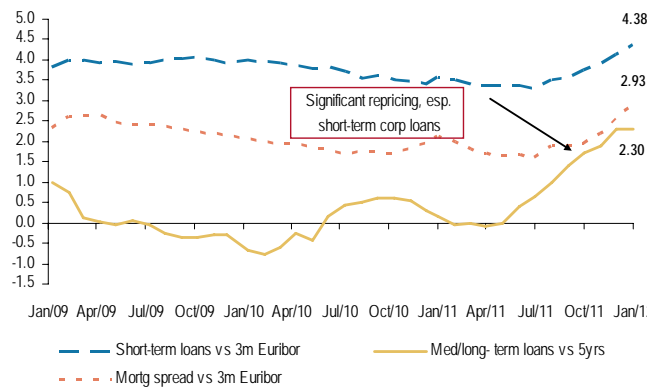
Source: Company data, MS estimates.

Focus on Italy: LTRO crucial for credit conditions; re-pricing also a game changer for banks earnings, further benefit from carry trade could provide a bridge for cyclically depressed earnings

1. Credit conditions still tightening for Italian corporates ...



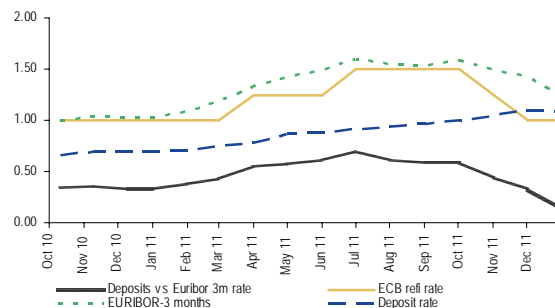
2. Asset pricing has accelerated, esp corporates



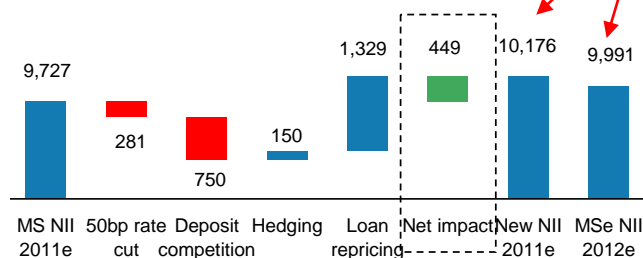
3. Relatively large portion of repriceable loans

Repriceable Loans % of ToT	
ISP	27%
UCG	34%
MPS	27%
UBI	29%
BAPO	36%
MB	36%
BPM	41%

4. Deposit spreads in Italy, pressures still high



5. NII 2011e scenario assuming full benefit of loan repricing (We model ISP here for illustration)



€bn	December LTRO take up	Funding needs 2012		Funding needs 2013		Expected February take up
		Wholesale	Retail	Wholesale	Retail	
ISP	12	12	10	11	25	
UCG	12-15	25	9	20	6	
UBI	4.5	3	6	3	6	
MPS	10	4	4	6	8	
BAPO	10	2	7	3	8	
MB	4	4	3	3	2	
BPM	ND	1	0	2	2	
Other Italians	ND					
Total	57					60-120

For more on detail on asset re-pricing amongst Italian banks see our note: [“Italian Banks: Loan repricing effort continues in January”](#) February 21, 2012

Source: Company data, Bank of Italy, ABI, Morgan Stanley Research Estimates

Italy: LTRO may help to neutralize the impact of higher funding cost

1. NIM development 2010-2014e, helped by LTRO and repricing

NIM €mn	FY 2008	FY 2009	FY 2010	FY 2011E	FY 2012E	FY 2013E	FY 2014E
BPM	2.59%	2.16%	1.62%	1.71%	1.86%	1.86%	1.86%
BP	2.29%	1.91%	1.69%	1.62%	1.70%	1.70%	1.70%
ISP	2.09%	1.85%	1.67%	1.63%	1.67%	1.68%	1.68%
MB	1.62%	1.55%	1.54%	1.81%	1.87%	1.91%	1.91%
MPS	2.28%	1.83%	1.70%	1.52%	1.57%	1.57%	1.57%
UBI	2.70%	2.26%	1.94%	1.82%	1.87%	1.87%	1.88%
UCG	1.93%	1.92%	1.86%	1.80%	1.86%	1.86%	1.88%

e = Morgan Stanley Research estimates; Source: Company data, Morgan Stanley Research

2. Impact on 2012-13 NII of higher funding costs – now removed from our forecasts

	Wholesale maturities	Retail maturities	Total 2012-13 bond expiry	Bond expiry as % of group loans	NII impact 2012-13e €mn
ISP	23	33	56	15%	-672
UCG	35	22	57	10%	-466
MPS	9	8	13	8%	-155
UBI	10	12	21	21%	-256
BAPO	9	11	20	21%	-241
MB	10	0	10	28%	-117
BPM	2	2	4	11%	-48

Source: Company data, Morgan Stanley Research; e = Morgan Stanley Research estimates

3. Changes to our ratings, price targets and estimates to account for the full LTRO impact

	EPS new				EPS old			RoNAV new				RoNAV old			TP		Rec	
	2011E	2012E	2013E	2014E	2011E	2012E	2013E	2011E	2012E	2013E	2014E	2011E	2012E	2013E	New	Old	New	Old
UCG	0.13	0.26	0.42	0.63	0.17	0.27	0.36	1.9%	3.4%	5.4%	7.8%	2.3%	3.5%	4.5%	4.50	2.40	EW	UW
ISP	0.14	0.14	0.17	0.21	0.14	0.14	0.14	6.9%	7.2%	8.2%	9.9%	7.3%	7.0%	7.0%	1.90	1.40	OW	EW
MPS	0.02	0.04	0.05	0.05	0.03	0.04	0.04	4.1%	6.9%	7.3%	7.7%	5.8%	6.1%	5.9%	0.35	0.25	UW	UW
Medio*	0.61	0.52	0.61	0.67	0.61	0.60	0.60	8.5%	7.2%	8.3%	8.7%	8.5%	8.3%	8.1%	5.80	4.95	EW	UW
UBI	0.18	0.28	0.34	0.38	0.19	0.22	0.21	2.9%	4.5%	5.5%	6.0%	3.1%	3.6%	3.4%	3.50	2.00	UW	UW
BP	0.11	0.19	0.24	0.27	0.08	0.18	0.19	3.1%	5.1%	6.3%	6.6%	2.3%	4.8%	5.0%	1.25	0.60	UW	UW
PMI	0.02	0.03	0.04	0.04	0.02	0.02	0.02	1.9%	2.6%	3.3%	3.9%	2.0%	1.9%	2.1%	0.40	0.25	UW	UW

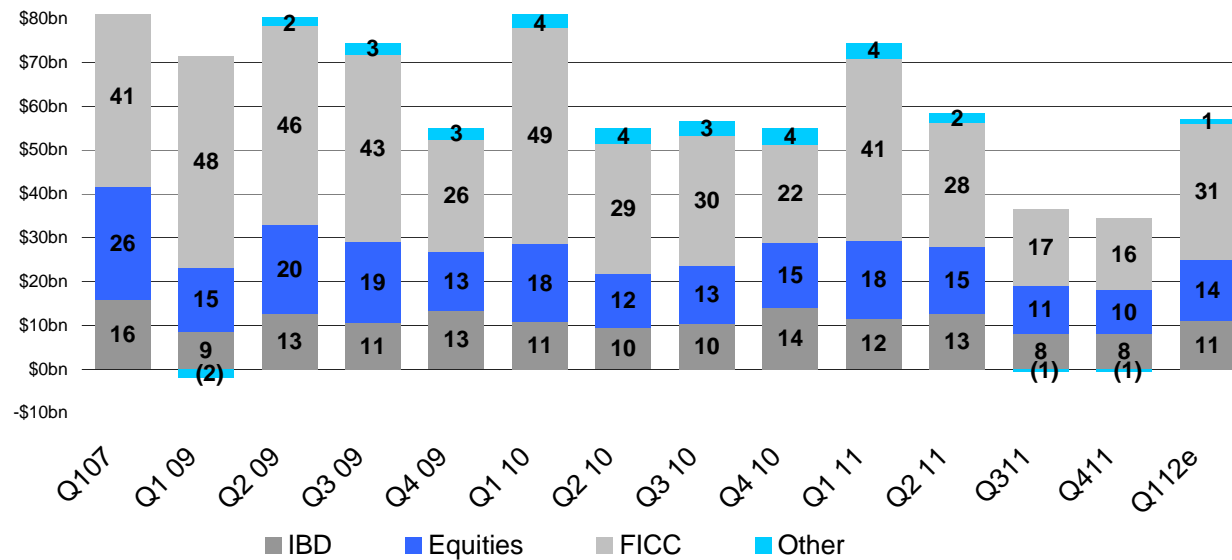
For valuation methodology and risks associated with any price targets above, please email morganstanley.research@morganstanley.com with a request for valuation methodology and risks on a particular stock. Source: Morgan Stanley Research estimates

We have increased our earnings forecasts by 10% in 2012, on average, and by 30% in 2013, to reflect removal of the impact of higher financing costs in our three-year forecast period (as this is now provided by the LTRO). However, we have also adjusted our NPL and LLP expectations to bring them into line with our economists' reduced GDP forecasts published in early January, as we believe that the transmission mechanism of higher liquidity into the real economy will operate with a delay.

Share prices at 21st February: MPS €0.39, BP €1.49; UCG €4.24, ISP €1.53, MB €4.85, UBI €3.82, PMI €0.52

Wholesale banks: Why we think LTRO could potentially lead to investment bank earnings upgrades after a difficult 2H...

Investment banking industry revenues – we forecast Q112e to be stronger than Q411:



- We think plausible we could see earnings upgrades and further rally in valuation for some wholesale and investment banks given expectations pegged more around 2H 2011.
- We think January has been the best month for credit trading for 2 years. We think many may have missed that GFI (a US inter dealer broker, predominantly credit focused) said on a recent conf call that revenues +2% y/y in January and February to date is running +9% y/y
- Clearly we need to see follow through to this after a big risk-on month. Cash and derivatives volumes we track are still running below last year. But we think this could help year on year given valuations
- We also realise valuations could be held back by regulatory uncertainty as we expect volatile revenues, high funding costs and deleveraging plans, but in our base cases we see upside.

e = Morgan Stanley Research estimates; Source: Company data, Morgan Stanley Research. In US\$, excludes DVA.

Agenda

Summary and Key Recommendations

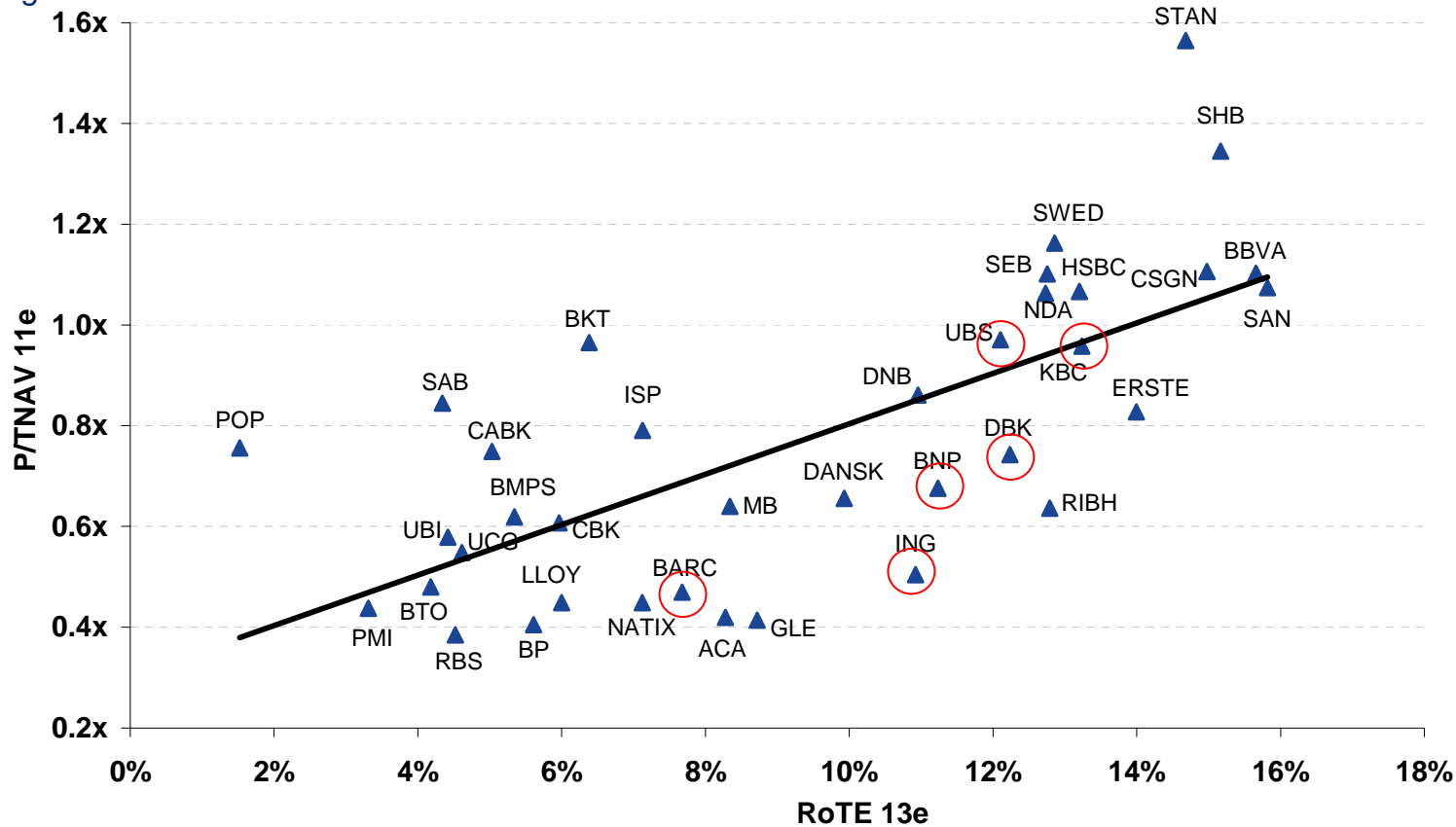
How the LTRO will ease a crunch but not stop the Great Deleveraging

Valuation and Trade Ideas

Bank Equity: We still like the ‘recovery trade’ of banks with reasonable odds of hitting cost of equity but trading well below book – such as KBC, ING, BNP, BARC, DB as well as UBS, SBER, Aberdeen. We also think some wholesale banks most likely to see earnings upgrades

Price to book vs RoTE in 2013

We think the first leg the sector’s recovery trade is now in the numbers: the sector (ex Asians) is now on 0.7x tangible book vs our base case 10% ROTE in 2013e. The next leg will be more dependent on whether we see earnings upgrades and how we navigate Greek uncertainties



NB: Clearly banks have different discount rates and growth assumptions, so shouldn't be one line. Source: Thomson Reuters Data as at February 20th 2012.

KBC; €17.8, ING €6.83, BNP €37.4, BARC 248p, DBK €33.85; UBS, CHF 13.19, SBER \$3.23; Aberdeen GBP2.57, Wells Fargo \$31.4, JPM, \$38.93. POP €3.23, MPS €0.39, BP €1.49; RBS GBp 0.28; LLOY GBP 0.36, CBK €2.14.

European Credit Strategy And Banks Research – Taking Chips Off The Table

- **In Europe, we still believe that the risk/reward is attractive for credit in 2012**, and that spreads are likely to eventually end this year tighter than today, but given the strong rally, we have grown more cautious. Near-term concerns still exist, and if anything have grown since end of last year:

- **The LTRO has done little to alter our economists' growth forecasts**, which see fiscal austerity and tight lending conditions driving weak economic data in 1Q12. Expectations about what it can do have also risen considerably over a very short timeframe.

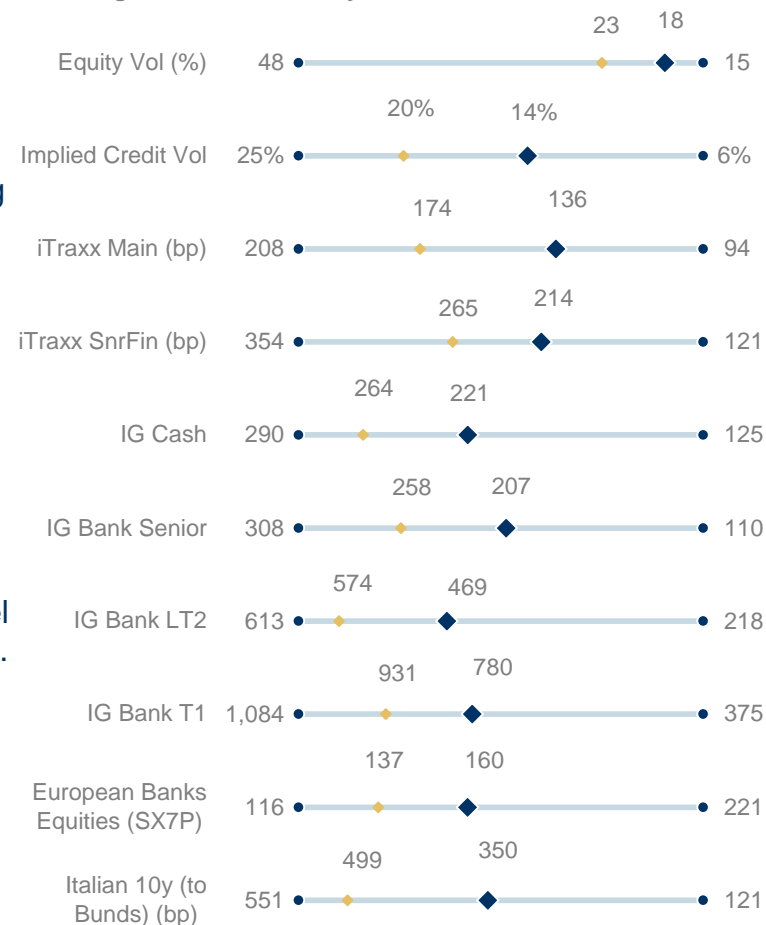
- **Europe's 4Q11 earnings season is still in its early stages (26% reported), but it has not been strong** -- 9% more companies have missed earnings expectations than have beaten, and EBIT margins have missed expectations by 67bps.

- **Uncertainty remains over Greece** – a deal on PSI must still be finalised, a process that will likely require the insertion and use of Collective Action Clauses to prevent holdouts in front-end bonds, as well as new commitments to austerity by the Greek government, in our view.

- **Risk in European financials** -- we are becoming gradually more cautious on the sector in light of the rally. In subordinated debt, specifically Tier 1, our concern is that the bulk of beneficial tender activity could be behind us, while negative ratings actions are set to continue. In light of these risks, and falling yield-to-perpetuity in the sector, we have downgraded Tier 1 to Underweight.

European Financials Have Lagged Overall Market, But Still Tightened Significantly Since January

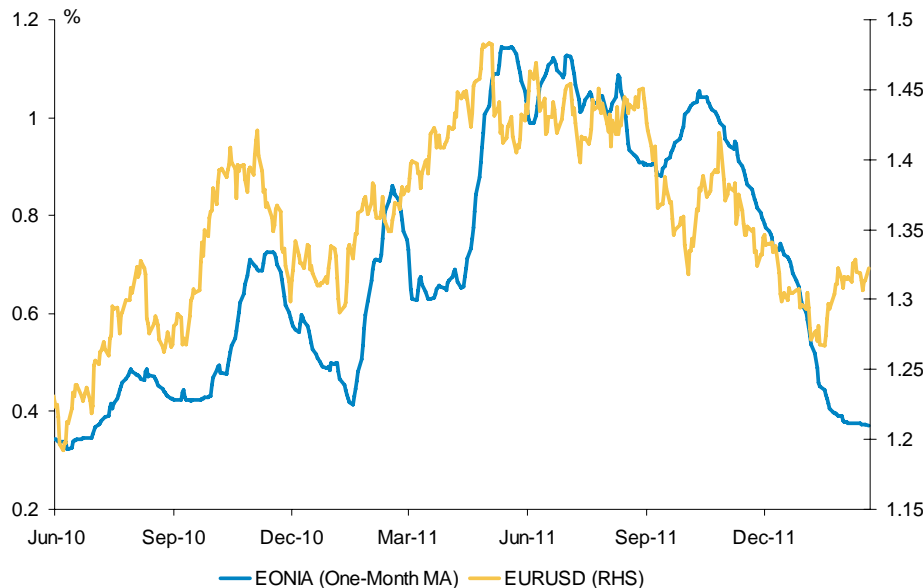
LTM Range, Jan 1st and Today



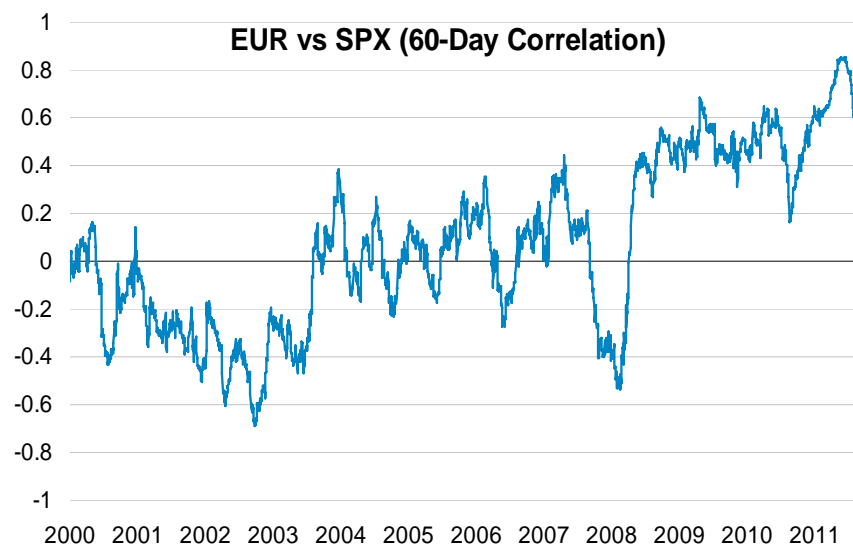
Source: Morgan Stanley Research, Markit iBoxx, Bloomberg

FX: Our FX team believes that post-LTRO, the markets will question the source of European market funding going forward. Furthermore, a large increase in the supply of EURs, combined with a weak growth outlook and high political risk, will move EUR to become the funding currency of choice.

Aggressive ECB Action to Weigh on EUR



Expect EUR Correlation with Risk to Come Off Further



As seen in the above exhibit, aggressive ECB easing policies are likely to pressure EUR lower over medium term as liquidity eventually makes its way out of the Euro system.

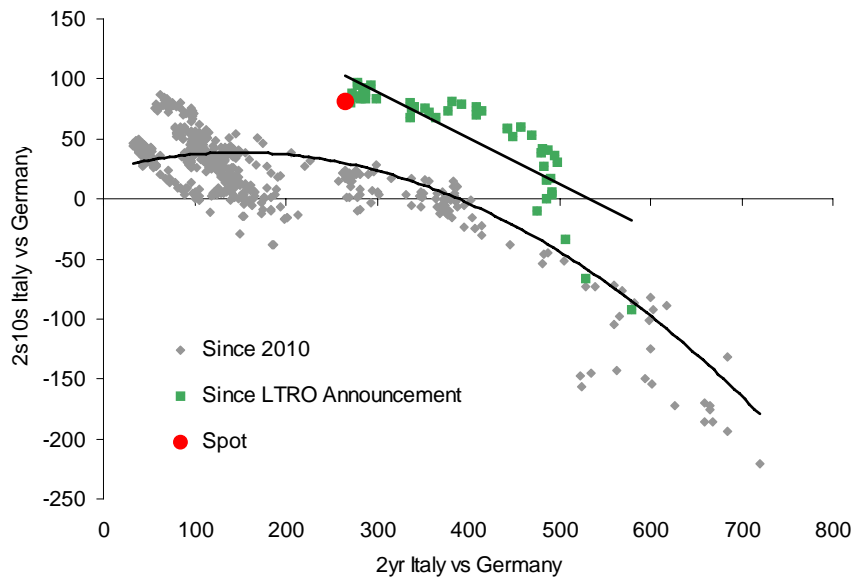
EUR correlation with risk (as proxied by the S&P) moved to record highs at the end of last year. One of our FX team's major themes for 2012 is a break-down in this correlation as EUR becomes the global funding currency of choice. They forecast EURUSD at 1.15 by year-end

Source: Bloomberg, Morgan Stanley Research

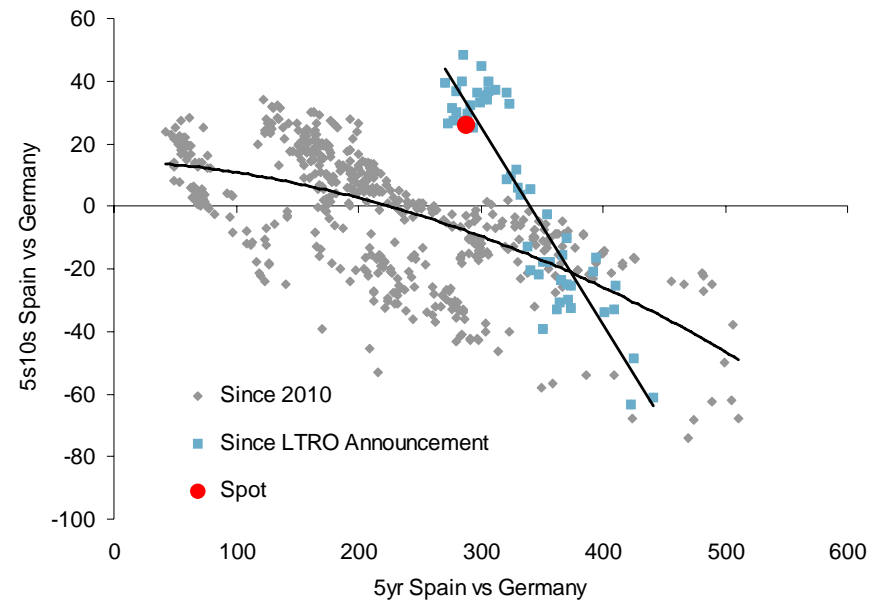
Rates: Spread tightening and curve steepening since the 3yr LTRO announcement has potential to reverse once the February's LTRO has passed

Since the announcement/allotment of extraordinary central bank action (\$ lines, 3y LTRO, dramatic widening of collateral) we have seen significant spread narrowing and steepening of the Spanish and Italian curves.

Italy 2s10s Credit Curve Has Steepened Too Far



Spain 5s10s Credit Curve Has Started to Flatten, But Still Room for More



Interest Rate Trade Recommendation: Italy 2s10s flattener vs long Belgium; Spain 5s10s flattener (outright or vs Germany):

Laurence Mutkin's team think the steepening thus far has gone beyond what is justified by the level of spreads, and data suggest that, with the exception of Spain, other countries have not used the liquidity to increase their government bond holdings materially. If the 3yr LTRO is the last one, the curve will likely flatten post the LTRO given the likelihood funding risk will resurface; and if positive risk sentiment continues after an exceptionally large take-up or if another 3yr LTRO happens, the curve could bullishly flatten.

Source: Bloomberg, Morgan Stanley Research. Data as at February 20th, 2012

ECB Refinancing Operation Collateral Eligibility – Marketable Assets

Eligible Asset Categories for Marketable Assets

Category I	Category II	Category III	Category IV	Category V
Central government debt instruments	Local and regional government debt instruments	Traditional covered bank bonds	Credit institution debt instruments (unsecured)	Asset-backed securities
Debt instruments issued by central banks ²	Jumbo covered bank bonds ³	Debt instruments issued by corporate and other issuers ⁴	Debt instruments issued by financial corporations other than credit institutions (unsecured)	
	Agency debt instruments ⁴	Other covered bank bonds ⁵		
	Supranational debt instruments			

1. In general, the issuer classification determines the liquidity category. However, all asset-backed securities are included in category V, regardless of the classification of the issuer, and jumbo covered bank bonds are included in category II.
2. Debt certificates issued by the ECB and debt instruments issued by the NCBs prior to the adoption of the euro in their respective Member State are included in liquidity category I.
3. Only instruments with an issuing volume of at least EUR 1 billion, for which at least three market-makers provide regular bid and ask quotes, fall into the asset class of jumbo covered bank bonds.
4. Only marketable assets issued by issuers that have been classified as agencies by the ECB are included in liquidity category II. Marketable assets issued by other agencies are included in liquidity category III or IV, depending on the issuer and asset type.
5. Non-UCITS compliant covered bonds, including both structured covered bonds and multi-issuer covered bonds are included in liquidity category III.

ECB Refinancing Operation Collateral Eligibility – Non-Marketable Assets

Eligible Asset Categories for Non-Marketable Assets

Non-marketable credit claims which meets following criteria:

- Must have a fixed, unconditional principle amount and interest rate that cannot result in a negative cash flow
- A debt obligation of a debtor vis-à-vis a Euro system counterparty
- Eligible debtors are non-financial corporates, public sector entities, and international or supranational institutions
- The debtor must be established in the euro area
- Quality of credit claims should satisfy credit assessment of credit quality step 3 or above (i.e. BBB- or above)
- Minimum size of of EUR500k
- Governed by law of a member state
- Denominated in euro

Non-marketable residential mortgage-backed debt instrument which meets following criteria:

- Secured by a pool of residential mortgages, with fixed, unconditional principle amount and interest rate that can not result in a negative cash flow
- Credit rating has to meet second best rating of AAA at issuance and A rating or above over the life of the security
- Eligible issuers are credit institutions that are eligible counterparties
- The issuer must be established in the euro area
- Must be denominated in euro

Haircut Schedule for Marketable and Non-Marketable Assets

ECB Valuation Haircut for Eligible Marketable Assets, %

Credit quality	Residual Maturity (years)	Category I		Category II		Category III		Category IV		Category V
		fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	fixed coupon	zero coupon	
Steps 1 and 2 (AAA to A-)	0-1	0.5	0.5	1	1	1.5	1.5	6.5	6.5	16
	1-3	1.5	1.5	2.5	2.5	3	3	8.5	9	
	3-5	2.5	3	3.5	4	5	5.5	11	11.5	
	5-7	3	3.5	4.5	5	6.5	7.5	12.5	13.5	
	7-10	4	4.5	5.5	6.5	8.5	9.5	14	15.5	
	>10	5.5	8.5	7.5	12	11	16.5	17	22.5	
0-Step 3 (BBB+ to BBB-)	0-1	5.5	5.5	6	6	8	8	15	15	Not eligible
	1-3	6.5	6.5	10.5	11.5	18	19.5	27.5	29.5	
	3-5	7.5	8	15.5	17	25.5	28	36.5	39.5	
	5-7	8	8.5	18	20.5	28	31.5	38.5	43	
	7-10	9	9.5	19.5	22.5	29	33.5	39	44.5	
	>10	10.5	13.5	20	29	29.5	38	39.5	46	

ECB Valuation Haircut for Eligible Non-Marketable Assets, %

Credit quality	Residual maturity (years)	Credit claims		Non-marketable RMB debt
		Fixed interest payment and a valuation based on a theoretical price assigned by the NCB	Fixed interest payment and a valuation according to the outstanding amount assigned by the NCB	
Steps 1 and 2 (AAA to A-)	0-1	8	10	24
	1-3	11.5	17.5	
	3-5	15	24	
	5-7	17	29	
	7-10	18.5	34.5	
	>10	20.5	44.5	
Step 3 (BBB+ to BBB-)	0-1	15.5	17.5	Not eligible
	1-3	28	34	
	3-5	37	46	
	5-7	39	51	
	7-10	39.5	55.5	
	>10	40.5	64.5	

Source: ECB, Morgan Stanley Research

Additional Collateral Eligible Assets Announced on Dec 8th ECB Meeting

ABS having a second-best rating of A at issuance and at all times subsequently will now be eligible, subject to following conditions:

- The underlying assets of which comprise residential mortgages and loans to small and SMEs
- The cash-flow-generating assets backing the ABS must all belong to the same asset class (either residential mortgage or loans to SMEs)
- The cash-flow-generating assets backing the ABS can not include loans which are non-performing at time of issuance of the ABS; or structured, syndicated or leveraged at any time

Credit Claims that satisfy specific eligibility criteria will be accepted, the responsibility entailed in the acceptance of such credit claims will be borne by the NCB authorising their use. Seven national central banks (NCBs) have put forward relevant proposals, specific national criteria and risk control measures for the temporary acceptance of additional credit claims. The seven NCBs include:

- Central Bank of Ireland
- Banco de España
- Banco de France
- Banca d'Italia
- Central Bank of Cyprus
- Oesterreichische Nationalbank
- Banco de Portugal

ECB approved for 7 NCB to temporarily allow additional credit claims on Feb 9, 2012

CB of Ireland	The Bank will accept pools of secured (including mortgages) and unsecured credit claims (other loans) subject to the Bank's valuation and risk control criteria and will be accepted by the Bank under contractual arrangements with individual counterparties.
Banco de España	Performing corporate and Public Sector Entity credit claims, other than mortgages, that are denominated in euro or in major foreign currencies and whose estimated credit risk, as assessed by the Banco de España using reliable sources, has a probability of default equal to or lower than 1%, although initially it will accept only collateral with a probability of default equal to or lower than 0.4%.
Banque de France	Minimum accepted credit standard is lowered from credit quality step 3 to credit quality step 4 in the Euro system's harmonized rating scale, which corresponds to a maximum probability of default of 1% at one year. Credit claims denominated in USD and Export credit guaranteed by Coface are also accepted insofar as all other eligibility criteria. Real-estate residential loans are eligible if they benefit from 1) a mortgage or a first-rank privilege, or 2) a guarantee (including French " <i>cautionnement</i> ") from a credit institution or an insurance company and 3) if they satisfy additional criteria, among which: debtor located in France, loan agreement governed by French law, and residual maturity of 1 month at least. These additional credit claims are subject to increased haircuts which are set according to their individual features.
Banca d'Italia	A probability of default over a one year horizon up to 1%. In addition to the other accepted ECAF sources, bank loans creditworthiness can be assessed according to the internal credit assessment system VALCRE run by Banca d'Italia. Only counterparties that have not already selected, as main credit assessment source, an Internal Rating based System (IRB) or an ECAI or a third party Rating Tool (RT) will be allowed to use VALCRE, unless the main credit assessment source selected does not provide sufficient coverage. Financial leasing and non-recourse factoring contracts, as well as loans guaranteed by SACE; in this regard leasing and factoring companies, including those without a banking license, will be considered as valid providers of pledge on credit claims in favour of the monetary policy counterparty that belong to the same banking group.
CB of Cyprus	Acceptance of performing additional credit claims with a probability of default over an one-year horizon up to 1.5%. The Central Bank of Cyprus' counterparties internal rating-based rating systems shall be used for the assessment of the additional credit claims' credit quality. Additional credit claims for which Central Bank of Cyprus counterparties can claim full repayment in case of default, other than leasing contracts, syndicated loans and credit claims backed by real estate assets, are eligible. The type of debtor /guarantor shall conform to the related provisions for eligible credit claims stated in the ECB's publication "The implementation of monetary policy in the euro area: General documentation on Euro system monetary policy instruments and procedures" . Furthermore, individuals, municipalities and other local authorities are eligible debtors. The debtor and the guarantor must be established in the euro area. Furthermore, the debtor and the guarantor can be established in the European Economic Area in cases where the Central Bank of Cyprus is the home supervisor of the counterparty. Additional credit claims must have a minimum residual maturity of one month at the time of their submission for use as collateral by the counterparty. There is no applicable minimum threshold for additional credit claim size. Additional credit claims can be denominated in euro, US dollar, pound sterling, Swiss franc, Japanese yen. All the other eligibility criteria for credit claims and the operational procedures regarding their mobilisation contained in the ECB's publication "The implementation of monetary policy in the euro area: General documentation on Euro system monetary policy instruments and procedures" remain unchanged.
OeNB	The OeNB has decided to lower the minimum credit score for credit claims to a one-year default probability of 1% on the part of the debtor. The related risk of the OeNB will be overcompensated by strongly raised haircuts.
Banco de Portugal	Accept individual credit claims with a probability of default not exceeding 1.5%, which shall be subject to more demanding risk control measures than those currently in force. Extend the acceptance of the COFACE Rating Tool as a tool to evaluate the credit quality of debtors belonging to Service, Trade and Other activity sectors. Accept homogeneous portfolios of credit claims relating to: i. Mortgage-backed loans to households; ii. Consumer credit to households; and iii. Loans to enterprises other than financial corporations. Credit claim portfolios shall not be subject to minimum credit quality requirements, but shall be subject to specific and strict risk control measures.

Source: NCBs, Morgan Stanley Research

Further Details on Credit Claims as of Feb 9, 2012

Banco de Portugal

Banco de Portugal has decided to introduce a number of changes in the general framework on credit claims, that aim to simplify the mobilisation of credit claims and which will be reflected in Instruction of Banco de Portugal No 1/99. Regarding individual credit claims accepted under Instruction No 1/99, Banco de Portugal has decided to:

1. Reduce the minimum amount of credit claims accepted as collateral from €500,000 to €100,000.
2. Allow for the simplification of the ex ante procedures regarding the authorisation to use credit claims.
3. Change the process for sending credit claims information, which will be made through BPnet's File Transfer service.
4. Adjust the set of information that must be reported on credit claims, changing some mandatory variables into optional, according to the new data scheme, to be made available on BPnet portal.
5. Adjust the codes of some variables to be reported. The new code list will be available on BPnet porta.

Central Bank of Cyprus

Haircut schedule for euro-denominated additional credit claims in %:

Maturity Bucket (yrs)	CQS 1&2	CQS 3	CQS 4	CQS 5
	PD: 0,1%	PD: 0,4%	PD: 1%	PD: 1,5%
0-1	10,0	17,5	42	54
1-3	17,5	34,0	62	70
3-5	24,0	46,0	70	78
5-7	29,0	51,0	78	83
7-10	34,5	55,5	78	84
>10	44,5	64,5	80	85

CQS = Credit Quality Step

PD = Probability of Default

Additional markdown for foreign currency denominated additional credit claims:

1. A mark-down of 16% for credit claims denominated in USD, GBP, CHF, CAD and AUD.
2. A mark-down of 26% for credit claims denominated in JPY.

Additional credit claims will be priced at their outstanding nominal value and consequently haircuts will be applied to the nominal value.

There will be no distinction between fixed- and floating-rate additional credit claims in the application of the haircuts.

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Overweight/Buy	1135	39%	460	44%	41%
Equal-weight/Hold	1248	42%	444	42%	36%
Not-Rated/Hold	107	4%	25	2%	23%
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February 22, 2012
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Industry Coverage: Banks

Company (Ticker)	Rating (as of)	Price* (02/21/2012)
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Hubert Lam

Julius Baer (BAER.VX)	E (02/09/2011)	SFr36.66
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Chris Manners, ACA

Barclays Bank (BARC.L)	O (08/11/2009)	248p
HSBC (HSBA.L)	O (04/19/2011)	580p
Lloyds Banking Group (LLOY.L)	U (02/25/2011)	36p
Royal Bank of Scotland (RBS.L)	U (10/17/2011)	28p
Standard Chartered Bank (STAN.L)	E (10/26/2009)	1,642p

Thibault A Nardin

BNP Paribas (BNPP.PA)	O (05/16/2011)	€37.45
Credit Agricole S.A. (CAGR.PA)	U (01/25/2012)	€5.21
DEXIA (DEXI.BR)	E (10/27/2010)	€31
KBC Group NV (KBC.BR)	O (01/25/2012)	€17.82
Natixis (CNAT.PA)	E (01/25/2012)	€2.36
Societe Generale (SOGN.PA)	E (01/25/2012)	€24.3

Morgan Stanley Research Europe

National Bank of Greece (NBGr.AT)	++	€2.68
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Henrik H Schmidt

Danske Bank (DANSKE.CO)	E (08/19/2011)	Dkr95.8
DnB NOR (DNB.OL)	E (01/18/2012)	Nkr71.7
Nordea (NDA.ST)	E (03/28/2011)	SKr64.5
SEB (SEBa.ST)	E (09/02/2010)	SKr50.25
Svenska Handelsbanken (SHBa.ST)	E (09/02/2010)	SKr219.2
Swedbank (SWEDa.ST)	O (08/19/2011)	SKr113.5

Alvaro Serrano

BBVA (BBVA.MC)	O (08/31/2011)	€7.07
Banca Civica SA (BCIV.MC)	E (09/20/2011)	€2.34
Banco Popular (ES) (POP.MC)	U (01/18/2012)	€3.23
Banco Sabadell (SABE.MC)	U (08/31/2011)	€2.56
Banesto (BTO.MC)	U (08/31/2011)	€3.97
Bankinter (BKT.MC)	U (08/31/2011)	€5.1
Santander (SAN.MC)	E (08/31/2011)	€6.55

Magdalena L Stoklosa

Erste Bank (ERST.VI)	E (05/05/2011)	€18.85
Raiffeisen Bank International (RBIV.VI)	E (11/14/2011)	€27.33

Francesca Tondi

Banca Monte dei Paschi di Siena S.p.A. (BMPS.MI)	U (11/08/2010)	€39
Banca Popolare di Milano S.c.a.r.l. (PMII.MI)	U (11/08/2010)	€52
Banco Popolare (BAPO.MI)	U (11/08/2010)	€1.49
Commerzbank (CBKG.DE)	U (11/08/2011)	€2.14
Intesa SanPaolo S.p.A. (ISP.MI)	O (02/06/2012)	€1.53
Mediobanca Banca Di Credito Finanziario (MDBI.MI)	E (02/06/2012)	€4.85
UniCredit S.p.A. (CRDI.MI)	E (02/06/2012)	€4.22
Unione di Banche Italiane SCPA (UBI.MI)	U (08/31/2011)	€3.82
Huw Van Steenis		
Credit Suisse Group (CSGN.VX)	E (10/04/2010)	SFr25.21
Deutsche Bank (DBKGn.DE)	E (10/11/2010)	€33.85
UBS (UBSN.VX)	O (01/18/2012)	SFr13.19
Hadrien de Belle		
TT Hellenic Postbank S.A. (GPSr.AT)	NA (03/10/2011)	€88

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* Historical prices are not split adjusted.