Morgan Stanley

MORGAN STANLEY RESEARCH

Morgan Stanley & Co. International plc+

**Marcus Rivaldi**
Marcus.Rivaldi@morganstanley.com
+44 (0) 207 677 1464

**Jackie Ineke**
Jackie.Ineke@morganstanley.com
+41 (44) 220 9246

January 13, 2010

**Europe**

Investment Grade Credit

# European Insurance

## Solvency II and Insurance Capital – All Change

**Impending Solvency II rules will make redundant most existing Tier 1 and Tier 2 insurance hybrids, in our view.**

**Expect grandfathering from 2012 but in a form that supports a manageable and swift transition.** We'd agree with our banks colleagues that a period defined by, say, the shorter of five years or to the first call date makes sense.

**Regulatory clarity combined with conducive market conditions could stimulate early, opportunistic liability-management exercises.**

**Strong relative value opportunities exist where the market remains to be convinced over issuer call intentions.** Rule changes reinforce first call dates as the effective maturity date of bonds – they should trade YTC.

**In euros, CCAMA € 6.298% PerpNC17s, offered at 75.75, stand out.** Comparisons with Deutsche Bank in relation to calls are unfounded, in our view. We continue to expect positive credit newsflow during 2010.

**In sterling, we see FRIPRO Tier 1s as obvious market laggards.** Resolution's consolidation project will enhance FRIPRO's capital market's access to support refinancing. YTC remain compelling on a relative value basis.

### Top Trades

**Buys**

- **AVLN € 4.7291% PerpNC14, offered at 84.25**
- **AXASA € 5.777 PerpNC16, offered at 90**
- **AXASA € 6.211 PerpNC17, offered at 90.5**
- **CCAMA € 6.298% PerpNC17, offered at 75.75**
- **FRIPRO £ 6.292% PerpNC15, offered at 74**
- **FRIPRO £ 6.875% PerpNC19, offered at 74**
- **FRIPRO £ 12% 2021, offered at G+440bp**
- **INTNED € 6.25% 21NC11, offered at 94.875**
- **LGEN £ 6.385% PerpNC17, offered at 84**
- **SCOTW £ 5.125% PerpNC15, offered at 84**

### Recent Research

| | |
|---|---|
| *Insurance Cracker – Our Preview for 2010* | Dec 18, 2009 |
| *Initiating on Non-Life Insurers – Defensive Premium Waning* | Dec 14, 2009 |
| *LGEN £ Tier 1: Solvency II – Pragmatism Reigns* | Nov 11, 2009 |
| *Allianz – Mandatory Deferral, But Problem Sorted* | Nov 11, 2009 |
| *Lloyds' Life Assurers – On the Up* | Nov 5, 2009 |
| *European Insurance: Tier 1 Cross-Currency Opportunities* | Oct 28, 2009 |
| *ING – State Aid Repayment and Disposals* | Oct 26, 2009 |
| *Swiss Life Upper Tier 2 – the Way to Go* | Oct 22, 2009 |

# European Insurance

## Solvency II and Insurance Capital – All Change

Marcus Rivaldi (44 20) 7677 1464

We have previously flagged that Solvency II will be a key theme for European insurers in 2010 (see *Insurance Cracker – Our Preview for 2010*, December 18, 2009). Our central call on this highly complex subject is that – in relation to future capital requirements – pragmatism will ultimately reign, i.e., we believe that while the roll-out of Solvency II will not be without its problems, the transition to it will generally be manageable for most insurers.

In relation to capital, our read of how current regulatory winds are blowing (in both the banks and insurance sectors) strongly suggests to us the following:

- Material changes to hybrid capital rules will result from Solvency II (radical even in relation to Tier 1) that will drive a full-scale replacement of existing instruments with ones compliant with the new rules. We believe we are unlikely to see a major dilution of CEIOPS' (Committee of European Insurance and Occupational Pensions Supervisors) latest proposals on hybrid form and eligibility (see below; the full details are here); and
- Consistent with our view in the banks space (*see Tier 1 – Basel Boosted*, December 17, 2009 and *Cutting Back to the Core*, January 11, 2010), we expect grandfathering arrangements to be put in place that, while not overly generous, will support a swift, manageable transition.

### Tier 1 Hybrid Form and Eligibility – CEIOPS to Hold the Line

As we discuss later, CEIOPS' proposals in relation to Tier 1 hybrids present the biggest challenge for current issued structures, in our view. We believe that the European insurance industry has to date been relatively confident that lobbying will successfully result in material changes to CEIOPS' current stance. A key argument we have often seen put forward is that new rules should be broadly in line with those for European banks, as set out within the recently amended Capital Requirements Directive (CRD), in order to prevent regulatory arbitrage.

Hence, insurers have demanded for example that future Tier 1 rules should allow moderate incentives to redeem to accompany call dates (e.g., higher of 100bp or 50% of the initial credit spread as per the Basel Sydney press release).

The current CEIOPS proposals explicitly exclude such incentives, whereas the amended CRD allows them (from year ten for perpetual instruments, at the maturity date for dated instruments).

However, we believe that insurers may have fully considered ramifications of recent developments in the banking space. In particular, we would highlight the consultation process launched by the Basel Committee, that is working on a similar timetable to Solvency II (i.e., proposals post consultation to be delivered at the end of 2010 for implementation in 2012), aimed at strengthening the resilience of the banking sector in the wake of the recent financial crisis.

The thrust of Basel's argument is that current outstanding hybrid Tier 1 doesn't cut it in terms of supporting a firm as a going concern through absorbing loss. As a result, the Committee has put forward proposals on the features required of Tier 1 hybrids in future that we feel bring it closer into line with CEIOPS' current position (that was equally established post-crisis) than that of the amended CRD (see Exhibit 1). For example, as per CEIOPS, Basel sets out that Tier 1 hybrids:

- Should not contain any incentive to redeem, plus (and a deviation from CEIOPS) a bank should not do anything that creates an expectation that a call will be exercised; and
- Explicitly must include principal loss absorption via either (i) conversion to equity; or (ii) write-down at a specified trigger point. In addition, write-down must reduce the claim in liquidation and reduce the amount repaid when a call is exercised (both appear to be a major challenge to existing current European Tier 1 structures with write-down/up), besides partially or fully reducing coupon payments.

By aligning itself with CEIOPS' views on how to make hybrid Tier 1 instruments truly loss-absorbing in a going concern, we believe that Basel (by accident or design) has substantially added credibility to and thereby materially strengthened the negotiating position of CEIOPS with the insurance industry.

In addition, we would expect the EU to follow Basel's lead, so should the Basel proposals remain as they are through the consultation process, we'd expect the EU to implement them via further amendments to the CRD. Were the EU to do so, we believe that a further major plank will have been removed from the insurance industry's arguments. How could the industry defend the continued usage of instruments that in a major stress situation, albeit in another financial sector, have failed in supporting firms as going concerns?

Exhibit 1

## Tier 1 Compared – CEIOPS versus CEBS versus Basel

| Tier 1 | European Insurers (CEIOPS) | European Banks (CEBS/CRD) | Banks Globally (Basel) |
|---|---|---|---|
| **General** | Fully paid up. | Fully paid up. | Fully paid up. |
| **Duration** | Perpetual or dated. If dated, the instrument should have a duration sufficient in relation to the firm's insurance/reinsurance obligations, subject to a minimum legal maturity of ten years. Ten-year minimum also applies to period from issue to first call date for all instruments. | Perpetual or with an original maturity of at least 30 years. | Perpetual. |
| **Redemption** | Redemption only at the sole discretion of the issuer, subject to regulatory approval. Redemption suspended if solvency capital requirement (SCR) is not met, it only being allowed in exceptional circumstances or if the item is replaced with 'like for like' or 'like for better'. | Redemption only at the sole discretion of the issuer, subject to regulatory approval. Calls and redemptions also conditional upon financial or solvency position not being unduly affected, and may be subject to 'like for like' or 'like for better' replacement. No redemption allowed pre-year five after the issue date. Redemption of dated instruments suspended if capital requirements are not met, and may be suspended at other times depending upon the financial or solvency situation of the firm. | Redemption only at the sole discretion of the issuer, subject to regulatory approval. Bank must demonstrate that its capital position is well above minimum requirements post-call; may be subject to 'like for like' or 'like for better' replacement No redemption allowable pre-year five after the issue date. |
| **Incentives to redeem** | No incentives to redeem permitted (i.e., a feature that in conjunction with a call would make the firm more likely to redeem the instrument). | Moderate incentives to redeem permitted (100bp or 50% initial credit spread as per Sydney press release). No incentive to redeem allowable for perpetual instruments prior to year ten nor for dated instruments other than at the maturity date. | No incentives to redeem permitted. Also a bank must not do anything which creates an expectation that the call will be exercised. |
| **Interest cancellation** | Institution must be able to freely cancel interest/dividends, and payments must at a minimum be cancelled if the SCR is not met (after which they can only be paid in exceptional circumstances and subject to regulatory consent). Full discretion over amount of payment – interest/dividends must not be at a fixed rate. No preference as to income or return of capital. | Institution must be able to freely cancel interest or dividends for an unlimited period of time on a non-cumulative basis, and must do so if capital requirements are not met. Regulator may require cancellation of payments based upon the financial or solvency situation of the firm – though this may not preclude the firm from substituting the payment of interest or dividend with a settlement in the form of equity. | Bank must have full discretion at all times to cancel distributions/payments. Cancellation must not place restrictions on the bank except in relation to distributions to common stockholders. |
| **Loss absorption** | Instrument must be able to fully absorb losses on going concern and winding up bases. Instrument must be the first to absorb losses (e.g., via equity conversion, write-down for so long as losses persist as and when needed, in any case upon a SCR breach) or rank pari passu with an instrument that substantially absorbs first losses, and must not hinder recapitalisation (i.e., the instrument absorbs losses in a going concern through appropriate mechanisms so that the potential future outflows to holders are reduced). | Principal, unpaid interest or dividends shall be available to absorb losses, a proviso being that the recapitalisation of the firm via appropriate mechanisms should not be hindered. | Must have principal loss absorption via either (i) conversion to equity at a pre-specified trigger point; or (ii) write-down at a specified point. Write-down must reduce the claim in liquidation, reduce the amount repaid when a call is exercised and partially or fully reduce coupon payments. Must not hinder recapitalisation. |
| **Subordination** | Must be the most deeply subordinated in a winding up. | Subordinated obligations that in the event of the firm's bankruptcy or liquidation rank after cumulative, perpetual instruments or cumulative preference shares (i.e., after Upper Tier 2). | Subordinated to depositors, general creditors and subordinated debt of the bank. |

Source: Morgan Stanley

As a result, while we could see some ground being given for Tier 1 in areas out of line with Basel (e.g., CEIOPS is currently proposing that interest/dividends must not be at a fixed rate), we believe it is unlikely that there will be material changes to CEIOPS' position, unless and unexpectedly we equally see a major change of heart at Basel.

## Current Insurance Tier 1 Will Not Qualify as Tier 1 Post 2012

We do not believe that any of the current Tier 1 hybrids in the market fit with CEIOPS' present framework for 'new' Tier 1. Exhibit 2 illustrates this point. We have compared typical Tier 1 structures from the UK (Aviva's £ 5.9021% PerpNC16s), France (AXA's € 5.777% PerpNC16s), Italy (Generali's € 5.317% PerpNC16s) and Germany (Allianz's € 5.5% PerpNC14s) against CEIOPS' proposals (according to CEIOPS' QIS4, about 85% of all hybrid capital issued in Europe has come from insurers in these four member states).

Exhibit 2

## Comparison of Selected European Insurance Tier 1 Against CEIOPS' Proposals

| | CEIOPS Tier 1 Requirements | AVLN £ 5.9021% PerpNC16 | AXASA € 5.777% PerpNC16 | ASSGEN € 5.317% PerpNC16 | ALVGR € 5.5% PerpNC14 | Notes |
|---|---|---|---|---|---|---|
| **General** | Fully paid up. | ✓ | ✓ | ✓ | ✓ | All fully paid in. |
| **Duration** | Perpetual or dated. If dated, the instrument should have a duration sufficient in relation to the firm's insurance/reinsurance obligations, subject to a minimum legal maturity of ten years. Ten-year minimum also applies to period from issue to first call date for all instruments. | ✓ | ✓ | ✓ | ✓ | All structured with first call dates at year ten. |
| **Redemption** | Redemption only at the sole discretion of the issuer, subject to regulatory approval. Redemption suspended if solvency capital requirement (SCR) is not met, it only being allowed in exceptional circumstances or if the item is replaced with 'like for like' or 'like for better'. | ✓ | ✓ | ✓ | ✓ | No investor 'put' features. Calls subject to some form of regulatory oversight. |
| **Incentives to redeem** | No incentives to redeem permitted (i.e., a feature that in conjunction with a call would make the firm more likely to redeem the instrument). | ✘ | ✘ | ✘ | ✘ | Interest rates include step-ups at first call dates when moving from fixed to floating. |
| **Interest cancellation** | Institution must be able to freely cancel interest/dividends, and payments must at a minimum be cancelled if the SCR is not met (after which they can only be paid in exceptional circumstances and subject to regulatory consent). Full discretion over amount of payment – interest/dividends must not be at a fixed rate. No preference as to income or return of capital. | ✘ | ✘ | ✘ | ✘ | AXASA, ASSGEN and ALVGR bonds contain 'dividend pushers' which could be interpreted as compromising ability to defer. Only AVLGR and AXASA have full coupon cancellation features in limited circumstances. No bonds bear interest that is fully variable. |
| **Loss absorption** | Instrument must be able to fully absorb losses on going concern and winding up bases. Instrument must be the first to absorb losses (e.g., via equity conversion, write-down for so long as losses persist as and when needed, in any case upon a SCR breach) or rank pari passu with an instrument that substantially absorbs first losses, and must not hinder recapitalisation (i.e., the instrument absorbs losses in a going concern through appropriate mechanisms so that the potential future outflows to holders are reduced) | ✘ | ✓ | ✓ | ✘ | ALVGR and AVLN bonds do not possess any write-down features. AXASA and ASSGEN do not have features that comply with Basel proposals, in our view. |
| **Subordination** | Must be the most deeply subordinated in a winding up. | ✘ | ✘ | ✘ | ✘ | Bonds rank above ordinary share capital in a winding up. |

Source: Morgan Stanley

In our view, current structures fall down against proposed future Tier 1 requirements in a number of areas including incentives to redeem, interest rate and subordination provisions among others.

We also note that while the Tier 1 structures appear to fit more closely with CEIOPS' proposed Tier 2 requirements, they fall down against certain current Basel Tier 2 hybrid proposals. In particular, we see that Basel is suggesting that Tier 2 instruments should not include an incentive to redeem, nor should banks do anything to create an expectation that a call will be exercised. Were CEIOPS to align itself with Basel, then potentially our selected Tier 1 structures would not qualify under Tier 2 rules either.

In light of our analysis, grandfathering is needed if current Tier 1 instruments are to continue qualifying as such post Solvency II's implementation.

### Current Tier 2 Instruments Will Also Not Work Post-2012

While the Tier 1 debate has grabbed all the limelight, the Solvency II implications for current issued Tier 2 should not be overlooked. In our view, CEIOPS' latest proposals throw into doubt the long-term capital qualification of instruments already in issue.

Exhibit 3

## Comparison of Selected European Insurance Tier 2 Against CEIOPS' Proposals

| | Tier 2 | ALVGR € 6.125% 22NC12 | ASSGEN € 6.9% 22NC12 | AVLN £ 6.125% 36NC26 | INTNED € 6.25% 21NC11 | Notes |
|---|---|---|---|---|---|---|
| **General** | Does not need to be fully paid in, but must be able to be called up. | ✓ | ✓ | ✓ | ✓ | All fully paid in. |
| **Duration** | Perpetual or dated. If dated, the instrument should not have a legal maturity of less than five years. Five-year minimum also applies to period from issue to first call date for all instruments. | ✓ | ✓ | ✓ | ✓ | All structured with first call dates at least at year ten. |
| **Redemption** | Redemption only at the sole discretion of the issuer, subject to regulatory approval. Redemption suspended if solvency capital requirement (SCR) is not met, it only being allowed if the item is replaced with 'like for like' or 'like for better'. | ✗ | ✗ | ✗ | ✗ | Bonds do not provide for regulatory approval of redemption at maturity date. Typically no ability to suspend redemption if capital requirements are not met – AVLN bonds provide for two-year delay in redemption at maturity. INTNED bonds include an investor 'put' in the event substantial amount of assets are sold. |
| **Incentives to redeem** | Moderate incentives to redeem are permitted (to be defined). | ✓ | ✓ | ✓ | ✓ | Interest rates include step-ups at first call dates when moving from fixed to floating. |
| **Interest cancellation** | At a minimum institution must defer dividends/interest for an indefinite period if the SCR is not met, after which payments can only be made subject to regulatory consent. | ✗ | ✗ | ✓ | ✗ | Dividend pusher language detached from regulatory capital requirements can remove optionality of coupons. Forced settlement of interest arrears may not be linked to regulatory capital requirements. |
| **Loss absorption** | Instrument must be able to absorb losses to some degree. The firm must defer coupon/dividend payments once the SCR has been breached | ✗ | ✗ | ✓ | ✗ | As above. |
| **Subordination** | Must be effectively subordinated in a winding up. No need to absorb losses first so can be senior to equity. | ✓ | ✓ | ✓ | ✓ | Unsecured and subordinated obligations, ranking senior to Tier 1 and share capital. |

Source: Morgan Stanley

When current Tier 2 instruments are compared against CEIOPS' requirements for Tier 2 (see Exhibit 3), they fall down against a number of criteria, including a lack of regulatory control over early and final redemption, plus the restricted nature of interest deferability (due to dividend pushers) and often its detachment from regulatory capital requirements.

Some other existing Tier 2 instruments fall down even further against the regulations via them lacking any form of coupon deferability (e.g., FRIPRO £ 12% 21s).

### Grandfathering – to Be Allowed but Limited

So far, CEIOPS has remained tight-lipped on the subject of transition arrangements for hybrid capital from Solvency I to II. The party line is that grandfathering has not yet been addressed, though will be dealt with as part of implementing measures (QIS5 providing input).

Again using the argument of cross-sector consistency, insurance industry participants have been arguing that grandfathering should be allowed on a similar basis to European banks and the amended CRD. Pre-crisis, the EU agreed to the grandfathering of bank hybrids that do not comply with the amended CRD from its implementation date (year-end 2010). In addition, it agreed to a very generous transition period, in our view, gradually reducing credit for non-compliant instruments over time, completing this task in 2040.

Post-crisis, the read of our bank colleagues is that Basel is now looking to shorten materially (and may even be considering the removal altogether of) grandfathering when its proposals come into effect at the end of 2012, an out-of-consensus view that it has had for a couple of months. As stated in *Tier 1 – Basel Boosted*, "*Basel simply recommends that member states "consider the possibility of allowing the grandfathering" of hybrid Tier 1s. We may be reading too much into it, but this certainly doesn't sound like a ringing endorsement of grandfathering – particularly as much of the document heavily criticises this type of capital*".

We believe that a grandfathering period should be provided for so as not to overly disrupt the marketplace, particularly at a time when capital markets are not yet fully out of the woods. However, we also feel that it makes a lot of sense that such a period be more compressed than per the CRD and that rules adopted encourage the transition to be completed as soon as reasonably possible, before the next crisis comes along.

A period defined by, say, the shorter of five years or to the first call date at first sounds relatively stringent, but in effect it could extend the transition period to as far out as 2017, given that Solvency II is due to come into effect in 2012. In doing so, it would capture the first call dates of most hybrids in issue.

### European Insurance Hybrids to Trade to Call – Liability Management to the Fore?

The conclusion of our analysis is similar to that in the banks space, i.e., pending regulatory changes, reinforce call dates as the effective maturity date of current insurance hybrids and therefore encourage bonds to trade on a YTC basis. This is perhaps not news for the largest and highest-quality names in European insurance, as they effectively trade on this basis already, but is more important for second tier names and below where to date there remains relatively more uncertainty.

We also believe that an important side-effect is that as regulatory certainty develops around the new rules, a strong incentive will be created to conduct early, opportunistic liability-management exercises (tenders, exchanges) if market conditions are suitably conducive, in order to retire ineligible hybrids or to restructure capital arrangements ahead of Solvency II. A key lesson learned by the insurance sector in 2009 was that the market may not necessarily be supportive of issuance when individual firms are ready to execute trades, so it may be best to restructure when windows of opportunity firmly present themselves. We note that the terms and conditions of many hybrids issued appear to provide for early redemption in the event that regulations change and the bonds no longer qualify as Tier 1 or Tier 2 (though typically at 'make-whole' amounts).

Finally, Solvency II will naturally encourage an increasing focus on quality as well as quantity of capital, in our view (it is introducing capital tiering for the first time EU-wide). As a result, we believe that capital quality metrics (e.g., Total Tier 1 % Solvency Capital Requirement) will begin to gain traction in the sector. Therefore, we see a further impetus to the retirement and replacement of current Tier 1 coming from its redundancy as investors and analysts increasingly disregard it from related Tier 1 metrics.

### Moody's – Are You Worth it?

The only major reason we can see as to why an insurer would want to keep outstanding current Tier 1 past its first call date, despite it potentially only qualifying as Tier 2 under future regulatory rules, is Moody's equity credit criteria.

Current dated subordinated issuance seen within the insurance sector typically gets 100% and 75% equity credit from S&P and Fitch, respectively (subject to limits) but zero from Moody's. To get meaningful equity credit from Moody's (i.e., 75% of nominal), the hybrid structure needs to be Tier 1-like, with either mandatory deferral or legally binding replacement language.

In our view, Moody's equity credit would be a very weak argument not to call, particularly when set against the material negative impact to an insurer's capital markets' franchise that would result from a non-call (capital markets access being the main reason insurers choose to pay Moody's for ratings in the first place, in our view).

Given where spreads have recently moved to, highest-quality insurers would also have to question whether economically it makes sense to pay up to maintain Moody's equity credit qualifying hybrids in issue rather than call and refinance with new and potentially cheaper dated subordinated debt.

### Trade Recommendations

On the back of our analysis (and consistent with our bank colleagues), we'd be more inclined to recommend bonds of insurers where there currently remains debate over their intentions with regard to first call dates, particularly where bonds have relatively low back ends. In addition, we have a preference for issuers that have a demonstrable track record of successfully accessing capital markets and whose bonds appear to have lagged the recent rally.

**Buy AVLN Tier 1 € 4.7291% PerpNC14, offered at 84.25, YTC of 8.8%, YTP of 6.8%.**

- In our view, Aviva (AVLN) has emerged as a winner from last year's crisis, with its reputation enhanced among credit investors.
- The group finished the year with an Insurance Groups Directive (IGD) solvency surplus in excess of £4 billion, plus £2 billion in cash sitting at its holding company following the recent IPO of a minority stake in Dutch subsidiary Delta Lloyd.

- Given AVLN's strong credit profile and capital market access that will support its refinancing activity to come (let's not forget that it was able to successfully tap investors twice last year in the depths of the crisis), we see strong value in the € Tier 1s.
- Current offer levels provide approximately 0.6% higher YTC than the group's £ 5.9021% PerpNC20s (mirroring bond structure). By further comparison, STALIF € 5.314% PerpNC15s are offered at 86 (YTC of 8.6%, YTP of 7.2%) – we consider AVLN to be a stronger credit than STALIF and currently have a sell recommendation on the € 5.314% PerpNC15s.

**Buy AXASA Tier 1 € 5.777 PerpNC16, offered at 90, YTC of 7.8%, YTP of 7.2%.**

**Buy AXASA Tier 1 € 6.211 PerpNC17, offered at 90.5, YTC of 7.9%, YTP of 7.3%.**

- AXSA is one of the largest and most diversified insurance groups globally, with very strong profit flows in non-life, life and savings, supported by asset management operations, and benefits from very strong capital markets access.
- Potential for some new supply in 2010 linked to inorganic growth, with the group currently involved in a bid for minorities in AXA Asia Pacific Holdings Ltd and hinting that it is investigating other opportunities.
- We see good relative value on offer versus the other highest-quality European insurers, the Tier 1 bonds presently trading noticeably wider than peers such as Generali (ASSGEN € 5.317% PerpNC16 offered at 96.5, YTC 6.0%, YTP 6.2%).

**Buy CCAMA Tier 1 € 6.298% PerpNC17, offered at 75.75, YTC of 11.1%, YTP of 8.9%.**

- We have been recommending this bond for a while now (see *Initiating on Non-Life Insurers – Defensive Premium Waning*, December 14, 2009). In our view, current YTC levels clearly reflect investor doubts over the 2017 call date, given CCAMA's failure last June to call €750 million of institutionally placed dated subordinated bonds – the only European insurer to do so.
- To us, the non-call decision was not comparable to that of Deutsche Bank. It reflected a combination of CCAMA's then-stressed solvency position, dislocated capital markets in the lead-up to the call date that prevented refinancing and rating agency threats of downgrades (which perversely came anyway) if bonds were called. We believe that the group has gone a long way towards repairing its capital markets franchise by raising €750 million of new dated subordinated debt (€ 7.875% 39NC19s) when markets reopened in 2H09, followed by it giving notice to redeem the bonds that were not called in June.
- The regulatory changes to capital we describe above strengthen the case for the call in 2017, in our view, and underline the strong relative value opportunity we have previously flagged. An offer level of 75.75 (YTC 11.1%, YTP 8.9%) maintains CCAMA as the one of the lowest cash price and highest-yielding names in our € Tier 1 coverage universe, substantially back from similarly rated names such as reinsurer SCOR (€ 6.154% PerpNC16s, offered at 89, YTC 8.4%, YTP 7.7%).
- Finally, pricing does not reflect expected further positive news in 1Q10 at the group's FY earnings with regards to:
  - Desensitising of the solvency position to investment market movements;
  - Progress with investment portfolio derisking; and
  - Underwriting catastrophe risk exposure derisking – CCAMA has stated that it is looking at solutions to reduce its current €240 million loss retention to major windstorm losses.

**Buy FRIPRO Tier 1 £ 6.292% PerpNC15, offered at 74, YTC of 13.3%, YTP of 9.1%.**

**Buy FRIPRO Tier 1 £ 6.875% PerpNC19, offered at 74, YTC of 11.3%, YTP of 9.4%.**

**Buy FRIPRO Lower Tier 2 £ 12% 2021, offered at G+440bp, YTM of 8.2%.**

- We have moved down the credit curve somewhat with these recommendations to a much smaller, though robustly capitalised insurance business.
- Our interest here is not so much what FRIPRO is today, but what it will become in the next few years by virtue of it being wrapped up in the consolidation project being driven by Resolution Limited (Resolution).

- Resolution's plan is to create a new major player in the UK life assurance industry. In doing so, it will enhance both FRIPRO's competitive position and capital markets access.
- We discuss the credit story and all the bond structures in more detail within *Initiating on Life Assurers – Diversity Trading*, September 2, 2009. We see strong relative value in the Tier 1 space on a YTC basis, in relation to other £ Tier 1 issues from its peer group (e.g., STALIF's £ 6.546% PerpNC20, offered at 89, YTC 8.2%, YTP of 7.5%, or LGEN's £ 6.385% PerpNC17, which does not benefit from an operating company guarantee, offered at 84, YTC of 9.5%, YTP of 7.6%).
- We have previously pointed out the very defensive structure of the FRIPRO £ 12% 2021s (no coupon deferability; at 12 years a relative short duration for insurance Lower Tier 2). However, by virtue of some of these, it also very clearly does not come anywhere close to what CEIOPS is looking for in Tier 2 capital going forward. The clock is ticking on this becoming very expensive senior debt. Given our thoughts on a more rapid transition period for insurer capital structures, this bond is a prime candidate for a liability-management exercise, in our view.

**Buy INTNED Lower Tier 2 € 6.25% 21NC11, offered at 94.875, YTC of 10.2%, YTP of 6.7%.**

(N.B. for INTNED's credit profile and more detail on bond features please see *Initiating on Global Composite Insurers – Big Can Be Beautiful*, July 21, 2009 and *ING – State Aid Repayment and Disposals*, October 26, 2009.)

- One of the highest-yielding euro issues in our coverage universe. By comparison, the 21NC11s of AVLN (€ 5.75%) and PRUFIN (€ 5.75%) are offered at 103 (YTC of 4.0%, YTM of 6.0% and YTC of 4.1%, YTM of 5.9%, respectively).
- As we have discussed in the past, our central case is for the piecemeal disposal of ING's insurance operations via IPOs, sales or a combination thereof. In our view, the disposal programme is supportive of the bonds' call in June 2011. In the context of a smaller, less capital-hungry insurance operation, the solvency credit provided by the bond may conceivably be largely or entirely surplus to requirements in 2011, reducing associated refinancing risk. The failings of the bond structure with regard to CEIOPS requirements (as set out in Exhibit 3) reinforce the call, in our view.
- In addition, as underlying operations are sold, bond language allows investors to demand repayment at par once all or a "substantial" (undefined) part of the issuer's assets are disposed.

**Buy LGEN Tier 1 £ 6.385% PerpNC17, offered at 84, YTC of 9.5%, YTP of 7.6%.**

- As we have previously discussed, in our view LGEN will be one of the biggest beneficiaries of a more pragmatic Solvency II framework in relation to capital requirements (see *LGEN £ Tier 1: Solvency II – Pragmatism Reigns*, November 11, 2009). Recent newsflow has materially reduced the risk of regulatory-driven capital shortfall, we believe.
- In addition, along with Aviva the group has proven its ability to access capital markets even in the most difficult conditions – it issued £300 million of dated subordinated debt last July.
- The bond continues to offer good relative value in the £ Tier 1 space, in our view. By comparison, STALIF 6.546% PerpNC20s are offered at 89 (YTC of 8.2%, YTP of 7.5%), and AVLN £ 5.9021% PerpNC20s are offered at 80 (YTC of 8.2%, YTP of 7.3%).

**Buy SCOTW Upper Tier 2 £ 5.125% PerpNC15, offered at 84, YTC of 8.8%, YTP of 7.0%.**

- We view SCOTW as a stable and strong credit that has suffered from association with parent Lloyds' travails and lower reporting transparency compared to peers. For more details, see *Initiating on UK Bancassurers – Lifting the Lid*, October 16, 2009.
- Strong positive newsflow of late has moved the bonds higher: (i) SCOTW benefited credit-wise by association from Lloyds' huge rights issue; (ii) bonds have been explicitly carved out from any future EC imposed block on optional coupons and redemptions; and (iii) rating agencies have reacted positively to the EC news, upgrading them to investment grade once more (Bloomberg composite rating of BBB).
- The bond structure fits relatively closely to CEIOPS' Tier 2 requirements, in our view. However, by being perpetual it is somewhat over-engineered in relation to what will be required going forward. Hence, the group has the opportunity to economically refinance the call with a relatively more defensive and investor-friendly structure, in our view.

# Disclosure Section

Morgan Stanley & Co. International plc, authorized and regulated by Financial Services Authority, disseminates in the UK research that it has prepared, and approves solely for the purposes of section 21 of the Financial Services and Markets Act 2000, research which has been prepared by any of its affiliates. As used in this disclosure section, Morgan Stanley includes RMB Morgan Stanley (Proprietary) Limited, Morgan Stanley & Co International plc and its affiliates.
For important disclosures, stock price charts and equity rating histories regarding companies that are the subject of this report, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures, or contact your investment representative or Morgan Stanley Research at 1585 Broadway, (Attention: Research Management), New York, NY, 10036 USA.

## Analyst Certification

The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report: Marcus Rivaldi, Jackie Ineke.
Unless otherwise stated, the individuals listed on the cover page of this report are research analysts.

## Global Research Conflict Management Policy

Morgan Stanley Research has been published in accordance with our conflict management policy, which is available at www.morganstanley.com/institutional/research/conflictpolicies.

## Important US Regulatory Disclosures on Subject Companies

As of December 31, 2009, Morgan Stanley beneficially owned 1% or more of a class of common equity securities of the following companies covered in Morgan Stanley Research: ING.
As of January 1, 2010, Morgan Stanley held a net long or short position of US$1 million or more of the debt securities of the following issuers covered in Morgan Stanley Research (including where guarantor of the securities): Generali, Standard Life, Legal and General, Aviva, AXA, ING, Friends Provident PLC.
Within the last 12 months, Morgan Stanley managed or co-managed a public offering (or 144A offering) of securities of Generali, ING.
Within the last 12 months, Morgan Stanley has received compensation for investment banking services from Generali, Standard Life, Legal and General, Aviva, AXA, ING, Groupama SA.
In the next 3 months, Morgan Stanley expects to receive or intends to seek compensation for investment banking services from Generali, Standard Life, Legal and General, Aviva, AXA, ING, Friends Provident, Scottish Widows, Groupama SA.
Within the last 12 months, Morgan Stanley has received compensation for products and services other than investment banking services from Standard Life, Legal and General, Aviva, AXA, ING, Friends Provident, ING Insurance, Scottish Widows.
Within the last 12 months, Morgan Stanley has provided or is providing investment banking services to, or has an investment banking client relationship with, the following company: Generali, Standard Life, Legal and General, Aviva, AXA, ING, Friends Provident, Scottish Widows, Groupama SA.
Within the last 12 months, Morgan Stanley has either provided or is providing non-investment banking, securities-related services to and/or in the past has entered into an agreement to provide services or has a client relationship with the following company: Generali, Standard Life, Legal and General, Aviva, AXA, ING, Friends Provident, ING Insurance, Scottish Widows.
Within the last 12 months, Morgan Stanley has either provided or is providing non-securities related services to and/or in the past has entered into an agreement to provide services or has a client relationship with the following company: AXA, ING.
Within the last 12 months, an affiliate of Morgan Stanley has received compensation for products and services other than investment banking services from AXA, ING.
An employee, director or consultant of Morgan Stanley is a director of Legal and General.
Morgan Stanley & Co. International plc is a corporate broker to Aviva.
The equity research analysts or strategists principally responsible for the preparation of Morgan Stanley Research have received compensation based upon various factors, including quality of research, investor client feedback, stock picking, competitive factors, firm revenues and overall investment banking revenues.
The fixed income research analysts or strategists principally responsible for the preparation of Morgan Stanley Research have received compensation based upon various factors, including quality, accuracy and value of research, firm profitability or revenues (which include fixed income trading and capital markets profitability or revenues), client feedback and competitive factors. Fixed Income Research analysts' or strategists' compensation is not linked to investment banking or capital markets transactions performed by Morgan Stanley or the profitability or revenues of particular trading desks.
Morgan Stanley and its affiliates do business that relates to companies/instruments covered in Morgan Stanley Research, including market making, providing liquidity and specialized trading, risk arbitrage and other proprietary trading, fund management, commercial banking, extension of credit, investment services and investment banking. Morgan Stanley sells to and buys from customers the securities/instruments of companies covered in Morgan Stanley Research on a principal basis. Morgan Stanley may have a position in the debt of the Company or instruments discussed in this report.
Certain disclosures listed above are also for compliance with applicable regulations in non-US jurisdictions.

### STOCK RATINGS

Morgan Stanley uses a relative rating system using terms such as Overweight, Equal-weight, Not-Rated or Underweight (see definitions below). Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we cover. Overweight, Equal-weight, Not-Rated and Underweight are not the equivalent of buy, hold and sell. Investors should carefully read the definitions of all ratings used in Morgan Stanley Research. In addition, since Morgan Stanley Research contains more complete information concerning the analyst's views, investors should carefully read Morgan Stanley Research, in its entirety, and not infer the contents from the rating alone. In any case, ratings (or research) should not be used or relied upon as investment advice. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations.

### Global Stock Ratings Distribution

*(as of December 31, 2009)*

For disclosure purposes only (in accordance with NASD and NYSE requirements), we include the category headings of Buy, Hold, and Sell alongside our ratings of Overweight, Equal-weight, Not-Rated and Underweight. Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we cover. Overweight, Equal-weight, Not-Rated and Underweight are not the equivalent of buy, hold, and sell but represent recommended relative weightings (see definitions below). To satisfy regulatory requirements, we correspond Overweight, our most positive stock rating, with a buy recommendation; we correspond Equal-weight and Not-Rated to hold and Underweight to sell recommendations, respectively.

| | Coverage Universe | | Investment Banking Clients (IBC) | | |
|---|---|---|---|---|---|
| Stock Rating Category | Count | % of Total | Count | % of Total IBC | % of Rating Category |
| **Overweight/Buy** | **953** | **39%** | **286** | **41%** | **30%** |
| **Equal-weight/Hold** | **1093** | **45%** | **322** | **46%** | **29%** |
| **Not-Rated/Hold** | **23** | **1%** | **3** | **0%** | **13%** |
| **Underweight/Sell** | **376** | **15%** | **82** | **12%** | **22%** |
| **Total** | **2,445** | | **693** | | |

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

**Analyst Stock Ratings**

Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

**Analyst Industry Views**

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

.

## Important Disclosures for Morgan Stanley Smith Barney LLC Customers

Citi Investment Research & Analysis (CIRA) research reports may be available about the companies or topics that are the subject of Morgan Stanley Research.  Ask your Financial Advisor or use Research Center to view any available CIRA research reports in addition to Morgan Stanley research reports.

Important disclosures regarding the relationship between the companies that are the subject of Morgan Stanley Research and Morgan Stanley Smith Barney LLC, Morgan Stanley and Citigroup Global Markets Inc. or any of their affiliates, are available on the Morgan Stanley Smith Barney disclosure website at www.morganstanleysmithbarney.com/researchdisclosures.

For Morgan Stanley and Citigroup Global Markets, Inc. specific disclosures, you may refer to www.morganstanley.com/researchdisclosures and https://www.citigroupgeo.com/geopublic/Disclosures/index_a.html.

Each Morgan Stanley Equity Research report is reviewed and approved on behalf of Morgan Stanley Smith Barney LLC.  This review and approval is conducted by the same person who reviews the Equity Research report on behalf of Morgan Stanley.  This could create a conflict of interest.

## Other Important Disclosures

Morgan Stanley produces an equity research product called a "Tactical Idea." Views contained in a "Tactical Idea" on a particular stock may be contrary to the recommendations or views expressed in research on the same stock. This may be the result of differing time horizons, methodologies, market events, or other factors. For all research available on a particular stock, please contact your sales representative or go to Client Link at www.morganstanley.com.

For a discussion, if applicable, of the valuation methods and the risks related to any price targets, please refer to the latest relevant published research on these stocks.

Morgan Stanley Research does not provide individually tailored investment advice. Morgan Stanley Research has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Morgan Stanley recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial adviser. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. The securities, instruments, or strategies discussed in Morgan Stanley Research may not be suitable for all investors, and certain investors may not be eligible to purchase or participate in some or all of them.

Morgan Stanley Research is not an offer to buy or sell or the solicitation of an offer to buy or sell any security/instrument or to participate in any particular trading strategy. The "Important US Regulatory Disclosures on Subject Companies" section in Morgan Stanley Research lists all companies mentioned where Morgan Stanley owns 1% or more of a class of common equity securities of the companies.  For all other companies mentioned in Morgan Stanley Research, Morgan Stanley may have an investment of less than 1% in securities/instruments or derivatives of securities/instruments of companies and may trade them in ways different from those discussed in Morgan Stanley Research. Employees of Morgan Stanley not involved in the preparation of Morgan Stanley Research may have investments in securities/instruments or derivatives of securities/instruments of companies mentioned and may trade them in ways different from those discussed in Morgan Stanley Research. Derivatives may be issued by Morgan Stanley or associated persons

With the exception of information regarding Morgan Stanley, Morgan Stanley Research is based on public information. Morgan Stanley makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete.  We have no obligation to tell you when opinions or information in Morgan Stanley Research change apart from when we intend to discontinue equity research coverage of a subject company. Facts and views presented in Morgan Stanley Research have not been reviewed by, and may not reflect information known to, professionals in other Morgan Stanley business areas, including investment banking personnel.

Morgan Stanley Research personnel conduct site visits from time to time but are prohibited from accepting payment or reimbursement by the company of travel expenses for such visits.

The value of and income from your investments may vary because of changes in interest rates, foreign exchange rates, default rates, prepayment rates, securities/instruments prices, market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in securities/instruments transactions. Past performance is not necessarily a guide to future performance.  Estimates of future performance are based on assumptions that may not be realized. If provided, and unless otherwise stated, the closing price on the cover page is that of the primary exchange for the subject company's securities/instruments.

Morgan Stanley may make investment decisions or take proprietary positions that are inconsistent with the recommendations or views in this report.

**The Americas**
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1)212 761 4000

**Europe**
20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
Tel: +44 (0) 20 7 425 8000

**Japan**
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0)3 5424 5000

**Asia/Pacific**
1 Austin Road West
Kowloon
Hong Kong
Tel: +852 2848 5200