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Europe

Investment Grade Credit

European Banks

Basel Boost

Constructive on banks into 2010. Recovery in the banks sector should play out over the next few years, not just 2010. We believe we're standing ahead of waves of new regulations on strengthening capital and liquidity, as well as the more risky parts of balance sheets. Over time, this should further strengthen the market's conviction on credit recovery – although admittedly it is not good for earnings.

Multi-year outperformance is expected by our credit strategists for sub financials, drawing the comparison with the telco sector from 2002 onwards. The greatest risk is a double-dip, but they attach a low probability to such an outcome.

LT2 should outperform senior. We're expecting a lot of senior debt issuance in 2010, although compared to pre-2008 levels, this should not be overwhelming. We view LT2 as a slowly dying asset class, and expect the basis between LT2 and senior debt to fairly rapidly diminish. We expect LT2 to continue to be called.

Tier 1 has a key catalyst. Our base case is that large banks continue to call Tier 1s, but the CEBS' allowance of grandfathering could be viewed as an argument that they should not. The market has ignored Basel's pronouncements on the topic so far, but we believe this could overturn grandfathering and cause Tier 1s to all trade on a yield to call (YTC) basis, or better, due to potential exchanges.

Recommendations across the board – the Basel boost to Tier 1s supports the whole sector, but we also like short-call LT2s in fixed and floating, specific credit stories such as Commerzbank, higher-quality names in Tier 1 with YTCs over 9%, ECNs and certain Lloyds Tier 1s with discretionary coupons.

Trade Recommendations

Bond	Ofr	YTC	YTP/M	Structure
BPCE € 5.25%	68.00	15.3	8.6	Vanilla Tier 1
UBS € 4.28%	63.00	14.7	8.4	Vanilla Tier 1
SWEDA $ 9%	96.50	21.2	7.0	Vanilla Tier 1
UCGIM $ 9.2%	98.00	11.6	7.6	Vanilla Tier 1
ACAFP $ 6.637%	80.00	10.6	7.7	Vanilla Tier 1
RABOBK $ 5.26%	87.00	9.1	6.9	Vanilla Tier 1
AIB $ FRN 10NC15	67.50	64.1	10.8	LT2
CMZB £ 5.905 %	46.00	19.4	13.4	Vanilla Tier 1

Source: Morgan Stanley, YTC: Yield to call; YTP/M: Yield to perpetuity/maturity

Basel Boost

Search for Yield in 2010 May Start in December

We have a very constructive view of European bank debt going into 2010. Indeed, considering the performance of the overall sector in 2009, we believe we are likely to see investors jostling to position themselves ahead of 2010, resulting in tightening spreads in December.

While senior debt may be somewhat buffeted by the pressure of new issuance, we expect LT2 to pull tighter towards senior levels, ultimately converging over time and significantly narrowing the senior/LT2 basis. **Tier 1 though remains our top pick,** primarily as we see a clear catalyst for transitioning the sector fully to a YTC basis (or better), and away from yield to perpetuity (YTP).

In this note, we'll first wrap up the background views from our strategists and economists, go through our thoughts on senior, LT2, UT2 and Tier 1 separately, and finish with a run-through of our recommendations.

BBB Backdrop – Good for Credit

Our economists are looking for a 'triple B' recovery in advanced economies – bumpy, below-par, boring. This type of recovery means central banks on hold for longer – in terms of rates and liquidity facilities – fuelling a 'triple A' liquidity cycle – ample, abundant, augmenting. Joachim Fels outlined this view in the *Morgan Stanley Strategy Forum*, November 2. The risks to this favourable fundamental backdrop for risky assets are that the global recovery could falter, leading to a double-dip, or that central banks could start to withdraw liquidity. In our economists' view, these fears are unfounded, with the global recovery being on track and monetary and fiscal policies remaining very stimulative in most countries, and likely extending well into 2010.

This type of recovery is positive for credit, and our strategists also view a double-dip as a remote risk (see *Don't Double-Dip Your Chips*, Andrew Sheets, November 6). Indeed, they are more concerned about the potential for stronger growth than expected, and the risks arising from that. **Our strategists remain overweight subordinated financials.** They point to a multi-year outperformance, akin to the telecom sector, which had six years of outperformance from 2003 – see our strategists' presentation, *Exit Stage Left*, October 29.

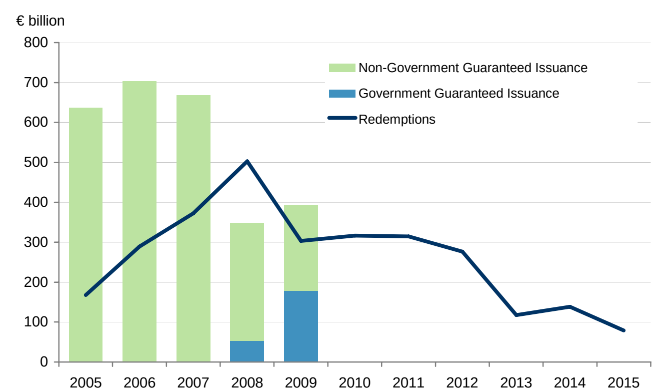
In our view, banks' healing will be driven in large part by regulation. This won't happen overnight, but will be a series of more conservative regulations over time covering capital, liquidity, risk-taking and de-leveraging, structurally de-risking the banking system. We've already had fairly draconian liquidity rules installed by the FSA, and the EU is set to follow suit (although it is unlikely to be as harsh).

All this is positive for debt investors, although the likely impact on bank earnings may well mean credit trumps equity while the regulatory burden mounts. As an aside, note that the majority of major banks are already at or above an 8% core Tier 1 ratio. Our equity analysts forecast that over three-quarters of the large banks will be at 8% by year-end – suggesting that we are already well into the recovery cycle for the sector.

Fears of Senior Supply, but Could Well Underwhelm

Investors are likely to be getting more confident in banks as the healing cycle plays out. One pressing concern is supply though. Our best estimate using Dealogic data suggests that there are around €310 billion of senior redemptions in 2010 and a similar level through to the end of 2012 (see Exhibit 1; note that these data do not include MTNs – either in terms of new issuance or maturities). If we add in MTN maturities for 2010, we get closer to €400 billion. Looking at a median figure of ECB lending of €450 billion pre-crisis, we are now around €600 billion, suggesting that there's €150 billion of extra liquidity that will be withdrawn – albeit over a lengthy timeframe, in our view.

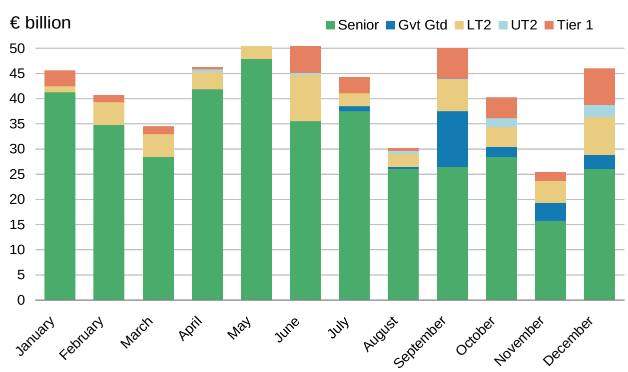
Exhibit 1
Senior Debt Issuance and Redemptions



Source: Morgan Stanley Research, Dealogic; Data exclude ABS and MTNs

As shown in Exhibit 1, in 2H09 we saw a strong re-opening of the market for unguaranteed senior issuance, with non-government guaranteed issuance outstripping government-guaranteed issuance in every month since April. The majority of guaranteed debt is of a 2-3-year maturity and so we would expect to see increased supply due to this in 2011 and 2012. In 2010, however, this is not likely to be a major driver, with only ~£20 billion of government-guaranteed debt maturing (mostly Irish). In the UK, the Special Liquidity Scheme (allowing banks and building societies to swap AAA RMBS and credit card securitisations for Treasury Bills which can then be repo'ed) stands at £185 billion. The Bank of England puts the roll off from this at £100 billion in 2011 and £85 billion in 2012.

Exhibit 2
2010 Redemptions



Source: Morgan Stanley Research, Dealogic; Excludes all ABS.

Exhibit 2 shows maturities for next year on a month-by-month basis, including bank capital and MTNs. **Considering the issuance levels pre-crisis, redemptions of €400 billion, plus what will be withdrawn by central banks, doesn't actually look huge, and senior supply should not overwhelm, in our view.** Issuance will certainly increase in 2010 as the government-guaranteed funding stops and banks are 'encouraged' to phase out ECB repo facilities (note that Spain and Ireland are most dependent on the ECB).

However, we do believe that there's downside at the margin on two fronts. While we expect the larger banks to easily tap the senior market, smaller banks may well struggle and have to issue at much wider levels. Again, though, we would not expect the central banks to put so much pressure on these banks that they would be forced to issue, no matter what. Second, aggregated data from the BoE suggest that our Dealogic data in the charts above are underestimating maturities. The BoE showed major UK banks' bond redemptions (not including government-guaranteed) at £150 billion in 2010 and £120 billion in 2011 and 2012. This assumes full take-up of the £250 billion Credit Guarantee Scheme, and allocates redemptions evenly across three years. The text accompanying these data states that, assuming full take-up, the major UK banks "might conceivably need to shrink their balance sheets or find alternative sources of funding of around £500 billion over the period to 2013, as various forms of public sector financing are progressively withdrawn". At the global level, the IMF states that rollover volumes peak at an "unprecedented" US$1.5 trillion in the euro area, UK and the US by 2012.

Set against this are other mitigating factors such as the ECB scheme to buy covered bonds (€22 billion so far, and expected to be completed in June 2010 when a ceiling of €60 billion should be reached), which also provides a way of senior financing, and this scheme has clearly opened up that market. We're expecting issuance volumes to increase here and for this market to be used for the longer maturities in particular, with a wider number of issuers including Italian, UK and Greek banks. The cost is lower than senior debt, but of course you need a very high-quality pool of mortgages to back such issues (note over mid-swaps for 5-year maturity, Italian covered bonds are around 40-45bp, Spain 60bp, Greece 80-85bp, UK 70-75bp and Ireland 160bp). Also, it feels like there's plenty of cash waiting for a home in senior debt, so new supply ought to be well absorbed. Finally, banks are deleveraging and fighting for increased deposits – two trends which we would expect to continue – which again may well dampen supply.

Taking all this together, the outlook for senior issuance does not look overwhelming, in our view, and we still like it as an asset class – **it just won't perform as well as LT2,** which we believe is 'as safe' as senior (albeit of course any mark-to-market volatility will be higher).

Lower Tier 2 – Still Calling

We are strong believers in calls (most recently discussed in *YTC – the New YTP*, October 26), and expect that **all 'on the run' banks we care about will continue to call – LT2s and Tier 1s.** From the regulatory side, there's a good reason to believe that this is a dying asset class. The UK FSA (in its Discussion Paper, published in March 2009) noted on page 61 that "for systemic banks there is little or no role for dated subordinated debt as eligible regulatory capital", and on page 69, relating to LT2, "these instruments are in fact of little or no value in terms of maintaining confidence in a firm in times of stress". Considering the very thin layer it provides below depositors and senior debt, this also suggests it has little value in protecting depositors in liquidation, although for certain smaller banks, this 'gone concern' loss absorption could well be important. The Swiss (outside the EU of course) have gone further, with the FINMA stating that LT2 will cease to form part of regulatory capital by 2020 (but can be issued through 2010).

Basel and the EU itself have yet to formally opine, but the mere absence of any mention of LT2 in statements regarding capital suggests that its future may well be bleak. While we're in limbo waiting for a Basel/EU edict on LT2, banks may well continue to issue LT2, as many regulators simply are loath to see total capital levels drop. However, we believe that over time issuance will tail off and LT2 will be called or mature, and not be re-financed – at least for the larger banks.

We prefer LT2 to senior due to this technical factor relating to a slowly dying asset class, the significant supply in senior versus LT2, the fact that far from all LT2s are being priced to call (and we're bullish there) and of course the yield pick-up versus senior. In our view, aside from the new UK Banking Act that allows debt to be moved around in a restructuring post-support (à la Northern Rock), and of course mark-to-market volatility, it's only subordination in liquidation that sets LT2 apart from senior. Note that the enhanced power of coupon cancellation for the BaFin only reaches down as low as UT2. Overall, we're expecting LT2 spreads to converge closer to senior.

UT2 – A Dead Asset Class

We won't dwell on it here as we've discussed it many times previously, but we believe UT2 is a dead asset class, and with senior funding levels having improved now, it looks less and less like cheap senior funding (albeit perpetual) if you ignore any regulatory benefit. Our view is that quality banks will call UT2 for reputational reasons and the fact it serves no purpose from a regulatory capital perspective. One argument for the existence of LT2 – that it absorbs regulatory deductions, 'saving' Tier 1 – can't really be made for UT2. Of the two, LT2 is always cheaper to issue, as a 'deductions absorber'. Looking through our outstanding € and £ UT2s, there's little to get excited about in terms of YTC, averaging around 6.5% – away from the hairier names. A bond which stands out (and is in our recommendation table) is SocGen in £.

Tier 1s – Boosted by Basel

Again, we believe that 'on the run' banks will call Tier 1s, and for more details of our reasoning here, please see again *YTC – the New YTP*. However, we understand the nervousness surrounding this generally, and the argument concerning grandfathering. The latter runs as follows. The EU began a debate on harmonising the variety of Tier 1 structures across Europe, well ahead of the crisis (in fact, the process was kicked off by the Capital Requirements Directive (CRD) in 2006). We published on this in *Tier 1 Under Review*, January 7, 2008, and *The EU and S&P – Looking Again at Capital*, April 23, 2008. The Commission charged the Committee of European Bank Supervisors (CEBS) with the task of coming up with a common definition of capital, and it has spent most of this year formulating specific guidelines for rational regulators (having spent 2008 getting broader principles agreed).

Decided very early on in this process was that effectively all outstanding hybrid Tier 1s would be grandfathered (see our research above for details). This means that when the new rules are implemented, old Tier 1 hybrids will continue to count as Tier 1 capital by regulators. Considering that hybrid Tier 1 under the new rules will have to be loss-absorbing, it may well be more expensive for banks to issue than old Tier 1 hybrids. **This reasoning would suggest that banks would be keen not to call old grandfathered hybrid Tier 1s,** leaving them outstanding as long as possible.

What the market seems to be less focused on is what's going on at the Basel/G20 level. Their review of capital that began AFTER the crisis showed that traditional Tier 1 does not absorb losses and is pretty much useless as a tool to support banks in the crisis. Basel's press release on September 7 included one sentence that is key for Tier 1 bondholders – **"Government injections will be grandfathered".** This followed broad statements relating to what capital should look like in the future. What we could take away from this statement is that other forms of hybrid (non-core) Tier 1, not provided by the government, will not be grandfathered. This may sound harsh, but bear in mind:

- The EU review started pre-crisis, before we knew Tier 1 hybrids 'didn't work' from a regulatory perspective. Hence grandfathering old Tier 1 was not a contentious issue.
- Basel/G20 began after it was clear they did not work. It would seem odd to point out that hybrid Tier 1 didn't help one jot in the crisis, and then allow the US$300 billion+ of hybrid Tier 1 out there to still be counted by the banks going forward as Tier 1.

The press release stated that the Basel Committee will issue concrete proposals by end-2009, with a final version being issued by end-2010. Considering the logistics of simply getting the Committee together, this could well be delayed, so we're looking for formal proposals in 1Q10.

So what would it mean, if we had such a proposal with explicit language relating to grandfathering of only government Tier 1? In our view, the EU would be loath to completely backtrack, and would not want to deliver any short, sharp shock to the system. In our view, what's likely is a compromise. This may well run along the lines of allowing grandfathering for, say, the shorter of five years or the call date. With the market expecting calls, tenders or exchanges (naturally, at a premium – otherwise the Tier 1 becomes senior debt) – **Tier 1s should start trading fully to the call date or better.**

New Tier 1 Should Be Palatable – CoCos Unlikely

CoCos (Contingent Convertibles) seem to be very much in vogue right now, with all investors wanting to talk about ECNs and other possible issuance of CoCo-like structures. We actually don't think this will be a large asset class. There are many reasons for this, but chief among them are the fact that ECNs aren't going into the indices (iBoxx undecided so far, but we expect it not to) and that every traditional Tier 1 buyer we have spoken to very much dislikes the conversion into equity feature. They certainly don't want to be 'forced buyers' and lobbied hard for their exclusion from the indices. Note also that Moody's has suggested it won't rate CoCos, depending on the structure.

Do remember the Lloyds' ECNs were an exchange – have these or end up with Tier 1s which may be illiquid, may not pay under certain circumstances, are unlikely to be called, and here are the ECNs with much better coupons and a final maturity... Selling such an instrument outright would have been far more difficult, in our view. We also question how CoCos would really work from a regulatory perspective – set the trigger too low and, for the larger banks, at least in the coming couple of years, the government intervenes before it's breached; set it too high, and the instrument becomes very expensive to issue.

The other key reason for not believing CoCos will thrive as an idea is that there is a better way. According to CEBS' deliberations so far (see CEBS' Consultation Paper 27, June 22, for details), new hybrid Tier 1 must be loss-absorbing – but this may well be structured like German silent participations – with a write-down but also a write-up. This certainly 'shares the burden' of losses with equity holders, while giving investors a future in terms of potential par back if the bank recovers. Due to this loss-absorption, we don't go back to the situation of value transfer from shareholders to other providers of capital, as we had in the crisis. It also provides an avenue for those banks which don't have equity.

These structures can have calls and steps, and immediate (if it fails, the coupon is lost) ACSM on the coupons (required in many jurisdictions to make them tax-deductible), making them again more palatable to investors. On the latter point though, there is some discussion as ACSM at a point when the coupon is being deferred is likely to be extremely dilutive. In terms of limits, 15% remains for Tier 1s with incentives to redeem, 35% for those without, and a 50% overlaid limit for instruments which convert into core Tier 1 in emergency situations.

All in all, we can certainly see how new hybrid Tier 1 would be attractive to the traditional investor base in the asset class, meaning that exchanges from old Tier 1, clearly at a premium, would be acceptable. At the last public meeting of CEBS, it noted that in terms of what new Tier 1 will look like, it did not expect any radical changes coming from the Basel process. Hence we feel pretty comfortable in expecting acceptable, affordable (for banks) new Tier 1 instruments to come out of the CEBS process (final deliberations expected by the end of this year). **Where there is a good chance of a shake-up of the Tier 1 sector is in grandfathering – pulling every bond much tighter.**

Trade Recommendations

Forgive us for the sheer number of bonds we mention below, but this is aimed as a 2010 outlook piece, and so we'd rather give a broad selection of bonds we like than drilling down too far. Ultimately, our strong view on a catalyst for Tier 1 spreads means we like most bonds in that asset class in general. With our Basel grandfathering thesis in mind, we'd be more inclined to pick up the recent laggards, focusing on those bonds with low back-end steps, which have significantly underperformed bonds, often from the same issuer, with high back ends. A simple example of this (and we have others in our tables) is **Credit Agricole**, whose 7.875% 19s were issued at par and have traded up to 106.5, while at the same time its 4.13% 15s went from 85 to 78.

Rather than indiscriminate buying of Tier 1, of course there's a much more conservative approach, and with our general view (quite aside from Basel actions) that banks will call, we'd be focusing on the short-to-medium-dated callable Tier 1s.

More generally in any adding of Tier 1s, we'd focus on the better names which are from high-quality issuers and still have good yields to call – again, a more conservative approach than indiscriminate buying, and certainly one potentially more palatable to investors approaching year-end right now. Note that we now have a financials trader making markets in retail Tier 1 – hence the inclusion in Exhibit 4 of SocGen's retail Tier 1 – showing a much better YTP than its institutional peers, if you're more worried than us about calls – and BBVA may also be of interest in that respect. We've also popped the £ UT2 of SocGen in there that we liked – as we do believe in calls, this is a nice 9.7% YTC and of course as UT2, it has better subordination and cumulative coupons.

In terms of a 'story' name, we like Commerzbank £ 5.905% Tier 1s, offered at 46 (19.4% YTC, 13.4% YTP). We believe that although the EC has turned off discretionary coupons, the coupons on this bond are in fact mandatory due to pusher language. Two of its parity bonds have mandatory pay coupons in their own right, and hence push the £ 5.905% coupon.

Exhibit 3

Short and Medium-Dated Calls

Rec	Bank	Ccy	Coupon	Call date	Offer price	YTC	YTP/ YTM	Step	Structure/comment
Medium-Dated Calls									
Buy	HVB	€	7.055	28-Mar-12	84.00	15.7	8.1	3-month Euribor+257bp	Vanilla Tier 1
Buy	HSBC	$	4.61	27-Jun-13	87.50	8.8	7.0	3-month $Libor+199.5bp	Vanilla Tier 1
Buy	Societe Generale	€	5.419	10-Nov-13	81.00	11.7	7.3	3-month Euribor+195bp	Vanilla Tier 1
Buy	BPCE	€	5.25	30-Jul-14	68.00	15.3	8.6	3-month Euribor+184bp	Vanilla Tier 1
Buy	UBS	€	4.28	15-Apr-15	63.00	14.7	8.4	3-month Euribor+158bp	Vanilla Tier 1
Buy	Danske	$	5.914	16-Jun-14	83.00	10.7	7.4	3-month $Libor+166bp	Cumulative Tier 1
Short-Dated Calls									
Buy	Barclays	$	7.375	15-Dec-11	93.00	11.3	7.3	3-month $Libor+233bp	RCI – cumulative
Buy	Unicredit	$	9.2	05-Oct-10	98.00	11.6	7.6	3m $Libor+335bp	Vanilla Tier 1
Buy	UBS	$	8.622	02-Oct-10	93.50	17.3	7.9	3-month $Libor + 307bp	Vanilla Tier 1
Buy	Swedbank	$	9	17-Mar-10	96.50	21.2	7.0	6-month $Libor+270bp	Vanilla Tier 1

Source: Morgan Stanley Research, Bloomberg

Exhibit 4

Higher-Quality Names

Rec	Bank	Ccy	Coupon	Call	Offer price	YTC	YTP/ YTM	Step	Structure/comment
Buy	Credit Agricole	$	6.637	31-May-17	80.00	10.6	7.7	3-month $Libor+123.25bp	Vanilla Tier 1
Buy	Credit Agricole	£	5.136	24-Feb-16	78.50	9.9	7.6	3-month £Libor+157.5bp	Vanilla Tier 1
Buy	Standard Chartered	$	6.409	30-Jan-17	83.00	9.8	7.7	3-month $Libor+151bp	Non-Step Tier 1
Buy	Rabobank	$	5.26	31-Dec-13	87.00	9.1	6.9	3-month $Libor+162.75bp	Vanilla Tier 1
Buy	BBVA	€	8.5	21-Oct-14	103.5	7.6	9.3	3-month Euribor+574bp	Non-Step Tier 1
Buy	BPIM	€	6.756	21-Jun-17	64.50	14.9	10.1	3-month Euribor+188bp	Non-Step Tier 1
Buy	Barclays	$	5.926	15-Dec-16	78.00	10.4	8.0	3-month $Libor+175bp	Cumulative Tier 1
Buy	Societe Generale	$	5.922	5-Apr-17	79.00	10.0	7.8	3-month $Libor+175bp	Vanilla Tier 1
Buy	Societe Generale	$	8.75	7-Apr-15	99.65	8.8	8.8	-	Retail Tier 1
Buy	Societe Generale	£	5.75	27-Mar-12	92.00	9.7	6.0	3-month £Libor+110bp	Upper Tier 2

Source: Morgan Stanley Research, Bloomberg

Exhibit 5

Lloyds' ECNs

Original security	Ccy	ECN coupon %	ECN maturity	Offer price	ECN YTM %	Amount exchanged
HBOS 4.939 %	€	6.439	23-May-20	74.75	10.5	710,523,000
HBOS 9.54 %	£	11.04	19-Mar-20	104.00	10.4	736,211,000
Lloyds 7.834 %	£	9.334	07-Feb-20	93.00	10.5	207,563,000
Lloyds 6.0884 %	£	7.5884	12-May-20	82.00	10.5	732,276,000
Saphir 6.369 %	£	7.869	25-Aug-20	83.50	10.5	596,665,000
Lloyds 4.385 %	€	6.385	12-May-20	74.75	10.5	661,955,000
Lloyds 13 %	£	15	21-Dec-19	125.00	10.9	775,158,000
Lloyds 13 %	€	15	21-Dec-19	123.00	11.1	486,527,000
Lloyds 13 %	£	15	22-Jan-29	127.00	11.5	67,853,000

Source: Morgan Stanley Research, Bloomberg

We're always asked nowadays about ECNs, so it's worth including an update on where they are trading. **We believe these will settle down at a 9-10% YTM** (see *Lloyds – Trigger Happy*, November 5). They may well benefit from a January 'grab for yield', as it's pretty hard to lock in anything over 10% in our financials sector, without relying on calls.

Of those Lloyds bonds which did not get exchanged, we stress-tested the 'may pay' bonds for two years' of missed coupons, to get a better feel for value. Note that although Lloyds cannot call in the next two years, we understand it verbally reiterated that it is not changing its current policy towards bonds that did not get exchanged, in terms of calling. Although Lloyds has not stated it outright, we view this as an indication that it will do what it can to call these bonds. Of course, our 'Basel Boost' thesis suggests that all these will be called – or exchanged into new Tier 1s. We recommended selling the $ prefs of Lloyds in our *Trigger Happy* note, and at current prices would still prefer other bonds such as the 'must pays' and 'may pays' below them in the table, all retail Tier 1s (the last four bonds). On the basis of best YTP, Lloyds £ 13% 29s stand out. Again, we'd go for best YTC for the reasons above, hence **the £ 8.117% look best value to us,** although they are hard to find.

Again with our strong view on calls, we've included in Exhibit 7 a number of LT2s with good yield to calls. As we've written about in the past, the AIB $ FRN is showing a 'worst' YTM of 10.8%. We believe that AIB won't be able to call bonds for the coming two years, but can call after then – hence potentially shortening the final maturity.

Exhibit 6

Lloyds Tier 1s Which Did Not Get Exchanged

Issuer	Ccy	Coupon	Call date	Offer price	YTC	YTM/ YTP	Step up	Structure	Coupons
Lloyds	£	8.117	31-May-10	75	15.3**	8.8	5yr UKT+385bp	Vanilla Tier 1	Must Pay
HBOS	£	7.286	31-May-16	76	12.8	9.9	5yr UKT+364.5bp	Vanilla Tier 1	Must Pay and ACSM
HBOS	£	6.461	30-Nov-18	65	13.2	10.2	5yr UKT+285bp	Vanilla Tier 1	Must Pay
Lloyds	£	7.754	31-May-21	78	11.2	10.2	5yr UKT+420bp	Vanilla Tier 1	Must Pay
HBOS	£	7.281	31-May-26	74	10.7	9.9	5yr UKT+409.5bp	Vanilla Tier 1	Must Pay and ACSM
Lloyds	£	13	21-Jan-29	108	11.9	12.4	5yr UKT+1340bp	Vanilla Tier 1	May Pay and ACSM
HBOS	£	7.881	09-Dec-31	76	10.4	10.4	5yr UKT+385bp	Vanilla Tier 1	Must Pay
Lloyds	$	6.657	21-May-37	56	11.3*	9.7*	3m $Libor+127bp	Non Step Tier 1	May Pay
Lloyds	$	5.92	01-Oct-15	56	15.6*	8.6*	3m $Libor+129.5bp	Non Step Tier 1	May Pay
Lloyds	$	6.267	14-Nov-16	56	14.4*	8.8*	3m $Libor+103.5bp	Non Step Tier 1	May Pay
Lloyds	$	6.413	01-Oct-35	56	10.3*	9.9*	3m $Libor+149.5bp	Non Step Tier 1	May Pay
Lloyds	$	6.9	22-Feb-10	69	25.6**	10.1	-	Retail Tier 1	Must Pay and ACSM
HBOS	$	6.85	23-Mar-10	64.5	28.8**	10.7	-	Retail Tier 1	Must Pay
Lloyds	$	7.875	29-Nov-13	61	17.9*	10.6*	-	Retail Tier 1	May Pay
Lloyds	€	7.875	29-Nov-13	60.5	17.9*	10.4*	-	Retail Tier 1	May Pay

Source: Morgan Stanley Research, Bloomberg; *Assume coupons missed 31 Jan 2010-12; **Call date taken as first possible call date after 31 Jan 2012; note that 8.117% is callable every 5 years.

Exhibit 7

LT2 with Short Calls

Rec	Bank	Ccy	Coupon	Call	Maturity	Offer price	YTC	YTM	Step	Structure
Buy	AIB	$	FRN	30-Jul-10	30-Jul-15	67.50	64.1	10.8	3-month $Libor+80bp	Callable LT2
Buy	Barclays	$	FRN	25-May-10	25-May-15	95.50	9.5	4.1	3-month $Libor+70bp	Callable LT2
Buy	Abbey	£	5.25	21-Apr-10	21-Apr-15	98.50	8.9	4.9	3-month £Libor+75bp	Bullet LT2
Buy	AIB	€	12.5	-	25-Jun-19	103.5	-	11.8	-	Bullet LT2

Source: Morgan Stanley Research, Bloomberg

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