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Industry View
In-Line

European Banks

Euro-TARP – 10 things you need to know

The market has misread the dimensions and some implications of EU bank recaps, we think. A €100bn+ recap should help reduce systemic risk but will not stop banks shrinking, and is dependent on effective sovereign backstops. We see value in a small handful of champions; bearish on earnings.

We think the “9%” the recap will use is *not* in the EBA “adverse” case but meant to be a new “benchmark” after Greek restructuring and sovereign stress. This means the capital deficit is rather €100bn+ (as we have argued before), lower than the €220-300bn in the market. Our analysis suggests deficits may be €2-5bn at Deutsche (vs. street €7-14bn), €0-3bn at BNP (vs. €5-14bn), €2-4bn at Soc Gen (vs. €5-13bn), and zero at RBS (vs. €5-€19bn). Banks will be given 5-8 months to recap, and with more deleveraging these deficits and dilution could be lower.

Implications: The success of the exercise depends on sovereign backstops and more intense bank funding support. Banks are not being recapped to a “stressed” loan book scenario, impacting credibility in Southern Europe. Bank and regulator behaviour (e.g. recap or shrink) will be key to how much risk there is to the economic outlook. We think banks will in any case shrink and are still likely to delever~€2tr by 2012 with risks to SME lending, trade finance, leasing and wholesale banking – and that is why we have argued since July that we see the risks of a credit crunch, although we hope intense policy response this weekend will reduce this risk.

We still see multi-year balance sheet retrenchment and challenging fundamentals. We are Underweight 3/4 of domestic Spanish and Italian stocks we cover and our estimates are 20-50% below street. But given extreme investor negative positioning and signs of steps to address bank/systemic risk, we are Overweight a handful of champions where we see TARP risk as low, such as HSBC, BNP, DnBnor and Sberbank.

What's Changed

| | |
|-------------------------------------|--------------------------------|
| Deutsche Bank (Equal-weight) | PT from €47 to €38 |
| (DBKGn.DE) | 2011e MW EPS down 16% to €5.14 |
| | 2012e MW EPS down 14% to €5.59 |
| | 2013e MW EPS down 12% to €6.30 |

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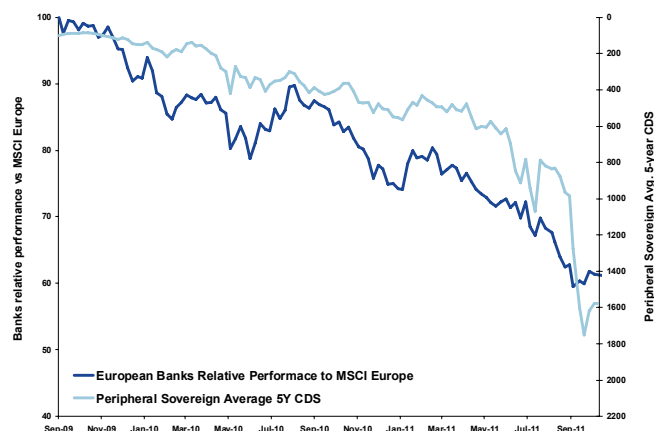
Investment Case

Summary & Conclusions

Our broad thesis over the last 18 months has been that without decisive measures to address the stress in sovereign funding, bank funding and bank solvency, the sector is a value trap faced with massive balance sheet retrenchment. Intense action is needed at each and every level. The sector has seen a 70% correlation with the spreads of peripheral/Southern European sovereigns funding – underscoring the key issue.

Exhibit 1

Banks equity and credit have largely been a function of sovereign risk - with intense feedback loops. Policy response so far has proved largely ineffective



Source: MSCI, FactSet, Quotient Analytics, Morgan Stanley Research. Data as at 14 October 2011

However we argued recently “*The intensity of policy debate to address the 3 interconnected issues of the stress in sovereign funding, the stress in bank funding and concerns on bank solvency we think has stepped up materially – although we think the action plans are still not agreed and worked up.*” As a result in recent weeks we have been encouraging investors to buy a very small basket of national champion banks to play systemic risk compression given extreme investor positioning and signs of steps to address bank/systemic risk – notwithstanding our long-standing concerns. These were banks we thought would benefit from systemic risk compression but had lower recap risk such as HSBC, DnBNor, Sberbank, KBC, Barclays, and BNP.

Many bank stocks have since rallied on the hope of the start of more coherent policy to address Europe’s crisis but we think the market has not correctly

factored the dimensions and implications of bank recaps. A €100bn+ recap should help reduce systemic risk but will not stop banks shrinking and is entirely dependent on effective sovereign backstops. We see value in only a handful of champions, and are bearish on earnings.

To be clear, we also still view high funding costs, deleveraging and weaker economies as major risks, and we remain 20-50% below consensus for domestic Spanish and Italian banks: we rate 3/4 of these stocks Underweight. **Least preferred:** BPM, BP, Bankinter, RBI, Lloyds.

Given we think the market may have misread the indications from the EU bank recap process and therefore the dimensions and implications of such a change, we’ve highlighted briefly 10 key points and then look at the scenarios for a number of Europe’s large-cap banks. Up front, we should clearly caveat we have tried to work out outside-in what the EU may do on bank capital rather than should do (in this note) and given numerous assumptions, we caution investors to have too literal a reading of any point estimate of capital shortfall.

1. We think the size of the recap is more likely to be €100bn+ and think the €200-300bn street estimates too high

We argued two weeks ago that we thought €100-200bn was likely the size of the recap rather than the €200-300bn the street has suggested. We show later that for the larger listed banks we cover, the amount to recap may be just €30-40bn, although could be higher if our assumptions are off. This means that the system maybe €100-150bn, although we realize the plan is still in flux. This said, we do also argue later that the lack of tiering by country/bank means that the EU recap may not be the ideal amount at a bank level that bank funding markets would wish to see. It also means the markets’ fear of dilution may well be too high.

2. To reduce the burden on the public purse, banks will be given 6 and maybe up to 9 months to recap – leaving many

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uncertainties

This means that uncertainties on the share count for banks could persist for a long while and for much of the sector this will be a clear overhang. It also places more weight on the other parts of the policy mix such as a hard backstop for Italy and Spain. Clearly – though – if the private round and lower aggregate recap numbers were to prove successful (at this stage a big if) we believe the pressure on some sovereign deficits will not be quite as harsh as the market is currently fearing. We think the instrument is likely to be a preferred share with some convertibility features. For example, if the instrument had not been paid back in the next 3 years and core Tier 1 had not reached say 7% or 8% in 3 years' time, then the instrument would convert into core Tier 1. But the hope is the bank raises capital to pay this down in an orderly fashion. It is also possible warrants may be attached for tax payers to enjoy any capital gains for their extraordinary support, should it happen. This clearly makes the impact on bank share counts very difficult to assess today.

3. We think the market has misread some of the dimensions around individual banks.

For instance the market is concerned about the size of a recap for BNP. Our analysis suggests at 1H 2011 the capital deficit may be €3bn – but BNP could earn this in less than 6 months and so the actual dilution could be very modest (although we cannot rule out capital raising). In contrast the street is estimating €5-13bn. On the other hand, the street assumes RBS would have the largest capital raise of any European bank on EBA methodology (€6-19bn), and yet we show that on what we think is the EBA methodology, RBS would not need to raise capital (although again one cannot rule out the company itself taking a different view to the EBA test). We show later on how we think the test is likely to score the banks in quite a different way than the sell side has been suggesting.

Exhibit 2

We compare our new methodology to that from the stress tests and consensus and see that the shortfall for a number of banks is significantly smaller (€bn)

| | Shortfall based on new Q2 B2.5 Method | Shortfall based on EBA 2011 stress test - 2012 Adverse | Consensus |
|--------------|---------------------------------------|--|-----------|
| RBS | 0.0 | 18.6 | up to 19 |
| BNP | 3.1 | 9.8 | up to 14 |
| DBK | 5.0 | 7.6 | up to 14 |
| Soc Gen | 3.7 | 11.3 | up to 13 |
| Barclays | 0.0 | 11.1 | up to 13 |
| BPCE | 3.4 | 11.8 | up to 13 |
| UCG | 3.7 | 12.5 | up to 12 |
| CBK | 0.6 | 8.8 | up to 12 |
| TOTAL | 19.5 | 91.5 | |

Source: EBA, Morgan Stanley Research, press reports

4. We fear that the “benchmarking” will not differentiate by quality of loan book and bank’s position, particularly for Spain, Italy and the periphery.

We have argued we think banks in the periphery should be depression-proofed and banks in the core recession-proofed. Whilst we realize that consensus building in Europe looks for common standards, we think it is a mistake to not take account of differences in business/funding model, asset quality and degree of national uncertainty in assessing bank capital. This was exactly what the stress tests got wrong on CAM, Dexia and so on. Funding markets will reflect on which banks are in AAA countries vs. ones with high NPLs and faced with massive austerity. This means the new EBA benchmarking exercise may not draw a line under capital needs in say Spain. Alvaro Serrano showed in his research a Blackrock-style scenario for Spain could lead to far higher capital needs. (See Alvaro’s note [Spanish Banks: Tough 2012 Ahead; OW BBVA for EM Growth](#)). We think this means the EU bank recap plan may not have the degree of credibility that policy makers would ideally like and also mean that Spain and other countries will still have risks into 2012.

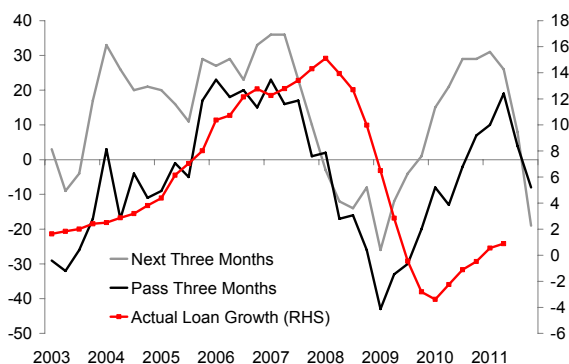
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5. We are very concerned banks will also have the incentive to delever more quickly (a “crash diet”) to pass the tests.

We have repeatedly argued that, unchecked by policy support, we see the risk of a credit crunch in parts of Europe due to sovereign stress and see banks shrinking their balance sheets €2tr by 2012e, negative for growth. Our recent analysis of the ECB lending survey showed us clearly the risks to the downside from funding and capital strains and a dramatic fall in business and consumer confidence. (See *ECB Lending Survey & funding strains underscore policy challenge*, October 10, 2011). Whilst some wholesale banks in the North can exit parts of wholesale banking where international competitors could pick up the slack, it less clear to us this is the case in retail/commercial banking in Southern Europe. We note the IMF suggests a (4)-(6)% change in bank lending recently, if unchecked by policy support. We also think that absent major moves on sovereign support, the market will find such a long timeline – in contrast to US TARP – lacks credibility.

Exhibit 3

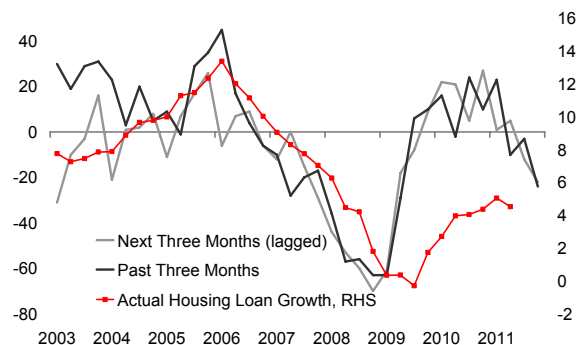
ECB lending survey showed a sharp fall in expected and actual corporate lending. Consumer fell materially too



Source: ECB

Exhibit 4

Whilst household demand continued to fall in Q3 - deteriorating significantly



Source: ECB

6. Bank and regulator behaviour (e.g. whether to recap or shrink fast) will be key to how much risk there is to economic recovery.

We hope many retail and commercial banks – alongside their regulators – will carry on lending domestically with the support of the ECB backstop. However, we think the risks of shrinking non-domestic/non-core lending will be very high. For instance we think the risks to CEE of bank shrinkage are very high – and in part is why we are bearish on the outlook for CEE banks (see Magdalena Stoklosa’s note [EEMEA Banks: Structural Rebalancing: Growth and Funding Risks](#)).

7. To slow bank deleveraging, more could be done to support bank funding during the uncertainty.

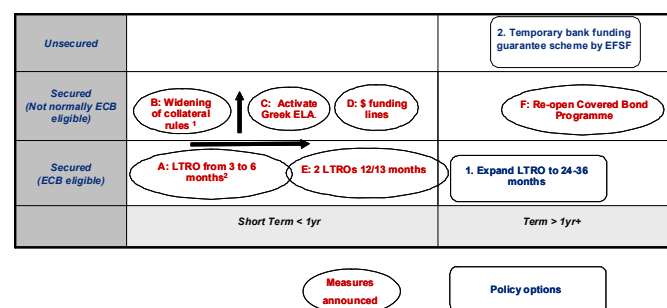
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We realise the ECB has undertaken 6 initiatives this summer to support bank funding but we still think this is insufficient (absent a bazooka for sovereign support). In our August think piece, we argued the case for a temporary bank funding guarantee scheme – we still think this is best solution to support bank funding. We think a scheme via EFSF or EIB would still be the single best outcome – like we saw with TLPG in the US or similar schemes in Europe. We think banks will be looking to shrink books that are capital consumptive and consume unsecured funds. **Areas in which banks will shrink include asset finance/leasing, commercial real estate, unsecured consumer lending, working capital for SME, trade finance and syndicated lending.** We do think that banks rationing unsecured funds too abruptly will be negative for economic growth – although we realize the execution of the new plans and backstops will be critical to the actual outcomes. We have argued elsewhere we see the risk of €2tr asset shrinkage by 2012. We also think that given these are businesses that consume unsecured funds, these are not assets which are easy to sell to private equity (as how would they finance them aside from vendor finance or equity?). Rather asset leasing businesses are likely to be run down or sold to Asian/Japanese or certain US banks. We think many of the sales maybe to other banks, given the funding issue.

Exhibit 4

There are 2 further policy options to support term funding for European banks; extend LTRO to 24-36 months; temporary bank funding guarantee



Source: Morgan Stanley Research

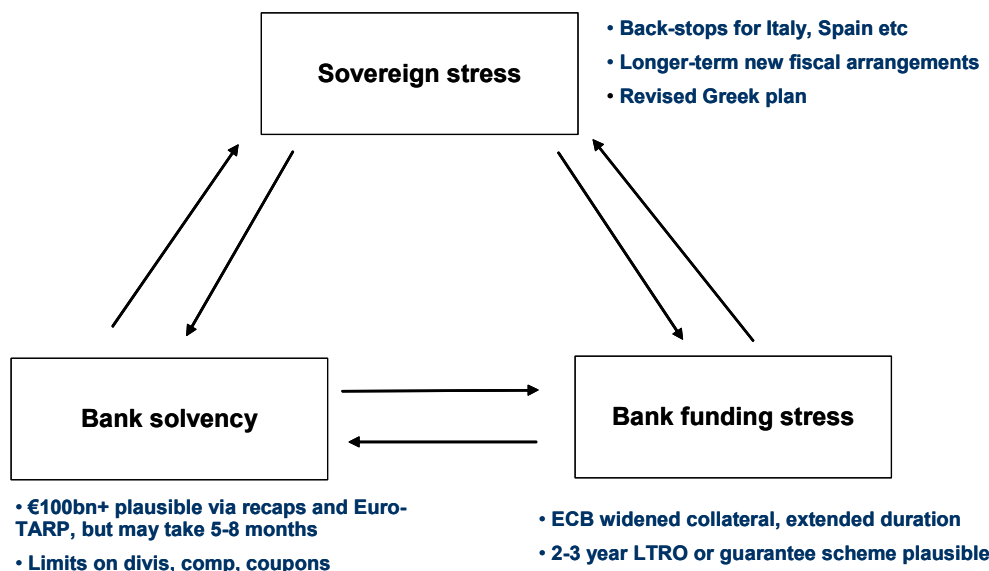
Areas which banks will shrink include asset finance/leasing, commercial real estate, unsecured consumer lending, working capital for SME, trade finance and syndicated lending.

8. The success of the exercise is entirely dependent on the nature of sovereign backstops since this number is not recapping to a “stressed” scenario.

We have regularly argued if Spain and Italy are not worth par, then the whole European banking system is in peril and capital needs an order of magnitude higher than this exercise may generate. We realize this is the single most important question – but for today we have tried to limit ourselves to the bank piece and advise investors to see related notes by Elga Bartsch, Joachim Fels, Neil McLeish and colleagues.

Exhibit 5

Sovereign stress is the key issue for banks, but the feedback loops between banks funding and solvency back on the sovereign are intense



Source: Morgan Stanley Research

9. Another key risk is on how banks appetite for sovereign bonds may change

An official exercise which haircuts Italian, Spanish and other sovereign bonds has the potential for some very negative signals. Will investors realize that this is simply the way the EU is trying to meet investors concerns with sincerity and manage around the problem of having tiered capital levels – or will investors get spooked by an official test with major market bonds being assessed below par? Clearly the nature of the sovereign backstop is everything. Also, banks surely will have reduced incentive to own bonds across borders and even bank in a market of long-dated bonds. Who will then buy long-dated Southern European government bonds? Whilst bank regulators may say this is already the direction of travel (viz Deutsche's shrinkage of Italian and other government bonds in 1H), it is hardly positive for the EU's ability to juggle the balls. We also think methodologically a test which takes off marks on Southern

European debt but does not give the positive uplift for German and other bonds is flawed.

10. We think investors should also reflect on the signal this sends about Basel III and impact on dividends and size of capital raises for wholesale banks

Whilst originally regulators signaled they didn't want to jack up capital ratios in the midst of the crisis – or else risk the mistakes of 1937 in the US (and other examples), this exercise clearly suggests otherwise, if we have understood it correctly. We think when investors and banks will need to reflect on capital raising, they will also need to lay out plans to hit Basel III targets at a time when the confidence in organic capital generation is much lower. That is why we think dividends are going to be highly constrained.

We are also intrigued over whether this sends a signal to US and other international banks about how fast the official

community wants banks to reach new standards, even if this exercise should in essence be about making European banks more resilient to sovereign shockwaves. JPM's Dimon suggested on its recent 3Q11 conference call that it is waiting for regulators to state whether or not the 2019 capital timeframe is being moved up. Either way, our US colleagues think JPM wants to maintain strong capital ratios. So even if the regulators remain silent on changes to Basel 3 timing, our US colleagues would not be surprised if JPM ceased buybacks until it got to a 10% common tier 1 ratio (est. mid-2013). Any regulator or market demand for more capital quickly reduces flexibility in the system to heal. That's because better capitalized banks are reluctant to buy riskier assets, even if today's cash flows are good, given need to show higher capital ratios. It will be difficult to purchase below investment grade assets due to high capital charges for bank borrowers. Also US banks may hesitate to buy large operating businesses until European risk fades. As a result, expect a somewhat slower reduction in troubled assets. Our US colleagues Betsy Graseck and Mike Cyprus see JPMorgan and Citi capital ratios at 9%+ on a like-for-like basis with Europe's capital ratios by YE '12 where Europe is calculating with a Basel 2 numerator and a Basel 2.5 denominator. BAC is more likely in the 7.5-8.5% range, in our view, and we'll tighten this range post the 3Q11 results on Tuesday, Oct 18.

Catalysts

We expect the plan to go to Ecofin this week and we hope it to be announced (at least in concept) this weekend. We expect the details by stock will take longer. Whilst the EBA originally said the details by company would not be made public, which strikes us as highly imprudent, we simply can't believe this is an acceptable, confidence-enhancing outcome and so discount it as unlikely.

Will it work and stock implications

In our last note we highlighted a parallel with GK Chesterton's quote that "When people stop believing in God, they don't

believe in nothing – they believe in anything". We thought it felt the same in European sovereign debt markets. If you start doubting whether you will get your money back on Italian or other sovereign bonds – as indeed investors have been – then you simply can't trace the full implications and there is no practical amount of recap which we think could persuade investors banks could withstand such a scenario. So, our answer on if this plan succeed is entirely dependent on what the plan is to backstop the sovereigns and how Greece is played out. We realize the fact the last 2 years would suggest to take the bearish tack, but with pressure from the G20 and IMF, and the realization from some policymakers that the alternative for Europe is not "Japan" but the 1930s should the backstop plan fail, we are open minded to have a small number of longs in European banks to play a bear market rally.

We keep with our selected market champions call, where we think banks should benefit from systemic risk compression but have lower TARP risk. For instance if our analysis proves correct, the market is over-estimating the risk of dilution at BNP – one of the stocks in our portfolio. Below we highlight the latest valuation given how much things have moved. HSBC, DnBNor, Sberbank, Barclays, and BNP are our "most preferred".

As we said above, we still believe the challenge for earnings is profound and that many banks will also see material hits to earnings power. **Least preferred:** BPM, BP, Bankinter, RBI, Lloyds.

Given this is our sixth note on the policy response on bank capital and bank funding in the last 3 months, we refer investors to four other related notes:

- [Banks: Euro-TARP intensifies, ECB aids funding: how to play it?](#), October 7, 2011
- [European Banks: Stress in bank funding and policy implications - update](#), September 9, 2011
- Neil McLeish and Greg Peters: [Cross-Asset Navigator: Europe: Expect Progress, But No Silver Bullet](#), September 30, 2011 and
- Arnaud Mares: [Sovereign Subjects: The Economic Consequences of Greece](#), August 31

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Exhibit 6

European Banks Valuation – many banks still at 0.3-0.7x TNAV

| 14 Oct 11 | Company name | MS Rating | Mkt cap (€bn) | Curr. | Price | Price Target | Up/Down side | Earnings per share | | | | | Price to earnings | | | | DPS | | P/ TNAV 2011e | RoTNAV 2011e | Core tier 1 ratio 2011E | Stock Performance | | | | Shares O/s | | |
|------------------|--------------------------|-----------|---------------|-------|-------|--------------|--------------|--------------------|-------|-------|-----------|-------|-------------------|--------------|-------|-------|-----------|------|---------------|--------------|-------------------------|-------------------|-------|------|------|------------|-----|-----|
| | | | | | | | | MS Estimates | | | Consensus | | 2013C | MS Estimates | | | Consensus | | | | | 2011e | DY11e | 1M | 3M | | 12M | YTD |
| | | | | | | | | 2011e | 2012e | 2013e | 2012C | 2011e | | 2012e | 2013e | 2012C | | | | | | | | | | | | |
| France | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | Societe Generale | O | 16.8 | EUR | 21.1 | 26.9 | 27% | 4.8 | 5.1 | 5.2 | 5.4 | 5.9 | 4.5x | 4.3x | 4.1x | 3.9x | 0.0 | 0.0% | 0.5x | 12.0% | 10.0% | 21% | -40% | -50% | -46% | 755 | | |
| | Natixis | U | 7.1 | EUR | 2.3 | 3.3 | 44% | 0.4 | 0.4 | 0.4 | 0.5 | 0.5 | 5.3x | 5.8x | 6.0x | 5.0x | 0.2 | 9.5% | 0.5x | 9.4% | 8.9% | 0% | -29% | -47% | -34% | 3,077 | | |
| | Credit Agricole | E | 13.2 | EUR | 5.3 | 9.6 | 82% | 1.4 | 1.5 | 1.5 | 1.6 | 1.8 | 3.8x | 3.5x | 3.5x | 3.3x | 0.4 | 7.2% | 0.5x | 13.3% | 9.7% | 3% | -41% | -55% | -44% | 2,495 | | |
| | BNP Paribas | O | 40.3 | EUR | 32.5 | 49.7 | 53% | 6.6 | 6.6 | 6.8 | 7.1 | 7.4 | 5.0x | 5.0x | 4.9x | 4.6x | 2.2 | 6.6% | 0.7x | 13.9% | 10.4% | 19% | -28% | -38% | -30% | 1,200 | | |
| Benelux | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | Dexia | E | 1.5 | EUR | 0.8 | 2.5 | 227% | 0.3 | 0.4 | 0.4 | 0.4 | 0.5 | 2.7x | 1.8x | 1.8x | 1.8x | 0.0 | 0.0% | 0.3x | 16.2% | 11.1% | -46% | -60% | -75% | -70% | 1,949 | | |
| | KBC | E | 6.6 | EUR | 18.0 | 32.9 | 83% | 5.0 | 5.7 | 7.0 | 5.2 | 5.8 | 3.6x | 3.1x | 2.6x | 3.5x | 0.05 | 0.2% | 0.7x | 20.3% | 6.8% | 18% | -25% | -43% | -27% | 340 | | |
| Germany | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | Commerzbank | E | 9.0 | EUR | 1.7 | 3.8 | 124% | 0.4 | 0.4 | 0.5 | 0.4 | 0.5 | 4.2x | 4.0x | 3.3x | 3.8x | 0.0 | 0.0% | 0.4x | 10.4% | 9.2% | 11% | -35% | -66% | -61% | 5,113 | | |
| Investment banks | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | UBS | E | 33.9 | CHF | 10.9 | 13.0 | 19% | 0.8 | 1.3 | 1.6 | 1.5 | 1.7 | 14.3x | 8.6x | 7.0x | 7.1x | 0.0 | 0.0% | 1.0x | 12.4% | 15.7% | 0% | -23% | -38% | -29% | 3,792 | | |
| | Deutsche Bank | E | 25.7 | EUR | 27.4 | 38.0 | 72% | 5.0 | 3.8 | 4.2 | 5.6 | 6.1 | 5.6x | 7.2x | 6.6x | 4.9x | 0.6 | 2.1% | 0.7x | 10.3% | 10.5% | 19% | -27% | -34% | -29% | 932 | | |
| | Credit Suisse | E | 24.3 | CHF | 25.4 | 28.0 | 10% | 3.4 | 3.9 | 4.4 | 3.7 | 4.1 | 7.6x | 6.5x | 5.8x | 6.9x | 0.8 | 3.2% | 1.2x | 19.6% | 14.0% | 23% | -19% | -42% | -34% | 1,174 | | |
| Italy | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | UniCredit | U | 17.9 | EUR | 0.9 | 1.0 | 11% | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 | 8.5x | 7.0x | 5.0x | 6.0x | 0.0 | 3.2% | 0.5x | 6.4% | 9.3% | 26% | -25% | -51% | -40% | 19,298 | | |
| | UBI Banca | U | 2.7 | EUR | 3.1 | 2.5 | -17% | 0.2 | 0.2 | 0.3 | 0.4 | 0.4 | 19.3x | 15.1x | 11.7x | 8.7x | 0.1 | 3.6% | 0.4x | 2.5% | 8.3% | 26% | -17% | -58% | -51% | 902 | | |
| | Monte dei Paschi | U | 4.4 | EUR | 0.4 | 0.4 | -1% | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 14.4x | 10.6x | 8.5x | 8.1x | 0.0 | 3.1% | 0.5x | 5.8% | 8.5% | 6% | -22% | -53% | -43% | 11,545 | | |
| | Mediobanca | U | 5.1 | EUR | 6.0 | 5.7 | -5% | 0.6 | 0.7 | 0.8 | 0.8 | NA | 11.4x | 8.0x | 7.2x | 7.3x | 0.2 | 2.4% | 0.8x | 10.0% | 11.2% | -1% | -6% | -17% | -11% | 844 | | |
| | Intesa SPI | E | 19.9 | EUR | 1.3 | 1.5 | 14% | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 | 10.5x | 9.8x | 8.4x | 7.3x | 0.1 | 7.8% | 0.6x | 6.1% | 10.4% | 39% | -22% | -46% | -32% | 16,434 | | |
| | Banco Popolare | U | 2.2 | EUR | 1.2 | 1.1 | -12% | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 13.4x | 7.8x | 5.8x | 7.8x | 0.0 | 2.4% | 0.3x | 4.1% | 6.7% | 15% | -13% | -61% | -50% | 640 | | |
| | Banca Popolare di Milano | U | 0.7 | EUR | 1.8 | 1.4 | -22% | 0.2 | 0.2 | 0.3 | 0.2 | 0.2 | 9.7x | 8.1x | 6.2x | 9.3x | 0.1 | 5.8% | 0.3x | 4.7% | 5.9% | 27% | 13% | -51% | -34% | 415 | | |
| Nordics | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | Swedbank | O | 8.4 | SEK | 82.5 | 112.0 | 36% | 11.1 | 10.2 | 10.3 | 10.6 | 11.1 | 7.3x | 7.9x | 7.8x | 7.8x | 5.5 | 6.8% | 1.1x | 14.0% | 14.7% | 5% | -22% | -15% | -14% | 1,099 | | |
| | Svenska Handelsbanken | E | 11.6 | SEK | 176.6 | 242.0 | 37% | 19.0 | 20.8 | 23.2 | 19.6 | 20.8 | 9.2x | 8.3x | 7.5x | 9.0x | 10.0 | 5.8% | 1.3x | 15.7% | 15.4% | 13% | -10% | -23% | -19% | 624 | | |
| | SEB | E | 9.0 | SEK | 38.5 | 53.0 | 38% | 5.8 | 5.1 | 5.4 | 4.8 | 5.1 | 6.5x | 7.5x | 7.0x | 8.0x | 2.0 | 5.3% | 1.1x | 14.2% | 14.3% | 14% | -23% | -27% | -32% | 2,194 | | |
| | Nordea | E | 25.4 | SEK | 58.0 | 78.0 | 34% | 0.8 | 0.8 | 0.9 | 0.8 | 0.9 | 8.0x | 7.7x | 7.1x | 8.0x | 0.3 | 4.8% | 1.1x | 14.7% | 11.3% | 12% | -13% | -22% | -21% | 4,043 | | |
| | DnB NOR | O | 13.0 | NOK | 61.9 | 98.0 | 58% | 8.6 | 9.2 | 10.2 | 8.6 | 9.2 | 7.1x | 6.7x | 6.0x | 7.2x | 4.5 | 7.3% | 0.9x | 13.8% | 11.2% | 13% | -22% | -23% | -25% | 1,629 | | |
| | Danske Bank | E | 9.5 | DKK | 77.1 | 116.0 | 50% | 7.3 | 12.5 | 14.2 | 10.7 | 13.6 | 10.4x | 6.1x | 5.3x | 7.2x | 2.0 | 2.6% | 0.7x | 11.1% | 11.6% | 17% | -22% | -43% | -42% | 932 | | |
| Spain | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | Sabadell | U | 3.7 | EUR | 2.7 | 2.1 | -21% | 0.2 | 0.1 | 0.2 | 0.2 | 0.3 | 14.3x | 21.7x | 13.4x | 11.5x | 0.1 | 2.5% | 0.8x | 3.6% | 9.4% | 7% | 4% | -25% | -9% | 1,584 | | |
| | Popular | + | 4.9 | EUR | 3.5 | ++ | -- | 0.3 | 0.2 | 0.3 | 0.4 | 0.4 | 12.3x | 16.3x | 11.1x | 9.7x | 0.1 | 4.1% | 0.7x | 4.5% | 10.1% | 10% | 0% | -23% | -9% | 1,616 | | |
| | Caixabank | E | 13.2 | EUR | 3.5 | 3.8 | 9% | 0.2 | 0.2 | 0.3 | 0.4 | 0.5 | 15.6x | 15.2x | 10.7x | 8.7x | 0.2 | 6.7% | 0.8x | 5.3% | 11.5% | 9% | -19% | -11% | -12% | 3,996 | | |
| | BBVA | O | 31.9 | EUR | 6.4 | 8.5 | 32% | 0.9 | 1.0 | 1.1 | 1.0 | 1.2 | 7.0x | 6.5x | 5.7x | 6.2x | 0.4 | 6.5% | 1.0x | 16.1% | 8.3% | 22% | -9% | -31% | -12% | 4,748 | | |
| | Bankinter | U | 2.1 | EUR | 4.5 | 2.8 | -38% | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 15.2x | 16.2x | 15.5x | 12.0x | 0.1 | 3.3% | 0.9x | 5.7% | 8.1% | 24% | 9% | -8% | 8% | 555 | | |
| | Banesto | U | 3.1 | EUR | 4.5 | 4.5 | 0% | 0.5 | 0.4 | 0.5 | 0.6 | 0.7 | 9.5x | 10.1x | 9.6x | 7.5x | 0.2 | 5.2% | 0.6x | 5.5% | 9.0% | -3% | -10% | -37% | -27% | 687 | | |
| | Santander | E | 53.2 | EUR | 6.3 | 6.7 | 7% | 0.9 | 0.9 | 1.0 | 1.0 | 1.1 | 7.1x | 7.1x | 6.5x | 6.1x | 0.6 | 9.5% | 1.1x | 15.6% | 9.5% | 15% | -14% | -34% | -21% | 8,974 | | |
| UK | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | Royal Bank of Scotland | E | 30.9 | Gbp | 24.6 | 39.0 | 58% | 1.4 | 3.9 | 4.7 | 3.8 | 4.9 | 17.4x | 6.3x | 5.1x | 6.6x | 0.0 | 0.0% | 0.5x | 8.0% | 10.2% | 10% | -32% | -49% | -38% | 110,158 | | |
| | Lloyds BG | U | 27.0 | Gbp | 34.3 | 46.0 | 34% | 1.8 | 4.8 | 5.9 | 4.5 | 6.5 | 19.4x | 7.1x | 5.8x | 7.5x | 0.0 | 0.0% | 0.6x | 8.3% | 10.7% | 8% | -23% | -53% | -48% | 68,726 | | |
| | Barclays Bank | O | 24.2 | Gbp | 178.0 | 230.0 | 29% | 32.5 | 33.4 | 39.3 | 34.7 | 41.8 | 5.3x | 5.2x | 4.4x | 5.1x | 6.0 | 3.5% | 0.5x | 10.1% | 10.1% | 17% | -24% | -41% | -34% | 12,432 | | |
| UK/Asia | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | Standard Chartered | E | 38.6 | Gbp | 1,423 | 1,600 | 12% | 1.9 | 2.1 | 2.3 | 2.2 | 2.5 | 11.7x | 10.8x | 9.8x | 10.0x | 0.7 | 3.3% | 1.6x | 15.0% | 12.0% | 5% | -13% | -22% | -18% | 2,371 | | |
| | HSBC | O | 107.3 | Gbp | 524.2 | 665.0 | 27% | 0.9 | 1.0 | 1.1 | 1.1 | 1.2 | 9.1x | 8.4x | 7.5x | 7.7x | 0.4 | 4.9% | 1.1x | 13.7% | 11.2% | 5% | -14% | -22% | -20% | 18,040 | | |
| Austria | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | Erste Bank | E | 6.4 | EUR | 17.1 | 37.0 | 117% | 2.5 | 3.6 | 4.5 | 3.3 | 4.1 | 6.7x | 4.8x | 3.8x | 5.1x | 0.7 | 3.9% | 0.8x | 17.2% | 9.7% | -17% | -50% | -47% | -52% | 378 | | |
| | Raiffeisen International | U | 4.4 | EUR | 22.9 | 37.0 | 62% | 4.3 | 5.0 | 6.4 | 5.3 | 6.6 | 5.3x | 4.6x | 3.6x | 4.3x | 1.1 | 4.7% | 0.7x | 15.8% | 8.3% | -6% | -33% | -42% | -45% | 196 | | |
| ALL European | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | 32% | 3.6 | 4.1 | 4.6 | 4.2 | 4.8 | 9.3 | 7.6 | 6.6 | 6.8 | | 4.4% | 0.9 | 12.5% | 11.0% | | | | | | | |

Source: Company data, Morgan Stanley Research. e=Morgan Stanley Research estimates. This report contains valuation methodology and risks for Deutsche Bank. For valuation methodology and risks associated with any other price targets above, please email morganstanley.research@morganstanley.com with a request for valuation methodology and risks on a particular stock. ‡Rating and price target for this company have been removed from consideration in this report because, under applicable law and/or Morgan Stanley policy, Morgan Stanley may be precluded from issuing such information with respect to this company at this time.

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Banks

How we think the EU/EBA is thinking about the EU bank recap

We argued last week that regulators had contemplated using the original EBA stress tests adverse case and deducting a Greek haircut and then recapping to a more realistic 7-9% than 5%, which would then generate €50-200bn of capital needed for the sector. We then said, after various objections from some policymakers and banks, there was a shift to a simpler “benchmarking” exercise, which seems to have gained interest. In part due to the flaws of the July stress test, which anticipated the risks at Dexia, CAM, Erste and others. This screen reportedly uses 1H 2011 core Tier 1 rebased for Basel 2.5 and then adjusted for MTM on sovereign holdings and then this should reach 9%. We have tried to replicate this too and this seems to still generate the €100-200bn capital raise we wrote about, although much lower than some on the street think.

Clearly even recognizing this, there were many assumptions which would need to be made – sovereign stresses, B2.5 inflation, duration of sovereign holdings and so on. We have tried to map this out at first for the key large-cap stocks and then have a few chapters on particular banks.

1) Methodology

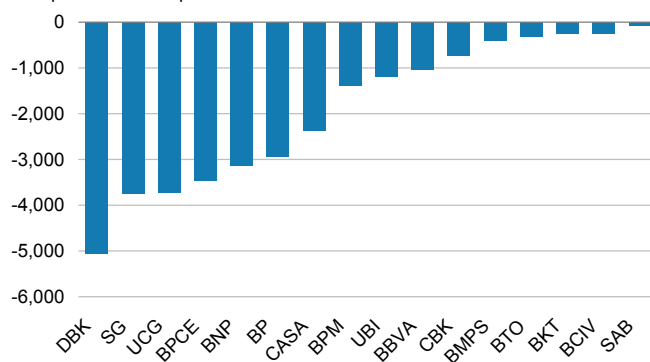
We have run our screens on two bases.

- First using H1 core Tier 1 capital less a sovereign haircut on peripheral exposure exposures and RWA as of H1 inflated for Basel 2.5. The haircut is based on implied pricing of sovereign cash bonds. This methodology may also be extended if banks are allowed to include a further 6 months of capital generation and thus we would extend our analysis to use RWA as of 2012e to give additional credit for de-leveraging.
- Second, we have retained the EBA methodology under the stress scenario and only haircutting Greece, to compare, especially where the asset quality has a big swing factor. We have not updated for 1H capital generation and this scenario assumes a flat balance sheet and does not consider further de-leveraging, which realistically banks are doing. This method produces the highest capital deficit as it considers not only a high hurdle but also under a punitive stressed scenario.

Exhibit 7

Based on MS analysis of the large listed players, we see that the undercapitalized banks are punctuated by French and German banks (although Greeks, etc. will be high)

European Banks Capital Shortfall



Source: Company data, Morgan Stanley Research

Assumptions: The key assumptions include sovereign exposures, sovereign haircuts and the Basel 2.5 charge as it takes reported capital ratios as of H1.

- **Sovereign exposures:** We take last reported net sovereign exposures as indicated by the banks, which is mostly as of H1, although realize the test will be done on Q3 balance sheet data. The disclosed holdings do not break down exposure by maturity so in our haircut assumption we assume they are all of the same maturity, which clearly will not be the case (those who have an investment portfolio will have far longer duration than liquidity buffer usage). Also, there is no disclosure for the split between banking and trading book and so we have applied it across both.
- **Sovereign haircut:** We largely have taken the marks as last implied by 5-year cash sovereign bonds. To note, based on press speculation – and also the methodology used by the IMF, we have only assumed negative marks on Ireland, Greece, Portugal, Spain, Italy and Belgium. However we have **not** assumed mark to market gains on bunds, OATs etc. We think this is a deficiency of the process, but we press reports suggest this is correct. We prefer this than taking the sovereign CDS as we think most sovereign holdings by banks

are cash bonds. We attempt to adjust for marks already taken by the bank – for example, Deutsche has already taken a ~21% haircut in Q2 for Greek sovereign debt which we adjust for.

Exhibit 8

Sovereign haircut assumptions based on cash bonds. Not we think EU not using MTM gains on bunds and other Northern European bonds

| Country | Haircut Assumption |
|----------|--------------------|
| Greece | 59% |
| Ireland | 10% |
| Portugal | 25% |
| Spain | 5% |
| Italy | 9% |
| Belgium | 5% |

Source: Bloomberg, Morgan Stanley Research

taken account of – as shown by Dexia passing the July test with flying colours and within 3 months of being rescued.

- Also, we think the sovereign marks will be intensely debated and changes may be made

In the company sections below we go into more detail bank by bank.

- **Basel 2.5 assumptions:** We take last disclosed Basel 2.5 RWA increases but assume no mitigation.

This said there are many uncertainties:

- How will converts and hybrids be treated? What instruments will be used for a recap and hence what is the potential dilution given most banks are trading below TNAV? We think converts will be converted but less convinced hybrids forcibly converted. See latest note by Jackie Inecke.
- How much de-leveraging will be considered? H1 numbers do not factor in additional de-leveraging which most banks are pursuing so arguably is a punitive starting point. We estimate EU wholesale banks will reduce balance sheets by €1-2tr.
- We think EU is using a common hurdle rate. We fundamentally think different banks should have different hurdle rates, and a pan-European test solving for the same number for banks in Greece as in Germany is not going to prove to be very credible. As we have written elsewhere – banks in the periphery should be depression-proofed, banks in the core recession-proofed. Different exposures and funding models should also be

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Exhibit 9

Based on H1 2011 data adjusted for Basel 2.5, we estimate that the core listed European banks will require ~€30bn of re-capitalisation

| | MS European Bank Coverage | | Summary Data | | | | | | | Periphery Sovereign Exposure | | | | | | | Post Periphery haircut | | | | | | |
|------------------------------------|---|-----|-------------------|------------------|------------------|-----------|-----------------------------|--------------|-------------------------|------------------------------|----------|---------|--------|-------|---------|--------|------------------------|-----------------|--------------|--------------|-----------------|-------------------|---------|
| | Rating | CCY | Price at 14/10/11 | Mse Target Price | Market Cap (€bn) | TNAV 2011 | Core tier 1 capital Q2 2011 | RWAs Q2 2011 | RWA Q2 2011 (Basel 2.5) | Core tier 1 ratio (%) | Portugal | Ireland | Greece | Spain | Belgium | Italy | Sov. Haircut Effect | Core Tier 1 Adj | As % of RWAs | As % of TNAV | As % of Mkt Cap | Deficit to 9% CT1 | |
| France | Exposures are shown as total of banking book and trading book | | | | | | | | | | | | | | | | | | | | | | |
| | BNP Paribas | O | EUR | 33.35 | 49.70 | 40.27 | 58,352 | 57,120 | 595,000 | 635,000 | 9.0% | 1,401 | 404 | 3,552 | 2,826 | 18,046 | 20,987 | 3,097 | 54,023 | 8.5% | 5.3% | 7.7% | (3,127) |
| | Crédit Agricole Groupe | NR | EUR | 5.28 | 9.60 | 13.19 | 28,624 | 51,961 | 571,000 | 596,000 | 8.7% | 658 | 144 | 278 | 1,765 | 2,189 | 7,843 | 685 | 51,276 | 8.6% | 2.4% | 5.2% | (2,364) |
| | BPCE | NR | EUR | 2.32 | 3.29 | 7.14 | 13,394 | 34,600 | 405,000 | 414,000 | 8.4% | 255 | 263 | 1,187 | 1,025 | 2,350 | 4,164 | 811 | 33,789 | 8.2% | 6.1% | 11.4% | (3,471) |
| Belgium | Société Générale | O | EUR | 21.61 | 26.90 | 16.77 | 32,859 | 30,056 | 333,000 | 373,000 | 8.1% | 200 | 300 | 1,100 | 1,200 | 292 | 1,500 | 234 | 29,822 | 8.0% | 0.7% | 1.4% | (3,748) |
| | KBC Bank | NR | EUR | 18.56 | 32.90 | 6.64 | 9,569 | 12,232 | 103,015 | 111,115 | 11.0% | 148 | 269 | 443 | 1,364 | 21,347 | 5,304 | 1,160 | 11,072 | 10.0% | 12.1% | 17.5% | 0 |
| Germany | Commerzbank AG | E | EUR | 1.76 | 3.80 | 8.98 | 21,821 | 23,762 | 239,488 | 261,488 | 9.1% | 900 | 0 | 2,200 | 2,900 | 615 | 8,700 | 903 | 22,859 | 8.7% | 4.1% | 10.0% | (675) |
| | Deutsche Bank AG | E | EUR | 27.65 | 47.00 | 25.70 | 24,817 | 32,517 | 319,669 | 412,669 | 7.9% | 153 | 296 | 1,154 | 1,070 | 0 | 997 | 435 | 32,082 | 7.8% | 1.8% | 1.7% | (5,058) |
| Italy | Banca Popolare di Milano | U | EUR | 1.73 | 1.40 | 0.72 | 2,617 | 3,145 | 46,400 | 46,586 | 6.8% | 0 | 0 | 0 | 10 | 0 | 5,983 | 361 | 2,784 | 6.0% | 13.8% | 50.3% | (1,409) |
| | Banco Popolare | U | EUR | 1.23 | 1.10 | 2.17 | 6,953 | 6,399 | 95,700 | 95,700 | 6.7% | 0 | 0 | 60 | 199 | 0 | 11,374 | 716 | 5,683 | 5.9% | 10.3% | 33.0% | (2,930) |
| | Intesa Sanpaolo | E | EUR | 1.28 | 1.50 | 19.90 | 33,609 | 32,850 | 320,795 | 324,395 | 10.1% | 45 | 187 | 501 | 950 | 36 | 34,473 | 2,313 | 30,537 | 9.4% | 6.9% | 11.6% | 0 |
| | Mediobanca | U | EUR | 5.95 | 5.70 | 5.12 | 6,410 | 6,109 | 55,045 | 55,045 | 11.1% | 0 | 0 | 200 | 0 | 0 | 3,400 | 175 | 5,934 | 10.8% | 2.7% | 3.4% | 0 |
| | Banca Monte dei Paschi di Siena | U | EUR | 0.41 | 0.40 | 4.41 | 10,051 | 10,800 | 106,093 | 106,093 | 10.2% | 261 | 11 | 14 | 237 | 0 | 24,960 | 1,563 | 9,237 | 8.7% | 15.5% | 35.4% | (311) |
| | Unione di Banche Italiane | U | EUR | 2.99 | 2.55 | 2.70 | 7,767 | 7,857 | 95,074 | 95,074 | 8.3% | 0 | 0 | 0 | 3 | 0 | 8,240 | 497 | 7,360 | 7.7% | 6.4% | 18.4% | (1,196) |
| Nordics | UniCredit SpA | U | EUR | 0.93 | 1.05 | 17.86 | 39,180 | 40,618 | 445,160 | 465,192 | 8.7% | 56 | 50 | 404 | 1,881 | 209 | 38,664 | 2,469 | 38,149 | 8.2% | 6.3% | 13.8% | (3,718) |
| | Danske Bank | E | DKK | 76.15 | 116.00 | 9.53 | 105,224 | 101,672 | 860,293 | 890,000 | 11.4% | 687 | 1,080 | 0 | 1,202 | 0 | 7,058 | 653 | 101,019 | 11.4% | 0.6% | 6.9% | 0 |
| | DNB NOR | O | NOK | 61.60 | 98.00 | 12.95 | 107,918 | 96,899 | 848,975 | 848,975 | 11.4% | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 96,899 | 11.4% | 0.0% | 0.0% | 0 |
| | Svenska Handelsbanken | E | SEK | 173.90 | 242.00 | 11.62 | 85,269 | 77,346 | 523,841 | 550,000 | 14.1% | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 77,346 | 14.1% | 0.0% | 0.0% | 0 |
| | Nordea Bank AB | E | SEK | 6.27 | 78.00 | 25.40 | 22,456 | 19,846 | 179,860 | 189,000 | 10.5% | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 19,846 | 10.5% | 0.0% | 0.0% | 0 |
| | SEB | E | SEK | 37.94 | 53.00 | 8.98 | 78,634 | 91,561 | 678,401 | 720,000 | 12.7% | 640 | 0 | 800 | 0 | 55 | 320 | 445 | 91,116 | 12.7% | 0.6% | 4.9% | 0 |
| Spain | Swedbank | O | SEK | 81.05 | 112.00 | 8.42 | 79,148 | 75,463 | 509,301 | 520,000 | 14.5% | 0 | 0 | 0 | 0 | 45 | 0 | 2 | 75,461 | 14.5% | 0.0% | 0.0% | 0 |
| | Banesto | U | EUR | 4.54 | 4.50 | 3.12 | 5,532 | 5,565 | 63,313 | 63,313 | 8.8% | 0 | 0 | 0 | 5,500 | 0 | 0 | 184 | 5,381 | 8.5% | 3.3% | 5.9% | (317) |
| | Bankinter | U | EUR | 4.44 | 2.75 | 2.13 | 2,681 | 2,400 | 30,378 | 30,378 | 7.9% | 0 | 0 | 0 | 3,100 | 0 | 0 | 104 | 2,296 | 7.6% | 3.9% | 4.9% | (438) |
| | BBVA | O | EUR | 6.50 | 8.50 | 31.92 | 29,169 | 28,773 | 321,282 | 321,282 | 9.0% | 130 | 0 | 100 | 25,000 | 0 | 0 | 899 | 27,874 | 8.7% | 3.1% | 2.8% | (1,041) |
| | Banco Popular | ++ | EUR | 3.51 | ++ | 4.91 | 7,723 | 8,917 | 90,639 | 90,639 | 9.8% | 600 | 0 | 0 | 9,100 | 0 | 0 | 405 | 8,512 | 9.4% | 5.2% | 8.3% | 0 |
| | Banco Sabadell | U | EUR | 2.67 | 2.10 | 3.72 | 5,444 | 5,122 | 55,248 | 55,248 | 9.3% | 100 | 0 | 0 | 0 | 6,000 | 0 | 218 | 4,904 | 8.9% | 4.0% | 5.9% | (68) |
| UK | Banca Civica | E | EUR | 2.40 | 2.70 | 1.19 | 3,920 | 4,300 | 44,292 | 44,292 | 9.7% | 0 | 0 | 55 | 24,812 | 0 | 0 | 853 | 3,447 | 7.8% | 21.8% | 71.5% | (539) |
| | CaixaBank | E | EUR | 3.43 | 3.75 | 13.18 | 16,943 | 16,443 | 147,584 | 147,584 | 11.3% | 0 | 0 | 0 | 22,500 | 0 | 0 | 754 | 15,889 | 10.8% | 4.4% | 5.7% | 0 |
| | Santander | E | EUR | 6.30 | 6.70 | 53.16 | 50,872 | 53,379 | 580,480 | 580,480 | 9.2% | 1,600 | 0 | 0 | 21,000 | 0 | 0 | 972 | 52,408 | 9.0% | 1.9% | 1.8% | 0 |
| | Barclays Plc | O | GBP | 173.20 | 230.00 | 24.24 | 43,342 | 43,537 | 396,700 | 436,700 | 10.0% | 970 | 331 | 69 | 4,800 | 1,534 | 5,443 | 752 | 42,785 | 9.8% | 1.7% | 3.1% | 0 |
| | Lloyds Banking Group Plc | U | GBP | 34.26 | 46.00 | 27.02 | 39,927 | 38,884 | 383,267 | 383,267 | 10.1% | 0 | 0 | 0 | 67 | 0 | 35 | 4 | 38,880 | 10.1% | 0.0% | 0.0% | 0 |
| | Royal Bank of Scotland Group Plc | E | GBP | 24.16 | 39.00 | 16.42 | 53,190 | 48,001 | 433,523 | 458,523 | 10.5% | 83 | 1,747 | 1,000 | (873) | 801 | 2,876 | 362 | 47,639 | 10.4% | 0.7% | 2.2% | 0 |
| Austria | HSBC Holdings Plc | O | GBP | 523.10 | 665.00 | 107.26 | 131,501 | 125,762 | 1,168,529 | 1,207,529 | 10.4% | 100 | 400 | 1,100 | 1,800 | 87 | 3,500 | 753 | 125,009 | 10.4% | 0.6% | 0.7% | 0 |
| | Standard Chartered Plc | E | GBP | 1411.50 | 1600.00 | 38.57 | 33,359 | 31,120 | 262,289 | 268,289 | 11.6% | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 31,120 | 11.6% | 0.0% | 0.0% | 0 |
| | Raiffeisen Bank International | U | EUR | 22.50 | 37.00 | 4.40 | 6,182 | 8,590 | 94,813 | 94,813 | 9.1% | 2 | 0 | 0 | 5 | 172 | 474 | 35 | 8,555 | 9.0% | 0.6% | 0.8% | 0 |
| | Erste Bank | E | EUR | 16.97 | 37.00 | 6.42 | 7,875 | 11,416 | 119,669 | 119,669 | 9.5% | 125 | 91 | 405 | 64 | 132 | 699 | 236 | 11,181 | 9.3% | 3.0% | 3.7% | 0 |
| Total Recapitalisation Requirement | | | | | | | | | | | | | | | | | | | | | | (30,411) | |

Source: Factset, Company Data, Morgan Stanley Research estimates

Note: Periphery exposures represent total exposures including banking book.

Note 2: Haircuts taken in H1 taken into account for French, Italian, KBC and RBS.

Note 3: KBC Bank values take into account the sale of KBC Private Bank

Note 4: We believe BBVA will be able to accumulate the €1bn capital required in our screening organically. We estimate a €4.3bn net profit 2011E, of which €2bn are paid out in dividends.

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Exhibit 10

The prior EBA stress tests showed a capital deficit for many banks to 7%, 8% and 9% and we think a 5% bar was a policy error

| Bank | | Total Sovereign trading loss €m | CT1 adverse + peripheral loss | Deficit to 7% CT1 | Deficit to 8% CT1 | Deficit to 9% CT1 | Mitigating measures planned | CT1 after mitigating factors | Deficit to 7% CT1 | Deficit to 8% CT1 | Deficit to 9% CT1 |
|---|----------------|---------------------------------|-------------------------------|-------------------|-------------------|-------------------|-----------------------------|------------------------------|-------------------|-------------------|-------------------|
| AGRICULTURAL BANK OF GREECE S.A. (ATEbank) | Greece | (2,601) | -14.6% | (2,676) | (2,800) | (2,924) | 835 | -7.8% | (1,841) | (1,965) | (2,089) |
| IT HELLENIC POSTBANK S.A. | Greece | (1,780) | -9.7% | (1,140) | (1,208) | (1,276) | 110 | -8.1% | (1,030) | (1,098) | (1,166) |
| PIRAEUS BANK GROUP | Greece | (2,696) | 1.3% | (2,239) | (2,631) | (3,022) | 398 | 2.3% | (1,841) | (2,232) | (2,624) |
| EFG EUROBANK ERGASIAS S.A. | Greece | (2,915) | 1.4% | (2,741) | (3,235) | (3,728) | 1,244 | 4.0% | (1,498) | (1,991) | (2,484) |
| MARFIN POPULAR BANK PUBLIC CO LTD | Cyprus | (1,132) | 3.0% | (1,140) | (1,426) | (1,712) | 1,103 | 6.9% | (37) | (323) | (609) |
| CAPA DE AHORROS DEL MEDITERRANEO | Spain | - | 3.0% | (1,912) | (2,395) | (2,878) | 1,001 | 5.1% | (911) | (1,394) | (1,877) |
| BANCO PASTOR, S.A. | Spain | (14) | 3.3% | (690) | (874) | (1,059) | 420 | 5.5% | (270) | (454) | (639) |
| GRUPO BANCO GRUPO CAPA3 | Spain | - | 4.0% | (417) | (555) | (694) | 362 | 6.6% | (55) | (194) | (332) |
| BANK OF CYPRUS PUBLIC CO LTD | Cyprus | (806) | 4.0% | (780) | (1,043) | (1,306) | 887 | 7.4% | - | (156) | (419) |
| NATIONAL BANK OF GREECE | Greece | (4,001) | 4.4% | (1,846) | (2,569) | (3,291) | 1,441 | 6.4% | (405) | (1,128) | (1,850) |
| Oesterreichische Volksbank AG | Austria | (38) | 4.5% | (859) | (1,197) | (1,535) | 1,483 | 8.8% | - | - | (53) |
| Unnim | Spain | - | 4.5% | (429) | (601) | (774) | 289 | 6.2% | (140) | (312) | (485) |
| Catalunya Caixa | Spain | - | 4.8% | (1,070) | (1,568) | (2,065) | 726 | 6.3% | (344) | (842) | (1,339) |
| ESPIRITO SANTO FINANCIAR GROUP, SA (ESFG) | Portugal | (104) | 5.0% | (1,499) | (2,266) | (3,033) | 947 | 6.3% | (553) | (1,320) | (2,087) |
| NOVA LPUBLPANSKA BANKA D.D. (NLB d.d.) | Slovenia | (7) | 5.3% | (270) | (427) | (583) | 14 | 5.4% | (256) | (413) | (570) |
| Bankinter | Spain | - | 5.3% | (555) | (877) | (1,200) | 482 | 6.8% | (73) | (395) | (718) |
| ALPHA BANK | Greece | (1,825) | 5.3% | (855) | (1,357) | (1,859) | 389 | 6.1% | (466) | (968) | (1,470) |
| BANCO COMERCIAL PORTUGUES, SA (BCP OR MILLENNIUM) | Portugal | (239) | 5.3% | (1,137) | (1,826) | (2,515) | 543 | 6.1% | (594) | (1,283) | (1,972) |
| Nova Caixa Galicia | Spain | (0) | 5.4% | (906) | (1,456) | (2,005) | 621 | 6.5% | (285) | (835) | (1,384) |
| Banco Popular | Spain | - | 5.4% | (1,571) | (2,525) | (3,479) | 1,956 | 7.4% | - | (569) | (1,523) |
| BFA-BANKIA | Spain | (18) | 5.4% | (3,507) | (5,671) | (7,834) | 2,497 | 6.5% | (1,011) | (3,174) | (5,337) |
| HSB Nordbank AG, Hamburg | Germany | (34) | 5.5% | (1,087) | (1,802) | (2,517) | 2,573 | 9.1% | - | - | - |
| Norddeutsche Landesbank -GZ- | Germany | (50) | 5.5% | (1,583) | (2,661) | (3,740) | - | 5.5% | (1,583) | (2,661) | (3,740) |
| CAPA DE AHORROS Y M.P. DE ONTINYENT | Spain | - | 5.6% | (9) | (16) | (23) | 11 | 7.2% | - | (5) | (12) |
| Ban Civica | Spain | (2) | 5.6% | (635) | (1,102) | (1,569) | 1,769 | 9.4% | - | - | - |
| BANCO POPOLARE - S.C. | Italy | (10) | 5.7% | (1,301) | (2,280) | (3,260) | 488 | 6.2% | (813) | (1,792) | (2,771) |
| Banco Sabadell | Spain | - | 5.7% | (713) | (1,278) | (1,843) | 1,292 | 8.0% | - | - | (551) |
| WestLB AG -Düsseldorf | Germany | (112) | 6.0% | (664) | (1,344) | (2,023) | - | 6.0% | (664) | (1,344) | (2,023) |
| BANCO MARE NOSTRUM | Spain | - | 6.1% | (352) | (757) | (1,162) | 1,292 | 9.3% | - | - | - |
| COMMERZBANK AG | Germany | (998) | 6.2% | (2,551) | (5,659) | (8,766) | - | 6.2% | (2,551) | (5,659) | (8,766) |
| COLONYA - CAIXA D'ESTALVIS DE POLLENSA | Spain | - | 6.2% | (1) | (3) | (5) | 3 | 8.0% | - | - | (2) |
| ROYAL BANK OF SCOTLAND GROUP plc | United Kingdom | (355) | 6.3% | (4,968) | (11,815) | (18,662) | - | 6.3% | (4,968) | (11,815) | (18,662) |
| BANCA MONTE DEI PASCHI DI SIENA S.p.A | Italy | (3) | 6.3% | (792) | (1,923) | (3,053) | 2,850 | 8.8% | - | - | (203) |
| La Caixa | Spain | - | 6.4% | (1,005) | (2,651) | (4,297) | 4,461 | 9.1% | - | - | - |
| SOCIETE GENERALE | France | (805) | 6.5% | (2,450) | (6,906) | (11,361) | - | 6.5% | (2,450) | (6,906) | (11,361) |
| CAIXA GERAL DE DEPÓSITOS, SA | Portugal | (17) | 6.5% | (421) | (1,223) | (2,025) | 208 | 6.7% | (213) | (1,015) | (1,817) |
| DEUTSCHE BANK AG | Germany | (422) | 6.5% | (2,509) | (7,508) | (12,507) | - | 6.5% | (2,509) | (7,508) | (12,507) |
| UNICREDIT S.p.A | Italy | (208) | 6.6% | (1,895) | (7,193) | (12,492) | 2,983 | 7.2% | - | (4,210) | (9,509) |
| Ibercaja | Spain | - | 6.7% | (76) | (317) | (657) | 159 | 7.3% | - | (158) | (398) |
| BPCE | France | (401) | 6.7% | (1,514) | (6,639) | (11,764) | - | 6.7% | (1,514) | (6,639) | (11,764) |
| EFFIBANK | Spain | (12) | 6.7% | (84) | (411) | (738) | 512 | 8.3% | - | - | (226) |
| DZ BANK AG Dt. Zentral-Genossenschaftsbank | Germany | (245) | 6.8% | (194) | (1,434) | (2,675) | - | 6.8% | (194) | (1,434) | (2,675) |
| Banco BPI, SA | Portugal | (109) | 6.9% | (32) | (301) | (570) | 79 | 7.2% | - | (222) | (490) |
| SNS BANK NV | Netherlands | (16) | 7.0% | (6) | (211) | (415) | - | 7.0% | (6) | (211) | (415) |
| Landesbank Baden-Württemberg | Germany | (248) | 7.0% | - | (1,219) | (2,460) | 414 | 7.4% | - | (805) | (2,046) |
| Bayerische Landesbank | Germany | (49) | 7.1% | - | (1,208) | (2,554) | 1,599 | 8.3% | - | - | (954) |
| BANK OF IRELAND | Ireland | - | 7.1% | - | (557) | (1,180) | 1,000 | 8.7% | - | - | (180) |
| CAPA ESPANA DE INVERSIONES, SALAMANCA Y SORIA, C/ | Spain | - | 7.3% | - | (175) | (427) | 288 | 8.5% | - | - | (139) |
| BANCAIAYS plc | United Kingdom | - | 7.3% | - | (4,509) | (11,083) | - | 7.3% | - | (4,509) | (11,083) |
| Deutsche Bank adjusted | Germany | (422) | 7.4% | - | (2,848) | (7,577) | - | 7.4% | - | (2,848) | (7,577) |
| UNIONE DI BANCHE ITALIANE SCPA (UBI BANCA) | Italy | - | 7.4% | - | (571) | (1,547) | 639 | 8.1% | - | - | (308) |
| BNP PARIBAS | France | (1,521) | 7.7% | - | (2,527) | (9,780) | - | 7.7% | - | (2,527) | (9,780) |
| LLOYDS BANKING GROUP plc | United Kingdom | - | 7.7% | - | (1,500) | (6,766) | - | 7.7% | - | (1,500) | (6,766) |
| Raiffeisen Bank International (RBI) | Austria | - | 7.8% | - | (197) | (1,197) | - | 7.8% | - | (197) | (1,197) |
| NOVA KREDITNA BANKA MARIBOR D.D. (NKBM d.d.) | Slovenia | - | 8.0% | - | (1) | (50) | - | 8.0% | - | (1) | (50) |
| Erste Bank Group (EBG) | Austria | (116) | 8.1% | - | - | (1,208) | - | 8.1% | - | - | (1,208) |
| Santander | Spain | - | 8.4% | - | - | (4,140) | 3,304 | 8.9% | - | - | (835) |
| HSBC HOLDINGS plc | United Kingdom | (61) | 8.5% | - | - | (5,745) | - | 8.5% | - | - | (5,745) |
| CREDIT AGRICOLE | France | (179) | 8.5% | - | - | (2,927) | - | 8.5% | - | - | (2,927) |
| WGZ BANK AG Westdt. Geno. Zentralbk. Ddf | Germany | (106) | 8.5% | - | - | (113) | - | 8.5% | - | - | (113) |
| ING BANK NV | Netherlands | (248) | 8.6% | - | - | (1,563) | - | 8.6% | - | - | (1,563) |
| Svenska Handelsbanken AB (publ) | Sweden | - | 8.6% | - | - | (394) | - | 8.6% | - | - | (394) |
| CAPA DE AHORROS DE VITORIA Y ALAVA | Spain | - | 8.7% | - | - | (21) | 36 | 9.2% | - | - | - |
| GRUPO BBK BANK | Spain | - | 8.8% | - | - | (67) | 739 | 11.3% | - | - | - |
| INTESA SANPAOLO S.p.A | Italy | (139) | 8.9% | - | - | (481) | 1,103 | 9.2% | - | - | - |
| DnB NOR Bank ASA | Norway | - | 9.0% | - | - | (42) | - | 9.0% | - | - | (42) |
| Total | | (26,396) | | (53,082) | (116,402) | (208,517) | 51,424 | | (29,075) | (82,162) | (164,828) |

MS Coverage Universe

(19,314) (61,898) (134,605) 19,558 (12,369) (49,566) (115,833)

Source: EBA stress tests, Company data, Morgan Stanley Research

How will this be implemented?

We outlined 2 weeks ago what we thought would be the key parameters. As an update – at a glance:

How much?

As above – we think €100-200bn is the most likely.

When?

We had assumed that any recap plan would be after the EFSF is ratified in mid October and therefore assumed November the most plausible. We are led to believe banks will be given at least 5 months to raise (and possibly could be until June 2012) months to raise capital privately. We think the plan goes to Ecofin this week and we hope signed will be off this weekend, although we don't expect much detail this weekend.

Who pays?

We see a 3-way waterfall. Private option via recap first, then sovereign and failing that the EFSF. We think Northern European governments would fund themselves whilst Southern European would use the EFSF. We appreciate in the programme countries (i.e. Portugal and Greece) funds are earmarked for bank recaps but we wonder if the EFSF may get involved given the funds are not yet allocated for next disbursements. Our current view is that without massive support for Italy/Spain/sovereigns and further bank funding support, then much capital may be needed from the EFSF, as investors won't have confidence in the earnings power of banks. However, the strong the sovereign backstop for Italy/Spain etc (e.g. monetisation of their debt via ECB), the more capital which could be raised privately.

What instrument?

Assuming we are correct that the base case is government capital, we think it would need to be somehow Basel 3 compliant. Discussions include a pref that has some convertibility features. For example, if core Tier 1 had not been paid back and the bank had not reached say 7% or 8% in 3 years' time, then the instrument would convert into core Tier 1. This is less dilutive for banks if it allows them to recap in a more orderly fashion when there is less stress in the markets. It is also possible warrants may be attached for tax payers to enjoy

any capital gains for their extraordinary support, should it happen. This makes the question of how much dilution any bank may see upfront very tough to foresee. In terms of price, we have no visibility. In the crisis, coupons were often 8% (vs. US TARP being 5%). We assume 8-10% non-tax deductible coupon book ends.

What else on funding?

We have argued that given the stress in term funding and unsecured funding, more can be done. **In recent months, we have seen six separate policy responses (expansion of LTRO from 3 to 6 months and then to 12/13 months, widening collateral rules, activation of Greek ELA, the re-opening of the covered bond program and coordinated central bank action for \$ funding – see below).**

However, these all address short-term collateralised funding – and as we saw in 2008 policymakers may need to support term funding too. We have seen the covered bond program re-opening so far (F) and think policy makers have two further options in their toolkit:

1. The best would be a creation of a Temporary bank funding guarantee scheme analogous to the TLPG – see our August note. This could be via re-opening existing domestic schemes but have the EFSF backstop them. Barroso's comments suggest interest in this, but as it is not in the EFSF language approved, we fear less likely, although it is still think a good outcome given the loss of confidence and risk of a massive credit squeeze without confidence enhancing measures.

2. *Second best would be an expansion of LTRO from 12 months to 12-24 months – given the recent action, we think that the odds of extending the LTRO to 24-36 months are increasingly material.*

Exhibit 5
There are 2 further policy options to support term funding for European banks; extend LTRO to 24-36 months; temporary bank funding guarantee

| | | |
|--|---|--|
| Unsecured | | 2. Temporary bank funding guarantee scheme by EFSF |
| Secured (Not normally ECB eligible) | <div>B: Widening of collateral rules¹</div> <div>C: Activate Greek ELA.</div> <div>D: \$ funding lines</div> | F: Re-open Covered Bond Programme |
| Secured (ECB eligible) | <div>A: LTRO from 3 to 6 months²</div> <div>E: 2 LTROs 12/13 months</div> | 1. Expand LTRO to 24-36 months |
| | Short Term < 1yr | Term > 1yr+ |

Source: Morgan Stanley Research

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Focus on German Banks (I): Deutsche

We have updated our analysis from two weeks ago to reflect new estimates of methodology. Depending on the degree of mitigation/deleveraging, sovereign stress, hurdle rate, this could lead to €2-5bn deficit at H1. However, if we roll forward 6 months, this could fall to €2-3bn. We also have used the EBA adverse case stress test, and Deutsche would have a larger deficit.

Our estimates account for additional sovereign stress which impacts capital by ~8bps. We stress for sovereign risk based on our haircuts and last reported net sovereign exposure at Deutsche of €3.7bn at H1. We estimate the net impact after tax on capital is ~€330m or ~8bps. Deutsche has already announced it will take further impairments on Greek sovereign of €250m in Q3 on top of the €155m taken in Q2. We estimate the impairment in Q2 was equivalent to a ~21% haircut so the additional amount in Q3 is ~34% we think giving a total of ~55% which is close to current trading levels.

We realize outside-in we cannot know Deutsche's marks on the different sovereign holdings (as don't know which book they are on). We note the potential flaws in our approach as we assume similar duration across Deutsche's book and we only adjust for Deutsche's haircut on Greek debt already taken and not for the other sovereigns. We think the maturities of Greek debt in Deutsche's books are relatively short with ~80% maturing by 2013 and ~99% by 2018. We also expect Deutsche to have further reduced these exposures in Q3 after having declined by 70% in H1. Therefore, our estimated implied losses are likely overstated, but nonetheless the hit on capital is relatively limited, about ~8bps.

Exhibit 11

We adjust for a further ~€330m sovereign haircut in our analysis

| H1 11 (€m) | H1 exposure | Haircut | Haircut | Split |
|--|--------------|---------|------------|-------|
| Greece | 1,154 | 38% | 279 | 57% |
| Ireland | 296 | 10% | 30 | 6% |
| Italy | 997 | 9% | 90 | 18% |
| Portugal | 153 | 25% | 38 | 8% |
| Spain | 1,070 | 5% | 54 | 11% |
| Belgium | | 5% | 0 | 0% |
| Total | 3,670 | | 490 | |
| Tax | | 32% | 157 | |
| Haircut total (€m) | | | 333 | |
| Impact on H1 CT1, RWA 2.5 (bps) | | | 8 | |

Source: Morgan Stanley Research estimates. Greece haircut adjusted for haircut already taken.

Exhibit 12

We show below the huge difference between using the EBA stress test to 9% vs. the "benchmarking" exercise we expect. Deficit more likely €2-5bn

| Capital Deficit (€m) | 7% | 8% | 9% |
|--------------------------------|-----------|-----------|-----------|
| EBA: Excluding H1 2011 | (2,509) | (7,508) | (12,507) |
| EBA: Including H1 2011 | 0 | (2,832) | (7,561) |
| H1 Core Tier 1, B2.5 RWA | 0 | (830) | (4,956) |
| H1 Core Tier 1, 12e RWA | 0 | 0 | (3,546) |
| 2011e Core Tier 1, B2.5 RWA | 0 | 0 | (2,981) |
| 2011e Core Tier 1, 12e RWA | 0 | 0 | (2,198) |
| Recap as % of last TNAV | 7% | 8% | 9% |
| EBA: Excluding H1 2011 | 7% | 21% | 36% |
| EBA: Including H1 2011 | 0% | 8% | 21% |
| H1 Core Tier 1, B2.5 RWA | 0% | 2% | 14% |
| H1 Core Tier 1, 12e RWA | 0% | 0% | 10% |
| 2011e Core Tier 1, B2.5 RWA | 0% | 0% | 8% |
| 2011e Core Tier 1, 12e RWA | 0% | 0% | 6% |

Source: Morgan Stanley Research estimates

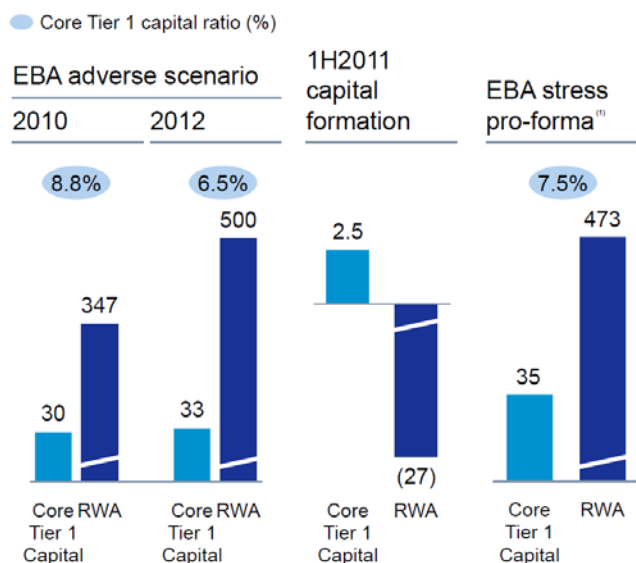
Deutsche had strong H1 capital generation. As EBA uses 2010 data, it ignores Deutsche's CT1 rising by 1.5% in H1 driven by 8% reduction in RWAs (€27bn) combined with 8% growth in CT1 (€2.5bn). If we consider this and recap to 9%, the capital deficit falls from ~€12.5bn to ~€7.5bn and is only 21% of TNAV instead of 36%. Therefore, we think a more suitable screen is one that includes H1 data.

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Exhibit 13

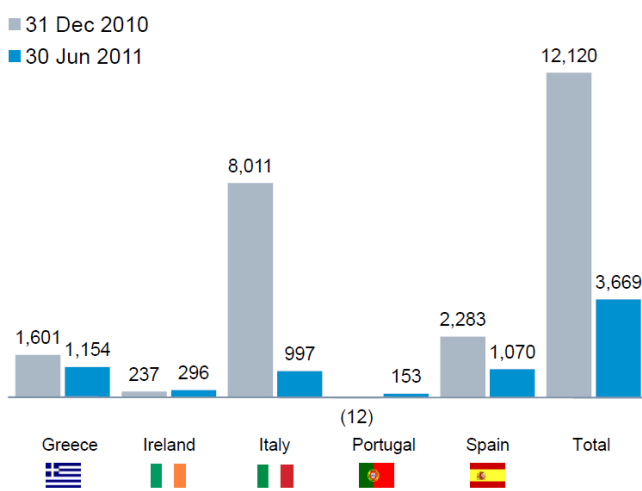
EBA stress test ignores capital generation and RWA reduction in H1, which increases CT1 by 1%



Source: Company data

Exhibit 14

Overview of net sovereign exposure at DBK: PIIGS exposure has declined 70% in H1



Source: Company data

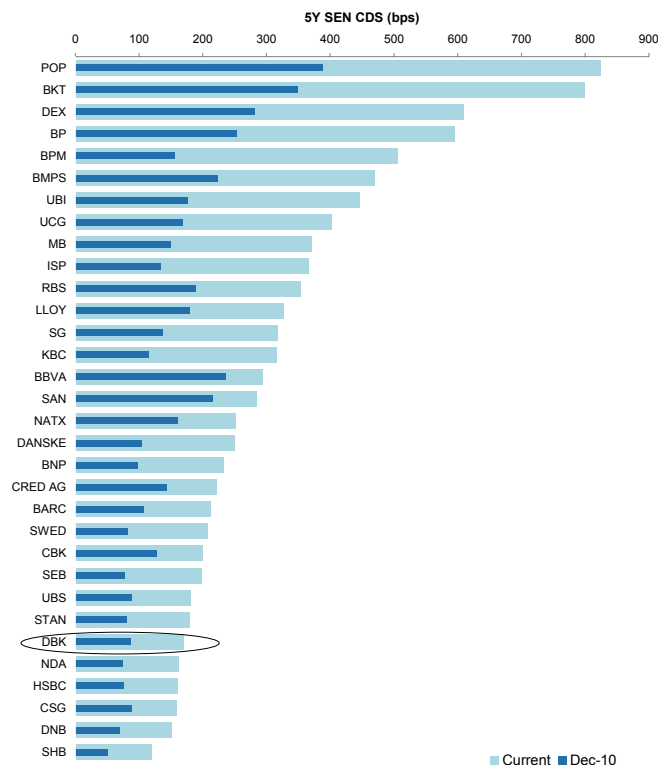
Deutsche – though - has many of the attributes we would like to buy, when share count becomes clear. Deutsche has been far shrewder in managing sovereign risks. They have also been far quicker to announce radical cost programmes

and we think as a “flow monster” will be better able to run a low-cost model in the investment bank. As seen in the above table though, dilution can be meaningful depending on hurdles and scenario. Given the numerous caveats and the process still in flux, we leave on Equal-weight, although on 0.7x TNAV Deutsche is not expensive should dilution risk be low.

We think banks should not all recap to the same level – which should benefit Deutsche: We think banks with higher wholesale funding skew and pressure (Dexia) or in worse economies (Greek/Portugal) should have a higher hurdle rate. ~70% of Deutsche’s funding in H1 is from more stable capital markets/equity and retail/transaction banking deposits (improving from ~45% in H1 2007). Deutsche at end Sept. showed it can still issue unsecured debt at reasonable levels (L+98bps for 2 yrs) despite a challenging environment for banks generally to issue unsecured term funding.

Exhibit 15

Deutsche has one of the lowest CDS spreads in the sector



Source: Bloomberg, Morgan Stanley Research

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What degree of freedom does management have?

We show that additional deleveraging and capital generation can reduce the capital deficit, making the starting point and assumptions for further deleveraging important in calculating capital needs.

Rolling over for an additional six months for H2 reduces capital needs by ~€2bn as Deutsche passes the 8% hurdle and reduces the capital deficit to ~€3bn for the 9% hurdle. Note that the 2011e estimate of the sovereign haircut is lower than H1 as we already include the €250m impact Deutsche says it will take in Q3 in our full-year estimates.

Exhibit 16

Additional capital generation in H2 through earnings growth and RWA reduction decreases capital deficit by €2bn

| H1 2011 | H1 11 B2.5 | 2011e B2.5 |
|------------------------|---------------|---------------|
| Core Tier 1 | 32,517 | 33,695 |
| Less: haircut | 333 | 163 |
| New Core Tier 1 | 32,184 | 33,532 |
| RWA (bn) | 320 | 313 |
| Add: Basel 2.5 | 93 | 93 |
| RWA 2.5 | 413 | 406 |
| Core Tier 1 | 7.8% | 8.3% |
| Deficit to: | | |
| 7.0% | 0 | 0 |
| 8.0% | (830) | 0 |
| 9.0% | (4,956) | (2,981) |
| % of TNAV: | | |
| 7.0% | 0% | 0% |
| 8.0% | 2% | 0% |
| 9.0% | 14% | 8% |

Source: Morgan Stanley Research estimates

We also show that assuming faster deleveraging under 2012e RWA but using 2011e capital, more capital can be saved.

Exhibit 17

Assuming faster deleveraging by using 2012e RWA saves ~€1.5bn of capital at H1

| H1 2011 | H1 11 B2.5 | 12e RWA |
|------------------------|---------------|---------------|
| Core Tier 1 | 32,517 | 32,517 |
| Less: haircut | 333 | 333 |
| New Core Tier 1 | 32,184 | 32,184 |
| RWA (bn) | 320 | 304 |
| Add: Basel 2.5 | 93 | 93 |
| RWA 2.5 | 413 | 397 |
| Core Tier 1 | 7.8% | 8.1% |
| Deficit to: | | |
| 7.0% | 0 | 0 |
| 8.0% | (830) | 0 |
| 9.0% | (4,956) | (3,546) |
| % of TNAV: | | |
| 7.0% | 0% | 0% |
| 8.0% | 2% | 0% |
| 9.0% | 14% | 10% |

Source: Morgan Stanley Research estimates

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Exhibit 18

Or ~€1bn of capital vs. 2011e estimates

| 2011e | 2011e B2.5 | 12e RWA |
|------------------------|---------------|---------------|
| Core Tier 1 | 33,695 | 33,695 |
| Less: haircut | 163 | 163 |
| New Core Tier 1 | 33,532 | 33,532 |
| RWA (bn) | 313 | 304 |
| Add: Basel 2.5 | 93 | 93 |
| RWA 2.5 | 406 | 397 |
| Core Tier 1 | 8.3% | 8.4% |
| Deficit to: | | |
| 7.0% | 0 | 0 |
| 8.0% | 0 | 0 |
| 9.0% | (2,981) | (2,198) |
| % of TNAV: | | |
| 7.0% | 0% | 0% |
| 8.0% | 0% | 0% |
| 9.0% | 8% | 6% |

Source: Morgan Stanley Research estimates

Underlying RWA would have to fall by ~17% vs. H1 and ~11% vs. 2011e to generate CT1 of 9% and to have no capital deficit.

Exhibit 19

We expect Deutsche's underlying RWA to fall by ~10% by 2013e helping Deutsche reach ~9% B3 CT1

| € m | 2010 | 2011e | 2012e | 2013e |
|--|----------------|----------------|----------------|----------------|
| Core Tier 1 | 29,972 | 33,695 | 38,436 | 43,938 |
| B3 adjustments: | | | | |
| Deductions | (8,000) | (7,000) | (6,000) | (6,000) |
| Add-back securitization deductions | 5,000 | 5,000 | 5,000 | 5,000 |
| Core Tier 1 (without DTA deduction) | 26,972 | 31,695 | 37,436 | 42,938 |
| RWA: | | | | |
| RWA (Basel 2) | 346,204 | 312,707 | 303,072 | 282,125 |
| Basel 2.5 | 93,000 | 93,000 | 93,000 | 93,000 |
| Basel 3 | 185,000 | 185,000 | 185,000 | 185,000 |
| Mitigation | (80,000) | (80,000) | (80,000) | (80,000) |
| RWA (new) | 544,204 | 510,707 | 501,072 | 480,125 |
| Core Tier 1 (post B3) - without DTA deduction | 5.0% | 6.2% | 7.5% | 8.9% |

Source: Morgan Stanley Research estimates

Changes to Forecasts

We cut our 2011e EPS by 16% and 2012e by 14% mainly on the back of weaker investment banking earnings and outlook – as we haven't written on Deutsche for some time. We now forecast Q3 investment banking revenues down ~30% QoQ mainly on the back of weaker FICC revenues and now assume investment banking PBT to break-even for the quarter. Our price target concurrently falls from €47 to €38. We leave DPS unchanged at 0.75c but assume 75% is paid through script.

Exhibit 20

Q311 investment banking forecasts

| Local currency (ex DVA) Q311e | CSG | DBK | UBS |
|-------------------------------|-------|-------|--------|
| Equities | 1,150 | 650 | -1,201 |
| FICC | 1,000 | 1,400 | 518 |
| IBD | 487 | 317 | 188 |
| Total IB Revenues | 2,612 | 2,737 | -495 |
| YoY (ex DVA) Q311e | CSG | DBK | UBS |
| Equities | 6% | -5% | -233% |
| FICC | -34% | -37% | -40% |
| IBD | -45% | -44% | -55% |
| Total IB Revenues | -25% | -35% | -123% |
| QoQ (ex DVA) Q311e | CSG | DBK | UBS |
| Equities | -10% | 17% | -214% |
| FICC | 57% | -39% | -55% |
| IBD | -50% | -56% | -54% |
| Total IB Revenues | -9% | -31% | -119% |

Source: Morgan Stanley Research estimates

Exhibit 21

Compared to the old DBK target, we now forecast €7.6bn

| 2011e PBT, in EURbn | MSe 11e | DBK 11e Target | Diff (bn) |
|--------------------------------|------------|----------------|------------|
| Corporate Banking & Securities | 3.7 | 6.4 | 2.7 |
| Global Transaction Banking | 1.1 | 1.0 | -0.1 |
| Asset & Wealth Mgmt | 0.8 | 1.0 | 0.2 |
| Private & Business Clients | 2.0 | 1.6 | -0.4 |
| Total | 7.6 | 10.0 | 2.4 |

Source: Morgan Stanley Research estimates

On our new earnings, Deutsche trades on 0.7x 11e TNAV for ~14% ROTNAV which is not expensive but we leave on Equal-weight as dilution risk is unknown and outlook for investment banking, which drives ~60% of profits, is uncertain.

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Exhibit 22

Summary of earnings changes

| EUR | Old | New | % Change |
|-----------|------|------|----------|
| EPS 2011e | 6.11 | 5.14 | -15.9% |
| EPS 2012e | 6.48 | 5.59 | -13.8% |
| TBV 2011e | 38.9 | 37.7 | -3.0% |
| TBV 2012e | 44.2 | 42.1 | -4.8% |

Source: Morgan Stanley Research estimates

Valuation methodology and risks

Our base case fair value is €41, our bull case fair value is €47, and bear case is €25. Our weighting to derive our price target is unchanged at 70% base, 20% bear and 10% bull. Deutsche would normally trade at a discount to its immediate peer group, given its investment-banking heavy franchise (~60% of core PBT), which is not offset to the same extent as peers with higher multiple franchises, such as wealth management.

To reach our valuation we use a P/BV multiple based on an adjusted Gordon growth model (which is our primary method and looks to longer-term earnings power of the franchise). Second, we test with a SoP, although this is not the primary driver. Third, we crudely check with a one-year forward P/E based on peers and historical trading ranges. In our base case we use a 12% COE, 2.8% growth and 14% post-tax ROTE. In our bear case we assume a COE of 14%, growth of 2% and post-tax ROTE of 10%. Our bull case has a ROTE of 15%, COE of 11.75% and growth of 3%.

We see risks from credit markets, equity market levels and volumes, FX, the macro and regulatory environment, as well as execution risk and risk management.

Exhibit 23

DBK price target methodology

| | Base case | Bull Case | Bear Case |
|--|------------|------------|------------|
| MW EPS | | | |
| 2007 | 7.10 | 7.10 | 7.10 |
| 2008 | -5.76 | -5.76 | -5.76 |
| 2009 | 5.88 | 5.88 | 5.88 |
| 2010 | 5.94 | 5.94 | 5.94 |
| 2011e | 5.14 | 5.36 | 4.95 |
| 2012e | 5.59 | 6.24 | 3.84 |
| 08 Tang BV | 23.5 | 23.5 | 23.5 |
| 09e Tang BV | 36.6 | 36.6 | 36.6 |
| 10 Tang BV | 34.3 | 34.3 | 34.3 |
| 11e Tang BV | 37.7 | 37.9 | 37.6 |
| 12e Tang BV | 42.1 | 42.9 | 40.5 |
| Valuation | | | |
| SOP FV | 53 | 55 | 47 |
| Sustainable ROTE | 14.0% | 15.0% | 10.0% |
| Cost of Equity | 12.0% | 11.8% | 14.0% |
| Growth | 2.8% | 3.0% | 2.0% |
| Theoretical P/TB | 1.2 | 1.4 | 0.7 |
| Implied FV on P/B | 41 | 47 | 22 |
| P/E 11e | 7.8 | 9.0 | 6.0 |
| P/E based FV | 40 | 48 | 30 |
| Fair value | 41 | 47 | 25 |
| Up/(Down)Side | 50% | 73% | -8% |
| Implied 11e P/E | 8.0 | 8.8 | 5.1 |
| Implied 10e P/B | 1.2 | 1.4 | 0.7 |
| % weight for FV | 70% | 10% | 20% |
| Fair value (weighted scenarios) | 38 | | |

Source: Morgan Stanley Research estimates

Focus on German Banks (II): Commerzbank

Commerzbank recapitalised in early 2011 and has repaid a large portion of government money (€1.9bn still outstanding but capital has been replenished only to 9.1% under B2.5 proforma. Given stress in its sovereign exposure it results still in a shortfall, albeit a relatively contained one (-€675m).

CBK earnings are weakening but it is possible that the shortfall may be at least in part covered with H2 2011 results.

Exhibit 24

Commerzbank can manage shortfall

| | MtM Govies |
|------------------------------------|------------|
| Capital deficits - H1 (€m) to 9% | (675) |
| Capital deficits - H1 (bps of RWA) | 26 |

Source: Company data, Morgan Stanley Research

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Exhibit 25

Detailed impact of sovereign haircuts

| | MTM |
|---------------------------------------|-------------|
| RWA H1 | 261,488 |
| Core Tier 1 Capital | 23,762 |
| Pro forma Basel 2.5 CT 1 ratio | 9.1% |

Sovereign Exposure 1H 2011

| | |
|----------|-------|
| Portugal | 900 |
| Ireland | - |
| Greece | 2,200 |
| Spain | 2,900 |
| Belgium | 615 |
| Italy | 8,700 |

Haircuts

| | |
|----------|-----|
| Portugal | 25% |
| Ireland | 10% |
| Greece | 59% |
| Spain | 5% |
| Belgium | 5% |
| Italy | 9% |
| Tax rate | 33% |

Sovereign losses

| | |
|----------------------------|--------------|
| Portugal | (151) |
| Ireland | - |
| Greece | (870) |
| Spain | (97) |
| Belgium | (21) |
| Italy | (525) |
| Total | (1,663) |
| Existing Greek impairments | (760) |
| Total losses | (903) |

| | MTM |
|---------------------------------------|--------------|
| Pro forma Core Tier 1 capital | 22,859 |
| Pro forma Basel 2.5 CT 1 ratio | 8.7% |
| capital shortfall to 9% | (675) |

Source: Company data, Morgan Stanley Research

Exhibit 26

Commerzbank can generate sufficient earnings to eliminate shortfall

| | 1H 2011 | 2011 YE |
|-------------------|-----------|----------|
| (€m) | (675) | - |
| bps of RWA | 26 | - |

Source: Company data, Morgan Stanley Research

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Focus on French

Using the same methodology explained in the sections above, the additional capital need for French banks could reach ~€13bn at H1 or ~67 bps of core capital. SocGen and BPCE appear with the largest capital shortfall at ~100bps each, while the additional capital cushion for BNPP and Credit Agricole Groupe appears milder at ~40-50bps.

Clearly, these levels of capital shortfall are extremely sensitive to the level of MtM used for European Sovereigns, especially for Italy and Belgium.

Adjusting, for own debt revaluations and expected MtM of Greek bonds in Q3, we think the four large French banks would generate 35-40ps of capital in the next 6m. This would be, we think, enough for CA Groupe and BNPP to reach the 9% Core Tier 1 threshold. However, this may mean SG and BPCE would

not be able to reach this level on a purely organic basis, within 6m.

We have run a similar analysis for KBC, at the bank level and adjusting for the sale of KBL epb. It seems the bank would not require additional capital under that scenario.

Exhibit 27

€12-18bn of capital shortfall under the new methodology

| Capital deficits - H1 (€m) | Capital deficit | in bps of RWAs |
|----------------------------|-----------------|----------------|
| BNPP | -3,289 | 52 bps |
| SG | -3,776 | 101 bps |
| CA Groupe | -2,402 | 40 bps |
| BPCE | -4,051 | 96 bps |
| KBC Bank | 0 | 0 bps |
| Total | -13,517 | -63 bps |

Source: Morgan Stanley Research estimates

Exhibit 28

Capital shortfall calculation assuming MtM of Sovereign bonds

| | BNPP | SG | Credit Agricole Groupe | BPCE | KBC Bank (*) |
|---|---------------|---------------|------------------------|---------------|---------------|
| RWA H1 | 595,000 | 333,000 | 571,000 | 405,000 | 103,015 |
| Core Tier 1 capital | 57,120 | 30,056 | 51,961 | 34,600 | 11,786 |
| Basel 2.5 | 40,000 | 40,000 | 25,000 | 15,000 | 8,100 |
| Pro forma Basel 2.5 CT 1 ratio | 9.0% | 8.1% | 8.7% | 8.2% | 10.6% |
| banking book | | | | | |
| Italy | 20,987 | 1,500 | 7,843 | 4,164 | 5,304 |
| Spain | 2,826 | 1,200 | 1,765 | 1,025 | 1,364 |
| Belgium | 18,046 | 292 | 2,189 | 2,350 | 21,347 |
| Greece | 3,552 | 1,100 | 278 | 1,187 | 443 |
| Portugal | 1,401 | 200 | 658 | 255 | 148 |
| Ireland | 404 | 300 | 144 | 263 | 269 |
| Haircuts | | | | | |
| Italy | 9.0% | 9.0% | 9.0% | 9.0% | 9.0% |
| Spain | 5.0% | 5.0% | 5.0% | 5.0% | 5.0% |
| Belgium | 5.0% | 5.0% | 5.0% | 5.0% | 5.0% |
| Greece | 59.0% | 59.0% | 59.0% | 59.0% | 59.0% |
| Portugal | 25.0% | 25.0% | 25.0% | 25.0% | 25.0% |
| Ireland | 10.0% | 10.0% | 10.0% | 10.0% | 10.0% |
| Sovereign losses | | | | | |
| Italy | -1,322 | -95 | -494 | -262 | -334 |
| Spain | -99 | -42 | -62 | -36 | -48 |
| Belgium | -632 | -10 | -77 | -82 | -747 |
| Greece | -1,467 | -454 | -115 | -490 | -183 |
| Portugal | -245 | -35 | -115 | -45 | -26 |
| Ireland | -28 | -21 | -10 | -18 | -19 |
| Total | -3,793 | -657 | -873 | -934 | -1,357 |
| Existing Greek impairments | -534 | -395 | -150 | -83 | -139 |
| Total losses | -3,259 | -262 | -723 | -851 | -1,218 |
| Pro forma core tier 1 ratio B2.5 | | | | | |
| BNPP | 53,861 | 29,794 | 51,238 | 33,749 | 10,568 |
| RWAs | 635,000 | 373,000 | 596,000 | 420,000 | 111,115 |
| Pro forma core tier 1 ratio B2.5 | 8.5% | 8.0% | 8.6% | 8.0% | 9.5% |
| capital shortfall to 9% | -3,289 | -3,776 | -2,402 | -4,051 | 0 |

Source: Company data, Morgan Stanley Research, (*) adjusted for divestment of KBL epb

Focus on Italy

Italian banks have €9.6bn of capital shortfall in our analysis (1/3 of our universe)

Using the same methodology on sovereign haircuts/mark to market and capital base, we highlight a capital shortfall of €9.6bn for the Italian banks we cover, or c. 1/3 of the total capital shortfall we highlight in our universe of European listed banks.

Clearly the shortfall for Italian banks is very much dependent and the value assumption for Italian sovereign bonds which is also why we strongly believe that the debate on capital cannot be closed until there is reasonable clarity that Italian (and indeed Spanish) government bonds are good money. Having said that, as we write earlier, we are also conscious that regulators may want to meet investors' concerns with sincerity and assess banks' capital using a test that assumes major market bonds at values below par.

Exhibit 29

Shortfall Overview

| Capital deficits - H1 (€m) to 9% | MtM Govies | (bps of RWA) |
|----------------------------------|----------------|--------------|
| Banca Popolare di Milano | (1,409) | 302 |
| Banco Popolare | (2,930) | 306 |
| Intesa Sanpaolo | - | - |
| Mediobanca | - | - |
| Banca Monte dei Paschi di Siena | (311) | 29 |
| Unione di Banche Italiane | (1,196) | 126 |
| UniCredit SpA | (3,718) | 80 |
| Total | (9,565) | 81 |

Source: Company data, Morgan Stanley Research

The relatively large shortfall in Italian banks (for example when assessed as % of NAV or market cap) is not just due to the haircut used for the Italian sovereign, but also the fact that Italian banks (with only a couple of exceptions) start with very low level of capitalisation. As we have extensively written in the past, while the more retail nature of the Italian banks may have justified lower capital buffer at the time of the structured credit crisis, the direction of the current crisis (which presents possible stresses from a weaker sovereign and some funding imbalances) may in our view indeed require higher capital buffers. To this, we also add that Italian banks' asset quality (when correctly assessed including all categories of problem loans, which make international comparison meaningful) is indeed one of the weakest in Europe and only just marginally better than Spain, at least among the larger countries. With NPLs on average representing 10% of loans and absorbing about 80% of CT1 capital in H1 alone (and still growing), we would argue that with the only notable exceptions of ISP and MB perhaps, substantially more capital needs to be added to the Italian banking system.

We also note that some Italian banks still have to repay government money that was injected in early 2009.

Exhibit 30

Government capital in Italian banks

| €m | PMI | BMPS |
|----------------------------|---------|--------|
| Outstanding Tremonti Bonds | 500 | 1900 |
| of RWA (B2.5 proforma) | 107 bps | 170bps |

Source: Company data, Morgan Stanley Research

Exhibit 7 offers an overview of haircuts we have used on sovereign exposures.

Exhibit 31

Detailed Impact of Sovereign haircuts

| | PMI | BP | ISP | MB | BMPS | UBI | UCG |
|--|-------------|-------------|--------------|--------------|--------------|-------------|-------------|
| RWA H1 | 46,586 | 95,700 | 324,395 | 55,045 | 106,093 | 95,074 | 465,192 |
| Core Tier 1 Capital incl. Tremonti Boi | 3,145 | 6,399 | 32,850 | 6,109 | 10,800 | 7,857 | 40,618 |
| Pro forma Basel 2.5 CT 1 ratio | 6.8% | 6.7% | 10.1% | 11.1% | 10.2% | 8.3% | 8.7% |

Sovereign Exposure 1H 2011

| | | | | | | | |
|----------|-------|--------|--------|-------|--------|-------|--------|
| Portugal | - | - | 45 | - | 261 | - | 56 |
| Ireland | - | - | 187 | - | 11 | - | 50 |
| Greece | - | 60 | 501 | 200 | 14 | - | 404 |
| Spain | 10 | 199 | 950 | - | 237 | 3 | 1,881 |
| Belgium | - | - | 36 | - | - | - | 209 |
| Italy | 5,983 | 11,374 | 34,473 | 3,400 | 24,960 | 8,240 | 38,664 |

Haircuts

| | | | | | | | |
|----------|-----|-----|-----|-----|-----|-----|-----|
| Portugal | 25% | 25% | 25% | 25% | 25% | 25% | 25% |
| Ireland | 10% | 10% | 10% | 10% | 10% | 10% | 10% |
| Greece | 59% | 59% | 59% | 59% | 59% | 59% | 59% |
| Spain | 5% | 5% | 5% | 5% | 5% | 5% | 5% |
| Belgium | 5% | 5% | 5% | 5% | 5% | 5% | 5% |
| Italy | 9% | 9% | 9% | 9% | 9% | 9% | 9% |
| Tax rate | 33% | 33% | 33% | 33% | 33% | 33% | 33% |

Sovereign losses

| | | | | | | | |
|----------------------------|--------------|--------------|----------------|--------------|----------------|--------------|----------------|
| Portugal | - | - | (8) | - | (44) | - | (9) |
| Ireland | - | - | (13) | - | (1) | - | (3) |
| Greece | - | (24) | (198) | (79) | (5) | - | (160) |
| Spain | (0) | (7) | (32) | - | (8) | (0) | (63) |
| Belgium | - | - | (1) | - | - | - | (7) |
| Italy | (361) | (686) | (2,079) | (205) | (1,505) | (497) | (2,331) |
| Total | (361) | (716) | (2,330) | (284) | (1,563) | (497) | (2,574) |
| Existing Greek impairments | | | -17 | -109 | | | -105 |
| Total losses | (361) | (716) | (2,313) | (175) | (1,563) | (497) | (2,469) |

| | PMI | BP | ISP | MB | BMPS | UBI | UCG |
|--------------------------------|----------------|----------------|---------------|--------------|--------------|----------------|----------------|
| Pro forma Core Tier 1 capital | 2,784 | 5,683 | 30,537 | 5,934 | 9,237 | 7,360 | 38,149 |
| Pro forma Basel 2.5 CT 1 ratio | 6.0% | 5.9% | 9.4% | 10.8% | 8.7% | 7.7% | 8.2% |
| capital shortfall to 9% | (1,409) | (2,930) | - | - | (311) | (1,196) | (3,718) |

Source: Morgan Stanley Research estimates

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Issue of Italian banks' low profitability, means that the passing of time does not help significantly but also poses the problem that injecting more equity will depress returns further, in the absence of offsetting actions

Even an additional 6 months of earnings would not make a huge difference for the Italians as we show in the table below; capital shortfall is only reduced to €8.5bn using FY11 numbers vs. €9.6bn using H1.

Additionally, with returns already in the low single-digit bracket, and little prospect of substantial improvement over the next two to three years, on the one hand it will be difficult to attract private capital. On the other, assuming that capital is injected using European TARP, the banks will continue to remain unattractive, even assuming an element of risk compression.

In our view, the only way to exit from this predicament is to undertake a more intense restructuring, possibly with meaningful branch closures, which will require a further substantial round of M&A in the country. Clearly the impact of such actions need to be carefully considered especially at a time when the country may face further economic and social challenges.

Exhibit 32

Future earnings are not sufficient to eliminate shortfall

| Shortfall (no dividend) | 1H 2011 | 2011 YE |
|----------------------------|----------------|----------------|
| PMI | (1,409) | (1,340) |
| BP | (2,930) | (2,921) |
| ISP | - | - |
| MB | - | - |
| BMPS | (311) | (174) |
| UBI | (1,196) | (1,120) |
| UCG | (3,718) | (2,893) |
| Total | (9,565) | (8,448) |

| Shortfall (bps of RWA) | 1H 2011 | 2011 YE |
|---------------------------|-----------|-----------|
| PMI | 302 | 288 |
| BP | 306 | 305 |
| ISP | - | - |
| MB | - | - |
| BMPS | 29 | 16 |
| UBI | 126 | 118 |
| UCG | 80 | 62 |
| Total | 81 | 71 |

Source: Company data, Morgan Stanley Research estimates (E)

Time may help deleveraging process, but the risk that intense deleveraging may border into credit crunch remains high

Even assuming banks are given time until early 2012, our analysis earlier shows that Italian banks do not accumulate sufficient earnings to be able to fill the capital gap. This could be helped by a more intense process of deleveraging, but as the table below shows, Italian banks' assets (and also those expiring within 12 months) are largely represented by securities (the majority of which are own government bonds, which banks are supposed to continue to support) or domestic loans, with the result that the impact of banks' shrinking has a more direct impact on the real economy, than for example the deleveraging planned by the French banks.

Anecdotal evidence for example already shows that the smaller banks have already reduced their lending to larger corporates (UBI and BP -9.7% and -19% resp in last 12 months) and retail has seen intense repricing that is affecting volumes; it is only a matter of time before banks also have to start reducing their lending to SME if current funding conditions persist. Loan

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growth in the country has already turned negative in July (-0.3%) and August (-0.4%) vs. 0.4% in June.

Exhibit 33

Reaming shortfall as % of total assets

| Shortfall as % of Total Asset | 2011 YE |
|-------------------------------|---------|
| PMI | 2.4% |
| BP | 2.1% |
| BMPS | 0.1% |
| Unione di Banche Italiane | 0.8% |
| UniCredit SpA | 0.3% |

Source: Morgan Stanley Research estimates

Exhibit 34

Short-term assets

| | Assets/ TA | ST Assets | o/w interbank | o/w securities | o/w loans |
|------|---------------|--------------|------------------|-------------------|----------------|
| PMI | 46% | 20535 | 1,362 7% | 1,388 7% | 17,784 87% |
| BP | 41% | 48677 | 4,399 9% | 3,988 8% | 40,289 83% |
| BMPS | 44% | 88420 | 10,593 12% | 10,588 12% | 67,239 76% |
| UBI | 41% | 46452 | 1,946 4% | 4,612 10% | 39,894 86% |
| UCG | 41% | 327303 | 59,012 18% | 42,895 13% | 225,395 69% |

Source: Company data, Morgan Stanley Research

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Exhibit 15

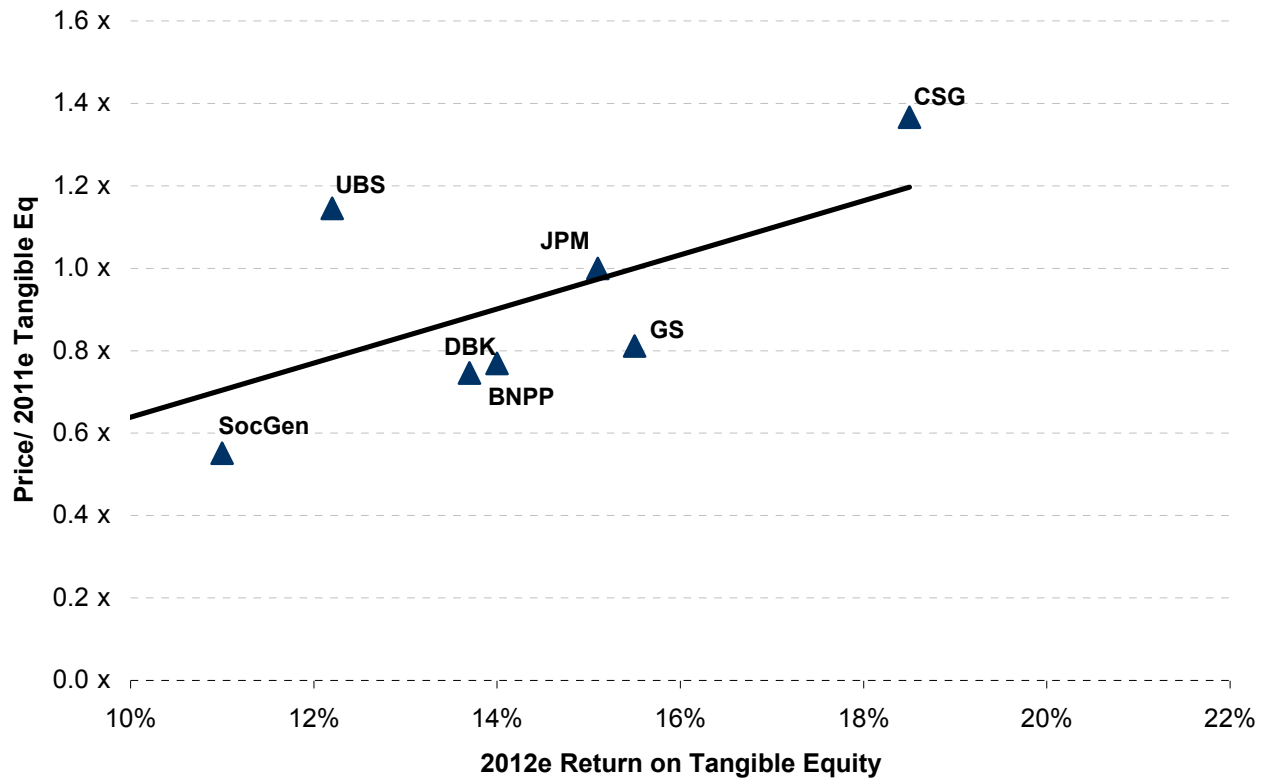
Wholesale banks valuation

| Company | Ccy | Price 14/10/2011 | EPS 2010 | P/E (x) 2010 | EPS 2011e | P/E (x) 2011e | EPS 2012e | P/E (x) 2012e | BVPS, Last Reported | | P/ TNAV (x) | | 2012e Core ROE (%) | |
|-------------------------|-----|---------------------|-------------|-----------------|--------------|------------------|--------------|------------------|---------------------|----------|-------------|------------|--------------------|------------|
| | | | | | | | | | Stated | Tangible | Latest | 2011e | Stated | Tangible |
| UBS | CHF | 10.8 | 1.35 | 8.0 | 0.76 | 14.2 | 1.27 | 8.5 | 12.5 | 10.0 | 1.1 | 1.1 | 10% | 12% |
| CSG | CHF | 25.0 | 4.42 | 5.6 | 3.37 | 7.4 | 3.90 | 6.4 | 26.0 | 18.4 | 1.4 | 1.3 | 14% | 19% |
| DBK | EUR | 27.3 | 5.94 | 4.6 | 5.14 | 5.3 | 5.59 | 4.9 | 53.9 | 36.7 | 0.7 | 0.7 | 10% | 14% |
| European IB | | | | 6.1 | | 9.0 | | 6.6 | | | 1.1 | 1.0 | 11% | 15% |
| BARC | p | 176.1 | 34.0 | 5.2 | 32.5 | 5.4 | 33.4 | 5.3 | 418.0 | 349.0 | 0.5 | 0.5 | 7% | 8% |
| RBS | p | 24.3 | 0.68 | - | 1.39 | 17.5 | 3.85 | 6.3 | 63.3 | 50.1 | 0.5 | 0.5 | 6% | 8% |
| UK Wholesale | | | | 5.2 | | 11.4 | | 5.8 | | | 0.5 | 0.5 | 7% | 8% |
| SocGen | EUR | 20.8 | 5.30 | 3.9 | 4.75 | 4.4 | 5.06 | 4.1 | 53.7 | 41.9 | 0.5 | 0.5 | 9% | 11% |
| BNPP | EUR | 32.3 | 6.24 | 5.2 | 6.65 | 4.8 | 6.61 | 4.9 | 56.7 | 45.5 | 0.7 | 0.7 | 11% | 14% |
| French Wholesale | | | | 4.5 | | 4.6 | | 4.5 | | | 0.6 | 0.6 | 10% | 12% |
| European Average | | | | 5.4 | | 8.4 | | 5.8 | | | 0.8 | 0.8 | 10% | 12% |
| GS | USD | 96.7 | 14.44 | 6.7 | 6.89 | 14.0 | 10.53 | 9.2 | 131.4 | 121.6 | 0.8 | 0.8 | 8% | 9% |
| BAC | USD | 6.2 | 0.98 | 6.3 | 0.79 | 7.8 | 1.07 | 5.8 | 20.3 | 12.7 | 0.5 | 0.5 | 5% | 8% |
| C | USD | 28.4 | 3.60 | 7.9 | 3.87 | 7.3 | 4.71 | 6.0 | 60.3 | 48.8 | 0.6 | 0.6 | 8% | 9% |
| JPM | USD | 31.9 | 3.96 | 8.1 | 4.43 | 7.2 | 4.37 | 7.3 | 45.9 | 33.1 | 1.0 | 0.9 | 9% | 13% |
| US Average | | | | 7.0 | | 8.9 | | 6.7 | | | 0.7 | 0.7 | 8% | 10% |
| Total Average | | | | 6.6 | | 8.6 | | 6.2 | | | 0.8 | 0.8 | | |

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

Exhibit 16

P/TNAV 2011e vs. RoTE 2012e



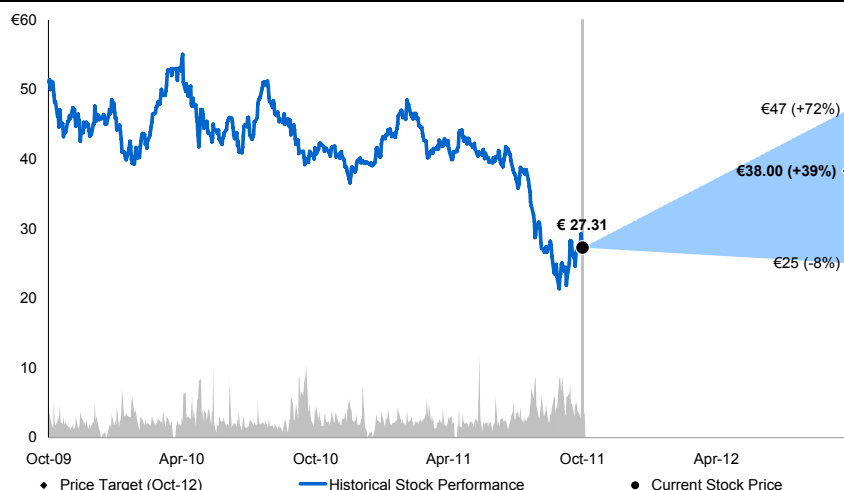
Source: Company data, Morgan Stanley Research e=Morgan Stanley Research estimates

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Banks

Deutsche Bank (DBKGn.DE, Equal-weight, €38)

Regulation, capital ratios, earnings mix, and legacy assets overhang confidence on upside



Why Equal-weight?

- Although DBK is executing well, the sustainability of investment banking earnings and uncertainty around legacy assets remain issues in the medium term. Also, there is uncertainty over share count if forced to recapitalize under new EBA stress hurdle.
- While debt formation has stabilised, legacy assets still remain ~0.7x last reported TNAV and IAS 39 benefit ~5% of TNAV pose some risks to earnings should the strong credit/cyclical recovery stall.
- Sustainability of IB an issue with pressure from deleveraging, contracting margins and regulation offset by market share gains and continued volatility.
- Possible upside case if DBK can deliver stronger earnings, asset quality does not deteriorate materially, DPB synergies are greater, and interest rates higher improving NII.
- Low rates can lead to bumper underwriting and in turn help drive systemic risks and credit spreads down, although will pressure NII in the retail businesses.
- Acquisition of DPB rebalances group with less dependence on ibanking (~60% of PBT)
- Capital ratios remain low against peers with core Tier 1 at end 2012 Basel 3 look-through of 7.3%.

Key risks

- Market risks, write-downs, monoline exposures, pressure on capital.

Catalysts

- Q3 report: October 25, 2011

| | | |
|-------------------------|------------------------|--|
| Price Target €38 | | We assign a weight of 70% to the base case scenario, 20% to the bull case and 10% to the bear case. |
| Bull Case | 8x Bull Case 12e EPS | Continued recovery in investment banking revenues with lower provisions. Stronger NNM in 11e. Cost of equity is 11.75%, with a long-term growth rate of 3% and a sustainable RoTE of 15% with a theoretical P/TB of 1.4x. |
| Base Case | 7x Base Case 12e EPS | Reported IB revenues -21% in 11e vs 10e. Group provisions are €2bn in 11e vs. €1.7bn a year ago. Cost of equity 12% with a sustainable RoTE of 14%, a long-term growth rate of 2.75% with a theoretical P/TB of 1.2x. |
| Bear Case | 6.5x Bear Case 12e EPS | Market healing peters out. DBK is forced to operate in renewed adverse markets with lower IB revenues and higher cost of risk. Cost of equity 14% with a long-term growth rate of 2% and a sustainable ROE of 10%, with P/TB of 0.7x. |

Source: FactSet (historical share price data), Morgan Stanley Research estimates

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Exhibit 17

Deutsche Bank P&L Forecasts

| DEUTSCHE BANK | | | | | | | | | | | | | | YoY % Chge | | | | | | | | | | |
|---|-------|-------|--------|-------|--------|-------|-------|-------|--------|--------|--------|--------|--------|------------|-------|------|-------|-------|-------|-------|-------|-------|-------|-------|
| | 1Q10 | 2Q10 | 3Q10 | 4Q10 | 1Q11 | 2Q11 | 3Q11e | 4Q11e | 2008 | 2009 | 2010 | 2011e | 2012e | 2013e | 1Q11 | 2Q11 | 3Q11e | 4Q11e | 2008 | 2009 | 2010 | 2011e | 2012e | 2013e |
| Stated P&L (€ mn) | | | | | | | | | | | | | | | | | | | | | | | | |
| Total Revenues | 9,001 | 7,155 | 4,983 | 7,426 | 10,474 | 8,541 | 6,882 | 7,209 | 13,514 | 27,924 | 28,565 | 33,106 | 32,746 | 34,440 | 16 | 19 | 38 | (3) | (57) | 107 | 2 | 16 | (1) | 5 |
| Operating Expenses | 5,943 | 5,387 | 5,671 | 6,314 | 8,081 | 6,299 | 5,657 | 5,807 | 17,347 | 20,089 | 23,315 | 24,844 | 23,792 | 24,473 | 19 | 17 | (0) | (8) | (19) | 16 | 16 | 7 | (4) | 3 |
| Policyholder benefits/claims | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | -273 | 0 | 0 | 0 | 0 | 0 | | | | | | | | | | |
| Pre-Prov. Operating Profits | 3,058 | 1,768 | -688 | 1,112 | 3,393 | 2,242 | 1,225 | 1,402 | -4,078 | 7,835 | 5,250 | 8,262 | 8,954 | 9,967 | 11 | 27 | (278) | 26 | (142) | (292) | (33) | 57 | 8 | 11 |
| Total Provisions | 261 | 245 | 363 | 405 | 373 | 464 | 427 | 427 | 1,091 | 2,632 | 1,274 | 1,691 | 1,673 | 1,543 | 43 | 89 | 18 | 5 | 78 | 141 | (52) | 33 | (1) | (8) |
| Post Provision Profits | 2,797 | 1,523 | -1,051 | 707 | 3,020 | 1,778 | 798 | 975 | -5,170 | 5,203 | 3,976 | 6,571 | 7,281 | 8,424 | 8 | 17 | (176) | 38 | (157) | (201) | (24) | 65 | 11 | 16 |
| Minority Interest | -1 | 0 | 0 | -1 | 0 | -1 | -32 | 6 | -61 | 1 | -2 | -27 | -53 | -53 | (100) | | (700) | | 6,000 | (102) | (300) | 1,250 | 96 | 0 |
| Restructuring expenses | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | | | | | | | | | | |
| Pre-tax Profits | 2,796 | 1,523 | -1,051 | 708 | 3,020 | 1,779 | 830 | 969 | -5,681 | 5,202 | 3,978 | 6,598 | 7,334 | 8,477 | 8 | 17 | (179) | 37 | (162) | (192) | (24) | 66 | 11 | 16 |
| Income tax expense | 1,016 | 358 | 170 | 102 | 891 | 545 | 286 | 334 | -1,845 | 243 | 1,646 | 2,057 | 2,420 | 2,797 | (12) | 52 | 68 | 228 | (182) | (113) | 577 | 25 | 18 | 16 |
| Reversal of tax rate chge credits | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | | | | | | | | | | |
| Net Income | 1,782 | 1,165 | -1,221 | 606 | 2,129 | 1,234 | 544 | 635 | -3,836 | 4,959 | 2,332 | 4,541 | 4,914 | 5,680 | 19 | 6 | (145) | 5 | (156) | (229) | (53) | 95 | 8 | 16 |
| Underlying P&L (€ mn) | | | | | | | | | | | | | | | | | | | | | | | | |
| Gains (Losses) on Ind. Holdings | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1435 | 0 | 0 | 0 | 0 | 0 | | | | | 110 | | | | | |
| Gains (Losses) from Eqty Inv. | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | -339 | 541 | 0 | 0 | 0 | 0 | | | | | (171) | (260) | | | | |
| Underlying Revenues | 9,001 | 7,297 | 7,284 | 7,549 | 10,249 | 8,673 | 6,882 | 7,209 | 12,510 | 27,592 | 31,131 | 33,013 | 32,746 | 34,440 | 14 | 19 | (6) | (5) | (58) | 121 | 13 | 6 | (1) | 5 |
| Severance Payments | 42 | 71 | 120 | 354 | 106 | 51 | 0 | 0 | 387 | 630 | 587 | 157 | 0 | 0 | 152 | (28) | (100) | (100) | 72 | 63 | (7) | (73) | | |
| Other One-off Costs | 164 | 56 | 0 | 0 | 104 | 40 | 300 | 100 | -11 | 1008 | 220 | 544 | 750 | 700 | (37) | (29) | | | (87) | (78) | 147 | 38 | (7) | |
| Underlying Costs | 5,737 | 5,260 | 5,551 | 5,960 | 6,871 | 6,208 | 5,357 | 5,707 | 17,018 | 18,451 | 22,508 | 24,143 | 23,042 | 23,773 | 20 | 18 | (3) | (4) | (20) | 8 | 22 | 7 | (5) | 3 |
| Underlying Provisions | 261 | 245 | 363 | 405 | 373 | 464 | 427 | 427 | 1,091 | 2,636 | 1,274 | 1,691 | 1,673 | 1,543 | 43 | 89 | 18 | 5 | 78 | 160 | (55) | 33 | (1) | (8) |
| Underlying Post-Prov. Op. Profits | 3,003 | 1,792 | 1,370 | 1,184 | 3,005 | 2,001 | 1,098 | 1,075 | -5,600 | 6,305 | 7,349 | 7,179 | 8,031 | 9,124 | 0 | 12 | (20) | (9) | (169) | (213) | 17 | (2) | 12 | 14 |
| Minority Interest | -1 | 0 | 0 | -1 | 0 | -1 | -32 | 6 | -61 | 1 | -2 | -27 | -53 | -53 | (100) | | (700) | | 6,000 | (102) | (300) | 1,250 | 96 | 0 |
| Underlying Pre-tax Profits | 3,004 | 1,792 | 1,370 | 1,185 | 3,005 | 2,002 | 1,130 | 1,069 | -5,539 | 6,304 | 7,351 | 7,206 | 8,084 | 9,177 | 0 | 12 | (18) | (10) | (169) | (214) | 17 | (2) | 12 | 14 |
| Tax | 1,091 | 645 | 493 | 427 | 887 | 613 | 390 | 369 | -1,195 | 2,096 | 2,656 | 2,259 | 2,668 | 3,028 | (19) | (5) | (21) | (14) | (142) | (275) | 27 | (15) | 18 | 14 |
| Underlying Net Profits | 1,913 | 1,147 | 877 | 758 | 2,118 | 1,389 | 740 | 700 | -4,344 | 4,208 | 4,695 | 4,947 | 5,416 | 6,149 | 11 | 21 | (16) | (8) | (182) | (197) | (197) | 926 | 9 | 14 |
| Key Per Share Data (€) | | | | | | | | | | | | | | | | | | | | | | | | |
| Basic EPS | 1.87 | 1.22 | -1.29 | 0.66 | 2.27 | 1.32 | 0.59 | 0.68 | -4.66 | 7.20 | 3.10 | 4.87 | 5.23 | 6.01 | 21 | 8 | (145) | 4 | (148) | (255) | (57) | 57 | 7 | 15 |
| ModelWare EPS | 1.93 | 1.15 | 0.93 | 0.80 | 2.19 | 1.43 | 0.77 | 0.73 | -5.76 | 5.88 | 5.94 | 5.14 | 5.59 | 6.30 | 14 | 25 | (177) | (9) | (181) | (202) | 1 | (13) | 9 | 13 |
| NAV/S | 41.0 | 43.4 | 40.8 | 52.4 | 53.2 | 53.9 | 54.5 | 55.2 | 35.1 | 52.7 | 52.4 | 55.0 | 59.2 | 65.1 | 30 | 24 | 34 | 5 | (32) | 50 | (0) | 5 | 8 | 10 |
| Tangible NAV/S (exc FV gains & diluted) | 27.6 | 29.0 | 28.4 | 34.6 | 35.9 | 36.7 | 37.2 | 37.9 | 23.5 | 36.6 | 34.3 | 37.7 | 43.5 | 49.3 | 30 | 26 | 31 | 10 | (37) | 55 | (6) | 10 | 11 | 14 |
| DPS | - | - | - | - | - | - | - | - | 0.33 | 0.50 | 0.75 | 0.75 | 0.75 | 0.75 | | | | | (89) | 50 | 50 | (1) | 1 | (0) |
| Average Diluted Shares Outst. (mn) | 993 | 996 | 944 | 948 | 968 | 968 | 959 | 959 | 754 | 716 | 791 | 963 | 970 | 976 | (2) | (3) | 2 | 1 | 2 | (5) | 10 | 22 | 1 | 1 |
| Share Buyback amount (€ mn) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | | | | | (100) | 0 | NM | NM | NM | 0 |
| Key Ratios | | | | | | | | | | | | | | | | | | | | | | | | |
| Underlying Cost-income ratio (%) | 63.7 | 72.1 | 76.2 | 79.0 | 67.0 | 71.6 | 77.8 | 79.2 | 136.0 | 66.9 | 72.3 | 73.1 | 70.4 | 69.0 | 5 | (1) | 2 | 0 | 0 | 0 | 8 | 1 | (4) | (2) |
| Tax Rate (%) | 36.3 | 23.5 | -16.2 | 14.4 | 29.5 | 30.6 | 34.5 | 34.5 | 32.5 | 4.7 | 41.4 | 31.2 | 33.0 | 33.0 | (19) | 30 | (313) | 139 | 32 | (86) | 786 | (25) | 6 | 0 |
| Payout Ratio (%) | - | - | - | - | - | - | - | - | -6.6 | 7.2 | 25.4 | 15.3 | 14.4 | 12.5 | | | | | (120) | (210) | 252 | (40) | (6) | (13) |
| Pre-tax Return on Ave Active Equity (%) | 29.8 | 15.2 | -10.4 | 6.1 | 24.7 | 14.3 | 6.6 | 7.6 | -21.8 | 15.0 | 9.6 | 13.3 | 13.8 | 14.6 | (17) | (6) | (164) | 25 | (177) | (169) | (36) | 38 | 4 | 5 |
| Underl. Return on Ave Active Equity (%) | 20.4 | 11.5 | 8.7 | 6.6 | 17.3 | 11.2 | 5.9 | 5.5 | -13.3 | 12.2 | 11.3 | 10.0 | 10.2 | 10.6 | (15) | (3) | (32) | (16) | 0 | 0 | (7) | (12) | 2 | 4 |
| Underl. Return on Ave Stated Equity (%) | 20.2 | 11.4 | 8.6 | 6.5 | 17.1 | 11.1 | 5.9 | 5.5 | -12.8 | 12.4 | 11.2 | 9.9 | 10.1 | 10.5 | (15) | (2) | (32) | (16) | 0 | 0 | (9) | (12) | 2 | 4 |
| Underl. Return on Ave Tangible Equity (%) | 28.4 | 16.2 | 12.6 | 10.1 | 24.9 | 15.9 | 8.4 | 7.8 | -17.9 | 17.8 | 15.7 | 14.2 | 14.0 | 14.0 | (12) | (2) | (34) | (23) | | | (12) | (10) | (2) | 0 |
| Underl. Provisions to Gross Loans (bps) | 39.3 | 34.9 | 50.6 | 46.8 | 36.9 | 46.6 | 42.8 | 42.5 | 47.7 | 106.5 | 37.9 | 41.5 | 41.0 | 36.9 | (6) | 34 | (16) | (9) | 50 | 123 | (64) | 10 | (1) | (10) |
| Core Tier 1 ratio | 7.5 | 7.5 | 7.6 | 8.7 | 9.6 | 10.2 | 10.5 | 10.8 | 8.7 | 8.7 | 8.7 | 10.8 | 9.7 | 11.7 | | | | | | | | | | 21 |
| Tier 1 Ratio (%) | 11.2 | 11.3 | 11.5 | 12.3 | 13.4 | 14.0 | 14.3 | 14.7 | 10.1 | 12.6 | 12.3 | 14.7 | 12.8 | 14.9 | 19 | 24 | 25 | 19 | 17 | 25 | (2) | 19 | (13) | 17 |
| BIS RWAs (€ bn) | 292 | 303 | 277 | 346 | 328 | 320 | 316 | 313 | 308 | 273 | 346 | 313 | 396 | 375 | 12 | 5 | 14 | (10) | (6) | (11) | 27 | (10) | 27 | (5) |

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

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(as of September 30, 2011)

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| Stock Rating Category | Coverage Universe | | Investment Banking Clients (IBC) | | |
|--------------------------|-------------------|------------|----------------------------------|----------------|----------------------|
| | Count | % of Total | Count | % of Total IBC | % of Rating Category |
| Overweight/Buy | 1130 | 40% | 457 | 46% | 40% |
| Equal-weight/Hold | 1168 | 42% | 419 | 42% | 36% |
| Not-Rated/Hold | 112 | 4% | 23 | 2% | 21% |
| Underweight/Sell | 400 | 14% | 104 | 10% | 26% |
| Total | 2,810 | | 1003 | | |

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October 17, 2011

Banks

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Industry Coverage: Banks

| Company (Ticker) | Rating (as of) | Price* (10/14/2011) |
|------------------|----------------|---------------------|
|------------------|----------------|---------------------|

Steven Hayne

| | | |
|----------------------------------|-----------------|--------|
| Allied Irish Banks PLC (ALBK.I) | NA (03/30/2010) | €0.06 |
| Bank of Ireland Group (BKIR.I) | U (12/10/2010) | €1 |
| HSBC (HSBA.L) | O (04/19/2011) | 525p |
| Standard Chartered Bank (STAN.L) | E (10/26/2009) | 1,419p |

Hubert Lam

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|-----------------------|----------------|----------|
| Julius Baer (BAER.VX) | E (02/09/2011) | SFr33.17 |
|-----------------------|----------------|----------|

Chris Manners, ACA

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|--------------------------------|----------------|------|
| Barclays Bank (BARC.L) | O (08/11/2009) | 176p |
| Lloyds Banking Group (LLOY.L) | U (02/25/2011) | 33p |
| Royal Bank of Scotland (RBS.L) | E (08/09/2010) | 24p |

Thibault A Nardin

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|--------------------------------|----------------|--------|
| BNP Paribas (BNPP.PA) | O (05/16/2011) | €32.25 |
| Credit Agricole S.A. (CAGR.PA) | E (05/16/2011) | €5.2 |
| DEXIA (DEXI.BR) | E (10/27/2010) | €6.69 |
| KBC Group NV (KBC.BR) | E (04/27/2010) | €17.38 |
| Natixis (CNAT.PA) | U (09/23/2010) | €2.24 |
| Societe Generale (SOGN.PA) | O (11/09/2009) | €20.84 |

Morgan Stanley Research Europe

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|-----------------------------------|-----------------|-------|
| Aareal Bank AG (ARLG.DE) | NA (06/18/2010) | €13.1 |
| Alpha Bank (ACBr.AT) | ++ | €1.07 |
| EFG Eurobank (EFG.AT) | NA (09/07/2010) | €7.3 |
| National Bank of Greece (NBGr.AT) | ++ | €1.82 |
| Piraeus Bank SA (BOPr.AT) | NA (01/17/2011) | €2.9 |

Henrik H Schmidt

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|---------------------------------|----------------|----------|
| Danske Bank (DANSKE.CO) | E (08/19/2011) | DKr74.4 |
| DnB NOR (DNBNOR.OL) | O (09/02/2010) | NKr63.85 |
| Nordea (NDA.ST) | E (03/28/2011) | SKr58.15 |
| SEB (SEBa.ST) | E (09/02/2010) | SKr38.81 |
| Svenska Handelsbanken (SHBa.ST) | E (09/02/2010) | SKr178.8 |
| Swedbank (SWEDa.ST) | O (08/19/2011) | SKr83.05 |

Alvaro Serrano

| | | |
|-----------------------------|----------------|-------|
| BBVA (BBVA.MC) | O (08/31/2011) | €6.46 |
| Banca Civica SA (BCIV.MC) | E (09/20/2011) | €2.4 |
| Banco Popular (ES) (POP.MC) | ++ | €3.52 |
| Banco Sabadell (SABE.MC) | U (08/31/2011) | €2.67 |
| Banesto (BTO.MC) | U (08/31/2011) | €4.57 |
| Bankinter (BKT.MC) | U (08/31/2011) | €4.48 |
| Santander (SAN.MC) | E (08/31/2011) | €6.23 |

Magdalena L Stoklosa

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|---|----------------|--------|
| Erste Bank (ERST.VI) | E (05/05/2011) | €16.38 |
| Raiffeisen Bank International (RBIV.VI) | U (03/02/2011) | €22.45 |

Francesca Tondi

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|---|-----------------|----------|
| Banca Monte dei Paschi di Siena S.p.A. (BMPS.MI) | U (11/08/2010) | €4.1 |
| Banca Popolare di Milano S.c.a.r.l. (PMI.MI) | U (11/08/2010) | €1.84 |
| Banco Popolare (BAPO.MI) | U (11/08/2010) | €1.24 |
| Commerzbank (CBKG.DE) | E (06/17/2011) | €1.67 |
| Intesa SanPaolo S.p.A. (ISP.MI) | E (07/15/2011) | €1.3 |
| Mediobanca Banca Di Credito Finanziario (MDBI.MI) | U (08/31/2011) | €6.08 |
| UniCredit S.p.A. (CRDI.MI) | U (08/31/2011) | €9.95 |
| Unione di Banche Italiane SCPA (UBI.MI) | U (08/31/2011) | €3.12 |
| Huw Van Steenis | | |
| Credit Suisse Group (CSGN.VX) | E (10/04/2010) | SFr24.95 |
| Deutsche Bank (DBKGn.DE) | E (10/11/2010) | €27.3 |
| UBS (UBSN.VX) | E (10/03/2011) | SFr10.92 |
| Hadrien de Belle | | |
| TT Hellenic Postbank S.A. (GPSr.AT) | NA (03/10/2011) | €3.8 |

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* Historical prices are not split adjusted.