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**Europe**

Investment Grade Credit

# European Financials

## SNS: Property Finance Concerns Remain

**We are sellers of SNS bonds on the risk of a material negative surprise, especially within the run-off Dutch Property Finance portfolio. For investors looking to stay involved, the insurer-issued €9% 41NC21 LT2s offer the best relative value, in our view.**

**SNS credit story still overshadowed by Property Finance performance,** though we are more concerned now about a material negative surprise emanating from the Dutch rather than International run-off portfolio. In our view, clear pressures on asset quality here could translate into a significant uptick in provisioning requirements.

**A resurgence of Property Finance problems could put at risk compliance with EBA capital requirements, in our view:** Not only would this likely delay the state aid repayment calendar further (we are not expecting any movement in 2012), it could even raise the question of whether more might be needed, with obvious negative implications for hybrid calls and optional coupons.

**Given nervousness over the credit, we'd be sellers of bonds on the back of the current broad market rally and recently concluded bank liability management.**

**For those looking to stay involved, go defensive:** The insurer €9% 41NC21 LT2s offer the best relative value, in our view (offered at 75, YTC of 14.0%; YTM of 12.2%). Switch into these from group and bank level hybrids. **Otherwise, switch from the Tier 1s into the SNS Bank €6.25% 2020 bullet LT2 (offered at 79, YTM of 10.0%).**

**Switches from SNS will necessitate yield reductions and the paying of higher prices:** However, for insurance alternatives look at CNP Assurances' long-dated € LT2s, in bank LT2s Lloyds € 6.5% 2020s and in Tier 1 issues from the likes of Credit Agricole.

**Risk factors to trades include** better-than-expected reporting at SNS Property Finance, resulting in group bonds performing stronger than anticipated and versus others recommended as switch ideas.

### Recent Insurance Research

| | |
|---|---|
| Phoenix: Awaiting a Debt Solution | Jan 16, 2012 |
| ING 'Par Put' Getting Closer | Jan 12, 2012 |
| Zurich Asian Retail Switch | Jan 11, 2012 |
| How Do They Do That? Policyholder Loss Sharing in French Life Savings Products | Jan 5, 2012 |
| 2012 Outlook: Solvency Stress Building | Dec 14, 2011 |
| Swiss Life 3Q: Positive Signals for Bondholders | Nov 15, 2011 |
| Ageas: Struggling for Comfort on Legacy Risks | Nov 7, 2011 |
| Investment Impact: Bank Senior Unsecured Debt | Oct 20, 2011 |
| Insurers: Strong First Call Track Record Continues | Oct 18, 2011 |
| Adding in Quality LT2 | Oct 12, 2011 |

# European Insurance

## SNS: Property Finance Concerns Remain

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### Reviewing the Big Debates Ahead of FY11 Results

**SNS REAAL N.V.** (**SNS or the group**) is due to release its full-year results on February 16, 2012. In this report, we review the major debates involving the credit, set out our expectations and look at trade positioning going into the numbers, including for the first time the €9% 41NC21 LT2 subordinated debt issued from the group's main insurance operation **SRLEV N.V.** (**SRLEV**; see Appendix I for a summary group structure chart).

For us the big credit issues remain:

- Performance of SNS Bank's run-off Property Finance portfolio;
- Progress with regard to state aid and Foundation repayment; and
- Implications of European bank (EBA) and insurance (EIOPA) stress-test results.

In our view, these continue to overshadow underlying performance at the group's ongoing bank and insurance operations (see Exhibit 1).

Exhibit 1

**Recent SNS Segmental Net Income Performance**

| € million | FY10 | 1Q11 | 2Q11 | 3Q11 |
|---|---|---|---|---|
| **SNS Bank Total** | **212** | **61** | **60** | **50** |
| *SNS Retail* | *139* | *42* | *45* | *34* |
| *SNS SME* | *73* | *19* | *15* | *16* |
| **Insurance Total** | **206** | **14** | **42** | **103** |
| *REAAL Life* | *208* | *15* | *36* | *105* |
| *REAAL Non Life* | *16* | *1* | *10* | *3* |
| *REAAL Other* | *-18* | *-2* | *-4* | *-5* |
| **Pensions Total** | **36** | **15** | **4** | **-14** |
| **Group Activities** | **-71** | **-12** | **-22** | **-28** |
| **Run-off Property Finance** | **-643** | **-57** | **-61** | **-69** |
| **Total** | **-260** | **21** | **23** | **42** |

Source: Morgan Stanley Research, company reporting

### Property Finance: Further Provisioning to Come

**The very poor performance of SNS's Property Finance portfolio remains a key area of concern for us.** In 4Q10 the group surprised the market by booking €413 million of fresh impairments on the portfolio, considerably more than the €377 million booked during the first nine months of the year. As a result, SNS booked a loss for FY10 of €260 million.

Most of the 4Q10 provisioning related to International lending, less so Dutch project finance activities. It reflected both the need to bring provisioning more into line with that of peers plus the impact of management's decision to accelerate the portfolio's run-off. Loan loss provision coverage of non-performing loans across the entire Property Finance portfolio jumped to 42% from 15% a year earlier.

Subsequently, SNS reorganised the portfolio, allocating a large part (€5.6 billion of FY10 total drawn commitments) of the Dutch portfolio to a new SME lending unit in the core bank, leaving a non-core run-off portfolio of €6.5 billion (at FY10), predominantly comprised of the International lending and Dutch project finance activities.

At its recent 2011 investor day, SNS provided further colour on the current make-up of the Property Finance portfolios. At 9M11, 167 International loans remained outstanding (versus 257 in the Dutch portfolio). The International book is the more concentrated of the two, its 20 largest loans representing 60% of the portfolio (41% of the Dutch one). Two International loans are over €100 million in size, averaging €105.5 million each, whereas the Dutch portfolio has only one loan over €100 million, with a size of €133 million (at the investor day, management stated that this loan was also the largest NPL of the Dutch portfolio). Finally, the International portfolio is also the more concentrated when it comes to NPLs, the 10 largest representing 61% of total International NPLs, the equivalent figure for the Dutch portfolio being 49%.

Management is aiming to have completed the vast majority of the Property Finance run-off by 2014. However, in the event of continuing challenging market conditions, we see a risk that this timetable will not be met.

**Throughout 2011, Property Finance performance has continued to be a material drag on that of the wider group.** To illustrate, SNS's core operations (excluding group activities) generated a €335 million net positive result for the first nine months of 2011, whereas run-off Property Finance produced a loss of €187 million, reflecting impairments averaging ~€70 million per quarter.

In Exhibit 2, we set out key performance metrics for Property Finance. To date, the market has understandably been most concerned with performance in the International portfolio, given its poor track record. As can be seen, SNS has made good progress in 2011 reducing International portfolio commitments (down 23% at the nine-month stage). The average LTV of this segment has also remained fairly steady at ~97%. However, **over the same period, loan loss provisioning has weakened somewhat** (NPL coverage down to 46.0% from 52.0%).

Exhibit 2

## SNS Property Finance Run-Off Portfolio Summary

| € million | FY10 | HY11 | 9M11 |
|---|---|---|---|
| **SNS Bank Core Tier 1** | **1,781** | **1,804** | **1,787** |
| **Total Portfolio** | | | |
| Drawn Commitments | 6,511 | 5,766 | 5,550 |
| *Change %* | - | *(11)* | *(4)* |
| Non-Performing Loans (NPLs) | 1,761 | 1,570 | 1,694 |
| *Change %* | - | *(11)* | *8* |
| NPLs % Drawn Commitments | 27.0 | 27..2 | 30.5 |
| Loan Loss Provisions % NPLs | 41.3 | 36.6 | 36.0 |
| Average LTV % | 96.4 | 95.7 | 100.5 |
| **Dutch Portfolio** | | | |
| Drawn Commitments | 3,547 | 3,428 | 3,295 |
| *Change %* | - | *(3)* | *(4)* |
| Non-Performing Loans (NPLs) | 788 | 962 | 995 |
| *Change %* | - | *22* | *3* |
| NPLs % Drawn Commitments | 22.2 | 28.1 | 30.2 |
| Loan Loss Provisions % NPLs | 28.2 | 28.3 | 29.0 |
| Average LTV % | 95.8 | 98.9 | 102.7 |
| **International Portfolio** | | | |
| Drawn Commitments | 2,965 | 2,338 | 2,255 |
| *Change %* | - | *(21)* | *(4)* |
| Non-Performing Loans (NPLs) | 973 | 608 | 699 |
| *Change %* | - | *(38)* | *15* |
| NPLs % Drawn Commitments | 32.8 | 26.0 | 30.6 |
| Loan Loss Provisions % NPLs | 52.0 | 49.8 | 46.0 |
| Average LTV % | 97.6 | 91.3 | 97.4 |

Source: Morgan Stanley Research, company reporting. Loan loss provisions breakdown at 3Q11 assumes published total breaks down between Dutch and International portfolios as per HY11.

**Looking ahead, for us the major Property Finance-related risk is performance deterioration within the larger Dutch portfolio (drawn commitments of ~€7.8 billion, including the ongoing SME operation). Ultimately, we are concerned that a downturn in the Dutch market could translate into a material uptick in provisioning requirements for SNS in future quarters.**

Unfortunately, we believe there are signs that portfolio deterioration could be happening. In the first nine months of 2011, reflecting softening market conditions, the average LTV in the run-off Dutch portfolio increased materially to 103%, while NPLs rose by 26%. Again at the 2011 investor day, management indicated that, going forward, new Property Finance NPL formation is likely to be skewed towards the Dutch rather than the International segment.

**Within the Dutch portfolio, we are particularly concerned about the group's exposure to offices-related loans.** Management has guided that the Dutch portfolio is more exposed to this sub-asset class compared to the overall run-off Property Finance offices total (34% of loans).

Our nervousness over the Dutch portfolio further reflects the views of Bart Gysens, who heads Morgan Stanley's equity research into the European Property sector. He views Dutch offices as an asset class which has the potential to be especially problematic in the near future.

### Dutch Office Values Overpriced

According to Bart, the low real interest rate environment has had a reflationary effect on asset prices across Europe. While this has been less pronounced in Dutch commercial property (owing to relatively weak fundamentals and lack of meaningful cyclicality), prime Amsterdam office yields are nevertheless back down to 5.5%, according to CB Richard Ellis, only 50bp off their 2007 lows, or, in other words, only 10% below the 2007 peak in commercial property prices.

### Negative Interest Coverage Impact of High Vacancy Rates and Obsolescence

The relaxed Dutch planning environment has facilitated significant supply of new office space in recent decades. When combined with a lack of meaningful demand growth, this has driven significant property vacancy in the Netherlands. Jones Lang LaSalle estimates that Amsterdam office vacancy is now at 20%, and Bart believes this is even higher in the Randstad area (covering Amsterdam, Rotterdam, The Hague and Utrecht), which is effectively littered with low-occupancy business parks. Indeed, he strongly believes that a significant part of the commercial property market, offices and industrial property in particular, will never be let and is effectively obsolete (a situation which he believes is yet to be fully recognised by owners – and lenders).

Admittedly, the current lack of availability of development finance is reducing supply of new space, but given lacklustre growth, Bart feels it will take time to absorb vacancy to such an extent that meaningful rental growth materialises. Meanwhile, tenants continue to enjoy a very strong bargaining position with their landlords over the renewal of rental agreements.

**In our view, the main concern for property finance lenders such as SNS is that as market conditions suppress rental income, the ability of borrowers to meet loan interest may become increasingly pressured. In turn this could increase the probability of loan non-performance and increased loss provisioning**.

## Fallout from German Open-Ended Fund Liquidation

Bart is also concerned about the impact on Dutch market yields of the ongoing liquidation of German open-ended property funds. (For a fuller discussion, see *German Open-Ended Funds: The Great Unwind*, October 24, 2011.)

These funds suffered large redemption demands in the wake of Lehman Brothers' collapse in 2008/09, mainly because they represented one of the few asset classes that offered daily liquidity. Heightened redemption demand led to funds representing about a third of aggregate assets under management halting redemptions. Under current legislation, funds can stop redemptions for a maximum of two years. Thereafter, they either have to allow redemptions to proceed, or they have to liquidate. The breathing space for the funds provided by the redemption moratorium is now coming to an end, with the result that liquidations are on the rise. Bart's analysis suggests that funds in liquidation own the equivalent of 4.6 times quarterly Dutch office transaction volumes in the last two years. As a result, in his view their disposal activity is having a clear detrimental impact on asset values in the Dutch market.

**In our view, higher LTVs (and by extension lower asset quality) are the obvious likely consequence.** When loans are renewed, unless lenders look to show a degree of forbearance, borrowers could be faced with more restricted refinancing options and more severe interest rates. In our view, this could potentially have negative impacts for the lending books of banks such as SNS Bank.

**As a result, we expect group earnings will continue to suffer from Property Finance provisioning in the coming quarters.** Performance in line with what has been reported for the first three quarters of 2011 would be manageable in our view (average net loss at the segment of ~€60 million per quarter). However, we believe there remains a risk that we see something meaningfully worse in future. In our view, were this to occur, it would be taken very negatively by the market.

## Repaying Capital Support – Not a Catalyst for 2012

In December 2008, SNS had to strengthen its capital position as a result of solvency problems driven by the financial crisis. Capital shortfalls surfaced mainly at its insurance operations due to falling equity markets but also realised fixed income losses, impairments and widening credit spreads.

Capital support came in the form of €1.25 billion of core Tier 1 capital securities subscribed to by the Dutch state (€750 million) and the SNS REAAL Foundation (€500 million; the 'Foundation'), SNS's majority shareholder.

In November 2009, using proceeds from an issuance of equity (€135 million) and excess capital at the insurance operations (€115 million), €250 million of the injected capital was repaid. With the Foundation's approval, repayment was directed more towards the Dutch state (€185 million). As a result, today €1 billion principal of the core Tier 1 securities remains outstanding with the following repayment terms:

- Dutch state: Amount outstanding of €565 million, repayable with a 50% premium, i.e., total cost of €848 million.
- Foundation: Amount outstanding of €435 million. The first €102 million is repayable penalty-free, the remainder with a 20% premium, i.e., total cost of €502 million.

With regard to the Dutch state investment, at any time after January 31, 2012, SNS can look to convert the securities into ordinary shares (subject to regulatory approval). Were SNS to exercise this option, the Dutch state can instead demand par repayment in cash.

With the Foundation's approval, **SNS has set itself the clear priority of first repaying the Dutch state aid.** While no firm deadline has been set, the group is very focused on completing the task by YE13, as repayment by then should effectively ensure that the Dutch state receives its 10% per annum investment return target.

From a credit perspective, state aid repayment is important for two main reasons:

**First, it sends an important signal to the markets of fundamental credit improvement at the group.** SNS's regulator, the DNB (De Nederlandsche Bank), can block payments if in its view the group still needs the explicit capital support provided by the core Tier 1 securities.

**Second, if state aid repayment is completed on target, then SNS will have reduced the risk that the EC could seek further compensatory actions from it beyond that set out in the viability plan submitted post receipt of state aid.** Given what we have seen at other institutions that received state aid, further action could potentially extend to hybrid capital redemption and/or coupon bans.

**To be clear, we do not believe the group currently has the financial flexibility to repay state aid at the moment.**

Having not paid a coupon on the core Tier 1 securities since issue, SNS has effectively made a 10% return harder to achieve for the Dutch state. As a result, and in compliance with the original approved viability plan, in early 2011 the Dutch state had to notify the EC to this effect.

If the EC had felt that the expected 10% target was unlikely to be met, it could have placed further requirements on SNS. However, in December 2011, it reconfirmed its approval for the aid provided to SNS with the proviso that, if necessary, SNS is required to "*execute sufficient additional measures to facilitate full state repayment by the end of 2013, subject to regulatory approval*".

SNS's central plan is to repay the state aid from a number of sources, including retained earnings and a capital release programme.

When launched in November 2008, the capital release programme was designed to remove highly capital-consumptive assets from the group balance sheet over an 18-month period in order to improve capitalisation and the prospects for state aid repayment.

The programme was originally designed to release €600 million of capital. However, given overachievement against original plans (SNS releasing more capital than expected at a faster rate), the group raised its capital release target 17%, to €700 million, and is targeting completion by June 2012.

Actions up until 9M11 have released €490 million of capital via the following:

- The sale of balance sheet first loss pieces to third parties and retail mortgages to group's insurance activities. By 9M11, in total €185 million of capital had been released (target: €120-150 million);
- In 1Q11, a traditional proportional reinsurance transaction of the group's insurance savings portfolio was concluded that released ~€225 million of capital (target: €150-200 million);
- The sale of Retail and SME mortgages. By 9M11 in total €80 million of capital had been released through this route (target: €150-220 million).

Further, following a detailed review of operations, SNS has upped guidance on a capital release target relating to the sale of other selected portfolios/activities from an original €80-120 million to €125-175 million.

We expect further progress to be announced in February at FY11 reporting.

**Despite SNS's progress to date, we are not anticipating a positive catalyst around state aid repayment activity in 2012.** This reflects our expectation of continuing Property Finance loan loss provisioning and macro market uncertainty for the short-to-medium term. Indeed, we note that the challenging market environment drove SNS to abandon at its 2011 investor day its normalised group earnings guidance of ~€400 million per annum (normalised to exclude results from Property Finance, and costs associated with the capital release programme) and to refrain from providing new guidance.

Until both Property Finance and the macro environment have stabilized, we believe it is unlikely that the DNB will permit repayment to proceed. **More likely, we expect a staged process of state aid reduction starting in 2013.** This contrasts with other Dutch financials that received state aid (but were not nationalised as per ABN AMRO). Insurer AEGON has now completed its state aid repayment and ING Group is 70% there and is guiding that further progress will be made in 2012.

In light of the statement from the EC upon reconfirming state aid approval, **if current plans prove to be insufficient to complete repayment before YE13, we believe other avenues will be explored, such as further equity rights issues or more significant asset sales.** For example, in line with Dutch peer ING, we'd not rule out the group reconsidering at some future point whether shareholder interests are best served via a bancassurance business model.

## Bank and Insurer Stress Tests

SNS's bank and insurance operations participated separately in the two EBA-led bank and single EIOPA-led insurance stress tests during 2011.

The insurance stress test results were only released on an aggregate basis. Further, the stress was performed using a base solvency framework that remains under development, i.e., the QIS5 iteration of Solvency II. Therefore, it has proven to be difficult to draw meaningful conclusions from the results. Regardless, at HY11 SNS reported that under all scenarios tested the insurance Solvency Capital Requirement (a key regulatory capital test) was met. A 9M11 regulatory solvency ratio of 185% points to a robust insurance capital position.

SNS Bank N.V. (SNS Bank) featured within the two EBA bank stress tests in 2011. **In our view, SNS Bank's results from both tests point to capital as being a relative weakness for the group's credit profile.**

As can be seen from Exhibit 3, the bank passed the July 2011 tests with a core Tier 1 capital ratio of 7.0% in the 2012 adverse case under scenario C. However, this pass did factor in successful material restructuring linked to both the capital release programme and the run-off of the Property Finance portfolio. We are obviously not privy to the detailed modeling that sat behind SNS Bank's submission. However, while recognising that the test reflected a static balance sheet (so ignored action successfully completed in 1Q11), we do question the ease of effecting for example nearly the 20% RWA reduction in 2012 embedded within the adverse scenario (RWAs reduced ~6% in 9M11).

Exhibit 3

### Dutch Market Bank July 2011 Stress Tests Results

| | SNS Bank N.V. | ABN AMRO Group N.V. | ING Bank N.V. | Rabobank |
|---|---|---|---|---|
| **Scenario A: Full static balance sheet without any mitigating actions, mandatory restructuring or capital raisings post YE10 (all government support measures fully paid in before YE10 included)** | | | | |
| Core Tier 1 Ratio: 2010 | **8.4%** | 9.9% | 9.6% | 12.6% |
| Core Tier 1 Ratio Under Adverse Scenario: 2011 | **7.3%** | 9.7% | 8.9% | 11.8% |
| Core Tier 1 Ratio Under Adverse Scenario: 2012 | **5.9%** | 9.2% | 8.7% | 10.8% |
| **Scenario B: Reflecting capital issuance and mandatory restructuring plans publicly announced and fully committed before YE10** | | | | |
| Core Tier 1 Ratio: 2010 | **8.4%** | 9.9% | 9.6% | 12.6% |
| Core Tier 1 Ratio Under Adverse Scenario: 2011 | **7.7%** | 9.7% | 8.9% | 11.8% |
| Assumed RWA Impact of Mandatory Restructuring Plans | **-13.2%** | 0.0% | 0.0% | 0.0% |
| Assumed Core Tier 1 Impact of Mandatory Restructuring Plans | **-8.7%** | 0.0% | 0.0% | 0.0% |
| Core Tier 1 Ratio Under Adverse Scenario: 2012 | **7.0%** | 9.2% | 8.7% | 10.8% |
| Assumed RWA Impact of Mandatory Restructuring Plans | **-18.6%** | 0.0% | 0.0% | 0.0% |
| Assumed Core Tier 1 Impact of Mandatory Restructuring Plans | **-4.0%** | 0.0% | 0.0% | 0.0% |
| **Scenario C: Reflecting capital issuance and mandatory restructuring plans publicly announced and fully committed before April 30, 2011** | | | | |
| Core Tier 1 Ratio: 2010 | **8.4%** | 9.9% | 9.6% | 12.6% |
| Core Tier 1 Ratio Under Adverse Scenario: 2011 | **7.7%** | 9.7% | 8.9% | 11.8% |
| Assumed RWA Impact of Mandatory Restructuring Plans | **0.0%** | 0.0% | 0.0% | 0.0% |
| Assumed Core Tier 1 Impact of Mandatory Restructuring Plans | **0.0%** | 0.0% | 0.0% | 0.0% |
| Core Tier 1 Ratio Under Adverse Scenario: 2012 | **7.0%** | 9.2% | 8.7% | 10.8% |
| Assumed RWA Impact of Mandatory Restructuring Plans | **0.0%** | 0.0% | 0.0% | 0.0% |
| Assumed Core Tier 1 Impact of Mandatory Restructuring Plans | **0.0%** | 0.0% | 0.0% | 0.0% |

Source: Company data, Morgan Stanley Research

**SNS Bank reported a small €159 million deficit to the 9% core Tier 1 threshold established for the October 2011 EBA stress test.** This test focused more fully on peripheral European sovereign exposures. In our view, this orientation was to the relative benefit of SNS Bank versus many other European banks, given its limited holdings of these assets. To its credit, the group has managed its peripheral Europe exposures down aggressively since 2009, the combined exposure to Greece, Ireland, Italy, Portugal and Spain standing at €1.4 billion at 9M11 (€4.3 billion YE09), with €0.9 billion relating to Italy. The bank further benefited under the test from being able to apply Basel 2.5 to RWA calculations (it is currently regulated on a more restrictive basis – capital requirements held at 80% of Basel I).

As with other banks showing a deficit, SNS Bank is required to meet the EBA shortfall by end-June 2012. In the absence of a major problem developing within the Property Finance portfolio, we believe it should do so, noting that it has already made progress towards meeting this goal via a recent bank LT2 exchange offer, which generated ~€72 million of net proceeds.

SNS Bank has set itself the ambition of reaching a 10% core Tier 1 ratio under Basel 2 (of course, this would have to comply with the 80% Basel 1 floor), viewing this as the new normal (9M11 core Tier 1 ratio of 8.6% on the same basis). **We note that no explicit guidance has been given by management as to when this ambition is to be realized.** While somewhat disappointing, this is perhaps understandable in light of performance uncertainty at Property Finance and the group in general (following recent abandonment of normalised group earnings guidance), plus the capital release programme nearing completion.

## Potential Rating Agency Risks

European bank ratings are generally under downward pressure, due to changing ratings methodologies, the introduction of resolution regimes/removal of support uplift, sovereign ratings downgrades and signs of weakening trends in bank fundamentals in a lower growth environment (see *Ratings: All You Need to Know in 5 Pages*, July 18, 2011, and *Still Value in LT2*, October 25, 2011). Since 4Q11, we have also detected that the agencies have become more anxious about insurer ratings in the context of the eurozone crisis.

In Exhibit 4, we summarise ratings across the SNS Group from the three major rating agencies. Fitch and Moody's legal entity ratings are stable, whereas those issued by S&P have a negative outlook, reflecting ongoing concerns over future property finance performance.

Exhibit 4

### SNS Ratings Overview

| Issuer/Issue | Fitch | Moody's | S&P |
|---|---|---|---|
| SNS Reaal N.V. (Group) | BBB+/Stable | Baa2/Stable | BBB+/Neg |
| SNS Bank N.V. (Bank) | BBB+/Stable | Baa1/Stable | A-/Neg |
| SRLEV N.V. (Insurer) | A-/Stable | A3/Stable | A-/Neg |
| **Group Level Issuance** | | | |
| € 6.258% PerpNC17 | Not Rated | Ba2/Stable | BBB-/Neg |
| **Bank Level Issuance** | | | |
| € 11.25% PerpNC19 | BBB-/Watch Neg | Ba3/Neg | BBB/Neg |
| € 6.25% 2020 | Not Rated | Baa2/ Watch Neg | BBB+/Neg |
| **Insurer Level Issuance** | | | |
| € 9% 41NC21 | Not Rated | Baa2/Neg | BBB/Neg |

Source: Rating agencies, Morgan Stanley Research

**Sentiment towards ratings on hybrid instruments is more negatively biased.** Past actions have already resulted in the group holdco (the € 6.258% PerpNC17s) and bank opco (the € 11.25% PerpNC19s) level Tier 1 instruments moving sub-investment grade in aggregate and, as a result, being expelled from investment grade indices. Fitch is currently reviewing its ratings on the € 11.25% PerpNC19s on the back of criteria changes. We expect that these will move lower in the near term (i.e., 1Q12).

**In terms of investment grade index expulsion, we believe that most action has probably been taken across the group's hybrids. Of those remaining investment grade, in our view, the €6.25% 2020 bank LT2s are most exposed to downgrades sufficient to drive index expulsion.** We already expect that Moody's will move these sub-investment grade in the coming months, linked to criteria changes around systemic support incorporation in ratings (note: split ratings may be a problem for some investors). Post action by Moody's, in our view, what is needed for index expulsion is a further two-notch downgrade. Given our bearish outlook on the group's property finance portfolio, we are worried that poor news flow from this source could encourage S&P to move beyond its existing negative outlook on the group and downgrade. We would expect investor nervousness to increase with regard to these bonds in the event of a single-notch downgrade.

By comparison, our calculations suggest that the € 9% 41NC21 LT2s issued by group insurer SRLEV N.V. are three notches away from sub-investment grade. They therefore offer greater relative protection to investors against rating agency risks, in our view.

## And Finally…

Before looking at trade recommendations, we should flag up two final items. **First, we believe that there is limited value gained from distinguishing between SNS bank and insurer in terms of credit quality.** In our view, bank and insurer bond valuations should equally reflect issues (both positive and negative) impacting the wider group while SNS remains committed to a bancassurance model. Hence, performance of the property finance portfolio should have a bearing on the trading of bonds issued by the group's insurance operations.

**Second, valuations need to consider our view of heightened non-call risk within the European banks space,** as clearly set out within various pieces of research including the 2012 European banks outlook (see *Outlook: Value into Year-End*, December 5, 2011). **In the case of bancassurers such as SNS, we believe that call behaviour in relation to bank hybrids directly reads across to instruments issued by insurance operations.**

The first of SNS's more liquid and actively traded callable hybrid instruments comes to call in 2017 (the € 6.258% PerpNC17s). However, before then there are a number of generally small subordinated deals up for redemption which should provide insight both to the regulator's view on the robustness of the group's capital position (will it allow calls to proceed or not?), plus management's intentions with regard to meeting investor call expectations.

**So far the group has maintained a good call track record**. However, in 2012 the quantum of callable subordinated debt increases materially via two tranches of the bank's unlisted, perpetual Tier 1 qualifying participation certificates (total nominal of €241 million, €125 million callable in June, €116 million in December). We understand that these instruments have been sold to retail investors.

## Trade Recommendations

Bonds issued across the SNS group demonstrated material volatility last year, prices moving across a 40-point range, despite the group being located in the AAA rated Netherlands and being generally underweight peripheral Europe. So far in 2012 they have performed strongly on the back of the current broad market rally and the announced bank LT2 liability management exercise.

**As we flagged earlier in this note, we remain very concerned about asset quality within SNS Bank's Property Finance book.** While problems in the International segment are well documented, we believe that the Dutch offices portfolio has the potential to materially surprise on the downside in 2012. We believe that any such news flow would be taken poorly by the market and could be compounded by subsequent rating agency actions. **In these circumstances, we would expect liquidity in bonds to dry up and believe that bonds at both the insurer and bank would underperform.**

A bad situation could be made worse if asset provisioning losses were material enough to put at risk the group's ability to meet EBA stress test capital requirements. **Depending upon the size of any expanded EBA deficit, given that we believe SNS has weaker financial flexibility versus larger and more diversified peers, further state aid could come into the equation.**

**In our view, fresh state aid would potentially have immediate negative consequences for optional bond coupons.** We believe that the July payment on the group level € 6.258% PerpNC17 Tier 1 is currently optional due to a lack of a coupon pushing payment to date (if not paid, coupons are cumulative; pay interest on interest). If this bond does not pay then the bank level € 11.25% PerpNC19 Tier 1 also becomes an optional payer in November (in contrast coupons here are non-cumulative). Coupons associated with the bank-issued € 6.25% 2020 LT2 are non-deferrable, so would not be at risk.

The annually payable April coupons on the insurer-issued 9% 41NC21 LT2s would most likely become optional if dividends were not paid up to its parent. **However, if potential capital problems are isolated solely within the group's banking operations, we believe that coupons will continue to be paid on these bonds.** Only by doing so would the group retain the flexibility to apply any excess regulatory capital at the insurance operations in support of the wider SNS Group. We have a precedent here in the European banking space involving Lloyds Banking Group. While coupon bans were put in place at the group level and at its banking operations linked to state aid, coupons were paid throughout the crisis on bonds issued by its insurance operations, Clerical Medical and Scottish Widows, so that dividend stopper language in these instruments would not halt future capital flows from the insurers.

## Go Defensive and/or Up the Credit Quality Curve

**Given our nervousness over the SNS credit story, we are more inclined to be a seller of the name than anything else. However, for investors looking to stay involved, we believe the €9% 41NC21 LT2s issued from the insurance operation SRLEV offer the best relative value (offered at 75, YTC of 14.0%; YTM of 12.2%).** We'd therefore be recommending a defensive switch into these from group- and bank-level hybrids. Despite the outright risks with the SNS name, the insurance bonds' yield is nigh on impossible to match in both the bank and insurance LT2 markets at large, without dipping into more challenged names. From a structure perspective, the 9% 41NC21 LT2s offer a final maturity date (subject to regulatory capital requirements being met), cash cumulative coupons and the largest ratings buffer to investment grade index expulsion among all SNS hybrids.

Exhibit 5

### SNS Bank to Insurer Switches

| Bond | Floating rate | | YTP/M | YTC | Z-Spd |
|---|---|---|---|---|---|
| | | **Bid** | | | |
| € 6.258% PNC17 T1 | 3m Euribor+229bp | 57.0 | 10.0% | 19.8% | 1,794 |
| € 11.25% PNC19 T1 | 5-yr Swaps+976bp | 81.0 | 14.5% | 15.6% | 1,351 |
| € 6.25% 2020 LT2 | NA | 77.0 | 10.4% | NA | 831 |
| | | **Offer** | | | |
| € 9.0% 41NC21 LT2 | 12m Euribor+617bp | 75.0 | 12.2% | 14.0% | 1,176 |

Source: Morgan Stanley Research

**If you cannot, for whatever reason, buy the insurance bonds, we'd be switching out of the Tier 1s into the bank €6.25% 2020 LT2,** offered at 79 and generating a YTM of 10.0%. Although clearly not as good as the insurance bonds, this yield is still hard to find in bank LT2 generally. With mandatory coupons, a hard final maturity and our view that, while clearly challenged, SNS will not end up being placed into a resolution regime, these bonds offer interesting long-term value. However, our concerns over EC-related risks linked to potential fresh state aid payments mean that they are likely to underperform the broader LT2 universe going forward, from a news flow perspective.

In switching out of SNS and up the credit curve, investors will have to bear lower yields and will need to pay up in price terms. **In relation to the €9% 41NC21 LT2s, we'd recommend a switch (bid at 73, YTM of 12.5%, YTM of 14.5%) into the long-dated LT2s issued by French insurer CNP Assurances,** such as the € 6.875% 41NC21s (offered at 77.5, YTC of 10.7%, YTM of 9.3%) or € 6% 40NC20 (offered at 75.5, YTC of 10.4%, YTM of 9.1%). We'd be trading the CNP bonds to the first call date, rather than to maturity in the case of the SNS bonds, and this does soften the yield reduction somewhat.

**We'd suggest switching out of SNS €6.25% LT2s at 77 and into other bank bullet LT2s,** such as any of the Barclays deals (6% 2018s, 6% 2021s and 6.625% 2022s, with the best yield on the latter at 6.8%, offered at 98.4). Finally there is the Lloyds € 6.5%, which in comparison to other Lloyds LT2s has a decent ratings buffer (three notches in aggregate) to investment grade index expulsion (see *Lloyds and RBS LT2: Not So Obvious Anymore...*, February 7, 2012).

Exhibit 6

### SNS Bank Bullet LT2 Switches

| Bond | | YTM (%) | Z-Spd (bp) |
|---|---|---|---|
| | **Bid** | | |
| € 6.25% 2020 LT2 | 77.0 | 10.4 | 831 |
| | **Offer** | | |
| BACR € 6% 2018 LT2s | 100.28 | 5.9 | 438 |
| BACR € 6% 2021 LT2s | 95.7 | 6.7 | 469 |
| BACR € 6.625% 2022 LT2s | 98.4 | 6.8 | 479 |
| LLOYDS € 6.5% 2020 LT2 | 90.75 | 8.1 | 609 |

Source: Morgan Stanley Research

In terms of structure, we believe that the best SNS Tier 1 is the €6.258%. This is the lowest cash price of the two, is issued out of the group, is cumulative, pays interest on interest and is pushed by any junior or parity payments, or redemptions (unless into equity) made six months prior to the coupon payment. Any of these trigger payment of deferred coupons, which accrue interest when deferred, and are paid via ACSM. Both SNS Tier 1s are sub-IG, so ratings are not an issue here. There is nothing to push the July payment this year (for the first time), but our view is that it will most likely be paid, considering that SNS would surely not wish to become the first bank to choose to not pay an optional coupon, by its own devices. However, there is no certainty around this, it is optional in our view, and it's unclear how closely the EC may be 'watching' such a decision. Offered at 59, YTP is 9.7% (moves to a floating rate back end of ms+229bp in 2020), which is by no means compensating you for the risks here, in our view, although coupons are indeed cumulative.

The SNS €11.25% Tier 1s pay annually in November and are non-cumulative. They are bank-level but are pushed by a July payment on the €6.258% – unless this has been mandatorily pushed itself. Although yields on this bond look optically attractive, naturally the loss of such a large coupon would be hard to take. Even so, stressing this bond at 82, and skipping both this year's and next year's coupon, we still get a YTC of 11.3% (steps to 5yr ms+975.5bp in 2019). However, we'd note that the 3-month low on this bond is 57, and we'll be happy to go back to this stress analysis if we reach those levels again. **For now, we'd be taking advantage of liquidity and switching into any of the non SNS Tier 1s we mention in Exhibit 7, although our preference is still for LT2s generally in the banks space**.

Exhibit 7
### SNS Tier 1 Switches

| Bond | Floating rate | | YTP (%) | YTC (%) | Z-Spd |
|---|---|---|---|---|---|
| | | **Bid** | | | |
| € 6.258% PNC17 T1 | 3m Euribor+229bp | 57.0 | 10.0 | 19.8 | 1,794 |
| € 11.25% PNC19 T1 | 5-yr Swaps+976bp | 81.0 | 14.5 | 15.6 | 1,351 |
| | | **Offer** | | | |
| ACAFP €6.0% PNC12 | Fixed Rate | 69.5 | 9.1 | 425.5 | NA |
| ACAFP €7.875 % PNC19 | 3m Euribor+642.4bp | 90.25 | 9.7 | 9.7 | 768 |
| SOCGEN €6.999% PNC17 | 3m Euribor+335bp | 77.5 | 8.5 | 12.7 | 1,082 |

Source: Morgan Stanley Research

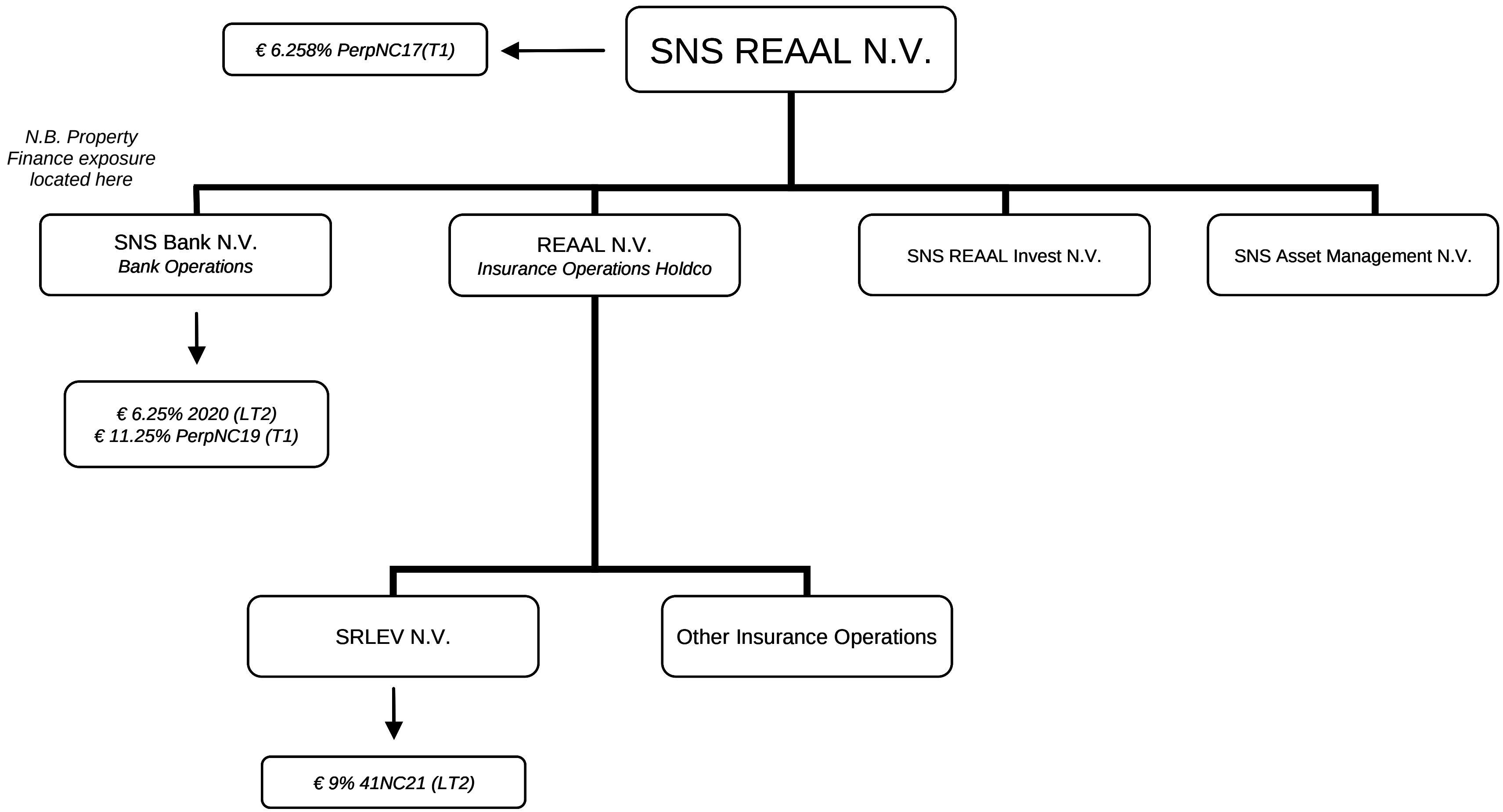
## Risk Factors

These would include:

On the back of better-than-expected reporting at SNS Property Finance, the group's bonds could perform stronger than anticipated and versus other bonds recommended as switch ideas.

Performance at insurance operations could underperform that at the bank, resulting in stronger relative performance of bank hybrids.

# Appendix I: SNS REAAL Summary Group Structure Chart




Source: Morgan Stanley, company accounts.
N.B. Summarised legal structure – does not include all operating, sub holding or other legal entities within the group

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|---|---|---|---|---|---|
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| **Not-Rated/Hold** | **107** | **4%** | **25** | **2%** | **23%** |
| **Underweight/Sell** | **454** | **15%** | **121** | **12%** | **27%** |
| **Total** | **2,944** | | **1050** | | |

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