

Banks & Sovereigns: When Two Become One

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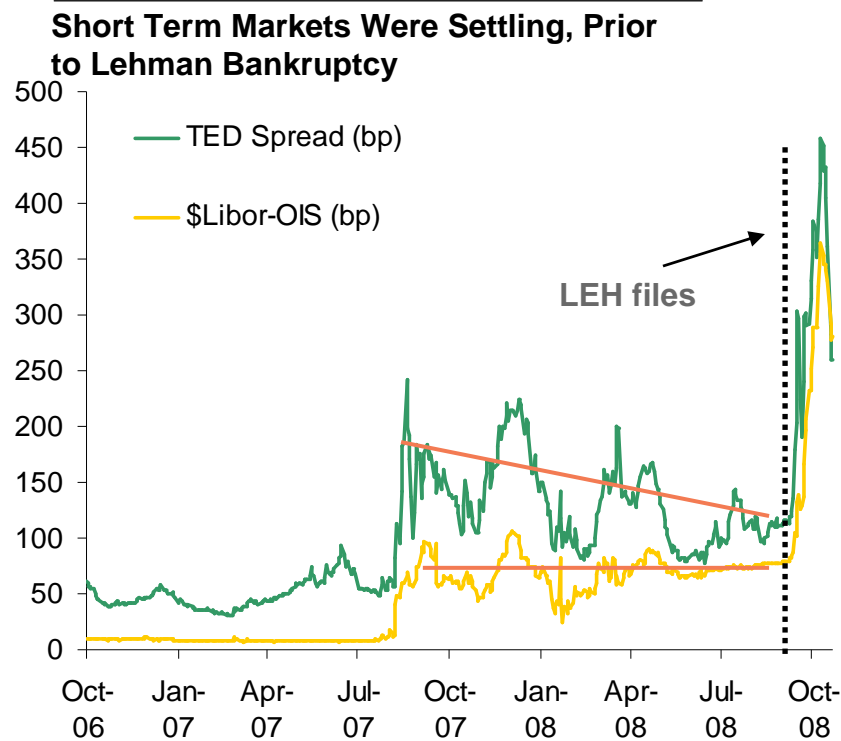
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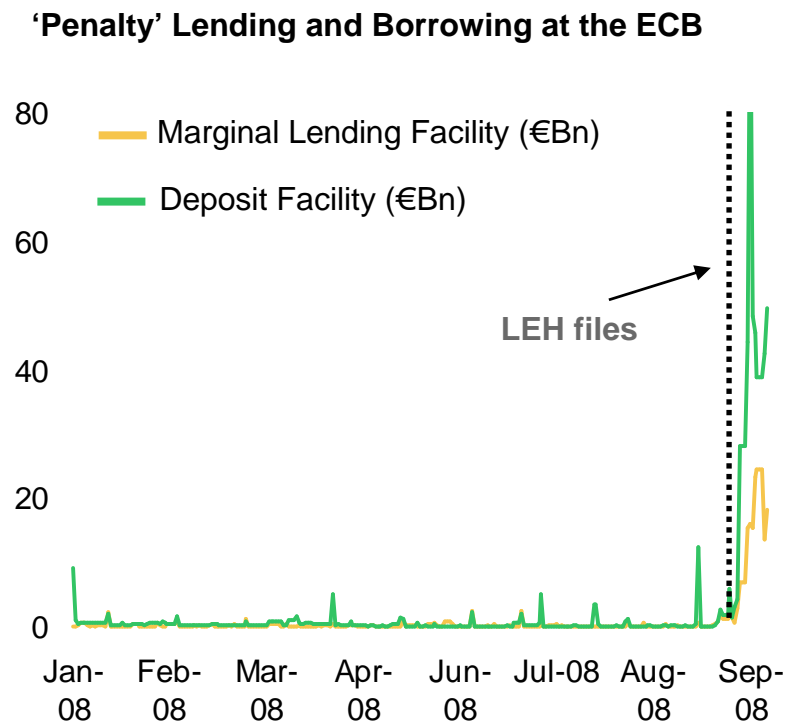
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Lehman was a Game-Changing Event

We find it easy to forget that, just a little over a month ago, real progress towards financial healing was underway. But the Lehman default shook confidence in the debt supercycle to its very core, and despite a flood of government initiatives since, we are still not back to a pre-Lehman state.

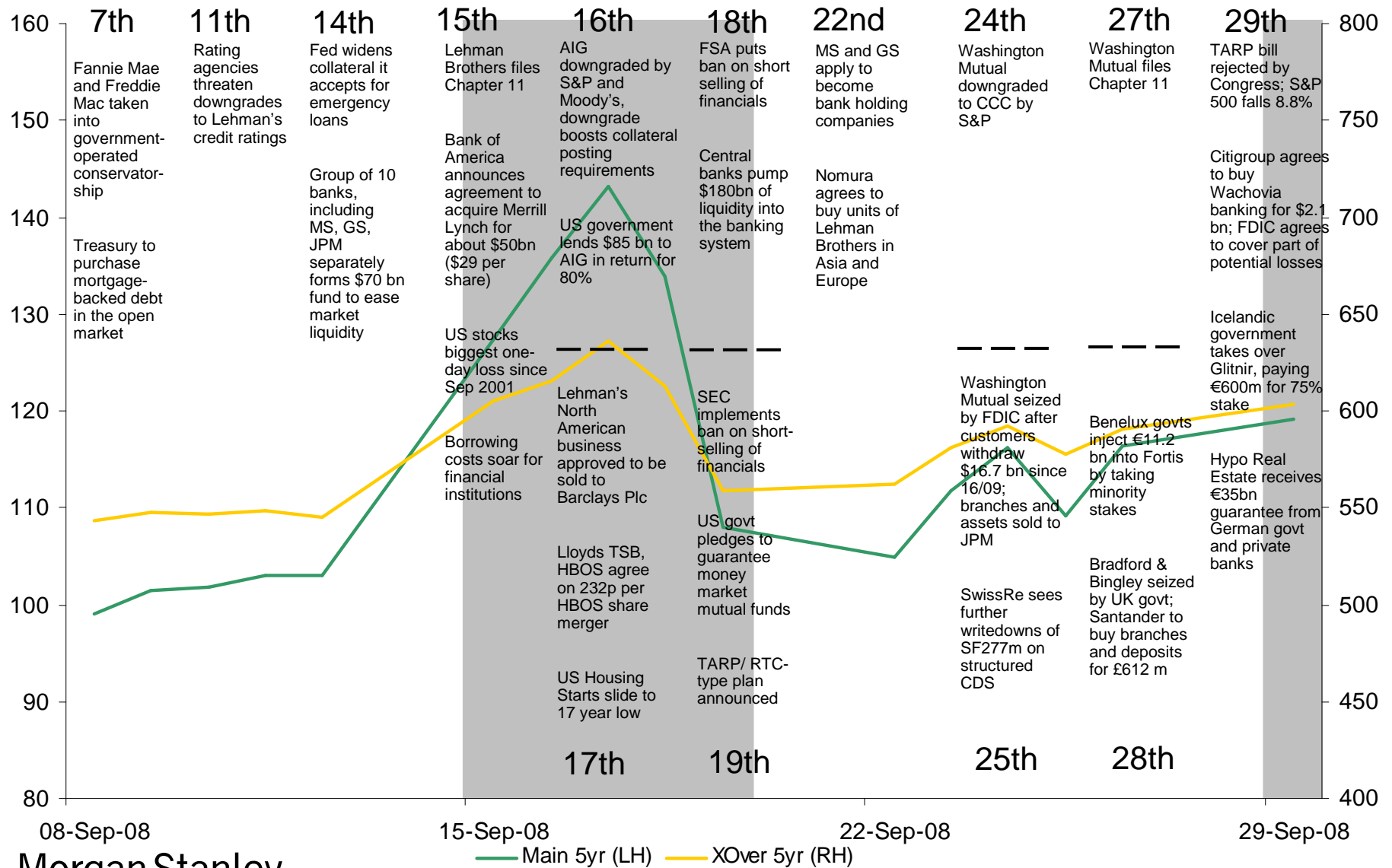


Source: Morgan Stanley Research, ECB



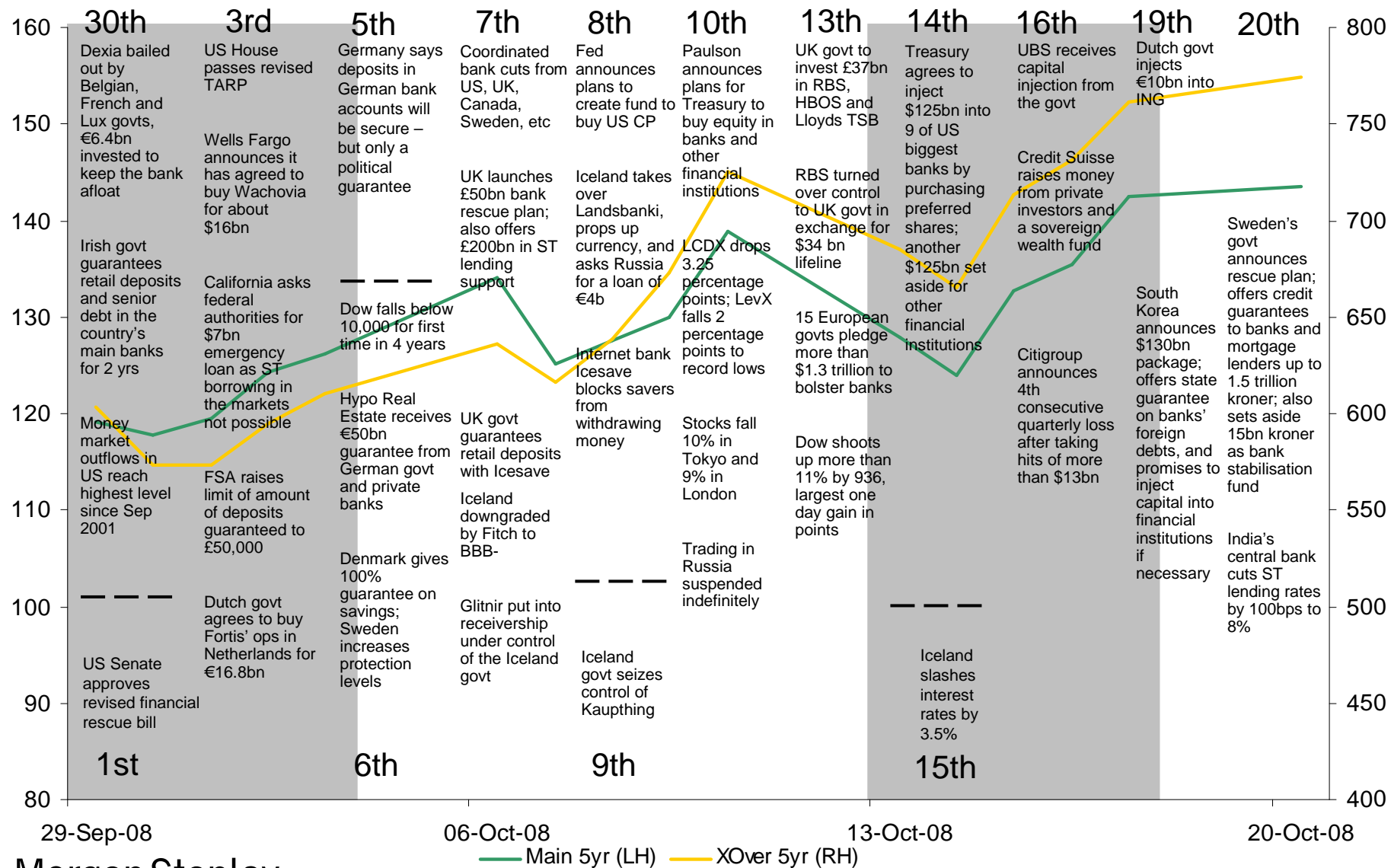
Source: Morgan Stanley Research, ECB

Markets Have Seen Extraordinary News Flow



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...But a Theme of Sovereign Support of Financials has become clear, and Persistent



Summary of European Responses to the Banking Crisis

	UK	Ireland	Belgium	France	Germany	Italy	Greece	Holland	Austria	Spain	Denmark	Sweden	Norway	Switzerland	US	
1. Maintain the banking system's liquidity through greater explicit guarantees.																
- Central bank funding support	Revised SLS, revised market operations, unlimited \$ support				Broad range of collateral and unlimited USD support							Yes	Yes	Yes	Yes	TAF, TSLF, PDCF, GSECF, MBS Purchases, GSE DN Purchases, AMLF, TARP
- Primary market guarantee/asset clearinghouse	Yes for maturing unsecured details pending applies to CD's, CP's, senior unsecured in £, \$ or €. Fee of 50bp's plus 100% of median 5yr CDS. Ends 2012 max maturity 3 years	Yes programs lasts 2 years	Yes, Dexia. Potentially for others	€320bn via govt backed SPV. Cost based on SPV funding cost + spread. Maturities up to 5 years	HRX and €320bn funding guarantee with a 2% fee	Yes for new liabilities. Program ends Dec 09		€200bn	€85bn to be lent against collateral (mostly illiquid)	€100bn at a fee reflecting risk to government. Up to 5 year maturities	Yes, program lasts 2 years	Yes, details to come	Yes		CPFF, senior unsecured debt of FDIC insured institutions. FDIC fee of 75bp's	
- Higher deposit insurance	From £35 to £50k	Blanket					To €100k	To €100k		To €100k	Blanket	From Skr250k to Skr500k			From \$100k to \$250k. Money market fund guarantee	
- All retail deposits		Blanket		Verbally all retail otherwise €70k	Yes broadened to money market funds	Yes for 3 years			Yes		Blanket				Yes on non interest bearing deposits (typically corporate and small business)	
- Blanket guarantee (all deposits+creditors)		Blanket				Possible					Blanket					
2. Support capital raising (whether private sector or government stakes)																
- Government stakes	£37bn (RBS (€20bn/60% stake), HBOS & Lloy (€17bn/43% stake) also BARC (£6.5bn private capital)		Dexia	€10bn of non-voting Tier 1 capital across all major banks	Dexia & up to €40bn for banking system recaps (preferred and straight equity)	Up to €80bn via Financial Market Stabilization Fund	Potentially but Bank of Italy must decree capital inadequacy	Potentially ING: via €10 bn non-dilutive core Tier 1 eligible securities. Convertible into common after 3 years. Callable by ING at 150%	€15bn, Constantia Privatbank taken over by a syndicate of banks & the Austrian central bank.	Potentially via preferred equity		Yes, details to come	Yes, 9.3% stake in UBS via a convertible security with a 12.5% coupon		AIG; \$250bn from TARP in injections in preferred stock with 5% coupon for 5 years and 9% afterwards with warrants for 15% face value of preferreds. BAC, JPM and C get \$25bn, WFC \$20-25bn, GS & MS \$10bn, BNY \$3bn and STT \$2bn	
3. Asset programs & nationalisations																
- Bank debtor preservation	Possible initiatives for homeowners and SME's														Yes, government to foster homeownership preservation on mortgages it acquires	
- Asset buyback programmes					Financial Market Stabilization Fund may also buy troubled assets					Up to €50bn of newly originated AAA assets			NoK350bn covered bond swap facility	Up to Str60bn in risky UBS assets transferred to a central bank controlled and funded SPV. UBS provides Str6bn in equity to the SPV	ESA/TARP \$450bn after \$250bn used to recap banks; Fed (Bear Stearns) + FDIC (proposed for Wachovia); FNM, FRE (\$40bn additional monthly mortgage buybacks)	
- Full nationalisation	Yes - NRK				Yes - IKB			Fortis	Potentially						FNM, FRE	
4. Regulatory forbearance.																
Ongoing (MTM)				Ongoing (includes transfer of trading book and AFS assets to loan book, review of mark to market)											Yes (inc FASB on MTM)	
5. Monetary easing/steepener curves																
50bps (but 3m/5yr still inverted though steepening)					50bps (but 3m/5yr still inverted though steepening)						Higher	50bp cut			Material loosening and curve now positively sloped	
6. Industry quid pro quo																
Commitment to UK/SME lending, executive compensation. No dividends				Less intervention if preferreds more if straight equity. Credit levels to the French economy, ethical and "general interest" requirements	Dividends, pay, credit to Germany control	Dividend policy revised. Commitment to a restructuring program. Management under restricted executive control		ING: gvt will have 2 directors in board, comp restriction, no final dvd in 2008		Aimed at fostering credit and investment in Spain					Executive compensation (for top CEO, CFO plus 3 other most highly compensated officers). Corporate governance requirements.	

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Source: Morgan Stanley Equity Research

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Capital Raising Gets Banks Ahead of Loss Curve

Aggressive capital raising has had varied implications for equity holders, but this has been nearly universally positive for senior and LT2 bank credit, in our view. Bank balance sheets have been mired in a struggle of raising capital, but then losing it through writedown. We believe the scale of recent measures goes to the heart of this problem, and gets banks out ahead of this curve, although we won't know the true extent of this advantage until 3Q reporting season is finished

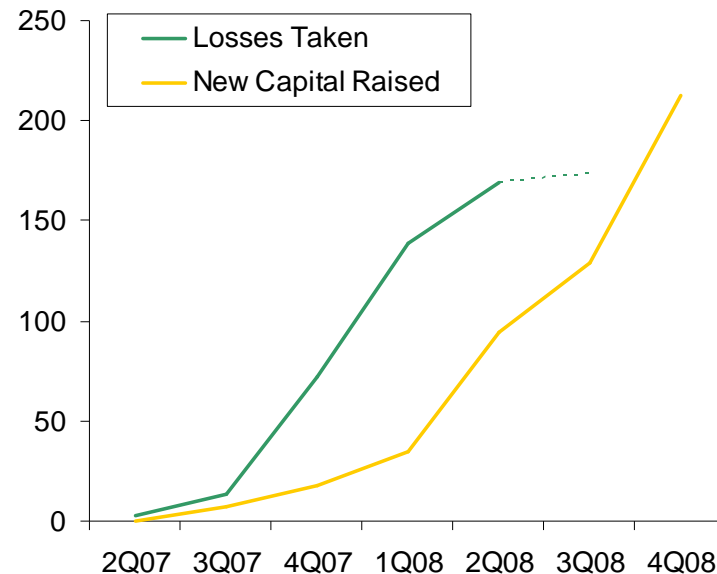
Summary of Capital Ratios Post Increases

	'Old' Core T1 Ratio	Increase	New Core T1 Ratio
UK Banks			
RBS	5.4%	4.0%	9.4%
Barclays	5.7%	1.7%	7.4%
HBoS	5.9%	3.4%	9.3%
Lloyds TSB	6.2%	3.4%	9.6%
French Banks			
BNP Paribas (post Fortis)	6.0%	1.9%	7.9%
Credit Agricole	6.6%	0.9%	7.5%
SocGen	6.6%	1.1%	7.7%
Swiss Banks			
Credit Suisse	9.3%	1.0%	10.3%
UBS	8.5%	1.8%	10.3%
Others			
ING	6.5%	1.5%	8.0%

Source: Morgan Stanley Research, Company Reports

Losses Taken vs. Capital Raised: Catching-Up

EUR Bn (Cumulative)

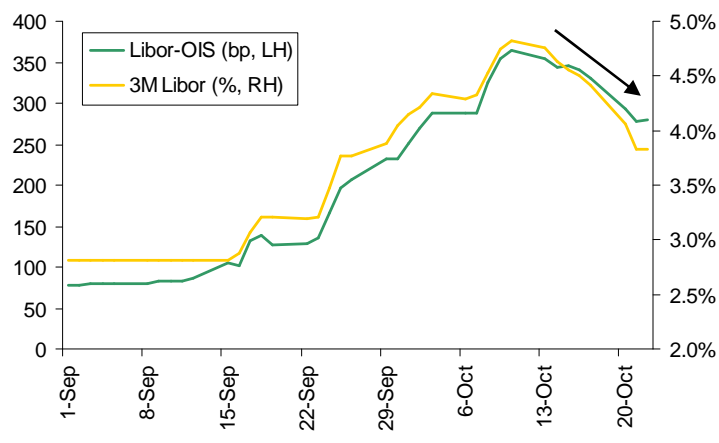


Source: Bloomberg

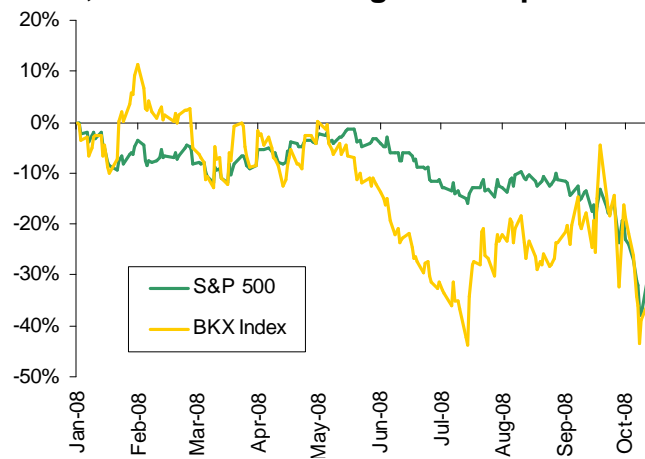
Healing at the Core, still Weakening at the Edges

Money markets are (slowly) improving, while price action in credit suggests movement from systemic to more economically focused risk, a much healthier outcome for markets, all things considered. We want to stay long 'core' credit risk, namely financials, and larger-cap non-cyclical names

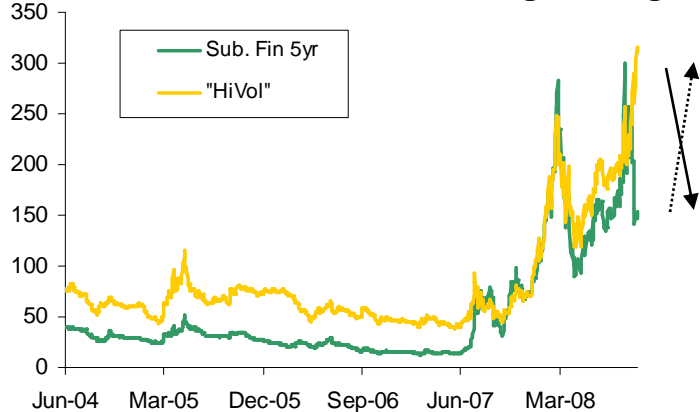
Libor and Money Markets are Improving



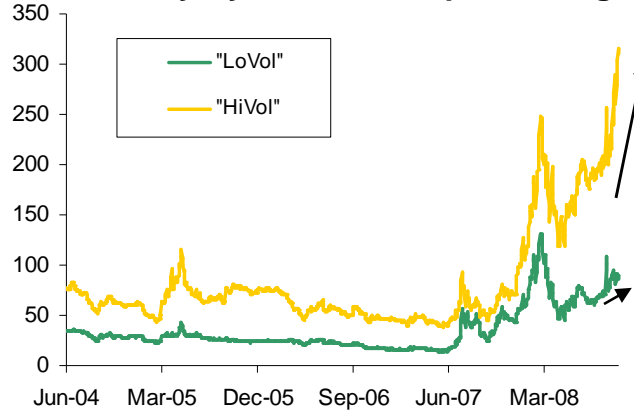
YTD, US Banks no Longer Underperforming...



HiVol, Sub-Financials Correlation goes Negative



Low-Quality Cyclicals Underperforming

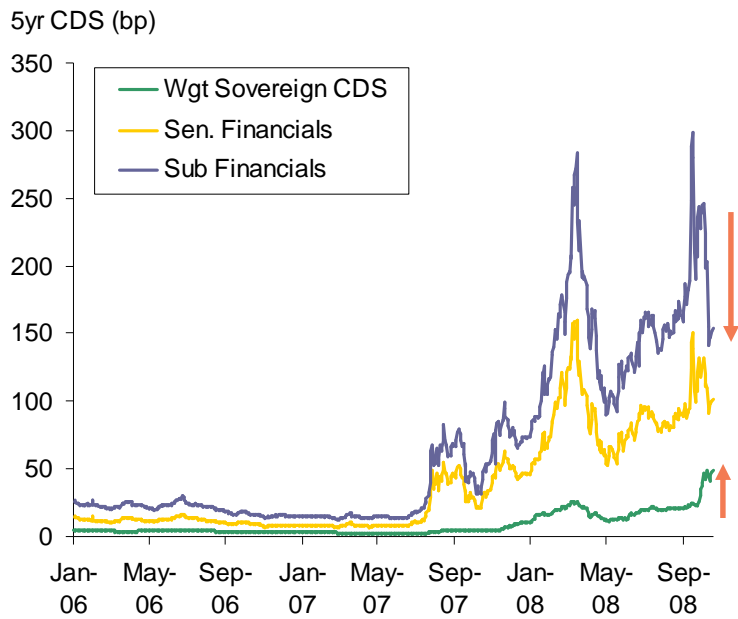


Sovereign & Banking Risk now Deeply Intertwined

The “socialization” of financial credit risk, focused on protecting senior creditors and preventing systemically-important institutions from failing, is clearly positive for Europe’s large, national champion banks. The deep involvement of sovereign governments across the capital structure, from the providing of funding to direct purchases of equities, means that the Credit Market’s largest sector now is even more closely linked with the sovereign’s own financial picture

Still, sovereign and bank credit markets are by no means moving in lock-step. Bank CDS curves remain inverted, while sovereign curves are upward sloping. And our colleagues in Interest Rate Strategy believe swap spreads are still too wide given the extent of official action. *While it may sound simplistic, a better convergence value than CDS is now in swapping government bonds for cash financial bonds*

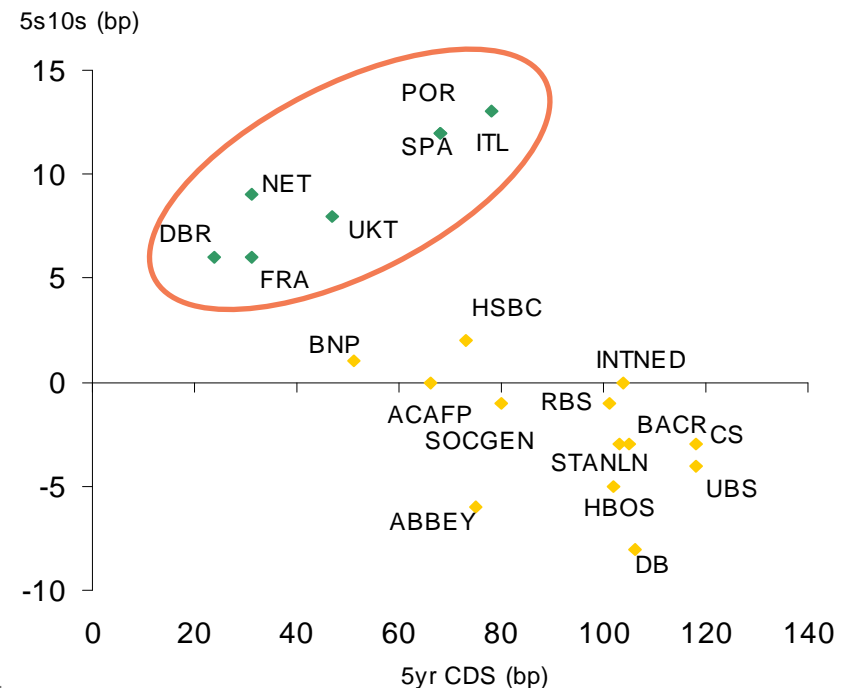
CDS Levels for Sovereigns and Financials have Started to Converge...



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Source: Morgan Stanley, Bloomberg

Bank Curves Inverted, Sovereign Curves Aren't



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State of the Economy: Size, Debt Burden, and Morgan Stanley Growth Forecasts

A closer look at sovereign fundamentals is now doubly important for credit investors, as both a indication of the true capacity of governments to act, and as a key determinate of broader loan performance on bank balance sheets. A strong sovereign is the best 'homefield advantage'

We look at two composite measures for the European countries. At right, the first of these two, is a focus on underlying economic strength, using Morgan Stanley economist estimates for 2008 and 2009 growth. While size of the economy doesn't necessarily equate to strength, we do see it as an indicator of diversification and shock absorption ability (i.e., UK GDP is 10x that of Ireland)

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Economic Size, Flexibility, and Direction

Country	Govt. Debt / GDP	2007 GDP (\$ Bn)	Real GDP		
			2007a	2008e	2009e
Austria	59%	373	3.1%	1.8%	0.3%
Belgium	85%	453	2.8%	1.5%	0.5%
Denmark	26%	312	1.7%	0.0%	0.6%
France	64%	2,560	2.1%	0.9%	0.3%
Germany	65%	3,322	2.5%	1.7%	0.1%
Ireland	25%	258	6.0%	-1.1%	-0.5%
Italy	104%	2,105	1.4%	0.0%	0.1%
Netherlands	46%	769	3.5%	2.2%	0.4%
Portugal	64%	223	1.9%	0.6%	0.2%
Spain	36%	1,439	3.7%	1.5%	-0.2%
Sweden	42%	455	2.9%	1.1%	0.6%
UK	44%	2,773	3.0%	1.1%	0.5%

Rankings (Lower is Better)

Country	Govt. Debt / GDP	2007 GDP (\$ Bn)	Real GDP			Macro Factors
			2007a	2008e	2009e	
Austria	7	9	4	2	6	6.0
Belgium	11	8	7	4	3	7.3
Denmark	2	10	11	10	1	7.3
France	9	3	9	8	6	6.7
Germany	10	1	8	3	9	5.0
Ireland	1	11	1	12	12	8.0
Italy	12	4	12	10	9	9.0
Netherlands	6	6	3	1	5	4.3
Portugal	8	12	10	9	8	9.7
Spain	3	5	2	4	11	5.0
Sweden	4	7	6	6	1	5.3
UK	5	2	5	6	3	4.3

Note: "Macro Score" is avg. of ranks on Debt/GDP, GDP, and average of 2008-09 est. growth

Source: Morgan Stanley Research, Bloomberg

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State of the Consumer? Savings, Debt, and HPA

As concerns about a shock to the system begin to ebb, focus will remain on the state of consumers across Europe, whose exposure to savings, debt, and home price booms varies widely across the region (and even across borders, see Denmark & Germany)

Denmark, the UK, and Iberia score the weakest across these broad consumer metrics, while Germany, France, Belgium and Austria appear in a much stronger position with regard to domestic credit threats

But foreign credit issues are another matter...

Consumer Wealth, Leverage, and Housing Risk

Country	Per Capita GDP	Savings Rate (% Disp. Inc)	Mortgage Debt / GDP	HP Growth 2001-2006
Austria	\$39,300	14.1%	24%	4%
Belgium	\$36,200	12.5%	36%	67%
Denmark	\$37,200	4.0%	106%	79%
France	\$32,600	15.6%	35%	78%
Germany	\$34,100	16.2%	40%	-7%
Ireland	\$46,600	11.0%	69%	66%
Italy	\$30,900	15.1%	17%	53%
Netherlands	\$39,000	12.5%	71%	25%
Portugal	\$21,800	9.2%	64%	5%
Spain	\$33,600	10.5%	61%	101%
Sweden	\$37,500	9.8%	42%	67%
UK	\$35,000	5.0%	85%	68%

Rankings (Lower is Better)

Country	Per Capita GDP	Savings Rate (% Disp. Inc)	Mortgage Debt / GDP	HP Growth 2001-2006	Consumer Factors
Austria	2	4	2	2	2.5
Belgium	6	5	4	7	5.5
Denmark	5	12	12	11	10.0
France	10	2	3	10	6.3
Germany	8	1	5	1	3.8
Ireland	1	7	9	6	5.8
Italy	11	3	1	5	5.0
Netherlands	3	6	10	4	5.8
Portugal	12	10	8	3	8.3
Spain	9	8	7	12	9.0
Sweden	4	9	6	7	6.5
UK	7	11	11	9	9.5

Note: Per Capita GDP and Savings rate are for 2007, or latest data available

Source: Morgan Stanley Research, Bloomberg

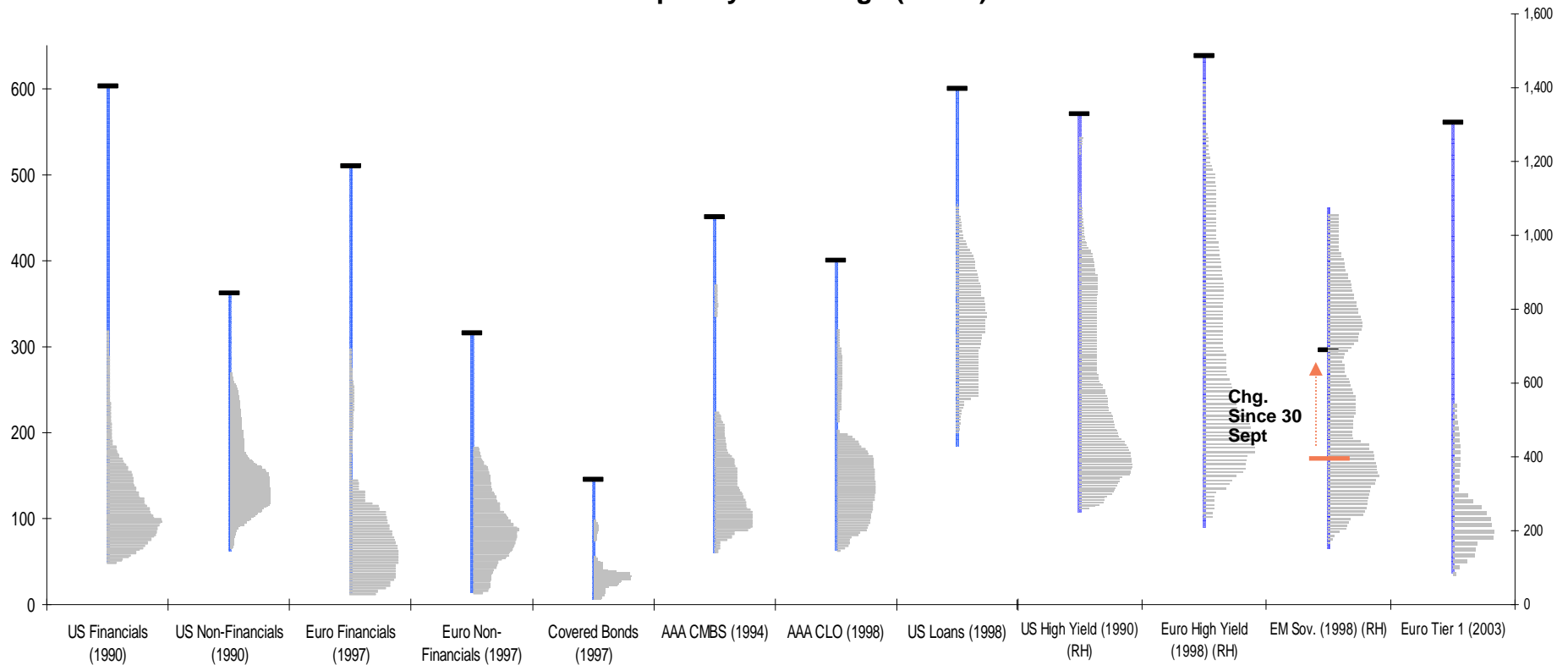
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Emerging Market Spreads: Catching Up is Hard to Do

But in an increasingly globalized world, strong domestic trends aren't necessarily an all-clear. In fact, for some banks, tepid local credit demand was a major factor that encouraged expansion into emerging markets.

EM spreads have been a standout in our CFAR model for some time, hanging near the tight end of their historical distribution while other credit assets were at, or making, new wides. While 'fundamentals' are certainly stronger this time around, that argument has so far proved unpersuasive with most other credit asset classes

Credit Frequency and Range (CFAR)



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Note: Horizontal bars indicate current spreads. Year in parenthesis indicates year spread data starts
Source: Morgan Stanley Research, The Yield Book, iBoxx

Which Banking Systems have the Most Banking Exposure to Emerging Markets?

We use data from the Bank of International Settlements to help quantify the exposure of various country's banking systems to different Emerging Markets. While an imperfect methodology, Austria certainly stands out for its exposures across eastern Europe

Consolidated Foreign Claims of Reporting Banks, to E. Europe, BRICs, and Selected Others % of Region's Banks total Foreign Claims:

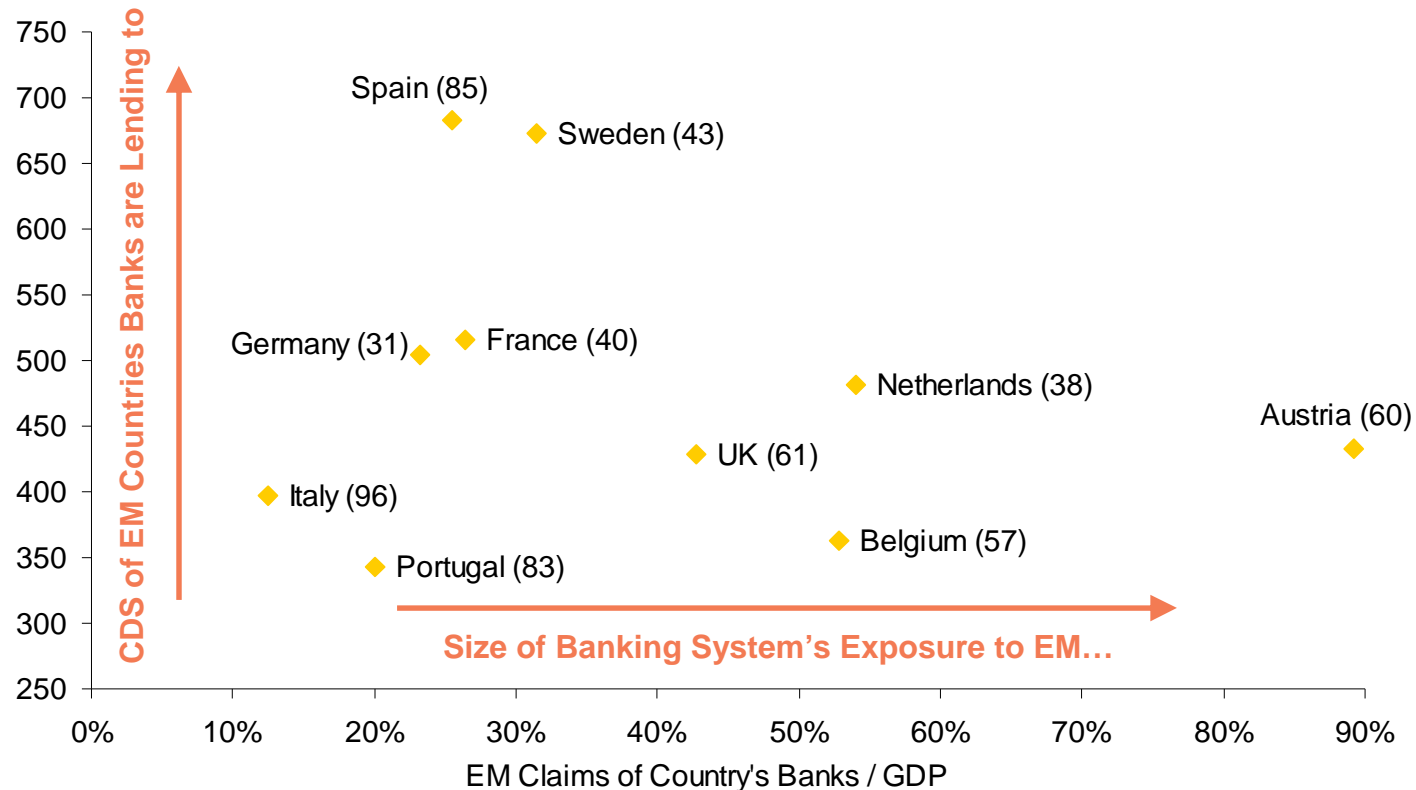
Eastern Europe	5yr CDS (bp)	Austria	Belgium	France	Germany	Italy	Netherlands	Portugal	Spain	Sweden	UK
Bulgaria	525	0.9%	0.1%	0.1%	0.1%	0.5%	0.0%	n.m.	0.0%	n.m.	n.m.
Croatia	375	6.2%	0.0%	0.2%	0.4%	2.6%	0.0%	0.0%	0.0%	0.0%	0.0%
Czech Rep.	180	10.2%	3.1%	0.9%	0.2%	1.3%	0.3%	0.0%	0.1%	0.0%	n.m.
Estonia	575	0.0%	0.0%	0.0%	0.0%	0.0%	n.m.	n.m.	n.m.	4.1%	n.m.
Hungary	540	5.9%	1.1%	0.3%	0.8%	2.1%	0.2%	0.4%	0.1%	0.0%	n.m.
Latvia	900	0.1%	n.m.	0.0%	0.1%	0.0%	n.m.	n.m.	n.m.	3.2%	0.0%
Lithuania	575	0.0%	n.m.	0.0%	0.1%	0.0%	0.0%	0.1%	n.m.	3.5%	n.m.
Poland	210	2.7%	1.5%	0.5%	1.1%	4.3%	1.2%	9.0%	0.4%	0.9%	0.0%
Romania	600	7.1%	0.1%	0.5%	0.1%	0.9%	0.3%	0.1%	0.0%	0.0%	0.0%
Slovakia	170	5.3%	0.6%	0.1%	0.1%	1.5%	0.2%	n.m.	n.m.	0.0%	n.m.
Turkey	705	0.4%	1.0%	0.4%	0.4%	n.m.	0.8%	0.8%	0.0%	0.0%	0.4%
Ukraine	2250	2.0%	0.0%	0.2%	0.1%	0.3%	0.1%	0.1%	0.0%	0.6%	0.0%
BRICs											
Brazil	440	0.1%	0.1%	0.4%	0.3%	0.2%	3.1%	3.9%	4.8%	0.1%	1.1%
China	240	0.3%	0.5%	0.6%	0.5%	0.2%	0.7%	0.0%	0.1%	0.2%	1.5%
India	475	0.1%	0.3%	0.3%	0.5%	0.1%	1.1%	0.1%	0.1%	0.1%	1.1%
Russia	810	3.5%	0.6%	0.9%	1.0%	1.7%	0.9%	0.3%	0.2%	1.0%	n.m.
Other											
Argentina	3500	0.0%	0.1%	0.1%	0.1%	0.0%	0.1%	0.1%	1.0%	0.0%	n.m.
Mexico	395	0.1%	0.0%	0.2%	0.1%	0.1%	0.6%	0.2%	11.5%	0.1%	n.m.
Venezuela	1850	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%	0.1%	1.7%	0.0%	n.m.
South Korea	480	0.3%	0.5%	1.0%	0.8%	0.2%	0.9%	n.m.	0.1%	0.0%	2.5%
U.A.E	450	0.3%	0.2%	0.3%	0.3%	0.1%	0.4%	n.m.	0.0%	0.0%	1.3%
Bank EM Lending / GDP		89%	53%	26%	23%	13%	54%	20%	25%	31%	43%
Weighted CDS of Exposures (bp)		477	387	539	529	437	502	368	691	709	436

Using CDS to Quantify EM Lending Risk for Banks

Lending preferences by country are far from identical. Austria's EM exposure remains the largest, although Sweden's are some of the riskiest based on the average CDS of the EM countries in question (due a heavy Baltic presence). Spanish banks are heavily exposed to Latin America (Brazil and Mexico), while Austria appears to carry the highest exposure to Russia scaled to GDP, per BIS data

Mapping Exposure of Country's Banks to EM (x-axis), versus Riskiness of that Exposure (EM CDS, y-axis)

Wgt. CDS Spread of EM Claims to Banks (bp)



Rating Distribution Table

Credit Products Rating Distribution Table

(as of Sep 30, 2008)

Rating	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight	82	36%	49	33%	60%
Equal-weight	89	39%	61	41%	69%
Underweight	56	25%	37	25%	66%
Total	227		147		

Coverage includes all companies that we currently rate. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Overweight (O) Over the next 6 months, the fixed income instrument's total return is expected to exceed the average total return of the relevant benchmark, as described in this report, on a risk adjusted basis.

Equal-weight (E) Over the next 6 months, the fixed income instrument's total return is expected to be in line with the average total return of the relevant benchmark, as described in this report, on a risk adjusted basis.

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