

Special Comment

Moody's Global Banking

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Table of Contents:

Summary Opinion	1
Current Responses from Stakeholders	2
Moody's Opinion on Extension Risk	2
Hybrids May Also Pose Extension Risk to Investors	2
Implications Going Forward	3
Moody's Related Research	3

Analyst Contacts:

New York **1.212.553.0377**

Jean-Francois Tremblay
Vice President

Barbara Havlicek
Senior Vice President, Chair of the New Instruments Committee (NIC)

Marc R. Pinto, CFA
Senior Vice President

David Fanger
Senior Vice President

Gregory W. Bauer
Group Managing Director

Paris **33.1.53.30.10.20**

Alain Laurin
Senior Vice President

London **44.20.7772.5454**

Johannes Wassenberg
Team Managing Director

Reynold R. Leegerstee
Team Managing Director

Frankfurt **49.69.707.30.700**

Detlef Scholz
Senior Managing Director

Debt Redemption Extension Risk

Summary Opinion

Earlier this week, Deutsche Bank broke with a banking practice of redeeming a callable bond at the first opportunity. While investors expected a Deutsche Bank Lower Tier 2 (LT2) bond to be called in January 2009, based on established practice in this market, the bank effectively extended the time for redemption anywhere from four additional months to five years, depending on whether it will exercise future call options or wait until final maturity¹.

Deutsche Bank's move sparked a broad-based market reaction, sending the value of similar instruments down in secondary markets (with widening spreads on associated credit default swaps), which indicates that investors are already assuming the possibility that other banks will take similar actions. In addition to repricing these instruments on the basis of their final maturities, investors are also struggling to interpret the move as to whether the action signals credit worthiness concerns that also should be considered.

Moody's provides the following three observations following this development:

- First, Moody's credit rating opinions are intended to reflect the probability of default over the life of an instrument and the potential severity of loss in the event of default. Moody's ratings do not reflect the likelihood that an instrument will be called prior to maturity.
- Second, the decision by issuers to extend redemption beyond the call date is in line with Moody's (and regulators') expectations that debt qualifying as regulatory capital should remain in place in difficult circumstances, particularly if the cost to replace it is prohibitively high, as is currently the case.
- Third, Moody's expects that extensions of callable debt will become more common than investors have experienced to date, including instruments that qualify as Tier 1 regulatory capital. We do not anticipate any rating implications to result from these recent events.

¹ While Deutsche Bank is the first major issuer to break with the practice of redeeming LT2 instruments at the first call date, it is not a precedent, as other, smaller banks did it recently. For instance, Credito Valtellinese Scrl decided not to redeem a 150 million euro LT2 bond that was callable on April 30, 2008.



Debt Redemption Extension Risk

Current Responses from Stakeholders

For Deutsche Bank, the move not to call this debt made economic sense, as extending the redemption beyond its first call date is less expensive than re-issuing replacement capital in current market conditions, and it is perfectly consistent with the terms of the security. The 1 billion euro bond has a maturity of January 2014 and a call feature, at the option of the bank, starting in January 2009 (and every 3 months thereafter).

Several other banks are in a similar position as Deutsche Bank, and we would expect to see them take similar actions, particularly in the current context - and especially if Deutsche Bank is perceived by other banks as having legitimized the waiving of call options on these debt instruments.

On the other hand, investors appear to have purchased this type of debt strictly on the basis of historical market practices and somewhat contrary to the terms of the securities and regulators' recognition of equity capital attributes. That being said, for those investors who have become accustomed to, and expect redemption at the first call date, any bank's redemption decision poses a number of challenges. Investors will immediately re-price outstanding instruments, taking into account the possibility that the issuer will hold on to the callable debt until maturity. Investors are also naturally concerned that such a move signals credit worthiness issues that should be considered in the pricing of the security, although in Moody's opinion, a non-call decision does not, in the absence of other factors, indicate such issues. As a result, the question as to whether these types of securities remain a cost-effective funding source in the future becomes an open question.

Moody's Opinion on Extension Risk

Moody's views extension risk — that is, the risk that a security will not be called at the call date — as pure market risk and, all else being equal, not a factor in the credit rating process. Also, redemptions beyond the call date do not constitute a default; as with other covenants, an issuer's right to not redeem a security at the call date is clearly stated in the security's documentation. Also, since our ratings assume that the debt will be outstanding until maturity, the existing credit rating is likely to prevail. Our ratings are not predicated on callable bonds being redeemed at the first or any subsequent opportunity.

Further, it is also important to remember that, in the current economic context, a bank's decision to extend the expected redemption of "cheap" debt is a sensible economic action that is in line with ongoing efforts to preserve capital. As long as the action does not result in further diminution of market confidence in a bank, which could potentially outweigh any savings on funding costs, the economics of the decision are beneficial. Moreover, for banks that are currently receiving government support, it sends a strong signal that investors providing junior regulatory capital may not have the ability to exit early, and possibly not in advance of the government's exit where the government has provided a capital injection.

Hybrids May Also Pose Extension Risk to Investors

Moody's classified the Deutsche Bank subordinated bond as debt due to its short-dated maturity and absence of coupon deferral mechanisms². As a result, equity credit analysis has no relevance. However, the possibility of a bank not exercising its option to call is clearly a consideration for hybrid securities, which can take the form of either junior subordinated debt or preferred stock and may receive equity credit depending on their structures. Among other equity-like features such as coupon non-payment mechanisms, hybrids either have a perpetual maturity or are very long-dated with 5- to 10-year call dates. Similar to the Deutsche Bank bond, these hybrids are typically priced by the market to the first call date.

While the decision not to call a hybrid on the call date has potential market repercussions, such behavior is in line with Moody's expectations for hybrids that warrant equity credit consideration. In Moody's hybrid methodology, we focus on the relative permanence of a hybrid in the capital structure. If a bank issues very long-dated junior subordinated debt or preferred stock with a call feature, our expectation is that due to

² For more detail on our hybrid methodology, see "Moody's Hybrid Tool Kit: A framework for Assessing Hybrid Securities", December 1999 and "Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!", February 2005.

Debt Redemption Extension Risk

regulatory oversight, it will only be called if the bank has the financial wherewithal to do so and, if called, will likely be replaced with the same or more equity-like security³.

For banks with hybrids approaching their call dates, we believe that not calling them is a real possibility. Given the high cost of replacement capital, it will likely be more economic to have them remain outstanding and even be subject to a step-up in rate⁴, if applicable, than to exercise a call and replace them. From an equity credit and regulatory perspective, such loss absorbing capital will remain in place to provide support for senior creditors and depositors, as designed.

Implications Going Forward

It appears that markets have so far only reacted to debt instruments in the same category as Deutsche Bank's subordinated debt, i.e., LT2. We expect that current pricing conditions on the issuance of replacement capital will act as an incentive for banks to consider the redemption extension of other callable securities such as hybrids, including instruments qualifying as Tier 1 capital, especially since these moves appear to be supported by regulators.

In Moody's view, the immediate consequence of serial redemption extensions may be a further dampening of investors' interest in hybrid issuances for some time. For banks that have fully utilized their hybrid capacity, which many have, this will put pressure on building capital and provide further incentives to not call outstanding instruments, particularly where existing debt pricing is relatively attractive.

Consequently, we expect investors to take note of these developments and, in the future, pay particular attention to call options and associated step ups when pricing an instrument at issuance. Investors should keep in mind, however, that there might be a point where overly punitive step-up conditions may, from a regulatory as well as Moody's point of view, affect the permanence of the funds and reduce the capital benefit that such an instrument might otherwise provide.

We do not anticipate any rating implications to result from these recent events, unless the market reaction to extension decisions is such that this means financing is permanently shut or if a bank's extension reveals deeper problems. We have no reason to believe that this is the case now. Moody's believes that Deutsche Bank has been proactive in obtaining funding in the last two years, leaving it in a good liquidity position with relatively modest capital markets funding requirements for 2009.

Moody's Related Research

Rating Methodologies

- Moody's Hybrid Tool Kit: A framework for Assessing Hybrid Securities, December 1999 (49802)
- Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!, February 2005 (91696)
- Refinement to Moody's Tool Kit: An Addendum for Banks and Insurers, January 2006 (96187)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

³ For more information on the issue of capital replacement, see "Refinement to Moody's Tool Kit: An Addendum for Banks and Insurers, January 2006, page 3.

⁴ Certain types of hybrid have step-up features where, if the security is called, the coupon steps up by an amount pre-specified at issuance.

Debt Redemption Extension Risk

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Authors

J-F Tremblay

Production Specialist

Ida Chan

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