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Credit Research

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Weekly Credit Strategy Update

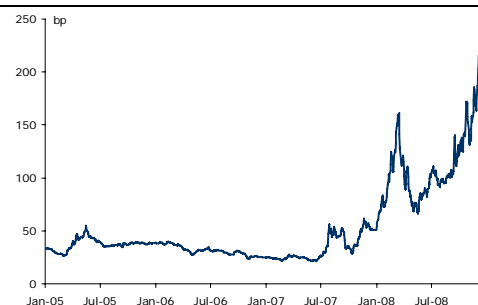
A dramatic 2008 will soon be history, and this week proved to be no exception to a frantic year as we saw some extraordinary events. We had the largest fraud scandal ever in financial markets. Then we had the Federal Reserve lower its key interest rate to 0-0.25%. Finally, on Wednesday Deutsche Bank dropped a 'debt market bomb' by announcing that it would not call a LT2 bond.

Eventually we are here: The last weekly credit update of an inconceivable 2008! And what better way to mark this than by the revelation of the largest fraud scandal in the history of financial markets; namely the fall of Bernard Madoff (please see more details below).

The FOMC meeting marked another noteworthy event this week as the Fed lowered its interest rate to between 0-0.25%. Thereby the Fed has used the last of its interest rate bullets and going forward it will be interesting to see what actions it undertakes if the crisis rumbles on. After the Fed announcement CDS indices moved tighter. Currently, the investment grade index, iTraxx Europe, trades at 188bp down from 212bp last Friday. The high yield index, iTraxx Crossover, trades at 1050bp down from 1090bp last week.

Subordinated CDS has underperformed considerably during the week on the back of the news from Deutsche Bank (more on this below). This is because investors now need to cover subordinated exposure until maturity rather than until call.

iTraxx Europe



Source: Markit

iTraxx Crossover



Source: Markit

As expected the activity in the primary market has fallen considerably as investors are closing books ahead of year-end. Svenska Handelsbanken issued a SEK 2.1bn hybrid bond to Swedish institutional investors. The price was rumoured to be around 750bp over mid-swaps.

In the beginning of 2009 we expect very strong activity in the primary market; it will pose a significant challenge for the market to digest this. Especially, the expected massive supply of state-guaranteed senior debt is likely to flood markets.

Madoff scandal may result in USD 50bn losses

By using a classic Ponzi (pyramid) scheme, Madoff attracted substantial inflow for his investment fund. Subsequently, he used the inflow to pay yield to existing investors but the scheme collapsed after the financial crisis resulted in outflows from the fund, which it could not honour.

The size of the total losses is currently estimated at some USD 50bn. These massive losses are currently being digested and a large number of banks have already disclosed their exposure. So far it seems that the lion's share of the losses will have to be borne by customers rather than the banks themselves as the exposures were mainly on behalf of customers. Obviously, such a fraud is very bad for an investment community already very low on confidence.

Sweden changes the limit for inclusion of hybrid core capital

The Swedish FSA has announced that it has changed the limit for the inclusion of hybrid core capital from 15% to 30% in the Tier 1 ratio. We assume that the new rules are made with the aim of raising the core capitalisation of the banking sector rather than increasing the leverage (by paying out dividends funded by hybrid issuance).

Obviously, it is currently hard for banks to raise hybrid capital in capital markets (although smaller private placements are possible – cf. the small issue by Sv. Handelsbanken earlier in the week) but we think there is a high possibility that the Swedish Government will buy the hybrid capital from the banks as the timing of the new rules otherwise would not make sense.

Such a move would bolster the Tier 1 ratio (not the Core Tier 1 ratio though) and would spell good news for Swedish senior debt and lower Tier 2 as it would provide a larger loss cushion in case of a bank not complying with minimum capital requirements.

Deutsche Bank will not call a LT2 bond – a buying opportunity for other LT2's!

On Wednesday, Deutsche Bank announced it is not going to call a Lower Tier-2 bond (3.875% 2004/2014 with call January 2009). With a step-up to 3M Euribor +88bp (initial spread of 38bp), the call option is out-of-the-money. To our knowledge, this is the first time a major bank voluntarily decides not to call a subordinated bond. With the move, the rules of the game for subordinated capital may have changed significantly, although the possibility remains that Deutsche Bank may end up being the only one to follow this route.

Deutsche argues that senior creditors, shareholders, other capital instrument holders, rating agencies, regulators and employees are served best by not calling the subordinated bond despite the obvious hit to existing note holders.

From an isolated economic point of view, the move makes sense due to the very low step-up. On the other hand, reputation risk is at stake. Deutsche clearly believes that the latter can be disregarded in the current environment. Another reason that Deutsche decided not to call the bond is probably the lack of amortization of the capital inclusion in the first three years after call. In this respect Germany differs from the other countries where amortization of the notes from first call date to maturity is typically 20% per year (in Denmark the amortization is 25% per year after call and final maturity is usually 3 years after the first call date). Coupled with the low step-up, this increases the likelihood that other *German issuers* may decide not to call their LT2 bonds at first call date.

We think Deutsche Bank is playing a “high risk, low reward” game as they risk the wrath of the international investment community for a rather limited short-term profit. In this respect it is worth noticing that senior bonds from Deutsche widened significantly after the announcement. Furthermore, a number of investors have indicated that they will not buy debt from Deutsche (or other banks not calling their LT2 bonds) in the primary market in the future.

Deutsche's decision has caused outstanding subordinated debt to be calculated to maturity rather than to call. We see this as a buying opportunity as investors thereby get a possible free upside if banks still decide to call their LT2 bonds before maturity. For bonds with larger step-ups and immediate amortization of capital after first call date, we still think banks more often than not will decide to call their LT2 bonds. Still, we highlight that investing in subordinated bonds from banks should be done with caution.

Unibanca and HBOS are next in line with first call on 30 January and 6 February 2009 respectively followed by Banco Sabadell (18 February 2009). It will be very interesting to watch their decision as this could establish the new market convention.

Finally, we wish our (faithful?) readers a merry Christmas and a happier New Year!

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