



Deutsche Bank: irregular calls but no regulatory calls

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- Deutsche Bank has finally announced that it will call its €1bn ex-5.33 Tier 1 at its next call date in March.
- As Credit Suisse looks at options for calling a Regulatory Event, Deutsche Bank could be tempted to follow suit on its high-coupon Tier 1s.
- We view the German regulations as less prone to regulatory calls and recommend investors to Hold or Buy:

DB € 9.5 Perp-03/2015 at 105.5

DB € 8 Perp-05/2018 at 109.5

Deutsche Bank calling its T1s after not calling its LT2s

Deutsche Bank (DB) has just announced overnight it will call its €1bn ex-5.33 Perp-09/2013 Tier 1 at the next call date in March. This date is effectively the first call date under the new Basel 3 regime.

On 1 January 2014, under the Basel 3/CRD4 grandfathering rules, the bonds lost their regulatory capital recognition as Tier 1 but also as Tier 2 because of the step-up that occurred last September.

Given the Trust Preferred format under Delaware law, the bonds would not even have been bail-inable as they would have failed the contractual recognition requirement under the Recovery and Resolution Directive (RRD). The coupon had reset in September to 3mE+199 so DB took the view that it was an expensive source of funding even if perpetual.

Also, as the bonds had lost all regulatory recognition, we think that BaFin did not even have to consent to the call.

After not calling its LT2s in January 2009, DB is now calling its T1s and this shows how times have changed. Focus from issuers and investors as well as regulators, is now on new AT1 formats.

We discuss below whether Deutsche Bank could get carried away in its calling policy by forcing Regulatory Events on its other Tier 1 instruments, following in the steps of Credit Suisse last week.

Credit Suisse calling a Regulatory Event – a first in Europe

Credit Suisse crossed the line in Europe by indicating last Thursday that they are looking at the early redemption of their old-style \$7.875 Perp-12/2015 Claudius bonds under a regulatory disqualification event.

Danske Bank and Societe Generale last year also tendered and subsequently called some old-style instruments but this was related to a change in S&P's rating methodology. Danske Bank called its \$1bn 7.125 2037-17 Tier 2 issued in September 2012 and Societe Generale its \$1.5bn 6.625 Perp-18 Lower Tier 2s: freshly issued in June 2013. Both issues were launched for their equity contribution to S&P Risk Adjusted Capital. S&P eventually changed its methodology on 16 July 2013 and that triggered the Rating Methodology Events where the issuers could call their bonds at par. Both issuers went down the tender route first (101.5 and 102 respectively) before ultimately calling the remaining bonds at par.

Breaking the Omerta backed by the spirit of Basel 3

Regulatory Events have been discussed for some time. The usual suspects have been Lloyds ECNs – see our thought-provoking note *Lloyds' cocos are callable too!* dated 11 December 2013 - and the very Tier 1 instruments issued by Deutsche Bank.

However, neither issuer had really overtly commented about any intention to trigger a regulatory disqualification. Reason being that the new Basel 3 framework had provided for grandfathering rules that would constrain the capital recognition at the portfolio (or 'grandfathered bucket') level, hence potentially leaving the capacity at the instrument level for full recognition, depending on the path of redemption and amortisation of the other instruments. This capacity for full





recognition, in theory, would exist until the end of 2021, when the grandfathering cap finally drops from 10% to 0% in 2022. Even if the letter of the rules ultimately suggests a full disqualification of all old-style instruments in 2022, the spirit of the text should be that old-style instruments had to be left outstanding as long as they could contribute to the grandfathered buckets. In our view, this should be the logical approach when anticipating a regulators' behaviour towards any early call.

Credit Suisse's interpretation

Credit Suisse is trying to prove this understanding wrong and their Investor Relations referred to the FINMA Circular 2011/2 *Capital buffer and capital planning – banks* dated 18 July 2012.

The grandfathering provisions indicated in this Swiss regulation stand in clause 5.2.1.2 as follows *From 1 January 2013, depending on their date of issue and the qualitative features, the current capital instruments will be directly disqualified, transferred into another category or gradually phased down over a maximum period of 10 years.*

We think that the regulation as it reads is enough to conclude that an old style Tier 1 instrument should be expected at best to phase down during ten years until 2022 when recognition will be reduced to zero.

Use of the future tense

However, this would be enough for Credit Suisse under the exact wording of their regulatory disqualification event. The key is that it uses the future tense. As long as a change to regulations **has, or will have the effect that the Bank, is no longer, or will no longer be capable of including in its Tier 1 Capital.**

We have been going through the prospectuses of some of the most commonly traded old style Tier 1 instruments and found that such a forward-looking regulatory event is very limited. In addition to Credit Suisse \$7.875 Perp-12/2015 Claudius bonds, we have identified similar language in all the Deutsche Bank Tier 1 securities and the Commerzbank Tier 1s issued under the Capital Funding Trusts (€5.012 Perp-16, £5.905 Perp-18, €ex-5.25 Perp-12). Given the market prices of these Commerzbank Tier 1s (100.5, 102.00, 83.50 respectively), we will disregard here their regulatory risk and focus on Deutsche Bank.

The two DB Tier 1s with the highest regulatory call risk are DB €9.5 Perp-03/2015 and DB €8 Perp-05/2018

Most DB Tier 1s had a regulatory call at par, apart from the instruments below.

DB €ex-5.33 Perp-09/2013 (being called) had a make-whole at DBR+35bp.

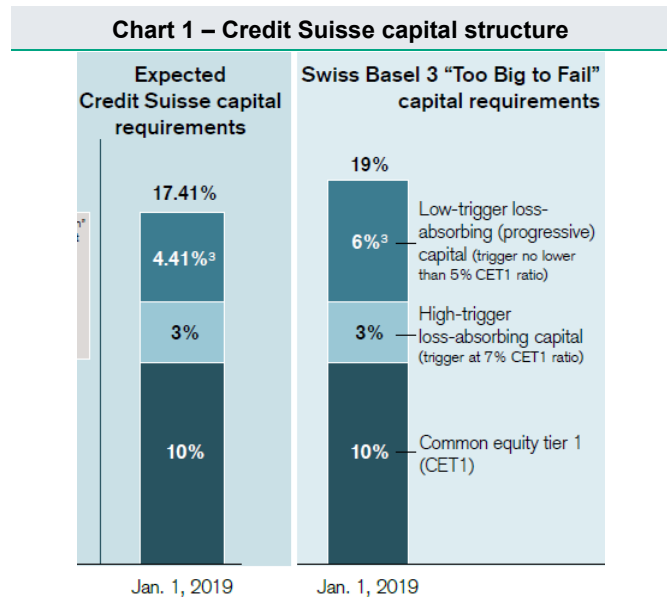
DB \$5.628 Perp-01/2016 has a make-whole at Tsy+37.5bp.

DPB € 5.983 Perp-06/2017 has a make-whole at DBR+50bp.

The tight spread of the make-whole price in effect takes out any value from the regulatory call for the issuer.

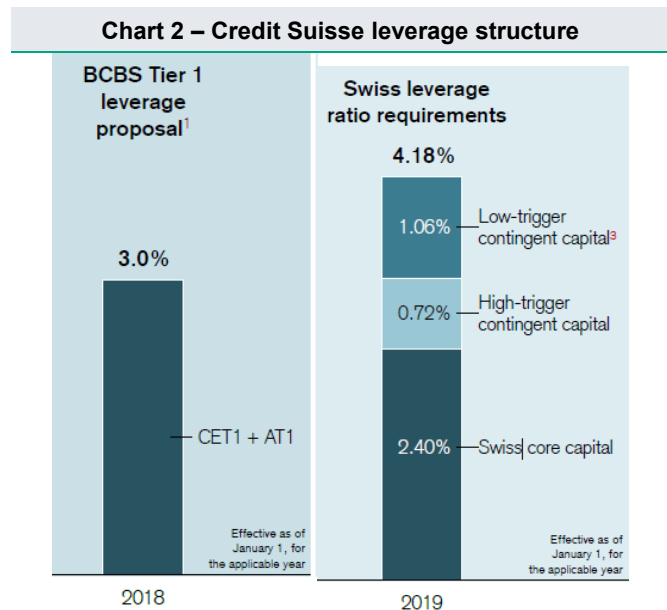
FINMA vs. BAFIN: expect a different reaction

Even though it has not been confirmed by Credit Suisse whether FINMA gave its consent to a potential call, we expect the regulator to be comfortable with such a move. The reason is that the new capital structure requirements will apply without any contribution required from any Additional Tier 1 Capital. See Chart 1.



Source: Credit Suisse

AT1 instruments, in fact, only contribute to the BCBS Tier 1 leverage ratio and Credit Suisse will be constrained on a Swiss leverage ratio that recognises core capital and Cocos only. See Chart 2. So the bank does not expect to need any contribution from grandfathered Tier 1 instruments.



Source: Credit Suisse



We expect BaFin to take a different approach as DB should still be considered to need AT1 capital, in particular the very contribution from its old style instruments through the Tier 1 grandfathered bucket, between now and the end of 2021, not only for its capital but also for its leverage ratio.

Hence, we see the German regulatory environment less prone to Regulatory Event and we expect BaFin to take a cautious, if not passive, approach towards any solicitation from DB to call on a Regulatory Event. In particular, BaFin should be expected to refer to the potential contribution of the instruments to the grandfathered bucket.

Mechanics of the grandfathering buckets

DB has a number of fixed rate T1s that it could call in 2014 (\$7.35, \$6.375, \$6.625, €6.15). See a suggestion for the T1 amortisation under the grandfathering cap in Table 1 below. If it calls a sufficient amount of these (for instance, the highest coupon \$7.35 and \$6.625), then it will create some marginal capacity for DB €9.5 to be fully recognised in 2014.

On 29 January, DB's management cited meetings with investors on AT1 capital and found a strong appetite. We should expect them to come to the market anytime.

Even if DB demonstrates to BaFin that it would no longer need the capital from the €9.5, we still expect BaFin to look at the potential rather than the effective contribution and refrain from being framed in a proactive decision that would be unfriendly to investors.

Trade recommendations

We recommend investors to Hold or Buy:

DB €9.5 Perp-03/2015 at 105.5

DB €8 Perp-05/2018 at 109.5

Target: 107 and 112 respectively



Table 1 - Suggested T1 amortisation under the grandfathering cap

Issuer	Cpn	Ccy	Amount		Current Price	Reset Lvl	Step (S)/ Non-Step (NS)	Next Call date	Estimated Year for Capital Loss	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
			Ccy	Eur-eq						2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Cap Fdg X	7.35	USD	805	590	25.6	fix-to-fix	NS	15/03/2014	2014	-	-	590	-	-	-	-	-	-	-	-
Cap Fdg VIII	6.375	USD	600	440	na	fix-to-fix	NS	18/04/2014	2016	-	-	-	-	440	-	-	-	-	-	-
Cap Fdg IX	6.625	USD	1,150	843	25.2	fix-to-fix	NS	20/05/2014	2014	-	-	843	-	-	-	-	-	-	-	-
Cap Fdg V	6.15	EUR	300	300	101.7	fix-to-fix	NS	02/06/2014	2016	-	-	-	-	300	-	-	-	-	-	-
Cap Fdg XI	9.5	EUR	1,300	1,300	104.9	fix-to-fix	NS	31/03/2015	2015	-	-	-	1,300	-	-	-	-	-	-	-
Ctgt Cap II	6.55	USD	800	586	25.2	fix-to-fix	NS	23/05/2017	2017	-	-	-	-	-	586	-	-	-	-	-
Ctgt Cap III	7.6	USD	1,975	1,448	26.3	fix-to-fix	NS	20/02/2018	2018	-	-	-	-	-	-	1,448	-	-	-	-
Ctgt Cap IV	8	EUR	1,000	1,000	109.0	fix-to-fix	NS	15/05/2018	2018	-	-	-	-	-	-	1,000	-	-	-	-
Ctgt Cap V	8.05	USD	1,385	1,015	26.9	fix-to-fix	NS	30/06/2018	2018	-	-	-	-	-	-	1,015	-	-	-	-
Silent Partic.	8.15	EUR	20	20	na	fix-to-fix	NS	31/12/2018	2019	-	-	-	-	-	-	-	20	-	-	-
Postbank I	CMS	EUR	300	300	75.9	CMS10+0.025	NS	02/06/2014	2022	-	-	-	-	-	-	-	-	-	-	300
Postbank III	CMS	EUR	300	300	76.0	CMS10+0.125	NS	07/06/2014	2022	-	-	-	-	-	-	-	-	-	-	300
Postbank II	CMS	EUR	500	500	102.0	4xCMS 10s2s	NS	23/12/2014	2022	-	-	-	-	-	-	-	-	-	-	500
Cap Fdg VI	CMS	EUR	900	900	101.4	4xCMS 10s2s	NS	28/01/2015	2022	-	-	-	-	-	-	-	-	-	-	900
DMG	frn	USD	200	148	na	6m\$+0.25	NS (down)	29/08/2014	2022	-	-	-	-	-	-	-	-	-	-	148
Cap Fdg I	ex-7.872	USD	650	480	93.8	3m\$+2.97	old S	30/03/2014	2016	-	-	-	-	480	-	-	-	-	-	-
Cap Trust IV	5yr reset	USD	162	120	na	CMS5+2.80	old S	30/06/2016	2016	-	-	-	-	120	-	-	-	-	-	-
Cap Trust I	5yr reset	USD	318	235	na	CMS5+2.7	old S	30/03/2019	2019	-	-	-	-	-	-	-	235	-	-	-
Cap Trust V	5yr reset	USD	225	166	na	CMS5+2.80	old S	Perp	2022	-	-	-	-	-	-	-	-	-	-	166
Cap Fdg IV	ex-5.33	EUR	1,000	1,000	97.8	3mE+1.99	S	19/03/2014	2013	-	1,000	-	-	-	-	-	-	-	-	-
Cap Trust III	frn	USD	118	87	95.3	CMS5+2.90	S	30/06/2014	2014	-	-	87	-	-	-	-	-	-	-	-
Cap Fdg VII	5.628	USD	800	590	103.8	3m\$+1.70	S	19/01/2016	2016	-	-	-	-	590	-	-	-	-	-	-
Postbank IV	5.983	EUR	500	500	106.1	3mE+2.07	S	29/06/2017	2017	-	-	-	-	-	500	-	-	-	-	-
Cap Trust II	5.2	JPY	20,000	144	na	CMS+1.62	S	27/04/2029	2022	-	-	-	-	-	-	-	-	-	-	144
Amortisation											10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
Cap (EUR mn)										12,500	11,250	10,000	8,750	7,500	6,250	5,000	3,750	2,500	1,250	0
Total left outstanding										na	9,980	8,680	7,751	6,664	3,201	2,947	2,947	2,947	489	
Headroom										(Gap)	na	20	70	- 251	- 414	1,799	803	- 447	-1,697	- 489

Source: Deutsche Bank 2012 Annual Report, Bloomberg, BNP Paribas



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Danske Bank	4
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