Deutsche bailout denial belies ratings assumption of government support; margin calls ahead? — ANALYSIS
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Will German taxpayers bail out all or parts of Deutsche Bank if the bank needs rescuing? At the very least, will German taxpayers subsidize certain obligations such as derivative contracts?

(The International Monetary Fund in June said Deutsche Bank may be the biggest contributor to risk among so-called global systemically important banks. The bank has gross notional derivatives exposure of EUR 46trn, according to an Investor Relations presentation published this month. After netting and collateral, reported derivative trading assets fall to EUR 41bn, the bank said.)

An answer of *"yes"* to either question will validate rating agencies that have been busy baking the assumption of government support for derivative contracts into counterparty evaluations. If this is the case, the bank's derivative counterparties and rating agencies win, German taxpayers lose and everyone knows the score.

In contrast, an answer of *"no"* to at least the second question will undermine the ratings of ABS and other types of debt where an issuer is counterparty to Deutsche Bank under a derivative contract.

If this is the case, the score *should* be changed. Derivative counterparties of the bank and rating agencies *should* both lose. The counterparties have one less protection against nonperformance by Deutsche Bank and the rating agencies have one less crutch to prop up ratings of the bank and trading partners. Conversely, German taxpayers *should* be spared the costs of a future bailout.

However, each rating agency is its one and only scorekeeper. None is obligated to notch down the counterparty evaluations of Deutsche Bank to reflect the bank's derivative contracts on a standalone basis without government support.

The likely result is that German taxpayers still lose as rating agencies continue to enable Deutsche Bank in under-capitalizing derivative contacts under the assumption of continued government support.

At least one German lawmaker is anything but subtle

Senior German parliamentarian Hans Michelbach kicked off the week with an emphatic *"no,"* as was widely reported. "It's unimaginable that we would help Deutsche Bank with taxpayers' money."

Michelbach doubled down later in the week in response to rumors that the German government was in fact preparing just such a plan modeled on the 2008 bailouts. "I cannot imagine that the state will repeat something like that," he was widely reported as having said.

The logical response for rating agencies such as Fitch and Moody's is to ease up on the assumption of government support for the derivative contracts of Deutsche Bank. For instance, Moody's should re-evaluate the bank's counterparty rating assessment of A3, which is two notches above the bank's senior unsecured rating of Baa2, according to the rating agency's website.

If Moody's were to downgrade the counterparty risk assessment, rating triggers in derivative contracts with ABS and other structured finance issuers might obligate Deutsche Bank to post collateral, novate the contracts to a higher-rated entity or perform other, costly remedial actions.

Easing up in response to *subtle* shifts, let alone emphatic ones, is also Moody's policy as stipulated in the bank methodology that describes the counterparty risk assessment, as previously reported (see article, 1 July).

"Our approach to government support is similar to that for determining support from an affiliate. Our assessment is designed to be qualitative and flexible in nature, enabling us to incorporate the often subtle real-world shifts that define attitudes to support for bank creditors."

Neither Fitch nor Moody's faces an analytical obstacle in notching down counterparty assessments from current levels because neither actually evaluates the derivatives portfolio of Deutsche Bank or any other bank in assigning the assessments, as previously reported (see article, 12 August).

Instead, the issue is one of preserving a rating franchise — the conflict of interest that has dogged ABS ratings from the outset. For instance, Moody's bases its counterparty risk assessment on the expectation of continued government support in large part to assign top ratings to a range of structured finance types such as ABS and ABCP that have derivative or other types of contracts with downgraded banks, as reported on 1 July.

Many US and EU banks have leveraged the Moody's assessment by amending the rating triggers in existing derivative contracts with ABS transactions to reference the Counterparty Risk Assessment rather than a debt rating such as the senior unsecured rating. By doing so, many European banks in particular avoided posting collateral or taking other remedial actions that derivative contracts specify are to occur upon breach of a rating trigger.

PS: Downgrading counterparty evaluations impacts watchlisted FFELP ABS

Tracking the ratings of all ABS and other structured finance instruments that rest in part on the counterparty evaluation of Deutsche Bank will be time-consuming. However, another ABS problem — the large FFELP watchlists of Fitch and Moody's — turned up at least one example, as previously reported (see article, 21 September).

The Class A-7 tranche of Nelnet Student Loan Trust 2006-2 is euro-denominated and the deal is party to a currency swap with Deutsche Bank AG as swap counterparty, according to Moody's announcements. The Class B tranche, which is USD-denominated, is also exposed to the swap by virtue of subordination.

Moreover, the swap with Nelnet 2006-2 may be substandard in attaching more counterparty exposure to the deal than is typical. Moody's downgraded the Class A-7 and B tranches in 2014 owing to exposure to Deutsche Bank as well as "an earlier error in assessing linkage between the transaction's ratings and the ratings of the swap counterparty," according to a Moody's announcement of 11 September 2014."

Spokespersons for Fitch and Moody's declined to comment.