Elstree

Is Deutsche Bank (DBK) going broke and does it need a bail out or bail in?

Well if you read a lot of press, you'd come to that conclusion. We don't think its anywhere near that situation. While it's not holidays in Fiji for Deutsche Bank, it's not the certain death experience that you might have read either.

Is Deutsche Bank different to Lehman and Bear Stearns?

Deutsche Bank is materially different. Banks can have problems with either the asset or liability side of the balance sheet and the source of the problems will determine whether they go broke slowly or quickly. They go broke quickly if the liability side of the balance sheet has problems and they go broke slowly if it's an asset problem (it takes banks years to write down assets usually). While Lehman had problems with both sides of the balance sheet, it was primarily with the way they borrowed (i.e the liability side). Their borrowings were largely short term and all the funding disappeared in the space of a week or so. Deutsche, post GFC, does not have nearly the same quantum of issues. Around 70% of liabilities are "safe" (cf 60% for Australian Majors) and Deutsche has an enormous chunk of cash and lots of very saleable assets. Nor does it have an asset problem. Loan losses have been about half its investment and commercial banking peer group since the GFC. There are some big numbers relating to derivatives, but net numbers are relatively small and, notwithstanding it's a 'black box' it hasn't caused them problems over the past 10 years. Risk management seems okay. So there are no obvious fatal liability or asset problems. However, large parts of its investment banking business are barely profitable and probably in terminal decline. And it has an ongoing litigation problem as a result of being an investment bank in those wonderful pre GFC years. The combination is that it has a big profitability and strategic problem, not an asset or liability problem.

But I keep on reading that it doesn't have enough equity and either the German government will have to take it over (Bail out) or CoCo's/AT1/Hybrids will be converted to equity (Bail in).

It's not obvious. It might need a few percentage points more of CET1, but until a few weeks ago, the market was happy that it could do that over time. And, you have to ask why a regulator would bail in or bail out. It doesn't change the total amount of protection available to deposit/bond holders and none of them are actually at risk (the assets are too high a quality). In the last ECB stress test, Deutsche was one of the worst performers, but capital was still above the minimum required level. The bank is still able to operate and raise debt (even though it doesn't need it), and if you are a regulator you have to weigh the possibility that by wading in, in such a formal manner, you trigger an even greater crisis of confidence. They need higher equity ratios, but it's not certain that means to a discounted share issue. It might come from asset reductions or sales of part of the bank or rights issues or the Qataris increasing their stake in the bank from 10% to 25%.

So the coupons on the AT1/CoCo will be stopped?

Well that's how CoCo's are meant to work and they may stop temporarily. In valuation terms, you get paid so much above risk free rates, that in general, you can still lose coupons and be better off than senior debt holders. For example, if you bought a 5 year Deutsche CoCo and did not receive 3 years of coupons, you are in the same financial position as a senior debt holder who gets paid every year. It is by no means certain

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that coupons will be stopped or temporarily halted.

But isn't the US Department of Justice (DoJ) fine of $14b larger than Deutsche's market capitalisation? Won't that send it broke?

Deutsche's equity is around 61bn EUR while its market capitalisation is 16bn EUR. Deutsche's share price is a combination of poor profitability and lots of short selling. The short sellers like going after banks because they hope that a weak bank will need to raise more capital (because of a lot of bank funding is confidence sensitive). It worked with the Italian banks a few months ago and Deutsche is a prime candidate (due to its perceived low capital levels). Interestingly, the DoJ $14b fine is probably the least of its problems.

- It's not the last of the fines and litigation.
- It's at least partially provisioned and
- It will almost certainly be negotiated down.

Aren't the headlines similar to the Italian bank "Mother of all Systemic Threats" crisis earlier this year?

There's not a lot of press about that Armageddon now, is there? The reason is that European banks have a profitability problem that will take years to work through (cutting expenses, changing strategy etc) and most headlines are stories looking for a reason to short sell.

So surely the price of the CoCo's has collapsed?

No, Deutsche's CoCo's are trading at around $81 after falling to $75. Markets are reasonably confident that Deutsche will fix itself. Interestingly, the prices of Unicredit (a damaged Italian Bank) CoCo's are back to $85 after falling to the low $70s a few months ago. The BofA ML CoCo index has returned 8.2% over the last 6 months and that time period includes Brexit, Italian Bank troubles and Deutsche Bank concerns. While the index includes some capital gains from falls in interest rates, it compares favourably with European equity markets which fell 2% over the same period.

Any read throughs to the Australian market

For whatever reason, CoCo/AT1/Hybrids seem to be the recipient of horrible headlines on a regular basis. Interestingly, most investors don't seem to care, the headline shocks have not materialised and returns have been reasonable. In the same vein the Australian market shrugged off the Deutsche headlines. We'll continue to see lots of headlines like the one below, but we still think the domestic banking system is sufficiently well capitalised and profitable that bank hybrid risks are remote.

FSI member Kevin Davis warns of bank hybrid risks