Is Deutsche Bank a Threat to the Global Financial System?

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Reading the financial news on a regular basis can be vexing. Oftentimes, it feels like an exercise in sorting through stories about “the next shoe to drop,” separating the ones that carry significant pricing power from the majority that are overblown. The recent story about Deutsche Bank’s problems may be in the unique position of being both.

Issues with Deutsche Bank started at the turn of the year when it posted a record earnings loss in Q4 2015. Concerns mounted when its U.S. unit failed the Federal Reserve’s stress test in June, and today it has reached somewhat of a tipping point as the Department of Justice announced it is seeking $14 billion for Deutsche’s misstating of risks associated with mortgage-backed securities. With Deutsche Bank’s role as a centerpiece of the European financial system and as a major counterparty to all relevant European banks, the unwinding of this situation is no doubt critical to the functionality of the European capital markets – and could also carry global implications.

Examining Deutsche Bank’s Liquidity Position

At the time the public was made aware of the potential $14 billion fine, Deutsche Bank’s (DB) market capitalization was also around $14 billion. This coincidence led many to the false conclusion that the fine was capable of wiping out the bank. But such a comparison confuses market capitalization with capital position. Looking at capital position, DB has a €1.7 trillion balance sheet with about €220 billion in liquid reserves (as of the end of Q2), with high-quality liquid assets totaling €196 billion. Its capital position is actually quite strong! Of its liquid reserves, Deutsche has about €5.5 billion in reserves set aside for litigation costs, and it can also sell new stock in the amount of about €5 billion without requiring shareholder approval. Add those two sums together, and the fine is basically covered.
Another fact worth considering, for perspective, is that Deutsche had about €65 billion in liquid reserves in 2007, which means that it was significantly less capitalized prior to the Great Recession and financial crisis than it is now. If Deutsche could survive the worst financial crisis in history with less than half as much cash as they have now, they should be able to withstand a $14 billion hit.

**Taking Action to Avoid Crisis**

At this point DB is posturing for the worst and has been cutting costs and exploring options to raise capital from additional share sales, asset disposals, or both. It has currently secured backing from its largest investor and is seeking advice from other banks. We would not expect a capital raise (issuing new shares of stock) until the actual fine is known, since the market won’t likely be receptive to new shares without knowing the full impact on DB’s capital position. But, investor interest in new shares has already been established, as some of Germany’s top industrial companies have revived a decades-old network to discuss taking a direct stake in the bank, and Qatari investors (who own the largest stake in the bank ~10%) have indicated they do not plan to sell their shares and would consider buying more.

Also, worth noting is that it still remains to be seen what the actual Department of Justice fine will amount to. In 2014, the DOJ sought $12 billion from Citigroup for similar allegations, but Citi ultimately knocked that number down to $7 billion. What’s more, in all likelihood the fines levied by the Department of Justice will involve forgiving existing loans or changing terms of loans for lower monthly payments. In those cases, it essentially means that DB would not have to write a check for those fines, they would just have to forego future cash flow sources. They can account for that.

Perhaps the biggest risk on the table is what will come of Deutsche Bank’s prime brokerage business. These clients and hedge funds account for about one-third of Deutsche’s liquid reserves, so a mass exodus would mean a sharp increase in the risk of failure. While it does not appear to be a pressing risk right now (Deutsche has lost less than 3% of hedge fund business so far), in our opinion it will be the key variable to watch closely.

**Bottom Line for Investors**

The Deutsche Bank story is unique in that it may have some future pricing power but is also likely overblown. Its future pricing power is really in its ability to remind us of the shaky state of European financials. With negative interest rate policy and flat yield curves squeezing net interest margins, and share issuance on the rise (which dilutes shareholder equity), the investment outlook for European banks is glum.

On the other hand, to compare the Deutsche situation to a “Lehman Brothers moment” is likely overblown. Deutsche appears to have adequate liquidity to cover the fine and its capital position is...
amongst the best of all European banks. The risk of imminent failure is low as of this writing, in our opinion. U.S. banks remain in fine shape and credit spreads globally have not shown worrisome signs of spiking. Global growth should remain largely undisturbed as a result.

-Mitch

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