Asia Credit Research

Deutsche Bank: Status Update

Thursday, 29 September 2016

Summary / Key credit considerations

- Deutsche Bank AG is creating waves in the market again although this time it's not entirely their doing.
- Market reaction appears different with impacts somewhat contained compared to earlier in the year although broader market volatility in the financial sub space has picked up.
- Local bank capital instruments remain better positioned considering relative fundamentals and supportive operating environments.

In the news again

Deutsche Bank AG (DB) is in the news again and like earlier this year, it hasn't been for the right reasons. Questions on the health of DB have resurfaced and this time, there is the spectre of timing uncertainty as to when these questions can be resolved. This has created market volatility and impacted prices along the Deutsche Bank curve, most notably in their capital instruments, and it seems that the longer this uncertainty persists, the more potential there is for impacts to be longer lasting. This time, there are more parties involved and with uncertainty abounding, it's opportune to visit the who and what of the current state of play.

Key factors in play

- The US Department of Justice ('DoJ'): Seeking a USD14bn fine in relation to civil claims regarding Deutsche Bank's US residential mortgage backed securities business during 2005-2007. This amount is far above market expectations for the fine of USD2-4bn and Deutsche Bank's current litigation reserves of ~USD6.2bn. There is no transparency as to how these reserves are allocated and how much was raised in anticipation of the DoJ's claim as DB is currently defending itself against more than 7,000 litigation cases, some of which are also expected to attract significant fines (eg: Russia mirror trades).

- The past: Market perception of DB was already on shaky ground following the so called 'Coco Crunch' of February where the Euro Stoxx 600 Banks price Index fell sharply on 12 February 2016 amidst a sell-off in both European financials' equity and credit markets. While this was prompted by general industry concerns surrounding negative preliminary earnings announcements and weak profit outlooks in the face of persisting low interest rates and rising liquidity and capital pressure for European banks, one of the sparks for the sell-off was DB's reported pre-tax losses for 4Q2015 due to restructuring impairments and litigation charges, resultant plans to stop dividend payments for 2015 and 2016 and questions around its ability to pay coupons on its AT1 capital instruments. While this raised concerns about DB's on-going viability, ultimately these concerns settled down over time. That said, it did not stop the rating agencies from subsequently downgrading DB's credit ratings in May (Moody's) and June (S&P) on persisting industry challenges which could threaten DB's capital position and the success of its restructuring initiatives.

- The present: DB's reply to the DoJ's claim was to state that it had "no intent to settle these potential civil claims anywhere near the number cited", that it was the first step in negotiations with the DoJ inviting DB to make a counter proposal, and finally that it expected negotiations to result in a "an outcome similar to those of peer banks which have settled at materially lower amounts." While precedents exist to support DB's final point, the range of settlements have been broad leading to a level of uncertainty as to the final amount. In addition, given the gap between the DoJ's opening claim and DB's (and the market's) claim expectations, the time to negotiate a settlement is likely to be prolonged. This ensures that uncertainty will persist which is expected to have (and has had) short term impacts on technicals but, if it drags further, longer term impacts on fundamentals. DB's fundamentals are a key reason why CEO John Cryan is undertaking a significant 5 year restructuring plan.

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Illustration 1

EXHIBIT 1

Selected RMBS Settlements, Market Share and Cost Per Basis Point

Bank	RMBS Market Share	Date	Total $ Billion	$ Millions per Basis Points of Share
JPMorgan (and Washington Mutual)	17.98%	11/19/2013	$3.1	$1.7
Citibank	4.94%	7/14/2014	$4.3	$8.7
Bank of America	16.48%	8/21/2014	$5.9	$3.6
Morgan Stanley	3.11%	2/11/2016	$2.8	$8.9
Goldman Sachs	7.35%	4/11/2016	$2.6	$3.6

Sources: Asset Backed Alert and US Department of Justice

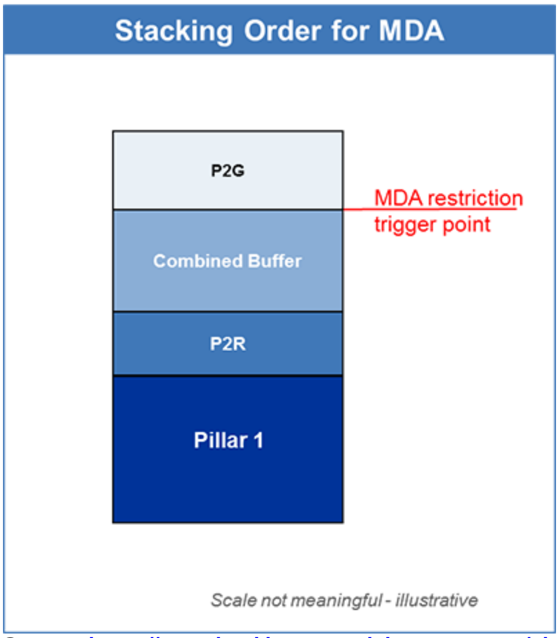
Source: Moody's Investors Service: Deutsche Bank Looks to Settle US Mortgage Legal Exposure at a Reasonable Cost, Sept 19 2016.

- The future: With persisting low interest rates and a weak economic growth outlook, DB's earnings generation is expected to remain subdued. Combined with anticipated restructuring expenses, inadequate reserves and the quantum of the DoJ's opening claim position, market participants expect DB's ability to pay coupons on its AT1's to be constrained and the bank to be reliant on external capital raisings to shore up its capital position ahead of rising capital requirements from Basel III implementation in 2019. This has led to DB's share price losing over 50% of its value in the past 12 months and its price to book value now hovering below the 30% mark. The problem however is whether the bank can tap equity markets when settlement negotiations are on-going and the final outcome uncertain. Of the 16 equity analyst with a recommendation on the bank since 16 September 2016, half of them have a "sell"/"underperform call. In other words, the future is likely to be a waiting game marked by uncertain outcomes from restructuring progress, clarity on negotiations and finally how DB's existing business segments fare in the weak operating environment. DB's restructuring plan already faces execution challenges (DB's sale of its ~USD4bn minority stake in Hua Xia Bank was expected to close by the end of 2Q2016 but was extended in July to the end of 2016 with possible difficulties in moving the sale proceeds out of China) and the longer the wait, the more likely it is that DB's restructuring plan could be put into jeopardy.

- Fundamental concerns: DB's restructuring plan aims to address fundamental weaknesses in the bank's businesses, namely its high capital consuming businesses (which constrain its capital position) and its structurally weak and volatile profitability which is more heavily dependent on external market conditions than peers. Profit quality is impacted by the high dependence on the bank's capital markets business which accounted for almost 35% of the bank's 2015 revenues and has been impacted by extreme market volatility and weaker customer activities. At the same time, DB's historical profitability has been influenced by high legacy costs stemming from an elevated cost to income ratio and on-going litigation, regulatory and restructuring costs in Germany's competitive, crowded and low return banking market. DB's fundamentals are also somewhat hamstrung by a weaker than peer commercial and retail business which starves the bank of access to stable earnings and stable funding sources. While the past acquisition of Deutsche Post-bank AG was meant to address this, the returns have not been as good as expected and hence the bank has been exploring its sale. These fundamental concerns add to the importance of the success of restructuring initiatives to improve DB's position, at least from a regulatory perspective.

- Banking Regulations: Coupon payment uncertainty stems from existing banking regulations which restrict a bank's ability to pay coupons on capital instruments if payments related to these instruments exceed a bank's resources to pay. These resources or 'Distributable Items' are generally defined by the aggregate of net profits generated in the year prior to the coupon due date and available 'distributable' reserves. What complicates things however is that the definition of Distributable Items is not consistent and dependent on how each individual country's regulator differentiates between distributable and non-distributable reserves. This has only added to investor uncertainty for coupon payments on DB's AT1s, contributing to a stronger sell off across the DB curve as risk off sentiments rise and given the weak and volatile profitability and heavy burden of on-going litigation and restructuring costs on DB's resources to meet an adequate 'ADI' level. Another aspect of banking regulations is the concept of the Supervisory Review and Evaluation Process (SREP) which uses a common methodology but incorporates bank specific measures to determine the minimum capital levels required by a bank and hence the buffer a bank has to pay coupons compared to its actual capital levels. However this too is in a state of flux with required capital levels varying in different countries depending on the phase in of pillar 2 buffers (capital conservation buffer), differing between banks depending on their designation of systemic importance, and the European Central Bank's recent proposal to split pillar 2 capital into Pillar 2 Required and Pillar 2 Guidance capital. These splits remain uncertain but are nevertheless a positive for AT1 coupon payment as it lowers the minimum capital requirement for a bank in order to ensure payment of AT1 coupons. That said, as mentioned above, DB's high capital consuming businesses mean DB's capital ratios remain weak compared to peers which impacts its buffer for paying coupons on capital instruments. This is not so much a constraint however compared to uncertainty in DB's ADI levels.

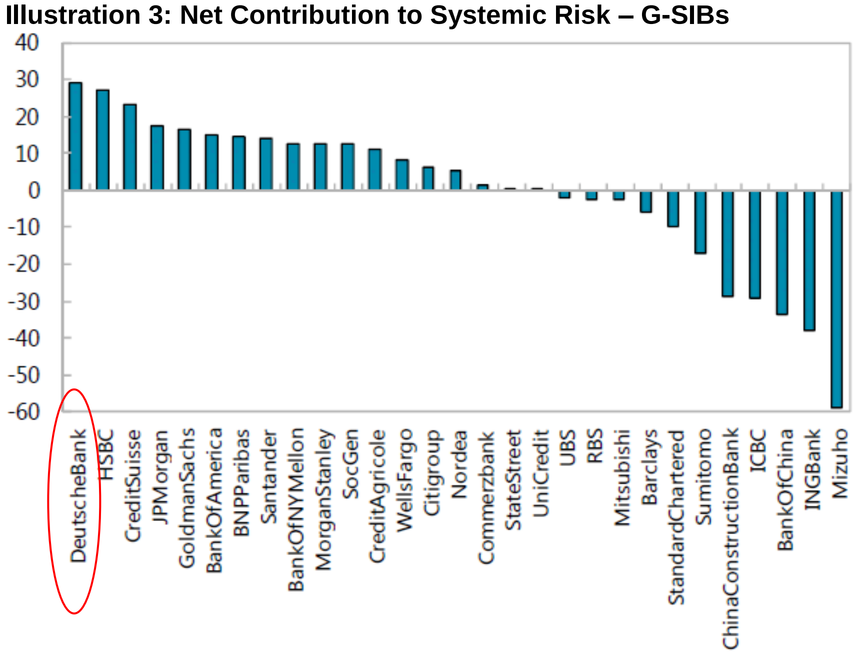
Illustration 2: Calculation of Minimum Distributable Amount ("MDA")



Source: https://www.bankingsupervision.europa.eu/about/ssmexplained/html/stress_test_FAQ.en.html
Note: P2R = Pillar 2 requirement, P2G = Pillar 2 guidance

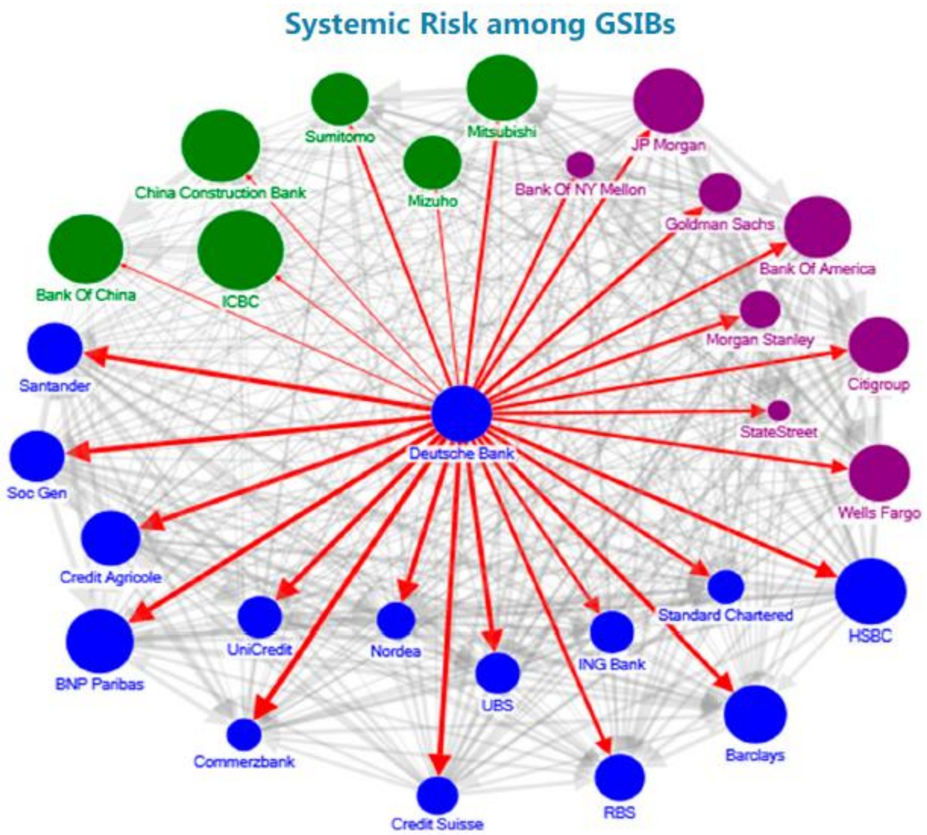
- DB's position in Europe's (and the world's) banking system: DB's health matters and questions on its viability impacts the entire EU due to the contribution of Germany's economy to the EU and DB's market position within Germany as the largest commercial bank. This prominence of size as well as its linkages throughout the global financial system has resulted in DB being classified as both a global (G-SIB) and domestic (D-SIB) systemically important bank with elevated minimal capital requirements. DB's systemic importance was re-emphasized in June 2016 in the International Monetary Fund's (IMF) Financial System Stability Assessment on Germany which highlighted the key role that Germany's financial sector plays in the global economy and DB's position as the most important net contributor to global systemic risks of G-SIBs. Put another way, DB is being seen as the most systemically important bank (but not in a good way) given its relationships with other systemically important financial institutions around the globe and hence potential contagion effects from a DB failure. When DB coughs therefore, the entire market sneezes.

Illustration 3: Net Contribution to Systemic Risk – G-SIBs



Source: http://www.imf.org/external/pubs/ft/scr/2016/cr16189.pdf

Illustration 4: Systemic Risk among G-SIBs



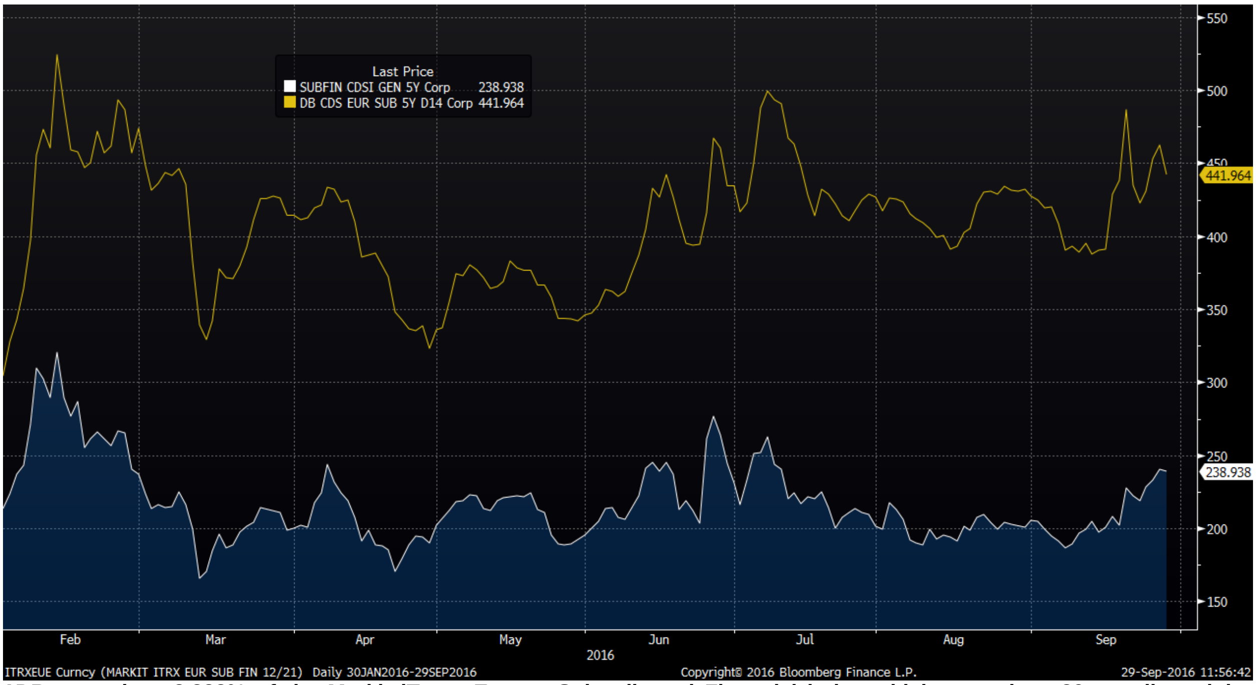
Source: **http://www.imf.org/external/pubs/ft/scr/2016/cr16189.pdf**

- The likelihood of public sector support: Given the affirmation of DB's global systemic importance, perhaps the final factor at play is the role of Germany's government and the possibility of state support. This again is not so easy to predict given that existing banking regulations have been devised to avoid this scenario and the German government's past stance has been publicly against tax-payer funded bail outs for distressed banks. This stance was repeated recently with Munich- based Focus magazine reporting that Chancellor Merkel had ruled out any state support for DB. Complicating these matters are Germany's upcoming elections in September 2017 with any possible indications of state aid likely to be publicly very unpopular and penalizing for Chancellor Merkel's governing coalition. DB has sought to calm markets on their own with Jorg Eigendorf, Head of Communications and Senior Group Director, stating that DB had neither asked for, nor been rejected from, a bail out by the German Government and that the bank intends to resolve its issues on its own. Ultimately should circumstances deteriorate, the German Government could be put in a very difficult position between politics with practicalities. Several market participants believe practicalities will prevail and the government will have no choice but to intervene to avoid a systemic failure, whether at the negotiation stage with the DoJ or to ensure DB's liquidity and solvency. However that in itself brings issues to DB and the sector as a whole with state support potentially triggering the European Union's Bank Recovery and Resolution Directive and resulting in resolution or bail in for the affected institution.

The Market appears more seasoned and perhaps less reactive

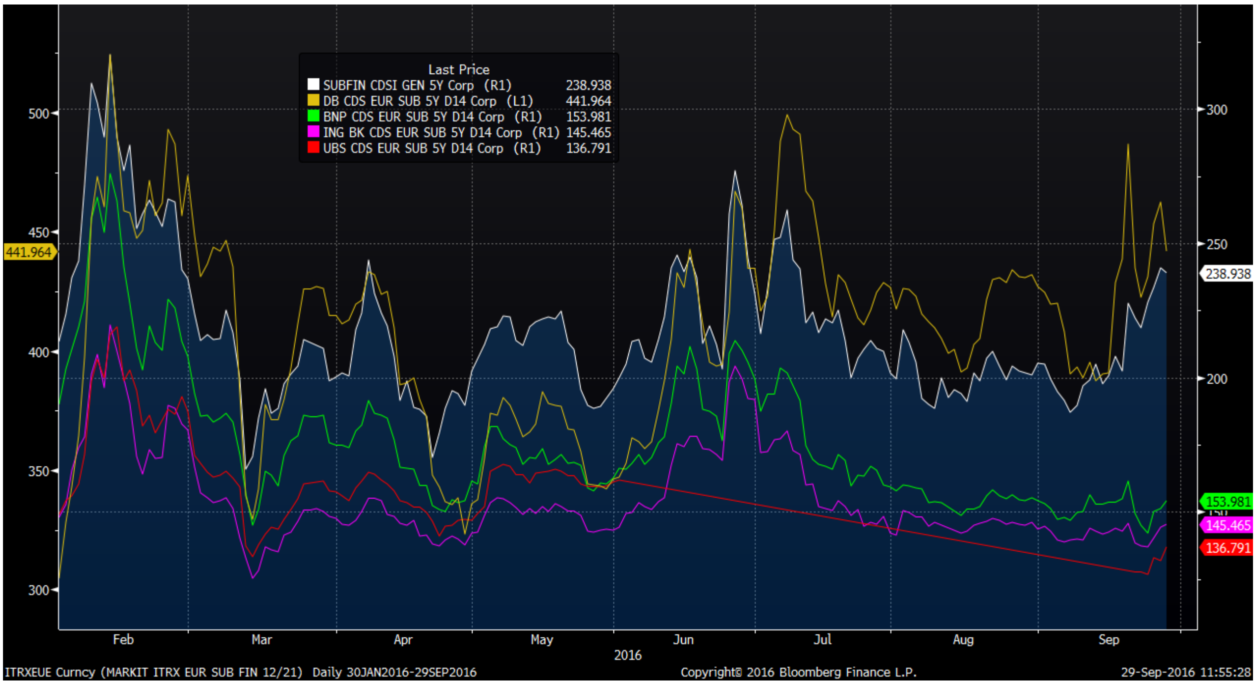
While February's CoCo crisis resulted in a material spike in CDS spreads, the reaction thus far in September has been more contained. That said, the consistent movement in the iTraxx Sub Financial (SUBFIN CDSI GEN 5Y Corp) and DB CDS EUR SUB 5Y continues to indicate how DB's woes can infect the entire market. Compared to other European G-SIBs, CDS movements again are divergent with the CDS of stronger bank names still widening but not as much as DB. This seems to indicate a broader market perception that DB's risks are more localized rather than systemic. The movement in CDS between DB's senior and subordinated instruments also indicates that concerns are also localized to the subordinated part of DB's capital structure with seniors widening less than the subs.

Illustration 5: CDS Movements – Deutsche Bank (EUR Sub 5yr) against the iTraxx Sub Financial Index^



^DB comprises 3.333% of the Markit iTraxx Europe Subordinated Financial index which comprises 30 equally weighted credit default swaps on investment grade entities. The composition of each Markit iTraxx index is determined by the Index Rules. Markit iTraxx indices roll every 6 months in March & September.

Illustration 6: CDS Movements – Deutsche Bank against other European G-SIBs (EUR Sub 5yr)



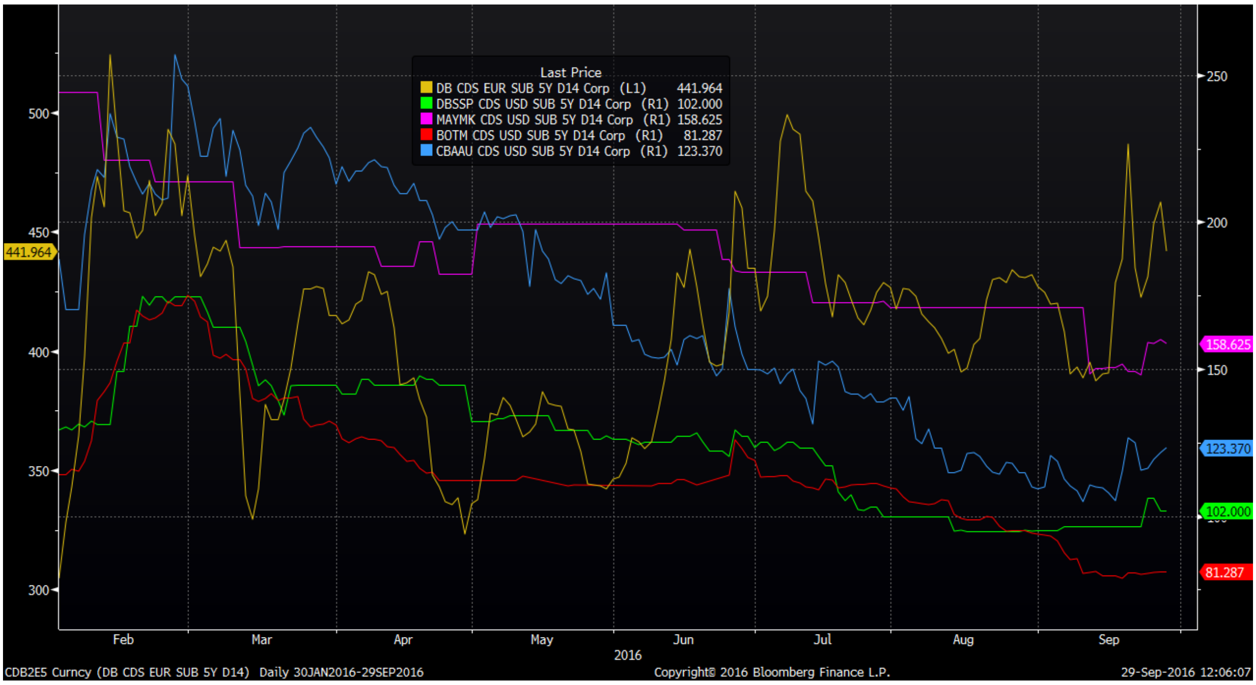
Source: Bloomberg, 29 November 2016

Illustration 7: CDS Movements – Deutsche Bank (EUR Sub 5yr) against Deutsche Bank (EUR SR 5yr)

Source: Bloomberg, 29 November 2016

Closer to home, CDS spreads of regional banks have also shown some impact with pricing volatility although at lower levels. This reflects the better fundamentals of Asia-Pacific's regional banks which continue to generate solid earnings given their market positions in their respective countries and diversified business models anchored mostly in core retail and commercial banking. Overall credit profiles of regional banks also continue to benefit from solid operating environments with on-going economic growth and supportive regulatory and government oversight. We expect regional bank capital instruments to remain better positioned than DB based on fundamentals although prices have benefitted from a solid technical environment.

Illustration 8: CDS Movements – Deutsche Bank (EUR Sub 5yr) against select APAC Banks (USD Sub 5yr)



Conclusion

Much depends on multiple and connected moving parts which add complexity and uncertainty to the current situation. Unfortunately, only time will resolve these issues. On a positive front, rating agencies have not made any rating actions on DB since the DoJ's announcement as current ratings or outlooks incorporate substantial litigation costs or because timing for a rating action is too early considering the uncertainty of the outcome. From a market confidence perspective, participants appear to be more seasoned following the CoCo crisis in February 2016 and focused on localised rather than systemic stress with the recent European Banking Stress Test indicating that, although further improvements are needed, banks capital positions have improved since the last stress test in 2014 and therefore somewhat lowering the contagion risk of prior years. Finally, DB's Strategy 2020 continues to be viewed somewhat favourably (notwithstanding execution risks) with on-going measures to protect capital and liquidity including suspension of dividend payments and accelerating asset sales (announcing this week the sale of British insurer Abbey Life for EUR1.1bn).

In terms of downside, there is potential for the DoJ's final settlement amount to be at the upper end of the scale given how active DB was in the RMBS market over 2005-2007. According to a 2010 article in The Wall Street Journal[1], DB was one of the top 4 issuers of mortgage collateralized debt obligations in 2007 just behind JP Morgan/Bear Sterns and significantly more than Goldman Sachs. Given this consideration, one way in which DB could lower its penalties would be if politics enter the fray and the EU and US arrive at a solution. However, politics could be a double edged sword with domestic politics also in play.

Overall, regulators have recently erred on the side of practicality to preserve the health of the banking system and we expect this time will be no different. Bloomberg reported that there are plans by regulators to give priority to payment of AT1 coupons ahead of dividends such that dividends can only be paid if AT1 coupons are paid in full[2]. This is in addition to the proposal to lower the SREP and enhance the buffer for payment of AT1's. These measures represent in our view a recognition of the importance of these instruments in a bank's capital structure and regulator interest in preserving its existence. More importantly, it is also recognition of the importance of the health of the financial sector and that regulations designed to improve its strength do not unintentionally weaken it instead.

[1] http://www.wsj.com/articles/SB10001424052748703900004575325232441982598
[2] http://www.bloomberg.com/news/articles/2016-08-17/bank-cocos-seen-stronger-on-eu-proposal-for-coupon-protection