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Signs of Trouble for Deutsche Bank

July 1, 2016 A crisis in Germany's largest bank would be felt by financial markets worldwide.

(https://geopoliticalfutures.com/wp-content/uploads/2015/11/realitycheck-headerbar.jpg)

By Jacob L. Shapiro and Lili Bayer

The International Monetary Fund (IMF) issued a damning 63-page report on the German banking and insurance sector yesterday. It is a long and thorough report, with the key point buried on page 42: "Deutsche Bank appears to be the most important net contributor to systemic risks in the global banking system."

Then, the U.S. Federal Reserve said that the U.S. subsidiary of Deutsche Bank was one of two banks (the other was Santander) that failed an annual stress test. Deutsche Bank failed the same test last year, and while the Fed noted that the U.S. subsidiary had strengthened its capital position since its previous failure, it said there was still much more work to be done. The markets punished Deutsche Bank, already reeling from Brexit, forcing shares down at one point to their lowest level in 30 years.

With all the news surrounding volatility in the markets due to Brexit (https://geopoliticalfutures.com/the-future-of-europe-after-brexit/), there is a temptation to dismiss this as more of the same. But in reality, these two developments, particularly the IMF report, are of far greater importance. If Deutsche Bank really is on the verge of a crisis – and we believe it is – the implications will be felt worldwide and the global financial system will shudder. First, however, the effects will be felt by Germany, and before we can explain why, Deutsche Bank's unique and important role in Germany's history and development must be placed in context.

Deutsche Bank is not merely Germany's biggest bank. The political role it plays in Germany is unique when compared with other countries. There is no good historical antecedent with which to compare it in the U.S.; Deutsche Bank's importance to Germany is many times greater than that of an investment bank like Lehman Brothers to the U.S. in 2008. Deutsche Bank is technically a private bank, but it is tied to the government informally and to most major German corporations formally. Its fate will be shared by all of Germany.

Deutsche Bank is technically a year older than Germany itself, having been founded in 1870, a year before Prussia declared that the German Reich had succeeded the Holy Roman Empire. It is one of the Big Three German banks – the others being Commerzbank (also founded in 1870) and Dresdner Bank (founded in 1872 and bought by Commerzbank in 2009) – that played the role of both capital provider and master puppeteer in the development of the German industrial machine over the last century and a half.

After its founding, Germany was extremely poor. Deutsche Bank provided short-term loans and in return received equity shares in the companies it bankrolled. By the mid-1980s, according to a German government study, the Big Three were estimated to control the voting authority of over three-quarters of the shares of most major German companies. A 1995 report by the U.S. Congress' Federal Research Division estimated that the Big Three by themselves, not counting the shares they held for their clients, held 30 percent of the seats on the advisory boards of all German companies. Disaggregating Deutsche Bank from the German government's political goals or the structure of German corporations is impossible. They are all inextricably linked.

In the 1990s and early 2000s, Deutsche Bank tried to maintain its unique role while at the same time taking advantage of financial globalization. That meant operating more and more like a typical investment bank. Deutsche Bank began prioritizing short-term gains and investing in risky assets, including securities backed by subprime mortgages in the U.S. real estate market. In Germany, the significance of the 2008 financial crisis was not just the loss of money, but the fact that Deutsche Bank, for so long a symbol of the German economy, was delegitimized and implicated in high-risk behavior. Besides the problems with its bottom line, it still faces a battery of investigations, legal troubles, scandals and potential fines to be paid in the coming years. The bank has fallen quite a way from its beginnings.

Fast forward to today, and Deutsche Bank, Commerzbank and indeed most German banks have been able to stanch the bleeding from 2008 but not to heal the wound. These banks are struggling in large part due to the ultra-loose monetary policy put in place by the European Central Bank (ECB) to attempt to stimulate the European economy. The ECB has cut interest rates, moved deposit rates to negative territory and embarked on an ambitious asset buying program in an attempt to boost inflation and stimulate economic growth across the bloc.

Low interest rates, however, cut into German banks' profit margins and have already forced some banks, most notably Deutsche Bank, to introduce new fees and implement job cuts. In fact, Germany's financial watchdog, BaFin, estimates that about half of Germany's banks have a heightened exposure to interest rate changes and as a result may have to hold more capital. Another side effect of low interest rates has been that, according to the IMF, some German banks have turned to riskier Spanish and Italian sovereign paper. With southern Europe experiencing its own banking problems, boosting investment in Italy and Spain is clouding the outlook for German banks even further.

Back in May, we published a study of the German economy entitled "Germany's Invisible Crisis." (https://geopoliticalfutures.com/germanys-invisible-crisis/) We pointed out Germany's dependence on exports, and how it is simply not feasible for Germany to maintain its current levels of exports in a global economy that is stagnant at best, and in many places around the world is in varying degrees of crisis. Should the U.S. enter a cyclical recession, what remains of the demand propping up the German economy will collapse, and what was once invisible will become clear as day.

In our report, we also noted that the most analogous problem for Germany's current predicament is Japan in the late 1980s and early 1990s. The first warning of the collapse of the Japanese miracle was the Bank of International Settlements' warning that Japanese banks would be suspended from international transactions because of low reserves. We cannot help but view yesterday's events, and particularly the publication of the IMF study, as a similar red flag.

The analogy is not watertight because capital reserves do not (yet) seem to be a problem for Deutsche Bank and for German banks on the whole. The IMF report makes it clear that there are "substantial capital buffers" across the board for all German banks, including Deutsche Bank (though it bears noting that Deutsche Bank's ratio of Tier 1 capital to assets dropped precipitously in response to the 2008 financial crisis). One thing that caught our eye though was the fact that compared to peer banks, German banks' ratio of risk-weighted assets to total assets was only 31.2 percent – barely a third of the ratio for U.S. banks, and 25 percent less than other eurozone peers. So overall, German banks are minimizing losses by avoiding riskier enterprises. This betrays the fact that there must be a weakness in the system that is forcing German banks to be extremely stingy.

Deutsche Bank is showing signs of that weakness more than any other German institution right now. Last year, Deutsche Bank posted a net loss of roughly 6.7 billion euros, or $7.4 billion. Deutsche Bank's chief financial officer told CNBC that he did not expect Deutsche Bank to find its way back into the black until 2018 at the earliest. Deutsche Bank's first quarter report for 2016 said revenue was down 22 percent year-over-year – and that's compared to a year when the bank took a 10-figure loss.

In just the last year, Deutsche Bank has laid off tens of thousands of workers and has seen rating downgrades from both Fitch and Moody's on its long-term debt and its deposit ratings. Deutsche Bank is also sitting on $41.9 trillion (not a typo) worth of derivatives, an inheritance no doubt from its pre-2008 activities, and perhaps even its post-2008 activities. The crisis is no longer invisible. The IMF, Germany and the markets all see it.

This is one of those situations where it brings us no pleasure to say that yesterday was a good day for our forecast. It was also a bad day for Deutsche Bank, and by extension for the global economy. If developments continue to unfold as we expect, it won't be the last.
