THE DEUTSCHE BANK LIABILITY

How much could the demise of Deutsche Bank damage the UK and EU as a whole?

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Bob Lyddon

THE storm clouds over Deutsche Bank are not only serious for the global financial system, the Eurozone and the EU as a whole: there is a British aspect that needs to be fully explored by the UK authorities.

The background

Deutsche Bank is a GSIB or Global Systemically Important Bank; in other words, if Deutsche goes down, the global financial system goes down. That must have a severe impact on the UK if it occurs, but how severe, and how likely is it to occur?

As a so-called ‘Bucket 3’ GSIB, Deutsche should be carrying an extra cushion of 2% of capital compared to a non-GSIB. It should also have its resolution and recovery plans in place by November 2016, not because of the recent crisis but because Deutsche is obligated to do this under the EU Bank Recovery and Resolution Directive. What do these plans say about Deutsche’s risks and exposures?

Being a GSIB means that Deutsche is a central pier in money dealing and transmission, holding substantial portfolios of government bonds to collateralise its positions in clearing systems like CHAPS and TARGET, and to comply with global rules on bank liquidity.

Deutsche has a large subsidiary in Italy (550 retail outlets) and an autonomous balance sheet of EUR15 billion in Spain. It has offices, branches and subsidiaries in most EU countries and can be counted as a high priest of the EU single financial market, of the Euro, and of the Single Euro Payments Area (“SEPA”).

Unfortunately, this stance as a Pan-European Bank of the front rank has not given it a sustainable and profitable competitive advantage or a dominant market position, even in Germany. Its main result has been high costs.

The heavy regulation imposed by the EU in order to create its version of a free market has reduced foreign exchange turnover and revenues, cut payment fees, and permitted market entry to substitutes and non-banks who benefit from the infrastructure investments made by the incumbent banks without paying an entry fee. At the same time central bank policy has been to reduce interest rates to below zero, and to flatten the yield curve, eliminating two archetypal banking operations (i) enjoy interest-free deposit balances and invest them to cover costs, and (ii) borrow short and lend long to benefit from a positive yield curve.

The unfortunate EU business model

Deutsche is a typical EU business: it cannot form the private capital needed to expand or continue its operations by itself, and it is unattractive to arm's-length investors in new equity because they cannot see how it is going to deliver high returns – and there are many better investment propositions out there, frequently ones backed by taxpayer support. Only an existing shareholder trying to protect themselves from realising a paper loss, or a "sugar-daddy" kind of investor, or a political investor would contemplate a new engagement at this stage – and Sheikh Hamad Al Thani, former Prime Minister of Qatar who invested €1.75bn in a circa 10% stake in the German lender in 2014 would count as all three. Since that investment Deutsche's shares have fallen 61% in value and the sheikh will be sitting on a paper loss of over €1bn.

Without an investor of that type, Deutsche can only create capital by cutting costs i.e. contracting, or by reducing lending i.e. contracting.

In the scenario of total and sudden contraction, its main UK creditor – the Bank of England – would sell off the gilts it has bought from Deutsche under the "purchase" leg of a "repurchase agreement", in order to obtain repayment of the cash the BoE has advanced to Deutsche - by putting it on Deutsche's BoE Settlement Account, thus enabling to Deutsche to settle its CHAPS payments.

Deutsche's liquidator would likewise sell off the gilts Deutsche was holding as High-Quality Liquid Assets pursuant to its compliance with global liquidity rules, in order to pay depositors.

These would be sizeable operations, that could on their own push gilt prices down, raising UK interest rates and the cost of borrowing – for the government and others.

The impact in EUR would be a multiple of this, seeing that Deutsche has the biggest turnover in TARGET, is a leading counterparty of the ECB in its monetary operations, and holds EUR liquidity pools in its major banks in the Eurozone, principally in Germany, Italy and Spain.

Deutsche would also cease to be either a market-maker in the secondary markets in all these securities, or an underwriter of new issues, reducing secondary-market liquidity, potentially raising yields, and increasing the cost at which borrowers could issue new debt, including the UK government.

For the direct impact on the UK we would want to know:

- The holdings of all Deutsche legal entities of gilts
- Deutsche UK's repurchase agreements with the BoE to create liquidity in CHAPS
- Global volume of Deutsche dealings in gilts over the last year, both in new issuance and in the secondary market
- Deutsche derivative contracts with the UK public sector (with government and government agencies, with financial market infrastructures and with public projects)
- UK projects subject to financing commitments that Deutsche may now not be good for
- UK projects part-funded by Deutsche where financing from the main EU financial mechanisms may not be available if Deutsche is no longer good for its commitment
- The potential indirect impact on the UK if the main EU financial mechanisms suffered losses and/or had to make new loans due to Deutsche's demise, and this caused them to ask for more capital from the UK

These last two points are important, as the UK is fully tied in to these mechanisms, the first of which is the European Central Bank, where the ECB could make losses on:

- liquidating Deutsche's positions in TARGET
- monetary operations where these have been conducted through Deutsche

It is no comfort that the ECB's dealings with Deutsche will be on a collateralised basis: the type of collateral is the same as Deutsche would have lodged with CHAPS, under repurchase agreements, with financial market infrastructures and so on, so all these institutions would be foreclosing simultaneously on the same type of collateral, in large size, and trying to sell it into a market from which one of the main market-makers had disappeared.

Deutsche being a professional trader in these instruments – meaning it would make a two-way price to other professionals right the way through normal business hours in market lot sizes – it would be one of the banks through whom these institutions would be relying on to sell their collateral, not the institution against which the foreclosure of the collateral had been exercised.

Collateral damage

These are the typical circumstances in which the price of the collateral would drop sharply, leaving unsecured losses, whilst at the same time pushing up interest rates for the economy as a whole.

The second of the EU mechanisms would be the European Investment Bank, and Deutsche would be doing business with EIB at several levels:

- Underwriting issuance of new bonds
- Entering into derivatives contracts to swap bonds in one currency into funds in another, and/or to alter the type of interest coupon between fixed and floating rate
- Acting as the Issuing and Paying Agent on the bonds
- Making a market in both new and secondary issues of EIB bonds
- Being one of the intermediary banks in the EIB's loan programmes to

SMEs, where EIB lends funds to Deutsche and Deutsche onlends the funds at its own credit risk to Deutsche's SME customers – Deutsche has an SME customer base not just in Germany but at least also in Italy, Spain and the Netherlands

- Co-financing the projects of both the EIB and its shadow, the EFSI or European Fund for Strategic Investments

We really do need to know EIB's exposure to Deutsche because the UK is one of the EIB's largest shareholders, with value-at-risk of nearly EUR40 billion.

Stating that Deutsche is a central pier of money transmission and distribution around the EU means, in practice, that Deutsche has a central role in the way the EU economy works, and how Germany has come to have such a large export surplus with the rest of the EU:

- Deutsche lends to German exporters, enabling them to offer credit terms to buyers in other member states
- These could be working capital loans or so-called 'supplier credits', where the suppliers grant credit to the buyer over a period of years and sell the resulting debts to a bank, sometimes 'without recourse' i.e. Deutsche's effective credit risk would be on the buyer in another Member State, not on the German supplier
- Deutsche lends through its network of branches in other Member States directly to the buyers of German exports
- These 'buyer credits' can be long-term loans, including co-financing with the EIB and insertion of layers of lending into the projects financed under the EFSI
- Co-financing of a given project where financing commitments from the EIB or the EFSI are contingent upon Deutsche paying out on commitments it has made regarding other tranches of the same overall financing package

The EIB and EFSI loans are variously made to government agencies and publicly-owned project companies, and these are the types of assets that are attractive to investors as well – as opposed to their taking a position in equity capital and running an entrepreneurial risk - because the source of debt service for these assets is always the same:

1. In the first instance that the general public pays for the offtake from the project, whether it be motorway tolls, water charges or similar "usage charges"
2. In the second instance, if that fails, a regional or municipal authority has to pay out from its other revenues
3. In the third instance the regional or municipal authority can normally count on the national government to bail it out

In other words the ultimate source of repayment is always the taxpayer in the borrower's country, like Hinkley Point or any UK Private Finance Initiative scheme, with wider fallback at each level: the first rank is the direct user of the service, the second rank is all taxpayers in the city or region where the asset is located, and the third rank is all taxpayers in the country where the asset is located.

These schemes, in which Deutsche has been an active intermediary, have risen sharply in volume since the Euro sovereign debt crisis, since debt markets became less accessible to the sovereign borrowers like the Kingdom of Spain and the Republic of Italy. The EU has seen it as its role to act "counter-cyclically" during this crisis (now of 8 years' duration) and to pump money into these same countries but to borrowers further down the public-sector pecking order than the sovereign.

Unlimited liability

There is no ceiling to the amount of debt that can be contracted from international investors and banks when there are so many levels into which debt can be inserted without the debt showing up in the "sovereign debt" figures:

- Central government agencies
- Regional public authorities
- Municipal public authorities
- Project companies owned by the above, and normally each with a minority stake so that none of them have to consolidate the project company – and its debts – into their own figures

The amount of financing available is limitless because, while the EIB and EFSI can only look down three levels to repayment from the taxpayer of the borrower's country, the investors financing the EIB and EFSI can look a further level down: to the taxpayers in the other EU Member States, notably Germany and the UK as the only highly-rated, large and solvent ones.

In the context of a co-financing by the EIB or EFSI with Deutsche, it is not inconceivable that the EIB/EFSI may have committed to backstop the commitments from commercial banks like Deutsche into the same project, or that, in a crisis such as Deutsche's demise, the management of the EIB/EFSI (they are one and the same) might decide that the project is "strategic" for the EU, that it should not be left high-and-dry and half-completed, and that the EIB/EFSI should advance Deutsche's portion themselves – and borrow more themselves to be able to advance these extra funds.

The UK on its own could not block this, and its result would be a further gearing of the EIB balance sheet – with the knock-on need to call up subscribed capital and/or to increase the subscribed capital from the Member States, including the UK.

This is why we need full disclosure of Deutsche's dealings with the UK, with the ECB, and also with the EIB/EFSI, because without that disclosure we will not know what the impact of Deutsche's demise would be directly on the UK, or indirectly through the UK's guarantee liabilities under the EU's financial mechanisms, and we will not know either how likely it is that Deutsche's demise will take place.

Bob Lyddon
21 October 2016

Summary of
The Deutsche Bank Liability

How much could the demise of Deutsche Bank damage the UK and EU as a whole?

- Deutsche Bank appears to be in serious trouble: it is highly leveraged and facing a fine that would make it even more highly leveraged
- It is a GSIB – a Global Systemically Important Bank – which means it is a very large bank and should be so well capitalised that its demise is unthinkable, since its demise would wreak havoc on the global financial system, including on the Eurozone, the EU and not least the UK
- It purports to be easily compliant with the required levels of capital for its status as a GSIB, and is at the same time highly leveraged, an oxymoron that is explicable if its assets, and also collateral pledged to it by its customers, carry very low credit risk and can be converted into cash without a haircut: these assumptions will be built into its computations to adjudge the adequacy of its capital and its liquidity
- Such assumptions have been found to be fallacious before, and we really need to know the potential direct and indirect damage of Deutsche's demise to the UK – which could cost billions
- Deutsche is a member of the CHAPS payment system, and is a major dealer in UK gilts
- Deutsche has major relationships with the European Central Bank and the European Investment Bank, in which the UK is a shareholder: losses booked at the ECB or the EIB could cause those institutions to call up new capital from the UK – this again could be bilions
- Deutsche is a typical EU bank: intimately involved in the financial mechanisms of the EU and the euro, but in itself unprofitable, because it has a retail base that is too small compared to the size of the bank as a whole, because the profitability of the bank has been eroded by EU regulations and directives, and because it has supported German exports by making loans to buyers of those exports in other EU Member States which may or may not be repaid
- A full examination of the risk Deutsche represents to the UK is required and now.

About the author...

Bob Lyddon

Bob Lyddon is an experienced management consultant both privately and with PwC. Recent engagements include running an international banking alliance, advising small payment providers how to access UK payment systems, and advising a major player in global payments as to the opportunities and threats arising from the establishment the UK's Payment Systems Regulator.

With PwC Bob managed several Euro implementation programmes. Prior to that, he had a diverse 17-year career in international banking, encompassing Transaction Banking, syndicated loans, export finance and derivatives.

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The Brexit Papers is a series of detailed essays designed to ask questions and provoke debate about the policies and strategies required to ensure the UK enjoys as optimal and clean a Brexit as possible. In this, the first, Bob Lyddon considers what a demise of Deutsche Bank could mean to the UK and EU as a whole.

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