



Mounting setbacks cloud Deutsche Bank's outlook

by [Anastasia Tracy Kurniawan](#)

Deutsche Bank AG (DB), one of the global top-10 investment banks, has been in the spotlight during these past few weeks as the Fed conducted the supervisory stress tests amidst the bank's critical financial and management conditions. [On June 28](#), the released results declared DB's US unit as the only firm that failed the stress test. [According to the Fed](#), the failure was due to "widespread and critical deficiencies" across the firm's capital-planning and risk management. The result follows months of turmoil for the bank, whose stock plunged 44.51% from Jan 4, 2018 to Jun 28, 2018 to its all-time low. Corresponding to the Fed stress test result, RMI-CRI 1-year PD for Deutsche Bank is much higher than the aggregate PD of the other global top-10 investment banks that take part in the Fed stress test, implying DB's underperformance among its peers. Prior to the Fed stress test result, RMI-CRI 1-year PD for Deutsche Bank, which suggests the bank's credit risk profile, has shown an upward trend. It has given warnings in advance that DB's credit profile has been weakening following the bank's worsening financial results and poor operational performances while restructuring woes aggravate its vicious circle of downturns.

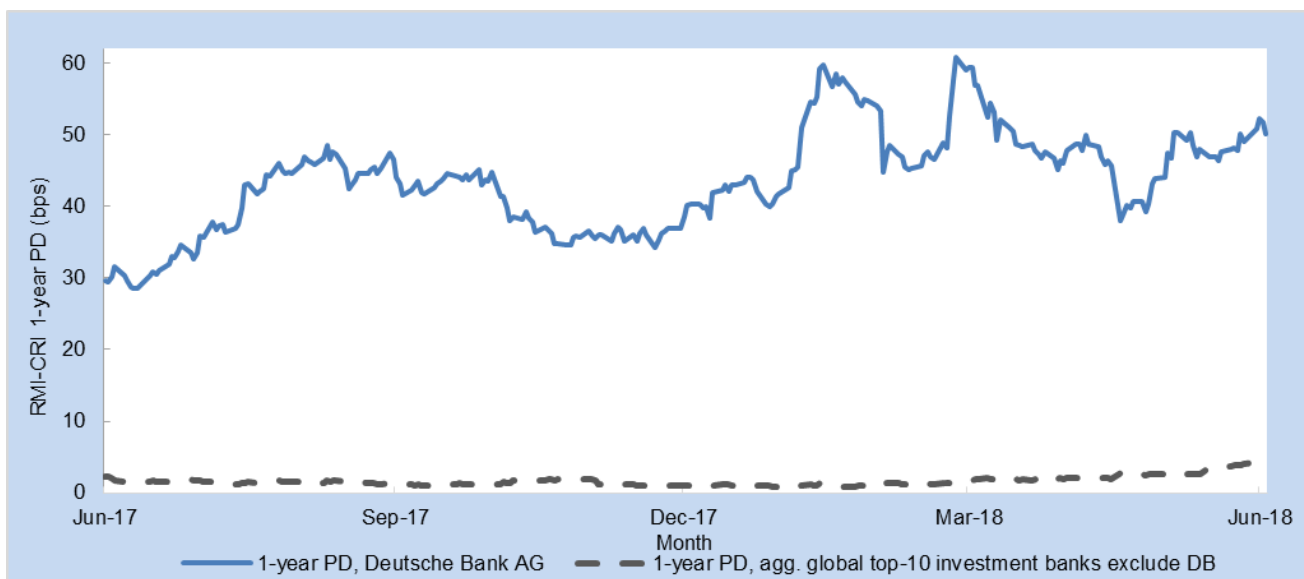


Figure 1: RMI-CRI 1-year PD for Deutsche Bank AG and aggregate global top-10 investment banks exclude Deutsche Bank AG. *Source: RMI-CRI.*

[The past few years](#) have been tough for Deutsche Bank due to numerous litigations, regulatory proceedings, unstable European economy, and the lender's involvement in scandals in and outside Germany. These factors impacted profits greatly, bringing the bank to a 3-year consecutive annual loss since 2015. The bank has been executing multiple turnaround which includes business restructuring to scale back its underperforming investment bank unit. Recently, the newly inaugurated CEO Christian Sewing initiated the fourth turnaround plan that involves significant retrenchment after three turnaround plans failed to revive DB's positive income. [However, according to Sewing](#), the new restructuring cost of EUR 800mn will dent the bank's 2018 result. Furthermore, with ECB keeping its main interest rate near zero, achieving longer-term profit targets will be challenging for DB, which is reflected in the [bank's modest return target for 2019](#). Sewing's statement, multiple recent poor risk management scandals, and deteriorating financial performance in the last two quarters brought [Fitch](#) to follow S&P's move in downgrading Deutsche Bank earlier this month, which aligned with the increasing RMI-CRI 1-year PD for DB in June 2018.

DB's last two-quarter result appears to be deteriorating with the decline in profit contributed mostly from its Corporate and Investment Bank (CIB) whose Q1 2018 revenues declined by 13% due to poor trading environment, multiples fines for misconduct, and fewer client trades. In Q1 2018, DB USA's traders suffered [a](#)

[one-day loss](#) that was 12 times higher than the amount of the calculated Value at Risk by the bank’s risk officers. DB’s June 2017 result also recorded an awry [USD 60mn loss](#) on a US rates derivative trade. On the other hand, restructuring cost and legal costs have also taken a toll on the firm’s profitability and increased its cost/income ratio by nearly 40 percentage points from Q3 2017 to Q4 2017 (See Table 1). Woeful litigation issues have required the institution to pay [USD 205mn](#) over improper forex conduct and [USD 1.4mn](#) over violation of equity and municipal bond reported earlier this week. A series of fat finger scandals have also questioned the firm’s reputation that led to fewer client trades. In 2015, they [accidentally paid USD 6bn to a hedge fund client](#) and in April 2018, [EUR 28bn](#) were accidentally transferred to an outside account. This series of reckless operation malfunctions has led to an inclusion of DB [in the Fed’s ‘problem bank’ list](#) after being in the ‘troubled bank’ list last year.

		Q2 2017	Q3 2017	Q4 2017	Q1 2018
Return on Equity (%)	Deutsche Bank AG	-1.41	-0.81	-1.69	-2.44
	Agg. Other Top-10 Investment Banks	7.53	7.69	5.05	5.47
Tier 1 Capital Ratio (%)	Deutsche Bank AG	17.30	17.00	16.80	15.80
	Agg. Other Top-10 Investment Banks	16.6	16.9	17.2	16.87
Total debt/ Equity (%)	Deutsche Bank AG	401.46	461.72	410.98	430.22
	Agg. Other Top-10 Investment Banks	336.85	350.82	350.75	391.44
Cost/Income Ratio (%)	Deutsche Bank AG	86.4	83.5	122.4	92.6
	Agg. Other Top-10 Investment Banks	64.630	63.29	70.39	62.78

Table 1: Key financial figures of Deutsche Bank AG and Aggregate Other Global Top-10 Investment Banks. *Source: Bloomberg*

The last two-quarters of financial-underperformance have reduced the shareholders’ confidence in Deutsche Bank. Return on equity continues to sink and leverage ratio stays higher than its peers. At the end of 2017, the lender’s CIB was sitting on EUR 2.5bn of Non-Performing Loans (NPL) and had provisioned EUR 1.6bn for loan losses, 62% of the loans’ face value. In the past one year, tier 1 capital ratio has constantly decreased, a sign of the firm’s declining ability to absorb losses (See Table 1).

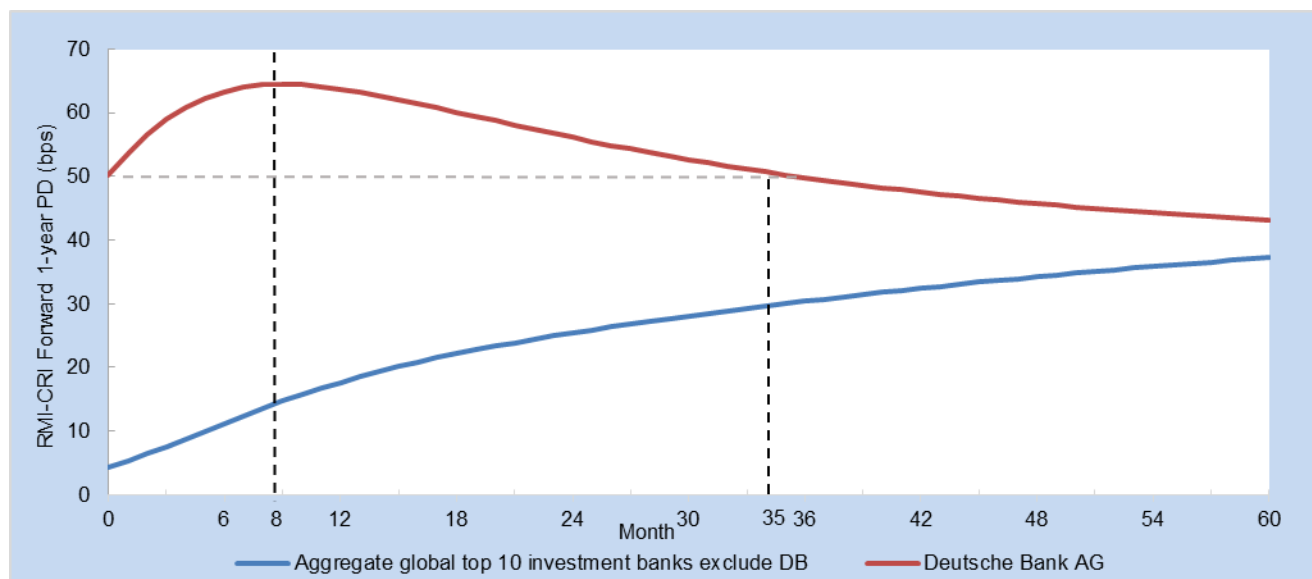


Figure 2: Comparison of RMI-CRI Forward 1-year PD term structures for Deutsche Bank AG and aggregate RMI-CRI Forward 1-year PD term structures for global top-10 investment banks exclude Deutsche Bank AG. *Source: RMI-CRI.*

The term structure of the RMI-CRI Forward 1-year Probability of Default (Forward PD) indicates an increasing probability of default in the short term as the firm takes time to restructure its operations, which will dent its financial result amid a weakening market (See Figure 2). The Forward PD represents the credit risk of a firm in a future period and works similarly to a forward interest rate. For instance, the 3-month Forward PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The term structures of the Forward 1-year PD for DB steepens with time to peak at around 8 months, suggesting that based on the market information on June 29, DB’s RMI-CRI 1-year PD is likely to remain above 50bps for the next 35 months but improve afterward as the restructuring ends. However, DB’s credit profile might remain worse compared to its peers.

A series of efforts initiated by Sewing to return the bank to sustainable profitability by slashing costs, deleveraging, and cutting underperforming operations might improve the bank’s performance. The bank [will be focusing on its traditional roots in European wholesale banking](#) and financing of European companies, while

scaling back its CIB unit through [EUR 1bn base cost cut](#) and [7,000 job cuts](#). Earlier this month, the bank reduced its backlog of non-performing loans by more than a third in a single deal through [selling EUR 870mn in toxic shipping loans](#). The bank has also reconciled services to [SmartStream](#) and [acquired an India-based FinTech start-up](#) to further improve processing while it is trying to [cut its adjusted costs by EUR 900mn](#).

The wave of setbacks on Deutsche Banks has inevitably hurt the clients' confidence on the bank, which threatens its profitability. Credit rating downgrades and bizarre risk management scandals have been followed by severe share plunges, aggravating the company's already weak financial performance. However, with Sewing's current turnaround efforts in cost-cutting, deleveraging, and enhancing profit-generators sectors, he may bring the bank's position back to being a profit-generating bank again. The outlook depends on the bank's ability to cut cost faster than losing revenue.

Credit News

Debt at UK listed companies soars to record high

Jul 2. Debt at UK listed companies has risen to an all-time high of GBP 390bn surpassing pre-crisis levels. Companies have suffered to maintain dividend payouts owing to shareholder's demand despite weak profitability. Net debt, which is total debt less cash, has escalated 69 percent since 2010-11 after the initial drop-down past financial crisis. With low-interest rates, most of this debt has been used to fund dividends as investments continued in spite of poor performance across several sectors in the past two years. But, with the profitability improving this year, the debt burden is becoming more bearable with the collective gearing level (debt relative to equity capital), which shot up to 83% in 2015-16, falling to 73% since then. With dependence on short-term debts less than ever in the near past and better profitability which has lowered the gearing levels, it implies that dividends and interest costs are being covered by profits much more comfortably. ([FT](#))

Turkey banks face pile of debt-restructuring demands

Jul 2. Turkish corporate borrowers are asking lenders to restructure their loans as interest rates have increased. The devaluation of the Turkish Lira has resulted in a surge of foreign currency liabilities, an equivalent to 40 percent of the country's economic output. Analysts say that the lack of a proper accounting standard has masked the true value of asset quality deterioration within the banks but estimates suggest that nearly USD 20bn of loans could be restructured. Billion dollar corporations such as Dogus Holding AS and Yildiz Holding AS are looking to restructure USD 2.5bn and USD 5.5bn of loans, respectively. ([Gulf News](#))

BOE warns of growing risks in global debt markets

Jun 27. On June 27, the Bank of England (BOE) warned of risks to the stability of the financial system including high US corporate borrowings and risky loans in Britain. This comes as global central banks step back from easy-money policies and trade tensions. According to the BOE, US corporate borrowing has surged to 290% of first-quarter earnings, which was accompanied by looser lending standards, leading to a surge in high-risk lending. In emerging markets, government and private sector dollar-dominated debt values have declined from a rising greenback and higher US interest rates. Borrowers may not repay loans if interest rates continue to rise or the global economy falters. Governor Mark Carney also warned that issues such as the legal framework for derivatives to prevent disruption to the provision of financial services need to be resolved, especially by EU authorities. ([WSJ](#))

Bahrain debt risk rises most on record amid Gulf Aid silence

Jun 26. Credit default swaps for Bahrain's sovereign bonds have risen to a nine-year high of 609bps, the second highest among emerging market economies. Last year, the central bank's foreign exchange reserves fell to the lowest level since 2001 and according to the IMF, the amount of debt in the country is projected to exceed 100 percent of GDP by 2019. Bahrain is seeking to avert a currency devaluation and has reached out to Saudi Arabia, the United Arab Emirates, and Kuwait for financial aid. ([Bloomberg](#))

Strong European bond sales line up Italy debt test

Jun 27. Following a strong bond sales of European sovereign debt, the markets face a big challenge as Italy seeks buyers for EUR 6.5bn of five-, seven- and ten-year bonds. Investors have been in quest of higher yields in Italy's recent debt sales after the market turbulence instigated by the newly formed populist Eurosceptic government. With the demand for Italy's inflation-linked debt exceeding the auction amount and huge sales of debt across Europe, the market has recovered well from the Italy sell-off. But, the issuers have delayed their debt sales plans for a better opportunity later in the year. This has led to a belief that there is a growing demand for new issuances in the market. On the contrary, according to Deutsche Bank, investors should secure the money they can before political risk rises further in the latter half of the year. The volatility is also expected to remain on the downside with sovereigns' reduced financing needs. ([FT](#))

Tata Steel to get debt relief from Thyssenkrupp deal ([Economic Times](#))

Ryobi Kiso suspends trading after unit defaults on loan repayments ([Business Times](#))

Nigeria eyes USD 2.8bn debt from offshore sources ([Reuters](#))

Regulatory Updates**Basel Committee issues technical amendment to the Net Stable Funding Ratio**

Jun 29. The Basel Committee on Banking Supervision approved a technical amendment in the liquidity-providing operations of Net Stable Funding Ratio (NSFR). After the amendment, in cases of exceptional central bank liquidity absorbing operations, claims on the central banks can receive a reduced required stable funding (RSF) factor. This is an attempt to introduce flexibility in the treatment of extraordinary central bank liquidity-absorbing monetary policy operations and ensure a balanced treatment of all the central bank operations under the NSFR. The RSF factor can't be less than 5% for central banks claims with a maturity of more than six months. The previously existing treatment might have negatively impacted the ability of the banks to participate in such operations for secured transactions with maturities of more than six months. ([BIS](#))

The Federal Reserve seeks comment on proposed 2019 resolution plan guidance

Jun 29. The US Federal Reserve and the Federal Deposit Insurance Corporation are planning to change the resolution plans for the eight largest US banks in 2019. The proposal lays out changes to the resolution capital adequacy, liquidity capabilities, governance mechanisms, operational, trading, payment, clearing and settlement activities of the banks, intended to streamline the firms' submissions and provide additional clarity to the guidelines set forth in previous years. The updated document should help US banks develop their preferred resolution strategies and describe the Agencies' expectations regarding the firms' resolution plans as well as highlight relevant areas for improvement. ([Federal Reserve](#))

EBA does not object to the Swedish FSA proposed measures to address macro-prudential risk ([EBA](#))

ECB announces methodology for calculating Euro Short-Term Rate ([ECB](#))