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Big sick puppy

Fears of Deutsche Bank AG's missing an interest payment on a contingent convertible security sent the bank's common-stock price skidding 7.8% on Monday. Deutsche's junior subordinated 7½% perpetuals—one of the bank's many contingent converts—ended the day at €68.80, down from €91.03 at year-end 2015 and from the €100.016 offered price in May 2014. Nor was the sell-off confined to the biggest loss-making bank in the eurozone's biggest economy. The common shares and the contingent convertible bonds of other giant eurozone institutions, including UniCredit SpA and Banco Santander SA, likewise took a knock.

CoCos—as adepts were wont to refer to contingent convertibles before they adopted more pungent language this week—are a kind of financial tripwire. They are designed to self-mutilate in response to financial difficulties at the institution that issued them. Thus, a weakening in certain balance-sheet ratios or a decline in the common-share price might trigger the cancellation of a CoCo coupon payment or a writedown of CoCo principal. CoCos didn't invent themselves; the regulators did. In the newfangled securities, the macroprudential brigades saw a latent store of emergency capital. "Break glass in case of fire; remove CoCos; convert to equity." Such was the grand plan.

You could have seen that it wasn't going to work. "CoCos, indeed, pose potential risks to the whole world of leveraged finance, we think," said we in the issue of *Grant's* dated July 11, 2014. "Conversions or write-downs, when they're finally forced, won't take place under wraps. The news will start a highly focused reassessment of the credit-

worthiness of the stricken CoCo issuer or issuers. Providers of short-dated liabilities—certificates of deposit, uninsured deposits, commercial paper—are likely to arrive at the same conclusion more or less simultaneously."

A curious feature of Monday's trading was the action in Deutsche's credit default swaps. It appears that the CoCo holders bought swaps to protect themselves against the impairment of their designed-to-be-impaired securities. Anyway, the price on Deutsche CDS jumped to 220 basis points from 189 basis points on Friday and 95.7 basis points at year end.

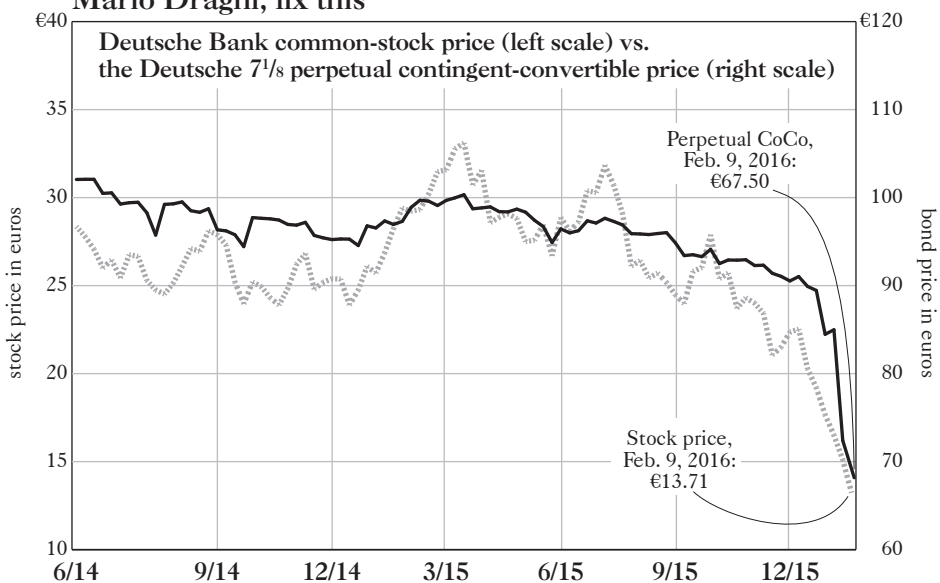
"It's perhaps ironic," colleague Evan Lorenz observes, "that CoCo holders would avail themselves of credit default swaps: Cancelling a CoCo coupon

or writing off CoCo principal does not trigger a default event for CDS. In fact, by writing off CoCo balances, a bank may improve its capitalization and so reduce its risk of default."

The CoCo market is big enough to worry about. Deutsche's issuance, €4.6 billion's worth, is a drop in the more-than-\$265-billion CoCo worldwide ocean. As for that, Deutsche is its own fixed-income ocean, with more than 5,000 separate bond issues to its name (more than a Bloomberg terminal has the horsepower to sort). In the year to date, the Credit Suisse Contingent Convertible Euro Total Return Index is down by 8%. As for U.S. banks, they seem to have issued none of it.

Especially retentive readers of the *Grant's* piece cited above will recall

Mario Draghi, fix this



source: The Bloomberg

our concern that the apparatus of post-crisis monetary policy could exacerbate a problem in the CoCo market. Money-market mutual funds, confronted with the fact of distress in a CoCo issuer, would probably stop lending to that stricken bank. They would rather throng the Fed's reverse repurchase facility. You know that Armageddon is not yet upon us because, on Monday, demand for accommodation from the RRP actually declined to \$39.1 billion from \$50.9 billion; at year end, the facility bulged with \$474.6 billion.

Anyway, with Deutsche, the fears are, or rather were, academic. Rated A-2/P-2 for short-term borrowing, the bank has effectively been cut off from the cleaner-than-clean, post-crisis U.S. unsecured funding market. Jan. 25 brought partial redemption in the form of a Moody's upgrade, to P-1. Let S&P follow suit, and Deutsche could conceivably resume its place in the bosom of American money-market portfolios. As recently as Jan. 31, 2014, it had placed \$63.6 billion with U.S. money funds.

Are Deutsche's problems idiosyncratic or systemic?

In the idiosyncratic column is the bank's front office. When John Cryan, one-half of the bank's two-person chief executive, joined the bank in 2015, he set out to rationalize Deutsche's unsystemic information-technology system. It was past time.

"Deutsche now has, for example, more than 100 different booking systems for trades in London alone, and has no common client identifiers," reported the *Financial Times* on Oct. 26. "It has even been unable to retrieve some of the data requested by regulators—which contributed to its failure in this year's U.S. bank stress tests." Many of those systems are reconciled

by hand at the end of each quarter, which might explain why the bank was unable to show a full balance sheet with its Jan. 28 earnings release.

The problems can cost money. Last summer, a Deutsche Bank trader accidentally credited a hedge fund's account by an extra \$6 billion. The hedge fund willingly—uncharacteristically—gave it back.

Deutsche closed out 2015 with a ratio of adjusted assets to tier-1 capital (CET1) of 11.1%. It's not as well capitalized as it might seem from that datum. Those are "risk-adjusted" assets in the CET1 calculation, as opposed to assets plain and simple. The risk-adjustment calculation turns €1.6 trillion into €396.7 billion. Who's to say that the regulators' ideas of risk are in sync with the risks that the world will throw Deutsche's way in the years to come? Using nominal assets—rather than risk-weighted ones—would reduce CET1 to 2.7%. Which is to say, at a glance, Deutsche's balance sheet is leveraged more than 30-fold.

Nor is there much hope of Deutsche's raising more capital through retained earnings. Last year delivered a net loss of €2.1 billion. Yes, regulatory fines and legal settlements took their toll, but Deutsche was not very profitable in 2012, 2013 and 2014, years in which it generated returns on equity of 0.5%, 1.2% and 2.7%, respectively. To boost equity, the bank must sell equity (not an inviting prospect with shares trading at 35% of tangible book value) or peel off assets.

In times past, the market forgave Deutsche's evident under-capitalization. For one thing, only €427.7 billion of today's €1.6 trillion assets are loans; surely, many reasoned, overall asset quality was good enough. For another, there was every expectation that the

German government would lend a hand if the need arose.

"Now there's cause for reappraisal," Lorenz points out, "which speaks to the question, Are the bank's problems unique to itself or general to leveraged finance? Deutsche's reported balance sheet is like the tip of an immense iceberg. As of Dec. 31, 2014, there was some €52 trillion (\$58.8 trillion) worth of derivatives lying beneath the water, including €41.7 trillion in interest-related derivatives, €6.7 trillion in currency derivatives, €1.4 trillion in credit derivatives and €135.3 billion (with a *b*) in commodity-related derivatives. (Deutsche, as noted, has yet to file complete 2015 financials.) How might negative nominal-interest rates, the collapse in the commodity complex and wild gyrations in currency prices affect Deutsche's book? How might Deutsche's failure as a counterparty impact those markets? The IMF estimates that world output in 2015 was \$73.2 trillion, only slightly larger than Deutsche's derivative book.

"Then, too," Lorenz proceeds, "the German government no longer has a free hand to bail out its biggest bank. The European Union's new Bank Recovery and Resolution Directive, which came into effect Jan. 1, requires that bank creditors and deposits over €100,000 suffer losses of at least 8% of a bank's liabilities before the first euro of state aid is disbursed. In other words, should Deutsche need help, its senior bonds may have to take a dent. Then, too, even if Angela Merkel were inclined to bail out Deutsche, the bank would take a heavy toll on state finances. German GDP foots to €3 trillion, not quite double the size of Deutsche's €1.6 trillion in (unadjusted) assets."

Are Deutsche's problems idiosyncratic or systemic? "Yes" is the answer.

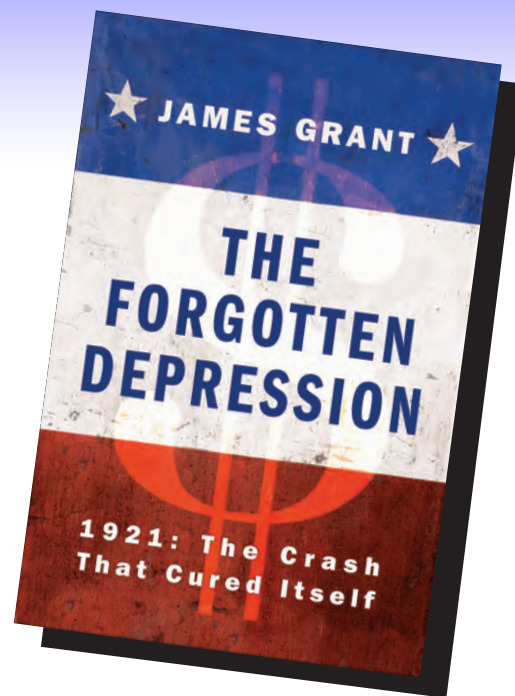
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