Deutsche Bank Robbery

By Klaus C. Engelen

The makings of a financial disaster. A bank morphs into a hedge fund.

Worries about the fragile state of the largest lender in both Germany and Europe, Deutsche Bank AG, dominated the unofficial agenda when bankers and finance officials from all parts of the world came to the annual meetings of International Monetary Fund, the World Bank, and the Institute of International Finance in Washington this October.

At the time, the headlines in the financial press on the smoldering Deutsche Bank crisis were indeed scary. On September 26, 2016, *The Telegraph* came out with the dire prediction: "The Deutsche Bank crisis could take Angela Merkel down—and the Euro." A day later, Bloomberg headlined, "Deutsche Bank Returns to Haunt Merkel in an Election Year."

During the IMF/World Bank meetings, Deutsche Bank's domestic rival Commerzbank—which still carries a large government rescue debt—kept up the tradition and invited the German financial community in attendance to a buffet cruise on the Potomac river aboard the *Cherry Blossom.* On the same day, EurActiv warned in its cover piece, "Financial expert: Deutsche Bank collapse 'would probably trigger new global financial crisis.'" On CNBC, U.S. Attorney General Loretta Lynch was confronted with the accusation, "How U.S. regulators may be creating panic around Deutsche Bank."

From IMF veteran Mohamed El-Erian, who ran the huge investment fund PIMCO and who still advises Allianz AG, came an explanation of why Deutsche Bank and other banks still have a confidence problem with the markets. "This uncertainty and especially the uncertainty around Level 3 assets

Klaus Engelen is a contributing editor for both Handelsblatt *and* TIE.

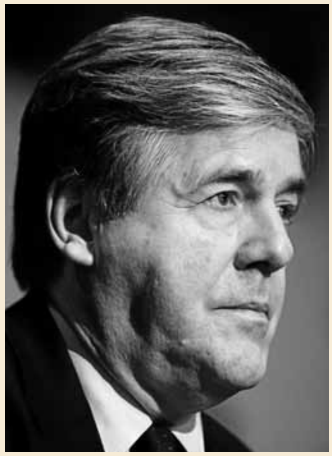
THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

[for which market pricing is lacking] causes people to price in a very high risk premia in the banking sector," he told Bloomberg. "It shows you Europe has been well behind the U.S. in strengthening its banking system."

At the IMF/World Bank meetings, Germany's official delegation headed by Finance Minister Wolfgang Schäuble and Bundesbank President Jens Weidmann strictly followed a no-comment strategy on the Deutsche Bank crisis, with other German bankers going into hiding on the haunting issue. Earlier this year, Schäuble made clear that he considered Deutsche Bank as "rock solid."

This year's Deutsche Bank presence at the Washington bankers' summit contrasted with those illustrious IIF gatherings in previous years. From 2006 to 2012, Deutsche Bank's head Josef Ackermann dominated the stage as chairman of the influential Institute of International Finance, the global association of the financial industry with nearly five hundred members from seventy countries. This year, however, current Deutsche Bank CEO John Cryan was not in sight. He did, however, attend a reception at the German Embassy where he spoke to his German banker colleagues about his dilemma. On the one hand, Deutsche Bank has been and is a major lender to the Trump real estate empire with a volume of loans of $2.5 billion since 1998 and outstanding loans to Trump entities of well over $300 million, the *Wall Street Journal* estimates. On the other hand, there is considerable uncertainty over whether the old or the new U.S. administration will eventually decide on Deutsche Bank's pending U.S. Department of Justice penalty claim of $14 billion.

What Bailout?



Josef Ackermann: *Shocked, shocked there's gambling going on in here!*

During the 2007–2009 financial crisis, Deutsche Bank's CEO Josef Ackermann boasted to the German press that his bank did not need and would not accept a government bailout. His assurance that "I would be ashamed, if we were to take state money during this crisis" put Deutsche above the shaken Western banking world.

But the banking experts behind the Deutsche Bank Risk Alert blog put big question marks behind Ackermann's statement. Deutsche Bank received $11.8 billion of the funds used to bail out the U.S. insurance giant AIG, and was the second-heaviest user of emergency low-cost funds from the Federal Reserve, borrowing more than $2 billion. Deutsche Bank was also the largest user of the Federal Reserve's TALF funding, sending the Federal Reserve more than $290 billion worth of mortgage securities. The TALF program allowed banks to use their assets, including troubled or hard-to-value assets, as collateral for short-term loans.

—K. Engelen

Among the global systemically important banks, Deutsche Bank appears to be the most important net contributor to systemic risks.

The crisis currently engulfing Deutsche Bank as the dominant financial institution at the helm of what used to be the economically powerful "Deutschland AG" is one that has taken many people outside the financial community by surprise. But experts and market pundits saw Deutsche's disaster coming for many years.

WORLD'S MOST DANGEROUS BANK?

In June 2016, the International Monetary Fund, as part of its Financial Sector Assessment Program report on Germany, expressed the dire warning: "Both Deutsche Bank and Commerzbank are the source of outward spillovers [of systemic risk] to most other publicly listed banks and insurers. Among the global systemically important banks, Deutsche Bank appears to be the most important net contributor to systemic risks, followed by HSBC and Crédit Suisse. In its report the IMF presented a chart showing the key linkages of the world's riskiest banks and warned, "The relative importance of Deutsche Bank underscores the importance of risk management and intense supervision of G-SIBs [globally significant banks] and the close monitoring of their cross-border exposures."

In reaction to the IMF paper, Simon Jack, the BBC's business editor, reminded his audience that Deutsche Bank's U.S. unit "was one of only two of thirty-three big banks to fail tests of financial strength set by the U.S. central bank earlier this year. (The other was Santander of Spain).

At the center of market concerns about Deutsche Bank is its huge derivative exposure and its extremely high amount of Level 3 assets. As follow-up to the IMF labeling Deutsche Bank as the most dangerous bank in terms of systemic risks, major magazines and newspapers have tried toassess the danger of the bank's huge derivatives exposure and Level 3 volume.

Fortune concluded in its September 27, 2016, piece "5 Things You Should Know About the Deutsche Bank Train Wreck" that Deutsche "has an inconceivably huge derivatives portfolio."

"Deutsche has the world's largest so-called derivatives book—its portfolio of financial contracts based on the value of other assets—in the world. It peaked at over $75 trillion, about twenty times German GDP, but had shrunk to around $46 trillion by the end of last year," said *Fortune* writer Geoffrey Smith. He added, "How scary is that? Less than it sounds. The overwhelming majority of those exposures are hedged against other trades, resulting in a far lower net exposure."

"Deutsche has the world's largest so-called derivatives book in the world."

Fortune, however, remains worried that Deutsche Bank is too interconnected to fail, not very well capitalized, already in the Fed's bad books, and is struggling because of weak earnings.

Mike Bird of the *Wall Street Journal* presented a very balanced perspective in his October 5, 2016, article on Deutsche Bank's derivatives book. On Deutsche Bank's exposure to derivatives, Bird argued that the "raw size can be misleading, since it covers the notional value of the derivatives." Bird concluded, however, with a somber note. "Deutsche Bank's situation is even grimmer, with forward EPS [earnings per share] more than 85 percent lower than its peak. A miserable outlook for earnings makes the company's shares less attractive, reducing their price. It also makes it more expensive for the company to raise capital. The worries about an opaque corner of the bank's derivative business don't help Deutsche Bank as it tries to soothe investors' concerns."

THE $14 BILLION BLOW FROM THE UNITED STATES

John Cryan, the British banker who became sole CEO of Deutsche Bank in July 2016, may be confronted with a mission impossible after U.S. authorities recently hit the bank with fines nearly at the level of its market capitalization.

Deutsche Bank's 2015 net loss of about €6.7 billion had already severely weakened the institution's capital base after the bank had shelled out €10 billion ($11 billion) in fines and other legal charges over the past three years. Deutsche has set aside €5.5 billion in provisions to cover the cost of future litigation related to the bank's pledge to resolve the biggest pending case with the U.S. authorities related to mortgage-backed securities sold in the run-up to the subprime crisis.

When the *Wall Street Journal* reported in September 2016 that the U.S. Justice Department proposed that Deutsche Bank AG pay $14 billion to settle a set of high-profile mortgage securities probes stemming from the financial crisis, the clouds over Deutsche Bank's Frankfurt twin towers darkened even more.

This penalty level—if not negotiated down substantially—amounts to a significant chunk of Deutsche Bank's current market capitalization of about $22 billion. This compares to a market capitalization of JPMorgan Chase, a major competitor, of around US$280 billion (€264 billion).

For Max Otte, a prominent German economist and stock market guru who predicted the financial crisis in his bestseller *Der crash kommt,* the $14 billion penalty by U.S. authorities is nothing but blackmail to get rid of the major remaining foreign competitor. He reminds his audience that short sellers including George Soros have speculated heavily against Deutsche Bank and that there is already an "economic war" going on globally. He blasts the German coalition government under Angela Merkel for remaining on the sidelines and not coming to the help of Deutsche Bank and its forty-six thousand German employees.

The bank, of course, is fighting the penalty, but would have to turn to investors for more money if it is imposed in full. Not surprisingly, worries over Germany's largest bank getting hit by such huge claims on its capital base and reserves are sending tremors through global markets and feeding speculation on the need for a government rescue.

When Bloomberg reported at the end of September that, amid mounting concern about Deutsche Bank's ability to withstand pending legal penalties, ten hedge funds had moved to reduce their financial exposure, the bank's shares slumped further, to a record low of €9.90. This means that in 2016 alone, Deutsche Bank shareholders had lost half of their stake. At the outset of the financial crisis in 2007, Deutsche's share price stood at €100.

To counter the erosion of confidence, Deutsche CEO Cryan reassured employees in a memo, arguing that the bank's balance sheet is safer than at any point in the past two decades and that "trust is the foundation of banking," but that "some forces in the markets are currently trying to damage this trust."

Deutsche's woes could be traced back to past mistakes made by the management.

Speaking to the German tabloid *Bild,* Cryan also tried to calm markets with assurances that "raising capital currently is not an issue" and that "accepting government support is out of the question." He made the point that the bank had twenty million customers and liquidity reserves of €223 billion ($250 billion) as of June 30, of which 56 percent was in cash.

Shortly after addressing Deutsche Bank's employees and talking to *Bild,* the weekly *Die Zeit* came out with the news that the Berlin finance ministry is working on a two-stage rescue plan to cope with a "worst-case scenario" under which the U.S. Department of Justice settlement is not reduced and Deutsche Bank fails to raise enough new capital. The paper claimed that in the first stage, Deutsche would have to sell parts of its business, with the German authorities issuing guarantees for potential losses. In a second stage, the German government would consider taking a stake of up to 25 percent in the troubled bank.

Such plans were denied immediately by the Berlin finance ministry, which stated that "The German government is not preparing a rescue plan, and there is no reason for such speculations." A similar denial also came from the Bonn-based Federal Financial Supervisory Authority (BaFin).

When the magazine *Focus* came up with the story that Chancellor Merkel had made clear that state support for Germany's largest lender was out of the question and that she would not get involved in diplomatic efforts with the American side to reduce the penalties, Deutsche Bank's shares took another tumble.

It became clear early on that the top managers of Deutsche Bank don't have friends among Berlin's coalition government. On the plane to Teheran, Sigmar Gabriel, the economic minister, told reporters: "I don't know whether to laugh or cry that the bank, which turned speculation into a business model, is now calling itself victim of it."

He thinks that Deutsche's woes could be traced back to past mistakes made by the management. "The scenario is that thousands of people will lose their jobs. They now have to bear the responsibility for the madness carried out by irresponsible managers." Gabriel also is vice-chancellor and leader of the Social Democrats, the junior partner in the coalition government.

A BANK HIJACKED BY INVESTMENT BANKERS

How could the largest and strongest publicly listed German bank get into such a precarious situation? In a long and well-researched cover story, *Der Spiegel* documented the rise and fall of Germany's banking icon and tried to give the answer. According to "How a Pillar of German Banking Lost Its Way" in the October 22, 2016, issue of *Der Spiegel*:

"For most of its 146 years, Deutsche Bank was the embodiment of German values: reliable and safe," begins the story. It goes on to make the case: "[T]he collapse of Deutsche Bank is the result of years, decades, of failed leadership, culminating in the complete loss of control of the company by top managers during the period between 1994 and 2012. …[T]he leaders of Deutsche Bank … essentially turned over the bank to a hastily assembled group of Anglo-American investment bankers before Anshu Jain, the prince of these traders, rose to the top and spent three more years sailing the bank full-speed-ahead into the shoals."

The bank, of course, is fighting the penalty.

Der Spiegel authors Ullrich Fichtner, Hauke Goos, and Martin Hesse explain: "The bank has a completely

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different internal structure. In 1994, most of the bank's earnings came from traditional commercial banking. But by the 2007 peak of the speculation party, the investment division's share of the bank's earnings, often made with the help of particularly risky deals, had climbed to over 70 percent."

The authors further point out: "At the beginning of the Ackermann era, the bank's core capital quota stood at 10 percent. By the high point of the boom and the onset of the crisis, Ackermann had pushed it down below 9 percent. That means that the bank's capital buffer was shrinking, which increases risk. In the language of the branch, Deutsche Bank was highly leveraged, investing with more of other people's money (debt) and less of its own. At Deutsche, this debt-to-equity ratio would sometimes reach as high as 40:1 in those days."

The cover story includes a long list of Deutsche Bank's misdeeds and ends with a damning judgement. "The proud institution became a self-serve buffet for a few, who became fantastically rich. The bank's old leaders, insofar as there were any left, didn't have the strength anymore to put an end to the chaos. They simply watched, lazily and cowardly. And so the work of generations went down the drain. And we are told that no one is to blame."

In August 2004, *The Economist* mocked the bank's slogan "passion to perform" under the CEO reign of Josef Ackermann, and referred to Deutsche Bank as "a giant hedge fund." The slogan "does not translate into much more than a passion to make money for its investment bankers. Deutsche is much less than it could be. While trying to broaden its horizons, it has shrunk them; by going global, it has ceased to be local."

Deutsche Bank veterans note that investment banker legend Edson Mitchell, who was hired by then-Board Chair Hilmar Kopper in 1995 from Merrill Lynch and died in a plane crash in 2000, reportedly made $30 million a year. Anshu Jain probably earned €300 million in his time with Deutsche Bank, and Josef Ackermann, after his years with Deutsche, may be worth now more than €100 million.

DIETER HEIN OF FAIRESEARCH: I TOLD YOU SO

When Dieter Hein and his analyst colleagues formed Fairesearch as an independent research company for institutional investors, banks, and brokers in 2003, Deutsche Bank's breathtaking global investment banking expansion had been in full swing for more than a decade.

Digging into the books of Germany's largest bank year after year, Hein found that Deutsche's expansion into global investment banking did not bring the results in terms of profits and increase in value that management had promised. After deep research into the real costs, profits, capital requirements, and risks of Deutsche's global investment banking operations, Hein became one of the sharpest critics of Deutsche Bank's management for losing control over its investment banking operations. Hein thoroughly examined the real profitability of global investment banking that—in the case of Deutsche Bank—at times comprised 80 percent of the bank's earnings. This explains why Anshu Jain, who headed the bank's global markets and investment banking divisions, was promoted to co-CEO along with the commercial banker Jürgen Fitschen in 2011.

On both sides of the Atlantic, the dangers of "regulatory capture" were ignored.

In October 2012, Hein's Fairesearch presented a study on Deutsche Bank's performance under the provocative heading "Close the investment bank and become rich." The report found that from 1998 to 2011, Deutsche earned an average annual return on its capital markets business of 11.1 percent, while its classic retail and asset management business earned an annual return of 21.1 percent. Fairesearch found similar results for two large Swiss banks—UBS and Credit Suisse.

These days, Hein argues that "Deutsche Bank has degenerated to an object of speculation," with a balance sheet of €1.8 trillion, about €60 billion in equity, and about €1.7 trillion in debt. In comparison, all Germany's municipal, regional, and state authorities carry a total debt amounting to €2 trillion.

Over the past few years, Hein and his analysts have published the most damaging reports on how Deutsche Bank's global markets division took huge risks, made huge profits, got most of the profits as bonuses at the expense of shareholders and other employees, but also piled up the billions in penalties that are now causing shareholders, investors, and creditors to look for the exit.

Looking at the accounts for 2012 and 2013, Hein makes the point that the bank shows total earnings of €903 million, not enough to cover the €1.53 billion paid in dividends to shareholders. But in spite of struggling for its survival, the bank made bonus payments of €6.33 billion for 2012/2013. Hein also points to the fact that in

2013, of 4,537 employees of the bank who received more than 100 percent of their fixed remuneration as bonus, only 8.4 percent worked in Germany and only 4.4 percent there in private banking. Hein draws attention to the fact that the bank's retail banking business in Germany—earning €1.52 billion in 2012 and €1.56 billion in 2013—made a higher contribution to total earnings than the two investment banking divisions of the bank.

A PERSONAL VIEW ON DEUTSCHE BANK'S DRAMA

These reports—especially from *Der Spiegel* and Fairesearch—are very informative, but don't paint the full picture.

As someone who has covered Deutsche Bank's rise and fall and the changing global market and regulatory environments, and has met legions of Deutsche Bank managers for half a century, I have a different perspective.

I was alarmed when the most respected members of Deutsche Bank's managing board and supervisory board left the bank in protest. Take Thomas R. Fischer, for example. I had met Fischer regularly at the European Forum Alpbach over the years. He was extremely worried about the risks that the London and New York investment branches were heaping on Deutsche Bank's balance sheet and how impossible it was to get them under control. When Fischer left the bank in January 2002, it was obvious that Ackermann and his investment bankers had won. I was impressed by how Fischer—along with Germany's top banking supervisor Jochen Sanio—organized the back-up clearing facilities of Deutsche Bank in New Jersey as part of the emergency team after the World Trade Center was destroyed in 2001. I was sorry that his stint as CEO of WestLB ended badly for him.

Fischer's concerns were shared by Ulrich Cartellieri, who—apart from Rolf Breuer— was the most qualified commercial banker on Deutsche Bank's supervisory board for years. Cartellieri stepped down two years after Fischer and had warned that the bank's supervisory board was set up to control a commercial bank, not a hedge fund structure. When the *Wall Street Journal* reported in October 2004 that Cartellieri "has acted as counterweight to the increasing influence of investment bankers based in London such as Anshu Jain and Michael Cohrs," I was not surprised. Knowing Cartellieri from his time at the German American Chamber of Commerce in New York in the late 1960s, before he joined Deutsche Bank in 1970, I considered him to be the architect of Deutsche Bank's global expansion as a commercial bank, especially in Asia. As early as 1991, Cartellieri predicted that in some years the banking sector would be like the steel industry in terms of structural problems.

I also had an important channel to the Deutsche Bank's supervisory board through Margret Mönig-Raane, a trade union representative, who under the German co-determination law represented Deutsche Bank's employees. As the Verdi trade union's deputy chairman, she held this position during Deutsche's turbulent years of dramatic changes from 1996 to 2008.

Mönig-Raane shared my high regard for Cartellieri and Fischer. At my urging, she secured a union-financed expert legal opinion on Ackermann's management reorganization proposals. I had suggested Professor Theodor Baums, who is considered the architect of the German corporate governance code defining best practices that all publicly listed companies in Germany must adhere to. Baums had acted as adviser to the German government, BaFin, and the Bundesbank. To have him on Deutsche Bank's supervisory board could protect the unions. They wanted to avoid what happened to the Mannesmann board some years ago, when Josef Ackermann and Klaus Zwickel, the IG Metall leader, were tried for criminal breach of trust because they signed off on illegal payments of €57 million to managers and pensioners of Mannesmann AG, which was taken over by Vodafone.

Deutsche Bank has been and is a major lender to the Trump real estate empire.

In the case of Deutsche Bank, the question was whether Ackermann's proposals for replacing the consensus-driven eight-member managing board, where each member holds joint responsibility, with a newly empowered U.S.-style executive committee was legally possible under German law. As it turned out, when Baums outlined the requirements for making Ackermann's Anglo-Saxon–style decision-making structure compatible with German law, the unions and the Berlin finance ministry gave a green light, overriding the bank supervisor BaFin's concerns that Germany's "four eyes" civil law principle was not met because Ackermann acted as *de facto* CEO.

What has to be taken into account is the frantic deregulation race and the spectacular breakdown of effective bank supervision during the years when investment bankers at Deutsche Bank—and other major financial institutions—went out of control.

On both sides of the Atlantic, the dangers of "regulatory capture" were ignored by the political, economic, and academic elites and new "masters of the universe" took full advantage of liberalized financial markets and a never-ending stream of new financial products which in many cases the bank chieftains didn't understand.

In the case of Germany, the governing parties at the federal and state level allowed the public sector Landesbanks to use refinancing privileges to become the largest investors in the collateralized U.S. subprime mortgage sector, as controlling state finance ministers and Germany's dual banking supervision by BaFin and the Bundesbank looked on. With WestLB and Bayerische Landesbank leading the pack, German taxpayers had to foot the bailout bill. On top of this, German banks and the Bundesbank had to bail out Germany's second-largest mortgage lender Hypo Real Estate, later put into the publicly funded Financial Markets Stabilization Fund (SoFFin).

The important role that key managers of Deutsche Bank played on the public stage during critical crisis situations over the years is another aspect to the story. One has to admit that under the management of Hilmar Kopper, Rolf Breuer, and Josef Ackermann—even in the years when the backstage hijacking by the London and New York branches was progressing—Deutsche Bank's public role was normal and sometimes impressive.

Ackermann took a leading role in mobilizing the private sector banking community in the euro sovereign debt crisis. In the lead-up to the Greek default, Ackermann worked at putting together a large private-public syndication of about €30 billion to cover Greece's rollover needs for 2010. But Chancellor Merkel and Jens Weidmann, then her chief economic advisor, rejected this idea. Ackermann's plan was a bridge loan given to Greece through the state-owned KfW Group, backed half by loan commitments from leading banks without guarantees and half by public loans from eurozone governments.

"Europe has been well behind the U.S. in strengthening its banking system."

What the Merkel chancellery and the Schäuble finance ministry missed was that such a liquidity bridge loan would have given Berlin and other eurozone governments some time to come up with a new financing framework for Greece and other over-indebted eurozone countries.

In what one may call "the old Deutsche Bank" era, Chairman Alfred Herrhausen made history on the Latin American debt crisis front. When, after half a decade of struggling with the Latin American debt crisis, and on the eve of the 1987 annual meetings of the IMF and World Bank, he published his controversial debt restructuring proposals in *Handelsblatt*, Herrhausen became the talk of the meetings. His proposals caused angry rebuttals from top U.S. bank chieftains and he was attacked by his fellow German bankers as an "innovative softie." What an irony.

Before I became U.S. correspondent for *Handelsblatt,* Germany's economic and financial daily, in 1964, my predecessor, Arno Morenz, and I published a page-long well-researched article that made Deutsche Bank's almighty Hermann Josef Abs very angry. He dispatched a harsh letter to *Handelsblatt*'s publisher protesting the allegations we got from German company managers already operating in the United States that Deutsche Bank—under the reign of Abs—was blocking other German banks from setting up offices in the United States by pointing to substantial legal uncertainties in the aftermath of World War II reparations. At the time, only Dresdner Bank was present on Wall Street with a small representative office.

As it turned out, Deutsche Bank was very slow to set foot abroad and opted to move along with other European banks, as in the case of European American Bank. Later, leading Western banks, in reaction to the Latin American debt crisis, formed the Institute of International Finance to improve country research in emerging markets. But Deutsche Bank remained on the sidelines. Wilfried Guth and other members of the managing board argued that the research that Deutsche Bank produced was so excellent that joining the IIF would be "money wasted." This is how the old chieftains of Deutsche Bank thought and acted. They would turn in their graves if they could see what happened to their bank.

The higher-ups of Deutsche Bank—and their friends in the financial and academic community—remain in denial of the disturbing reality. This was demonstrated recently at a joint evening gathering of those interested in Deutsche Bank's history. Deutsche Bank and Germany's leading daily *Frankfurter Allgemeine* together celebrated the twenty-fifth anniversary of the founding of the Historical Association of Deutsche Bank. Present were former leaders of the bank such as Hilmar Kopper and Clemens Börsig. One Deutsche Bank veteran left the meeting saddened and angry, complaining: "There was not a word on the demise of the bank, on the penalty damage caused by the investment bankers, on the record low share price, on the fallen ratings, on the eroding confidence in the markets." ◆