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Deutsche's problems reverberate through global banks

By James Eyers

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Like chaos theory's butterfly effect, concerns that the European Central Bank might have to provide support to Deutsche Bank if its stock price continues to plunge reverberated into Australia's banking sector on Tuesday.

Bank equities were savaged and the cost of insuring bank debt against default continued to climb, on fears that raising funding from nervous offshore investors would become more expensive, crimping Australian banks' net interest margins.

Deutsche Bank's share price plunged 10 per cent on Monday to its lowest level since 1984. KRISZTIAN BOCSI

Many offshore investors are losing faith in European and United States banks. The bears are pointing to the potential for bad debts to rise because of exposure to commodities, slowing growth from emerging economies, and for bank profits to remain depressed if interest rates stay lower for longer.

But with Deutsche Bank's equity price plunging 10 per cent on Monday to its lowest level since 1984 – which forced the German bank to assuage the market that it can meet interest payments on its bonds – credit investors are also discussing the prospect that the ECB will need to step in and provide financial support to Deutsche.

In the last week of January Deutsche reported a terrible profit result, a €6.89 billion loss for the year and a €2 billion loss in the fourth quarter. Over the past year, Deutsche's core equity Tier 1 capital has fallen from €60 billion to €52 billion. But the equity market now values Deutsche's total shareholder equity at closer to €19 billion. The market reckons two-thirds of its loans are impaired.

"The issue is equity holders are fairly losing patience and are becoming increasingly concerned on [Deutsche's] asset quality," said Andrew Papageorgiou, co-founder and investment manager at Melbourne-based fixed-income investor Realm Investment House.

"The problem with a collapsing equity price is that the bank is seeing the biggest part of its regulatory capital structure written off, which in turn limits its ability to raise additional capital as circumstances deteriorate."

Affected by new laws

But credit investors are also concerned that their exposure to Deutsche could be affected by new laws, following changes to Germany's banking act in November.

In line with diminishing state support for banks that are "too big to fail", Germany said senior debt was a distinct category of liability that could be "bailed-in" ahead of derivative counterparties and depositors. This made German law compliant with new rules on "total loss absorbing capacity" (TLAC) that have been pushed by the Financial Stability Board and the G20.

In a note sent to Realm's investors on Tuesday evening, Mr Papageorgiou said the complexity created by these TLAC rules might have created a rod for investors' backs, by "making any kind of support and resolution a veritable minefield".

"Regulators could open Pandora's box here," he said. "If they resolve or bail in or threaten senior debt, the market will adjust and start pricing for all risks, including idiosyncratic ones, which could see the senior spreads across the European continent explode wider."

European bank investors are concerned that Portugal's left-field bail-in of Novo Banco senior creditors just after Christmas might have created a precedent that could lead to them trying to apply a "Living will" to Deutsche. On December 29, Portugal's central bank unilaterally transferred $US3.1 billion worth of five senior bonds from a "good bank", Novo Banco, to a "bad bank", Banco Espirito Santo, which is in liquidation, and in so doing, actively discriminated against a sub-set of senior bonds.

Too big to resolve

Mr Papageorgiou said if European regulators sought to resolve a struggling Deutsche, this would send the spreads on Tier 1 and Tier 2 bank debt skyrocketing, but if they determined that Deutsche was too big to resolve, that "would mean that the Basel continuum has failed to protect the global economy from being susceptible to bank failure".

"They seem like two bad choices," he said. "The other is that Deutsche somehow muddles through with support from central bankers and regulators. However, that would be a slow burn – and the equity market is already sounding alarm bells, which means the time for doing nothing has passed."

This is a savage market, into which Commonwealth Bank of Australia will report first-half profit on Wednesday morning. The potential for higher offshore funding costs to restrict CBA's net interest margin will be a key focus, given the extent to which global investors have been sent scurrying from bank equity and debt in recent days.

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