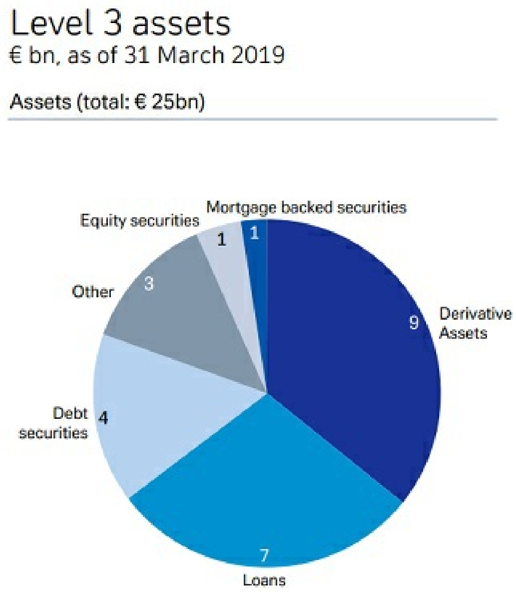
No hiding Deutsche's derivatives time-bomb

On 7 July the world's leader in dangerous derivatives trading, Deutsche Bank, laid out its plans to set aside US$83 billion of its dodgiest gambling bets into a "Bad Bank". Once the world's leading industrial bank, in its quest to become a major investment bank Deutsche bought UK merchant bank Morgan Grenfell in 1990, and swallowed up Bankers Trust in 1999, which had been one of the world's two top derivatives traders. Now, the bank is widely considered in financial circles to have finally given up on its global ambitions. "The business has been weighed down by a massive derivatives book which was a profit-spinner before the global financial crisis but saddles the bank with liabilities that will endure for many years", the *Australian Financial Review* acknowledged on 9 July.

Along with troubled assets, the Bad Bank would also host selected Deutsche operations such as its global equities-trading arm. Deutsche is closing its equities operations, including in Australia. The plan to restructure and save the bank includes no dividend payment in 2019-20, and 18,000 job cuts by 2022. The Bad Bank will be liquidated over time, which presumes that the non-performing, zombie securities it contains can somehow be offloaded, which hasn't been possible for more than a decade and isn't about to happen now.



Deutsche Bank's Level 3 Assets

The bank's survival plan could itself trigger a global derivatives blowout, by exposing the contracts to the light of day. The IMF in June 2016 described Deutsche Bank as "the most important net contributor to systemic risks" due to its high level of interconnection with other megabanks globally, including as counterparties for a mammoth US$49 trillion of derivatives contracts. Much of what will be transferred to the Bad Bank are known as "Level 3" assets, relatively illiquid assets that are almost impossible to value. At the end of the March 2019 quarter, Deutsche Bank estimated those holdings at €25 billion which includes more-complex over-the-counter derivatives, distressed debt, highly-structured bonds, illiquid asset-backed securities, illiquid collateralised debt obligations (cash and synthetic) and more. This figure is a complete guesstimate, made according to the bank's own model; given that such assets are so toxic there is no market for them, *they have no real market value*.

Another measure which reveals the extent of the problem is that the bank's Level 3 assets are worth 72 per cent of its Tier 1 assets—the bank's primary capital reserves—according to JPMorgan Chase analysts. The average of 12 global banks is 38 per cent.

EU waves its hands

An investigation by Italian financial daily *Il Sole 24 Ore* published 17 March 2017 revealed that the EU's Single Supervisory Mechanism (SSM) failed twice, in 2014 and 2016, to assess Deutsche Bank's Level 3 derivatives assets because they do not possess the time or competency to do so!

In 2014 the SSM openly decided not to assess the assets, *Il Sole* wrote, because as team head Ian Shipley explained, "it would not be possible to certify highly structured products because both central banks and consultants such as Oliver Wyman lack the competence". Only the American investment banks such as Goldman Sachs and Morgan Stanley, who invented the products, said Shipley, would be able to proof the balance sheets, but "to involve them, would mean a potential conflict of interest".

In a 3 November 2014 European Parliament hearing, SSM head Daniele Nouy admitted that the SSM did not assess Level 3 assets for lack of time. Consequently, stress tests of Deutsche Bank have not included pricing its derivatives, *Il Sole* stated. Instead, the bank is allowed to provide its own valuation, according to its own model.

Member of the European Parliament from Italy, Marco Zanni, confirmed to *Executive Intelligence Review* magazine on 3 February 2017 that he had quizzed Nouy in October 2014 on the ECB's assessment of Level 3 assets, "and basically the reply of the ECB was 'we cannot assess the Level 3 asset risk because we are not able to evaluate or to decide the value of those instruments, because they are highly speculative instruments". Therefore, he continued, "the most important banks in Europe, such as Deutsche Bank or HSBC, BNP Paribas and so on use internal models in order to establish the value of these illiquid derivatives. So, basically, it is the bank itself that is deciding what is the balance value, the asset value of the derivatives—and the ECB, the institution that should supervise and should control those banks, is clearly stating that they are not able to assess the risk and the value of those instruments."

Return to commercial banking

According to *AFR*, the former country chairman of Deutsche Bank and Bain & Co (taken over by Deutsche) in Australia, Maurice Newman, blamed the previously proud and powerful bank's downturn on the infiltration of Wall Street culture. "It was very much a teutonic bank, very honest, very straightforward, probably a little sleepy it can be said. Over time, the German culture was diluted and more and more Americans were brought in, some Brits, and more and more Germans were sacked. So it became more of an investment bank than the traditional commercial bank it started out being. That's the sad and sorry story." On an 8 July conference call, Deutsche's Global Chairman Christian Sewing said he was reinventing the bank. "We kept too many options open", he said; *AFR* added that Sewing was "referring to its persistence in areas where it is uncompetitive, and the need to return to its origins". This tale should be a lesson for all banks, about the risks of combining retail and investment banking operations. More importantly, it is a lesson for governments. In the face of this inestimable derivatives mess, immediate legislation of 1930s USA-modelled Glass-Steagall banking separation is required, in order to mitigate against the inevitable meltdown. Once Deutsche Bank—a model of universal banking which proves its failure—collapses, it will be too late.

Australian Alert Service 17 July 2019
