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MARKETS | HEARD ON THE STREET

Why Fear of Deutsche Bank Bailout Is Wide of the Mark

Amount of money the bank would have to lose even to hit its first line of defense is huge

Deutsche Bank
X-markets

The fear swirling around Deutsche Bank was sparked by news that U.S. prosecutors had made an initial proposal that it pay $14 billion to settle mortgage-bond probes. *PHOTO: KAI PFAFFENBACH/REUTERS*

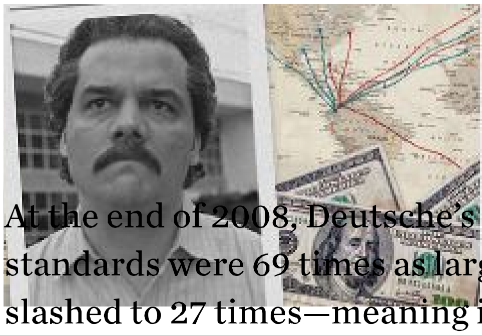
By **PAUL J. DAVIES**

Updated Sept. 30, 2016 1:26 p.m. ET

Deutsche Bank stock has endured such stomach-lurching drops this week that some have questioned its survival, or talked of the need for a government bailout.

Such talk is unrealistic, even wild. Here are the numbers that will show you why.

Deutsche's balance sheet has changed a lot since 2008 when it was one of the most highly leveraged banks in the world. The simplest way to see this is simply to look at assets and equity.



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At the end of 2008, Deutsche's total assets as measured by international accounting standards were 69 times as large as its total equity. Now, that leverage multiple has been slashed to 27 times—meaning it has more than twice the equity per euro of assets on its balance sheet than it did back in 2008. Losses are less harmful because its balance sheet has more support.

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But what really matters today is regulatory capital, which is calculated in relation to risk-weighted assets—a measure of the loans and bonds it owns adjusted by a kind of complicated credit-scoring system.

The rules around how this works have changed so much since 2008 that today's capital ratios aren't comparable. But it is useful to look at just how much equity Deutsche would have to burn through in order for its situation to become truly dire.

On the strictest view of its capital base, which is to only count the equity that qualifies when all postcrisis changes come fully into force in 2019, Deutsche had €43.5 billion ($48.82 billion) of common equity tier 1 capital at the half year. That gives it a capital ratio of 10.8%. By 2019 that needs to get to 12.25%.

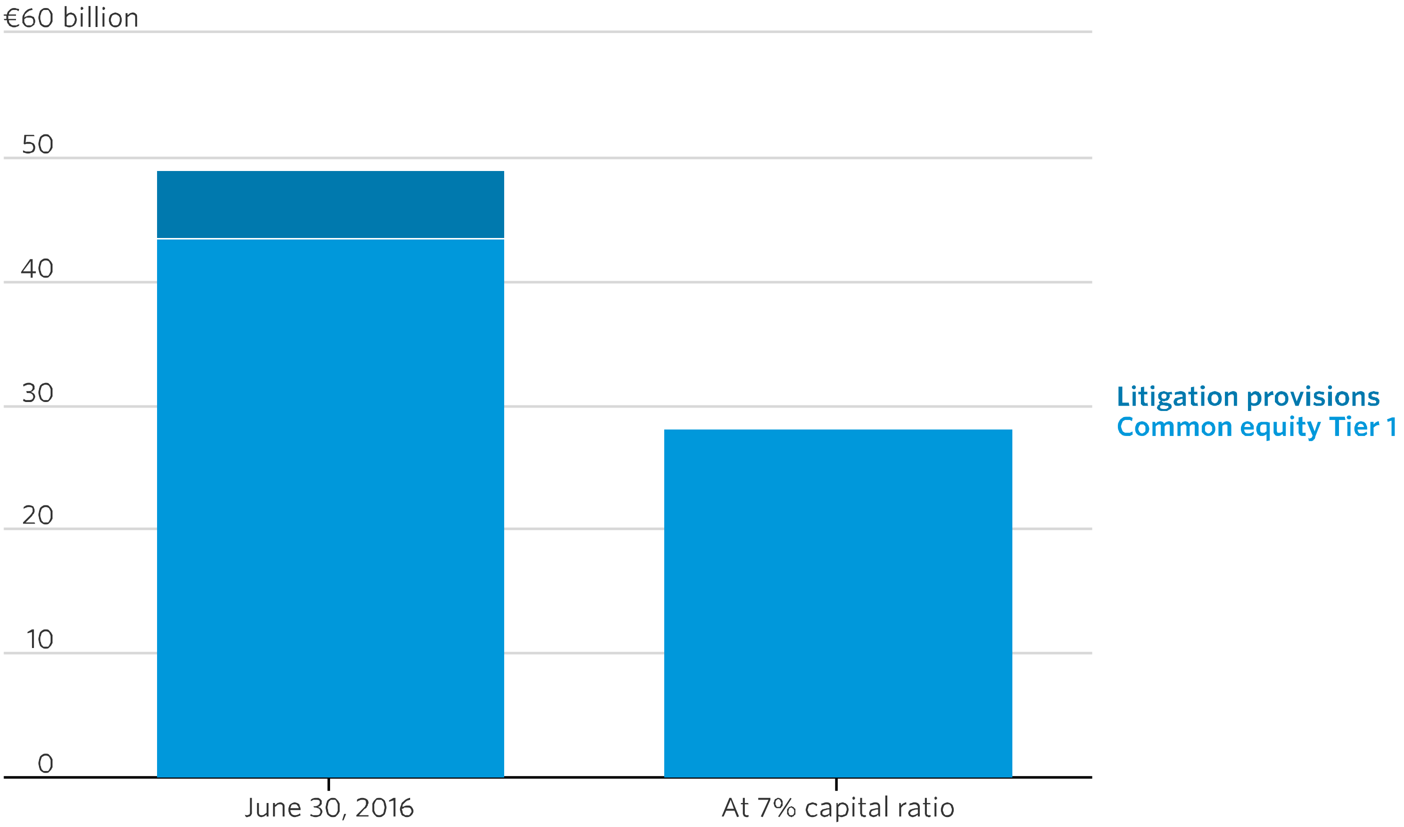
If a bank gets into real trouble, one of the first things that happens is that a set of junior bonds, known as Cocos, get converted into fresh equity. This typically would happen if the bank's capital ratio drops to 7%. For Deutsche, that would mean losing more than €15 billion of equity.

The fear swirling around Deutsche was sparked by news that U.S. prosecutors had made an initial proposal that it pay $14 billion to settle mortgage-bond probes. But the bank already has put aside €5.5 billion of reserves for settling lawsuits.

To drop to that 7% capital ratio trigger point, the mortgage settlement and other losses would have to amount to almost €21 billion. Actually, the loss would have to be bigger than that because Deutsche would first also not pay any bonuses to its bankers (or pay them in stock or other instruments). In 2015, total variable pay was worth €2.5 billion.

Big Loser

Deutsche Bank's capital and reserves versus the level at which junior debt would convert to equity



Source: the company

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That would be a huge amount of money to lose very suddenly just to reach the first major line of defense.

Deutsche's real problems are longer term with its costs, its profitability and the capital hurdle it must clear by 2019. That isn't helped by reports of hedge funds taking their business elsewhere.

This will cut revenues further, which as J.P. Morgan analysts point out could force the bank to seek fresh equity soon. Perceptions that the bank is high risk aren't going to lead to a government bailout, but they will make it ever harder for Deutsche to repair its profitability and build the extra capital it still needs.

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