Deutsche Bank: Some Considerations on our Mind

The first months of 2017 were again loaded with headlines for Deutsche Bank (A- Issuer Rating; BBB+ senior unsecured debt ratings; Negative Outlook), despite there being less unease over the bank than from one year earlier. Scope Ratings regards Deutsche Bank's recent capital increase and strategy update as important initial steps for the bank to being able to manage better its way to improved profitability. Nevertheless, in our view these recent actions in and of themselves do not guarantee an imminent turnaround in the bank's evolution. First-quarter 2017 results might have indicated an initial stabilisation of the bank's performance, but the path ahead remains rather steep. The growth ambitions indicated by management should be watched carefully. We argue that the bank still has to deliver more thoroughly and consistently on its cost-savings programme, provide evidence of a more stable governance and compliance culture, and convincingly re-integrate Deutsche Postbank AG.

Deutsche Bank's Q1 2017 results show positive signs, but market reactions are mixed

From a credit point of view, Deutsche Bank's situation has so far improved strongly in 2017. The settlement and closure of its RMBS case with the US Department of Justice (which included a civil monetary penalty of USD 3.1bn and USD 4.1bn in consumer relief) had a considerable impact on the bank's 2016 year-end results. However, the outcome seems to have drawn a line under market concerns regarding even-higher penalties and further headline risks. Deutsche notes that it has been able to gradually restore confidence with clients and market participants and that its various business segments, especially Global Markets and Wealth Management, could re-establish some lost client relationships and business. Our view is that a more benign market environment has also contributed to this. Furthermore, typically Q1 results should be relatively stronger, particularly in trading; this pattern was also evident among Deutsche Bank's global competitors. In fact, in a comparison with peers, Deutsche's results look actually less favourable.

Deutsche Bank's long-established market position obviously has some strong value, and the bank is an important participant in various capital market segments. We would regard a controlled and low-profile business performance more valuable for the bank than volatile and unduly increased short-term results.

Another positive is Deutsche's good progress on cost controls. That being said, and in a more general context (also with regard to the increased digitalisation of businesses), we believe banks need to focus on more-sustainable cost/income ratios. Figure 1 below shows that among global peers Deutsche is still at the high-cost end of the range, implying room for improvement. We caution, however, that this will not be easy in the context of high restructuring costs, the need for further IT investments, and the future costs related to the UK's exit from the EU, which banks will most likely have to bear (see below for further details).

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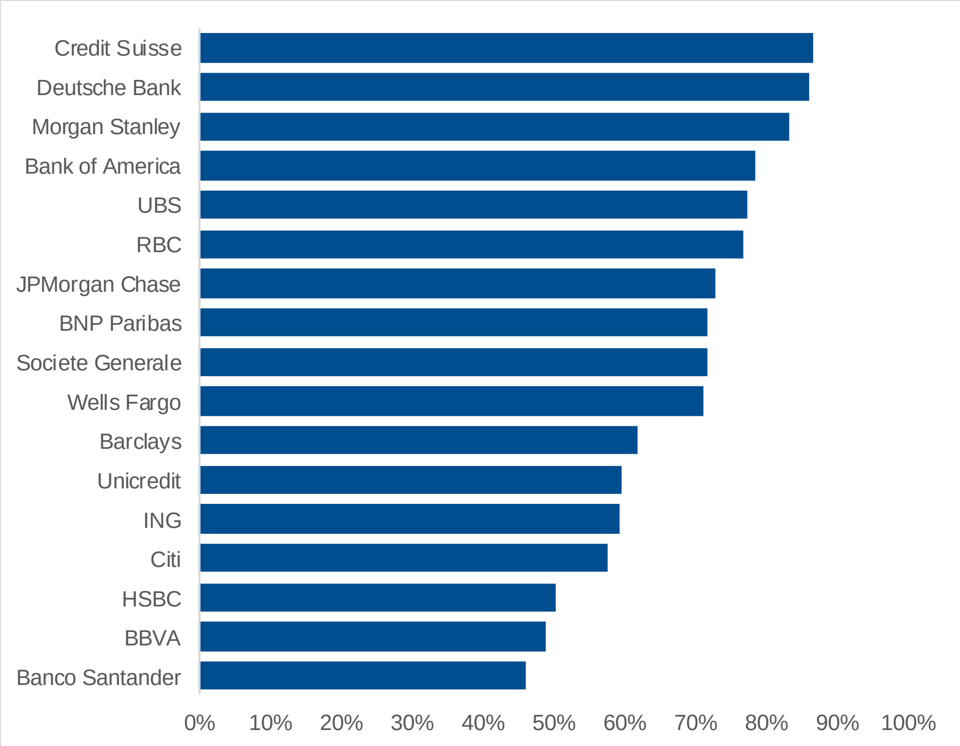
Figure 1: Cost/income ratios of selected European and US banks as of Q1 2017



Source: Reports,SNL, Scope Ratings

Litigation costs have hit performance over the past years

Deutsche Bank's litigation reserves decreased from EUR 2bn as of year-end 2016 to around EUR 1.2bn as of 31 March 2017; in the same period, regulatory enforcement reserves also fell from EUR 5.6bn to EUR 2bn. The movement in reserves was mainly due to the settlement payment for the RMBS case with the US Department of Justice, along with other settlements related to various smaller litigation and regulatory enforcement cases. Total reserves for the various classes of provisions decreased from EUR 10.6bn to EUR 6.4bn. Deutsche has stated publicly that it has around 16 individual proceedings outstanding as of Q1 2017, with more or less complex involvements. This compares to 14 cases as of year-end 2015.

It is difficult to judge the impact these cases will still have on the bank, from both financial and reputational aspects. Deutsche Bank's management tries to be as transparent as realistically possible regarding these pending cases, which we view as very positive. Among investors, however, it is not surprising that sensitivity remains high and further headline risk could once again undermine the bank's credibility.

When announcing its 2016 annual results last February, Deutsche noted its strong focus on 'Compliance and Anti-Financial Crime'. In 2016, more than 350 employees were hired in this area, with at least 600 additional new hires planned for 2017. While these numbers speak for themselves, we highlight that, beyond this, the introduction of a tighter risk control culture is often difficult for employees, and may lead to some disruptions in workflows, possibly undermining some otherwise legitimate business opportunities. Such effects may be difficult to quantify, but in some cases might affect performance and profitability if the risks of certain activities are deemed too high under a changed culture.

Can the recently announced strategy update turn around the bank's challenged market position?

The strategy update presented by senior management last March was overdue, in our view. In line with the targets of its 'Strategy 2020' the bank intends to further simplify its business model. This will involve having just three business units going forward: Private & Commercial Banking, Deutsche Asset Management, and Corporate & Investment Bank. Furthermore, management aims to strengthen the bank's position in its German home market, while retaining a global reach in Corporate & Investment Banking, Wealth Management and Asset Management. We do not see this updated strategy as a radical change, but we appreciate the better clarity of the planned business model, reflecting a more transparent and realistic management culture at Deutsche Bank.

We view as less optimal that these strategic clarifications have come rather late – after the appointment of the new senior management team in July 2015, several early chances to change strategic direction were missed. For example, during the past two years the bank has accrued unnecessary costs, and might have also missed out on business opportunities. One case in point is Postbank. In April 2015, Deutsche Bank announced the deconsolidation of Postbank, a move which at year-end 2015 resulted in an impairment of EUR 2.8bn, as well as EUR 670m of provisions for restructuring and severances. In addition, we believe that since 2015 various restructuring exercises have been undertaken regarding the separation of Postbank. In 2016 this process came to a halt, when it became clear it would be difficult to sell the entity at an economically viable price. Any costs incurred during this period are most likely sunk costs, which are difficult to specify in detail. Having said that, we nevertheless regard the re-integration of Postbank as a prudent decision, as we believe retail banking in Germany still has the potential to raise greater profitability due to still idle cross-selling opportunities. Although it might take more time to return to greater stability in this business area, the bank might achieve better profitability within retail banking in the medium term.

Another example of accrued costs arising from the bank's delayed repositioning is the re-alignment of the bank's corporate divisions: Global Markets, Corporate Finance and Global Transaction. In general, restructuring the bank's divisions is not only costly and time-consuming for any institution, but also takes up a lot of management effort. Specifically, management might be so strongly focused on internal challenges that attention is diverted away from opportunities to develop new business. In brief, we suggest that Deutsche Bank's convoluted decision-making processes in recent years to re-align its businesses – the latest is the third such exercise since 2014 – could in fact have been more costly than what the bank's results imply at first glance.

This, however, does not mean that we at Scope do not regard positively Deutsche Bank management's more vigorous strategic re-positioning plan. At the same time, we note that the competitive environment for the bank has become much more challenging and that, due to some reputational damage, the group might need more time to achieve its targets.

Costs from upcoming Brexit negotiations difficult to pinpoint, but competitive advantages might provide some winning margin for Deutsche Bank compared to its US peers

Deutsche Bank has been dividing its wholesale operations between its Frankfurt head office and its large London branch. Given the importance of the London entity's activities, previous management had suggested at one point to shift the German bank's head-office functions to London. However, shareholder and political resistance undermined the bank's plans. We understand that some of the bank's core functions, particularly its client-facing business, are now conducted at Deutsche Bank's London premises. Reuters recently reported that European regulators are already reviewing the affected business areas of banks across Europe. Deutsche Bank is regarded as particularly vulnerable because it is one of the big European dealers of euro-denominated derivatives in London. With the bank's business division in mind, recent media reports have suggested that Deutsche Bank might look into moving up to 4,000 jobs from the UK to Frankfurt and other EU locations as a result of Brexit. Across the UK, Deutsche Bank employs around 9,000 staff, including around 7,000 in its office in the City of London.

In some recent interviews Deutsche Bank's Chief Regulatory Officer, Sylvie Matherat, stated that capital charges on banks for processing euro-denominated derivative trades in London could climb dramatically when the UK leaves the EU. Ms Matherat also indicated that if front-office employees are moved from London to Frankfurt, in order to retain the ability to deal with EU clients, Deutsche Bank would have to build up its information technology in Frankfurt. Furthermore, if risk management needs to be done locally, the bank would have to move more employees from London to its offices in the EU. We therefore expect that over the coming quarters Deutsche Bank will face increased costs related to the re-organisation and relocation of several business units, which are currently not accounted for in this context.

The Bank of England has requested financial firms to provide contingency plans on their strategy regarding the UK's departure from the EU by 14 July. We expect to receive further clarity on this matter as a result of this exercise.

However, in principle, we believe that Deutsche Bank should nevertheless have a competitive advantage due to its dual business structure in London and Frankfurt. This is particularly important compared to its US peers, which have mainly focused on building up their European head offices in London. Furthermore, the bank will most likely retain a larger presence in the UK, due to its local business interests, and based on the fact that London's financial centre has a long-established and developed infrastructure, which is not expected to be replaced in the short to medium term by any other European city.

Recent capital increase did not lead to a rating upgrade for Deutsche Bank but did prevent a rating downgrade

Scope's ratings for Deutsche Bank are: A- Issuer Rating, BBB+ senior unsecured debt ratings, BBB- Tier 2 ratings, B+ AT1 ratings, and S-1 short-term ratings. All ratings have a Negative Outlook.

In our view, a stronger capital basis can help shore up confidence in the bank among clients and market participants, but it will not necessarily guarantee better profitability and stability for the bank in the short to medium term. Any such meaningful improvements in this direction are instead more likely to occur over time. The overall financial situation for the bank should only change with a proven track record over several quarters.

The latest capital increase (April 2017) is the fifth in the past 10 years (Figure 2). Whereas part of the capital increases between 2008 and 2010 focused on the bank's growth in order to support the Postbank acquisition, later ones aimed at stabilising the bank's capital base to safeguard the bank's prudential metrics and market confidence.

Figure 2: Deutsche Bank: recent capital increases and related usage of funds

Date	Amount (in EUR)	Purpose of capital increase
September 2008	2.2bn	Acquisition of minority stake in Deutsche Postbank AG
March 2009	958m	Capital increase in kind for the purchase of a minority shareholding in Deutsche Postbank AG from Deutsche Post AG
September 2010	10.2bn	Primarily for the acquisition of Deutsche Postbank AG
April 2013	2.96bn	Strengthen the capital base
June 2014	8.5bn	Safeguard Deutsche Bank against challenges in capital funding, to remain flexible, and to strengthen the bank's competitive position
April 2017	8bn	Strengthen the capital base to stabilise client relations

Source: Deutsche Bank, Scope Ratings

It is a fair assumption that, in the absence of new capital being issued (including this latest transaction), the financial and business situation of Deutsche Bank would have been more difficult on a forward-looking basis. Our ratings would have had to reflect that situation, and therefore they would have very plausibly been lowered. This is to say that, while the recent capital increase has not be sufficient to boost our ratings on Deutsche Bank, it has nonetheless been instrumental in holding them at the current level – albeit with a Negative Outlook. This analysis is reflected in the rating drivers and rating-change drivers underpinning our analysis of the group.

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