

Did Deutsche Bank pass their initial test?

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In the midst of accommodative central bank policy, investors continue to focus on Deutsche Bank (DB) and whether they will be able to successfully rebound from poorly performing business units. Last year the CEO of Deutsche Bank, Christian Sewing, undertook a large-scale restructuring plan to reduce prior firm objectives of expansion as a global investment bank and return to its core business as a lender to European companies meanwhile maintaining a large fixed income desk. DB made bold moves in 2019 in an aim to reduce their costs and now we can see the initial results of these initiatives. On 30 January 2020, Deutsche Bank AG hosted their Q4 2019 earnings call and the picture appears to be improving¹. While their overall results were mixed, we did note quite a few positive signals from the call.

A few highlights:

1. Core revenue increased 5% to 5.29 billion Euros. While they reported a pre-tax loss of 2.6 billion Euros, 2019 included significant charges associated with their transformation plan. They indicated that around 70% of their total planned transformation effects occurred in 2019 and they anticipate lesser impact in coming years.
2. DB remains focused on costs and they have now reported eight consecutive quarters of year-on-year reductions in adjusted costs excluding transformation charges and bank levies.
3. DB signalled that they were committed to keeping their Common equity Tier 1 ratio (CET1) ratio above 13% at the end of 2019, and they reported the CET1 ratio at the end of the fourth quarter at 13.6%. Meanwhile they promised a leverage ratio of 4% for the same period and met this target at 4.2%.
4. DB reported stronger-than-anticipated risk-weighted asset reductions in the Capital Release Unit in the realm of 30% to 46 billion Euro at year-end 2019. This unit was created at the start of the third quarter of 2019.
5. Reaffirmed commitment to keeping their core Tier one ratio above 12.5% at all times.

Deutsche Bank is an example of a European bank which faced strong pressures from a cost perspective meanwhile remained committed to maintaining a strong Common equity Tier 1 (CET1) ratio of above 13%. As DB remains in the limelight, this commitment continues to provide a positive momentum for the European banking sector. More specifically selecting this asset class which has experienced more rating upgrades than downgrades by S&P in recent years but obtaining a yield pick-up by going down within the bank's capital structure to enhance yield has been gaining investor attention. Additional tier 1 capital (AT1's) for example sit below subordinated debt within the bank's capital structure and offer a

yield pick-up over the bank's more senior debt. AT1's are considered hybrid instruments with embedded contingencies and as such provide investors will greater yield to compensate for the additional risks. AT1s have an embedded trigger which, if triggered, can be converted to equity or written-down. The triggers are generally associated with a CET1 ratio of 7% for high-trigger Contingent Convertible Bonds (CoCos) and 5.125% for low-trigger CoCos. As an overview, if we take a snapshot of the maximum trigger levels of AT1s issued by large European banks and their respective CET1 ratios, we currently note large capital buffers from the maximum trigger levels of their AT1's within their balance sheet. AT1s were one of the top performing asset classes within fixed income in 2019 and continue to provide an attractive yield relative to other risk assets.

In the case of DB, they have AT1 CoCos bonds approaching their first call on 30 April of this year which will certainly continue to draw investor attention as to whether they will call the outstanding bonds or extend their maturity date. Interestingly, DB has issued \$1bn of new AT1 CoCos this year suggesting confidence in their long-term performance objectives and expectations that investors are willing to buy this riskier debt from the issuer.

Figure 1: Top 10 AT1 CoCo issuers CET1 ratios and AT1 CoCo Issuers CET1 ratio breakdown

Source: WisdomTree, Markit, Bloomberg. Data as of 31 December 2019. Large European bank issuers is based on the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. Maximum trigger level is represented by the maximum trigger observed across all CoCo issues of a given issuer. The CET1 ratio is the Common Equity Tier 1 Capital ratio.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

¹Source: **Deutsche Bank AG (NYSE:DB)**, Q4 2019 Analyst Conference Call, 30 January 2020 transcripts.

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