Fiscal Competition & Economic Freedom

November 2015

Financial & Fiscal Features Newsletter

INSTITUTE FOR RESEARCH IN ECONOMIC AND FISCAL ISSUES

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US regulations blamed for banks turning away deposits

by Gordon Kerr and John Butler, with Enrico Colombatto

Will this add further impetus to non-banking deposit and payment businesses?

In our last Newsletter, we argued that central banks were warming to the notion of negative interest rates, and even considering the abolition of physical cash. In the past two weeks we have learned that many US banks have been aggressively persuading customers to withdraw their cash deposits, some of them by imposing charges. JP Morgan is reportedly "pleased" to have reduced its deposits by $150 bn this year alone.

Ostensibly this is because of new Liquidity Coverage Ratio rules which have recently been implemented, which are designed to ensure that banks are able to cover sudden

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Even More Bad news from Deutsche Bank. Can the Bank be Turned Around?

by Gordon Kerr and John Butler, with Enrico Colombatto

With the notable exception of HSBC, October was a month of bad news for banks. HSBC announced a strong increase in profits, but UBS reduced its profit target. Standard Chartered announced plans to raise $5 billion new capital and cut jobs. Deutsche Bank stunned markets with a Q3 loss of €6 billion, €1.2 billion of which were attributed to litigation charges.

DB's new CEO, John Cryan, won plaudits for his radical turnaround plans. A quarter of the staff will be laid off. Postbank, the retail business will be sold, and the bank will concentrate on investment banking and wealth management, which will undergo radical change. Cryan also criticised outdated internal systems and slow internal procedures.

Investment banking is to be reduced and clearly split between sales/trading and corporate finance. DB will exit ten countries and reduce its investment banking customer base by 50%. These changes, Cryan hopes, will boost core "Tier 1" equity to 12.5% (above the regulatory minimum of 11.5%) and reduce leverage to a mere 20 times equity, both by 2018.

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CENTRAL BANKS

(cont'd) ... Banks turning away depositors

outflows of deposits. The rules oblige banks to categorise depositors in a manner designed to enable the estimation of how "hot" the cash is, and then compel the banks to reinvest such cash in 'highly liquid' assets such as central bank reserves and government bonds. So, for example, some hedge funds are regarded as so prone to sudden withdrawals of liquidity that their banks must put all of their deposits into these highly liquid investments.

This news is important on three levels, since it evidences:

How to read US banks' lack of interest in taking deposits:

1. More micro-management of banks by regulators.
2. The reluctance of investors and depositors to take risk exposure to the US economy: domestic deposits at US banks totalled $10.5 trillion at the end of Q2, up 38% over the last five years. The hedge funds with these large cash deposits are macro funds betting on indices, not private equity funds looking for businesses to back.
3. Big US banks are no longer dependent on deposit funding at all. This point illustrates how zero to negative interest rates have managed to turn the logic and economy of savings and banking on its head. Savers used to seek safety in modest interest yielding bank accounts (say 5%), trusting their banks to deploy funds at superior returns by lending to sound businesses. Because banks needed to bridge the liability side shortfall between the sum of equity and deposits with market funding, depositors knew they could withdraw their funds if their bank got into difficulties because the cost of the bank's market debt would jump and get noticed. Today, however, depositors no longer know whether their banks are solvent, since they can no longer rely on the signals received from the market, i.e. higher interest rates charged on their banks' liabilities.

The news that banks are happily turning away depositors hardly reassures large holders of cash who are now exposed to being bailed in should their bank fail. This simply encourages the further growth of shadow banking. One effect could be that if deposits trend away from banks, political and public pressure to bail out banks in the future will abate; they will be less able to argue that they are critical to the liquidity lifeblood of national economies, and the Too Big To Fail problem might start to recede.

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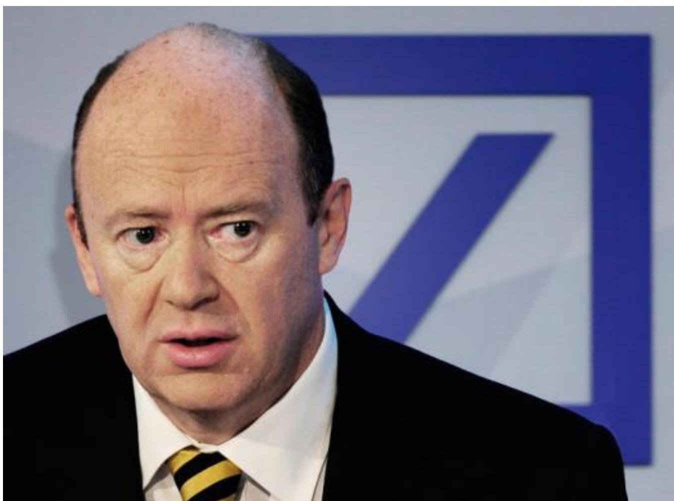
(cont'd) Bad news from Deutsche Bank...

FINANCIAL MARKETS



Cryan could be described as optimistic to think that investment banking can be turned around in three years given that the macro environment remains rather hostile. Specifically, low/negative interest rates seem to be here to stay, so volatilities are compressed; seemingly everything has now been securitised, corporate restructurings and associated fee income have already been extracted (the carcass has been picked over); risk premia have compressed (a general indicator that assets are fully valued); and all banks talk of the end of the long 'duration rally' – the multi-decade decline in bond yields which has inflated asset prices across the board. Banks of course make money when yields fall, so if this rally is indeed over, DB will face another headwind.

Further, it is noteworthy that the turnaround strategy is focused on investment banking at all. The trend in both the UK and Switzerland has been for bank senior managements to downplay investment banking when devising recovery strategies. The media and political 'take' on investment banking has been that it represents the risky side of banking, with mortgage lending being the safe side. However, so hard and aggressively has DB's previous management pushed into investment banking over 25 years that, without investment banking, it could be argued that DB might as well shut down. Cryan therefore had little choice but to retain investment banking in some slimmed down format and hope for the best.

> *Trend has been for senior managements to downplay investment banking when devising recovery strategies. However, so hard and aggressively has DB's previous management pushed into investment banking over 25 years that, without investment banking, it could be argued that DB might as well shut down.*

Is Cryan ready for a fresh start with the crew he needs? In our February Newsletter we cited Co-CEO Anshu Jain as praising new regulations for helping to clean up bad banking practices. German media remained unconvinced. Respected TV channel ZDF aired a withering exposé in May "Der Fall Deutsche Bank" in which it quoted multiple reputable sources who had voiced their concerns about manipulation of Libor, Euribor,

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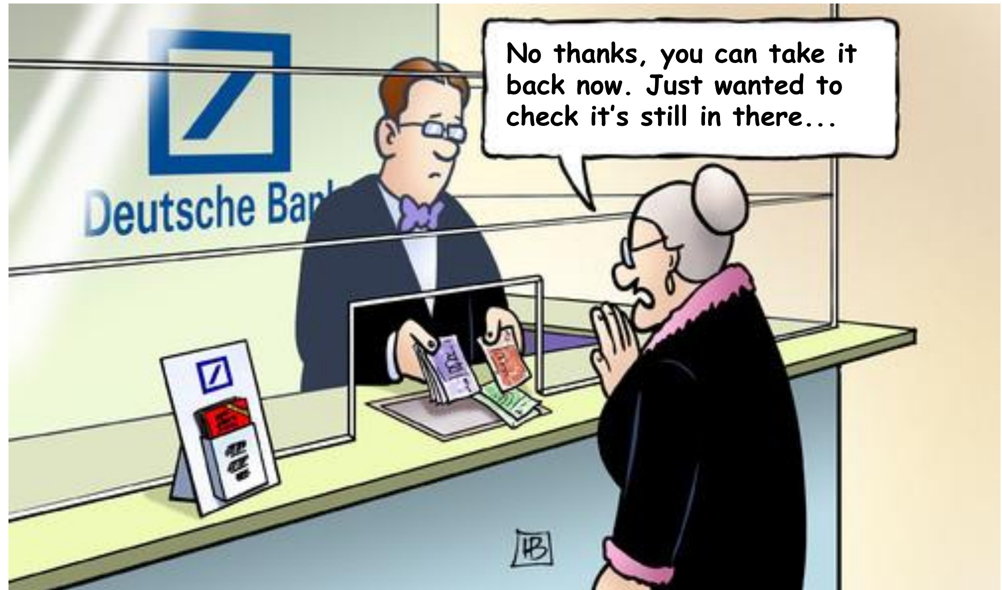
(cont'd) Bad news from Deutsche Bank

gold and metal price fixings long before regulators showed any interest. Over these years the new and hungry staff took advantage of the scale of the total assets of the Bank to place large and risky financial bets. A culture of greed and almost unbridled risk had set in.

In June 2015, DB was fined $2.5 bilion by the UK's Bank of England division investigating Libor fixing. A component of the fine was to punish the bank for repeatedly misleading the regulator during the investigation.

Over these years the new and hungry staff took advantage of the scale of the total assets of the Bank to place large and risky financial bets. A culture of greed and almost unbridled risk had set in. .

The June and October events have left these German media feeling vindicated. Mr Cryan's speech implies that all of the scandals have now come to light, but we doubt this, for two reasons:



Source: von Harm, harmbengen.de

Two reasons why it is difficult to believe that all Deutsche Bank's scandals have come to light:

The first reason is the snail's pace of regulatory investigations of major scandals. Libor fixing was, according to the settlement documents, well established in 2005, but it was not until July 2012 that the scandal broke with the resignation of top Barclays bankers. Also in the past month, as a consequence of Milanese prosecutors' probes into off balance sheet derivatives between the bailed-out Banca Monte dei Paschi di Siena and Nomura, the Italian regulator Consob is mulling whether to demand that MPS restates its accounts. The trades concerned were very similar to ones executed with DB.

The second reason is the assumption of "normality" which underlies the thinking behind continuing attempts to support struggling large banks. Although the numbers headlined in reports of fines and civil lawsuits sound large, the media shows little interest in the level of previously reported bank profits attributed to all these improper activities. It may the case that, so great was the contribution to prior profits and capital of improper transactions, that once properly cleansed of its bad businesses and stripped of retail, DB will be left with a barely profitable minor role in financial services. Politicians and regulators know this. If Germany's leaders want to continue to dictate other geopolitical events in Europe, it may be more convenient for them to maintain the line that with a tweak and a nudge, DB can be restored to its pre-eminent role (according to Der Spiegel) as the "Absolute Symbol of the German Economy".

So great was perhaps the contribution to prior profits and capital of improper transactions, that once properly cleansed of its bad businesses and stripped of retail, DB will be left with a barely profitable minor role in financial services.

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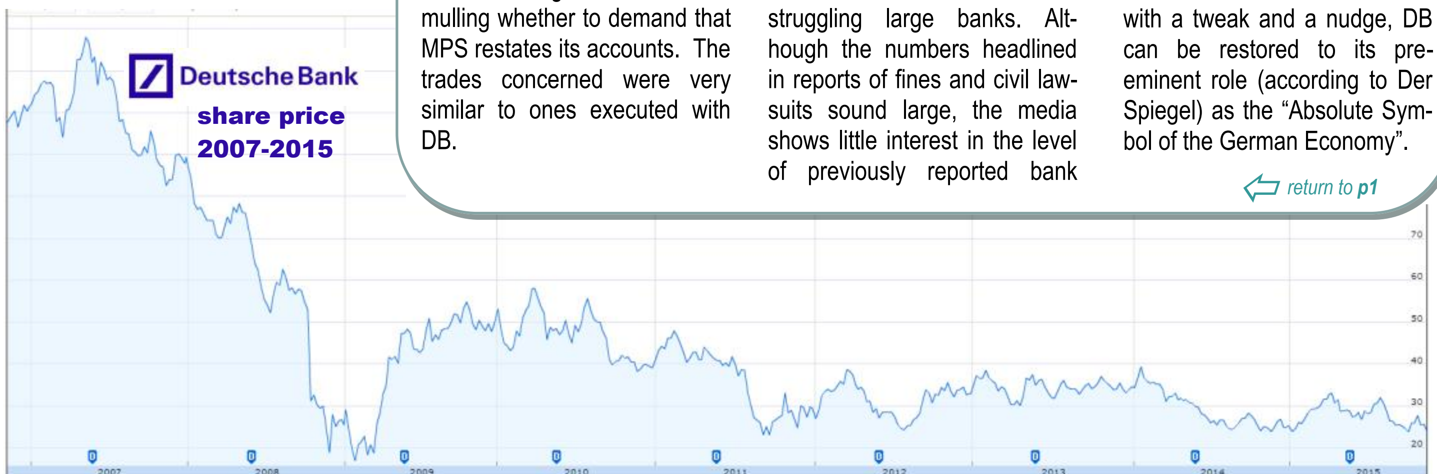

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