Deutsche Bank, the future of CoCos and US Regional banks

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In this note, we address the following topics:

- **Does the collapse of Credit Suisse's AT1 CoCos cast a shadow over the whole asset class?**
- **Will Deutsche Bank be the next domino to fall?**
- **How can the situation of US regional banks be resolved?**

1/ Have AT1 CoCos become "uninvestable"?

Following the collapse of CHF15.8bn of AT1 CoCos from Credit Suisse on Sunday 19th, March 2023, which represented c. 6.2% of the universe as at the end of 2022 (ICE BofaML CoCo index), several voices were quick to claim that AT1 CoCos were "dead" and that the segment had become "uninvestable".

a) The breach of "creditor hierarchy" could not have happened in Europe or in the United Kingdom.

The handling of Credit Suisse's takeover by UBS was particularly messy, as FINMA and the Swiss government had to change the law during the weekend in order for AT1 CoCos to be permanently written-down to zero without having to put first equity down to zero as well. This was a breach in what we call "creditor hierarchy", and was used as an argument that AT1 CoCo bond prospectuses or regulations could not be relied upon.

The ECB's regulatory arm, along with the Bank of England, as well as Singaporean, Canadian and Hong-Kong regulators each published statements reminding investors that they would have handled a similar case differently. The ECB explicitly stated that "common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier 1 be required to be written down. This approach has been consistently applied in past cases and will continue to guide the actions of the SRB and ECB banking supervision in crisis interventions. Additional Tier 1 is and will remain an important component of the capital structure of European banks."

b) AT1 CoCos are still necessary for banks.

AT1 capital is a necessary layer of regulatory capital for banks from all over the world. In Europe & in the UK, AT1 capital forms a stack that usually has to stand between 1.5% to 2.5% of a bank's risk-weighted assets.

Should banks be required by regulators of forced by investors to forego this capital stack, then, they would have to replace it with common equity, whose cost of capital is currently estimated at c. 15-16%. This would not be an efficient, nor a cost effective, replacement.

The AT1 CoCo format might evolve in the future, as the "CoCo" layer of complexity is made redundant by the fact that authorities can declare a bank as "non-viable" in order to trigger either the write-down of these instruments or their theoretical conversion to equity. We had written about this in April 2022 ("Does the ECB want to end CoCos?").

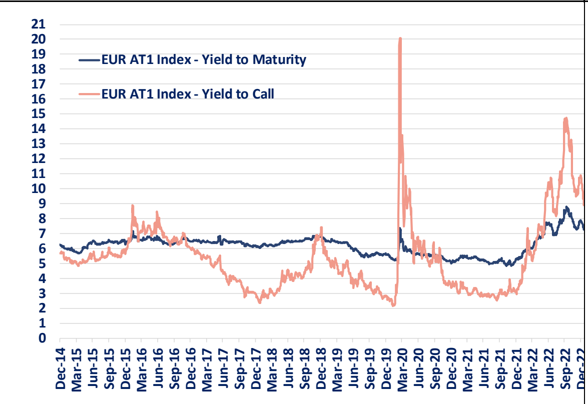
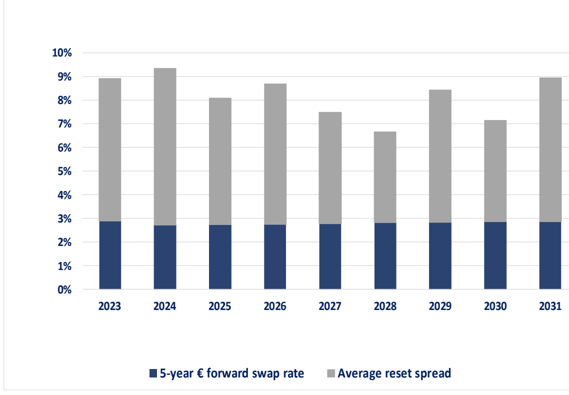
c) AT1 CoCo investors will not disappear.

"Investors will never come back to the asset class or this issuer after such an event!" We have heard this several times on bond markets: after Greece's debt restructuring in 2012, after the unequal treatment of bondholders from Banco Espirito Santo in 2015, after the nationalization of Banca Monte dei Paschi di Siena in 2016…

Yes, the collapse of Credit Suisse's AT1s is significant for the AT1 market, but we do not really see why investors would be willing to leave altogether the space on AT1s from other banks, whose fundamentals were nowhere near those of Credit Suisse. AT1 buyers are (or at least are supposed to be) aware that these instruments can jump to default with no hope for recovery if the issuing bank is regarded as no longer viable. This story is a reminder that defaults rarely happen, but when they do, they come in with a bang. Again, Banco Popular Español was a similar case in 2017 and was eventually seen as idiosyncratic, while on a much smaller scale.

Yields on AT1s have exploded, as most bonds now trade below par and are no longer priced to a call basis. The average Yield-to-call of €AT1s currently stands at 16.3%, thus pricing in a wide convexity against an average 8.6% yield-to-maturity (index as at 24/03/23). **This type of yield can, and does, and will continue to attract investors**. Even if one assumes that no bond will ever be called because no bank can issue new bonds anymore, reset coupons would still look quite decent on average (see chart below on the right) and may attract investors as well. While some investors may leave the space for a while or permanently, **we do not see the risk of a shrinking investor base as a danger for the asset class.** One can remember that CoCos were not as largely traded a few years ago as nowadays, but this has never prevented them from returning decent performances across time.

Call assumptions have logically retreated to a large extent, and Deutsche Pfandbriefbank has announced a few days ago that it would not call its sole AT1 bond callable in April 2023. Several more non-calls are to be expected in our opinion, as was the case in 2020 during the peak of the Covid-19 market stress or in late 2022. **These events have grown more common within the space and are not disruptive in themselves,** since holders are repricing bonds every day depending on what they assume to be their call probability.

<table>
<tr><td>Average Yield-to-call and average Yield-to-maturity of €AT1s (in %)</td><td>Theoretical average reset coupon for €AT1 CoCos in the event of a non-call by year of first call date (in %)</td></tr>
<tr><td>
</td><td>
</td></tr>
<tr><td>Source: Bloomberg, data as at 24/03/2023</td><td>Source: Bloomberg, data as at 24/03/2023</td></tr>
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2/ Will Deutsche Bank be the next domino to fall?

No, not at all, in our opinion.

a) A panic move for a bank that still holds a bad reputation.

The price action that we witnessed on Deutsche Bank's share price, CDS contracts and bonds were divorced from an actual catalyst. There was absolutely no news about it, and it seems like market participants and commentators were trying to rationalize the price action as it unfolded. **Why was Deutsche Bank at the forefront of price action on Thursday and Friday? Because of panic, and because of the stigma that its name still holds as of today**.

Its fundamental situation is, however, nowhere near that of Credit Suisse, that had suffered from a CHF7.3bn net loss in 2022 and had lost around a third of its investor base in Q4 22, while announcing that they would be expecting another significant net loss for 2023. On the other hand, Deutsche Bank announced a full year record profit of €5.7bn, the highest mark since 2007, and sell-side analysts are still expecting very good profits for the German bank in 2023 (Citi's equity analysts expect it to record a €6.5bn pre-tax profit in 2023).

Deutsche Bank is not the bank it used to be. Yet, it usually remains traded as a "high beta" issuer by bond investors. This is understandable, as it is a global systemic bank with a troubled past, especially when the bank was trading at distressed levels back in early 2016. Since then, it has successfully achieved a significant restructuring of its Corporate and Investment Bank and has downsized its off-balance sheet exposures, while solving its significant litigation issues and restoring its capital and profitability metrics.

It can be pointed out that the bank has some exposure to commercial real estate (CRE), but we do not view it as particularly elevated or worrisome. Its CRE portfolio amounted to €33bn at end-2022, or 7% of the bank's total loan book. 51% of CRE exposures are in US, 36% in Europe and 13% in Asia. Weighted average Loan-to-Value is around 61% in the Investment Bank and 53% in the Corporate Bank.

b) Could that panic be self-fulfilling and trigger a liquidity crisis for Deutsche Bank or other European banks?

We don't think so. We acknowledge that deposit velocity has increased tremendously with the advent of mobile banking, but we hardly see any reason why Deutsche Bank or other European banks would suffer from a liquidity crisis. Social media and some newspapers have been aflame with cries of an imminent collapse of the banking system by compromised actors, but this is not real life. **Liquidity crises do not hit banks without a true cause for it. SVB and Credit Suisse were very different one from another, but each had its own problems, which were visible on their balance sheets and P&Ls.**

For a bank to collapse, the recipe usually needs at least two of these three ingredients: (i) depositors lacking trust in the bank and leaving it, (ii) no longer having any access to interbank markets, (iii) being embroiled in significant controversies and financial scandals with heightened regulatory scrutiny. We do not see any sign of such things for European banks at the moment.

This is not the 2008 playbook; this is actually the 2011 one. Do you remember August 2011? British newspaper Daily Mail had published an article which stated that Société Générale was in a "perilous" state and on the "brink of disaster". Headlines and rumours were hitting the screens during several weeks, with some even stating that the bank would soon be nationalized. And it was not the only one to be hit by headlines and extreme market moves. Yet, claims without rational and fundamental support end up lacking substance and vaporize after a few months.

We are not saying that volatility should retreat soon and that bonds will rally, but that fundamentals usually end up winning the argument in the end. Three US banks and one Swiss bank have "collapsed" in two weeks, and some other may fall in the US in our opinion, but it does not imply that all apples are rotten, and especially not in Europe.

Yet, and it is important to stress this once again, volatility should continue to affect bond markets for the time being, and what happened on Friday is a stark reminder of this.

3/ The market panic was induced by the troubles of US regional banks, in our opinion

a) A crisis of confidence and depositor flights

The true reason behind Friday's "panic" on bank stocks and bonds lies, in our opinion, in the troubles that have yet to abate in the US regional banking system. We have already written about the failure of SVB, Signature Bank and Silvergate two weeks ago and how it has spread to other regional banks, such as First Republic Bank, Pacwest Bancorp and others.

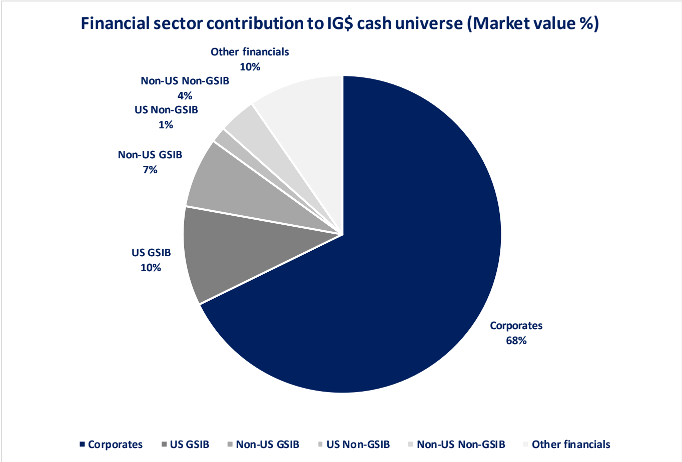
Recent regulatory and private actions have failed to restore confidence. The FDIC receivership of SVB and Signature Bank with a full guarantee of ALL deposits (even those not insured by the FDIC), the Fed's new Bank Term Funding Program, the injection of $30bn of deposits by a consortium of big US banks in First Republic Bank seem to fail to fully convince depositors that they can trust their smaller regional institutions.

The extent of outflows is impossible to determine, but it seems obvious than the constant stream of worrisome headlines cannot help the sentiment of retail depositors and professional investors. The increased use of liquidity facilities from the Fed these last two weeks has been the focus of market watchers on Thursday evening, while Mrs Yellen stated that they "have used important tools to act quickly to prevent contagion. And they are tools we could use again. The strong actions we have taken ensure that Americans' deposits are safe. Certainly, we would be prepared to take additional actions if warranted." These last words are very important. Now the question is: how big may it be? And how will it look?

As we argued above, deposit velocity has increased tremendously, and US depositors have been taking their money off their banks to invest in Treasury money market funds, which provide them with higher yields. It is impossible to assess the reaction function of smaller banks to retain deposits by providing higher yields, at the detriment of their own net interest margins. It seems though that they may not all have what it takes to compete in such an environment.

US regional banks do not really have a material weight on bond markets (only 1.6% of the $ Investment Grade market, see chart below), **but they certainly are very important for the US economy**, as we explained in our webinar. And, as such, their situation needs to be properly addressed and resolved to instill some sense of confidence into financial markets.

Financial sector contribution to the $ Investment Grade credit market



Note: GSIB = Global Systematically Important Bank
Sources: Bank of America C0A0 Index using March 2023 universe, La Française AM.

b) How to restore confidence?

The liquidity crisis of US regional banks cannot end without ensuring that smaller banks are being properly managed. Excessive deregulation[1] and insufficient supervision in the US led to the demise of SVB and Signature Bank, which highlighted the broader issues among regional banks and – in turn – led to the present round of financial market stress. As we explained in our notes and webinar: what level of trust can you give to a system where banks below $250bn of assets can manage their balance sheet with what seems to be a complete lack of incompetence (SVB barely had any interest rate hedging policy during 2022 and spent most of the year without a Chief Risk Officer!) without triggering any regulatory alerts?

What do we need to calm down the current liquidity crisis of US regional banks?

- More regulation and scrutiny: all banks over $50bn of assets should become subject to liquidity ratios, stress tests and TLAC (Total Loss Absorbing Capacity) rules.

- More consolidation: either via private takeovers by bigger banks of via FDIC receivership;

- Potentially more firepower by the Fed and the government: a full FDIC guarantee of all deposits looks difficult to achieve on a broad basis but could be a good solution, support for CRE assets (via agencies or the Fed?) …

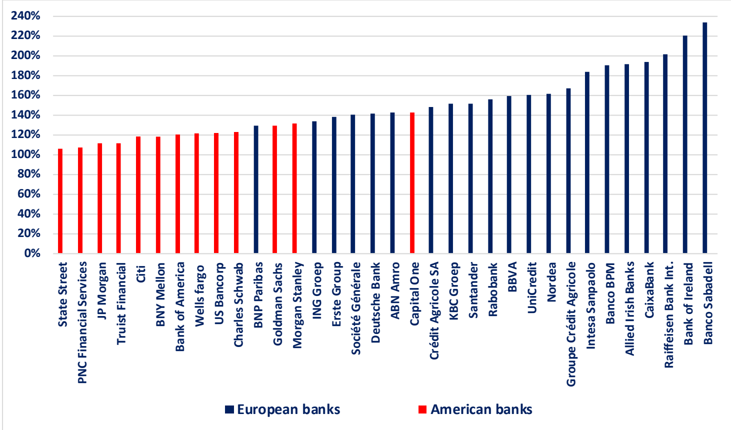
- US big banks to the rescue: more global support than just injecting deposits into FRC. As a reminder, we view the top US banks as beneficiaries from the current crisis, as they should be gaining deposits from this "flight to quality" of money flows.

On a longer-term basis, we do think that a review of Basel III liquidity ratios should also be on the cards, as the Liquidity Coverage Ratio can fail to reflect the velocity of deposit outflows. It is also worth highlighting that among c. 5,000 US credit institutions, only 14 must publish/abide by a Liquidity Coverage Ratio. Meanwhile, virtually all European banks must comply with this liquidity standard...

It seems like, for once, US regulators may want to follow the path of Europeans by holding their banking system to the same standards as ours. It serves to show that bank deregulation never is, and never will be a good thing. Bank bondholders require stability, that can only be achieved by up-to-date regulatory standards (that is necessary for US banks) and precise resolution frameworks (that is necessary for Swiss banks).

[1] In 2018, the Trump administration raised the threshold for liquidity requirements and full Fed supervision of banks to $250bn in assets, from the $50bn established under Dodd-Frank in 2010.

Liquidity Coverage Ratios for a selection of US and European banks



Sources: companies, Bloomberg, La Française AM. Latest data published by issuers.

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