

Deutsche Bank's roller coaster on the stock market

Sebastian Plóciennik

On 24 March shares in Deutsche Bank (DB), one of Europe's largest credit institutions, plunged 14%. The flight by investors sparked speculation about whether the German bank was still on a stable footing, or whether it was in danger of going bankrupt, as Silicon Valley Bank in the US and Credit Suisse in Switzerland recently did. Although Deutsche Bank's share price rose again on 27 March, calming the markets, questions are still being asked as to whether its problems should be seen as a harbinger of a more serious crisis in the EU banking sector.

The current financial record of the bank hardly explains this volatility: in 2022 DB posted its largest profit in 15 years: €5.5 billion, which marked the success of the strategies its directors adopted in recent years to ensure its financial recovery. In addition, the bank is relatively well protected against the bond risks and interest rate fluctuations that hit Silicon Valley Bank. Nor are there any clear threats to its liquidity: the financial instruments it holds provide a sufficient reserve in case of a bank run. Also, its large exposure (up to \$17 billion) to the stagnant US commercial real estate market does not pose an undue risk to DB, thanks to its solid collateral.

Commentary

- The fluctuation in Deutsche Bank's share price demonstrates the great nervousness prevailing in the financial markets. Investors are still estimating the risks of Credit Suisse's collapse to the European banking system and checking its weaknesses. The mood is not helped by the confusion over deposit protection in the US, which could lead to more bankruptcies in the market there. Fears are growing of a domino effect that could also reach the European Union's banking sector through international financial ties.
- The most convincing explanation for DB's price wobble links the bank's listing to the CDS (credit default swap) market; these are financial instruments that offer guarantees against the risk of bank failures. Interest in these instruments increased among investors after the bankruptcies of Silicon Valley Bank and Credit Suisse. In the case of Deutsche Bank, the cost of CDS rose from 1.42% to more than 2% of the value of investments (such as shareholdings) in two days. However, the derivatives became more expensive for other banks, including those in France and the UK, and that also triggered declines in their share prices.
- The volatility on the stock markets is also the result of a fundamental change in investors' attitudes toward the effects of inflation and rising interest rates on the financial sector. Until recently, the prevailing view was that banks would be the

beneficiaries of a tighter monetary policy stance, as there was now an opportunity to increase profits on lending after years of zero-interest rates. Over time, however, the risks to this approach have also become apparent. Banks have been buying a lot of low-interest government bonds in recent years – also because they are preferentially treated by the regulations on minimum capital requirements for financial institutions. The rise in interest rates caused the price of these bonds to start falling, and that affected the balance sheets of many banks and provoking doubts as to their liquidity.

- In the case of Deutsche Bank, the question remains as to why exactly its stock price has suffered the most. Some clues lie in the relatively low confidence it enjoys among investors, as well as the incriminating burden of scandals, legal violations and lawsuits trailing it. DB's directors have been accused in the past of spying on the bank's critics, manipulating interest rates, circumventing US sanctions, helping companies corrupt officials, and laundering money. For some investors, Deutsche Bank has now become an institution of limited trust, especially in volatile times. They may therefore feel that the data in the bank's balance sheet from the end of 2022 should be treated with caution, as it does not contain the latest information on the extent to which it has been exposed to risky financial instruments. According to another interpretation, the scales were tipped in Deutsche Bank's disfavour by the announcement that it was redeeming bonds which had originally been scheduled to expire in 2028. This move was probably supposed to signal the bank's financial strength, but paradoxically it only generated anxiety in the investors, who began to wonder whether the management was trying in this way to divert attention from the problems on the balance sheets.
- Deutsche Bank's plummeting stock price also worries politicians. Chancellor Olaf Scholz insisted that the bank is in good financial shape and "there is no reason to be alarmed". The European Central Bank (ECB)'s president Christine Lagarde also argued that the European banking sector remains stable. These politicians have based their positions on their confidence in the institutions of banking integration which have been created in the last decade in the eurozone: Deutsche Bank is subject to the ECB's financial supervision (the Single Supervisory Mechanism, SSM) and mechanism for resolution (the Single Resolution Mechanism SRM), which apply directly to over a hundred of Europe's largest banks. If there is a risk of failure, the above institutions would implement a resolution plan which could result in the use of the bank's reserves and capital buffers, a merger with another large European bank, or financial support from a special banking fund (the Single Resolution Fund, SRF), as well as indirectly from the European Stability Mechanism (ESM). Aid from the German state is also an option being kept in reserve.
- Extensive barrages against the spread of the banking crisis such as these may calm the situation as far as the market is concerned, but politically they may not necessarily be enough. Deutsche Bank's problems coincided with a meeting of the European Council and encouraged representatives of its member states to assess the EU's existing banking regulations. Southern countries have long pointed out that the security system lacks an equivalent of the European Deposit Insurance Scheme (EDIS), which in tense situations would prevent the flight of deposits from (for example) Greek to German banks. The Estonian prime minister Kaja Kallas and the head of Eurogroup Paschal Donohoe also called for a joint effort to complete this missing pillar of the banking union.

- Until a few months ago, it seemed that supporters of the EDIS were doomed to failure. The 'Donohoe plan' presented to the member states, which was based on the reinsurance of national funds and a gradual transition to a common financial pool, failed to gain support. Germany is the plan's staunchest opponent: Berlin is under serious pressure from the cooperative and public banking sector, which has criticised the idea of a common system for years. Berlin also fears turning the EDIS into a transfer mechanism, in which 'strong' German banks finance 'weak' ones from southern countries. Germany has made its agreement to move forward with integration in this regard contingent on southern banks reducing the level of government bonds on their balance sheets and tightening capital requirements.
- The problem of finalising the 'banking union' widens the pool of difficult topics for the EU around which negotiations are taking place and which will be resolved this year. Talks are currently underway on how to reform the fiscal discipline rules of the Stability and Growth Pact (SGP), and on the creation of a 'sovereignty fund' for increased investment in new technologies and the energy transition. The EDIS could become an additional bargaining chip in these negotiations. In this sense, the collapse of Deutsche Bank's shares was a political gift to the countries of the south, which for years have been trying to convince Germany that completing the 'banking union' and getting the security system up and running is also in the interest of Germany's economy.