THE AUSTRALIAN

Deutsche Bank turmoil raises questions of Australian regulators

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Although it is unlikely to precipitate a broader crisis, the turmoil affecting Deutsche Bank — the biggest bank in Europe's largest economy — highlights the risks still confronting the global financial system. And as markets struggle with those risks, there are serious questions to be asked about the decisions Australian regulators are taking to ensure the stability of our banking sector.

Deutsche Bank's woes, which drove its share price to a 33-year low, were triggered by reports the US government had demanded $US18 billion ($23.5bn) to settle claims of financial misconduct before the global financial crisis. Fears that the payment would reduce the bank's capital below the levels regulators require, perhaps forcing it to sell parts of its business, caused investors to dump its shares, whose value had already been hammered by poor earnings prospects.

That unleashed a downward spiral. Deutsche Bank's falling market valuation meant it could not readily raise additional capital, should it be needed, all the more so as issuing new shares would further dilute its return on equity. As that fact sank in, several hedge funds — in a sequence eerily reminiscent of the death agony that gripped Lehman Brothers in September 2008 — withdrew their funds and tried to decrease their exposure to the bank's difficulties.

With Deutsche Bank heavily involved in trading complex financial derivatives, even a slight chance of those withdrawals escalating cast a shadow over its ability to back its trades. The risk, as those doubts spread, was that its counter-parties would rush to liquidate their positions, pushing the bank over the precipice. Given the scale of the bank's balance sheet — which, at €1.8 trillion ($2.6 trillion), is equivalent to 1½ times Australia's national income — the outcome would be devastating. Little wonder the International Monetary Fund warned in June that Deutsche Bank was "the most important net contributor to systemic risks" affecting global finance.

But the dangers of the bank collapsing seem overstated. While $US18bn is a large amount, Deutsche Bank sits on cash reserves that are nearly 20 times greater. And it is likely that the final settlement with the US authorities will be much smaller than the initial demand, limiting the bank's loss.

Moreover, though Deutsche Bank's earnings are below investor expectations, they scarcely threaten its viability, especially if the bank's travails force it to rethink its strategy. That doesn't mean, however, that the market's reaction has been mere sturm und drang. Rather, it reflects deeper concerns that are well founded.

Nearly a decade after the global financial crisis, world economic growth remains slow and patchy. Just as an already weak US recovery winds down, the eurozone is stuck in a rut, with data suggesting that despite negative interest rates and quantitative easing by the European Central Bank, inflation expectations are lower than they were four months ago. Compounding the gloom, Italy is headed for a major banking crisis, with its banks' valuation halving over the past year as non-performing loans have climbed to 15 per cent of bank assets.

With Italy's always fractious government consumed by a constitutional referendum in early December, elections looming in France and Germany, and the continuing fallout from Brexit, the eurozone has little ability to effect an orderly restructuring of Italy's banks, which would require closing those that are plainly not viable. Instead, the problems are left to fester, increasing the risk of a meltdown in the eurozone's third-largest economy.

To make matters worse, the reverberations of that meltdown would hit a global banking system that is in anything but glowing health. Indeed, after examining a broad range of indicators, Harvard's Larry Summers and Natasha Sarin conclude in a recent paper that there is "little support for the view that major (financial) institutions are significantly safer than they were before the (global financial) crisis and some support for the notion that risks have actually increased".

Investors are therefore not irrational in being on edge. And given the costs major banking crises inflict, policymakers should be wary too.

That makes it disappointing so little attention is paid to the decisions Australia's banking regulators are taking. With virtually no public discussion, the Reserve Bank's committed liquidity facility is offering banks taxpayer-secured borrowing facilities at rates well below those the banks would pay for comparable quality liquidity from financial markets. Despite the myriad safeguards the RBA has in place, that invites banks to take on more risk than they should.

Even more surprisingly, in a barely noticed release last week, the Australian Prudential Regulation Authority reversed its position and decided to allow banks to treat as very low risk assets they had themselves securitised, effectively permitting the banks to guarantee the quality of their own loans. That decision, at odds with international standards, makes it materially easier for banks to meet regulatory obligations and reduces the pressure they face to replace risky short-term borrowing from overseas with locally sourced deposits.

None of that is to suggest that Australian banks are on the brink of failure. On the contrary, while Summers and Sarin find that our banks are riskier now than they were before the financial crisis, they also find them less fragile than most of their foreign rivals.

But though the RBA and APRA are highly competent regulators, the financial crisis shows how readily regulatory errors can lead to costly disasters. And experience also shows that banking systems are inherently precarious — a word that in common usage connotes risk but etymologically means “contingent on the answer to prayer”.

With Europe’s banking pains far from over, relying on divine intercession is hardly a sensible way of securing shelter from the storm.