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Deutsche Bank and its Strategy Change: What it Means for the German Financial System*

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Abstract

In early July 2019, Christian Sewing, the CEO of Deutsche Bank, proclaimed a fundamental shift of the bank's strategy after finally obtaining the approval of the Supervisory Board, which the management seems to have requested for quite some time. The essential point of the reorientation is a deep cut into the bank's investment banking activities. At the same time, those parts of the bank's activity portfolio that had been the mainstay of Deutsche Bank's business 20 to 25 years ago, in particular lending to large and mid-sized German and European corporate clients, shall be strengthened in spite of a simultaneous reduction of the bank's staff by 18,000 FTEs over the next three years.

The bank's CEO, who has only been in office since about one year, was reported to have called this shift of strategy a "return to the roots of Deutsche Bank" at the press conference at which it was announced, without, however, making it clear to which roots he was referring: those of some 40 years ago, when Deutsche Bank was essentially a Germany-focused commercial bank, or even those from the late 19th century, when the bank had been founded with the mission to become an international bank with a strong capital market-orientation. In any event, the press was impressed and keeps repeating these words, that deserve to be taken seriously and irrespective of their vagueness may be justified. If it were successfully implemented, this change of strategy would indeed be fundamental and imply undoing what Deutsche Bank's former management teams had aspired to do in the last 20 or 25 years.

The newly announced strategy shift raises two questions. Can it be successful, and what does it mean for the bank itself and its shareholders, for its staff and for its clients? And what does it imply for the German financial system? This note focuses on the latter question. What makes it interesting is the fact that the last fundamental change of Deutsche Bank's strategy of two decades ago, which aimed at transforming Deutsche Bank from a Germany-centered commercial bank into a leading international investment bank, had a profound – and in my view clearly negative - effect on the entire German financial system.

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[1] SAFE Policy Paper repräsentieren die persönlichen Ansichten der Autoren und nicht notwendigerweise die von SAFE oder seiner Mitarbeiter.

I. The former consistency of the German financial system

Until the last years of the 20th century, the German financial system had a very important property: It was consistent. A system is called consistent if its main elements are such that they fit together well. Or, in slightly more technical words, if the individual elements of the system take on values such that their respective strengths reinforce each other. The press was impressed and keeps repeating these words that their respective weaknesses mitigate each other. In the case of financial systems, the most important elements are the structure of the financial sector, the financing patterns of firms and the corporate governance regimes of large exchange-listed corporations. Consistency is important because a consistent financial system is stable and has positive effects on the entire economy.

As could be shown, shortly before the turn of the century, that is, 25 or 20 years ago,

- the big German commercial banks were the dominant power in the entire German financial sector and as such were able to keep competition from the organized capital markets as a source of funding for corporations at bay;
- large German corporations used mainly long-term bank loans provided by the big private commercial banks for financing their investments;
- corporations could rely on the support of their „house banks“ even in difficult situations, which enabled them to pursue long-term strategies;
- by law and in practice the governance of most German corporations – both in the financial and the non-financial sectors – and corporate policies were not shareholder- but stakeholder-oriented; and
- the big banks played the central coordinating role in the stakeholder-oriented corporate governance of Germany' large non-financial corporations and thereby could obtain the information and exert the influence that they needed to protect their massive credit exposures.

This was indeed a consistent system of complementary elements, and at least in this specific sense, it was a good financial system. Deutsche Bank was more than just one element of this system and more than merely one among several big banks. It was the central player in the system, the uncontested market leader among the banks and the trendsetter whose peers at that time, Dresdner Bank and Commerzbank, essentially imitated what Deutsche Bank was doing.

II. … and its demise 20 years ago

All of this changed around the year 2000. The composition of the group of the three big commercial banks changed when Dresdner Bank was acquired by the insurance giant Allianz. The traditional group of big banks cut back their corporate lending, withdrew from their former status of being the "house-banks" of large corporations and, most importantly, they relinquished their former active role in the governance of non-financial corporations. HVB and Postbank, which later joint the group called big banks in the official statistics of the Bundesbank, never even aspired to play a similar role to that of the "classical" triumvirate of big banks, Deutsche, Dresdner and Commerzbank. Large corporations reacted to the change of the banks' policies by turning to the capital market as a source of funding much more than they had done before, and under the resulting stronger pressure from the capital market, they switched to a more shareholder value-oriented policy.

Some of these changes made economic sense from the perspective of the respective actors. However, from an economic policy perspective, their most important consequence was that the German financial system lost its former consistency with all of its presumable benefits.

There were several factors that had induced these changes, some external and some internal to the financial system. Among the external ones were the usual suspects: globalization, European integration and advances in information and communication technology. By far the most important internal driver of change was the fundamental switch of strategy that Deutsche Bank initiated and implemented under its CEOs Rolf-E. Breuer and Josef Ackermann. With great determination, they undertook to transform the Germany-focused Deutsche Bank into an international investment bank. They rightly regarded the former roles of the bank as the main lender and "house-bank" of large corporations and the pivotal player in the old regime as incompatible with the new ambition of the bank to become an important investment bank. The two other traditional German big banks tried to essentially imitate the strategic turn of Deutsche Bank, though with less determination and limited (initial) success. Thus, the role that Deutsche Bank played in the transformation of the German financial system was in one sense equal to this bank's former role in the old German financial system: While it had formerly kept the system going Deutsche Bank now made the first move to do away with this system.

At first the strategy switch of 20 years ago appeared to be successful, Deutsche Bank was able to join the group of "bulge bracket" investment banks, it was called the bank of the year and was the largest bank of the world in terms of total assets in the early years after the turn of the century. However, as is well known, in a longer time perspective, also for Deutsche Bank the change of strategy did not lead to the aspired success. In fact, the decline started after the financial crisis had wrought havoc for the entire banking world.

Looking back at the parallel developments at Deutsche Bank and in the entire German financial system that started in the late 1990s raises two questions: Is the strategy switch that Mr. Sewing now proclaimed and allegedly called a return „to the roots of Deutsche Bank „at all possible and promising; and might it even contribute to regaining the former consistency of the German financial system?

III. Back to the roots of the Deutsche Bank of 1998

Whether the radical strategy change can put an end to the many years of decline of a bank that had for a long time been rightly regarded as a model of success and even lead to recovery is, of course, an open issue. Its success is in no way assured. Possibly, and hopefully, Deutsche Bank is still strong enough to make the turn-around a success. But it is also possible that the losses of the recent years, the loss of the bank's former reputation and of the trust of its clients, the tremendous cost of the restructuring and the frustration and demotivation of staff members at all levels weigh so heavily that failure is inevitable. However, in spite of all doubts: there is no sensible alternative to what Mr. Sewing and his team are now trying to do. The crucial issues are how the turn-around is implemented in detail, which parts of investment banking will be scrapped altogether and if and how the remaining parts can be made to generate synergies with the bank's main business of again serving German corporations and private clients. In any event, the planned switch of strategy would be a huge step "back to the roots of Deutsche Bank" as it was 25 years ago.

Six or seven years ago, after Josef Ackermann had left office, a similar change of strategy was already necessary. At the latest, the great financial crisis had made it sufficiently clear that the heydays of investment banking were over. The example of the equally radical strategic reorientation of the large Swiss banking group UBS, which discontinued most of its risk-prone investment banking activities, suggests that a similar strategy switch of Deutsche Bank would then also have been possible and probably also successful. Interestingly, the successful turn-around at UBS after a very serious crisis was initiated and implemented after former Bundesbank president Axel Weber had become the president of that bank. In the view of Ackermann, Axel Weber would have been his ideal successor as the CEO of Deutsche Bank. Unfortunately, he did not prevail in his conflict with the chairman of the supervisory board at that time. As is well known, instead of Axel Weber, Anju Jain, Deutsche Bank's highest-ranking investment banker, became one of the two new CEOs. This appointment was almost a guarantee that Deutsche Bank would not cut back investment banking in a big way, even though this would already have made perfect sense at that time.

III. Also back to the German financial system of 1998?

It would, of course, be a great loss for the German economy if the only remaining important German bank disappeared from the market, as already Dresdner Bank had done some time ago, as long as we do not yet have truly European banks. Especially in hard times, it is essential for the economy of any country to have a national bank with an international outreach on which firms can rely. But what would a successful turn-around of Deutsche Bank, which would reverse exactly those developments at this bank that had once lead to the loss of consistency of the entire German financial system, imply for this system? Could it help to restore the consistency of the system?

The decision of the top management of Deutsche Bank of 20 to 25 years ago to radically change the bank's strategy forced other players in the financial system and in the real sector of the German economy to react. It thereby led to profound effects on the entire financial system, and these effects would not be reversed by the mere fact that Deutsche Bank reversed its own course. Even if Deutsche Bank succeeded in leaving many segments of the investment banking market, its former "house bank" relationships with large corporations would not simply come back to life. It would evidently be impossible for Deutsche Bank to buy back its blocks of shares which had been essential for the functioning of the old system. It is more than questionable if other banks would again accept the role of Deutsche Bank as a market leader and a trendsetter. Large and mid-sized non-financial corporations cannot be expected to react with enthusiasm to a more generous offer of long term loans Deutsche Bank might now be inclined to make. In an equal sense, it is difficult to imagine that the trust of clients and other business partners would all of a sudden flourish again only because Deutsche Bank pulls out of several important areas of investment banking. Moreover, there are no reasons to expect that its envisioned strategy switch – even if it were implemented successfully - would make Deutsche Bank again become the leading force in the German financial sector, as it had once been, and again obtain a strong role in the governance of large non-financial corporations, Other players are not likely to give up the positional gains they made in the course of the last two decades.

All of this can be summed up by saying that what had changed since the turn of the century – with Deutsche Bank as the most influential change agent – is not reversible.

Even if the former paragon of German banking succeeded with its ambitious plan to turn around the bank – and in this sense go "back to its roots" - the former consistency of the German financial system could not be regained, and in this sense the "roots of Deutsche Bank" are no longer within reach. For the bank itself as an entity, its shareholders, its clients and its staff members the success of the top management's efforts to "go back to the roots" is certainly of great importance. However, for the quality of the German financial system – and more precisely: for its consistency as a determinant of quality – it is by now irrelevant.