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Deutsche Bank Payday Burgeons on Subprime Trading Bet (Update1)

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By Jacqueline Simmons and Elena Logutenkova



July 30 (Bloomberg) -- Deutsche Bank AG analyst [Eugene Xu](#) recognized a financial train wreck in the making two years ago when he predicted "quite probable" losses from the least creditworthy home loans in America's runaway property market.

Now Germany's largest bank is poised to reap a bonanza of at least \$270 million and as much as \$540 million from a strategy that enabled its traders to sell subprime mortgage loans with derivatives contracts that appreciated as the U.S. housing market suffered its worst slump in 16 years.

"It was definitely a good trade," said [Thomas Radinger](#), who helps manage about \$96 billion at Pioneer Investments in Munich and holds Deutsche Bank shares.

While mortgage-related losses staggered Zurich-based UBS AG and London-based HSBC Holdings Plc, Frankfurt-based Deutsche Bank may report Aug. 1 that second-quarter net income rose 19 percent, according to the median estimate of 19 analysts surveyed by Bloomberg. The fixed-income group, overseen by 44-year-old global markets chief [Anshu Jain](#), produced about 33 percent of the company's revenue in the quarter, analysts said.

"With the situation in the U.S. subprime market worsening, I can't imagine Deutsche Bank changing its position," said Radinger.

Mortgage defaults would surge as soon as price appreciation slowed, Xu wrote in September 2005. Since then, Deutsche Bank traders, led by [Greg Lippmann](#), sold ABX index contracts, providing 200 million euros (\$272 million) of revenue in the first quarter and possibly another 200 million euros in the past quarter, assuming the position wasn't changed, said [Kinner Lakhani](#), the top-rated banking analyst at ABN Amro Holding NV in London.

Subprime 'Contamination'

The ABX-HE-BBB- 06-1 index, tied to mortgage-backed bonds with the lowest investment-grade ratings, fell 17 percent last week, increasing this year's drop to more than 60 percent, according to London-based Markit Group Inc., administrator of the ABX indexes.

Jain, Lippmann and Xu declined to comment.

Trading profits may help [Deutsche Bank](#) overcome declines in fees from underwriting mortgage-backed securities and a potential revenue slide at the MortgageIT Holdings Inc. and Chapel Funding LLC units in the U.S., according to analysts. The bank has said it gets less than 2 percent of revenue from residential mortgage-backed securities.

After Deutsche Bank reports earnings, "the question will be more about whether there is contamination of subprime to other areas," said [Jean Sassus](#), a Paris-based analyst at Raymond James Financial Inc., who has a "fair value" rating on the company's stock.

Cracks in LBOs

Deutsche Bank was paid almost \$550 million of fees by leveraged buyout firms in the first half for advising and financing takeovers, data compiled by New York-based Freeman & Co. and Thomson Financial show. That may drop in the second half as LBO firms scale back their record pace of acquisitions.

Last week, Deutsche Bank was among banks forced to hold on to 5 billion pounds (\$10.1 billion) of loans for [Kohlberg Kravis Roberts & Co.](#)'s purchase of U.K.-based pharmacy chain Alliance Boots Plc as investors balk at riskier assets following losses in the U.S. subprime mortgage market.

Deutsche Bank's stock fell 5.8 percent last week on concern that debt market declines would hurt earnings in the second half of 2007. The company probably outperformed its European competitors in the second quarter, said [Andreas Weese](#), a Munich-based analyst at UniCredit SpA, who recommends investors "buy" Deutsche Bank shares.

Dillon Read

"Deutsche Bank was well prepared for the subprime crisis," Weese said. "Others clearly got caught on the wrong foot" of loans to people with bad credit records, he said.

UBS, Switzerland's biggest bank, may report Aug. 14 that [second-quarter net income](#) fell 7.5 percent, excluding a one-time gain of 2 billion Swiss francs (\$1.65 billion) from the sale of Julius Baer Holding AG shares, according to estimates by [Matthew Clark](#), a London-based analyst at Keefe, Bruyette & Woods Ltd.

Dillon Read Capital Management LLC, one of UBS's hedge-fund units, collapsed in May after more than \$120 million of losses from mortgage-related holdings. Dillon Read probably cost UBS another 150 million francs in the second quarter, said Clark, who has a "market perform" rating on UBS.

"We know UBS still had trading exposure to subprime at least at the start of May and they would have had difficulty unwinding those positions," Clark said. The debacle led to the ouster of [Peter Wuffli](#) as chief executive officer earlier this month.

Xu's Job Change

HSBC, Europe's largest bank by market value, reported today that first-half [net income](#) climbed 25 percent to \$10.9 billion, helped by asset sales in China and lower taxes. Costs for potential bad loans rose 63 percent to almost \$6.4 billion and pretax earnings in North America fell 35 percent to \$2.4 billion.

Shares of [Deutsche Bank](#) advanced 7.4 percent during the past 12 months, compared with the 1.6 percent drop of UBS and the 9.6 percent decline of HSBC.

Xu, who was born in Shanghai and has a doctorate in mathematics from the University of California in Los Angeles, analyzed U.S. mortgage lending practices in August 2005. He found that banks were lowering their prices and standards as competition for new clients increased. Lower-rated mortgage-backed bonds were "ripe for a correction," he wrote.

A year later, Xu moved to Lippmann's trading desk. Lippmann, 38, is Deutsche Bank's head of asset-backed securities trading in New York.

ABX Index

The traders started selling the ABX index contracts in late 2006 because they "felt that the U.S. mortgage market was probably overheating and would potentially soften," Deutsche Bank Chief Financial Officer [Anthony di Iorio](#) said in May.

Deutsche Bank was among the firms that helped create the ABX.HE index in January 2006. The credit-derivatives index provides mortgage-backed bondholders with insurance against defaults on U.S. home loans. Bondholders can use the index to hedge against losses spurred by an increase in mortgage defaults or to bet on the credit quality of the debt.

Derivatives are financial instruments derived from bonds, loans, stocks, currencies and commodities, or linked to specific events like changes in the weather or interest rates.

Jain, who started his career as a derivatives strategist at Merrill Lynch & Co. and was brought to Deutsche Bank by [Edson Mitchell](#) in 1995, said earlier this month that he doesn't expect widespread panic in the subprime market.

"Most of the participants in this market are real money investors who don't employ irresponsible leverage ratios," he told the Financial Times on July 12. Losses are concentrated in subprime loans made in 2006, he said.

Beating Goldman

Deutsche Bank was the seventh-ranked underwriter of "home-equity" securities last year, most of which were backed by subprime or second mortgages, according to industry newsletter Inside MBS & ABS in Bethesda, Maryland.

The debt trading unit, which Jain has overseen since 2001, hasn't recorded a year-over-year decline in revenue for 11 straight quarters. Deutsche Bank may surpass New York-based [Citigroup Inc.](#), the biggest U.S. bank, and New York-based Goldman Sachs Group Inc. as the world's biggest fixed-income trader, when it reports a 10 percent gain in second-quarter revenue to 2.7 billion euros, analysts estimate.

[Goldman](#), the biggest U.S. securities firm by market value, said last month that lower demand for mortgage-backed bonds caused the biggest quarterly drop in its fixed-income revenue in almost four years.

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