Deutsche Bank AG (DBK), adding assets as other lenders trim their balance sheets, leapfrogged France’s BNP Paribas SA (BNP) to reclaim the title of Europe’s largest bank.

Assets at the Frankfurt-based company rose 14 percent to 2.16 trillion euros ($2.88 trillion) in 2011, making it the largest publicly traded bank in Europe for the first time in five years, according to data compiled by Bloomberg.

Chief Executive Officer Josef Ackermann, who has called proposals to limit bank size “misguided,” will leave behind a balance sheet about 40 percent larger than in 2006, and more than 80 percent as big as Germany’s economy, when he steps down in May. The firm is the second-most leveraged and third-least capitalized of Europe’s 10 largest banks, even after Ackermann boosted reserves and trimmed dependence on borrowed money.

“Deutsche Bank has been pretty decidedly opposed to reducing its balance sheet,” said Lutz Roehmeyer, who helps manage about $15 billion at Landesbank Berlin Investment. “It’s understandable: The higher your leverage, the higher the returns when times are good. They want to cut as little as possible to keep doing as much business as possible.”

The higher leverage also makes Deutsche Bank’s earnings more volatile and dependent on market swings. When debt markets rallied in 2009, the bank posted a return on average equity of 14.6 percent. The following year, as Europe’s sovereign-debt crisis roiled investors, that measure of profitability fell to 5.5 percent. It stood at 8.2 percent last year.

**Price to Book**

Shares (DBK) trade at a price-to-book ratio of 0.65, implying that investors don’t believe the bank’s assets are worth as much as the company says. Deutsche Bank’s ratio is the seventh lowest among the 50 global banks with the closest market value, data compiled by Bloomberg show.

“There’s no doubt that leverage and lack of capital are impacting Deutsche Bank’s valuation,” said Christopher Wheeler, a London-based banking analyst at Mediobanca SpA, who has an underperform rating on the stock.

Still, shares have gained 37 percent since Dec. 21, when the European Central Bank made its first round of three-year loans to stave off a credit crunch, compared with a 20 percent gain on the Bloomberg Europe Banks and Financial Services Index.

The bank is able to maintain less capital than peers and borrow more to enhance returns because clients believe the German government would never let it fail, Roehmeyer said. That may be reflected in the company’s share-price performance and cost of funding, he said. Insuring against default on Deutsche Bank’s debt with credit-default swaps is less expensive than it is for any of the 10 biggest banks except HSBC Holdings Plc.
Ackermann, 64, has criticized proposals to shrink banks or split them up, saying risk isn’t related to size and that global banks are important to international trade and economic growth.

“It is not size as such that is the problem but the interconnectedness of banks,” Ackermann wrote in the Financial Times in July 2009, citing the collapse of New York-based Lehman Brothers Holdings Inc. and German property lender Hypo Real Estate Holding AG, which he said weren’t big.

Size can help firms win market share as clients will work with banks able to offer a broader array of services, said Andrew Lim, an analyst at Espirito Santo Investment Bank in London. Still, Lim cut his rating on Deutsche Bank to sell from neutral on Feb. 8 on concern that a lower level of capital would force the bank to forgo some trades, reducing profitability.

“You can be big, but you have to have the capital backing you up,” Lim said in an interview.

Those doubts may help explain why Deutsche Bank’s market value, at 36 billion euros, lags European competitors such as HSBC, Spain’s Banco Santander SA (SAN), BNP Paribas, Switzerland’s UBS AG (UBSN) and Royal Bank of Scotland Group Plc. (RBS)

Deutsche Bank has expanded in tandem with Germany’s economy, which grew in four of the last five years, posting its only decline in 2009 following the collapse of Lehman Brothers, data compiled by Bloomberg show. The bank’s loan book, which includes credit to companies and consumers, increased in each of those years save 2009, when it shrunk 3.7 percent, according to presentations published on the company’s website.

Increasing Assets

The bank increased assets even as the financial crisis that began in 2007 and accelerated in 2008 forced governments to rescue banks at taxpayer expense. While the firm navigated the credit crunch and Europe’s sovereign-debt crisis with smaller losses than many competitors and no direct state aid, its size worries some policy makers.

“The truth of the matter is we haven’t solved the too-big- to-fail challenge in this country,” Ralph Brinkhaus, a member of German Chancellor Angela Merkel’s Christian Democratic Union who sits on the finance committee, said in an interview. “And that problem becomes all the more a matter of concern the bigger the bank is -- and in the case of Deutsche Bank, is becoming.”

Deutsche Bank’s balance sheet has been buoyed by acquisitions and its derivatives book, one of the biggest in Europe, which increases in value during periods of market volatility. The jump comes as banks across Europe have pledged to cut at least 950 billion euros of assets over the next two years to meet tougher capital standards, according to data compiled by Bloomberg News.

BNP Shrinking

BNP Paribas, the largest bank in Europe in 2010 after snapping up Fortis assets, shrank its balance sheet by
1.7 percent last year to 1.97 trillion euros, the lowest since 2007, as the Paris-based lender reduced U.S. dollar-funding needs. HSBC, the biggest bank in Europe by market value, was the second biggest by assets at the end of last year, after the London- based company’s balance sheet expanded 4 percent, and BNP Paribas was third.

Since the end of 2009, Deutsche Bank has increased its assets 44 percent, while the nine other largest European banks on average posted a 5 percent rise.

European and U.S. banks use different accounting standards, making comparisons difficult. One variance: U.S. lenders net out derivatives positions, while most European banks don’t.

Deutsche Bank, which had 2.16 trillion euros of assets at the end of 2011 under international financial reporting standards, or IFRS, had total adjusted assets after netting derivatives of 1.27 trillion euros, up about 5 percent from the previous year.

JPMorgan Chase & Co. (JPM), the largest U.S. bank, based in New York, reported assets of $2.27 trillion, or 1.7 trillion euros, up 7 percent in 2011, under generally accepted accounting principles used in the U.S. Assets at Charlotte, North Carolina- based Bank of America Corp, were $2.13 trillion, or 1.6 trillion euros, down 6 percent.

BNP’s size after netting derivatives would be about 965 billion euros, according to the company.

**Bigger Balance Sheet**

Deutsche Bank’s bigger balance sheet is partly the result of acquisitions aimed at lowering the company’s dependence on investment banking. In the last three years, it bought German consumer lender Deutsche Postbank AG, adding about 200 billion euros in assets, wealth manager Sal. Oppenheim Group and part of ABN Amro Holding NV. The bank’s goal is to raise pretax earnings from consumer lending, money management and transaction banking to 50 percent of the total from 29 percent in 2009. Deutsche Bank said last month it’s in talks to sell part of its asset- management business to Guggenheim Partners LLC.

Net income last year rose 79 percent to 4.13 billion euros as gains at the retail unit and asset and wealth-management businesses helped offset a decline in investment banking. Still, Deutsche Bank scrapped its forecast for operating pretax profit of 10 billion euros for 2011 in October, citing a slowdown in client business amid the sovereign-debt crisis.

**Potential Damage**

As the bank’s assets have grown, so has the potential damage from the firm’s collapse on counterparties, companies, retail clients and German taxpayers, said Konrad Becker, a Munich-based analyst at Merck Finck & Co.

“If a jumbo jet crashes, the damage is larger than a propeller plane, even if size doesn’t necessarily determine the likelihood of an accident,” Becker said. “More problems can arise from a bigger balance sheet, and there’s a risk of a shift from quality to quantity.”

With Ackermann’s departure, the challenge of balancing size and capital strength will fall to co-CEOs Anshu Jain, 49, who now runs the corporate and investment bank, and Juergen Fitschen, 63, head of the bank’s German business. Deutsche Bank announced this month that Chief Risk Officer Hugo Banziger and Chief Operating Officer Hermann-Josef Lamberti will leave May 31. Stuart Lewis, who will become chief risk officer, Stephan Leithner and Henry Ritchotte will join the management board.
Capital Rules

Banking consolidation “sadly” will be “one of the many potential unintended consequences of regulation,” Jain said in a Bloomberg Television interview on Jan. 26. When asked about the systemic risks posed by bigger banks, Jain said that “you have the tradeoffs of too-big-to-fail on the one side and the benefits of diversification on the other.”

Lehman’s bankruptcy, which led to more than $2 trillion in losses and taxpayer bailouts worldwide, spurred regulators to introduce stricter capital rules for financial firms.

Deutsche Bank increased its core Tier 1 capital ratio, a measure of financial strength that takes into account risk-weightings assigned to various assets, to 10.8 percent by the end of 2011 from 7 percent at the end of 2008.

Risk-Weightings

Risk-weighted assets at Deutsche Bank will rise to 499 billion euros at the beginning of 2013 from 381 billion euros at the end of 2011 as new rules from the Basel Committee on Banking Supervision, known as Basel III, increase the value of the assets by 105 billion euros, according to a simulation included in a Feb. 2 company presentation.

The amount would be higher if it excluded mitigation plans, which Deutsche Bank hasn’t broken down. The firm previously reduced risk-weighted assets by selling securitized products, allowing assets to expire and engaging in hedging.

The new rules assign higher risk-weightings to force banks to increase the amount of capital they hold against assets and boost their ability to withstand shocks in financial markets.

Deutsche Bank’s ratio of common equity to risk-weighted assets using Basel III standards would be 7.4 percent by the end of this year compared with 9.9 percent at Morgan Stanley, 9.7 percent at Goldman Sachs Group Inc. (GS) and 8.5 percent at Citigroup Inc., JPMorgan analysts Kian Abouhossein and Amit Ranjan estimated in a Jan. 24 note.

Banks worldwide will be required to hold common equity of at least 7 percent of risk-weighted assets by 2019 when the rules take effect, and firms deemed systemically important, such as Deutsche Bank, will need more.

Leverage Ratio

Deutsche Bank is focusing on reining in assets weighted according to risk instead of its total balance sheet to boost capital levels, said Dirk Becker, a Frankfurt-based analyst at Kepler Capital Markets.

Total assets exceeded Tier 1 capital by 44 times as of Dec. 31, making the German lender the second-most leveraged among the 10 biggest European banks, behind France’s Credit Agricole SA (ACA) at 46 times, data compiled by Bloomberg show.

Deutsche Bank’s leverage is down from 68 times at the end of 2007, when the U.S. subprime crisis was claiming its first casualties.

Deutsche Bank’s leverage ratio, as calculated under an in-house “target definition” that makes it more comparable to U.S. peers, is 21, higher than JPMorgan’s, which is about 15.

“Leverage alone is not a good risk measure as it ignores balance-sheet composition,” said Christian Streckert, a
spokesman for Deutsche Bank. “For example, our growth in cash and liquid assets improved the bank’s risk position and at the same time resulted in an increased leverage.”

**Counterparty Risk**

Deutsche Bank in the fourth quarter also cut its trading risk at the corporate and investment-banking unit to the lowest since at least 2003, according to company filings on average value at risk, or VaR, a measure of how much it could lose in trading in one day.

The bank will increase its VaR because the fourth-quarter level isn’t sustainable, Chief Financial Officer Stefan Krause said in February.

The German lender has one of the biggest derivatives books in Europe because it’s the largest trader of fixed income, currencies and commodities, Kepler’s Becker said. The notional value of those contracts increased last year because of higher market volatility and the appreciation of the dollar against the euro, he said.

“The larger your derivatives book, the more counterparty and price risks you have,” Kepler’s Becker said. “Deutsche Bank managed risk extremely well under Banziger. The question is whether it will work as well under the new risk chief.”

‘Can Go Wrong’

Derivatives are a type of security whose price is dependent upon or derived from underlying assets such as stocks, bonds, commodities and currencies. The contracts between two or more parties are often used to hedge risk.

“Derivatives used properly can reduce risk, but things can go wrong, especially if there’s too much concentration in your book,” said Matthew Czepliewicz, a London-based analyst at Canaccord Genuity Corp. who has a hold rating on the bank’s shares. “From an analytical perspective, my primary focus is rarely total size, but it does attract regulatory and media attention.”

**Beyond Basel**

Global regulators have tried to address issues of too-big-to-fail with measures that go beyond Basel rules.

The Financial Stability Board, a body set up by the Group of 20 nations that includes regulators and central bankers, in November published a provisional list of 29 systemically important lenders that must hold additional capital. Deutsche Bank and Barclays Plc (BARC) may get the second-highest surcharge of 2 percentage points, while banks including JPMorgan and BNP Paribas may face the top charge of 2.5 percentage points, according to a copy of a second list obtained by Bloomberg News.

Germany has introduced a law aimed at helping the government restructure lenders and avoid bailouts. Beginning in 2011, the Federal Agency for Financial Market Stabilization began to oversee a restructuring fund and collect a bank levy that will enable it to reorganize lenders and protect systemically relevant parts of struggling firms.

Germany’s governing coalition of Christian Democrats and Free Democrats is considering copying the U.K. by introducing a legal separation of lenders’ investment-banking and consumer arms, and the Finance Ministry is drawing up a feasibility study, lawmakers have said.

‘A Juggernaut’
“We have introduced multilevel checks and balances globally as well as in Germany that show we’ve learned from the crisis,” Bjoern Saenger, a Free Democrat member of the finance committee, said in an interview. “Clearly Deutsche Bank has become a juggernaut, and it makes good political sense to be aware of that development. But I don’t see a problem. Most in Germany would say having a global player is a good thing.”

Germany and France led efforts in 2009 to weaken capital regulations proposed by the Basel committee for lenders worldwide. The group softened its original proposals for how much capital banks will be required to have in proportion to assets weighted according to their perceived risk, while the plan to limit banks’ gross assets in comparison to capital is still under review.

That contrasts with Switzerland and Sweden, which are requiring lenders to boost capital beyond Basel requirements and sell securities that become equity in times of market turmoil.

**UBS Losses**

The danger of balance-sheet expansion came to light during the last credit crisis. Before global credit markets froze in 2007, UBS added assets to boost earnings and shareholder returns. Profit at the Zurich-based bank doubled between 1999 and 2006 as its balance sheet more than doubled.

Once the crisis hit, the bank found itself with losses and writedowns of more than $57 billion from securities such as super-junior tranches of collateralized debt obligations, which often had top ratings and were perceived to be risk-free. The near collapse of the firm, which was rescued by the Swiss government, illustrated how high leverage can translate into greater risk and unforeseen losses.

A more recent example of assets once seen as almost risk-free turning sour is sovereign debt. Long-term Greek government bonds were rated A-, six levels below the top rating by Standard & Poor’s and Fitch Ratings, until December 2009. Moody’s Investors Service kept an equivalent rating until June 2010.

The Greek government this month carried out the biggest sovereign-debt restructuring in history after banks, insurers and other investors backed a plan to forgive more than half of the 206 billion euros in debt held by private investors.

**Systemically Important**

Deutsche Bank cut its net exposure to the sovereign debt of Greece, Ireland, Italy, Portugal and Spain to 3.67 billion euros at the end of last year from 12.1 billion euros in 2010, helped by hedging, writedowns and maturing bonds. The lender has been praised by investors and analysts for holding fewer U.S. subprime mortgages and less sovereign debt than many peers.

At the end of 2010, Deutsche Bank was ranked the world’s most systemically important financial institution by Japan’s Financial Services Agency and central bank, based on estimates about the impact a failure would have on the global financial system, according to Mainichi newspaper.

“On the one hand, it made us proud, but on the other hand, of course, we’re aware of the responsibility,” Ackermann said at an earnings press conference in February 2011 when asked about being deemed the world’s most systemically important bank.

By the end of May, the Swiss native will no longer carry that weight on his shoulders. After the shareholders meeting, he’ll pass the baton to Jain and Fitschen.

The co-CEOs may sleep comfortably, knowing they’ve got German taxpayers behind them, Merck Finck’s
Becker said.

“No government in this world would let a bank with comparable significance to Deutsche Bank go bust,” he said.

To contact the reporters on this story: Aaron Kirchfeld in Frankfurt at akirchfeld@bloomberg.net; Elena Logutenkova in Zurich at elogutenkova@bloomberg.net; Nicholas Comfort at ncomfort1@bloomberg.net

To contact the editors responsible for this story: Frank Connelly at fconnelly@bloomberg.net; Edward Evans at eevans3@bloomberg.net