Commerzbank AG
Issuer Rating Report

SCOPE A NEGATIVE

Overview

Scope Ratings has assigned an issuer rating of A, a senior non-preferred debt rating of A-, a short-term debt rating of S-1, and a preferred senior debt rating of A to Commerzbank AG. All ratings have a Negative Outlook, except for the short-term debt rating which has a Stable outlook.

Highlights

- The rating reflects Scope's view that Commerzbank can retain a leading position in private and commercial banking in its home market of Germany. Commerzbank is one of the few remaining national universal banks in Germany, though its market share and pricing power is limited by the fragmented structure of a banking system dominated by public and cooperative banks. Scope sees potential for in-market mergers in Germany, but we are concerned that consolidation will progress only very slowly.
- The transformation programme initiated in 2016 has de-risked the balance sheet but has proved to be costlier and lengthier than expected, thus, failed to deliver a lasting improvement in profitability. In response, management recently launched "Commerzbank 5.0", targeting further cost cuts across the group and a significant number of branch closures in Germany. Meanwhile, elevated spending on new technologies is set to continue in view of fast changing customer preferences and innovative market entrants. Scope believes this initiative provides the necessary reinforcement for the German franchise. However, in line with management guidance Scope does not expect any meaningful profitability improvement for some time.
- Asset quality has improved materially over the past couple of years as the bank worked out its legacy exposures. However, Scope expects the credit cycle to turn in view of poor economic data from Germany and globally. Provisions at Commerzbank were already up in the first half of 2019 and we believe that visibility for 2020 is limited. Furthermore, Scope is concerned that new stringent accounting and regulatory rules risk exacerbating the impact of the NPL cycle on bank capital compared to previous episodes of economic weakness. Scope anticipates that the bank enters this period with only limited prospects for pre-provision income generation due to falling policy rates and flat yield curves in its key markets. Low cash flow from its core intermediation businesses will therefore limit Commerzbank's ability to absorb rising credit cost and higher risk-weighted assets due to credit migration and increasing regulatory requirements.
- Liquidity and solvency ratios remain strong, although declining profitability is affecting capital build-up. Management plans to free up capital by selling its profitable Polish subsidiary mBank. Scope believes that this can offset pressure on capital but will also reduce earnings power and diversification going forward. Most likely, Commerzbank will have to retain a legacy book of foreign currency loans that exposes it to lengthy and potentially costly litigation in Poland, which Scope believes will partly offset the benefits of the sale..

Ratings & Outlook

Issuer rating	A
Outlook	negative
Senior preferred debt rating	A
Senior unsecured debt rating	A-
Tier 2 instruments	BBB
Short-term debt rating	S-1/ stable

The ratings are not applicable to debt issued by unguaranteed subsidiaries of the rated parent.

Lead Analyst

Dierk Brandenburg
d.brandenburg@scoperatings.com

Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- Commerzbank has materially de-risked and restructured its balance sheet, creating a good foundation to rebuild a strong retail, SME and corporate franchise in Germany. However, the bank has yet to achieve adequate returns.
- The liquidity and funding metrics of the bank remain strong and capital ratios are satisfactory, although the latter compare less favourably with European peers.
- Low interest rates continue to be a drag on the bank's profitability.
- Having improved substantially since 2016, asset quality has recently shown weakness in view of slowing economic growth and specific corporate exposures.

Rating-change drivers

↑	Strong efficiency gains and improving capital ratios, based on the successful restructuring of the bank's business model.
↓	A material decline in profitability, rising NPLs as well as a deterioration in asset quality – for example, due to any excessive risk-taking in response to the current subdued margins – with a pronounced impact on the bank's capital ratios.
↓	Any reduced capital market access could challenge an appropriate funding and capital profile.

Rating drivers (details)

Transformation proved more costly & lengthy than anticipated

Successful de-risking

Commerzbank made only modest progress in implementing its Commerzbank 4.0 strategy since 2016. Between 2016 and 2019, management successfully integrated the investment bank into the corporate bank and de-risked the corporate banking division, allowing an internal bad bank to be discontinued as of Q2 2019. Over the same time period, German retail bank was refocused on asset gathering and market share gains as well as digitalisation and cost savings. However, the strategy proved costly and so far failed to achieve the desired level of profitability.

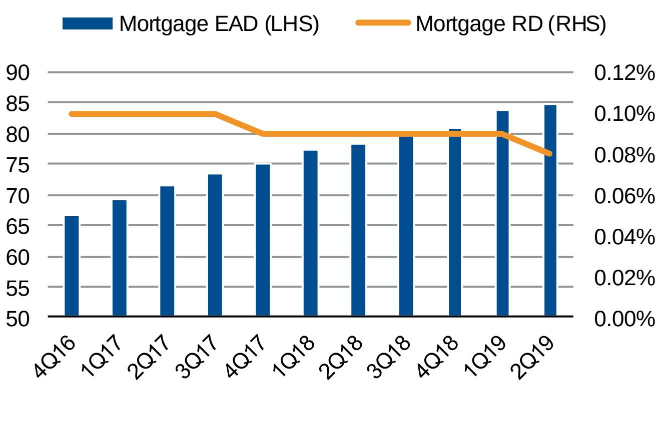
Lower returns for longer

Having abandoned an in-market merger with domestic rival Deutsche Bank in early 2019, management launched a new “Commerzbank 5.0” strategy that sets targets for 2023. While the initial program had targeted a 6% ROE by 2020, the new strategy only seeks to stabilise ROE at 4% by 2023 while incurring significant additional restructuring cost. The lower-for-longer return target reflects above all the ongoing difficulties of Commerzbank and indeed other banks in German retail and commercial banking.

Retail volume key to growth

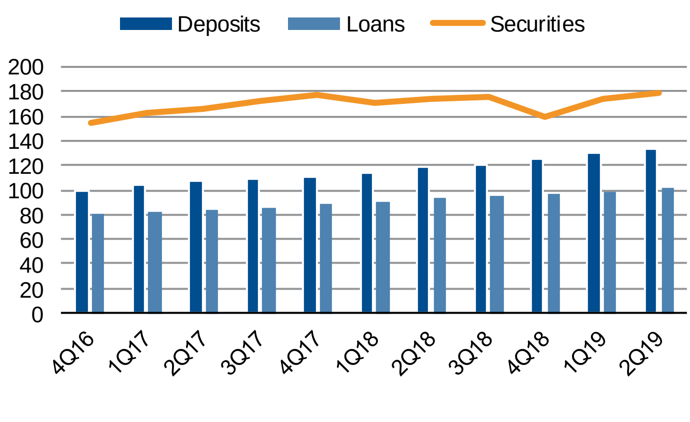
Between 2016 and 2019, Commerzbank attracted 1.3m new retail clients (11.1mn in total as of June 2019). Over the same period the bank added a net EUR 34bn of deposits and EUR 20bn of loans, mainly German mortgages. Mortgage volume went up by 10% to EUR 73.9bn in 2018 alone, though growth in high yielding consumer (3.9bn portfolio) credit was much more muted. Since 2016, the total value of securities held for retail customers is up by EUR 23bn, though that number is heavily influenced by market movements. The combined total of these products reached EUR 413bn as of mid-2019, which put management slightly ahead of its EUR 400bn volume target.

Figure 1: German mortgage business



Source: Source Company data, Scope Ratings

Figure 2: German retail assets under control



Source: Company data, Scope Ratings

Limited pricing power

Despite the progress, Commerzbank remains a small player in the German retail market, which has traditionally been dominated by the savings and co-operative bank sector and started to transform more recently by new entrants in the Fintech space. With limited pricing power, Commerzbank has yet to transform volume growth into better margins and profits, which will be very difficult in this operating environment. The strategy also proved costly in view of the 1000 strong branch network that was used to support the expansion in addition to investment into digital channels.

Expensive digitalisation efforts weigh on profitability

Costly Digitalisation

In 2016, Commerzbank recognised, with some delay compared to other lenders but with convincing commitment, the need for maximum digitalisation across all group processes. The digitalisation drive has proven costly, however, and after a heavy front-loading of costs in 2017 and 2018, management had to scale back investments recently in view of ongoing revenue pressures.

Cost overruns require new strategy

Operating expenses have, nevertheless, fallen from more than EUR 7bn in 2016 to below 6.8bn expected for 2019 (incl. 700mn related to mBank), despite ongoing cost inflation. The target for 2020 had originally been set at EUR 6.5bn but management now expects to miss its target by 200mn due to higher than expected IT and regulatory cost. The new strategy aims at a cost base of EUR 6.3bn by 2023, or 5.5bn without Polish subsidiary mBank.

Staff cuts and branch closures

To achieve the 600mn (10%) net annual cost savings compared to 2018, Commerzbank plans to close 200 of its branches in Germany (20%) and reduce headcount by a further 2’300 FTEs (net). The reduction to 29’300 total FTEs by 2023 (excl. 6’600 staff at mBank) brings the bank in line with the goal initially set for 2020 under the previous cost cutting program. Management expects to take restructuring charges of EUR 850mn to fund the 2023 cost reduction program.

Corporate business has yet to recover after restructuring

Lower risk profile in corporate banking

The corporate client business that also includes the former investment banking division has significantly reduced its risk profile in recent years. Most of the assets that were transferred into an internal bad bank have been worked out since 2016 and the unit will be discontinued in 2019, leaving only a small portfolio (EUR 10.4bn of risk-weighted assets) that will be managed as part of the corporate centre going forward.

Sale of structured business

In November 2018, Commerzbank and Société Générale signed an agreement for the sale of Commerzbank’s EMC business, including the assets and underlying operating structure (staff and IT infrastructure). The sub-segment contributed around 4% to group revenues over the past three years. Following the carve-out, the bank expects its cost base to decrease by between EUR 200m and EUR 300m by 2020 (approx. 3%-4% of total costs).

The reduction of trading activities has so far allowed Commerzbank to offload EUR 3bn of risk-weighted assets; the gradual transfer of portfolios and structures associated with EMC will lead to further de-recognition of RWAs: in total, Commerzbank expects a net capital relief of ca. EUR 500m from these operations.

Disappointing growth

However, despite the restructuring, the corporate division has struggled to generate growth within the core German SME business. While the division added EUR 13bn of loan volume since 2016 and exceeded its 2020 target of EUR 85bn already in mid-2019 by EUR 3bn, most of the additional volume was generated in the international business.

The development highlights the increasing competitive pressure caused by foreign lenders in Germany with established franchises in Germany such as ING or HSBC. In the corporate business these banks can draw on their global network – a feature which is particularly attractive for export-oriented German firms. Nevertheless, Commerzbank initially targeted 10,000 net new corporate customers by 2020 and is currently ahead of its acquisition plan, reaching 11,400 net new customers in mid-2019.

Poor top-line progression

Despite the progress in volume, core interest and commission revenues have stagnated, and trading income has declined since 2016. In response, Commerzbank hired a new business head from its competitor ING, who is tasked to reposition the business upon joining the company in early 2020.

Asset recovery unit dissolved as of Q3

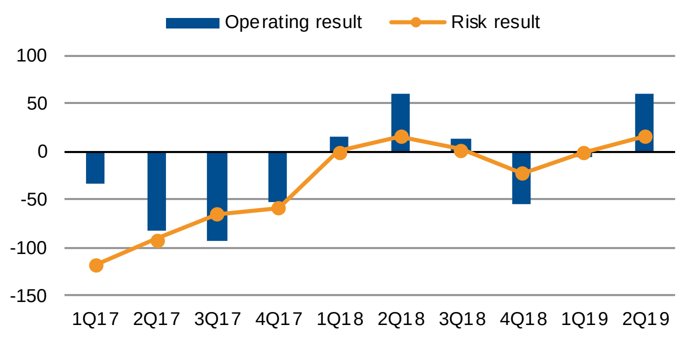
With effect from 1 July 2019, Commerzbank's Asset and Capital Recovery (ACR) segment, which comprised the remaining complex legacy assets in the areas of commercial real estate, shipping and public finance, has been discontinued. The remaining assets, mainly the UK public finance portfolio with long maturities, will be reported as part of the corporate centre. We therefore expect no further drag on profitability from these assets in line with guidance.

Table 1: Asset and Capital Recovery exposure development

Exposure at Default	2016	2017	2018	Jun-19
Commercial Real Estate	2.7	1.7	0.9	0.7
Shipping	5	3.3	0.8	0.2
Public Finance	9.5	9.3	7.5	3.5
Asset & Capital Recovery	**17.2**	**14.3**	**9.2**	**4.4**

Source: Source Company data, Scope Ratings

Figure 3: Asset and Capital Recovery result

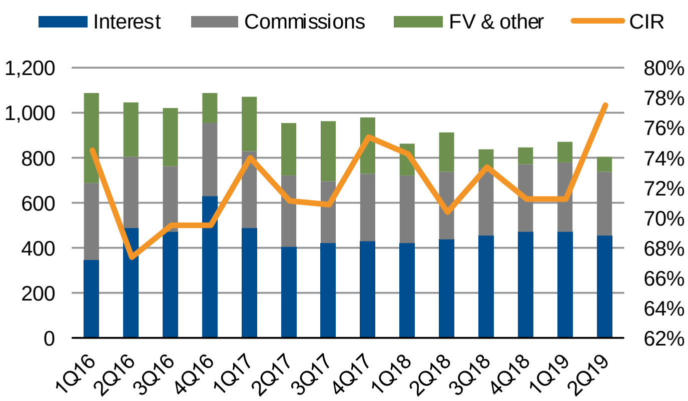


Source: Company data, Scope Ratings

Financial results have been below management expectations

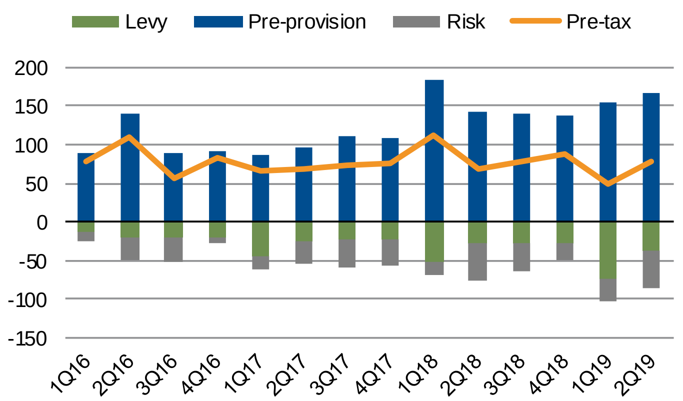
In 2018, the bank increased its underlying income by 8.4% on the previous year, leading to an operating profit of EUR 1,245 bn and a net result of EUR 865 m for the reporting year.

Figure 4: Quarterly revenues (EUR m, excl. exceptional items)



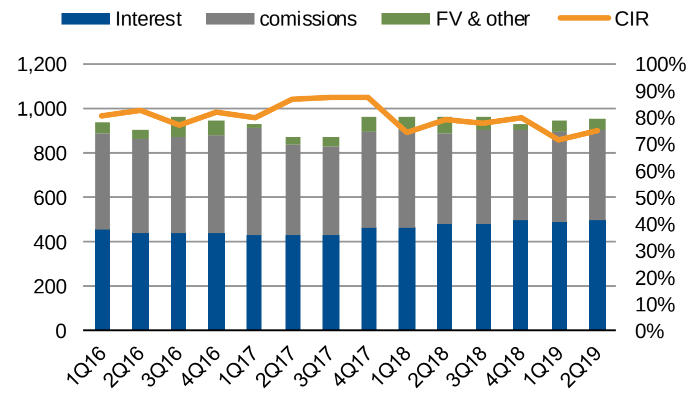
Source: Company data, Scope Ratings

Figure 5: Quarterly results (EUR m)



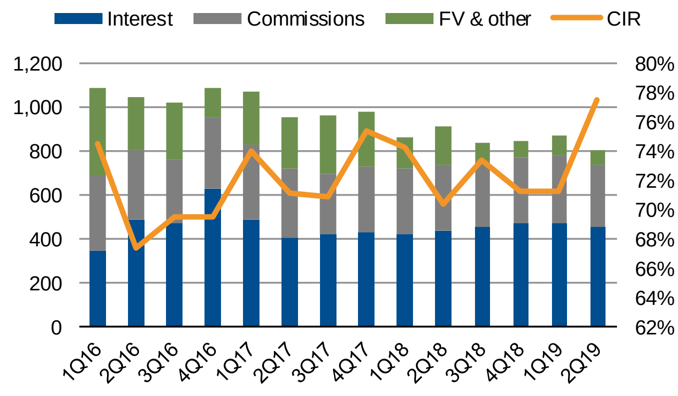
Source: Company data, Scope Ratings

Figure 6: PSBC revenues (EUR m, excl mBank)



Source: Company data, Scope Ratings

Figure 7: CC revenues



Source: Company data, Scope Ratings

Volume growth only partly compensates falling margins

The expansion of the mortgage book has led to a steady expansion of net-interest income of the retail division, thus offsetting the margin pressure in the low rate environment. Given the outlook for even lower rates, management is less optimistic about interest income growth going forward. Commission income remained flat during the period, despite the increase in customer assets. While management has started to reprice the retail product offering, it will be hard to pass on the cost of negative rates to depositors in a fragmented market.

High cost income ratio to stay

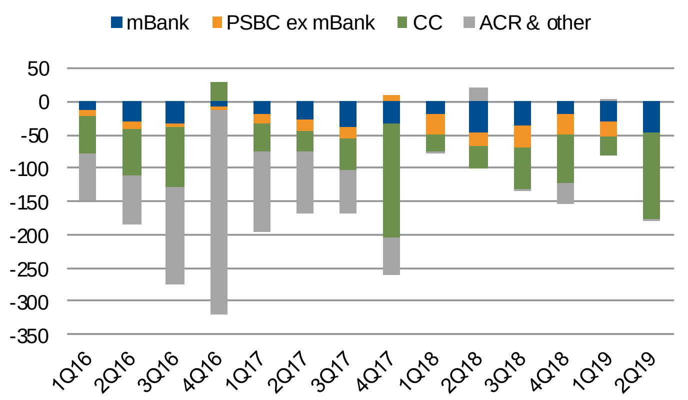
As a result, the cost-income ratio remains stubbornly high at around the 75% mark (excluding banking levies), well above the <66% target announced at the outset of the strategy in 2016. Such a goal remains beyond reach even with last cost cutting goals, unless revenues were to grow by 10% or more over the coming quarters. The cost income ratio compares poorly with international and even some of the unlisted domestic peers.

Asset quality has peaked

Asset quality peaked in 2018

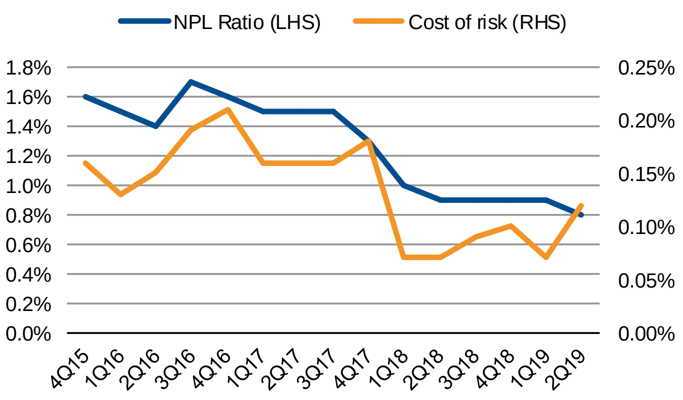
Thanks to a decisive restructuring of legacy assets, the group's risk result has stabilised since 2017 and annual provisioning hit a cyclical low of EUR 446m in 2018 due to improving asset quality and write-backs. Commerzbank's asset quality metrics have improved materially in recent years with stage 3 assets falling to less than 1% of exposure at default (EaD) or 1.5% of net loans.

Figure 12: Risk cost by business segment (EUR m)



Source: Source Company data, Scope Ratings

Figure 13: Group asset quality ratios (% of EaD)



Source: Company data, Scope Ratings

Credit cost rise in Q2 2019

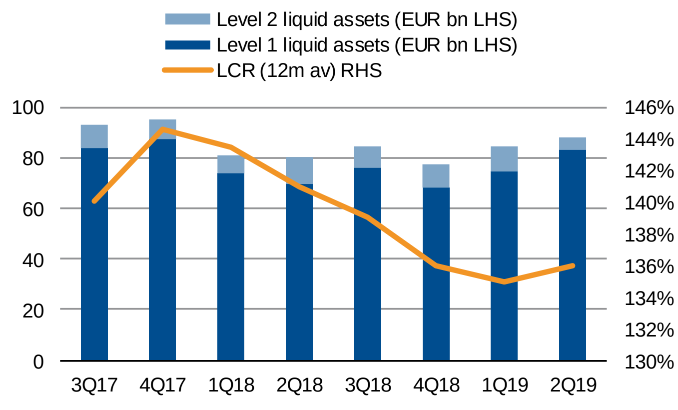
Potential asset quality concerns manifested themselves in Q2 2019, when the risk result spiked to EUR 178m due to a few large but apparently isolated problems in its corporate book. Management expects risk cost to rise further in the second half of 2019 up to a total of at least EUR 550m for 2019 (+23% yoy). Guidance for 2020 will depend on the bank's internal expect loss estimates at the beginning of next year.

The liquidity and funding metrics of the bank remain strong and capital ratios are satisfactory, although the latter compare less favourably with European peers.

Reassuring liquidity and funding metrics

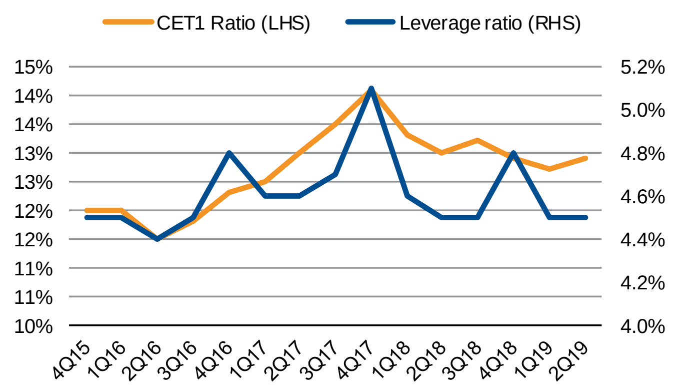
The balance sheet metrics of Commerzbank have improved substantially over the past years, with reassuring liquidity and funding metrics. Liquidity ratios have been consistently strong over the past reporting periods, significantly exceeding regulatory requirements. The LCR averaged 136% during the 12-month period ending in June 2019. We regard this as more than adequate in the current environment, bearing in mind the significant cost to German banks to fund negative yielding high-quality liquidity reserves.

Figure 8: Liquidity position



Source: Source Company data, Scope Ratings

Figure 9: Solvency position



Source: Company data, Scope Ratings

Capital is adequate

Commerzbank's capital ratios are satisfactory, although given the current levels of profitability, capital build-up is subdued and leaves limited leeway to respond to Basel IV and any one-off adjustments should the need arise.

Commerzbank's CET1 ratio was 12.9% as of June 2019 compared to a SREP CET1 requirement of 10.1%. Having set the minimum at 12.75% in the past, management now targets a range between 12-13%. The ratio does not yet reflect the full impact of the ECB's model review (TRIM), nor does it reflect any of the marked-to-market volatility of the sovereign bond book (EUR 8.9bn exposure to Italy as of June 2019). The leverage ratio was 4.5%, which is adequate and was recently strengthened by the issuance of AT1 capital.

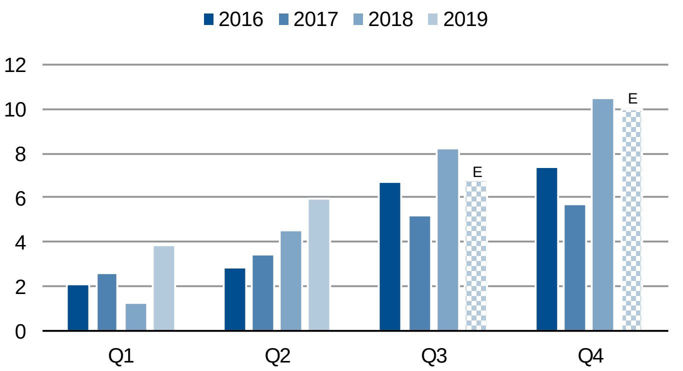
AT1 a useful addition to the capital structure

We view it as positive that Commerzbank recently strengthened its capital position further by raising USD 1bn of AT1 capital in July 2019 for the first time since the crisis. We expect the bank to issue more AT1 to fill its bucket.

MREL covered by new issuance

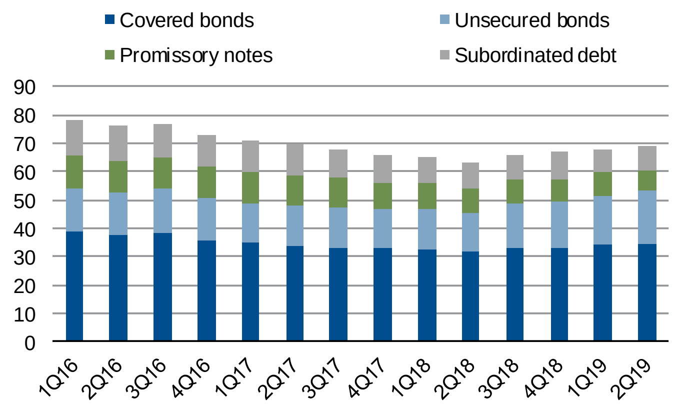
MREL is sufficiently covered but subject to further requirements. The SRB set Commerzbank's initial MREL requirement at 27.27% of RWAs (12.8% of TLOF), though the bank expects this to be revised later in 2019. As of end-2018 Commerzbank's MREL ratio was 28.8%, including the issuance of EUR 1.5bn of non-preferred senior debt issued under Germany's new contractual subordination regime that came into force during 2018. In the first 6 months of 2019, issued a further 700mn of non-preferred senior debt an USD 1bn AT1, which support the MREL ratio.

Figure 10: Quarterly gross issuance (EUR bn)



E is Scope estimates
Source: Source Company data & Scope estimates

Figure 11: Wholesale funding (EUR bn)



Source: Company data, Scope Ratings

mBank sale provdes capita relief but leaves foreign currency loan legacy

mBank sale frees up capital

To fund the 850mn of additional restructuring cost, management decided to sell its profitable Polish subsidiary mBank. This will lead to a 17bn reduction in RWAs and avoids future capital charges for D-SIBs(50bps) that were postponed by regulators this year. In addition, Commerzbank expects to generate a premium above book value to offset the planned restructuring charges. In addition, Commerzbank expects to disburse a small amount to buy out the minorities in its subsidiary Comdirect that is otherwise already fully consolidated.

Commerzbank will retain CHF risk in Poland

As of H1 2019, mBank, Commerzbank's Polish subsidiary, reported ca. PLN 14 bn (or EUR 3.2bn) of CHF mortgages, the majority of which were extended in 2008/2009. We expect that Commerzbank will have to retain these assets in the case of a sale of mBank.

A verdict on unfair clauses contained in CHF-indexed loan agreements by the European Court of Justice was announced this week. The decision of the ECJ allows for abusive clauses to be substituted, however, it should follow provisions in the Polish Law. The ruling will spur on more court cases; acting as a precedent to convert the loans into PLN or annul the contracts. The annulment of the contracts could also mean that the banks would have to refund customers on payments already made.

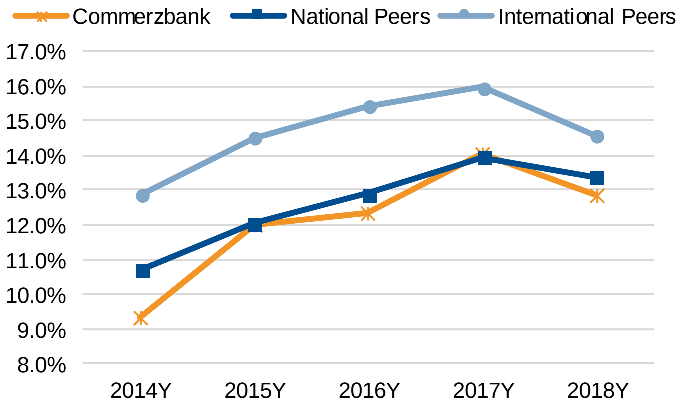
Some estimates show a PLN 60bn-80bn cost for the Polish banking sector, if the loans were converted to the original FX rate. For mBank this forced conversion could cost it PLN 3bn in the hypothesis that half of their housing loans in CHF are indexed, or up to PLN 4.6bn with the share up to 80%, corresponding to 20% to 30% of the bank's ordinary equity.

Extra provisions may be required

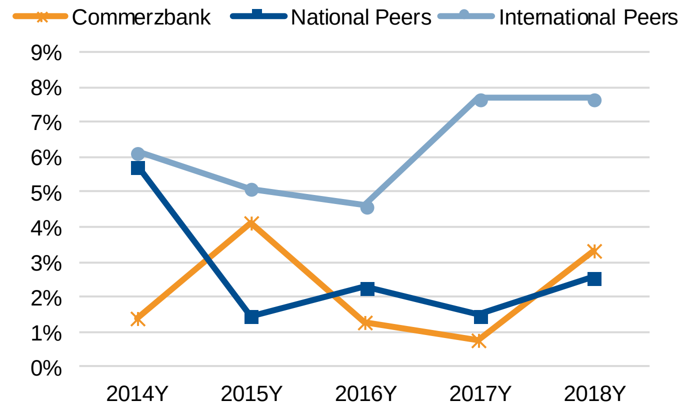
The bank is currently facing one class action amounting to EUR 87m regarding the (indexed) loan agreements. The bank has provisioned litigation at EUR 29 mn.

I. Appendix: Peer comparison

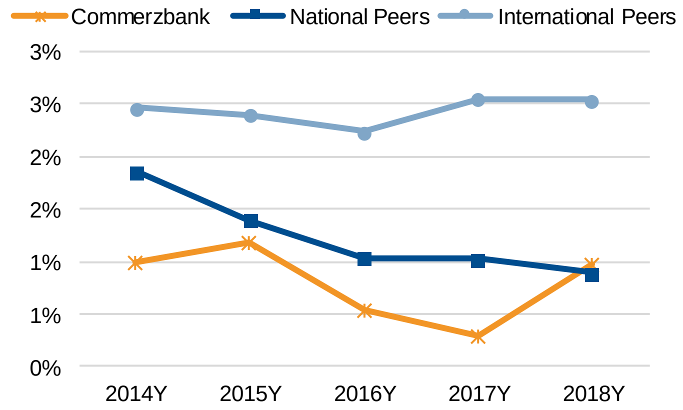
CET1 Ratio (%, fully loaded)



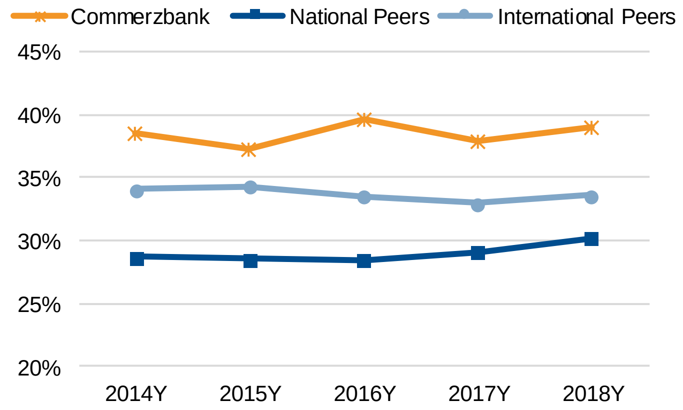
Return on average equity (%)



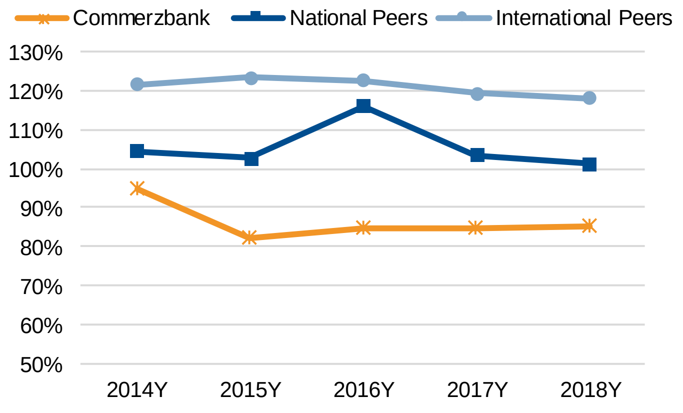
Pre-provision income/RWA (%)



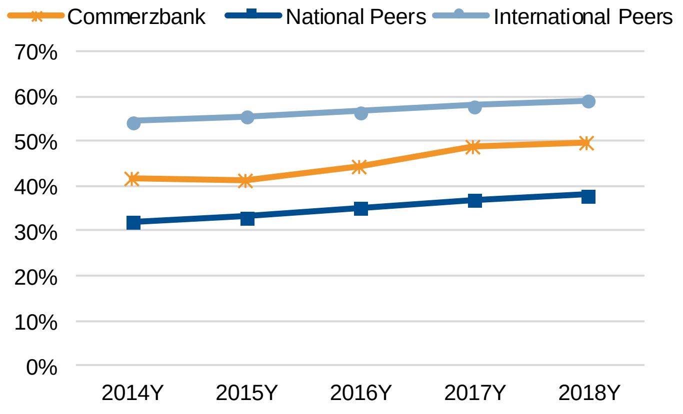
RoRWA (%)



Amortised loans/deposits



Net loans/assets



Source: SNL

*National peers: Commerzbank, Deutsche bank, DZ bank

*International peers: Commerzbank, Danske, DZ bank, Credit Agricole, RBS, BPCE, Lloyds, Rabobank, Credit Mutuel, Intesa, ABN AMRO, CaixaBank, Handelsbanken, DNB, SEB, Swedbank, Banque Postale, Sabadell, Bank of Ireland, UBI Banca, National Bank of Greece, Allied Irish

II. Appendix: Selected financial information – Commerzbank AG

	2015Y	2016Y	2017Y	2018Y	2019H1
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	100,314	93,941	100,137	105,609	121,509
Total securities	200,078	160,383	120,106	102,925	113,209
of which, derivatives	80,036	64,590	49,400	39,723	43,929
Net loans to customers	218,875	214,139	221,385	229,406	256,436
Other assets	13,434	11,973	10,867	24,429	26,876
Total assets	**532,701**	**480,436**	**452,495**	**462,369**	**518,030**
Liabilities					
Interbank liabilities	83,154	66,903	56,360	59,263	76,813
Senior debt	45,616	51,587	49,606	46,439	51,014
Derivatives	84,548	70,034	51,197	42,258	46,387
Deposits from customers	261,179	248,219	255,824	262,963	293,259
Subordinated debt	11,858	NA	0	0	0
Other liabilities	16,221	NA	9,486	22,035	21,140
Total liabilities	**502,576**	**450,863**	**422,473**	**432,958**	**488,613**
Ordinary equity	29,121	28,547	28,858	28,211	28,173
Equity hybrids	0	0	0	0	0
Minority interests	1,004	1,027	1,164	1,200	1,244
Total liabilities and equity	**532,701**	**480,436**	**452,495**	**462,369**	**518,030**
Core tier 1/ common equity tier 1 capital	27,303	26,494	25,607	23,206	24,023
Income statement summary (EUR m)					
Net interest income	5,727	4,165	4,295	4,748	2,505
Net fee & commission income	3,430	3,212	3,192	3,089	1,507
Net trading income	455	796	532	485	174
Other income	181	103	111	246	60
Operating income	**9,793**	**8,276**	**8,130**	**8,568**	**4,246**
Operating expenses	7,258	7,219	7,620	6,873	3,487
Pre-provision income	**2,535**	**1,056**	**511**	**1,695**	**759**
Credit and other financial impairments	694	875	780	446	256
Other impairments	13	636	22	6	NA
Non-recurring items	0	0	0	0	0
Pre-tax profit	**1,828**	**643**	**341**	**1,245**	**542**
Discontinued operations	0	0	96	-10	12
Other after-tax Items	0	0	0	0	0
Income tax expense	629	261	215	268	123
Net profit attributable to minority interests	115	103	94	103	41
Net profit attributable to parent	**1,084**	**279**	**128**	**865**	**391**

III. Appendix: Selected ratios – Commerzbank AG

	2015Y	2016Y	2017Y	2018Y	2019H1
Funding and liquidity					
Net loans/ deposits (%)	82.2%	84.8%	84.9%	85.1%	85.8%
Liquidity coverage ratio (%)	NA	NA	144.2%	135.7%	136.0%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/ assets (%)	41.1%	44.6%	48.9%	49.6%	49.5%
Problem loans/ gross customer loans (%)	3.2%	3.2%	2.5%	1.6%	1.5%
Loan loss reserves/ problem loans (%)	54.2%	53.1%	55.2%	56.1%	56.8%
Net loan growth (%)	-6.2%	-2.2%	3.4%	3.6%	23.6%
Problem loans/ tangible equity & reserves (%)	23.4%	22.9%	18.7%	13.3%	13.2%
Asset growth (%)	-4.6%	-9.8%	-5.8%	2.2%	24.1%
Earnings and profitability					
Net interest margin (%)	1.0%	0.8%	0.9%	1.0%	1.1%
Net interest income/ average RWAs (%)	2.7%	2.1%	2.4%	2.7%	2.7%
Net interest income/ operating income (%)	58.5%	50.3%	52.8%	55.4%	59.0%
Net fees & commissions/ operating income (%)	35.0%	38.8%	39.3%	36.1%	35.5%
Cost/ income ratio (%)	74.1%	87.2%	93.7%	80.2%	82.1%
Operating expenses/ average RWAs (%)	3.4%	3.7%	4.2%	3.9%	3.8%
Pre-impairment operating profit/ average RWAs (%)	1.2%	0.5%	0.3%	1.0%	0.8%
Impairment on financial assets / pre-impairment income (%)	27.4%	82.9%	152.6%	26.3%	33.7%
Loan loss provision/ average gross loans (%)	0.3%	0.4%	0.3%	0.2%	0.2%
Pre-tax profit/ average RWAs (%)	0.9%	0.3%	0.2%	0.7%	0.6%
Return on average assets (%)	0.2%	0.1%	0.0%	0.2%	0.2%
Return on average RWAs (%)	0.6%	0.2%	0.1%	0.6%	0.5%
Return on average equity (%)	4.1%	1.3%	0.7%	3.3%	2.9%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	12.0%	12.3%	14.1%	12.9%	12.9%
Common equity tier 1 ratio (%, transitional)	13.8%	13.9%	14.9%	12.9%	12.9%
Tier 1 capital ratio (%, transitional)	13.8%	13.9%	15.2%	13.4%	13.3%
Total capital ratio (%, transitional)	16.5%	16.9%	18.3%	16.3%	16.0%
Leverage ratio (%)	4.5%	4.8%	5.1%	4.8%	4.5%
Asset risk intensity (RWAs/ total assets, %)	37.2%	39.7%	37.9%	39.0%	36.1%
Market indicators					
Price/ book (x)	0.5x	0.4x	0.6x	0.3x	0.3x
Price/ tangible book (x)	0.2x	0.0x	0.0x	NA	NA
Dividend payout ratio (%)	22.2%	0.0%	0.0%	NA	NA

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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