15 November 2018 | Financial Institutions

Deutsche Bank AG
Issuer Rating Report

SCOPE BBB+ NEGATIVE

Overview

Scope Ratings has assigned Deutsche Bank AG an Issuer Rating of BBB+, a senior preferred unsecured debt rating of BBB+ and a senior non-preferred unsecured debt rating of BBB. In June 2018, Scope changed Deutsche Bank's long-term debt outlook to Negative from Stable. The Stable Outlook for the S-2 short-term debt rating remains unchanged.

Highlights

- The rating and outlook on Deutsche Bank reflect our view that the road to successful business model recalibration and a return to sustainable profitability is still steep and fraught with uncertainties. Following the financial crisis, Deutsche Bank has been operating as a global universal bank with an emphasis on wholesale and investment banking, alongside its more marginally profitable domestic retail franchise which has been weighing on the bank's cost base. Deutsche Bank's Strategy 2020, presented in 2015, updated in 2017 and fine-tuned in 2018, addresses numerous intrinsic weaknesses in the bank's business model and fundamentals.
- The formerly relatively strong cross-cycle resilience of Deutsche Bank's wholesale and investment bank performance has been challenged by difficult market and operating conditions. Several top management changes, recent news regarding the US business and headline risk related to ongoing litigation cases are affecting the bank's relationship-based businesses. At a time in which new management is already finding it difficult to sell the restructuring process to investors, counterparties and bank employees, these factors are placing additional pressure on its ability to deliver and have the potential to weaken the bank's governance.
- Reporting on the implementation of Strategy 2020 has improved. At the same time, convincing progress in the critical areas of cost reduction and process streamlining is still to be made.
- The 2017 EUR 8bn rights issue improved the bank's capital position. However, weak profitability over past quarters suggests a reduced ability to pursue organic capital formation for the time being.

Ratings & Outlook

Issuer Rating	BBB+
Outlook	Negative
Senior Preferred Debt rating	BBB+
Senior Non-Preferred Debt rating	BBB
Tier 2 rating instruments	BB+
Additional Tier 1 rating instruments	B
Short-term debt rating	S-2

Lead Analyst

Chiara Romano
c.romano@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

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

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Rating drivers (summary)

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

- A challenged business model with a high cost base; Strategy 2020 is tackling the weaknesses, but at a relatively slow pace
- Prudent capital and liquidity ratios should provide the bank with some temporary stability to overhaul its business model
- Internal capital generation capacity remains clouded for the short and medium term due to large restructuring needs and related costs, further uncertainties regarding litigation charges, as well as the impact of reputational risks
- Previously resilient investment banking earnings are under pressure from general market shifts, driven primarily by technology, changed client behaviour, less demand, and heightened regulations

Rating-change drivers

The integration of Postbank with Deutsche Bank's retail banking franchise could provide some efficiency and profitability gains in the medium to longer term.

While we welcome the financial path of Strategy 2020, we see material execution risk. However, we regard positively the enhanced clarity which the newly appointed CEO has been able to provide regarding the end game and the path forward.

A further deterioration of the bank's profitability and a lack of progress in the areas of cost reduction and efficiency gains will put downward pressure on the bank's ratings.

Recent events

Increasingly tangible Corporate & Investment Bank (CIB) initiatives and a clearer picture for Private & Commercial Bank (PCB) division

Recent initiatives undertaken by the new top management, such as the review of the equities business and the decision to scale back the US rates business to refocus on Europe and steer the international corporate finance business towards segments more directly linked to European activities, indicate more target-oriented activity within the strategic framework.

In parallel, Deutsche Bank intends to grow its PCB division as well as DWS, so that in 2021 these segments should represent 50% of revenues, up from 47% at present. Together with the Global Transaction Banking division they should provide a stable revenue stream to compensate for more structurally volatile earnings in sales and trading activities.

In May 2018 DB Privat- und Firmenkundenbank AG was launched, concluding the legal merger between Postbank and Deutsche Bank’s private and commercial clients business. This was an important step and gave a clear message to stakeholders on the new management’s willingness to refocus on domestic activities and become more competitive in the German banking landscape. Management is adhering to its goal of achieving EUR 900 in cost synergies from the integration in 2022, including EUR 0.9bn in severance and restructuring costs over four years and EUR 1bn in IT investment.

Rating drivers (details)

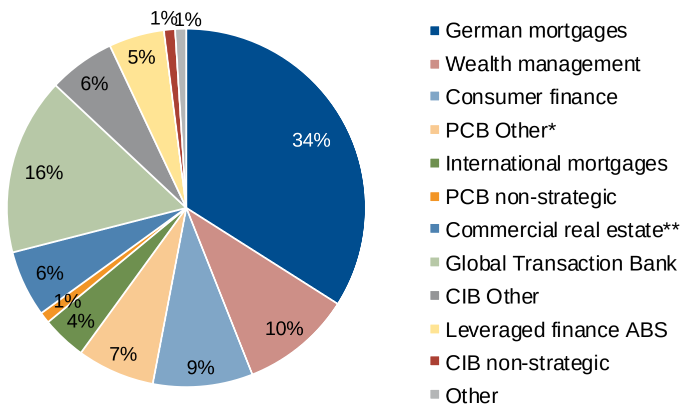
A challenged business model with a high cost base; Strategy 2020 is tackling the weaknesses, but at a relatively slow pace

Deutsche Bank's core business model is that of a global bank, servicing a range of institutional, corporate and private clients, combined with a relatively strong home base in Germany. Having maintained an adequate earnings track record between 2008 and 2011, management was slow to recognise the need to restructure and refocus on potential growth opportunities. Shortly after the Strategy 2020 presentation in 2015, a number of factors, including a slowdown in profitability coupled with the emergence of legal issues, led top management to resign. The new CEO, John Cryan, proceeded with a further strategy update, a EUR 8bn capital increase and the re-integration of Postbank. However, continuous losses and a lack of progress in the turnaround of the organisation led to the outing of Cryan. Cryan was replaced in April 2018 by Christian Sewing who had previously led the Private & Commercial Bank division. The bank's plan is still based on its four initial goals, namely, to become: i) simpler and more efficient; ii) less risky; iii) better capitalised; and iv) better run with more disciplined execution. Sewing has finetuned the strategy further, announcing the reshaping of the bank's main operating areas.

The three business divisions were initially reorganised into:

- CIB which combines markets, advisory, financing and transaction banking businesses.
- PCB, combining the German PCB business (Postbank and Deutsche Bank PCB in Germany), the international PCB business and Global Wealth Management activities.
- And Deutsche Asset Management.

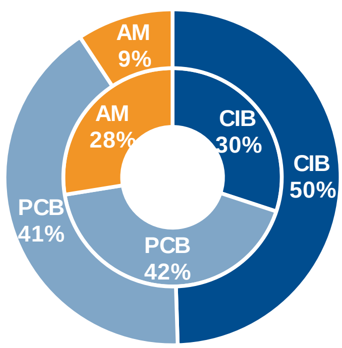
Figure 1: Loan book by business, Q3 2018



Source: Company data, Scope Ratings

* PCB other predominantly includes (a) Postbank Commercial and Corporate Loans (b) Individual loans above 1 million ** Commercial Real Estate Group in CIB and Postbank non recourse CRE business

Figure 2: Distribution of total revenues (outer ring) and income before income tax (inner ring) per business unit, Q3 2018



Source: Company data, Scope Ratings

The integration of Postbank and PCB's German business reflects Deutsche Bank's aim of creating a leading retail presence in Germany, with greater efficiency through economies of scale and the potential to provide better earnings and funding stability.

In Corporate and Investment Banking, the bank has refocused on serving European clients worldwide, scaling back its US rates business and initiating a global equities business review with the intention of reducing its platform.

In addition to the relatively simple organisational and business unit restructuring, we note positively the latest management changes to the bank's culture at group level, towards the better communication of initiatives and faster decision-making processes. The top management's teams have introduced a culture of transparency, which is considered a welcome improvement.

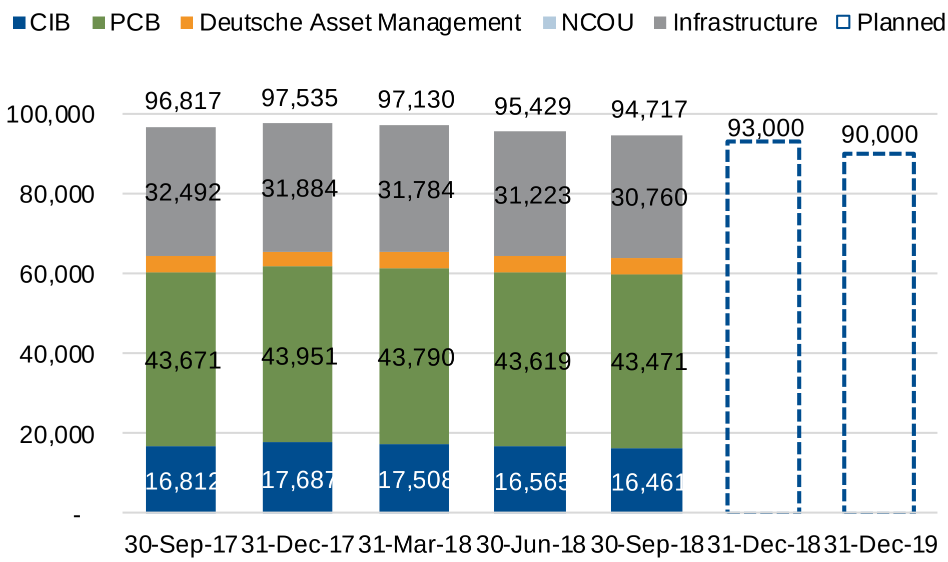
Deutsche Bank's complex structure and business model have so far been a main reason for the bank's unsustainable cost base. We therefore view positively the establishment of a cost reduction programme aimed at achieving adjusted costs of approximately EUR 21bn by 2021. In the first nine months of 2018, adjusted costs decreased by 1% YoY, indicating some progress on cost targets reduction. However, the decline in fees for professional services was more than offset by bank levies.

Deutsche Bank is understandably tackling its compensation and benefits cost structure, given that this component accounts for 50% of total adjusted costs (Figure 4). With around 1400 layoffs in the quarter, the workforce has mainly been cut in infrastructure. The expected reduction in Q4 2018 to meet the target for the end of the year will mostly come from the disposal of the Polish retail business.

We believe that further cost savings will pose the greatest challenge as they will be largely based on still more workforce reductions aimed at lowering the headcount to below 90,000 by the end of 2019 (Figure 3).

We also expect IT costs to remain considerably high, based on the bank's efforts to redevelop its IT infrastructure and advance its digital platform strategy across its business segments.

Figure 3: Group headcount (full-time equivalents, at period end)



Source: Company data, Scope Ratings

Figure 4: Deutsche Bank breakdown of adjusted costs* (EUR m)

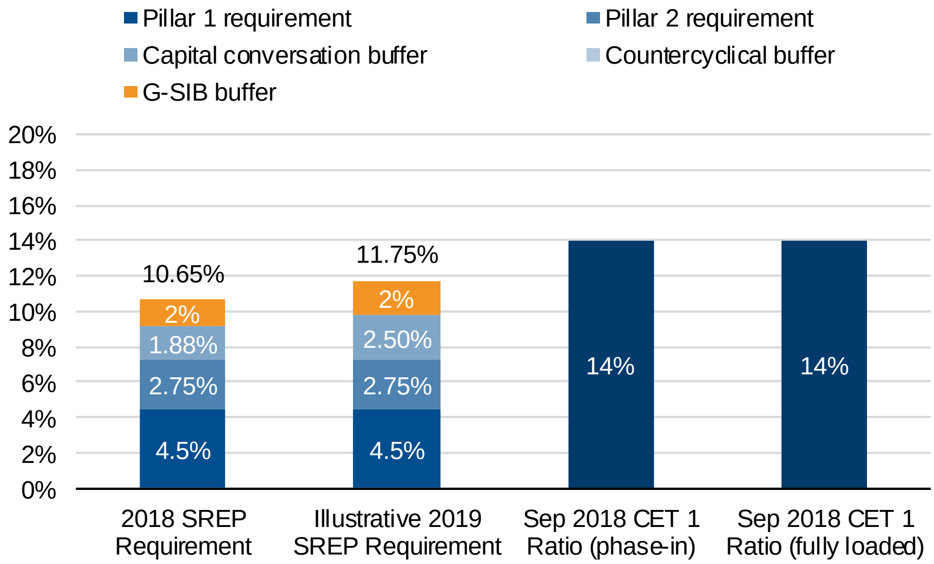
	9M 2018	9M 2017	*YoY change*
Compensation and benefits	**8,787**	8,783	*0%*
IT costs	**2,865**	2,811	*2%*
Professional service fees	**1,141**	1,248	*-9%*
Occupancy	**1,312**	1,345	*-2%*
Bank levy	**863**	766	*13%*
Communication data services, marketing	**692**	723	-4%
Other	**1,728**	1,815	-5%
Adjusted costs	**17,388**	17,489	-1%

*Note: Total non-interest expense excluding restructuring and severance, litigation, impairment of goodwill and other intangibles and policyholder benefits and claims; Source: Company data, Scope Ratings

Prudent capital and liquidity ratios should provide the bank with some temporary stability to overhaul its business model

In March 2017, Deutsche Bank initiated its most recent capital increase which was completed at the beginning of April with gross proceeds of approximately EUR 8bn, bringing the bank's capital ratios more in line with its European peers (see also Appendix A: Peer comparison). Although the prudent capital ratio is helping to buy some time for the bank's restructuring via improved client and counterparty confidence, it can only be regarded as a secondary contributor to the objective of increasing profitability and more stable earnings performance. As of Q3 2018, the bank's CET 1 ratio on a fully loaded basis was 14% and its total capital ratio 18.4%. The bank's capital currently provides a sufficient buffer based on the most recent SREP requirements (Figure 5).

Figure 5: Deutsche Bank SREP requirements versus current CET 1 ratios



Source: Company data, Scope Ratings

Deutsche Bank's shareholder structures have changed, with various strategic investors, including Chinese HNA group, Qatar, Blackrock, Cerberus and, more recently, Hudson Executive Capital, acquiring major stakes. This may place external pressure on senior management and jeopardise the bank's ability to honour long-term management commitments over short-term profitability gains.

Deutsche Bank's leverage ratio on a fully loaded basis stood at 4.0% as of September 2018. The metric has greatly improved driven by a significant reduction of exposure YoY as the bank continues to shrink its balance sheet in selected areas. The bank targets a ratio of 4.5%. We believe that the current pace of targeted assets reduction should allow it to meet this goal.

As the bank reduces its balance sheet there is an increased likelihood that it will move down a bucket in its G-SIB buffer requirement. However, as the O-SII requirement would still be set at 2% the total requirement would remain unchanged.

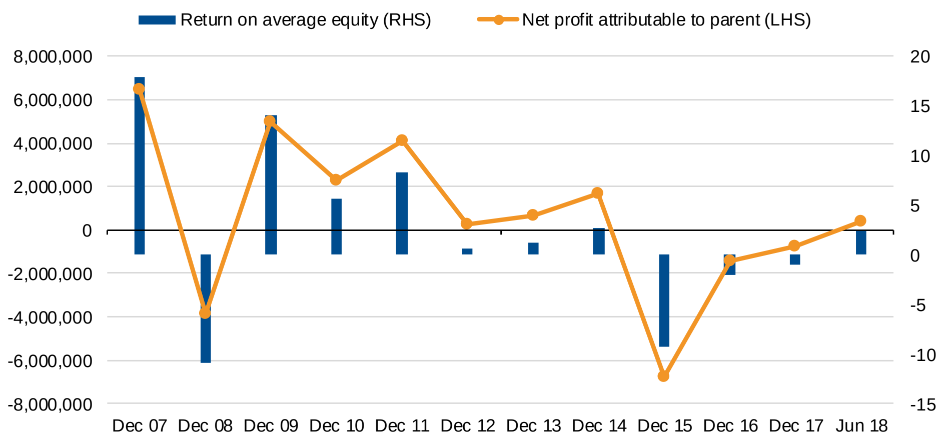
Given Deutsche Bank's experience of undermined market access, particularly in 2016, the bank has shored up its liquidity reserves, amounting to around EUR 268bn, and moved into holding securities rather than cash. The liquidity coverage ratio amounted to around 148% as of Q3 2018 and represented a EUR 76bn buffer above the 100% level required in 2018.

One area of concern for investors so far has been the bank's payment capacity for Additional Tier 1 securities. As of year-end 2017, the bank reported around EUR 1bn of available funds to cover interest payments on AT1 notes and other Tier 1 instruments. It is our understanding that given the legal merger with Postbank, Deutsche Bank should be able to upstream approx. EUR 2bn of general reserves held at the subsidiary level, if required. However, the amount of available distributable items, to be disclosed in Q1 2018 could still be affected by potential future litigation charges.

Internal capital generation capacity remains clouded for the short and medium term due to large restructuring needs and related costs, further uncertainties regarding litigation charges, as well as the impact of reputational risks

Over the past years, Deutsche Bank's overall profitability has been relatively volatile. Furthermore, its somewhat weakened operating income has left little room for a clear and defensible business strategy. Looking at Deutsche Bank's performance across business segments, results in the first nine months of 2018 have been influenced by more muted client activities as well as continued low eurozone interest rates. Although the bank's peers have encountered the same market issues, the earlier restructuring of their businesses, combined with higher efficiencies and less headline risk, have resulted in comparatively better results.

Figure 6: Profitability track record (Dec 2007 – June 2018)



Source: Company data, Scope Ratings

In addition to the current dynamics of the global wholesale and investment banking markets – driven primarily by technology, changed client behaviour, less demand, and heightened regulations – Deutsche Bank also faces various intrinsic difficulties on the road toward adjusting its business model and restoring healthier profitability metrics, more in line with those of global peers. Moreover, the group's retail franchise does not appear to be on par with similar franchises of other large European banks with ratings in the A range.

The impact of ongoing headwinds posed by regulatory reforms and, in particular, Brexit on the bank's business is uncertain. However, in Q3 Deutsche Bank announced that it had moved most of its euro clearing activities from London to Frankfurt, without significant relocation of staff.

In 2017 and the first three quarters of 2018, Deutsche Bank made significant progress on potential litigation risk resulting in relatively low litigation provisions and expenses for the resolution of several matters and lower-than-expected settlements, the Libor settlement among others. Nevertheless, the bank is subject to several jurisdictions and ongoing litigation inside and outside Germany, especially in the US. Litigation expenses are difficult to predict and may have a somewhat cyclical nature. For example, they were low in the first three quarters of 2018 and the bank anticipates that they will rise in the last quarter of 2018.

In Q3 2018 the bank adjusted its expectations for restructuring charges for the full year, from EUR 800m to EUR 600m, leaving EUR 200m of restructuring and severance to be booked in Q4. However, restructuring charges related to the integration of the German retail business, as well as other potential restructuring efforts, have not yet been incurred.

As per the strategy update in March 2017, the bank expects restructuring and severance costs of approximately EUR 2bn over the 2017 to 2021 period, approximately 70% of which is expected to be incurred in 2018 and 2019, leaving approx. EUR 600m to materialise in 2019 in a best case scenario.

Previously resilient investment banking earnings are under pressure from reputational issues, as well as general market shifts

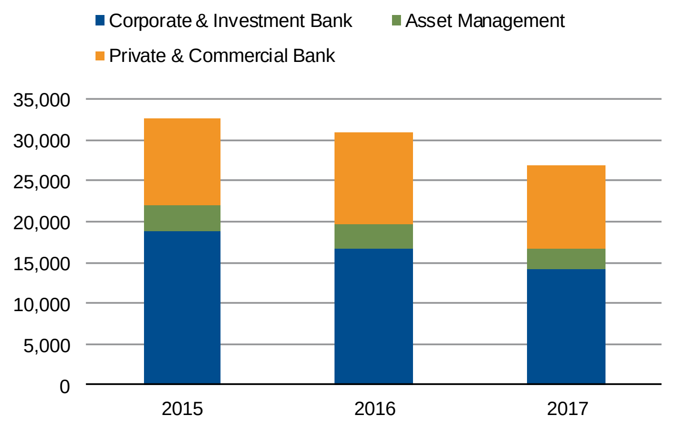
Much attention has been paid to the performance of Deutsche Bank's core CIB segment. Over the past years, the bank's general performance has been supported by resilient, good results in the underlying segments. However, CIB seems to have been hit hardest by the ongoing crisis of confidence affecting the bank. In recent presentations, senior bank management has stated that some of the bank's lost client relationships, mainly during the past two years, have been regained, but the full impact is difficult to assess.

Investment banking revenues declined sharply between 2012 and 2017. The reasons for this include costly internal restructuring efforts combined with reputational risks, as well as challenging markets for fixed income and currencies sales and trading. Furthermore, between 2011 and 2013 assets in the investment banking segment dropped by around 30%. In the past, the bank was considered a 'warehousing' trading house. However, regulatory changes and increased capital costs have undermined this business set up and trading strategies are consequently now more flow focused.

As the scope of CIB activities shrinks, with risk-weighted assets declining by 6% YoY, management has guided for lower revenues in 2018 (versus 2017). However, notwithstanding seasonal effects, less volatile businesses such as Global Transaction Banking (which includes advisory, equity and debt origination services) have so far had a weak 2018. Given the uptick in CIB expenses in Q4, we could expect weak bottom line profitability from the segment in 2018.

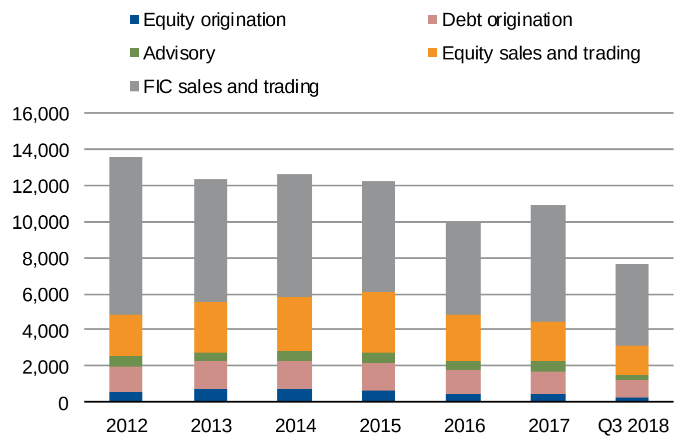
Deutsche Bank still regards CIB as a core business and is focusing on defending a leading European CIB franchise, with the aim of achieving the scale and strength to again pursue growth options. Any proof of stabilising revenues and improving profitability in this business segment should have a positive impact on the bank's credit standing.

Figure 7: Total revenue breakdown (EUR m)



Source: Company data, Scope Ratings

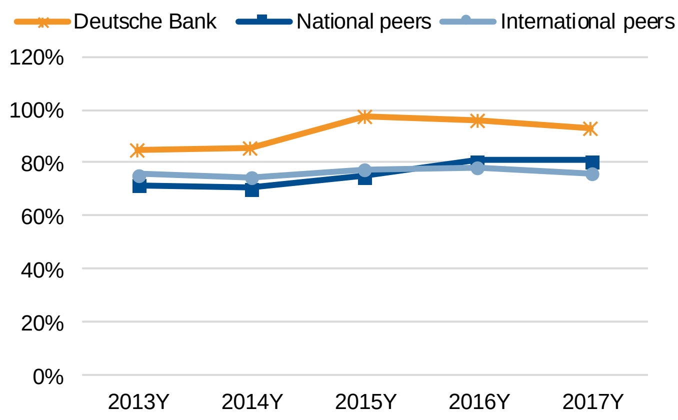
Figure 8: Investment banking revenue breakdown (EUR m)



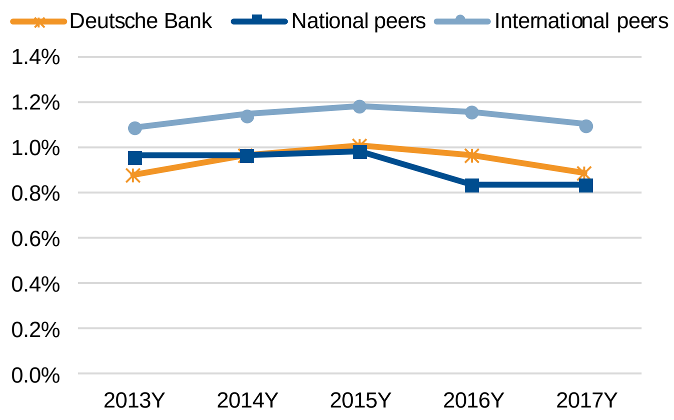
Source: Company data, Scope Ratings

I. Appendix: Peer comparison

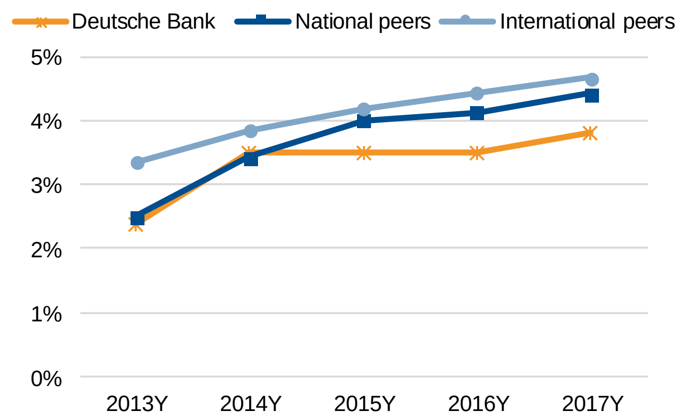
Cost income ratio (%)



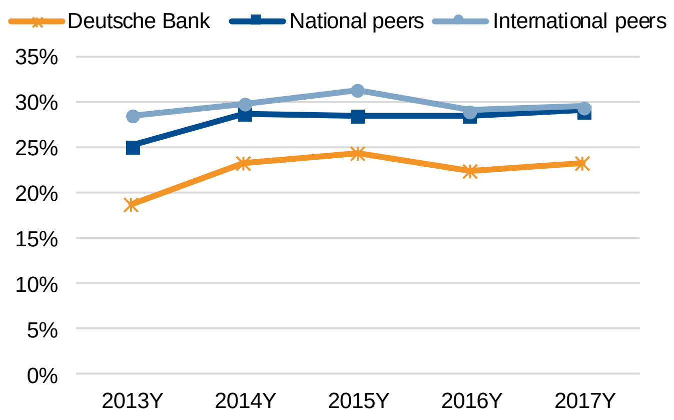
Net interest margin (%)



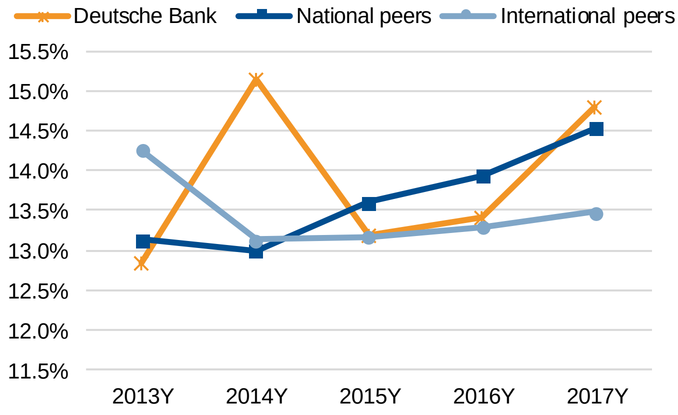
Tier 1 leverage ratio (%)



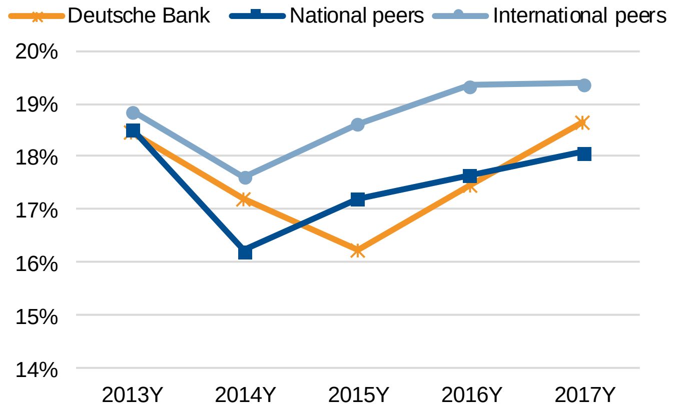
Asset risk intensity (RWA % total assets)



Common equity tier 1 ratio (transitional) (%)



Total capital ratio (%, transitional)



Source: SNL, Scope Ratings
*National peers: Commerzbank, Deutsche Bank, DZ Bank.
**International peers: BNP Paribas, Societe Generale, Deutsche Bank, UBS, Credit Suisse, Barclays, HSBC.

II. Appendix: Selected financial information – Deutsche Bank AG

	2014Y	2015Y	2016Y	2017Y	9M2018
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	106,631	123,965	206,246	247,758	NA
Total securities	1,020,363	922,603	819,640	701,030	609,716
of which, derivatives	634,361	518,730	488,666	364,185	326,166
Net loans to customers	417,444	444,577	419,090	407,225	423,432
Other assets	164,265	137,985	145,570	118,719	NA
Total assets	**1,708,703**	**1,629,130**	**1,590,546**	**1,474,732**	**1,379,982**
Liabilities					
Interbank liabilities	108,350	119,065	NA	NA	NA
Senior debt	266,785	285,026	324,690	326,254	NA
Derivatives	615,265	500,441	468,451	344,020	311,487
Deposits from customers	424,584	447,909	NA	NA	NA
Subordinated debt	16,965	14,845	14,135	13,590	NA
Other liabilities	203,532	194,220	NA	NA	NA
Total liabilities	**1,635,481**	**1,561,506**	**1,525,727**	**1,406,633**	**1,311,194**
Ordinary equity	68,351	62,678	59,833	63,174	62,577
Equity hybrids	4,619	4,675	4,669	4,675	4,675
Minority interests	253	270	316	250	1,535
Total liabilities and equity	**1,708,703**	**1,629,130**	**1,590,546**	**1,474,732**	**1,379,982**
Core tier 1/Common equity tier 1 capital	60,103	52,429	47,782	50,808	47,767
Income statement summary (EUR m)					
Net interest income	14,272	15,881	14,707	12,378	9,698
Net fee & commission income	12,409	12,765	11,744	11,002	7,813
Net trading income	3,239	3,478	744	2,852	1,956
Other income	1,789	1,250	1,632	252	274
Operating income	**31,709**	**33,374**	**28,827**	**26,484**	**19,741**
Operating expense	27,079	32,417	27,659	24,612	17,820
Pre-provision income	**4,630**	**957**	**1,168**	**1,872**	**1,921**
Credit and other financial impairments	1,183	1,062	1,425	562	273
Other impairments	331	5,994	1,409	82	NA
Non-recurring items	NA	NA	854	0	0
Pre-tax profit	**3,116**	**-6,097**	**-810**	**1,228**	**1,650**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	1,425	675	546	1,963	900
Net profit attributable to minority interests	28	21	45	15	58
Net profit attributable to parent	**1,663**	**-6,794**	**-1,402**	**-751**	**692**

Source: SNL

III. Appendix: Ratios – Deutsche Bank AG

	2014Y	2015Y	2016Y	2017Y	9M2018
Funding and liquidity					
Net loans/deposits (%)	90.1%	92.3%	NA	NA	NA
Liquidity coverage ratio (%)	119.0%	119.3%	127.2%	143.6%	146.2%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	24.4%	27.3%	26.3%	27.6%	30.7%
NPLs/net loans (%)	2.9%	2.4%	2.3%	2.1%	NA
Loan-loss reserves/NPLs (%)	46.6%	51.1%	50.4%	48.4%	NA
Net loan growth (%)	7.4%	6.5%	-5.7%	-2.8%	5.3%
NPLs/tangible equity and reserves (%)	17.6%	15.7%	14.9%	12.8%	NA
Asset growth (%)	6.0%	-4.7%	-2.4%	-7.3%	-8.6%
Earnings and profitability					
Net interest margin (%)	1.0%	1.0%	1.0%	0.9%	1.0%
Net interest income/average RWAs (%)	3.7%	3.8%	3.8%	3.5%	3.7%
Net interest income/operating income (%)	45.0%	47.6%	51.0%	46.7%	49.1%
Net fees & commissions/operating income (%)	39.1%	38.2%	40.7%	41.5%	39.6%
Cost/income ratio (%)	85.4%	97.1%	95.9%	92.9%	90.3%
Operating expenses/average RWAs (%)	7.1%	7.8%	7.1%	7.0%	6.8%
Pre-impairment operating profit/average RWAs (%)	1.2%	0.2%	0.3%	0.5%	0.7%
Impairment on financial assets /pre-impairment income (%)	25.6%	111.0%	122.0%	30.0%	14.2%
Loan-loss provision charges/net loans (%)	0.3%	0.2%	0.3%	0.1%	0.1%
Pre-tax profit/average RWAs (%)	0.8%	-1.5%	-0.2%	0.3%	0.6%
Return on average assets (%)	0.1%	-0.4%	-0.1%	0.0%	0.1%
Return on average RWAs (%)	0.4%	-1.6%	-0.3%	-0.2%	0.3%
Return on average equity (%)	2.6%	-9.2%	-2.0%	-1.1%	1.5%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	11.7%	11.1%	11.8%	14.0%	14.0%
Common equity tier 1 ratio (%, transitional)	15.2%	13.2%	13.4%	14.8%	14.0%
Tier 1 capital ratio (%, transitional)	16.1%	14.7%	15.6%	16.8%	16.2%
Total capital ratio (%, transitional)	17.2%	16.2%	17.4%	18.6%	18.0%
Leverage ratio (%)	3.5%	3.5%	3.5%	3.8%	4.0%
Asset risk intensity (RWAs/total assets, %)	23.2%	24.4%	22.4%	23.3%	24.8%

Source: SNL

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

33 rue La Fayette
F-75009 Paris

Phone +33 1 82885557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

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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