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26 April 2024

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RATINGS

Commerzbank AG

Outlook	Positive
LT/ST Deposit rating	A2/P-1

LT Senior unsecured debt rating	A3
Junior senior unsecured debt rating	Baa1
Subordinated debt rating	Baa3
Baseline Credit Assessment (BCA)	baa2

Source: Moodys.com

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Commerzbank AG

Higher profitability supports credit positive restructuring

Summary

Commerzbank AG (A1 positive/A2 positive, baa2[1]) has made substantial strides to cut costs, solidify its revenue base and raise its underlying profit potential[2]. The bank's profitability remains modest compared with European bank peers, but earnings struggles of its retail and corporate banking segments have abated as interest rates rose. Additionally, legacy charges from its Polish subsidiary mBank S.A. (Baa1 positive, ba1) and contributions to the Single Resolution Fund (SRF) will recede, increasing Commerzbank's profitability. Together with its substantially reduced fixed cost base, these factors should move the bank towards the financial targets set out in its refined strategic plan until 2027. These prospects, along with Commerzbank's existing credit strengths of sound capital and liquidity, are reflected in our 24 April affirmation of the bank's ratings and change in outlook to positive from stable.

Revenue growth focus carries higher execution risk but cost control will support financial targets. Under its revised three-year plan, Commerzbank aims to grow revenue to around €12.5 billion by 2027 from €11.6 billion in 2023[3], while containing costs at a higher-than-forecasted level of €6.8 billion[4]. We expect reaching the revenue targets will be ambitious, yet anticipate continued low loan losses to support the bank's thrive and get close to its net return on tangible equity (ROTE) target of 11.5% by 2027, compared with 7.7% in 2023[5]. The bank's payout strategy through a combination of dividends and more flexible share buybacks will further help maintain its Common Equity Tier 1 (CET1) capital ratio at or above 13.5% by 2027, a decline from 14.7% in 2023. The updated medium-term targets represent a bondholder-friendly evolution of Commerzbank's strategic overhaul since 2020, although successful execution increasingly relies on less predictable revenue growth.

The bank's loan book is well diversified, with moderate risk concentrations. Commerzbank's €255 billion Germany-focused loan book is well spread across regions, segments and asset classes. About 80% of its lending is to German retail and corporate customers and exposure to riskier commercial real estate (CRE) loans account for only 3.5% of total gross loans. Asset risks arise from the bank's loan book in Poland, which is concentrated in CRE and construction lending, and residual risks related to its legacy Swiss franc mortgage lending portfolio, although the risk from the latter is mitigated by a solid legal risk coverage.

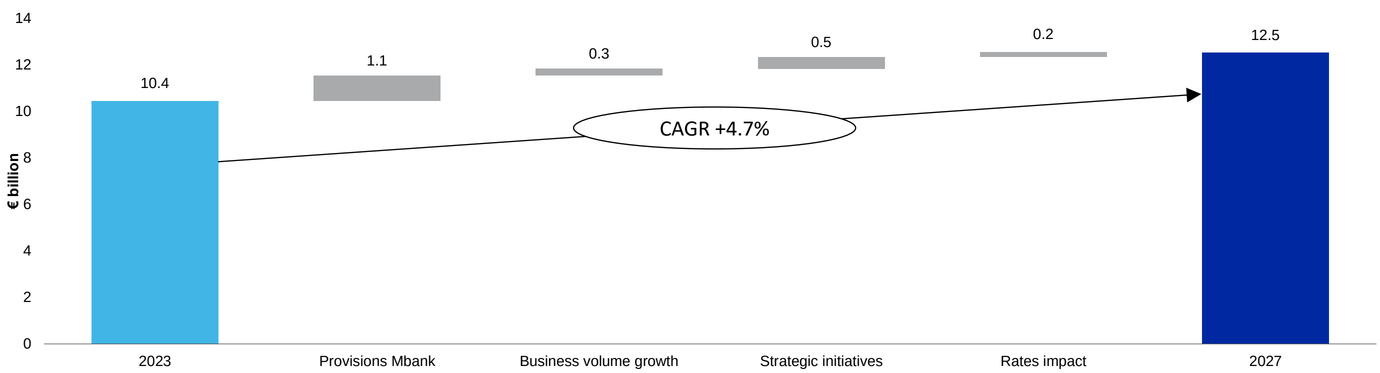
Sound capital and strong liquidity provide sturdy buffers against losses. We expect the bank to maintain a CET1 capital ratio at or above 13.5% in 2027 and potentially beyond, providing a good capital base to absorb anticipated asset quality deterioration. Further, Commerzbank will keep a substantial pool of high-quality liquid assets, significantly reduced its refinancing risk.

Revenue growth focus carries higher execution risk but cost control will support financial targets

Commerzbank's revenue guidance of €12.5 billion in 2027 builds on enhancing its strengths in its Corporate Clients (CC) and Private and Small Business Customers (PSBC) segments. Net revenue growth of about €1.0 billion from the 2023 adjusted level[6] of €11.6 billion will likely be supported by a cumulative €500 million net positive effect from higher interest rates and volume growth (see Exhibit 1). Additionally, €500 million higher income generated across the group, stemming from ongoing strategic initiatives focusing on the generation of additional fee and commission income, will likely add to revenue. Commerzbank's revenue growth will be constrained by higher interest expenses mainly stemming from repricing its large and stable deposit base and lower treasury income as and when rates start to fall.

Exhibit 1

Commerzbank's execution success increasingly relies on revenue growth



As reported, including legal provisions in Poland.

Sources: Company reports and Moody's Ratings

During the 2024-27 planning period, Commerzbank envisages further franchise and efficiency improvements in the CC and PSBC segments targeted to bring in additional revenue or, at the very minimum, safeguard its existing base:

» In PSBC Germany, Commerzbank aims to generate higher revenue from strong growth in deposits. This higher base should allow for increased reinvestment gains from the growing volume of modeled deposits despite a shift to term deposits (which provide higher interest rates) from sight deposits in 2023. Further, growth in payment and asset and wealth management revenue – where Commerzbank has a strong digital brand 'Comdirect' – should improve underlying revenue by around €1.2 billion to €5.3 billion until 2027, from €4.1 billion in 2023. However, considering the highly uncertain and likely volatile interest-rate environment and client behavior determining securities volumes and related fee and commission as well as trading income, the revenue growth targets in PSBC look ambitious.

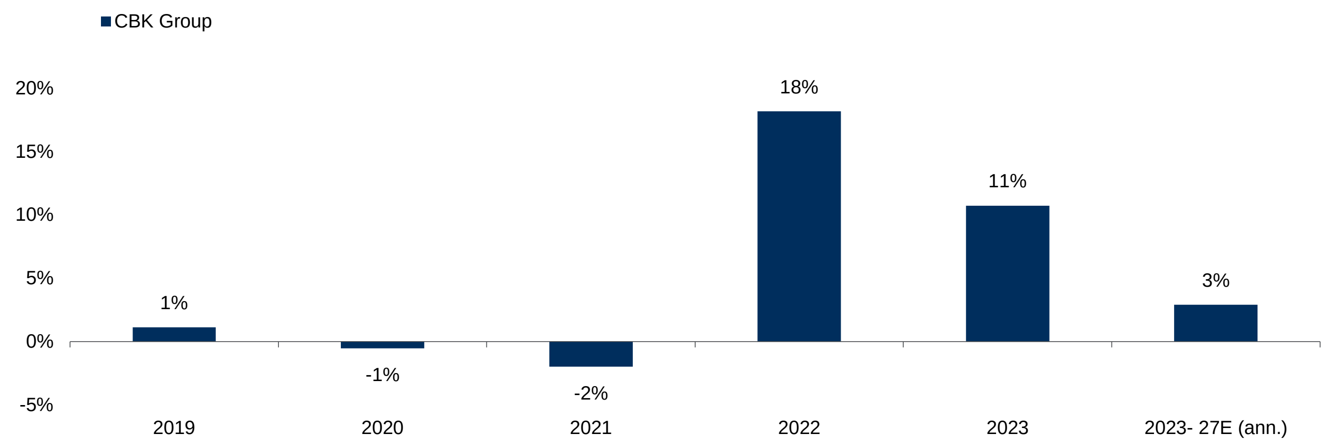
» Within CC, Commerzbank aims to maintain a favourable cost-to-income ratio of 48% by 2027 (2023: 48%), with revenue remaining virtually unchanged from €4.5 billion recorded in 2023. We expect this stability to be supported by revenue growth stemming from higher loan balances, particularly in Germany, and green finance. Additionally, higher net fee and commission income from increased cash and trade finance revenue, accompanied by an extension of its e-foreign-exchange (eFX) platform will help add to growth. These initiatives should help offset the strain on revenue from higher refinancing costs. However, Commerzbank's expectation of a cumulative 15% growth in loans in CC through 2027 is ambitious since it ultimately depends on macroeconomic developments within Germany.

At the same time, at the group level, the swift decrease in the bank's operating cost base to €6.4 billion as of the end of 2023 from €6.9 billion in 2018 helped restore its operating leverage (see Exhibit 2), making it more resilient to setbacks in revenue. Moreover, retreating legacy charges from the bank's Polish operations and lower banking levies will support overall profitability, reducing its dependence on revenue generation which will help the bank to progress and, ultimately, get close to its target returns by 2027.

Exhibit 2

Maintaining operating leverage will be key to success after larger-scale restructuring

Revenue less cost growth, annual



As reported, including legal provisions in Poland.

Sources: Company reports and Moody's Ratings

The bank's loan book is well diversified, with moderate risk concentrations

Commerzbank has been able to absorb additional charges during the first phase of its restructuring because of its reduced operating cost base and stable revenue base. With less operating leverage to be generated by cost savings, it will be important to contain loan loss charges potentially arising from asset quality deterioration in a highly uncertain macroeconomic environment.

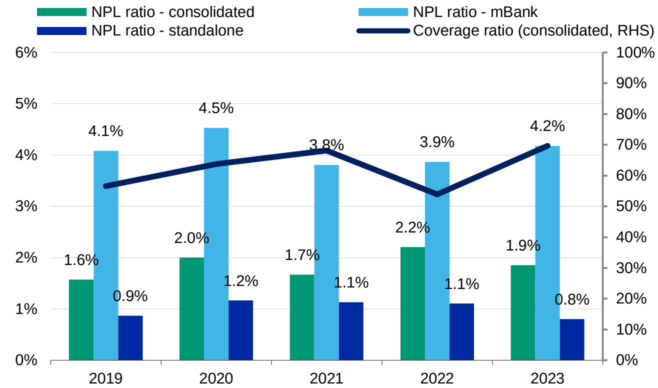
During the 2024-27 outlook period, Commerzbank anticipates loan loss charges to stay at around 25 basis points of gross loans, which is a realistic target in light of its solid customer base and favourable loan book split. More than 80% of Commerzbank's gross loan balances stem from its home domicile of Germany, where corporate debt was 72% of GDP and household debt was 55% at the end of 2022[7], among the lowest levels in Europe.

Although CRE is no longer considered a strategic asset class since the restructuring and wind-down of former real-estate lender Eurohypo AG between 2012-16, Commerzbank still holds around €9.0 billion in exposure to this asset class, equivalent to only 3.5% of total gross loans as of year-end 2023, meaningfully lower than the EU banks' average of 7.5% as of the same date. The sharp increase in interest rates created challenges for CRE property market values, making refinancing more difficult and is likely to erode asset quality in coming years. However, we believe resulting risks are manageable because the portfolio is almost exclusively in Germany (99%) with around 60% in prime locations (so-called A-cities), an average loan-to-value of 51% and low problem loans of around 4% at the end of 2023. In addition, nearly 50% of the portfolio has full or partial recourse to the sponsor or borrower.

Since the end of 2019, Commerzbank's asset quality has remained largely stable, as reflected in its overall nonperforming loans ratio of 1.86% as of year-end 2023, compared with 1.72% in 2018 (see Exhibit 3). However, in 2022 and 2023, Stage 2 exposures have increased more meaningfully for both client groups (see Exhibit 4), indicating rising financial challenges for private households and corporate customers, despite overall low indebtedness levels.

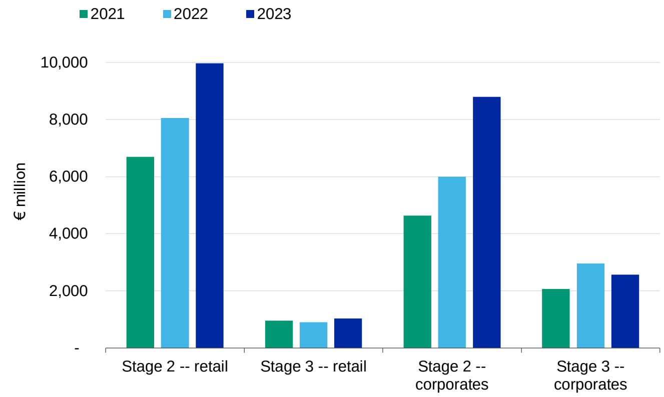
Nevertheless, we believe Commerzbank will be able to withstand moderate asset quality deterioration because of its now stronger operating performance. The bank has also continued to conservatively build provisions for performing loans and has only been releasing smaller portions of forward-looking provisions built since the onset of the coronavirus pandemic in 2019 (as of the end of 2023 its top level adjustment was €453 million), which will continue to provide a substantial buffer against unexpected shocks.

Exhibit 3
Commerzbank's asset quality held steady during the challenging 2019-2023 period



Sources: Company reports and Moody's Ratings

Exhibit 4
Increase in Stage 2 exposures points to gradually rising strain for households and corporates



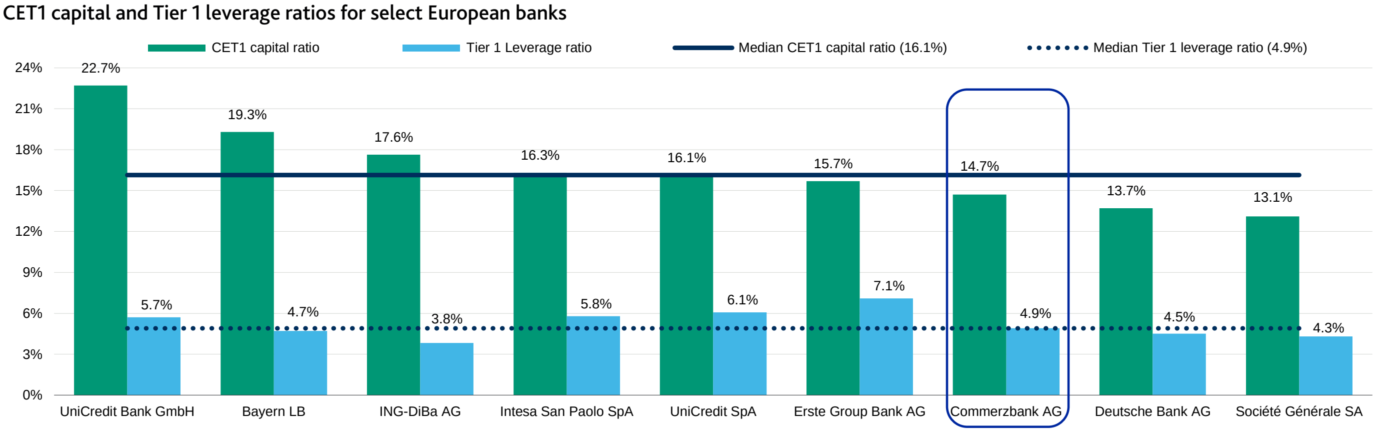
Sources: Company reports and Moody's Ratings

However, Commerzbank continues to face unresolved litigation risk from Swiss franc-denominated mortgages at mBank, which has repeatedly burdened the bank's consolidated earnings because it had to build significant legal reserves. The nonbinding opinion of the Advocate General of the European Court of Justice and subsequent ruling of the European Court of Justine in-line with the opinion has triggered sizeable model adjustment and a reassessment of litigation risk during the second quarter of 2023 and subsequent quarters, bringing the bank's total provisions to €1.9 billion as of year-end 2023 from €1.4 billion in 2022. The increase in provisions adjustments means Commerzbank's coverage ratio has increased to almost 100% of its remaining €1.9 billion exposure to Swiss franc-denominated mortgages, one of the highest coverage ratios in Poland.

Sound capital and strong liquidity continue protecting bondholders

Commerzbank's Common Equity Tier 1 (CET1) capital ratio was 14.7% as of the end of 2023, about 200 basis points higher than the 2019 level when it initiated its restructuring programme 'Commerzbank 5.0'. Management intends to keep a capital buffer of at least 250 basis points over its regulatory requirements[8], safeguarding its capital position well above the ECB's regulatory requirements (see Exhibit 5).

Exhibit 5
Commerzbank will remain solidly capitalised
CET1 capital and Tier 1 leverage ratios for select European banks



Notes: BayernLB = Bayerische Landesbank AöR; Q3 2023 for ING-DiBa AG; Q4 2023 for rest of the banks. The Tier 1 leverage ratios of UK and European banks are calculated per the Capital Requirement Regulation.
Sources: Company reports and Moody's Ratings

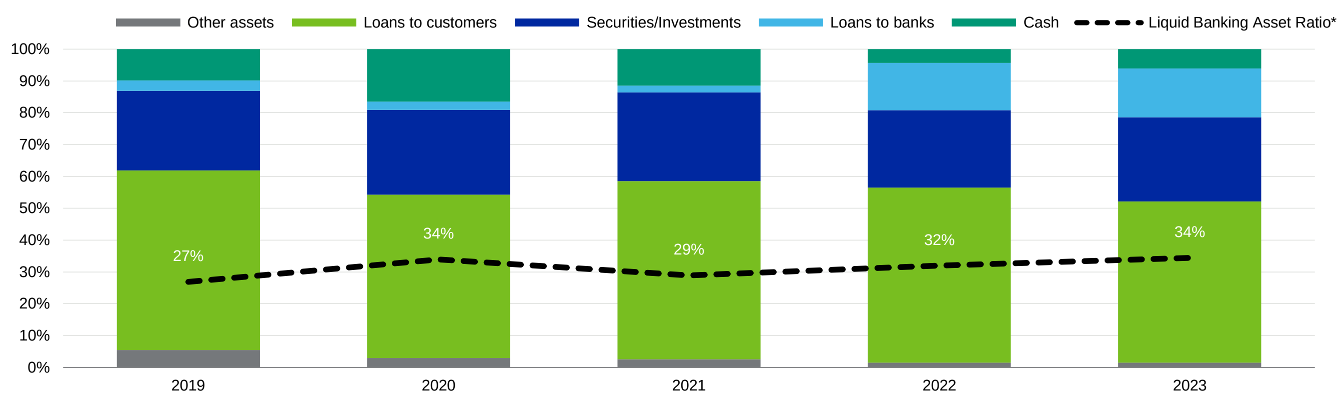
For 2023, Commerzbank will pay a cash dividend of €0.35 per share, equivalent to around €400 million of dividend payments. Commerzbank also concluded a €600 million share repurchase programme on 4 April. For 2024 and beyond, Commerzbank aims to achieve a total payout ratio of well above 50% - but no more than 100%[9] - through a combination of gradually growing cash dividends and more flexible share buybacks. This capital distribution policy, although potentially paying out up to 100% of net profit from 2025, allows for sufficient flexibility by limiting the anticipated total payout such that it would always maintain a CET1 capital ratio of at least 13.5%, a credit positive.

In addition to its solid capitalisation and flexible capital distribution policies, high balance-sheet liquidity remains a strength. Commerzbank's strong €134 billion high-quality liquidity reserve in the fourth quarter of 2023 was well above requirements stipulated by the liquidity coverage ratio, which was 145%. The bank's liquidity further benefits from a moderate gross loan-to-deposit ratio of 77.4% as of 31 December 2023 compared with 84.7% in 2022. We do not expect the bank to reduce this liquidity buffer substantially, despite having returned the remaining €3.5 billion of ECB funding obtained under targeted longer-term refinancing operations (TLTRO III) in March 2024.

Commerzbank's sound liquidity is expressed in our Liquid Banking Assets ratio (see Exhibit 6), which increased to 34.4% as of the end of 2023 from 31.9% in 2022, including reported cash and interbank facilities of around €110 billion compared with €92 billion in 2022 and €69 billion of investment securities compared with €63 billion in 2022.

Exhibit 6

Sound liquidity supports financial profile



Sources: Company reports and Moody's Ratings

Moody's related publications

» Rating action - Moody's Ratings affirms Commerzbank's long-term deposit, issuer and senior unsecured debt ratings, changes outlook to positive, 24 April 2024

» Banks - Germany: Banking System Profile, 23 April 2024

» Credit Conditions – European Area: Euro Area Credit Compass will ebb on slow growth and high rates but still near average, 15 April 2024

» Banks – Europe: ECB's decision to keep rates unchanged will weigh on banks' lending and stabilise margins, 11 March 2024

» Banks - Germany: Banking System Outlook - Faltering economy and deteriorating loan quality shift outlook to negative, 7 March 2024

» Commerzbank AG: Key facts and statistics - Q3 September 2023, 16 November 2023

» Commerzbank AG: Decade-high profit supports ambitious strategic and financial targets, 17 February 2023

Endnotes

1 The ratings shown are Commerzbank's deposit and senior unsecured debt ratings together with their corresponding outlooks, and its Baseline Credit Assessment (BCA).

2 Commerzbank was bailed out by the German government after the 2008 financial crisis. Since then, the bank has had to cut over 10,000 jobs, closed branches and appointed several new management teams as part of its evolving strategy of refocusing and streamlining the bank, the latest being the Commerzbank 5.0 strategy unveiled in 2019 and completed in 2023.

3 Excludes mBank's €1.1 billion legal charges in 2023 related to legacy Swiss franc mortgages.

4 The strategic plan Commerzbank 5.0 announced in December 2019 aimed at lower operating expenses to below €6.3 billion by 2023.

5 Excludes mBank's legal charges.

6 Excludes mBank's legal charges of €1.1 billion in 2023 related to its legacy Swiss franc mortgages.

7 IMF data. Total stock of loans and debt securities of households as a share of GDP.

8 Maximum Distributable Amount (MDA) requirement of 10.34% and resulting buffer of 435 basis points as of 1 January 2024.

9 As a percentage of net income in accordance with international accounting standards after coupon payments for Additional Tier 1 (AT1) debt securities.

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EMEA	44-20-7772-5454

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