S&P Global Ratings

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Research Update:

Commerzbank Outlook Revised To Stable On Improving Revenue Prospects, Reduced Transformation Risk; 'BBB+' Affirmed

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Overview

- Commerzbank AG´s multiyear transformation is on track, and we consider execution risk has reduced.
- The bank's revenue prospects are improving thanks to rising interest rates and solid fee income.
- We acknowledge downside economic risks and Commerzbank's current depressed earnings capacity, but see the bank's solid capitalization as allowing some headroom to absorb higher credit losses than we currently project.
- We have revised the outlook on Commerzbank to stable from negative and affirmed our 'BBB+/A-2' long- and short-term ratings.
- Our stable outlook reflects our expectation that there will be no major setbacks in the transformation and Commerzbank will largely reach its financial targets.

Rating Action

On May 23, 2022, S&P Global Ratings revised its outlook on Commerzbank AG to stable from negative, and affirmed its 'BBB+/A-2' long- and short-term issuer credit ratings.

We affirmed all related senior unsecured, senior subordinated, and other hybrid issue ratings.

Rationale

The risk that Commerzbank's multi-year transformation could fail has been significantly reduced. Under our economic base case, we believe that improving earnings prospects from rising interest rates in Poland and the eurozone, as well as continued solid fee income, will provide Commerzbank with momentum to meet its 2024 financial targets. While asset quality could deteriorate moderately and Commerzbank's earnings capacity remains depressed, its reserves and capital buffers provide some mitigation to an expected increase in credit losses. Our forecast includes credit losses of 30-40 bps annually until 2024. We also consider measures taken by Commerzbank to reduce its structural cost base to be broadly on track, and see reduced tail risks from the legacy Swiss franc retail mortgage portfolio of its Polish subsidiary, mBank.

Tough measures are needed to address the bank's structurally weak profitability. In January 2021, Commerzbank announced a revised strategic plan shortly after its new CEO took office (see "Commerzbank AG 'BBB+/A-2' Ratings Affirmed On Strategy Announcement; Outlook Remains Negative," published Feb. 26, 2021, on RatingsDirect). Top priorities include achieving a 20% lower cost base over four years and the transition to a digital operating model while defending the revenue pool during a complex multiyear restructuring. As previous attempts had little success, we have been particularly cautious about revenue in the challenging environment of low interest rates and fierce competition.

We have now revised upward our earnings forecasts. Commerzbank has beaten market expectations in the early phase of its restructuring, driven by strong operating performance in the securities business and in mBank, and manageable pressure on interest income. We continue to forecast solid fee income and believe that rising interest rates in Poland and the eurozone will allow the bank to steadily increase its revenue base through 2024. This is likely to more than offset expected cost increases due to inflationary pressures and expected credit losses due to the war in Ukraine, allowing the bank to reach its target of a 7% return on tangible equity in 2024.

The fulfilment of financial targets nevertheless implies that Commerzbank's profitability will remain modest compared with its peers'. Although execution risk has reduced and our stand-alone credit profile (SACP) on Commerzbank remains at 'bbb', we continue to consider profitability as a rating constraint for Commerzbank. A stronger assessment would require a track record of sustained profitability that covers Commerzbank's cost of capital and is more on par with higher rated peers.

We expect solid ongoing operating performance at mBank and think tail risk from its Swiss franc retail mortgage portfolio has reduced. Most customer loans have variable interest rates and mBank's earnings are benefiting greatly from the sharp rise in interest rates in Poland. We also include further provisioning needs on Swiss franc loans in our forecast but consider the tail risk to earnings and capitalization has materially reduced. This reflects strong additions in 2021 and solid coverage of the remaining Swiss franc portfolio. We recognize that the Polish government's plans to mitigate the impact of rising interest rates and inflation on customers, as well as Getin Noble Bank's unclear future, may result in significant but ultimately manageable costs for Polish banks, including mBank (see "There's No Easy Way Out Of Getin Noble's Troubles," May 6, 2022)

We expect solid capitalization through the transformation. Commerzbank's common equity tier 1 (CET1) ratio was 13.5% as of March 31, 2022, but we expect it will decrease over the coming years in line with management's guidance to maintain a sustained buffer of 200-250 basis points (bps) above the maximum distributable CET1 capital requirement, which is expected to be 10.2% in 2024. We anticipate that achievement of financial targets would set the stage for sizable capital returns in the form of dividends and share buybacks, as guided by management. This means that our risk-adjusted capital ratio (RAC) will likely remain close to but below 10% through 2024, despite a calculated RAC ratio of 10.4% at the end of 2021.

We expect Commerzbank's sizable bail-in-able buffers to reduce over time but to still allow for one notch of rating uplift. Commerzbank is operating under a multiple point of entry (MPE) resolution strategy, so we include only the German subgroup's bail-in-able instruments and risk-weighted assets in our additional loss-absorbing capacity (ALAC) measure for Commerzbank. Based on full-year 2021 data, the ALAC ratio was 6.8%, which is above our 6% threshold for two notches of uplift. However, we expect it will decline to less than 5.5% by 2024. This reflects our assumption of only partial replacement of maturities, due to strong buffers against Commerzbank's subordinated MREL requirements and due to the focus on cost optimization during the transformation.

Outlook

The stable outlook reflects our view that Commerzbank's multiyear restructuring will succeed and that its financial targets will be largely achieved. We anticipate a steady improvement in structural profitability over the coming 12-24 months and sound capital levels.

Downside scenario

We see the most likely downgrade scenario for Commerzbank as one in which our economic forecasts weaken materially, implying depressed fee income and far weaker asset quality than expected.

While less likely, we could also downgrade the bank if its transformation seemed likely to fail to improve structural profitability, for example due to failure to realize cost savings or if it becomes evident that the revenue potential is significantly weaker after the restructuring.

Upside scenario

While currently an unlikely scenario, we could revise upward the SACP and all of its ratings over our two-year horizon if we see Commerzbank delivering significantly improved structural profitability, closer to peers with 'bbb+' group SACPs. We may also raise the rating if we have certainty that the RAC ratio would remain well above 10% on a sustainable basis, while the bank maintained strong asset quality.

We could also raise Commerzbank's issuer credit rating and our ratings on its senior preferred instruments if we were to believe that the bank would sustainably hold a ALAC buffer that comfortably exceeds our 6% threshold for two notches of uplift.

Ratings Score Snapshot

	To	**From**
Issuer Credit Rating	**BBB+/Stable/A-2**	**BBB+/Negative/A-2**
SACP	bbb	Bbb
Anchor	bbb+	bbb+
Business position	Moderate	Moderate
Capital and earnings	Adequate	Adequate

	To	From
Issuer Credit Rating	**BBB+/Stable/A-2**	**BBB+/Negative/A-2**
Risk position	Adequate	Adequate
Funding	Adequate	Adequate
Liquidity	Adequate	Adequate
Comparable ratings analysis	0	0
Support		
ALAC support	+1	+1
GRE support	0	0
Group support	0	0
Sovereign support	0	0
Additional factors	0	0

SACP--Stand-alone credit profile.

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- There's No Easy Way Out Of Getin Noble's Troubles, May 6, 2022,
- When Rates Rise: Eurozone Bank Earnings Will Too--Especially For Retail, Feb. 17, 2022
- German Bank Ratings Affirmed Under Revised Financial Institutions Criteria, Jan. 28, 2022
- Update: Commerzbank AG, Nov. 22, 2021
- Commerzbank AG 'BBB+/A-2' Ratings Affirmed On Strategy Announcement; Outlook Remains

Negative, Feb. 26, 2021

- Bulletin: Sustainable Profitability Remains A Challenge For Commerzbank Despite Further Cost Cuts Under Revised Strategy, Jan. 29, 2021
- Bulletin: CEO's Exit Complicates Commerzbank's Strategy Execution, July 6, 2020

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Commerzbank AG		
Issuer Credit Rating	**BBB+/Stable/A-2**	**BBB+/Negative/A-2**
Resolution Counterparty Rating	A-/--/A-2	
Senior Unsecured	BBB+	
Senior Unsecured	BBB+p	
Senior Subordinated	BBB-	
Subordinated	BB+	
Junior Subordinated	BB-	
Commercial Paper	A-2	
Commerzbank U.S. Finance Inc.		
Commercial Paper	A-2	
Dresdner Funding Trust I		
Junior Subordinated	BB-	
Dresdner Funding Trust IV		
Subordinated	BB+	

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914