Research Update:

Commerzbank AG 'BBB+/A-2' Ratings Affirmed On Strategy Announcement; Outlook Remains Negative

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Overview

- On Feb. 12, 2021, Commerzbank announced details of its revised restructuring plan under its new CEO, Manfred Knof, aiming at addressing the bank's structurally low profitability.
- We think management is aligning Commerzbank's structural cost base to its midterm revenue potential
- Although it will take until 2024 to fully deliver these measures, they will meaningfully improve the bank's subpar profitability.
- We are affirming our 'BBB+/A-2' long- and short-term issuer credit ratings on Commerzbank.
- The outlook remains negative, reflecting significant execution risks, particularly on delivering the associated revenue targets amid difficult operating conditions during the COVID-19 pandemic.

Rating Action

On Feb. 26, 2021, S&P Global Ratings affirmed its 'BBB+/A-2' long- and short-term issuer credit ratings on Commerzbank AG. The outlook is negative.

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

At the same time, we withdrew our 'BBB+' issuer credit rating on HT1 Funding GmbH at the issuer's request.

Rationale

We think Commerzbank's revised strategic plan is necessary to address the bank's structurally weak profitability. However, in our view, execution will be challenging. The rating affirmation reflects our central scenario that management will execute the strategy prudently, reach its cost target, and make tangible progress in restoring the bank's profitability.

Strong headwinds in a weakened operating environment have increased the pressure to implement wholesale changes to the bank's operating model. Whereas most peers had already addressed their larger restructuring needs before the outbreak of COVID-19, Commerzbank's previous attempts under former management had shown limited progress in moving the bank toward a sustainable and at least moderately profitable business model. Although the bank reached cost targets, it consistently under-delivered on its revenue goals, resulting in a continuous need to further adjust its cost structures. We think the planned reduction in operating costs of about 20% until 2024 will bring Commerzbank's structural cost base in line with its midterm revenue potential amid a very difficult operating environment with very low rates and intense competition.

We think execution risk is significant, but delivery would narrow the gap to peers. Under the revised strategic plan presented by Mr. Knof, Commerzbank targets a pretax return on tangible equity of 7% and cost efficiency of 61% by 2024. This would bring profitability closer to the bank's cost of capital. That said, the plan includes more ambitious targets than previously. We see material execution risk, particularly in the delivery of its revenue targets amid a difficult operating environment and considering Commerzbank's past weak track record. The bank also faces challenge in striking the fine balance between managing its regulatory capital ratios and defending its revenue base through a transition process that will take several years.

We think Commerzbank's overhaul to its operating model addresses the main source of the problem--a structural cost base unsuitable for its earnings potential. The bank's revised strategic plans particularly rest on strict cuts to costs while accelerating the digitalization of services and processes along the bank's value chain. It includes a radical downsizing of employee numbers and branch network to adapt to changed customer demand in an increasingly digitalized financial ecosystem. It also involves the exit of unprofitable products, foreign locations, and client relationships, mainly in its corporate segment.

We remain unsure about Commerzbank's revenue targets. The bank is seeking additional revenue via the repricing of its product range, an optimized client coverage model, and ambitious growth targets in the securities and lending business. These should compensate for the anticipated decrease in its revenue pool--stemming from exits, customer reaction to repricing, and asset securitization--and ongoing elevated revenue headwinds in an ultra-low-rate environment. Commerzbank's moderate revenue growth targets until 2024 largely rest on increasing contributions from its Polish subsidiary, mBank (BBB/Negative/A-2), after it abandoned its sale last year.

We forecast sufficient capital headroom over regulatory minimums through the restructuring process. Commerzbank intends to manage its regulatory risk-weighted assets (RWA) prudently through the restructuring process. This should allow the private and small business customer segment to expand, fund the open €0.9 billion restructuring costs and €1.7 billion IT investment, and compensate for an expected inflation in RWA from phasing-in of regulatory rules. In a low point, likely over 2021-2022, Commerzbank expects a buffer of about 200-250 basis points (bps) above its maximum distributable amount requirement of Common Equity Tier 1 (CET1) at about 9.5%. This compares with a CET1 ratio of 13.2% as of year-end 2020 and a current buffer of 370 bps.

We consider the plan as generally achievable but the pandemic could prevent successful execution. In our base case, Commerzbank would come close to its targeted return on equity by 2024. However, our central scenario hinges on the assumption that the economic disruption from the COVID-19 pandemic does not last longer than we currently expect--otherwise, it would likely increase credit losses, depress revenue, and impede Commerzbank's restructuring process. We also note that potential external shocks, such as further elevated levels of litigation-related provisions on mBank's Swiss franc denominated lending portfolio, could disrupt the success of its transition (see "mBank's 2020 Results Reflect The Ongoing Swiss Franc Legacy Mortgage Loan Saga In Poland And Pandemic-Induced Recession," published Feb. 9, 2021). This is especially pertinent given that Commerzbank plans to manage its regulatory capitalization levels within a relatively narrow range.

Over the coming 18 to 24 months, we will monitor Commerzbank's progress in delivering its interim goals, such as reducing its cost base, maintaining the support of its clients, and introducing measures that will not lead to a material, irrevocable loss in revenue.

HT1 Funding GmbH has now redeemed its final outstanding security, a legacy Tier 1 instrument. We are withdrawing the issuer credit rating on HT1 Funding GmbH at the issuer's request. At the time of withdrawal, the outlook was negative, reflecting that on the ultimate parent, Commerzbank AG.

Outlook

The success of the revised restructuring plans is the key consideration for our ratings on Commerzbank. The negative outlook reflects the significant challenges that management faces to recover to more solid, sustainable profitability amid weak operating conditions.

Downside scenario

We could lower our ratings on Commerzbank within the next 12-24 months if we observed a material setback in the bank's transformation, for example because of a significant delay in anticipated cost savings or increasing uncertainty over whether Commerzbank can widely preserve its revenue base during the restructuring process.

We could also consider a downgrade if we saw materially higher risks for the German banking industry, potentially triggered by a further deterioration of operating conditions during the COVID-19 pandemic. This would lead to a downgrade of all outstanding senior and hybrid instruments.

Upside scenario

We could revise our outlook back to stable if we saw tangible progress in the restructuring process. This would require improved profitability and reduced execution risk. An outlook revision would also hinge on our view that downside risks from the COVID-19 pandemic were abating for German banks.

Ratings Score Snapshot

Table 1

Commerzbank AG -- Ratings Score Snapshot

Issuer Credit Rating	BBB+/Negative/A-2
SACP	bbb
Anchor	a-
Business Position	Moderate (-1)
Capital and Earnings	Adequate (0)
Risk Position	Moderate(-1)
Funding and Liquidity	Average and Adequate (0)
Support	(+1)
ALAC Support	(+1)

ALAC--Additional loss-absorbing capacity. SACP--Stand-alone credit profile.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- 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
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- mBank's 2020 Results Reflect The Ongoing Swiss Franc Legacy Mortgage Loan Saga In Poland And Pandemic-Induced Recession, Feb. 9, 2021
- Sustainable Profitability Remains A Challenge For Commerzbank Despite Further Cost Cuts

Under Revised Strategy, Jan. 29, 2021

- Restructuring Costs And Goodwill Write-Off Highlight Challenges Facing New Commerzbank CEO, Jan. 8, 2021
- Commerzbank AG, Aug. 12, 2020
- CEO's Exit Complicates Commerzbank's Strategy Execution, July 6, 2020
- Commerzbank's Q1 2020 Loss And Abandoned Sale Of mBank Highlight Restructuring Hurdles, May 13, 2020
- Commerzbank AG Downgraded To 'BBB+' On Vulnerability In The Wake Of COVID-19 Pandemic; Outlook Negative, April 23, 2020

Ratings List

Ratings Affirmed		
Commerzbank AG		
Issuer Credit Rating	BBB+/Negative/A-2	
Resolution Counterparty Rating	A-/--/A-2	
Commerzbank AG		
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+	
Ratings Withdrawn		
	To	**From**
HT1 Funding GmbH		
Issuer Credit Rating	NR/--	BBB+/Negative/--

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

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