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Fitch Ratings: Deutsche Bank/Commerzbank Merger Talks Highlight Challenges

Fitch Ratings-London/Frankfurt-18 March 2019: Deutsche Bank's announcement that it is reviewing strategic options including a potential merger with Commerzbank highlights the pressure on both banks to improve profitability, Fitch Ratings says.

German banks' earnings have been depressed by low interest rates and intense competitive pressure for several years, especially in corporate banking. Deutsche is engaged in a restructuring programme that has yet to sustainably produce adequate returns. More generally, German banks have mitigated the earnings pressure through unusually high new business volumes on the back of the strong domestic environment. But recent downward revisions of the economic growth outlook point to weaker credit demand, which could prompt banks to look for alternative ways to defend their earnings.

To be credit positive, we believe a merger would have to be based on a solid strategic plan that entails credible revenue synergies, but the necessary restructuring measures are likely to be protracted and result in material execution risk. A merger would initially create one of Europe's largest banking groups, with pro-forma combined assets of about EUR1.8 trillion at end-2018, although post-merger streamlining would probably result in significant balance-sheet shrinkage.

Combining Deutsche and Commerzbank's retail banking operations would add critical mass and could result in cost savings but would also give rise to material execution risk. This is particularly the case because Deutsche is still integrating the former Postbank, which it absorbed in 2018. Combining these operations with Commerzbank's business would add complexity and be likely to generate material upfront restructuring costs.

Deutsche and Commerzbank's combined domestic loan and deposit market shares would be 10%-15%, but this is still well below that of Germany's savings banks and co-operative banks. These two umbrella organisations each have closer to a 25% market share, with particularly strong franchises in the retail and small corporate segments.

In our opinion, simply aggregating Deutsche and Commerzbank's operations would not automatically improve revenue generation as both banks lag the savings and co-operative banks' size and leading insurance product offering through bancassurance and sizeable high-margin operations such as consumer finance. It is also critical to achieve levels of cross-selling that are sufficient to ensure strong customer loyalty and pricing power in retail banking.

In investment banking, there is less overlap between the two groups following Commerzbank's reduced international activities. Deutsche has also cut its product offering but remains one of the largest players in fixed income, and currency sales and trading, both globally and in Europe. A combination with

Commerzbank, which relies less on trading income, would ease the combined group's exposure to the earnings volatility arising from Deutsche's investment banking.

Both banks' Long-Term Issuer Default Ratings are 'BBB+', and the Negative Outlook on Deutsche's rating reflects our view that the bank's strategic targets remain challenging. Deutsche reported a small net profit of EUR341 million for 2018, its first since 2014, but reaching its targeted 4% return on tangible equity (RoTE) in 2019 will depend on a recovery in market share and client activity as well as a more benign market environment.

Commerzbank's Outlook is Stable. The bank is halfway through a four-year strategic plan, has been modestly profitable for the past few years and reported full-year net profit of EUR865 million for 2018. This is equivalent to a net RoTE of 3.4% and is still short of the bank's (recently lowered) 5%-6% target for 2020.

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