

## Commerzbank AG

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# Commerzbank AG

<b>SACP</b>	<b>bbb+</b>	+	<b>Support</b>	<b>+1</b>	+	<b>Additional Factors</b>	<b>0</b>
<b>Anchor</b>	<b>a-</b>		<b>ALAC Support</b>	<b>+1</b>		<b>Issuer Credit Rating</b>	
<b>Business Position</b>	Moderate	-1	<b>GRE Support</b>	0		<b>A-/Negative/A-2</b>	
<b>Capital and Earnings</b>	Strong	+1	<b>Group Support</b>	0		<b>Resolution Counterparty Rating</b>	
<b>Risk Position</b>	Moderate	-1	<b>Sovereign Support</b>	0		<b>A/--/A-1</b>	
<b>Funding</b>	Average	0					
<b>Liquidity</b>	Adequate						

## Major Rating Factors

<b>Strengths:</b>	<b>Weaknesses:</b>
<ul style="list-style-type: none"> <li>A sound domestic market position in corporate banking, helped by Germany's robust economy.</li> <li>Superior capitalization in light of the largely restructured noncore activities.</li> <li>Material levels of additional loss-absorbing capital (ALAC) to protect senior creditors in the event of a resolution.</li> <li>Prudent funding and liquidity management and metrics.</li> </ul>	<ul style="list-style-type: none"> <li>Need to demonstrate improved shareholder returns to substantiate sustainability of its business model and increase investor confidence under the less benign credit and economic cycle, high competition, and low yields.</li> <li>Below-average market share and earnings from domestic retail activities.</li> <li>Loan book quality metrics and composition needs to be tested through a full business cycle and are generally below those of some international peers.</li> </ul>

**Outlook: Negative**

S&P Global Ratings' outlook on Germany-based global financial institution, Commerzbank AG, is negative, indicating we could downgrade Commerzbank within the next two years. The main risk is Commerzbank's possible failure to improve its subpar risk-adjusted profitability in the medium term, which is partly driven by its high cost structures. We believe there is little room for a major setback in its multiyear "CBK 4.0" stand-alone strategy to strengthen its leading franchise in German corporate banking and to improve the market share and performance of its retail banking and private wealth management divisions. This is because Commerzbank needs sustainable improvement in its overall risk-adjusted earnings and capital position to weather the current less benign credit cycle, high pressures from competition, and historic low interest environments, and also because of its currently weak equity valuation and its potential attractiveness as a merger target.

**Downside scenario**

We could lower our issuer credit rating (ICR) on Commerzbank, as well as the related issue ratings on the bank's senior preferred debt, if we see weakening of aggregate levels in bail-in-able debt or additional loss-absorbing capital (ALAC) that protects senior creditors in the event of a resolution. In particular we are monitoring if Commerzbank continues to meet our rolling two-year forecast in maintaining a sustainable ALAC buffer of 5%-8% of our risk-weighted assets (RWA). If it fails to do this, we would likely remove our current one-notch uplift in our calculation of the ICR, because senior preferred debt creditors would be less protected in the event of a resolution. Under the same ALAC-related one-notch downgrade scenario, we emphasize that we would not change our 'BBB' issue ratings on Commerzbank's senior subordinated debt or our ratings on its regulatory capital instruments, because these are derived from our assessment of Commerzbank's 'bbb+' stand-alone credit profile (SACP).

We could revise down the SACP and lower the ICR if Commerzbank fails to deliver on its multiyear strategy to strengthen its capitalization and earnings. For this we track our rolling two-year forecast for Commerzbank's risk-adjusted capital (RAC) ratio looking for it to improve sustainably above 10%. This could lead us to lower our issue ratings on Commerzbank's senior subordinated debt and regulatory capital instruments. We would also lower the ICR and related senior unsecured issue ratings if we saw no offsetting rating factors, such as higher amounts of excess total adjusted capital (TAC) in the bank's ALAC buffer.

**Upside scenario**

We could revise the outlook to stable if Commerzbank succeeds in strengthening its business position with more stable, diverse retail and midsize corporate banking, alongside less volatile and sustainably improved earnings and risk position than that of similarly rated international peers.

We could also revise the outlook to stable if the bank's capitalization and ALAC buffers materially strengthened beyond our base-case assumptions, providing an ample cushion against unexpected setbacks in its transformation process and underpinning the one-notch uplift in our long-term ICR.

**Rationale**

We base our ICR on Commerzbank on its domicile and main lending focus, Germany, benefitting from the very best economic risk environment of all banking systems globally, and we forecast benign credit conditions will persist for the next two years. Accordingly, the 'a-' anchor, which is the starting point for our ICR on Commerzbank, represents our view of the economic environment in the main countries where Commerzbank operates globally and on German

banking industry risk. Its individual rating factors and the anchor combine for Commerzbank's 'bbb+' SACP, which is pivotal for the rating level of its hybrid issuances.

We continue to view Commerzbank's "CBK 4.0" strategy as positive. Notwithstanding this, we consider Commerzbank's business position to be a weakness compared with similarly rated international peers, because the management team remains under pressure to build investor confidence in its stand-alone business model. In particular we believe the bank needs to demonstrate improvements in its subpar profitability while navigating the slowdown in the domestic and European economies (which has been bigger than expected), equity and capital markets that remain lackluster, longer periods of ultra-low interest rates, and persisting stiff competition. At the same time the bank needs to see some fruit from its sound but ambitious ongoing medium-term digitalization strategies, which puts further temporary pressure on its unfavorably high cost structures.

In our view, the bank's strong franchise in the small and midsize enterprises segment and its stable and granular deposit base, combined with a weak equity valuation and the relatively steady state of its operations, still make it potentially attractive as a merger target. Some European banking groups have already tentatively expressed their interest in a combination, according to media reports. In April 2019, Deutsche Bank and Commerzbank halted early stage merger discussions, concluding that the overall business case was insufficiently strong (see "As Commerzbank And Deutsche Bank Talks End, What Now For The Two Banks?," April 26, 2019).

We currently assess Commerzbank's capital and earnings as a rating strength, mainly because we project our main indicator, the RAC ratio, for Commerzbank will gradually increase to a sustainable 10%-11% over the next two years, after 9.4% at year-end 2018. At this stage, however, we still see challenges ahead for Commerzbank, notably, in delivering sufficient and more stable shareholder returns absent the currently supportive economic business cycle. We estimate that the bank will generate only a 5.5% return on equity (ROE) in 2021. We continue to believe that Commerzbank's risk position, in combination with our capital assessment, is only a neutral rating factor, despite the significant progress that management has already made in restructuring the bank, reducing the nonstrategic asset portfolio, and restoring a degree of more stable profitability. Positively, the bank further reduced problem exposures to industries such as shipping to low levels we now consider manageable and absorbable according to our forecasts in pre-provision earnings. To improve our combined capital and risk position assessment, we would look for a longer track record of sound and profitable underwriting quality through a less favorable cycle and despite high competitive pressures in the German banking industry. Also, Commerzbank's nonperforming loans (NPLs) and loan loss provisions (LLPs) would need to decrease further, more in line with those of some of its peers with similar weighted economic risk exposure.

We expect that Commerzbank will maintain the prudent management and solid metrics in its liquidity and funding ratios that it has achieved in recent years. We view as positive the availability of refinancing from the bank's increasing domestic franchise and large retail branch network, and its close relationships with domestic corporate clients. We incorporate one notch of uplift into our long-term ICR on Commerzbank because we forecast that the bank will maintain an ALAC buffer at about 5.7% in 2020, above our 5% threshold for a one-notch uplift. Commerzbank's ALAC buffer enlarged materially after the reclassification of standard term debt as senior subordinated instruments under the retroactive change to German law introduced in January 2017.

We set the resolution counterparty rating (RCR) on Commerzbank at 'A', one notch above the 'A-' long-term ICR, reflecting the typical approach under our framework when the ICR ranges from 'BBB-' to 'A+'. It also reflects our jurisdiction assessment on Germany.

**Anchor: 'a-', sensitive to a revision of economic risk assessment or a shift in geographic strategy**

Our bank criteria use our Banking Industry Country Risk Assessment's economic and industry risk scores to determine a bank's anchor, the starting point in assigning an ICR. Our anchor for a commercial bank operating mainly in Germany is 'a-', based on an economic risk score of '1' and an industry risk score of '3'. We view the economic risk trend and the industry risk trend in the German banking industry as stable.

Our 'a-' anchor for Commerzbank reflects its domicile in Germany, where it is primarily regulated, and our view of the blended economic risk of the markets in which it operates. The anchor is based on our understanding that Commerzbank's strategy will remain focused on Germany. About 65% of the bank's private-sector credit exposure is domestic. This has a favorable impact on the anchor because we view Germany as having the lowest economic risk of all banking systems globally.

However, about 40% of Commerzbank's credit exposure is in countries with higher economic risk, mainly Poland and other European countries. Consequently, our weighted economic risk score for Commerzbank is '2', weaker than for banks operating solely in Germany. This means that the anchor is sensitive to a potential downward revision of our economic risk assessment for Germany by one category, or a shift into riskier countries from its geographic strategy.

Germany has a highly diversified and competitive economy, and we continue to expect that its robust export-led economy will remain vigorous amid a broader European recovery over our forecast horizon through 2020. We believe that the impact of Brexit is manageable and will have only a limited negative effect for the German economy. We see a low likelihood of a nationwide credit-driven housing bubble, in light of limited credit growth and historically favorable affordability ratios, which suggest that house prices will remain undervalued until the end of 2020. We forecast that house price inflation will soften to below 2% in 2019 and 2020, on par with expected GDP growth, compared with our estimate for 2017-2018 of about 4.6% attributable to recent years of favorable economic conditions, strong national and international demand, tight housing supply in economic centers, a buoyant labor market, high net immigration, and low interest rates.

We continue to regard industry risk for German banks as intermediate, in line with that for peers in many other European countries. The industry benefits from Germany's extensive funding market, banks' domestic funding surpluses, and a material strengthening of banking regulation and supervision, owing to the ongoing EU-wide regulatory harmonization and convergence under Basel III. Returns in the German banking industry have compared well with those of many European banking industries in recent years, thanks to a continued track record of low credit losses. Although we believe the low-interest-rate environment and intense competition act as a drag on profitability, this is partly compensated by the German banking industry's progress in implementing measures to improve cost efficiency and fee generation.

We regard the likelihood of the German government providing extraordinary support to systemic domestic banks as uncertain, as we do for most other European banks. This is because, following the full implementation of the EU's enhanced bank resolution framework in 2015, governments are constrained from providing bailouts to distressed

banks directly.

**Table 1**

<b>Commerzbank AG Key Figures</b>					
	<b>--Year ended Dec. 31--</b>				
<b>(Mil. €)</b>	<b>2018</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>
Adjusted assets	459,123	449,181	477,403	529,116	554,279
Customer loans (gross)	231,519	224,460	204,156	207,757	215,644
Adjusted common equity	24,446	26,141	25,952	26,494	23,936
Operating revenues	8,572	8,830	9,555	10,040	9,775
Noninterest expenses	6,351	6,606	7,086	7,209	7,795
Core earnings	1,505	963	1,343	1,503	593

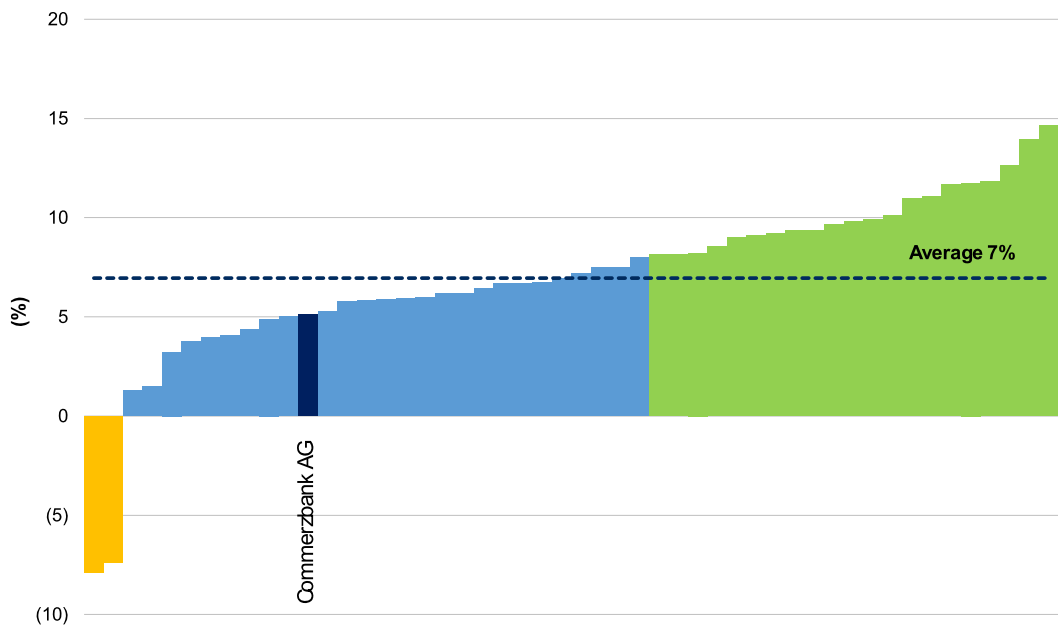
**Business position: "CBK 4.0" strategy must deliver profitable sound domestic market position, particularly in corporate banking**

We recognize Commerzbank's progress in implementing its "CBK 4.0" strategy, further building its leading franchise in German corporate banking, particularly among large and midsize enterprises and in trade finance, and the strong focus of its retail banking division on private wealth management. We also consider that the bank has regained market share, in particular attracting high numbers of net new retail banking clients, and increasing assets under control for private customers.

As part of the strategy, the bank continues to demonstrate a more stringent focus on business backed by core competencies and franchise, digitalization, and efficiency measures. We continue to believe that Commerzbank's main weakness remains its low profitability by international standards, and believe that further improvements in line with its strategy are needed to substantiate sustainability of its long-term business model in more difficult operating environments and to strengthen investor confidence. Given ongoing fierce competition in German banking and the challenging revenue situation, Commerzbank slightly revised downward its targeted post-tax return on tangible equity (ROTE) to between 5%-6% for the next two years, from a previous 6% target and compared with 3.1% at year-end 2018. Commerzbank's results are just below the subdued 6%-7% ROTE average that we forecast for the top 50 European banks in 2019, scarcely earning its cost of capital, and well below the double-digit results of many global banks, and compared with many similarly rated banks.

Chart 1

European Top 50 Banks: S&P Forecast Of 2019 Return On Tangible Equity



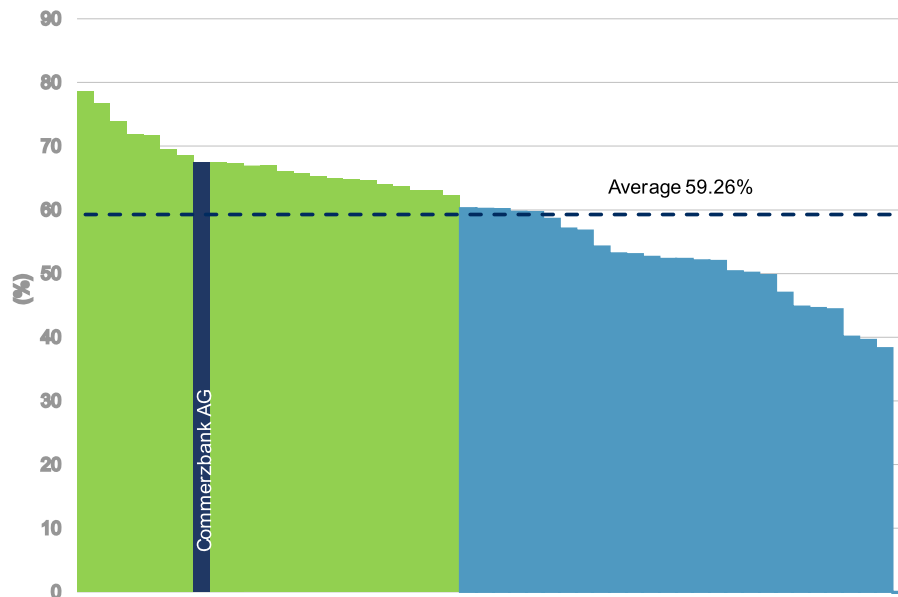
Source: S&P Global Ratings.  
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In line with the strategy, the bank's management needs to deliver on its ambitious medium-term digitalization strategy, which is to improve franchise, market shares, and leverage in its multichannel strategy. This temporarily puts further pressure on Commerzbank's unfavorably high cost structures, but the bank continues to guide a cost-to-income ratio below 70% by 2020, down from the too-high 75% in 2018.

In a sustained weak revenue environment, measures to reduce the efficiency gap with international peers is very important in our view, given our average 59% cost-to-income forecast for the top 50 European banks in 2019.

Chart 2

## European Top 50 Banks - Forecast Of 2019 Cost-To-Income



Commerzbank's data as of April 4, 2019. Top 50 EU bank's data as of Oct. 31, 2018. The average and chart excludes data for Dexia S.A. Source: S&P Global Ratings.

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In addition, Commerzbank targets a fully phased-in regulatory Basel III core tier 1 capital ratio higher than the 12.75% regulatory requirement (Commerzbank's was 12.9% in 2018). In our view, Commerzbank has remained consistent in its philosophy of setting strategic targets without major shifts in focus. We understand that the bank has somewhat adjusted its targets in light of higher regulatory capital requirements and unfavorable interest rates by continuing to focus on cost management, rather than by increasing its risk appetite materially or by embarking on costly large-scale restructuring.

While we recognize Commerzbank's well-focused and consistent strategy, we continue to consider Commerzbank's business position to as a rating weakness, owing to its low profitability. We compare Commerzbank with its domestic peers. In Germany, traditional retail lending and small business banks with strong annuity characteristics are dominated by savings banks and mutually owned cooperative banks. Furthermore, the low-margin, high-cost German retail banking market squeezes profit margins to absorb potential revenue volatility.

We also compare Commerzbank's business position with the positions of its international peers in countries with similar banking industry risk as Germany, such as the U.K., France, and Belgium. Banks with adequate or stronger business positions relative to Commerzbank's tend to have higher market shares, particularly in retail banking. Some of these banks have broad international diversification. Commerzbank's international diversification hinges mainly on



Poland, where it has a 69.4% stake in mBank, which is the country's fourth-largest bank and contributes about 25% of Commerzbank's pretax profit, excluding one-time charges.

We do not rule out that we would improve our business position assessment for Commerzbank if it were to further improve its business mix with stable retail and midsize corporate banking. However, Commerzbank is currently some way off, even under their "CBK 4.0" multiyear restructuring program, as it is struggling to the cover cost of capital. Commerzbank's restructuring started after receiving support from the German government following its acquisition of Dresdner Bank in 2008.

Additionally, Commerzbank's mix of businesses, in particular its lower reliance on lending and deposit-taking, could make the bank less sensitive to low interest rates than some of its domestic peers.

**Table 2**

<b>Commerzbank AG Business Position</b>					
	<b>--Year ended Dec. 31--</b>				
<b>(%)</b>	<b>2018</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>
Total revenues from business line (currency in millions)	8,572	9,163	9,770	10,215	9,902
Commercial & retail banking/total revenues from business line	53.3	52.7	48.7	72.2	72.8
Trading and sales income/total revenues from business line	38.0	43.5	44.8	19.6	20.1
Other revenues/total revenues from business line	8.7	3.7	6.5	8.2	7.1
Investment banking/total revenues from business line	38.0	43.5	44.8	19.6	20.1
Return on average common equity	3.0	0.5	1.0	3.8	1.0

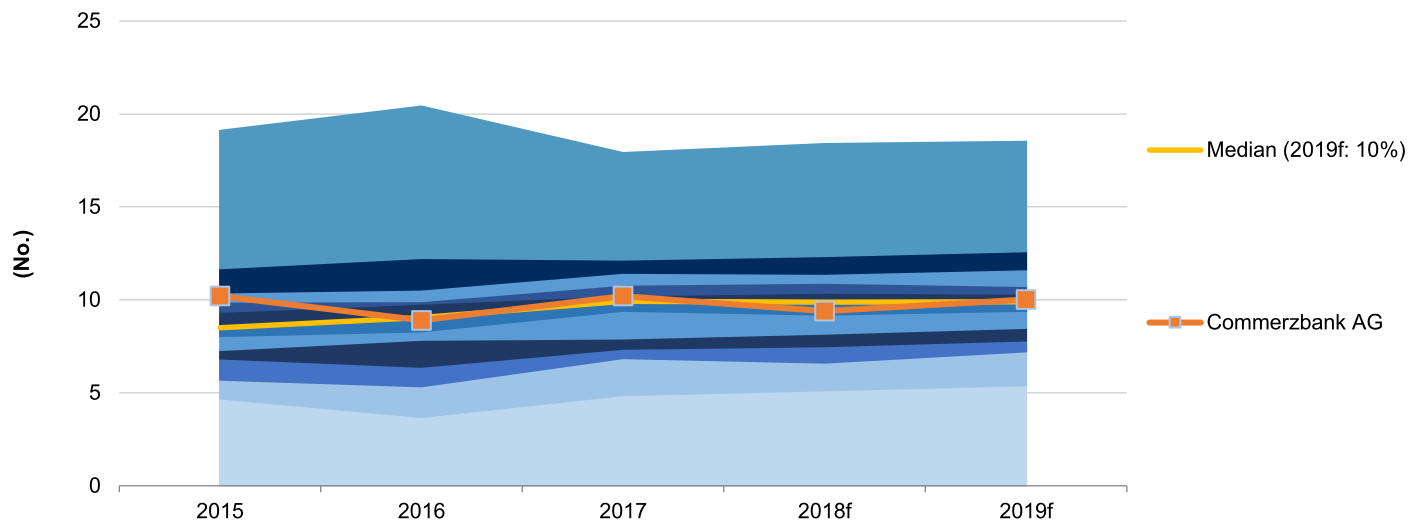
### **Capital and earnings: Capital strengthening to continue at a slower pace**

We assess Commerzbank's capital and earnings as a mild rating strength, which mainly reflects our projection that the bank's RAC ratio (our main measure of a bank's future capital adequacy), before diversification, will rise moderately to about 10.5% by year-end 2021, compared with 9.4% at year-end 2018. We base this forecast on our expectations of improving profitability and retention of related earnings into capital reserves, growth in lower-risk lending, particularly in Germany, further risk reductions in remaining nonstrategic portfolios. Commerzbank's RAC ratio is in line with the much improved capital metrics of many of the large European banks.

## Chart 3

### RAC Ratio Before Diversification For The Top 50 Rated Western European Banks, 2017, Dispersion Around The Median

Comparison of Commerzbank's RAC ratio with the Top 50 Western European banks



f--Forecast. Source: S&P Global Ratings.

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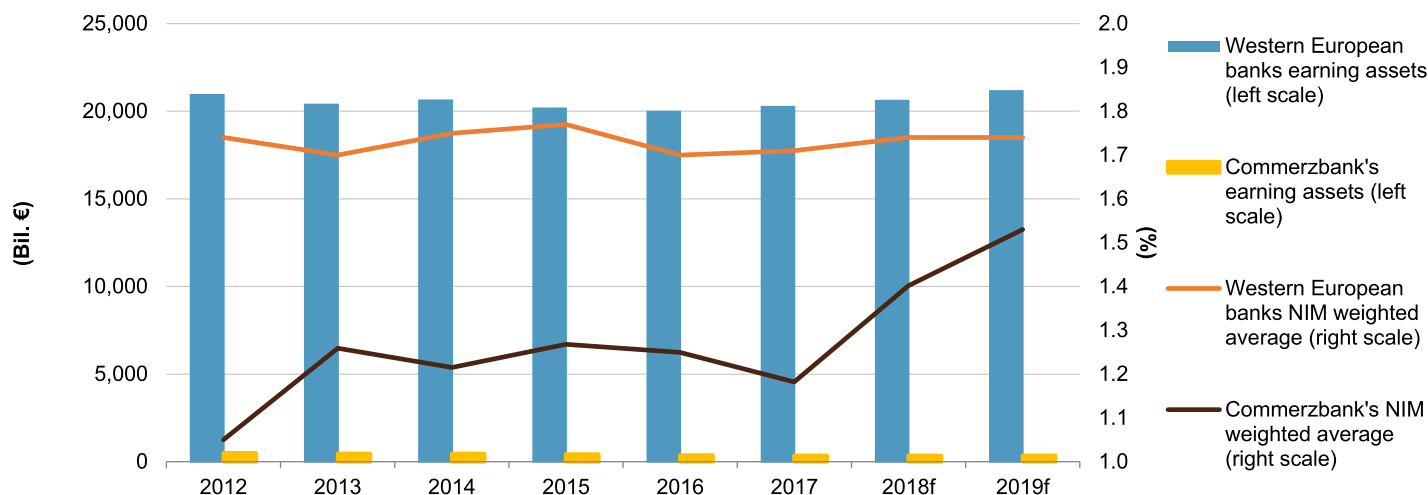
Commerzbank is set to meet future regulatory capital requirements. It reported a fully phased-in Basel III common equity Tier 1 (CET1) ratio of 12.9% at the end of 2018, down from 14.1% in 2017, but up from 9.3% in 2014. The CET1 ratio decreased to 12.9% at the end of 2018, mainly due to the impact of International Financial Reporting Standard No. 9 and low market valuations of its nonstrategic portfolio, shipping in particular. This compares well with the European Central Bank's (ECB's) reduced 10.11% pure CET1 requirement for Commerzbank for 2019, lowered owing to Commerzbank's substantial progress in de-risking, for which the ECB reduced by 25bps to 2.0% Commerzbank's individual Pillar 2 requirement announced in February 2019.

Accordingly, in a parallel shift, Commerzbank lowered its CET1 ratio to 12.75% on a fully phased-in Basel III basis, which is in line with most large international peers. Commerzbank's 10.11% requirement incorporates as well the ECB's 2019 supervisory review and evaluation process in which the ECB postponed the originally scheduled increase to 1.5% of the buffer for otherwise systemically important institutions (so it remained at 1.0% for 2019). The ECB also kept the 4.5% Pillar 1 minimum, 2.5% Capital Conservation Buffer, and 0.11% Countercyclical Capital Buffer.

Commerzbank has increased its revenue stability and closed its margin gap with peers, but we believe Commerzbank's earnings improvements will remain moderate until 2021. Our forecasts for Commerzbank are mainly driven by limited growth opportunities and high competition in Germany, pressure on net interest margins from low interest rates where, at best, the ECB might gradually raise the policy rate not before 2020.

Chart 4

## Non-Resilient NII And Consistently Low NIMs Of Commerzbank



S&P Global Ratings F--Forecast. NIM--Net interest margin. Source: S&P Global Ratings.

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Moreover, in Commerzbank's sound core lending portfolios we anticipate a moderate increase in credit losses to more normalized levels through a less beneficial economic cycle, and substantially lower but still disproportionately elevated risk losses in its remaining nonstrategic legacy portfolios.

Accordingly, under our base-case expectation we roughly project Commerzbank's return on average common equity will improve to about 5.5% in 2021, from 3.0% in 2018. Our current forecast for the average of the top 50 European banks in 2019 is 6%-7% (see chart 1). Our projection also includes the potential for gradually improving revenues from Commerzbank's enlarged and more diversified customer base, a fairly stable cost base from efficiency gains and cost measures offsetting ongoing high investment needs for the digitalization strategy, and increasing general cost levels and regulatory costs.

Under our base-case projections assumptions, we assume an unchanged €0.20 dividend payment policy until 2021, but we acknowledge that Commerzbank follows a flexible dividend policy depending on over- or undershooting its key performance targets and conducive to strengthening its capital base. We anticipate that our RWA figure for Commerzbank will increase only slightly, based on our understanding that Commerzbank will expand and diversify its strategic businesses, mainly by reallocating further risk capital from the wind-down of its noncore asset portfolio and financial institutions business. Commerzbank's earnings predictability has increasingly converged toward the domestic industry average, thanks to a reduction of nonstrategic exposures and strategic refocusing on its everyday business. Nonrecurring items and market-sensitive income affected earnings more materially before 2018.

Table 3

Commerzbank AG Capital And Earnings					
	--Year ended Dec. 31--				
(%)	2018	2017	2016	2015	2014
Tier 1 capital ratio	13.4	15.2	13.9	13.8	11.7
S&P Global Ratings' RAC ratio before diversification	9.4	10.2	8.9	10.2	8.8
S&P Global Ratings' RAC ratio after diversification	10.0	10.8	9.4	11.8	10.3
Adjusted common equity/total adjusted capital	98.3	98.4	98.5	98.7	98.7
Net interest income/operating revenues	55.4	47.6	51.4	54.6	56.5
Fee income/operating revenues	36.0	36.0	33.6	34.1	32.8
Market-sensitive income/operating revenues	5.1	13.5	5.7	4.9	4.9
Noninterest expenses/operating revenues	74.1	74.8	74.2	71.8	79.7
Provision operating income/average assets	0.5	0.5	0.5	0.5	0.4
Core earnings/average managed assets	0.3	0.2	0.3	0.3	0.1

Table 4

Commerzbank AG--Risk-Adjusted Capital Framework Data					
(Mil. €)	Exposure*	Basel III RWA	Average Basel III RW(%)	S&P Global Ratings RWA	Average S&P Global Ratings RW (%)
<b>Credit risk</b>					
Government and central banks	105,542.1	8,167.8	7.7	8,108.4	7.7
Institutions and CCPs	50,114.6	21,194.8	42.3	23,277.0	46.4
Corporate	153,567.9	79,984.9	52.1	108,568.5	70.7
Retail	133,155.7	21,899.9	16.4	52,904.6	39.7
Of which mortgage	86,393.8	9,715.3	11.2	19,109.2	22.1
Securitization§	17,540.1	2,449.5	14.0	6,931.7	39.5
Other assets†	6,338.0	3,328.5	52.5	13,614.7	214.8
Total credit risk	466,258.4	137,025.4	29.4	213,405.0	45.8
<b>Credit valuation adjustment</b>					
Total credit valuation adjustment	--	3,451.3	--	11,218.2	--
<b>Market Risk</b>					
Equity in the banking book	3,321.4	2,283.7	68.8	10,082.0	303.5
Trading book market risk	--	7,349.5	--	13,432.9	--
Total market risk	--	9,633.2	--	23,514.9	--
<b>Operational risk</b>					
Total operational risk	--	21,393.4	--	16,112.3	--
(Mil. €)	Exposure	Basel III RWA	Average Basel II RW (%)	S&P Global Ratings RWA	% of S&P Global Ratings RWA
<b>Diversification adjustments</b>					
RWA before diversification	--	177,420.1	--	264,250.3	100.0
Total Diversification/ Concentration Adjustments	--	--	--	(16,121.0)	(6.1)
RWA after diversification	--	177,420.1	--	248,129.3	93.9

Table 4

## Commerzbank AG--Risk-Adjusted Capital Framework Data (cont.)

(Mil. €)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global Ratings RAC ratio (%)
<b>Capital ratio</b>				
Capital ratio before adjustments	24,110.0	13.6	24,861.7	9.4
Capital ratio after adjustments†	24,110.0	13.6	24,861.7	10.0

\*Exposure at default. §Securitization Exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions.

‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data, S&P Global Ratings.

**Risk position: Reduced noncore assets appear manageable in light of preprovisioning earnings**

Our assessment of Commerzbank's overall risk position as a slight weakness mainly takes into account its new business generation from core customers, balanced by the residual risks from the nonstrategic asset portfolio and weaker loss experience than its peers. What's more, our assessment of a capital and earnings strength combined with identifying relative weakness in its risk position means that these factors offset each other. This aligns with our view that capitalization at Commerzbank--after taking into account its risk exposures--remains a neutral factor for the ICR compared with peers. In particular, we put risks into the context of our projected RAC ratio, which had weakened modestly below the 10% threshold at year-end 2018, and therefore remains vulnerable to unexpected charges.

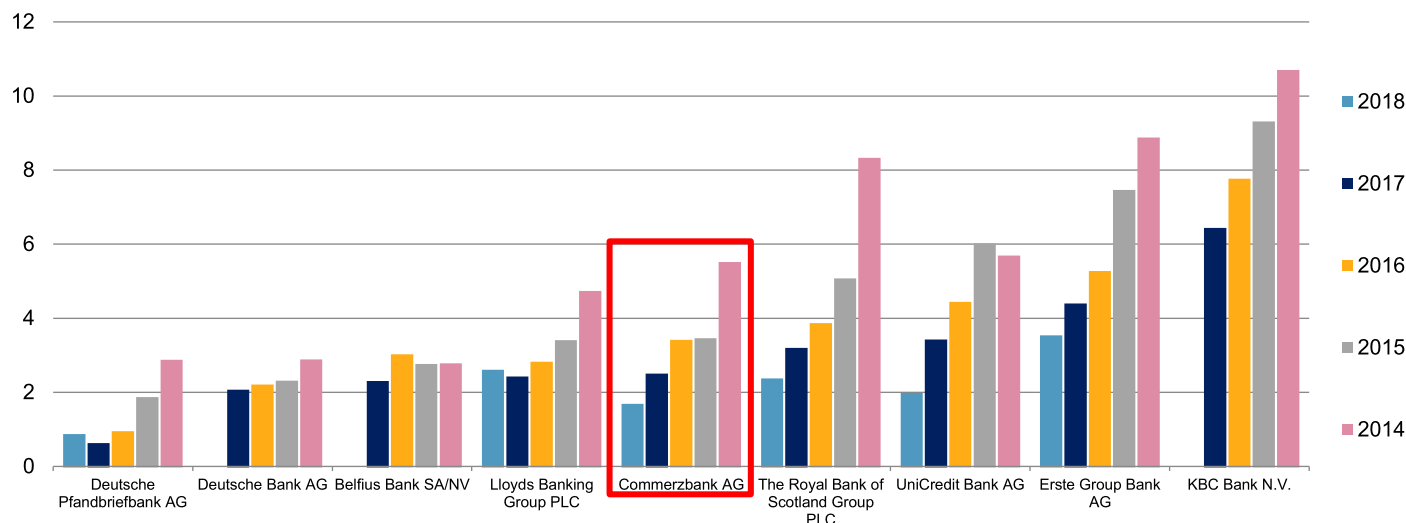
In our risk position assessment, we compare Commerzbank with peers with similarly strong weighted economic risk profiles. Besides some internationally active German banks, this includes peers in countries like Sweden, Switzerland, Belgium, and Canada.

Commerzbank's German retail mortgage lending is showing the strongest growth, exceeding the market-average, but from relatively low levels. We believe Commerzbank is achieving this without weakening underwriting standards. We also recognize recent years of strengthening capital ratios and a significant reduction of nonstrategic and high-risk portfolios, particularly in commercial real estate (CRE) and shipping finance. These portfolios' exposure at default had reduced more than management's initial target: to about €0.4 billion in shipping, €0.9 billion in CRE, and €7.7 billion in public finance at the end of 2018, from about €50 billion in total at year-end 2013. The majority of CRE exposures are now in Germany, which we consider generally lower risk in light of favorable economic conditions.

As a result, Commerzbank more than halved its gross NPL ratio since 2012 to about 0.9% of customer loans at the end of 2018. New LLPs also reduced materially to about 20bps of customer loans on the same date, from 73bps in 2013 (which owed to setbacks in the shipping industry). This has reduced the gap in relation to many of Commerzbank's peers, many of which are also recording immaterial amounts of NPLs or LLPs thanks to a benign credit cycle. Given substantial reductions in nonstrategic portfolios, shipping finance in particular, we forecast limited risk cost burdens for Commerzbank's profitability in the next two years.

Chart 5

## Positive Development In NPL Ratio 2014-2018



NPL--Nonperforming loan. Source: S&P Global Ratings.

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Although we continue to see the bank's quality of exposure to industries such as shipping as weak, we believe these exposures are manageable and absorbable by preprovision earnings, as they were in 2018. The bank has significantly strengthened the reserve coverage of its NPLs in shipping, sold material parts of the NPL portfolio, and generally has reduced single-name concentration risks. Although credit losses reduced to €8 million in 2018 in its exit portfolio, the bank still incurred substantial credit losses in 2017 of €336 million, which was down from €599 million in 2016. Nevertheless, the CRE and shipping finance portfolios still represent about 7% of Commerzbank's TAC.

More generally, Commerzbank's loan portfolio remains skewed toward corporate and public-sector lending, which tends to be more exposed to event risk than retail lending. For example, Commerzbank's public finance assets represented about 1.5x TAC at year-end 2018, and we believe that our standard assumptions in the RAC calculation may not appropriately capture the potential risks from these exposures. In terms of Commerzbank's focus portfolios, sovereign exposure to Italy and Spain diminished markedly to less than €10.0 billion as of Dec. 31, 2018, of which by far the most is from Italy.

Table 5

## Commerzbank AG Risk Position

(% )	--Year ended Dec. 31--				
	2018	2017	2016	2015	2014
Growth in customer loans	3.1	9.9	(1.7)	(3.7)	(3.8)
Total diversification adjustment/S&P Global Ratings' RWA before diversification	(6.1)	(5.9)	(5.1)	(14.3)	(14.4)
Total managed assets/adjusted common equity (x)	18.9	17.3	18.5	20.1	23.3
New loan loss provisions/average customer loans	0.2	0.4	0.4	0.3	0.5
Net charge-offs/average customer loans	N.M.	0.7	0.6	1.1	1.0

Table 5

Commerzbank AG Risk Position (cont.)					
(%)	--Year ended Dec. 31--				
	2018	2017	2016	2015	2014
Gross nonperforming assets/customer loans + other real estate owned	1.7	2.5	3.4	3.4	5.5
Loan loss reserves/gross nonperforming assets	55.0	55.2	53.1	54.2	47.8

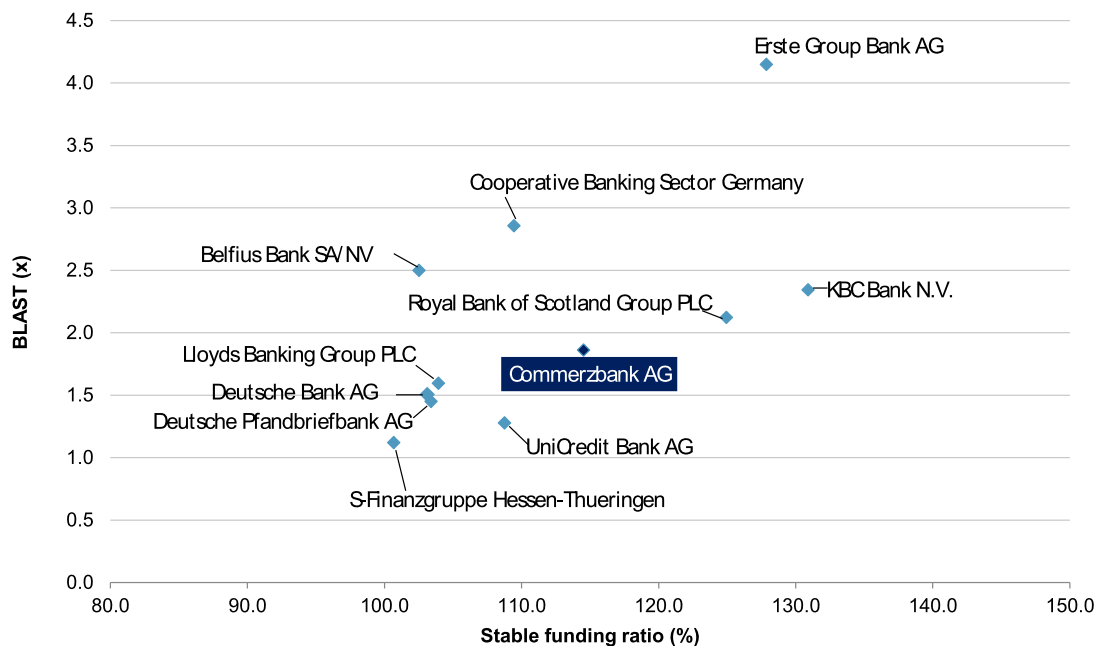
### Funding and liquidity: Benefit from increasing core deposits and deleveraging

We continue to view Commerzbank's funding and liquidity management and related metrics as a neutral rating factor. The bank's funding and liquidity metrics compare well with many domestic and international peers', after having materially improved over the past several years. They do not qualify for a higher assessment because they compare less favorably with those of the German savings and cooperative bank groups, particularly when factoring the qualitative factors that these metrics do not fully reflect.

Chart 6

### Key Funding And Liquidity Metrics

As of year-end 2017



BLAST--Broad liquid assets/short-term wholesale funding. Commerzbank AG's 2018 actual SFR and BLAST ratios are shown in above chart. Source: S&P Global Ratings.

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Commerzbank's restructuring and deleveraging in recent years have also significantly reduced its dependence on wholesale funding and strengthened its liquidity position.

Our stable funding ratio for Commerzbank was 115% on Dec. 31, 2018, indicating appropriate matching of assets and

liabilities. Furthermore, broad liquid assets covered 1.9x short-term wholesale funding. We anticipate that Commerzbank will maintain prudent management standards comfortably above regulatory requirements.

We also believe, however, that Commerzbank targets further earnings improvement through lowering its funding and liquidity cost, for which we believe related funding and liquidity ratios may gradually decrease further in next two years. This is not a major concern for us in light of its substantial progress in de-risking the bank, and which the ECB acknowledged by reducing Commerzbank's Pillar 2 capital requirement by 25bps in early 2019. As a result, we expect that in particular the issuance of more expensive Tier 2 and nonpreferred senior debt (NPS) will remain well below what S&P Global Ratings anticipated earlier in 2018.

We still believe that our funding and liquidity metrics do not fully capture Commerzbank's refinancing and liquidity risks because some of its liquid securities are needed to secure steadily decreasing public-sector covered bonds, and require stable funding since they are not available for liquidity purposes. What's more, a considerable amount of the bank's securities formerly classified as available for sale were reclassified as loans and receivables with a view to holding the assets until maturity, due to inactive markets.

In terms of strengths, Commerzbank's large retail branch network and expanding relationships with domestic retail and corporate clients provide it with a stable core deposit base to meet its funding needs. Furthermore, Commerzbank's longer-term covered bonds refinance its real estate and public finance exposures. By year-end 2018, about 50% of the bank's long-term capital market funding was sourced from covered bonds. Due to the bonds' collateralized nature and the more favorable treatment of covered bond assets in banks' regulatory liquidity metrics, we anticipate that these instruments would benefit from more reliable investor demand in a stressed environment than unsecured bonds.

We expect Commerzbank's funding needs will continue to benefit from further reductions of public finance, CRE lending, and shipping finance, although at a much lower pace. We believe that Commerzbank's partial ownership by the German government (about 15%) supports its access to funding markets. However, we consider such ownership to be temporary.

**Table 6**

<b>Commerzbank AG Funding And Liquidity</b>					
	<b>--Year ended Dec. 31--</b>				
<b>(%)</b>	<b>2018</b>	<b>2017</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>
Core deposits/funding base	70.8	70.3	64.6	61.0	54.1
Customer loans (net)/customer deposits	87.2	86.5	82.2	81.8	91.8
Long-term funding ratio	80.2	85.5	82.5	77.5	73.3
Stable funding ratio	114.5	124.6	128.6	123.4	113.6
Short-term wholesale funding/funding base	21.2	15.6	18.8	24.0	28.2
Broad liquid assets/short-term wholesale funding (x)	1.9	2.4	2.2	1.8	1.5
Net broad liquid assets/short-term customer deposits	32.2	34.4	39.5	36.7	27.0
Short-term wholesale funding/total wholesale funding	72.5	52.2	53.0	61.3	61.4
Narrow liquid assets/3-month wholesale funding (x)	N/A	N/A	N/A	2.2	1.8

N/A--Not applicable.



### **External Support: A one-notch uplift for the stronger ALAC buffer**

We think Commerzbank will maintain a large pool of bail-in-able capital buffers that benefit the banks' cushions for preferred senior unsecured debt holders. Accordingly, our assessment of Commerzbank's SACP is one notch higher than that for the unsupported SACP. We estimate that the bank will continue to maintain its total loss-absorbing capital capacity at about 5.7% by 2020, well above the 5% minimum threshold for a one-notch rating uplift.

Commerzbank's ALAC buffer increased significantly after accounting for the reclassification of standard term debt as senior subordinated instruments under the retroactive change to German law, introduced in January 2017. In line with our expectations, Germany's parliament passed legislation effective July 21, 2018, that aligned German law with an EU directive that enables German banks to issue plain-vanilla term bonds as higher-ranking senior unsecured instruments.

As we expected, the amendment did not alter the seniority of existing plain-vanilla term bonds, which remain subordinated based on a grandfathering provision in the new legislation, therefore, they will rank *pari passu* with the new senior nonpreferred instruments (see "Senior Nonpreferred Notes In Germany: The Best Of Both Worlds For German Banks, And Clarity For Investors," July 10, 2018). As a result, Commerzbank's considerable buffers of senior subordinated liabilities, which are intended to absorb losses in the event of resolution remain available until maturity.

We assess Commerzbank's ALAC to S&P Global Ratings' RWA at about 6.2%, including senior subordinated instruments, as of year-end 2018, and forecast that its ALAC buffer will stabilize at about 5.7% in 2020. Our forecast continues to include Commerzbank's Tier 1 and Tier 2 updated issuance plans, senior subordinated instruments, and respective debt maturities, and our forecast of a gradual rise in the bank's RAC ratio. Our projection also incorporates Commerzbank's updated plans to improve earnings by lowering funding cost, which means that the issuance of more expensive Tier 2 and NPS will remain well below earlier plans we anticipated last year.

Moreover, we believe the bank will have a smaller surplus in its TAC as a component of ALAC buffers, since the bank's RAC ratio is modestly above our 10% minimum for our strong capital assessment. In our calculation, we exclude subordinated instruments issued under U.S. law, which do not explicitly refer to bail-in, given the risk that bail-in by the European regulator could be challenged by investors holding these instruments.

In our view, Commerzbank has high systemic importance in Germany, mainly reflecting its material share of the country's retail deposits. Since June 2015, we have regarded the prospect of extraordinary government support for German banks as uncertain, in view of the clear intent of the authorities to avoid taxpayer bail-outs of failing banks, and the well-advanced and effective resolution framework. As a result, systemically important banks in Germany are not eligible for any rating uplift for possible future government support. We view the German resolution regime as effective under our ALAC criteria because, among other factors, we believe it contains a well-defined bail-in process under which authorities would permit nonviable systemically important banks to continue critical functions as going concerns following a bail-in of eligible liabilities. We consider Commerzbank to be systemically important to Germany, and, given its complexity, expect that it would be subject to a well-defined bail-in plan.

### **Issue ratings: Hybrid capital instruments**

Commerzbank has issued hybrid capital instruments directly and through special-purposes entities, whose issuances it has guaranteed.

We notch down from Commerzbank's 'bbb+' unsupported SACP to derive the ratings on these instruments, in

accordance with tables 1 and 2 of our bank hybrid criteria, depending on their features. Accordingly, we assess Commerzbank's funding vehicles Dresdner Funding Trust I, and Dresdner Funding Trust IV under the loan participation note approach, according to our Group Rating Methodology (Appendix F), because all relevant conditions are met. In the case of HT1 Funding GmbH, we expect timely support in our assessment of HT1 Funding as a core member of the Commerzbank group (see "Commerzbank's Financing Vehicle HT1 Funding GmbH Assigned 'A-' Rating; Outlook Negative," published March 26, 2018).

In addition, the change to German law on Jan. 1, 2017, turned certain standard long-term senior unsecured bonds into subordinated instruments in a resolution and liquidation. Accordingly, we reclassified such affected instruments as senior subordinated debt. For the senior subordinated instruments, the starting point for the issue ratings is each bank's unsupported SACP. We then deduct one notch for subordination, given that the starting point for rating all four of Germany's systemic banks, including Commerzbank, is 'bbb-' or higher.

A default on the hybrid instruments would not automatically lead to a default on the ICR.

### **Resolution counterparty ratings (RCRs)**

We have assigned RCRs to Commerzbank, and its rated subsidiary mBank.

For European entities, these RCRs are one notch above the long-term ICRs on these entities reflecting our jurisdiction assessments for these countries. An RCR is a forward-looking opinion of the relative default risk of certain senior liabilities that may be protected from default through an effective bail-in resolution process for the issuing financial institutions. RCRs apply to issuers in jurisdictions where we assess the resolution regime to be effective and we consider the issuer likely to be subject to a resolution that entails a bail-in if it reaches nonviability.

## **Related Criteria**

- 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: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Anchor Matrix										
Industry Risk	Economic Risk									
	1	2	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

#### Ratings Detail (As Of June 18, 2019)\*

##### Commerzbank AG

Issuer Credit Rating	A-/Negative/A-2
Resolution Counterparty Rating	A/--/A-1
Commercial Paper	
Local Currency	A-2
Senior Subordinated	A-
Senior Subordinated	BBB
Senior Unsecured	A-
Short-Term Debt	A-2
Subordinated	BBB-

##### Issuer Credit Ratings History

28-Mar-2017	A-/Negative/A-2
15-Dec-2016	BBB+/Watch Pos/A-2
11-Mar-2016	BBB+/Stable/A-2
09-Jun-2015	BBB+/Negative/A-2
03-Feb-2015	A-/Watch Neg/A-2

##### Sovereign Rating

Germany	AAA/Stable/A-1+
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##### Related Entities

##### Dresdner Funding Trust I

Junior Subordinated	BB
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##### Dresdner Funding Trust IV

Subordinated	BBB-
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##### HT1 Funding GmbH

Issuer Credit Rating	A-/Negative/--
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## Ratings Detail (As Of June 18, 2019)\*(cont.)

Junior Subordinated	BB-
<b>mBank</b>	
Issuer Credit Rating	BBB+/Negative/A-2
Resolution Counterparty Rating	A-/--/A-2
Senior Unsecured	A-2
Senior Unsecured	BBB+

\*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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