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Update

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Commerzbank Finance & Covered Bond S.A.

Update to credit analysis

Summary

Commerzbank Finance & Covered Bond S.A.'s (CFCB) ratings and rating inputs are aligned with those of its parent bank, Commerzbank AG (A1 stable/A2 stable, baa2)[1], reflecting our assessment that CFCB is a highly integrated and harmonised subsidiary of Commerzbank.

CFCB's A2 issuer rating reflects Commerzbank's baa2 BCA and Adjusted BCA; the results of our Advanced Loss Given Failure (LGF) analysis its parent bank's liabilities, resulting in two notches of uplift for CFCB's issuer rating; and the moderate probability of CFCB receiving indirect government support through Commerzbank, resulting in one additional notch of rating uplift.

We consider CFCB a highly integrated subsidiary of Commerzbank, reflecting its limited proprietary franchise; the magnitude of management integration and its role as a group service provider, being fully integrated into Commerzbank's treasury operations; and Commerzbank's influence on CFCB's financials, in particular asset exposures and funding. Our assessment is further supported by the existing letter of comfort between CFCB and Commerzbank, as well as several service-level agreements between these two entities, which supports CFCB's operational stability.

In the case of resolution, we expect CFCB to form part of Commerzbank's resolution perimeter. We therefore apply Commerzbank's LGF analysis, as well as the same government support assumption for Commerzbank's long-term senior unsecured debt ratings to CFCB.

For further details, please refer to the credit opinion of Commerzbank AG.

Credit strengths

» CFCB is fully integrated into its parent bank's risk management and treasury operations, thereby benefiting from Commerzbank's credit strength and access to liquidity and funding

» CFCB's creditors benefit from a letter of comfort (*Patronatserklärung*) which link its ability to repay funding to the credit strength of Commerzbank

Credit challenges

» CFCB exhibits high concentration risks from public sector lending

» Optically high capital ratios, driven by low risk-weights for public sector exposure, balanced by market values which are significantly lower than book values

» Focus on public sector lending drives CFCB' low standalone profitability

Outlook

» The stable outlook on CFCB's issuer rating follows the stable outlook on Commerzbank's senior unsecured debt rating.

» The stable outlook reflects our view that Commerzbank's intrinsic financial strength will remain broadly stable over the outlook horizon and that the bank will be able to keep sufficient volumes of bail-in-able liabilities, safeguarding the currently assigned rating uplift resulting from our Advanced LGF analysis.

Factors that could lead to an upgrade

» An upgrade of CFCB's ratings would require an upgrade of Commerzbank's ratings.

» For factors that could lead to an upgrade of CFCB's parent please refer to the credit opinion of Commerzbank AG.

Factors that could lead to a downgrade

» A downgrade of CFCB's issuer rating would follow a downgrade of Commerzbank's ratings.

» In addition, CFCB's ratings could be downgraded if our assumption of CFCB as a highly integrated and harmonised subsidiary of Commerzbank is undermined by Commerzbank no longer being committed to orderly unwinding CFCB's legacy portfolios; reducing funding support or separating CFCB from its treasury operations; or withdrawing the letter of comfort or the existing service-level agreements with CFCB.

» For factors that could lead to an downgrade of CFCB's parent please refer to the credit opinion of Commerzbank AG.

Key indicators

Exhibit 1
Commerzbank Finance & Covered Bond S.A. (Consolidated Financials) [1]

	12-22 [2]	12-21 [2]	12-20 [2]	12-19 [2]	12-18 [2]	CAGR/Avg. [3]
Total Assets (EUR Million)	5,953.5	6,931.5	7,064.6	8,222.5	10,720.8	(13.7) [4]
Total Assets (USD Million)	6,353.8	7,854.2	8,644.0	9,229.8	12,255.4	(15.1) [4]
Tangible Common Equity (EUR Million)	1,056.0	1,109.0	1,141.7	1,173.6	1,188.2	(2.9) [4]
Tangible Common Equity (USD Million)	1,127.0	1,256.6	1,396.9	1,317.3	1,358.3	(4.6) [4]
Problem Loans / Gross Loans (%)	0.0	0.0	0.0	0.0	0.0	0.0 [5]
Tangible Common Equity / Risk Weighted Assets (%)	62.3	56.9	58.4	55.8	44.5	55.6 [6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	0.0	0.0	0.0	0.0	0.0	0.0 [5]
Net Interest Margin (%)	1.6	1.6	1.7	1.4	1.6	1.6 [5]
PPI / Average RWA (%)	-2.7	-2.0	-1.5	-1.5	2.1	-1.1 [6]
Net Income / Tangible Assets (%)	-0.9	-0.5	-0.5	-0.2	0.5	-0.3 [5]
Cost / Income Ratio (%)	-83.2	-138.9	-305.8	-155.5	31.7	-130.4 [5]
Market Funds / Tangible Banking Assets (%)	77.6	85.5	86.2	87.5	89.8	85.3 [5]
Liquid Banking Assets / Tangible Banking Assets (%)	69.8	73.0	73.9	74.2	53.8	68.9 [5]
Gross Loans / Due to Customers (%)	244384.6	--	7416.7	4765.0	535.6	64275.5 [5]

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully loaded or transitional phase-in; IFRS. [3] May include rounding differences because of the scale of reported amounts. [4] Compound annual growth rate (%) based on the periods for the latest accounting regime. [5] Simple average of periods for the latest accounting regime. [6] Simple average of Basel III periods.
Sources: Moody's Investors Service and company filings

Profile

Based in Luxembourg, Commerzbank Finance & Covered Bond S.A. (CFCB)[2] is a specialized lender and covered bond bank and solely performs public sector lending (*Kommunalkreditgeschäft*) in accordance with Luxembourg's Covered Bond law. This includes offers via an integrated agency function, syndicated loans and fiduciary notes.

CFCB is a wholly owned subsidiary of Commerzbank and benefits from a letter of comfort (*Patronatserklärung*) from its Frankfurt-based parent bank.

Detailed credit considerations

Close integration into Commerzbank drives alignment of BCA

We align CFCB's BCA with the BCA of Commerzbank, based on our rating approach for highly integrated entities (HIE). Our assessment reflects CFCB's close integration with and dependence on its parent bank with regard to funding and capital support, as well as key controlling and risk management functions:

» Most of CFCB's unsecured funding is sourced from its German parent.

» CFCB relies on capital support from Commerzbank to meet regulatory requirements.

» CFCB's credit risk management is integrated into Commerzbank's group-wide risk management and control systems, including limit allocations and risk monitoring. Further, CFCB is part of its parent's treasury operations.

Our view is further underpinned by the existence of a letter of comfort (*Patronatserklärung*) from Commerzbank and various service-level agreements in favour of CFCB. We therefore believe that CFCB's probability of failure, as measured by its BCA, is similar to that of its parent bank.

High concentration risks from public sector lending

CFCB's status as a covered bond bank limits its lending activities, in accordance with Luxembourg's Covered Bond law. Therefore, CFCB's credit exposure almost exclusively relates to the financing of the public sector because these loans can be pledged as collateral in order to issue covered bonds, including *lettre de gage*.

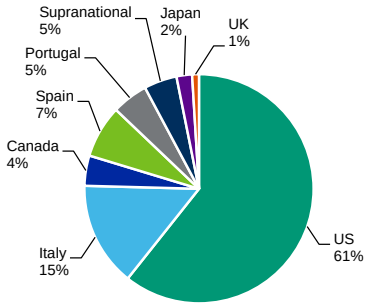
At the end of 2022, CFCB's public sector loans accounted for around €4.8 billion or 76% of assets (2021: 73%), with around three quarters allocated to public sector entities in the United States of America (Aaa stable, 61%) and Italy (Baa3 negative, 15%). After significant reductions of its public sector exposures to the United Kingdom (Aa3 negative), its share accounts for only 1% of the total as of end-2022, compared to 27% in 2018. CFCB's most important group of creditors from loans and financial securities are public sector entities, banks, and financial institutions.

Given CFCB's public sector activities, asset quality is very high, as demonstrated by zero problem loans at the end of 2022, unchanged from 2021. To cover for potential unexpected credit losses, CFCB has set aside provisions of around €0.2 million at the end of 2022, compared with €0.3 million in 2021. CFCB's assets accounted for around 1.3% of Commerzbank's consolidated assets at the end of 2022 (2021: 1.7%).

Exhibit 2

Three quarters of CFCB's public sector lending relates to the US and Italy

Data in percent, as of end-2022

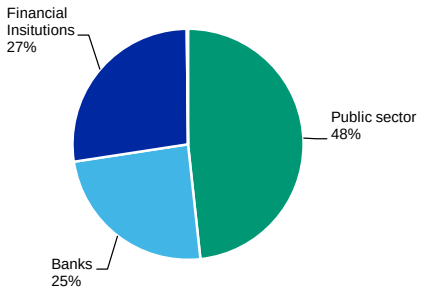


Source: Company reports and Moody's Investors Service

Exhibit 3

CFCB's assets relate to public sector entities, banks and financial institutions

Data in percent, as of end-2022



Source: Company reports and Moody's Investors Service

We consider CFCB's public sector exposures large in comparison with its standalone solvency. At the end of 2022, CFCB's risk-bearing ratio[3] (*Risikotragfaehigkeit*) improved to 165.9%, compared with 101.7% in 2021, reflecting declining market risks during 2022 as well as lower credit risks because of CFCB's ongoing asset wind-down.

Optically high capital ratios, driven by low risk-weights and balanced by unrealized losses

With a Tier 1 capital ratio of 62.2% as of end-2022 (2021: 56.8%), CFCB operates with very high capital ratios compared with commercial banking peers. However, the optically high solvency reflects low risk-weights from public sector lending activities, as underpinned by risk-weighted assets (RWA) that represented only 26.6% of assets at the end of 2022 (2021: 24.3%). For some parts of its public-sector portfolio, CFCB benefits from a zero risk weight.

If necessary, we believe Commerzbank will compensate for any capital shortfall that may arise at CFCB and may be triggered by the decision to reduce its public sector exposures before legal maturities. At the end of 2022, market values of CFCB's public sector assets remain lower than book value, at around €261 million, compared with €243 million in 2021. Because of the bank's intention to hold these assets until maturity, market values do not apply. However, we expect that CFCB continues to reduce its portfolio in a value-preserving manner.

Commerzbank's strategic overhaul means many CFCB activities will either be canceled or moved to its parent bank

CFCB's low profitability reflects the low assets risks from public sector lending activities. Net interest margins from these loans typically range at around 10 basis points and the usage of derivatives to hedge interest rates, currencies, and credit risks introduces earnings volatility from fair value adjustments.

In accordance with Commerzbank's strategic overhaul, CFCB further reduced assets by around 21% to €6.4 billion at the end of 2022 (2021: €8.0 billion), and Commerzbank will relocate or discontinue most of its business activities in Luxembourg to Germany by 2024. CFCB's net interest income declined by around 8% to €111 million, compared with €120 million in 2021. A €2.6 million provision for

credit costs (2021: €5.9 million reversal of provisions), 41% lower fee and commission income of €3.2 million (2021: €5.4 million) and slightly lower operating expenses of €19.5 million (2021: €20.2 million) triggered, again, a net loss for CFCB of €54.3 million in 2022 (2021: net loss of €33.7 million).

Access to liquidity and funding support from Commerzbank

CFCB is highly dependent on liquidity and funding support from its parent bank. At the end of 2022, Commerzbank provided around €3.6 billion or 56.6% of CFCB's total liabilities (2021: 52.0%, 2020: 48.4%). The close integration into Commerzbank's group treasury means that CFCB benefits from lower funding costs because funding is passed through to CFCB on market terms.

Since October 2015, the European Central Bank no longer considers *Lettres de Gage* eligible securities under its repo program. As a result, CFCB has stopped the issuance of these covered bonds (*Lettres de Gage*) and aims to reduce its funding needs by further reducing its asset base and filling any potential gaps by tapping senior funding from Commerzbank. As of 31 December 2022, CFCB had €0.6 billion of outstanding covered bonds, a 13% decline from €0.7 billion as of year-end 2021.

Structural and support considerations

Affiliate support

Because of its strong integration into Commerzbank and the existing letter of comfort (*Patronatserklärung*), we believe that CFCB benefits from a "very high" probability of affiliate support. Our assessment also takes into account the sizeable funding which CFCB receives from its parent bank. As a result of this assumption, CFCB's baa2 Adjusted BCA is aligned with Commerzbank's BCA.

Loss Given Failure (LGF) analysis

We perform our Advanced LGF analysis on the consolidated financials of Commerzbank, based on the assumption that resolution would be addressed for the German parent bank and its Luxembourg subsidiary at the same time. Common resolution with the parent is likely, given that CFCB is strongly interconnected with its parent, as illustrated by its funding reliance for most of its balance sheet. Such interconnectedness implies limited options for a subsidiary's ring-fencing in resolution.

CFCB is subject to the European Union Bank Recovery and Resolution Directive (BRRD), which we consider an operational resolution regime. In the case of resolution, we expect CFCB to form part of Commerzbank's wider resolution perimeter. We therefore apply Commerzbank's LGF analysis to CFCB, considering the risks relating to different debt and deposit classes across the bank's liability structure at failure.

Our Advanced LGF analysis follows the insolvency legislation in Germany. In line with our standard assumptions, we assume a residual TCE of 3%, as well as asset losses of 8% of tangible banking assets in a failure scenario. We also assume a 25% runoff of junior wholesale deposits and a 5% runoff in preferred deposits. Moreover, we assign a 25% probability to junior deposits being preferred to senior unsecured debt. We apply a standard assumption for European banks that 26% of deposits are junior

For CFCB's long-term issuer ratings, our Advanced LGF analysis indicates a very low loss given failure, leading to two notches of rating uplift from the bank's baa2 Adjusted BCA.

Government support

As a result of the Luxembourg-based bank's close integration with its Germany-based parent, we expect any potential German government support to be available for the benefit of CFCB's senior creditors, in case of need. Such support from the Government of Germany (Aaa stable) would likely be made available to and through Commerzbank in the event of stress.

Therefore, CFCB's long-term A2 issuer rating benefits from one additional notch of rating uplift from government support, mirroring our moderate support assumption at the level of Commerzbank for this class of debt.

Counterparty Risk Ratings

CFCB's CRRs are A1/P-1

The bank's CRRs, before government support, are three notches above the baa2 Adjusted BCA, reflecting the extremely low loss given failure from the high volume of instruments, primarily junior senior unsecured debt, which are subordinated to CRR liabilities. CFCB's CRRs further benefit from one additional notch of rating uplift provided by government support, in line with our support assumptions on deposits and senior unsecured debt.

Counterparty Risk Assessment

CFCB's CR Assessments are A1(cr)/P-1(cr)

The bank's CR Assessment, before government support, is three notches above the baa2 Adjusted BCA, based on the substantial buffer against default provided by more subordinated instruments, primarily junior senior unsecured debt, to the senior obligations represented by the CR Assessment. In addition, CFCB's CR Assessment benefits from one further notch of rating uplift provided by government support.

The CR Assessment is an opinion on the likelihood of a default by an issuer on certain senior operating obligations and other contractual commitments

Methodology

The principal methodology we use in rating Commerzbank Finance & Covered Bond S.A. is the Banks Methodology, published in July 2021.

Ratings

Exhibit 4

Category	Moody's Rating
COMMERZBANK FINANCE & COVERED BOND S.A.	
Outlook	Stable
Counterparty Risk Rating	A1/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Counterparty Risk Assessment	A1(cr)/P-1(cr)
Issuer Rating -Dom Curr	A2
PARENT: COMMERZBANK AG	
Outlook	Stable
Counterparty Risk Rating	A1/P-1
Bank Deposits	A1/P-1
Baseline Credit Assessment	baa2
Adjusted Baseline Credit Assessment	baa2
Counterparty Risk Assessment	A1(cr)/P-1(cr)
Issuer Rating	A2
Senior Unsecured	A2
Junior Senior Unsecured	Baa2
Junior Senior Unsecured MTN	(P)Baa2
Subordinate	Baa3
Pref. Stock Non-cumulative	Ba2 (hyb)
Commercial Paper -Dom Curr	P-1
Other Short Term	(P)P-1

Source: Moody's Investors Service

Endnotes

1 The ratings shown are Commerzbank's deposit ratings and outlook, its senior unsecured debt ratings and outlook, as well as the bank's BCA.

2 CFCB resulted from the merger of two former Luxembourg-based Commerzbank subsidiaries that used Lettres de Gage (covered bonds) to refinance their portfolios of public-sector loans. On 4 July 2016, Julius Baer Group Ltd. acquired selected parts of Commerzbank's Luxembourg private banking and wealth management business (former Commerzbank International S.A. [CISAL], renamed Bank Julius Baer Luxembourg S.A.). As part of the deal, some of former CISAL's assets and liabilities, as well as certain businesses from Commerzbank's Luxembourg branch, were transferred to CFCB or were reintegrated into Commerzbank, thereby finalising the restructuring of Commerzbank's Luxembourg operations.

3 In accordance with the bank's Internal Capital Adequacy Assessment Process (ICAAP).

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