Headlines on private German banks over the summer months have resulted in a rollercoaster ride for investors. From potential merger plans between Commerzbank and Deutsche Bank earlier in August, to the recent questioning of government support options for Deutsche Bank after leaked potential DOJ Mortgage Securities Settlement fines, a wide scale of extreme scenarios showed up on the news. In this brief report, Scope looks at the two banks with regard to some of the key credit drivers of our existing ratings. Commerzbank’s Issuer Credit-Strength Rating (ICSR) is A, its senior unsecured debt ratings are A-, and short-term ratings are S-1, all with Stable Outlook. Deutsche Bank’s ICSR is A-, its senior unsecured debt ratings are BBB+ (both recently downgraded in September by one notch), the short-term rating is S-1, and the rating for AT1 securities is B+, all with Negative Outlook.

In our view, the two large banks, in their own different ways, display evolving characteristics that are illustrative of the challenges facing the banking industry in Germany going forward. In this respect, the current strong focus on capital and liquidity ratios is not only important from a regulatory point of view, but also to support investor confidence. Beyond it, however, we also highlight soft factors, like management culture and corporate communications, as relevant to shape investors’ views on these banks.

After headlines on a possible merger between Deutsche Bank and Commerzbank made the rounds in early August, the perception of these two German banks evolved differently. Although there may be some good reasons why such merger considerations may have made sense, we believe that, at this point, the two institutions are under different areas of pressure, and this could not be convincingly addressed by a merger. On the one hand, both institutions are at different stages of their restructuring. On the other hand, more recently outlined strategy updates reveal two different and opposing ways ahead.

The first and most prominent difference lies in the fact that Commerzbank has a well-defined business structure and focus which was once again confirmed in the newest published strategy update on 30 September 2016. However, the presentation of the new “Commerzbank 4.0” strategy also reveals the challenge this and other German banks are currently facing, that is, ever-changing and moving goalposts. Since the beginning of the financial crisis, Commerzbank has been confronted with various threats, but the bank was nevertheless able to go relatively successfully through various restructuring cycles and to rebuild confidence with clients and market participants and, hence, to stabilise and grow business. Now, however, changed market conditions, combined with continuing structural problems in an overbanked German market, demand once more to further streamline and simplify business structures as to being able to achieve higher efficiency gains in a tight margin environment.
Hence, going forward, Commerzbank announced a continuous focus on its core strengths of retail and SME banking in Germany and in the euro area (EA), as well as via its subsidiary mBank in Poland. Non-core and complex higher-risk investment banking areas will be scaled down and exited as far as possible. The bank is very open regarding costs, time scales and the consequence of enhanced restructuring efforts. One point which drew strong media attention is that with some business activities being discontinued, and the digitalisation and automation of workflows, this will lead to staff reductions amounting to around 9,600 full-time positions, slightly offset by the creation of around 2,300 new jobs.

With current full time employees of around 50,000, this amounts nevertheless to a reduction of the bank's number of employees by around 15%. Staff reductions on this scale are not only a cost issue, but need to be managed in a sensible way to not undermine confidence and business attitude of employees. Nevertheless, the new strategy plan looks feasible on paper, although challenging within the targeted period until 2020.

Timescales are one of the major issues management typically has to administer. As seen with Deutsche Bank's announced strategy update in October 2015, market participants are continuously trying to measure the progress and success of restructuring plans. For banks with an underlying, long-term established and engrained business profile, fundamental structural changes are difficult to achieve in the short term, especially given the scale of changes some banks have to implement. However, in such situations, next to transparency and clear communication, a well-defined targeted outcome should help all market participants to manage expectations and project trust in the success of a bank in the future. Here lies the main difference we see between Commerzbank’s and Deutsche Bank’s restructuring plans. Albeit Deutsche Bank’s management targets some of the main issues of the bank by introducing essential cost cutting and streamlining of businesses, the overall aim of the bank with regard to its aspired market position may lack sufficient clarity. Germany and Europe certainly need strong investment banking, but this regional focus does not seem to be a defined role or goal for Deutsche Bank. On a global scale, a downsized Deutsche Bank might struggle to compete.

One of the widely discussed topics last week was also if and how government support could come forward for large European financial institutions. Although we would at the moment disregard the question of support by the German government for any financial institutions, we believe that it is important for a large bank to have a defined home market with defendable positions and niches. Such a fallback can provide support in a different way, via, for example, the continuous trust of retail clients, which is as important as the open commitment of larger commercial clients. And in this respect, Deutsche Bank profits strongly from a corporate support network within Germany, with senior management of large German institutions currently publicly bolstering the importance of the bank for the German economy.

It is generally accepted that the role of Deutsche Bank in Germany is important, but it is not always easy to pin down exact market shares for financial institutions, as calculations and viewpoints in this context may vary strongly. Nevertheless, risk exposures may provide some guidance in this respect. Out of Deutsche Bank’s total credit exposure of EUR 1.03trn, around EUR 274bn (27%) referred to credit exposure in Germany and another c. EUR 274bn to the rest of Western Europe. Looking at Commerzbank, as of year-end 2015, about 50% (EUR 218bn) of Commerzbank's exposure at default (EUR 437bn) was assigned to risk in Germany and another 24% (EUR 104bn) to risk in the rest of Western Europe. As these numbers indicate, the importance of German and western European exposures with respect to the balance sheet size of the two institutions...
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varies strongly. However, measured by the absolute amount, both banks should have about an equal weight on the German economy.

Furthermore, it is also important to look at the wider scale of banking in Germany, where both banks are confronted with growing competition from savings and cooperative banks, as well as from foreign banks. In this respect, we believe that it is important that financial institutions possess and be able to communicate clearly a longer term strategy in concrete terms and thus be able to make a difference and gain market share.

We see the need to advance in technology and remote banking – mobile and internet -- but we nevertheless understand that particularly banking for SMEs and corporates in general is reliant on different drivers. It has been often remarked in the past that personal contacts and consistency are key elements for a banking relationship. In our view, this situation has not changed. Of course, costs and prices of services are key factors, but for a longer-term business relationship clients are still keen to have a certain consistency in services. Commerzbank has been working on rebuilding relationships and trust with its clients. The new strategy of the bank confirms a continuation on this path by focusing on a wider branch network, albeit with slightly changed service structures. On the other hand, Deutsche Bank is looking to reduce its branch network in Germany. Modern banking in our view is a tightrope walk, finding the right balance between technology-based services and platforms to increase efficiency and reduce costs, on the one hand, and preserving and enhancing relationship banking with all customers. Commerzbank’s evolving strategy seems to address this conundrum.

Lastly, the more immediate focus of market participants is the profitability and solvency of a bank. Commerzbank and Deutsche Bank have both been facing strong pressure on their respective capital positions over the past quarters. In addition, they have fared less convincingly during the recent EU stress test. Commerzbank experienced a decline in its capital position during the second quarter due to higher operational risk calculations and pension liabilities, as well as strains on various business areas due to the negative interest rate environment. As of June 2016, Commerzbank’s fully phased-in CET1 ratio stood at 11.5%, down from the 12% reported as of Q1 2016. However, continuously positive, albeit smaller, net profits should allow the bank to a degree to strengthen its capital basis organically. Commerzbank has also taken a prudent approach by suspending dividend payments to refinance incurring restructuring costs.

Deutsche Bank’s CET1 ratio stood at 10.8%, as of Q2 2016, down from 11.1% in Q1. In principle, and looking at the challenging market conditions, Deutsche Bank currently faces similar problems to Commerzbank. On top, Deutsche Bank’s ongoing litigation cases are a major concern. It is unlikely that Deutsche Bank will have to face fines in the US of around USD 14bn, but even a much lower amount could be worrying, as we reckon that the bank’s EUR 5.5bn provisions may be insufficient to cover all ongoing litigation cases. As such, we believe that it is important going forward to rebuild investor and client confidence via a clearer business strategy of the bank.
A Tale of Two Strategies:
Deutsche Bank and Commerzbank

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