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Deutsche Bank Long-Term Rating Lowered To 'BBB+' On Elevated Strategy Execution Risks; Outlook Stable

01-Jun-2018 01:15 EDT
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On May 24, Deutsche Bank announced further details of its planned multi-year restructuring, focusing notably on its U.S. equities sales and trading business.
We consider that management is taking tough actions to cut the cost base and refocus the business in order to address the bank's currently weak profitability.
However, we see significant execution risks in the delivery of the updated strategy amid a continued unhelpful market backdrop, and we think that, relative to peers, Deutsche Bank will remain a negative outlier for some time.
We are lowering to 'BBB+' from 'A-' our long-term issuer credit rating on Deutsche Bank and its core operating subsidiaries.
We are affirming our ratings on Deutsche Bank's subordinated debt issues, including our 'BBB-' rating on its senior subordinated (also known as senior non-preferred) instruments.
The stable outlook reflects our view that management will execute its strategy in earnest and, over time, will show progress against its 2019 financial objectives and so achieve its longer-term objective of a more stable and better-functioning business model. Our central scenario assumes that cost-cutting measures will be tailored and targeted enough to preserve the bank's capital markets franchise, in particular in Europe, and avoid substantial revenue loss.

LONDON (S&P Global Ratings) June 1, 2018--S&P Global Ratings today lowered its long-term issuer credit ratings (ICR) on Deutsche Bank AG and its core subsidiaries to 'BBB+' from 'A-'. The outlook is stable.

We removed the ratings from CreditWatch negative.

At the same time, we affirmed our 'A-2' short-term ICRs and our 'trAAA/A-1' Turkish national scale ratings on Deutsche Bank. We also affirmed our issue credit ratings on all the hybrid instruments issued or guaranteed by the bank, including our 'BBB-' rating on the bank's senior subordinated debt instruments.

The lowering of our long-term issuer credit rating reflects that Deutsche Bank's updated strategy envisages a deeper restructuring of the business model than we previously expected, with associated non-negligible execution risks. While we consider management is taking tough, although likely inevitable, actions and proposes a logical strategy to successfully restore the bank to more solid, sustainable profitability over the medium to long term, the bank appears set for a period of sustained underperformance compared with peers, many of whom have now finished restructuring. Over the coming 18 months, we will look in particular for robust delivery against 2019 objectives, such as the €22 billion cost target, and evidence that the bank retains the solid support of its clients, something that would help underpin the revenue base in the CIB division amid a period of downsizing. While we regard capital markets earnings as inherently more volatile than retail and commercial banking, we consider a well-balanced blend of profitable businesses to be supportive of the bank's creditworthiness. Therefore the bank's ability to preserve its global capital markets franchise, focused in particular on Europe, underpins our stable outlook.

Our removal of the CreditWatch follows a three-month period during which Deutsche Bank has been under intense scrutiny, which culminated in it parting company with former CEO John Cryan (on April 8). Then, new CEO Christian Sewing delivered a high-level communication of the updated strategy on April 26, with further elaboration on May 24, and ultimately won shareholder support for that strategy at the annual general meeting the same day. This is the latest iteration in the bank's longer-term restructuring story that started under John Cryan in 2015 and which has already yielded some key actions to strengthen the bank. This includes the rundown and divestment of noncore assets and businesses, a substantial capital raising, and an operational overhaul to reduce complexity and control risk and improve efficiency. The gradual resolution of outstanding litigations has reduced some earnings-event risk, but so far management has not delivered any marked upturn in financial performance, which remains burdened by a high cost base.

By 2021, the bank targets a sustainable revenue share of approximately 50% from the Private & Commercial Bank and the DWS asset management business. Adding the revenues of Global Transaction Banking, the share of more stable revenues would be around 65%, which we view positively, especially compared with Deutsche Bank's historical earnings dependence on more volatile markets businesses. Likely coinciding with this, management targets a post-tax return on tangible equity (ROTE) of about 10% in a normalized operating environment--that is, assuming a modest rise in central bank base interest rates and moderately higher market volatility and activity after the nadir of 2017. Aside from one-off restructuring costs of up to €800 million in 2018, the Management Board has committed to keep the adjusted cost base at €23 billion for 2018 and bring it to €22 billion by 2019. The execution of the strategy notably includes:

In the Personal and Commercial Banking (PCB) division:

The delivery of the planned cost efficiency program following the May 25 legal merger of the group's two principal domestic markets subsidiaries--Deutsche Postbank AG and Deutsche Bank Privat- und Geschäftskunden AG--into DB Privat- und Firmenkundenbank AG, the largest private and commercial bank in Germany.

Seeking more revenue growth in Germany, something that depends in large part on eventual central bank interest rate rises, and in markets like Italy and Spain.

Ensuring that the above actions and investment in digital transformation bring the cost-to-income ratio of this business to 65% by 2022.

In the Corporate & Investment Bank (CIB) division:

A sharp focusing of activities and resources on its European and multinational clients and the products that are most relevant for them.
Refocusing cash equities on electronic trade execution solutions, growing structured product capabilities in equity derivatives, and refocusing resources on key clients in prime finance.
Scaling back other areas where Deutsche Bank no longer has a competitive advantage in the changed market environment, such as U.S. rates sales and trading.
Shrinking the balance sheet, notably via a €100 billion cut in leverage exposure (around 10% of the group's exposure at March 2018).

We believe that management is taking decisive actions to address the fundamental cost issue the bank has, notably in some market segments. We expect management will also pursue broader efficiency measures to delayer management structures, to remove duplication and overlaps, and to increase the speed of decision making. The accelerated cost reduction that the steps above imply will see group headcount fall to well below 90,000 from 97,000.

Our use of the negative peer adjustment notch reflects our view that relativities with 'A' rated peers became too strained and are unlikely to move back into line quickly. Notably, while much of the heavy-lifting should be completed in 2018, Deutsche Bank's restructuring will likely only start bearing fruit in 2019, and only fully by 2021. By contrast, key peers such as Barclays, Commerzbank, Credit Suisse, and the Royal Bank of Scotland (RBS) have now worked through their restructuring and business model optimization and are already starting to see improved performance.

That said, we continue to be broadly supportive of the strategy. We expect the planned refinements to optimize the CIB division around its strongest franchises and anticipate that a well-performing, more efficient CIB division will ultimately support Deutsche Bank's creditworthiness. In PCB, the size of the domestic franchise is clear, but we consider it critical that these efficiencies deliver, with the Asset Management division, the solid base of predictable profitability that we observe among major European peers. The unchanged 'bbb' stand-alone credit profile (SACP) remains underpinned by the actions that management took in 2017 to strengthen the balance sheet (in terms of capitalization, liquidity, and asset quality). These actions gave the bank good solvency and liquidity buffers and restored investors' confidence, which in our view helps the new management to deliver its strategy. While litigation risks remain--the main outstanding case, in our view, is a U.S. Department of Justice investigation into mirror trades in Russian equities--we see them as having reduced significantly and are no longer a material downside risk.

We anticipate that Deutsche Bank's profitability in the second quarter of 2018 could be muted given flat period-to-date market conditions, with only a very low single-digit return on equity for the full year 2018. Depending in part on market conditions and activity, we expect that profitability will improve in 2019 as the benefits of strategic execution emerge, leading to a mid-single-digit ROTE. We assume that asset quality will remain robust, and liquidity buffers strong. We estimate the bank's capitalization measured under our risk-adjusted capital (RAC) methodology to have been close to 10.0% at end-2017, but we expect this to decline to 9.0%-9.5% during 2018/2019. The bank reported a fully-loaded Common Equity Tier 1 ratio of 13.4% at March 2018, down from 14.0% at end-2017.

On April 19, 2018, we published new criteria for assigning resolution counterparty ratings (RCRs) to certain financial institutions. We consider that there is an effective resolution regime in Germany, and that an RCR may be relevant to Deutsche Bank under these criteria. In coming weeks, we will review our analysis of the resolution regime across 26 countries, including Germany. This review will identify liability categories, if any, that are protected from default risk by structural or operational features of a given resolution framework. Upon completion of this review, we may assign RCRs under our new criteria to banks located in Germany, including Deutsche Bank.

The stable outlook acknowledges the continued execution risks inherent in Deutsche Bank's restructuring, but reflects our view that the refreshed management team has the backing of the Supervisory Board, is pressing ahead in earnest, and has taken decisive actions to help the bank deliver more solid and more sustainable returns. Still, we will continue to observe how the execution of this strategy unfolds and to what extent the franchise of Deutsche Bank, and its earning generation capacity, has been damaged or not by the management changes and restructuring. Over the coming 18 months, we will look in particular for robust delivery against 2019 objectives, such as the €22 billion cost target, a meaningful improvement in reported ROTE, and evidence the bank has retained the solid support of its clients, something that would help underpin the revenue base in the CIB division amid a period of substantial downsizing.

We could lower our long-term issuer credit rating on the bank if we see setbacks in the delivery of the updated strategy or signs that 2019 financial objectives could materially slip, leading to a stalling of improving profitability. This would be consistent with a view that, notwithstanding Deutsche Bank's position as a leading European bank, the business stability that comes with an end to restructuring and delivery of satisfactory financial performance is likely to remain elusive, and also that its franchise and competitive position have weakened. In this scenario, we would very likely revise down the 'bbb' SACP, and so lower our issue credit ratings on all rated debt, including the senior subordinated debt and regulatory capital instruments.

An upgrade is unlikely in the coming 18 months because we expect the financial benefits of strategic execution in 2018 to become more evident only in 2019 and to represent progress in the ongoing journey rather than its conclusion. Still, we could upgrade the bank once we gain greater confidence in Deutsche Bank's execution such that it appears well set to achieve a more stable and predictable business model, thereby narrowing the gap with its global peers in terms of revenue generation and cost control. We would likely make this revision by removing the notch of adjustment to the issuer credit rating. It would therefore affect only the senior (preferred) debt, not our ratings on the senior subordinated debt and regulatory capital instruments.

RELATED CRITERIA

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