FitchRatings

Fitch Ratings: Outlook for Deutsche Bank's Turnaround Still Difficult; 2018 Cost Targets Met

Fitch Ratings-London-01 February 2019: Deutsche Bank's reliance on an improved market environment and increased market share to reach its modest 4% return on tangible equity (RoTE) target for 2019 highlights the vulnerability of its business model to external developments, Fitch Ratings says. The Negative Outlook on the bank's 'BBB+' Long-Term Issuer Default Rating reflects our view that it continues to face challenges in reaching its strategic targets in 2019, in particular with respect to improving its profitability. The bank's capitalisation and liquidity and the bank's good asset quality continue to support its ratings.

Deutsche Bank reported a EUR319 million pre-tax loss for 4Q18, but the bank posted a small positive net profit (EUR341 million) for the full year for the first time since 2014. Earnings in 4Q18 were affected by a difficult market environment for the fixed income businesses that the bank is most exposed to, particularly credit, and revenue fall-outs from the deep cuts to the investment bank in 2H18. More positively, non-interest expenses decreased sharply by EUR1.3 billion yoy meaning the bank slightly exceeded its 2018 cost target.

Management expects to improve pre-tax profitability in 2019 by reducing adjusted costs by a further EUR1 billion, by investing excess liquidity in higher-yielding assets and optimising the balance sheet and by further growth in stable businesses following 5% loan growth in 2018. These measures, which are largely under the bank's control, should add about 2.5pp to the bank's weak 0.5% RoTE generated in 2018. In addition, to reach the targeted 4% the bank relies on a recovery in market share and client activity as well as a more benign market environment.

The decrease in operating expenses in 2018 was driven by lower than targeted adjusted costs of EUR21.8 billion, reflecting headcount reductions, lower variable compensation and a reduction in non-compensation costs. Expenses not included in this measure also decreased, reflecting mainly lower litigation provisions. Adjusted costs included EUR1billion of expenses targeted at improving the bank's control functions, which have come under scrutiny following involvement in several money laundering investigations.

Deutsche Bank has stated that it has to date not discovered any internal wrongdoings related to its activities connected to Danske Bank or in relation to facts that arose from the publication of the 'Panama Papers'. Effective compliance and anti-money laundering controls are fundamental for Deutsche Bank's business model and its international operations, and failure to manage risks arising from these activities is a rating sensitivity.

In 2018, revenues decreased by 4%, affected by the bank's business exits, loss of market share in some segments and a weak trading environment in the main products and geographies of its Corporate and Investment Bank (CIB). In 4Q18 revenues decreased by 2% yoy, dragged down by the CIB in a difficult quarter where market conditions affected trading and underwriting activities across the sector.

In CIB a 5% increase in Global Transaction Banking revenues in 4Q18 was not sufficient to offset declines across the capital markets businesses. Fixed income sales and trading revenue declined 23% yoy, led by rates and credit, where mark-to-market losses on the bank's inventory affected results. However, the bank's foreign exchange and emerging markets sales and trading saw a yoy improvement in revenue. Equity sales and trading revenue remained flat yoy.

A decline in debt origination income also dragged overall origination and advisory revenues down by 23% yoy in 4Q18 and highlighted the impact of leveraged finance activity on the bank's earnings, but leveraged finance activities did not result in any loan impairment charges in 4Q18.

Revenues also decreased in the asset management division (AM), by 17% yoy, as the division saw a EUR7 billion net new money outflow, and 4Q18 pre-tax profit fell 48% yoy. Revenue in the Private and Commercial Bank (PCB) was stable yoy, excluding the 4Q17 impact of the sale of the Polish operation, but profitability in the segment remained weak at EUR23 million in the quarter. We believe that PCB's performance will only improve materially once the bank has made further progress in integrating Postbank, but further growth in higher-margin consumer lending and in commercial lending in Germany should help stabilise revenue in the business, which continues to suffer from low interest rates.

Loan impairment charges increased in 4Q18 reflecting higher provisioning needs for stage 1 and stage 2 assets, including because of a weakening macro-economic outlook impacting IFRS9 estimations. Overall they remain very low, at 13bp of loans at amortised cost for the full year, and stable yoy.

Deutsche Bank's fully-loaded CET1 ratio decreased in 4Q18 to 13.6%, from 14% at end-3Q18, mainly because of higher risk-weighted assets (RWA) from business growth and higher market risk RWA, and because deductions relating to prudent valuation adjustments increased.

The bank expects the CET1 ratio to come under further pressure from regulatory adjustments in 2019 (40bp are expected from the Targeted Review of Internal Models undertaken by the ECB and from a change in lease accounting), which should be partly offset by lower market risk RWA (equivalent to 15bp CET1 ratio benefit). We expect the bank to maintain a CET1 ratio above 13%, which remains an important sensitivity for the bank's rating. The fully-loaded leverage ratio increased to 4.1%, helped by a seasonal effect from lower settlement balances, and by a decrease in cash and deposits with banks.

Liquidity reserves decreased to EUR259 billion (from EUR280 billion) in line with the bank's prior guidance. The share of cash and equivalents decreased to 71% from 79%, as the bank looked to hold a higher share of its liquidity buffer in liquid securities, to minimise the income drag from negative rates on ECB deposits. The liquidity coverage ratio is comfortably above requirements at 140%, and we expect the bank to continue to manage its liquidity buffer conservatively during its turn-around period.

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