DZ BANK AG

Capital markets rebound supports improved 2019 results as pressure on interest margins persists

**Summary of DZ BANK’s full year 2019 earnings announcement**

DZ BANK AG [DZ BANK, Aa1/Aa1 negative, baa2] reported significantly improved full-year 2019 profits supported by stronger capital market performance, but guided towards a lower result for 2020 due to persisting macroeconomic and political uncertainties as well as the headwinds from persistently low interest rates. Reported pre-tax profits reached €2.7 billion, a five-year high. The result was supported by a strong performance of capital markets, which particularly benefitted the group’s trading result as well as the segment results of R+V Versicherungen (R+V), the group’s insurance specialist and of DZ HYP, its real estate lender. DZ BANK achieved an improvement in its regulatory capitalisation, to a 14.4% Common Equity Tier 1 ratio (December 2018: 13.7%). Tier 1 capital was further supported by a successful placement of €1.4 billion of additional tier 1 capital instruments within the cooperative sector. For 2020, DZ BANK guided towards pre-tax profits at the lower end of the €1.5 billion to €2 billion long-term target range.

**Solid results across segments, as benefiting from rebound of capital market revenues**

On 27 February 2020, DZ BANK reported a net profit of €1.9 billion for 2019, more than double its €0.9 billion 2018 net result. The improvement was driven by a recovery of key segments following capital markets weaknesses in the prior year, which helped offset the normalisation of risk provisions and margin pressure on its traditional lending businesses.

**Exhibit 1**

Group result benefitted from income rebound in key revenue segments

Changes in 2019 vs 2018 full-year pre-tax earnings contribution per segment

Note: "Others" combines the changes in pre-tax profit contribution of the segments DZ BANK AG - Holding Function, DVB BANK SE, TeamBank AG, VR Smart Finanz (formerly VR leasing) as well as Other/Consolidation; “DZ BANK” is the group’s cooperative central bank and commercial bank

Source: Moody’s Investors Service and company data
Capital market result mitigates margin pressure and higher risk costs

The bank’s pre-tax income increased by 98% year-over-year to €2.7 billion reflecting the positive jaws as operating income increased 23% to €6.9 billion and operating costs remained flat at €4.1 billion. Increased net fee income (+1% to €2.0 billion), higher trading (+66% to €0.5 billion) and insurance business results (251% to €1.2 billion, including about €520 million of one-off gains), primarily stemming from increased client activity as well as sizeable valuation gains on own debt issues and the group’s securities portfolio, more than offset the margin pressures across the bank’s other businesses (net interest income: -4% to €2.7 billion) and the normalisation of risk costs. The significantly improved results from capital market activities led to a recovery across key divisions, as shown in exhibit 1. This rebound, following the dip in 2018, emphasises our view of DZ BANK’s relevant earnings correlation with the performance of capital markets.

Foremost driven by capital markets, DZ BANK’s insurance company R+V as well as its asset management subsidiary Union Investment Management (UMH) recorded pre-tax segment profit increases of 270% and 29%, respectively, as investment returns for R+V and performance-related fees for UMH rebounded. UMH further benefitted from the sale of its Polish business.

DZ HYP, the commercial real estate specialist of DZ BANK, which had been the third important subsidiary to contribute to a dip in 2018 results saw its pre-tax segment result almost triple, mainly because of more favourable credit spreads at end-2019 in the entity’s securities portfolio, which contributed around €250 million of one-off gains, and higher real estate lending volumes at €50.2 billion (+11%).

DZ BANK reported similarly strong portfolio growth in its corporate banking activities, where lending volumes expanded to €58.5 billion (+10%).

Good operational performance at DZ BANK’s private banking subsidiary, DZ PRIVATBANK, contributed positively to the 2019 full-year result following the sizeable goodwill write-down in the prior year. DZ BANK used a €250 million extraordinary gain from sales of non-shipping financing activities of DVB BANK S.E. (DV8) to partially absorb the cost of the further shipping portfolio wind-down, leaving DVB with a pre-tax loss of €108 million, improved from minus €130 million in 2018.

Bausparkasse Schwaebisch Hall’s weaker result highlights the headwinds for the cooperative retail banking franchise

The weaker €189 million (2018: €295 million) segment contribution of Germany’s largest building and loan association, Bausparkasse Schwaebisch Hall AG (BSH, Aa1/Aa1 negative, baa2), to DZ BANK’s pre-tax results confirms the lasting results pressure on Germany’s building and loan associations (Bausparkassen) and in our view points to ongoing results pressure on the primary banks of the cooperative banking sector, which closely interact with BSH in their core residential mortgage lending activity.

BSH’s segment results include a range of extraordinary items, in particular an around €300 million interest expense for additional interest-rate bonus reserves driven by a further decline in market interest rates during 2019. According to Bundesbank data, sector-wide interest expenses on building and loan deposits have remained fairly high in 2019 and their decline was by far outpaced by lower interest rates on both new and outstanding German residential mortgage loans, the core lending product of German building and loan associations (see exhibit 2).
Despite anecdotal evidence of a higher propensity of Germany’s cooperative banks to charge depositors negative rates, we believe average interest expenses on their retail deposits are also unlikely to have kept pace with declining mortgage rates in 2019. In part, the cooperative primary banks will have continued to offset this structural pressure through lending volume growth, which for the sector reached a post financial crisis high of +6.0% in 2019 according to Bundesbank data. In addition, a moderate recovery in net new assets sales to private customers reported for DZ BANK’s UMH mutual funds business to €8.1 billion in 2019 from €7.5 billion in 2018 (2017: €9.9 billion) will - together with higher account maintenance fees - have supported the primary banks’ fee income because of their sales cooperation with UMH.
Endnotes

1. DZ BANK’s ratings are the deposit ratings, the senior unsecured ratings and outlook and the Baseline Credit Assessment.
2. BSH’s ratings are the deposit ratings, the issuer ratings and outlook and the Baseline Credit Assessment.
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