FitchRatings

RATING ACTION COMMENTARY

Fitch Downgrades Aareal to 'BBB'; Outlook Stable

Wed 14 Feb, 2024 - 1:19 PM ET

Fitch Ratings - Frankfurt am Main - 14 Feb 2024: Fitch Ratings has downgraded Aareal Bank AG's Long-Term Issuer Default Rating (IDR) to 'BBB' from 'BBB+' and Viability Rating (VR) to 'bbb' from 'bbb+'. The Outlook on the Long-Term IDR is Stable. The Short-Term IDR has been affirmed at 'F2'.

The downgrade reflects our expectation that the challenges in the US office property market are weighing on Aareal's asset quality and operating profitability.

The Stable Outlook reflects Fitch's expectation that Aareal's pre-impairment operating profit will continue to provide a sufficient buffer for higher loan impairment charges in the coming quarters, which should allow the bank to generate adequate operating profitability. It also incorporates Fitch's view that Aareal's funding and liquidity, which benefits from a stable deposit base and the bank's established role as a Pfandbrief issuer, remains sound.

KEY RATING DRIVERS

Concentrated Business Profile: The ratings reflect Aareal's core business as an international commercial real estate (CRE) lender and our expectation that capitalisation will remain sound despite pressure on profitability and asset quality. Profitability and revenue diversification benefit from services to the institutional housing sector, which also gives it access to a stable deposit base.

Tested Underwriting Standards: Aareal mainly finances properties in prime locations. The underwriting standards and collateralisation of its loan book are broadly in line with market practice. The bank's risk profile is also underpinned by its centralised, sophisticated risk control framework and good record of impaired loans work-out, which we view as crucial for weathering the current challenging conditions in real estate markets.

Asset Quality Deterioration: Aareal's asset quality has come under additional pressure, especially in its sizeable US office portfolio, which accounted for EUR4.3 billion, equal to 13% of its total CRE portfolio at end-3Q23. We expect loan impairment charges to be higher than we previously expected, which will put pressure on profitability and we expect the bank to continue to actively manage its non-performing loan portfolio. Further inflows of impaired loans would increase the bank's gross impaired loan ratio, which with a 4% four-year average to end-1H23, is high compared with domestic peers.

The bank's asset quality could deteriorate further if valuation pressure in the US office sector persists longer than expected, or if the quality of the bank's European office portfolio, which to date has performed solidly, weakens.

Adequate Profitability Albeit Under Pressure: The bank's revenue generation improved materially in 9M23 as higher interest rates resulted in improved deposit margins. Fitch expects higher loan impairment charges to weigh on Aareal's operating profit/risk-weighted assets (RWAs) ratio.

Resilient Capitalisation: We expect Aareal's capitalisation to remain a relative rating strength, with its end-3Q23 CET1 ratio of 19.4% comfortably exceeding regulatory requirements and a Basel III leverage ratio (end-3Q23: 6.3%) that is adequate and above that of European peers. Our assessment of capitalisation incorporates Aareal's high single-borrower and sector concentrations and our view that asset quality deterioration could result in RWA inflation.

Diversified Funding: Aareal's funding profile benefits from its established covered bond franchise, stable deposits from the institutional housing sector and to a lesser extent, retail term deposits collected through independent online platforms, which reduce the bank's reliance on unsecured debt market funding. We expect covered bond issuance to remain resilient even in periods of market stress but consider Aareal's deposit funding more price- and confidence sensitive.

Aareal's Short-Term IDR is the higher of the two short-term ratings that maps to its Long-Term IDR and reflects our assessment of its funding and liquidity.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

Aareal's ratings would likely be downgraded if the bank's gross impaired loan ratio increases above 6% for an extended period with no credible reduction plan or if elevated loan impairment charges weigh on its operating profitability in the longer term.

The ratings would also come under pressure if we do not see a clear path for the bank's operating profit/RWA ratio to sustainably remain around 1.5%. This could result from an additional severe stress in the US office property market or spill-over to European property markets or specific sectors that are sensitive to higher rates and widening spreads. Significantly higher funding costs or signs of challenges to access the wholesale funding market or instability in its deposit base could also impair Aareal's profitability and funding and result in a downgrade.

Aareal's Short-Term IDR is sensitive to a downgrade of the Long-Term IDR or a downgrade of the funding and liquidity score.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

An upgrade of Aareal's Long-Term IDR is unlikely in the near term, given that Aareal's business profile is concentrated on CRE. In the longer term, an upgrade would require a sustainable recovery of US office property markets and resilient asset quality in the bank's other property segments and regions.

An upgrade would also be contingent on the bank significantly strengthening its profitability, with an operating profit/RWA ratio sustained above 2%, and improving its impaired loans ratio to around 3% on a sustained basis.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

DCR, Deposit and Senior Debt Ratings: The one-notch downgrades of Aareal's Derivative Counterparty Rating (DCR), long-term deposit rating, senior preferred debt rating and long-term senior non-preferred debt rating mirror the downgrade of the Long-Term IDR. The senior preferred rating remains one notch above the Long-Term IDR, and the long-term senior non-preferred debt rating remains aligned with the Long-Term IDR. This reflects the large and sustainable layer of non-preferred and junior debt that provides preferred creditors and counterparties with additional protection in a resolution.

The short-term senior preferred and senior non-preferred debt and deposit ratings are the lower of the two options mapping to the respective long-term ratings.

Subordinated Debt: The one-notch downgrades of the Tier 2 debt and additional Tier 1 (AT1) ratings mirror the downgrade of the VR. The Tier 2 debt rating remains two notches below the VR to reflect higher loss severity relative to senior creditors in a resolution. The AT1 notes are rated four notches below the VR (two notches for loss severity and two notches for non-performance risk) to reflect our expectation that

Aareal will maintain large capital buffers above the notes' mandatory coupon omission triggers.

Government Support Rating (GSR): Aareal's GSR of 'no support' reflects Fitch's view that senior creditors cannot rely on full extraordinary state support. This is driven by the EU's resolution framework that is likely to require senior creditors participating in losses, if necessary, instead, or ahead, of a bank receiving government support.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

A downgrade of the Long-Term IDR would trigger a downgrade of the DCR, long-term senior preferred and senior non-preferred debt and deposit ratings. We could also downgrade these ratings if the bank no longer retained a senior non-preferred and junior debt buffer that is large enough to cover its total resolution buffer requirement, and if at the same time the senior non-preferred and junior debt buffer declines below 10% of RWAs.

An upgrade of Aareal's IDRs would trigger an upgrade of the DCR, senior preferred and non-preferred debt and deposit ratings, unless the buffer of junior and senior non-preferred debt decreases below the level required to maintain the senior preferred ratings' one-notch uplift above and the senior non-preferred debt's alignment with the Long-Term IDR. Short-term debt ratings are sensitive to changes to the Short-Term IDR.

A downgrade of the VR would lead to a downgrade of the Tier 2 and AT1 notes. The ratings of AT1 notes could also be downgraded if we perceive a heightened risk that capital cushions above the maximum distributable amount trigger points could fall below 100bp.

An upgrade of the GSR would require a higher propensity of sovereign support. While not impossible, the EU's resolution regime makes this highly unlikely, in Fitch's view

VR ADJUSTMENTS

The capitalisation & leverage score of 'a-' has been assigned below the 'aa' implied category score due to the following adjustment reason(s): risk profile and business model (negative).

The funding & liquidity score of 'bbb' has been assigned below the 'a' implied category score due to the following adjustment reason(s): non-deposit funding (negative).

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Aareal Bank AG	LT IDR	BBB Rating Outlook Stable Downgrade		BBB+ Rating Outlook Negative
	ST IDR	F2	Affirmed	F2
	Viability	bbb	Downgrade	bbb+
	DCR	BBB+(dcr)	Downgrade	A-(dcr)
	Government Support	ns	Affirmed	ns
long-term deposits	LT	BBB+	Downgrade	A-
Senior preferred	LT	BBB+	Downgrade	A-
subordinated	LT	BB+	Downgrade	BBB-

subordinated	LT	BB-	Downgrade	BB
Senior non-preferred	LT	BBB	Downgrade	BBB+

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Roger Schneider
Director
Primary Rating Analyst
+49 69 768076 242
roger.schneider@fitchratings.com
Fitch Ratings – a branch of Fitch Ratings Ireland Limited
Neue Mainzer Strasse 46 - 50 Frankfurt am Main D-60311

Patrick Rioual
Senior Director
Secondary Rating Analyst
+33 1 44 29 91 21
patrick.rioual@fitchratings.com

Olivia Perney
Managing Director
Committee Chairperson
+33 1 44 29 91 74
olivia.perney@fitchratings.com

MEDIA CONTACTS

Peter Fitzpatrick
London
+44 20 3530 1103
peter.fitzpatrick@thefitchgroup.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

Bank Rating Criteria (pub. 01 Sep 2023) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Aareal Bank AG	EU Issued, UK Endorsed

DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read these limitations and disclaimers by following this link: https://www.fitchratings.com/understandingcreditratings. In addition, the following https://www.fitchratings.com/rating-definitions-document details Fitch's rating definitions for each rating scale and rating categories, including definitions relating to default. ESMA and the FCA are required to publish historical default rates in a central repository in accordance with Articles 11(2) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

Published ratings, criteria, and methodologies are available from this site at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance, and other relevant policies and procedures are also available from the Code of Conduct section of this site. Directors and shareholders' relevant interests are available at https://www.fitchratings.com/site/regulatory. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed. Fitch Ratings makes routine, commonly-accepted adjustments to reported financial data in accordance with the relevant criteria and/or industry standards to provide financial metric consistency for entities in the same sector or asset class.

The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. Sector-specific best- and worst-case scenario credit ratings are listed in more detail at https://www.fitchratings.com/site/re/10238496

The information in this report is provided “as is” without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001.Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the “NRSRO”). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the “non-NRSROs”) and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

dv01, a Fitch Solutions company, and an affiliate of Fitch Ratings, may from time to time serve as loan data agent on certain structured finance transactions rated by Fitch Ratings.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.