FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Aareal at 'BBB+'; Outlook Negative

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Fitch Ratings - Frankfurt am Main - 25 Oct 2023: Fitch Ratings has affirmed Aareal Bank AG's Long-Term Issuer Default Rating (IDR) at 'BBB+' with a Negative Outlook and Viability Rating (VR) at 'bbb+'.

KEY RATING DRIVERS

CRE Sector Risk: Aareal's ratings reflect its focus on lending to the cyclical commercial real-estate (CRE) sector, which is offset by the bank's good geographical diversification relative to peers, sound capitalisation, adequate funding and liquidity and resilient profitability. The latter benefits from rising net interest margins, which have so far offset higher loan impairment charges (LICs) in the bank's US office portfolio.

The Negative Outlook on the IDR reflects downside risks resulting from higher-for-longer interest rates and structural changes in the office segment, which could lead to a further decline in the market values and debt service capacity of these properties and consequently greater-than-anticipated pressure on asset quality and profitability.

Diversified CRE Presence: Aareal's business profile benefits from a diversified presence in international markets and across different market sectors. It is underpinned by the bank's flexible approach to changing market conditions and transaction volumes and leverage on higher margin international lending compared with domestic-focused peers.

Credit Standards Reflect Market Practice: Aareal mainly finances properties in prime locations and the credit standards at underwriting and the 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 work-out record of its legacy impaired loans, which it needs to operate in more volatile real estate markets. Structural interest rate and foreign-currency risks are modest.

Downside to Asset Quality: Aareal's post-pandemic impaired loans reduction was reversed by new inflows in 1H23, mainly from its US office portfolio, and we expect the impaired loan ratio (end-1H23: 4.1%) to remain above domestic peers in the next two years. The negative outlook on the asset quality score reflects our view that higher-for-longer interest rates, along with a potential increase in vacancy rates in the bank's office and retail portfolios also in other geographies, would pressure debt yields and increase refinancing risk for these properties more than we currently expect. This would lead to an increase in the impaired loan ratio to a level no longer commensurate with a 'bbb' asset quality score.

LICs Weigh on Profits: We expect Aareal's operating profit/risk-weighted assets (RWA) ratio to average above 1.5% over the next two years. Aareal's pre-impairment operating profit will increase in 2023, reflecting higher margins in new business, stronger commission income and slow repricing of its institutional housing deposits. However, a high portion of it will be absorbed by higher LICs, which we expect to remain elevated in the next two years.

Sound Capitalisation: Aareal is well capitalised and its capital ratios comfortably exceed regulatory requirements. Its leverage ratio of 6.2% at end-1H23 is well above that of peers. We believe that the owners' commitment to retaining an adequate portion of profits will balance the expected impact from regulatory and credit risk-driven RWA inflation and the bank's envisaged growth strategy. Our assessment of capitalisation also factors in Aareal's high single borrower and sector concentrations.

Diversified Funding, Good Liquidity: Aareal's funding profile benefits from a sound deposits base from the institutional housing sector and the bank's successful gathering of retail deposits through online platforms. Combined with the bank's covered bond franchise, this lowers its reliance on unsecured debt market funding. When assessing the bank's funding and liquidity, Fitch uses its alternative core metric 'gross loans/customer deposits + covered bonds' as Aareal is a regular covered bond issuer, which in the agency's opinion structurally strengthens its funding. The bank's liquidity profile is underpinned by a large pool of highly-rated, unencumbered, and ECB-eligible assets.

RATING SENSITIVITIES

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

We could downgrade the ratings if the impaired loans ratio exceeds 5% for an extended period with no credible reduction plan. Asset quality would constitute a weakest link and would no longer be commensurate with a 'bbb+' VR. In this scenario, we would also expect that the operating profit/RWA ratio could drop below 1.5%. This could result from an acceleration of current stress in the US office property market or spillover to European property markets or specific sectors that are sensitive to higher rates and inflation. Significantly higher than expected LICs could also impair Aareal's profitability.

Aareal's Short-Term IDR would be downgraded if its Long-Term IDR and funding and liquidity score were both downgraded.

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

The Outlook on the Long-Term IDR could be revised to Stable if the bank limits the deterioration of its asset quality and the negative impact on its profitability while maintaining broadly stable capitalisation despite the economic recession, inflation and geopolitical risks.

An upgrade is unlikely in the near term, given the unclear impact of the global environment for CRE markets. In the longer term, an upgrade would require successful execution of Aareal's strategic plan leading to stronger profitability, higher revenue diversification, as well as strengthened asset quality. An operating profit/RWA ratio sustainably above 2% combined with an impaired loans ratio sustainably below 3% could result in an upgrade.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

DCR, Deposit and Senior Debt Ratings: Aareal's Derivative Counterparty Rating (DCR) and long-term deposit and senior preferred debt ratings are one notch above its Long-Term IDR. Its long-term senior non-preferred debt rating is aligned with the Long-Term IDR. This reflects the large and sustainable layer of non-preferred debt that provides preferred creditors and counterparties with additional protection in a resolution. The short-term senior-preferred debt and deposit ratings are the baseline options mapping to the 'A-' long-term ratings, because the bank's funding & liquidity score does not warrant higher short-term ratings.

Subordinated Debt: The Tier 2 subordinated notes are rated two notches below the VR to reflect their higher loss severity relative to senior creditors in a resolution. The additional Tier 1 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 can no longer rely on full extraordinary state support. This is driven by the EU's Bank Recovery and Resolution Directive and the Single Resolution Mechanism, which provide a 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 SNP debt and deposit ratings. We could also downgrade the long-term senior-preferred and SNP debt ratings if the bank no longer retains a SNP and junior debt buffer that is large enough to cover its total resolution buffer requirement, and if at the same time the SNP and junior debt buffer declines below 10% of RWA.

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

Aareal's GSR is at the bottom of Fitch's rating scale and therefore cannot be downgraded.

An upgrade of the GSR would require a higher propensity of sovereign support. While not impossible, the Banking Recovery and Resolution Directive makes this highly unlikely.

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 Negative	Affirmed	BBB+ Rating Outlook Negative
	ST IDR	F2	Affirmed	F2
	Viability	bbb+	Affirmed	bbb+
	DCR	A-(dcr)	Affirmed	A-(dcr)
	Government Support	ns	Affirmed	ns
long-term deposits	LT	A-	Affirmed	A-
Senior preferred	LT	A-	Affirmed	A-
subordinated	LT	BBB-	Affirmed	BBB-
subordinated	LT	BB	Affirmed	BB
Senior non-preferred	LT	BBB+	Affirmed	BBB+

VIEW ADDITIONAL RATING DETAILS

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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

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