FITCH AFFIRMS AAREAL BANK'S MORTGAGE PFANDBRIEFE AT 'AAA'; OUTLOOK STABLE

Fitch Ratings-Frankfurt/London-08 May 2017: Fitch Ratings has affirmed Aareal Bank's (Aareal; BBB+/Stable/F2) outstanding mortgage covered bonds at 'AAA' with a Stable Outlook, following a periodic review of the programme.

KEY RATING DRIVERS
The rating is based on Aareal's Long-Term Issuer Default Rating (IDR) of 'BBB+', an unchanged IDR uplift of 2, the unchanged payment continuity uplift (PCU) of four notches, and the 'AAA' breakeven overcollateralisation (OC) of 28.5%. The affirmation also reflects the issuer's intention to increase OC to at least 28.5% by the end of this month. The Stable Outlook mirrors that on Aareal's Long-Term IDR.

The breakeven OC has increased to 28.5%, from 24%. This is mainly driven by an increased credit loss component, up to 24.5% from 20.4%. Following the recent downward revision of Italy's Country Ceiling (CC) to 'AA' Fitch now also sizes for redenomination risk for expected recoveries on defaulted Italian assets in the 'AA+' scenario as per the agency's Country Risk Criteria. Previously the adjustment was limited to Fitch's 'AAA' credit loss expectation.

To a lesser extent, the increased loss reflects an increase of non-German exposure, particularly an increase of loans secured by properties located in the US, the share of which had increased by 6.5% year on year to March 2017.

The asset disposal loss component remains the second largest driver of the breakeven OC despite a significant decrease (down to 2.5% from 5.3%). The reduction in this component stems from the programme being more vulnerable to a high prepayment scenario, whereas low prepayments constituted the modelled worst case in the previous analysis. Higher cash inflows result in lower modelled asset sales to bridge liquidity gaps.

The well-matched asset and liability profile combined with the inclusion of privileged derivatives, reducing open interest and currency positions, lead to the cash flow valuation component remaining the smallest component at 1.4%, up from -1.8%. The increase is driven by the different worst case prepayment scenario. High prepayments limit excess spread generation in the programme, negatively impacting the cash flow valuation component.

Fitch applied a variation from the "Criteria for Analyzing Multiborrower U.S. and Canadian Commercial Mortgage Transactions", published on 6 March 2017. Fitch applied stressed capitalisation rates and respective multiples from these criteria for the commercial real estate loans secured by properties located in the US to calculate the properties' stressed market values and recovery rates instead of applying generic market value decline assumptions (80% in 'AAA' scenario) stipulated in "Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds". The variation is reflected in the analysis and has no impact on the rating of Aareal's Mortgage Pfandbriefe.

Fitch applied two variations from "Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds", published on 17 November 2016. Firstly, in the absence of respective country default benchmarks for loans to operating companies for France and Poland in Criteria for Rating Granular Corporate Balance-Sheet Securitisations (SME CLOs) as a representative default rate assumption for tenants, Fitch assumed default assumptions for the French and Polish tenants to be in line with the assumptions for the Netherlands (4%) and Italy (4.75%), respectively. Without applying this variation credit loss would increase by a maximum of 2pp for this programme.

Secondly, in the absence of CMBS guidance assumptions for the length of the enforcement process for the US, Austria, Belgium, Denmark, Finland, Luxembourg, Sweden, Canada, Norway, Switzerland, Czech Republic and Estonia, Fitch assumed recovery timings for these jurisdictions to be in line with the agency's available assumptions for several property markets based on their level of liquidity, ranging from 24 to 60 months. Without applying this variation credit loss would increase by a maximum of 3pp for this programme.

Fitch has applied a variation to the "Covered Bonds Rating Criteria" published 26 October 2016. Substitute assets that may vary in quantity and in nature are generally not included when calculating the rating spread levels for a specific programme. As Aareal commits to holding at least EUR 700 million of such assets at any time, we included an amount up to this level included in the calculation of the rating spread levels. Without applying this variation asset disposal loss would increase by around 40bp for the programme.

RATING SENSITIVITIES
The 'AAA' rating would be vulnerable to downgrade if any of the following occurs: (i) the IDR is downgraded by two notches or more to 'BBB-' or lower; or (ii) the combined number of notches represented by the IDR uplift and the PCU is reduced to four or lower; or (iii) the OC that Fitch considers in its analysis drops below Fitch's 'AAA' breakeven level of 28.5%.

If the OC that Fitch considers in its analysis drops to the legal minimum requirement of 2% on a net present value basis, it would not sustain timely payment in scenarios above the IDR adjusted by the IDR uplift, and would support recoveries given default commensurate with one further notch. As a result, the covered bond rating would likely be downgraded to 'A+'.

The Fitch breakeven OC for the covered bond rating will be affected, among others, by the profile of the cover assets relative to outstanding covered bonds, which can change over time, even in the absence of new issuance. Therefore the breakeven OC to maintain the covered bond rating cannot be assumed to remain stable over time.

Contact:
Primary Analyst
Thomas Kaber
Associate Director
+49 69 768076 172
Fitch Deutschland GmbH
Neue Mainzer Strasse 46-50
D-60311 Frankfurt am Main

Secondary Analyst
Vessela Krmnicek, CFA
Director
+49 69 768076 298

Committee Chairperson
Rebecca Holter
Senior Director
+49 69 768076 261

Media Relations: Athos Larkou, London, Tel: +44 203 530 1549, Email: athos.larkou@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
Covered Bonds Rating Criteria (pub. 26 Oct 2016)
https://www.fitchratings.com/site/re/888874
Criteria for Analyzing Multiborrower U.S. and Canadian Commercial Mortgage Transactions (pub. 06 Mar 2017)
https://www.fitchratings.com/site/re/895002
Criteria for Country Risk in Global Structured Finance and Covered Bonds (pub. 26 Sep 2016)
https://www.fitchratings.com/site/re/881269
Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds (pub. 17 Nov 2016)
https://www.fitchratings.com/site/re/890302
Fitch's Cover Assets Refinancing Spread Level (RSL) Assumptions - Excel file (pub. 20 Jan 2017)
https://www.fitchratings.com/site/re/893377
Fitch's Interest Rate Stress Assumptions for Structured Finance and Covered Bonds - Excel File (pub. 17 Feb 2017)
https://www.fitchratings.com/site/re/894478
Fitch’s Foreign-Currency Stress Assumptions for Residual Foreign-Exchange Exposures in Covered Bonds and Structured Finance – Excel File (pub. 26 Oct 2016)
https://www.fitchratings.com/site/re/888865
Global Bank Rating Criteria (pub. 25 Nov 2016)
https://www.fitchratings.com/site/re/891051
North America and Asia-Pacific Multiborrower CMBS Surveillance Criteria (pub. 14 Apr 2017)
https://www.fitchratings.com/site/re/896703
Rating Criteria for Commercial Mortgage-Backed Securities (CMBS) and Loans in EMEA (pub. 23 Dec 2016)
https://www.fitchratings.com/site/re/892422
SME Balance Sheet Securitisation Rating Criteria (pub. 03 Mar 2017)
https://www.fitchratings.com/site/re/894773
Structured Finance and Covered Bonds Counterparty Rating Criteria (pub. 20 Mar 2017)
https://www.fitchratings.com/site/re/894432
Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum (pub. 20 Mar 2017)
https://www.fitchratings.com/site/re/894433
Structured Finance and Covered Bonds Interest Rate Stresses Rating Criteria (pub. 17 Feb 2017)
https://www.fitchratings.com/site/re/893890