

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

Fitch Ratings-Frankfurt/London-09 May 2016: Fitch Ratings has affirmed Aareal Bank's (ARB; 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 ARB's Long-term Issuer Default Rating (IDR) of 'BBB+', an unchanged IDR uplift of 2, an unchanged Discontinuity Cap (D-Cap) of 4 (moderate risk) as well as the 24.4% over-collateralisation (OC) that Fitch relies upon, which provide more protection than the 24% 'AAA' breakeven OC. The Stable Outlook mirrors that on ARB's Long-term IDR.

The 'AAA' breakeven OC has remained unchanged over the last 12 months with its main constituent being the stressed credit loss component of 36.2%, up from 34.9% a year ago. In a 'AAA' scenario, Fitch has calculated a weighted average frequency of foreclosure for the cover assets of 92.8% (previously 91.1%) and a weighted average recovery rate of 71.3% (previously 71.8%), resulting in a weighted average credit loss of 26.6% (previously 25.7%).

The slightly wider credit loss was mainly due to the application of the recently published foreign currency stresses in the asset analysis. In addition, 16.7% of mortgage cover assets are located in countries with a Country Ceiling (CC) below 'AAA'. This means that under Fitch's sovereign risk criteria, the agency has stressed recoveries for currency redenomination risk from eurozone assets with a CC below 'AAA'. The reflection of this potential unhedged currency risk accounts for 4.4% of expected losses.

Portfolio composition and asset-liability mismatches are stable compared with 12 months ago. However, the asset disposal loss component increased to 5.3% from 3.5% a year ago. This increase is mainly due to a modelling assumptions change. In its current cash flow analysis, Fitch tested the point at which recourse against the cover pool is enforced at up to six quarters after the pool cut-off date rather than up to four quarters previously.

In addition, as the issuer is rated below 'A' and 'F1', we assumed a commingling loss to occur just prior to the issuer default. These assumptions, together with the high default rate assumption and the front-loaded default distribution applied lead to an increased need for forced asset sales to ensure timely payment of all outstanding Pfandbriefe after the recourse against the cover pool is enforced.

Initial open interest and currency positions are significantly mitigated by the inclusion of privileged derivatives in the cover pool. Combined with the well-matched profile, this led to the cash flow valuation component remaining the smallest component at -1.8%, down from 0% previously, reflecting the positive excess spread of the programme. This reduction largely offset the increases of the other two breakeven OC constituents and left the 'AAA' breakeven OC unchanged at 24%.

Fitch applied variations from "Covered Bonds Rating Criteria - Mortgage Liquidity and Refinancing Stress Addendum" published 23 September 2015 for cases where no specific mortgage refinancing stress assumptions for commercial real estate assets were available. For cover assets located in Austria, Belgium, Canada, Czech Republic, Finland, France, Iceland, Netherlands, Slovakia, Switzerland, the UK, and the US, amounting to 54% of the cover pool, refinance spreads between 450bps and 753bps were applied. In addition, it was assumed that a

rational special administrator would first sell assets with a lower discount (refinancing spread) if they were available in the cover pool at the time of the sale. However, in the recovery scenario calculation, the weighted-average refinancing spread of all cover assets was used to calculate the stressed net present value of the entire cover pool. The variations are reflected in the asset disposal loss component and have no impact on the rating of Aareal's Pfandbriefe.

Fitch applied a variation from "Covered Bonds Rating Criteria" published 11 March 2016 for one case where no specific foreign currencies stress assumptions were available. For the EUR/CZK currency pair we applied the category 3 stress assumptions. The variation is reflected in the analysis and has no impact on the rating of Aareal's Pfandbriefe.

In the absence of CMBS guidance assumptions, Fitch assumed market value declines in line with the assumptions for German multifamily properties for office, retail, industrial and multifamily properties in Austria, Belgium, Finland, Sweden and Switzerland for which Fitch is provided with rental information.

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 D-Cap is reduced to 4 or lower; or (iii) the OC that Fitch considers in its analysis drops below Fitch's 'AAA' breakeven level of 24%.

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.

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Applicable Criteria

Counterparty Criteria for Structured Finance and Covered Bonds (pub. 14 May 2014)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=744158

Counterparty Criteria for Structured Finance and Covered Bonds: Derivative Addendum (pub. 14 May 2014)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=744175

Covered Bonds Rating Criteria (pub. 11 Mar 2016)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=878761

Covered Bonds Rating Criteria – Mortgage Liquidity and Refinancing Stress Addendum (pub. 23 Sep 2015)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=871331

Criteria for Interest Rate Stresses in Structured Finance Transactions and Covered Bonds (pub. 19 Dec 2014)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=838868

Criteria for Sovereign Risk in Developed Markets for Structured Finance and Covered Bonds (pub. 20 Feb 2015)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=862115

Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds (pub. 10 Dec 2015)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=874686

Fitch's Foreign Currency Stress Assumptions for Residual Foreign Exchange Exposures in Covered Bonds - Excel file (pub. 11 Mar 2016)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=878760

Fitch's Interest Rate Stress Assumptions for Structured Finance and Covered Bonds - Excel File (pub. 22 Dec 2014)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=840189

Fitch's Mortgage Covered Bond Refinancing Stresses - Excel File (pub. 12 Feb 2016)

https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=877778

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