

Rating Action: Moody's assigns first-time A3 deposit and Baa1 issuer ratings to Aareal Bank AG; outlook stable

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Moody's also assigns provisional (P)Baa1 senior unsecured debt program ratings

Frankfurt am Main, January 12, 2017 -- Moody's Investors Service today assigned first-time A3/P-2 deposit ratings, first-time Baa1/P-2 issuer ratings as well as (P)Baa1 senior unsecured debt program ratings to Aareal Bank AG (Aareal). The rating agency further assigned a first-time A3(cr)/P-2(cr) Counterparty Risk (CR) Assessment as well as a first-time baa3 baseline credit assessment (BCA) and baa3 Adjusted BCA to Aareal. The outlook on Aareal's long-term deposit and issuer ratings is stable.

A full list of assigned ratings and rating inputs can be found at the end of this press release.

RATINGS RATIONALE

-- BASELINE CREDIT ASSESSMENT

Moody's has assigned a baa3 BCA and Adjusted BCA to Aareal Bank, an internationally diversified commercial real-estate lender that also offers important non-lending services to the housing industry in Germany and other European countries.

The assigned baa3 BCA captures Aareal's high concentration risks in international commercial real-estate (CRE) lending, which is mitigated to a large extent by the bank's strong capitalisation. Following the acquisitions of Corealcredit Bank AG (unrated) in 2014 and Westdeutsche ImmobilienBank AG (unrated) in 2015, Aareal's total loan exposure to the CRE sector amounts to €28.4 billion as of end-September 2016, constituting sizeable concentration risks when compared with the group's tangible common equity (TCE) of approximately €2.6 billion as of the same date. The related high sector, single-name and single-location risks, as well as low revenue and income diversity outside of the commercial mortgage-lending business, constrain Aareal's BCA.

Despite these constraining factors, Aareal's total CRE portfolio has a sound history of low credit losses, owing to the bank's focus on prime locations with strong asset coverage (average loan-to-value 61% as of 30 September 2016 and properties with a high level of cash-flow based investment financing). Aareal has a proven 11-year track record of sound risk management of its internationally diversified CRE lending book, generally with a low volatility of loan loss charges; the bank was able to withstand the financial crisis without a loss-making quarter. The rating agency expects management to continue to adhere to its value-preserving strategy when entering new lending agreements at unchanged strict lending criteria.

The bank's non-performing loan (NPL) ratio of 4.9% is high relative to its closest domestic peers; the majority of NPLs stem from the bank's legacy exposures to Italy, originated before the financial crisis, where the bank reports an NPL ratio of 23.6%. The bank has initiated measures to effectively reduce risks resulting from these exposures which would prove to be a significant relief for the bank's asset quality metrics if executed successfully.

Aareal's solid capitalisation mitigates risks from any unexpected losses not recognized in existing provisions. The bank has grown its tangible common equity by more than €800 million since year-end 2012 by a combination of high retained earnings, the issuance of €300 million of high-trigger additional Tier 1 (AT1) securities as well as the aforementioned acquisitions (significantly below book value), and displayed a strong TCE ratio of 17.1% as of 30 September 2016. Moody's estimates the bank's TCE as well as its leverage ratios (5.1% Tier 1 fully-loaded leverage ratio as of 30 September 2016) to improve further on the back of the planned reduction of non-strategic parts of Aareal's lending portfolios acquired in 2014 and 2015, which will effectively reduce its overall balance sheet and risk-weighted asset base significantly from current levels.

Aareal's robust liquidity management and funding profile are additional key credit strengths. Aareal thereby benefits from its two-pillar business model by attracting sizeable, relatively stable and sticky housing industry deposits, owing to its dominant market share for banking services to the German housing industry of

approximately 60%. The bank's diverse funding mix further benefits from covered bond funding, effectively mitigating the bank's partial and declining reliance on wholesale funding. Aareal's balanced liquidity profile benefits from high cash and interbank assets as well as a high-quality treasury portfolio comprising mainly public-sector debtors and covered bonds, 98% of which are rated investment grade.

-- LONG-TERM DEPOSIT, ISSUER AND PROGRAM RATINGS

Aareal's A3 long-term deposit, Baa1 long-term issuer and (P)Baa1 senior unsecured debt program ratings reflect (1) the bank's baa3 BCA and Adjusted BCA; and (2) the results of Moody's Advanced Loss Given Failure (LGF) analysis.

Aareal Bank is subject to the European Bank Recovery and Resolution Directive (BRRD), which Moody's considers to be an Operational Resolution Regime. Moody's therefore applies its Advanced LGF analysis to Aareal, considering the risks faced by the different debt and deposit classes across the liability structure at failure.

For Aareal's A3 deposit ratings, Moody's LGF analysis indicates an extremely low loss-given-failure, leading to three notches of rating uplift from the bank's baa3 Adjusted BCA.

For Aareal's (P)Baa1 senior unsecured debt program and Baa1 issuer ratings, Moody's LGF analysis indicates a very low loss-given-failure, leading to two notches of rating uplift from the bank's baa3 Adjusted BCA.

The bank's long-term ratings do not benefit from any additional rating uplift from government support, reflecting the rating agency's assumption of a low probability of such support being made available to Aareal in the event of a stress scenario. This is owing to the bank's marginal importance to the domestic deposit-taking market and the local payment systems.

The stable outlook on Aareal's long-term deposit and issuer ratings reflects Moody's inclusion of all foreseeable risks in the ratings.

WHAT COULD CHANGE THE RATING UP/DOWN

An upgrade of Aareal's long-term ratings would be likely in the event of a higher BCA; the bank's senior unsecured debt ratings could further be upgraded if Moody's Advanced LGF analysis resulted in higher rating uplift.

The bank's BCA could be upgraded in the event of a combination of two or more of the following factors: (1) a significant reduction in absolute as well as relative levels of problem loans, reaching levels sustainably superior to those of its closest peers; (2) higher and sustained profitability metrics, which would further enhance Aareal's loss-absorption capacity; (3) a further significant strengthening of the bank's capital base; and/or (4) Aareal substantially reducing single-name and single-location concentrations within its highly-cyclical CRE book.

In addition, Aareal's issuer and senior unsecured debt program ratings could be upgraded if the volume of subordinated instruments increases relative to the bank's tangible banking assets. This could result in one additional notch of rating uplift resulting from Moody's LGF analysis.

A downgrade of Aareal's long-term ratings could be triggered following (1) a downgrade of the bank's BCA; and/or (2) fewer notches of rating uplift as a result of Moody's Advanced LGF analysis.

Downward pressure on Aareal's BCA could develop as a result of (1) a deterioration in its risk-adjusted capitalisation or an increase in leverage; (2) a material erosion in Aareal's asset quality beyond levels that are consistent with the bank's risk-absorption capacity; (3) a sustained weakening of the bank's recurring earnings power and operating efficiency; and/or (4) an increase in the bank's risk appetite with regard to its CRE lending policies.

In addition, Aareal's long-term ratings could be downgraded if their volume or that of its subordinated instruments decreases relative to the bank's tangible banking assets. This could result in fewer notches of rating uplift resulting from Moody's LGF analysis.

RATINGS RATIONALE

LIST OF AFFECTED RATINGS

Issuer: Aareal Bank AG

Assignments:

...LT Issuer Rating (Local & Foreign Currency), Assigned Baa1, Outlook assigned Stable

...ST Issuer Rating (Local & Foreign Currency), Assigned P-2

...LT Bank Deposits (Local & Foreign Currency), Assigned A3, Outlook assigned Stable

...ST Bank Deposits (Local & Foreign Currency), Assigned P-2

...Senior Unsecured MTN (Local & Foreign Currency), Assigned (P)Baa1

...Adjusted Baseline Credit Assessment, Assigned baa3

...Baseline Credit Assessment, Assigned baa3

...LT Counterparty Risk Assessment, Assigned A3(cr)

...ST Counterparty Risk Assessment, Assigned P-2(cr)

Outlook Actions:

...Outlook, assigned Stable

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks published in January 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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