FitchRatings

Fitch Upgrades Aareal's IDR to 'A-'/Stable and Preferred Ratings to 'A'

Fitch Ratings-Frankfurt/London-21 January 2019: Fitch Ratings has upgraded Aareal Bank AG's Long-Term Issuer Default Rating (IDR) and long-term senior non-preferred unsecured debt rating to 'A-' from 'BBB+'. The Outlook on the Long-Term IDR is Stable. Fitch has also upgraded the bank's Derivative Counterparty Rating (DCR) to 'A(dcr)' from 'A-(dcr)' and its long-term senior preferred debt rating and Deposit Rating to 'A' from 'A-'. Aareal's Viability Rating (VR) has been affirmed at 'bbb+'.

A full list of rating actions is at the end of this commentary.

KEY RATING DRIVERS
IDRs, VR AND SENIOR NON-PREFERRED UNSECURED DEBT RATING
The upgrade of the Long-Term IDR and long-term senior non-preferred unsecured debt rating reflects Aareal's large buffer of qualifying junior debt of almost 12% of the bank's risk-weighted assets (RWAs) at end-9M18. This buffer has been resilient and within the 10%-12% range for years and, in our view, is sufficient to protect senior creditors in case of failure triggering a resolution or a private-sector solution (i.e. a distressed debt exchange) aimed at avoiding a resolution. We believe the size of the qualifying junior debt buffer adequately mitigates the risks arising from Aareal's company profile as a primarily wholesale-funded commercial real estate (CRE) lender.

The bank's Long-Term IDR and long-term senior non-preferred unsecured debt rating are now one notch above the VR, as we believe the risk of default on senior non-preferred unsecured obligations, as measured by the Long-Term IDR, is lower than the risk of failure, as measured by the VR.

We have also affirmed Aareal's Short-Term IDR at 'F2', which is the lower of two options corresponding to a 'A-' Long-Term IDR and long-term senior non-preferred unsecured debt rating, because the Long-Term rating is notched up from the VR.

The affirmation of Aareal's VR reflects the bank's stable company profile as a CRE lender, which exposes its operations to the inherent cyclicality of the CRE sector. The bank's concentration on large single CRE exposures is mitigated by its resilient performance, geographical diversification and sound capitalisation.

Aareal's management has consistently demonstrated its commitment and ability to maintaining sizeable buffers over its regulatory capital requirements, thanks to its robust earnings generation. In 9M18, the bank's common equity Tier 1 (CET1) ratio improved further by 120bp to 20.8%, predominantly from a reduction in RWAs driven by maturing non-core assets, increased loan syndication to third parties and the application of the internal rating-based approach to a legacy portfolio.

The total capital ratio increased to a very high 32.6%, almost three times Aareal's 2018 transitional Supervisory Review and Evaluation Process (SREP) requirement of 11.72%. Consequently, unlike other specialised CRE lenders, the bank is not constrained by its regulatory leverage ratio, which at 6.1%, is solid.

The bank has been increasingly using loan syndication to optimise its business mix by reacting to market developments in a more flexible manner. The resulting relief in terms of capital usage, in addition to the wind-down of the non-core portfolios, also supports the bank's increased focus on dividend distribution. At end-9M18, Aareal's core loan portfolio had decreased to the lower end of its targeted range of EUR25 billion-EUR28 billion. The opportunistic, non-strategic acquisition, closed at end-2018 of Duesseldorfer Hypothekenbank (DHB), a small German Pfandbrief issuer with total assets of less than EUR3 billion, will only temporarily inflate Aareal's balance sheet as Aareal will continue the wind-down initiated by DHB's previous owners in 2015.

We do not expect the main CRE markets in which Aareal operates to deteriorate materially in the short term. The bank is moderately exposed to pockets of risks that are building up in the German CRE market, where the low interest rate environment continues to drive very strong demand and price inflation. The bank's non-performing loan (NPL) ratio rose to 5.5% (IFRS stage 3) at end-3Q18 from 4.4% at end-2017. However, it would have declined to about 3.7% without the implementation of IFRS 9, as the legacy Italian portfolio, which concentrates most NPLs, further improved, although it remains by far the weakest. We expect further NPL reduction in 2019, notably through workout.

Aareal's operating performance has been remarkably stable through the current credit cycle despite its concentration on the cyclical CRE market. Management expects a positive gain of EUR52 million from DHB's consolidation in 2018, and we expect profitability to remain sound in 2019. Relative to its domestic peers, the bank strongly benefits from its broad and flexible geographic diversification, notably its large exposure to the US CRE market, which structurally allows for more comfortable margins. This limits the bank's reliance on the low margins prevailing in the German CRE market, driven by intense competition.

The RWA output floor to be introduced under the revised Basel III will significantly inflate Aareal's RWA by curtailing the benefits of its extensive use of internal rating models and its focus on secured lending with moderate loan-to-value ratios. However, with a solid pro-forma CET1 ratio of 13.4% under the new regime including the output floor at end-3Q18, the bank (which already manages its capital on a pro-forma revised Basel III basis) is well prepared and in a more comfortable position than other CRE lenders.

Aareal's solid funding mix consists predominantly of mortgage Pfandbriefe, which ensure cheap and resilient funding. Its large, growing and resilient institutional housing deposit base is a key competitive advantage compared with other wholesale CRE lenders. Not only does it (similar to Pfandbriefe) result in low reliance on unsecured market funds. Its inelastic pricing should also result in a funding cost advantage when interest rates rise. The bank sources most of its unsecured funding via private placements (mostly Schuldscheine) from an established investor base, which further limits its exposure to funding market volatility.

DCR, DEPOSIT AND SENIOR PREFERRED DEBT RATINGS
The upgrades of the DCR, Long-Term Deposit Rating and long-term senior preferred debt rating to 'A' from 'A-' are driven by the upgrade of the Long-Term IDR. We are maintaining the one-notch uplift from the Long-Term IDR to reflect our view that Aareal's large buffer of senior non-preferred unsecured debt of 57% of RWAs at end-9M18 provides its preferred creditors and counterparties with considerable additional protection compared with senior non-preferred creditors in a resolution.

We have also upgraded the bank's Short-Term Deposit Rating and short-term senior preferred debt rating from 'F2' to 'F1', which corresponds to the long-term Deposit Rating and long-term senior preferred debt rating of 'A'.

Three rated notes (DE000A12T762, XS0196076318, DE000A12T705) contain embedded derivatives that make them rank senior preferred under the German resolution regime.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)

Aareal's SR and SRF reflect our view that due to the EU's Bank Recovery and Resolution Directive (BRRD), senior creditors can no longer rely on full extraordinary support from the sovereign if Aareal becomes non-viable.

TIER 2 SUBORDINATED DEBT AND HYBRID SECURITIES
Aareal's Tier 2 notes are notched down once from the VR to reflect their higher loss severity relative to senior debt. The Basel III-compliant additional Tier 1 (AT1) notes are rated five notches below the VR, twice for loss severity to reflect their write-down on breach of their 7% trigger, and three times for non-performance risk to reflect fully discretionary coupon payments. The bank's large distributable reserves significantly mitigate the non-performance risk.

RATING SENSITIVITIES
IDRs, VR AND SENIOR NON-PREFERRED UNSECURED DEBT RATING
The IDRs and senior non-preferred unsecured debt ratings are primarily sensitive to changes in the VR, which is primarily vulnerable to asset quality deterioration. An upgrade of the VR would require further significant progress in diversifying the bank's business model into revenue sources that do not directly rely on or correlate with its dominant large-ticket CRE lending, most likely through growth of granular fee income from its consulting and services division Aareon.

The IDRs and senior non-preferred unsecured debt ratings are also sensitive to the development of the qualifying junior debt buffer relative to the recapitalisation amount likely to be needed to restore Aareal's viability and prevent default on senior non-preferred unsecured notes. The RWA inflation that will result from the implementation of the output floor under the revised Basel III is a key negative sensitivity.

DCR, DEPOSIT AND SENIOR PREFERRED DEBT RATINGS
The DCR, Deposit Ratings and senior preferred debt ratings are primarily sensitive to changes in the IDRs. They are also sensitive to the development of the senior non-preferred unsecured debt buffer relative to the recapitalisation amount likely to be needed to restore viability and prevent default on derivative obligations, deposits and senior preferred notes.

SR AND SRF
An upgrade of Aareal's SR and an upward revision of its SRF would require a higher propensity of sovereign support. While not impossible, the BRRD makes this highly unlikely, in our view.

TIER 2 SUBORDINATED DEBT AND HYBRID SECURITIES
The ratings of the Tier 2 and AT1 notes are primarily sensitive to changes in the VR. They are also sensitive to changes in their notching.

The rating actions are as follows:

Aareal Bank AG:
Long-Term IDR: upgraded to 'A-' from 'BBB+'; Outlook Stable
Short-Term IDR: affirmed at 'F2'
Viability Rating: affirmed at 'bbb+'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Derivative Counterparty Rating: upgraded to 'A(dcr)' from 'A-(dcr)'
Deposit Ratings: upgraded to 'A'/'F1' from 'A-'/'F2'
Senior preferred debt issuance programme and notes: upgraded to 'A'/'F1' from A-'/'F2'
Senior non-preferred unsecured debt issuance programme and notes: upgraded to 'A-' from 'BBB+'
Tier 2 subordinated notes: affirmed at 'BBB'
Additional Tier 1 securities (DE000A1TNDK2): affirmed at 'BB-'

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Applicable Criteria

Bank Rating Criteria (pub. 12 Oct 2018) (https://www.fitchratings.com/site/re/10044408)

Additional Disclosures

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