Moody's INVESTORS SERVICE

Rating Action: Moody's affirms ratings of Aareal Bank AG, changes outlook to negative

21 Apr 2020

Frankfurt am Main, April 21, 2020 -- Moody's Investors Service (Moody's) has today affirmed the A3 long-term deposit and issuer ratings of Aareal Bank AG (Aareal Bank) and changed the outlook on these ratings to negative from stable. Concurrently, Moody's affirmed Aareal Bank's baa3 Baseline Credit Assessment (BCA) and Adjusted BCA.

For a list of all affected ratings, please refer to the end of this press release.

RATINGS RATIONALE

-- AFFIRMATION OF THE BASELINE CREDIT ASSESSMENT

Moody's affirmation of Aareal Bank's baa3 BCA reflects the resilience of the banks' intrinsic financial strength, even in a more deteriorating operating environment from the coronavirus outbreak. Despite the rapid and widening spread of the coronavirus outbreak, deteriorating global economic outlook and asset price declines, which are creating a severe and extensive credit shock across many sectors, regions and markets and will weigh on the bank's solvency, Moody's currently views Aareal Bank largely prepared to withstand these pressures on a standalone basis. Moody's regards the coronavirus outbreak as a social risk under its environment, social and governance (ESG) framework, given the substantial implications for public health and safety.

Being an internationally active commercial real estate (CRE) lending specialist Aareal Bank is exposed to severe concentration risks in highly cyclical CRE lending; compared with peers the bank has a stronger focus on the hotel and retail sector, which are particular impacted by the outbreak. Absent meaningful (earnings) diversification Moody's considers Aareal Bank to operate a monoline business model.

While the rating agency expects Aareal Bank's non-performing loan ratio to rise in the looming recession, government-implemented measures to support the corporate and retail sector provide some smoothing of the negative economic implications of the present lock-down situation in many, but not all of the jurisdictions which the bank is exposed to.

The limited diversification benefits from other businesses and Aareal Bank's elevated asset risks,- are largely mitigated the bank's strong capitalization. With more than 19% Common Equity Tier 1 (CET1) ratio, Aareal Bank has strong buffers available to cope with a deterioration of its asset quality in a recession scenario; despite some improvement in the second half of 2019 the bank reports a still comparably high non-performing loan ratio of 3.6% as of 31 December 2019. An average loan-to value of below 60% in its performing CRE lending book provides further buffers for a deterioration of market prices.

The affirmation also reflects a sound track record of low credit losses though the past credit cycle. Aareal Bank's sound liquidity management and funding profile are additional risk mitigants. Aareal Bank thereby benefits from its software service activities for the housing and commercial property industries by attracting sizeable, relatively stable and sticky housing industry deposits, and its covered bond franchise, enabling the bank to withstand some market dislocation in more confidence-sensitive capital-market funding.

-- AFFIRMATION OF DEBT AND DEPOSIT RATINGS

The affirmation of the Aareal Bank's ratings reflects the affirmation of its BCA, unchanged results from Moody's Advanced Loss Given Failure (LGF) analysis and unchanged results from the rating agency's assumption for government support.

Because of significant volumes of subordinated and junior senior unsecured debt outstanding, the rating agency's Advanced LGF analysis results in three notches of rating uplift for deposits and senior unsecured debt for Aareal Bank. Being considered as a non-systemically relevant institution the resulting low government support assumption results in no further rating uplift.

-- OUTLOOK CHANGE TO NEGATIVE FROM STABLE

The change of the outlook for Aareal Bank's long-term issuer and deposit ratings reflects downward pressure on the bank's BCA driven by the deteriorating operating environment from the global coronavirus outbreak. The negative economic repercussions will weigh on the bank's solvency, as Aareal Bank's international commercial real estate lending book is particularly exposed to sectors that are amongst the hardest hit initially, like hospitality and retail. Moody's expects the bank's already modest-only asset quality and profitability to somewhat weaken due to higher problem loans.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

As indicated by the negative outlook, upward pressure on the ratings is currently unlikely. An upgrade of Aareal Bank's ratings could follow an upgrade of its BCA, which would require a substantially more diversified business model, such that it eliminates the existing strong concentration risks in CRE lending.

Aareal Bank's ratings could be downgraded as result of a downgrade of its BCA or if loss-absorbing liabilities decline significantly and beyond Moody's expectations, thereby resulting in fewer notches of rating uplift from the rating agency's LGF analysis. Downward pressure on Aareal Bank's BCA could develop as a result of a material deterioration in its asset quality, a significant and sustained drop in profitability, or an overall weakening of the bank's combined liquidity profile.

LIST OF AFFECTED RATINGS

Affirmations:

..Issuer: Aareal Bank AG

.... Adjusted Baseline Credit Assessment, Affirmed baa3

.... Baseline Credit Assessment, Affirmed baa3

...LT Counterparty Risk Assessments, Affirmed A3(cr)

....ST Counterparty Risk Assessments, Affirmed P-2(cr)

....LT Counterparty Risk Ratings, Affirmed A3

....ST Counterparty Risk Ratings, Affirmed P-2

....LT Issuer Ratings, Affirmed A3, Outlook, Changed To Negative From Stable

....ST Issuer Ratings, Affirmed P-2

.... ST Bank Deposit Ratings, Affirmed P-2

...LT Bank Deposit Ratings, Affirmed A3, Outlook, Changed To Negative From Stable

Outlook Actions:

..Issuer: Aareal Bank AG

....Outlook, Changed To Negative From Stable

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1147865 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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