



## RATING ACTION COMMENTARY

# Fitch Maintains Aareal's 'BBB+' Long-Term IDR on RWN

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Fitch Ratings - Frankfurt am Main - 24 Sep 2020: Fitch Ratings has maintained Aareal Bank AG's 'BBB+' Long-Term Issuer Default Rating (IDR) on Rating Watch Negative (RWN).

The maintained RWN on Aareal's ratings reflects the continued near-term risks to the bank's ratings from the likely deterioration of its financial profile as a result of the economic fallout from the coronavirus pandemic. Fitch expects to resolve the RWN in 4Q20, by which time 3Q20 results should provide greater visibility of the pandemic's impact on several factors that are important to the bank's ratings, notably:

- i) prospects for asset quality after a worsening of expected credit losses in 1H20 and in light of Aareal's elevated exposure to hotels (34% of total real estate loans at end-1H20) and retail property (23% at end-1H20), partially in more volatile regions. We believe that the 3Q20 results could provide some indication of the resilience of the bank's portfolio, in particular the bank's hotel and retail segments, after the reversal of lockdown conditions in most of its countries of operation and the summer holiday period;
- ii) the resilience of Aareal's revenues, in particular its ability to generate a sufficiently high level of profitable new business volumes to cover potential future loan impairment charges (LICs); and

iii) the resilience of Aareal's capital to potential risk-weighted assets (RWA) inflation and profitability challenges.

## KEY RATING DRIVERS

Unless noted below, the key rating drivers for Aareal are those outlined in our Rating Action Commentary published in March 2020 ('Fitch Takes Action on 6 German Banking Groups on Coronavirus Uncertainties').

Fitch placed Aareal's VR in March 2020 on RWN to signal that the economic fallout from the coronavirus crisis represented a near-term risk to the VR. We also placed Aareal's Long-Term IDR, Derivative Counterparty Rating and long-term debt and long-term deposit ratings on RWN, as they are directly or indirectly driven by its VR. Aareal's mono-line commercial real estate-focused business model exposes the bank to increased vulnerabilities, even though the bank managed to further improve its asset quality in 1H20 through de-risking measures. Uncertainties still exist, in our view, and the magnitude of the impact on its financial profile remains unclear. Accordingly, Fitch has maintained the RWN. At the same time, we still believe that the bank's capitalisation will remain a relative rating strength.

The bank's profitability has come under some pressure in 1H20, with the bank reporting a lower operating profit, as Aareal incurred elevated LICs of EUR106 million. Similar to other banks, a large part of LICs was due to management overlays and macroeconomic parameters updates rather than due to new non-performing loan (NPL) cases. In 2Q20 Aareal also suffered from lower business volumes amid widespread lockdowns.

The bank's reported NPL ratio (which includes off-balance sheet, fair-value NPLs and IFRS Stage 3 in the numerator) decreased to 3.7% at end-July 2020 from 4.2% at end-2019 and a peak of 7.3% at end-1H19. The reduction was achieved mainly through the sale and repayment of NPLs. Given the significant volume of government support and continued regulatory flexibility, we believe that the impact from the pandemic will be reflected in the bank's asset quality with a delay. We expect inflows of new impaired loans to increase towards end-2020 and more significantly in 2021 when the effect of the crisis becomes more apparent.

The bank's common equity Tier 1 (CET1) ratio of 19.8% at end-1H20 is solid and well above the SREP CET1 requirement of 8.28% in 2020 (with Pillar 2 Requirements relief). Unlike other specialised commercial real estate (CRE) lenders, Aareal is not constrained by its regulatory leverage ratio, which at 5.8% at end-1H20 has fallen (temporarily due to the participation in TLTRO) but remains sound. In addition, the bank already achieves

a pro-forma CET1 ratio of 14.2% under the revised Basel III framework, including the output floor and which accounts for the effects from the prudential provisioning guidelines for non-performing exposures. This leaves the bank in a comfortable position relative to other CRE-focussed lenders, in our view. The expected sale of a 30% stake of its IT subsidiary Aareon (subject to regulatory approval) will lead to a capital gain of approximately EUR180 million (after tax) according to the bank, which could also help strengthen the bank's capital position, provided the proceeds are kept in the bank. The bank expects the closure of the transaction to take place in 4Q20.

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

## **RATING SENSITIVITIES**

Unless noted below, the rating sensitivities for Aareal are those outlined in our Rating Action Commentary published in March 2020 ('Fitch Takes Action on 6 German Banking Groups on Coronavirus Uncertainties').

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The bank's ratings could be affirmed if Aareal manages the challenges arising from the economic downturn, limiting downside risks to its asset quality and profitability, while maintaining current capital levels.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

The RWN on Aareal's ratings reflects the continued near-term risks to its ratings from the coronavirus crisis, which we believe will materialise with a delay relative to our original expectations. We would likely downgrade the bank if we expect the COVID-19 crisis to weaken earnings, through asset quality pressure or stresses in the property market, to the extent that would ultimately weaken Aareal's substantial capital buffers.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating

horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [<https://www.fitchratings.com/site/re/10111579>]

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

### RATING ACTIONS

| ENTITY/DEBT    | RATING    |                            | PRIOR                   |                            |
|----------------|-----------|----------------------------|-------------------------|----------------------------|
| Aareal Bank AG | LT IDR    | BBB+ Rating Watch Negative | Rating Watch Maintained | BBB+ Rating Watch Negative |
|                | ST IDR    | F2                         | Affirmed                | F2                         |
|                | Viability | bbb+ Rating Watch Negative | Rating Watch Maintained | bbb+ Rating Watch Negative |
|                | Support   | 5                          | Affirmed                | 5                          |

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Aareal Bank AG

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