FitchRatings

Banks
Wholesale Commercial Banks
Germany

Aareal Bank AG

Update

Ratings

Foreign Currency	
Long-Term IDR	BBB+
Short-Term IDR	F2
Derivative Counterparty Rating	A-(dcr)
Viability Rating	bbb+
Government Support Rating	ns

Sovereign Risk	
Long-Term Foreign-Currency IDR	AAA
Long-Term Local-Currency IDR	AAA
Country Ceiling	

Outlooks	
Long-Term Foreign-Currency IDR	Negative
Sovereign Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Local-Currency IDR	Stable

Applicable Criteria

Bank Rating Criteria (November 2021)

Related Research

Failed Bid for Aareal Does Not Affect Ratings (February 2022)

Fitch Affirms Aareal at 'BBB+'; Outlook Negative (November 2021)

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Key Rating Drivers

Pandemic Drives Negative Outlook: The Negative Outlook on Aareal Bank AG's Long-Term Issuer Default Rating (IDR) reflects remaining risks from the pandemic. Fitch Ratings believes these risks could result in greater-than-expected asset quality and profitability challenges.

CRE-Focused Business Model: Aareal's Viability Rating (VR) reflects the bank's established business model focusing on the cyclical commercial real estate (CRE) sector and its exposure to associated risks. The risks include immediate pressure from the pandemic, with the bank's asset quality vulnerable to pressure on borrower performance in the hotel and retail segments, the areas worst affected by the pandemic so far. The VR benefits from Aareal's good geographical diversification relative to peers, diversified funding mix, and sound capitalisation.

Asset Quality Pressure: Aareal's reported impaired loan ratio (which includes off-balance sheet exposures, impaired loans at fair value and IFRS Stage 3 loans) declined to 5.2% at end-2021 from a peak of 6% at end-1H21, but is above its pre-pandemic level of 4.1% at end-2019 and above that of peers. UK retail properties and, to a lesser extent, hotels, have driven most new impaired loans since end-2019. 34% of Aareal's loans are to hotels and 20% to retail properties.

Fitch expects the four-year average impaired loans ratio to remain close to 4% by end-2022. The bank should be able to reduce impaired loans as recovering consumer spending, the easing of travel bans and vaccine rollouts should support the performance and valuation of retail and hotel assets. Aareal's direct exposure to Russia is small, amounting to less than 1% of its real estate exposure.

Earnings Stabilise: The bank's operating profit/risk-weighted assets (RWAs) rebounded to 1.2% at end-2021 from minus 0.6% in 2020, when high pandemic-driven loan impairment charges (LICs) triggered an annual loss despite only a slight decrease in net interest income. We expect earnings to recover over the next 24 months, supported by profitable loan growth, downward normalisation of LICs, and steadily rising income at the bank's subsidiary Aareon.

Strong Capitalisation: The common equity Tier 1 (CET1) ratio of 18.2% at end-2021 was well above the Supervisory Review and Evaluation Process requirement (9.75% for 2022). Aareal is not constrained by its leverage ratio of 5.5%, which is higher than that of other CRE lenders despite a temporary dip due to drawings from the ECB's TLTRO. CRE lending is particularly exposed to RWAs inflation from planned Basel III revisions. However, we believe Aareal is well positioned to absorb the application of the output floor without mitigating measures.

Diversified Funding: Aareal's funding consists primarily of Pfandbriefe and resilient, stable deposits from the institutional housing sector. This limits the bank's reliance on unsecured market funding, which mostly consists of private placements from an established investor base.

Rating Sensitivities

Receding Pandemic-Related Risks: We could revise the Outlook on the Long-Term IDR to Stable if Aareal weathers the challenges arising from the pandemic while strengthening its asset quality and profitability and maintaining a broadly stable capitalisation.

Prolonged Stress in Major CRE Markets: We could downgrade the VR and the Long-Term IDR if the Stage 3 ratio exceeds 5% for an extended period with no credible reduction plan, combined with an operating profit/RWAs ratio durably below 1.5%. This could result from prolonged stress in key property markets leading to unexpectedly high asset quality pressure.

Debt Rating Classes

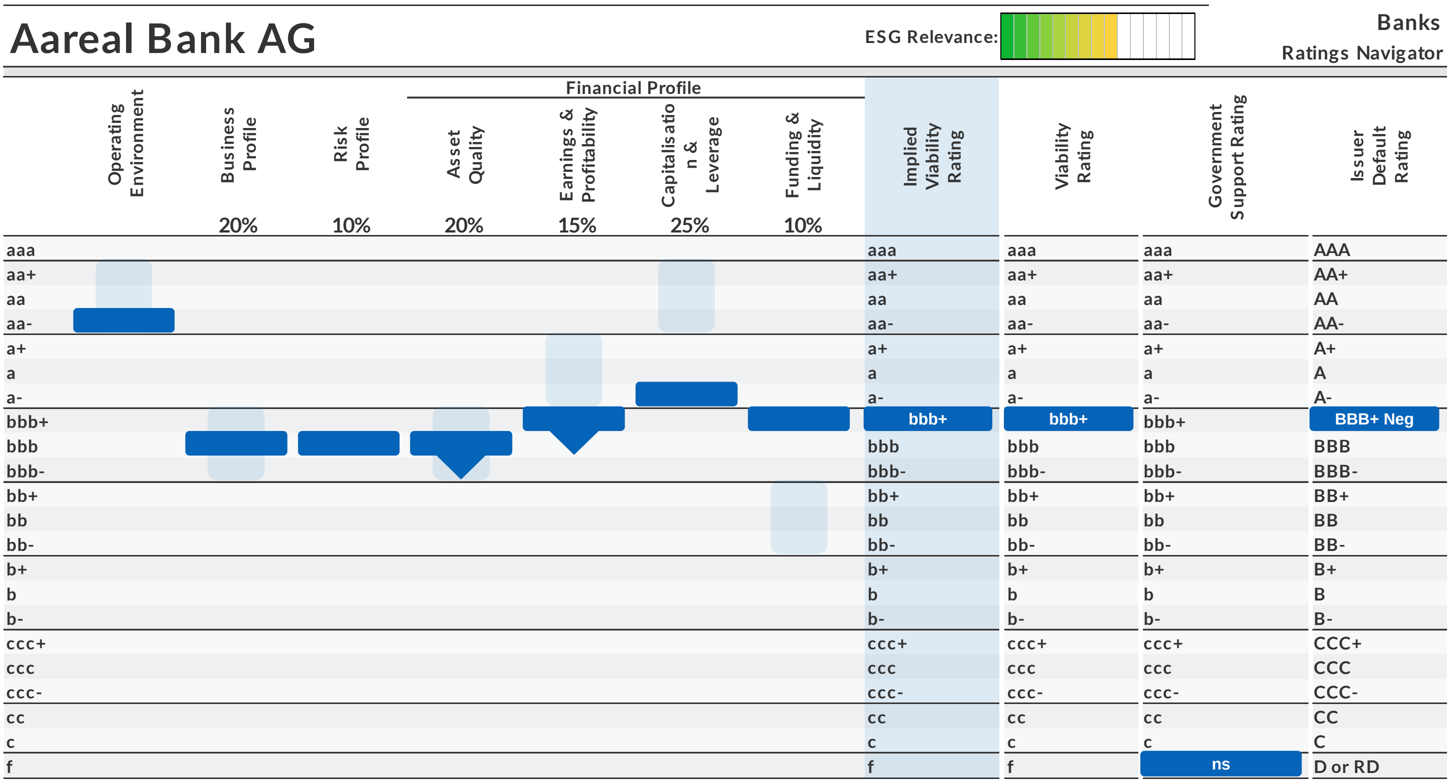
Rating Level	Rating
LT Senior non-preferred	BBB+
Senior preferred (SP)	A-/F2
Deposits	A-/F2
Tier 2 subordinated debt	BBB-
Additional Tier 1 Notes	BB

Source: Fitch Ratings

Aareal's Derivative Counterparty Rating (DCR) and its long-term deposit and SP debt ratings are one notch above its Long-Term IDR. This reflects the large and sustainable layer of SNP debt which provides preferred creditors and counterparties with additional protection in a resolution. The short-term SP debt and deposit ratings are the baseline options mapping to the long-term preferred ratings of 'A-'. This is because the bank's Funding & Liquidity score does not warrant higher short-term ratings.

The Tier 2 subordinated notes are rated two notches below the VR to reflect the notes' higher loss severity relative to senior creditors in a resolution. The Capital Requirements Regulation-compliant AT1 notes are rated four notches below the VR to reflects our expectation that Aareal will maintain large capital buffers above the notes' mandatory coupon omission triggers.

Ratings Navigator



The Key Rating Driver (KRD) weightings used to determine the implied VR are shown as percentages at the top. In cases where the implied VR is adjusted upwards or downwards to arrive at the VR, the KRD associated with the adjustment reason is highlighted in red. The shaded areas indicate the benchmark-implied scores for each KRD.

VR Adjustments

The Earnings and Profitability score of ‘bbb+’ has been assigned below the ‘a’ category implied score, to reflect the bank’s low revenue diversification, resulting from high reliance on a single business line. The Capitalisation and Leverage score of ‘a-’ has been notched down from the ‘aa’ category implied score reflecting the cyclicality of the CRE asset class, typical for the risk profile and business model of a monoline lender. The Funding and Liquidity score of ‘bbb+’ has been assigned above the ‘bb’ category implied score, due to Aareal’s strong liquidity coverage and stable deposit structure.

Significant Changes

Pandemic Risk Is Subsiding; War in Ukraine Dents Europe's Economic Recovery

Fitch expects most European economies to remain exposed to high energy prices and supply-chain disruptions in 2022 reflecting the impact from the war in Ukraine. Several corporate sectors are particularly exposed to second-round effects from slowing economic growth. Consequently, Fitch revised down its 2022 growth forecast for the eurozone in March by 1.5 % to 3.0% (2.3% in 2023) with a particularly large revision in Germany. This could imply a deterioration in banks' asset quality, particularly in Central and Eastern Europe and delay the recovery of some CRE segments.

CRE benefits from robust investor demand in the current ultra-low rate environment as it provides some protection against inflation and is perceived as a relatively safe asset class in times of uncertainty. However, a durably high price inflation driven by high energy and material costs would increase building costs, which would weigh on investors' yields and, consequently, on demand in the CRE market globally. Demand from tenants could also suffer from higher operational costs for buildings and weaker economic prospects.

Satisfactory 2021 Results

Aareal's profitability rebounded in 2021 as solid new business (EUR8.5 billion, +18% yoy), improved margins in the international CRE portfolio and lower funding costs increased the bank's net interest income (NII). Aareal's operating profit also benefited from an increase in fee income, mainly stemming from its IT subsidiary Aareon. Materially lower pandemic-driven LICs than previously expected also strongly contributed to Aareal's financial turnaround in 2021.

Globally, governments have materially loosened or fully abandoned protective measures to curb the pandemic amid declining infection rates. This should mildly benefit the retail, travel and hotel sectors and support Aareal's asset quality.

Upward Revision to Business and Earning Targets

The management has refined its growth and earnings strategy enabled by Aareal's strong capitalisation and set new ambitious targets. The bank aims to expand its property portfolio annually by EUR1 billion to EUR33 billion (EUR30 billion at end-2021) and double its operating profit to up to EUR350 million by end-2024. However, if current economic uncertainty weighs on activity in the CRE markets, these targets could become challenging to achieve.

The management also expects further growth at Aareon, the main driver of the bank's fee income, in part by acquisitions co-financed by the bank. Given its low-risk, stable, capital-light model, Aareon's contribution to Aareal's profits should become increasingly material. It should support the bank's return on equity and operating profit/RWAs in the longer term, although it will continue to weigh on the cost-income ratio.

New Tender Offer Based on Higher Share Price

Following a failed attempt to acquire a majority stake in the bank in February 2022, a group of financial investors renewed its public offer on revised terms more likely to appeal to current shareholders. The bidders are willing to close the deal (which is still pending shareholder approval) by 4Q22 or 1Q23.

Aareal's management is supporting the offer as the bidders' strategic objectives are backing the bank's existing set-up, in particular maintaining Aareon's integration. In Fitch's view the proposed acquisition would not have materially changed Aareal's established business profile and is neutral to its VR. The bidders' intention to accelerate Aareal's growth plans does not entail any substantial strategic shift and should be broadly neutral for its risk appetite and financial profile. However, should the emergence of a majority shareholder drive aggressive loan growth or profit distribution to the point that it significantly depletes Aareal's capital ratios, this factor could weigh on its VR and Long-Term IDR.

Summary Financials and Key Ratios

		31 Dec 2021	31 Dec 2020	31 Dec 2019	31 Dec 2018
	Year End	Year End	Year End	Year End	Year End
	USDm	EURm	EURm	EURm	EURm
	Audited - Unqualified	Audited - Unqualified	Audited - Unqualified	Audited - Unqualified	Audited - Unqualified
Summary Income Statement					
Net interest and dividend income	675	597.0	512.0	533.0	535.0
Net fees and commissions	277	245.0	234.0	229.0	215.0
Other operating income	-43	-38.0	-19.0	62.0	45.0
Total operating income	909	804.0	727.0	824.0	795.0
Operating costs	584	516.0	458.0	486.0	462.0
Pre-impairment operating profit	326	288.0	269.0	338.0	333.0
Loan and other impairment charges	150	133.0	344.0	90.0	72.0
Operating profit	175	155.0	-75.0	248.0	261.0
Other non-operating items (net)	n.a.	n.a.	n.a.	n.a.	55.0
Tax	98	87.0	-6.0	85.0	90.0
Net income	77	68.0	-69.0	163.0	226.0
Other comprehensive income	63	56.0	-48.0	-82.0	-28.0
Fitch comprehensive income	140	124.0	-117.0	81.0	198.0
Summary Balance Sheet					
Assets					
Gross loans	35,879	31,723.0	29,847.0	28,656.0	29,257.0
- of which impaired	1,702	1,505.0	1,549.0	944.0	1,587.0
Loan loss allowances	553	489.0	588.0	383.0	577.0
Net loans	35,326	31,234.0	29,259.0	28,273.0	28,680.0
Interbank	1,430	1,264.0	1,029.0	1,363.0	1,000.0
Derivatives	1,280	1,132.0	2,218.0	1,794.0	1,934.0
Other securities and earning assets	7,583	6,705.0	6,919.0	6,995.0	9,031.0
Total earning assets	45,619	40,335.0	39,425.0	38,425.0	40,645.0
Cash and due from banks	7,851	6,942.0	4,744.0	1,494.0	1,265.0
Other assets	1,641	1,451.0	1,309.0	1,218.0	777.0
Total assets	55,111	48,728.0	45,478.0	41,137.0	42,687.0
Liabilities					
Customer deposits	17,088	15,109.0	13,680.0	12,404.0	13,421.0
Interbank and other short-term funding	6,909	6,109.0	5,629.0	906.0	858.0
Other long-term funding	24,548	21,705.0	20,428.0	21,928.0	22,815.0
Trading liabilities and derivatives	2,129	1,882.0	1,906.0	2,165.0	1,934.0
Total funding and derivatives	50,674	44,805.0	41,643.0	37,403.0	39,028.0
Other liabilities	975	862.0	868.0	873.0	731.0
Preference shares and hybrid capital	339	300.0	300.0	300.0	300.0
Total equity	3,123	2,761.0	2,667.0	2,561.0	2,628.0
Total liabilities and equity	55,111	48,728.0	45,478.0	41,137.0	42,687.0
Exchange rate		USD1 = EUR0.884173	USD1 = EUR0.821963	USD1 = EUR0.89015	USD1 = EUR0.873057

Source: Fitch Ratings, Fitch Solutions, Aareal Bank

Summary Financials and Key Ratios

	31 Dec 2021	31 Dec 2020	31 Dec 2019	31 Dec 2018
Ratios (annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	1.2	-0.6	2.2	2.0
Net interest income/average earning assets	1.5	1.3	1.3	1.4
Non-interest expense/gross revenue	64.0	63.1	59.1	58.1
Net income/average equity	2.5	-2.7	6.3	8.7
Asset quality				
Impaired loans ratio	4.7	5.2	3.3	5.4
Growth in gross loans	6.3	4.2	-2.1	5.1
Loan loss allowances/impaired loans	32.5	38.0	40.6	36.4
Loan impairment charges/average gross loans	0.4	1.2	0.3	0.3
Capitalisation				
Common equity Tier 1 ratio	18.2	18.8	19.6	17.2
Tangible common equity/tangible assets	4.9	5.4	5.8	5.8
Basel leverage ratio	n.a.	5.9	6.3	6.1
Net impaired loans/common equity Tier 1	43.7	42.0	25.6	45.1
Funding and liquidity				
Gross loans/customer deposits	210.0	218.2	231.0	218.0
Liquidity coverage ratio	n.a.	264.9	221.4	234.3
Customer deposits / total non-equity funding	35.0	34.2	34.9	35.9

Source: Fitch Ratings, Fitch Solutions, Aareal Bank

Government Support

Aareal's Government Support Rating (GSR) of 'no support' (ns) reflects Fitch's view that due to the EU's Bank Recovery and Resolution Directive, senior creditors can no longer rely on full extraordinary support from the sovereign if the bank becomes non-viable.

GSR Key Rating Drivers

Typical D-SIB GSR for sovereign's rating level (assuming high propensity)	a+ to a-
Actual country D-SIB GSR	ns
GSR	**ns**
Government ability to support D-SIBs	
Sovereign Rating	AAA
Size of banking system	Negative
Structure of banking system	Neutral
Sovereign financial flexibility (for rating level)	Positive
Government propensity to support D-SIBs	
Resolution legislation	Negative
Support stance	Negative
Government propensity to support bank	
Systemic importance	Negative
Liability structure	Neutral
Ownership	Neutral

The colours indicate the weighting of each KRD in the assessment.
Higher influence Moderate influence Lower influence

Environmental, Social and Governance Considerations

FitchRatings **Aareal Bank AG** Banks Ratings Navigator

Credit-Relevant ESG Derivation

Aareal Bank AG has 5 ESG potential rating drivers

- Aareal Bank AG has exposure to compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security) but this has very low impact on the rating.
- Governance is minimally relevant to the rating and is not currently a driver.

			Overall ESG Scale
key driver	0	issues	5
driver	0	issues	4
potential driver	5	issues	3
not a rating driver	4	issues	2
	5	issues	1

Environmental (E)

General Issues	E Score	Sector-Specific Issues	Reference	E Scale
GHG Emissions & Air Quality	1	n.a.	n.a.	5
Energy Management	1	n.a.	n.a.	4
Water & Wastewater Management	1	n.a.	n.a.	3
Waste & Hazardous Materials Management; Ecological Impacts	1	n.a.	n.a.	2
Exposure to Environmental Impacts	2	Impact of extreme weather events on assets and/or operations and corresponding risk appetite & management; catastrophe risk; credit concentrations	Business Profile (incl. Management & governance); Risk Profile; Asset Quality	1

Social (S)

General Issues	S Score	Sector-Specific Issues	Reference	S Scale
Human Rights, Community Relations, Access & Affordability	2	Services for underbanked and underserved communities: SME and community development programs; financial literacy programs	Business Profile (incl. Management & governance); Risk Profile	5
Customer Welfare - Fair Messaging, Privacy & Data Security	3	Compliance risks including fair lending practices, mis-selling, repossession/foreclosure practices, consumer data protection (data security)	Operating Environment; Business Profile (incl. Management & governance); Risk Profile	4
Labor Relations & Practices	2	Impact of labor negotiations, including board/employee compensation and composition	Business Profile (incl. Management & governance)	3
Employee Wellbeing	1	n.a.	n.a.	2
Exposure to Social Impacts	2	Shift in social or consumer preferences as a result of an institution's social positions, or social and/or political disapproval of core banking practices	Business Profile (incl. Management & governance); Financial Profile	1

Governance (G)

General Issues	G Score	Sector-Specific Issues	Reference	G Scale
Management Strategy	3	Operational implementation of strategy	Business Profile (incl. Management & governance)	5
Governance Structure	3	Board independence and effectiveness; ownership concentration; protection of creditor/stakeholder rights; legal /compliance risks; business continuity; key person risk; related party transactions	Business Profile (incl. Management & governance); Earnings & Profitability; Capitalisation & Leverage	4
Group Structure	3	Organizational structure; appropriateness relative to business model; opacity; intra-group dynamics; ownership	Business Profile (incl. Management & governance)	3
Financial Transparency	3	Quality and frequency of financial reporting and auditing processes	Business Profile (incl. Management & governance)	2
				1

How to Read This Page
ESG scores range from 1 to 5 based on a 15-level color gradation. Red (5) is most relevant and green (1) is least relevant.

The Environmental (E), Social (S) and Governance (G) tables break out the individual components of the scale. The right-hand box shows the aggregate E, S, or G score. General Issues are relevant across all markets with Sector-Specific Issues unique to a particular industry group. Scores are assigned to each sector-specific issue. These scores signify the credit-relevance of the sector-specific issues to the issuing entity's overall credit rating. The Reference box highlights the factor(s) within which the corresponding ESG issues are captured in Fitch's credit analysis.

The Credit-Relevant ESG Derivation table shows the overall ESG score. This score signifies the credit relevance of combined E, S and G issues to the entity's credit rating. The three columns to the left of the overall ESG score summarize the issuing entity's sub-component ESG scores. The box on the far left identifies some of the main ESG issues that are drivers or potential drivers of the issuing entity's credit rating (corresponding with scores of 3, 4 or 5) and provides a brief explanation for the score.

Classification of ESG issues has been developed from Fitch's sector ratings criteria. The General Issues and Sector-Specific Issues draw on the classification standards published by the United Nations Principles for Responsible Investing (PRI) and the Sustainability Accounting Standards Board (SASB).

Sector references in the scale definitions below refer to Sector as displayed in the Sector Details box on page 1 of the navigator.

CREDIT-RELEVANT ESG SCALE
How relevant are E, S and G issues to the overall credit rating?

5	Highly relevant, a key rating driver that has a significant impact on the rating on an individual basis. Equivalent to "higher" relative importance within Navigator.
4	Relevant to rating, not a key rating driver but has an impact on the rating in combination with other factors. Equivalent to "moderate" relative importance within Navigator.
3	Minimally relevant to rating, either very low impact or actively managed in a way that results in no impact on the entity rating. Equivalent to "lower" relative importance within Navigator.
2	Irrelevant to the entity rating but relevant to the sector.
1	Irrelevant to the entity rating and irrelevant to the sector.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.