FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Aareal at 'BBB+'; Outlook Negative

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Fitch Ratings - Frankfurt am Main - 17 Nov 2021: Fitch Ratings has affirmed Aareal Bank AG's Long-Term Issuer Default Rating (IDR) at 'BBB+' with Negative Outlook and Viability Rating (VR) at 'bbb+'. A full list of rating actions is below.

The Negative Outlook on the Long-Term IDR reflects remaining risks from the pandemic, which could result in greater-than-anticipated asset-quality pressures and profitability challenges.

Aareal's VR is constrained by the bank's focus on lending to the cyclical commercial real-estate (CRE) sector and exposure to risks associated with this market. These risks include the immediate pressure from the pandemic, as the bank's asset quality is exposed to weaker borrowers' performance in the hotel and retail segments. Risks also stem from structural trends that are being accelerated by the pandemic and could affect parts of the CRE sector in the long term.

The VR is supported by, the bank's good geographical diversification relative to peers', diversified funding mix and sound capitalisation. However, Aareal's profitability, which has been recovering in 9M21, remains vulnerable to the pandemic, in particular if asset quality does not recover as swiftly as currently expected.

Following the update of Fitch's Bank Rating Criteria on 12 November 2021, we have withdrawn Aareal's Support Rating of '5' and Support Rating Floor of 'No Floor' as they are no longer considered by Fitch to be relevant to the agency's coverage. In line with the updated Criteria, we have assigned Aareal a Government Support Rating (GSR) of 'No Support'.

KEY RATING DRIVERS

IDRs, VR AND SENIOR NON-PREFFERRED (SNP) DEBT RATING

Aareal's reported non-performing loan (NPL) ratio (which includes off-balance sheet, fair-value NPLs and IFRS Stage 3 loans) rose to 6% at end-1H21 from 4.1% at end-2019. The large NPL inflow was mainly driven by UK retail properties and, to a smaller extent, hotels, to which Aareal has a large exposure (hotel and retail properties represented 32% and 20% of total loans at end-3Q21). Both segments have been most affected by the pandemic so far, and our negative outlook on the bank's asset-quality score reflects the risk of further NPL inflows in the short term as state support (e.g. furlough schemes) is being phased out.

We expect the four-year average Stage 3 ratio (5.4% at end-1H21) to reduce to about 4% by end-2022. The bank should be able to reduce NPLs in the foreseeable future, as recovering consumer spending and business travel should support the performance and valuation of retail and hotel properties. Additionally, Aareal is likely to consider de-risking measures similar to 2019, amid a recovering operating environment in 2021 that is supported by the vaccine rollout. Aareal's reported NPL ratio stood at 4.9% at end-3Q21.

We maintain a negative outlook on Aareal's earnings and profitability score, as a slow recovery of the hotel and retail sectors could temper the stabilisation of the bank's results. The bank's operating profit/risk-weighted assets (RWA) rebounded to 1.5% in 9M21 from -0.6% in 2020, when high pandemic-driven loan impairment charges (LICs) of EUR344 million (EUR90 million in 2019) triggered an annual loss of EUR69 million, despite only a slight decrease in net interest income.

The bank's long-term profitability record is better than German peers', as its international focus results in above-average margins, with a four-year average operating profit/RWA above 2% before the pandemic. We expect profitability to recover toward the long-term average over the next 24 months, supported by profitable loan growth, normalisation of LICs and steadily rising income at the bank's service and consulting subsidiary Aareon.

Aareal's capitalisation remains a rating strength, despite the 2020 annual loss and RWA inflation from recent asset-quality deterioration. Its sound common equity Tier 1 (CET1) ratio of 21.5% at end-3Q21 is well above the SREP CET1 requirement of 8.28% in 2021 (accounting for Pillar 2 requirements relief). The bank is not constrained by its regulatory leverage ratio, which at 5.7% at end-3Q21 compares well with other specialised CRE lenders' and the overall banking sector's. The bank is well-positioned to absorb the finalisation of the Basel III framework, including the output floor, given its pro-forma Basel IV (fully phased-in) CET1 ratio of 12.5% at end-3Q21.

Beside Pfandbriefe, Aareal's diversified funding mix consists primarily of resilient and 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.

Aareal's Short-Term IDR of 'F2' is the baseline option mapping to the 'BBB+' Long-Term IDR, because the bank's funding & liquidity score of 'bbb+' does not allow for a higher option.

DERIVATIVE COUNTERPARTY RATING (DCR), DEPOSIT AND SENIOR PREFERRED (SP) DEBT RATINGS

Aareal's DCR, long-term deposit and SP debt ratings are one-notch above the bank's Long-Term IDR to reflect the large buffer of SNP and junior debt of 41% of RWAs at end-2Q21, which provides the bank's preferred creditors and counterparties with additional protection compared with SNP creditors in a resolution. The short-term deposit and SP debt ratings of 'F2' are the baseline option mapping to the long-term preferred ratings 'A-', because the bank's funding & liquidity score of 'bbb+' does not allow for a higher option.

GSR

We have assigned a GSR of 'No Support'. This reflects Fitch's view that due to the EU's Bank Recovery and Resolution Directive (BRRD) senior creditors of the bank can no longer rely on full extraordinary support from the sovereign if the bank becomes non-viable.

TIER 2 SUBORDINATED DEBT AND HYBRID SECURITIES

Aareal's Tier 2 notes are notched down twice from the VR, which is the baseline notching for this type of debt under Fitch's criteria, to reflect their poor recovery prospects. The additional Tier 1 (AT1) notes are rated four notches below the VR: twice for loss severity, due to their deep subordination and write-down on a breach of the 7% CET1 trigger, and twice for incremental non-performance risk relative to the VR to reflect fully discretionary coupon payments.

RATING SENSITIVITIES

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

We could downgrade the VR (and, thus 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/RWA ratio durably below 1.5%. This could result from stress in the property market leading to unexpectedly high asset-quality pressure. Should the emergence of a majority shareholder drive aggressive loan growth or profit distribution to the point that it would significantly deplete Aareal's capital ratios, this could also weigh on the VR.

A downgrade of the Long-Term IDR would trigger a downgrade of the DCR, long-term SP and SNP debt and deposit ratings. We could also downgrade the long-term SP and SNP debt ratings if the bank no longer retains an SNP and junior debt buffer that is large enough to cover its total resolution buffer requirement, and if at the same time the SNP and junior debt buffer declines below 10% of RWA.

A downgrade of the VR would lead to a downgrade of the Tier 2 and AT1 notes. The ratings of AT1 notes could also be downgraded if we perceive a heightened risk that capital cushions above maximum distributable amount trigger points could fall below 100bp.

Aareal's GSR is at the bottom of Fitch's rating scale and therefore cannot be downgraded.

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

The Outlook on the Long-Term IDR could be revised to Stable if the bank weathers the challenges arising from the pandemic, limiting risks to its asset quality and profitability, while maintaining broadly stable capitalisation.

An upgrade of the VR (and, thus, of the Long-Term IDR) is unlikely in the near term given the risks posed by the pandemic. In the longer term, an upgrade would require significant diversification of its business model into revenue sources that are not directly dependent on large-ticket CRE lending, as well as strengthened asset quality. An operating profit/RWA sustainably above 2% combined with a Stage 3 ratio sustainably below 3% could result in an upgrade.

An upgrade of Aareal's IDRs would trigger an upgrade of the DCR, SP and SNP debt and deposit ratings, unless the buffer of junior and SNP debt decreases below the level required to maintain the SP ratings' one-notch uplift above and the SNP debt' alignment with the Long-Term IDR. An upgrade of Aareal's VR would lead to an upgrade of the Tier 2 and AT1 notes.

An upgrade of the GSR would require a higher propensity of sovereign support. While not impossible, the Banking Recovery and Resolution Directive makes this highly unlikely.

VR ADJUSTMENTS

The earnings and profitability score of 'bbb+' has been assigned below the 'a' category implied score, due the following adjustment reason: revenue diversification (negative).

The capitalisation and leverage score of 'a-' has been assigned below the 'aa' category implied score, due to the following adjustment reason: risk profile and business model (negative).

The funding and liquidity score of 'bbb+' has been assigned above the 'bb' category implied score, due to the following adjustment reasons: liquidity coverage (positive); deposit structure (positive).

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

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

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Aareal Bank AG	LT IDR	BBB+ Rating Outlook Negative	Affirmed	BBB+ Rating Outlook Negative
	ST IDR	F2	Affirmed	F2
	Viability	bbb+	Affirmed	bbb+
	Support	WD	Withdrawn	5
	Support Floor	WD	Withdrawn	NF
	DCR	A-(dcr)	Affirmed	A-(dcr)
	Government Support	ns	New Rating	
Senior preferred	LT	A-	Affirmed	A-
subordinated	LT	BBB-	Affirmed	BBB-
subordinated	LT	BB	Affirmed	BB
long-term deposits	LT	A-	Affirmed	A-
Senior preferred	LT	A-	Affirmed	A-

Senior non-preferred	LT	BBB+	Affirmed	BBB+
short-term deposits	ST	F2	Affirmed	F2
Senior preferred	ST	F2	Affirmed	F2

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 12 Nov 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Aareal Bank AG	EU Issued, UK Endorsed

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