Aareal Bank AG

Mortgage Pfandbriefe

Update

Rating/Outlook

Mortgage Pfandbriefe	AAA/Stable

Rating Rationale

IDR/Outlook	BBB+/Stable
IDR uplift	2 notches
Payment continuity uplift	4 notches
Tested Rating on a probability of default (PD) basis	AA+
Recovery given default uplift	1 notch
Covered bond rating	AAA
OC Fitch considers in analysis (%)	28.5
'AAA' Breakeven OC (%)	28.5

Key Data

	Mar 17
Asset type	Mortgage
Cover assets (EURbn)	11.6
Pfandbriefe (EURbn)	9.2
Nominal OC (%)	29.9[a]
WAL of assets (years)	3.8
WAL of liabilities (years)	3.2

[a]as of 31 May 2017

Key Rating Drivers

Rating Rationale: The 'AAA' rating of Aareal Bank AG's covered bonds is based on the bank's Long-Term Issuer Default Rating (IDR) of 'BBB+', an unchanged IDR uplift of two notches, the unchanged payment continuity uplift (PCU) of four notches and the 'AAA' breakeven overcollateralisation (OC) of 28.5%. It also reflects the issuer's intention to maintain OC of at least 28.5%. The Stable Outlook mirrors that on Aareal's Long-Term IDR.

Credit Loss Is Main Driver: The main constituent of the breakeven OC remains the credit loss of 24.5% (up from 20.4% 12 months ago). The increase mainly reflects the downward revision of Italy's Country Ceiling to 'AA'. Fitch Ratings now also sizes for redenomination risk for expected recoveries on defaulted Italian assets in the 'AA+' scenario as per our country risk criteria. The adjustment was previously limited to Fitch's AAA' credit loss expectation.

To a lesser extent, the increased loss reflects an increase of non-German exposure, particularly an increase of loans secured by properties located in the US, the share of which had increased by 6.5 percentage points in the 12 months to March 2017.

Prepayment Scenario Limits Asset Sales: The asset disposal loss component remains the second-largest driver of the breakeven OC despite a significant decrease (to 2.5% from 5.3%). The reduction in this component stems from the programme now being more vulnerable to a high prepayment scenario, whereas low prepayments constituted the modelled worst case in the previous analysis. Higher cash inflows result in lower modelled asset sales to bridge liquidity gaps.

Well-Matched Programme: The well-matched asset and liability profile, combined with the inclusion of privileged derivatives, reducing open interest and currency positions, led to the cash flow valuation component remaining the smallest component at 1.4%, up from -1.8%. The increase is driven by the different worst-case prepayment scenario. High prepayments limit excess spread generation in the programme, negatively affecting the cash flow valuation component.

Programme Highlights

Diversified Pool: The cover pool comprises geographically widespread loans with the largest exposures (above EUR1 billion) in Germany, France, the UK and the US, carrying a combined weight of about 65% of the commercial real-estate assets. The remaining 35% of assets are relatively evenly spread across a further 15 countries. Property types securing the loans are also diverse, ranging from standard types, such as offices, retail sites and multifamily homes, to more specialised types, such as industrial units and hotels.

One-Notch Recovery Uplift: The programme's rating is based on a 'AA+' rating on a tested probability of default basis and one-notch recovery uplift. Although the programme would be eligible for a two-notch recovery uplift, this rating composition provides the lowest protection needed for a 'AAA' Pfandbriefe rating.

Criteria Variations: See Page 3 of this report for a detailed explanation on the criteria variations applied in the analysis for Aareal's mortgage Pfandbriefe.

Related Research

Fitch Affirms Aareal Bank's Mortgage Pfandbriefe at 'AAA'; Outlook Stable (May 2017)

Aareal Bank AG (April 2017)

Covered Bonds Surveillance Snapshot (January 2017)

2017 Outlook: Covered Bonds (December 2016)

'B' Portfolio Loss Rates for Covered Bonds (September 2016)

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Cover Pool Characteristics: March 2017

Total balance (EURbn)	**11.6**
Commercial	10.0
Residential	0.8[a]
Substitute assets	0.8
Number of loans	625
Number of borrowers	611
Number of properties	1691
Interest rate type (%)	
Floating rate	57.6
Fixed rate	42.4
Repayment type (%)	
Bullet/interest only	46.9
Amortising	53.1
Seasoning (years)	5.2
Top 10 exposures (%)	12.0

Currency breakdown (EURbn)[b]

	Assets	Pfandbriefe
EUR	10.8	8.4
USD	0.7	0.8

[a] Includes EUR0.76bn loans secured by multifamily properties

[b] Post-swap exposures above EUR100 million
Source: Fitch

Related Criteria

Covered Bonds Rating Criteria (October 2016)

Criteria for Analyzing Multiborrower U.S. and Canadian Commercial Mortgage Transactions (March 2017)

Criteria for Country Risk in Global Structured Finance and Covered Bonds (September 2016)

Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds (November 2016)

Fitch's Interest Rate Stress Assumptions for Structured Finance and Covered Bonds - Excel File (February 2017)

Fitch's Foreign-Currency Stress Assumptions for Residual Foreign-Exchange Exposures in Covered Bonds and Structured Finance – Excel File (October 2016)

Global Bank Rating Criteria (November 2016)

Rating Criteria for Commercial Mortgage-Backed Securities (CMBS) and Loans in EMEA (December 2016)

SME Balance Sheet Securitisation Rating Criteria (March 2017)

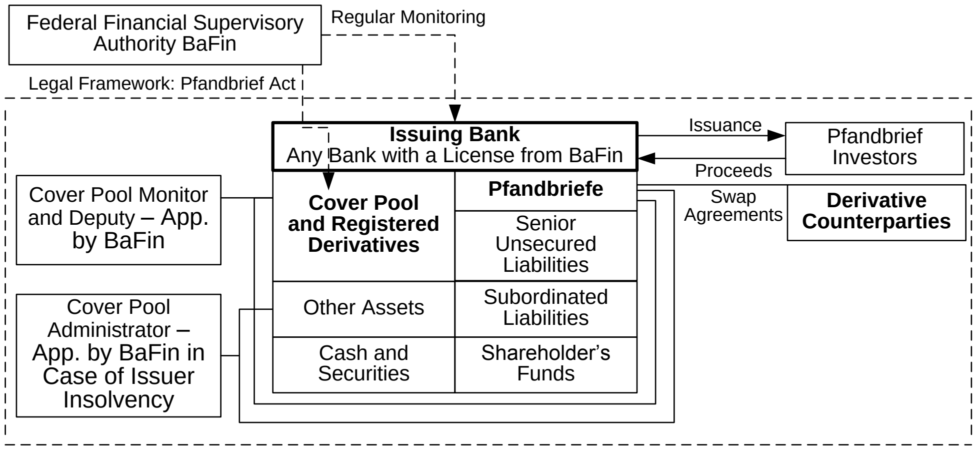
Structured Finance and Covered Bonds Counterparty Rating Criteria (March 2017)

Structured Finance and Covered Bonds Counterparty Rating Criteria: Derivative Addendum (March 2017)

North America and Asia-Pacific Multiborrower CMBS Surveillance Criteria (April 2017)

Asset Analysis Criteria for Covered Bonds and CDOs of Public Entities (January 2017)

Diagram of a Pfandbrief Issuance



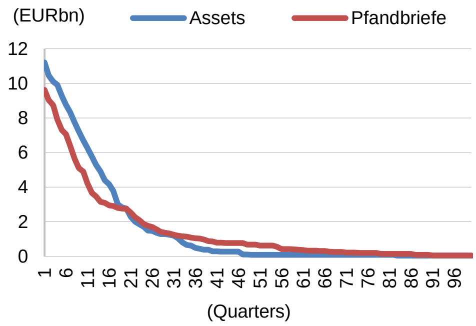
Source: Fitch

Fitch Default Model Output (%)

Rating level	AAA	AA+	AA
Rating default rate (RDR)	93.6	92.4	91.1
Rating recovery rate (RRR)	72.3	78.7	86.2

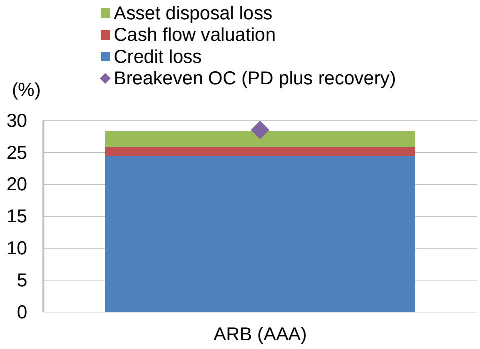
Source: Fitch

Amortisation Profile
(As of Sep 16)



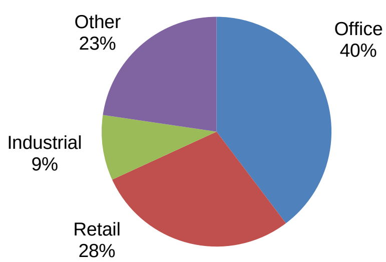
Source: Fitch/Aareal

Breakeven OC Components



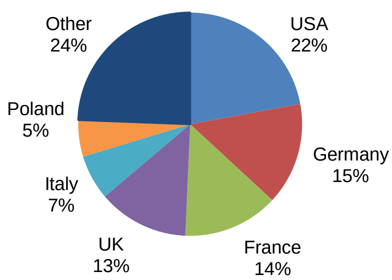
Source: Fitch

Commercial Real Estate - Property Type
(% of commercial real estate assets)



Source: Fitch/Aareal

Commercial Real Estate - Property Location
(% of commercial real estate assets)



Source: Fitch/Aareal

Criteria Variations

Fitch applied a variation from the “Criteria for Analyzing Multiborrower U.S. and Canadian Commercial Mortgage Transactions”, published on 6 March 2017. Fitch applied stressed capitalisation rates and respective multiples from these criteria for the commercial real-estate loans secured by properties located in the US to calculate the properties' stressed market values and recovery rates instead of applying generic market value decline assumptions (80% in a ‘AAA’ scenario) stipulated in “Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds”. The variation is reflected in the analysis and has no impact on the rating of Aareal’s mortgage Pfandbriefe.

Fitch applied two variations from “Criteria for the Analysis of Commercial Real Estate Loans Securing Covered Bonds”, published on 17 November 2016. Firstly, in the absence of respective country default benchmarks for loans to operating companies for France and Poland in Criteria for Rating Granular Corporate Balance-Sheet Securitisations (SME CLOs) as a representative default rate assumption for tenants, Fitch assumed default assumptions for the French and Polish tenants to be in line with the assumptions for the Netherlands (4%) and Italy (4.75%), respectively. Without applying this variation credit loss would increase by a maximum of 2pp for this programme.

Secondly, in the absence of CMBS guidance assumptions for the length of the enforcement process for the US, Austria, Belgium, Denmark, Finland, Luxembourg, Sweden, Canada, Norway, Switzerland, the Czech Republic and Estonia, Fitch assumed recovery timings for these jurisdictions to be in line with the agency’s available assumptions for several property markets based on their level of liquidity, ranging from 24 to 60 months. Without applying this variation credit loss would increase by a maximum of 3pp for this programme.

Fitch has applied a variation to the “Covered Bonds Rating Criteria”, published on 26 October 2016. Substitute assets that may vary in quantity and in nature are generally not included when calculating the rating spread levels for a specific programme. As Aareal commits to holding at least EUR700 million of such assets at any time, we included an amount up to this level included in the calculation of the rating spread levels. Without applying this variation, asset disposal loss would increase by about 40bp for the programme.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.