FitchRatings

RATING ACTION COMMENTARY

# Fitch Affirms Aareal at 'BBB'; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 11 Oct 2024: Fitch Ratings has affirmed Aareal Bank AG's (Aareal) Long-Term Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook and Viability Rating (VR) at 'bbb'.

## KEY RATING DRIVERS

**Concentrated CRE Business:** Aareal's ratings reflect the bank's concentrated core business as a medium-sized international commercial real estate (CRE) lender, which exposes the bank to sector risks despite geographic diversification. The ratings also reflect cyclical asset quality, adequate operating profitability that provides a sufficient buffer to absorb high loan impairment charges (LICs) in the coming quarters, and sound capitalisation, adequate funding and liquidity.

**Tested Underwriting Standards**: Aareal mainly finances properties in prime locations. The underwriting standards and collateralisation of its loan book are broadly in line with market practice. The bank's risk profile is also underpinned by its centralised, sophisticated risk control framework and good record of impaired loans work-out, which we view as crucial for weathering the current challenging conditions in most real estate markets.

**Asset Quality Stabilising**: Aareal's asset quality has varied through the cycle reflecting the bank's strategic sector concentrations. It has come under pressure in the past year, mostly in its sizeable US office portfolio, which is by far the biggest contributor to the bank's 3.7% impaired loans ratio (Stage 3/gross loans) at end-1H24. However, Aareal demonstrated good capacity to actively manage its non-performing loan portfolio through work-outs and sales. We expect these to continue offsetting further moderate inflows of impaired loans in 2H24 and 2025, which drives the stable asset quality outlook.

**Adequate Profitability**: Aareal's total income generation will moderately decrease following the sale of Aareon, its former IT subsidiary. However, Aareon's overall profit contribution was limited. In addition, higher net interest income due to solid margins in its structured property portfolio and material interest income in its banking segment (where Aareal holds housing industry deposits) in 1H24 could well absorb a temporarily higher level of LICs, leading to an operating profit/risk-weighted assets (RWAs) of 2.7%.

**Sound Capitalisation**: Aareal's common equity Tier 1 (CET1) ratio of 19.3% (including discontinued operations) at end-1H24 is comfortably exceeding regulatory requirements. It provides an adequate cushion, considering the bank's property finance business model with high single-borrower and sector concentrations. However, continuing risk on CRE markets drive our negative outlook on the score. The ratio will be temporarily boosted by the expected net gain on the sale of Aareon. Over time, we believe it will be paid out to shareholders.

**Diversified Funding**: Aareal's funding profile is sound and benefits from its established covered bond franchise, which is its main funding source. It is supplemented by stable deposits from the institutional housing sector, which reduce the bank's reliance on unsecured debt market funding and retail term deposits collected through independent online platforms.

## RATING SENSITIVITIES

### Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

Aareal's ratings would likely be downgraded if the bank's impaired loans ratio increases above 6% for an extended period with no credible reduction plan, or if heightened LICs weigh on its operating profitability lowering its operating profit/RWAs ratio below 0.5% in the longer term. This could result from further severe stress in the US office property market, and a spill-over to European property markets.

Significantly higher funding costs triggered by a material loss of deposits in the housing sector or signs of challenges to access the wholesale funding market also impair Aareal's profitability and funding and result in a downgrade.

### Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

An upgrade of Aareal's ratings would be contingent on a sustainable recovery of US office property markets and a resilient asset quality in the bank's other property segments and regions. An upgrade would also be contingent on the bank further strengthening its profitability, with an operating profit/RWAs ratio sustainably above 2%, combined with an impaired loans ratio of around 3%, while maintaining sound capitalisation.

## OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

DCR, Deposit and Senior Debt Ratings

Aareal's Derivative Counterparty Rating (DCR), long-term deposit and senior preferred debt ratings are one notch above the Long-Term IDR, and the long-term senior non-preferred debt rating is aligned with the Long-Term IDR. This reflects the large and sustainable layer of non-preferred and junior debt that provides preferred creditors and counterparties with additional protection in a resolution.

The short-term senior preferred and deposit ratings are the lower of the two options mapping to the respective long-term ratings.

Subordinated Debt

The Tier 2 debt rating is two notches below the VR to reflect higher loss severity relative to senior creditors in a resolution. The AT1 notes are rated four notches below the VR (two notches for loss severity and two notches for non-performance risk) to reflect our expectation that Aareal will maintain large capital buffers above the notes' mandatory coupon omission triggers.

Aareal's Short-Term IDR is the higher of the two short-term ratings that map to its Long-Term IDR, and reflects our assessment of its funding and liquidity.

Government Support Rating (GSR): Aareal's GSR of 'no support' reflects Fitch's view that senior creditors cannot rely on full extraordinary state support. This is driven by the EU's resolution framework that is likely to require senior creditors participating in losses, if necessary, instead, or ahead, of a bank receiving government support.

## OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

The DCR, long-term senior preferred and non-preferred debt and deposit ratings are sensitive to changes in the IDRs. We could also downgrade these ratings if the bank no longer retained a senior non-preferred and junior debt buffer that is large enough to cover its total resolution buffer requirement, and if at the same time the senior non-preferred and junior debt buffer declines below 10% of RWAs.

The Tier 2 and AT1 debt ratings are sensitive to a change in the VR. The AT1 notes' rating could also be downgraded if we perceive a heightened risk that capital cushions above the 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.

An upgrade of the GSR would require a higher propensity of sovereign support. While not impossible, the EU's resolution regime makes this highly unlikely, in Fitch's view.

### VR ADJUSTMENTS

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

The funding & liquidity score of 'bbb+' has been assigned below the 'a' implied category score due to the following adjustment reason(s): non-deposit funding (negative).

### 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 is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

## RATING ACTIONS

| ENTITY / DEBT | RATING | | | PRIOR |
|---|---|---|---|---|
| Aareal Bank AG | LT IDR | BBB Rating Outlook Stable | Affirmed | BBB Rating Outlook Stable |
| | ST IDR | F2 | Affirmed | F2 |
| | Viability | bbb | Affirmed | bbb |

| | | | | |
|---|---|---|---|---|
| | DCR | BBB+(dcr) | Affirmed | BBB+(dcr) |
| | Government Support | ns | Affirmed | ns |
| subordinated | LT | BB- | Affirmed | BB- |
| subordinated | LT | BB+ | Affirmed | BB+ |
| long-term deposits | LT | BBB+ | Affirmed | BBB+ |
| Senior preferred | LT | BBB+ | Affirmed | BBB+ |
| Senior non-preferred | LT | BBB | Affirmed | BBB |

VIEW ADDITIONAL RATING DETAILS

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## APPLICABLE CRITERIA

Bank Rating Criteria (pub. 15 Mar 2024) (including rating assumption sensitivity)

## ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

## ENDORSEMENT STATUS

| | |
|---|---|
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