FitchRatings

Aareal Bank AG

Update

Key Rating Drivers

Concentrated Business Profile: Aareal Bank AG's ratings reflect the bank's core business as an international commercial real estate (CRE) lender, and Fitch Ratings' expectation that capitalisation will remain sound, despite pressure on profitability and asset quality. Profitability and revenue diversification benefit from services to the institutional housing sector, which also gives it access to a stable deposit base.

Stable Outlook: The Stable Outlook reflects Fitch's expectation that Aareal's pre-impairment operating profit will continue to provide a sufficient buffer to absorb higher loan impairment charges (LICs) in the coming quarters. This buffer should allow the bank to generate adequate operating profitability. The Stable Outlook also incorporates Fitch's view that Aareal's funding and liquidity, which benefit from a stable deposit base and the bank's established role as a Pfandbrief issuer, remain sound.

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 real estate markets.

Asset Quality Deterioration: Aareal's asset quality has come under additional pressure, especially in its sizeable US office portfolio, which accounted for EUR4.3 billion, equal to 13% of its total CRE portfolio at end-3Q23. We expect LICs to be higher than we previously expected, but also that the bank will continue to actively manage its non-performing loan portfolio. Further inflows of impaired loans would increase the bank's gross impaired loan ratio, which, with a 4% four-year average to end-1H23, is high compared with domestic peers.

The bank's asset quality could deteriorate further if valuation pressure in the US office sector persists longer than expected, or if the quality of the bank's solid European office portfolio weakens.

Adequate Profitability, Albeit Under Pressure: The bank's revenue generation improved materially in 9M23 as higher interest rates resulted in improved deposit margins. Fitch expects higher loan LICs to weigh on Aareal's operating profit/risk-weighted assets (RWAs) ratio.

Resilient Capitalisation: We expect Aareal's capitalisation to remain a relative rating strength, with its end-3Q23 common equity Tier 1 (CET1) ratio of 19.4% comfortably exceeding regulatory requirements, and a Basel III leverage ratio (end-3Q23: 6.3%) that is adequate and above that of European peers. Our assessment of capitalisation incorporates Aareal's high single-borrower and sector concentrations, and our view that asset quality deterioration could result in RWA inflation.

Diversified Funding: Aareal's funding profile benefits from its established covered bond franchise and stable deposits from the institutional housing sector, which reduce the bank's reliance on unsecured debt market funding. We expect covered bond issuance to remain resilient even in periods of market stress, but we consider Aareal's retail term deposits collected through independent online platforms to be more price- and confidence-sensitive.

Banks
Wholesale Commercial Banks
Germany

Ratings

Foreign Currency	
Long-Term IDR	BBB
Short-Term IDR	F2
Derivative Counterparty Rating	BBB+(dcr)
Viability Rating	bbb
Government Support Rating	ns
Sovereign Risk (Germany)	
Long-Term Foreign-Currency IDR	AAA
Long-Term Local-Currency IDR	AAA
Country Ceiling	AAA
Outlooks	
Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Foreign-Currency IDR	Stable
Sovereign Long-Term Local-Currency IDR	Stable

Applicable Criteria

Bank Rating Criteria (September 2023)

Related Research

Fitch Downgrades Aareal to 'BBB'; Outlook Stable (February 2024)

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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 gross impaired loan ratio increases above 6% for an extended period with no credible reduction plan, or if heightened loan impairment charges weigh on its operating profitability in the longer term.

The ratings would also come under pressure if we do not see a clear path for the bank's operating profit/RWA ratio to sustainably remain around 1.5%. This could result from an additional severe stress in the US office property market, or spill-over to European property markets or specific sectors that are sensitive to higher rates and widening spreads. Significantly higher funding costs or signs of challenges to access the wholesale funding market or instability in its deposit base could 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 Long-Term IDR is unlikely in the near term, given that Aareal's business profile is concentrated on CRE. In the longer term, an upgrade would require a sustainable recovery of US office property markets and resilient asset quality in the bank's other property segments and regions.

An upgrade would also be contingent on the bank significantly strengthening its profitability, with an operating profit/RWA ratio sustained above 2%, and improving its impaired loans ratio to around 3% on a sustained basis.

Other Debt and Issuer Ratings

Rating level	Rating
Deposits	BBB+/F2
Senior non-preferred	BBB
Senior preferred	BBB+/F2
Additional Tier 1 (AT1)	BB-
Tier 2 subordinated	BB+

Source: Fitch Ratings

DCR, Deposit and Senior Debt Ratings

Aareal's Derivative Counterparty Rating (DCR), long-term deposit rating, senior preferred debt rating, is one notch above the Long-Term IDR, and the long-term senior non-preferred debt rating remains 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.

Significant Changes from Last Review

Rising LICs in the US Undermine Benefits from Higher Interest Rates

CRE markets have come under increasing pressure since early 2023 as high interest rates have led to increasing defaults and the need for valuation adjustments. This is particularly the case in the US office segment, where vacancy rates are high, partly because of a structural shift to hybrid working. Aareal's exposure to this segment amounted to EUR4.3 billion at end-3Q23, equal to 13% of its total CRE portfolio. The bank's LICs haven risen throughout 9M23, with almost 60% of non-performing loans concentrated in the office segment at end-3Q23.

We expect LICs to remain heightened, which will undermine the positive impact from rising net interest income, but we believe that the bank will continue to generate adequate profitability in 2024 and 2025, assuming no further escalation on US property markets or broad-scale contagion towards Europe. We expect a high level of net interest income in Aareal's banking and digital solutions segment (BDS), where the bank provides residential property-related services and collects and manages deposits from the housing industry. After continued investments in Aareon in 2023, which led to a moderate segment loss in 9M23, the bank also expects improved earnings from this business, which is Aareal's main source of commission income as a leading provider in integrated Enterprise Resource Planning systems for the European housing sector.

Asset Quality Challenges Non-Performing Loan Reduction Plan

Aareal had earmarked EUR60 million LICs at the beginning of 2023 to facilitate a swift reduction of non-performing loans. The bank increased this amount to around EUR100 million during 9M23, which allowed it to dispose of its small remaining Russian exposure. The bank aims to achieve a gross impaired loan ratio of around 3% of its property finance portfolio. We consider this target ambitious in the current environment, but expect the bank to continue to manage its impaired assets proactively.

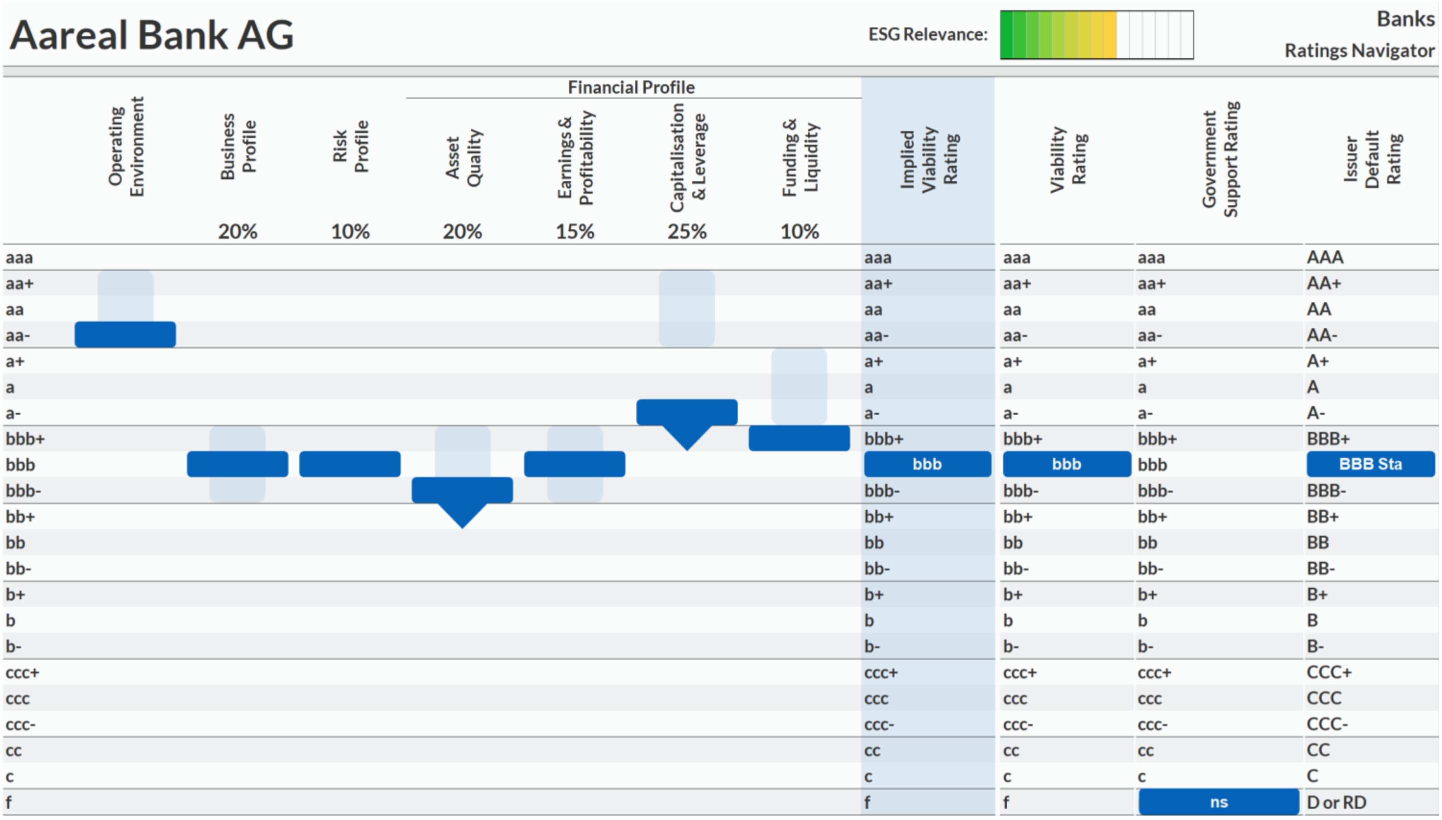
Capitalisation Remains Rating Strength

Aareal has stable capitalisation, and its CET1 ratio of 19.4% at end-3Q23 is above peers', and comfortably above regulatory requirements. We expect no material impact on its capitalisation from the current market developments, but a widespread deterioration of the European property market that results in losses could put capitalisation under pressure.

Stable Deposits Base and Strong Liquidity

Aareal's funding is based on covered bond issuance, supplemented by customer deposits from the housing sector and additional online retail term deposits, which have grown consistently. We believe that the bank's funding profile, in combination with its robust liquidity coverage, can withstand periods of heightened spread volatility. The bank has moderate funding needs, and issued a EUR500 million covered bond in 1Q24.

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 to Key Rating Drivers

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).

Financials

Financial Statements

	30 Sep 23		31 Dec 22	31 Dec 21	31 Dec 20
	9 months (USDm)	9 months (EURm)	12 months (EURm)	12 months (EURm)	12 months (EURm)
Summary income statement					
Net interest and dividend income	752	710	702	597	512
Net fees and commissions	238	225	277	245	234
Other operating income	-34	-32	23	-38	-19
Total operating income	957	903	1,002	804	727
Operating costs	515	486	571	516	458
Pre-impairment operating profit	442	417	431	288	269
Loan and other impairment charges	278	262	192	133	344
Operating profit	164	155	239	155	-75
Tax	54	51	86	87	-6
Net income	110	104	153	68	-69
Other comprehensive income	—	—	53	56	-48
Fitch comprehensive income	110	104	206	124	-117
Summary balance sheet					
Assets					
Gross loans	34,027	32,119	31,720	31,723	29,847
– Of which impaired	—	—	985	1,505	1,549
Loan loss allowances	395	373	487	489	588
Net loans	33,632	31,746	31,233	31,234	29,259
Interbank	—	—	1,914	1,264	1,029
Derivatives	1,867	1,762	1,825	1,132	2,218
Other securities and earning assets	9,169	8,655	5,329	6,705	6,919
Total earning assets	44,667	42,163	40,301	40,335	39,425
Cash and due from banks	5,862	5,533	5,424	6,942	4,744
Other assets	1,850	1,746	1,606	1,451	1,309
Total assets	52,379	49,442	47,331	48,728	45,478
Liabilities					
Customer deposits	13,636	12,871	16,895	15,109	13,680
Interbank and other short-term funding	—	—	1,981	6,109	5,629
Other long-term funding	30,570	28,856	21,050	21,705	20,428
Trading liabilities and derivatives	3,680	3,474	3,514	1,882	1,906
Total funding and derivatives	47,886	45,201	43,440	44,805	41,643
Other liabilities	957	903	633	862	868
Preference shares and hybrid capital	318	300	300	300	300
Total equity	3,218	3,038	2,958	2,761	2,667
Total liabilities and equity	52,379	49,442	47,331	48,728	45,478
Exchange rate		USD1 = EUR0.943931	USD1 = EUR0.937559	USD1 = EUR0.884173	USD1 = EUR0.821963

Source: Fitch Ratings, Fitch Solutions, Aareal Bank AG

Key Ratios

	30 Sep 23	31 Dec 22	31 Dec 21	31 Dec 20
Ratios (%; annualised as appropriate)				
Profitability				
Operating profit/risk-weighted assets	1.5	1.9	1.2	-0.6
Net interest income/average earning assets	2.3	1.7	1.5	1.3
Non-interest expense/gross revenue	53.9	56.9	64.0	63.1
Net income/average equity	4.6	5.3	2.5	-2.7
Asset quality				
Impaired loans ratio	—	3.1	4.7	5.2
Growth in gross loans	1.3	0.0	6.3	4.2
Loan loss allowances/impaired loans	—	49.4	32.5	38.0
Loan impairment charges/average gross loans	1.1	0.6	0.4	1.2
Capitalisation				
Common equity Tier 1 ratio	19.4	19.3	18.2	18.8
Fully loaded common equity Tier 1 ratio	—	—	—	—
Fitch Core Capital ratio	—	—	—	—
Tangible common equity/tangible assets	4.7	4.9	4.9	5.4
Basel leverage ratio	—	—	5.5	5.9
Net impaired loans/common equity Tier 1	—	20.2	43.7	42.0
Funding and liquidity				
Gross loans/customer deposits	249.6	187.8	210.0	218.2
Gross loans/customer deposits + covered bonds	—	109.3	115.5	117.5
Liquidity coverage ratio	—	—	255.4	264.9
Customer deposits/total non-equity funding	30.6	42.0	35.0	34.2

Source: Fitch Ratings, Fitch Solutions, Aareal Bank AG

Support Assessment

Commercial Banks: Government Support	
Typical D-SIB GSR for sovereign's rating level (assuming high propensity)	A+ to A-
Actual jurisdiction D-SIB GSR	ns
Government Support Rating	ns
Government ability to support D-SIBs	
Sovereign Rating	AAA/ Stable
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

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.

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.

Environmental, Social and Governance Considerations

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

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.

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

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.

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.

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