

Rating Action: Moody's affirms Aareal Bank AG's A3 long-term deposit and issuer ratings, outlook remains negative

18 May 2022

Frankfurt am Main, May 18, 2022 -- Moody's Investors Service (Moody's) has today affirmed the A3 long-term deposit and issuer ratings of Aareal Bank AG (Aareal Bank), the outlook on these ratings remains negative. Concurrently, Moody's affirmed Aareal Bank's baa3 Baseline Credit Assessment (BCA) and Adjusted BCA.

For a list of all affected ratings, please refer to the end of this press release.

RATINGS RATIONALE

-- AFFIRMATION OF THE BASELINE CREDIT ASSESSMENT

Moody's affirmation of Aareal Bank's baa3 BCA reflects the resilience in the bank's fundamental credit profile, despite the more challenging economic outlook amid geopolitical tensions and considering the bank's results during the pandemic. Being an internationally active commercial real estate (CRE) lending specialist Aareal Bank is exposed to severe concentration risks in highly cyclical CRE lending; absent meaningful earnings diversification Moody's considers Aareal Bank to operate a monoline business model.

The rating agency expects Aareal Bank's asset quality to remain stable, though non-performing loans of around 5% of the loan book remain at elevated levels compared with its closest peers. The bank's geographical diversification based on its international business provides benefits because some regions, particularly those outside of Europe, are less exposed to the economic repercussions of the military conflict in Ukraine. However, rising rates, together with subdued economic growth prospects, will make it more challenging for Aareal Bank's clients to serve loans and keep loan losses above levels seen in the years ahead of the pandemic.

Aareal Bank's elevated asset risks are largely mitigated by the bank's strong capitalization. With a 17.9% Common Equity Tier 1 (CET1) ratio as of March 2022, Aareal Bank has strong buffers available to cope with a deterioration of its asset quality. An average loan-to value of below 60% in its performing CRE lending book provides further buffers for a potential property market correction.

The affirmation also reflects some recovery in profits, after the loss in 2020 because of the pandemic related high risk provisioning needs. However, the positive dynamics were less forceful than for peers, with 2021 results well below the observed profitability levels of competitors as risk provisions remained more elevated, reflecting Aareal Bank's severe concentration risks in highly cyclical CRE sectors like hotel and retail that were more exposed to the consequences of the pandemic, despite the availability of government support measures for these sectors.

Aareal Bank's sound liquidity management and funding profile remain risk mitigants. Aareal Bank thereby benefits from its software service activities for the housing and commercial property industries by attracting sizeable, relatively stable and sticky housing industry deposits, and its covered bond franchise, enabling the bank to withstand some market dislocation in more confidence-sensitive capital-market funding.

While Aareal Bank targets a meaningful improvement in the profitability of its software service activities, Moody's considers the current status quo and the track record to be insufficient to mitigate the concentration risks from its lending operations. As such, the rating agency continues to view Aareal Bank operating a monoline business model and constrains the bank's intrinsic strength at the lowest investment grade level, within which it remains weakly positioned.

-- AFFIRMATION OF ISSUER AND DEPOSIT RATINGS

The affirmation of Aareal Bank's ratings reflects the affirmation of its BCA, unchanged results from Moody's Advanced Loss Given Failure (LGF) analysis and unchanged results from the rating agency's assumption for government support.

Because of significant volumes of subordinated and junior senior unsecured debt outstanding, the rating agency's Advanced LGF analysis results in three notches of rating uplift for deposits and issuer ratings for Aareal Bank. Being considered as a non-systemically relevant institution the resulting low government support assumption results in no further rating uplift.

-- OUTLOOK REMAINS NEGATIVE

While the negative outlook previously captured potential downside risks from the coronavirus pandemic, specifically on the bank's solvency, maintaining the negative outlook now mostly reflects Moody's concerns about the bank's subdued profitability which provides only a limited buffer against downside risks.

Higher provisioning needs as a result of geopolitical tensions, rising rates and subdued economic growth, possible additional costs around the planned takeover and the high investment needs around the growing digital businesses are the key challenges for Aareal Bank to restore its profitability as part of its ambitious medium-term profitability targets and to levels commensurate with its investment-grade baa3 standalone BCA. Though the bank will benefit from positive effects on its net interest income because of the growing financing portfolio and supported by rising rates, as well as on its net commission income by Aareon AG growth, the aforementioned cost drivers are likely to largely offset those effects in 2022 and 2023.

Going forward, success factors to sustainably improve profitability include the implementation of the bank's plans to strongly expand its digital and IT businesses, while at the same time soundly managing its asset risks, limiting provisioning needs and a successful cost management, particularly relevant given the significant investment needs for the digital businesses.

Moody's expects other Aareal Bank's key financial metrics like asset quality, capital and the bank's funding and liquidity profile to remain broadly stable over the next 12 to 18 months.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

An upgrade of Aareal Bank's ratings is currently unlikely. An upgrade could follow an upgrade of its BCA, which would require a more diversified business model, such that it provides a sustainable and visible buffer relative to the existing strong concentration risks in CRE lending.

Aareal Bank's ratings could be downgraded as result of a downgrade of its BCA or if loss-absorbing liabilities decline significantly and beyond Moody's expectations, thereby resulting in fewer notches of rating uplift from the rating agency's LGF analysis.

Downward pressure on Aareal Bank's BCA could develop in case the bank fails to sustainably restore the bank's profitability to levels more in line with the performance observed ahead of the pandemic, or a deterioration in its asset quality that negatively affects its current good capitalisation levels. Further, a stronger recourse to market funding, or an overall lower level of liquid reserves in relation to its balance sheet could exert downwards rating pressure.

LIST OF AFFECTED RATINGS

Issuer: Aareal Bank AG

..Affirmations:

....Long-term Counterparty Risk Ratings, affirmed A3

....Short-term Counterparty Risk Ratings, affirmed P-2

....Long-term Bank Deposits, affirmed A3, outlook remains Negative

....Short-term Bank Deposits, affirmed P-2

....Long-term Counterparty Risk Assessment, affirmed A3(cr)

....Short-term Counterparty Risk Assessment, affirmed P-2(cr)

....Long-term Issuer Ratings, affirmed A3, outlook remains Negative

....Short-term Issuer Ratings, affirmed P-2

...Baseline Credit Assessment, affirmed baa3

...Adjusted Baseline Credit Assessment, affirmed baa3

...Commercial Paper, affirmed P-2

..Outlook Action:

...Outlook remains Negative

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks Methodology published in July 2021 and available at https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1269625 . Alternatively, please see the Rating Methodologies page on www.moody.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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