

MOODY'S

RATINGS

Rating Action: Moody's downgrades Aareal Bank AG's long-term issuer ratings to Baa1 from A3, outlook remains negative

20 Mar 2024

Baseline Credit Assessment downgraded to ba1 from baa3

Frankfurt am Main, March 20, 2024 -- Moody's Ratings (Moody's) has today downgraded by one notch Aareal Bank AG's (Aareal) long-term deposit, senior unsecured and issuer ratings to Baa1 from A3. The outlook on these ratings remains negative. Moody's also downgraded Aareal's long-term Counterparty Risk Ratings (CRR) to Baa1 from A3, its senior unsecured MTN program ratings to (P)Baa1 from (P)A3, its junior senior unsecured MTN program ratings to (P)Baa3 from (P)Baa2, and affirmed Aareal's short-term CRR, deposits, issuer ratings, and Commercial Paper at P-2.

Further, the rating agency downgraded Aareal's Baseline Credit Assessment (BCA) and Adjusted BCA to ba1 from baa3, its long-term Counterparty Risk Assessment (CR Assessment) to Baa1(cr) from A3(cr), and affirmed the bank's short-term CR Assessment at P-2(cr).

RATINGS RATIONALE

-- DOWNGRADE OF AAREAL'S BASELINE CREDIT ASSESSMENT

The downgrade of Aareal's BCA to ba1 from baa3 reflects Moody's assessment that the current cyclical downturn in US office commercial real estate (CRE) results in more persistent challenges to the bank's asset quality and profitability than previously anticipated. Key credit strengths remain Aareal's solid capitalization, good liquidity and a diversified funding profile. However, taken together, the bank's weakening fundamentals are more appropriately reflected in a non-investment grade standalone credit assessment in Moody's opinion.

Being an internationally active CRE lending specialist, Aareal is exposed to severe concentration risks in highly cyclical CRE lending; absent meaningful earnings

diversification Moody's considers Aareal to operate a monoline business model. While Aareal targets a considerable 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.

Moody's expects that Aareal's earnings will remain burdened by elevated credit provisions, reflecting rising non-performing loans (NPL) and the bank's proactive measures to reduce problematic exposures, leading to subdued profitability which provides only a limited buffer against downside risks, are no longer commensurate with an investment grade intrinsic strength. Aareal's elevated asset risks are somewhat mitigated by an average loan-to-value of 56% in its performing CRE lending book. Also, with its solid capitalization, a 19.4% phase-in Common Equity Tier 1 (CET1) ratio as of year-end 2023, Aareal has strong buffers available to cope with rising risk-weighted assets because of asset quality deterioration.

While Aareal attracts sizeable and growing deposits and its covered bond franchise enables it to withstand some market dislocation in more confidence-sensitive capital-market funding, Moody's still expects some challenges for the bank to fund at attractive rates, requiring a more opportunistic approach for its funding strategy.

-- DOWNGRADE OF LONG-TERM RATINGS

The downgrade of Aareal's long-term ratings reflects the downgrade of its BCA and Adjusted BCA, as well as unchanged results from Moody's Advanced Loss Given Failure (LGF) analysis and low government support assumption.

Because of significant volumes of subordinated and junior senior unsecured debt outstanding, Moody's Advanced LGF analysis results in three notches of rating uplift for deposit, senior unsecured and issuer ratings for Aareal. For Aareal's junior senior unsecured program rating, the LGF analysis results in one notch of rating uplift from the bank's ba1 Adjusted BCA.

-- OUTLOOK REMAINS NEGATIVE

The negative outlook on the long-term deposit, issuer and senior unsecured ratings reflects Moody's expectation that the weak economic environment for commercial real estate exposures will likely require the bank to take additional provisions, that will continue to drag on its profitability. Depending on the comprehensive countermeasures taken by the bank, like NPL sales, it may be able to maintain its current rating levels, while sustaining an unchanged liability structure over the 12-18 months outlook horizon.

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

Aareal's ratings could be upgraded in case of an upgrade of its BCA and Adjusted BCA. In addition, the bank's junior senior unsecured program rating may be upgraded

following a significant increase in the volume of lower-ranking bail-in-able liabilities, relative to its tangible banking assets.

Aareal's BCA could be upgraded if the bank manages to achieve a sustained and significantly increased profit contribution from its subsidiary, Aareon AG, such that Moody's would not consider the bank to operate a monoline business any longer. Also, the BCA could be upgraded if Aareal achieves a joint improvement of the bank's solvency and liquidity profile.

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

Aareal's BCA could be downgraded in case the bank fails to sustain its current financial profile, for example in case of a further significant deterioration in asset quality or in case of unexpected funding challenges.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks Methodology published in March 2024 and available at <https://ratings.moodys.com/rmc-documents/409852>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of this methodology.

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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 on <https://ratings.moodys.com/rating-definitions>.

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