Research Update:

Deutsche Pfandbriefbank 'BBB+/A-2' Ratings Affirmed On Ability To Manage CRE Market Challenges; Outlook Stable

October 6, 2023

Overview

- German midsize commercial real estate (CRE) lender Deutsche Pfandbriefbank's (pbb's) robust risk-adjusted capitalization and sufficient pre-provision earnings enable the bank to cope with the impact of adverse structural changes in CRE markets, in our view.
- We continue to expect that pbb will maintain a large additional loss absorbing capacity (ALAC) buffer and that the Single Resolution Board's (SRB's) preferred resolution strategy for the bank would prioritize the maintenance of full and timely payment to senior preferred creditors.
- We therefore affirmed our 'BBB+/A-2' long- and short-term issuer credit ratings and our 'A-/A-2' long- and short-term resolution counterparty ratings on pbb.
- The stable outlook reflects our view that pbb's solid balance sheet and longstanding cautious approach to credit underwriting solidly position the bank to weather difficult CRE markets.

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Rating Action

On Oct. 6, 2023, S&P Global Ratings affirmed its 'BBB+/A-2' long- and short-term issuer credit ratings on Germany-based Deutsche Pfandbriefbank AG (pbb). The outlook is stable. We also affirmed our 'A-/A-2' long- and short-term resolution counterparty ratings on the bank.

Rationale

We assume pbb will maintain high risk-adjusted capital (RAC) buffers and that manageable risk cost increases support pbb's stand-alone creditworthiness amid persisting CRE challenges. We forecast pbb's RAC ratio will stay strong at 12.0%-13.0% until 2025, after 13.3% at end-2022. This, in our view, should help to mitigate pbb's very high concentration risks in an increasingly difficult CRE market; we consider the secondary effects from the Russia-Ukraine war as well as structural changes in the office sector related to the COVID-19 pandemic. We anticipate about 6%

pre-tax returns on average common equity in 2025 and a meager 4%-5% for the full 2023, which is on par with mid-year 2023 results, versus 6.0% at end-2022. pbb's slow net interest income improvements--in sharp contrast to larger, more diversified retail-deposit-driven universal banks--mainly reflects pbb's wholesale business model structurally benefiting less in the near term from the material interest rate increases and related deposit margin improvements since 2022. We forecast ongoing assets margin improvements on pbb's new CRE loans, but effects on portfolio margins take time due to its longer average term structure of four to five years, alongside muted new business in difficult markets.

Single, but meaningful, defaults may still occur given pbb's geographically diversified but relatively large-ticket CRE financings with sizeable existing office and retail exposures. We project our nonperforming loans (NPLs) ratio for pbb will remain elevated at 2.5%-3.5% of total loans, from 2.8% mid-2023, and 2.2% end-2022. We continue to anticipate difficult CRE market conditions into early 2024, particularly in office, retail, and hotel segments, which comprise about 65% of pbb's real estate finance portfolio. This is particularly relevant in secondary locations, where a likely increase in average vacancy rates could weigh further on market valuations. This comes on top of reduced debt-servicing capacity for some clients due to quickly rising interest rates. Nonetheless, we view positively that pbb's new loan loss provisions to average customer loans stood at a relatively low 11 basis points (bps) on June 30, 2023, same as in 2022; this is an improvement from the peak during the pandemic of 31 bps. The improvement highlights the bank's asset quality resilience, based on sound proactive risk management and solid, highly collateralized prudent underwriting. Moreover, we recognize pbb's proactivity in setting aside high loan loss reserves and management overlay buffers since 2020 in view of deteriorating CRE markets, and that pbb has no direct exposure to Russia or Ukraine.

We continue to expect that pbb, if it failed, would be subject to a resolution action that prioritizes the maintenance of full and timely payment to senior preferred creditors. We think this scenario is more likely than liquidation and therefore we continue to include one notch for ALAC uplift above the 'bbb' stand-alone credit profile (SACP). In our view, the authorities' first choice would be to try and sell the entire business, with a second option to recapitalize the bank through an open bank bail-in. We expect that pbb will maintain a sizable buffer of ALAC to S&P Global Ratings' risk-weighted assets (RWA) of 7%-9% by year-end 2025, compared with 9.7% on Dec. 31, 2022. We include one ALAC notch in the long-term issuer credit rating on pbb rather than the two notches common for banks with ALAC ratios comfortably above 6%. This considers pbb's nuanced case in terms of resolution measures to ensure continuity of its operations, and comes in light of its overall creditworthiness relative to higher-rated banks (see "Deutsche Pfandbriefbank 'BBB+/A-2' Ratings Affirmed On Confidence In Resolution Strategy, Capital Buffer; Outlook Stable, published Nov. 29, 2022, on RatingsDirect).

Outlook

The stable outlook reflects our expectation that pbb will maintain solid going- and gone-concern capital buffers and manageable risk cost in the next two years, thereby weathering difficult CRE markets. This is indicated, for example, by our forecast of a sustained RAC ratio well above our 10% threshold and its ALAC ratio above 6% of S&P Global Ratings' RWAs. The outlook remains underpinned by ongoing sound underwriting standards as well as our assumption of a meaningful portion of the exposure remaining within Germany.

Downside scenario

We could lower the issuer credit ratings if we have to materially revise down our capital projection for pbb or anticipate far weaker loan portfolio quality. For example, high loan loss impairments indicating weaker-than-anticipated asset quality resilience compared with peers, or aggressive business growth, might bring the RAC ratio below the 10% threshold. We could consider lowering pbb's hybrid rating only if we see a weakening of pbb's SACP, indicated for example by a surge in credit cost or sustained softer profitability than that of peers at the same rating level. Such a case might not necessarily prompt us to take a rating action on the bank's ICR and related senior unsecured debt if we were to grant pbb's two notches of ALAC support based on seeing more certainty around pbb's resolution story and ALAC levels comfortably above 6%.

Upside scenario

Given the very difficult CRE environment, we consider an upgrade very unlikely over the coming 24 months. We could upgrade pbb if it maintains its ALAC ratio well above 6% and we have greater certainty that resolution strategies for the bank, in case of failure, would support full and timely payment to senior preferred creditors under all foreseeable circumstances. This could lead us to add a second ALAC notch to the long-term issuer credit rating if at the same time we have greater confidence in our assessment of pbb's SACP. A positive reassessment of the 'bbb' SACP including upgrading its related hybrids and pbb's ICR ratings are unlikely amid the current operating challenges.

Ratings Score Snapshot

Issuer Credit Rating	BBB+/Stable/A-2
SACP	bbb
Anchor	bbb+
Business position	Constrained (-2)
Capital and earnings	Strong (+1)
Risk position	Moderate (-1)
Funding and liquidity	Adequate and adequate (0)
Comparable ratings analysis	1
Support	1
ALAC support	1
GRE support	0
Group support	0
Sovereign support	0
Additional factors	0

SACP--Stand-alone credit profile.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed	
Deutsche Pfandbriefbank AG	
Issuer Credit Rating	BBB+/Stable/A-2
Resolution Counterparty Rating	A-/--/A-2
Deutsche Pfandbriefbank AG	
Senior Unsecured	BBB+
Senior Subordinated	BBB-
Subordinated	BB+
Junior Subordinated	BB-
Commercial Paper	A-2