Research Update:

Deutsche Pfandbriefbank Ratings Lowered To 'BBB' On Risk Cost Acceleration In Difficult CRE Markets; Outlook Negative

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Overview

- We have revised down our base-case earnings projections for German midsize commercial real estate (CRE) lender Deutsche Pfandbriefbank (PBB) after it announced materially higher--albeit manageable--risk costs in the third quarter of 2023.
- PBB's high risk-adjusted capitalization and preprovision earnings are key mitigants to heightened risks and uncertainty in CRE markets.
- We lowered our long-term issuer credit ratings on PBB to 'BBB' from 'BBB+' and our long-term resolution counterparty ratings to 'BBB+' from 'A-', while affirming our 'A-2' short-term ratings.
- The outlook is negative because we see a risk that deteriorating CRE markets, particularly in the U.S., could further increase the risk cost in PBB's highly concentrated CRE portfolio beyond our base case in the next two years.

Rating Action

On Nov. 17, 2023, S&P Global Ratings lowered its long-term issuer credit ratings on Germany-based Deutsche Pfandbriefbank AG (PBB) to 'BBB' from 'BBB+'. The outlook is negative. We also lowered our long-term resolution counterparty ratings on PBB to 'BBB+' from 'A-'.

We affirmed our 'A-2' short-term issuer credit ratings and resolution counterparty ratings on the bank.

In a related rating action, we lowered by one notch all our ratings on PBB's instruments, including senior unsecured, senior subordinated, and other hybrid issues.

Rationale

Our rating actions reflect PBB's elevated loan loss provisions and non-performing loans in difficult CRE markets. PBB's nine-month 2023 results, published Nov. 14, 2023, showed an increase in nonperforming loans (NPLs) to €1.3 billion, from €1.1 billion for the first six months of the year, owing to materially worsened CRE markets, particularly in the U.S. This followed PBB's announcement on Nov. 7 that its risk costs had soared to €104 million in the first nine months of 2023 from €21 million in the first six months. As a result, PBB also revised down its profit-before-tax guidance to €90 million-€110 million for full-year 2023, from €170 million-€200 million previously.

We have revised our assessment of PBB's stand-alone credit profile (SACP) to 'bbb-' from 'bbb'. This is because we believe PBB's intrinsic strengths are no longer better than those of similarly rated peers, particularly with regards to earnings stability, risk costs, and asset quality. We project that PBB's nonperforming loans (NPLs) ratio may deteriorate further to 4.1% of total loans in 2023 from 3.3% in the third quarter, and 2.2% at year-end 2022. We anticipate difficult CRE market conditions will continue through midyear 2024, particularly in the office, retail, and hotel segments, which comprise about 65% of PBB's total real estate finance portfolio, and particularly in the U.S., which represents 15% of its total CRE 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 the reduced debt-servicing capacity of some clients due to quickly rising interest rates. We forecast PBB's net new loan loss provisions could average about 45 basis points (bps) of customer loans in 2023, up from a very low 11 bps in 2022 and as of June 30, 2023. We consider such elevated loan loss levels generally manageable, considering PBB's relatively large CRE financings in currently very difficult market conditions. This supports our view that PBB's asset quality generally benefits from its geographic and property type diversifications, and highly collateralized underwriting.

We forecast that revenue can cover risk cost increases and risk-adjusted capital (RAC) buffers to remain strong. In our base case, we forecast PBB's RAC ratio will remain a still-strong 12%-13% until 2025, after 13.3% at year-end 2022. This, in our view, should help mitigate PBB's very high concentration risks in an increasingly difficult CRE market. In this context, we consider the secondary effects from the Russia-Ukraine war, as well as ongoing structural changes in the office sector related to consequences of the COVID-19 pandemic. Following recent developments, we anticipate a pre-tax return on average common equity of only about 2.5% for full-year 2023, versus 6.0% at end-2022, before recovering to 5%-6% in 2025. PBB shows slow net interest income improvement, in sharp contrast to that of larger, more diversified retail-deposit-led universal banks. This mainly reflects PBB's wholesale business model, which have structurally benefited less from materially higher interest rates and related deposit-margin improvements since 2022. We forecast ongoing margin improvements on PBB's new CRE loan underwritings, but stronger portfolio margins will take time due to relatively long average loan terms of four to five years, alongside muted new business in difficult markets.

We continue to expect that, in a stress scenario, PBB would be subject to a resolution action that prioritizes full and timely payment to senior preferred creditors. We think this scenario is more likely than liquidation and therefore continue to add one notch of uplift for additional loss-absorbing capacity (ALAC) to the 'bbb-' SACP assessment. We expect PBB can maintain a sizable ALAC buffer equivalent to 7%-9% to S&P Global Ratings' risk-weighted assets (RWA) 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.

Outlook

The negative outlook reflects our view of the risk that deteriorating CRE markets, particularly in the U.S., could further increase PBB's risk cost in its highly concentrated CRE portfolio beyond our base case expectations in the next two years. We currently forecast that PBB will remain reasonably profitable and maintain its high capitalization, thereby sufficiently weathering difficult CRE markets. This is indicated, for example, by our forecast of our RAC ratio staying well above 10% and the ALAC ratio above 6% of S&P Global Ratings' RWAs.

Downside scenario

We could lower our ratings over the next two years if CRE markets remain challenging for an extended period and further weaken PBB's loan portfolio quality and capital position. This could happen, for example, if loan loss impairments were to increase significantly, causing material annual losses, indicating accelerated poor asset quality.

Upside scenario

We could revise our rating outlook to stable over the next two years if PBB remains solidly profitable and demonstrated that its asset quality can remain resilient to the difficult CRE market environment. Currently, outside our base-case expectations, we could upgrade PBB and related senior unsecured debt if the bank keeps 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.

Ratings Score Snapshot

	To	**From**
Issuer Credit Rating	**BBB/Negative/A-2**	**BBB+/Stable/A-2**
SACP	bbb-	bbb
Anchor	bbb+	bbb+
Business position	Constrained (-2)	Constrained (-2)
Capital and earnings	Strong (+1)	Strong (+1)
Risk position	Moderate (-1)	Moderate (-1)
Funding and liquidity	Adequate and adequate (0)	Adequate and adequate (0)
Comparable ratings analysis	+0	+1
Support	+1	+1

	To	From
Issuer Credit Rating	**BBB/Negative/A-2**	**BBB+/Stable/A-2**
ALAC support	+1	+1
GRE support	0	0
Group support	0	0
Sovereign support	0	0
Additional factors	0	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

Downgraded; Outlook Action

	To	From
Deutsche Pfandbriefbank AG		
Issuer Credit Rating	BBB/Negative/A-2	BBB+/Stable/A-2
Resolution Counterparty Rating	BBB+/--/A-2	A-/--/A-2

Downgraded

	To	From
Deutsche Pfandbriefbank AG		
Senior Unsecured	BBB	BBB+
Senior Subordinated	BB+	BBB-
Subordinated	BB	BB+
Junior Subordinated	B+	BB-

Ratings Affirmed

Deutsche Pfandbriefbank AG	
Commercial Paper	A-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.