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Ratings

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Research Update:

Deutsche Pfandbriefbank Downgraded To 'BBB-/A-3' On Challenges From Commercial Real Estate; Outlook Negative

February 14, 2024

Overview

- Deutsche Pfandbriefbank AG's (pbb's) strong risk-adjusted capitalization, solid pre-provision earnings, and material term funding should keep the bank moderately profitable in 2024.
- However, pbb's risk position is constrained, in our view, due to protracted asset quality pressure from the structural shift in commercial real estate (CRE) markets, particularly in the U.S.
- We therefore lowered our long- and short-term issuer credit ratings to 'BBB-/A-3' from 'BBB/A-2' and our long-term resolution counterparty ratings on pbb to 'BBB' from 'BBB+'.
- The negative outlook reflects our view that weak CRE markets, notably in the U.S., could increase the cost of risk in pbb's highly concentrated loan portfolio beyond our base-case expectation.

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Rating Action

On Feb. 14, 2024, S&P Global Ratings lowered its long- and short-term issuer credit ratings to 'BBB-/A-3' from 'BBB/A-2' on Germany-based Deutsche Pfandbriefbank AG (pbb). The outlook is negative. We also lowered our long-term resolution counterparty ratings on pbb to 'BBB' from 'BBB+'. We affirmed our 'A-2' short-term resolution counterparty ratings on the bank.

At the same time, we lowered our issue ratings on pbb's senior unsecured debt by one notch. In addition, we lowered by two notches our ratings on pbb's hybrid instruments, including the senior subordinated notes.

Rationale

The downgrade captures on the protracted pressure from CRE markets on pbb's asset quality. pbb has significant concentration in CRE financing, where there have been material structural changes, particularly in the office and retail segments. We expect that pbb's nonperforming loan (NPL) ratio deteriorated to about 3.9% of total loans at year-end 2023, from 3.4% in third-quarter 2023 and 2.2% at year-end 2022. We anticipate difficult CRE market conditions will persist through 2024, notably in the U.S.--which represents roughly 15% of pbb's total CRE portfolio--and Germany. This prompted us to negatively reassess the bank's risk position.

Our base-case expectation is that pbb will remain moderately profitable. The bank earned a pre-tax profit of €90 million last year, according to its preliminary 2023 results shared on Feb. 7, 2024. Its €210 million-€215 million loan loss provisions for the full year increased materially, representing about 55 basis points (bps) of customer loans, coming in worse than our earlier 40-50 bps projection. The increase predominantly reflects a management overlay in anticipation of ongoing difficulties in U.S. CRE markets. Although this benefits pbb's 2024 risk costs, it shows that CRE markets are likely to remain very difficult. Our base-case expectation is that pbb's 2024 earnings will strengthen moderately from the 2023 outcome amid potentially brewing risks.

pbb's material term funding base lowers its 2024 issuance needs. The bank's 212% liquidity coverage ratio (LCR) at year-end 2023 was more than double the minimum regulatory requirement, as the bank disclosed on Feb. 8, 2024. According to pbb, this liquidity cushion enables the bank to operate for more than six months without new capital market funding. Covered bonds represent 50%-60% of pbb's funding base, and a large majority of its retail deposits is fixed-term balances. pbb does not plan to issue senior unsecured debt this year, and its secured refinancing requirement is also largely covered for 2024. We consider pbb's liquidity stress testing capabilities to be adequate, and we think the bank has a good track record of funding and liquidity management.

pbb's capitalization underpins its credit quality. We forecast a strong 12%-13% risk-adjusted capital (RAC) ratio through year-end 2025, after 13.3% at year-end 2022. Such robust capital levels help to mitigate pbb's concentration in the CRE market. Although we continue to expect that pbb's pre-provision earnings will continue to cover its elevated risk costs, its meagre 2.5% return on equity (RoE) for 2023 already indicates the limited leeway.

We continue to think pbb would be subject to a resolution action that prioritizes full and timely payment to senior preferred creditors. This leads to a one-notch uplift for additional loss-absorbing capacity (ALAC) to our 'bb+' assessment of pbb's stand-alone credit profile (SACP). We continue to think this kind of resolution action is more likely than liquidation and assume that the authorities' first choice would be to try to sell the entire business. Recapitalizing the bank through a bail-in would be the second option. Our expectation that pbb will maintain a sizable ALAC buffer remains unchanged; we project a buffer equivalent to 7%-9% of S&P Global Ratings' risk-weighted assets (RWA) through year-end 2025, compared with 9.7% at year-end 2022.

Our two-notch downgrade of pbb's hybrid instruments reflects increased subordination risk. Under our standard notching approach, we deduct two notches rather than one for subordination risk when the SACP is below 'bbb-'.

Outlook

The negative outlook indicates our view that weak CRE markets, especially in the U.S., could increase pbb's cost of risk in its highly concentrated CRE portfolio beyond our base-case expectation in the next two years. The negative outlook also reflects heightened risk from deteriorated investor confidence on pbb's monoline business model and predominantly wholesale funding structure. Mitigating some of the risk is our forecast that pbb will remain profitable and maintain its high capitalization, with 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 erode pbb's asset quality and capital position. We could also lower the ratings if restricted capital market access weakens its wholesale-driven funding model.

Upside scenario

We could revise the outlook to stable in the next two years if pbb sustains solid profitability and its asset quality remains resilient to CRE market challenges.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB-/Negative/A-3	BBB/Negative/A-2
SACP	bb+	bbb-
Anchor	bbb+	bbb+
Business position	Constrained (-2)	Constrained (-2)
Capital and earnings	Strong (+1)	Strong (+1)
Risk position	Constrained (-2)	Moderate (-1)
Funding and liquidity	Adequate and adequate (0)	Adequate and adequate (0)
Comparable ratings analysis	0	0
Support	+1	+1
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 | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, 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

Related Research

- Deutsche Pfandbriefbank AG, Jan. 23, 2024
- Research Update: Deutsche Pfandbriefbank Ratings Lowered To 'BBB' On Risk Cost Acceleration In Difficult CRE Markets; Outlook Negative, Nov. 17, 2023
- Research Update: Deutsche Pfandbriefbank 'BBB+/A-2' Ratings Affirmed On Ability To Manage CRE Market Challenges; Outlook Stable, Oct. 6, 2023
- Banking Industry Country Risk Assessment: Germany, June 6, 2023
- Bulletin: Deutsche Pfandbriefbank AG's Strategic Step Into Asset Management Could Improve Earnings But Comes With Risk, Dec. 21, 2022

Ratings List

Downgraded

	To	From
Deutsche Pfandbriefbank AG		
Issuer Credit Rating	BBB-/Negative/A-3	BBB/Negative/A-2
Senior Unsecured	BBB-	BBB
Senior Subordinated	BB-	BB+
Subordinated	B+	BB
Junior Subordinated	B-	B+
Commercial Paper	A-3	A-2

Downgraded; Ratings Affirmed

	To	From
Deutsche Pfandbriefbank AG		
Resolution Counterparty Rating	BBB/--/A-2	BBB+/--/A-2