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Research Update:

German Deutsche Pfandbriefbank Upgraded To 'A-' On Higher ALAC Buffer; Outlook Neg; Sr Sub Debt Cut To 'BBB-'

Primary Credit Analyst:

Harm Semder, Frankfurt (49) 69-33-999-158; harm.semder@spglobal.com

Secondary Contact:

Benjamin Heinrich, Frankfurt +49 (0) 69 33999 167; benjamin.heinrich@spglobal.com

Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria

Related Research

Ratings List

Research Update:

German Deutsche Pfandbriefbank Upgraded To 'A-' On Higher ALAC Buffer; Outlook Neg; Sr Sub Debt Cut To 'BBB-'

Overview

- A recent retroactive German law change has very significantly increased Deutsche Pfandbriefbank's (PBB) additional loss-absorbing capacity buffer, protecting more-senior creditors in a resolution scenario.
- We are therefore raising our long-term counterparty credit rating on PBB to 'A-' from 'BBB' and affirming our 'A-2' short-term rating.
- We are raising to 'A-' from 'BBB' the issue ratings on PBB's instruments that we continue to view as senior unsecured debt under the new law, and lowering to 'BBB-' from 'BBB' our issue ratings on its instruments that we have reclassified as senior subordinated debt.
- The negative outlook on PBB mainly reflects our view that we might lower our ratings if economic risks in Germany worsen within the next two years and hurt the bank's earnings and asset quality.

Rating Action

On March 28, 2017, S&P Global Ratings raised its long-term counterparty credit rating on Deutsche Pfandbriefbank AG (PBB) to 'A-' from 'BBB'. We removed this rating from CreditWatch, where we placed it with positive implications on Dec. 15, 2016 (see "Four German Banks On Watch Positive, Various Banks' Snr Unsecured Debt On Watch Developing Or Neg, Pending Notes Review," on RatingsDirect). The outlook is negative. We affirmed our 'A-2' short-term counterparty credit rating on the bank.

At the same time, we lowered the long-term issue ratings on PBB's instruments that we reclassified as senior subordinated under Germany's new law to 'BBB-' from 'BBB'. Furthermore, we raised our long-term issue ratings on PBB's instruments that we continue to assess as senior unsecured to 'A-' from 'BBB'. We removed all of these issue ratings from CreditWatch, where we placed them with developing implications on Dec. 15, 2016.

Rationale

The upgrade of PBB reflects the substantial boost to the bank's buffer of additional loss-absorbing capacity (ALAC), after accounting for standard term debt reclassified as senior subordinated instruments under the German law that was introduced in January 2017 with retroactive effect. The authorities' action was negative for those instruments, since they could well be bailed-in

in a resolution scenario. However, the buffer that they create would likely help PBB in servicing its senior unsecured debt and pari passu liabilities if the bank fails. Our action also acknowledges the progress that management has made in restructuring PBB. While the bank remains narrowly focused on the commercial real estate (CRE) sector, we now see its asset quality as solid and note the geographic diversity of its loan book. While the bank targets only moderate shareholder returns (about a 6% return on equity), its profitability appears likely to remain subpar through end-2018, despite its satisfactory efficiency, due to low interest rates and the low-activity environment. We also see some vulnerability if the economic environment in Germany deteriorates.

We revised our assessment of PBB's group credit profile (GCP) to 'a-', two notches higher than its 'bbb' stand-alone credit profile (SACP), because we estimate the ratio of the bank's ALAC to S&P Global Ratings' risk-weighted assets at about 26% (pro forma the add-on for senior subordinated instruments) at end-2016, and we expect it will remain far above the 8% threshold for a two-notch uplift. Specifically, we forecast that the bank will maintain this ALAC buffer well above 15% over the next two years. This forecast takes into account PBB's Tier 1 and Tier 2 issuance plans, senior subordinated instruments and respective maturities, and our forecast of a gradual rise in the bank's risk-adjusted capital (RAC) ratio. However, we expect that the ALAC buffer could fall through this period for two reasons:

- We believe the bank will have a smaller surplus in its total adjusted capital as a component of the ALAC buffer, since the bank's RAC ratio is modestly above our 10% minimum for a strong capital assessment.
- Depending on where the regulators set the bank's minimum requirement on own funds and eligible liabilities, it is possible that the bank may replace some maturing senior subordinated debt with senior unsecured debt. This would require a change in the law to enable such issuance, however.

Our assessment of PBB's SACP remains unchanged at 'bbb', reflecting our view that, as one of the largest CRE lenders in Germany, the bank is concentrated in cyclical wholesale business and more vulnerable to industry risks than our German industry risk score of '3' indicates. Given the bank's business profile, we expect the bank's RAC ratio before diversification effects--our measure for capital adequacy--will only gradually increase to about 11% by year-end 2018 from about 10% at year-end 2016. This is in contrast to the bank's Basel III fully phased in CET1 ratio, which was 19% at end-2016. Despite high sector concentrations, which are intrinsic to PBB's business, we believe the bank's management has a prudent moderate growth strategy that is limited to core products and regions, with a focus on the typically lower-risk covered bond-eligible business.

We have now reviewed the terms and conditions for PBB's rated senior unsecured issuances and reclassified some of them as senior subordinated debt as appropriate. The 'BBB-' issue ratings on the senior subordinated debt are one notch below the SACP, reflecting their status as bail-in instruments. These senior subordinated bonds consist of standard, long-term fixed or floating

rate notes.

The 'A-' issue ratings on instruments that we continue to regard as senior unsecured debt remain in line with our counterparty credit rating on PBB. PBB's senior unsecured instruments primarily comprise structured notes and our understanding is that they continue to rank alongside liabilities, such as corporate and institutional deposits and short-term money market instruments.

Outlook

The negative outlook reflects that we might lower our ratings in the next two years if economic risks in Germany worsen. We currently ascribe a negative economic risk trend to our assessment of the German banking system, due to the potential for higher-than-anticipated credit expansion, and house price increases.

If German economic risk increases, we would likely revise downward our assessment of PBB's anchor to 'bbb+' from 'a-'. This would reflect our view that PBB's asset quality could weaken and may exert pressure on its low earnings performance, compared to other banks in our 'A-' rating category. Moreover, our negative outlook reflects the risk that the bank may fail to sustain a RAC ratio above the 10% threshold that supports our strong assessment of its capital and earnings, particularly if PBB were to follow a higher-than-expected credit expansion in a worsening economic cycle. Although a weakening of German economic conditions might challenge both these assessments, we currently see downside risk to the SACP and rating as limited to one notch at most.

We could revise the outlook to stable if we considered the economic risk trend for the German banking industry had stabilized, or, alternatively, if we see material improvements in PBB's earnings and capital position that would mitigate the negative economic trend. Furthermore, a revision of the outlook to stable would be supported by PBB maintaining a very substantial ALAC buffer in the coming years, underpinning the respective two-notch uplift in the rating.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	A-/Negative/A-2	BBB/Watch Pos/A-2
SACP	bbb	bbb
Anchor	a-	a-
Business Position	Weak (-2)	Weak (-2)
Capital and Earnings	Strong (+1)	Strong (+1)
Risk Position	Moderate (-1)	Moderate (-1)
Funding and	Average and	Average and

Liquidity	Adequate (0)	Adequate(0)
Support	+2	0
ALAC Support	+2	0
GRE Support	0	0
Group Support	0	0
Sovereign Support	0	0
Additional Factors	0	0

Related Criteria

- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 01, 2016
- Criteria - Financial Institutions - Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Assessing Bank Branch Creditworthiness, Oct. 14, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 06, 2010
- Criteria - Financial Institutions - Banks: Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 04, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- Various Rating Actions Taken On Four Systemically Important German Banks

On Improved Loss-Absorbing Capacity, March 28, 2017

- Various German Banks' Snr Unsecured Debt Lowered/Affirmed After Notes Review; Off Watch; Four Banks Remain On Watch, Feb. 9, 2017
- Four German Banks On Watch Positive, Various Banks' Snr Unsecured Debt On Watch Developing Or Neg, Pending Notes Review, Dec. 15, 2016

Ratings List

Upgraded; CreditWatch Action; Rating Affirmed

	To	From
Deutsche Pfandbriefbank AG Counterparty Credit Rating	A-/Negative/A-2	BBB/Watch Pos/A-2

Upgraded; CreditWatch Action

	To	From
Deutsche Pfandbriefbank AG Senior Unsecured	A-	BBB/Watch Dev

Downgraded; CreditWatch Action

	To	From
Deutsche Pfandbriefbank AG Subordinated [1]	BBB-	BBB/Watch Dev

Ratings Affirmed

Deutsche Pfandbriefbank AG Subordinated	BB+
Commercial Paper	A-2

Hypo Real Estate International Trust I Preferred Stock [2]	BB-
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[1]Previously rated as senior unsecured.

[2]Guaranteed by Deutsche Pfandbriefbank AG.

Additional Contact:

Financial Institutions Ratings Europe; FIG_Europe@spglobal.com

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