

Research Update:

Deutsche Pfandbriefbank 'A-' Rating Placed On CreditWatch Negative On Resolution Strategy Uncertainty

September 15, 2020

Overview

- We consider it likely that the Single Resolution Board (SRB) has changed its stance on the preferred resolution strategy for a number of banks under its remit, including Deutsche Pfandbriefbank (pbb).
- pbb has a business franchise focused on international commercial real estate lending funded through covered bonds. We think pbb's importance to financial stability and functioning of the economy is rather limited, which, in our view, reduces the likelihood of pbb benefitting from a bail-in-led resolution if it were to fail.
- We are therefore placing our 'A-' long-term issuer credit ratings as well as our 'A/A-1' long- and short-term resolution counterparty ratings on pbb on CreditWatch with negative implications
- The CreditWatch placement reflects that we may decide to no longer include two notches of uplift for additional loss-absorbing capacity (ALAC) in our ratings on pbb, which would result in a downgrade to 'BBB'. We intend to resolve the CreditWatch within the next three months, following our review of the consequences of this potential change in regulatory stance.

Rating Action

On Sept. 15, 2020, S&P Global Ratings placed its 'A-' long-term issuer credit rating and 'A/A-1' long- and short-term resolution counterparty ratings on Deutsche Pfandbriefbank AG on CreditWatch with negative implications.

At the same time, we placed on CreditWatch negative our 'A-' long-term issue ratings on pbb's senior unsecured debt.

We affirmed our 'A-2' short-term issuer credit rating on the bank.

We also affirmed all issue ratings on the bank's hybrid instruments, including its senior nonpreferred debt.

PRIMARY CREDIT ANALYST

Benjamin Heinrich, CFA, FRM

Frankfurt

+ 49 693 399 9167

benjamin.heinrich
@spglobal.com

SECONDARY CONTACT

Harm Semder

Frankfurt

(49) 69-33-999-158

harm.semder
@spglobal.com

ADDITIONAL CONTACT

Michal Selbka

Frankfurt

+49 (0) 69-33999-300

michal.selbka
@spglobal.com

Rationale

We consider it likely that the SRB has changed its preferred resolution strategy for a number of banks under its remit, including pbb. As a result, we consider it possible that the SRB would decide for insolvency proceedings if pbb failed. This diverges from our current base case under which the bank would be subject to a bail-in-led resolution that ensures full and timely payment to all senior preferred creditors.

The SRB reviews regularly and on an event-related basis the preliminary public interest assessment (PIA) for each bank under its remit. The PIA is the key determinant of whether the SRB would likely use resolution powers if that bank fails, and so the preferred resolution strategy and the appropriate bail-in buffer requirement for the bank (also known as the minimum requirement for own funds and eligible liabilities [MREL]). While a bank might be sizeable, the PIA focuses on aspects such as whether the bank provides services that are critical to the functioning of the economy, its reliance on insured deposits, and its interconnectedness with the broader financial system. Banks that do not pass the PIA are likely to be liquidated if they fail.

We recently placed our ratings on pbb's German peer Hamburg Commercial Bank (HCOB) on CreditWatch with negative implications after the SRB lowered its MREL requirement to 6.1% of total liabilities and own funds (TLOF) from 8.4% (see "Hamburg Commercial Bank 'BBB/A-2' Ratings Placed On CreditWatch Negative On Resolution Strategy Uncertainty," published Aug. 27, 2020, on RatingsDirect). We saw this MREL revision as a likely consequence of a revised PIA. While pbb is a larger institution than HCOB (with total assets of €61 billion at end-June 2020), we note strong similarities between them. Both are predominantly wholesale-funded, lending-focused institutions with few insured deposits, and neither provides current accounts or payment services. pbb's franchise is focused on providing lending to the commercial real estate market to a large extent funded by covered bonds.

In line with other issuers, pbb does not publish its MREL requirement, but currently targets at least 8% of TLOF. While it has not announced a significant revision to its MREL, we consider it possible. If so, this suggests that pbb might not benefit from a bail-in-led resolution or a meaningful recapitalization if it were to fail.

If this is the case, we are very likely to remove ALAC uplift in the ratings on pbb. ALAC uplift reflects the existence of a substantial bail-in buffer as well as our view that the associated resolution strategy would likely ensure full and timely payment on the bank's senior preferred obligations.

We will review pbb's ALAC eligibility and any implications from a potential change in the regulatory stance over the coming weeks. We acknowledge that pbb today has a sizable MREL ratio of about 14% of TLOF, mainly due to a retroactive German law implemented on Jan. 1, 2017, that turned certain long-term standard senior unsecured bonds into subordinated instruments in a resolution and liquidation scenario. This translates into a ratio of the bank's ALAC to S&P Global Ratings' risk-weighted assets of above 20%, and even without any new issuances, it will remain well above our 8% threshold for a two-notch uplift over the next two years. We will consider whether, irrespective of the preliminary PIA, the existence of a high available subordinated buffer could influence the resolution authorities' actions if the bank failed.

Additionally, we will continue to monitor the possible impact on the bank from the current unsupportive economy in Germany and the bank's other main markets, including the U.S. in the wake of COVID-19 (see "Negative Rating Actions Taken On Multiple German Banks On Deepening COVID-19 Downside Risks," published April 23, 2020). In our view, pbb has so far demonstrated resilience against difficult operating conditions in its main markets in Europe and the U.S. In the first six months of 2020, it reported higher net loan loss provisions of €70 million that led to

pre-tax profit declining to €31 million from €117 million one year ago. We expect moderate further loss provisioning over the second half of the year, but not to the extent that it would impair our 'bbb' assessment of pbb's stand-alone credit profile (SACP). However, we also note relatively higher single-name concentrations intrinsic with its business model that could yet lead to material losses. We expect the full extent of credit losses in its commercial real estate portfolio may only materialize in 2021.

In our base case, we expect our risk-adjusted capital (RAC) ratio for the bank will remain comfortably above 10% over the coming two years, also supported by pbb's removal of the dividend proposal in line with the European Central Bank's recommendation. In our view, this provides a further buffer to absorb increases in credit losses.

If we remove the two-notch ALAC uplift in the ratings on pbb, this would result in the long-term issuer credit rating dropping to 'BBB' from 'A-', in line with our 'bbb' assessment of its SACP. We would also lower our ratings on pbb's senior preferred instruments, but not our ratings on its hybrid instruments including senior subordinated debt, since they are derived from the SACP.

CreditWatch

We expect to resolve the CreditWatch within the next three months, once we conclude our review of pbb's ALAC eligibility and any implications from a potential change in the SRB's regulatory stance.

We would very likely lower the 'A-' long-term ratings by two notches to 'BBB' and withdraw the 'A/A-1' resolution counterparty ratings if we conclude that pbb would not be targeted for a bail-in-led resolution that ensures full and timely payment to all senior preferred creditors.

We would affirm the current ratings if we conclude that a bail-in-led resolution is the most likely scenario if the bank failed.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	A-/Watch Neg/A-2	A-/Negative/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 (0)	Average and (0)
Liquidity	Adequate	Adequate
Support	(+2)	(+2)
ALAC support	(+2)	(+2)
GRE support	(0)	(0)
Group support	(0)	(0)
Government support	(0)	(0)

	To	From
Additional factors	(0)	(0)

SACP--Stand-alone credit profile. ALAC--Additional loss-absorbing capacity. GRE--Government-related entity.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, April 19, 2018
- 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
- Criteria | Financial Institutions | Banks: Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011

Related Research

- Hamburg Commercial Bank 'BBB/A-2' Ratings Placed On CreditWatch Negative On Resolution Strategy Uncertainty, Aug. 27, 2020
- Negative Rating Actions Taken On Multiple German Banks On Deepening COVID-19 Downside Risks, April 23, 2020

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Deutsche Pfandbriefbank AG		
Issuer Credit Rating	A-/Watch Neg/A-2	A-/Negative/A-2
Resolution Counterparty Rating	A/Watch Neg/A-1	A/--/A-1
Senior Unsecured	A-/Watch Neg	A-
Senior Subordinated	BBB-	
Subordinated	BB+	

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Junior Subordinated	BB-	
Commercial Paper	A-2	

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