S&P Global Ratings

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Research Update:

Deutsche Pfandbriefbank Outlook To Stable From Negative On Resolution Clarity And Sound Performance; Ratings Affirmed

March 18, 2022

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Overview

- We expect that Deutsche Pfandbriefbank AG (pbb) will remain an important issuer in the German covered bond market and that it will be considered a systematically important institution.
- We also see the bank's substantial bail-in buffer requirement as likely consistent with a resolution action that would support substantial recapitalization or else support full and timely payment to senior preferred creditors through the use of other resolution tools.
- We revised our outlook on pbb to stable from negative and affirmed our 'BBB+/A-2' issuer credit ratings and 'A-/A-'2 resolution counterparty ratings.
- In addition, we raised our issue ratings on the bank's hybrid instruments by one notch because we expect pbb to maintain high capital buffers, sound underwriting standards, and stable earnings performance that compare favorably with similarly rated peers.
- The stable outlook reflects less doubt about the protection buffers for the bank's senior preferred obligations at the hypothetical point of nonviability, under our base-case scenario.

Rating Action

On March 18, 2022, S&P Global Ratings revised its Deutsche Pfandbriefbank AG (pbb) outlook to stable from negative and affirmed the 'BBB+/A-2' long- and short-term issuer credit ratings.

We also affirmed our 'A-/A-2' long- and short-term resolution counterparty ratings on the bank.

In addition, we raised all our issue ratings on the bank's hybrid instruments by one notch, including its senior nonpreferred debt.

Rationale

We now consider it quite likely that the preferred resolution strategy for pbb would ensure full and timely payment to all senior preferred creditors. The Single Resolution Board (SRB) conducts regular and event-related reviews of 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 a bank fails, and so informs the SRB's 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]). Although we think pbb undertakes few critical public functions, our assessment is guided in part by the SRB's 2021 revision to its PIA policy, which placed greater weight on the relevance of a bank's failure amid a theoretical systemic stress event. We understand that in its resolution planning, the SRB has concluded that pbb passes the PIA, given its meaningful scale and, most importantly, its role in the German covered bond market--its outstanding Pfandbrief issuances account for about 7% of the total. We therefore consider it quite likely that the SRB would employ a resolution strategy to ensure timely, as well as full, repayment for senior preferred creditors.

Our one-notch rating uplift for additional loss absorbing capacity (ALAC) recognizes the sizeable buffer of protection for senior preferred creditors. We note that the bank publicly states a long-term MREL-ambition level of at least 8% of total liabilities and own funds (TLOF), in line with its binding regulatory target. We assume therefore that the regulator qualifies pbb as a top-tier bank, despite its balance sheet being below €100 billion, and we note that the bank must meet its MREL using only subordinated instruments, which is not the case across the whole European banking sector. This implies the ratio of the bank's ALAC to S&P Global Ratings' risk-weighted assets (RWA) would not fall far below the 11% level that we estimate for Dec. 31, 2021. Indeed, we anticipate the ALAC ratio will vary between 8%-10% by December 2023. This assumes that the bank substantially, but not totally, replaces upcoming larger maturities of senior nonpreferred debt.

We limit our recognition of ALAC support to one notch only. So long as the bank maintains an ALAC ratio comfortably above 6%, we could assign up to two notches of ALAC uplift to our long-term issuer credit rating. Although we ordinarily do this for banks where we have good visibility on the likely use of resolution tools to ensure continuity of operations, we see pbb as a more nuanced case. In part, this reflects that the German Pfandbrief Act already provides strong protection to the covered bond investors comprising 50%-60% of pbb's funding base. Also, we see pbb's passing of the PIA in the resolution planning may prove to be quite borderline in case of a hypothetical fail or likely to fail event, and assume that the ultimate decision about the orderly resolution or liquidation of the bank may only be made at the actual point of nonviability.

We improved our assessment of the bank's standalone credit profile (SACP) to 'bbb' from 'bbb-' because we see this as a better reflection of its strengths relative to peers. In our view, the bank's strong risk-adjusted capital (RAC) buffer should help to mitigate the concentration risks or some level of structural changes in the commercial real estate market. We expect the lending portfolio to remain relatively stable with only a limited increase in past-due exposure toward 2.0%-2.5% of loans being nonperforming by 2024. This should support our RAC ratio remaining at 12%-13% over the next two years, which is one of the higher levels in the German banking sector, if compared with publicly traded peers. We note that pbb capitalized its full 2019 earnings but restarted dividend payments from 2020 profit (€78 million paid by December 2021), in line with its publicly known profit-sharing policy. Our current capitalization forecast already assumes the expected €159 million pay-out on a robust €228 million reported profit for 2021, and the continued normalization of profit distribution through 2024.

We note pbb's lack of direct exposure to Russia or Ukraine.

However, an indirect impact remains possible. S&P Global Ratings acknowledges a high degree of uncertainty about the extent, outcome, and consequences of the military conflict between Russia and Ukraine. Irrespective of the duration of military hostilities, sanctions and related political risks are likely to remain in place for some time. Potential effects could include dislocated commodities markets--notably for oil and gas--supply chain disruptions, inflationary pressures, weaker growth, and capital market volatility. As the situation evolves, we will update our assumptions and estimates accordingly. See our macroeconomic and credit updates here: Russia-Ukraine Macro, Market, & Credit Risks. Note that the timing of publication for rating decisions on European issuers is subject to European regulatory requirements.

Outlook

The stable outlook reflects our view of expected sustainable capitalization buffers maintained by pbb, with the RAC ratio remaining sufficiently above 10% in the next two years. The outlook remains underpinned by sound underwriting standards but also our assumption of a meaningful portion of the exposure remaining within the country risk of Germany. We also assume that the bank will maintain an ALAC ratio above 6%.

Downside scenario

We could downgrade pbb if we revise down our capital projection for the bank or anticipate far weaker loan portfolio quality. For example, high impairments or aggressive business growth might bring the RAC ratio below the 10% threshold.

Upside scenario

We see an upgrade scenario as rather remote for pbb. Nevertheless, in time, we could raise the ratings if either:

- We see the bank's intrinsic credit strength as having improved. For example, this view could be supported by the projected RAC ratio increasing sustainably above 15%, with sustainably improved profitability compared to peers; or
- If we have even greater certainty that a resolution action on the bank, in case of failure, would support full and timely payment to senior preferred creditors, for example, because the evolution of pbb's business profile implies that it is undertaking more functions critical to financial stability.

Environmental, Social, And Governance

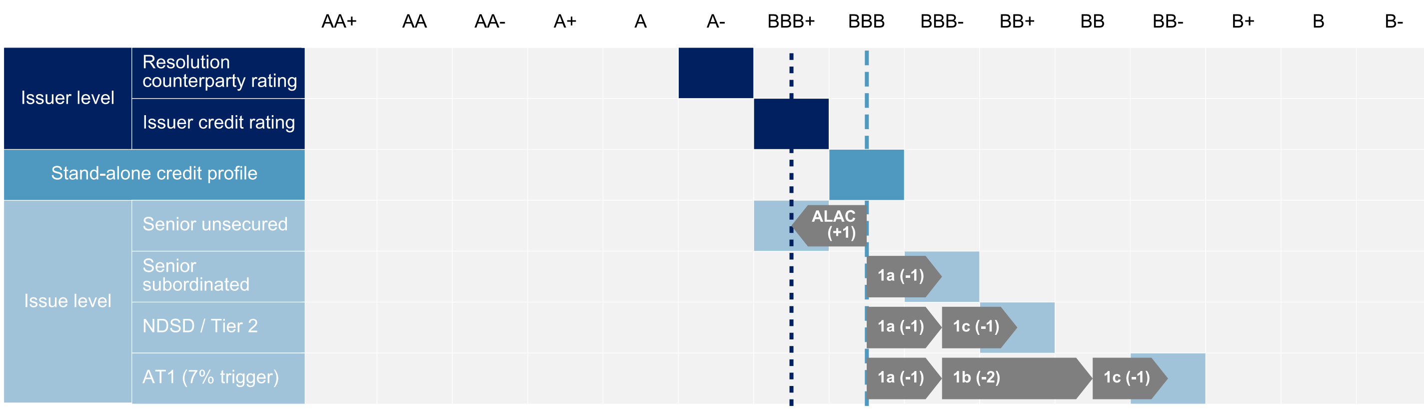
ESG credit indicators: E-2, S-2, G-2

We believe that environmental, social, and governance (ESG) factors for pbb are broadly in line with its industry and domestic peers. We note that the bank has developed green concepts for its own funding instruments and a green lending framework in relation to properties with high environmental standards. We believe that the environmental specifications of buildings have become increasingly important to investors or property tenants. Therefore, reflecting these factors should help to defend rent levels and the market value of the properties in the longer term.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	**BBB+/Stable/A-2**	**BBB+/Negative/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	Adequate	Adequate
Liquidity	Adequate (0)	Adequate (0)
Comparable ratings analysis	+1	0
Support	+1	+2
ALAC support	+1	+2
GRE support	0	0
Group support	0	0
Sovereign support	0	0
Additional factors	0	0
SACP--Stand-alone credit profile.		

Deutsche Pfandbriefbank AG: Notching



Key to notching

- - - Stand-alone credit profile

- - - - Issuer credit rating

ALAC Additional loss-absorbing capacity buffer

1a Contractual subordination

1b Discretionary or mandatory nonpayment clause and whether the regulator classifies it as regulatory capital

1c Mandatory contingent capital clause or equivalent

Note: The number-letter labels in the table above are in reference to the notching steps we apply to hybrid capital instruments, as detailed in table 3 of our "Hybrid Capital: Methodology And Assumptions" criteria, published on July 1, 2019.
AT1--Additional Tier 1. NDSD--Non-deferrable subordinated debt.

Related Criteria

- 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
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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

- German Bank Ratings Affirmed Under Revised Financial Institutions Criteria, Jan. 28, 2022
- Deutsche Pfandbriefbank AG, Oct. 14, 2021
- Banking Industry Country Risk Assessment: Germany, Oct. 5, 2021
- Various German Banks Downgraded On Persistent Profitability Challenges And Slow Digitalization Progress, June 24, 2021
- Germany 'AAA/A-1+' Ratings Affirmed; Outlook Stable, March 26, 2021
- Hamburg Commercial Bank AG And Deutsche Pfandbriefbank AG Ratings Removed From CreditWatch Negative And Affirmed, Dec. 15, 2020

Ratings List

Ratings Affirmed		
Deutsche Pfandbriefbank AG		
Resolution Counterparty Rating	A-/--/A-2	
Deutsche Pfandbriefbank AG		
Senior Unsecured	BBB+	
Commercial Paper	A-2	
Ratings Affirmed; Outlook Action		
	To	**From**
Deutsche Pfandbriefbank AG		
Issuer Credit Rating	BBB+/Stable/A-2	BBB+/Negative/A-2
Upgraded		
	To	**From**
Deutsche Pfandbriefbank AG		
Senior Subordinated	BBB-	BB+
Subordinated	BB+	BB
Junior Subordinated	BB-	B+

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.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914