Research Update:

Deutsche Pfandbriefbank 'BBB-/A-3' Ratings Affirmed On Strategic Update; Outlook Still Negative On Asset Quality Risk

October 14, 2024

PRIMARY CREDIT ANALYST

Benjamin Heinrich, CFA, FRM
Frankfurt
+49 69 33999 167
benjamin.heinrich
@spglobal.com

SECONDARY CONTACTS

Heiko Verhaag, CFA, FRM
Frankfurt
+49 69 33999 215
heiko.verhaag
@spglobal.com

Harm Semder
Frankfurt
+49 69 33999 158
harm.semder
@spglobal.com

Overview

- On Oct. 10, 2024, German lender Deutsche Pfandbriefbank (pbb) announced that it was adjusting its commercial real estate (CRE)-centric business model to sustainably improve profitability and diversification.
- We think this could improve its resilience if executed successfully, but we see the prospects for success as sensitive to conditions outside management's control, with the main risk to pbb's credit profile being higher credit losses amid continued difficult CRE markets.
- We affirmed our 'BBB-/A-3' long- and short-term issuer credit ratings on pbb because we do not expect any immediate impact on its credit profile following the announcement.
- The outlook remains negative and reflects our view that weak CRE markets, notably in the U.S., could increase the credit losses in pbb's highly concentrated loan portfolio beyond our base-case expectation.

Rating Action

On Oct. 14, 2024, S&P Global Ratings affirmed its 'BBB-/A-3' long- and short-term issuer credit ratings on Germany-based Deutsche Pfandbriefbank AG (pbb). The outlook remains negative.

We also affirmed our 'BBB/A-2' long- and short-term resolution counterparty ratings on pbb. At the same time, we affirmed all issue ratings.

Rationale

We do not expect any immediate impact on pbb's credit profile. On Oct. 10, 2024, pbb announced adjustments to its commercial real estate (CRE)-centric business model and the goal of achieving a pre-tax return on tangible equity of 8% by 2027, while targeting a reduction in concentration risks and dependence on interest income. The measures include ending the loss-making U.S. West Coast business, adjusting the property mix away from office buildings toward higher-demand property types including data centers, and building up the asset management and brokerage business linked to pbb's proven expertise in CRE financing. If successful, improved structural profitability and a higher share of fee income could benefit its resilience and its ability to absorb credit losses from its lending portfolio over the medium term. However, we believe prospects for success remain highly sensitive to conditions beyond management's control, notably interest rates, the recovery of CRE markets, and also pbb's own market perception. We don't anticipate any direct material impact on pbb's earnings, capital, or risk profile and, if any, they are only expected to materialize very gradually over the medium term.

The biggest risk remains higher credit losses. The bank continues to navigate through difficult CRE markets, particularly in its U.S. and development businesses, and we expect further significant, but decreasing, levels of credit losses in the second half of 2024. Positively, lower interest rates could allow the bank to release some of the modelled and interest-rate sensitive stage 1 and stage 2 credit loss provisions. The level of credit losses remains the main consideration in our ratings, and it assumes that pbb remains overall profitable. We forecast credit losses in 2024 to materialize at 40 basis points (bps)-45bps, compared with 55bps in 2023, but to reduce structurally to below 30bps from 2025. We believe the main risk to this projection is if interest rates remain higher than expected or if there is a significant recession in the U.S. or Germany.

We see pbb's prospects of sustainably increase fee income as uncertain. The bank aims to establish an institutional asset management business and plans to achieve assets under management of €4 billion-€6 billion in 2027, from a combination of organic growth and purchases of smaller asset management providers. It also plans to establish a CRE-focused broker service to intermediate between investors. We believe the prospects depend heavily on market interest and stability of the CRE markets and we are uncertain whether pbb's economies of scale are sufficient to offer a competitive product. We also remain mindful of potentially new sources of risk stemming from these activities, including reputational or operational risk, but also potentially warehousing risks.

Dependence on unsecured wholesale markets has reduced significantly. pbb has also successfully accessed the Pfandbrief market and already fully pre-funded its 2024 needs. We note that pbb intends to issue unsecured instruments again from next year, which may have negative implications on its average funding costs.

Outlook

The negative outlook reflects 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 to 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 risk-adjusted capital ratio staying well above 10% and the additional loss absorbing capacity ratio above 6% of S&P Global Ratings' risk-weighted assets.

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 weakening investor confidence restricts pbb's market access, which remains critical to its wholesale-driven funding model.

Upside scenario

We could revise the outlook to stable in the next two years if pbb's asset quality remains resilient, and we see market conditions in the CRE market stabilizing. This would also likely require us to see pbb making tangible progress in delivering on strategic objectives, which could also have a positive impact on investor confidence.

Ratings Score Snapshot

Issuer Credit Rating	BBB-/Negative/A-3
Stand-alone credit profile	bb+
Anchor	bbb+
Business position	Constrained (-2)
Capital and earnings	Strong (+1)
Risk position	Constrained (-2)
Funding and liquidity	Adequate and adequate (0)
Comparable ratings analysis	0
Support	+1
ALAC support	+1

Related Criteria

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, April 30, 2024
- 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
- 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 Continues To Navigate Difficult Commercial Real Estate Markets, Aug. 14, 2024
- Deutsche Pfandbriefbank’s First Quarter Results Show A Mixed Picture, May 14, 2024
- Deutsche Pfandbriefbank Downgraded To 'BBB-/A-3' On Challenges From Commercial Real Estate; Outlook Negative, Feb. 14, 2024

Ratings List

Ratings Affirmed	
Deutsche Pfandbriefbank AG	
Issuer Credit Rating	BBB-/Negative/A-3
Resolution Counterparty Rating	BBB/--/A-2
Deutsche Pfandbriefbank AG	
Senior Unsecured	BBB-
Senior Subordinated	BB-
Subordinated	B+
Junior Subordinated	B-
Commercial Paper	A-3