

# Specialised German Commercial Real Estate Banks

## Benign Real Estate Market Fundamentals Eclipsed by Regulatory Challenges

### Special Report

Figure 1

#### Ratings of Specialised German Commercial Real Estate Lenders

Banks	LT IDR	Outlook	ST IDR	Viability Rating	Support Rating	Support Rating Floor
Aareal Bank AG (Aareal)	A-	Stable	F1	bbb	1	A-
Berlin-Hannoversche Hypothekbank AG (Berlin Hyp)	A+	Stable	F1+	bbb-	1	NR
COREALCREDIT BANK AG (COREALCREDIT)	BBB-	Stable	F3	bb	2	BBB-
Deutsche Genossenschafts-Hypothekbank AG (DG Hyp)	A+	Stable	F1+	NR	NR	NR
Deutsche Pfandbriefbank AG (PBB)	A-	Stable	F1	bb	1	A-
Duesseldorfer Hypothekbank AG (Duess Hyp)	BBB-	Stable	F3	c	2	BBB-
Hypothekbank Frankfurt AG (HFAG)	A-	Stable	F1	NR	1	A-

Source: Fitch Ratings

**Support-Driven IDRs:** The IDRs of Germany's commercial real estate (CRE) lenders are support-driven, resulting in IDRs that can be multiple notches above their respective Viability Ratings (VRs). Support considerations reflect the magnitude of extraordinary support provided by public authorities and the German Deposit Protection Fund (GDPF) throughout the financial crisis or strong institutional support assumptions due to banks' integration into a larger group.

**Cliff Risk for IDRs:** Fitch's view on support is sensitive to developments in the regulatory and legal framework, particularly emanating from the European Commission with regard to bail-ins, centralised regulatory oversight and adjustments to deposit insurance schemes, and the changing attitude of the German authorities to using their resolution tools. Current VRs provide a broad indicator of where rated Pfandbrief issuers' IDRs could end up if Fitch changed its view on support (see [Support is Key to German Pfandbrief Issuers' Ratings](#), published 28 August 2012).

**Sound Real Estate Market:** The prime German and European CRE investment markets performed soundly in 2012. Investor demand was strong, while credit supply was supported by robust Pfandbrief issuance and private placements. Some European markets were depressed, which could be a source of increasing loan impairment charges (LICs) for German CRE lenders with high CRE loan exposures to Spain or Italy in particular.

**Attractive Margins; Low LICs:** Some German CRE lenders have been able to realise increasing gross margins in new business due to less competition and a repricing of credit risk in the last few years, although further increases will be difficult to achieve. At the same time, banks are reducing their amount of low-yielding public-sector assets. However, low LICs remain one of the most important drivers of profitability.

**Funding Model Needs Changing:** Most German CRE lenders are wholesale funding reliant. Their lack of stable deposits will make it difficult for some banks, especially independent ones, to meet the net stable funding ratio (NSFR) requirements under Basel III, although the rules are still in flux. In light of this strategic challenge, some banks have started to collect internet retail deposits. In combination with concentrated and cyclical credit risks, the VRs of German CRE lenders are most likely to remain confined to the 'bbb' range.

**Improving Capital Levels:** Capital levels have improved. Aareal, COREALCREDIT and PBB have already achieved Basel III-compliant capitalisation levels.

#### Related Research

[Banks' Use of Covered Bonds: 2013 Update \(June 2013\)](#)

[German Multifamily Housing \(May 2013\)](#)

[Support is Key to German Pfandbrief Issuers' Ratings \(August 2012\)](#)

[No Signs of Real-Estate Bubble in Germany \(August 2012\)](#)

[Major European Banks' Balance-Sheet Encumbrance \(August 2012\)](#)

#### Analysts

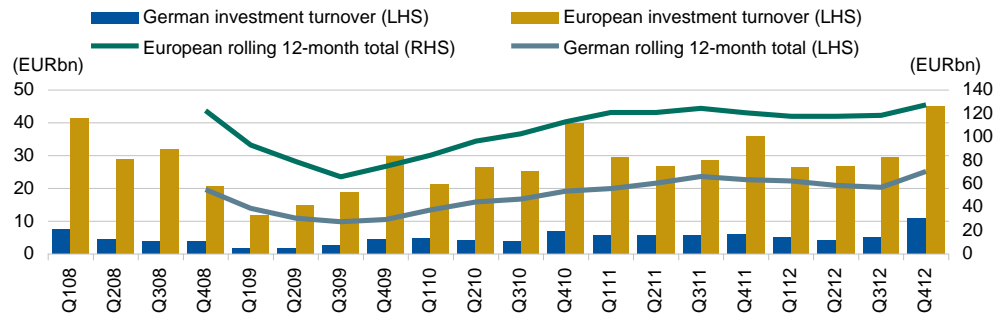
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Real Estate Market Fundamentals Still Positive

Figure 2

German and European CRE Investment Turnover



Source: CB Richard Ellis

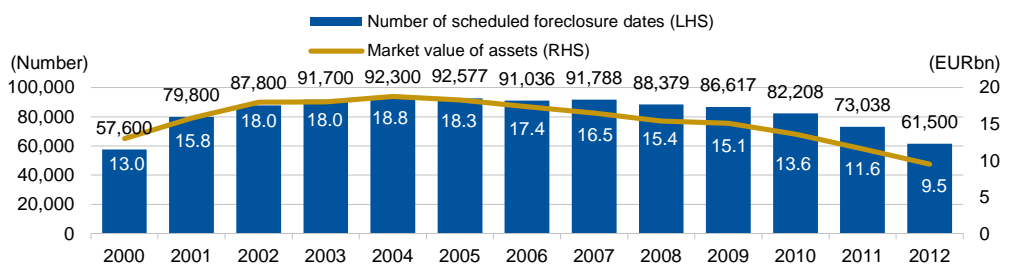
Strong Investment Activity in Germany and Europe

Due to strong year-end activity, 2012 German and European CRE transaction volumes increased to EUR25.2bn (2011: EUR22.2bn) and EUR127.2bn (2011: EUR120.3bn), respectively, according to data from CB Richard Ellis. Germany was one of Europe's most active markets. In Q113, German CRE investment market turnover increased to EUR6.7bn (Q112: EUR5.1bn), which is 36% more than its Q108-Q113 average.

In Fitch's view, Germany will continue to attract investors due to its perceived safe haven status. The benign real estate investment climate is driven by multiple factors, including a low interest rate environment, low domestic unemployment, increasing private consumption, the still existing yield gap vs other asset classes, and inflation fears, which cannot yet be seen, resulting in value-preserving property investments. In addition, low, albeit increasing, construction activity, net migration to metropolitan areas and an increasing number of households are fuelling demand for living space, while foreign investors are showing substantial interest in buying German property. This is all driving investment activity and property prices.

Figure 3

Declining Foreclosure Dates in Germany Since 2005



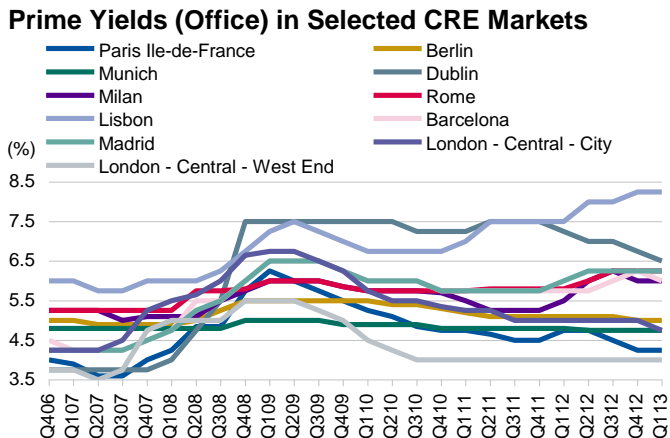
Note: The share of CRE assets was stable 26% between 2010-2012 (of the number of scheduled foreclosure dates)  
Source: www.argetra.de

Related Criteria

- Evaluating Corporate Governance (December 2012)
- Assessing and Rating Bank Subordinated and Hybrid Securities (December 2012)
- Global Financial Institutions Rating Criteria (August 2012)
- Recovery Ratings for Financial Institutions (August 2012)
- Rating FI Subsidiaries and Holding Companies (August 2012)
- Country-Specific Treatment of Recovery Ratings (June 2012)

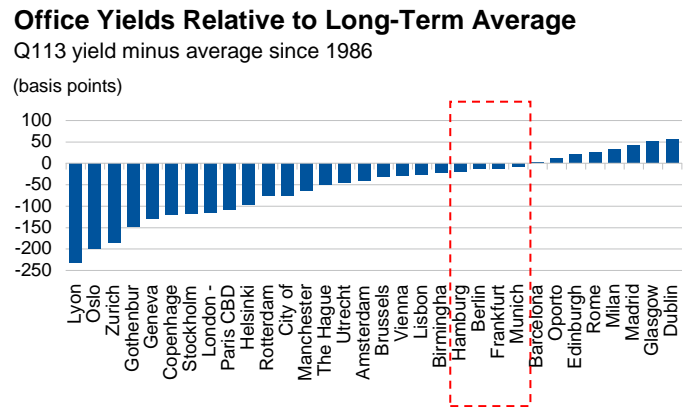
Fitch believes that markets in southern European countries will continue to experience depressed demand. For German CRE lenders exposed to these countries, this could result in further LICs.

Figure 4



Source: CBRE

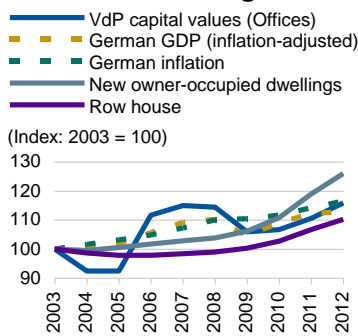
Figure 5



Source: CBRE

Figure 6

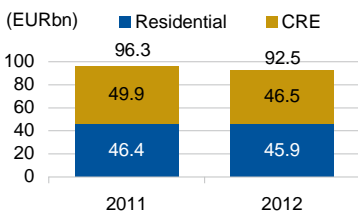
**German House Price Trend Not Alarming Yet**



Source: VdP, Bundesbank, Destatis

Figure 7

**Declining New Business by vdp Member Banks<sup>a</sup>**



Note: The reduction of CRE new business is entirely driven by non-domestic new business which has declined by EUR3.4bn

<sup>a</sup> vdp member banks (reporting entities only)

Source: vdp, Fitch estimate

**Market Indicators Suggest No Irrational Prices Yet**

Fitch views the risk of asset prices reaching irrationally high levels in Germany as remote, although the volume of CRE transactions has reached its highest level since 2007. Today's CRE investors are still disciplined and are investing at prime yields ranging from 4.3% to 6.5% for CRE assets in the office, industrial and retail segments, according to data from CB Richard Ellis (end-Q113). However, we believe that if investment activity shifts to second-tier markets away from the core locations in the "search for yield", this could be an indicator of speculative lending. Fitch notes that a material shift in CRE lending to secondary assets could result in a re-assessment of underwriting standards and asset quality.

**German CRE Lenders Still Benefit From Moderate Competition**

CRE lenders in Germany include specialised mortgage banks, most of the Landesbanken, especially Landesbank Hessen Thüringen as well as Bayerische Landesbank and Landesbank Baden-Württemberg and universal banks. In addition, larger German Sparkassen (savings and loans institutions) and Volks- und Raiffeisenbanken (cooperatives) account for a significant amount of lending, especially through small loans and sub-participations in their region.

Non-bank senior debt and mezzanine lenders have not changed the competitive landscape in Germany till now and are rather welcome as complementary credit suppliers. In addition, Fitch notes that some larger US banks have (re-)activated their CRE lending in Europe, attracted by margins that reflect a multiple of pre-2008 lending conditions. However, the last few years' positive trend of improving average yields on CRE loan books is more likely to come under pressure from domestic competition. We understand that in the segment of higher than EUR50m lending tickets, margins are still robust at about 250bp.

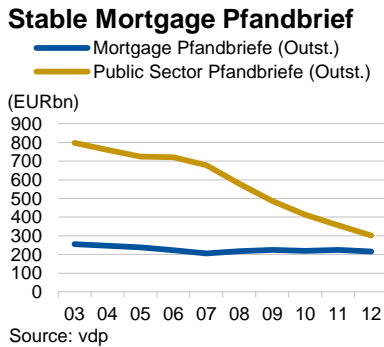
**Underwriting Standards Are Sound**

In conjunction with attractive margins, German CRE lenders have improved the risk characteristics of transactions since the onset of the financial crisis. Loan/value ratios (LTVs) for new business have decreased and have ranged between 55% and 65% in recent quarters, resulting in attractive returns on risk adjusted capital and a higher share of Pfandbrief-eligible loans. Subordinated lending or financing of developments has been reduced, and CRE lenders have mainly been focusing on senior secured loans.

**CRE Refinancing Pressure in Europe; German Banks Not Negatively Affected**

Based on market estimates, European banks have up to EUR3trn of CRE lending on their balance sheets, a result of excessive loan growth before 2008. In light of the future regulatory requirements to hold more capital and to penalise long-term assets with short-term wholesale

Figure 8



funds, banks' reduced appetite to finance CRE loans could have a negative impact on valuations of underlying assets, as seen in non-core market across Europe, particularly in Spain. Fitch expects no refinancing risks for German CRE lenders because of the robust Pfandbrief market, banks' access to a diverse private placement investor base, and in many cases their integration into a private universal, co-operative or public-sector banking group with access to stable deposits.

The risk that in some regions in Europe banks' inability or unwillingness to extend outstanding CRE loans will have a negative impact on property prices cannot be ruled out. However, German CRE lenders are mainly active in the capital cities or main economic centres of other European countries. Hence the impact on their asset quality is likely to be modest.

### Resolution of German Open-Ended Funds an Opportunity

Fitch does not believe the resolution of the assets of open-ended real estate funds in Germany is having a negative impact on German property prices. The business model of domestic real estate funds ran into trouble in the financial crisis when retail investors were allowed to withdraw their investments without significant penalties. Currently, funds' assets worth EUR18bn are in resolution, and EUR2bn temporarily stopped payouts to investors at end-February 2013. Although both numbers could increase, the current plan foresees EUR3bn-4bn of asset sales per annum over the next five years.

Only about one-third of these amounts reflect properties in Germany. In Fitch's view, these amounts can be funded without any negative impacts on national property prices. In Fitch's view, the higher-quality properties of assets in resolution represent a good opportunity for CRE lenders' new business if the margin/LTV balance is attractive.

### Resolution of German CMBS No Material Impact on Loan Portfolio LTVs

As bank refinancing is largely restricted to higher-quality assets, a mixture of restructuring and liquidation remains the most likely outcome for the majority of legacy loans of the type securitised in European CMBS. An acceleration of enforcement activity began in 2012, as large numbers of loans from peak vintage transactions reached (original or extended) maturity. We do not believe that German CMBS have a material impact on domestic prime CRE asset prices.

### Stable Performance for Most Banks Expected in 2013

#### Margin Repricing to Hit Ceiling

CRE loan margin growth has offset increasing funding costs in the senior unsecured funding market. Fitch believes that CRE loan gross margin repricing has now hit its ceiling, which will prevent material increasing net margins going forward. While the ECB actions in H212 led funding spreads to decline, investor appetite for German Pfandbriefe, the primary funding instrument of Germany's largest CRE financiers, has remained strong and kept funding costs low. We do not expect this to change in 2013. However, different ownership structures and financial fundamentals among Germany's specialised CRE lenders result in a wide dispersion of funding spreads, which could result in material differences between the top lines of banks as interest income is dominating total revenues. Low-yielding legacy public-sector assets are a result of fixed-for-floating interest rate swaps, which negatively affects net interest revenue.

#### Favourable LIC Levels

We believe Germany's specialised CRE lenders should be able to achieve 2013 profits in line with 2012, unless the sovereign debt crisis deteriorates. In particular, German banks with sound portfolios indicated by relative low NPL ratios and low LTVs in new business should continue to benefit from further low to moderate LICs, which are a major driver of profitability. Banks with legacy portfolios, originated before 2008, however, still face relatively high LIC ratios. Most of Germany's CRE lenders have significantly reduced their exposure to Greece, Italy, Ireland, Portugal and Spain, although tail risks still exist.

### Risks of Business Model Remain

Germany's CRE lenders provide loan tickets for commercial properties up to EUR250m. Due to the size of these loan tickets, CRE loan books are typically very concentrated, somewhat mitigated by granular tenant structures, by existing cash flow streams or through cross-collateralisation. Nevertheless, risk concentration is very high as the top 20 exposures characteristically reflect a multiple of a bank's capitalisation.

### Reliance on Healthy CRE Investment Market

Germany's CRE lenders provide loan tickets with an economic life time of 15-20 years, but loan maturities range between three and five years. Due to the mismatch of the economic life time of a property and the usage of all cash flows until a property is theoretically debt-free and the loan matures, lenders are required to extend loans if the property cannot be sold during or at the loan maturity (and the initial lender cannot be refinanced). CRE lenders' reliance on a volatile CRE investment market combined with interest-only or bullet repayment structures reduces the benefits of being a secured lender in times of stress. Fitch views positively controlled geographic diversification of loan books in order to mitigate these risks to some extent.

## Regulatory Changes Challenge CRE Banks' Business Model

### Net Stable Funding Ratio Difficult to Meet

In Fitch's view, the introduction of the NSFR (based on the latest draft, which could ultimately be significantly adjusted) will result in additional challenges for German CRE lenders. The banks will have to build or grow deposits, preferable (internet) retail deposits. In this context, *Schuldscheindarlehen*, which are used heavily by German CRE lenders to cover their unsecured funding, are not considered deposits under the current NSFR draft.

This exposes banks without retail or other customer deposits to a "cliff risk" under the NSFR. When the maturity of long-term debt instruments falls below 12 months, they lose their eligibility in the NSFR calculation. Banks without a sufficient amount of deposits in order to balance this gap would need a significant buffer held in highly liquid assets, weighing on net interest income. This challenge will be covered in more detail by a forthcoming Fitch Special Report.

### Improved Capital Levels at Most CRE Lenders

In Fitch's view, economic capitalisation levels at specialised German CRE lenders have improved and will likely comply with the Basel III rules when fully implemented. Aareal and COREALCREDIT in particular are already Basel III-compliant capitalised, and both fulfil the NSFR and liquidity coverage ratio (LCR) requirements on a pro-forma basis. PBB has made progress in improving its regulatory capital in connection with its de-leveraging strategy and fulfils the leverage ratio requirements on a pro-forma basis, albeit with no material buffer yet.

Berlin Hyp's capitalisation has so far been satisfied by occasional capital increases from LBB due to its existing profit-and-loss-transfer agreement (PLTA). As a result of the ongoing disentanglement process, the future ownership structure has not yet been finalised. Fitch believes that if Berlin Hyp maintains the PLTA with its future owner, one solution could be that Berlin Hyp distributes only some of profits to the owner, with the remaining share allocated to retained earnings in order to build up capital. Fitch understands that risk weights for CRE loans will not be altered under Basel III.

Figure 9

Appendix: Comparison of German CRE Banks

Bank	Aareal	Berlin Hyp	COREALCREDIT	PBB	Duess Hyp
<b>Key credit strengths</b>	<ul style="list-style-type: none"> <li>• Basel III-compliant capitalisation.</li> <li>• Pro-forma fulfilment of NSFR and LCR.</li> <li>• High amount of excess liquidity.</li> <li>• Funding benefits from institutional housing industry deposits and direct investor access.</li> <li>• Strong and tested risk management practice.</li> <li>• International diversification covered by higher margins and currently low LTVs.</li> </ul>	<ul style="list-style-type: none"> <li>• Benefits from integration into Sparkassen organisation (particularly origination and funding/liquidity).</li> <li>• Significantly reduced tail risk to Southern peripheral countries.</li> <li>• Strongly declined NPLs (which have now reached a bottom, in Fitch's view).</li> </ul>	<ul style="list-style-type: none"> <li>• Basel III-compliant capitalisation.</li> <li>• Pro-forma fulfilment of NSFR and LCR.</li> <li>• Start of internet retail funding platform could reduce capital market and wholesale funding reliance.</li> <li>• Has shown great effort in reducing its GIIPS exposure.</li> </ul>	<ul style="list-style-type: none"> <li>• Basel III-compliant capitalisation although no significant buffer on leverage ratio yet.</li> <li>• Sound liquidity overhang.</li> <li>• Start of internet retail funding platform could gradually help to reduce capital market and wholesale funding needs in the long-term and to fulfil NSFR.</li> <li>• Low NPL ratio (which is not sustainable, in Fitch's view).</li> </ul>	<ul style="list-style-type: none"> <li>• Management has made great efforts to reduce risk exposures over the last few years.</li> </ul>
<b>Key credit weaknesses</b>	<ul style="list-style-type: none"> <li>• Monoliner (mitigated by its subsidiary Aareon).</li> <li>• Concentrated CRE loan book.</li> <li>• High exposure to Spanish and Italian assets.</li> <li>• Global portfolio exposes Aareal naturally to a minimum level of NPLs and LICs.</li> </ul>	<ul style="list-style-type: none"> <li>• Monoliner.</li> <li>• Concentrated CRE loan book.</li> <li>• High domestic and Berlin concentration.</li> <li>• High amount of secured short-term funding challenges NSFR compliance (under latest NSFR draft).</li> <li>• No significant stock of stable deposits.</li> </ul>	<ul style="list-style-type: none"> <li>• Monoliner.</li> <li>• Concentrated CRE loan book.</li> <li>• Elevated NPL ratio.</li> <li>• Low profitability.</li> <li>• Earnings significantly affected by one-offs.</li> </ul>	<ul style="list-style-type: none"> <li>• Monoliner.</li> <li>• Concentrated CRE loan book.</li> <li>• High exposure to Southern peripheral countries (mainly public-sector assets).</li> <li>• PBB's planned CRE loan growth depends on increasing senior unsecured funding, which is uncertain to be achieved at current spreads post privatisation.</li> </ul>	<ul style="list-style-type: none"> <li>• Monoliner.</li> <li>• Very weak capital base.</li> <li>• Structural negative net interest income.</li> <li>• Adequate liquidity but it is dependant on ECB and short-term wholesale funding rolling over.</li> <li>• Very high exposure to troubled countries.</li> <li>• Long maturities of sizeable public-sector assets and small CRE loan book prevent rapid improvement of RoA.</li> </ul>

(%)	2012	2011	2012	2011	2012	2011	2012	2011	2012	2011
<b>Volume and margin</b>										
Adj. total assets (EURbn) <sup>a</sup>	45,734	41,814	34,205	38,553	7,444	9,094	97,056	108,779	13,934	16,118
Net interest margin	1.17	1.38	0.57	0.55	0.51	0.94	0.29	0.27	0.66	-0.45
<b>Profitability/efficiency</b>										
ROAE	8.9	10.4	24.2	13.7	1.7	0.7	5.9	8.0	-189.6	-220.1
ROAA	0.40	0.45	0.54	0.29	0.14	0.05	0.13	0.13	-0.57	-2.27
Cost/income ratio	58.5	59.8	38.1	34.6	77.9	57.0	79.5	74.3	33.8	-26.8
<b>Asset quality</b>										
NPL ratio	3.3	3.5	3.3	4.3	10.8	13.3	2.2	2.4	3.6	2.6
NPL coverage	38.7	37.9	39.6	36.0	37.2	48.3	29.8	35.8	24.1	44.6
LIC ratio	0.43	0.46	-0.09	0.10	0.19	0.03	-0.01	-0.02	0.40	0.54
GIIPS <sup>b</sup> /FCC	170.8	175.6	20.4	76.7	34.6	55.6	408.0	599.9	6,958.7	6,555.4
<b>Funding and liquidity</b>										
Adj. loans/deposits <sup>c</sup>	122.0	140.5	754.9	750.1	238.6	641.2	416.9	446.8	87.2	99.3
Adj. deposits/total assets <sup>c</sup>	44.4	43.3	8.4	8.1	24.6	8.7	12.3	11.4	18.6	15.6
Nominal covered bonds issued/total assets <sup>c</sup>	27.1	28.4	50.1	49.6	49.7	46.4	44.7	44.6	38.9	36.9
Interb. assets/interb. liabilities	63.1	129.8	25.6	30.2	57.5	54.0	102.5	92.8	71.3	59.6
<b>Capital</b>										
FCC ratio	11.8	9.9	10.3	9.0	20.0	16.6	14.1	11.3	1.9	2.3
Tier 1 ratio	16.7	16.3	9.4	8.6	20.0	16.6	18.9	16.3	8.5	9.5
Total capital ratio	20.6	19.5	12.7	12.1	22.5	20.6	-	-	13.0	17.2
Equity/total assets	4.5	4.5	2.6	2.2	9.5	7.6	2.4	1.9	0.4	0.4
RWA/total assets	31.7	36.6	24.7	23.6	47.5	45.9	15.8	15.6	18.8	16.8

Notes: DG Hyp and HFAG have been excluded in the absence of Viability Ratings; FCC = Fitch core capital; Aareal, PBB = IFRS; Berlin Hyp, COREALCREDIT, Duess Hyp = German GAAP. This limits comparison to some extent. Regulatory capital ratios are calculated by different approaches; Aareal = AIRBA; Berlin Hyp = FIRBA; COREALCREDIT, Duess Hyp = credit standard approach; PBB = Predominantly AIRBA.

<sup>a</sup> Total assets exclude own debt instruments.

<sup>b</sup> GIIPS exposure; Aareal = book values; Berlin Hyp, COREALCREDIT, Duess Hyp = nominal values; PBB = exposure at default; The exposure excludes CRE loans.

<sup>c</sup> Most of the banks mentioned above have no or only a small (internet) retail deposit base. Here, deposits reflect total liabilities to customer (according to the balance sheet) minus issued Pfandbriefe in the absence of publicly available information on the breakdown of customer liabilities by type. The residual figure represents to a large extent funds from German Schulscheindarlehen investors to which the issuers have a direct relationship.

Source: Fitch

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