Fitch Keeps HRE Bank's Mortgage and Public Sector Pfandbriefe on RWN on Merger

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Fitch Ratings-London/Frankfurt-27 November 2008: Fitch Ratings is maintaining Hypo Real Estate Bank AG's (HRE Bank, rated 'A-'(A minus)/Outlook Stable/'F1') mortgage and public sector Pfandbriefe, rated 'AA+' and 'AAA' respectively, on Rating Watch Negative (RWN), where they were placed on 30 September 2008.

The continued RWN on the mortgage and public sector Pfandbriefe follows the merger of HRE Bank with Hypo Real Estate International (HRI), which leads to a legal merger of HRE Bank`s and HRI's mortgage and public sector pools. Fitch does not publicly rate the HRI Pfandbriefe. After receiving additional information on the cover pool composition and scheduled cash flow data for HRE Bank's and HRI's cover pools, Fitch analysed the merged programmes in accordance with its covered bond methodology. As the cover pools have not been managed jointly, merging the pools will lead to higher interest rate and currency mismatches between the cover pools and the covered bonds.

The group will manage the pools jointly and expects to change their composition to mitigate the increased risks of the merged pools. The group plans to inject additional over-collateralisation (OC) if these risks can not be fully mitigated. If the group fails to do this in the near term, this would lead to a significant downgrade of both the mortgage and public sector Pfandbriefe.

As of 30 September 2008, HRE Bank's mortgage Pfandbriefe amounted to EUR15.99bn and were backed by a cover pool of EUR16.93bn, resulting in 5.9% nominal OC. HRE Bank already posted additional OC so that as of 23 October 2008 HRE Bank's mortgage Pfandbriefe amounted up to EUR16.15bn backed by a cover pool of EUR17.50bn (8.4% nominal OC). The merged pool as of 30 September 2008 amounts to EUR26.43bn covering outstanding mortgage Pfandbriefe of EUR24.95bn resulting in a nominal OC of 5.9%. Taking the injected OC into account, the nominal OC of the merged pool increases to 7.5%. The weighted average maturity of cover assets and liabilities are five and 4.7 years, respectively. The FX risk has increased significantly on the asset and on the liability side compared to HRE Bank's pool on a stand alone basis. While a minor portion of HRE Bank's pre-merger cover pool consisted of foreign currency assets, they now represent the majority of the merged pool. On the other hand the non Euro portion of the merged liabilities only accounts for a small portion of all outstanding covered bonds. The merged pool will include privileged FX swaps which hedge some of the FX risk. However the pool still has a substantial portion of unhedged FX positions, especially GBP, USD and SEK. Thus exposure to adverse exchange rate movements is one of the main risks post issuer default, in Fitch's view. Another significant risk driver is the high open interest rate position as floating-rate assets exceed floating-rate liabilities substantially after taking privileged interest rate swaps into account.

As of 30 September 2008, HRE Bank's public sector Pfandbriefe amounted to EUR14.81bn, and were backed by a cover pool of EUR15.36bn, resulting in a 3.7% nominal OC. The merged pool amounts to EUR26.19bn covering outstanding public sector Pfandbriefe worth EUR25.23bn resulting in a similar nominal OC at 3.8%. The weighted average maturity of cover assets and liabilities are 5.3 and 4.8 years, respectively. The open FX position has increased slightly in comparison to HRE Bank's stand alone public sector Pfandbriefe. The merged pool only includes short term FX swaps leading to a significant open position within one year. Another risk driver is the high open interest rate position as floating rate assets exceed floating rate liabilities substantially even after taking privileged interest rate swaps into account.

Fitch will review HRE's merged mortgage and public sector Pfandbriefe rating in light of changes in the pool composition and the OC available to reduce the credit and market risk between the cover pool and the covered bonds. The agency expects to resolve the RWN within the next three months.

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