



Moody's Investors Service

Credit Opinion: [Deutsche Pfandbriefbank AG](#)

Global Credit Research - 23 Feb 2010

*Munich, Germany*

## Ratings

Category	Moody's Rating
Outlook	Negative(m)
Bank Deposits	A3/P-1
Bank Financial Strength	E+
Public-sector Pfandbriefe MTN -Dom Curr	Aaa
Mortgage Pfandbriefe MTN -Dom Curr	Aa3
Senior Unsecured	A3
Subordinate -Dom Curr	Baa1
Commercial Paper -Dom Curr	P-1
Other Short Term -Dom Curr	P-1
Outlook	Negative
Bkd Sr Unsec MTN -Dom Curr	A3

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## Key Indicators

### Hypo Real Estate Group

	[1]2009	[2]2008	2007	2006	2005	[3]Avg.
Total assets (EUR billion)	386.37	419.65	400.17	161.59	152.34	[4]22.38
Total capital (EUR billion)	5.69	3.28	11.69	5.71	5.11	[4]-9.04
Return on average assets	-0.56	-1.35	0.22	0.35	0.25	-0.07
Recurring earnings power [5]	0.00	-0.31	0.25	0.47	0.40	0.23
Net interest margin	0.39	0.44	0.56	0.55	0.52	0.52
Cost/income ratio (%)	97.76	250.12	53.45	32.53	37.21	82.76
Problem loans % net loans	--	2.24	0.81	2.63	3.30	2.25
Tier 1 ratio (%)	6.90	3.40	7.00	7.00	7.80	6.70

[1] As of June 30. [2] Statement period in which the bank switched to Basel II accounting framework. [3] The average calculations are based on Basel I and Basel II data where applicable. [4] Compound annual growth rate. [5] Preprovision income % average assets.

## Opinion

### RECENT CREDIT DEVELOPMENTS

On 2 February 2009, Moody's downgraded to A3 from A2 the senior unsecured debt and deposit ratings of Deutsche Pfandbriefbank AG (pbb) along with the ratings of all other operating members of Hypo Real Estate

Group (HRE Group), which at the time reflected our expectation of a substantial recapitalisation by the German government, and, subsequently, of the group's nationalisation. Both of these expectations have materialised and further capitalisation measures are still under way.

On 13 October 2009 the German government took 100% ownership of the group holding, Hypo Real Estate Holding AG, via its agency in charge of supporting the German banking system (i.e. Sonderfonds Finanzmarktstabilisierung or the SoFFin) and made capital injections totalling EUR 6 billion during 2009. These developments had the effect of somewhat alleviating the earlier pressure on the ratings, principally as the envisaged support has been - and continues to be - provided, in line with our expectations.

The pbb downgrade in February 2009 also affected Depfa Bank Plc, Depfa Deutsche Pfandbriefbank AG (which was later merged with Hypo Real Estate Bank AG to form pbb) and Depfa ACS Bank. At the same time, the subordinated debt ratings of all HRE Group members were downgraded to Baa1 from A3.

The bank financial strength ratings (BFSRs) for all HRE Group entities are at the E+ level, which translates into a Baseline Credit Assessment (BCA) of B3, reflecting the banks' intrinsic financial weaknesses without taking into account the probability of further government support. The outlook on all the ratings remains negative, owing to (i) the fact that support for the group remains necessary and is still ongoing with major measures and transactions yet to be initiated or finalised and (ii) the uncertainty relating to the group's profound restructuring process, as we cannot yet assess the future viability of any of the rated group entities.

Next step in ongoing support: a sizeable "bad-bank" with positive credit implications for the BFSR

On 21 January 2010, HRE Group applied for the establishment of a so-called "bad bank" to be regulated under the bank rescue legislation, i.e. Financial-Market Stabilisation Fund Act (Finanzmarktstabilisierungsfondsgesetz or FMStFG), to facilitate the offloading and unwinding of selected assets. Legally, the bad bank is a public sector entity (Anstalt in der Anstalt, or AidA) and is effectively a work-out vehicle, into which HRE plans to transfer up to EUR 210 billion of assets and exposures, accounting for roughly half of the group's total assets. The AidA transaction, which remains subject to various approvals, is expected to materialise in H2 2010 and will have a material immediate impact on the profile of all entities in the group. The most important, largely positive aspects offered by this type of transaction are as follows:

1. The offloading of non-strategic and non-performing assets at book value (i.e. no write-down required) with potentially positive implications for asset quality;
2. A faster compliance with the expected European Commission's compensation measures of shrinking the balance sheet and RWA;
3. A structural improvement of the balance sheet as short-term liabilities can be transferred along with long-term assets, resulting in a better matching maturity profile of assets and liabilities;
4. A positive effect on future profitability if low-margin assets (with negative carry) are offloaded.

Rating stability at the A3 level depends on a medium-term commitment of the SoFFin

While the above-mentioned aspects are rating-positive for the group members' BFSRs, they may at the same time lead to an early downsizing and divestment of the group (or single entities), which in turn may require us to reassess the very high probability of systemic support that we currently factor into the senior unsecured ratings. That said, we do not expect HRE Group to offload assets and liabilities representing cover pools and covered bonds, which principally implies that the group will maintain much of its current systemic importance, even after the AidA transaction.

Ratings of all three rated HRE Group entities remain aligned for the time being

Moody's maintains aligned ratings for all rated HRE entities, which reflects the fact that support from the German government is available to all the members of HRE Group. Our decision is based on several factors: (i) the ultimate 100% ownership of the group by the SoFFin; (ii) recapitalisation and stabilisation measures for the group, in which the Irish entities have been equally included, and (iii) the interdependence of the rated entities given the substantial intra-group borrowings, although this may change in the course of 2010. For the time being, support for all the entities of HRE Group remains essential to prevent the failure of single entities and, consequently, prevent the remaining group sustaining potentially severe collateral damage. As and when the ongoing support measures are finalised and strategies for the single entities become clearer, we may

change this approach and again apply individual ratings.

Given the above, we will, for the time being, continue to assess and rate pbb in the context of the whole group. The following analysis is thus based on group financials. At the same time, we would emphasise that pbb - as the remaining core bank of the group, and solely in charge of generating new business - is more likely to remain a going concern in the long term than its sister companies which, we understand, are subject to divestment. If a divestment were to prove unviable, we do not rule out an orderly unwinding of pbb's sister entities.

## **SUMMARY RATING RATIONALE**

Moody's assigns a BFSR of E+ to pbb. The E+ BFSR translates into a Baseline Credit Assessment (BCA) of B3, which reflects the intrinsic financial weaknesses of the bank without government support. Notwithstanding the pending recapitalisation of the group by the German government, the BFSR reflects serious challenges to the longer-term viability of their commercial real estate (CRE) lending and public sector finance businesses, constrained profitability, and continued restricted market access.

The senior unsecured debt and deposit ratings of pbb - as well as all rated operating members of HRE Group - are A3, reflecting our expectation of a very high probability of systemic support. The uplift which had been factored into the A3 debt and deposit ratings under Moody's joint default analysis (JDA) methodology is nine notches from the bank's BCA of B3.

Moody's fully recognises the strong systemic support that has been evolving since the group first experienced distress and needed financial assistance in late September 2008. The rating takes into account (i) the substantial support rendered to date, i.e. EUR 6 billion in capital and liquidity facilities and commitments of EUR 95 billion (as of December 2009) which initially included the concerted efforts of the sovereign and the German banking system, and (ii) the recent nationalisation of the group that enables the government to provide for a more sustainable, long-term support and to stabilise the financial markets. That said, we will closely monitor the government's road map for exiting from its interest in the group and reducing support measures, as this will be critical for rating stability at the A3 level.

Subordinated debt of pbb and its sister banks is Baa1. The short-term ratings of all HRE Group entities continue to be Prime-1. The outlook on all ratings is negative.

### **Credit Strengths**

- Large-scale support from the SoFFin underpinned by a statement (through a Letter of Intent) to support the group with adequate capital and liquidity
- Specialised CRE lender, particularly in the German market, with proven risk management procedures, albeit with a tarnished brand name

### **Credit Challenges**

- Successful and timely realisation of the restructuring plan, restoration of the brand name and repositioning of the franchise
- Regaining access to debt capital markets for non-backed issues to complement covered bond funding, which may remain difficult for several years and/or only possible at prohibitive costs for pbb's lower margin businesses
- Returning to sustainable profitability which remains burdened by one-off charges, elevated funding costs and risk charges
- Managing the final step in recapitalisation measures, envisaged for H2 2010, in the face of further, potentially large-scale credit losses on CRE exposures and changing regulation

### **Rating Outlook**

The outlook on all ratings is negative. While Moody's is of the opinion that the A3 rating level for senior

unsecured debt duly reflects the German government's support towards HRE Group, the ratings remain under pressure.

### **What Could Change the Rating - Up**

There is currently no upward pressure on the E+ BFSR, as reflected by the negative outlook. This is not expected to change in the foreseeable future as - according to Moody's guidelines - banks that need ongoing support are generally rated in the E range. The E+ BFSR will likely remain constrained for the foreseeable future given (i) the damage to the group's franchise and reputation, (ii) the poor outlook on profitability for the next two to three years, and (iii) the impairment of HRE's funding franchise, coupled with Moody's expectation that it may take years before pbb will be able to access the market with non-backed, senior unsecured bond issues of meaningful size. Upward pressure on the BFSR would be subject to (i) visible positive credit implications from the planned AidA transaction, assuming it will materialise, (ii) the group's ability to fund itself independently, and (iii) evidence that the (post-AidA) franchise allows for sustainable profits.

Upward pressure on the group's senior debt and deposit ratings is also unlikely, as any upgrade would need to be prompted by an upgrade of the banks' BFSR.

### **What Could Change the Rating - Down**

A downgrade of the E+ BFSR could be triggered by (i) a lower-than-expected recapitalisation of the group, (ii) a lack of success in regaining access to debt capital markets, (iii) renewed set-backs due to higher-than-expected credit losses in either of HRE's main areas of business.

Downward pressure on the A3 ratings could result from (i) a further downgrade of the E+ BFSR, (ii) less substantial support than currently expected or any sooner-than-warranted exit strategy of the German government and/or (iii) a decrease over time of the systemic importance of HRE Group.

### **Recent Results and Company Events**

Since the acquisition of Depfa Group in 2007, HRE Group's structure has been - and currently continues to be - subject to a major overhaul. The most important transactions in the past two years were the merger of the two German entities Hypo Real Estate Bank AG (HREB) and Hypo Real Estate Bank International AG in November 2008, and the merger of the enlarged HREB with Depfa Deutsche Pfandbriefbank AG to form pbb in June 2009. These transactions were targeted at centralising all German operations in one main entity, and also giving this entity a new start with a fresh brand name and image.

The group year-to-date results of an after tax loss of EUR 1.7 billion as at 30 September 2009 (versus a loss of EUR 2.9 billion for the first nine months of 2008) were primarily driven by two factors: (i) the EUR 304 million negative net commission result (which contained EUR 382 million in fees paid for SoFFin guarantees) and (ii) a massive rise in risk provisions to EUR 1.9 billion (first nine months of 2008: EUR 250 million) that - unlike in 2008 - were mostly driven by CRE and corporate loans, and, only to a small extent, by structured credit products. The result in the same period of 2008 was adversely affected by a EUR 2.5 billion impairment of goodwill taken on Depfa. We expect HRE to post additional losses in Q4 2009.

### **DETAILED RATING CONSIDERATIONS**

Detailed considerations for pbb's currently assigned ratings are as follows:

#### **Bank Financial Strength Rating**

Moody's assigns an E+ BFSR to pbb. The rating is constrained by the bank's poor franchise value and limited access to debt capital markets, which may result in funding constraints for an extended period. In this particular case, Moody's bank financial strength scorecard, which contains backward-looking financial ratios, is of limited value for the assessment of the bank's current and future financial strength.

Qualitative Factors (50%)

Factor 1: Franchise Value

Trend: Weakening

The events of H2 2008 have severely damaged the group's reputation in the market and we believe that it will take several years to restore it. That said, pbb has accumulated valuable expertise in financing CRE and in sourcing long-term funding which we continue to consider highly valuable. Moreover, the new management is working on a new strategy and business model that will be based on Pfandbrief-eligible (i.e. high-quality) new business and focus on primary market origination in Germany and Europe. Various higher-risk businesses will no longer feature in the revised business model, such as (i) high LTV or speculative development loans in CRE, (ii) all infrastructure finance and high leverage finance in Public Sector & Infrastructure Finance (PS & IF), as well as (iii) proprietary trading and asset repackaging. The group will also generally abstain from business in emerging markets.

We take the view that reaching these targets will remain challenging, particularly in light of the sole focus on writing high-quality, Pfandbrief-eligible new business, given that most of new business in CRE will effectively comprise prolongations of existing CRE loans, whereby options of obtaining higher-value collateral or other credit enhancements will likely be limited in the foreseeable future. However, the ongoing restructuring does address the earlier shortcomings of the group's franchise and should eventually result in a leaner group structure, a lower risk profile, maturity-matched funding and the more focused business model described above. Regarding the de-risking and streamlining of the group, major milestones have been reached following a number of intra-group mergers and the recent successful sale of portions of structured product portfolios.

Although the time horizon for support has not been specified by the SoFFin, its commitment to support HRE Group aims at offering the group adequate time to reach these targets. However, despite notable progress to date, the eventual success and speed of the targeted restructuring remain very difficult to predict. Possible execution risks have to be taken into account, and if the group's future performance lags behind targets, the SoFFin may review its approach to (or time horizon for) supporting the group as a going concern. More importantly, the final approval of the targeted restructuring by the European Commission (EC) is still outstanding, implying additional uncertainties.

Although pbb could not tap the market with major Pfandbrief issues for approximately one year, pbb's outstanding Pfandbriefe still account for roughly 10% of the German Pfandbrief market. However, the group's critically important funding franchise - albeit slowly resuming issuance activity - remains weak and fragile and therefore highly exposed to further shocks in the market.

HRE scores a D on franchise value with a weakening trend.

## Factor 2: Risk Positioning

Trend: Neutral

Depfa's strategy of funding a large portion of the total public finance portfolio on a short-term basis to contribute to profits - based on the belief that secured and unsecured funding sources would always be available - has put the whole HRE franchise at risk. Moreover, interest rate and FX movements as well as spread developments have been significant drivers of volatility of HRE's liquidity needs relating to its long-dated public finance assets which had exacerbated the group's major liquidity shortfall during the months after the Lehman collapse.

Maturity and interest rate mismatches have proven highly risky which the group now aims to address, chiefly through offloading low-margin, long-term assets into the AidA. Inflated refinancing costs - arising since in September 2008 when HRE Group first had to face distress - have undermined the profitability of the low-margin public finance activities, and capital generation may remain impaired for several years. While the difficult funding situation (i.e. access to debt capital markets) may persist for some time, the AidA is expected to improve the balance sheet and funding profile, particularly as it eliminates some of the current maturity mismatches.

We note positively HRE's progress in improving risk management procedures with regard to credit risk and counterparty risk of its core loan and derivatives portfolios. We believe that the new management is dedicated to introducing best practices in risk management and strengthening structures that enable adequate supervision; also progress is being made in integrating the risk management and IT infrastructure necessary to assure due monitoring and supervision of the entire group. If a large portion of problem loans along with Depfa's infrastructure lending can be off-loaded into the AidA, then the forthcoming transaction could represent a major milestone in improving the group's risk profile.

We consider the group's reporting and standard of disclosures to be satisfactory, following improvements in disclosing the quality of various asset portfolios in the recent past. That said, an array of non-recurring items have impacted the group's financials over the past few years, and the ongoing external support make comparisons with peers and predictions for the future almost impossible.

As a specialised lender in the CRE business, the group's asset profile displays some concentrations to riskier regions such as the UK, Spain and the US, although these exposures have already been substantially reduced over the past two years. Single borrower concentrations, however, remain considerable in both of pbb's main business segments.

While liquidity and market risk remain important risk drivers, the bank's current liquidity position is and will remain strongly supported by guarantees from SoFFin to back the issuance of new debt. On a stand-alone basis, access to debt capital markets remains difficult, although pbb successfully placed three jumbo-Pfandbrief issues in September 2009 and January 2010. We understand that HRE continues to have the option of using SoFFin guarantees which, in any case, remain available to German banks until year-end 2010.

The score for HRE risk positioning is D- in Moody's bank financial strength scorecard.

### Factor 3: Regulatory Environment

Refer to Moody's latest Banking System Outlook for Germany to obtain a detailed discussion on the regulatory environment.

### Factor 4: Operating Environment

Trend: Neutral

This factor is common to all German banks. Moody's assigns a B score for the overall operating environment. Refer to Moody's Banking System Outlook for Germany, published in April 2009, and Moody's latest sovereign analysis on Germany, to obtain a detailed discussion on the operating environment.

### Quantitative Factors (50%)

#### Factor 5: Profitability

Trend: Neutral

Following heavy losses during 2008 and 2009 and in view of the various obstacles faced by the group relating to the ongoing restructuring and funding issues, we take a very cautious outlook on the group's future profitability, not just for 2010 but also beyond. Firstly, net interest income (NII) will remain under pressure as the group cannot fully take advantage of the improved margins given restrictions on new business and as funding costs remain considerably above peers. Secondly, we expect loan loss provisions to stay at elevated levels: even if economic indicators are gradually improving, real estate markets will likely continue to suffer throughout the next six to eight quarters. Thirdly, further investments in IT and restructuring charges will likely continue to burden the group for some time.

At the same time, we expect positive effects from the AidA transaction, particularly if primarily low-margin assets are transferred to the vehicle along with SoFFin-supported (i.e. higher cost) funding. The actual impact, however, can only be assessed once the transaction is finalised.

In the medium term, the key issue in terms of future profitability will be whether the group is able to obtain funding on the capital market at levels necessary to run the business profitably. As regards the public finance business, this is considered challenging even for better-positioned players in the market.

HRE's score for profitability remains E.

#### Factor 6: Liquidity

Trend: Neutral

The group's strong reliance on (partly unsecured) short-term capital market funding proved unsustainable and led to the funding crisis that HRE faced in Q3 2008 and the problems that the group continues to face. The CRE business of pbb has historically been funded with largely matching maturities; however, given the major intra-group obligations, the whole group remains adversely affected by the impairment of its funding franchise, in particular Depfa Bank plc.

HRE group remains dependent on liquidity support. Although pbb re-entered debt capital markets with three major Pfandbrief issuances between September 2009 and January 2010 (which were successfully placed with investors), the group will not be able to secure sufficient funding for the foreseeable future; however, we expect that this situation will be alleviated by the AidA transaction. The transaction will probably not be cash positive for the core bank, as we expect an equal amount of funding will be transferred; it should, nonetheless, considerably improve the funding structure with asset maturities better matching the average duration of remaining debt. However, at this stage we cannot assess the extent to which pbb will remain dependent on liquidity support after the transaction.

Based on the continuing requirement of funding support and the uncertainties of future liquidity needs, HRE scores E on liquidity.

#### Factor 7: Capital Adequacy

Trend: Improving

As a result of mounting losses in 2008 and 2009, the group's capitalisation eroded very quickly and even fell below the regulatory minimum ratios (standing at 3.4% as of year-end 2008 on group level), which, however, have since been restored. The SoFFin made two major capital injections during 2009, the first in June 2009 by subscribing to new shares worth EUR 2.96 billion, which at the same time provided the government with a 90% stake in the group. The stake was raised to 100% through a squeeze-out in Q3 2009. A further injection of EUR 3 billion (which included EUR 1 billion hybrid Tier 1 capital) followed in November 2009, bringing the (pro-forma) ratios up to more adequate levels.

At end-September 2009, the group reported a Tier 1 capital ratio of 6.1% and a total capital ratio of 8.0%, which included the first capital injection but did not account for the accrued EUR 1.7 billion net loss for the year-to-date. HRE Group further reported a pro-forma Tier 1 ratio of 9.7% which - if accounting for the loss in the nine months to end-September - was probably at roughly 7.5%.

Although the group is again in compliance with minimum regulatory capital ratios, further recapitalisation measures will be necessary, which we expect to materialise during the course of 2010. A further EUR 4 billion may be injected or made available in the context of the AidA transaction planned for H2 2010, as required. We expect that a major portion of that amount will be needed to absorb the expected losses of the AidA transaction, while the core banks in Germany, Ireland and Luxembourg will benefit from RWA reduction and, thus, capital relief.

As the AidA transaction will not need to comply with minimum regulatory capital ratios, but rather the economic capital required to absorb future losses, the total amount of capital needed at group level might be reduced through the offloading exercise. For the time being, a Letter of Intent from the SoFFin to sufficiently recapitalise the group (i.e. all entities) provides due comfort.

The E+ score for capital adequacy reflects the weak capital levels as at year-end 2008. The trend is improving based on the ongoing capital support measures.

#### Factor 8: Efficiency

Trend: Neutral

HRE Group's recent underlying efficiency has been obscured by major volatility of revenues, particularly by the major losses charged against its trading income and net income from financial investments. Moreover, net commission income has been burdened by additional fees on guarantees obtained from the SoFFin and thus turned negative in the course of 2009 (with a EUR 304 million deficit for the nine months to September 2009). A return to stable and sustainable revenues that would eventually allow for an improvement in efficiency, will be subject to not only deliverables relating to cost cutting but also depend on whether the group will succeed in reducing its funding costs which still remain substantially above those of peers.

We do view positively the major efforts made by the new management in the area of cost management: The group recently reported that staff reductions are in line with the earlier plan, with expenses down 25% year-on-year in the nine months to September 2009. Of the 26 office locations earmarked for closure, 21 have been closed. We further believe that there could be positive implications on efficiency from the AidA transaction as we expect the group to offload low-yielding, long-term assets that currently have a negative carry due to elevated costs of short-term, SoFFin-guaranteed funding.

In the short term, various one-off charges - including restructuring costs - will likely weigh on efficiency. In the long term we do not expect the bank to return to pre-crisis levels of efficiency (with very low cost-to-income ratios of 35-40%) because these levels had relied on maturity mismatches which will not be pursued (nor allowed by the regulator) in the future.

HRE's score on efficiency is E.

#### Factor 9: Asset Quality

Trend: Weakening

While the main driver of HRE Group's asset quality is the EUR 61 billion global CRE book, it more recently emerged that Depfa Bank plc's EUR 15 billion Infrastructure Finance book (comprising loans to state-regulated companies such as utilities, other corporate loans and project finance globally) also represents considerable risk. At the end of 2008, the PS & IF segment contained EUR 5 billion of sub-investment-grade loans that we believe are to a large extent related to Infrastructure Finance.

Following the extraordinary economic downturn in 2009, HRE's CRE portfolio currently displays an alarming trend of rising problem loans requiring significant special and general LLP. Total problem loans across CRE and PS & IF rose by 67% to reach EUR 8.4 billion at the end of September 2009 - which is twice the group's pro-forma tangible common equity (which excludes available-for-sale (AfS) reserves, CF hedge reserves, intangibles and a proportion of hybrid capital). The CRE-related problem loans accounted for the vast majority: at EUR 7.3 billion (up 74% in the nine months to September), CRE problem loans as a proportion of the total CRE exposure reached a high 12%, which is above the industry average. At EUR 1.1 billion (up by 33% in the nine months to September), PS & IF problem loans also reflect a considerable deterioration in asset quality, largely driven by infrastructure finance.

The score on asset quality is D+, however, with a weakening trend, although the AidA transaction will probably have a positive impact on asset quality.

#### Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns global local currency (GLC) deposit ratings of A3/Prime-1 to all rated operating members of Hypo Real Estate Group (HRE Group), i.e. Deutsche Pfandbriefbank AG, Depfa Bank Plc and Depfa ACS Bank.

The A3 GLC deposit ratings take into account the substantial support rendered to date and the recent nationalisation of the group that enables the government to provide for a more sustainable, long-term support. Our systemic support assessment reflects the bank's prominent position as a Pfandbrief issuer and derivatives counterparty. Backed by Germany's Aaa local -currency deposit ceiling (LCDC), Hypo Real Estate Group receives a multiple-notch uplift from its Baseline Credit Assessment, bringing the GLC rating to A3.

The BFSR of E+, which measures the banks' poor intrinsic strength without government support, translates into a BCA of B3.

#### Notching Considerations

The upper Tier-2 securities (profit participation rights, or Genussscheine) issued by various predecessor institutions of pbb (i.e. Westfaelische Hypothekenbank AG and Wuerttembergische Hypothekenbank AG) are rated C. The rating reflects the large portion of the principal that was written down (roughly 70%) following the loss reported for 2008 and Moody's expectation that there is little, if any, chance of a write-back of principal before their respective repayment dates in 2010, 2011, and 2012. Moreover, as a principal write-back always has priority over coupon payments, no interest payments are expected either.

These ratings are based on an individual expected loss calculation and carry a stable outlook.

### **Foreign Currency Deposit Rating**

The Foreign Currency Deposit Ratings of Hypo Real Estate Bank are unconstrained given that Germany, in common with other EU members, has a country ceiling of Aaa.

Moody's foreign currency deposit ratings for HRE Group's operating companies are A3/Prime-1.

### **Foreign Currency Debt Rating**

The Foreign Currency Debt Ratings of Hypo Real Estate Bank are unconstrained given that Germany, in common with other EU members, has a country ceiling of Aaa.

Moody's foreign currency debt ratings for HRE Group's operating companies are A3/Prime-1.

## **ABOUT MOODY'S BANK RATINGS**

### **Bank Financial Strength Rating**

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

### **Global Local Currency Deposit Rating**

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

### **National Scale Rating**

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

### **Foreign Currency Deposit Rating**

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

### Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

### About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

## Rating Factors

### Hypo Real Estate Group

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
<b>Qualitative Factors (50%)</b>						<b>D+</b>	
<b>Factor: Franchise Value</b>						<b>D</b>	<b>Weakening</b>
<b>Market Share and Sustainability</b>					x		
<b>Geographical Diversification</b>	x						
<b>Earnings Stability</b>					x		
<b>Earnings Diversification [2]</b>					x		
<b>Factor: Risk Positioning</b>						<b>D-</b>	<b>Neutral</b>
<b>Corporate Governance [2]</b>							
- Ownership and Organizational Complexity							
- Key Man Risk							
- Insider and Related-Party Risks							
<b>Controls and Risk Management</b>				x			
- Risk Management				x			
- Controls				x			
<b>Financial Reporting Transparency</b>		x					
- Global Comparability	x						
- Frequency and Timeliness	x						
- Quality of Financial Information		x					
<b>Credit Risk Concentration</b>					x		
- Borrower Concentration					x		
- Industry Concentration					x		

Liquidity Management					x		
Market Risk Appetite				x			
Factor: Operating Environment						B	Neutral
Economic Stability			x				
Integrity and Corruption		x					
Legal System	x						
Financial Factors (50%)						E+	
Factor: Profitability						E	Neutral
PPP % Avg RWA - Basel II					-1.26%		
Net Income % Avg RWA - Basel II					-5.56%		
Factor: Liquidity						E	Neutral
(Mkt funds-Liquid Assets) % Total Assets					41.74%		
Liquidity Management					x		
Factor: Capital Adequacy						E+	Improving
Tier 1 ratio (%) - Basel II					3.40%		
Tangible Common Equity / RWA - Basel II				3.04%			
Factor: Efficiency						E	Neutral
Cost/income ratio					112.04%		
Factor: Asset Quality						D+	Weakening
Problem Loans % Gross Loans		1.89%					
Problem Loans % (Equity + LLR)					240.41%		
Lowest Combined Score (15%)						E	
Economic Insolvency Override						E+	
Aggregate Score						E+	
Assigned BFSR						E+	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information [2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral



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