

## **FITCH PUTS HFI LUX'S LETTRES DE GAGE ON RWN; ASSIGNS LUXEMBOURGIAN COVERED BONDS OUTLOOKS & D-CAPS**

Fitch Ratings-Frankfurt/London-12 September 2012: Fitch Ratings has placed Hypothekenbank Frankfurt International S.A. (Eurohypo)'s (HFI Lux, 'A-/Stable) Lettres de Gage Publiques' (LdGP) 'AAA' rating on Rating Watch Negative (RWN) following the publication of the agency's updated Covered Bonds Rating Criteria. Fitch has also assigned a Stable Outlook to NORD/LB COVERED FINANCE BANK S.A.'s (CFB, 'A'/Stable) LdGPs' 'AAA' rating. Fitch has assigned Discontinuity Caps (D-Caps) of 4 to both programmes.

The RWN on HFI Lux's covered bond programme reflects that the level of overcollateralisation (OC) that Fitch takes into account in its analysis of 2% (legal minimum in Luxembourg) is below the 16.5% breakeven OC in line with Fitch's 'AAA' rating. Under its updated criteria, Fitch considers the HFI Lux programme to be in wind-down and therefore relies on a publicly stated OC level, or if there is no such statement, on the legal minimum level of OC. Previously, Fitch took into account the lowest OC of the last 12 months (16.5%).

Fitch expects to receive feedback from HFI Lux within one month regarding any plans to change the programme. If no changes are proposed, Fitch expects to downgrade the rating. If changes likely to impact the ratings are proposed, Fitch will review any implementation plans to determine how the RWN should be resolved. If changes are implemented that address the drivers of a potential downgrade, the agency will affirm the rating.

The Stable Outlook assigned to the rating of CFB's LdGP reflects Fitch's expectation that both the asset performance and OC maintenance will remain stable.

D-Caps determine the maximum rating notch uplift from the IDR to the covered bond rating on a probability of default (PD) basis reflecting Fitch's view of the likelihood of a programme defaulting in the aftermath of an issuer default. The D-Cap is based on the highest risk assessment of the following components: asset segregation, liquidity gap and systemic risk, alternative management (systemic and cover pool-specific) and privileged derivatives.

Fitch has assigned a very low risk assessment of asset segregation for Luxembourgian covered bonds. This assessment is based on the agency's view that the Luxembourgian legislation ensures that all assets recorded on the dedicated register will be available for covered bond investors in the event of the issuer's insolvency. Fitch is of the opinion that this also applies to excess collateral, as the law specifies that residual assets in the cover pool must be returned to the insolvency estate only after full redemption of covered bond holders.

For both Luxembourgian programmes, the liquidity gap and systemic risk is assessed as moderate. This reflects the lack of legal or contractual liquidity mechanisms, which is partly counterbalanced by high proportions of liquid assets for both programmes. CFB follows an internal liquidity rule which provides limited additional comfort.

The agency assesses the systemic alternative management risk component of the Luxembourgian programmes as very low due to the significant role performed by the financial services regulator Commission de Surveillance du Secteur Financier (CSSF) post issuer default. Luxembourg's covered bond law foresees the CSSF taking over responsibility for the management of the covered bonds and the related cover assets upon the insolvency of the issuer. In practice, it is likely the regulator would find a substitute manager or transfer the programme to another covered bond issuer. However, the last resort management function of the supervisory authority provides much comfort that an appropriate solution would be found and that the cover pool could be managed without interruption.

Regarding cover pool-specific alternative management, both programmes contain a limited number of public sector assets, a significant amount of which are considered highly liquid, and a high number of privileged swaps. In Fitch's view, the limited number of assets and their liquidity improves the alternative manager's ability to take over the cover pool and repay the covered bond investors in time, but the derivatives add complexity to this task. In addition, Fitch worsened the assessment for HFI Lux's programme as it is considered in wind-down. This leads to a low risk assessment for CFB's and a moderate assessment for HFI Lux's programme.

The risk assessment for privileged derivatives is moderate for both programmes and reflects the materiality of the exposure, the involvement of intra-group entities as swap counterparties and the lack of compliance of the documentation with Fitch's Covered Bonds Counterparty Criteria in terms of replacement provisions and the calculation of the collateral amount to be posted. This is counterbalanced by the fact that the rating of the counterparties currently does not constrain the rating of the LdGP. This component is not the sole driver of the D-Cap for any of the listed programmes.

The programmes' D-Caps and the risk assessments of the D-Cap components are as follows:

#### HFI Lux

Public sector covered bonds: 'AAA'; on RWN

D-Cap: 4 (moderate risk)

Asset segregation: very low

Liquidity gap and systemic risk: moderate

Cover pool-specific alternative management: moderate

Systemic alternative management: very low

Privileged derivatives: moderate

The RWN is due to a lack of public OC commitment. According to the updated covered bonds criteria for wind-down programmes, Fitch only takes into account OC levels to which the issuer publicly commits, otherwise the agency relies on the legal minimum.

The drivers of the D-Cap are the moderate risk assessments of liquidity gap and systemic risk, cover-pool specific alternative management and privileged derivatives. The assessment of liquidity gap and systemic risk is driven by the lack of legal or contractual liquidity mechanisms, which is partly counterbalanced by sufficient liquidity of the assets.

The agency considers the programme in wind down and has therefore assessed the cover pool specific alternative management risk as moderate instead of low to reflect the greater link of the wind down programme to the issuer.

Risk arising from privileged derivatives is assessed as moderate due to partly internal counterparties considered material to the programme and swap documentation not being fully compliant with Fitch's Covered Bonds Counterparty Criteria

#### CFB

Public sector covered bonds: 'AAA'/Stable

D-Cap: 4 (moderate risk)

Asset segregation: very low

Liquidity gap and systemic risk: moderate

Cover pool-specific alternative management: low

Systemic alternative management: very low

Privileged derivatives: moderate

The drivers of the D-Cap are the moderate risk assessments for liquidity gap and systemic risk and privileged derivatives. The former is driven by CFB's internal liquidity mechanisms and a sufficient marketability of the assets, the latter by partly intragroup swap counterparties considered very material to the programme and swap documentation not being fully compliant with the agency's Covered Bonds Counterparty Criteria. This is mitigated by all counterparties unilaterally providing

collateral in the amount of the contracts' mark-to-market value regardless of their current rating.

Fitch may have provided another permissible service to CFB or its related third parties. Details of this service can be found on Fitch's website in the EU regulatory affairs page.

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Additional information is available at [www.fitchratings.com](http://www.fitchratings.com). The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

Applicable criteria: 'Covered Bonds Rating Criteria', dated 10 September 2012, 'Covered Bonds', are available at [www.fitchratings.com](http://www.fitchratings.com).

Applicable Criteria and Related Research:

Covered Bonds Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=688092](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=688092)

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