Moody's Investors Service

Credit Opinion: Münchener Hypothekenbank eG

Global Credit Research - 18 Dec 2009

Munich, Germany

Ratings

Category	Moody's Rating
Outlook	Negative
Bank Deposits	A1/P-1
Bank Financial Strength	C-
Public-sector Pfandbriefe MTN -Dom Curr	Aaa
Mortgage Pfandbriefe MTN -Dom Curr	Aaa
Senior Unsecured	A1
Subordinate -Dom Curr	A2
Other Short Term -Dom Curr	P-1
GFW Capital GmbH	
Outlook	Negative
Jr Subordinate -Dom Curr	Baa2
Isar Capital Funding I Limited Partnership	
Outlook	Negative
Preferred Stock -Dom Curr	Baa2

Contacts

Analyst	Phone
Claude Raab/Frankfurt	49.69.707.30.700
Uwe Barth/Frankfurt	
Carola Schuler/Frankfurt	
George Yiannakis/Frankfurt	

Key Indicators

Muenchener Hypothekenbank eG

	[1][2]**2008**	**2007**	**2006**	**2005**	**2004**	[3]**Avg.**
Total assets (EUR billion)	**36.13**	**32.93**	**31.93**	**34.01**	**32.88**	[4]**3.01**
Total capital (EUR billion)	**0.85**	**0.78**	**0.80**	**0.83**	**0.68**	[4]**5.97**
Return on average assets	**0.03**	**0.04**	**0.03**	**0.03**	**0.03**	**0.03**
Recurring earnings power [5]	**0.16**	**0.15**	**0.19**	**0.14**	**0.11**	**0.15**
Net interest margin	**0.38**	**0.33**	**0.28**	**0.29**	**0.23**	**0.30**
Cost/income ratio (%)	**50.90**	**52.12**	**48.10**	**54.79**	**61.66**	**53.51**
Problem loans % net loans	**--**	**--**	**--**	**--**	**--**	**--**
Tier 1 ratio (%)	**5.60**	**--**	**--**	**--**	**--**	**5.60**

[1] As of December 31. [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 7 December 2009, the bank financial strength rating (BFSR) of Münchener Hypothekenbank eG (MünchenerHyp) was downgraded to C- from C+, its senior debt and deposit ratings to A1 from Aa3 and its subordinated debt ratings to A2 from A1. The Tier 1 instrument issued by GFW Capital GmbH was also downgraded to Baa2 from A2, a Baa2 rating was assigned to the new fixed-rate capital securities issued by Isar Capital Funding I Limited Partnership. The outlook on all the ratings is negative. We affirmed MünchenerHyp's Prime-1 short-term rating.

The rating action concluded the review for possible downgrade on MünchenerHyp's BFSR and senior and subordinated debt ratings initiated on 19 November 2009 and the review for possible downgrade of the Tier 1 securities issued by GFW Capital GmbH initiated on 18 November 2009.

The lower BFSR reflects our concerns about MünchenerHyp's capacity to absorb potential future losses given the bank's shift towards riskier commercial real estate lending in recent years. We believe that the international commercial real estate segment potentially represents a major source of future credit losses, with limited visibility over the next 12-18 months.

The long-term ratings reflect our view that MünchenerHyp will continue to benefit from the existing support mechanism available to members of the group of co-operative banks in Germany (the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, BVR).

MÜNCHENERHYP'S CAPITAL LEVELS CONSIDERED WEAK GIVEN ITS INCREASED RISK PROFILE

Following the stress testing of MünchenerHyp's earnings, assets and capital, we downgraded the bank's BFSR to C-, which maps to a baseline credit assessment (BCA) of Baa2. The outcome of the tests reflects that MünchenerHyp is only weakly capitalised in the context of its risk profile and low earnings generation capacity.

The shift in the lending portfolio mix due to a steep rise in its domestic and international commercial real estate lending over the past few years represents a considerable challenge for the bank. According to our expectations, higher risk provisions in MünchenerHyp's commercial real estate business could rapidly erode the bank's historically weak profits and exert pressure on its capital. This justifies the two-notch downgrade of the BFSR to C-.

At the same time, we note positively that the bank has taken measures to bolster its capitalisation by renewed issuance of hybrid capital instruments, which should increase its Tier 1 ratio towards 10% for FY2009.

Should losses in 2010 - particularly from MünchenerHyp's commercial real estate business - absorb the bank's pre-provision profits and weigh on its capital, this could exert further pressure on the BFSR, especially in the absence of any meaningful capital injections that could improve the bank's resilience against such potential losses. The negative outlook on the BFSR reflects these concerns.

SUMMARY RATING RATIONALE

Moody's assigns a BFSR of C- to MünchenerHyp, which translates into a BCA of Baa2. The rating reflects the bank's solid business franchise as a residential mortgage lender, its significant position as a Pfandbrief issuer in the German market and its affiliation with the German co-operative banks, which gives the bank access to a nationwide network of branches. However, it also takes into account the bank's weak risk-weighted profitability and modest capitalisation.

MünchenerHyp's long-term global local currency (GLC) debt and deposit ratings are at the A1 / Prime 1 level based on (i) the bank's intrinsic credit strength, reflected in its BCA of Baa2; (ii) Moody's assessment of a very high probability of cross-sector support from FinanzVerbund "BVR" (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken - the German co-operative banks association); and (iii) our opinion that there is a moderate probability of systemic support.

Consequently, there is a four-notch uplift for MünchenerHyp's GLC deposit rating from its Baa2 BCA.

Credit Strengths

- Diversified portfolio including residential mortgages in Germany as well as public sector and commercial real estate lending

- Stable domestic franchise built on close ties with the German co-operative sector, further strengthened by its membership in the FinanzVerbund

- Asset quality supported by high granularity and low average LTV in the loan portfolio

- Stable funding profile based on good access to a broad investor base

Credit Challenges

- Limited visibility for international commercial real estate markets and a limited track-record managing a large portfolio of international real estate loans through the cycle

- Margin pressure due to the competitive nature of the business

- Weak risk-weighted profitability and modest ability for internal capital generation

- Significant growth in international business over recent years could lead to asset quality deterioration

Rating Outlook

The outlook on all ratings is negative. The negative outlook on the A1 senior debt and deposit ratings reflects the fact that any further downgrade of the C- BFSR would likely result in a downgrade of the long-term ratings. We note that this could occur in the event of MünchenerHyp's regulatory capital levels declining further and/or persistent pressure on the bank's current capitalisation.

What Could Change the Rating - Up

We see limited rating upside at this time. However, over time positive pressure on the BFSR could result from a sustainable improvement in the bank's risk-adjusted profitability and internal capital generation towards levels that are commensurate with MünchenerHyp's credit profile.

What Could Change the Rating - Down

The rating could be lowered if increasing loan losses lead to a deterioration in profitability and a weakening of the capital base. A material deterioration in asset quality beyond our expectations could have further negative implications for the ratings. A weakening in MünchenerHyp's links to (and expected support from) the co-operative banks would exert pressure on the senior unsecured debt and deposit ratings, although the probability of this occurring is remote.

Recent Results and Company Events

For the first nine months of 2009, MünchenerHyp's total assets declined moderately to EUR 35.3 billion from the EUR 36.1 billion reported for FY 2008, reflecting a decline in lending volume to the financial sector and reduced new business activity in commercial real estate.

New mortgage lending business was down sharply to less than EUR 1.7 billion, compared with more than EUR 6.0 billion in 2008, reflecting the overall reduction in mortgage financing as well as a more selective approach by management.

MünchenerHyp's reported a pre-tax income of EUR 20.1 million for the first nine months in 2009 (EUR 22.3 million after 9m 2008) reflecting a moderately lower net interest result of EUR 91.9 million (EUR 92.3 million) and a negative net fee and commission result of EUR 21.1 million (EUR 20.1 million). At the same time, operating expenses increased to EUR 43.2 million (EUR 39.1 million). Risk provisions at EUR 15.3 million were slightly lower than the previous year's levels (EUR 20.1 million).

At the end of June 2009, the bank reported a core - capital ratio according to Basel II (SolvV) of 5.6% and a total - capital ratio of 8.7%, which we believe is sub-par for the risk profile at this stage of the real estate cycle. We expect both capital ratios to improve following the issuance of Tier-1 capital.

MünchenerHyp is not invested in US subprime assets. However, it is exposed to commercial real estate lending with a EUR 5 billion book including exposure to the domestic (45%), US (40%) and other European markets.

DETAILED RATING CONSIDERATIONS

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

Bank Financial Strength Rating

Moody's BFSR of C- for MünchenerHyp is supported by the bank's solid franchise as a residential mortgage lender in Germany, its affiliation with the German co-operative banks as well as its excellent access to the German covered bond market and its highly diversified loan portfolio. The bank's established public finance activities and selective growth in commercial real estate complement the profile.

The BFSR also takes into account the bank's good cost efficiency and low risk profile, demonstrated by its historic track-record of sound asset quality. This is characterised by both one of the lowest loan-to-value profiles among German mortgage banks and an increasing, but still relatively low, level of commercial real estate financing. A key element constraining the BFSR is the bank's modest profitability and its weak capitalisation.

As a point of reference, the assigned BFSR is at the level of the C- outcome of Moody's bank financial strength scorecard.

Qualitative Factors (50%)

Factor 1: Franchise Value

Trend: Neutral

MünchenerHyp is a mortgage bank in the German co-operative banking sector, focusing on residential mortgage - lending to private individuals in Germany and Switzerland, and is also involved in commercial real estate and public sector finance in Germany and abroad. Public sector lending still accounts for the majority of the bank's assets. However, the public sector finance activities are declining as public sector loans or finance activities are only entered into if they comply with management's risk-return targets.

The bank's domestic real estate business benefits from its close ties with the local co-operative banks in Germany providing access to a large customer base through their distribution capabilities and market penetration with a market share of above 20%. Although the residential mortgage loan business still dominates the bank's real estate business, MünchenerHyp has steadily developed its commercial real estate activities, driven primarily by the increase in loans to international borrowers, especially in the US, the Netherlands, the UK and France. In our view, such activities can provide diversification and earnings enhancement to the traditional lending activities, but could have a negative effect on the bank's earnings stability going forward due to the inherent cyclicality of commercial real estate markets.

The overall score for the bank's franchise value is C-.

Factor 2: Risk Positioning

Trend: Neutral

MünchenerHyp's overall risk profile is adequate within the scope of its operations. The bank's activities are dominated by low-risk/low-margin businesses. We expect the bank to maintain its low risk profile, which is supported by the high quality of its assets and low concentration risks in the loan and investment portfolios. Concentration risks in public sector and the interbank sector are not of major concern, given that these are largely highly rated borrowers.

However, we believe that the rapid expansion of the bank into the international commercial real estate sector in recent years could provide a future challenge for MünchenerHyp if market values continue to decline and markets suffer from excess supply, creating further pricing pressure on property valuations. In such an event and given the limited visibility of the market, even MünchenerHyp - which holds senior positions in the majority of its loans - could face an increase in credit losses which would weigh on the ratings.

In recent years, MünchenerHyp has improved its risk management systems and has continued to comply with its conservative underwriting standards. We expect MünchenerHyp to maintain its more cautious stance, relative to some of its peers with similar public sector lending business, by largely refraining from taking yield curve exposure and engaging in trading activities.

MünchenerHyp's low risk profile is also supported by sound liquidity management, i.e. effective measurement, monitoring and control systems, and by a moderate risk appetite in terms of market risk. Market risk is confined almost exclusively to interest rate risk as foreign exchange and trading risks are manageable in our view. While the use of derivatives is high in terms of notional values, these largely reflect interest rate swaps used for hedging.

MünchenerHyp's score for risk positioning is D.

Factor 3: Regulatory Environment

All German banks are subject to the same score on the regulatory environment. This factor does not address bank-specific issues; instead, it evaluates whether regulatory bodies are independent and credible demonstrate enforcement powers and adhere to global standards of best practices for risk control. According to Moody's country assessment, Germany has an advanced regulatory environment. Refer to Moody's most recent Banking System Outlook for Germany to obtain a detailed discussion on the regulatory environment.

Factor 4: Operating Environment

Trend: Neutral

This factor is also common to all German banks. Moody's assigns a B score for the overall operating environment. Refer to Moody's most recent Banking System Outlook for Germany to obtain a detailed discussion on the operating environment.

Quantitative Factors (50%)

Factor 5: Profitability

Trend: Neutral

The bank's profitability has historically been low even by German mortgage bank standards, but in particular on an international basis, principally reflecting its concentration on low-yielding residential mortgage and public sector lending activities. The bank's increased exposure to international commercial real estate lending has not altered overall profitability levels.

The overall score for profitability is E.

Factor 6: Liquidity

Trend: Neutral

Although MünchenerHyp's funding profile is geared towards market funding, the banks liquidity profile benefits from a broad diversification of funding sources. The bank's funding strategy is supported by its membership in the FinanzVerbund, its good access to the German covered bond (Pfandbrief) market and its established institutional deposit base.

The overall score for liquidity is C.

Factor 7: Capital Adequacy

Trend: Neutral

MünchenerHyp's risk-weighted capitalisation ratios are low relative to other German banks as well as with peers in the rating category and the mortgage banking sector. We believe that MünchenerHyp's capital ratios are currently below those of the rating category and we will closely monitor further steps to enhance the bank's capitalisation. We note that MünchenerHyp still uses the standard approach to credit risk, bearing some potential for risk-weighted assets relief once the bank starts using the internal rating based approach (IRBA) under Basel II. We already anticipate the expected relief in our capitalization score and expect the bank to preserve its additional financial flexibility, while carefully balancing any expansion into businesses that considered riskier in terms of lending.

In our analysis, we recognise the bank's substantial portion of assets with a zero or low risk-weighting, but these have to be weighed against the increasing share of riskier international commercial real estate loans in the portfolio, which could adversely impact the bank's future capitalisation levels according to our stress test results.

A large portion of Tier 1 capital is made up of hybrid capital products (silent participations). We acknowledge the financial flexibility from such instruments and the immediate boost in capitalisation. However, we also incorporate such a weaker quality of capital in our analysis.

The overall score for capital adequacy is D+.

Factor 8: Efficiency

Trend: Neutral

MünchenerHyp's efficiency is satisfactory. Although the cost-to-income ratio has been declining over recent years towards 50% thanks to efficiency improvements and the increase in revenue, we believe that it will be difficult to preserve such efficiency levels during a more difficult operating environment and increasing demands on the bank's infrastructure.

The overall score for efficiency is B.

Factor 9: Asset Quality

Trend: Neutral

MünchenerHyp has historically maintained a sound asset quality for its established businesses. The public finance portfolio is of low risk and primarily includes exposures to German and European sovereign and sub-sovereigns as well as domestic financial institutions. The real estate portfolio is very granular and we are comfortable with the characteristics of MünchenerHyp's loan portfolio comprising more than 115,000 single loans split into approximately 68% residential and 32% commercial real estate. The overall LTV levels across the portfolio reflect management's conservative underwriting standards. While such policies are also true for the international commercial real estate lending, we believe that the severe downturn in selected property markets does not fully shelter MünchenerHyp from the expected rising trend in non-performing loans in the future.

The score for asset quality is B.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a global local currency (GLC) deposit rating of A1 to MünchenerHyp.

The GLC rating is supported by MünchenerHyp's BCA of Baa2, as well as by the ratings of its underlying support providers:

- The creditworthiness of the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR) sector.

- Germany's Aaa local-currency deposit ceiling

The bank thus receives a four-notch uplift from its BCA, bringing the GLC deposit rating to A1.

Based on MünchenerHyp's membership of the Association of Co-operative Banks, Moody's assesses the probability of cooperative sector support for the bank in the event of a stress scenario as very high. The bank's membership of the FinanzVerbund provides MünchenerHyp with two forms of sector-specific support: the Garantiefonds (a support fund that is maintained by annual contributions from member banks) and the Garantie-Verbund (a further contractually defined support agreement, which invariably takes the form of a performance guarantee in favour of a co-operative bank in difficulty).

Additionally, the probability of systemic support is judged to be moderate. This is based on MünchenerHyp's relative small national market share but high importance to the German mortgage and Pfandbriefe market. Germany is characterised as a medium support country.

Notching Considerations

In line with Moody's notching guidelines published in April 2007, MünchenerHyp's subordinated debt is rated at A2, i.e. one notch below the bank's senior debt rating. The bank's hybrid securities are rated Baa2.

Foreign Currency Deposit Rating

MünchenerHyp's foreign currency deposit ratings are A1/Prime-1.

Foreign Currency Debt Rating

MünchenerHyp's foreign currency debt ratings are A1/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

Münchener Hypothekenbank eG

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (50%)						**C-**	
Factor: Franchise Value						**C-**	**Neutral**
Market Share and Sustainability				**x**			
Geographical Diversification		**x**					
Earnings Stability				**x**			
Earnings Diversification [2]							
Factor: Risk Positioning						**D**	**Neutral**
Corporate Governance [2]							
- Ownership and Organizational Complexity	--	--	--	--	**--**		
- Key Man Risk	--	--	--	--	--		
- Insider and Related-Party Risks	--	--	--	--	--		
Controls and Risk Management		**x**					
- Risk Management			x				
- Controls	x						
Financial Reporting Transparency				x			
- Global Comparability				x			
- Frequency and Timeliness				x			
- Quality of Financial Information				x			
Credit Risk Concentration	**--**	**--**	**--**	**--**	**--**		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
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%)						**D+**	
Factor: Profitability						**E**	**Neutral**
PPP % Avg RWA - Basel II					0,49%		
Net Income % Avg RWA - Basel II					0,09%		
Factor: Liquidity						**C**	**Neutral**
(Mkt funds-Liquid Assets) % Total Assets					34,75%		
Liquidity Management		x					
Factor: Capital Adequacy						**D+**	**Neutral**
Tier 1 ratio (%) - Basel II				5,60%			
Tangible Common Equity / RWA - Basel II			5,39%				
Factor: Efficiency						**B**	**Neutral**
Cost/income ratio		50,37%					
Factor: Asset Quality						**B**	**Neutral**
Problem Loans % Gross Loans	0,72%						
Problem Loans % (Equity + LLR)			20,37%				
Lowest Combined Score (15%)						**D**	
Economic Insolvency Override						**Neutral**	
Aggregate Score						**C-**	
Assigned BFSR						**C-**	

[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