

FITCH DOWNGRADES DUESSELDORFER HYPOTHEKENBANK TO BBB-; OFF RATING WATCH NEGATIVE

Fitch Ratings-Frankfurt/London-02 July 2010: Fitch Ratings has downgraded Germany-based Duesseldorfer Hypothekenbank AG's (DHB) Long-and Short-term Issuer Default Ratings (IDRs) to 'BBB-' and 'F3', from 'A-' and 'F1' respectively, and removed them from Rating Watch Negative (RWN) where they had been placed in February 2009. The Outlook is Stable.

The bank's Support Rating has been downgraded to '2' from '1' and removed from RWN. Its Individual Rating has been upgraded to 'E' from 'F'. At the same time, Fitch assigned DHB a Support Rating Floor of 'BBB-'. Given DHB's still low Individual Rating, its IDRs are at its Support Rating Floor and are likely to remain so in the foreseeable future.

The rating actions follow the announcement on 30 June 2010 that a fund owned by US-based investor Lone Star has agreed to acquire 100% of DHB for an undisclosed price. The transaction is expected to close in August 2010. This concludes a protracted search for a buyer by DHB's hitherto ultimate majority shareholder, Bundesverband deutscher Banken (BdB) since DHB was rescued by the German banking community via BdB in April 2008. The BdB is a banking association that represents the interests of about 230 German private commercial banks. Fitch understands that BdB will not retain any assets of the bank.

"While Fitch considers that institutional support from the bank's new owner cannot be relied upon, systemic support would ultimately be forthcoming from the German government, in case of need, and this is reflected in the Support Rating Floor," says Patrick Rioual, Director in Fitch's Financial Institutions team. This is because as a Pfandbrief (German covered bonds) issuer, DHB should benefit from the strong willingness from the public authorities, Pfandbrief issuers and investors to safeguard the standing of Pfandbriefe as an asset class and, by extension, of Pfandbrief issuers. Fitch further notes that past events have shown public authorities supporting not only for the outstanding Pfandbriefe noteholders but also for the bank as a whole. However, the agency's view of support may change if proposals for a new bank resolution regime result in lower likelihood of full support for banks.

The upgrade of the Individual Rating reflects Fitch's expectation that DHB will soon resume new business, following its hiatus since April 2008. This is notably made possible by the substantial capital increase that the bank is receiving in relation to its change of ownership. This will also materially improve its tight capitalisation (tier 1 capital ratio was 7.4% at end-2009), although the bank's leverage is likely to remain relatively high due to the generally low risk weights of its public sector assets.

At the same time, the bank's low Individual Rating reflects its still questionable ability to sustainably generate adequate profitability. This is compounded by its legacy (and still dominant) low-margin secondary market public sector lending portfolio. After reporting a modest net profit of EUR1.6m in 2009, DHB's profitability might come under additional pressure, should the current difficult market environment translate into higher-risk costs from the bank's large public finance securities portfolio. The Individual Rating is also constrained by the bank's need to demonstrate its ability to attract sufficient wholesale funding at acceptable conditions without external support and amid an increasingly challenging funding market for wholesale banks.

Fitch will closely monitor DHB's progress to sustainably restore a viable business model that no longer relies on external funding support and reduce its funding needs, in light of the expiration of the SoFFin guarantee. Despite its ample use of Pfandbrief issuance, DHB will remain reliant on senior unsecured issuance for a significant part of its funding needs. This should be alleviated by its

planned balance sheet shrinkage.

Fitch expects Lone Star to pursue DHB's already initiated diversification into commercial real estate (CRE) lending, similar to the way it repositioned COREALCREDIT BANK AG (Coreal, rated 'BBB-', Stable Outlook) following its acquisition in 2005. However, the progress achieved thus far by DHB in this respect remains limited and the absence of new business during the past two years has increased the challenge of restoring the bank's capacity to originate high-quality and profitable new business amid a competitive CRE market. In addition, Fitch expects the resumption of significant new business to be preceded by a phase of risk reduction and balance sheet shrinkage, mostly via asset sales. While this will benefit from Lone Star's proven track-record with comparable restructuring, this could be subject to delays depending on market conditions. It remains unclear whether Lone Star's intention to achieve synergies between Coreal and DHB might imply a merger of both entities at a later stage; however, Fitch does not expect this to occur before DHB has achieved significant restructuring progress.

Fitch will publish a separate comment shortly on the implications of the present rating action for DHB's public sector Pfandbriefe.

In Fitch's rating criteria, a bank's standalone risk is reflected in Fitch's Individual ratings and the prospect of external support is reflected in Fitch's Support ratings. Collectively these ratings drive Fitch's Long- and Short-term IDRs.

Applicable criteria, 'Global Financial Institutions Rating Criteria', dated 29 December 2009, are available on www.fitchratings.com

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