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Credit Opinion: **EEPK**

Global Credit Research - 24 Mar 2015

Luxembourg

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Baseline Credit Assessment	*caa2
Adjusted Baseline Credit Assessment	ba2
Issuer Rating -Dom Curr	**Ba2
Parent: Commerzbank AG	
Outlook	Rating(s) Under Review
Bank Deposits	Baa1/P-2
Baseline Credit Assessment	ba1
Adjusted Baseline Credit Assessment	ba1
Issuer Rating	**Baa1
Senior Unsecured	**Baa1
Subordinate	Ba2
Commercial Paper -Dom Curr	P-2
Other Short Term	(P)P-2

* Placed under review for possible upgrade on March 17, 2015

** Placed under review for possible downgrade on March 17, 2015

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Key Indicators

EEPK (Consolidated Financials)[1]

	[2]6-14	[3]12-13	[3]12-12	[3]12-11	Avg.
Total Assets (EUR million)	-	-	-	-	-
Total Assets (USD million)	-	-	-	-	-
Tangible Common Equity (EUR million)	-	-	-	-	-
Tangible Common Equity (USD million)	-	-	-	-	-
Tangible Common Equity / Risk Weighted Assets (%)	-	9.7	11.0	11.0	-
Net Interest Margin (%)	0.2	0.2	0.3	0.2	[4]0.2
PPI / Average RWA (%)	-	-1.6	-1.3	-8.3	-
Net Income / Tangible Assets (%)	0.1	-0.3	-0.1	-1.0	[4]-0.3

Cost / Income Ratio (%)	22.0	-16.9	-21.4	-2.7	[4]-4.8
Market Funds / Tangible Banking Assets (%)	77.7	76.0	74.5	76.7	[4]76.2
Liquid Banking Assets / Tangible Banking Assets (%)	8.2	11.5	11.4	17.1	[4]12.1
Gross Loans / Total Deposits (%)	-	52.6	59.3	45.9	[4]52.6

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 17 March, we placed on review for downgrade the Ba2 long-term issuer ratings of Erste Europaeische Pfandbrief- und Kommunalkreditbank Aktiengesellschaft in Luxemburg S.A. (EERP). At the same time, we put on review for upgrade the bank's caa2 baseline credit assessment (BCA). The current long-term issuer ratings benefit from six notches of support from EERP's sole parent Commerzbank (Baa1 on review for downgrade, BCA ba1).

The review for downgrade on the bank's Ba2 long-term ratings was prompted by our advanced loss given failure (LGF) analysis. Our preliminary LGF analysis indicates a high loss-given-failure for senior debt instruments leading us to expect to position their Preliminary Rating Assessment (PRA) one notch below the Adjusted BCA. Our preliminary indication of the expected outcome following the review conclusion is a Ba3 long-term issuer rating.

EERP's standalone caa2 BCA is on review for upgrade, but remains constrained by (1) Commerzbank's decision to unwind EERP's entire business in the context of challenging market conditions for its divestment (which was required by the European Commission); and (2) some residual tail risk with regard to the bank's moderate asset quality related to its exposures to local authorities in the US, and regional creditors in Italy and Spain. These constraints are only partly offset by recently improved capitalisation as a result of the merger of Hypothekbank Frankfurt International S.A. (HFI, unrated) and the previous EERP entity.

EERP'S BCA IS CALIBRATED AGAINST ITS MACRO PROFILE OF STRONG+

The bank's BCA is calibrated to reflect its Strong+ Macro Profile, which is determined by the bank's international exposure of its public finance book. The bank has significant exposures to the US (EUR4.8 billion), the UK (EUR2.2 billion), Spain (EUR1.9 billion) and Italy (EUR1.8 billion) out of a total book of EUR17.2 billion as of end 2013. The weighted average of the respective macro profiles comes out one notch below the macro profile for the US and the UK which we have determined at "very strong - " and reflects some of the weaknesses experienced in the operating environment in the European periphery.

Rating Drivers

- Moderate asset quality, with tail risks in the public finance portfolio
- High leverage is a rating constraint
- Weak profitability as a result of EERP's status as a wind-down entity
- Modest liquidity risk owing to funding support from Commerzbank

Rating Outlook

EERP's issuer rating is on review for downgrade, reflecting the downward pressure from the LGF analysis. EERP's caa2 standalone BCA is on review for upgrade.

What Could Change the Rating - Up

Upward pressure on EERP's rating could develop on the back of a strengthening of its creditworthiness, following a possible orderly wind-down and a further strengthening of its capital base. EERP's ratings would also benefit from improvements in Commerzbank's fundamental credit strength. Upward pressure could also result from a

change in EEPK's liability structure in case the bank increases the amount of debt which could be bailed in.

What Could Change the Rating - Down

The support from Commerzbank incorporated into the rating is key for EEPK's issuer rating. If Commerzbank were no longer committed to the orderly unwinding of EEPK and opted to withdraw the LoC, EEPK's rating could face a multiple notch downgrade as a result of a review of the support uplift factored into EEPK's ratings.

Further pressure would likely develop for EEPK's rating in the event of a significant worsening of the credit quality for the more critical parts of its exposures (exposures to local authorities in the US, and regional creditors in Italy and Spain).

DETAILED RATING CONSIDERATIONS

Since 1 September 2014, EEPK comprises the merged businesses of two Luxembourg-based Commerzbank subsidiaries: previous EEPK, which holds a portfolio of public-sector loans, and previous Hypothekenbank Frankfurt International S.A. (HFI, unrated), a wind-down entity that used to be a subsidiary of Hypothekenbank Frankfurt (HF, deposits Baa3 on review for upgrade; BCA caa2 on review for upgrade) and contained HF's international public finance portfolio in Luxembourg. Both entities use "Lettres de Gage"(covered bonds) to refinance a portfolio of public-sector loans.

End of June 2012, HFI was put into wind-down together with HF (collectively former Eurohypo) as part of Commerzbank's state-aid ruling. On 1 September 2014, previous EEPK was merged into HFI which was then renamed into EEPK.

MODERATE ASSET QUALITY, WITH TAIL RISKS IN THE PUBLIC FINANCE PORTFOLIO

EEPK's asset quality is moderate and contains considerable tail risk from public sector exposures to the US, UK, Italy and Spain.

As of December 2013, the former EEPK, if combined with HFI, managed a EUR17.2 billion public-finance portfolio. The portfolio mainly comprised exposures to public sector entities in the US (EUR4.8 billion), the UK (EUR2.2 billion), Spain (EUR1.9 billion) and Italy (EUR1.8 billion). In addition, HFI had some exposure to US student loans (EUR2.7 billion) and Lobo-loans (EUR2.2 billion). HFI, prior to its merger with EEPK, had a negative difference of book values to market values of EUR755 million as of June 2014.

HIGH LEVERAGE IS A RATING CONSTRAINT

The bank's pro forma common equity tier 1 (CET1) capitalisation of 16.8% as of 1 September 2014 increased from 9.1% at former HFI as a result of the merger. The bank benefits from a 0% risk-weight for public-sector exposures in the European Economic Area for former HFI. EEPK's substantial leverage at 2.86% (equity as % of total assets) on the back of EUR676 million equity is a further rating constraint.

WEAK PROFITABILITY AS A RESULT OF HF'S STATUS AS A WIND-DOWN ENTITY

For the first half year 2014, former HFI reported a pre-tax profit of EUR10.8 million (H1 2013 pre-tax loss of EUR62.0 million). Former EEPK reported a EUR5.2 million pre-tax profit (H1 2013 pre-tax loss of EUR11.8 million). On a pro forma basis, EEPK reported a EUR26.8 million pre-tax profit for the eight months to August 2014.

We expect profitability to remain weak during the next few years, partly because the bank may decide to take losses actively by selling assets below par in order to accelerate the unwinding process. We expect less pressure both from further write-downs on EEPK's exposures or from additional provisioning needs, to the extent that EEPK's exposures continue to benefit from the economic recovery in Europe.

MODEST LIQUIDITY RISK OWING TO LIQUIDITY SUPPORT FROM COMMERZBANK

The bank is funded by 'Lettres de Gage' and it obtains senior funding mainly from Commerzbank group (EUR7.1 billion at year-end 2013 for former HFI). The bank remains closely integrated into Commerzbank's group treasury, and benefits from Commerzbank's funding costs, as group funds are passed through on favourable terms.

The assigned scores result in a Financial Profile score of b2 which we plan to adjust down by one notch for the monoline nature of the business profile of the bank focusing on public sector finance. The resulting BCA range of b2 to caa1 indicates upward pressure for the currently assigned BCA of caa2 which is therefore on review for

upgrade.

NOTCHING CONSIDERATIONS

We assign an issuer rating of Ba2 to EEPK that is on review for downgrade. The rating is supported by EEPK's adjusted BCA of Ba2 and will likely be notched down one notch to reflect the results of our advanced LGF analysis.

AFFILIATE SUPPORT

EEPK's adjusted BCA benefits from our assessment of a very high probability of support from its parent, Commerzbank. The adjusted BCA of EEPK is placed one notch below Commerzbank's BCA to reflect some remaining, though remote, tail risk of a future break up. Following the review, we expect EEPK's adjusted BCA to continue to come out at ba2.

LOSS GIVEN FAILURE

EEPK is subject to the EU Bank Resolution and Recovery Directive, which we consider to be an Operational Resolution Regime. We therefore apply our advanced LGF analysis, considering the risks faced by the different debt and deposit classes across the liability structure should the bank enter resolution. We assume residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits, and assign a 25% probability to deposits being preferred to senior unsecured debt. These ratios are in line with our standard assumptions.

For the long-term issuer ratings our initial LGF analysis indicates a high loss-given-failure, leading us to expect that EEPK's Preliminary Rating Assessment (PRA) will be positioned one notch below the Adjusted BCA. According to our preliminary analysis, the bank has hardly any debt on its balance sheet which could be bailed in, therefore the review for downgrade for the bank's long term issuer rating which is likely to come out one notch below the current ratings.

GOVERNMENT SUPPORT

The ratings of EEPK do not incorporate any government support.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard 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

EEPK

Macro Factors	
Weighted Macro Profile	Strong +

Financial Profile						
Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
<i>Problem Loans / Gross Loans</i>	0.0%	aa1	↓ ↓	b1	Sector concentration	Long-run loss performance
Capital						

TCE / RWA	9.7%	ba1	↑ ↑	b1	Access to capital	Nominal leverage
Profitability <i>Net Income / Tangible Assets</i>	-0.3%	caa1	↑	caa1		
Combined Solvency Score		baa2		b2		
Liquidity Funding Structure <i>Market Funds / Tangible Banking Assets</i>	76.0%	caa3	← →	b3	Market funding quality	
Liquid Resources <i>Liquid Banking Assets / Tangible Banking Assets</i>	11.5%	ba1	← →	b1	Asset encumbrance	
Combined Liquidity Score		b3		b2		

Financial Profile

b2

Qualitative Adjustments

Adjustment

Business Diversification
Opacity and Complexity
Corporate Behavior

-1
0
0

Total Qualitative Adjustments

-1

Sovereign or Affiliate constraint

Aaa

Scorecard Calculated BCA range

b2 - caa1

Assigned BCA

caa2 Possible Upgrade

Affiliate Support notching

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Adjusted BCA

ba2

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
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