MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades covered bonds of FHB Mortgage Bank and OTP Mortgage Bank (Hungary)

Global Credit Research - 10 Dec 2010

Frankfurt am Main, December 10, 2010 -- Moody's Investors Service has today taken the following rating actions on covered bonds issued under Hungarian law:

- Mortgage covered bonds issued by FHB Mortgage Bank (FHB): Downgraded to Baa1 from A3; previously on 27 July 2010, placed on review for possible downgrade

- Mortgage covered bonds issued by OTP Mortgage Bank (OTP): Downgraded to Baa1 from A2; previously on 27 July 2010, placed on review for possible downgrade.

This concludes Moody's rating review of these mortgage covered bonds.

RATINGS RATIONALE

Moody's says that the downgrades were prompted by a combination of the downgrade of Hungary's government debt rating to Baa3 from Baa1 on 6 December 2010 and the exposure of covered bondholders to both significant refinancing risk and foreign-exchange risk. In addition, the timely payment indicators (TPIs) of FHB's and OTP's covered bonds have been lowered to "Very Improbable" from "Improbable".

The Baa1 ratings assigned to the existing covered bonds of FHB and OTP are expected to be assigned to all subsequent covered bonds issued under their programmes and any future rating actions are expected to affect all such covered bonds. If there are any exceptions to this, Moody's will in each case publish details in a separate press release.

The difficulties for the Hungarian economy have been highlighted by rating actions and opinions issued by Moody's sovereign rating group. On 6 December 2010, Moody's published a special comment, "Key Drivers of Hungary's Downgrade to Baa3", in which Moody's expressed its concerns about Hungary's medium- to long-term fiscal sustainability and a higher external vulnerability than most of its rated peers.

Against this backdrop -- and given the covered bondholders' exposure to both refinancing and foreign-exchange risk -- Moody's believes that any recovery against the cover pool could be severely distressed if one of the issuers defaults. Both FHB's and OTP's covered bond programmes are exposed to refinancing risk and foreign exchange risk:

- Refinancing risk. The covered bonds issued are "bullet" bonds. Therefore, following an issuer default, the natural amortisation of the assets in the cover pool cannot be relied on to fully repay the covered bonds in a timely manner. This implies that funds may need to be raised against the assets backing the covered bonds, possibly through the fire-sale of the assets in the cover pool. In the current volatile environment, Moody's expects that recoveries from such a sale would be highly stressed.

- Foreign-exchange risk. Both of FHB's and OTP's covered bonds programmes include a certain amount of unhedged foreign-exchange-rate risk. As of June 2010, approximately 50% of the covered bonds and 50% of assets in FHB's programme -- and, as of September 2010, 50% of the covered bonds and 55% of assets in OTP's programme -- were foreign-currency denominated (mainly Euros and/or Swiss francs). Moody's notes that the issuers may have swaps hedging these risks; however, Moody's has not currently given value to these in its covered bond analysis.

In the light of this, two potential risks in a weakened economy include: (i) whether borrowers would continue to be able to make payments if the currency depreciates further; and (ii) the covered bondholders' exposure to unhedged foreign-exchange-rate risks after issuer default, if part of the assets are re-denominated.

Generally, covered bond ratings are determined after applying a two-step process: an expected loss analysis and a TPI framework analysis.

EXPECTED LOSS: Moody's determines a rating based on the expected loss on the bond. The primary model used is Moody's Covered Bond Model (COBOL) which determines expected loss as a function of the issuer's probability of default and the stressed losses on the cover pool assets following issuer default.

TPI FRAMEWORK: Moody's assigns a TPI that indicates the likelihood that timely payment will be made to covered bondholders following issuer default. The effect of the TPI framework is to limit the covered bond rating to a certain number of notches above the issuer's rating.

A multiple notch downgrade of the covered bonds might occur in certain limited circumstances. Some examples might be (i) a sovereign downgrade negatively affecting both the issuer's senior unsecured rating and the TPI; (ii) a multiple notch downgrade of the issuer; or (iii) a material reduction of the value of the cover pool.

For further details on Cover Pool Losses, Collateral Risk, Market Risk, Collateral Score and TPI Leeway across all covered bond programmes rated by Moody's please refer to "Moody's EMEA Covered Bonds Monitoring Overview", published quarterly. These figures are based on the most recent reporting by the issuer and are subject to change over time.

The principal methodology used in this rating was "Moody's Rating Approach to Covered Bonds," published in July 2010. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found on Moody's website.

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