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Heta Resolution Spares Covered Bonds from Losses

From Credit Outlook

Analyst Contacts:

LONDON	+44.20.7772.5454
Martin Rast *Vice President - Senior Credit Officer* martin.rast@moodys.com	+44.20.7772.8676
Jane Soldera *Vice President - Senior Credit Officer* jane.soldera@moodys.com	+44.20.7772.5318

On Sunday, the Austria's financial markets regulator, Finanzmarktaufsicht (FMA), imposed several resolution measures on Heta Asset Resolution AG (Heta AR, backed senior unsecured Ca developing), including a write-down and bail-in of liabilities and a takeover of Heta AR from its shareholders. However, the covered bonds issued by Heta AR are not directly affected by these measures. The FMA taking control of Heta AR is credit positive for Heta AR's covered bondholders because it ensures that Heta AR continues to operate, albeit in wind-down mode. Additionally, European covered bondholders benefit from this latest precedent because it shows that covered bonds are likely to be protected in a resolution.

The covered bonds' exclusion from FMA's bail-in of Heta AR demonstrates how covered bonds are protected from bail-in under the European Union's (EU) Bank Resolution and Recovery Directive (BRRD) as implemented in Austria. In contrast, Heta AR's subordinated liabilities have been written down to zero, and its senior unsecured liabilities to 46.02% of their nominal value. Heta AR's senior unsecured liabilities have been subjected to a payment moratorium until 2023.

Although clear on no bail-in, the BRRD is less explicit on how covered bonds should be further treated in a resolution of an issuer. As such, it is positive that to date in the EU, regardless of whether a surviving entity is a good bank or bad bank (in Heta AR's case, it is the latter), the entity holding the covered bonds has not been subject to traditional insolvency proceedings. That means the covered bonds are not at risk of a sudden operational or liquidity shock that would make repayment of the bonds more difficult.

However, Heta AR's covered bonds continue to face risks. Among them is a possibility that Heta AR will remove uncommitted over-collateralisation, although this risk is relatively low. The covered bonds consist of one series (rated Ba2) that matures on 13 June 2016 and is backed by a cover pool composed of public-sector assets of €825 million backing CHF250 million of covered bonds. This translates into over-collateralisation of around 250%. Of this amount, the issuer is only contractually committed to hold at least 38.5%, and is legally allowed to remove over-collateralisation that exceeds the commitment. However, the current over-collateralisation levels have been in place for some time and with the imminent maturity of the bonds there seems to be limited rationale to remove the over-collateralisation.

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Another risk is outstanding litigation. Creditors have challenged previous Heta AR resolution measures in court, particularly as to whether debt governed by foreign law should be subject to resolution measures. A successful legal challenge would significantly affect Heta AR's ability to carry out its future operations in line with the resolution measures.

A third risk is that the cover pool itself contains significant exposures to Heta AR's home state of Carinthia (B3 negative), which has guaranteed Heta AR's debt. Carinthia's view is that resolution measures do not trigger the guarantees and that the guarantees would be limited to the new payment promise after the resolution measures, a position that creditors are challenging. If Carinthia was obliged to make payments under the guarantees, it would weaken Carinthia's credit strength and may negatively affect the value of the cover pool. Debt related to Carinthia constitutes one third of the cover pool backing Heta AR's covered bonds.

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Authors
Martin Rast
Jane Soldera

Production Associate
Gomathi M