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ISSUER COMMENT

Hypo Alpe-Adria-Bank International AG: Orderly Wind-Down Reduces Fire-Sale Risk, Credit Positive for Covered Bonds

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Executive Summary

On 22 March, Austria's Finance announced the transfer of the nationalised Hypo Alpe-Adria-Bank International AG (HAA, unrated) to a state owned corporate holding company.[1] The government's plan for an orderly wind down of HAA reduces the risk of asset fire sales, which is credit positive for HAA's covered bonds. However, the government's plan does not entail a guarantee for HAA's liabilities by its ultimate owner, the state of Austria (Aaa stable). Furthermore, there is a lack of transparency towards the future positioning of the covered bond programme.

[1] Österreichische Industrieholding AG (ÖIAG)

The Austrian government has decided to avoid HAA's insolvency…

The plan is for HAA to be organised as a limited liability company without a banking license. The reorganisation will require a special law that is scheduled to be enacted by mid 2014. To comply with EU state aid regulation HAA must sell the South-Eastern-European business by 2015. The remaining part of HAA is scheduled to be run down in an orderly fashion by selling its assets in a value-maximising fashion.

The government's decision dissipates any remaining doubts regarding potential insolvency proceedings against HAA. Comments made by the Austrian Finance Minister Michael Spindelegger in early February led to rising uncertainty around the intentions of HAA's owner, the Austrian government, with regards to the bank's future. At that time, Austria's Finance Minister sparked a public debate about HAA's future in which insolvency was not conclusively ruled out.

On 14 March, Michael Spindelegger announced that the government would no longer pursue the previously contemplated insolvency of HAA and will instead put the bank into wind-down via a bad-bank structure.

More clarity was added on 22 March, when the government announced that HAA would be transferred to a state owned holding company ÖIAG. ÖIAG administers the holdings of the Republic of Austria in partially or entirely nationalised companies.

…Which is credit positive for the covered bonds because it avoids a covered bond anchor event…

The government's plan for an orderly wind-down of HAA reduces the risk of a covered bond anchor event[2] (CB anchor event) and avoids the crystallisation of cover pool losses. The cover pool losses determine the value of the cover pool and take into account the credit quality of the cover pool collateral, refinancing risk and interest rate or currency mismatches.

The cover pool value is of particular importance for the covered bonds of HAA, because the cover pool losses are the highest observed for public-sector covered bonds in Austria, both because of high collateral and market risk. As of 31 December 2013, the cover pool losses for HAA's programme stand at 43% vs. an Austrian average of 20%[3].

The high cover pool losses drive the minimum over-collateralisation (OC) levels for this programme. The minimum OC that is consistent with the Aa2 target rating of the guaranteed covered bonds is 53.5% and the minimum OC that is consistent with the A3 target rating of the unguaranteed covered bonds is 53.0%. Although the current nominal OC of 338% comfortably exceeds the minimum OC levels for both the guaranteed and unguaranteed covered bond ratings, we do not fully rely on uncommitted OC. HAA may remove the OC at its discretion, or at the behest of a third party with authority or influence over the bank.[4] Committed OC stands at 38.5%.

…But the future of HAA's covered bond programme is uncertain

Even though a crystallisation of cover pool losses is subdued because of the government's announcement of an orderly wind-down of the bank, uncertainties remain with regards to the future of HAA's covered bond programme. These uncertainties distinguish the current wind-down plan for HAA from similar plans observed for bad-bank schemes recently set up in Germany.

For research publications that reference Credit Ratings, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated Credit Rating Action information and rating history.

2 Reference point for determining the probability that a covered bond issuer will cease making payments under the covered bonds.

3 See Moody's Global Covered Bonds Monitoring Overview: Q3 2013, January 2014 for an overview of collateral and market risk in Austrian covered bond programmes.

4 This could be a court or the regulator.

Firstly, HAA will not benefit from a guarantee of its ultimate owner, the state of Austria. This is different from the bad-banks of former WestLB AG[5] and Hypo Real Estate Group.[6] Erste Abwicklungsanstalt benefits from a guarantee mechanism provided by the Land of North Rhine-Westphalia and FMS Wertmanagement benefits from a loss compensation obligation from Germany's Financial Market Stabilisation Fund (SoFFin).

Secondly, the plan for the wind-down of HAA lacks transparency towards the future positioning of the covered bond programme. In Germany, the covered bond programmes of former WestLB AG and Hypo Real Estate Group were transferred to the newly founded Portigon AG[7] and Deutsche Pfandbriefbank AG.

In the case of HAA we expect that the covered bonds will form part of the wind-down entity, for two reasons. Firstly, 79% of the outstanding covered bonds benefit from a guarantee of the federal state of Carinthia. If the guaranteed covered bonds were to be sold together with the South-Eastern-European business this may increase the risk that the deficiency guarantees for senior debt will be triggered if the acquirer of the assets is a lower quality credit. Secondly, the cover pool would need to be split in two parts if only the unguaranteed covered bonds were to be sold together with the South-Eastern-European business. To date, we have not observed a cover pool split of a programme that we rate and uncertainty remains with regards to the allocation of committed and uncommitted OC following such a split.

Lastly, the wind-down plan for HAA considers a potential bail-in of subordinated debt of €1.9 billion and participation capital of €1.1 billion. The subordinated debt partially benefits from a deficiency guarantee by the Federal State of Carinthia, one of the former owners of HAA. A bail-in of guaranteed debt would, however, require a change to the law and could greatly reduce the value of the deficiency guarantee to ensure full and timely payment of interest and principal. About 79% of the covered bonds issued by HAA benefit from the same type deficiency guarantee. It is unclear to what extent a law change, intended to change the value of the deficiency guarantee for subordinated debt, could impact the value of the guarantee for the Aa2 rated covered bonds. More clarity may provide a law change, which is the condition precedent for the reorganisation of HAA, and which is scheduled to be enacted by mid 2014.

5 In December 2009 former WestLB AG was split in two parts: (i) Portigon AG (the good bank) and (ii) Erste Abwicklungsanstalt (the bad bank). Erste Abwicklungsanstalt's rating of Aa1reflects the entity's direct credit linkage to the Land of North Rhine-Westphalia (Aa1, stable), which is derived from the guarantee mechanism provided by the Land.

6 In July 2010, former Hypo Real Estate Group was split in two parts: (i) Deutsche Pfandbriefbank AG (the good bank) and (ii) FMS Wertmanagement (the bad bank). FMS Wertmanagement is rated on par with the German sovereign (Aaa stable). This is because of a loss compensation obligation from the Financial Market Stabilisation Fund (SoFFin) vis-à-vis the bad bank, which is ultimately an obligation of the German sovereign.

7 Portigon's covered bonds were transferred to Landesbank Hessen-Thueringen GZ(A2 stable) in September 2012.

EXHIBIT 1

Key Indicators

Hypo Alpe-Adria-Bank International AG Public-Sector Covered Bonds

	31 December 2014
Type	**Public Sector**
Issuer Rating	**Unpublished**
Covered Bond Rating	**guaranteed covered bonds are rated Aa2** **unguaranteed covered bonds are rated A3**
Over-Collateralisation	
Current	338%
Committed	38.5%
Required for Aa2 Required for A3	53.0%, thereof 35.5% in committed form 53.5%, thereof 24.5% in committed form
TPI	High
TPI Leeway for: » guaranteed covered bonds » unguaranteed covered bonds	 1 notch n/d
Cover Pool Losses	**43.6%**
Collateral Risk	10.1%
Market Risk	33.6%
Collateral Score	20.1%

Source: Moody's Performance Overview

Moody's Related Research

Rating Methodology:

» Moody's Approach to Rating Covered Bonds, March 2014 (SF345822)

Special Comment:

» Moody's Global Covered Bonds Monitoring Overview: Q3 2013, January 2014 (SF354852)

Performance Overview:

» Hypo Alpe Adria Bank International AG - Public Sector - Covered Bond Programme, April 2014 (SF363745)

Webpage:

» www.moodys.com/coveredbonds

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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