

SPECIAL COMMENT

Key Drivers of Austrian Bank Rating Actions

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Summary

Today, we took various rating actions on Austrian banks, including downgrades of the debt and deposit ratings of the three largest Austrian banking groups. The ratings for Raiffeisen Bank International (RBI, A2 stable, D+/ba1 stable¹) and UniCredit Bank Austria (UBA, A3 negative, D+/ba1 stable) were downgraded by one notch, while those for Erste Group Bank AG (Erste, A3 negative, D+/baa3 negative) were downgraded by two notches reflecting the combination of the recent significant asset quality deterioration and the sizable concentration to Hungary and Romania (see today's press release entitled "Moody's downgrades Austrian banks; ratings carry stable or negative outlooks"). We also downgraded the ratings for several banks' subordinated debt rating, withdrawing systemic support for this debt class.

This report provides more detailed information on the key drivers of today's downgrades of the three largest banks further to the reviews we initiated, or extended, on 15 February 2012 as part of a wider review of European bank ratings.² The rating downgrades for the three largest Austrian banks reflect their vulnerability to the adverse operating conditions in some of their core markets in Central and Eastern Europe and the Commonwealth of Independent States (CEE/CIS) and the increased risk of further shocks from the ongoing euro area debt crisis. Specifically, the main drivers underlying today's rating actions are:

- » **Risks to asset quality**, given that (i) the three largest Austrian banks have considerable exposures to CEE/CIS countries with significant economic and political risks and (ii) increased uncertainty from the euro area crisis and its potential negative repercussions to the operating and economic environment in Europe.
- » **Limited capital buffers to absorb losses in a stressed environment**, which leave banks vulnerable to further asset quality deterioration and other potential shocks. While Austrian banks have improved capital and reserves, loss-absorption capacity in an adverse scenario remains below that of many European banking peers.
- » **Moderate reliance on wholesale funds**, which renders the banks susceptible to the increased risk of possible disruptions amidst the adverse and highly uncertain current environment. And while we recognise the banks' progress in accessing local funding for their CEE/CIS operations, a significant portion of foreign assets remain funded in wholesale markets by the Austrian parent banks. This contributes to strong profitability, but also results in currency and maturity mismatches.

¹ The bank ratings shown in this report are the deposit ratings, the standalone bank financial strength rating (BFSR) / baseline credit assessment (BCA), and the corresponding outlooks.

² For review announcements, see: [Rating Action: Moody's Reviews Ratings for European Banks](#) 15 February 2012.

We recognise mitigating factors. The limited magnitude and scope of today's downgrades for Austrian banks take into account several mitigating factors, including (i) the three largest banks' solid franchises, which generate sizeable pre-provision earnings; (ii) the relatively stable domestic environment, with slower but still positive economic growth and sound government finances (as reflected in our Aaa government bond rating for Austria, with a negative outlook); (iii) the benefits derived from being an integral part of the intrinsically strong Austrian cooperative sector (in the case RBI), of the Austrian savings banks sector (in the case of Erste), and the broader franchise and access to funding that UBA obtains via its parent UniCredit Spa (UniCredit, A3 negative, C-/baa2, negative). We also recognise positively that the three banks have limited direct exposures to countries in Europe's southern periphery.

Support assumptions have not changed. Our assumptions about parental, cooperative and government (systemic) support for Austrian banks have not changed. The senior debt and deposit ratings for the three largest groups are positioned between three and five notches above their standalone credit assessments, reflecting our expectation that they would have access to several external support sources, if needed. We note that future support assumptions are subject to review in the context of the ongoing EU-wide resolution regime introduction.

UBA benefits from two notches of parental support given its strategic importance for the group and having been a key contributor of profits to its parent company UniCredit.

RBI's senior debt and deposit ratings contain two notches of support uplift from the co-operative banking sector in Austria. We believe RBI to be an integral part of the Raiffeisen banking group holding a 31% market share in Austria and thus to have access to sector funds if in need.

In addition, our ratings for the three largest Austrian banks contain up to three notches of systemic (government) support. We continue to consider Austria as a medium support country and maintain current high support assumptions in the ratings of the three largest banks on the following grounds:

- » Concentrated banking sector with the three largest sectors or groups (Raiffeisen, Savings Banks and UBA) accounting for approximately 65% of all banking assets. All command significant domestic market shares and at the same time are heavily involved in CEE/CIS countries.
- » Proven track record of the federal government to support its major banking institutions. Throughout the crisis to date, the government provided ample support in the form of capital injections (total of EUR7.4 billion), funding guarantees (total of EUR17 billion) and/or the timely (partial) nationalization of failed institutions. It continues to be actively involved in the restructuring of nationalized institutions such as Hypo Alpe Adria group (unrated); Kommunalkredit (Baa3; E/caa1), KA Finanz (unrated) and partially nationalized Österreichische Volksbanken (Baa2 on review for downgrade; E+/b1 review for downgrade).

Given the high leverage of the banking system at almost four times the Austrian GDP and some wholesale funding dependence we continue to believe that the Austrian government will continue to support its banking system, in particular its major players. Further, in view of the importance of the banking system for Austria's economy and industrial backbone together with the long standing political tradition of the country in the CEE/CIS region, any failure of major banking institution with subsequent bail ins of senior debt is likely to trigger a severe confidence crisis for the Austrian banking system. We therefore expect further emphasis on macro-prudential measures to contain these risks rather than a withdrawal of support.

As a result, the debt and deposit ratings for RBI and Erste continue to reflect three notches of rating uplift from government support whilst UBA's debt and deposit ratings benefit from two notches.

Rating outlooks differ for the three largest banks. The debt and deposit ratings and the standalone credit assessment for RBI carry stable outlooks, reflecting our view that currently foreseen risks for creditors are incorporated into the ratings. The debt and deposit ratings for UBA carry negative outlooks, because the negative outlook on its parent's ratings implies a risk that our parent support assumptions for UBA may decline. The standalone credit assessment for UBA carries a stable outlook. The debt and deposit ratings and standalone credit assessment for Erste carry negative outlooks, given adverse and uncertain conditions in Romania and Hungary, where Erste has sizeable operations.

The following events could lead to downward rating pressure for all Austrian banks: (i) asset quality deterioration beyond current expectations; (ii) deteriorating earnings and capital levels; and (iii) increasingly restricted capital markets access.

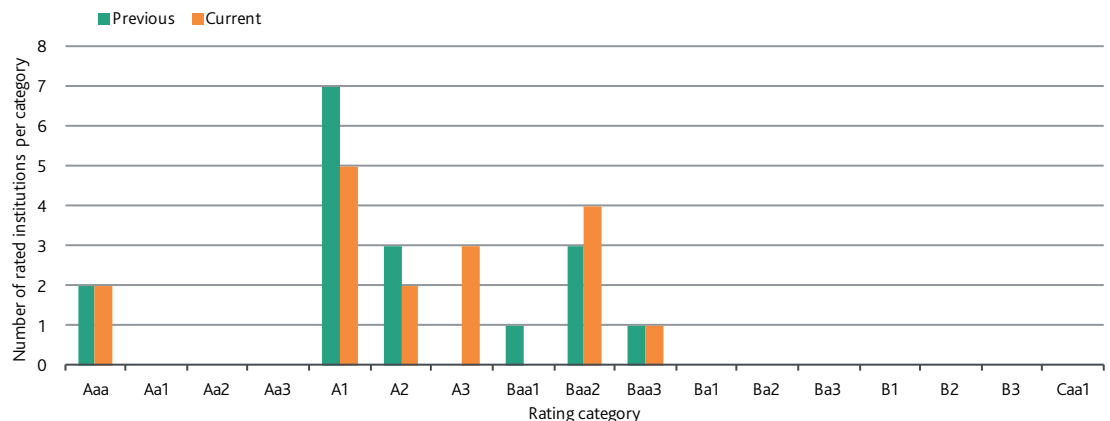
The average deposit rating for Austrian banks now ranks in the mid- to lower range among western European peers, while average standalone credit assessments are positioned in the lower range. The relative ranking of standalone credit assessment reflects our view that the banks will be challenged by the prevailing adverse operating conditions in the CEE/CIS region as well as in western Europe. The ranking of the deposit ratings reflects these banks' access to external support. Given the ongoing reviews for downgrade of other European bank ratings, the relative rankings may change.

Overview of Austrian bank ratings

- » Today's rating actions are briefly summarised below.
 - **RBI:** The debt and deposit ratings were downgraded by one notch to A2, and we assigned a stable outlook. The standalone credit assessment also declined by one notch to ba1, with a stable outlook. The short-term ratings remained unchanged at Prime-1.
 - **UBA:** The debt and deposit ratings were downgraded by one notch to A3, with a negative outlook driven by the negative outlook on the credit strength of the bank's parent, UniCredit. The standalone credit assessment also declined by one notch to ba1, but with a stable outlook. The short-term ratings were downgraded to Prime-2.
 - **Erste:** The debt and deposit ratings for Erste were downgraded by two notches to A3. The standalone credit assessment also declined by two notches to baa3. The negative outlook on the ratings is driven by the tail risk resulting from Hungary and Romania. The short-term ratings were downgraded to Prime-2.
- » Figure 1 shows the distribution of deposit ratings, while Figure 2 provides detailed ratings information for each rated Austria-domiciled financial institution.

FIGURE 1

Long-term deposit ratings for Austrian banks (Number of rated banks per rating category)



Note: Includes all rated Austrian financial institutions and their respective subsidiaries.

Source: Moody's Investors Service

- » In addition, we have today downgraded the subordinated debt and hybrid instruments ratings for seven Austrian banks (including the three largest banks), following the removal of systemic support for these securities. The removal of support for this debt class reflects Moody's view that, among Austrian banks, systemic support for subordinated debt is no longer sufficiently predictable and reliable to warrant incorporating uplift into Moody's ratings.
- » **Four issuers** remain on review for downgrade: The ratings of Hypo Tirol Bank AG (A2 review for downgrade; D / ba2 review for downgrade) and Oesterreichische Volksbanken AG (Baa2 review for downgrade; E+ / b1 review for downgrade) together with its subsidiary Investkredit AG (Baa2 review for downgrade; E+ / b1 review for downgrade) remain on review for downgrade. While these banks are also affected by the difficult European operating environment and the increased risk of adverse shocks in Europe, their ongoing reviews are mainly driven by reasons specific to each institution and will be resolved in due course. Moody's also maintains the review on the

backed ratings of Pfandbriefstelle der Oesterreichischen Landes-Hypothekenbanken (senior Aaa, review for downgrade) that were put on review on 21 February 2012 as a result of the gradual credit deterioration of Pfandbriefstelle's member banking groups and their statutory guarantors, the respective Austrian states or municipalities.

- » **A further four issuers** are unaffected by today's rating actions, and their ratings carry stable outlooks (Figure 2 below) given our assessment that they are less vulnerable to the prevailing risks.

FIGURE 2

Overview of rated Austrian banks and subsidiaries

Issuer	L-t deposit rating	L-t deposit rating outlook	Standalone credit assessment	Standalone credit assessment outlook	Parent / coop / RLG support	Systemic support	Prior l-t deposit rating	Prior standalone credit assessment
Issuers downgraded today:								
Erste Group Bank AG	A3	Neg	baa3	Neg	0	3	A1	baa1
Raiffeisen Bank International	A2	Sta	ba1	Sta	2	3	A1	baa3
Raiffeisen Zentralbank Oesterreich AG	A3	Sta	--	--	--	--	A2	--
UniCredit Bank Austria	A3	Neg	ba1	Sta	2	2	A2	baa2
card complete Service Bank AG	Baa2	Neg	ba2	Sta	3	0	Baa1	ba2
Issuers remaining on review for downgrade:								
Hypo Tirol Bank AG	A2	RuRd	ba2	RuRd	2	4	A2	ba2
Oesterreichische Volksbanken AG (ÖVAG)	Baa2	RuRd	b1	RuRd	2	3	Baa2	b1
Investkredit Bank AG	Baa2	RuRd	b1	RuRd	2	3	Baa2	b1
Pfandbriefstelle der Oesterr. Landes-Hypothekenbanken	Aaa	RuRd	NR	--	--	--	Aaa	NR
Issuers where only subdebt ratings are affected:								
BAWAG P.S.K.	Baa2	Sta	ba2	Sta	0	3	Baa2	ba2
Kommunalkredit Austria AG	Baa3	Sta	caa1	Sta	0	7	Baa3	caa1
Vorarlberger Landes- und Hypothekenbank AG	A1	Neg	baa3	Sta	2	3	A1	baa3
Issuers not affected by today's rating actions:								
Raiffeisenlandesbank Niederoesterreich-Wien	A1	Sta	baa1	Sta	1	2	A1	baa1
Raiffeisenlandesbank Oberoesterreich AG	A1	Sta	baa2	Sta	2	2	A1	baa2
Raiffeisen-Landesbank Steiermark AG	A1	Sta	baa2	Sta	2	2	A1	baa2
Raiffeisenlandesbank Vorarlberg	A1	Sta	baa2	Sta	2	2	A1	baa2

Notes: L-t deposit rating = Long-term deposit rating which reflects a bank's standalone profile and support considerations; Standalone credit assessment = Baseline Credit Assessment (BCA) which reflects credit strength without support considerations; Parental/coop/RLG support = number of notches of ratings uplift due to support from parent, cooperative group, regional and local government; Systemic support = number of notches of ratings uplift due to support from the government; The table includes all rated Austrian banks, including those not affected by today's rating actions.

Source: Moody's Investors Service

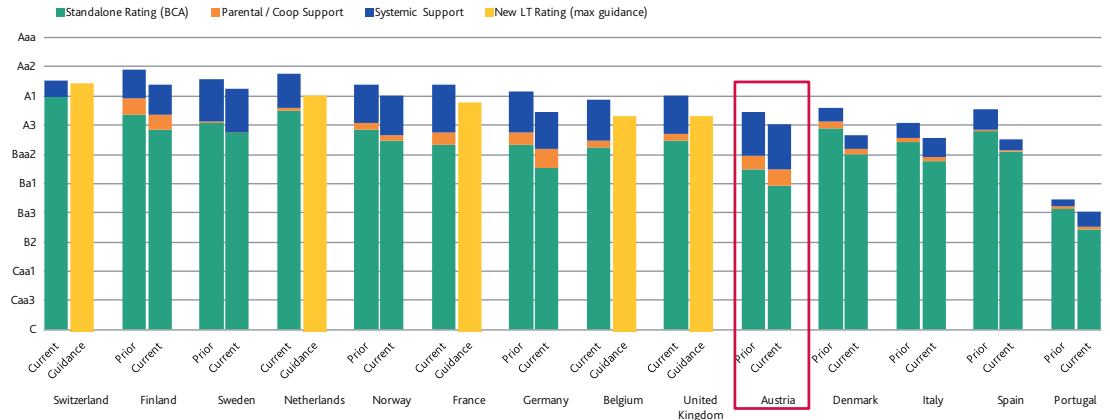
System-wide considerations

Deposit ratings for Austrian banks rank in the mid- to lower range among European peers

- » The (asset-weighted) average deposit rating for Austrian banks of approximately A3 now ranks in the middle to lower range across western European banking systems (Figure 3 below). The (asset-weighted) average standalone credit assessment of approximately ba1 ranks at the lower end compared with many European peers.
- » As stated above, the relative positioning of standalone credit assessments reflects our view that the three largest Austrian banks will be challenged by adverse operating conditions in the CEE/CIS region and western Europe, which we expect to persist through 2012 and likely beyond. At the same time, the three banks generate sizeable pre-provision earnings from these CEE/CIS activities, which limited the extent of today's downgrades.
- » The positioning of the deposit ratings reflects the access of these three banks to significant external support, including sector support for RBI and parent support for UBA, as well as government support.
- » Given the ongoing reviews for downgrade of other European bank ratings, relative rankings may change.

FIGURE 3

Average bank ratings across European countries and prospective ratings



Note: 'New LT Rating (max guidance)' refers to ratings for which the review has not been concluded yet.

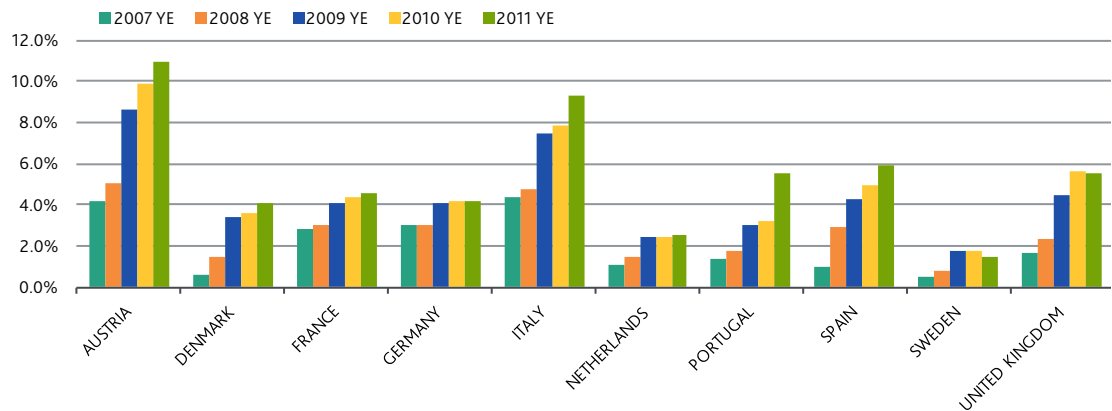
Source: Moody's Investors Service

Asset quality concerns contributed to downgrades

- » We expect that problem loan levels at the largest Austrian banks will remain persistently high in 2012 and beyond, causing elevated provisioning requirements that may consume a large portion of these banks' pre-provision earnings, particularly if combined with possible further shocks from the euro area debt crisis. This outlook considers the banks' large exposures to CEE/CIS markets that are more volatile (both economically and in some cases politically) than most western European economies, except for countries most stressed by the euro area debt crisis. Concerns about asset quality risks have been key drivers of today's downgrades.

- » As Figure 4 below shows, average problem loan levels of rated Austrian banks rank among the highest across western European banking systems. The average problem loan ratio for rated Austrian banks as of year-end 2011 of 11.0%³ (Figure 4) reflects ongoing asset quality deterioration, although we note that this number is slightly distorted by the very high 38% NPL ratio of Hypo Alpe Adria group (unrated) which is in wind-down mode after a government bailout. Adjusting for this, the problem loan ratio for the Austrian banking system stood at a continued high 8.9% as of year-end 2011, up sharply from only 4.1% at year-end 2007. The high problem loan levels of the three largest Austrian banks are reflected in weak system-wide asset-quality metrics.

FIGURE 4
Problem loan ratios among Moody's-rated banks, average by country



Note: Aggregates are based on rated banks' results available as of early May 2012. For some systems, sufficient results may not be available for 2011.
Source: Moody's Banking Financial Metrics (publicly-adjusted results)

Rising problem loans among Austria's three largest banks are driven by weakening CEE/CIS exposures

- » At year-end 2011, problem loans of the three largest banks amounted to approximately 9.2% of gross loans on average, mainly as a result of CEE/CIS activities for which the banks report ratios well in excess of 10%.⁴
- » The deterioration in CEE-related asset quality is to a large extent driven by exposures to countries that have seen significant economic volatility, like Hungary (where adverse legal changes also contributed to problem loan growth⁵), as well as Ukraine, Romania and Kazakhstan. By contrast, credit performance has been much more stable in countries like the Czech Republic, Slovakia, Poland and Russia whose economies have been less pressured to date.

Largest Austrian banks have substantial exposure to Central and Eastern Europe

- » As of June 2011, the total assets of fully consolidated CEE/CIS subsidiaries of Austrian-domiciled banks amounted to around EUR270 billion which compares to total consolidated banking sector assets of EUR1,137 billion.⁶ A substantial portion of these exposures is held by the three largest banks, for which CEE/CIS exposures comprise a high percentage of total lending (between 36% at

³ Source: Moody's Banking Financial Metrics

⁴ Source: Company reports

⁵ See [Hungarian Banks on Review for Downgrade due to Law to Haircut FX-Denominated Mortgages](#), 7 October 2011

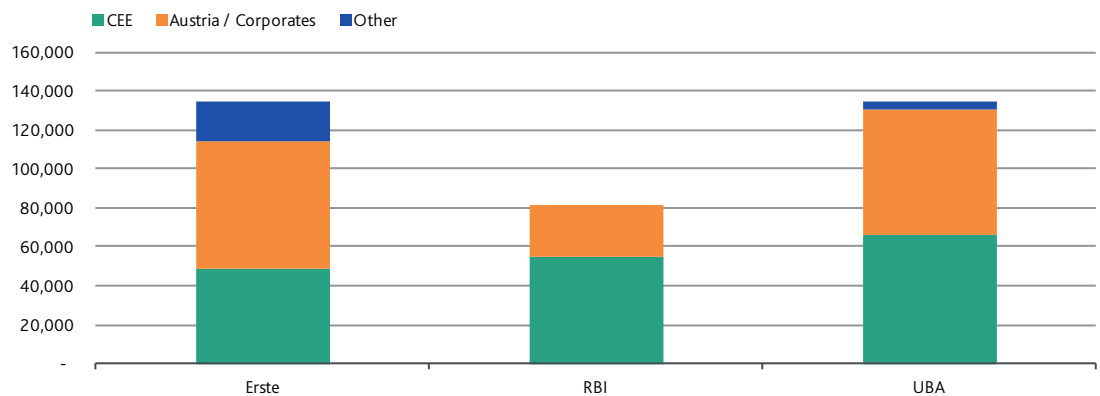
⁶ Source: Austrian National Bank (OeNB), Financial Market Stability Report, Number 22, December 2011

Erste and 67% at RBI of total customer loans at year-end 2011⁷). The high level of foreign exposures among the three largest Austrian banks (see Figure 5), the bulk of which are to CEE/CIS countries, is a key asset quality concern in the current environment.

- » On a more positive note, and following excessive growth in pre-crisis years, the three largest Austrian banks' exposures to the CEE/CIS region have remained stable since 2007. In addition, a high proportion of exposures to the CEE/CIS region is to borrowers in more stable EU member states like the Czech Republic and Slovakia.

FIGURE 5

Total domestic and non-domestic assets of major Austrian banking groups, in EUR million



Source: Companies' annual reports 2011

- » However, the sharp increase in problem loans in recent years demonstrates the elevated volatility and risk content of the banks' non-domestic exposures, particularly in the CEE/CIS region. We expect non-performing loan levels to continue increasing in light of the substantial slowdown that is expected for some of the countries in the CEE/CIS region (see Moody's [sovereign statistical handbook](#)). We recognise, however, that these activities also generate sizeable pre-provision profits, as discussed below.

Stable domestic economy and limited exposures to stressed euro area countries limit risks

- » Loan performance in domestic Austrian operations has been a stabilising factor for the three largest banks, given the slower but still positive expected GDP growth of 0.8% for Austria in 2012 and moderate unemployment of 4.2% as of year-end 2011,⁸ We expect domestic operating conditions to remain relatively benign compared with more risky CEE/CIS markets or the more stressed euro area countries throughout 2012.
- » The three largest Austrian banks' direct exposure to sovereigns that are most affected by the euro area debt crisis – Greece, Portugal, Ireland, Spain and Italy – was limited to EUR3.8billion as of September 2011.⁹ As such, these direct exposures are not the main driver of today's downgrades. But the ongoing euro area debt crisis increases the risk of unforeseen shocks and sudden shifts in investor confidence. These conditions exacerbate the risks to creditors posed by the existing vulnerabilities of the three largest Austrian banks with regard to asset quality, capital and wholesale funding.

⁷ Source: Company reports

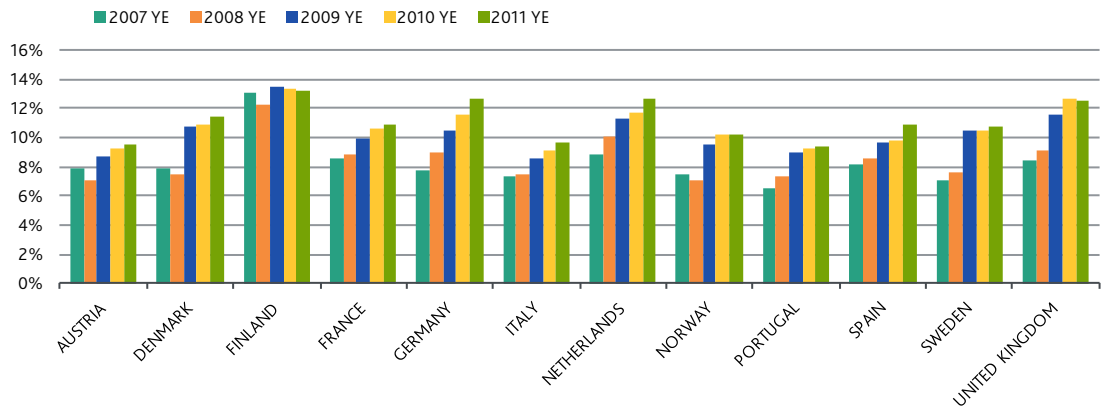
⁸ Source: [Moody's sovereign statistical handbook](#), 31 May 2012

⁹ Source: EBA capital exercise, September 2011

Largest banks have limited capital buffers to absorb losses in a stressed environment

- » Limited capital cushions are a key negative credit driver for the three largest Austrian banks. As Figure 6 below shows, the rated Austrian banks' asset-weighted average Tier 1 ratios rank below those of many western European peer systems, and this is driven in large part by limited capital at the three largest institutions.
- » The average Tier 1 ratio of rated Austrian banks as of year-end 2011 was 9.5%, the lowest among the banking systems shown in Figure 6. The combination of elevated asset quality risks and limited capital buffers restricts the ability of the largest Austrian banks to withstand severe stress conditions. Given increased capital demands from regulators and investors, the banks may restrict volume and lending growth and possibly cut existing exposures, particularly in more volatile CEE/CIS countries. A sharp retrenchment strategy would reduce their profitability and franchise strength, which would at least partly offset the benefit of higher capital buffers for creditors.

FIGURE 6
Tier 1 ratios among Moody's-rated banks, average by country



Note: Aggregates are based on rated banks' results available as of early May 2012. For some systems, sufficient results may not be available for 2011.
Source: Moody's Banking Financial Metrics (publicly-adjusted results), Companies' annual reports 2011

- » We recognise that, as of 31 March 2012, the three largest Austrian banks were already compliant with requirements from the European Banking Authority (EBA) to meet a minimum 9.0% Core Tier 1 by 30 June 2012. Moreover, we understand that they would be able to comply with the upcoming implementation of more stringent capital standards under the Basel III regulatory framework in the European Union (Capital Requirements Directive, or CRD IV).
- » Nevertheless, despite improved capital levels, the three banks' capital positions would be significantly affected under a severe stress scenario. In view of the comparatively high risk profile of the three largest Austrian banks given their large CEE/CIS exposures, we consider capital levels and buffers to be relatively low in a European context.

Scenario analyses reveal vulnerabilities of banks

- » We regularly assess every rated bank's ability to absorb estimated losses under two scenarios (see appendix for detail). For the Moody's-rated Austrian banks, we estimate aggregated losses of EUR26.4 billion under our base stress scenario and EUR54.6 billion in our severe stress scenario. These estimates compare with an aggregated Tier 1 capital of EUR45.9 billion at year-end 2011.

- » We recognise that our loss estimates reflect a conservative approach towards historical loan performance. We believe that elevated risks, particularly in the current volatile and uncertain environment, are highlighted by the recent deterioration in asset quality, including losses in longstanding markets for Austrian banks like Hungary.

Reliance on wholesale funding renders banks susceptible to market disruptions

- » Another factor contributing to today's downgrades is our view that the moderate reliance of the three largest Austrian banks on wholesale funding, while manageable, increases their susceptibility to external shocks. Such shocks may emanate from their exposure to volatile CEE/CIS markets or from the ongoing euro area debt crisis. Given the current difficult European operating environment, the risk of sudden market movements and changes in investor confidence have increased. This increased likelihood of shocks – rather than any change to the banks' funding profiles – is a key input in our assessment that the risks faced by creditors of the three largest Austrian banks have increased (as reflected in the revised ratings).

Gap between foreign assets and liabilities is partly funded with potentially volatile wholesale sources

- » A source of potential vulnerability is the fact that Austrian banks' foreign assets significantly exceed their foreign liabilities. At year-end 2011, the gap amounted to €70 billion or 28% of Austrian banks' total foreign assets.¹⁰ Mismatches between assets and liabilities in the various foreign operations and currencies are mainly funded via intra-group flows. We acknowledge the banks' focus on prudently balancing currency and liquidity risks.
- » The Austrian banking supervisors – Austrian National Bank (OeNB) and the Financial Markets Authority (FMA) – recommended in November 2011 that new lending in Eastern European markets should be limited to 110% of local deposits, plus funding in local capital markets and funding from supranational institutions.¹¹ This limitation encourages Austrian banks to further improve the balance of assets and liabilities in foreign markets. However, a sharp reduction in intra-group funding flows would restrict the banks' ability to grow lending in some CEE/CIS markets, which could affect their earnings and franchise strength.
- » We note that, after relying largely on wholesale funds to finance rapid loan growth in CEE/CIS markets prior to the crisis, Austrian banks have only recently shifted their focus towards raising local funding. This reduces the need to access more costly wholesale funds and offers a more sustainable business model in the future. For now, however, a significant portion of foreign assets are still funded in international capital markets, including with short-term interbank deposits which we regard as a potentially volatile funding source.

Sizeable deposit franchises limit wholesale funding reliance

- » The three largest Austrian banks have sizeable deposit franchises, both domestically and also in their core foreign CEE/CIS markets. At year-end 2011, deposits as a percentage of total liabilities comprised approximately 60% for UBA and Erste, respectively, and 50% for RBI, thereby limiting the banks' reliance on generally more confidence-sensitive wholesale funds.¹²

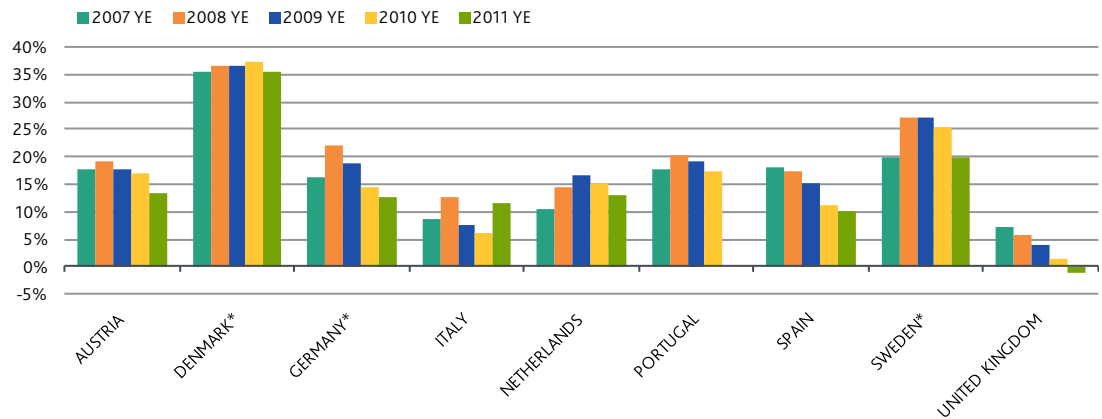
¹⁰ Source: Austrian National Bank (OeNB)

¹¹ See [Lending Limits for Eastern Europe Subsidiaries Are Credit Positive for Austrian Banks and Sovereign](#), 28 Nov 2011

¹² Source: Company reports

- » Figure 7 below shows rated Austrian banks positioned in the mid-range of western European peers in terms of their average market funds ratios of 14% at year-end 2011.¹³

FIGURE 7
Adjusted market funds ratio among Moody's-rated banks, average by country



Note: * Ratios for Denmark and Sweden would be much lower if adjusted for covered bonds. Furthermore, we believe the reported market funds ratio for German banks overstates their reliance on confidence-sensitive funding, because a large portion of market funds are provided via relatively stable intra-sector relationships. This is the case to a lesser extent in Austria and other systems. Aggregates are based on rated banks' results available as of early May 2012. For some systems, sufficient results may not be available for 2011.

Source: Moody's Banking Financial Metrics (fully-adjusted data)

Solid pre-provision profits have been largely offset by loan loss charges and other losses

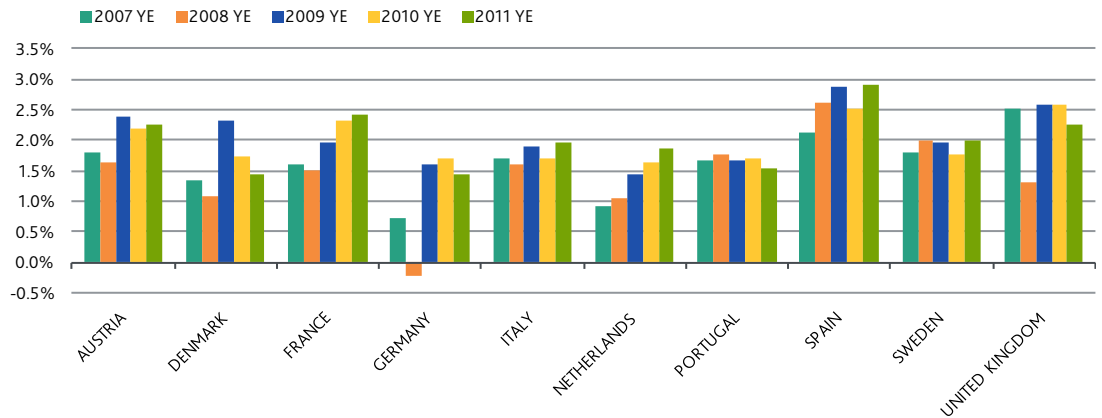
- » We view the geographically diverse franchises and the solid pre-provision earnings generated by the three largest Austrian banks as positive factors that have limited the magnitude of today's downgrades. These strengths underpin the banks' credit profiles and their new rating levels.
- » On an underlying basis (before provisions and taxes, and excluding extraordinary gains and losses), rated Austrian banks continue to generate solid pre-provision profit margins (as a percentage of risk-weighted assets), compared to western European peers (Figure 8 below).
- » The three largest banks are key contributors to the system-wide earnings of Austrian banks shown in Figure 8. They benefit from their higher-risk, but also much more profitable CEE/CIS operations, which generated approximately 90% of the three banks' 2011 overall pre-provision profits (and approximately 75% in 2010 and 2009, respectively).¹⁴ By contrast, margins are thin, albeit much more stable, in domestic Austrian banking. Here, the three largest banks and most other rated and domestically focused Austrian banks generate margins comparable to the modest levels recorded in markets such as Germany and the Nordics. The lower margins reflect price competition among domestic Austrian banks and low perceived risks.

¹³ Source: Moody's Banking Financial Metrics

¹⁴ Source: Company reports, segment data

FIGURE 8

Pre-provision earnings among Moody's-rated banks, average by country



Note: Aggregates are based on rated banks' results available as of early May 2012. For some systems, sufficient results may not be available for 2011.
 Source: Moody's Banking Financial Metrics (publicly-adjusted results)

- » However, the three banks' combined 2011 results showed elevated loan loss provisions and, in some cases, other charges which largely absorbed pre-provision earnings. UBA and RBI still recorded healthy pre-tax results for 2011, demonstrating a level of earnings resilience under challenging conditions. However, Erste reported a significant loss, largely due to impairment charges related to Hungary and to extraordinary charges.
- » Our concerns about the three banks' limited capital and increased problem loans are partly mitigated by loan loss reserves that covered an average of around 60% of non-performing loans as of year-end 2011,¹⁵ as well as their above-mentioned pre-provision earnings capacity. These elements bolster the banks' ability to weather possible losses on their rising problem loans.

¹⁵ Source: Company reports

Bank-specific factors

Downgrades for three largest banking groups reflect continued asset quality problems and vulnerability to external pressures

- » **Erste Group Bank (Erste)** is exposed to high credit-risk concentration towards Hungary and Romania and shows a high vulnerability to external pressures in our capital stress tests, which is particularly reflected in the negative rating outlook. We currently consider that Erste's operations in Hungary and Romania pose the highest risk to the group's earnings. Its operations in other countries might not be sufficient to compensate for shocks to earnings and capital that exceed our assumptions under stressed scenarios. In addition, we note that (i) Erste's capital buffer underpinning its riskier and more concentrated CEE franchise looks lower than those of its domestic peers, and (ii) a high proportion of its Tier 1 capital comprises hybrids and silent participations. These weaknesses are partly counterbalanced by its strong domestic Austrian franchise (carrying the savings bank brand) and the relatively low exposure to CEE as a percentage of the total loan book (36%). This is further supported by its coverage ratio of problem loans (60%), which compares well to those of its domestic peers.
- » The vulnerability of **Raiffeisen Bank International (RBI)** to further asset-quality deterioration due to its elevated exposure to riskier CEE/CIS countries (67% of its loan book, 24% in non-investment-grade countries) and its tight capital profile were the main reasons behind our rating downgrade. However, we changed the outlook on the ratings to stable, driven by our view that the current ratings capture RBI's credit weaknesses. We acknowledge that RBI has a well-diversified business mix and sound NPL coverage ratios, which mitigate the potential credit-negative effects of external events eroding RBI's capital generation.
- » The key weakness that constrains the standalone credit profile of **UniCredit Bank Austria (UBA)** is its level of non-performing loans (NPLs) at 10.1 %, the highest amongst the three largest Austrian banks. UBA also has the lowest problem loan coverage (52%). The bank's relatively high gearing towards wholesale funding as expressed by its loan-to-deposit ratio of 136% as of FY2011 renders the bank more vulnerable to confidence-sensitive funding than its Austrian peers. Factors that support the rating include the bank's solid capital adequacy levels and its well-diversified CEE/CIS franchise (49% of its loan book, 31% in non-investment-grade countries). In addition, UBA recorded resilient earnings during the crisis. UBA's fundamental credit strength incorporates a further moderate deterioration of the operating environment in CEE/CIS, and therefore carries a stable outlook. The negative outlook is driven by the negative outlook on the credit strength of the bank's parent, UniCredit.

Appendix: Moody's scenario analysis for Austrian Banks

Consistent with our global methodology, we estimate for each rated bank the life-time losses embedded in its balance sheet under two scenarios. Our scenario analysis assumes that estimated lifetime losses embedded in bank loans and markdowns on securities must be absorbed within 12 months. Our anticipated (or central) scenario uses loss assumptions that are lower than our severe stress (or adverse) scenario, which simulates a less likely, but still possible, loss scenario to assess a bank's ability to cope with additional stress.¹⁶

The table below shows the underlying assumptions for Austrian banks, which we have amended to incorporate observations specific to the Austrian banking market and which drive the increase in our underlying expected loss (EL) assumptions for our scenario analysis.

Our review is based on the following observations that prompted us to adjust our credit loss estimates for Austrian banks at this stage:

1. High NPL levels among Austrian corporates, especially in the SME and micro segment. Against earlier expectations, these did not recover from the 2009 levels that form the basis of our previous EL assumptions. Moody's recognises that some of the high NPL levels can be explained by the usual long time it takes to write off inventory. In addition, Austrian banks keep NPLs on their balance sheet until the legal cases have been resolved.
2. Moody's views the large volumes of outstanding foreign currency loans – both in Austria and in CEE/CIS – as constituting a considerable credit risk for domestic banks. Specifically, the rating agency considers local Swiss Franc lending in the domestic economies in both Austria and CEE/CIS as a key driver behind today's changes in expected loss assumptions. The decoupling of the Swiss Franc from the Euro and other currencies to the extent witnessed since the end of 2009 was not covered at the time of original stress test setup, and we have updated our calculations accordingly.

Moody's Summary Scenario Analysis Assumptions for Austrian banks (domestic books)

	Base Case			Stressed Case		
	Probability of Default	Loss Given Default	Expected Loss	Probability of Default	Loss Given Default	Expected Loss
Residential mortgage loans to individuals (owner-occupied)						
<80% loan-to-value	n.a.	n.a.	0.70%	n.a.	n.a.	1.50%
80%-90% loan-to-value	n.a.	n.a.	0.85%	n.a.	n.a.	2.71%
90% -100% loan-to-value	n.a.	n.a.	2.97%	n.a.	n.a.	5.38%
>100% loan-to-value	n.a.	n.a.	6.42%	n.a.	n.a.	9.11%
Other retail loans						
Consumer financing (secured)	6.00%	75%	4.50%	12.00%	85%	10.20%
Consumer financing (unsecured)	6.00%	100%	6.00%	12.00%	100%	12.00%

¹⁶ Please see [Moody's Approach to estimating Austrian Banks' Credit Losses](#), November 2009 and [European Banking Credit Loss Assumptions](#), August 2010.

Moody's Summary Scenario Analysis Assumptions for Austrian banks (domestic books)

	Base Case			Stressed Case		
	Probability of Default	Loss Given Default	Expected Loss	Probability of Default	Loss Given Default	Expected Loss
Expected losses on corporate and enterprise loans						
Real estate (non-owner occupied)						
<80% loan-to-value	n.a.	n.a.	1.05%	n.a.	n.a.	2.25%
80%-90% loan-to-value	n.a.	n.a.	1.28%	n.a.	n.a.	4.06%
90% -100% loan-to-value	n.a.	n.a.	4.45%	n.a.	n.a.	8.06%
>100% loan-to-value	n.a.	n.a.	9.63%	n.a.	n.a.	13.67%
Large corporates (>EUR50 mill rev p.a.)	3.10%	40%	1.24%	7.90%	50%	3.85%
Small and medium-sized enterprises	10.36%	50%	5.18%	15.54%	60%	9.32%
Micro SMEs / Construction / CRE	15.80%	50%	7.90%	23.70%	60%	14.22%

Source: Moody's Investors Service

Detailed changes to our loss assumptions

Corporate loss assumptions – central scenario

We assume an average probability of default (PD) of 10.4% for the SME enterprise sector and an average probability of default (PD) of 15.8% for micro SMEs, which reflects the following considerations:

- » SME corporate non-performing loans (NPLs) of about 6% at year-end 2011
- » Micro non-performing loans (NPLs) of about 10% at year-end 2011

Moody's has further increased the probability of default in its base scenario by ten percentage points to 50% reflecting risks to Austrian banks credit losses stemming from the uncertain economic environment and the euro area debt crisis.

Corporate loss assumptions – stressed scenario

We assume an average EL of twice the base case, based on an average probability of default (PD) of 15.8% for the SME enterprise sector and an average probability of default (PD) of 23.7% for Micro SMEs. The difference between the base and stressed loss assumptions changes over time as economic conditions evolve. The reason for this is that, whereas the base case is more dynamic – changing with expectations of the future economic environment – the stressed case represents a severe downturn scenario and is expected to change only under exceptional economic or structural events.

Moody's Related Research

Analysis:

- » [Austria, Government of, June 2011 \(133549\)](#)

Special Comments:

- » [Moody's Approach to estimating Austrian Banks' Credit Losses, November 2009 \(121246\)](#)
- » [European Banks: How Moody's Analytic Approach Reflects Evolving Challenges, January 2012 \(139207\)](#)
- » [Euro Area Debt Crisis Weakens Bank Credit Profiles, January 2012 \(137981\)](#)
- » [Hungarian Banks on Review for Downgrade due to Law to Haircut FX-Denominated Mortgages, October 2011 \(135717\)](#)
- » [Lending Limits for Eastern Europe Subsidiaries Are Credit Positive for Austrian Banks and Sovereign, November 2011 \(137673\)](#)
- » [Why Global Bank Ratings Are Likely to Decline in 2012, January 2012 \(139205\)](#)
- » [European Banking Credit Loss Assumptions, August 2010 \(126599\)](#)

Country Credit Stat Handbooks:

- » [Moody's sovereign statistical handbook, May 2012 \(141528\)](#)
- » [Global Macro-Risk Outlook 2012-2013: Further Slowdown in Growth and Increase in Uncertainty, February 2012 \(139852\)](#)

Rating Action:

- » [Moody's Reviews Ratings for European Banks, 15 February 2012](#)

Rating Implementation Guidances:

- » [How Sovereign Credit Quality May Affect Other Ratings, February 2012 \(139495\)](#)
- » [Alternate Liquidity For Banks' Commercial Paper, October 2000 \(60286\)](#)

Rating Methodologies:

- » [Bank Financial Strength Ratings: Global Methodology, February 2007 \(102151\)](#)
- » [Incorporation of Joint-Default Analysis into Moody's Bank Ratings: Global Methodology, March 2012 \(138100\)](#)

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.

Websites

- » [Global Bank Rating Methodology webpage](#)
- » [Moody's Bank Ratings 2012](#)
- » [Euro Area Sovereign Crisis & Affected Credits](#)

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