Moody's
INVESTORS SERVICE

Rating Action: Moody's downgrades VBAG to Baa2, affirms E+ BFSR; outlook stable (Austria)

Global Credit Research - 06 Apr 2011

Ratings of VBAG's subsidiary Investkredit affirmed at Baa2/E+; stable outlook

Frankfurt am Main, April 06, 2011 -- Moody's Investors Service has today downgraded the long-term senior debt and deposit ratings of Österreichische Volksbanken AG (VBAG) by one notch to Baa2 from Baa1, following Moody's re-assessment of future extraordinary systemic support assumptions.

Concurrently, the rating agency affirmed VBAG's E+ standalone bank financial strength rating (BFSR), mapping to B1 on our long-term scale. Both the BFSR and the senior debt and deposit ratings now carry a stable outlook. VBAG's Prime-2 short term ratings were affirmed.

Moody's has also affirmed at Baa2 the long-term debt and deposit ratings of VBAG's subsidiary Investkredit Bank AG (Investkredit). The rating agency affirmed Investkredit's E+ standalone BFSR (mapping to B1 on our long-term scale). Both the BFSR and the long-term debt and deposit ratings now carry a stable outlook. Investkredit's Prime-2 short-term ratings were affirmed.

VBAG's senior subordinated debt was downgraded to Baa3 from Baa2. Its hybrid securities continue to be rated on an expected-loss basis and are not affected by today's rating action.

Investkredit's senior subordinated debt was affirmed at Baa3. As of March 2011, Investkredit resumed coupon payments on its hybrid capital. As a result, the ratings are no longer positioned based on an expected loss analysis, but are in line with normal notching conventions for hybrid securities and anchored from Investkredit's Adjusted Baseline Credit Assessment (Adjusted BCA) of Ba2. The Adjusted BCA reflects the bank's standalone credit strength, including parental and/or cooperative support, if applicable. The Adjusted BCA excludes systemic support expectations. The rating agency upgraded Investkredit's non-cumulative hybrid securities (Tier 1 instruments) to B2 (hyb) from Caa1 (hyb). It also upgraded Investkredit's Upper Tier 2 securities ("Ergänzungskapitalanleihen") to B3 (hyb) from Caa2 (hyb). The outlook on all the hybrid instruments is stable. For a detailed list of ratings affected please refer to the section on Investkredit's hybrid capital below.

Any subsequent short-term and long-term senior debt, subordinated debt and hybrid debt instruments issued by VBAG will be rated P-2, Baa2, Baa3 and Caa2 (hyb), respectively.

Any subsequent short-term and long-term senior debt, subordinated debt and hybrid debt instruments issued by Investkredit will be rated P-2, Baa2, Baa3, B2 (hyb) (Tier 1), B3 (hyb) (Ergänzungskapital), respectively.

For a detailed list of ratings affected please refer to the end of the press release.

RATINGS RATIONALE

VBAG's LONG-TERM RATING DOWNGRADED TO Baa2 STABLE, BFSR AFFIRMED AT E+

The downgrade of VBAG's senior debt ratings by one notch to Baa2 from Baa1 reflects the reduction in Moody's systemic support assumptions for the bank from those previously factored into the ratings during the financial crisis. The Baa2 long-term ratings now include two notches of sector and three notches of systemic support over the B1 standalone level. Moody's assumptions for high sector support are underpinned by the substantial levels of funding from the cooperative sector while recognizing the limited financial capabilities of the sector to provide capital assistance, in case of need.

"We continue to factor a very high level of systemic support into VBAG's ratings to reflect Moody's assumption of ongoing support from the government for the Austrian Volksbanken as a systemically important sector", explains Mathias Külpmann, a Senior Vice President at Moody's and lead analyst for the bank. The reversal of some of the extraordinary systemic support reflects the necessity and measures taken to repay parts of the capital provided by the Austrian government. However, given the ongoing fragility of VBAG's standalone profile, the rating still includes a component of extraordinary support.

The long-term ratings now carry a stable outlook. If the sector dispatches of its interest in VBAG, Moody's will revisit its support assumptions for both the sector and the central government.

The affirmation of the E+ BFSR reflects Moody's view that VBAG will likely continue to face substantial challenges in its efforts to rebuild some of its previous financial strength and that it has yet to demonstrate that its business model is economically viable and that its franchise is sustainable.

Despite the fact that VBAG has managed to stabilise its capitalisation (a Tier 1 ratio relative to total risk of 8.9% as of Q3 2010) and funding profile, Moody's argues that the BFSR currently continues to be constrained by several factors, particularly:

(i) Continued concerns about the long-term viability of VBAG's lending-biased franchise and VBAG's limited earnings power, particularly after the planned divestment of its retail operations in Central and Eastern Europe (CEE);

(ii) Low capital quality, consisting mostly of hybrid capital components (including the EUR1 billion participation capital provided by the Austrian government during the financial crisis) and of minority interests resulting in a 2.4% Core Tier 1 ratio; and

(iii) Impaired asset quality, although this has stabilised at the current low levels.

Moody's anticipates that VBAG's owners will raise EUR300 million capital in order to repay the part of the participation capital to the Republic of Austria that is due by year-end 2011; if not repaid it would allow the Republic to become the bank's majority owner.

The rating action on VBAG also takes into account the declared downsizing (from EUR50 billion of total assets currently to EUR30 billion) and streamlining of the structure of the group:

(i) The targeted disposal of VBAG's 51% stake in Volksbanken International (VBI; total assets of EUR13.9 billion, unrated) with its retail franchise in CEE should improve VBAG's financial profile in terms of capitalisation, liquidity profile and asset quality. Furthermore, VBAG's trimmed operations should become more compatible with the commercial interests and financial means of its majority owner, the Austrian Volksbanken or credit cooperatives (total assets of EUR29 billion in the primary sector; unrated). At the same time, VBAG will lose major parts of its earnings generation capacity.

(ii) The intra-group merger with its subsidiary, Investkredit, targeted for later this year and a consequence of VBAG's planned divestment of its retail business, aims to focus the group's business activities on corporate and real estate lending as well as being a service provider for the cooperative banks. The merger should also achieve more efficient corporate governance, capital allocation and cost benefits over time.

The rating also reflects VBAG's access to and reliance on the reserve requirements and excess liquidity of the Austrian Volksbanken sector that provides a significant and vital part of VBAG's funding. While Moody's considers VBAG's liquidity buffer of EUR3 billion to be adequate, it also notes that EUR3 billion of state-guaranteed bonds will mature over the next 2.5 years. Given VBAG's limited access to wholesale funding, the sale of VBI within the next 12-18 months is expected to provide for the necessary relief.

The rating agency revised the outlook on the BFSR to stable from negative, given (i) that challenges from a potential adverse change in the overall economic environment should be contained; and (ii) the bank's improved capital and liquidity situation following government's support.

INVESTKREDIT'S BFSR STABILISED AT E+, LONG-TERM RATING AT Baa2 STABLE

Moody's affirmation of the E+ BFSR for Investkredit primarily accounts for (i) the challenges that Investkredit faces in re-establishing its lending-biased franchise, both on the corporate and the real-estate side, in particular given a limited product portfolio and few cross-selling opportunities; (ii) Investkredit's funding dependence on VBAG; and (iii) Investkredit's impaired asset quality.

The BFSR also reflects that Investkredit's liquidity and risk management is fully integrated into VBAG and also reflects Investkredit's capital levels, which are able to absorb losses in a base-case scenario.

Investkredit's portfolio was severely hit by the financial crisis, with non-performing loans (NPLs) at 9.4% as of year-end 2009, resulting mainly from a leveraged finance portfolio and loans originated to borrowers in CEE. The portfolio now benefits from an increased coverage of 70%.

The rating agency moved the outlook to stable from negative as asset quality has stabilised, albeit at an impaired level. Asset-quality risks have been reduced in a downside scenario as Investkredit has moved to a more cautious borrowing approach, which has led to significant reductions in its balance sheet.

Investkredit's senior bank and deposit ratings include five notches of parental support, which aligns VBAG's and Investorkredit's senior debt and deposit ratings at the Baa2 level.

INVESTKREDIT'S HYBRID CAPITAL UPGRADED

As of March 2011, Investkredit resumed coupon payments on its hybrid capital. Moody's therefore returned to normal notching conventions for these securities, which are anchored from Investkredit's Adjusted BCA of Ba2. As a result, Moody's upgraded the ratings of the non-cumulative hybrid securities (Tier 1 instruments) issued by Investkredit's subsidiaries, Investkredit Funding Ltd and Investkredit Funding II Ltd, to B2 (hyb) from Caa1 (hyb). The ratings are positioned three notches below the Adjusted BCA, reflecting their deeply subordinated claim in liquidation and non-cumulative coupon skip mechanism tied to the breach of a balance sheet loss trigger. Moody's also upgraded the ratings of the Upper Tier 2 securities ("Ergänzungskapitalanleihen" AT0000A0H874, AT0000322581, AT0000A05HC5) to B3 (hyb) from Caa2 (hyb). The ratings are positioned four notches below the Adjusted BCA, reflecting their deeply subordinated claim in liquidation and non-cumulative coupon skip mechanism tied to the breach of a net loss trigger. The outlook on all the hybrid instruments is stable.

WHAT COULD CHANGE THE RATING UP/DOWN

Positive implications for VBAG's BFSR would depend on (i) a significant improvement in VBAG's earnings generation capacity on the back of a re-established franchise; (ii) a substantial relief on its needs to refinance outstanding debt obligations; and (iii) an improvement in the quality of capital. At present, upward pressure on VBAG's debt and deposit rating is limited, as a possible improvement in the BFSR is likely to be compensated by a further reduction of support uplift that still includes a component of extraordinary support.

Downward pressure on the VBAG's BFSR could be exerted if (i) the sector reduces its commitment and withdraws its liquidity from the bank; or (ii) asset quality problems are exacerbated in (a) VBAG's future core portfolio, including corporate loans or real estate loans; or (b) in VBAG's CEE operations, as represented by VBI, thereby precluding a sale of VBI. Downward pressure on VBAG's senior rating would result from pressure on its BFSR and/or weakening support from the sector, which would imply pressure on both cooperative support and systemic support.

DETAILED LIST OF RATING ACTIONS

Österreichische Volksbanken AG (VBAG)

- BFSR: E+ (B1), outlook changed to stable from negative

- senior debt and deposit ratings: Baa2, outlook changed to stable from negative

- subordinated debt ratings: Baa3, outlook changed to stable from negative

- short-term rating: Prime-2 affirmed

- junior subordinated rating (Ergänzungskapital): Caa2 (hyb), with stable outlook

- non-cumulative preferred securities (Tier 1 instruments): Caa2 (hyb), with stable outlook

Investkredit Bank AG (Investkredit)

- BFSR: E+ (B1), outlook changed to stable from negative

- senior debt and deposit ratings: Baa2, outlook changed to stable from negative

- subordinated debt ratings: Baa3, outlook changed to stable from negative

- short-term rating: Prime-2 affirmed

- junior subordinated rating (Ergänzungskapital): B3 (hyb), with stable outlook

- non-cumulative preferred securities (Tier 1 instruments): B2 (hyb), with stable outlook

PRINCIPAL METHODOLOGIES

The principal methodologies used in this rating were Bank Financial Strength Ratings: Global Methodology published in February 2007, Incorporation of Joint-Default Analysis into Moody's Bank Ratings: A Refined Methodology published in March 2007, and Moody's Guidelines for Rating Bank Hybrid Securities and Subordinated Debt published in November 2009.

LAST RATING ACTIONS

Moody's most recent rating action on VBAG was on 11 Aug 2010, when the rating agency withdrew the ratings of two covered bonds issued by VBAG.

Moody's most recent rating action on Investkredit was on 03 Nov 2009, when the rating agency corrected several hybrid security ratings of Investkredit.

Headquartered in Vienna, Austria, VBAG reported total assets of EUR47.8 billion as at September 2010 and a pre-tax profit for the first nine months 2010 of EUR72.9 million.

Headquartered in Vienna, Austria, Investkredit reported total assets of EUR11.5 billion as at September 2010 and a pre-tax profit for the first nine months 2010 of EUR42.8 million.

REGULATORY DISCLOSURES

Information sources used to prepare the credit rating are the following: parties involved in the ratings, public information, and confidential and proprietary Moody's Investors Service information.

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