MOODY'S INVESTORS SERVICE

Rating Action: Moody's downgrades Hypo Alpe Adria's guaranteed debt ratings; ratings placed on review for downgrade

Global Credit Research - 14 Feb 2014

Review reflects increased uncertainty around the impact of the bank's restructuring on bondholders

Frankfurt am Main, February 14, 2014 -- Moody's Investors Service has today downgraded the guaranteed senior unsecured debt ratings of Hypo Alpe-Adria-Bank International AG (HAA) to Baa2 from A1 and the guaranteed subordinated debt ratings to Baa3 from A2. These securities benefit from the statutory deficiency guarantee of the Austrian state of Carinthia, one of the former owners of the bank. The ratings are placed on review for further downgrade.

The main driver for the action is the rising uncertainty around the intentions of the bank's current owner, the Austrian government (Aaa negative), with regards to the bank's future. Senior officials and politicians are engaged in a public debate on alternative approaches to financing the bank's resolution. In the public debate around how to effect the bank's resolution the possibility has been mooted, and has not been conclusively ruled out, that bondholders may not be fully protected in that process, notwithstanding the statutory deficiency guarantee on their holdings. Even if such an outcome is unlikely, Moody's considers that the fact that it is even part of the debate and has not been ruled out, implies risks for bondholders that are not commensurate with ratings in the 'A' range; as such, the ratings have been placed in the 'Baa' range, which Moody's says better reflects the evolving risks to HAA's bondholders.

The ratings remain on review for further downgrade to allow Moody's to assess the government's intentions and the implied risks for bondholders.

RATINGS RATIONALE

Previously, the ratings of HAA's guaranteed debt reflected Moody's view that it was appropriate to look through HAA to the provider of the deficiency guarantee, the state of Carinthia. However, recent discussions of how to effect the resolution of HAA have revealed that the Austrian government is willing to countenance, even if not yet to favour, outcomes which might greatly reduce the value of such a deficiency guarantee to ensure full and timely payment of interest and principal.

HAA continues to suffer from asset-quality deterioration, which triggered renewed recapitalisation needs throughout 2013. As of June 2013, HAA reported EUR 9.4 billion of non-performing loans against EUR3.5 billion of provisions and capital of EUR1.8 billion. HAA is expected to achieve the regulatory minimum capitalization of 12.4% at year-end 2013 only on the back of EUR1.75 billion capital support received during H2 2013.

The European Commission's state aid approval from 3 September 2013 requires Austria to explore how best to wind down the bank's restructuring unit. This process seems likely to involve the transfer of assets into a wind-down entity that does not have a banking license. So far, there has been lack of transparency on how this would be achieved, how the associated losses would be allocated, and whether HAA bondholders may be affected. However, government officials have acknowledged in public statements that taxpayer costs are a concern, raising the prospect of actions that could be detrimental to bondholder interests notwithstanding the apparent protection of the deficiency guarantee from the State of Carinthia, and despite the potential reputational cost to the Austrian government.

Moody's continues to believe that such outcomes are unlikely to materialise. Indeed, it is not clear how a distressed exchange or a haircut to bondholders would be achieved at an advantage to taxpayers given the existence of a statutory state deficiency guarantee. However, the fact that these options continue to gain traction in the public debate without being conclusively ruled out implies a level of risk to bondholders which is incommensurate with previous rating levels. Accordingly, in order to reflect the increased risk, Moody's has decided to cease applying full credit substitution for debt benefitting from this statutory support, and instead to position the ratings of these bonds at a level below that of the guarantor. The Baa2 rating of guaranteed senior debt reflects Moody's view of the implied risk to bondholders.

--- FOCUS OF THE REVIEW

During the review, Moody's will seek clarity on the Austrian authorities' intentions in order to assess whether bondholders can, in Moody's view (1) continue to rely fully on the deficiency guarantee from Carinthia; and (2) whether the likely resolution path will ensure full and timely payments to bondholders.

The downward direction of the review reflects the fact that, even if the government confirms its present intentions not to seek to impose losses on bondholders, that would not imply a return towards previous rating levels. The fact that such options appear to have been considered implies risks to bondholders which need to be reflected in the rating on an ongoing basis.

WHAT COULD MOVE THE RATINGS UP / DOWN

Downward pressure could develop on HAA's guaranteed debt if Carinthia's credit quality deteriorates or if Moody's considered that Austria's willingness and/or ability to support HAA was lower than previously assumed. Lower ratings would also result if HAA enters insolvency without the State of Carinthia or the Austrian government immediately stepping in to make bondholders good. The need for bondholders to seek to enforce the guarantee in parallel with the insolvency process would imply that timely payment of HAA's debt obligations would not be achieved.

Moody's would consider a further downgrade of the guaranteed debt, in particular, if the agency believes that the likelihood is higher than currently anticipated that the government may seek to impose losses on bondholders of guaranteed debt as part of a wind-down solution, or if the resolution process may result in payment disruptions.

The review for downgrade also reflects the lack of upward pressure on HAA's guaranteed debt. Upward pressure could develop if additional remedial measures became available to the bank; such as, the transfer of HAA into a bad bank scheme benefitting from a direct guarantee by the Austrian government.

PRINCIPAL METHODOLOGY

The principal methodologies used in this rating was Global Banks published in May 2013, and "Rating Transactions Based on the Credit Substitution Approach: Letter of Credit backed, Insured and Guaranteed Debts" published inMarch 2013 . Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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