Peer Review: Major Austrian Banks

Growth Outlook Still Fragile

Special Report

This report is limited to rating trends affecting the major Austrian banks and does not include separate commentary regarding rated subsidiaries of Austrian banks across Central and Eastern Europe (CEE). Please see separate research for CEE subsidiaries of Austrian banks on www.fitchratings.com.

Long-Term IDRs Affirmed: Following a peer review, Fitch Ratings affirmed the Long-Term Issuer Default Ratings (IDRs) of the four major Austrian banks on 17 September 2013. The IDRs of Erste Group Bank AG (Erste), Raiffeisen Bank International AG (RBI), UniCredit Bank Austria AG (Bank Austria) and Volksbanken Verbund (VB Verbund, including its central institution, Oesterreichische Volksbanken-Aktiengesellschaft (OeVAG)) were all affirmed at 'A' with Stable Outlooks.

Sovereign Support Reducing: The IDR affirmation was based on Fitch's view that, as systemically important banks with leading or significant domestic market shares, support from the Republic of Austria (AAA/Stable) is extremely probable if needed. However, Fitch also notes that dynamics with respect to potential future sovereign support are changing across Europe (see Fitch's special report, *Bank Support: Likely Rating Paths*, published 11 September 2013), which may put pressure on support-driven ratings in the medium term.

Wide Viability Rating (VR) Range: Downside risk from the potential eventual removal of sovereign support in Fitch's ratings is currently limited to one notch for Erste (ie, in the most extreme support scenario, its IDR of 'A' would be downgraded to its current VR of 'a−'), two notches for Bank Austria (VR of 'bbb+') and three notches for RBI ('bbb'). VB Verbund's VR ('bb−') is considerably weaker, reflecting its weaker franchise and continued challenges to reposition the bank following extraordinary support provided to OeVAG in 2012.

CEE and Capital Determine Upside: Given the still difficult operating environment across much of Central and Eastern Europe (CEE) and subdued credit demand in Austria, upside potential for the banks' VRs is currently limited. However, stronger core capital ratios, particularly at RBI, and an asset quality trend reversal in the banks' major CEE markets could lead to positive action on the banks' VRs in the medium term.

Hungary, Croatia, Romania Downside: The performance in the banks' Austrian home market and many larger CEE markets, notably Poland, the Czech Republic and Russia, remains adequate despite sluggish loan growth; activities in Romania, Croatia and Hungary continue to be loss-making or underperforming. While Romania is showing some first signs of improvement, Fitch expects Hungary and Croatia to remain a drag on profitability in H213.

Cost Management Remains Focus: With core revenue under pressure, all the banks have started to contain operating expenses by streamlining their branch networks and disposing of underperforming subsidiaries (Erste in Ukraine, Bank Austria in Kazakhstan).

Asset Quality Yet to Stabilise: Non-performing loan (NPL) ratios deteriorated further in H113 in most markets, as a result of sluggish or negative loan growth and continued inflows of net NPLs. Fitch expects a further, albeit more moderate, worsening of asset quality in most markets, including Austria, in H213. While loan deleveraging in CEE has to date not been significant, Fitch does not expect any meaningful loan growth in the short to medium term, which will negatively affect profitability and asset quality ratios (due to the base effect).

Improving Funding Profiles: Erste, RBI and Bank Austria's funding positions have improved as a result of efforts to increase local funding in CEE but also due to slow or non-existent loan growth. VB Verbund's funding profile benefits from its primary banks' deposit base and OeVAG's non-core asset wind-down. Wholesale maturities are manageable and ECB funding balances, already moderate, are being actively reduced.

Related Research

Bank Support: Likely Rating Paths (September 2013)
The Evolving Dynamics of Support for Banks (September 2013)
Impact of European Banking Union on Banks (September 2013)

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- Sovereign support remains key
- Support Rating Floors could be downgraded in medium term
- CEE main limiting factor for VR upgrades

All IDRs Driven by Sovereign Support

Since the downgrade of Individual Ratings (now VRs) and the upward revision of Support Rating Floors (SRFs) following the macroeconomic deterioration in CEE followed by extraordinary banking sector support provided by Austrian authorities in 2009, all the large Austrian banks' IDRs are at their 'A' SRFs and are driven by Fitch's expectation of sovereign support being available to the banks. The four banks either have meaningful or leading deposit market shares in Austria (VB Verbund, Erste, Bank Austria), are part of a domestically dominant banking group (RBI as part of Raiffeisen Banking Group (not rated)) or are partly state-owned (VB Verbund's central institution, OeVAG, is 43% owned by the Republic of Austria).

Figure 1

Rating of Major Austrian Banks

	Long-Term IDR	Outlook	Short-Term IDR	Support Rating	Support Rating Floor	Viability Rating
Erste	A	Stable	F1	1	A	a−
RBI	A	Stable	F1	1	A	bbb
Bank Austria	A	Stable	F1	1	A	bbb+
VB Verbund	A	Stable	F1	1	A	bb−
OeVAG	A	Stable	F1	1	A	NR

Source: Fitch

Figure 2

Domestic Market Shares

Most recent date	Deposits	Loans
Erste	18.3[a]	19.0[a]
Bank Austria	13.8	15.0
RBI	n.m.	n.m.
RBG (not rated)	c.30	c.30
OeVAG	n.m.	n.m.
VB Verbund	6.9	7.0

[a] Retail segment only
Source: Fitch; banks' presentations

However, in the medium term, Fitch expects sovereign support to play a less prominent role in bank ratings. There is clear political intent ultimately to reduce the implicit state support for banks in Europe, as demonstrated by a series of policy and regulatory initiatives aimed at curbing systemic risk posed by the banking industry. This may result in Fitch revising major Austrian banks' SRFs down in the medium term, although the timing and degree of any change will depend on ongoing developments and policy discussions on support and bail-in for eurozone banks. Resolution legislation is developing quickly, and the implementation of creditor bail-in is starting to make it look more feasible for taxpayers and creditors to share the burden of supporting banks.

Wide Range of VR Upside Potential

The large Austrian banks' VRs range from 'bb−' at VB Verbund to 'a−' at Erste. The difficult and volatile operating environment in CEE is a common factor limiting VR upside potential for all the banks, but there are also bank-specific limitations:

- Erste's VR has the highest upside probability among its peers in the medium-term. Should macroeconomic conditions in Romania, Croatia and Hungary stabilise, leading to improved profitability, this could lead to an upgrade of Erste's VR – all else being equal.
- RBI's below-average core capitalisation due to the high proportion of state and private participation capital in its capital structure is a key limiting factor for a VR upgrade; should core capitalisation improve more into line with peers', this could be positive for RBI's VR.
- Bank Austria's VR is currently identical to that of its parent, UniCredit S.p.A. (BBB+/Negative); any negative rating action on UniCredit would limit Bank Austria's VR upgrade potential, as per Fitch criteria (*Rating FI Subsidiaries and Holding Companies*, dated 10 August 2012). The potential uplift of a subsidiary's VR from the parent's VR is limited to a maximum of three notches due to contagion risk.
- VB Verbund's standalone financial profile is significantly weaker than that of its larger domestic peers. Its central institution, OeVAG, is 43% government owned and still undergoing a major restructuring. Until this process is completed and the government has started divesting its stake in OeVAG, VB Verbund's VR is unlikely to be investment-grade.

Related Criteria

Global Financial Institutions Rating Criteria (August 2012)

- Weakening of state support: banks are at different stages of the process
- Significant costs relating to supporting second-tier banks
- Romania and Hungary as swing factors; reliance on Russian earnings increasing

Recent Developments

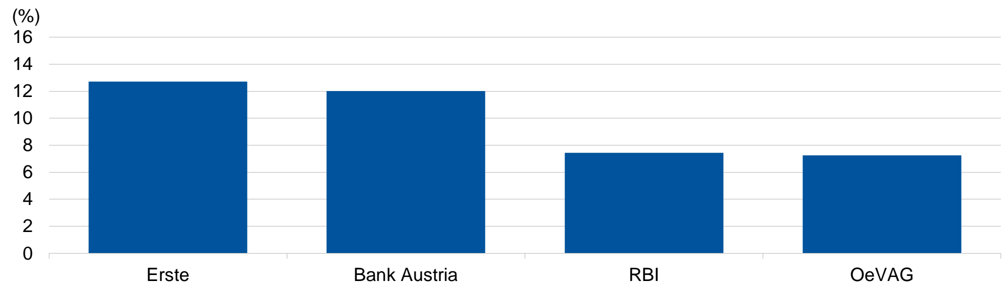
All Eyes on Capital

Below-average core capitalisation has been a key rating driver for most Austrian banks in recent years, notably for RBI and VB Verbund, at which state and private participation capital have represented a large share of regulatory Tier 1 capital. As a result, Fitch core capital (FCC) ratios, a key capital metric for Fitch, were – with the exception of Bank Austria and Erste – weaker than at most of the banks' international peers at end-H113 (see Figure 3).

Figure 3

Fitch Core Capital/Weighted Risks

End-H113



Source: Fitch, statements adjusted by Fitch

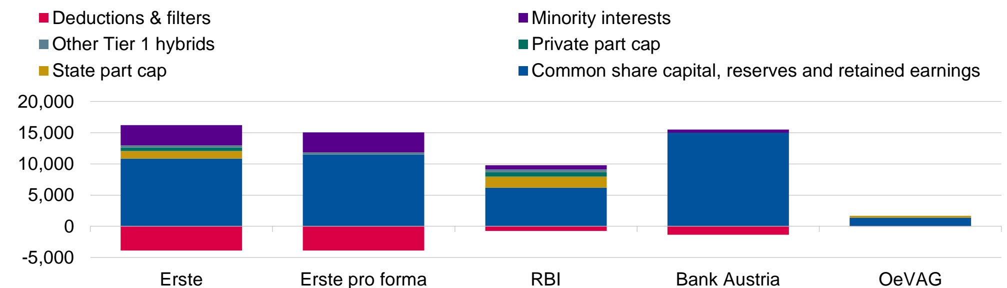
As most participation capital issued in 2009 has several coupon step-ups from 2014 and – more importantly – will eventually no longer qualify as Tier 1 capital under Basel III, the banks have had to formulate strategies to replace participation capital either through share capital increases, risk-weighted asset (RWA) optimisation or improving retained earnings.

In July 2013, Erste addressed this issue by repaying EUR1.76bn in state and private participation capital following a EUR660m share capital increase in July 2013. As a result, its end-H113 pro forma, fully loaded, Basel III CET1 ratio improved to 10.3%. RBI's core capitalisation remains weaker than peers' and the bank's management has repeatedly stated that a capital increase is one option to remedy the bank's below-average capitalisation.

Figure 4

Tier 1 Capital Breakdown

End-H113



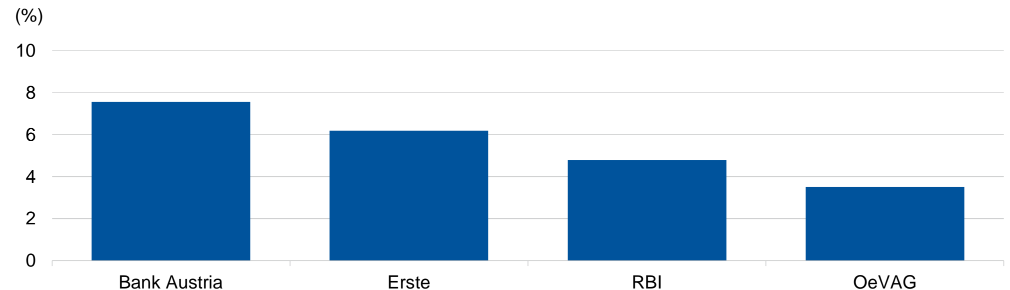
Source: Fitch, statements adjusted by Fitch

Unlike more wholesale-oriented banks with large repo or bank books with low risk-weights, the relatively high risk-weights of CEE and to a lesser extent Austrian lending mean that the large Austrian banks are only moderately leveraged (see Figure 5). As a result, Fitch expects all of the banks to comfortably comply with upcoming Basel III leverage ratios.

Overall, Fitch expects the large Austrian banks' capital and leverage ratios to further improve in the medium term. However, given subdued profitability and pressure on RWA (largely calculated under Basel's internal ratings-based approach) from increasing probabilities of

default and loss-given defaults in much of CEE, Fitch expects the banks to remain at the lower end of their international peer group in terms of capitalisation.

Figure 5
Tangible Common Equity/Tangible Assets
End-H113



Source: Fitch, statements adjusted by Fitch

Sorting Out Bailed-Out Banks

Second-tier banks, notably Hypo Alpe-Adria-Bank International AG (Hypo Alpe; not rated), Kommunalkredit Austria AG (KA; A/Stable) and KA Finanz AG (KF; A+/Stable), nationalised in the wake of the 2008/2009 financial crisis, stood again at the centre of a public debate in 2012 and H113. Hypo Alpe and, to a lesser extent, KF required additional capital support from the government to mitigate further asset quality deterioration in CEE (Hypo Alpe) and to comply with Basel III requirements (KF).

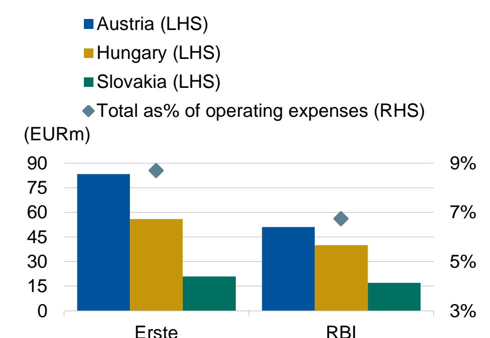
Partly, the discussion centred on the question of whether the larger Austrian banks should contribute beyond their bank levy contribution (see below) to supporting the wind-down process of these banks. While further financial contributions, for instance in the context of a “bad bank” model for Hypo Alpe or even for all three banks, represent a contingent liability for the large Austrian banks, any financial contribution from the large Austrian banks should be of manageable size and should therefore not have a rating impact.

Bank Levies Here to Stay?

Bank levies and regular and extraordinary transaction taxes in Austria, Slovakia and notably Hungary have started to negatively affect the large Austrian banks’ profitability in recent years. A bank levy introduced in Slovenia in 2011 has had only a negligible impact on the Austrian banks’ performance due to their limited presence in this country. While many of these levies have been designed as temporary measures, Fitch believes that some of them are likely to end up being permanent or at least long-term additional banking taxes, burdening the profitability of Austrian banks active in these countries.

In H113, bank levies and financial transaction taxes combined accounted for between 5% and close to 9% of operating expenses and significantly more than 10% of non-staff expenses at Austria’s four largest banks (see Figure 6 for Erste and RBI). As a result, cost containment measures will, in Fitch’s view, have to remain in place at all the banks to ensure that increasing bank levies, transaction taxes and generally higher regulatory expenses do not undo the effects of the cost efficiency gains made since the 2008/2009 financial crisis.

Figure 6
Bank Levies
(H113, pro rata; includes Hungarian FTT)



Source: Banks' financial statements; Fitch

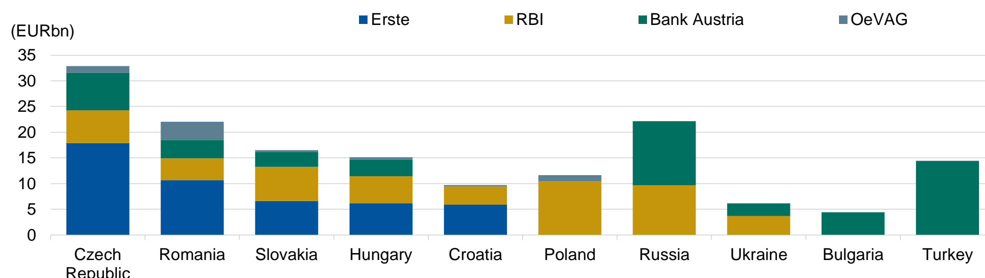
Romania Improving

As one of the most important CEE markets for Austrian banks (see Figure 7), the challenging operating environment in Romania has had a significant negative impact on most large Austrian banks, particularly Erste, which with Banca Comerciala Romana S.A. (BCR; BBB+/Stable) is a market leader in the country. BCR returned to profitability in H113 (helped by one-off gains) due in part to an extensive restructuring programme implemented in 2012. While Fitch expects the operating environment in Romania to remain difficult in H213 and 2014, impaired loan inflows should slow down and loan impairment charges in 2013 should remain below levels seen in 2012.

Figure 7

CEE Loan Book Breakdown

(Selected countries as at end-2012)



Source: Fitch, statements adjusted by Fitch

Ongoing Uncertainty in Hungary

While Bank Austria's small Hungarian subsidiary was profitable in H113 (EUR33m pre-tax profit), Erste's and RBI's Hungarian operations continued to report sizeable losses (of EUR97.1m and EUR81m, respectively, pre-tax). These losses related partly to the ongoing deleveraging process in Hungary, most notably by Erste (Erste's subsidiary shrank its loan book by 13% yoy in 2012 and by 10% in the first six months of 2013; RBI: −6% and +2%; Bank Austria: −9% and −3%), but also to Hungary's fairly punitive bank levy and financial transaction tax (see Figure 6).

While asset quality indicators in Hungary have shown signs of stabilisation since late 2012, the risk of unorthodox policy measures affecting banks remains high, in Fitch's view. In particular, the Hungarian government's proposal to convert foreign-currency (largely Swiss Franc) mortgages into local-currency mortgages at a pre-defined exchange rate or to shorten the maturity of mortgage loans could have a negative impact on banks operating in Hungary, including the Austrian subsidiaries.

While a negative outcome of the negotiations between banks and the Hungarian government could cause the Hungarian subsidiaries to remain (or become) loss-making in H213 and 2014, the subsidiaries are, in Fitch's view, sufficiently small for the potential loss to be absorbed by adequate profitability elsewhere in CEE and in Austria. At end-H113, Erste's Hungarian loan book stood at EUR5.5bn, RBI's at EUR5.3bn and Bank Austria's at EUR3.2bn.

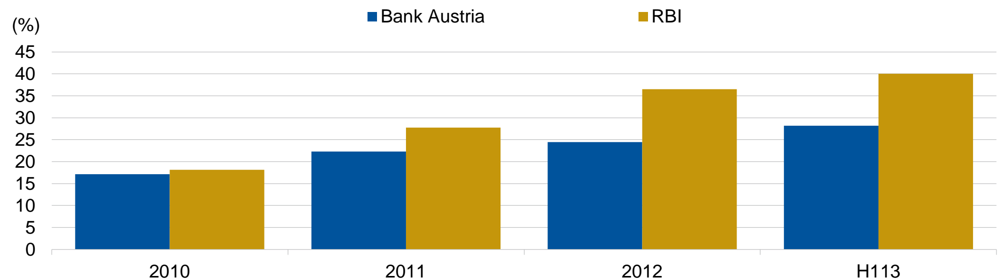
Increasing Reliance on Russia

With subdued profitability in some of the banks' major markets, including Romania and much of South-Eastern Europe, RBI and Bank Austria increasingly rely on the well-performing Russian market for a big chunk of their revenue (Erste is not present in Russia). In H113, pre-tax profit from their respective Russian subsidiaries accounted for 28% of total pre-tax profit (excluding corporate-centre effects) at Bank Austria and a high 40% at RBI. This compares with around 17% and 18% respectively in 2010 (see Figure 8).

Since Fitch considers the large Austrian banks' risk and earnings diversification to be a positive rating factor, increasing reliance on a single CEE market such as Russia could ultimately be

rating-negative. However, once conditions in other CEE markets improve, earnings contributions from Russia should fall automatically in relative terms.

Figure 8
Contribution From Russia
(% of pre-tax income excluding corporate centre and reconciliation)



Source: Banks' financial statements adjusted by Fitch

Regulatory Complexity

Like their EU peers, the large Austrian banks will be affected by various regulatory initiatives currently being discussed at the EU level. In H213 and 2014, progress toward a banking union at the EU level and the asset quality review conducted by the ECB will be of particular importance for the Austrian banks, in Fitch's view.

Assumptions used for the 2014 asset quality review have not yet been published, but given the Austrian banks' loan book composition, assumptions regarding foreign-currency and commercial real estate loans will be of particular importance. Fitch expects the impact of the asset quality review to be strongly correlated with the banks' VRs; ie, Erste should be least challenged by the exercise, while VB Verbund – if included – is likely to struggle the most due to OeVAG's remaining non-core assets in the CEE.

Concerning the single supervisory mechanism proposed by the EU, Fitch expects two of Austria's three mutual banking groups, the savings bank group under Erste Bank and the co-operative Volksbanken group, to be directly regulated by the ECB in full. Developments in their group structures and mutual support arrangements mean that entities within these two groups are becoming increasingly integrated. The story is more complex for the largest Austrian mutual group, the Raiffeisen group. Fitch calculates that around EUR65bn of Raiffeisenbanks' assets will not fall under the banking union, which constitutes around a third of the group's assets in Austria and a quarter globally.

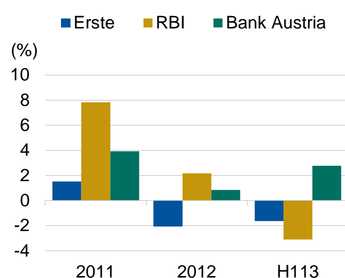
Performance Outlook

Core Revenue Under Pressure

Sluggish or negative loan growth (see Figure 9), low interest rates and difficulties in repricing assets further in the current difficult macroeconomic environment have put pressure on the large Austrian banks' core revenue base. Net interest income, by far the most important source of revenue, suffered from a compression of the banks' net interest margins: compared to end-2011, RBI's net interest margin was 58bp lower at end-H113, Erste's 35bp lower and Bank Austria's 4bp lower. Fitch expects this trend to continue in H213 and 2014.

Nonetheless, cost containment programmes implemented at all the banks from 2010 have supported their operating profitability, which remains acceptable considering the adverse operating environment: all of the above three banks remained profitable on an operating profit basis, with end-H113 operating ROAE ranging from 5% at Erste to 11.5% at RBI (see Figure 10). Bank Austria was the only bank to report improved profitability in H113, supported by a moderately growing loan book. Loan growth at Erste and RBI remained negative in H113. While negative loan growth in 2012 was at least partly driven by the need to meet the

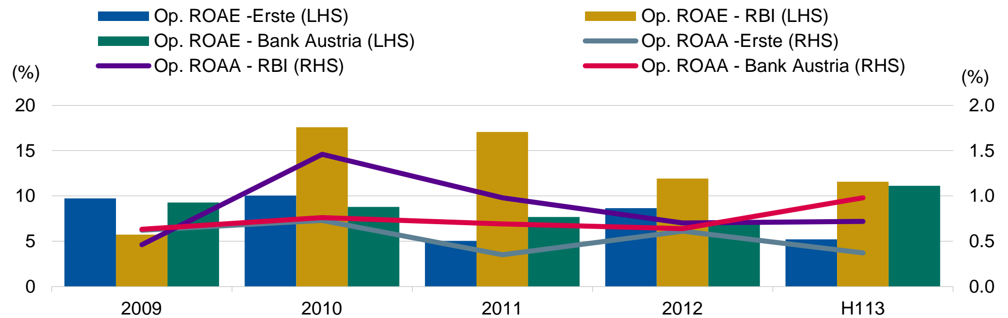
Figure 9
Loan Growth (yoy)



Source: Banks' financial statements; Fitch

European Banking Authority stress test exercise, Fitch views capital considerations as less of a constraint in H213 and would expect the banks to resume loan growth once client appetite for credit across CEE and Austria improves.

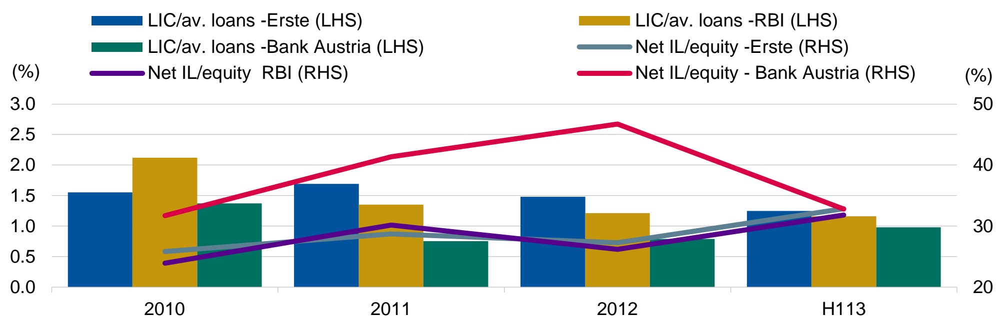
Figure 10
Performance



Source: Banks' financial statements adjusted by Fitch; RBI 2009 figures not fully comparable due to the merger with RZB

Despite generally somewhat lower loan impairment charges (LICs) from their Hungarian and Romanian subsidiaries (compared to 2012), overall LICs remained high in H113, ranging from 98bp of average gross loans at Bank Austria to 125bp at Erste (see Figure 11). Fitch expects the LICs/average gross loan ratios to improve further in H213 and 2014 at all three banks, although improvements are likely to remain moderate.

Figure 11
Impairment Charges



Source: Banks' financial statements adjusted by Fitch

As a result and also due to pressure on earnings, LICs will continue to absorb a large proportion of pre-impairment profitability. In H113, LICs/pre-impairment operating profit ratios ranged from 67% at Erste to 50% at RBI and 41% at Bank Austria.

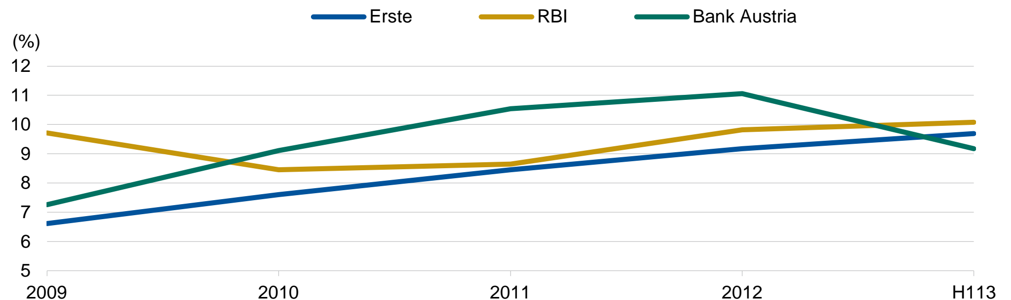
Asset Quality

Moderate Deterioration in Domestic Lending

Asset quality in Erste's and Bank Austria's domestic loan books remained largely unchanged in H113, despite some large corporate defaults in Austria. As a result, asset quality trends remained largely driven by developments in CEE. While Fitch expects asset quality in the domestic retail loan books to remain broadly unchanged in H213 and 2014, supported by modest GDP growth and low unemployment, NPLs from the banks' corporate loan books, particularly from the construction and commercial real estate sectors, are expected to increase in the short to medium term. RBI does not have a domestic retail loan book. Foreign-currency loans, largely in Swiss Francs, are higher-risk than euro-denominated retail loans, in Fitch's view. However, FX loan volumes have fallen significantly (down 15.4% yoy to EUR28.9bn at end-H113 for the Austrian banking system), and the exchange rate floor imposed by the Swiss National Bank should limit further downside risk.

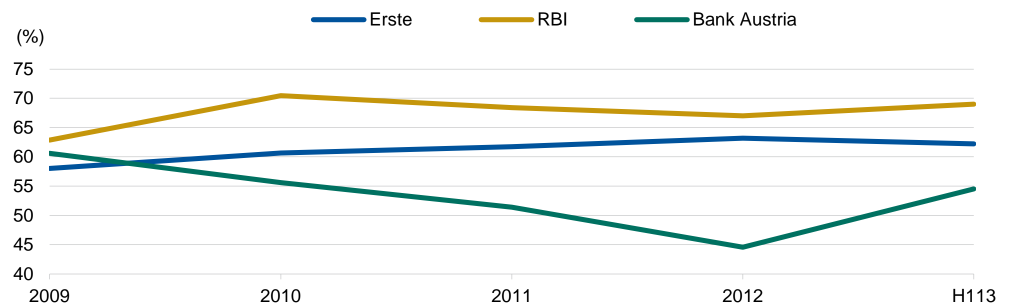
In H113, Bank Austria was the only major Austrian bank with a moderately improving NPL ratio (see Figure 12), helped by 2% loan growth. Bank Austria was also the only bank with an improved loan loss reserve coverage ratio, partly as a result of its parent's decision to boost loan loss coverage in Q412, but the bank's coverage ratio continued to lag those of its peers (see Figure 13) and Bank Austria remains more reliant on collateral values than Erste or RBI.

Figure 12
NPL Ratios



Source: Banks' financial statements; Fitch

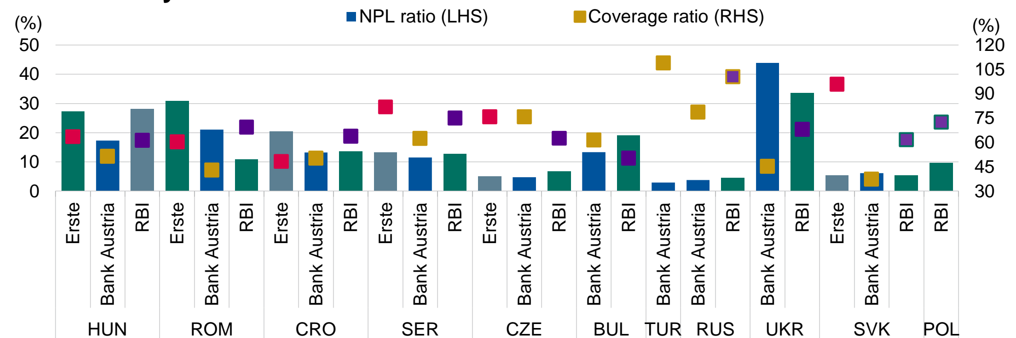
Figure 13
Coverage Ratios



Source: Banks' financial statements; Fitch

Mixed Picture in CEE, with Limited Downside Risk

Figure 14
Asset Quality - CEE



Source: Fitch, statements adjusted by Fitch; Bank Austria's NPL ratios include the first two imapired categgories as per UniCredit classificiation

Despite a slowdown in the inflow of new impaired loans in many CEE countries, impaired loans ratios deteriorated further in H113, largely as a result of negligible or even negative loan growth. Both impaired loan ratios (see Figure 14) and inflows of new impaired loans were still considerably higher in Romania, Hungary and to a lesser extent Croatia than elsewhere in CEE. Asset quality in the Czech Republic and Slovakia, the largest and third-largest markets

respectively in terms of credit exposure, proved resilient in H113 despite disappointing GDP and other macroeconomic indicators.

While loan loss coverage ratios vary considerably from country to country, with the exception of RBI in Russia (where the coverage ratio stood at 100% at end-H113) and Erste in Slovakia (96%), all banks rely on the resilience of collateral values in CEE countries, notably real estate.

In H213 and 2014, Fitch expects further asset quality deterioration in Croatia and, more moderately, Romania. While a further worsening of asset quality in Hungary is also likely, in Fitch's view, the magnitude of the effect on the banks' income statements largely depends on the outcome of the negotiations between the government and the banks, which is difficult to predict.

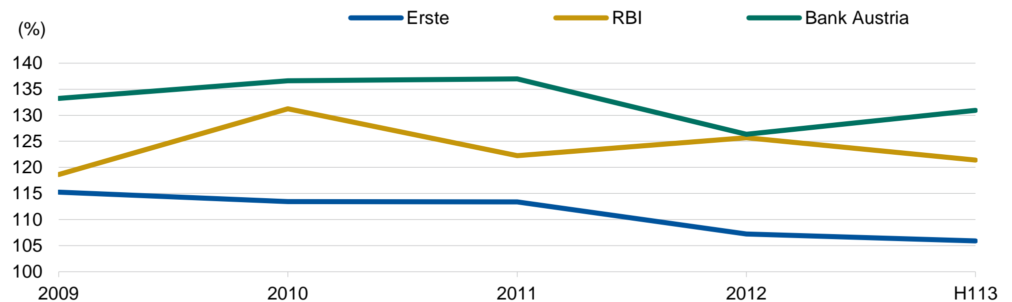
Funding and Liquidity

Funding Profiles Improving

The funding position of Erste, RBI and Bank Austria improved in 2012 and H113 due largely to efforts to increase local funding in CEE but also to slow or non-existent loan growth. Consequently, loans/deposits ratios have improved at all three banks compared to 2010 (see Figure 15), most notably at Erste, which benefits from leading deposit franchises in Austria, the Czech Republic, Slovakia and Romania. In addition, the loans/deposits ratios of both Bank Austria and RBI overstate their reliance on external wholesale funding as the former obtains funding from its parent, UniCredit, and the latter from within the Raiffeisen sector (via its parent bank, Raiffeisen Zentralbank Oesterreich AG).

Figure 15

Loans/Deposits Ratios



Source: Banks' financial statements; Fitch

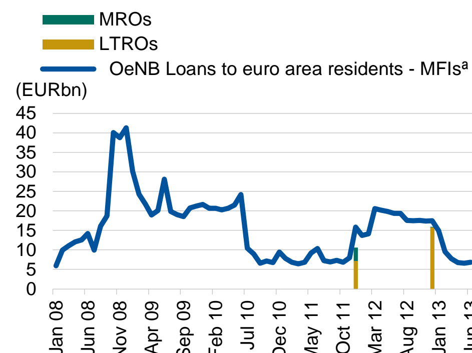
OeVAG's deposit base has shrunk through restructuring, although VB Verbund as a whole benefits from the primary banks' deposit base. In line with VB Verbund's joint liquidity and funding scheme, all excess liquidity is placed with OeVAG, which can then provide emergency credit lines to weaker primary banks if need be. The wind-down of OeVAG's non-core assets has also provided VB Verbund with more liquidity through increased redemptions and asset disposals, as well as reducing OeVAG's funding needs as its asset portfolio shrinks.

Wholesale maturities at all the banks are manageable, in Fitch's view, although some sizeable government-guaranteed bonds with a maximum maturity of five years issued in 2008/2009 fall due in late 2013 and early 2014. Usage of ECB funding facilities has fallen considerably since a peak in late 2008 (see Figure 16; using the Austrian central bank's lending exposure to euro area monetary financial institutions as a proxy), and most banks started to repay ECB Long-Term Refinancing Operations funding in H113.

Fitch expects improvements in CEE subsidiaries' funding positions to remain a key management objective for all of the major Austrian banks. Given the limited fungibility of liquidity between different CEE subsidiaries due to regulatory restrictions, the focus of the

banks will be on improving their funding positions in countries with loans/deposits ratios above 120% or 130% (eg, Romania and Hungary) rather than improving deposit market shares in countries where they already have a strong funding position, such as the Czech Republic.

Figure 16
ECB Facilities Usage



[a] Loans to euro area residents - MFIs" consists all funds lent to MFIs other than shares
Source: BIS

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