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4 February 2016

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RATINGS

Heta Asset Resolution AG

Carinthian-state-guaranteed senior unsecured debt	Ca, Developing
Carinthian-state-guaranteed subordinated debt	C

Source: Moody's

Contacts

Swen Metzler, CFA 49-69-70730-762
VP-Senior Analyst
swen.metzler@moodys.com

Carola Schuler 49-69-70730-766
Managing Director - Banking
carola.schuler@moodys.com

Alexander Hendricks, CFA 49-69-70730-779
Associate Managing Director - Banking
alexander.hendricks@moodys.com

Heta Asset Resolution AG

Carinthia's Tender Offer to Buy Heta Debt Presents Creditors with Continued Uncertainties

Summary

On 21 January, the regional government of Carinthia (B3 negative[1]), an Austrian province, made a tender offer to senior and subordinated creditors of Heta Asset Resolution AG (Heta, Ca developing[2]) who benefit from a deficiency guarantee from the Austrian province. Heta is the wind-down remnant of former Hypo Group Alpe Adria, a failed Austrian bank, and owned by the Republic of Austria (Aaa negative[3]). Carinthia is offering 75% of the face value of the bonds, including interest accrued until 1st March 2015, to senior bondholders, and 30% to holders of subordinated debt.

We believe uncertainties remain high for creditors surrounding the extent to which Carinthia will honour its deficiency guarantee, even despite a compensatory payment for the guarantee included in the offer. However, risks for creditors at Moody's rated banks and entities in Austria that remain directly or indirectly exposed to the repayments risks of Carinthia remain unchanged for now. These entities and their affected liabilities are:

» Heta's Carinthian-state-guaranteed senior unsecured and subordinated debt which are rated Ca and C respectively. Our Ca unsecured debt ratings imply recovery rates of between 35% and 65% while the C subordinated debt ratings imply recovery rates of below 30%. The developing outlook we assign to these senior unsecured debt ratings reflect the continued uncertainties surrounding the extent to which Carinthia will honour its deficiency guarantee.

» Pfandbriefbank (Oesterreich) AG (Pfandbriefbank, Ba1 negative[4]), a special issuing vehicle; Vorarlberger Landes- und Hypothekenbank AG (VLH, Baa1 negative/Baa1 negative, baa3[5]) and Hypo Tirol Bank AG (Hypo Tirol, Ba1 negative/Ba1 negative, ba3[6]). VLH and Hypo Tirol have provisioned in 2015 for visible risks up to 50% of their pro rata share under the joint and several liability scheme for Pfandbriefbank's liabilities. The negative outlooks on the ratings of all three entities indicate further downside risks if no solution is found to fulfill Heta's obligations.

The tender offer, which expires on 11 March, is meant to relieve the province of Carinthia from guarantees by imposing around EUR3 billion of losses on creditors. However, if the offer is not accepted, Heta creditors may enter unchartered legal territory and face a default by Heta and, potentially, Carinthia. There has never been a provincial default in Austria, and there are no specific rules for such a case.

Heta stopped servicing its debt in March 2015, when the Austrian Financial Market Authority (FMA) announced it would initiate resolution measures on the wind-down entity and ordered a payment moratorium until 31 May 2016. Austrian authorities have repeatedly expressed their unwillingness to provide further support after injecting capital totalling around €5.5 billion into Heta between 2009 and 2014. In Austria, the Federal Banking Restructuring and Resolution Act (BaSAG), which transposes the European Union's Bank Recovery and Resolution Directive (BRRD) into Austrian law, also applies to this wind-down entity.

Tender Offer includes compensation for Carinthia's deficiency guarantee

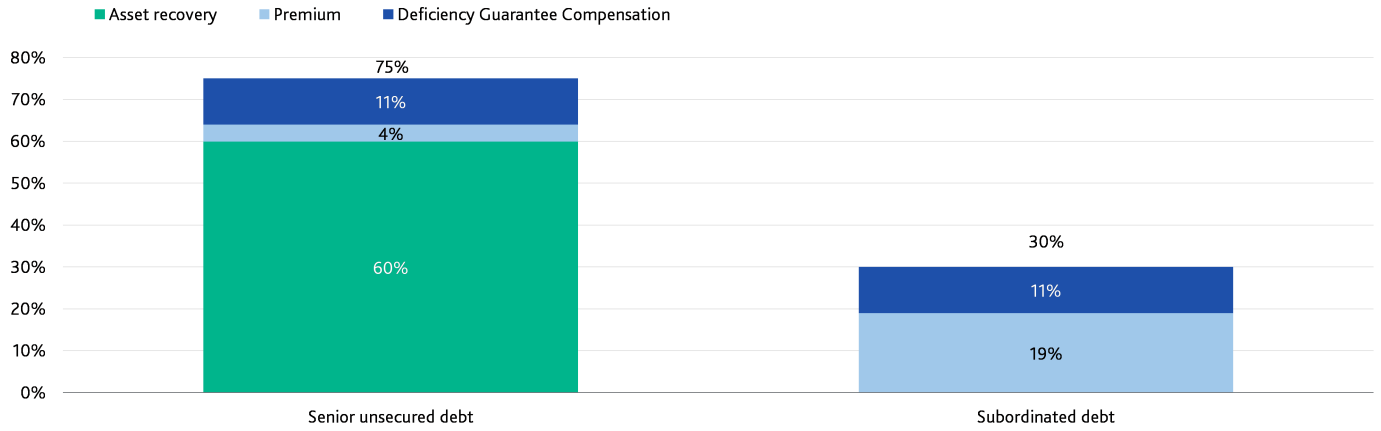
A public trust set up by Carinthia, Kaerntner Ausgleichszahlungs-Fonds, is offering to buy about €10.8 billion of Heta bonds which benefit from a deficiency guarantee from the Austrian province of Carinthia. The trust is offering 75% of the face value of the bonds (including interest accrued until 1st March 2015) to senior bondholders, and 30% to subordinated debtholders. The offer runs until 11 March 2016 and is conditional on two-thirds of creditors tendering their bonds. If the offer is accepted, both participating and non-participating creditors will bear the same losses. They will lose the right to claim the difference (i.e. the 25% or 70% haircut) from Carinthia because Carinthia's deficiency guarantee will be lowered by the amount of the haircut. This reduction in the value of the guarantee was made possible by an amendment to Austria's financial market stability law, approved in December 2015[7].

The proposed offer price has four components. The first is a projected but uncertain recovery value on Heta's assets of 59.91%, which only applies to senior unsecured creditors. The offer does not foresee any asset recovery for subordinated debt holders. The second component is a premium to entice the acceptance of both creditor classes; 4.12% for senior unsecured and 19.03% for subordinated debtholders. The third is a compensatory amount for Carinthia's deficiency guarantee, which is 10.97% percentage points for both debt classes. Finally, creditors benefit from a call option that retains the upside potential if the resolution and wind-down of Heta's assets lead to better recovery values than the 60% projected (a so-called "earn-out clause"). Any cash payback from the latter component will not be known before Heta's wind-down is concluded in 2020, however.

Exhibit 1

Components of the Tender Offer

in % of face value including accrued interest



Source: Moody's Investors Service, Kaerntner Ausgleichszahlungs-Fonds

Assuming the two-thirds acceptance rate is achieved, the Austrian governments will provide funding of up to €7.8 billion to the Kaerntner Ausgleichszahlungs-Fonds in order to compensate bondholders within days of the offer's expiry. The funding includes €6.6 billion reflecting the assumed 59.91% asset recovery rate for senior unsecured debt (0% for subordinated debt) and the premium. Carinthia's contribution of €1.2 billion, or 10.97% of the outstanding debt, is intended to compensate for the Austrian province's deficiency guarantee attached to Heta's bonds and is also funded by the central government.

Both the Offer and Heta's wind-down leave creditors with significant risks

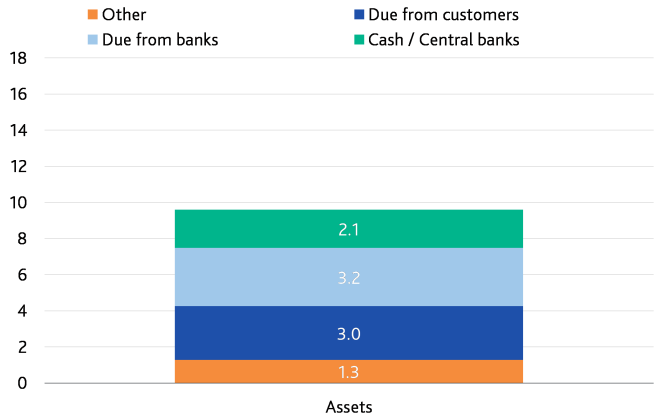
The offer itself and uncertainty around any payback from the wind-down of Heta's assets present creditors with sizeable legal and economic risks. If the offer is accepted, creditors will benefit from an immediate cash payment, including the asset recovery rate of around 60% proposed, but they must renounce any further claim. Investors could, however, reject the offer and instead rely on the deficiency guarantee, expecting the Republic of Austria to support Carinthia in honoring the full amount of the claim. However, if the offer is rejected, and the federal government chose not to step in, the immediate cash return becomes invalid and an accelerated disposal of Heta assets (possibly in an insolvency scenario) may lead to even lower asset recovery. In this latter case, creditors may also find themselves mired in a long legal dispute over the value of the deficiency guarantee. Creditors also face the risk that Austria's Financial Market Authority, the body in charge of winding-down Heta, which neither approved nor validated the asset recovery ratio, may announce a lower recovery rate. This is because, in Austria, BaSAG, which transposes the European Union's BRRD into Austrian law, also applies to Heta.

At the end of June 2015, the riskiest components of Heta's €9.6 billion balance sheet (according to local GAAP) included €3.2 billion of loans to banks and €3.0 billion of loans to customers. Despite sizeable balance sheet reserves for these exposures, additional impairments may become necessary, in particular if valuations drop further under a fire-sale scenario. According to the entity's own forecasts, it expects €6.3 billion in cash to remain after the ultimate completion of its wind-down in 2020, but it notes that there are significant downside risks attached. These risks include Heta's remaining claims against its disposed South-Eastern-Europe (SEE) banking network and Hypo Alpe-Adria-Bank S.p.A (HBI, unrated). In addition there may be potential cash outflows from interest expenses for liabilities currently affected by the FMA debt moratorium, as well as market and litigation risk.

Exhibit 2

Heta's Asset Profile

as of June 2015 in € billion

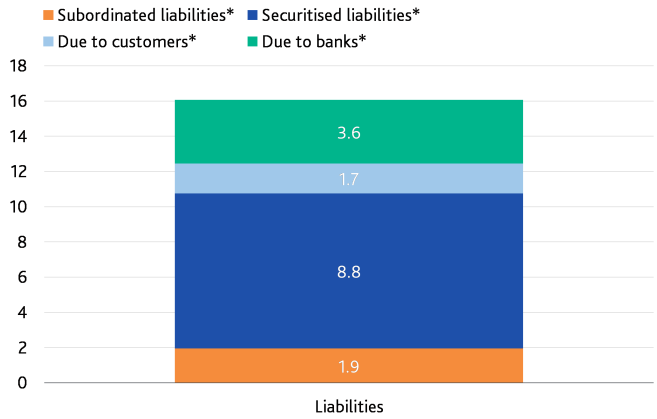


Note: The gap between Heta's €9.6 billion assets compared to its €16.1 billion liabilities reflect the wind-down entity's negative equity according to local GAAP.
Source: Moody's Investors Service, Heta presentation

Exhibit 3

Around 70% of Heta's liabilities are backed by Carinthia

as of June 2015 in € billion



* These liabilities include debt components which benefit from Carinthia'S deficiency guarantee.
Sources: Moody's Investors Service, Heta presentation

On top of these economic risks, creditors face legal uncertainty. The Austrian government has repeatedly introduced or amended legislation in order to protect taxpayers. This has included passing special legislation (later deemed unconstitutional by the Constitutional Court) to allow the bail-in of Heta's subordinated debtholders and void the deficiency guarantee of Carinthia on that portion of the bank's debt. We believe, following a Constitutional Court decision in July 2015 that declared this legislation unconstitutional[8], a positive value for the beneficiaries of such deficiency guarantees generally results from this verdict. In October 2015, amendments to the BaSAG bank resolution law clarified the rights of holders of bailed-in debt that benefit from third-party guarantees, but again left open the question to what extent these guarantees must be honoured.

The tender offer aims to relieve Carinthia from a substantial amount of guarantees by imposing losses on creditors of around €3 billion. However, if the offer is rejected, Heta creditors may enter unchartered legal territory and face a default by Heta and, potentially, Carinthia. Such a provincial insolvency in Austria is without precedent and there are no special rules for such a case.

No clear commitment to guaranteed debt in Austria

While the outcome of the tender offer remains unclear, we consider there is no clear commitment to deficiency-guaranteed debt in Austria. Consequently, the risks for Moody's rated banks in Austria that remain directly or indirectly exposed to the repayments risks of Carinthia guaranteed obligations as well as by the payment moratorium imposed on Heta, remain unchanged for now. Exhibit 4 shows affected banks that issued large amounts of guaranteed debt in the past.

In 2015, Hypo Tirol and VHL have provisioned for visible risks up to 50% of the notional value of Heta's Carinthia-guaranteed liabilities. The negative outlooks on the banks' ratings indicate there may be further downside risk if no solution is found to fulfil Heta's obligations that arise from Pfandbriefbank.

Exhibit 4

Rated Austrian Banks' Outstanding Guaranteed Debt as of Year-end 2014

Name of Bank	Outstanding Guaranteed Debt as of Year-end 2014, € billion	Total Assets as of Year-end 2014, € billion	Backed Senior Unsecured Debt Rating	Backed Subordinated Debt Rating	Guarantor and Rating
Heta Asset Resolution AG	10.2	9.6*	Ca DEV	C	State of Carinthia (B3 negative)
Hypo Tirol Bank AG	3.6	8.3	Baa2 NEG	Ba2	State of Tyrol (unrated)
Pfandbriefbank (Oesterreich) AG	5.5	5.6	Ba1 NEG	--	Various Guarantors**
UniCredit Bank Austria AG	1.9	189.1	A3 STA	Baa3	City of Vienna (Aaa negative)
Vorarlberger Landes- Hypothekenbank AG	3.9	14.2	A3 NEG	Baa3	State of Vorarlberg (unrated)

* According to local GAAP; ** Pfandbriefbank's liabilities benefit from the multi-recourse statutory liability scheme of its member banks, the joint and several liability obligation of the Austrian regional mortgage banks, and of the Austrian federal states.
Sources: Moody's Investors Service, company reports

As in Germany, grandfathered deficiency-guaranteed debt in Austria is subject to bail-in and treated *pari passu* with all other unsecured debt of equal seniority under the BRRD and Austria's local implementation (BaSAG). An amendment to BaSAG in October 2015 clarifies that the recourse in principle to the guarantors under these grandfathered deficiency structures is entirely unaffected by bail-in because failing to honour the guarantor's liability would be against European Union law. As such, the amendment confirms the verdict from the Austrian Constitutional Court in July 2015. We believe that the court decision provides positive value for the beneficiaries of such deficiency guarantees.

In December 2015, however, the Austrian parliament approved further legislation that paved the way for the tender offer, including a payment to settle the legal battle between Heta and its previous owner Bayerische Landesbank (A1 stable/A2 stable, ba1[9]). Under this amendment, participating and non-participating creditors in the tender offer will lose the right to claim the difference (i.e. the haircut) from Carinthia because the law reduces Carinthia's deficiency guarantee by the amount of the haircut.

Moody's Related Research

Rating Actions:

» Moody's affirms government-guaranteed ratings on three Austrian banks; changes outlooks to negative, October 2015 (PR_337172)

» Moody's changes outlook on Heta's Ca Carinthian-state-guaranteed debt ratings to developing; affirms ratings, August 2015 (PR_331588)

» Moody's downgrades Heta Asset Resolution's Carinthian-State-Guaranteed Debt Ratings, March 2015 (PR_319197)

Sector and Issuer Comments

» Austria's Proposed Amendments to Its Resolution Act Are Credit Positive for Grandfathered Debtholders, October 2015 (184969)

» BayernLB Would Benefit from Austria and Bavaria's Settlement over Heta, July 2015 (183026)

Banking System Outlook

» Austria, July 2015 (1006349)

Endnotes

1 The rating shown is the State of Carinthia's issuer and senior unsecured debt rating and outlook.

2 The rating shown is the entity's Carinthian state-guaranteed senior unsecured debt rating and outlook.

3 The rating shown is the Republic of Austria's issuer and senior unsecured debt rating and outlook.

4 The rating shown is the bank's backed senior unsecured debt rating and outlook.

5 The ratings shown are the bank's deposit rating and outlook, its senior unsecured debt rating and outlook, and its baseline credit assessment.

6 The ratings shown are the bank's deposit rating and outlook, its senior unsecured debt rating and outlook, and its baseline credit assessment.

7 See Austrian Financial Market Stability Law, §2a.

8 The Hypo Reorganisation Act (HaaSanG) which was introduced in August 2014.

9 The ratings shown are the bank's deposit rating and outlook, its senior unsecured debt rating and outlook, and its baseline credit assessment.

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