

European Rates Strategy

The dust is settled: Austrian fixed income markets post HAA

- **Wrap up:** The Hypo Alpe Adria situation has shaken the Austrian government, SSA and covered bond markets during recent months, with a final political decision which many investors did not expect. We summarise what happened and what we expect between now and the final chapter of this story.
- **Spread reaction:** While Austrian sovereign debt did not suffer any weakness compared to EGB markets, Austrian SSA and covered bonds have not recovered from the HAA decision and idiosyncratic risks of the Austrian banking sector. It remains to be seen when/if doubtful investors flock back into these markets.
- **Rating outlook:** The upcoming reviews are not expected to change the rating or rating outlook of the sovereign. The same should apply for Austrian agencies. In the covered bond space we believe some amendments cannot be ruled out.
- **Long-term impact:** For the sovereign market, the long-term impact seems to be limited. However, we expect investors to be somewhat doubtful even if guarantees are explicit. Austrian banks will probably be most affected. For now we think geopolitical risks are overarching idiosyncratic risks.

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The dust has settled: Austrian FI markets post HAA

The Hypo Alpe Adria situation has shaken the Austrian government, SSA and covered bond markets during recent months, with a result which most people did not expect. While Austrian sovereign debt didn't suffer any weakness compared to EGB markets, Austrian SSA and covered bonds have not recovered completely from the idiosyncratic risks of the Austrian banking sector.

Bail-in of state guaranteed bank debt in core Europe – a new level?

Dedicated law for HAA to be implemented

Finally, the story of Hypo Alpe Adria seems to have come to an end. The Austrian lender, which was nationalized during the European debt crisis, is expected to be wound down. However, the Austrian political decision makers agreed to take a step which many market participants considered as impossible. In June, it was agreed upon to bail in subordinated bonds issued by HAA and guaranteed by the state of Carinthia. For this, the Austrian parliament approved a specifically designed legislation by which the imposition of losses on holders of the subordinated guaranteed bonds becomes possible (Gesetz über Sanierungsmaßnahmen für die Hypo Alpe Adria Bank International, HaaSanG). In our understanding, this would be the first time that bonds supported by a deficiency guarantee from a solvent guarantor would be bailed in. The law is not yet in place; the federal assembly (Bundesrat) has to approve it, and the legislation has to be signed by Austria's Federal President.

Bail-in of some subordinated bondholders on the cards

The plan of the Austrian government is to wind up the nationalized Hypo Alpe Adria with the sale of all assets, while shareholders as well as subordinated bondholders should bear losses via restructuring costs. For the sale of the assets an asset management company (without a banking license) should be set up to which HAA International will be transferred whereas a wind-up company would be set up for the Italian subsidiary and Hypo SEE Holding AG, which shall be sold, according to the Ministry of Finance. The overall burden of €1.69bn will be split among the former shareholder (€800mn) and subordinated bondholders (€890mn). This doesn't include the subordinated bond guaranteed by the Republic of Austria or the senior bonds of the entity guaranteed by Carinthia. More exceptions might become valid if put to the court: on the one hand, one of the investors in Carinthia guaranteed subordinated bonds seems to be the World Bank via IBRD, according to Bloomberg. The IMF and World Bank are usually exempt from any bailouts. On the other hand, insurance companies were invested in these bonds mostly due to their state of being "gilt-edged" (mündelsicher), according to §230b Austrian civil code. Being seen as the safest among all investments, it should not be completely ruled out that insurance companies would be treated differently when it comes to burden sharing.

The new law might be challenged by the Austrian constitutional court

It remains to be seen if HaaSanG will comply with Austria's constitution. One main obstacle which is under scrutiny is that expropriation can only be conducted if this is not reasoned by budgetary drivers. At the same time one criticism is that the potential bail-in would only affect a few bondholders while other investors and/or bondholders (among others those which hold subordinated debt guaranteed by the Austrian state) would not bear any losses. Moreover, it can be questioned if this law complies with European regulation. The Austrian decision makers mention that the bail-in of specific bondholders would be in line with latest changes to European resolution regimes, i.e. the European Bank Recovery and Resolution Directive (BRRD). However, in our opinion, this argument might not be entirely valid. Firstly, the BRRD applies from the beginning of 2015 when provisions setting up the single resolution will take effect. Additionally, the bail-in regime would only take effect as of January 2016. Hence, there might be a lack of legal backing from the

European level at least at the current stage, especially given the fact that such bonds were guaranteed by Carinthia and therefore different to ordinary bank subordinated debt. An additional point of discussion is the fact that European law also asks for equal treatment of creditors. Hence, it cannot be completely ruled out that the law still has to be amended if it is accepted that it would not comply with Austrian or European law.

Market reactions – mixed picture

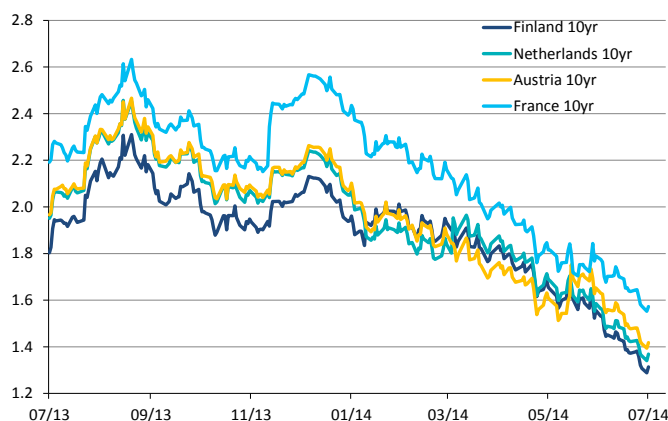
Reactions have been muted in the sovereign space...

The eventual solution found by Austrian politics for HAA has probably been surprising for many market participants as it has not been assumed to be possible to declare deficiency guarantees null and void, irrespective of the fact that the guarantor has been too small to stem all guaranteed claims in the first place. More surprising in our opinion, has been the market's reaction on the bail-in of state guaranteed debt.

... with RAGB trading line line with OAT and DSL

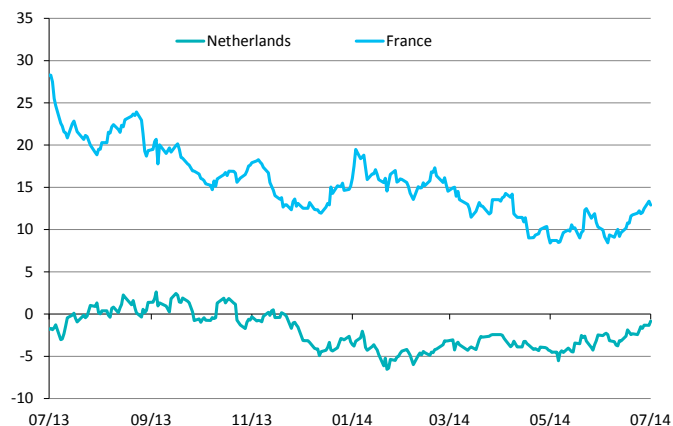
Austrian government bonds: While HAA has been a dominant topic in the Austrian markets, it didn't affect RAGB yield development during the last months (Figure 1). One main threat at the beginning of the year was the potential loss of Austria's Aaa rating at Moody's. However, this didn't materialize, as Moody's confirmed the Aaa rating and changed the outlook from negative to stable. Spreads to other (semi)-core countries show that OATs outperformed RAGBs in the first months of the year until the end of May (Figure 2). However, this was mainly driven by the OAT leg. Compared to the DSL market, spreads have been extremely stable during the course of 2014. While one might have assumed that HAA could have had negative implications on funding levels for Austria as well, this has not been the case – rather the contrary. During recent weeks, i.e. when it has become more evident that a bail-in of state guaranteed debt was planned, Austrian government bonds were well sought, and outperformed peers.

Figure 1. 10yr (semi)-core yields (%)



Source: Citi Research

Figure 2. 10yr (semi)-core spreads to RAGB (bp)



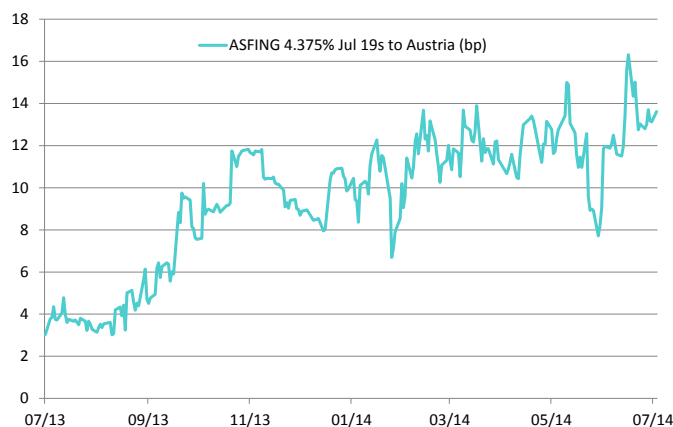
Source: Citi Research

ASFING underperformance versus RAGB and peers is very remarkable

Austrian SSAs: The Austrian SSA market is clearly dominated by agency debt as sub-sovereigns are mainly financed by the central government. Hence, the biggest SSA market share is obtained by two agencies, ASFING and OBND. Both entities are explicitly guaranteed by the Austrian sovereign. The ratings of the entities move in line with the guarantor. However, one might expect investors to become more cautious on such names as the guarantee's reliability might be questioned after the guarantee nullification of gilt edged securities. When comparing Austrian agencies to RAGB, it can be seen that yield spreads have widened consistently during recent months, having reached a high at the beginning of July. This is contrary to the

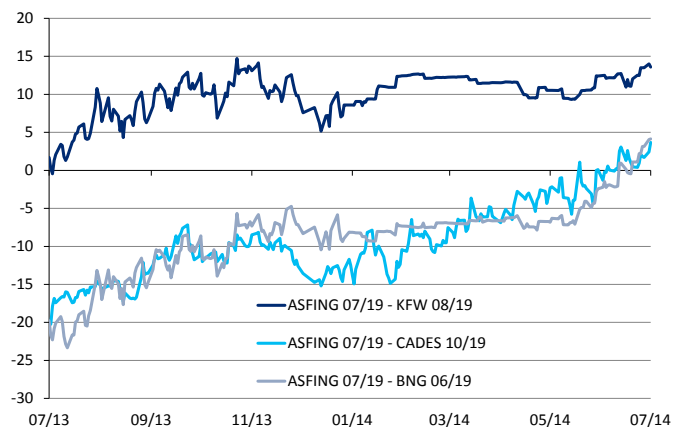
development of spreads of explicitly guaranteed agencies (and supranationals) to respective government bonds (to France) in other European countries recorded during the last months ([European SSA Strategy - Weekly SSA Chart Pack](#)).

Figure 3. Yield spread ASFING vs RAGB in the 5yr area (bp)



Source: Citi Research

Figure 4. Yield spread ASFING to peers in the 5yr area (bp)



Source: Citi Research

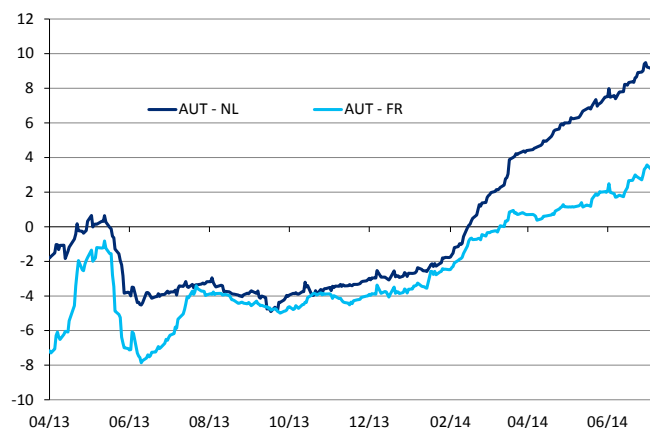
One reason could be the uncertainty around HAA

While RAGB was range trading to other (semi-)core government bonds, ASFING underperformed other European agencies during the last months. The hunt for yield might be a valid argument for the underperformance of Austrian agencies versus formerly higher yielding French and Dutch agencies, but this doesn't fit to the underperformance against German agency KFW. In our opinion this can probably be traced back to higher cautiousness of investors on Austrian state guaranteed debt following the uncertainty around HAA and the final decision on it.

Austrian covered bonds underperformed (semi-)core peers

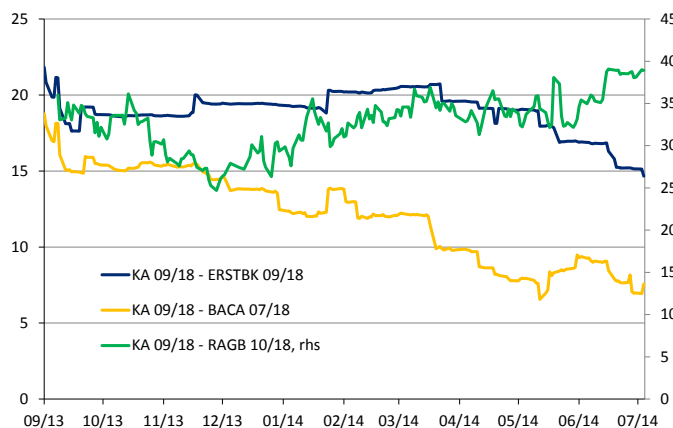
Austrian covered bonds: The biggest negative impact was probably felt in the Austrian covered bond market. Although Austrian bank debt has been under pressure due to geopolitical risk in Eastern Europe and some negative performance announcements (Erste Group) during recent weeks, HAA was probably an additional substantial risk contributor. Moreover, rating agencies have been active, as systemic support assumptions have been adjusted, which led to downgrades of a few covered bonds (Kommunalkredit Austria, Hypo Tirol).

Figure 5. ASW spread of iBoxx Covered bond indices (bp)



Source: Markit, Citi Research

Figure 6. Yield spread KA covered bonds versus peers (bp)



Source: Citi Research

However, this might mainly be traced back to the banks' CEE exposure

Figure 5 indicates the underperformance of Austrian covered bonds versus (semi)-core peers on an index level during the last months. Moreover, it should not surprise that covered bonds also underperformed sovereign debt during the last few months while the spread to agencies remained very stable. On an intra-segment basis, Figure 6 proves that covered bonds of other state owned banks have not underperformed peers. Instead, higher yielding KA covered bonds were preferred to peers. This suggests that the hunt for some extra yield was an overarching factor while investors were able to make a clear differentiation between the guarantee/ownership structures of HAA and KA.

Rating agencies: mixed implications but banks' support limited

The rating agencies have been very outspoken and critical about the final decision of the Austrian politics concerning HAA. In spite of this, rating actions have been absent for the sovereign and SSA debt. However, for covered bonds, which are much more tied to bank ratings and systemic support assumptions, some pressure has been felt, and should eventually increase in the future.

Rating effects to be limited for sovereign and guaranteed agency debt...

Moody's: Moody's draws a very distinct picture for Austrian markets following the legislative proposal to bail-in subordinated bonds and defy the deficiency guarantee¹. For the sovereign, the assessment looks mixed:

- Moody's does not see a "weakening of the federal government's commitment to service its own debt or honor its obligations if called upon to service debt instruments for which it provides a direct guarantee". At the same time, it is made clear that the government aims to contain the costs of bank resolutions and restructurings on its own balance sheet. However, "the retroactive abrogation of parts of the deficiency guarantee is unprecedented, raises questions about policy predictability at times of political stress, and thus is not conducive to supporting the investment climate in Austria".

For agency and sub-sovereign debt markets Moody's continues to assume high systemic support with no immediate negative credit implications:

- The law on HAA doesn't have an immediate effect on the creditworthiness of agencies guaranteed by the sovereign, as the new law targets a specific situation within the Austrian banking sector. For sub-sovereigns Moody's continues to incorporate a high likelihood of extraordinary support from the federal government in the event of need. Carinthia's A2 rating has been confirmed at this relatively low level as Carinthia remains liable for guarantees on HAA senior debt which is equivalent to more than five times the state's operating revenues.

...but bank debt including covered bonds is under increasing pressure at Moody's

The most negative effects of this law have already been incorporated into bank ratings and partly covered bond rating actions during the last few weeks while the pressure on covered bond ratings will be higher in the future:²

- Moody's decreased systemic support assumptions by one step to "high", resulting in a removal of one notch of systemic support for long-term senior unsecured debt. This led to a one-notch downgrade of eleven banks' senior unsecured ratings in June. Eventually, this already had negative implications for some covered bond ratings (Hypo Tirol and Kommunalkredit Austria). Moreover, Moody's lowered the Timely Payment Indicator (TPI) which is one main factor within the covered bond rating methodology. This led to a decrease of the rating

¹ Moody's: "Implications for Austrian Credits of Hypo Alpe Adria Law", 22.07.2014

² Moody's: "Austrian Banks: Lower Support Assumptions Post Hypo Alpe Adria Law Are Credit Negative", 22.07.2014

buffer for covered bond ratings. Hence, the number of covered bond programs without a rating buffer increased from six to eight while the number of covered bond programs with a rating buffer of one notch increased from three to six.

The picture is similar at S&P...

S&P: For Austrian covered bond markets S&P plays a minor role as they are solely rated by Moody's. For the sovereign as well as for guaranteed agency debt, S&P remained silent on any repercussion of the new legislative proposal. However, some effects have been recorded for sub-sovereigns.

- Last April, the rating agency affirmed the AA+ rating of the sovereign with a stable outlook. As contingent liabilities from the banking industry have already been a drag for the sovereign rating the reclassification of contingent liabilities would not have negative effects as it has already been incorporated in the agency's rating approach. S&P sees more downside risk for the sovereign from geopolitical risks in CEE which could hamper the Austrian banking industry.
- Guaranteed agency debt has been affirmed as well, in line with sovereign debt. S&P reiterated that it will rate government related corporations in line with the sovereign, reflecting their role for and link to the government in March.³ For government related entities (GRE), i.e. banks and corporations being supported by the sovereign, as well as banks, S&P is more critical. Hence, for systemically important banks like Erste Group and Unicredit Bank Austria the extraordinary state supported will is questioned while for GREs like KA Finanz and Hypo NOE Gruppe Bank AG it needs to be clarified if the introduction of the law led to deterioration in the banks' role for and link to their respective governments.⁴

...although support for sub-sovereigns and GREs will probably be questioned

- For Austrian sub-sovereigns, S&P was also more cautious, which eventually led to a credit watch negative for the state of Burgenland's AA+ rating. S&P stated that if the legislation was put into the law they would reduce the implemented supportiveness within the sub-sovereign ratings, while such a move would also limit the predictability of the institutional framework for Austrian states. For many federal states this would not directly translate into downgrades given their own strong fiscal situation.

Conclusion and RV opportunities

We would not rule out that the law still has to be amended

The Austrian decision makers took an unexpected step in their treatment of HAA debt and state guarantees. In our opinion, it should not be ruled out that the decision to implement a law which allows a bail-in of specific guaranteed bonds from a bank which has not declared insolvency will be questioned in the near future, by the domestic constitutional court as well as European courts, not speaking of international investors. It also seems that the law has been constructed in a manner which enables Austria to make the former shareholder participate in sharing the overall burden.

Carinthia continues to guarantee an extremely high volume of outstanding HAA bonds

One main argument of Austrian politicians incurring a loss on investors was that the insolvency of HAA would probably have led to the insolvency of Carinthia, as the outstanding volume of debt guaranteed by Carinthia has been substantially higher than the federal state's yearly operating revenue. However, with the new legislation, Carinthia would continue to guarantee for the senior debt issued by HAA, decreasing the original guaranteed volume only marginally. Therefore, one might ask why senior bonds are not affected, especially as the Austrian Ministry of

³ S&P: "Decision Pending Over Hypo Alpe Adria's Future Has No Immediate Rating Impact On Austrian Banks Or GREs", 07/03/2014

⁴ S&P: "Seven Austrian Banks Placed On CreditWatch Negative On Planned Bail-In Of State-Guaranteed Debt Of Hypo Group Alpe Adria", 10.06.2014

Finance emphasized that the bail-in of subordinated debt would be a premature implementation of the latest European regulation (BRRD). The most important characteristic of the BRRD is the attempt to bail in not only subordinated bondholders but also senior bondholders. Hence, if Austria implemented BRRD stringently, senior bonds could have been bailed in as well, which would have eventually decreased the volume of debt guaranteed by Carinthia substantially. However, this still lets aside the fact that deficiency guarantees would have had to be declared null and void not only for subordinated but also for senior bonds which as itself cannot be reasoned by the resolution directive.

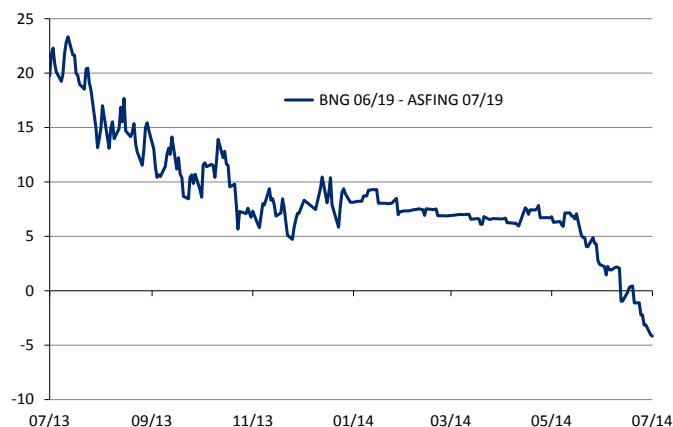
The implications for Austrian markets seem to be manageable – thanks to very resilient markets at the current stage

Has the financial marketplace Austria suffered due to HAA? We would probably have to say yes. While funding levels for the sovereign (and eventually for sub-sovereigns) have not deteriorated, we believe this has been the case for Austrian agencies and banks when compared to European peers in the current market environment. Obviously, refinancing on swap levels are also at multi-year lows for Austrian agencies and banks issuing covered bonds. However, this should not be a surprise given the strong demand for highly rated debt driven by regulation in a market substantially supported by ECB backstops. Against this background, the relative underperformance of agency bonds against the sovereign, but also against peers, is significant, in our view. That said, it has to be noted that ASFING is less liquid than many of its peers. Covered bank bonds which have shown the same trading pattern as agency debt are probably more affected by geopolitics than by HAA. Nevertheless, the AAA dominated market has been mainly pushed to the last step before downgrades of banks directly translate into downgrades of covered bonds.

ASFING should be able to retract in the long-term

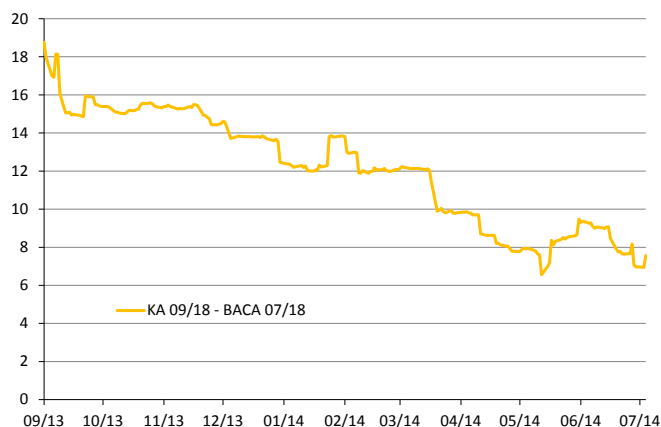
Are there relative value opportunities in the current Austrian market environment? While Austrian agencies look cheap versus RAGB as well as other EGB and SSA markets we don't see a near-term catalyst for these spreads to tighten back to FY13 levels. We would instead expect spreads to trade sideways in the near-term. In the longer term, ASFING should be able to retract given the investors' very high demand for HQLA. Given this long-term conviction we prefer ASFING (AA+/Aaa; 0% RW) to BNG (AA+/Aaa/AAA; 20% RW) which is currently trading more expensive than ASFING in the 5yr sector. Moreover, we remove our longer-term preference for KA over other Austrian covered bonds as further outperformance should be limited while a downgrade of KA covered bonds into the single-A area by Moody's appears to be on the cards.

Figure 7. Prefer ASFING 07/19 to BNG 06/19, yield spread (bp)



Source: Citi Research

Figure 8. KA performance potential to peers limited, yield spread (bp)



Source: Citi Research

Appendix A-1

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