

## ISSUER IN-DEPTH

30 June 2016

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## RATINGS

## BAWAG P.S.K.

Outlook	Positive
Baseline Credit Assessment	baa2
Counterparty Risk Assessment	A2(cr)/P-1(cr)
Bank Deposit Ratings	A3/P-2
Senior Unsecured Debt and Issuer Ratings	A3/P-2
Covered Bond Ratings	Aaa

Source: Moody's

## KEY METRICS:

## BAWAG P.S.K.

	2015	2014	2013
PL ratio(1)	2.3	2.8	3.5
TCE/RWA(2)	16.2	13.0	10.9
NI/TA(3)	1.2	1.0	0.6
MF/TBA(4)	22.1	22.7	21.6
LA/TBA(5)	16.7	19.5	27.5

Source: Moody's Financial Metrics, Ratios in %

Note: (1) Problem loans(PL)/Gross loans; (2) TCE: Tangible Common Equity, RWA: Risk-weighted assets; (3) NI: Net Income, TA: Total assets; (4) MF: Market Funds, TBA: Tangible Banking Assets; (5) LA: Liquid Assets

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## BAWAG P.S.K.

## Strong, Sustainable Profits Buck Trends in the Austrian Banking Sector

BAWAG P.S.K. is delivering strong and sustainable profit growth at a time when persistently low interest rates are constraining the underlying profits of its domestic peers. It is also expanding its capital base at a faster pace than the rest of the market. Over the past three years, the bank has significantly reduced the costs of its deposit funding base and has successfully pared back spending in its core domestic businesses. It has shed unprofitable and/or higher-risk assets and fully repaid state aid provided by the Republic of Austria (Aa1, stable). These measures have helped the bank to become the most profitable in Austria, delivering a net profit of €418 million in 2015, a return on equity of 16.2%.

Its restructuring has included a 10% staff reduction and an overhaul of products and internal processes. This has made it the country's most efficient bank, with a cost-to-income ratio of 46.7% versus a peer average of 65.6%. At a time of significantly falling interest rates, BAWAG has been able to reduce the interest it pays on deposits by 50% from 2010 to 2015, at a faster pace than its peers who managed to reduce liability costs by 28%.

BAWAG has also cleaned up its balance sheet. The bank has divested its entire structured product and collateralised loan obligation (CLO) portfolios and sold non-performing loans to the market. Another key reason behind BAWAG's ability to outpace the Austrian market is because, unlike its Austrian peers, the bank was not heavily invested in Central and Eastern Europe (CEE). This has helped it to avoid the heavy losses suffered by its peers in several stressed eastern European markets, including Russia, Ukraine, Romania and Hungary.

All these measures resulted in a strong rebuild of its capital buffers. BAWAG reported a fully-loaded common equity Tier 1 (CET1) capital ratio of 13.1% at the end of 2015 (2014: 12.1%, 2013: 9.4%), making it one of the best capitalised banks in Austria. We expect BAWAG to strengthen its capital adequacy and thus its loss absorption capacity further over the coming 12 to 18 months, despite dividend payouts resumed in 2015.

There remain risks on the horizon, however. In recent years, BAWAG has diversified away from its home market by building a portfolio of international loan assets. We consider these newly acquired international assets may add to problem loans if the credit cycle turns.

BAWAG's covered bond (CB) programme further mirrors the bank's sound financial fundamentals, and benefits from the bank's A2(cr) long-term Counterparty Risk Assessment, the anchor point for our CB ratings, which is the highest among Austrian banks. Investors in BAWAG'S CBs are therefore less exposed to the risk that they would have to rely on the cover pool for payment.

## BAWAG is outpacing the market in sustainable profit growth

BAWAG received a €550 million state bailout after the financial crisis but has since transformed itself into Austria's highest rated bank. It delivered a record €418 million net profit in 2015, producing a return on equity of 16.2% that significantly surpassed the average return of 9.1% of its Austrian peers. We expect the trend of improving net profits to continue in 2016 and potentially beyond.

Persistently low interest rates in Europe are hurting the profitability of banks in Austria and across the wider region. The banks have lowered the rates they receive from borrowers but are unable to significantly reduce the rates they pay on deposits for fear of eroding their funding base. Heavy losses in some parts of Central and Eastern Europe where many Austrian banks have large subsidiaries have also taken a toll on the bottom line.

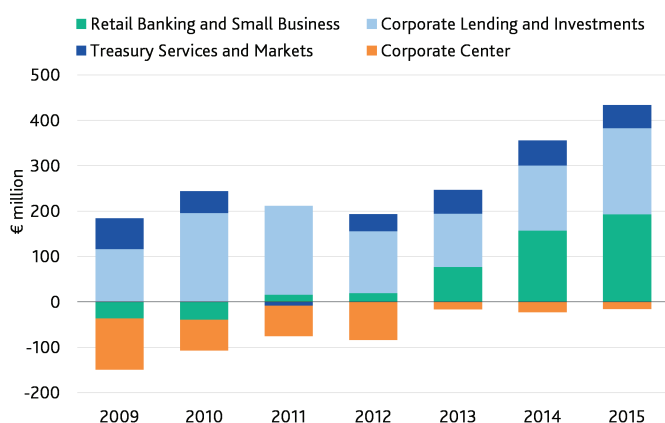
BAWAG has virtually no CEE exposure and so has avoided rising loan losses. The bank has also undergone a costly restructuring and cleaned up its balance sheet. It has divested its entire structured product and collateralised loan obligation (CLO) portfolios, and sold nonperforming loans to the market.

These measures have helped the bank to become the most profitable in Austria. While profitability is picking up at other banks, too, BAWAG has had a head start. Moreover, some of the profitability gains, specifically those at the Raiffeisen-Landesbanks (RLBs) were driven by one-off gains on shareholdings in 2015.

BAWAG has recovered its core profitability largely by cutting costs in its domestic retail banking business, making it the most profitable Austrian bank (Exhibits 1 and 2).

Exhibit 1

### BAWAG Has Rebuilt its Earnings Power Within Core Segments

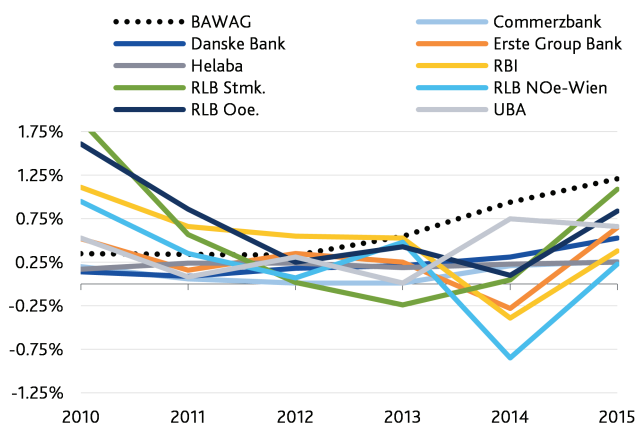


Source: BAWAG annual reports, Moody's Bank Financial Metrics

Exhibit 2

### The Bank's Net Income Is Now Best in Class

Net income/Average total assets, 2010-2015



Sources: Annual reports, Moody's Bank Financial Metrics

## Restructuring has delivered best-in-class efficiency

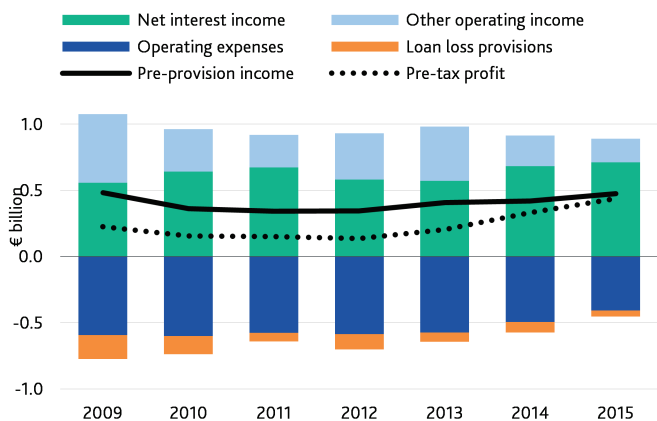
BAWAG started a productivity and efficiency programme in 2010. As a first step, it laid off 500 full-time staff or 10% of the bank's year-end 2009 workforce, largely by means of natural fluctuation and retirement. This programme involved enhancing existing processes and increasing technology investment (e.g. into a centralised 'credit factory') to be able to free up resources. Proprietary trading activities were discontinued and products were aligned and simplified. The project delivered overall cost savings of more than the targeted €60 million annually from year-end 2013 and significantly increased efficiency as well as customer service capabilities.

Over the past two years, BAWAG has further exploited opportunities to create an even more flexible operating infrastructure by further rationalising products and services, operating locations and internal structures. Overall, BAWAG reduced its headcount by 27% between 2009 and 2015. It achieved an even stronger reduction if measured in full-time equivalent (FTE) units, with FTE down

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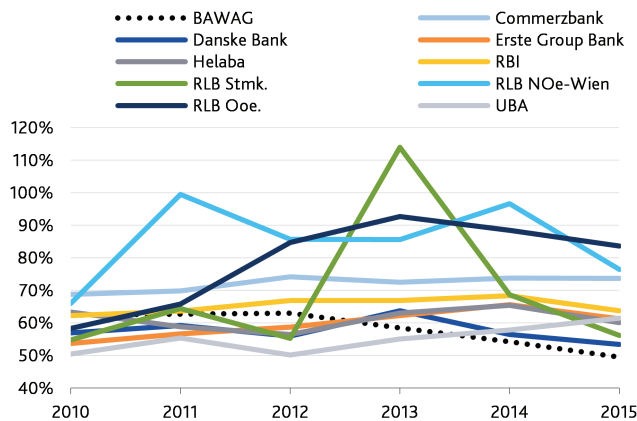
38% during the same period. These measures led to a reduction in BAWAG's cost-to-income ratio to 46.7% from above 60%, and supported its strong leap forward in earnings power (Exhibits 3 and 4).

Exhibit 3  
**Substantial Cost Efficiency Gains Have Boosted BAWAG's Profitability...**



Sources: BAWAG annual reports, Moody's Bank Financial Metrics

Exhibit 4  
**...Making It The Most Efficient Bank In Austria**  
 Cost-income-ratio, 2010-2015



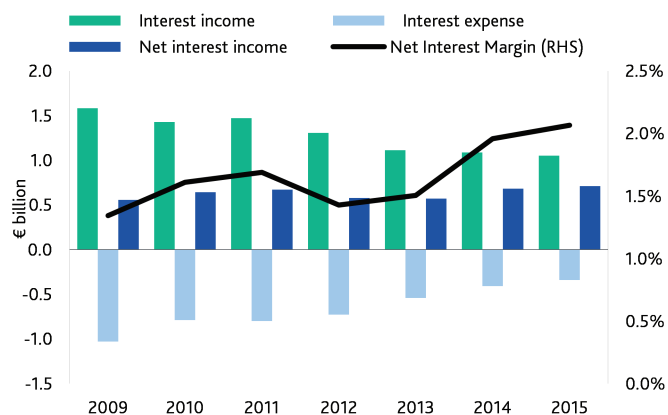
Sources: Annual reports, Moody's Bank Financial Metrics

### BAWAG has reduced the interest it pays on deposits

In addition to its cost-cutting program, BAWAG has reduced the interest it pays on deposits by more than 50% over the past few years. BAWAG's average deposit rate fell to 0.32% in 2015, down from 0.77% in 2013. The bank has shifted maturing fixed-rate deposits into variable-rate products, increasing the share of variable-rate deposits to 86% of total private client deposits, up from 70% in 2013. Consequently the bank's net interest margin improved to 2.07% as of year-end 2015, up from 1.43% in 2012, according to Moody's calculations.

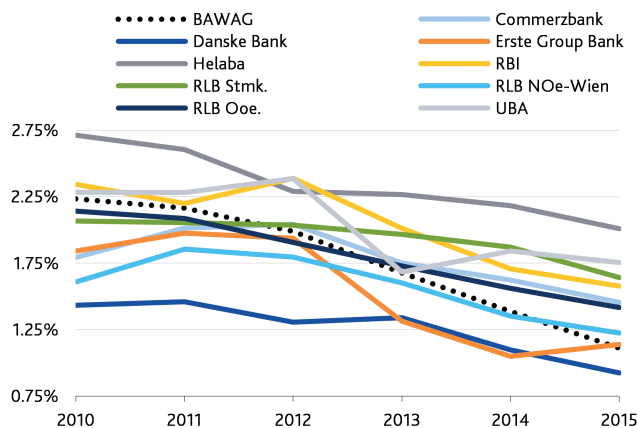
We expect the net interest margin to stay relatively stable even if interest rates rise, owing to the high share of variable-rate deposits that will likely re-price faster than the bank's variable-rate assets (largely mortgages).

Exhibit 5  
**BAWAG's Deposit Re-pricing Has Supported Revenue Stability Despite Low Interest Rates**  
 Net interest income components and net interest margin, 2009-15



Sources: BAWAG annual reports, Moody's Bank Financial Metrics

Exhibit 6  
**Substantial Reduction in Deposit Costs Has Safeguarded Earnings**  
 Interest expense/interest-bearing liabilities, 2010-2015



Sources: Annual reports, Moody's Bank Financial Metrics

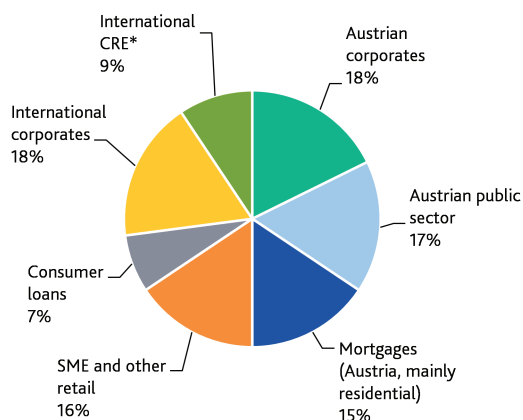
## Balance sheet de-risking has further supported profitability

BAWAG's asset profile differs from its Austrian peers because the bank is not heavily invested in CEE. The bank also sold its entire structured product and collateralised loan obligation (CLO) portfolios and sold non-performing loans to the market. At the same time, BAWAG has diversified away from its home market by building a portfolio of international loans. We consider this ongoing expansion may add to problem loans if the credit cycle turns (see section below).

As a result of its overall de-risking strategy that effectively started in 2008, BAWAG displays one of the lowest asset risk ratios in Austria. Problem loans<sup>1</sup> comprised 2.3% of total loans at the end of 2015, down from 4.9% in 2012, and benefit strongly from the currently benign credit cycle in Austria and Western Europe. In contrast, problem loans averaged 6.4% for its Austrian peers, largely driven by CEE exposures.

Exhibit 7

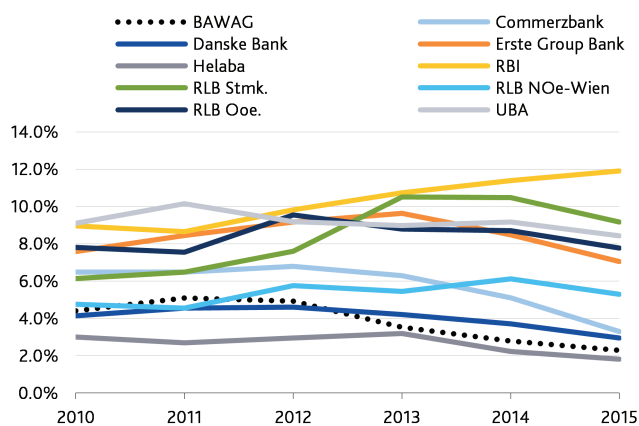
### BAWAG's International Loan Book Is Focused on Western Europe Loan book split as of 30 Sept 2015



Sources: BAWAG interim reports, Moody's Bank Financial Metrics

Exhibit 8

### BAWAG Is Now Largely De-risked Problem loans/Gross loans, 2010-2015



Sources: Annual reports, Moody's Bank Financial Metrics

## The bank has reshaped its capital structure and restored capital buffers

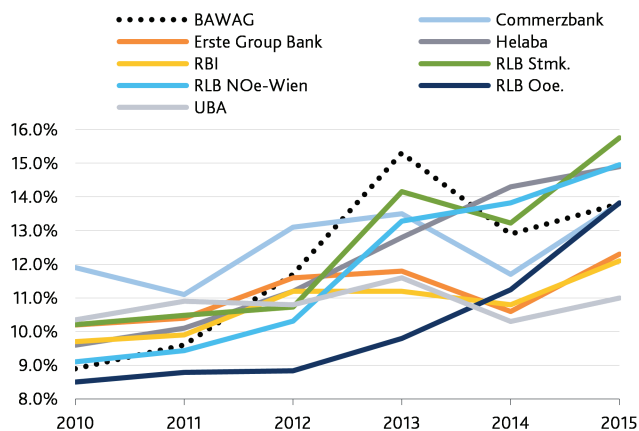
With a fully-loaded CET1 ratio of 13.1% as of 31 December 2015 (2014: 12.1%, 2013: 9.4%), BAWAG has improved its capital cushion.

The ratio has benefitted from the adoption of an internal ratings-based approach to calculating risk-weighted assets and risk reductions during 2013 and 2014. The quality of capital also improved significantly during 2014, as BAWAG paid back the remaining €350 million in state aid (known as participation capital in Austria) to the Austrian state, redeemed outstanding minorities (€400 million) and raised another €125 million in core capital from its owners. These quality-enhancing measures led to a temporary drop in BAWAG's Tier 1 capital ratio in 2014 (Exhibits 9 and 10).

BAWAG also fully redeemed its non-Basel III-compliant hybrid capital in June 2015. All these measures, coupled with the meaningfully higher capital retention (and loss absorption) capacity have made BAWAG one of the best capitalised banks in Austria.

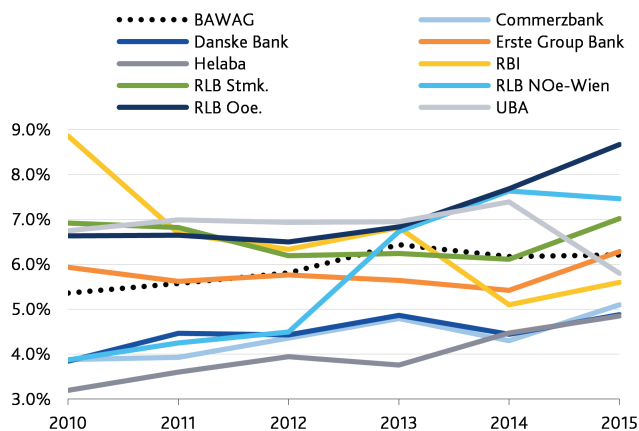
Exhibit 9  
**BAWAG's Capitalisation Has Improved Qualitatively and Quantitatively**

Tier 1 ratio (phase-in view), 2010-2015



Source: Annual reports, Moody's Bank Financial Metrics

Exhibit 10  
**BAWAG's Leverage Is in Line with Similarly Rated Peers**  
 Tier 1 leverage ratio (phase-in view), 2010-2015



Sources: Annual reports, Moody's Bank Financial Metrics

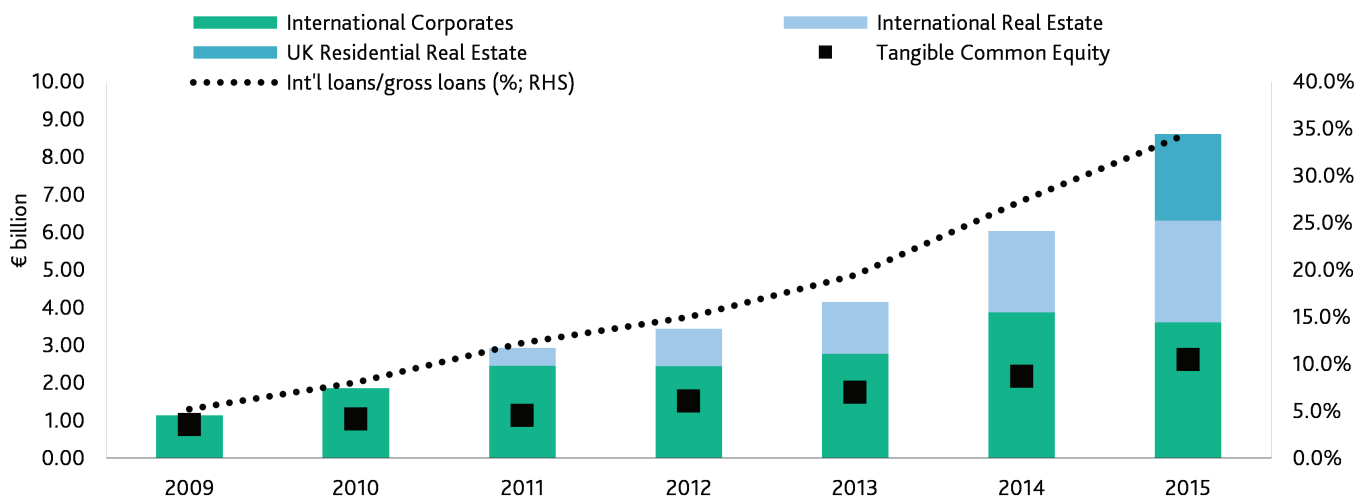
### Expansion into non-domestic assets creates potential risks in a downturn

BAWAG has diversified away from its home market by building a portfolio of international loans. These are focused on large corporates and commercial real-estate lending in core Western European countries and made up 330% of the bank's tangible common equity as of year-end 2015. While the historic performance of the international portfolios has been very solid, we caution that the resulting concentration risks can trigger large losses in a highly adverse macroeconomic scenario, potentially eroding the bank's capital ratios.

In addition, the acquisition of a residential mortgage-loan portfolio in the UK in December 2015 added new risks to BAWAG's balance sheet, especially when considering the outcome of the UK referendum on 23 June. At the same time, the UK portfolio is highly granular and promotes further diversification of the bank's earnings streams.

At present, BAWAG's solid profitability mitigates pressures potentially arising from BAWAG's international assets.

Exhibit 11  
**Strong Growth in International Loan Portfolios Adds Concentration Risks**



Sources: BAWAG annual reports, Moody's Bank Financial Metrics

## BAWAG's covered bond programmes mirror the bank's solid fundamental performance

BAWAG is currently the highest-rated Austrian bank with A3 long-term debt and deposit ratings. This is mirrored in BAWAG's covered bond (CB) programme, which benefits from the bank's A2(cr) Counterparty Risk Assessment, an assessment of the ability of the issuer to avoid defaulting on its operating obligations. BAWAG's Counterparty Risk Assessment was upgraded in April and is now the highest among Austrian banks.

Exhibit 12

### BAWAG Has Highest Counterparty Risk Assessment Across Selected Austrian Mortgage and Public-Sector Covered Bond Programmes

Issuer	Total outstanding mortgage-backed covered bonds (€)	Total outstanding public-sector covered bonds (€)	CRA
BAWAG P.S.K.	1,014,409,761	202,070,593	A2(cr)
Vorarlberger Landes- und Hypothekenbank AG	1,420,000,000	649,061,633	A3(cr)
UniCredit Bank Austria AG	5,036,573,100	4,579,655,600	Baa1(cr) on review for upgrade
Erste Group Bank AG	9,449,910,189	1,465,009,855	A3(cr)

Source: Moody's Q4 2015 Performance Overview Report, [www.moody.com](http://www.moody.com)

BAWAG's covered bond ratings show the highest resiliency of all Austrian covered bond ratings against a possible future deterioration in the bank's credit strength. BAWAG's A2(cr) credit strength means for investors in BAWAG covered bonds a lower risk that they ever need to rely on the cover pool for payment. BAWAG's covered bonds are also less likely to be downgraded than other Austrian covered bonds - at least from the perspective of our timely payment indicator, or TPI. The TPI measures the likelihood of timely payments to covered bondholders following an adverse event that may affect the CB anchor. The TPI framework limits the covered bond rating to a certain number of notches above the CB anchor. BAWAG's covered bond can withstand a two-notch downgrade of the issuer, while other Austrian covered bonds are closer linked to the credit strength of the issuer.

Exhibit 13

### BAWAG's Mortgage and Public-Sector Covered Bonds Are More Resilient

Issuer	CRA	TPI leeway (notches) - public-sector covered bonds	TPI leeway (notches)* - mortgage-backed covered bonds
BAWAG P.S.K.	A2(cr)	3	2
Vorarlberger Landes- und Hypothekenbank AG	A3(cr)	2	1
UniCredit Bank Austria AG	Baa1(cr) on review for upgrade	1	0
Erste Group Bank AG	A3(cr)	2	1

\* Number of rating notches by which a covered bond Anchor can be lowered before the covered bonds may face a downgrade based on the current Timely Payment Indicator (TPI) of the covered bonds.

Source: Moody's Q4 2015 Performance Overview Report, [www.moody.com](http://www.moody.com)

BAWAG's covered bonds' low exposure to riskier asset classes like commercial real-estate financings mean that its mortgage covered bond programme exhibits the lowest collateral risk of all Austrian mortgage covered bond programmes. BAWAG's mortgage covered pool exhibit a 5.2% share to commercial real estate financings, compared to a level of between 25% and 47% at other major domestic issuers' covered bond programmes.

Exhibit 14

**BAWAG's Covered Bond Expected Losses Are Lower**

Issuer	Collateral risk* (%)	Share of commercial real-estate financings in cover pool (%)
BAWAG P.S.K.	4.10	5.20
Vorarlberger Landes- und Hypothekenbank AG	14.60	46.90
UniCredit Bank Austria AG	10.50	33.50
Erste Group Bank AG	6.10	24.90

\* Level of losses solely as a result of the credit quality of the cover pool in a scenario where the issuer ceases to make payments under the covered bonds.  
Source: Moody's Q4 2015 Performance Overview Report, [www.moody.com](http://www.moody.com)

## Company Snapshot

BAWAG P.S.K is a universal bank domiciled in Austria. It offers a range of retail and corporate banking products, including deposit-taking, loans and investment services. Moreover, it provides international business products, such as commercial real-estate financing, capital market solutions as well as securities and asset management services. While the bank operates primarily in Austria, it also has a presence in core Western European markets. In October 2014, it opened a branch office in London to support its international operations.

The bank holds total assets of €35.5 billion as of 31 December 2015 and serves approximately 1.6 million customers through a nationwide network of about 480 branches which are operated in cooperation with Oesterreichische Post AG (Austrian Post, unrated). BAWAG holds a 5.6% market share in terms of key deposit products in Austria as of 31 December 2015.

As of 31 December 2015, the bank's major shareholders were Cerberus Capital Management L.P. (Cerberus, approximately 52% stake) and GoldenTree Asset Management L.P. (GoldenTree, approximately 40%).

## Moody's Related Research

### Peer Group:

- » [Erste Group Bank AG](#)
- » [UniCredit Bank Austria AG](#)
- » [Raiffeisen Bank International AG](#)
- » [Danske Bank A/S](#)

### Issuer Research:

- » [BAWAG P.S.K. Credit Opinion, April 2016](#)
- » [BAWAG's Improving Profitability and Capital Ratios Are Credit Positive](#)

### Covered Bond Research:

- » [Regulation is Now the Main Driver of Changes to Covered Bonds' Credit Quality, June 2016](#)
- » [BAWAG P.S.K.'s Public Sector Covered Bonds, June 2016](#)
- » [BAWAG P.S.K. - Mortgage Covered Bonds, February 2016](#)

## Endnotes

- 1 Defined as assets where the repayment schedule is more than 90 days past due.



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