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ISSUER COMMENT

BAWAG P.S.K.'s continued risk reduction and improved Basel III core capital ratio is credit positive

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On Wednesday, 13 November 2013, BAWAG P.S.K. (BAWAG; Baa2 stable, D/ba2 stable)[1] announced that it targets to achieve a fully-phased Basel III common equity Tier 1 ratio (CET1 ratio) of at least 9.0% by year-end 2013, up significantly from our H1 2013 estimate of approximately 7.0%.

The announcement is credit positive because it demonstrates BAWAG's commitment to significantly improve its capital ratios through a variety of measures including (1) lowering of asset risk-weights through the adoption of the internal ratings-based approach (IRB implemented in April 2013); (2) continued risk reduction; and (3) its improving internal capital generation from very low levels in the past. In addition, this development bodes well for the upcoming European asset quality review (AQR) in 2014 demanding a minimum CET1 threshold of 8.0%.

During the first ten months of 2013, BAWAG focused on improving its CET1 ratio mainly through the IRB-related lowering of mortgage- and corporate-loan risk-weights of EUR1.8 billion, further supported by meaningful risk reduction in non-core business areas. The latter was mainly realized through a full sale of the bank's legacy high-risk structured credit book (SCB) finalized during October 2013. Sold with a net gain, this transaction freed up a total of EUR175 million of CET1 capital, adding almost 100bps to the bank's CET1 ratio.

As a result of the legacy SCB sale, the bank's exposure to structured credit products and the euro area periphery fell by approximately EUR0.6 billion to EUR1.8 billion during the June-October 2013 period and is now unchanged if compared to year-end 2012 levels. Nevertheless, the remaining exposures – albeit considered lower risk if compared to the bank's prior legacy book positions – still represent a meaningful proportion of the bank's total capital (approximately 67%). We continue to consider these investments, despite being small in proportion of the bank's EUR38.2 billion balance sheet, to be non-core and thus incongruent to BAWAG's overall domestic retail and corporate lending strategy.

[1] The bank ratings shown in this report are the bank's deposit rating, its standalone bank financial strength rating/baseline credit assessment and the corresponding rating outlooks

Nevertheless, in our view, these improvements – together with BAWAG's recent EUR300 million Basel III-compliant Tier 2 capital issuance – facilitate a further redemption of and reduced reliance on the remaining EUR500 million of participation capital injected by the Austrian government[2] that currently represents a significant burden to BAWAG's profitability and thus internal capital generation capacity. Assuming the bank repays EUR150 million of such participation capital with Tier 2 capital, this would lift net profits by approximately EUR5.5 million, or 5% of the bank's reported 2012 net profits.[3]

We note that the significant difference in the bank's targeted CET1 ratio of 9.0% under the fully-loaded Basel III regulatory framework if compared with the current Basel 2.5 framework (equivalent CET1 ratio of more than 14.0%) is due to the bank's high proportion of 'lower-quality' (hybrid) capital elements subject to phasing-out under the Basel III regulatory capital regime (EUR500 million remaining participation capital, EUR404 million minorities as well as EUR142 million preference shares out of a total EUR2.715 billion own funds as of 30 June 2013).

As a result, and despite the aforementioned credit positive effects, we believe BAWAG needs to preserve and continue improving its CET1 capital ratio through both internal capital generation and continued risk reduction.

[2] Total of EUR550 million participation capital provided and a first tranche of EUR50 million repaid in June 2013

[3] Coupon payment on participation capital of 9.3% net (step-up to 9.8% in 2014) versus coupon payment of 8.125% pre-tax on BAWAG's Tier 2 subordinated bond issuance

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