

Erste Bank der oesterreichischen Sparkassen AG Public-Sector Covered Bonds

Covered Bonds / Austria

Closing Date

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DEFINITIVE RATINGS

Cover Pool (€ million)	Cover Assets	Covered Bonds (€ million)	Rating
735.6	Public Sector Debt	599.5	Aaa

The ratings address the expected loss posed to investors by the legal final maturity. Moody's ratings address only the credit risks associated with the transaction. Other non-credit risks have not been addressed, but may have a significant effect on yield to investors.

SUMMARY

Moody's has assigned definitive long-term ratings of **Aaa** to the Public-Sector Covered Bonds¹ (the "**Covered Bonds**") issued by Erste Bank der österreichischen Sparkassen AG ("**Erste Bank**" or the "**Issuer**") according to the provisions of the Austrian Mortgage Bank Act (the "**Act**"). Amongst others, the rating takes into account the following factors:

1. The credit strength of Erste Bank (rated **Aa3/Prime-1**).
2. The Austrian legal framework. Pursuant to the terms of the Act, the Issuer is regulated and supervised by the Austrian Financial Supervisory Authority. Investors will – on a *pari-passu* basis – have the benefit of a priority right in respect of a pool of assets (the "**Cover Pool**"). In addition, according to the law, the nominal value of the cover pool assets has to exceed the nominal value of all outstanding Covered Bonds by 2% at all times.
3. The Cover Pool. The Covered Bonds are backed by the Cover Pool, which comprises public-sector debt from Austrian local and regional governments as well as the central government of Austria and other member states of the European Union or debt guaranteed by these public-sector entities.

As is the case with other covered bonds, Moody's considers the credit strength of the transaction to be linked to that of certain parties, in particular the Issuer. Should such credit strength deteriorate, all other things being equal, the rating of the Covered Bonds may be negatively affected. However, the Issuer has the ability, but not the obligation, to commit voluntary enhancements to the transaction such as further over-collateralisation in order to increase the level of de-linkage to its credit strength. Currently Moody's is not relying on any collateral over and above that required by the covered bond law in Austria.

¹ Kommunalbrief, Kommunalschuldverschreibung or öffentlicher Pfandbrief according to the Austrian Mortgage Bank Act (Hypothekenbankengesetz).



STRENGTHS AND WEAKNESSES WITH MITIGANTS

Strengths

- The Act: The Public-Sector Covered Bonds (“Covered Bonds”) are issued in accordance with the 2005 Austrian Mortgage Bank Act,² which explicitly protects the status of the Covered Bond holders. The law stipulates that:
 - Covered Bonds are secured by a separated pool of assets (“the Cover Pool”), which are subject to conservative eligibility criteria. In general, only debt of public-sector entities located in Austria or other member states of the European Economic Area and Switzerland are eligible assets.
 - A minimum 2% nominal over-collateralisation has to be maintained at all times. The Issuer has elected under the Act to include in its articles of association a requirement to match the Cover Pool and Covered Bonds in accordance with a net present value (“NPV”) test.
 - In case of a declaration of bankruptcy of Erste Bank, the Cover Pool will be segregated from the Issuer’s general insolvency estate.
 - A special cover pool administrator (*besondere Verwalter*) appointed by a court will undertake the necessary administrative measures to satisfy those claims of the creditors of the Covered Bonds.
 - A cover pool monitor (*Treuhänder*) will monitor various operations with respect to the Cover Pool.
- The Issuer: The Public-Sector Covered Bonds are full recourse to Erste Bank (**Aa3/Prime-1**).
- The Cover Pool: The Public-Sector Covered Bonds are supported by a Cover Pool backed by high-quality assets. The majority of the claims are direct debt of the central government of Austria and other central governments of member states of the European Union or debt guaranteed by the central government of Austria.
- The limited hedging risks: The amount of the Cover Pool exposed to currency risk is low (less than 1%) and interest risk is mitigated by the Issuer’s option to choose the “stressed” net present value calculation.

Weaknesses with Mitigants

- Like most covered bonds, the probability of default of the Covered Bonds is expected to be linked to the probability of Issuer Default.³ Reasons for this include:
 - Principal redemption: The duration of the assets may be longer than the duration of the Covered Bonds. Therefore, following Issuer Default investors may need to rely on the proceeds from the sale of all or part of the Cover Pool, liquidity borrowing or other form of funding for repayment before final maturity.
 - Liquidity: the Issuer does not benefit from any designated source of liquidity if cash flow collections are interrupted, which could affect ongoing interest payments or principal redemption of the Covered Bonds.

Mitigants: Moody’s has considered stressed scenarios which include amongst others the sale of the Cover Pool at stressed refinancing margins. Furthermore, the 2% nominal over-collateralisation has to be maintained at all times and the interest yielded of the assets has to be at least as high as that owed to the Covered Bonds. The NPV of all cover pool assets has to be maintained at all times and also in a stressed interest rate environment at least as high as the NPV of the outstanding Covered Bonds (“NPV test”). According to the law, upon the insolvency of the Issuer the special cover pool administrator is entitled to sell the Cover Pool in part or in full, or to arrange for bridge financing in order to raise liquidity for any possible shortfall.

- As of April 2007 the Cover Pool is concentrated with respect to the following aspects: (i) geographical concentration: 79% of the claims are against public-sector

² Mortgage Bank Act (*Hypothekbankengesetz* as of June 2005)

³ Sponsor Bank Default or Issuer Default is defined in Moody’s rating methodology for European Covered Bonds as removal from the Cover Pool of (i) support provided by entities within the Issuer/Parent group, (ii) ancillary activities of the Issuer/Parent group (i.e. those not related to the Cover Pool) and (iii) usually, management functions of the Issuer.

entities, which are situated in Austria; (ii) obligor concentration: the 10 largest obligors account for around 75% of the total loan balance of the public-sector loans of the Cover Pool. **Mitigants:** (i) Moody's public-sector calculator takes into account the impact of concentration on borrower, regional and country levels; and (ii) by far the largest exposure (just under 50%) is to the central government of Austria (rated **Aaa**).

- As with most Covered Bonds in Europe, there are few restrictions or limitations on the future composition of the Cover Pool. This may have the effect of creating substitution risk. **Mitigants:** The quality of the Cover Pool, over time, will be protected by, among others, the requirements of the Act. The Austrian Mortgage Bank Act sets out rules detailing which assets qualify as ordinary cover assets for Public-Sector Covered Bonds. In addition, Moody's will monitor the Cover Pool. If the quality of the collateral deteriorates below a certain threshold, the Issuer will have the ability, but not the obligation, to increase the over-collateralisation in the Cover Pool. Failure to increase the level of over-collateralisation following a marked deterioration in the Cover Pool could lead to negative rating actions.

STRUCTURAL AND LEGAL ASPECTS

Erste Bank issues Covered Bonds in accordance with the Austrian Mortgage Bank Act

Erste Bank has established a Public-Sector Covered Bond programme according to the 2005 Austrian Mortgage Bank Act, under which Public-Sector Covered Bonds will be issued from time to time, in each case constituting direct, unconditional and senior obligations of the Issuer. The outstanding Covered Bonds are secured by a pool of assets ("Cover Pool"). Eligible assets for this Cover Pool are (i) direct claims against public-sector entities located in Austria and member states of the European Economic Area or Switzerland or local and regional governments located in these countries, or (ii) debt guaranteed by the aforementioned public-sector entities.

Upon Issuer Default a special cover pool administrator takes over management responsibility of the covered bond programme

Upon the insolvency of Erste Bank, the Cover Pool will be segregated from the insolvency estate of the Issuer. A special cover pool administrator will be appointed upon the commencement of insolvency procedures. This special cover pool administrator will undertake the necessary administrative measures to satisfy claims by the creditors of the Covered Bonds by collecting claims that are due, selling individual cover assets or organising bridge financing. Moody's understanding from legal and industry advisors is that the party providing bridge financing to the Cover Pool (upon the segregation of the Cover Pool) would enjoy senior status with respect to the Covered Bond holders.

Having an independent cover pool administrator may reduce potential conflict of interest between the Covered Bond investors and other creditors

Having an independent cover pool administrator upon the insolvency of the Issuer may reduce potential conflicts of interest between the Covered Bond investors and other creditors. In the event of insolvency of the Issuer, the following scenarios may occur:

1. The special cover pool administrator may transfer - if feasible - the Cover Pool, as well as all obligations under the Covered Bonds (and the obligations vis-à-vis pari-passu creditors, such as hedge counterparties or liquidity providers) to another suitable bank, which will assume the obligations of the Cover Pool.
2. If the Cover Pool and the outstanding Covered Bonds are not transferred and the cover pool assets are not sufficient to satisfy all claims of Covered Bond holders against the Cover Pool, the special cover pool administrator may dispose of the cover pool assets, subject to the approval of the competent court. In this case, all Covered Bonds will become due and payable and the special cover pool administrator will distribute the proceeds stemming from the disposal of the cover pool assets among the Cover Bond holders on a pari-passu basis. If the proceeds are not sufficient to meet all claims of the Covered Bond holders, then the Covered Bond holders will have a senior unsecured claim against the general insolvency estate of the Issuer.
3. If the Issuer has opted for an early redemption at present value in its articles of association, and if there is sufficient cover, the Cover Pool will not be transferred but the claims of the Covered Bond holders (and pari-passu creditors) will be redeemed early at the then current NPV. This would be subject to the approval of the competent court as well. Erste Bank has not opted for this latter alternative.

Nominal over-collateralisation of 2%

The Act requires the Issuer to maintain a minimum 2% nominal over-collateralisation for the Covered Bonds at all times. The Issuer has elected under the Act to include in its articles of association a requirement to match the Cover Pool and Covered Bonds in accordance with an NPV test as well. Covered Bond holders may benefit from voluntary and prescribed over-collateralisation in the Cover Pool following the commencement of Issuer insolvency proceedings. Claims of hedge counterparties rank equally with Covered Bond investors. To date Erste Bank has not entered any swap into the Cover Pool register.

Commingling risk: payments and receivables on the cover pool assets are not separated from other cash flows from the Issuer prior to the declaration of bankruptcy of the Issuer

Erste Bank services the cover pool assets entered in the register. Payments and receivables on the cover pool assets are not separated from other cash flows from the Issuer prior to the declaration of bankruptcy of the Issuer. Upon the commencement of insolvency proceedings, the Covered Bond holders would have preferential claim on all receivables in the Cover Pool. The appointed special cover pool administrator will be obliged by operation of law to apply all collections to satisfy the preferential claims against the Cover Pool.

Set-off risk is mitigated by the operation of law

Moody's understanding from legal and industry advisors is that set-off against claims that have been entered into the Cover Pool is excluded by the operation of the covered bond law.

MOODY'S RATING METHODOLOGY

The approach used by Moody's for rating covered bond transactions is detailed in a Rating Methodology.⁴ The impact of the credit strength of the Issuer, quality of the collateral, refinancing and market risks is considered below.

1) Credit Strength of the Issuer

The Public-Sector Covered Bonds are full recourse to Erste Bank, rated Aa3/Prime-1

The Public-Sector Covered Bonds are full recourse to Erste Bank, rated **Aa3/Prime-1**. The ratings of Erste Bank are based on its financial strength (reflected in its Bank Financial Strength Rating of C), which takes into consideration strong retail franchises throughout Austria and the more mature economies in Central & Eastern Europe (CEE), as well as its satisfactory financial fundamentals. Furthermore Erste Bank's ratings also take into account Moody's assessment that the probability of both sector and systemic support for Erste Bank is high.

For more information on the fundamental credit quality of the Issuer, please see Related Research: Moody's latest Credit Opinion on Erste Bank, published in May 2007.

2) Quality of the Collateral

Total Cover Pool volume amounts to €735.6 million

As of April 2007 the Cover Pool comprises 539 loans or bonds to 162 public-sector entities or loans guaranteed by public-sector entities. These claims add up to a volume of €735.6 million. The nominal value of Erste Bank's currently outstanding Public-Sector Covered Bonds amounts to €599.5 billion, so on a nominal basis these numbers translate into an over-collateralisation of 22.7%.

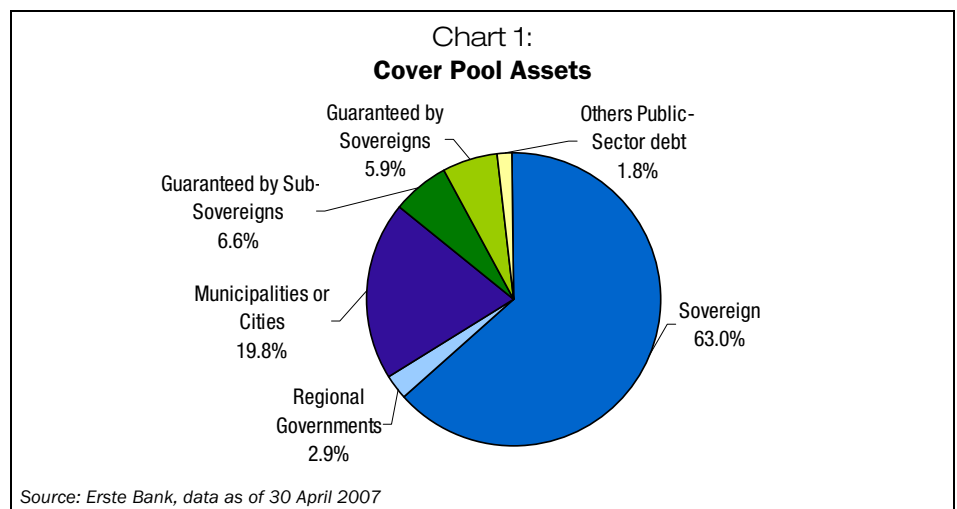
Table 1:

Overview Cover Pool Assets

	Cover Assets
Total pool (€ million)	735.6
Number of loans	539
Number of borrowers	162
Average exposure to borrower (€ million)	4.5

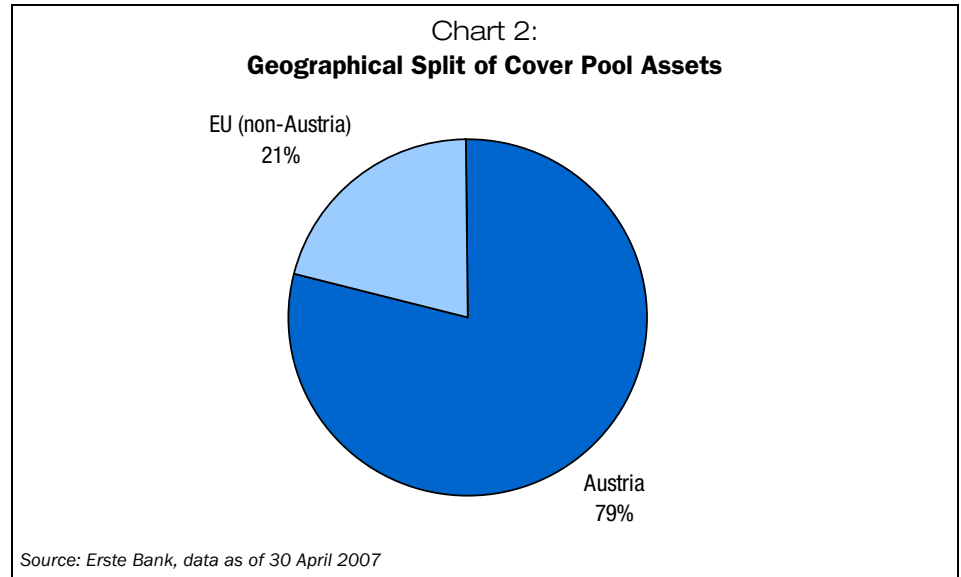
Claims against the Austrian government are largest portion of the Cover Pool

Direct or indirect claims against the Austrian central government are currently the largest portion of the Cover Pool. These are either direct claims against the central government of Austria or claims backed by the guarantees of the Austrian government. The Cover Pool also contains claims against other European sovereigns, including Germany, Portugal and Greece.



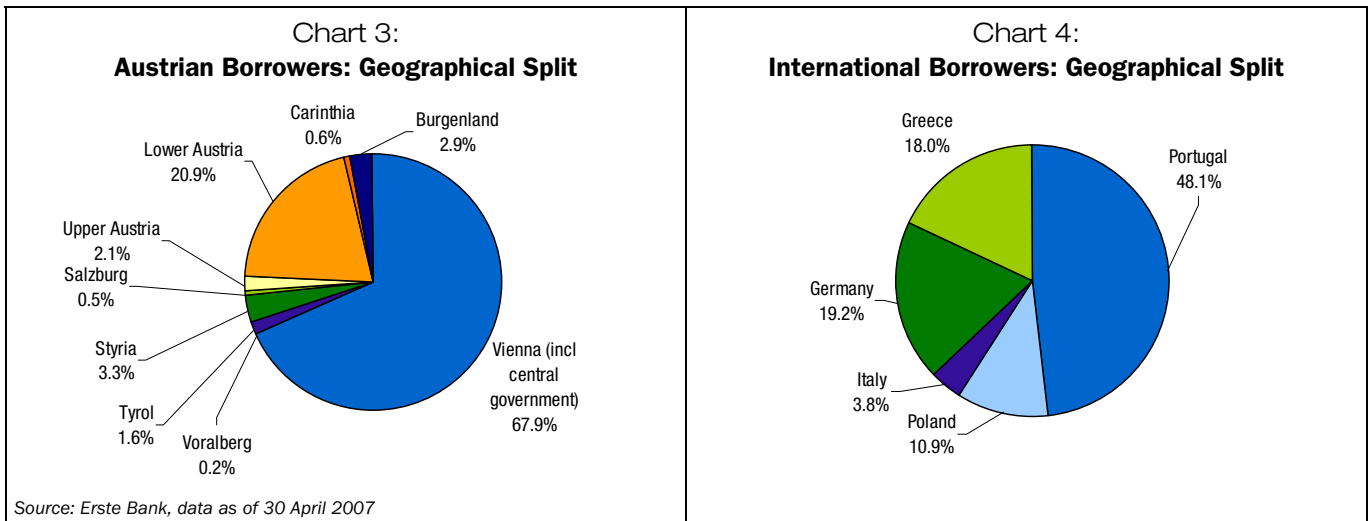
⁴ "Moody's Rating Approach to European Covered Bonds" published in June 2005 (see Related Research)

The credit quality of the Cover Pool as of the date of this report is good. In order to assess the credit risks within the Cover Pool, Moody's employed a Monte Carlo-based model. For the simulations the current ratings for Moody's-rated public-sector entities were applied accordingly. However, not every borrower is rated by Moody's. Therefore, a rating estimate was used for those public-sector entities that have no Moody's rating assigned.



The geographical focus of Erste Bank's Cover Pool is Austria, where the majority of obligors are situated. Austrian public-sector borrowers account for around 79% of the volume of all cover pool assets. Claims against the Austrian central government as well as public-sector entities situated in Vienna and Lower Austria account for the majority of the Austrian assets.

The public-sector assets outside Austria currently include claims against public-sector entities from five different countries, and exclusively claims against central governments from other European Union member states.



From a credit perspective, Moody's sees the following characteristics of the Cover Pool as positive:

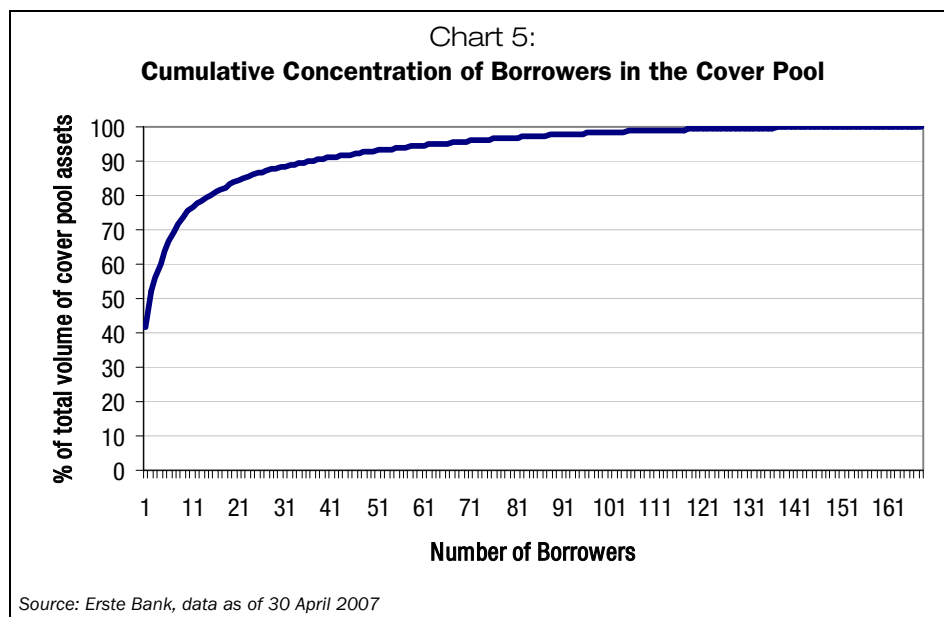
Average credit quality of cover pool assets is good

- In general, public-sector loans can be associated with a low expected loss in the event of a payment disruption on the loan. This is reflected in the credit ratings of Erste Bank's cover pool assets.
- Direct or indirect claims against the Austrian central government are currently the largest portion of the Cover Pool.
- The claims against the public-sector entities currently included in the Cover Pool are allotted to 162 different borrowers.

From a credit perspective, Moody's regards the following portfolio characteristics as negative:

Some borrower concentration

- Borrower concentration: The 10 largest obligors account for around 75% of the total cover pool assets.
- Country concentration: The majority of the public-sector entities are located in Austria. These entities account for around 79% of the volume of the cover pool assets.



Moody's has been provided with comprehensive data on the collateral, hence very few assumptions have been necessary in Moody's analysis. The above-mentioned factors have been incorporated into Moody's analysis. The result of the Cover Pool analysis is the Collateral Score.⁵ Moody's calculates a Collateral Score based on the credit quality of the public-sector loan pool using a Monte Carlo simulation. For this transaction, the Collateral Score is 5.7%, based on the current pool.

Substitution risks are mitigated by the Act

As with most Covered Bonds in Europe, there are few restrictions or limitations on the future composition of the Cover Pool. This may have the effect of creating substitution risk. Mitigants to substitution risk, which should protect the quality of the Cover Pool over time, include:

- Requirements of the Act. The Act limits the eligible cover pool assets to (i) direct claims against public-sector entities located in Austria and member states of the European Economic Area or Switzerland or local and regional governments located in these countries, or (ii) debt guaranteed by the aforementioned public-sector entities.
- The Cover Pool composition will be monitored. If the quality of the collateral deteriorates below a certain threshold, the Issuer will have the ability, but not the obligation, to increase the over-collateralisation in the Cover Pool in order to support the current rating. If additional over-collateralisation is not added following a marked deterioration of the collateral, this could lead to negative rating actions.

3) Refinancing the Cover Pool

The refinance margin stress used for public sector assets is much lower than that for commercial and residential assets

Where the "natural" amortisation of the Cover Pool assets alone cannot be relied on to repay principal, Moody's assumes that funds must be raised against the Cover Pool at a discount.

In the modelling of this transaction, Moody's has used its standard assumptions regarding refinance margins for public-sector assets. Moody's assumes lower refinance margins for public-sector assets compared to residential or commercial mortgage loans.

⁵ The Collateral Score can be seen as the amount of risk-free enhancement required to protect a Aaa rating from otherwise unsupported assets - therefore, the stronger the credit quality of the collateral, the lower the Collateral Score. This considers only the credit deterioration of the assets and ignores any risk from refinancing and market risk (see Rating Methodology "Moody's Rating Approach to European Covered Bonds").

Following Issuer Default the transaction may have exposure to increases in interest rates

Currency risk in this programme is currently very limited (less than 1%)

The exposure to interest rates movements is mitigated by the NPV test

The creditworthiness of the Covered Bonds will be impacted by the credit strength of the Issuer and the Cover Pool

4) Market Risk

As with the majority of European Covered Bonds, there is potential for market risks. For example, following Issuer Default, Covered Bond investors may be exposed to interest risk, which may arise from the different payment promises and durations made on the Cover Pool and the Covered Bonds. Following Issuer Default, the Moody's Covered Bond Model looks separately at the impact of increasing and decreasing interest rates on the expected loss of the Covered Bonds, and takes the path of interest rates that leads to the worst result.

Currently the majority of the cover pool assets and the majority of the outstanding Public-Sector Covered Bonds have a fixed rate. Currently all of Erste Bank's Public-Sector Covered Bonds and the vast majority of cover pool assets are denominated in euros. However, there is a small amount of currency risk in this transaction as of April 2007; therefore, in its analysis Moody's has assumed a small (1%) currency mismatch across this programme.

As of the date of this report, Erste Bank has not entered into any swaps that qualify for the Cover Pool register. However, interest rate risk is mitigated by the "stressed" net present value calculation opted for by Erste Bank under its articles of association. This internal approach stresses interest rates by applying ten basis points key rate shocks of every term point extrapolated to a 100-basis-point shock.

In the case of insolvency of the Issuer, Moody's does not assume that the special cover pool administrator will be able to take full advantage of any natural hedge between the Cover Pool and the Covered Bonds.

The result of Moody's calculations is that the most stressful scenario is currently one of increasing interest rates. Post-Issuer Default, in the event that a sale of assets is required to meet a principal payment, a sale of fixed-rate assets would lead to a crystallisation of interest rate losses in an increasing interest rate environment. The NPV test applied by the Issuer does partially immunise the assets against interest rate movements. Moody's has given value to an interest rate stress of 100 basis points, reflecting a parallel downside and upside shift on the swap rates. However, in some scenarios the stresses applied by Moody's approach when modelling interest rate shifts exceed this level.

DE-LINKAGE

All covered bonds have an element of rating linkage to (a) the transaction counterparties and (b) the supporting collateral. In other words, the creditworthiness of the Covered Bonds will be affected by the credit strength of the transaction counterparties and the value of the Cover Pool.

There are a number of other areas of linkage that affect most covered bond transactions, including:

- Refinancing risk. Following Issuer Default, if principal receipts from collections of the Cover Pool are not sufficient to meet the principal payment on a Covered Bonds, funds may need to be raised against the Cover Pool. However, the fact that the Issuer has defaulted may negatively impact the ability to raise funds against the Cover Pool.
- The dynamic nature of the transaction up until Issuer Default. For example, up to Issuer Default, new assets may be added to the Cover Pool, new bonds issued and new hedging arrangements entered into.
- More generally, by the incorporation of the credit strength of the Issuer in Moody's rating methodology.

The probability of default on the Covered Bonds may be higher than expected for Aaa-rated senior unsecured debt. However, Moody's primary rating target is the expected loss, which also takes severity into account. In this case this is consistent with a Aaa rating. Furthermore, the Covered Bonds will come under increasing rating stress as the Issuer's credit strength deteriorates. This is a consequence of the linkage of the transaction to the probability of default of the Issuer.

The following are selected features of the Covered Bonds that reduce the linkage of the Covered Bonds to the credit strength of the various transaction parties and the collateral:

Mitigants to linkage to the collateral

Mitigants to linkage to the collateral include:

- The legal nominal matching cover test and the requirement according to the Act to hold 2% over-collateralisation on a nominal basis.
- Requirement according to Erste Bank's articles of association to also maintain coverage of outstanding Covered Bonds on a "stressed" net present value basis.
- The pool composition will be monitored. If the quality of the collateral deteriorates below a certain threshold, Erste Bank will have the ability, but not the obligation, to increase the over-collateralisation in the Cover Pool.

The provisions above should mean there is substantial value in the Cover Pool at the time of Issuer Default.

Mitigants to the linkage to Erste Bank

Mitigants to linkage to Erste Bank can be contemplated from an expected loss and timeliness of payment perspective.

Mitigants to linkage to Erste Bank from an expected loss perspective include the following:

- The quality of the Cover Pool at time of Issuer Default (see above);
- The segregation of the Cover Pool from the insolvency estate of the Issuer.

Mitigants to linkage to Erste Bank from a timeliness of payment perspective include the level of support that the Austrian legislation provides to mitigate any delay of payments on the Covered Bonds following an Issuer Default. Examples of this include the following:

- The Austrian Mortgage Bank Act offers a variety of ways in which financing can be achieved against the Cover Pool, including complete and partial sales of the Cover Pool and raising liquidity against the Cover Pool;
- A special cover pool administrator takes over management responsibility for the programme upon Issuer Default. The special cover pool administrator acts independently of the insolvency administrator of the Issuer, and his duty of care is to the Covered Bond investors.

MONITORING

Moody's will monitor the transaction on an ongoing basis to ensure that it continues to perform in the manner expected, including checking the supporting ratings and reviewing the assets on an ongoing basis. Any subsequent changes in the rating will be publicly announced and disseminated through Moody's Client Service Desk.

RELATED RESEARCH

For a more detailed explanation of Moody's approach to this type of transaction as well as similar transactions, please refer to the following reports:

Rating Methodology

- Moody's Rating Approach to European Covered Bonds, June 2005 (English version - SF57011) (German version – July 2005: SF58550)

Special Report

- 2006 Review and 2007 Outlook EMEA Covered Bonds: Dramatic Growth Recorded in 2006, and Trend to Continue as Market Diversifies in 2007, January 2007 (SF89507)
- European Covered Bond Legal Frameworks: Moody's Legal Checklist, English version: December 2005 (SF66418) – (German version – January 2006: SF67969)

Credit Opinion

- Moody's Global Credit Research – Credit Opinion: Erste Bank der oesterreichischen Sparkassen AG, 16 May 2007

Analysis

- Erste Bank der oesterreichischen Sparkassen AG, 3 January 2007

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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