Moody's Investors Service

Credit Opinion: NLB InterFinanz AG

Global Credit Research - 30 Oct 2009

Zurich, Switzerland

Ratings

Category	**Moody's Rating**
Outlook	Stable
Issuer Rating	Baa2
Ult Parent: KBC Group NV	
Outlook	Negative
Issuer Rating	A1
Senior Unsecured -Dom Curr	A1
ST Issuer Rating	P-1
Parent: Nova Ljubljanska banka d.d.	
Outlook	Stable
Bank Deposits	A1/P-1
Bank Financial Strength	C-
Bkd Senior Unsecured -Dom Curr	Aa2
Subordinate -Dom Curr	A2
Jr Subordinate -Dom Curr	A2

Contacts

Analyst	**Phone**
George Chrysaphinis/Limassol	357.25.586.586
Constantinos Kypreos/Limassol	
Mardig Haladjian/Limassol	
Christos Theofilou, CFA/Limassol	

Key Indicators

NLB InterFinanz AG

	[1]**2008**	**2007**	**2006**	**2005**	**2004**	**Avg.**
Total assets (CHF billion)	**0.87**	**0.83**	**0.58**	**0.43**	**0.31**	[2]**24.98**
Total assets (EUR billion)	**0.59**	**0.50**	**0.36**	**0.28**	**0.20**	**--**
Total capital (CHF billion)	**0.06**	**0.04**	**0.03**	**0.03**	**0.02**	[2]**35.04**
Return on average assets	**1.68**	**1.85**	**2.02**	**2.55**	**1.35**	**1.89**
Recurring earnings power [3]	**2.86**	**2.95**	**3.26**	**3.56**	**3.26**	**3.18**
Net interest margin	**3.94**	**4.28**	**4.06**	**4.66**	**4.69**	**4.33**
Cost/income ratio (%)	**22.30**	**22.85**	**23.51**	**23.47**	**25.66**	**23.56**
Problem loans % gross loans	**--**	**--**	**--**	**--**	**--**	**--**
Tier 1 ratio (%)	**--**	**--**	**--**	**--**	**--**	**--**

[1] As of December 31. [2] Compound annual growth rate. [3] Preprovision income % average assets.

Opinion

RECENT CREDIT DEVELOPMENTS

On 20 October 2009 Moody's downgraded the issuer rating of NLB InterFinanz, (NLBI) to Baa2 from A3, with a stable outlook. This rating action was driven by the downgrade of the BFSR of its parent bank, Nova Ljublanska Banka (NLB) to C- (mapping onto a baseline credit assessment (BCA) of Baa2) from C (mapping onto a BCA of A3).

NLBI's issuer rating is based on the company's own standalone financial strength and also incorporates a few notches of uplift to reflect the very high likelihood of support from its parent, NLB. The degree of rating uplift is determined by both the likelihood of support and also by the parent bank's standalone financial strength represented by its BFSR and BCA.

The evolution of NLBI's standalone financial strength was not a factor in this rating decision, notwithstanding some deterioration in profitability and asset quality. Moody's rating review considered the vulnerability of the company's capital position to increasing non-performing loans and found that it maintains sufficient loss absorption capacity under Moody's anticipated scenario

Rating Rationale

The A3 issuer rating of NLB InterFinanz ("NLBI") is based on the company's moderate intrinsic financial strength along with a very high likelihood of support from its parent bank, Nova Ljubljanska Banka ("NLB").

Our assessment of the company's intrinsic financial strength is constrained by (i) the company's modest franchise quality as a niche provider of collateralised corporate loans and forfaiting services to customers in Central, Southern and Eastern Europe, (ii) by high single-party exposure concentrations to some of these customers, (iii) by high reliance on market funding, and (iv) a weak economic environment in its target markets, amplifying credit risk.

The company's intrinsic financial strength is supported by (i) good recurring profitability founded on its lean operating model and (ii) adequate risk positioning based on the close integration with its parent in the areas of liquidity management, internal control and risk management (iii) satisfactory capital and provisions levels, and (iv) stable and experienced senior management.

The assumptions we make about the likelihood of external support are based on full ownership by NLB and by the high (and increasing) level of operational integration with the parent

Rating Drivers

- Good expertise in forfaiting and in lending in markets of Central, Southern and Eastern Europe, though franchise value constrained by narrow business focus

- Healthy profitability, driven by strong margins and low operating expenses

- Adequate loss absorption capacity, given large provision reserves

- High reliance on market funding constrains liquidity profile, though concerns mitigated by availability of funding from its parent bank

- Very high likelihood of support from its parent bank

- High single party exposure concentration to some corporate customers and banks

- Weak economic environment in core markets increases company's exposure to credit risk

Rating Outlook

The Baa2 issuer rating has a stable outlook

What could change the rating - Up

Any upward movement in NLBI's issuer rating is likely to be driven by an upward rating shift in its parent's BCA. Any upward movement in NLBI's standalone financial strength is limited by its niche business profile as a small wholesale-funded corporate lender to Central, Southern and Eastern Europe.

What could change the rating - Down

NLBI's ratings could be downgraded if (i) the ratings of its parent NLB are downgraded, or (ii) if changes in the operating environment constrain the company's ability to generate new business with an adequate risk-reward relationship.

Recent Results and Developments

In the first six months of 2009 NLBI reported unaudited net income of CHF5.6 million, down 28%year-on-year. This decline was driven by (i) lower net interest income, down 28% year-on-year to CHF9.16 million, partly compensated by (ii) lower provisioning expenses, down 28% year-on-year at CHF4.0 million. Although profits are small, in absolute terms, we consider the company's overall profitability to be moderately strong.

At the end of June 2009 NLBI maintained total assets of CHF816.4 million (EUR552.0 million), down 6% year on year. As a non-bank financial company under Swiss regulation, NLBI is not subject to capital adequacy requirements, nor does it have to report on asset quality.

DETAILED RATING CONSIDERATIONS

Franchise Value

NLB InterFinanz (NLBI) is a niche, Zurich-based financial institution that specialises in providing corporate loans and non-recourse forfaiting services to emerging markets customers especially in South Eastern, and Central and Eastern Europe ("SEE" and "CEE"). In providing such services NLBI functions as a highly integrated part of its Slovenian parent bank, Nova Ljubljanska Banka ("NLB"), which operates a regional franchise in these markets.

Because of its relatively small market position and narrow business focus we consider that NLBI maintains modest franchise value. Among its franchise strengths we note the bank's forfaiting product expertise and good knowledge of its target markets in the SEE and CEE, reflected in a solid loan origination track record in the 20 years since inception. We also consider NLBI's close operating relationship with its parent bank to be another source of franchise strength, with the most obvious benefit being access to funding, but also including risk management and business origination resources.

The sustainability of NLBI's niche corporate lending and forfaiting business is supported by the company's ability (implicit in its business model) to open new markets while exiting maturing and therefore less profitable ones. It is within this context that the company had extended of its forfaiting activities within the Balkans and to the Ukraine, and Belarus in recent years as profit margins in some of the maturing CEE markets faded. In general forfaiting opportunities arise when other lending opportunities subside during periods of reduced liquidity and greater risk aversion. As a result of the crisis previously liquid markets are once again presenting attractive forfaiting opportunities and this segment is expected to become the primary growth driver within NLBI's portfolio over the medium term.

At the end of June 2009 NLBI's assets totalled CHF816.4 million, (EUR552.0 million) including gross loan exposures of CHF763.5 million, stable over the year, having grown very rapidly earlier in the decade. About 70% of these exposures were corporate loans secured by collateral or bank guarantee in the countries of former Yugoslavia and the balance were forfaiting (trade finance) assets in other CEE markets. The company presently maintains offices in six locations outside of Switzerland and employs twenty-four staff.

Risk Positioning

In our assessment of NLBI's risk positioning, we note that the company's business model exposes it to moderately high level of risk, primarily credit risk and liquidity risk, but that the institutional arrangements in place are generally effective in managing and mitigating such risks.

We consider that exposure to corporate borrowers in the countries of former Yugoslavia, accounting for about 70% of the loan book and more than three times capital and provisions, represents a relatively high level of credit risk. This risk is amplified by very high concentration, whereby the top twenty exposures are equivalent to more than two times capital and provisions and more than eight times pre-provision earnings. We note similar levels of concentration in the company's forfaiting book, though in this case the exposure is to banks. High concentrations are consistent with the company's business model.

Credit risk concerns are mitigated by what we consider to be fairly sound credit risk practices, relatively good collateralisation and oversight by the Bank of Slovenia, as regulator for the parent bank NLB. As a niche corporate financier and forfaiting service provider the company typically targets the strongest corporates and banks as a first mover in an emerging market and secures its loans with bank guarantees or prime real estate collateral. The company applies the risk management methodologies of NLB and shares risk management resources given that its credit risk function is located within NLB, in Slovenia.

In terms of liquidity management the role of the parent bank is even more significant and serves to mitigate liquidity risks. As a non-deposit taking institution, NLBI relies only on market funding and about half of this originates directly from NLB in the form of short term revolving loans. The rest of the funding is a mix of medium-term (3-year) and short-term (6-12 month) facilities obtained from several European banks with the help of the parent bank's relationship banking network. The funding structure, therefore largely matches the maturity of the loan book, composed primarily of three-to-five-year instalment loans, with about a third of this maturing in any given year.

Finally, we note the existence of adequate corporate governance practices at the company, characterised by active supervision by the parent bank at board level and through internal control processes. The board of directors is composed by executives of the parent bank and as well as professionals from outside the bank. Three of the five members are fully independent.

Operating Environment

In assessing the operating environment we consider the political and economic conditions that prevail in the company's major markets and also the competitive conditions of its business environment. Together these factors have a strong influence on the quality and stability of a finance company's earnings.

Although the predominant factor in assessing the quality of the operating environment is currently the weak economic conditions in the company's core markets of SEE and Central Europe, we also focus on the level of institutional development. We highlight less effective foreclosure procedures and the slower enforcement of property rights, that require a strong focus on the quality of collateral, good knowledge of the markets and also higher risk premiums to compensate for the greater risk,

We consider that NLBI's approach to this environment is appropriate. It retains a focus on the risk-return characteristics of the markets it operates in and has the ability to enter new markets to replace declining returns in its existing ones. This goes some way towards shielding the bank from increasing competition and reduced margins. Its small size relative to other providers of corporate loans and forfaiting services suggests that it has more flexibility in adjusting to periods of intensifying competition.

Financial Fundamentals

NLBI generates most of its earnings in the form of net interest income and in that respect is similar to commercial banks. In recent years it has achieved strong pre-provision return on average assets, upwards of 3% and post-provision return on assets of about 2%. This is driven by relatively healthy interest margins of over 3% and by a very favourable efficiency profile. This performance has slipped during 2009, reflecting a squeeze on interest margins.

The company's corporate lending business model benefits from small staff numbers and modest infrastructure requirements. To the extent that NLBI is able to sustain its business volumes and margins, it can continue to generate healthy profits over the medium term. Of course this is subject to maintaining strong asset quality, which in the prevailing economic conditions is becoming increasingly difficult.

Although not subject to regulation and therefore a minimum capital ratio, NLBI's business model requires it to maintain a capital cushion capable of absorbing credit losses. Following an injection of CHF16.0 million by its parent in September 2008, the ratio of capital to total has risen to over 6%, which we consider to be on the low side, given the company's risk profile. However, if we were to add excess provisions accumulated in recent years, the ratio rises to above 10%, which is a more comfortable level. Full ownership by NLB and its small size relative to its parent means that additional capital is likely to be available.

During our review of NLBI's ratings we examined the vulnerability of the company's capital position to increased loan defaults. We concluded that NLBI maintains adequate loss absorption capacity - composed of capital, existing provisions and ongoing earning capacity - to cope with the expected further deterioration in asset quality over the next few months. Our expectations incorporate the possibility that the recent pace of non-performing loan growth could continue into 2010.

Accounting standards for finance companies (as opposed to banks) in Switzerland, do not provide for the disclosure of non-performing loans. Management accounts, however, show that loans with payments that are at least ninety days past due have jumped to over 4% of gross loans by mid October 2009, up from just over 3% at the end of 2008 We note that though European economies appear to have stabilised, there could be further asset quality deterioration depending on the strength of the eventual economic recovery.

External Support

NLBI's Baa2 issuer rating incorporates our assumptions about the very high likelihood of external support from its parent, NLB. This assumption pushes the rating up to a level that is considerably higher than would otherwise be achieved on a standalone basis.

Our view on the very high likelihood of support in case of need is based on (i) full ownership of the company by NLB, (ii) the high level of operational integration with its parent and the close oversight that the parent exercises, (iii) the significant dependence of the company on its parent for funding, and (iv) the severe risks to NLB's reputation and to its ability to fund itself in international markets if its relationship banks were to lose money financing its subsidiary.

notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from $1,500 to approximately $2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moodys.com under the heading "Shareholder Relations - Corporate Governance - Director and Shareholder Affiliation Policy."