MOODY'S
INVESTORS SERVICE

Rating Action: Moody's upgrades Kommunalkredit Austria AG's public sector covered bonds

Global Credit Research - 17 Mar 2017

London, 17 March 2017 -- Moody's Investors Service has upgraded to Baa2 from Baa3 the covered bond ratings issued by Kommunalkredit Austria AG (Kommunalkredit; the issuer, not publicly rated). The covered bonds are backed by a pool of Austrian public sector assets and governed by the Covered Bond Act.

RATINGS RATIONALE

The decision to upgrade the covered bond ratings is based on two positive developments, namely (1) a reduction in the currency risk and (2) a reduction in the credit risk of this covered bond programme.

Unlike most other Austrian covered bond programmes, Kommunalkredit's programme has a significant currency mismatch as the majority of covered bonds are denominated in Swiss Francs, while almost all cover pool assets are denominated in Euros (the exposure is however hedged by Kommunalkredit with swaps that are not part of the cover pool). This currency mismatch has been reduced over the course of last year as Swiss Francs denominated covered bonds have been repaid at their maturity date. Now 73.5% of the issuer's covered bonds are denominated in Swiss Francs and we understand from the issuer that he will focus future funding activities on Euro bonds to further reduce the currency mismatch in the programme.

Kommunalkredit's programme has further benefitted from the rebound in the credit strength of the State of Carinthia, now rated A3 with a positive outlook. We have upgraded State of Carinthia's ratings to A3 from B1, reflecting a massive reduction in Carinthia's contingent liabilities as the KAF fund backed by the Austrian government (Aa1 stable) acquired HETA instruments for which Carinthia is statutorily liable as deficiency guarantor. For more information, please refer to the press release "Moody's upgrades State of Carinthia's ratings to A3; outlook changed to positive" http://www.moodys.com/viewresearchdoc.aspx?docid=PR_356467 .

KEY RATING ASSUMPTIONS/FACTORS

Moody's determines covered bond ratings using a two-step process: an expected loss analysis and a TPI framework analysis.

EXPECTED LOSS: Moody's uses its Covered Bond Model (COBOL) to determine a rating based on the expected loss on the bond. COBOL determines expected loss as (1) a function of the probability that the issuer will cease making payments under the covered bonds (a CB anchor); and (2) the stressed losses on the cover pool assets should the issuer cease making payments under the covered bonds (i.e., a CB anchor event).

The CB anchor for this programme is the CR assessment plus 1 notch. At the request of the issuer, the CR assessment is not published. The CR assessment reflects an issuer's ability to avoid defaulting on certain senior bank operating obligations and contractual commitments, including covered bonds. Moody's may use a CB anchor of CR assessment plus one notch in the European Union or otherwise where an operational resolution regime is particularly likely to ensure continuity of covered bond payments.

The cover pool losses for this programme are 36.0%. This is an estimate of the losses Moody's currently models following a CB anchor event. Moody's splits cover pool losses between market risk of 32.4% and collateral risk of 3.6%. Market risk measures losses stemming from refinancing risk and risks related to interest-rate and currency mismatches (these losses may also include certain legal risks). Collateral risk measures losses resulting directly from cover pool assets' credit quality. Moody's derives collateral risk from the collateral score, which for this programme is currently 7.2%.

The over-collateralisation in the cover pool is 17.6%, of which Kommunalkredit provides 0% on a "committed" basis. The minimum OC level consistent with the Baa2 rating is 8.5%, of which the issuer should provide 0% in a "committed" form (numbers in nominal value terms). These numbers show that Moody's is relying on "uncommitted" OC in its expected loss analysis.

All numbers in this section are based on Moody's most recent modelling (based on data, as per 30.12.2016).

The cover pool losses are an estimate of the losses Moody's currently models following a CB anchor event. Moody's splits cover pool losses between market risk and collateral risk. Market risk measures losses stemming from refinancing risk and risks related to interest-rate and currency mismatches (these losses may also include certain legal risks). Collateral risk is derived from the collateral score, which measures losses resulting directly from the cover pool assets' credit quality.

For further details on cover pool losses, collateral risk, market risk, collateral score and TPI Leeway across covered bond programmes rated by Moody's please refer to "Moody's Global Covered Bonds Monitoring Overview", published quarterly.

TPI FRAMEWORK: Moody's assigns a "timely payment indicator" (TPI), which measures the likelihood of timely payments to covered bondholders following a CB anchor event. The TPI framework limits the covered bond rating to a certain number of notches above the CB anchor.

For Kommunalkredit's covered bonds, Moody's has assigned a TPI of Probable-High.

Factors that would lead to an upgrade or downgrade of the ratings:

The CB anchor is the main determinant of a covered bond programme's rating robustness. A change in the level of the CB anchor could lead to an upgrade or downgrade of the covered bonds. The TPI Leeway measures the number of notches by which Moody's might lower the CB anchor before the rating agency downgrades the covered bonds because of TPI framework constraints. The TPI Leeway is not published for this programme.

A multiple-notch downgrade of the covered bonds might occur in certain circumstances, such as (1) a country ceiling or sovereign downgrade capping a covered bond rating or negatively affecting the CB Anchor and the TPI; (2) a multiple-notch downgrade of the CB Anchor; or (3) a material reduction of the value of the cover pool.

RATING METHODOLOGY

The principal methodology used in these ratings is "Moody's Approach to Rating Covered Bonds" published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions of the disclosure form.

Moody's did not use any stress scenario simulations in its analysis.

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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