

Rating Action: Moody's changes the ongoing rating review to "Aa3, direction uncertain" for Kommunalkredit Austria's public sector covered bonds

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London, 09 September 2015 -- Moody's Investors Service has changed the ongoing rating review to review with direction uncertain from review for downgrade for the Aa3 rating on the covered bonds issued by Kommunalkredit Austria AG (the issuer; deposits Ba3 on review direction uncertain, adjusted baseline credit assessment b3 on review direction uncertain, Counterparty Risk (CR) Assessment Ba2 (cr) on review direction uncertain). The review for downgrade was initiated on 23 June 2014 and extended as the issuer announced that its owner, Finanzmarkteteiligung Aktiengesellschaft des Bundes (FIMBAG), signed a share purchase agreement with a buyer consortium leading to a proportionate demerger according to the Austrian Demerger Act (Spaltungsgesetz).

RATINGS RATIONALE

The review with direction uncertain reflects upside and downside risks to the current Aa3 rating level. On 28 August 2015, the issuer published its interim report and stated that all contracts regarding the demerger process have been signed and approved by the shareholders of Kommunalkredit Austria AG and KA Finanz AG at an extraordinary shareholder meeting on 27 July 2015. However, the regulatory approvals are still outstanding.

The partial sale of Kommunalkredit Austria has uncertain implications for creditors. The issuer's standalone credit profile is characterised by highly concentrated exposures, the growing short-term orientation of its funding profile and improving regulatory capital ratios, despite high leverage. The issuer's long-term debt and deposit ratings, as well as the bank's baseline credit assessment, Counterparty Risk Assessment and subordinated debt are under review with direction uncertain, reflecting (1) the lack of visibility as to the impact on the bank's standalone profile of the planned, but yet to be fully substantiated, asset and liability split; and (2) the need to re-assess government support for the future obligors of debt issued by Kommunalkredit Austria or its successor entities. For further information, see "Credit Opinion: Kommunalkredit Austria AG", published on 14 August 2015.

Covered bond investors are exposed to additional uncertainty as the issuer announced its intention to split its covered bond programme with issuances totalling EUR3.8 billion. As part of the issuer's demerger process, the issuer intends to transfer assets and covered bonds; about EUR2.7 billion of covered bonds are intended to be transferred to KA Finanz AG; there is also some uncertainty on the selection criteria that will be applied for the asset and covered bond split between the two entities. Further, the demerger gives the issuer the option to terminate with a notice period of three months a contract that commits it currently to hold 28% minimum over-collateralisation. For further information, see "Demerger of Kommunalkredit Allows Lower Over-Collateralisation of Covered Bonds, a Credit Negative", published on 19 March 2015.

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 event); and (2) the stressed losses on the cover pool assets following a CB anchor event.

The CB anchor for this programme is CR assessment plus 1 notch. 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 28.3%. 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 19.9% and collateral risk of 8.5%. 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 17.0%.

The over-collateralisation in the cover pool is 33.5%, of which the issuer provides 28.0% on a "committed" basis. The minimum OC level consistent with the Aa3 on review direction uncertain rating target is 28.5%, of which the issuer should provide 21.5% in a "committed" form (numbers in nominal value terms). These numbers show that Moody's is relying on to a minor degree 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. June 2015). 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 Austria's public sector covered bonds, Moody's has assigned a TPI of High.

FACTORS THAT WOULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATING:

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.

Based on the current TPI of "High", the TPI Leeway for this programme is zero notches. This implies that Moody's might downgrade the covered bonds because of a TPI cap if it lowers the CB anchor by one notch all other variables being equal. A downgrade could also occur if the level of over-collateralisation were to decrease. On the other side, Moody's might upgrade the covered bonds if the CB anchor were to improve and the over-collateralisation were to remain at the current level. 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, for example because of a reduction in over-collateralisation.

RATING METHODOLOGY

The principal methodology used in these ratings was "Moody's Approach to Rating Covered Bonds" published in August 2015. Please see the Credit Policy 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.

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