

# Transaction Update: Kommunalkredit Austria AG (Public Sector Covered Bonds)

## Fundierte Bankschuldverschreibungen

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## Fundierte Bankschuldverschreibungen

### Ratings Detail

Reference Rating Level	bbb		Jurisdictional-Supported Rating Level	a		Maximum Achievable Covered Bond Rating	a		Covered Bond Rating	
Resolution Regime Uplift	+2	+	Assigned Jurisdictional Support Uplift	+3	+	Collateral Support Uplift	0	=	A/Stable	
Systemic Importance	Very Strong		Jurisdictional Support Assessment	Very Strong		Overcollateralization Adjustment	-1		Rating Constraints	a
Adjusted Issuer Credit Rating	--		Legal Framework	Very Strong		Liquidity Adjustment	-1		Counterparty Risk	a
GRE And Sovereign Support	--		Systemic Importance	Very Strong		Potential Collateral-Based Uplift	0		Country Risk	aaa
Issuer Credit Rating*	--		Sovereign Credit Capacity	Very Strong						

\*The overcollateralization needed for the 'A' rating represents our 'hard' credit enhancement floor at 'A', or 1.50%. It is the minimum required credit enhancement to achieve the current 'A' rating, on the sole basis of the available jurisdictional support.

### Major Rating Factors

#### Strengths

- Very strong jurisdictional support assessment.
- Majority of the cover pool assets are located in Austria.

#### Weakness

- High concentration of Austrian local and regional governments in the cover pool, which we reflect in our analysis.
- The derivatives replacement framework, which is not in line with our current counterparty criteria, caps our rating on the program at 'A'.

## **Outlook: Stable**

The stable outlook on our covered bonds ratings reflects our view of the credit strength of the issuer.

## **Rationale**

On June 13, 2017, S&P Global Ratings assigned its 'A' credit ratings to Kommunalkredit Austria AG's public sector covered bond program and related issuances of "Fundierte Bankschuldverschreibungen" (see "Kommunalkredit Austria's Public Sector Covered Bonds Assigned 'A' Ratings; Outlook Stable").

Our covered bond ratings process follows the methodology and assumptions outlined in our "Covered Bonds Criteria," published on Dec. 9, 2014, and "Covered Bond Ratings Framework: Methodology And Assumptions," published on June 30, 2015.

The 'A' ratings reflect our reference rating level (RRL) of 'bbb' and jurisdiction-supported rating level (JRL) of 'a' and the coverage of foreign exchange risk at the 'A' rating level. We have not assigned any notches of collateral-based uplift above the JRL, because the available credit enhancement of 26.58% is below the level that we would consider to be commensurate with the first notch of collateral-based uplift, which is currently 27.45%. This represents the "AAA" level credit risk and 75% refinancing costs, in the absence of the liquidity and overcollateralization commitments.

The replacement framework on the interest rate (IR) derivatives is not in line with our current counterparty criteria (see "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013). Therefore, our criteria cap our ratings on the program and related issuances at the JRL.

Lastly, the ratings on the program and related issuances are not constrained by legal, operational, or country risks.

## **Program Description**

Kommunalkredit Austria is a privately owned Austrian specialist bank focused on public sector/infrastructure financing.

The covered bond program was established in 2003 (by the predecessor entity) and several covered bond series have been issued since then. Kommunalkredit Austria intends to be more active in the market, with further mainly euro denominated issuances going forward.

The assets in the cover pool represent public sector assets located mainly in Austria and are mainly euro-denominated.

Liabilities are denominated in euro and in Swiss francs (CHF). As no cross currency swap is registered in the cover pool, the covered bond program is exposed to significant unhedged foreign exchange risk. We understand that the issuer will reduce the foreign exchange risk over time upon CHF denominated covered bonds scheduled redemptions. Foreign exchange risk positions are hedged at the bank book level, outside the cover pool.

In addition, the program also includes interest rate swaps, where the replacement framework is not in line with our

current counterparty criteria.

The covered bonds are governed by the Austrian covered bank bonds act ("Gesetz betreffend fundierte Bankschuldverschreibungen").

**Table 1**

Program Overview*	
Jurisdiction	Austria
Covered bond type	Legislation-enabled
Redemption profile	Hard bullet
Underlying assets	Public sector
Jurisdictional support uplift	3
Unused notches for jurisdictional support	0
Target credit enhancement (%)	33.81
Available credit enhancement (%)	26.58

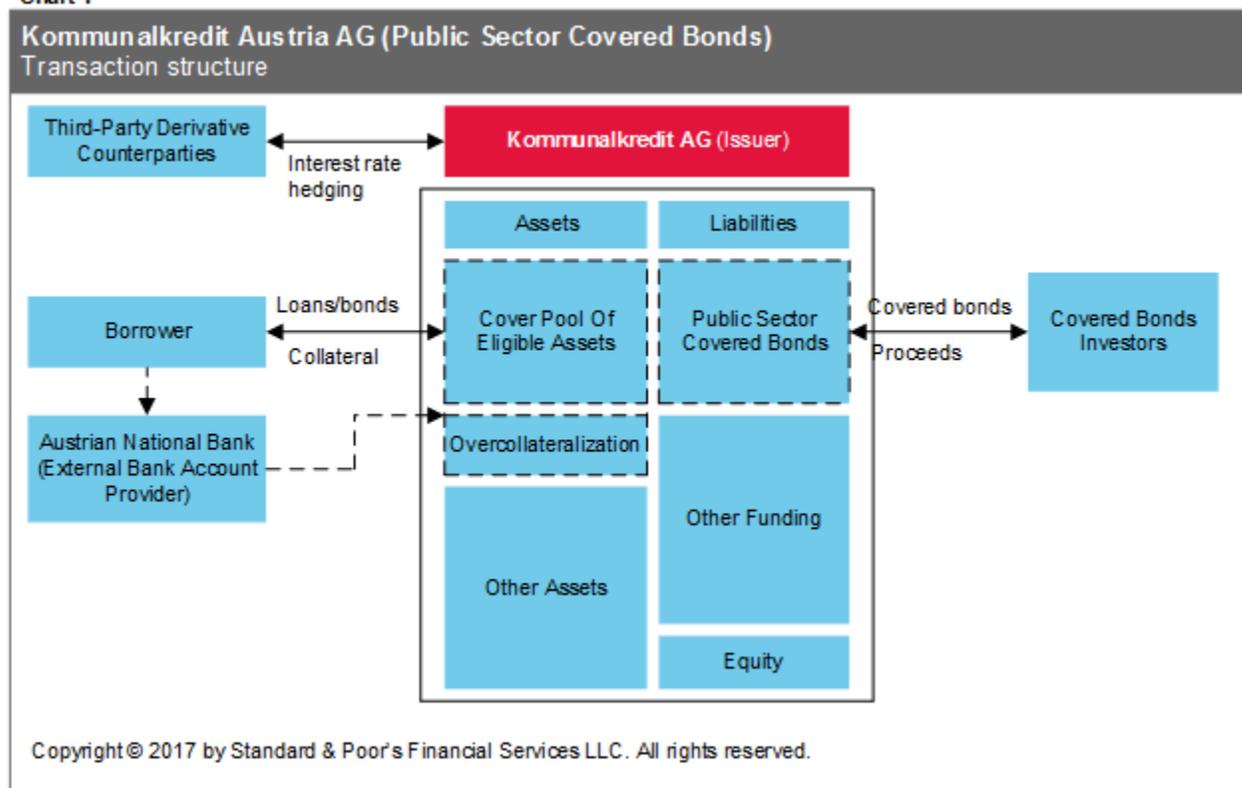
\*Based on data as of May 1, 2017

**Table 2**

Program Participants			
Role	Name	Rating	Rating dependency
Issuer	Kommunalkredit Austria AG	--	Yes
Bank account provider	Austrian National Bank	AAA*	Yes

\*As long as we believe Austria is unlikely to exit the eurozone (European Economic And Monetary Union), we consider Austrian National Bank's credit standing to be indistinguishable from that of the European Central Bank (unsolicited; AAA/Stable/A-1+).

Chart 1



## Rating Analysis

### Legal and regulatory risks

We base our legal analysis on our "Asset Isolation And Special-Purpose Entity Methodology," published on March 29, 2017, and our covered bond ratings framework.

The covered bonds are governed by the Austrian covered bank bonds act ("Gesetz betreffend fundierte Bankschuldverschreibungen").

From our analysis, we have concluded that the cover pool assets are effectively isolated from the insolvency of the issuer for the benefit of the covered bondholders. Upon issuer insolvency, a cover pool administrator is appointed by a court to continue the management of the cover pool and to satisfy the claims of the covered bondholders. The protection of the assets and continued management of the cover pool allows us to assign a higher rating to the covered bond program than that corresponding to Kommunalkredit Austria's credit strength.

### Operational and administrative risks

We review operational risk according to our covered bonds rating framework criteria.

There are no operational risks that would require a particular adjustment to our standard credit or cash flow assumptions. The issuer has a track record of managing risks and overcollateralization within the covered bond

program. We also believe that there is a high likelihood that the issuer could appoint a replacement cover pool manager if it became unable to manage the program following its default.

### **Resolution regime analysis**

The rating reference level (RRL) on the issuer, which is the starting point for any further uplift in our analysis, is 'bbb'. We consider the following factors:

- The issuer is domiciled in Austria, which is subject to the EU's Bank Recovery And Resolution Directive (BRRD).
- We assess the systemic importance for Austrian public covered bonds programs as very strong.
- The issuer's credit strength.
- The two notches of resolution support uplift above the adjusted credit strength of the issuer.

### **Jurisdictional support analysis**

In our jurisdictional support analysis, we assess the likelihood that a covered bond program facing stress would receive support from a government-sponsored initiative instead of from the liquidation of collateral assets in the open market.

Our assessment of the expected jurisdictional support for Austrian public sector covered bond programs is very strong, allowing three notches of uplift from the RRL to achieve a JRL of 'a' (see "Assessments For Jurisdictional Support According To Our Covered Bonds Criteria," published July 20, 2016).

In order to assign full jurisdictional-based uplift in the absence of any collateral-based uplift (see "Collateral support analysis"), and as the covered bond program is exposed to unhedged foreign exchange risk, coupled with the local legislation's lack of provisions to address this additional risk (such as stress testing the exposure, or the ability to require increased minimum overcollateralization levels, for example), we have included foreign exchange risk when calculating the required credit enhancement for a 'A' rating.

We have considered the foreign exchange risk when establishing the minimum required credit enhancement level commensurate with the JRL. The available credit enhancement is sufficient to cover the foreign exchange risk, in our view. We expect the covered bonds to be supported by a minimum amount of credit enhancement of 1.5% for a 'A' rating.

Only a small portion of the assets but a significant portion of the liabilities are denominated in CHF. We have incorporated the simulated CHF/EUR exchange rate in our cash flow model, which is a mean reverting model. The simulation currency rate depreciates the value of the CHF to the long-term mean, which benefits the transaction. We have reflected this in our analysis.

### **Collateral support analysis**

We base our analysis on the loan-level data provided by the issuer as of May 2017. The pool almost entirely comprises public sector assets located in Austria (96.44%). We do not assign any notches of collateral-based uplift above the JRL, currently.

Of the total cover pool assets, 81% represent Austrian local and regional governments (LRGs). The remaining assets are principally non-LRG public finance assets located mainly in Austria and, to a limited degree, assets guaranteed by the German and Polish sovereigns and German LRGs.

The scenario default rate that we consider to be commensurate with a 'AAA' credit stress is 47.33% as of May 2017. We have also determined a weighted-average recovery rate of 69.68%, based on our classification of the cover pool assets under our criteria for assessing public sector cover pools (see "Methodology And Assumptions For Assessing Portfolios Of International Public Sector And Other Debt Obligations Backing Covered Bonds And Structured Finance Securities," published on Dec. 9, 2014).

We have not assigned any notches of collateral-based uplift above the JRL, as the available credit enhancement of 26.58% is below the level that we would consider commensurate with the first notch of collateral-based uplift, representing 27.45% (or "AAA" credit risk and 75% refinancing costs, as no commitments on 180 days liquidly coverage or overcollateralization are in place. In addition, any notch of collateral uplift would need to cover 23.53% of overcollateralization, representing the coverage of our supplemental tests in our public sector criteria. The driving test for this covered bond program is the largest industry test, which reflects the concentration of Austrian LRGs.

The target credit enhancement that is commensurate with the maximum collateral-based uplift under our covered bonds criteria is 33.81%.

The tables below further summarize the results of our collateral based analysis.

**Table 3**

Key Credit Metrics	
<b>As of Feb. 28, 2017</b>	
Weighted-average cover pool asset rating*	BB'
Weighted-average loan asset maturity (years)	6.49
Largest obligor (% of the cover pool)	10.91
20 largest obligors (% of cover pool)	57.47
<b>Credit analysis results</b>	
AAA Scenario default rate (%)	47.33
Weighted-average recovery rate (%)	69.98
Weighted-average time to recovery (years)	3.27
Largest industry test result (% of covered bonds)	23.53

\*The weighted-average cover pool rating reflects the weighted-average product of the rating on the individual obligors and the respective exposures to them. The weighted-average rating is computed as the credit rating that would have a probability of default and maturity that best approximates the portfolio's weighted-average maturity and expected portfolio default rate. The latter is the weighted-average default rate of the portfolio, based on the asset default rates specified in S&P Global Ratings' default table, which, in turn, are based on historical default rates we have compiled.

**Table 4**

Asset Distribution By Geography	
<b>By sovereign</b>	
	Percentage of cover pool (%)
Austria	96.44
Germany	2.18
Poland	1.38

**Table 5****Asset Distribution By Geography (Austrian LRGs)**

	Share (%)
Lower Austria	24.40
Upper Austria	21.90
Burgenland	15.30
Carinthia	15.00
Styria	13.50
Vorarlberg	3.40
Tirol	2.40
Salzburg	2.10
Wien	2.00
Total Austrian LRG	100.00

LRG--Local and regional governments.

**Table 6****Recovery Assumptions For Cover Pool Assets\***

Borrower type	'AAA' recovery rate (%)	Time to recovery (years)	Percentage of cover pool (%)
Category A LRG without currency risk§	90	4	41
Category B LRG without currency risk†	75	4	41
Non-LRG international public finance assets	10	0	15
Sovereigns	37	0	3

\*According to our criteria for pools of public sector assets. §Primarily Austrian and German states and Swiss cantons. †Austrian and Swiss municipalities. LRG--Local and regional governments.

**Table 7****Asset Distribution By Rating**

	Percentage of cover pool (%)
AAA	1.53
AA	31.94
A	0.54
BBB	40.35
BB or lower	25.64
Total	100.00

**Table 8****Collateral Uplift Metrics\***

Asset WAM (years)	6.81
Liability WAM (years)	7
Available credit enhancement (%)	26.58
'AAA' credit risk (%)	8.3
Required credit enhancement for first notch of collateral uplift (%)	14.73
Required credit enhancement for second notch of collateral uplift (%)	21.09
Required credit enhancement for third notch collateral uplift (%)	27.45
Target credit enhancement for maximum uplift (%)	33.81

**Table 8**

<b>Collateral Uplift Metrics* (cont.)</b>	
Potential collateral-based uplift (notches)	0
Adjustment for liquidity (Y/N)	Y
Adjustment for committed overcollateralization (Y/N)	Y
Collateral support uplift (notches)	0

\*Based on data as of May 1, 2017. WAM--Weighted-average maturity.

## Counterparty Risk

### Bank accounts

For amounts channeled to dedicated accounts with Austrian National Bank, the account provider for the program, we would cap our rating on the program to the rating on the Austrian National Bank. We consider Austrian National Bank's credit standing to be identical to that of the European Central Bank (unsolicited; AAA/Stable/A-1+).

### Derivatives

There are only IR derivatives registered in the cover pool. The replacement framework for these derivatives is not in line with our current counterparty criteria and the termination costs are not subordinated (Swap termination costs rank pari passu with the covered bonds under the law).

As the issuer credit ratings (ICRs) on the swap counterparties and the RRL on the issuer are at least 'BBB', our criteria cap the rating on the covered bond program at the higher of (i) the issuer's RRL plus one notch, (ii) the JRL, and (iii) the lowest ICR on the counterparties. Consequently, our ratings on the covered bonds are currently capped at 'A'.

We have analyzed the counterparty risks according to our current counterparty criteria (see "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013, and "Counterparty Risk Analysis In Covered Bonds," published on Dec. 21, 2015).

### Country risk

The covered bond cover pool includes loans to obligors in multiple jurisdictions. When assigning covered bond ratings for multijurisdictional pools that exceed the ratings on sovereigns we apply structured finance ratings above the sovereign criteria (see "Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions," published on Aug 8, 2016). We consider that, based on the geographic diversification of the cover pool and the high sovereign ratings of the largest exposures, sovereign default risk is appropriately captured in our credit analysis. The final result of the sovereign stress test is 1.40% of overcollateralization. As this is below the result of the largest industry test, it does not floor the credit risk for any collateral based uplift in this pool. Consequently, country risk does not constrain our ratings on the covered bonds.

## Related Criteria And Research

## Related Criteria

- Legal Criteria: Structured Finance: Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Structured Finance - General: Ratings Above The Sovereign - Structured Finance: Methodology And Assumptions, Aug. 8, 2016
- Criteria - Structured Finance - Covered Bonds: Counterparty Risk Analysis In Covered Bonds, Dec. 21, 2015
- Criteria - Structured Finance - Covered Bonds: Covered Bond Ratings Framework: Methodology And Assumptions, June 30, 2015
- Criteria - Structured Finance - Covered Bonds: Covered Bonds Criteria, Dec. 9, 2014
- Criteria - Structured Finance - Covered Bonds: Methodology And Assumptions For Assessing Portfolios Of International Public Sector And Other Debt Obligations Backing Covered Bonds And Structured Finance Securities, Dec. 9, 2014
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- General Criteria: Methodology: Credit Stability Criteria, May 3, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related Research

- Kommunalkredit Austria's Public Sector Covered Bonds Assigned 'A' Ratings; Outlook Stable, June 13, 2017
- European Economic Snapshots For 2Q 2017 Published, May 15 2017
- Global Covered Bond Characteristics And Rating Summary Q1 2017, April 20, 2017
- Republic of Austria 'AA+/A-1+' Ratings Affirmed; Outlook Stable, March 17, 2017
- Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings, Jan. 31, 2017
- Request for Comment: Methodology For Assigning Financial Institution Resolution Counterparty Ratings, Jan. 31, 2017
- International Public Finance Rating Trends: German, Austrian, And Swiss Local And Regional Governments, Nov. 2, 2016
- Assessments For Target Asset Spreads According To Our Covered Bonds Criteria, Aug. 15, 2016
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, July 20, 2016

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