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

Fundierte Bankschuldverschreibungen

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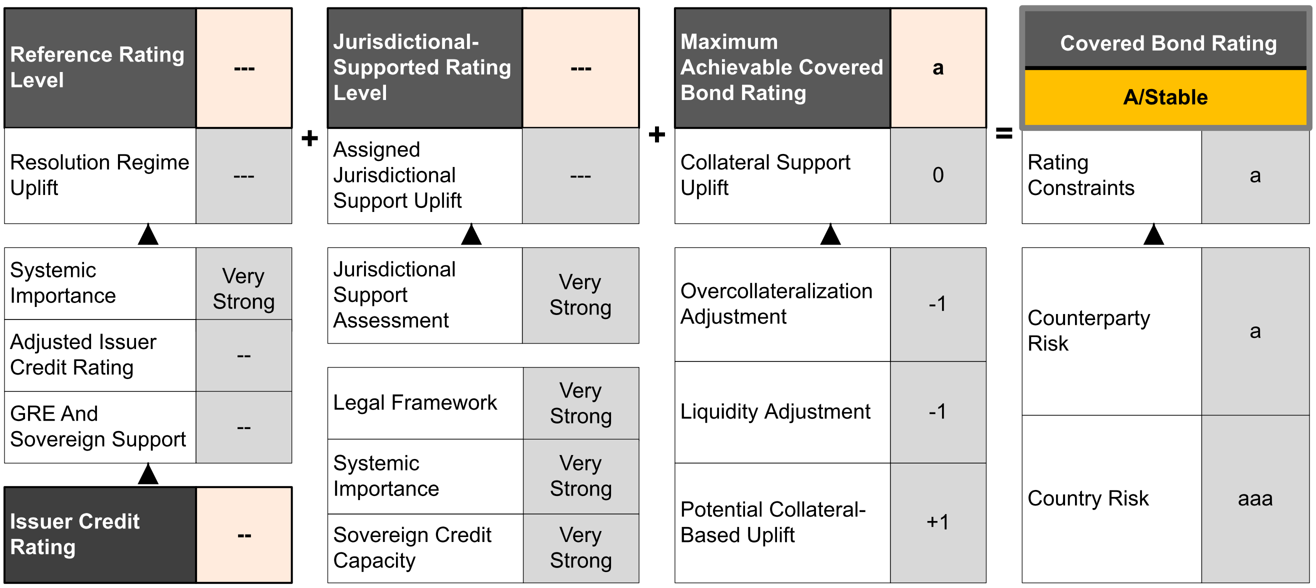
Ratings Detail



Major Rating Factors

Strengths

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

Weaknesses

- 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

We are publishing this transaction update as part of our periodic review of Kommunalkredit Austria AG's public sector covered bond program and related issuances of "Fundierte Bankschuldverschreibungen".

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 on the covered bonds reflect our reference rating level (RRL) and jurisdiction-supported rating level (JRL) of the covered bonds and the coverage of foreign exchange risk. 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. We have not assigned any notches of collateral-based uplift above the JRL, because the available credit enhancement of 26.55% is below the level that we would consider to be commensurate with the first notch of collateral-based uplift, which is currently 34.22%. This represents the 'AAA' credit risk and 75% refinancing costs, in the absence of the liquidity and overcollateralization commitments.

The replacement framework on the interest rate derivatives is not in line with our current counterparty criteria (see "Counterparty Risk Framework Methodology And Assumptions," published on June 25, 2013). Therefore, our counterparty 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 infrastructure/public sector 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 primarily 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 unhedged foreign exchange risk. We understand that the issuer reduced the foreign exchange risk in the past and will continue to do so (e.g. upon Swiss franc-denominated covered bonds scheduled redemptions or euro-denominated issuances). 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	---
Unused notches for jurisdictional support	0
Target credit enhancement (%)	40.76
Available credit enhancement (%)	26.55

*Based on data as of March 30, 2018.

Table 2

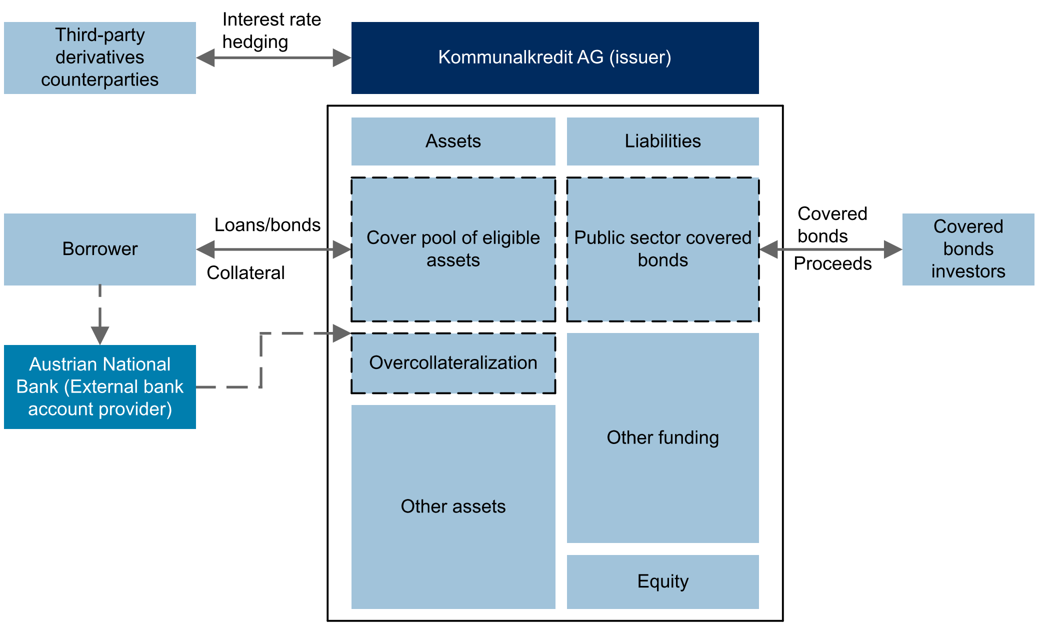
Program Participants

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

*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

Kommunalkredit Austria AG (Public Sector Covered Bonds)



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 Law on Secured Bank Bonds (Law of 12/27/1905, "Gesetz betreffend fundierte Bankschuldverschreibungen"). As of March 31, 2018, the €962.3 million of public sector covered bonds are secured by €1.218 billion of public sector assets recorded by the issuer in a cover pool register. The cover pool register is monitored by a trustee ("Regierungskomissär") appointed by the Ministry of Finance. The trustee has to ensure among other factors, that the prescribed cover for the covered bonds exists at all times and that the assets are recorded correctly. Assets may not be removed from the register without the approval of the trustee. The issuer is also subject to audits by the Austrian Financial Market Authority.

The Law on Secured Bank Bonds provides, among other things, that the total volume of assets in the cover pool register must at least cover the total nominal amount of the outstanding covered bonds, the interest payable on the outstanding covered bonds, and the potential running costs if the issuer becomes insolvent. Furthermore, we understand that according to the issuer's articles of association, a minimal overcollateralization of at least 2% on a net present value basis is maintained at all times. The issuer also calculates a risk-adjusted cover value to take into account currency, interest, and credit risk of the cover pool assets, which is included in the monthly reporting to the cover pool monitor.

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

Our analysis of operational risk follows the principles laid out in our covered bonds rating framework and our covered bonds criteria. We consider the procedures used by the issuing bank in the origination and monitoring of the cover pool assets.

In our opinion, there are no operational risks from the cover pool's management and loan origination that would constrain the covered bond ratings to the same level as the long-term issuer credit rating (ICR). In our view, potential back-up servicers would be available if the issuer became unable to manage the program, considering that Austria is an established covered bond market and that the cover pool does not comprise product features that would materially limit the range of available servicers.

Resolution regime analysis

The rating reference level (RRL) on the issuer, which is the starting point for any further uplift in our analysis, is above the ICR on the issuer. 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 up to three notches of uplift from the RRL (see "Assessments For Jurisdictional Support According To Our Covered Bonds Criteria," published on Nov. 3, 2017).

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.

Collateral support analysis

We base our analysis on the loan-level data provided by the issuer as of March 2018. The pool almost entirely comprises public sector assets located in Austria (96.8%). We do not assign any notches of collateral-based uplift above the JRL, currently.

Of the total cover pool assets, 82% 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 44.47% as of March 2018. We have also determined a weighted-average recovery rate of 71.42%, 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 26.55% is below the level that we would consider commensurate with the first notch of collateral-based uplift, representing 34.22% (or 'AAA' credit risk of 14.58% plus 75% refinancing costs), as no commitments on 180 days liquidity coverage or overcollateralization are in place. In addition, any notch of collateral uplift would need to cover 24.58% 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 40.76%.

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

Table 3

Key Credit Metrics

	As of March 31, 2018	As of Feb. 28, 2017
Weighted-average cover pool asset rating	'BB+'	'BB'
Weighted-average loan asset maturity (years)	6.41	6.49
Largest obligor (% of the cover pool)	10.99	10.91
20 largest obligors (% of cover pool)	58.84	57.47
Credit analysis results		
'AAA' scenario default rate (%)	44.47	47.33
Weighted-average recovery rate (%)	71.42	69.98
Weighted-average time to recovery (years)	3.27	3.27

Table 3

Key Credit Metrics (cont.)

	As of March 31, 2018	As of Feb. 28, 2017
Largest industry test result (% of covered bonds)	24.58	23.53

Table 4

Asset Distribution By Geography

By sovereign

	As of March 31, 2018	As of Feb. 28, 2017
	Percentage of cover pool (%)	
Austria	96.78	96.44
Germany	2.02	2.18
Poland	1.20	1.38
Total	100.00	100.00

Table 5

Asset Distribution By Geography (Austrian LRGs)

	As of March 31, 2018	As of Feb. 28, 2017
	Percentage of Austrian LRGs (%)	
Lower Austria	25.10	24.40
Upper Austria	22.20	21.90
Burgenland	15.90	15.30
Carinthia	14.40	15.00
Styria	13.90	13.50
Vorarlberg	3.10	3.40
Tirol	2.20	2.40
Salzburg	1.80	2.10
Wien	1.60	2.00
Total Austrian LRG	100.00	100.00

LRG--Local and regional governments.

Table 6

Recovery Assumptions For Cover Pool Assets*

As of March 31, 2018

Borrower type	'AAA' recovery rate (%)	Time to recovery (years)	Percentage of cover pool (%)
Category A LRG without currency risk§	90	4	41.98
Category B LRG without currency risk†	75	4	39.81
Non-LRG international public finance assets	18	0	15.54
Sovereigns	37	0	2.67

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

Table 7

Asset Distribution By Rating*

	As of March 31, 2018	As of Feb. 28, 2017
	Percentage of cover pool (%)	
AAA	1.46	1.53
AA	33.51	31.94
A	0.53	0.54
BBB	39.29	40.35
BB or lower	25.21	25.64
Total	100.00	100.00

*According to S&P Global Ratings' stressed assumptions.

Table 8

Collateral Uplift Metrics

	As of March 31, 2018	As of Feb. 28, 2017
Asset WAM (years)	6.02	6.81
Liability WAM (years)	5.31	7.00
Available credit enhancement (%)	26.55	26.58
AAA' credit risk (%)	14.58	8.30
Required credit enhancement for first notch of collateral uplift (%)	21.13	14.73
Required credit enhancement for second notch of collateral uplift (%)	27.67	21.09
Required credit enhancement for third notch collateral uplift (%)	34.22	27.45
Target credit enhancement for maximum uplift (%)	40.76	33.81
Potential collateral-based uplift (notches)	1	0
Adjustment for liquidity (Y/N)	Y	Y
Adjustment for committed overcollateralization (Y/N)	Y	Y
Collateral support uplift (notches)	0	0

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 view Austrian National Bank's creditworthiness to be identical to that of the European Central Bank (unsolicited; AAA/Stable/A-1+).

Derivatives

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).

There are only interest rate 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 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'.

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 our 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 distribution of the cover pool assets and the high sovereign ratings of the largest exposures, sovereign default risk is appropriately captured in our credit analysis. The result of the sovereign stress test is 1.22% of outstanding covered bonds, which is well covered by the available credit enhancement of 26.55%. Consequently, country risk does not constrain our ratings on the covered bonds.

Potential Effects Of Proposed Criteria Changes

Our ratings are based on our applicable criteria, including our "Covered Bonds Criteria," published on Dec. 9, 2014. However, the resolution regime analysis section of these criteria is under review (see "Methodology For Assigning Financial Institution Resolution Counterparty Ratings," published on April 19, 2018 and "Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings," published on Jan. 31, 2017). As a result of this review, we may amend certain paragraphs of our covered bonds criteria. This change may affect the ratings on the outstanding covered bonds issued under this covered bond program. Until this time, we will continue to rate and surveil these covered bonds using our existing criteria (see "Related Criteria").

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

- Global Covered Bond Characteristics And Rating Summary Q2 2018, June 13, 2018
- Transaction Update: Kommunalkredit Austria AG (Public Sector Covered Bonds), June 30, 2017
- Criteria Guidance: Covered Bonds Criteria, May 2, 2018
- Glossary Of Covered Bond Terms, April 27, 2018
- European Economic Snapshots For 2Q Published, April 9, 2018
- EMEA March 2018 – Trade And market Volatility Threaten To Overshadow Brexit, March 28, 2018
- Austria 'AA+/A-1+' Ratings Affirmed; Outlook Stable, March 16, 2018
- Considerable Tax Inflows Will Curtail German, Swiss, And Austrian Local And Regional Government Borrowing In 2018, Feb. 22, 2018
- Assessments for Target Asset Spreads according To Our Covered Bonds Criteria, Nov. 3, 2017
- Assessments For Jurisdictional Support According To Our Covered Bonds Criteria, Nov. 3, 2017
- Kommunalkredit Austria's Public Sector Covered Bonds Assigned 'A' Ratings; Outlook Stable, June 13, 2017
- Request For Comment: Methodology For Incorporating The Effect Of Resolution Regimes Into Covered Bond Ratings, Jan. 31, 2017
- Covered Bond Monitor: Technical Note, Aug. 12, 2015