MOODY'S INVESTORS SERVICE

Credit Opinion: Kommunalkredit Austria AG

Global Credit Research - 22 Jun 2012

Vienna, Austria

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Baa3/P-3
Bank Financial Strength	E
Baseline Credit Assessment	(caa1)
Adjusted Baseline Credit Assessment	(caa1)
Senior Unsecured	Baa3
Subordinate -Dom Curr	Caa2
Other Short Term -Dom Curr	(P)P-3

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Key Indicators

Kommunalkredit Austria AG (Consolidated Financials) [1]

	[2]**12-11**	[2]**12-10**	[2]**12-09**	**Avg.**
Total Assets (EUR million)	**16,749.1**	**16,271.1**	**18,283.2**	[3]**-4.3**
Total Assets (USD million)	**21,742.7**	**21,828.4**	**26,231.6**	[3]**-9.0**
Tangible Common Equity (EUR million)	**189.4**	**338.7**	**314.0**	[3]**-22.3**
Tangible Common Equity (USD million)	**245.8**	**454.3**	**450.6**	[3]**-26.1**
Net Interest Margin (%)	**0.3**	**0.3**	**0.0**	[4]**0.2**
PPI / Avg RWA (%)	**0.8**	**1.3**	**0.1**	[5]**0.7**
Net Income / Avg RWA (%)	**-5.8**	**1.0**	**0.1**	[5]**-1.6**
(Market Funds - Liquid Assets) / Total Assets (%)	**65.4**	**65.7**	**58.4**	[4]**63.2**
Core Deposits / Average Gross Loans (%)	**18.6**	**20.0**	**13.6**	[4]**17.4**
Tier 1 Ratio (%)	**12.0**	**15.7**	**14.3**	[5]**14.0**
Tangible Common Equity / RWA (%)	**7.8**	**12.9**	**11.0**	[5]**10.5**
Cost / Income Ratio (%)	**68.1**	**48.2**	**61.7**	[4]**59.3**
Problem Loans / Gross Loans (%)	**0.0**	**0.0**	**0.0**	[4]**0.0**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**0.0**	**0.2**	**0.0**	[4]**0.1**

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

We assign an E bank financial strength rating (BFSR) to Kommunalkredit Austria AG (KA), which maps to a caa1 standalone credit assessment. KA's long-term senior debt and deposits are rated Baa3, whilst its senior subordinated debt is rated Caa2. The BFSR and all senior and subordinated debt ratings carry a stable outlook. The rating for short-term liabilities is Prime-3.

The E/caa1 BFSR, downgraded from E+/b2 on 2 February 2012, is constrained by KA's (i) evolving franchise as a provider of public infrastructure finance and services; (ii) the recent material reduction in KA's Tier 1 capital, due to write-downs on its exposure to the Greek sovereign; (iii) our anticipation of weak profitability going forward, due to the very low yield on most of KA's legacy assets in the context of rising funding costs for banks; and (iv) developing risk management. We acknowledge the sound quality of most of KA's assets and the gradual progress that it has made in transforming its business model. However, its business model is currently overshadowed by short-term risk in the context of the ongoing financial crisis.

KA's long-term global local currency (GLC) debt and deposit ratings are at the Baa3 level, based on our assumption of a very high probability of systemic support from the bank's 99.78% shareholder, the Republic of Austria (rated Aaa, negative), resulting in a seven-notch uplift from the caa1 standalone credit strength. Whilst the targeted privatisation of KA is credit negative, it does not immediately exert pressure on the Baa3 ratings given that, from our current point of view, a successful sale within 18 months appears unlikely. As a consequence, we expect the current ownership to be maintained for the foreseeable future.

Credit Strengths

- The government of Austria owns 99.78% of KA, and has demonstrated its willingness and ability to support the bank

- Core operating performance is resilient (relative to KA's rated peers) and the public-sector finance loan book is of sound credit quality

Credit Challenges

- Complying with the compensation measures set by the EC, and satisfying the EC even if the June 2013 deadline for KA's privatisation cannot be met

- KA is highly dependent on market funds, making it vulnerable to distortions or shocks in the financial markets

- The increased capital requirements under Basel III might exert medium-term pressure, in particular with regards to leverage

- Restoring sustainable levels of profitability against the headwinds of the persistent euro area sovereign debt crisis, in addition to the low yields on most of KA's assets

Rating Outlook

The stable outlook on KA's E BFSR reflects the rating's position at the low end of the BFSR rating scale. The stable outlook on its Baa3 long-term ratings reflects our view that in the context of the ongoing sovereign debt crisis, KA will likely continue to receive government support, in case of need.

While we acknowledge that the Republic of Austria aims to exit from its ownership as early as June 2013, we believe that such a sale will only be possible in the medium to long term, and only once KA has established a track record of delivering sustainable returns and having regular access to (unsecured) funding. Depending on the degree of financial stability achieved, an early divestment by the government would exert adverse pressure on the unsecured ratings, as we would need to reassess our assumption for the probability of systemic support post-divestment.

What Could Change the Rating - Up

We see little upside potential for the BFSR at this stage. Positive pressure on the BFSR would require a track record of sustainable profits and sound liquidity and risk management.

An upgrade of the Baa3 long-term senior debt and deposit ratings could be triggered by a stronger commitment by the Austrian government, in particular an explicit guarantee for the bank's obligations. However, we believe that such a guarantee is unlikely to be granted at present.

What Could Change the Rating - Down

Although the outlook on the E BFSR is stable, the BFSR could be remapped to a lower level on the long-term scale from the current caa1 level, if there is further erosion of KA's capitalisation and/or if KA has limited access to debt capital markets for an extended period. A lower remapping within the E/caa rating category could have an immediate effect on the long-term ratings.

A downgrade of the Baa3 long-term senior debt and deposit ratings could be triggered by (i) a downgrade of the rating of the government of Austria from the current Aaa (negative) level; and/or (ii) an early sale of the bank by the government, or other indications of a change in the probability of future systemic support for KA. Although we do not expect either of these to occur for foreseeable future, we will monitor the state's commitment towards KA and its timetable for withdrawing its support.

Recent Developments

2011 Results

In 2011, KA had to write-down most of its exposure to Greece in 2011 (the nominal amount was EUR 224 million). KA therefore posted a EUR 157.6 million pre-tax loss for the year, compared with a pre-tax profit of EUR 31.7 million in 2010. The total charges relating to Greece were EUR 176.3 million, which caused a 29% reduction in the bank's Tier 1 capital, to EUR 290.8 million. Adjusted for this extraordinary loss, a EUR 4.5 million loss proactively taken on the sale of loans, as well as a EUR 12.2 million profit on the repurchase of own debt instruments - the pre-tax result was modest, at EUR 11 million. We note that all remaining exposure to Greece has meanwhile been sold (at manageable costs).

In addition to the charges relating to Greece, other items that weighed on KA's income statement were a EUR10.6 million valuation loss and a first-time bank levy of EUR7.4 million that KA must pay to the Republic of Austria.

KA's underlying operating performance was relatively resilient, but remained modest. Net interest income (+3% year-on-year) as well as fee and commission income (+20%), in total EUR63.4 million, developed favourably during 2011. However, the underlying growth was more than offset by considerably higher net operating costs of EUR35.4 million (+14%, net of charges relating to services for KF). Core pre-provision income - i.e. excluding results from trading, investments and participations - amounted to EUR28.0 million, after EUR28.5 million in 2010.

KA maintained its core performance throughout 2011. However, recent developments show that the loss-absorption power of KA's income statement is limited and inadequate for large-scale unexpected losses, such as those related to Greece. Given that the ongoing euro area sovereign debt crisis remains unresolved, we maintain a cautious outlook on the bank's future performance.

Approval for State Aid Obtained, Sale Targeted by Mid-2013

The Austrian Ministry of Finance reported on 29 November 2011 that it has initiated the process of divesting KA in order to comply with what we consider the most challenging of the compensation measures for state aid, i.e., a change of ownership, as stipulated by the EC. As market conditions for bank funding remain hostile and banks across Europe shed assets to improve capital levels, the time limit of mid-2013 appears extremely difficult to meet. Whilst we believe that it may be possible to renegotiate the time limit closer to the deadline, we caution that: (i) the required sale may weigh on investor confidence in KA's future with adverse implications for the bank's funding costs; and (ii) that the EC has shown in the past that non-compliance with compensation measures can sometimes have major consequences for a bank's franchise and future.

KA obtained approval from the EC for the state aid on 31 March 2011. With the approval, the bank's previously submitted restructuring plan was also approved, reflecting an endorsement by the Commission of the bank's new strategy. Other compensation measures that have been agreed include unspecified compensation payments to the government of Austria. While we expect that the bank should maintain some leeway to build reserves, we understand that this compensation measure represents a limitation of KA's internal capital generation.

DETAILED RATING CONSIDERATIONS

Franchise Value

KA is the surviving core bank that emerged from a rescue in late 2008 and the subsequent breakup of the former Kommunalkredit Austria AG ("KA Old") in November 2009, that was orchestrated by the Austrian government (Aaa, negative). The break-up (or, legally, demerger) resulted in two independent entities: KA and KA Finanz AG (KF, not rated except for government-guaranteed, Aaa-rated bond issues). Both banks have received government support which has allowed them to meet their financial obligations until today. However, as KF serves as a wind-down vehicle for non-core assets, only KA is a going concern.

KA aims to build a franchise as a financier for infrastructure and as a specialist lender to public-sector authorities and related entities, focusing on higher-margin municipal project-finance business in Austria, as well as in neighbouring EU new-member countries. The bank offers the full product range in infrastructure project and public-sector finance including leasing, advisory services, private placements, debt restructuring and asset management. However, the chosen strategy remains challenging, as the competition in these markets is high. Moreover, KA has still a large legacy, low-margin public-sector lending book, representing almost half of the group's total assets of EUR 16.75 billion (as of December 2011). KA's public-sector loan book will be wound down only slowly over time and, according to the strategy of the bank, replaced by higher-margin infrastructure and project finance business.

We consider it yet uncertain as to whether KA will be able to demonstrate a full restoration of its franchise. Its business will face additional hurdles when the higher requirements for capital and liquidity under Basel III will be phased in, starting from 2013. We are also concerned that lending margins may remain too low to allow for sufficient returns on the higher capital levels.

Risk Positioning

The credit risk of KA's business is relatively low, because KA's public-sector finance book represents most of its assets. However, KA currently remains vulnerable given the bank's weak, albeit increasingly focused business profile characterised by high leverage, high dependence on market funds and low profitability. Moreover, we consider that the large loss in 2011 and the reduction in Tier 1 capital by almost one third are major set-backs for KA's fragile recovery, leaving the bank more vulnerable to further unexpected losses.

According to the bank's plans, its low-margin legacy assets will be replaced with higher margin assets over time, which we expect will translate into gradually increasing credit risk over time. In the initial period of building a targeted lending business, we caution that it may be difficult to accurately price the risk as well as monitor risk adjusted performance, partly as the bank's risk management capabilities are still evolving. We will closely monitor the bank's progress in establishing an appropriate risk management system for the new business and in building a credible track record of a sound risk culture.

KA's asset profile displays considerable concentration risk in terms of both, borrower and industry concentrations. Although the exposures are predominantly towards highly rated public-sector entities, we note that these include further exposures to the more pressured countries in Europe's periphery, given that the credit profile of several of these countries shows a deteriorating trend.

Profitability

The first two years of KA's performance following the 2009 restructuring show that the bank can generate stable, albeit very modest operating results. Its risk-adjusted returns - based on the bank's EUR28 million pre-provision income (PPI) in 2011 - accounted for 1.20% of risk-weighted assets.

Whilst this risk-adjusted earnings power appears adequate, we note that KA's earnings power is not sufficient to cope with (unexpected) losses on its highly concentrated single-borrower exposures, as incurred in 2011. We also note the relatively high degree of earnings volatility, given the volatile trading and valuation results since 2009. In 2011, the EUR10.6 million valuation loss on fixed-income investments represented 38% of its PPI. The first-time payment of EUR7.4 million stability tax (bank levy) represented another 26% of PPI.

Given the bank's low-risk / low-return business model, its low economies of scale as well as these additional costs, KA's net profits will likely remain weak. Besides, we note that the average yield is low on its legacy public-sector finance assets, which could, over time, lead to additional margin pressure if funding costs stay at elevated levels. Future profits (as reported under local GAAP) will have to be paid to the Austrian government.

Liquidity

KA is heavily reliant on capital market funds and thus dependent on regular access to debt capital markets. Since its establishment in late 2009, KA has had limited access to debt capital markets for unsecured funds (initially only with the support from the Austrian government), which is one of the main constraining factors for the E BFSR.

The bank's break-up in 2009 had an indirect, positive effect on KA's funding profile, because some long-term assets were left behind in KF for unwinding, for which alternative funding was provided, while KA still has the long-term debt of KA Old on its balance sheet. We understand that this resulted in a somewhat better-matched profile of assets and liabilities, which continues to be beneficial for the bank.

However, issuing senior unsecured debt at viable pricing levels has remained challenging, although KA has resumed issuing small senior unsecured tranches under its EUR2.0 billion debt issuance program. In 2011, KA tapped the markets only once, in February, with a five-year EUR0.5 billion public-sector covered bond issuance. Since then, KA has met its medium-term funding needs primarily through drawings under the ECB's three-year LTROs offered in December 2011 and February 2012. KA drew EUR1.5 billion in total under these facilities (equivalent to 8.7% of the balance sheet), which the bank reported was sufficient to maintain independence from debt capital markets throughout 2012; we note that this limits short-term funding risk, which is credit positive.

In this context, we note that an increasing portion of KA's total liabilities are secured. At the same time, the bank has committed to maintaining 28% of over-collateralisation for its public-sector covered bonds and therefore requires substantial portions of unsecured debt (or deposits) for the funding of its core business. KA currently holds EUR1.65 billion in institutional client deposits, which the bank has been aiming to increase.

A EUR1.0 billion government-guaranteed bond is neutral for the bank's funding profile, as it is routed through to KF, whereby the respective claim will mature when the bond matures in 2013.

We believe that, under the current market conditions, KA strongly benefits from its public ownership background and the implicit support from the Austrian government. Judging from recent market volatility and concerns over public-sector credit quality, however, the funding situation remains potentially fragile and government ownership and commitment critically important for several years yet.

Capital Adequacy

KA's Tier 1 capital ratio stood at 12.0% as of December 2011, down from 15.7% one year earlier. The erosion was due to write-downs on exposures to Greece, which led to a EUR120.6 million reduction in the bank's Tier 1 capital (-29%) to currently EUR291 million. The total capital ratio was 15.0% at year-end 2011 (2010: 19.7%) and the adverse impact from the 2011 loss more than offset a 11% reduction in RWA.

KA's balance-sheet capital under IFRS stood at EUR240million as of December 2011, 42.6% lower year-on-year. This is because it was additionally affected, with EUR30 million, by a further reduction of the negative revaluation reserve.

We consider that KA's economic capital levels have been critically weakened. Currently there is only a small capital cushion for unexpected losses, in the context of its high leverage and material concentration risks. Before the write-down on its exposure to Greece, we had estimated KA's capital cushion (to maintaining a 9% Tier 1 ratio) to be roughly EUR 170 million. Following the loss and subsequent charges against capital in 2011, this cushion was low, at EUR81 million. For this reason, as well as KA's relatively low loss-absorption power from its income statement, we consider the risk of further capital erosion to be relatively high.

With a pro-forma Basel III leverage ratio of 1.74% (i.e., Tier 1 capital in % of total assets as of December 2011), KA's balance sheet displayed very high leverage at year-end 2011, and will be challenged to meet the higher capital requirements under Basel III. That said, we also expect gradual progress in total asset reduction.

Efficiency

Given the loss of economies of scale following the break-up, we consider KA's efficiency as one of the challenges for the standalone bank. Progress on the efficiency of KA will partly depend on the execution of its planned re-focusing and a recovery in core revenues. We caution that the potential for improving efficiencies is limited for the small bank.

Asset Quality

As a specialised public-sector lender, KA's asset quality is fairly sound. The bank's assets are dominated by public-sector loans and bonds, complemented by inter-bank loans. The level of problem loans is very low. Maintaining high asset quality and, as a natural consequence, a low level of risk provisions is a key element in the overall low risk profile of the bank.

Global Local Currency Deposit Rating (Joint Default Analysis)

We assign a global local currency (GLC) deposit rating of Baa3 to KA. The rating is based on KA's standalone credit strength of caa1, as well as by the Aaa local-currency deposit rating of its main shareholder, the Republic of Austria. KA therefore receives a seven-notch uplift from its standalone credit strength, bringing the long-term debt and deposit ratings to Baa3.

We view the probability of systemic support by the Republic of Austria to be very high based on: (i) the Republic of Austria's 99.78% ownership in KA; and (ii) Austria's demonstrated willingness to support KA.

Notching Considerations

KA's subordinated debt is rated at Caa2, which is one notch below the bank's adjusted BCA of caa1.

Foreign Currency Deposit Rating

Our foreign-currency deposit ratings for KA are Baa3/Prime-3.

Foreign Currency Debt Rating

Our foreign-currency debt ratings for KA are Baa3/Prime-3.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honour its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognise the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's baseline credit assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Kommunalkredit Austria AG

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (50%)						**D**	
Factor: Franchise Value						**E+**	**Neutral**
Market Share and Sustainability					**x**		
Geographical Diversification				**x**			
Earnings Stability					**x**		
Earnings Diversification [2]					**x**		
Factor: Risk Positioning						**D-**	**Neutral**
Corporate Governance [2]				**x**			
- Ownership and Org. Complexity							
- Key Man Risk							
- Insider and Related-Party Risks				x			
Controls and Risk Management				**x**			
- Risk Management					x		
- Controls			x				

Financial Reporting Transparency		**x**					
- Global Comparability	x						
- Frequency and Timeliness				x			
- Quality of Financial Information		x					
Credit Risk Concentration					**x**		
- Borrower Concentration					x		
- Industry Concentration					x		
Liquidity Management					**x**		
Market Risk Appetite					**x**		
Factor: Operating Environment						**B**	**Neutral**
Economic Stability			**x**				
Integrity and Corruption		**x**					
Legal System	**x**						
Financial Factors (50%)						**D+**	
Factor: Profitability						**E+**	**Improving**
PPI / Average RWA - Basel II				0.70%			
Net Income / Average RWA - Basel II					-1.57%		
Factor: Liquidity						**E**	**Neutral**
(Market funds - Liqud Assets) / Total Assets					63.21%		
Liquidity Management					x		
Factor: Capital Adequacy						**A**	**Neutral**
Tier 1 Ratio - Basel II	14.00%						
Tangible Common Equity / RWA - Basel II	10.54%						
Factor: Efficiency						**C**	**Neutral**
Cost Income ratio			59.32%				
Factor: Asset Quality						**A**	**Neutral**
Problem Loans / Gross Loans	0.00%						
Problem Loans / (Shareholders' Equity + Loan Loss Reserves)	0.10%						
Lowest Combined Financial Factor Score (15%)						**E**	
Economic Insolvency Override						**Neutral**	
Aggregate Score						**D+**	
Assigned BFSR						**E**	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information. [2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.

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