MOODY'S
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Credit Opinion: Kommunalkredit Austria AG

Global Credit Research - 20 Feb 2013

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]**6-12**	[2]**12-11**	[2]**12-10**	[2]**12-09**	**Avg.**
Total Assets (EUR million)	**16,678.5**	**16,749.1**	**16,271.1**	**18,283.2**	[3]**-3.0**
Total Assets (USD million)	**21,165.9**	**21,742.7**	**21,828.4**	**26,231.6**	[3]**-6.9**
Tangible Common Equity (EUR million)	**189.5**	**189.4**	**338.7**	**314.0**	[3]**-15.5**
Tangible Common Equity (USD million)	**240.4**	**245.8**	**454.3**	**450.6**	[3]**-18.9**
Net Interest Margin (%)	**0.4**	**0.3**	**0.3**	**0.0**	[4]**0.2**
PPI / Average RWA (%)	**1.9**	**0.8**	**1.3**	**0.1**	[5]**1.0**
Net Income / Average RWA (%)	**1.1**	**-5.8**	**1.0**	**0.1**	[5]**-0.9**
(Market Funds - Liquid Assets) / Total Assets (%)	**64.4**	**65.4**	**65.7**	**58.4**	[4]**63.5**
Core Deposits / Average Gross Loans (%)	**--**	**18.6**	**20.0**	**13.6**	[4]**17.4**
Tier 1 Ratio (%)	**12.4**	**12.0**	**15.7**	**14.3**	[5]**13.6**
Tangible Common Equity / RWA (%)	**8.1**	**7.8**	**12.9**	**11.0**	[5]**9.9**
Cost / Income Ratio (%)	**55.8**	**68.1**	**48.2**	**61.7**	[4]**58.4**
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 figures and 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 a standalone E bank financial strength rating (BFSR) to Kommunalkredit Austria AG (KA), which maps to a caa1 standalone credit assessment. The BFSR is constrained by KA's (1) evolving franchise as a provider of public infrastructure finance and services; (2) weak economic capitalisation; (3) our expectation of weak profitability going forward, due to the very low yield on most of KA's legacy assets; and (4) developing risk management. Whilst KA displays sound quality of most assets and is gradually making progress in transforming its business model, it 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 by mid-year 2013 appears unlikely. As a consequence, we expect the current ownership to be maintained for the foreseeable future.

KA's 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.

Rating Drivers

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

- Market conditions remain challenging for KA's privatisation - to be achieved by June 2013 - which implies uncertainties regarding KA's ability to comply with this compensation measure set by the European Commission (EC)

- While KA's core operating performance is resilient (relative to rated peers), profits are modest and recent one-off gains and losses have been large in the context of core revenues and profits

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

- The increased capital requirements under Basel III might exert pressure on the bank in the medium term, particularly with regard to leverage

Rating Outlook

The stable outlook on KA's E BFSR reflects the position of the rating at the low end of the BFSR scale. The stable outlook on its Baa3 long-term ratings reflects our view that in the context of the unresolved sovereign debt crisis, senior creditors 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 take the view that -- considering the adverse market conditions for such a divestment -- a successful sale may 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 likely exert negative 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 limited 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 (1) a stronger commitment by the Austrian government, albeit not expected, or (2) a successful privatisation with favourable credit implications, particularly if a strong parent bank explicitly supports (or guarantees the obligations of) KA.

What Could Change the Rating - Down

Although the outlook on the E BFSR is stable, the BFSR could be remapped to a lower standalone credit assessment (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 exert pressure on the long-term ratings.

A downgrade of the Baa3 long-term senior debt and deposit ratings could be triggered by any of the following: (1) a lowering of KA's standalone credit assessment; (2) a downgrade of the rating of the government of Austria from the current Aaa (negative) level; and/or (3) KA's privatisation, if the new ownership implies only limited prospects for parental support, and/or indications of a change in the probability of future systemic support for the bank.

Recent Results and Developments

JUNE 2012 RESULT

KA reported a EUR 16.3 million pre-tax profit for the six months to June 2012 which, however, benefited from positive one-off effects. Adjusted for exceptional gains and charges - i.e., (1) the EUR 17.4 million costs of either selling or fully provisioning its remaining exposure to Greece, including a loan guaranteed by Greece; and (2) the EUR 27.9 million gain on the repurchase of own debt below par - the pre-tax profit was EUR 5.8 million .

As in 2011, KA's underlying operating performance during H1 2012 was relatively resilient; however, the size of one-off effects was again large in the context of its core revenues and profits. KA's core revenues - i.e., net interest income (+15% year-on-year) as well as fee and commission income (+10%), in total EUR 34.6 million - developed favourably. This growth was only partly offset by higher net operating costs of EUR 17.8 million (+6%, net of charges relating to services for KA Finanz). Core pre-provision income - i.e., excluding results from trading, investments and participations - amounted to EUR 16.8 million for H1 2012, after EUR 13.7 million in H1 2011.

We expect that KA will report a relatively stable core performance for the full year 2012, considering the pre-funding obtained for 2012 from the European Central Bank (ECB; see details under Liquidity) and the improved market conditions during H2 2012. 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 stance on the bank's future performance.

2011 RESULTS

KA posted a EUR 157.6 million pre-tax loss for 2011 as it had to write-down most of its EUR 224 million exposure to Greece (2010: pre-tax profit of EUR 31.7 million). 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 - i.e., 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.

In addition to the charges relating to Greece, other items that weighed on KA's income statement were a EUR 10.6 million valuation loss and a first-time bank levy of EUR 7.4 million that KA must pay to the Republic of Austria.

APPROVAL FOR STATE AID OBTAINED; PRIVATISATION TARGETED BY MID-2013

The Austrian Ministry of Finance initiated the process of divesting KA in late 2011 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 in order to improve capital levels, the time limit of mid-2013 appears difficult to meet. Whilst we believe that it may be possible to renegotiate the time limit as the deadline approaches, we caution that: (1) the required sale may weigh on investor confidence as regards KA's future, with adverse implications for the bank's funding costs; and (2) 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, and, together with this agreement, the bank's previously submitted restructuring plan was also approved, reflecting an endorsement by the EC of the bank's new strategy. Other compensation measures that have been agreed include the payout of the bank's annual profits to the government of Austria. While the bank maintains some leeway to build reserves, this compensation measure represents a limitation of KA's internal capital generation.

DETAILED RATING CONSIDERATIONS

FRANCHISE VALUE - BURDENED BY LEGACY PORTFOLIOS AND LIMITED BY MODEST FINANCIAL RESOURCES

Following its rescue in late 2008 by the Austrian government and a fundamental overhaul of the bank, KA currently aims to build a franchise as a financier for infrastructure and as a specialist lender to public-sector authorities and related entities, focusing on 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, advisory services, private placements, debt restructuring and asset management. However, the chosen strategy remains challenging, as (1) competition in these markets is high; and (2) KA has still a large legacy, low-margin public-sector lending book that represents almost half of the group's total assets of EUR 16.7 billion (as of June 2012). Moreover, the compensation measures for state aid imposed by the EC - including limitations to KA's earnings retention - weigh heavily on the bank's franchise.

In our opinion, there is continued uncertainty as to whether KA will be able to demonstrate a full restoration of its franchise. Its business will face additional obstacles, as the higher requirements for capital and liquidity under Basel III are being phased in. We also note that lending margins may remain too low to allow for sufficient returns on the higher capital levels.

RISK POSITIONING - LOW LOSS ABSORPTION POWER AND DEPENDENCE ON MARKET FUNDS IMPLY MAJOR RISKS

The credit risk of KA's business is relatively low, partly because its public-sector finance book represents most of its assets. However, KA remains vulnerable given the bank's weak, albeit increasingly focused, business profile which is characterised by high leverage, high dependence on market funds and low profitability. The large loss in 2011 and the near one-third reduction in Tier 1 capital were major setbacks 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 earnings, but also higher credit risk. In the initial period of building a targeted lending business, it may be difficult to accurately price the risk as well as monitor risk-adjusted performance.

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 sizeable exposures to the more pressured countries in Europe's periphery.

PROFITABILITY - CORE PERFORMANCE IS STABLE, BUT INSUFFICIENT TO SHIELD THE BANK FROM LARGE LOSSES

Since its 2009 restructuring, KA's performance has shown that the bank can generate stable, albeit very modest, operating results. The bank's risk-adjusted returns - based on its EUR 28 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 2011-12. We also note the relatively high degree of earnings volatility, given the volatile trading and valuation results since 2009. In 2011, the EUR 10.6 million valuation loss on fixed-income investments represented 38% of its PPI. The first-time payment of EUR 7.4 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 modest. We also 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. Profits (as reported under local GAAP) have to be paid to the Austrian government.

LIQUIDITY - DEPENDENCE ON AND LIMITED ACCESS TO (UNSECURED) MARKET FUNDS IMPLY CHALLENGES

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 standalone E BFSR.

KA's 2009 restructuring had a positive effect on the bank's funding profile as it resulted in a somewhat better-matched duration of assets and liabilities. However, issuing senior unsecured debt at viable pricing levels in order to refinance new long-term lending transactions with matching maturities has remained challenging, although KA has resumed issuing small senior unsecured tranches under its EUR 2.0 billion debt issuance programme as well as privately placed unsecured notes.

Since KA issued a five-year EUR 500 million public-sector covered bond in February 2011, the bank has met its medium-term funding needs primarily through drawings under the ECB's three-year long-term refinancing operations (LTROs) offered in December 2011 and February 2012. KA drew EUR 1.5 billion in total under these facilities (equivalent to 9% of the balance sheet), which was sufficient to maintain independence from debt capital markets throughout 2012. We understand that the bank has already repaid a small portion of the LTRO drawings and maintains leeway for additional ECB-repo operations.

An increasing portion of KA's total liabilities is secured. 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 is able to close a part of the gap through institutional client deposits which stood at EUR 2 billion as of June 2012 (+30% since December 2011).

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 the market volatility during 2011-12 and concerns over public-sector credit quality, however, the bank's funding profile remains potentially fragile and government ownership and commitment (or alternative backing) may remain critically important for several years.

CAPITAL ADEQUACY - HIGH LEVERAGE AND SMALL ABSLOUTE CAPITAL BUFFER LEAVES KA EXPOSED TO TAIL RISK

KA's Tier 1 capital ratio stood at 12.4% as of June 2012, down from 15.5% one year earlier. The erosion was due to write-downs on exposures to Greece, which led to the bank's Tier 1 capital falling to EUR 291 million (a decline of EUR 120.6 million or 29%). We note positively that KA could recover some loss absorption capacity through earnings retention and transfers to reserves during H1 2012 which lead to a slight improvement in its Tier 1 capital ratio. The total capital ratio was 16.9% as of June 2012, up from 15.0% as of December 2011.

The impairment of KA's former Greek exposure (which it has either sold or fully provisioned) has critically weakened the bank's economic capital levels. Notwithstanding the capital improvement during H1 2012, 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 (in order to maintain a 9% Tier 1 ratio) to be roughly EUR 170 million. Following the loss and subsequent charges against capital in 2011-12, this cushion is now a modest EUR 91 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 roughly 2% (i.e., Tier 1 capital as a percentage of total assets as of June 2012), KA's balance sheet displays very high leverage, and will be challenged to meet the higher capital requirements under Basel III. That said, we also expect gradual progress in its asset reduction strategy.

ASSET QUALITY - CORE ASSET QUALITY IS SOUND BUT EXPOSURE TO EUROPE'S PERIPHERY IS SUBSTANTIAL

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 interbank 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 credit risk profile of the bank.

As of June 2012, KA's loans and investments included roughly EUR 600 million in exposures to the more pressured countries in Europe's periphery (Cyprus, Italy, Slovenia, Spain and Portugal; the exposure to Greece was nil). Given that this is more than twice the amount of KA's Tier 1 capital, the bank remains vulnerable to setbacks in the euro area sovereign debt crisis.

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 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 consider the probability of systemic support by the Republic of Austria to be very high based on: (1) the Republic of Austria's 99.78% ownership of KA; and (2) 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 standalone credit assessment of caa1.

Foreign Currency Deposit Rating

KA's foreign-currency deposit ratings are Baa3/Prime-3.

Foreign Currency Debt Rating

KA's foreign-currency debt ratings are Baa3/Prime-3.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Ratings

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 Organizational 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 - Liquid 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 % (Equity + LLR)	0.10%						
Lowest Combined Financial Factor Score (15%)						E	
Economic Insolvency Override						Neutral	
Aggregate BFSR Score						D+	
Aggregate BCA Score						baa3/ba1	
Assigned BFSR						E	
Assigned BCA						caa1	

[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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