MOODY'S INVESTORS SERVICE

Credit Opinion: Kommunalkredit Austria AG

Global Credit Research - 02 Jun 2014

Vienna, Austria

Ratings

Category	**Moody's Rating**
Outlook	Negative
Bank Deposits	Baa3/P-3
Bank Financial Strength	E
Baseline Credit Assessment	caa3
Adjusted Baseline Credit Assessment	caa3
Senior Unsecured	Baa3
Subordinate -Dom Curr	Ca
Other Short Term -Dom Curr	(P)P-3

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Key Indicators

Kommunalkredit Austria AG (Consolidated Financials)[1]

	[2]**12-13**	[2]**12-12**	[2]**12-11**	[2]**12-10**	[2]**12-09**	**Avg.**
Total Assets (EUR million)	**12,330.1**	**15,852.4**	**16,749.1**	**16,271.1**	**18,283.2**	[3]**-9.4**
Total Assets (USD million)	**16,990.1**	**20,899.7**	**21,742.7**	**21,828.4**	**26,231.6**	[3]**-10.3**
Tangible Common Equity (EUR million)	**212.8**	**207.5**	**189.2**	**338.7**	**314.0**	[3]**-9.3**
Tangible Common Equity (USD million)	**293.2**	**273.6**	**245.7**	**454.3**	**450.6**	[3]**-10.2**
Net Interest Margin (%)	**0.0**	**0.3**	**0.3**	**0.3**	**0.0**	[4]**0.2**
PPI / Average RWA (%)	**0.6**	**-0.3**	**0.3**	**0.7**	**0.1**	[5]**0.3**
Net Income / Average RWA (%)	**-0.2**	**-0.3**	**-6.1**	**0.5**	**0.1**	[5]**-1.2**
(Market Funds - Liquid Assets) / Total Assets (%)	**69.4**	**67.1**	**66.3**	**65.7**	**58.4**	[4]**65.4**
Core Deposits / Average Gross Loans (%)	**13.4**	**19.9**	**18.6**	**20.0**	**13.6**	[4]**17.1**
Tier 1 Ratio (%)	**18.6**	**12.3**	**12.0**	**15.7**	**14.3**	[5]**14.6**
Tangible Common Equity / RWA (%)	**14.0**	**9.1**	**7.8**	**12.9**	**11.0**	[5]**10.9**
Cost / Income Ratio (%)	**77.4**	**120.7**	**85.0**	**63.8**	**61.7**	[4]**81.7**
Problem Loans / Gross Loans (%)	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	[4]**0.0**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**0.0**	**0.0**	**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 Baa3 long-term and Prime-3 short-term deposit ratings (negative outlook) to Kommunalkredit Austria AG (KA). These ratings incorporate nine notches of support uplift from KA's standalone baseline credit assessment (BCA) of caa3, equivalent to a standalone bank financial strength rating of E. The rating lift reflects our view of a very high probability of systemic support from the bank's 99.78% shareholder, the Republic of Austria (Aaa stable). We anticipate neither a change in bank ownership nor any reduction of Austria's demonstrated willingness and ability to support the bank. Importantly, the European Commission's (EC) approval of 19 July 2013 allows "contingent capital and liquidity support", which is in line with our previous expectations of an orderly run-off.

The BCA is constrained by (1) KA's unwinding, which was decided by the Austrian government in May 2013 and approved by the EC in July 2013; (2) uncertainties relating to the costs of (and potential need of support for) the bank's unwinding, in order to protect bondholders from incurring losses; and (3) KA's modest economic capitalisation.

Rating Drivers

- EC approval of KA's run-off implies improved transparency for bondholders

- KA's unwinding could exert additional pressure on already weak and volatile profits

- Reliance on wholesale funds renders KA vulnerable to shocks in the financial markets

- High leverage and small absolute capital buffer expose KA to tail risk

- KA's core asset quality is sound, but exposure to countries in Europe's periphery is substantial

Rating Outlook

The outlook on KA's ratings is negative. The negative outlook takes into account the recent adoption of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) regulation in the EU. In particular, this reflects that, with the legislation underlying the new resolution framework now in place and the explicit inclusion of burden-sharing with unsecured creditors as a means of reducing the public cost of bank resolutions, the balance of risk for banks' senior unsecured creditors has shifted to the downside. Although our support assumptions are unchanged for now, the probability has risen that they will be revised downwards to reflect the new framework. For further details, please refer to our Special Comment entitled "Reassessing Systemic Support for EU Banks," published on 29 May 2014.

What Could Move the Rating - Up

There is no upwards ratings momentum for the standalone E BFSR based on our understanding that the discontinuation of underwriting and KA's unwinding is final. An upgrade of the Baa3 long-term senior debt and deposit ratings could be triggered by Austria granting an explicit guarantee for the bank's obligations, which we, however, do not expect.

What Could Move the Rating - Down

We might lower the BCA from caa3 if (1) there is a rapid erosion of KA's capital because of heavy credit losses that materially exceed current expectations; and (2) the bank has no access to debt capital markets for an extended period, leading to distress. A lowering of the BCA below the caa category could trigger a downgrade of the long-term ratings.

We also note the potential for adverse rating migration if our expectation of government support declines. However, we do not expect the government to withdraw its support for KA for the foreseeable future.

DETAILED RATING CONSIDERATIONS

EC APPROVAL OF KA'S RUN-OFF IMPLIES IMPROVED TRANSPARENCY FOR BONDHOLDERS

In the context of the opacity with regard to KA's future financial performance, we regard as credit positive for senior bondholders the EC's decision (in 2013) to approve KA's run-off and to explicitly state that the Austrian State will provide contingent capital and liquidity support, if needed. Although we do not rule out entirely the possibility that future changes in state-aid-related regulation could challenge such renewed government support, we take the view that the latest EC decision has enhanced planning security for the bank and its lenders. This decision may also have positive implications for KA's ability to independently manage required funding in the market during the run-off.

On16 May 2013, the Austrian authorities made the decision to put KA in run-off after it had discontinued attempts to divest of the bank in the face of challenging market conditions.

Whilst recent developments may have positive implications on certain fundamentals (in particular, KA's prospects of securing funding), the bank's standalone E BFSR remains constrained by our assessment that KA's franchise is impaired.

KA'S UNWINDING COULD EXERT ADDITIONAL PRESSURE ON ALREADY WEAK AND VOLATILE PROFITS

The discontinuation of loan underwriting in 2013 will probably weaken KA's earnings in coming years. The bank's net interest income (NII) was lower by -10% year-on-year in 2012, a trend which we expect to continue given the scheduled balance sheet reduction. The bank's modest fee and commission income (FCI) will also be under pressure as revenue from new underwriting falls away, although we see some additional revenue potential from the bank's continued advisory business. We therefore consider KA to be at risk of generating weaker or even negative results due to operational shortfalls over the next few years. That being said, KA expects to remain profitable in the next few years. We also note that favourable market conditions during H2 2013 yielded positive one-off effects. We therefore expect a smaller loss, if any, for the full year 2013, after KA reported a EUR16.8 million loss for H1 2013 (under IFRS).

In our view, KA will be challenged to reduce costs at a pace that reflects the deterioration of core revenues. In the six months to June 2013, the bank's EUR18.0 million of net operating costs (i.e., net of EUR4.8 million in compensatory receipts) compared with adjusted core revenues of EUR19.7 million (the sum of reported NII, adjusted for a EUR19.7 million one-off effect, and reported FCI). Based on these figures, we consider that KA has limited tolerance for further revenue erosion. Moreover, KA's performance during recent quarters illustrates that one-off effects on the income statement are disproportionately large in the context of core revenues and profits.

RELIANCE ON WHOLESALE FUNDS RENDERS KA VULNERABLE TO SHOCKS IN THE FINANCIAL MARKETS

The prospect of KA remaining a government-owned entity in the foreseeable future is credit positive for its funding situation. The bank will continue to require regular access to debt capital markets, albeit for decreasing amounts of debt as the balance sheet runs off. We do not rule out intermittent challenges for the bank's ability to access debt capital markets as well as for its funding costs; however, funding risks have eased since KA refinanced several large "bulk" maturities during 2013 and February 2014. KA has to manage a few more large maturities, which we expect it to refinance with new covered bond issues.

A considerable portion of KA's total liabilities is secured; however, the bank requires substantial portions of unsecured debt (or deposits). We note positively that KA has maintained its institutional client deposits during recent quarters (EUR1.7 billion as of June 2013) to close part of the gap. KA still relies on drawings of EUR1.35 billion (equivalent to 9% of the balance sheet) under the ECB's three-year, long-term refinancing operations (LTROs) offered in December 2011 and February 2012.

KA has, to date, raised funding at acceptable terms and managed liquidity satisfactorily, despite relatively concentrated maturities. A EUR1 billion covered bond maturity in September 2013 needed partial refinancing, which KA achieved with a EUR500 million benchmark issue . Q1 2014 maturities have already been refinanced with another EUR 500 million covered bond issue with a seven-year maturity . In addition, KA raises senior unsecured funds through private placements in order to complement its funding through covered bonds.

HIGH LEVERAGE AND SMALL ABSOLUTE CAPITAL BUFFER EXPOSE KA TO TAIL RISK

KA's regulatory capitalisation is satisfactory, but capital ratios remain at risk of gradual erosion as a decline in the bank's revenues may lead to operational shortfalls in KA's income statement in the next few years. Moreover, the prospect of occasional, large losses cannot be ruled out, given relatively large single borrower concentrations in KA's loans and investments. At the same time, risk-weighted asset reduction will alleviate capital pressures and may even support ratios in the near term.

KA's balance sheet displayed very high leverage, with a Tier 1 leverage ratio of 1.9% (i.e., Tier 1 capital as a percentage of total assets) as of June 2013. According to the bank, this ratio has notably improved during the six months to December 2013, and KA expects to meet the higher absolute capital requirements under Basel III through asset maturities, although this may take several years yet.

We recognise the improvement in regulatory capital ratios. KA's reported a Tier 1 capital ratio of 13.7% as of June 2013 (year-end 2012: 12.3%). According to the bank, the CET1 ratio under Basel III as of 1 January 2014 is expected to be even higher (based on preliminary financials), following further risk-weighted asset reduction. This ratio, however, still includes a large portion of hybrid capital. As of June 2013, the hybrid capital content of KA's Tier 1 capital was EUR138.4 million, or 49%, which under the Basel III rules is subject to gradual phase-out, at a rate of 20% in 2014 and 10 % per annum from 2015.

We consider KA's economic capitalisation to be modest given a capital cushion (in order to maintain a 9% Tier 1 ratio) of EUR126 million, rendering the bank vulnerable to market shocks and/or large one-off losses. Tier 1 capital was stable at EUR282 million during the six months to June. A EUR30 million reserve (i.e., a general provision for unspecified risk under local GAAP) is included in our calculation of the aforementioned buffer.

KA'S 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. However, as of June 2013, KA's loans and investments included EUR556 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 exposure is around twice the amount of KA's Tier 1 capital, the bank remains vulnerable to setbacks in the euro area sovereign debt crisis. Almost three quarters of this exposure was to Italy (EUR325 million) and Spain (EUR82 million).

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 BCA of caa3, as well as the Aaa local-currency deposit rating of its main shareholder, the Republic of Austria. KA therefore receives a nine-notch uplift from its BCA, 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 Ca, which is one notch below the bank's adjusted BCA of caa3.

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)					0.19%		
Net Income % Average RWA (Basel II)					-2.23%		
Factor: Liquidity						E	Neutral
(Market Funds - Liquid Assets) % Total Assets					67.58%		
Liquidity Management					x		
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio (%) (Basel II)	14.30%						
Tangible Common Equity % RWA (Basel II)	10.28%						
Factor: Efficiency						E	Neutral
Cost / Income Ratio					94.36%		
Factor: Asset Quality						A	Neutral
Problem Loans % Gross Loans	0.00%						
Problem Loans % (Equity + LLR)	0.02%						
Lowest Combined Financial Factor Score (15%)						E	
Economic Insolvency Override						Neutral	
Aggregate BFSR Score						D	
Aggregate BCA Score						ba2	
Assigned BFSR						E	
Assigned BCA						caa3	

[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.