MOODY'S INVESTORS SERVICE

Credit Opinion: Kommunalkredit Austria AG

Global Credit Research - 23 Dec 2014

Vienna, Austria

Ratings

Category	Moody's Rating
Outlook	Rating(s) Under Review
Bank Deposits	*Ba1/NP
Bank Financial Strength	E
Baseline Credit Assessment	caa3
Adjusted Baseline Credit Assessment	caa3
Senior Unsecured	**Ba1
Subordinate -Dom Curr	Ca
Other Short Term -Dom Curr	(P)NP

* Rating(s) within this class was/were placed on review on June 20, 2014
** Placed under review for possible downgrade on June 20, 2014

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Key Indicators

Kommunalkredit Austria AG (Consolidated Financials)[1]

	[2]**6-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	[3]**12-10**	**Avg.**
Total Assets (EUR million)	**12,370.2**	**12,330.1**	**15,852.4**	**16,749.1**	**16,271.1**	[4]**-6.6**
Total Assets (USD million)	**16,936.7**	**16,990.1**	**20,899.7**	**21,742.7**	**21,828.4**	[4]**-6.1**
Tangible Common Equity (EUR million)	**221.4**	**212.8**	**207.5**	**189.2**	**338.7**	[4]**-10.1**
Tangible Common Equity (USD million)	**303.1**	**293.2**	**273.6**	**245.7**	**454.3**	[4]**-9.6**
Net Interest Margin (%)	**0.2**	**0.0**	**0.3**	**0.3**	**0.3**	[5]**0.2**
PPI / Average RWA (%)	**1.3**	**0.6**	**-0.3**	**0.3**	**0.7**	[6]**1.3**
Net Income / Average RWA (%)	**1.0**	**-0.2**	**-0.3**	**-6.1**	**0.5**	[6]**1.0**
(Market Funds - Liquid Assets) / Total Assets (%)	**67.5**	**69.4**	**67.1**	**66.3**	**65.7**	[5]**67.2**
Core Deposits / Average Gross Loans (%)	**--**	**13.4**	**19.9**	**18.6**	**20.0**	[5]**18.0**
Tier 1 Ratio (%)	**15.5**	**18.6**	**12.3**	**12.0**	**15.7**	[6]**15.5**
Tangible Common Equity / RWA (%)	**13.6**	**14.0**	**9.1**	**7.8**	**12.9**	[6]**13.6**
Cost / Income Ratio (%)	**66.7**	**77.4**	**120.7**	**85.0**	**63.8**	[5]**82.7**
Problem Loans / Gross Loans (%)	**--**	**0.0**	**0.0**	**0.0**	**0.0**	[5]**0.0**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**--**	**0.0**	**0.0**	**0.0**	**0.2**	[5]**0.1**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - transitional phase-in; IFRS

[3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

We assign Ba1 long-term and Not-Prime short-term deposit ratings to Kommunalkredit Austria AG (KA). These ratings incorporate eight 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), which compares favorably with the average "high" systemic support assumption for the Austrian banking sector. We anticipate no change in bank ownership. Importantly, the European Commission's (EC) approval of 19 July 2013 allows "contingent capital and liquidity support", which is in line with our expectation of an orderly run-off. Earlier this year, we lowered our systemic support assumptions for the Austrian banking system to high from very high. This follows the 11 June 2014 proposal by the Austrian government to enact legislation designed to allow the government to bail-in nationalised Heta Asset Resolution AG`s (Heta, former Hypo Alpe-Adria-Bank International AG) subordinated debt holders and void the State of Carinthia's (A2 stable) deficiency guarantees on that portion of the bank's debt. The unprecedented nature of the government's decision indicates, in our opinion, that Austrian authorities are now generally more willing to countenance bank resolutions in which losses may also be imposed on senior creditors.

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

- The partial sales process for KA launched in August has uncertain implications for creditors

- Unclear interaction between existing EC approval of KA's run-off and BRRD provisions on resolution triggers

- KA's unwinding of a low-margin portfolio limits its flexibility to absorb funding cost increases or credit losses

- High leverage exposes KA to asset quality tail risk

Rating Outlook

KA's long-term deposit ratings are under review for downgrade. The review was opened following the reduction in our support assumptions for the Austrian banking system after the Austrian Government presented a draft law proposal designed to allow the government to bail-in nationalised Heta's subordinated debt holders and void Carinthia's deficiency guarantees on that portion of the bank's debt. The review was later extended to include the implications of the partial sale process of KA launched by its fiduciary owner, Finanzmarktbeteiligung Aktiengesellschaft des Bundes (Fimbag, unrated), in August 2014.

What Could Move the Rating - Up

Since the Ba1 long-term senior debt and deposit rating is under review for downgrade an upgrade is unlikely. An upgrade of the long-term rating could be triggered by Austria granting an explicit guarantee for the bank's obligations, which we, however, do not expect.

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.

What Could Move the Rating - Down

The rating review is focused on the appropriateness of the lowered, but still very high support assumptions incorporated into the bank's senior unsecured ratings. In addition, during the extended review we expect to obtain more clarity regarding (1) the identity and strategic intentions of KA's future owners; and (2) the treatment of KA's outstanding debt, if there is a successful partial sale.

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.

DETAILED RATING CONSIDERATIONS

THE PARTIAL SALES PROCESS FOR KA LAUNCHED IN AUGUST HAS UNCERTAIN IMPLICATIONS FOR CREDITORS

At present, the implications of a successful partial sale of KA for unsecured creditors are unclear. Our future rating assessment will depend on 1) the financial strength of the future obligor of KA's rated debt instruments and on 2) our opinion as to the future availability of systemic support for the benefit of that obligor and its rated debt instruments.

On 11 August 2014, KA stated in a press release that Fimbag invited interested parties to submit expressions of interest for an acquisition of a size-reduced KA with up to EUR5.8 billion of assets. According to a separate press release by KA Finanz AG (KF, unrated), a wind-down entity previously separated from KA, the remainder of KA's assets - approximately EUR4.7 billion as of 30 June 2014 based on Austrian local GAAP - could be merged into KF, if the bid is successful.

Following the receipt of non-binding offers in October 2014 and a due diligence phase, Dr. Klaus Liebscher, Fimbag's CEO and President of KA's Supervisory Board announced in a recent media interview the extension of the deadline for submission of binding offers upon request by the unnamed bidders to mid-December from end-November.

As a result of the extended due diligence phase, Moody's does not expect a sales contract to be signed before January 2015. Until then, the treatment of KA's liabilities remains uncertain, in particular whether its current liabilities would (1) be transferred to KF; (2) remain with KA; or (3) be assumed by an acquirer.

UNCLEAR INTERACTION BETWEEN EXISTING EC APPROVAL OF KA'S RUN-OFF AND BRRD PROVISIONS ON RESOLUTION TRIGGERS

Austria will implement the EU Bank Recovery and Resolution Directive (BRRD) and the full range of resolution tools including unsecured creditor bail-in by 1 January 2015. The BRRD's emphasis on creditor burden sharing prior to the use of taxpayer money may limit the ability of the Republic of Austria to provide additional support in case of need.

After the Austrian authorities had discontinued in 2013 attempts to divest of the bank in the face of challenging market conditions, the European Commission (EC) approved the run-off plan for KA which foresees ample leeway for the provision of contingent capital and liquidity by the Republic of Austria in case of need.

In the absence of clearer specifications within the Austrian BRRD implementation draft law, we do not rule out that the provision of future capital within the EC-approved framework may nevertheless trigger the application of resolution tools. Despite the run-off, KA continues to operate as a CRR-regulated entity with a full banking license, making it subject to BRRD.

KA'S UNWINDING OF A LOW-MARGIN PORTFOLIO LIMITS ITS FLEXIBILITY TO ABSORB FUNDING COST INCREASES OR CREDIT LOSSES

Going forward, we expect net interest income to remain compressed 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 in the case of funding cost increases or unexpected credit events in its concentrated portfolio which is currently free from problem loans.

In our view, KA will be challenged to reduce costs at a pace that reflects the deterioration of core revenues. Partially, this aspect is offset by the exemption from the Austrian bank levy which has been put in place as of July 2013. Prior to this exemption, semi-annual bank levy expenses were EUR4.6 million in 2013 (EUR9.2 million for the full year 2012). Even so, with net interest income and fee and commission income accounting for a combined EUR19.9 million in the first half 2014, less than the EUR21.9 million administrative expenses, we consider that KA has limited tolerance for further revenue erosion. Moreover, KA's performance during recent years illustrates that one-off effects on the income statement can be disproportionately large in the context of core revenues and profits.

Following the EC approval decision in 2013, the prospect of KA remaining a government-owned entity was credit positive for KA`s funding situation. Depending on the details of the planned partial sale of KA, the entity may face a reversal of the increased investor comfort which benefitted its access to cheap funding over the past quarters. 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 in 2014. KA has to manage only one remaining large maturity of a EUR1.0 billion covered bond in February 2015 - which we expect it to refinance with new covered bond issuance should the partial sale process not progress.

A considerable portion of KA's total liabilities is secured; however, the bank requires substantial portions of unsecured debt (or deposits). KA continues to hold institutional client deposits. After a decline of EUR0.7 billion to EUR1.0 billion in the second half of 2013, the deposits slightly increased in the first half 2014 to EUR1.2 billion. In addition, KA still relies on drawings of EUR1.35 billion (equivalent to 9% of the balance sheet) of ECB funding, which originates from its participation in the ECB's three-year, long-term refinancing operations (LTROs) offered in December 2011 and February 2012.

HIGH LEVERAGE EXPOSES KA TO ASSET QUALITY 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 continue to support ratios in the near term, as evidenced during 2013.

We recognise the slight improvement in regulatory capital ratios. KA reported a CET 1 capital ratio of 15.5% as of June 2014 (01.01.2014: 15.3%, Basel II YE 2013: 18.6%). At this date, CET 1 capital stood at EUR253 million (01.01.2014: EUR252 million) with risk-weighted assets of EUR1.6 billion (total risk) under Basel III. This IFRS ratio, however, still includes a large portion of hybrid capital while it excludes undisclosed reserves which the bank has built under local GAAP. As of June 2014, the hybrid capital content of KA's Tier 1 capital was EUR110.7 million, after 20% of year-end 2013's EUR138.4 million of hybrid capital has become ineligible. The remaining hybrid capital is subject to gradual phase-out of 10% p.a. As a function of KA's low risk-weighted asset density - a characteristic shared with other public sector lenders - KA's Tier 1 leverage ratio remained close to 2% as of June 2014 and under the assumption of an orderly portfolio run-off, we expect an improvement towards a 3% level to take several years.

As a former specialised public-sector lender, KA's asset quality is fairly sound, as expressed by a current 0% non-performing loan ratio. As of June 2014 KA's loans and investments included EUR225 million in exposures to sovereign obligors in the more pressured countries Cyprus (B3, stable), Spain (Baa2, positive), and Italy (Baa2, stable) down from EUR288 million of such exposures as of year-end 2013. In the second half of 2014, these exposures have come down further, not least because the remaining Cypriot government debt of EUR28 million was fully repaid in July. Within the highly rated part of KA's exposure portfolio, we note that exposure concentrations remain high in comparison to KA's CET 1 capital. As of year-end 2013, the largest 20 obligor groups (excluding the Austrian sovereign and regions) in KA's portfolio accounted for one quarter of the bank's total exposures.

Global Local Currency Deposit Rating (Joint Default Analysis)

We assign a global local currency (GLC) deposit rating of Ba1 to KA. The rating is based on KA's BCA of caa3, as well as the Aaa rating of its main shareholder, the Republic of Austria. KA therefore receives an eight-notch uplift from its BCA, bringing the long-term debt and deposit ratings to Ba1.

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.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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