FitchRatings

FITCH MAINTAINS NEGATIVE WATCH ON KOMMUNALKREDIT'S IDRS AFTER DISCONTINUED PRIVATISATION PROCESS

Fitch Ratings-London-17 May 2013: Fitch Ratings has maintained Kommunalkredit Austria AG's (Kommunalkredit) Long- and Short-term Issuer Default Ratings (IDRs) of 'A' and 'F1', respectively, as well as its Support Rating Floor (SRF) of 'A' and Support Rating of '1' on Rating Watch Negative (RWN). In addition, Fitch has affirmed the government guaranteed note at 'AAA'. Kommunalkredit's Viability Rating (VR) of 'b+' is unaffected. A full list of rating actions is at the end of this rating action commentary.

This rating action follows yesterday's announcement by Kommunalkredit that the Austrian government agency Finanzmarktbeteiligung Aktiengesellschaft des Bundes (FIMBAG), who was mandated with privatising Kommunalkredit, has discontinued the privatisation process of Kommunalkredit, and that the bank will remain 99.78% owned by the Austrian government (rated 'AAA'/Stable) for the foreseeable future.

The Austrian government had initiated the privatisation process in early-2012 in line with European Commission (EC) state aid rules and was working towards a mid-2013 completion deadline. FIMBAG stated that several offers for Kommunalkredit had been received, but due to their complexity, low offer prices and conditionality regarding on-going government support following the privatisation, the offers were not in the best interest of the Republic of Austria and had therefore been rejected.

Following the discontinued privatisation process, Kommunalkredit will cease to write new business as long as it remains in government ownership, although it will continue to actively manage its existing balance sheet. Consequently, the Austrian government has asked the EC not to appoint a divestiture trustee who would be mandated to sell Kommunalkredit at any price.

The RWN on Kommunalkredit's ratings (apart from its VR) reflects Fitch's view of the uncertainty regarding Kommunalkredit's medium-term future. Should the EC approve the Austrian government's proposal to maintain ownership of KA as long as it ceases new business, it is likely that the RWN will be removed and the ratings affirmed at their current levels.

Downside risk arises from a potential rejection of the Austrian government's proposal by the EC. This would likely mean that a divestiture trustee would be appointed and that the bank would be privatised in the near term.

KEY RATING DRIVERS - IDRs, Support Rating, Support Rating Floor and Senior Debt
Kommunalkredit's IDRs are driven solely by Fitch's view that support from Kommunalkredit's 99.78% ultimate owner, the Republic of Austria, is extremely probable. Fitch assigns a Support Rating Floor of 'A' to state-owned banks in Austria. Fitch's assessment of support is based on Kommunalkredit's government ownership, strong track record of support from Austrian authorities and Fitch's expectation that timely support would continue to be forthcoming as long as the Republic of Austria owns Kommunalkredit. Moreover, the government has committed itself to maintaining a Basel II Tier 1 ratio of at least 7% in Kommunalkredit as long as the bank's previous owners remain invested in Kommunalkredit's participation capital.

RATING SENSITIVITIES - IDRs, Support Rating, Support Rating Floor and Senior Debt
Kommunalkredit's support-driven ratings are primarily sensitive to the bank's future relationship with the Austrian government. Continued state-ownership would likely lead to the removal of the RWN and an affirmation of Kommunalkredit's ratings at current levels.

A rejection by the EC of the Austrian government's application to remain Kommunalkredit's majority owner in the long-term could result in a divestiture trustee being imposed, in which case a multi-notch downgrade of Kommunalkredit's ratings would be likely, depending on the creditworthiness of the new owner. In this scenario, Fitch assumes that the divestiture trustee would sell Kommunalkredit to a buyer whose creditworthiness (and rating) would most likely be weaker or significantly weaker than that of the Republic of Austria.

However, unlike in the case of KA Finanz AG (KF; 'A+'/'F1+'/'1'/'A+'), it does not appear to be the Austrian government's intention to own Kommunalkredit indefinitely. Consequently, even if EC approval for continued state ownership is received, Fitch is likely to maintain the one notch differential between Kommunalkredit and KF. KF has been established in 2009 as a wind-down bank to remain in government ownership following the take-over of the former Kommunalkredit by the Republic of Austria. KF's SRF benefits from a one-notch uplift compared to systemically important Austrian banks based on the government's commitment not to privatise it.

Kommunalkredit's support-driven ratings are also sensitive to a change in Fitch's assumptions around the availability of sovereign support for the bank.

There is a clear political intention to ultimately reduce the implicit state support for systemically important banks in Europe, as demonstrated by a series of policy and regulatory initiatives aimed at curbing systemic risk posed by the banking industry. This might result in Fitch downgrading SRFs in the medium term, although the timing and degree of any change would depend on developments with respect to specific jurisdictions. In this context, Fitch is paying close attention to ongoing policy discussions around support and 'bail in' for Eurozone banks. Until now, senior creditors in major global banks have been supported in full, but resolution legislation is developing quickly and the implementation of creditor 'bail-in' is starting to make it look more feasible for taxpayers and creditors to share the burden of supporting banks.

While this largely affects large, systemically relevant banks, it could ultimately also put pressure on SRFs of government-owned banks.

In addition, the support-driven ratings could be downgraded if the ability, as expressed in the sovereign rating, or propensity of the Republic of Austria to support the bank change. The rating of the government-guaranteed note, which is equalised to that of Austria, is also sensitive to changes in Austria's sovereign rating.

Fitch expects to resolve the respective Rating Watches once it becomes clearer under what conditions Kommunalkredit will be allowed to operate in the medium-term, most likely following the EC's announcement of its decision regarding the Austrian government's proposal.

Following a significant net loss in 2011 due to sizeable impairments on Greek government bond exposures, Kommunalkredit returned to modest profitability in 2012 (pre-tax profit of EUR18.4m; operating return on average equity of 14.8%) supported by one-off gains of bond buy-backs and offset by losses on the disposal of assets in the year. Kommunalkredit's balance sheet fell by around 5% yoy to EUR15.9bn at end-2012 largely due to a reduction in loan balances. While Kommunalkredit's leverage remained high due to its public sector lending business model (tangible common equity ratio of 0.86% at end-2012), the bank's capitalisation remained acceptable with a Basel 2.5 Tier 1 ratio of 12.3% at end-2012.

Kommunalkredit, based in Vienna, specialises in municipal and infrastructure-related financing and consultancy services, predominately in Austria, Germany, Switzerland and selected central and eastern European countries. Following the take-over of its predecessor, also called Kommunalkredit (KA Old) by the Republic of Austria, KA Old's strategic, operating business was transferred to Kommunalkredit while non-core assets were transferred to KF and put in orderly wind-down.

The rating actions are as follows:

Long-term IDR 'A'; maintained on Rating Watch Negative (RWN)
Short-term IDR 'F1'; maintained on RWN
Viability Rating unaffected at 'b+'

Support Rating '1'; maintained on RWN
Support Rating Floor 'A'; maintained on RWN
Long-term senior unsecured notes rating 'A'; maintained on RWN
Short-term senior unsecured notes rating 'F1'; maintained on RWN
Senior market-linked notes rating 'Aemr'; maintained on RWN
Government guaranteed note (ISIN XS0437341307) affirmed at 'AAA'

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Additional information is available on www.fitchratings.com

Applicable criteria, 'Global Financial Institutions Rating Criteria', dated 15 August 2012, and 'Evaluating Corporate Governance', dated 12 December 2012, are available at www.fitchratings.com.

Applicable Criteria and Related Research
Global Financial Institutions Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686181
Evaluating Corporate Governance
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=694649