

Global Credit Research - 06 Sep 2013

Vienna, Austria

Ratings

Category	Moody's Rating
Outlook	Stable
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

Contacts

Analyst	Phone
Katharina Barten/Frankfurt am Main	49.69.707.30.700
Swen Metzler/Frankfurt am Main	
Carola Schuler/Frankfurt am Main	
Na Luo/Frankfurt am Main	

Key Indicators

Kommunalkredit Austria AG (Consolidated Financials)[1]

	[2]12-12	[2]12-11	[2]12-10	[2]12-09	Avg.
Total Assets (EUR million)	15,852.4	16,749.1	16,271.1	18,283.2	[3]-4.6
Total Assets (USD million)	20,899.7	21,742.7	21,828.4	26,231.6	[3]-7.3
Tangible Common Equity (EUR million)	207.5	189.2	338.7	314.0	[3]-12.9
Tangible Common Equity (USD million)	273.6	245.7	454.3	450.6	[3]-15.3
Net Interest Margin (%)	0.3	0.3	0.3	0.0	[4]0.2
PPI / Average RWA (%)	-0.3	0.3	0.7	0.1	[5]0.2
Net Income / Average RWA (%)	-0.3	-6.1	0.5	0.1	[5]-1.5
(Market Funds - Liquid Assets) / Total Assets (%)	67.1	66.3	65.7	58.4	[4]64.4
Core Deposits / Average Gross Loans (%)	19.9	18.6	20.0	13.6	[4]18.1
Tier 1 Ratio (%)	12.3	12.0	15.7	14.3	[5]13.6
Tangible Common Equity / RWA (%)	9.1	7.8	12.9	11.0	[5]10.2
Cost / Income Ratio (%)	120.7	85.0	63.8	61.7	[4]82.8
Problem Loans / Gross Loans (%)	0.0	0.0	0.0	0.0	[4]0.0
Problem Loans / (Equity + Loan Loss Reserves) (%)	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 long-term global local currency (GLC) debt and deposit ratings of Baa3 (stable outlook) to Kommunalkredit Austria AG (KA), which is strongly supported by our assumption of a very high probability of systemic support from the bank's 99.78% shareholder, the Republic of Austria (Aaa negative).

KA's standalone bank financial strength rating (BFSR) is E, which is equivalent to a caa3 baseline credit assessment (BCA). The BFSR (which carries no outlook) is constrained by (1) KA's unwinding, which was decided by the Austrian government in May 2013 and approved by the European Commission (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 weak economic capitalisation and our expectation that the bank's profitability will deteriorate.

Our support assumptions result in a nine-notch uplift from the caa3 BCA, reflecting the prospect that the government of Austria will maintain its majority ownership of KA for the foreseeable future, as well as its demonstrated willingness and ability to support the bank. Importantly, the EC's 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 rating for short-term liabilities is Prime-3.

Rating Drivers

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

KA's standalone E BFSR carries no outlook. The outlook on KA's Baa3 long-term ratings is stable.

What Could Move the Rating - Up

There is no upwards ratings momentum for the 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 a stronger commitment from the Austrian government, in particular 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 high 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 consider the recent decision of the EC to approve KA's run-off and to explicitly state that the Austrian State will provide contingent capital and liquidity support, if needed, credit positive for senior bondholders. 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 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.

On 16 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. According to the bank's restructuring plan, a change of KA's ownership was to be achieved by year-end 2012 in compensation for the receipt of state aid.

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 WILL EXERT ADDITIONAL PRESSURE ON ALREADY WEAK AND VOLATILE PROFITS

The recently decided discontinuation of loan underwriting will gradually weaken KA's earnings. We consider KA to be at risk of generating losses due to our expectations of operational shortfalls over the next few years, although we note that KA expects to post a profit in 2014. For 2013, the bank will post a loss, as returns in H2 2013 will not suffice to compensate for the EUR16.8 million loss reported for H1 2013 (based on IFRS, at group level).

The bank's net interest income (NII, 2012: -10% year-on-year) will probably erode at a slightly faster pace than observed in recent years, and the bank's modest fee and commission income (FCI) will be under pressure as revenue from new underwriting falls away.

In our view KA will be challenged to reduce costs at a pace that reflects the deterioration of core revenues. In the six month to June 2013, the bank's EUR18.0 million 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 the past six 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

Whilst the prospect of KA remaining a government-owned entity in the foreseeable future is in some respects credit positive, we do not rule out adverse implications for the bank's ability to access debt capital markets as well as for its funding costs.

KA is heavily reliant on wholesale funds and thus dependent on regular access to debt capital markets. Whilst it could periodically raise modest amounts of senior unsecured funds through private placements (2012: EUR95 million), we take the view that KA may require funding support during the next few quarters, which we expect to be available from the government in order to ensure that KA can unwind its loan book in an orderly fashion.

A considerable portion of KA's total liabilities is secured. As the bank has committed to maintaining 28% of over-collateralisation (OC) for its public-sector covered bonds, however, it also 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.

Following the repayment of EUR150 million in early 2013, 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.

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

KA's balance sheet displays 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. The bank may be challenged to meet the higher capital requirements under Basel III. In this context, we note that EUR138.4 million (49%) of KA's Tier 1 capital is hybrid, which under the new Basel rules is subject to gradual phase-out, at a rate of 10% per annum.

We recognise the improvement in KA's regulatory ratios. KA reported a Tier 1 capital ratio of 13.7% as of June 2013 (year-end 2012: 12.3%). However, we consider its 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.

We forecast that a decline in KA's revenues will likely lead to operational shortfalls in KA's income statement in the next few years (or even quarters), which would gradually erode the bank's current capital position. Moreover, the prospect of occasional, large losses cannot be ruled out, in our view, after losses on Greek assets critically weakened the bank's economic capital levels during 2011-12, and triggered breaches of its regulatory large loan limits.

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.

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
Economic Stability			x				
Integrity and Corruption		x					
Legal System	x						
Financial Factors (50%)							D+
Factor: Profitability							E+
PPI % Average RWA (Basel II)				1.06%			
Net Income % Average RWA (Basel II)					-1.34%		
Factor: Liquidity							E
(Market Funds - Liquid Assets) % Total Assets					65.80%		
Liquidity Management					x		
Factor: Capital Adequacy							A
Tier 1 Ratio (%) (Basel II)	13.33%						
Tangible Common Equity % RWA (Basel II)	9.91%						
Factor: Efficiency							C
Cost / Income Ratio			59.52%				
Factor: Asset Quality							A
Problem Loans % Gross Loans	0.00%						
Problem Loans % (Equity + LLR)	0.09%						
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							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.

MOODY'S
INVESTORS SERVICE

© 2013 Moody's Investors Service, Inc. and/or its licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. ("MIS") AND ITS AFFILIATES ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S

CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources Moody's considers to be reliable, including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

MIS, a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MIS have, prior to assignment of any rating, agreed to pay to MIS for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moodys.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

For Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail clients. It would be dangerous for retail clients to make any investment decision based on MOODY'S credit rating. If in doubt you should contact your financial or other professional adviser.