MOODY'S INVESTORS SERVICE

Credit Opinion: Kommunalkredit Austria AG

Global Credit Research - 08 Jun 2012

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]**12-11**	[2]**12-10**	[2]**12-09**	**Avg.**
Total Assets (EUR million)	**16,749.1**	**16,271.1**	**18,283.2**	[3]**-4.3**
Total Assets (USD million)	**21,742.7**	**21,828.4**	**26,231.6**	[3]**-9.0**
Tangible Common Equity (EUR million)	**189.4**	**338.7**	**314.0**	[3]**-22.3**
Tangible Common Equity (USD million)	**245.8**	**454.3**	**450.6**	[3]**-26.1**
Net Interest Margin (%)	**0.3**	**0.3**	**0.0**	[4]**0.2**
PPI / Avg RWA (%)	**-6.1**	**1.3**	**0.1**	[5]**-1.6**
Net Income / Avg RWA (%)	**-5.8**	**1.0**	**0.1**	[5]**-1.6**
(Market Funds - Liquid Assets) / Total Assets (%)	**65.4**	**65.7**	**58.4**	[4]**63.2**
Core Deposits / Average Gross Loans (%)	**18.6**	**20.0**	**13.6**	[4]**17.4**
Tier 1 Ratio (%)	**12.0**	**15.7**	**14.3**	[5]**14.0**
Tangible Common Equity / RWA (%)	**7.8**	**12.9**	**11.0**	[5]**10.5**
Cost / Income Ratio (%)	**-63.9**	**57.0**	**60.7**	[4]**17.9**
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 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 an E bank financial strength rating (BFSR) to Kommunalkredit Austria AG (KA), which maps to a Caa1 standalone credit assessment on the long-term scale. KA's long-term senior debt and deposits are rated Baa3, whilst its senior subordinated debt is rated Caa2. The BFSR and all senior debt and subdebt ratings carry a stable outlook. The rating for short-term liabilities is Prime-3.

The E BFSR, downgraded from E+ on 2 February 2012, is constrained by KA's (i) evolving franchise as a provider of public infrastructure finance and services; (ii) a material reduction in KA's Tier 1 capital that is expected due to the required write-down of major portions of KA's risk exposure to the Greek sovereign; (iii) our anticipation of weak profitability going forward, due to the very low yield on most of KA's legacy assets in the context of rising funding costs for banks; and (iv) developing risk management. We acknowledge the sound quality of most of KA's assets and the gradual progress that it has made in transforming its business model, which, however, 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, 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 within 18 months appears unlikely. As a consequence, we expect the current ownership to be maintained for the foreseeable future.

Credit Strengths

- 99.78% Government of Austria ownership with a demonstrated willingness and ability to support the bank

- A capital level that we expect will be sufficient to absorb the expected losses incurred by the private-sector participation in the restructuring of Greek debt, without triggering any support requirements

- Sound asset quality of the public sector finance lending book, with 68% in the Aaa and Aa rating categories, albeit also with 4% in non-investment grade

Credit Challenges

- Complying with the compensation measures set by the EC, and satisfying the EC even if the June 2013 deadline for KA's privatisation cannot be met

- A high dependence on market funds, which makes KA vulnerable to distortions or shocks in the financial markets

- Potential medium-term pressure from the increased capital requirements under Basel III, in particular with regard to leverage

- Restoring sustainable levels of profitability against the headwinds of the persistent euro area sovereign debt crisis, in addition to the low yields on most of KA's assets

Rating Outlook

The stable outlook on KA's E BFSR reflects the rating's position at the low end of the BFSR rating scale. The stable outlook on its Baa3 long-term ratings reflects our view that in the context of the ongoing sovereign debt crisis, KA 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 believe that such a sale will 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 exert adverse 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 little 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 a stronger commitment by the Austrian government, in particular an explicit guarantee for the bank's obligations. However, we believe that such a guarantee is unlikely to be granted.

What Could Change the Rating - Down

Although the outlook on the E BFSR is stable, the BFSR could be remapped to a lower level on the long-term scale 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 Caa rating category could have an immediate effect on the long-term ratings.

A downgrade of the Baa3 long-term senior debt and deposit ratings could be triggered by a downgrade of the rating of the government of Austria from the current Aaa (neg.) level and / or an early sale of the bank by the government or other indications of a change in the probability of future systemic support for KA. Although this is not expected for the foreseeable future, we will very closely monitor the state's commitment towards the entity and its timetable for withdrawing its support.

Recent financial development

HALF YEAR RESULTS AS OF JUNE 2011

For the six months to June 2011, the bank reported a modest pre-tax income of EUR 1.2 million (which compares with a EUR 2.2 million for the same period in 2010), as the bank had to write down EUR 31.3 million on its exposure to Greece. Adjusted for this charge as well as valuation gains on other security holdings, the pre-tax result would have been higher year-on-year at roughly EUR 10 million.

The EUR 21.5 million in revenues (EUR 16.4 million) were adversely impacted by a negative EUR 9.1 million (negative EUR 13.2 million) trading and valuation result, which included the EUR 31.3 million loss on Greek bonds, as well as adverse valuation changes on the bank's public sector bond portfolio.

POOR OUTLOOK FOR 2011

Given that that KA will need to write-down the lion's share of its exposure to Greece in its 2011 results, we expect KA to post a three-digit million loss for the year. Following a EUR31 million write-down in H1 2011, the remaining exposure on KA's books was EUR204 million as of June 2011 (representing roughly 50% of its Tier 1 capital).

From the latest developments in the negotiations of a private-sector participation in the restructuring of Greek debt, we note that a write-down to 30% of the notional value of bonds cannot be ruled out. This would cause a total charge against KA's Greek exposure exceeding EUR 150 million for FY2011. This loss amounts to roughly 5x the bank's annual pre-provision income, which we estimate at between EUR 25 million to EUR 30 million per year.

APPROVAL FOR STATE AID OBTAINED, SALE TARGETED BY MID-2013

The Austrian Ministry of Finance reported on 29 November 2011 that it has initiated the process of divesting KA 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 to improve capital levels, the time limit of mid-2013 appears extremely difficult to meet. Whilst we believe that it may be possible to renegotiate the time limit closer to the deadline, we caution that: (i) the required sale may weigh on investor confidence in KA's future with adverse implications for the bank's funding costs; and (ii) that 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. With the approval, the bank's previously submitted restructuring plan was also approved, reflecting an endorsement by the Commission of the bank's new strategy. Other compensation measures that have been agreed include unspecified compensation payments to the government of Austria. While we expect that the bank should maintain some leeway to build reserves, we understand that this compensation measure represents a limitation of KA's internal capital generation.

DETAILED RATING CONSIDERATIONS

Franchise Value

KA is the surviving core bank that emerged from a rescue in late 2008 and the subsequent breakup of the former Kommunalkredit Austria AG ("KA Old") in November 2009, that was orchestrated by the Austrian government (Aaa, negative). The break-up (or, legally, demerger) resulted in two independent entities: KA and KA Finanz AG (KF, not rated except for government-guaranteed, Aaa-rated bond issues). Both banks have received government support which has allowed them to meet their financial obligations until today. However, as KF serves as a wind-down vehicle for non-core assets, only KA is a going concern.

KA aims to build a franchise as a financier for infrastructure and as a specialist lender to public-sector authorities and related entities, focusing on higher-margin 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 including leasing, advisory services, private placements, debt restructuring and asset management. However, the chosen strategy remains challenging, as the competition in these markets is high. Moreover, KA has still a large legacy, low-margin public sector lending book, representing roughly half of the group's total assets of EUR 16.5 billion (as of June 2011). KA's public sector loan book will be wound down only slowly over time and, according to the strategy of the bank, replaced by higher-margin infrastructure and project finance business.

While we consider it yet uncertain as to whether KA will be able to demonstrate a full restoration of its franchise, its business will face additional hurdles when the higher requirements for capital and liquidity under Basel III will be phased in, starting from 2013. We are also concerned that lending margins may remain too low to allow for sufficient returns on the higher capital levels.

Risk Positioning

Given that the lion's share of KA's assets is represented by its public sector finance book, the credit risk of KA's business is relatively low. However, KA currently remains vulnerable given the bank's weak, albeit increasingly focused business profile that is marked by high leverage, high dependence on market funds and low profitability. Moreover, some of its public sector assets that were previously perceived as risk-free, have come under heightened pressure during recent quarters, and the persistent euro area sovereign debt crisis seems far from resolved at the current stage. In the context of the ongoing negotiations of a private-sector participation in the restructuring of Greek sovereign debt, KA has to manage a considerable setback given the required write-down on its sizeable exposure to Greece, which - based on our estimates - may cost the bank roughly one third of its Tier 1 capital (EUR 411 million as of June 2011). As a result, its remaining loss-absorption capacity would be reduced, leaving KA more vulnerable to any further set-backs.

According to the bank's plans, its low-margin, low-risk legacy assets will be replaced with higher margin assets over time, which we expect will translate into gradually increasing credit risk over time. In the initial period of building a targeted lending business, we caution that it may be difficult to accurately price the risk as well as monitor risk adjusted performance, partly as the bank's risk management capabilities are still evolving. We will closely monitor the bank's progress in establishing an appropriate risk management system for the new business and in building a credible track record of a sound risk culture.

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 further (non-Greek) exposures to the more pressured countries in Europe's periphery, given that the credit profile of several of these countries shows a deteriorating trend.

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 E BFSR.

Profitability

KA's earnings profile is mostly driven by its low-margin public sector loan book, allowing for only weak returns from net interest income. Fee and commission income was also weak during the first quarters of KA's establishment. We are also concerned about the relatively high degree of earnings volatility, given the volatile trading and valuation results since 2009. For 2011, KA is expected to post a large loss, because of the need to write-down the lion's share of its exposure to Greece.

Given various structural features of KA's business, size and balance-sheet profile, we take a conservative view on KA's future profitability. KA's intrinsic earnings power (adjusted for one-off items) developed in line with our expectations during 2010 and 2011. However, 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.

While we believe that the demand for municipal project financing will remain high despite austerity measures, especially in KA's targeted CEE markets, we also observe increasing competition from larger institutions that have more diversified franchises and financial flexibility.

Liquidity

KA is fully dependent on wholesale funds and therefore on regular access to debt capital markets. Issuing senior unsecured debt at viable pricing levels has remained challenging during the first few quarters since KA's establishment, although the bank has resumed issuing small senior unsecured tranches under its new EUR 2.0 billion debt issuance program. The weak independent funding franchise of KA currently remains one of the main rating constraints.

Notwithstanding the above mentioned shortcomings, we nevertheless recognise that KA was successful in tapping the markets with a 5-year EUR 0.5 billion public sector covered bond issue in February 2011, which the bank reported was oversubscribed and could be placed with investors in various European countries. That being said, KA has committed to maintaining 28% of over-collateralisation which requires substantial portions of unsecured debt (or deposits) for the funding of its core business. Nonetheless, in combination with EUR 0.2 billion in unsecured private placements and EUR 0.3 billion additional customer deposits, KA could fund its new business during H1 2011.

The bank's break-up in 2009 had an indirect, positive effect on KA's funding profile, because some long-term assets were left behind in KF for unwinding, for which alternative funding was provided, while KA still has the long-term debt of KA Old on its balance sheet. We understand that this resulted in a somewhat better-matched profile of assets and liabilities, which continues to be beneficial for the bank.

Apart from EUR 11 billion of secured and unsecured market funds and EUR 1.9 billion interbank borrowings, KA currently holds EUR 1.9 billion in (institutional) client deposits which showed a healthy increase during recent quarters. We also note that KA remains a net lender in the interbank market. A EUR 1.0 billion government-guaranteed bond is neutral for the bank's funding profile, as it is routed through to KF, whereby the respective claim will mature when the bond matures in 2013.

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 recent market volatility and concerns over public sector credit quality, however, the funding situation remains potentially fragile and government ownership and commitment critically important for several years yet.

Capital Adequacy

KA's Tier 1 ratio stood at 15.5% as of June 2011, slightly lower than the 15.7% reported for December 2010. Notwithstanding satisfactory regulatory capitalisation, we consider that KA's economic capital levels are weak, given its high leverage and the limited absolute capital cushion for unexpected losses. Before the write-down on its exposure to Greece, we had estimated KA's capital cushion (to maintaining a 9% Tier 1 ratio) to be roughly EUR 170 million. Based on our expectation that KA's Tier 1 capital (reported to be EUR 411 million as of June 2011) could be reduced by 30-35%, the cushion will likely be materially reduced, even if it proactively manages (i.e., reduces) its risk-weighted assets (RWA).

We also evaluate capital levels in the context of the borrower concentrations in the loan book, which are high for KA. In addition, we note that there is a persistent risk of stress to the income statement - and thus capital erosion - that could stem from unforeseen credit losses or rising funding costs. We therefore consider that the (reduced) Tier 1 ratio expected for end-2011 may decline over time as KA takes on new lending business in order to rebuild its core franchise.

With a pro-forma Basel III leverage ratio of 2.5% (i.e., Tier 1 capital in % of total assets as of June 2011), KA displayed considerable leverage and may struggle to meet the higher capital requirements under Basel III, which will be phased-in starting from 2013. The losses on Greek bond holdings will likely cause this ratio to slip below 2%. That said, we also expect gradual progress in total asset reduction that might ensure a positive trend in leverage over coming quarters.

Efficiency

Given the loss of economies of scale following the break-up, we consider KA's efficiency as one of the challenges for the standalone bank. Progress on the efficiency of KA will partly depend on the execution of its planned re-focusing and a recovery in core revenues. We caution that the potential for improving efficiencies is limited for the small bank.

Asset Quality

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 inter-bank 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 risk profile of the bank.

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 by the Aaa local-currency deposit ceiling (LCDC) of its underlying support provider and 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 view the probability of systemic support by the Republic of Austria, to be very high based on: (i) the Republic of Austria's 99.78% ownership in KA; and (ii) Austria's demonstrated willingness to support KA over the course of the break-up.

Notching Considerations

KA's subordinated debt is rated at Caa2, which is one notch below the bank's adjusted BCA of caa1.

Foreign Currency Deposit Rating

Our foreign currency deposit ratings for KA are Baa3/Prime-3.

Foreign Currency Debt Rating

Our foreign currency debt ratings for KA are Baa3/Prime-3.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

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 recognize 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%)						**C-**	
Factor: Profitability						**E+**	**Improving**
PPI / Average RWA - Basel II				0.67%			
Net Income / Average RWA - Basel II					-1.57%		
Factor: Liquidity						**E**	**Neutral**
(Mkt 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						**A**	**Neutral**
Cost / Income Ratio	17.92%						
Factor: Asset Quality						**A**	**Neutral**
Problem Loans / Gross Loans	0.00%						
Problem Loans / (Equity + LLR)	0.10%						
Lowest Combined Score (15%)						**E**	
Economic Insolvency Override						**Neutral**	
Aggregate Score						**D+**	
Assigned BFSR						**E**	

[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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