MOODY'S INVESTORS SERVICE

Credit Opinion: Kommunalkredit Austria AG

Global Credit Research - 22 May 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

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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)	207.7	189.4	338.7	314.0	[3]-12.9
Tangible Common Equity (USD million)	273.8	245.9	454.3	450.6	[3]-15.3
Net Interest Margin (%)	0.3	0.3	0.3	0.0	[4]0.2
PPI / Average RWA (%)	1.2	0.8	1.3	0.1	[5]0.8
Net Income / Average RWA (%)	0.8	-5.8	1.0	0.1	[5]-1.0
(Market Funds - Liquid Assets) / Total Assets (%)	66.2	65.4	65.7	58.4	[4]64.0
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 (%)	62.5	67.9	48.2	61.7	[4]60.1
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 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 is constrained by (1) KA's announcement on 16 May 2013 that it will discontinue new business underwriting, and the resulting further franchise impairment; (2) uncertainties relating to the bank's expected unwinding, which may require support to safeguard bondholders from incurring losses; (3) KA's weak economic capitalisation; and (4) 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. The recently reported suspension of the privatisation process was broadly in line with our earlier expectations, which drove our decision to affirm the Baa3 senior debt and deposit ratings in our rating action dated 21 May 2013.

The BFSR and the senior debt ratings carry a stable outlook. The rating for short-term liabilities is Prime-3.

Rating Drivers

- KA's franchise is likely to incur further impairment because of the unsuccessful privatisation and discontinuation of new underwriting

- The run-off of the loan book will exert additional pressure on already weak and volatile profits

- KA is heavily reliant on wholesale funds, rendering it vulnerable to distortions or shocks in the financial markets

- We recognise the improvement in KA's regulatory ratios, but its economic capitalisation is weak and its high leverage exposes KA to tail risk

- As a specialised public-sector lender, KA's asset quality is sound relative to its peers, but its exposure to euro area periphery countries remains substantial

Rating Outlook

KA's standalone E BFSR carries no outlook, reflecting the position of the rating at the low end of the BFSR scale and that there are no prospects of franchise recovery.

The stable outlook on KA's Baa3 long-term ratings reflects our view that in the context of the ongoing sovereign debt crisis, the Republic of Austria is unlikely to risk further disruption of the financial system by allowing a relatively small state-owned bank to default on its senior obligations.

What Could Change the Rating - Up

We consider that upwards ratings momentum is limited. This is based on our expectation 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 Change 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 have an immediate effect on the long-term ratings.

We also note the potential for rating migration if the probability of government support declines and will therefore closely monitor the state's commitment towards KA. However, we do not expect the government to withdraw its support for KA for the foreseeable future.

DETAILED RATING CONSIDERATIONS

FURTHER FRANCHISE IMPAIRMENT EXPECTED BECAUSE OF UNSUCCESSFUL PRIVATISATION AND DISCONTINUATION OF NEW UNDERWRITING

After the Austrian Ministry of Finance had initiated the process of divesting KA in late 2011 in order to comply with the EC-imposed compensation measures for state aid (i.e., a change of ownership), it reported on 16 May 2013 that the efforts to privatise the bank had failed. Given challenging market conditions, the time limit of 30 June 2013 was too difficult to meet.

We take the view that the discontinuation of new underwriting implies a material further impairment of KA's franchise, even though the bank will be allowed to continue certain advisory services that may secure continued fee income. 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.

THE RUN-OFF OF THE LOAN BOOK WILL PLACE FURTHER PRESSURE ON ALREADY WEAK AND VOLATILE EARNINGS

According to KA's earlier forecasts, the replacement of low-margin legacy assets with higher-margin loans would have over time translated into gradually increasing margins and profits. However, as illustrated in 2012, this strategy was not feasible in a challenging environment. The bank's net interest income (NII) eroded by 9.6% during 2012, which was due to a combination of higher funding costs, the lower asset base and a EUR3.5 million loss (negative carry) in the context of the reduced yield on a EUR1.1 billion claim against the Republic of Austria. The recently decided discontinuation of loan underwriting will gradually weaken KA's earnings.

For the financial year 2012, KA reported weak pre-tax profit of EUR18.4 million, which, however, included major (mostly positive) one-off effects that we consider disproportionately large in the context of core revenues and profits. Adjusting for these effects, KA recorded a EUR4.2 million pre-tax loss, i.e., after (1) deducting a EUR34.9 million gain on the repurchase of own debt below par; and (2) adding back a EUR12.3 million loss realised on the sale of assets (loans and securities), which the bank may not have realised in the absence of the one-off gain. The result also includes a EUR10.6 million valuation loss on securities held at fair value, which we do not typically adjust for, and a EUR9.2 million bank levy (2011: EUR7.4 million). KA's adjusted pre-provision income (PPI) was a low EUR4.0 million, or 0.18% of risk-weighted assets (RWA).

Recent developments (reflected in our most recent rating action on KA) illustrate that its income statement is unable to absorb large-scale unexpected losses. The bank also has limited tolerance for further gradual revenue erosion, and it remains to be seen whether KA will manage to reduce costs at a pace that reflects the deterioration of NII.

DEPENDENCE ON, AND LIMITED ACCESS TO, (UNSECURED) MARKET FUNDS IMPLY LIQUIDITY CHALLENGES

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 would expect to be available from the government in order to ensure that KA can unwind its loan book in an orderly fashion. Even before the discontinuation of its lending business was decided, KA's limited access to debt capital markets for unsecured funds was one of the main constraining factors for the standalone E BFSR.

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). It remains to be seen whether KA will be in a position to maintain its institutional client deposits (EUR1.6 billion as of December 2012) to close part of the gap. Available surplus OC of 16% as of year-end 2012 indicates that KA still has flexibility to undertake further covered bond issues.

Following the repayment of EUR150 million in early 2013, KA still relies on drawings of EUR1.35 billion (equivalent to 8.5% 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 reported an improved Tier 1 capital ratio of 12.3% as of year-end 2012 (2011: 12.0%) as the bank was able to reduce RWA by 5.9% to EUR2.29 billion, which more than compensated for a slight decrease in Tier 1 capital to

EUR282 million (-3.1%). KA's total capital ratio was 17.4% as of December 2012 (2011: 15.0 %).

Whilst we recognise the improvement in KA's regulatory ratios, we consider its economic capitalisation to be weak. KA's capital cushion (in order to maintain a 9% Tier 1 ratio) is a modest EUR119 million , leaving the bank vulnerable to market shocks and/or large one-off losses. A EUR42.7 million transfer to reserves (i.e., a general provision for unspecified risk under local GAAP) during 2012 is included in our calculation of the aforementioned buffer.

In addition, an accelerated decline in revenues would likely lead to operational shortfalls in KA's income statement at some point in the next few years (or even quarters), which would gradually erode the bank's current capital position. Moreover, further, occasional, large losses cannot be ruled out, in our view, as illustrated by the impairment of KA's former Greek assets (such assets since sold or fully provisioned), which critically weakened the bank's economic capital levels during 2011-12, and triggered breaches of its regulatory large loan limits.

Furthermore, KA's balance sheet displays very high leverage, with a Tier 1 leverage ratio of 1.8% (i.e., Tier 1 capital as a percentage of total assets as of December 2012), and 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.

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 December 2012, KA's loans and investments included approximately EUR560 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.

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

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