

FITCH DOWNGRADES AUSTRIA'S KA AND KF TO 'BBB+' ON SUPPORT REVISION; OUTLOOK STABLE

Fitch Ratings-Frankfurt/London-19 May 2015: Fitch Ratings has downgraded Kommunalkredit Austria's (KA) and KA Finanz's (KF) Long-term Issuer Default Ratings (IDRs) to 'BBB+' from 'A' and 'A+' respectively. The Outlooks are Stable.

A full list of rating actions is available at the end of this rating action commentary.

The rating actions are in conjunction with Fitch's review of sovereign support for banks globally, which the agency announced in March 2014. In line with its expectations announced in March last year and communicated regularly since then, Fitch believes legislative, regulatory and policy initiatives have substantially reduced the likelihood of sovereign support for US, Swiss and European Union commercial banks.

The EU's Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) are now sufficiently progressed to provide a framework for resolving banks that is likely to require senior creditors participating in losses, if necessary, instead of or ahead of a bank receiving sovereign support. The BRRD has been fully implemented (ie including its bail-in tool) into Austrian law with effect from 1 January 2015.

Although KA and KF are subject to BRRD, Fitch believes that it will not be applied to them as long as their orderly wind-down progresses in line with plans agreed with the European Commission's (EC) state aid authorities. However, should state aid be required further to what has been approved by the EC, the bank may be required to take resolution measures potentially including some bail-in of senior creditors. This risk is reflected in today's downgrade of the IDRs.

Furthermore, we believe that the recent measures taken by the Austrian authorities to resolve Heta Asset Resolution AG (Heta), which includes a 15-month moratorium on Heta's debt payments, could indicate a decrease in the Austrian state's propensity to provide support for wind-down banks. The resulting uncertainty is no longer commensurate with Support Rating Floors (SRF) in the 'A' range.

KEY RATING DRIVERS

The ratings of KA and KF reflect Fitch's view of the high likelihood of support from the Republic of Austria (AA+/Stable), KF's sole owner, which also owns 99.78% of KA. The government has stated that it intends to remain KF's sole shareholder until the bank's wind-down is completed.

Austria's approach to KA's and KF's wind-down was clearly formulated at an early stage, consistently executed since the inception of both banks' wind-down plans and is progressing ahead of expectation. We expect that KA and KF, unlike Heta, will not suffer major losses in the foreseeable future under reasonable stress assumptions. In our view, these characteristics significantly and positively differ from the aggressive resolution measures imposed on Heta since 2014, driven by the government's clear intention to impose a large-scale burden sharing on Heta's senior creditors. The measures taken with Heta were driven by the large scale and highly volatile development of Heta's losses.

Fitch's assessment of the remaining high likelihood of state support for KA and KF is driven by qualitative factors, primarily the banks' state ownership, Austria's commitment and some flexibility to provide support to KA and KF, as outlined in their EC state aid decisions. The strength of the support structures in place for KA and KF and Austria's financial strength are the key rating drivers for both banks. Given the small size of KA and KF in relation to Austria's financial resources, the

downgrade of the sovereign's rating to 'AA+' from 'AAA' in February 2015 has not affected Fitch's view of the sovereign's ability to support.

As part of the EC state aid decisions, the Austrian government is committed to maintaining a Tier 1 ratio of 7% for KF and we understand from management that this commitment (and the EC's state aid decisions) is unaffected by the planned partial merger of KA's assets and liabilities into KF. KF has received net EUR2bn in state support, including EUR1bn in 2011 following Greece-driven losses, and a shareholder contribution of EUR350m in 2013 that allowed the bank to comply with Basel III regulations (it maintained a total capital ratio of 20.9% and a CET1 ratio of 14.5% at end-2014) while actively reducing risk-weighted assets.

Fitch expects that KF will need no additional capital for the foreseeable future, given the nature of its remaining assets which are systematically running off. Concentration in KF's public sector-focussed portfolio remains high but is rapidly declining, increasingly mitigating the risk of significant single losses.

The EC state aid decision concerning KA allows Austria to provide capital and liquidity support, if required, although we understand from management that KA's wind-down plan does not assume any draw-down on available state support. However, depending on the magnitude of any credit losses that may arise and the speed of asset disposal and run-off, further capital injections by the Austrian government could, in Fitch's view, become necessary. Should this be the case, Fitch believes that the Austrian government's propensity to provide capital and/or funding support to KF remains high, even if additional capital requirements would prove to be substantial. This is also true for KA to the extent it remains under Austria's ownership, either directly or as part of KF.

KF benefits from substantial funding guarantees from Austria. These guarantees are large in absolute terms and compared with total liabilities: they amounted to 35% of non-equity funding at KF based on EUR2.4bn utilisation at end-2014. This could be diluted to around 20% of non-equity funding after the planned integration of KA and assuming a full utilisation of EUR3bn. In our view, this represents a strong incentive for the authorities to provide additional support, if required, to protect their investment until the banks' assets are wound down. Moreover, we understand from management that the EC state aid decisions would allow a substantial increase of the volume of state-guaranteed debt.

Most of KA's rated debt securities are on Rating Watch Negative (RWN) following the bank's announcement in March 2015 about the partial sale of KA, in which the government will spin off about EUR4.3bn of KA's assets and a corresponding volume of its debt to a newly established bank to be sold to a consortium consisting of English Interritus Limited and Irish Trinity Investments Limited, managed by London-based asset manager Attestor Capital LLP.

The RWN signals an expected multi-notch downgrade of the notes on transfer to the newly established bank, as they would no longer benefit from sovereign support. We expect this new entity's credit profile to be substantially weaker than necessary to support 'BBB+' ratings. The extent of the downgrade of the notes could be to below investment grade, depending on whether Fitch considers new capital and liquidity buffers substantial enough to protect the senior notes at an investment grade level. The extent of the downgrade will also take into account Fitch's view of likely support from the new owners. Fitch does not usually factor in support from private equity investors into its ratings as their ability and/or commitment to fully support creditors typically cannot be relied upon.

The remainder of KA's assets (about EUR7bn) and liabilities will then be merged into KF. A failure of KA's sale to the private investors could result in 100% of KA's assets and liabilities being merged into KF. Therefore, KF is highly likely to become KA's legal successor and we expect it to retain all rights and obligations attached to this status. For this reason, we have equalised the ratings of the two entities.

Approval for the transaction is pending from KA's relevant governing bodies and regulatory authorities. The transaction is expected to complete by mid-2015. The planned merger of KA's remaining assets and liabilities into KF could necessitate some formal changes to the existing support structures in place for KF and agreed with the EC. However, we would expect any changes to have limited effects because the planned merger of KA's remaining assets and liabilities into KF is unlikely to hinder their wind-down.

KA has published a list of notes which it expects to transfer to KF. The notes on this list rated by Fitch are: XS1017111029, XS1072804484, XS1003354252, XS0235597068, XS1020014608, XS1016032457, XS1040273267, XS1015492595, AT0000329859 and XS0255439803. We believe that further rated notes might eventually be transferred to KF. However, until the full list has been published, most notes will remain on RWN (see full list at the end of this commentary) to reflect the risk that they may be transferred to the private investors.

Fitch does not assign Viability Ratings to KA or KF because they are wind-down institutions whose business models would not be viable without external support.

RATING SENSITIVITIES

KA's and KF's ratings will remain primarily sensitive to Austria's ability and propensity to provide support. Fitch does not believe that the ability of Austria to support KA and KF will diminish materially as long as it remains in the 'AA' category.

The ratings are particularly sensitive to KF's continued progress with its orderly wind-down in accordance with the plan agreed with the EC once it has absorbed the assets and liabilities it receives along with the KA transfer. Deviation from the plan would likely trigger a fresh state aid review and heighten the likelihood of the EC and/or the Single Resolution Board requiring more stringent measures, which could include burden-sharing for senior creditors. This scenario could be driven by large single credit losses that would mean KF requiring further state support, although this is unlikely given that KF's concentration risk has declined significantly in recent years.

We expect to resolve the RWN on KA's notes when the final list of notes to be transferred to the new private investor-owned entity is provided, which we expect to be by end-2Q14. The ratings of the notes to be retained by KF will be equalised with KF's IDRs while the ratings of the notes to be transferred to the new entity are could be downgraded by several notches, potentially to below investment grade, at the time of transfer. The extent of the downgrade will depend on whether Fitch considers new capital and liquidity buffers substantial enough to protect the senior notes at an investment grade level. The extent of the downgrade will also take into account Fitch's view of the likelihood support from the new owners.

KEY RATING DRIVERS AND SENSITIVITIES- SUBORDINATED LOWER TIER 2 DEBT

The 'B' ratings of performing subordinated lower Tier 2 debt securities issued by KF reflect the still material credit risk if state support is excluded and lack of financial flexibility for subordinated instruments. The material credit risk is driven by potential bail-in of the banks' subordinated debt holders that would be triggered by any additional state support to accompany the orderly wind down of these banks and facilitated by BRRD legislation.

In the absence of a VR or alternative rating that could act as an anchor, Fitch has adopted a bespoke analysis of the risks of non-performance and loss severity risks for KF's subordinated lower Tier 2 debt. Fitch differentiates between KF's subordinated lower Tier 2 debt ratings and those of its wind-down bank peers within the 'B' category by comparing these banks' respective operating income forecasts, credit exposures and related potential losses and available capital buffers to determine the potential need for further extraordinary state support. The notching differences reflect Fitch's view of the somewhat different probability of further state support requirement for each bank.

There is upside potential for the subordinated lower Tier 2 debt rating should KF's wind-down progress significantly with capital being retained at the same time. Downside pressure arises from the risk of the instruments being bailed-in if new state aid is required. Should these instruments be bailed in then loss severity would likely be high, which could result in a downgrade to 'CC' or 'C'.

KEY RATING DRIVERS AND SENSITIVITIES - JUNIOR SUBORDINATED DEBT

KF's junior subordinated debt rating of 'C' reflects the deferral of coupon payments and Fitch's view that payments are unlikely to be resumed given that KF is in wind-down. Fitch does not expect that this instrument will become performing and therefore sees no upside for the instruments' ratings.

KEY RATING DRIVERS AND SENSITIVITIES - GUARANTEED DEBT

The Short-term rating of KF's government-guaranteed commercial paper programme (EUR3bn, of which about EUR2.4bn was outstanding at end-2014) has been affirmed at 'F1+' and reflects the state guarantee supporting the programme. A negative rating action would be triggered in the highly unlikely event of a downgrade of Austria's Short-term IDR.

The rating actions are as follows:

Kommunalkredit Austria AG

Long-term IDR: downgraded to 'BBB+' from 'A', Stable Outlook

Short-term IDR: downgraded to 'F2' from 'F1'

Support Rating: downgraded to '2' from '1'

Support Rating Floor: revised to 'BBB+' from 'A'

Long-term senior unsecured notes: downgraded to 'BBB+' from 'A'. The following notes are affected: XS1017111029, XS1072804484, XS1003354252, XS0235597068, XS1020014608, XS1016032457, XS1040273267, XS1015492595, AT0000329859 and XS0255439803.

Long-term senior unsecured notes: downgraded to 'BBB+' from 'A'; maintained on RWN

The following notes are affected:

, XS0219895413, XS0219500500, XS0220012727, XS0223008813, XS0312417313,
XS0312417743, XS0972624117, XS0200950599, XS0981809584, XS0238189657,
XS0238190150, XS0234510930, XS0236347240, XS1005197477, XS0238071228,
XS0241451581, XS0186736228, XS0187975262, XS0247759094, XS1048251091,
XS1055031139, CH0025370906, XS1073920255, XS0266826659, XS0223929216,
XS0363735712, XS0252593198, XS0171595183, XS0172076365, XS0214564972,
XS0190348952, XS0192480977, XS0100920353, AT0000320858, XS0163624504,
XS0104786263, XS0208913276, XS0210167218, XS0212470149, XS0213230047,
XS0215049395, XS0215865287, XS0218474533, XS0252786669, XS0218874633,
XS0221102840, XS0222391632, XS0224859545, XS0231018747, XS0231084293,
XS0239396905, XS1013581274, XS0243179354, XS0157911958, XS0161439954,
XS0162167398, XS0169415659, XS0170583123, XS0190871409, XS0194530571,
XS0201565115, XS0214981812, XS0216184621, XS0222762477, XS0234789351,
XS0243771218, XS0253410236, XS0253139686, XS0231118455, XS0184959376,
XS0205974701, XS0168795689, XS0169291829, XS0169321832, XS0169641312,
XS0170243702, XS0169901328, XS0172801986, XS0173644724, XS0188313414,
XS0189430183, XS0200492436, XS0215839019, XS0238702400, XS0242667888,
XS0243373247, XS0244638770, XS0245268015, XS0248796749, XS0254901852,
XS0254902405, XS0258515443, XS0306952598.

Long-term senior unsecured market-linked notes: downgraded to 'BBB+emr' from 'Aemr'; maintained on RWN

The following notes are affected:

XS0313834557, XS0227969929, XS0233055424, XS0169312179, XS0172124603, XS0193213393,
XS0230962002, XS0340901908, XS0158079540, XS0158239680, XS0164432394,
XS0166841121, XS0160009493, XS0162912934, XS0164603036, XS0167712016,
XS0167426864, XS0168578317, XS0168909108, XS0170112519, XS0171468746,
XS0181793935, XS0185849568.

Short-term senior unsecured notes rating: downgraded to 'F2' from 'F1', remains on RWN
Debt issuance programme: downgraded to 'BBB+/'F2' from 'A/'F1', remains on RWN

KA Finanz AG

Long-term IDR: downgraded to 'BBB+' from 'A+'; Outlook Stable

Short-term IDR: downgraded to 'F2' from 'F1+'

Support Rating: downgraded to '2' from '1'

Support Rating Floor: revised to 'BBB+' from 'A+'

Long-term senior unsecured notes: downgraded to 'BBB+' from 'A+'

Short-term senior unsecured notes: downgraded to 'F2' from 'F1+'

Subordinated lower tier 2 debt (XS0257275098, AT0000441209, XS0185015541, XS0144772927
and XS0255270380): affirmed at 'B'

Junior subordinated debt (XS0284217709 and XS0270579856): affirmed at 'C'

Government-guaranteed commercial paper programme: affirmed at 'F1+'

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Additional information is available on www.fitchratings.com

Applicable criteria, 'Global Bank Rating Criteria', dated 20 March 2015 are available at
www.fitchratings.com.

Applicable Criteria and Related Research:

Global Bank Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=863501

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