



Moody's Investors Service

## Rating Action: Moody's assigns E+/Baa1 ratings to "new" Kommunalkredit after break-up

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Frankfurt, December 02, 2009 -- Moody's Investors Service today assigned an E+ bank financial strength rating (BFSR), Baa1 long-term senior debt and deposit ratings and Baa2 ratings for subordinated liabilities to the newly established Kommunalkredit Austria AG (Kommunalkredit). All these ratings carry a stable outlook. Moody's also assigned Prime-2 short-term ratings to the bank.

At the same time, Moody's downgraded the ratings of KA Finanz AG (the renamed former Kommunalkredit Austria AG and its legal successor) to Baa3 and the ratings of KA Finanz AG's subsidiary, Kommunalkredit International Bank Ltd (KIB), to Ba1, and also downgraded various hybrid instruments of KA Finanz AG, as detailed below.

The rating actions follow the break up of the former Kommunalkredit Austria AG ("old Kommunalkredit") on 28 November 2009.

"Old Kommunalkredit" was nationalised by the Republic of Austria (now a 99.78% shareholder) after a liquidity squeeze in November 2008. Mostly due to the valuation losses on its excessive CDS portfolio -- the group sold protection of a nominal EUR13.5 billion in relation to total assets of EUR37.5 billion at the end of 2008 -- Kommunalkredit group reported a consolidated pre-tax loss of EUR1.5 billion for financial year 2008 and negative equity of EUR1.2 billion under IFRS. The bank has now been broken up into a going concern entity (the "new" Kommunalkredit Austria AG) and a company to be wound down.

The performing assets, i.e. the public lending, the municipal project finance and a part of the securities portfolio, were transferred to Kommunalkredit Depotbank AG, a 100% subsidiary of "old Kommunalkredit" that was then renamed Kommunalkredit Austria AG. The assets that led the former Kommunalkredit into severe financial trouble, i.e. the CDS portfolio, the structured securities portfolio and the largest part of the securities portfolio, remained on the books of "old Kommunalkredit". This entity changed its name to KA Finanz AG on 28 November 2009, but remains the legal successor to "old Kommunalkredit".

### E+ BFSR OF NEW ENTITY REFLECTS WEAK FRANCHISE AND CAPITAL GENERATION CAPACITY

The "new" Kommunalkredit's E+ BFSR translates to a Baseline Credit Assessment (BCA) of B2 and reflects Moody's assessment of the bank's weak overall financial profile.

Moody's notes that, although the bank is no longer being burdened by its problem portfolios, the newly formed Kommunalkredit still has the franchise of a public sector lender with its roughly EUR10 billion low-margin public sector lending book in relation to total assets of around EUR15 billion. The public sector loan portfolio will be wound down only slowly over time and, according to the bank's strategy, be replaced by higher-margin municipal project finance business, which, however, will expose the bank to higher and different sorts of risk. In this context, Moody's has concerns about the bank's risk management track record and whether it will manage to establish an appropriate risk management system for its new business.

"We understand that Kommunalkredit has parted with its non-performing portfolios and is trying to establish a new and sustainable franchise. However, building this new franchise and providing a track record of sustainable profits and sound risk management will be very challenging and, at best, will take several years. In the meantime, the 13% Tier 1 ratio provides some degree of buffer in the event of losses exceeding the bank's marginal profits, but we also note the bank's high leverage and the very low risk weighting of many of its assets. We certainly expect the Tier 1 ratio to decline over time as the company takes on new business that weighs more heavily on the risk-weighted assets than the current public sector lending book," explains Dominique Nutolo, a Moody's Assistant Vice President and lead analyst for Austrian banks.

Moody's understands that, despite the break up of "old Kommunalkredit", the future entities will both be liable for legacy obligations existing at the time of the break up. However according to Austrian law and information provided by the bank, "new" Kommunalkredit's liabilities against KA Finanz AG's creditors are

limited to the realizable value of the net assets conveyed to "new" Kommunalkredit in the break up. This was estimated at EUR 40 million by Kommunalkredit's management, a formal appraisal not being required in the course of the break up, without this appraisal being necessarily authoritative and enforceable in a court of law, as Moody's understands. As KA Finanz AG is primarily short-term funded, Moody's expects this contingent liability to decrease relatively quickly over time.

Overall, Moody's believes that the E+ BFSR adequately reflects Kommunalkredit's profile given its weak franchise of a public lender with a growing project finance book, at-best marginal profits and weak track record in risk management. As a consequence, Moody's believes that Kommunalkredit may again become reliant on outside systemic support to continue as a going concern in the short-to-medium term.

The break-up of Kommunalkredit is part of a restructuring plan that was handed to the European Commission in June 2009 for approval. The approval process is still ongoing and Moody's will need to assess whether its outcome will further affect Kommunalkredit's ratings.

The stable outlook on the E+ BFSR reflects Moody's view that, in the short-to-medium term, there is unlikely to be significant upward or downward pressure on the rating. Any upgrade would most likely depend on the group providing a track record of sustainable profits and sound risk management over several quarters; the through-a-cycle sustainability of the group's business model is likely to take several years to be demonstrated. A downgrade could be triggered if losses exceed those expected under Moody's baseline stress scenario, exerting pressure on the bank's capital ratios and undermining its strategy and longer-term viability.

#### SENIOR DEBT RATINGS RECEIVE LARGE UPLIFT FROM BCA DUE TO VERY HIGH PROBABILITY OF SYSTEMIC SUPPORT

Kommunalkredit's Baa1 long-term debt and deposit ratings benefit from Moody's assessment of a very high probability of systemic support. This support has already been demonstrated by the rescue and takeover of the bank by the Republic of Austria in the course of the financial crisis and also by the injection of a further EUR250 million of fresh capital in the course of the break up, which underpins the multi-notch uplift from the BCA.

At the Baa1 level, the bank's ratings reflect the nationalisation and the current support from the Aaa-rated Austrian government, but also its impaired franchise and longer-term uncertainty about its future as a standalone viable entity, as well as the absence of unconditional and irrevocable guarantees by the Austrian government. However, Moody's also notes the potential for a large rating migration should the probability of government support decline and will therefore very closely monitor the state's commitment towards the entity and its timetable for withdrawing its extraordinary support. The latter could lead to a multi-notch downgrade in the event of the bank's intrinsic credit profile not being sufficiently strengthened.

The stable outlook on the senior debt ratings reflects Moody's view that, in the short term, there is only very limited up or downside potential for the ratings. While Moody's acknowledges that the Republic of Austria will need to sell the bank due to legal requirements, the rating agency also believes that such a sale will only be possible in the medium-to-long term, which could then exert severe adverse pressure on the ratings as the rating agency would need to reassess the probability of systemic support. Positive pressure on the ratings could be exerted by either a multi-notch upgrade of the BFSR or the Republic of Austria's explicit guarantee of all outstanding debt. Moody's believes that both scenarios are very unlikely at this point in time.

#### KA FINANZ AG'S LONG-TERM RATINGS DOWNGRADED TO Baa3; BCA LOWERED TO Caa3

Moody's lowered KA Finanz AG's BCA to Caa3 from Caa2 (although it still maps to an E BFSR) and downgraded its long-term debt and deposit ratings to Baa3 from Baa1, subordinated ratings to Ba1 from Baa2 and short-term ratings to Prime-3 from Prime-1. The BFSR carries a stable outlook, while the outlook on the long-term debt and deposit ratings is negative. The Aaa rating for debt guaranteed by the Republic of Austria was affirmed with a stable outlook.

The E BFSR reflects Moody's view that KA Finanz AG, as an entity in the process of being wound down, lacks a franchise and will be loss making during its wind-down, requiring ongoing support.

KA Finanz AG holds a nominal CDS portfolio of approximately EUR10 billion, structured credit of approximately EUR2 billion and a securities portfolio of approximately EUR9.5 billion (i.e. the assets that led

Kommunalkredit into financial trouble), while its total assets amount to around EUR17 billion. The portfolios will mature over time and the entity will not generate any new business. As Moody's expects that the bank will be loss making going forward, its orderly wind down depends on ongoing systemic support.

The stable outlook on the E BFSR reflects Moody's view that, in the short-to-medium term, there is no upward pressure on the rating.

The Baa3 senior long-term debt and deposit ratings benefit from Moody's assessment of a very high probability of systemic support. The Republic of Austria has again demonstrated its willingness to support by providing an EUR1 billion guarantee for a debtor warrant for KA Finanz AG. Moody's believes that the Austrian government will step in if required to allow for an orderly winding down of the bank such that its senior debt holders are protected. The negative outlook on the Baa3 ratings indicates the high transition risk in the ratings. Pressure on the ratings could be exerted by a reassessment of the probability of systemic support, for example if the bank's Tier 1 ratio were to decline from the current 7.3%, as this level is only maintained with strong systemic support.

#### DOWNGRADE OF HYBRID INSTRUMENTS REFLECTS INCREASED RISK OF COUPON LOSSES AND PRINCIPAL WRITE DOWNS

Moody's downgraded the following hybrid instruments of KA Finanz AG to C from Ca:

- Participation Capital Notes (balance-sheet loss trigger, non-cumulative with principal write-down feature, ISINs: XS0252707624, XS0285503248);

- Ergänzungskapital (junior subordinated notes, net loss trigger, cumulative with principal write-down feature ISINs:XS0270579856, XS0284217709);

- Kommunalkredit's JPY5 billion Schuldscheindarlehen, due 2034 (net loss trigger, cumulative with principal write-down feature); and

- Capital Notes issued by Kommunalkredit Capital I Limited (balance-sheet loss trigger, non-cumulative, ISIN: DE000A0DHT43).

Moody's understands that the hybrid capital notes remain on KA Finanz AG's book after the break up of Kommunalkredit, whereby the principal of the Participation Capital Notes and the Ergänzungskapital was reduced to 75.83% of the original claim. As compensation, the note holders receive new instruments issued by Kommunalkredit with a nominal claim of 24.17% and with identical features to the original instruments.

As Moody's stated earlier, it regards coupon losses for KA Finanz AG's hybrids as very likely since the company announced that it expects a net loss for the 2009 financial year on its standalone financial statements under local GAAP, which will likely exceed the reserves and therefore might also result in a balance-sheet loss. Hence, the rating agency expects that the balance-sheet loss trigger and the net loss trigger of the above hybrid instruments will be breached and as a result coupon payments on the hybrid securities will not be made for the foreseeable future.

In addition, all of the hybrid instruments listed above, except for the Capital Notes, have a principal write-down feature. Therefore, Moody's expects severe principal losses going forward for those instruments.

As all the hybrid instruments are deeply subordinated, Moody's believes that their recovery under a wind-down scenario would be very unlikely.

The outlook on all the hybrid instruments is stable.

#### DOWNGRADE OF KIB'S LONG-TERM RATINGS; LOWERING OF ITS BCA

Moody's lowered KIB's BCA to Caa3 from Caa2 (although it still maps to an E BFSR), and downgraded its long-term ratings to Ba1 from Baa2 and its short-term ratings to Not Prime from Prime-2. The BFSR carries a stable outlook, while the outlook on the long-term debt and deposit ratings is negative. KIB has remained a subsidiary of KA Finanz AG since Kommunalkredit's break up.

KIB's ratings are aligned with the ratings of its parent, KA Finanz AG, reflecting that the 100% subsidiary is an integral part of the bank. Its long-term ratings are one notch lower than those of its parent due to the lower probability of systemic support from the Austrian government for a Cyprus-based non-guaranteed

entity. Like its parent, KIB has stopped initiating new business and is now in the process of winding down its operations. Moody's understands that the bank will be absorbed by its parent over the course of the next year.

#### RATING HISTORY AND MOODY'S METHODOLOGIES

Moody's previous rating action on Kommunalkredit was published on 13 October 2009 when the rating agency downgraded the bank's BFSR to E from D, its long-term senior debt and deposit ratings to Baa1 from Aa3 and its short-term ratings to Prime-2 from Prime-1.

The principal methodologies used in rating Kommunalkredit were "Moody's Bank Financial Strength Ratings: Global Methodology", published in February 2007, "Incorporation of Joint-Default Analysis into Moody's Bank Ratings", published in March 2007, and "Moody's Guidelines for Rating Bank Hybrid Securities and Subordinated Debt", published in November 2009, and are available on [www.moody.com](http://www.moody.com) in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Headquartered in Vienna, Kommunalkredit Austria reported consolidated assets of EUR33.5 billion at the end of June 2009 and an after-tax profit of EUR224.6 million in H1 2009.

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