



Moody's Investors Service

Rating Action: **Moody's downgrades Kommunalkredit to Baa1/E from Aa3/D**

Global Credit Research - 13 Oct 2009

Kommunalkredit's subsidiary Kommunalkredit International Bank Ltd downgraded to E/Baa2

Frankfurt, October 13, 2009 -- Moody's Investors Service today downgraded the bank financial strength rating (BFSR) of Kommunalkredit Austria AG (Kommunalkredit) to E from D. The long-term senior debt and deposit ratings were downgraded to Baa1 from Aa3 and the subordinated liabilities to Baa2 from A1. All these ratings carry a stable outlook. Kommunalkredit's short-term rating was downgraded to Prime-2 from Prime-1. At the same time, Moody's also downgraded Kommunalkredit's subsidiary, Kommunalkredit International Bank Ltd (KIB), and various hybrid instruments of Kommunalkredit, as detailed below.

Moody's affirmed, with a stable outlook, Kommunalkredit's Aaa ratings for debt guaranteed by the Republic of Austria. The rating actions conclude the review of Kommunalkredit and KIB initiated in February 2009.

"The downgrade of Kommunalkredit's ratings reflects the bank's lack of financial flexibility, as expressed by its negative equity under IFRS principles. However, the weakness of its standalone credit quality is mitigated by our expectation of ongoing support from the Austrian government, which is now the bank's owner following nationalisation last year. The Baa1 ratings include a very high probability of systemic support, but also incorporate a degree of longer-term uncertainty about the bank's strategy and viability," says Dominique Nutolo, Assistant Vice President and lead analyst for Austrian banks at Moody's.

DOWNGRADE OF BFSR DUE TO NEGATIVE EQUITY AND LACK OF CAPITAL GENERATION CAPACITY

Kommunalkredit's downgraded E BFSR translates to a Baseline Credit Assessment (BCA) of Caa2 and reflects Moody's assessment of the bank's overall very strained financial profile. The bank 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 of EUR2.6 billion on its excessive CDS portfolio -- the group has sold protection of a nominal amount of EUR13.5 billion compared with total assets of EUR37.5 billion at the end of 2008 -- Kommunalkredit group reported a consolidated pre-tax loss of EUR1.5 billion for the 2008 financial year and negative equity of EUR1.2 billion under IFRS. Despite the bank reporting a pre-tax profit of EUR225 million in H1 2009, its equity still remains at a negative EUR490 million under IFRS accounting principles. The H1 result was driven by the positive valuation result of the CDS portfolio of EUR343.4 million.

Despite its negative equity at a group level, Moody's notes that Kommunalkredit is still classified as a going concern by the Austrian regulator with a Tier 1 ratio of 8.3% at the end of June 2009 under local GAAP. Under local accounting rules, the bank's financial performance has been unaffected by fair value fluctuations as CDS are treated like guarantees. Consequently, the bank reported positive EUR604 million equity on a standalone basis at the end of June.

However, Moody's ratings are based on the group's financials under IFRS. They are designed to show the financial performance of an economic entity and are therefore in the focus of the financial market participants, while the standalone financial statements focus on the legal entity. Therefore, Kommunalkredit's negative equity under IFRS is a sign of its severe financial distress.

Moody's also remains concerned about the group's business franchise as a public lender. Its business model of short-term funding and low-margin long-term lending to the public sector has been exposed during the crisis as unsustainable and does not supply a sufficient margin with which to buffer the high volatility of Kommunalkredit's CDS portfolio. In addition, the business faces higher capital requirements, while the margins will most likely be too low to generate sufficient returns on such higher capital levels.

Moody's notes that Kommunalkredit's funding flexibility is very constrained. The bank previously relied on a high proportion of medium- and short-term debt for the funding of its long-term assets. It now fully depends on the support of the Austrian government for its refinancing.

According to Moody's, it may take the group an extended time to become profitable again. The low margins in its core business leave only a small buffer against the increased funding costs and the incremental costs

for guarantees and capital provided by the Republic of Austria.

As a consequence, Moody's believes that it will take at least several years for Kommunalkredit to be able to again tap the capital markets as a standalone, unsupported entity. Market access will likely remain limited until the group has been restructured and shows sustainable profits from its core business.

Overall, Moody's believes that the E BFSR now adequately reflects Kommunalkredit's profile given its negative equity and its impaired franchise as a public lender with a low margin business and -- in relative terms -- an oversized CDS portfolio. As a consequence, Kommunalkredit is currently dependent on outside systemic support to continue as a going concern.

Moody's notes that Kommunalkredit in June 2009 provided a restructuring plan to the European Commission, whose review has not yet been finalised. The plan proposes that the bank will be divided into a 'going concern' bank and an entity to be wound down. Moody's understands that, despite the bank's planned break-up, the future entities will both be liable for all legacy obligations. Therefore, it believes that the restructuring will have no impact on the financial strength of the 'going concern' bank or the entity to be wound down. According to the restructuring plan, the 'going concern' bank will focus on municipal and infrastructure-related project business going forward. The rating agency will reassess the bank's credit profile once the restructuring plan has been agreed with the European Commission.

The stable outlook on the E BFSR reflects Moody's view that, in the short-to-medium term, there is very limited upward pressure on the rating. Any upgrade would depend on the group being adequately recapitalised and returning to profitability, and its franchise recovering on a sustained basis, among other factors.

SENIOR DEBT RATINGS RECEIVE LARGE UPLIFT 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 (demonstrated by the rescue and takeover of the bank by the Republic of Austria in the course of the financial crisis) and therefore receive a multi-notch uplift from the BCA.

Despite the bank's nationalisation and the support from the Aaa-rated Austrian government, the Baa1 ratings reflect the bank's impaired franchise and longer-term uncertainty about its future as a standalone viable entity.

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. Moody's believes that the Republic of Austria will be able to sell the bank only in the medium-to-long term, which could then exert adverse pressure on the ratings as the rating agency would reassess the probability of systemic support. Positive pressure on the ratings could be exerted by either a multi-notch upgrade of the BFSR or by the Republic of Austria's explicit guarantee of all outstanding debt. Moody's believes that both scenarios are very unlikely at the moment.

DOWNGRADE OF HYBRID INSTRUMENTS REFLECTS INCREASED RISK OF COUPON LOSSES

Moody's notes that coupon losses for Kommunalkredit's hybrid securities have become 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 and therefore does not expect to pay coupons on its hybrid instruments in 2010 for the 2009 financial year.

i) Moody's downgraded Kommunalkredit's participation capital notes (ISINs: XS0252707624, XS0285503248) to Ca from Caa1. The downgrade reflects the rating agency's expectation of a high likelihood that coupons will not be paid for 2009 and 2010 and 2011 due to a breach of the distributable profit trigger and a high likelihood of a principal write-down, as announced by the bank. The instruments are non-cumulative.

ii) The Capital Notes issued by Kommunalkredit Capital I Limited (ISINs: DE000A0DHT43) were downgraded to Ca from Caa1 as a result of the high likelihood of three coupon losses for 2009 and 2010 and 2011. The instruments have a distributable profit trigger and are non-cumulative. Moody's believes that Kommunalkredit's reserves are not sufficient to compensate for losses in coming years.

iii) Moody's downgraded Kommunalkredit's JPY5 billion Schuldscheindarlehen, due 2034 and the bank's Subordinated notes (ISINs: XS0270579856, XS0284217709) to Ca from B1. The downgrade reflects the

rating agency's expectation of a high likelihood that coupons will not be paid for 2009 and 2010 and 2011 due to a breach of the net loss trigger. Due to the net loss principal write-down trigger and the bank's announcement that it expects to report a loss in 2009, there is an increased likelihood of a principal write-down. The instruments are cumulative and have a long maturity (2019, 2021 and 2034). However, due to Kommunalkredit's current financial performance, it is uncertain whether deferred coupons will be paid out in the future.

The outlook on all the hybrid instruments is stable.

DOWNGRADE OF KIB'S BFSR AND LONG-TERM RATINGS

Moody's downgraded KIB's BFSR to E (BCA of Caa2) from D, its long-term ratings to Baa2 from A1 and its short-term rating to Prime-2 from Prime-1.

KIB's ratings are fully aligned with the ratings of its parent Kommunalkredit, reflecting that the 100% subsidiary is an integral part of Kommunalkredit. KIB has stopped initiating new business and is now in the process of winding down its operations. The bank will most likely be absorbed by its parent in the course of the group's restructuring.

The one-notch difference between the long-term ratings of the parent (Baa1) and the ratings of KIB (Baa2) reflect the lower probability of systemic support for a foreign subsidiary.

RATING HISTORY AND MOODY'S METHODOLOGIES

Moody's previous rating action on Kommunalkredit was implemented on 17 February 2009, when the rating agency downgraded the bank's BFSR to D from C- and kept all the ratings, including the Aa3 senior debt and deposit ratings, on review for further downgrade.

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 "Guidelines for Rating Bank Junior Securities", published April 2007, and are available on 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.

Frankfurt
Dominique Nutolo
Asst Vice President - Analyst
Financial Institutions Group
Moody's Deutschland GmbH
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

Frankfurt
Carola Schuler
Managing Director
Financial Institutions Group
Moody's Deutschland GmbH
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454



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