

RatingsDirect®

KA Finanz AG

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Major Rating Factors

Strengths:

- Very high likelihood of extraordinary government support from the Republic of Austria.
- Strong implicit benefits for the stand-alone credit profile, due to the state's strategic ownership and repeated support actions.

Counterparty Credit Rating

A/Watch Neg/A-1

Weaknesses:

- Business limits owing to its run-off status.
- Very low earnings from the legacy portfolio.
- Reliance on government support to meet capital, funding, and liquidity needs.

CreditWatch

Standard & Poor's Ratings Services' ratings on Austria-based KA Finanz AG are on CreditWatch with negative implications. This reflects our opinion that the introduction of special legislation to bail-in Hypo Group Alpe Adria's (HGAA's) subordinated debtholders, despite a grandfathered guarantee provided by the State of Carinthia, and the political considerations around the restructuring of HGAA may decrease the likelihood of state support from the Republic of Austria to 100%-owned government-related entity (GRE) KA Finanz.

In our view, if losses are ultimately imposed on HGAA's bondholders despite the grandfathered guarantee from Carinthia, or if developments surrounding HGAA trigger a general change in the Austrian government's attitude toward bank support, the result may be a weakening of state support for systemically important banks and GREs in the country. In such a scenario, we might change our opinion on the probability of support for KA Finanz from the Austrian government if we believed that KA Finanz's role for, and link to, Austria had weakened. We note that Austria has no legal obligation to support KA Finanz indefinitely.

We would likely downgrade the bank if the law is enacted as currently under discussion. We expect to resolve the CreditWatch over the next three months or once there is clarity on the timing and details of the upcoming law.

A downgrade could also be triggered by our reassessment of the economic and industry risks for banks operating in Austria, leading to a weaker starting point for our ratings on Austrian banks.

Deterioration of KA Finanz's stand-alone financial profile would likely trigger a negative rating action on the bank unless the government provided timely support. We would lower the ratings if the government did not deliver on its commitment to sustain the bank's regulatory Tier 1 capital ratio at more than 7%. Its failure to sustain the ratio above this threshold would cause a deterioration of capital and lead us to reassess our view of the likelihood of state support. We would also lower the ratings if the bank proved unable to sustain its current funding and liquidity profile.

We could affirm the ratings if the government decided not to impose losses on HGAA's grandfathered bondholders.

In contrast to our rating on KA Finanz's unguaranteed commercial paper program (CP), our 'A-1+' rating on the state-guaranteed CP program is not on CreditWatch. This reflects our expectation that the Republic of Austria will honor its guarantees on that program.

Rationale

Our ratings on KA Finanz reflect its anchor of 'bbb+', which represents our view of the economic environment in the countries the bank is exposed to and banking industry risk in Austria.

We assess KA Finanz's stand-alone credit profile (SACP) at 'bbb-'. We consider the bank's business position to be "adequate," as our criteria define this term, and a neutral ratings factor. This is because, following its legal separation from Kommunalkredit Austria AG, KA Finanz has been working out its legacy portfolio and no longer engages in new business. We assess the bank's capital and earnings as "moderate." We also assume that the state is committed to keeping the bank's regulatory Tier 1 capital ratio higher than 7%. In our assessment, KA Finanz's risk position is "moderate." The portfolio run-off has led to a reduction of concentration risk, which was an improvement year on year. However, single-name risk concentrations remain relatively high.

We view funding as "average" and liquidity as "adequate." Our assessment is based on KA Finanz's close ties to, and likely ongoing support from, its sole owner, the Austrian government.

The ratings factor in the bank's status as a GRE and our view of a "very high" likelihood of extraordinary support from the Austrian government. Due to expected extraordinary state support, we currently rate the bank four notches above its SACP.

Anchor: 'bbb+' reflecting internationally diverse portfolios

Our bank criteria use our Banking Industry Country Risk Assessment's economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating only in Austria is 'a-', based on an economic risk score of '2' and an industry risk score of '3'.

KA Finanz's exposure is primarily in securities widely spread outside Austria. Because KA Finanz's assets include riskier portfolios than its Austrian assets, our anchor for KA Finanz is 'bbb+', one notch lower than that for banks operating exclusively in Austria.

The geographic split of the securities portfolio is likely to change during the run-off process. In the medium term, we don't expect this shift to be significant enough to trigger a change in the anchor. However, the combination of a change in our assessment of economic risks in the portfolio and industry risks for banks operating in Austria may lead to a weaker starting point for our ratings on KA Finanz.

Table 1

KA Finanz AG Key Figures					
	--Year-ended Dec. 31--				
(Mil. €)	2013	2012	2011	2010	2009
Adjusted assets	8,194.2	10,969.5	14,901.3	16,491.6	17,657.3

Table 1

KA Finanz AG Key Figures (cont.)					
Customer loans (gross)	2,301.9	2,782.8	3,440.2	3,549.0	2,140.4
Adjusted common equity	403.6	403.6	474.3	110.6	(59.6)
Operating revenues	(50.1)	(153.6)	(187.2)	(228.5)	(140.2)
Noninterest expenses	17.5	19.9	30.3	26.3	31.7
Core earnings	0.0	(70.7)	(1,052.6)	(2.3)	(1,117.0)

Business position: A run-off entity executing political will

KA Finanz is 100% state owned and was formed to execute political policy to stabilize the Austrian banking market. Its only task is the orderly run-off of legacy portfolios, without engaging in new business. The "adequate" assessment reflects our expectation that KA Finanz's business model will be preserved until the run-off is completed; therefore we consider its business position to be a neutral factor for the rating.

As part of Kommunalkredit Austria's restructuring, initiated after the liquidity crisis in 2008, it was split into two independent entities: Kommunalkredit Austria and KA Finanz. KA Finanz's function is to manage down all the non-core assets of the former Kommunalkredit. The European Commission approved the restructuring plan on March 31, 2011.

We expect any unforeseen volatility relating to KA Finanz's work-out efforts to be mitigated by timely support from the Republic of Austria. As such, weaknesses of the run-off-entity model are compensated by implicit state support, in our view. Also, risks regarding KA Finanz's reliance on the new Kommunalkredit Austria for certain services and expertise are mitigated by the state's ownership of both entities.

Table 2

KA Finanz AG Business Position					
	--Year-ended Dec. 31--				
(%)	2013	2012	2011	2010	2009
Return on equity	0.0	(16.1)	(182.7)	0.0	(605.8)

Capital and earnings: Moderate assessment, including implicit benefits of state support

The risk-adjusted capital (RAC) ratio stood at 9.2% as of Dec. 31, 2013, having improved more than we anticipated from 6.15% as of Dec. 31, 2012. Our forecast, however, reflects uncertainties about potential impairment charges, in light of still relatively high risk concentrations. We are also uncertain about the bank's capital policy during the run-off process. We cannot rule out the risk that the Austrian government may ask KA Finanz to upstream capital at any point during the run-off process.

Reflecting the uncertainties, we project the RAC ratio to be in the 5%-7% range over the next two years. We therefore assess KA Finanz's capital and earnings as "moderate," reflecting repeated support measures from the state in the past and our expectation that Austria will provide KA Finanz with the necessary capital support in times of need.

The weak link in the capital assessment is our expectation of volatility in the bank's earnings. This is owing to KA Finanz's concentration risks and exposure to cyclical industries that might lead to loan loss impairments, particularly in

light of its modest profitability. We acknowledge, however, that the volatility of earnings will decrease with the ongoing reduction of concentration risks. Also, we expect the bottom line to benefit from the maturity of the relatively expensive state-guaranteed funding.

Despite the recent strong improvement of KA Finanz's capital ratios, we believe its capital position needs ongoing government commitment and support, but also that Austria would be able and willing to provide support if needed. The Austrian government has committed to ensuring that KA Finanz will sustain a Tier 1 regulatory capital ratio higher than 7%.

Table 3

KA Finanz AG Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2013	2012	2011	2010	2009
Tier 1 capital ratio	12.4	8.3	7.3	7.5	7.6
S&P RAC ratio before diversification	9.2	6.1	5.2	1.6	(0.7)
S&P RAC ratio after diversification	9.1	6.1	4.6	1.5	(0.7)
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	75.2	100.0
Net interest income/operating revenues	26.3	28.3	10.5	7.2	(7.6)
Fee income/operating revenues	105.2	65.9	98.7	85.5	102.3
Market-sensitive income/operating revenues	(31.5)	6.4	(8.5)	7.5	9.4
Noninterest expenses/operating revenues	(34.9)	(13.0)	(16.2)	(11.5)	(22.6)
Preprovision operating income/average assets	(0.7)	(1.3)	(1.4)	(1.5)	(0.7)
Core earnings/average managed assets	0.0	(0.5)	(6.7)	(0.0)	(4.7)

Table 4

KA Finanz AG RACF [Risk-Adjusted Capital Framework] Data					
(Mil. €)	Exposure*	Basel II RWA	Average Basel II RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)
Credit risk					
Government and central banks	5,973	988	17	1,901	32
Institutions	2,526	425	17	268	11
Corporate	1,892	1,143	60	1,447	76
Retail	0	0	0	0	0
Of which mortgage	0	0	0	0	0
Securitization	622	622	100	676	109
Other assets	84	79	93	93	110
Total credit risk	11,098	3,256	29	4,385	40
Market risk					
Equity in the banking book¶	0	0	0	0	1,250
Trading book market risk	--	0	--	0	--
Total market risk	--	0	--	0	--
Insurance risk					
Total insurance risk	--	--	--	0	--

Table 4

KA Finanz AG RACF [Risk-Adjusted Capital Framework] Data (cont.)

Operational risk					
Total operational risk	--	0	--	0	--
(Mil. €)	Basel II RWA		Standard & Poor's RWA	% of Standard & Poor's RWA	
Diversification adjustments					
RWA before diversification	3,256		4,385	100	
Total adjustments to RWA	--		72	2	
RWA after diversification	3,256		4,457	102	
(Mil. €)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	Standard & Poor's RAC ratio (%)	
Capital ratio					
Capital ratio before adjustments	404	12.4	404	9.2	
Capital ratio after adjustments§	404	12.4	404	9.1	

*Exposure at default. Securitisation exposure includes the securitisation tranches deducted from capital in the regulatory framework. ¶Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. §Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31, 2013, and Standard & Poor's.

Risk position: High single-name concentrations

Our assessment of KA Finanz's risk position as "moderate" is mainly due to its exposure to tail risk and concentration in the securities portfolio. Following KA Finanz's legal separation from Kommunalkredit Austria, its sole business purpose has been winding down the portfolio.

High risk concentration will remain the greatest weakness to the risk profile, in our view. KA Finanz's exposure mainly relates to securities. The majority of exposures are to public-sector customers and international banks. The portfolio run-off has led to a reduction of the concentration risk and an improvement year on year. However, single-name risk concentrations remain relatively high, in light of the bank's profitability and capitalization.

On a positive note, we see that risk is diminishing in line with the portfolio run-off and active sales. Between November 2008 and Dec. 31, 2012, risk exposure decreased by €20.3 billion, of which €5.7 billion was the contractual run-off of assets and €14.6 billion was due to portfolio sales. As of March 31, 2014, KA Finanz's residual portfolio amounted to €7.2 billion. The bulk of the remaining €0.5 billion of credit default swap exposure relates to the Austrian government.

Table 5

KA Finanz AG Risk Position

(%)	--Year-ended Dec. 31--				
	2013	2012	2011	2010	2009
Growth in customer loans	(17.3)	(19.1)	(3.1)	65.8	(82.6)
Total diversification adjustment / S&P RWA before diversification	1.6	(0.0)	14.4	6.8	7.4
Total managed assets/adjusted common equity (x)	20.3	27.2	31.4	149.2	(296.2)
New loan loss provisions/average customer loans	10.4	(3.3)	26.5	(8.4)	15.1

Funding and liquidity: Neutral to the ratings, reflecting the benefits of state ownership

We consider KA Finanz's funding to be "average" and its liquidity position "adequate." Our assessment is based on KA Finanz's close ties to and expected ongoing funding and liquidity support from its owner, the Austrian government. KA Finanz's status as a GRE allows it to tap the senior unsecured funding market, which, in our view, would be closed to KA Finanz on a stand-alone basis. Furthermore, the Republic of Austria has provided a guarantee for some of KA Finanz's senior bonds and a €3 billion commercial paper program to allow sufficient funding.

Liquidity is another area in which we believe the government would step in, in case of need.

Table 6

KA Finanz AG Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	2013	2012	2011	2010	2009
Core deposits/funding base	5.8	3.6	3.9	0.8	0.5
Customer loans (net)/customer deposits	546.3	769.3	643.7	2,908.6	2,814.2
Long term funding ratio	29.1	34.3	48.8	54.5	31.5
Stable funding ratio	61.8	77.6	105.2	116.2	N/A
Short-term wholesale funding/funding base	74.9	68.3	53.0	47.2	70.0
Broad liquid assets/short-term wholesale funding (x)	0.8	1.0	1.3	1.4	N/A
Net broad liquid assets/short-term customer deposits	(225.4)	(33.2)	464.0	2,357.1	N/A
Short-term wholesale funding/total wholesale funding	79.5	70.9	55.2	46.2	68.5

N/A--Not applicable.

External support: Four notches of uplift to the SACP

We regard KA Finanz as a GRE, under our criteria, with a "very high" likelihood of timely and sufficient extraordinary support from the Austrian government in the event of financial difficulties.

In accordance with our criteria for GREs, our current view of a "very high" likelihood of extraordinary government support is based on our assessment of KA Finanz's:

- "Very important" role for the Austrian government. If KA Finanz were to default this could destabilize the Austrian banking system and tarnish Austria's reputation. In addition, the bank is meeting a key political objective; and
- "Very strong" link with the government. The bank plays an important public policy role as the work-out entity of the former Kommunalkredit Austria. The government has displayed a track record of support for KA Finanz and has stated its commitment to supporting the bank in the future.

In our view, if losses are ultimately imposed on HGAA's bondholders despite the grandfathered guarantee from Carinthia, or if developments surrounding HGAA's restructuring trigger a general change in the Austrian government's attitude toward bank support, the result may be a weakening of state support for systemically important banks and GREs in the country. As a result, we might change our opinion on the probability of support for KA Finanz from the Republic of Austria, if we believed that KA Finanz's role for, and link to, Austria had weakened. Thus we might reduce or remove the four notches of uplift that we currently incorporate in our long-term rating on KA Finanz.

Additional rating factors: None

No other factors affect the ratings.

Related Criteria And Research**Related Criteria**

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Seven Austrian Banks Placed On CreditWatch Negative On Planned Bail-In Of State-Guaranteed Debt Of Hypo Group Alpe Adria, June 10, 2014
- Ratings On Seven Austrian Banks Affirmed, With Various Outlooks, On Stabilizing Economic Risks, June 3, 2014
- Banking Industry Country Risk Assessment: Austria, June 3, 2014
- Banking Industry Country Risk Assessment Update: May 2014, May 13, 2014
- Standard & Poor's Takes Various Rating Actions On European Banks Following Government Support Review, April 29, 2014
- Credit FAQ: The Rating Impact Of Resolution Regimes For European Banks, April 29, 2014
- Austria (Republic of), April 25, 2014
- Decision Pending Over Hypo Alpe Adria's Future Has No Immediate Rating Impact On Austrian Banks Or GREs, March 7, 2014

Ratings Detail (As Of June 30, 2014)**KA Finanz AG**

Counterparty Credit Rating	A/Watch Neg/A-1
Senior Unsecured	A/Watch Neg

Counterparty Credit Ratings History

10-Jun-2014	A/Watch Neg/A-1
25-Jan-2012	A/Stable/A-1
08-Dec-2011	A/Watch Neg/A-1
03-Mar-2010	A/Stable/A-1

Sovereign Rating

Austria (Republic of)	AA+/Stable/A-1+
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Related Entities**Austria (Republic of)**

Issuer Credit Rating	AA+/Stable/A-1+
Transfer & Convertibility Assessment	AAA
Commercial Paper	
<i>Local Currency</i>	A-1+
Senior Unsecured	A-1+
Senior Unsecured	AA
Senior Unsecured	AA+

Ratings Detail (As Of June 30, 2014) (cont.)

Short-Term Debt	A-1+
Subordinated	AA+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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