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### Research Update:

# Austria-Based KA Finanz 'A/A-1' Ratings Placed On Watch Negative Following Sovereign Rating Action

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## Research Update:

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## Overview

- On Dec. 5, 2011, we placed the 'AAA' long-term sovereign credit rating on the Republic of Austria on CreditWatch with negative implications and affirmed the short-term rating.
- As a result, we are placing our 'A' long-term and 'A-1' short-term counterparty credit ratings on KA Finanz AG on CreditWatch with negative implications.
- Under our revised bank criteria (published on Nov. 9, 2011), we view KA Finanz as having an adequate business position, very weak capital and earnings, a moderate risk position, average funding, and adequate liquidity, reflecting a stand-alone credit profile of 'b+'.
- We classify KA Finanz as a government-related entity under our criteria and consider that there is a "very high" likelihood of timely and sufficient extraordinary government support for KA Finanz in case of need. The ratings therefore benefit from eight notches of uplift above the SACP.
- We expect to resolve the CreditWatch placement on KA Finanz within four weeks of resolving the CreditWatch on Austria.

## Rating Action

As previously announced, on Dec. 8, 2011, Standard & Poor's Ratings Services placed its 'A' long-term and 'A-1' short-term counterparty credit ratings on Austria-based KA Finanz AG on CreditWatch with negative implications.

On Dec. 5, 2011, the 'AAA' long-term issue ratings on KA Finanz's debt that is guaranteed by the Republic of Austria were placed on CreditWatch negative, and the 'A-1+' short-term issue ratings on debt guaranteed by the Republic of Austria were affirmed.

## Rationale

The CreditWatch action on KA Finanz follows a similar action on the Republic of Austria (AAA/Watch Neg/A-1+).

Standard & Poor's bases its stand-alone credit profile (SACP) on KA Finanz on the company's "adequate" business position, "very weak" capital, and earnings, "moderate" risk position, "average" funding, and "adequate" liquidity, as our criteria define these terms. The SACP is at 'b+'.

Our bank criteria use our Banking Industry Country Risk Assessment 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-' and is based on an economic risk score of '2' and an industry risk score of '3'. Our economic risk assessment reflects Austria's highly competitive and diverse economy, with strong economic fundamentals, strong ties to Eastern Europe, and a comparably high level of domestic foreign currency lending. With regard to industry risk, Austrian banks, in our view, benefit from an increasing share of core customer deposits, both domestically and at their foreign operations. At the same time, we expect that strong competition from a relatively high number of banks will maintain the pressure on risk-adjusted margins.

The 'b+' SACP assessment for KA Finanz draws on our BICRA methodology and our view of the economic risk of its asset portfolio. Because the company's risks are internationally widely spread and include riskier portfolios than the BICRA group 2 for Austria indicates, KA Finanz's SACP is one notch lower than the anchor for banks exclusively active in Austria.

We regard KA Finanz's business position as "adequate". This is mainly because its function is to manage down all the noncore assets of the former Kommunalkredit AG, which was taken over by the Republic of Austria during the financial market crisis in 2008. The business position is therefore a neutral rating factor because KA Finanz was formed to execute political policy to stabilize the Austrian banking market. We expect any unforeseen volatility relating to KA Finanz's workout efforts to be mitigated by a timely response from the Republic of Austria, KA Finanz's sole owner.

We currently view KA Finanz's capital and earnings as "very weak" because we expect sizable losses from the planned restructuring of Greek government debt to have a detrimental impact on its capital base. However, we expect that additional short-term government support will restore KA Finanz's capital and raise it to moderate levels. This is because the Austrian government has committed itself to ensuring that KA Finanz will sustain a Tier 1 ratio of more than 7%. We further believe that Austria is able and willing to provide necessary support in times of need. However, we do not expect the risk-adjusted capital (RAC) ratio, which stood at less than 2% as of Dec. 31, 2010, to reach a level we would consider adequate in the near future. In addition, we believe the company's capital position would continue to need ongoing government commitment and support.

Our assessment of KA Finanz's risk position as "moderate" reflects our view that the quality of KA Finanz's credit exposures is satisfactory but is exposed to tail risks. The majority of exposures are to public-sector customers and international banks. However, a sizable portion of the credit risk consists of short positions in credit default swaps, resulting in high sensitivity toward spread movements. Because all trades are fully collateralized, subsequent collateral calls from correspondent banks could trigger sizable liquidity needs. This illustrates that KA Finanz's risk,

funding, and liquidity positions are highly interlinked.

We currently consider KA Finanz's funding to be "average" and its liquidity "adequate", exclusively based on its close ties to and expected ongoing support from its owner, the Austrian government. In addition, KA Finanz's status as a government-related entity (GRE) allows it to tap the senior unsecured market, which, in our view, would be closed to KA Finanz on a stand-alone basis. Furthermore, Austria has provided a guarantee for some of KA Finanz's senior bonds and a commercial paper program to allow sufficient funding. Liquidity is another area in which we believe the government would step in, in case of need. We understand that the government is willing, and has the sources available, to provide support in a timely manner.

The long-term counterparty credit rating on KA Finanz is eight notches higher than the SACP, reflecting an uplift for potential government support. Under our GRE criteria, we consider there to be a "very high" likelihood that KA Finanz would receive timely and sufficient extraordinary support from the Austrian government in case of need. This is based on KA Finanz's:

- "Very important" role for the government because KA Finanz's default could destabilize the Austrian banking system and tarnish Austria's reputation and the company is meeting a key political objective; and
- "Very strong" link with the government, owing to its public policy role as the workout entity of the former Kommunalkredit Austria.

Any change in KA Finanz's role for and link to the Austrian government could lead us to review the likelihood of KA Finanz receiving extraordinary government support.

Our expectation of additional short-term support provides a four-notch uplift of the SACP to 'bbb-' from 'b+'. We will factor this additional uplift into the SACP after the government commits the support.

## CreditWatch

We intend to resolve the CreditWatch placement within 4 weeks of any associated resolution of the CreditWatch on the Republic of Austria. The article "Analytical Linkages Between Sovereign And Bank Ratings," published Dec. 6, 2011, explains the links between bank and sovereign ratings. There are two main links. The first relates to the application of government support and the second relates to impacts on the SACP. We will review both links before resolving the CreditWatch.

The long-term rating is eight notches higher than the SACP based upon expected short-term and continued ongoing long-term extraordinary government support.

- If the sovereign rating is lowered by one notch and the bank SACP does not change, we would likely not lower the ratings on KA Finanz.
- It may take longer to assess the impact on the SACP because of the indirect links on the economic and industry conditions for banks

operating in Austria including the impact on the anchor, and our assessments of KA Finanz's business position, capital and earnings, risk position, funding, and liquidity.

If the 'AAA' sovereign rating on the Republic of Austria is affirmed, there is likely to be no change in the ratings on KA Finanz. Rating changes under this scenario, however, may be caused by adjustments to the components of KA Finanz's SACP.

We could also lower the ratings if additional short-term support for KA Finanz did not materialize or were lower than we currently expect.

We consider a positive rating action remote in the medium term, since this would require a strengthening of the support framework for all of KA Finanz's outstanding unsecured debt.

## Ratings Score Snapshot

|                       |                          |
|-----------------------|--------------------------|
| Issuer Credit Rating  | A                        |
| SACP                  | b+                       |
| Anchor                | bbb+                     |
| Business Position     | Adequate (0)             |
| Capital and Earnings  | Very weak (-5)           |
| Risk Position         | Moderate (-1)            |
| Funding and Liquidity | Average and Adequate (0) |
| Support               | 8                        |
| GRE Support           | 4                        |
| Group Support         | 0                        |
| Sovereign Support     | 4                        |
| Additional Factors    | 0                        |

## Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

### Related criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Group Rating Methodology For Banks, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related research

- Analytical Linkages Between Sovereign And Bank Ratings, Dec. 6, 2011
- Austria's 'AAA' Long-Term Rating Placed On CreditWatch Negative, Dec. 5, 2011

## Ratings List

### CreditWatch/Outlook Action

|                            | To              | From         |
|----------------------------|-----------------|--------------|
| KA Finanz AG               |                 |              |
| Counterparty Credit Rating | A/Watch Neg/A-1 | A/Stable/A-1 |
| Certificate Of Deposit     | A/Watch Neg/A-1 | A/A-1        |
| Commercial Paper           | A-1/Watch Neg   | A-1          |

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