FITCH AFFIRMS KA AT 'A' & KF AT 'A+', NEGATIVE OUTLOOK

Fitch Ratings-Frankfurt/London-20 February 2015: Fitch Ratings has affirmed Kommunalkredit Austria's (KA) Long-term Issuer Default Ratings (IDR) at 'A' and KA Finanz's (KF) Long-term IDR at 'A+'. The Outlooks are Negative. A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS - IDRS, SUPPORT RATINGS, SUPPORT RATING FLOORS AND SENIOR DEBT

The IDRs and senior debt ratings of KA and KF are support-driven and reflect Fitch's view of the extremely high likelihood of support from the Republic of Austria (AA+/Stable), KF's sole owner and KA's majority owner.

Fitch's assessment of the extremely high likelihood of state support for KA and KF is driven by qualitative factors, primarily the banks' state ownership, as well as Austria's commitment to provide support to KA and KF, as outlined in their European Commission (EC) state aid agreements. The strength of the support structures in place for KA and KF and Austria's financial strength are the key rating drivers for KA and KF. Given the relatively small size of KA and KF in relation to Austria's financial resources, the recent downgrade of the sovereign's rating to 'AA+' from 'AAA' has not affected Fitch's view of the likelihood of support.

The Negative Outlooks on both entities' ratings reflects our expectation that the implementation of the bank resolution framework in Austria will reduce sovereign support for banks in the country as in other EU member states. Austria implemented the EU's Bank Recovery and Resolution Directive (BRRD) into national law on 1 January 2015, included early adoption of the bail-in tool.

The Austrian government has stated that it intends to remain KF's sole shareholder until KF has been wound down. KA is 99.78%-owned by Austria but in contrast to KF, a partial sale of KA is possible under the EC state aid agreement, and Fitch understands that the process for a potential sale of KA is underway.

The one-notch differential between KF's and KA's Long-term IDRs reflects this potential for KA to be privatised while taking into account that a successful sale of KA, while possible, is not a certainty. The one-notch difference is also driven by KF's large proportion of government-guaranteed funding, which would make a default of KF more costly for the Austrian government compared with KA, making support for the former slightly more likely in Fitch's view. Austria's recognition of its obligation to support KF is demonstrated by KF's inclusion as sovereign exposure under Eurostat rules. KA is not included in Eurostat's calculation.

As part of the EC state aid agreement, the Austrian government committed to maintaining a minimum Tier 1 ratio of 7% for KF. KF has received a net EUR2bn in state support, including EUR1bn in 2011 following Greek-driven losses, and a shareholder contribution of EUR350m in 2013 that allowed the bank to comply with Basel III regulations 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 is declining, mitigating the risk of significant single losses, and its European periphery sovereign exposure remains high but has shrunk significantly, to EUR0.7bn at end-1H14 (a 46% decline from end-2013). 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 extremely high, even if additional capital requirements would prove to be substantial.

The EC state aid decision concerning KA allows Austria to provide capital and liquidity support, if required, although we understand that KA's management does not expect to draw down on available state support. Fitch expects that timely support would nevertheless be forthcoming if needed, as long as Austria owns KA. Fitch understands that state liquidity support is available for both KA and KF if needed.

Fitch generally does not assign VRs to banks in orderly wind-down, such as KA and KF, because they do not in our view have a viable standalone business model, meaning that they could not operate without the presence of an external support mechanism.

RATING SENSITIVITIES - IDRS, SUPPORT RATINGS, SUPPORT RATING FLOORS AND SENIOR DEBT

KF's and KA's IDRs are primarily sensitive to Austria's ability and propensity to provide support.

We do not expect that the implementation of BRRD will necessitate a change to the existing support structures in place for KA and KF agreed with the European Commission, given that the entities are progressing with wind-down in accordance with their respective plans. However, Fitch believes that the implementation of the bail in tool, in particular, under BRRD is increasing the likelihood of senior creditors having to participate in any future recapitalisation of KF or KA should the need arise. This is reflected in the Negative Outlooks on the Long-term IDRs, which Fitch is likely to downgrade by end-1H15 along with KF's and KA's Short-term IDRs, Support Ratings, Support Rating Floors and senior debt ratings.

The downgrades of the Long-Term IDRs are likely to be limited to 'BBB+' for KF and the 'BBB' range for KA, reflecting our expectation that risk of senior creditor bail-in will remain low for entities with a clear, established wind-down plan agreed with the Commission and sponsored by sovereigns rated in the 'AAA' and 'AA' categories. This view is also reflected in our expectation that the Support Rating would be downgraded to '2' for both entities.

In addition, KA's ratings are sensitive to the outcome of its partial privatisation process. We expect to maintain state support-driven ratings for KA only if the bank remains state-owned. Should a partial sale of KA be successful, we do not expect that KA will continue to benefit from state support. A privately-owned KA would be rated based on our view of the likelihood of institutional support from the bank's new owner(s), as well as of the viability of KA's new business model. In the event of privatisation, its Support Rating Floor would be revised to 'No Floor'.

Fitch understands that preferred bidders have been shortlisted and that the government expects a sale agreement for KA, assuming a sale takes place, to be signed shortly. Fitch also understands that, in the event that KA is partially sold, the government plans to merge the remaining unsold parts of KA into KF. Therefore, Fitch would also expect KA as a whole to be merged into KF if the planned sale does not materialise. This would likely result in an equalisation of the two entities' ratings.

KF's and KA's IDRs and issue ratings are further sensitive to any severe deterioration in the creditworthiness of Austria. 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.

KEY RATING DRIVERS AND SENSITIVITIES- SUBORDINATED LOWER TIER 2 DEBT

The 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 limited margin of safety for full performance of the debt is situated in the 'B' category on Fitch's rating scale. 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 the BRRD legislation.

In line with its "Assessing and Rating Bank Subordinated and Hybrid Securities Criteria", 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 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. This scenario could be driven by large single credit losses that would mean KF requiring further state support, although KF's concentration risk has declined significantly in recent years. 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
KF's government-guaranteed commercial paper programme (EUR3bn, of which about EUR2bn is currently outstanding) has a Short-term rating of 'F1+', in line with Austria's Short-term IDR, and reflects the state guarantee supporting the programme. A negative rating action would be triggered if Austria's Short-term IDR was downgraded.

The rating actions were part of a review of EU wind-down banks. Fitch will issue a peer report shortly.

The rating actions are as follows:

Kommunalkredit Austria
Long-term IDR: affirmed at 'A'; Outlook Negative
Short-term IDR: affirmed at 'F1'
Support Rating: affirmed at '1'
Support Rating Floor: affirmed at 'A'
Long-term senior unsecured notes rating: affirmed at 'A'
Short-term senior unsecured notes rating: affirmed at 'F1'
Senior market-linked notes rating: affirmed at 'Aemr'

KA Finanz AG
Long-term IDR: affirmed at 'A+'; Outlook Negative
Short-term IDR: affirmed at 'F1+'
Support Rating: affirmed at '1'
Support Rating Floor: affirmed at 'A+'
Long-term senior unsecured notes: affirmed at 'A+'
Short-term senior unsecured notes: affirmed at 'F1+
Subordinated lower tier 2 debt (XS0257275098, AT0000441209, XS0185015541, XS0144772927 and XS0255270380): affirmed at 'B'

Junior subordinated debt (ISINs XS0284217709 and XS0270579856): affirmed at 'C'
Government-guaranteed commercial paper programme: affirmed at 'F1+'

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Applicable criteria, 'Global Financial Institutions Rating Criteria', dated 31 January 2014, 'Assessing and Rating Bank Subordinated and Hybrid Securities', dated 31 January 2014, are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Global Financial Institutions Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=732397
Assessing and Rating Bank Subordinated and Hybrid Securities Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=732137