



Fitch Affirms Kommunalkredit at 'A' and KA Finanz at 'A+'; Outlooks Stable

Ratings

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Fitch Ratings-London-23 December 2010: Fitch Ratings has affirmed Austria-based Kommunalkredit Austria AG's (KA) Long-term Issuer Default Rating (IDR) at 'A' with a Stable Outlook. Simultaneously, the agency has upgraded KA's Individual Rating to 'D' from 'E'. At the same time, the agency has affirmed KA Finanz AG's (KF) Long-term IDR at 'A+' with Stable Outlook.

The 'A' rating of KF's subordinated (lower tier 2) bonds has been placed on Rating Watch Negative (RWN) pending European Commission (EC) approval of KF's restructuring plan, expected in H111. A full list of ratings for both KA and KF is provided at the end of this release.

KA and KF are the result of a demerger of former Kommunalkredit Austria (KA Old) in November 2009. KA Old, a wholesale-funded public sector lender, was acquired by the Republic of Austria (rated 'AAA/Stable') in November 2008 following severe funding and liquidity difficulties. KF, the legal successor of KA Old, holds KA Old's non-core assets and will be wound down over time. KA holds KA Old's core public sector assets and continues to write new business, predominately in Austria and neighbouring countries. At end-Q310, both banks were 99.78% owned by the Republic of Austria.

KA's and KF's ratings, apart from KA's Individual Rating, are based on Fitch's view that due to the banks' close affiliation with the Austrian government, there is an extremely high likelihood of ongoing support from the Austrian state. KA's (but not KF's) ratings are furthermore underpinned by KA's importance as a municipal lender and a public service provider on behalf of the Austrian state.

The one-notch differential between KA's and KF's Long-term IDR reflects Fitch's belief that KF will remain government-owned until it has been wound down (unlike KA). The necessary EC ruling has not been finalised yet but considering that KF is a non-competing entity in run-off mode, Fitch does not anticipate the ruling (expected in H111) to require the state to sell off KF in the short to medium term. However, should the ruling impose such or similar conditions, Fitch would take appropriate negative rating action.

KA's restructuring plan foresees a privatisation of the bank in 2012 or 2013. The Stable Outlook on KA's Long-term IDR indicates that Fitch does not expect a privatisation in the short term. The agency will review the Outlook closer to an actual privatisation date. If a potential buyer is rated lower than 'A+', this would likely have a negative impact on KA's Long-term IDR.

The upgrade of KA's Individual Rating to 'D' takes into account the bank's progress in implementing its revised business model. However, it also reflects Fitch's view that KA will be challenged to maintain an adequate funding profile once the Austrian state starts privatising KA.

The RWN on KF's subordinated (lower tier 2) bonds reflects the potential risk that in its restructuring plan approval, the EC, in the context of a "burden sharing" concept, could require subordinated debt investors to carry losses. While Fitch (and KF's management) views the possibility of this happening as remote, should the EC decide to transfer losses onto subordinated debt holders, this would result in a multiple-notch downgrade of KF's subordinated bonds. The RWN will be resolved once the EC ruling has been made public.

KA is predominately exposed to credit and funding/liquidity risks. Credit risk in its EUR17.6bn balance sheet (at end-H110) is predominately to Austrian and other Western European public sector entities. Considerable concentration risk is to some extent mitigated by the quality of KA's credit exposures. Management intends to run a well-controlled liquidity policy with a significant proportion of long-term funding to account for KA's typically long-dated assets, which, in Fitch's view, is challenging in the current funding environment. KA aims to maintain a core Tier 1 ratio above 10% (15.6% at end-H110) which Fitch considers acceptable, although KA's capital ratios should be viewed in the context of low risk weightings for public-sector lending.

At end-H110, KF's EUR22.1bn total assets predominately related to non-Austrian (and other non-core) public sector bonds and loans. At the same time, KF also held a CDS portfolio of around EUR10bn. Around 93% of CDS exposure related to sovereign risk and 92.5% to counterparties within the EU. KF is intentionally funded short term and through government-guaranteed bond issuances. Despite significantly negative IFRS equity, at end-H110 KF remained compliant with regulatory capital ratios (calculated under Austrian GAAP, which treats CDS as financial guarantees and parts of the fair-valued assets at cost). The Austrian state has committed to maintaining a Tier 1 ratio of 7% as long as the bank's former owners remain invested in KF's participation capital.

The rating actions are as follows:

Kommunalkredit Austria AG (KA)

Long-term IDR: affirmed at 'A'; Outlook Stable

Short-term IDR: affirmed at 'F1'

Individual Rating: upgraded to 'D' from 'E'

Support Rating: affirmed at '1'

Support Rating Floor: affirmed at 'A'

Senior unsecured notes: affirmed at 'A'

Senior market-linked notes: affirmed at 'Aemr'

Government guaranteed notes: affirmed at 'AAA'

KA Finanz AG (KF)

Long-term IDR: affirmed at 'A+'; Outlook Stable

Short-term IDR: affirmed at 'F1+'

Support Rating: affirmed at '1'

Support Rating Floor: affirmed at 'A+'

Senior unsecured notes: affirmed at 'A+'

Subordinated (lower tier 2) notes: 'A' placed on Rating Watch Negative

Junior subordinated: affirmed at 'C'/Recovery Rating 'RR5'

Government guaranteed notes: affirmed at 'AAA'

A full rating report on KA and an update report on KF will be available shortly at www.fitchratings.com.

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Additional information is available on www.fitchratings.com

Applicable criteria, 'Global Financial Institutions Rating Criteria', dated 13 August 2010, and 'Short-Term Ratings for Corporate Finance', dated 2 November 2010, are available at www.fitchratings.com.

Applicable Criteria and Related Research:

Global Financial Institutions Rating Criteria

Short-Term Ratings for Corporate Finance

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