

CREDIT OPINION

15 December 2022

Update



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RATINGS

KommuneKredit

Domicile	Copenhagen, Denmark
Long Term CRR	Not Assigned
Long Term Debt	Aaa
Type	Senior Unsecured - Fgn Curr
Outlook	Stable
Long Term Deposit	Not Assigned

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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KommuneKredit

Update to credit analysis

Summary

We assign Aaa long-term senior unsecured debt and issuer ratings to [KommuneKredit](#), a Danish municipal lender.

KommuneKredit's Aaa long-term ratings reflect the institution's close links with Danish regional and local governments (RLGs) and ultimately the [Government of Denmark](#) (Aaa stable). The main drivers of the ratings are the support offered by the joint and several guarantee provided by its RLG members; the agency's close association with the central government; its public-policy mandate and dominant franchise in Denmark; and its prudent financial management.

Credit strengths

- » Benefits from a joint and several guarantee provided by all Danish RLGs
- » Direct oversight by the sovereign
- » Excellent asset quality
- » Very solid capitalisation

Credit challenges

- » Some lending concentration, although mitigated by very strong asset quality
- » Low profitability, although relatively stable and linked to its public-policy mandate
- » High reliance on market funding, mitigated by a very strong access

Outlook

The outlook on KommuneKredit's ratings is stable, in line with that on the ratings of the Government of Denmark.

Factors that could lead to a downgrade

Although currently unlikely, downward pressure on KommuneKredit's ratings could arise as a result of any deterioration of the joint and several guarantee, a weakening of its association with the central government or its public-policy mandate, or sustained weak financial performance.

Key indicators

Exhibit 1

KommuneKredit (Unconsolidated Financials) [1]

	06-22 ²	12-21 ²	12-20 ²	12-19 ²	12-18 ²	CAGR/Avg. ³
Total Assets (DKK Million)	221,244.0	243,012.0	219,675.0	227,633.0	226,609.0	(0.7) ⁴
Total Assets (USD Million)	31,102.6	37,028.7	36,110.0	34,194.5	34,713.7	(3.1) ⁴
Tangible Common Equity (DKK Million)	9,241.0	8,773.0	8,395.0	8,184.0	7,754.0	5.1 ⁴
Tangible Common Equity (USD Million)	1,299.1	1,336.8	1,380.0	1,229.4	1,187.8	2.6 ⁴
Tangible Common Equity / Risk Weighted Assets (%)	56.8	63.3	73.0	68.7	56.0	63.6 ⁵
Net Interest Margin (%)	0.2	0.2	0.2	0.2	0.2	0.2 ⁵
PPI / Average RWA (%)	8.0	3.9	2.2	4.5	3.2	4.3 ⁵
Net Income / Tangible Assets (%)	0.4	0.2	0.1	0.2	0.2	0.2 ⁵
Cost / Income Ratio (%)	17.2	23.9	34.1	18.9	20.4	22.9 ⁵
Market Funds / Tangible Banking Assets (%)	95.3	95.9	95.7	95.9	96.1	95.8 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	18.4	19.3	11.6	15.6	16.5	16.3 ⁵

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully loaded or transitional phase-in; IFRS. [3] May include rounding differences because of the scale of reported amounts. [4] Compound annual growth rate (%) based on the periods for the latest accounting regime. [5] Simple average of Basel III periods. [6] Simple average of periods for the latest accounting regime.

Sources: Moody's Investors Service and company filings

Profile

KommuneKredit is one of the world's oldest local government lenders. It was established more than 120 years ago as a credit association (a membership organisation). Membership is voluntary; however, currently, all Danish regions and municipalities are members. KommuneKredit does not have any separate ownership organisation. As of the end of June 2022, all Denmark's municipalities (98) and regions (5) were members of KommuneKredit.

The main purpose of KommuneKredit is to provide stable financing to the Danish local government sector, and semi-public entities guaranteed by one or more regions or municipalities.

KommuneKredit operates under a special legislative act. The Act on KommuneKredit states that "the members shall be directly, jointly and severally liable for obligations assumed by the institution". This guarantee has been safeguarding all creditors of KommuneKredit since 1899 and has never been invoked.

KommuneKredit is currently supervised by the Danish Ministry of Industry, Business and Financial Affairs. However, the responsibility is expected to be transferred to the Danish Financial Supervisory Authority (FSA) on 1 July 2023, when an updated Act on KommuneKredit is expected to come into force.

Recent developments

In April 2022, our [outlook](#) for the Denmark's (Aaa Stable) banking system remained stable, unchanged from last year. This reflects our view that the Danish banking system will remain broadly resilient to the coming economic downturn.

Following a real GDP expansion of 4.9% in 2021 in Denmark as the economy recovered from the pandemic-induced recession, we [forecast](#) a real GDP growth of 2.8% in 2022 and 0.2% in 2023. However, increased geopolitical risks stemming from Russia's invasion of Ukraine create significant uncertainty, mainly through higher inflation, including energy costs, and a lower willingness to invest.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on <https://ratings.moody.com> for the most updated credit rating action information and rating history.

Detailed credit considerations

The financial data in the following sections are sourced from KommuneKredit's financial statements, unless otherwise stated.

KommuneKredit benefits from a joint and several guarantee

The Danish regions and municipalities are jointly and severally liable for KommuneKredit's liabilities. A creditor can claim payment from any of them in the unlikely event that KommuneKredit could not honour its obligations. While the agency is not the only public-sector-related issuer in the Nordic region to benefit from public-sector guarantees, its joint and several guarantee is unique in that it is backed by every single RLG in Denmark.

High market share reflects the importance of KommuneKredit to Danish RLGs

KommuneKredit's government-related footprint is significant. Established through special legislation, the association's activities are supervised by the Danish Ministry of Industry, Business and Financial Affairs, and lending is restricted to Danish regional and local authorities and institutions benefiting from a full guarantee from an RLG.

Danish RLGs have close financial cooperation with the central government in the annual budget agreements, where budgets — for the sector as a whole — need to be balanced. The central government has also imposed regulations and strict controls, which effectively limit RLGs from accumulating debt beyond agreed levels. The central government also has effective powers and can easily intervene in an RLG to ensure prudent and balanced budgets, as well as in very rare cases of financial distress. RLGs are also prohibited by law from declaring bankruptcy.

KommuneKredit benefits from a very dominant market share of RLG financing, reaching close to 100%. Competition is limited because the agency can offer very competitive funding costs and is also supported by its long track record.

In June 2020, a political agreement was reached regarding the future structure of the waste management sector. This led to a decision to allow KommuneKredit to continue to grant loans for the management of incinerable waste within the auspices of EU state aid regulation.

Direct oversight by the sovereign and prudent risk management

The Danish Ministry of Industry, Business and Financial Affairs supervises KommuneKredit and is responsible for approving any changes to the association's by-laws. The Ministry sets limits for liquidity, pre-financing and approves the agency's rules for management of financial risks and the use of financial instruments.

However, there is currently a proposal for a new law under which KommuneKredit would be supervised by the Danish Financial Supervisory Authority (FSA), expected to take effect as of 1 July 2023. An addition added to the latest draft of the Act enables KommuneKredit to grant loans — which will be fully guaranteed by the Danish State — to municipalities and certain municipal entities in Greenland and the Faroe Islands. The FSA expects that minor changes or adjustments in KommuneKredit's management structure, policies, controls and processes may be needed.

The Ministry has determined that KommuneKredit may pre-finance of up to 25% of total lending at the end of the preceding quarter, and as of end June 2022, the upper limit was set at DKK46.4 billion, while the agency's pre-financing was DKK41.0 billion. The total holding of liquidity stood at DKK51.1 billion as of end of June 2022. KommuneKredit's management board and its auditors have a legal obligation to inform the Ministry of any material information that may prevent it from meeting its obligations.

KommuneKredit uses swaps to hedge the currency risks taken on through foreign-currency funding. Moreover, the association's guidelines include an interest rate risk limit of 4.5% of its equity base, equivalent to DKK416 million as of end June 2022.

KommuneKredit has signed standardised swap and collateral documentation with all its largest counterparties. Terms include daily valuation and collateral transfer to and from KommuneKredit, and eligible collateral is limited to mortgage bonds and government bonds.

Excellent asset quality, although there is some lending concentration

KommuneKredit has never incurred a credit loss on any of its loans in its about 120-year history. Its creditworthiness rests on the RLG sector. We consider the sub-sovereign sector financially strong because Danish municipalities can increase revenue by raising income taxes, although they have an obligation to deliver services such as healthcare, social security and education. An additional significant

revenue source for the RLG sector is provided by grants from the central government. In addition, Danish municipalities participate in a financial redistribution system, under which revenue is spread so that all citizens, irrespective of their geographical location, are guaranteed the above-mentioned public services. We expect the sector to perform well in the forthcoming economic downturn, given the RLGs strong liquidity and the Danish government's strong track record of mitigating external shocks.

Nevertheless, KommuneKredit's loan exposures are inevitably concentrated because of the small size of its customer base, that is, the Danish regions and municipalities, which also vary in size.

As of June 2022, the value of lending and leasing stood at DKK179.5 billion, a decrease of DKK11.6 billion from year-end 2021, as a result of DKK3.4 billion increase in new lending which was offset by a DKK19.0 billion negative value adjustment. Overall, in 2021, the issuer disbursed over 700 new loans for DKK34.8 billion, which consisted in part of extraordinary loans to allow municipalities to pay out accrued holiday pay to their employees, following a decision by the Danish government to freeze disbursements of holiday funds in response to the pandemic. Loans related to the holiday funds amounted to DKK6.4 billion, and loans to the district heating sector totaled DKK 5.2 billion.

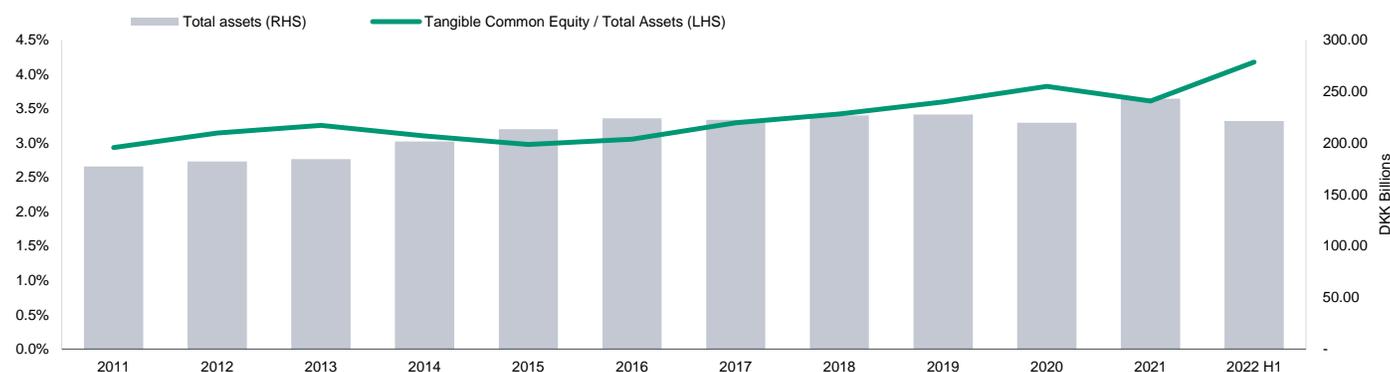
Very solid capitalisation

KommuneKredit is not required to report a Tier 1 capital ratio, but has indicated that its capital ratio (capital base divided by risk-weighted assets) was 56% as of the end of June 2022, which is mainly because of the zero risk weights assigned to its RLG lending.

KommuneKredit's leverage ratio (Moody's adjusted: tangible common equity/total assets) was 4.2% as of the end of June 2022. This ratio is higher than the 1% (defined as equity divided by total obligations) requirement specified in its articles of association and also higher than those of other Nordic specialised lenders. KommuneKredit's leverage ratio has increased slightly to 4%, primarily due to a reduction in total assets (see Exhibit 2), meeting the Board of Director's target of 3.0%, and we expect it to remain over the outlook period of 12-18 months.

Exhibit 2

Leverage has increased, while assets have contracted KommuneKredit's total assets and Moody's calculated leverage ratio



Source: Moody's Financial Metrics

Low profitability, although relatively stable and linked to its public-policy mandate

Like that of other specialised lenders, KommuneKredit's profitability primarily depends on the spread between its lending rates and funding costs. KommuneKredit is frequently accessing international capital markets with issuances in multiple currencies, where it benefits from favourable rates.

We consider KommuneKredit's profitability predictable because the association effectively has a monopoly position, supporting its ability to maintain stable margins. Its customer base is likely to remain unchanged in the long term because membership is limited to Danish RLGs and all of them are members. In addition, demand for KommuneKredit's loans is likely to remain predictable as RLGs continue to invest in the infrastructure required to deliver key services as mandated by the Danish central government. The creditworthiness of its customer base is closely linked to the Aaa-rated Danish sovereign with a stable outlook.

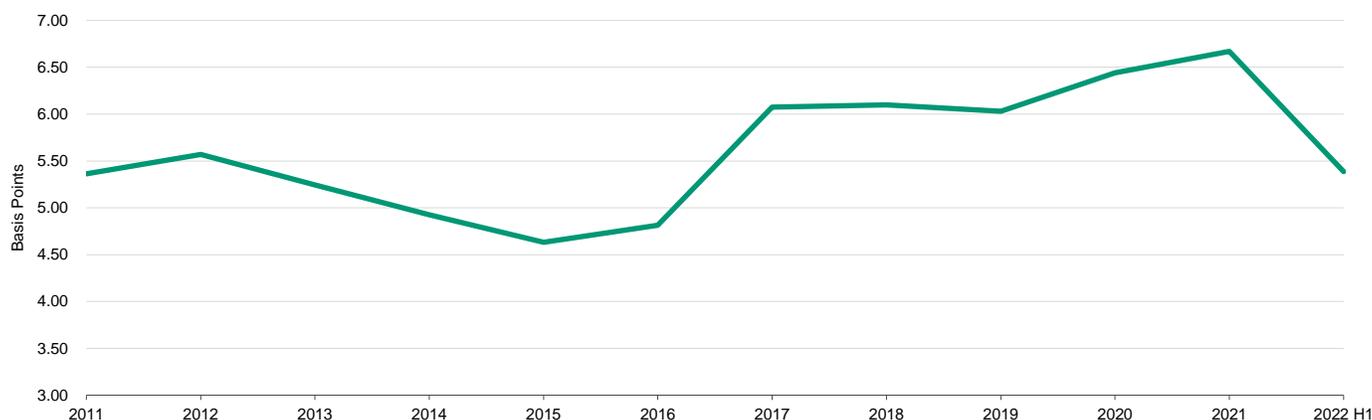
In 2018, KommuneKredit implemented a new method for fixing interest rates on new loans called the funds transfer pricing model, with the aim of aligning the interest rate on an individual loan to the costs and risks associated with it.

KommuneKredit's monoline business model and efficient distribution channels allow the association to keep operating expenses at very manageable levels. The lender employed 94 people and reported total assets of DKK245.3 billion (around €33.0 billion) as of the end of June 2022. Its operating expenses/total average assets remained at a low 5.4 basis points as of the end of June 2022 (see Exhibit 3).

Exhibit 3

Operating expenses were low at 5.4 basis points as of the end of June 2022

KommuneKredit's operating expenses/average total assets



The H1 2022 figure has been annualised

Source: Moody's Financial Metrics

High reliance on market funding, mitigated by a very strong access

The maturity of the agency's liabilities is typically at least as long as the contractual maturity of its assets. More than one-third of the loans have a long-term economic duration, despite the fact that they are short term on a contractual basis because of their call features. These loans imply some gaps, which have been reduced recently as KommuneKredit lengthened the term structure of the funding allocated to this portfolio. The risks arising from these gaps are also mitigated by a large liquidity reserve and closely managed through the monitoring of the institution's survival period under stress.

Most of the outstanding funding before currency hedging was in euros, US dollars and Danish kroner as of end June 2022.

As of the end of June 2022, funding from credit institutions and debt securities issued was DKK221.8 billion, a DKK12.1 billion decrease from end of December 2021 due to negative value adjustments of issued securities. Approximately €4.5 billion has been raised during the first six months of 2022, which is in line with KommuneKredit's strategy.

Similar to its peers, KommuneKredit has issued six green bonds, totalling DKK19.1 billion, to fund sustainable lending across Denmark, and as of year-end 2021, the value of disbursed loans amounted to DKK19.1 billion. In February 2022, KommuneKredit launched a new Green Bond Framework (GBF) consisting of six categories: energy, sustainable water and wastewater management, pollution prevention and control, green buildings, clean transportation and climate change adaptation.

The association maintains a substantial liquidity portfolio, consisting of highly rated securities with various maturities (most securities have maturities below three years and an important share below one year as of year-end 2021), with the bulk of investments in covered bonds and government bonds. As of the end of June 2022, the size of the liquidity portfolio amounted to 22.8% of tangible banking assets. KommuneKredit's liquidity portfolio is comparable with the portfolios of its peers in terms of size and credit quality. However, unlike some peers, KommuneKredit does not have direct access to central bank liquidity.

ESG considerations

KommuneKredit has low exposure to environmental risks, in line with our view of the banking sector. In 2021, the issuer's Green Bond Committee approved 148 loans as being green, with total lending of just under DKK5.0 billion. The majority of the approved green

loans were granted for projects in district heating and water and wastewater management, but a small part of the green loans were granted for projects within energy-saving initiatives. See our [Environmental risks heat map](#) for further information.

Because of KommuneKredit's role as one of Denmark's largest credit institutions specialising in the financing of Danish municipalities, it is susceptible to politically and socially motivated decisions, which could affect its financial profile. Its borrowers are exposed to the challenges of providing services to an ageing population, leading to increasing dependency ratios. Over time, these challenges can add pressure on municipalities' finances, although the sector's institutional framework overlying KommuneKredit's clients help manage these risks. The framework includes municipalities' constitutional right to set local level tax rates independently, an equalisation mechanism supporting financially weaker municipalities, and the joint guarantee, where each member is responsible for others' commitments in proportion to their individual commitment to KommuneKredit. Overall, the issuer has moderate exposure to social risks.

We also regard the pandemic as a social risk under our environmental, social and governance (ESG) framework, given the substantial implications for public health and safety. Other social risks in terms of customer relations or changes in consumer preferences, which are generally relevant for the banking industry, are less important for KommuneKredit, given that the institution does not engage in retail activities. See our [Social risks heat map](#) for further information.

Governance is highly relevant for KommuneKredit's creditworthiness. Corporate governance weaknesses can lead to a deterioration in a company's credit quality, while governance strengths can benefit its credit profile. Governance risks are largely internal rather than externally driven. We do not have any particular concern around KommuneKredit's corporate governance, which is regulated by law and influenced by its public ownership structure.

Ratings

Exhibit 4

Category	Moody's Rating
KOMMUNEKREDIT	
Outlook	Stable
Issuer Rating	Aaa
Bkd Senior Unsecured	Aaa
Bkd Commercial Paper	P-1
Bkd Other Short Term	(P)P-1

Source: Moody's Investors Service

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