

CREDIT OPINION

21 March 2019

Update

 Rate this Research

RATINGS

Domicile	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 reflects (1) the support offered by the joint-and-several liability provided by its public sector members; (2) the agency's close association with the national government; (3) its public policy mandate and dominant franchise in Denmark; and (4) prudent financial management.

Credit strengths

- » KommuneKredit is closely linked to the government and benefits from a joint and several liability provided by all Danish regional and local governments (RLGs)
- » Direct oversight by the sovereign, with prudent counterparty risk policies
- » Excellent asset quality
- » KommuneKredit's profitability is stable as a result of its public policy mandate
- » Solid capitalisation, funding and liquidity relative to peers

Credit challenges

- » Some lending concentration, although mitigated by very strong asset quality

Outlook

The outlook on KommuneKredit's senior unsecured debt ratings is stable.

Factors that could lead to a downgrade

Although not currently anticipated, downward pressure on KommuneKredit's ratings could arise over time as a result of sustained weak financial performance, a weakening of its public policy mandate, or a deterioration of the joint-and-several liability.

Key indicators

Exhibit 1

KommuneKredit (Unconsolidated Financials) [1]

	12-18 ²	12-17 ²	12-16 ³	12-15 ³	12-14 ³	CAGR/Avg. ⁴
Total Assets (DKK million)	226,609	222,564	223,938	213,199	201,413	3.0 ⁵
Total Assets (EUR million)	30,367	29,893	30,117	28,569	27,049	2.9 ⁵
Total Assets (USD million)	34,714	35,895	31,766	31,034	32,730	1.5 ⁵
Tangible Common Equity (DKK million)	7,736	7,333	6,844	6,347	6,244	5.5 ⁵
Tangible Common Equity (EUR million)	1,037	985	920	851	839	5.4 ⁵
Tangible Common Equity (USD million)	1,185	1,183	971	924	1,015	4.0 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	55.9	41.8	-	-	-	48.8 ⁶
Net Interest Margin (%)	0.2	0.3	0.3	0.3	-	0.3 ⁷
PPI / Average RWA (%)	3.4	3.6	-	-	-	3.5 ⁶
Net Income / Tangible Assets (%)	0.2	0.2	0.2	0.0	0.1	0.2 ⁷
Cost / Income Ratio (%)	20.3	17.9	14.2	43.0	21.9	23.5 ⁷
Market Funds / Tangible Banking Assets (%)	96.1	96.2	96.5	96.5	96.5	96.4 ⁷
Liquid Banking Assets / Tangible Banking Assets (%)	19.0	19.0	15.9	16.3	16.1	17.3 ⁷

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully-loaded or transitional phase-in; IFRS. [3] Basel II; IFRS. [4] May include rounding differences due to scale of reported amounts. [5] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [6] Simple average of Basel III periods presented. [7] Simple average of periods presented for the latest accounting regime.

Source: Moody's Financial Metrics

Profile

KommuneKredit is one of the world's oldest local government lenders and was established over 120 years ago as a credit association (a membership organization). Membership is voluntary and currently all Danish municipalities and regions are members. KommuneKredit has no separate ownership organization.

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 county or municipality.

KommuneKredit is neither subject to the Danish banking law, nor to Danish FSA regulations, and is supervised by the Ministry of Economic Affairs and the Interior.

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 municipalities and regions are jointly and severally liable for KommuneKredit's liabilities. A creditor can claim payment from any of them in the currently unlikely event of failure. 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 liability is unique in that it is backed by every single RLG in Denmark.

High market share reflects the importance of KommuneKredit to the Danish RLGs

KommuneKredit's government-related footprint is significant. Originally established through special legislation, the association's activities are supervised by the Ministry for Economic Affairs and the Interior (rather than the Danish financial supervisory authority), and lending is restricted to Danish local and regional authorities and any semi-municipal institutions benefiting from a full guarantee from a local or regional authority.

KommuneKredit benefits from a very high market share of RLG financing, which we understand is consistently above 90%. Competition is limited because of the agency's low funding cost and not-for-profit mandate, combined with its long track-record.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Recent changes in legislation regarding the financing of loans in the subsidised housing sector are expected to have minimal impact to KommuneKredit's business prospects. Based on the agreement signed between the Danish government and the mortgage credit institutions in November 2017, KommuneKredit will continue to finance municipal housing for the elderly through the state, which will also buy the underlying bonds in 2019.

However, the spring 2018 proposal by the government of exposing the utilities sector to more competition, may affect KommuneKredit's opportunities for continued financing depending on the future organization and ownership structure in the utilities companies, i.e. if the district heating system were to be privatised, KommuneKredit would no longer be able to continue lending to all district heating networks in Denmark.

Overall, at the end of 2018, loans and leasing to municipalities and regions accounted for 59% of KommuneKredit's total lending, related to purposes such as housing for the elderly, climate proofing initiatives, hospital equipment and vehicles for the municipal home care service.

Direct oversight by sovereign with prudent counterparty risk policies

The Danish Ministry for Economic Affairs and the Interior 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 the management of financial risks and the use of financial instruments. 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 agency's guidelines include an interest rate risk limit of 4.5% of its equity base (calculated using a one percentage point parallel shift of the interest curve), equating to DKK 348 million in 2018.

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

Excellent asset quality, albeit some lending concentration

KommuneKredit has never incurred a credit loss on any of its loans in its 120-year history. Its creditworthiness rests on the RLG sector which we consider financially strong as the Danish municipalities can increase revenues through raising income taxes. These powers are balanced against their obligation to deliver services such as healthcare, social security and education. Grants from the central government form an additional significant revenue source for the municipalities. Moreover, Danish municipalities participate in a financial redistribution system under which revenues are spread so that all citizens, irrespective of geographical location, are guaranteed the above mentioned public services.

Prudential regulations imposed by the central government provide strict controls and effectively limit regional and local governments from accumulating debt beyond agreed levels. Effective powers of intervention by the central government ensure prudence, balanced budgets and highly infrequent cases of financial distress. Moreover, regional and local governments are prohibited by law from declaring bankruptcy.

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

Although KommuneKredit has never incurred a credit loss, the introduction of IFRS9 in January 2018, resulted in the municipal lender having to take a DKK 2.1 million higher impairment charge linked to the leasing portfolio.

KommuneKredit's profitability is stable as a result of its public policy mandate

Like other specialised lenders, KommuneKredit's profitability depends primarily 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 as very predictable because the association is effectively in a monopoly position, facilitating its ability to maintain stable margins. Its customer base is likely to remain unchanged in the long term as membership is limited to

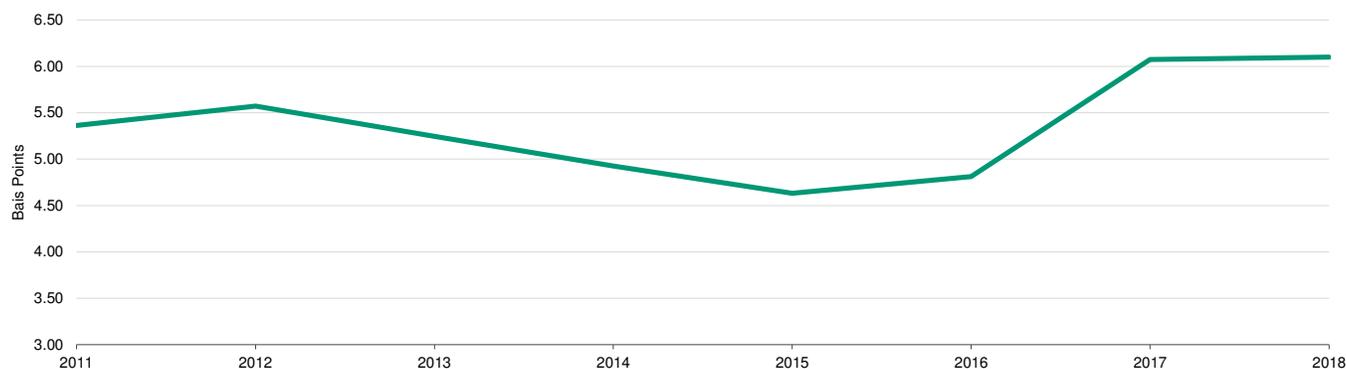
Danish regional and local governments and all of them are already members. In addition, demand for KommuneKredit's loans is likely to remain predictable as regional and local governments continue to invest in the infrastructure required to deliver key services as mandated by the Danish central government; and 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 attached to it.

KommuneKredit's monoline business model and efficient distribution channels allow the association to keep operating expenses at very manageable levels. The lender employed 70 people in 2018, had total assets of DKK 226.6 billion (approximately EUR 30.4 billion) at year-end 2018. Its ratio of operating expenses to total average assets has remained low, despite a slight increase to 6 basis points over the last two years (see Exhibit 2).

Exhibit 2

Operating expenses are low, but increased slightly to 6 basis points of average assets in the last two years
KommuneKredit's operating expenses to average total assets "basis points"



Source: Moody's Financial Metrics

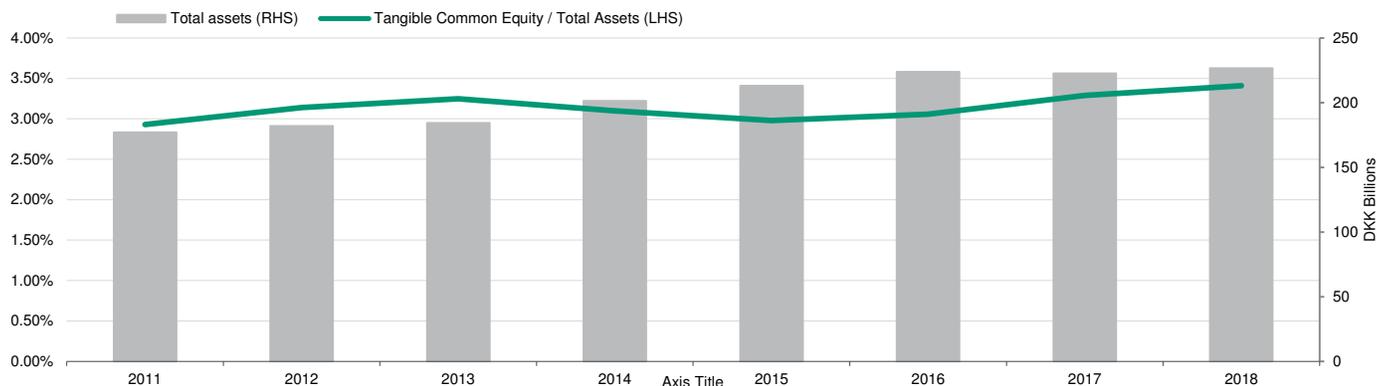
Solid and stable leverage ratio

At 3.4% as of year-end 2018, KommuneKredit's leverage ratio (Moody's calculated: tangible common equity to total assets) already meets the 3% threshold that is likely to become a requirement for similar institutions under Basel III (which the institution is exempt from). This is higher than the 1% (defined as equity divided by total obligations) requirement specified in its articles of association and also higher than the other Nordic specialised lenders. KommuneKredit's leverage ratio has remained broadly unchanged around 3% over the past five years, and has grown broadly in line with total assets (see Exhibit 3).

Exhibit 3

Leverage has remained stable while assets have grown

KommuneKredit's total assets and Moody's calculated leverage ratio



Source: Moody's Financial Metrics

KommuneKredit does not pay dividends, nor does it forecast extraordinary balance sheet growth, which should enable it to maintain its leverage ratio at around 3%.

The lender is not required to report a Tier 1 capital ratio, but indicated that its solvency ratio (capital base divided by risk-weighted assets) was 54% as of year-end 2018, which is largely a reflection of the zero risk weights assigned to its lending.

A wholesale funded entity with sound liquidity

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 due to 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.

Similar to peers, some funding comes with option-like features, which suddenly could shorten its liability profile. This relates to funding in Japanese yen, where the majority are callable Uridashi bonds. This type of funding, together with other structured financing, has materially reduced over the past few years. For its liquidity planning, KommuneKredit assumes that all such funding is called at first call date.

At year-end 2018 funding due to credit institutions and debt securities issued stood at DKK 209 billion, an increase by DKK 5.1 billion compared to year-end 2017. The nominal increase in funding resulted from the financing of increased lending operations and also a slightly larger securities portfolio and thus a bigger liquidity buffer. In 2018, KommuneKredit continued its strategy of making large public bond issues to fund its lending operations by making benchmark issuances in USD, EUR and GBP for DKK 40 billion, which have been well received by investors. Overall, the lender's total funding amounted to DKK 209 billion as of December 2018, of which DKK 60 billion was sourced in 2018.

Similar to its peers, KommuneKredit issued inaugural green bonds for EUR 500 million in May 2017 followed by a EUR 750 million issuance in June 2018 to fund sustainable lending across Denmark. The lender's target is to increase the green loan portfolio with an expectation of an issuance of at least one more green bond in 2019. The green bonds are aimed at investors with a green investment mandate such as portfolio managers, insurance companies and banks.

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 also below one year), with the bulk of investments in supra-nationals, agencies and covered bonds. As of December 2018 the size of the liquid portfolio amounted to 19.0% of tangible banking assets. KommuneKredit's liquidity portfolio is comparable with the portfolios of its peers in terms of size and credit quality. Unlike some peers, KommuneKredit does not have direct access to central bank liquidity, however.

Ratings

Exhibit 4

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

Source: Moody's Investors Service

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