

Research Update:

Danish Public-Sector Funding Agency KommuneKredit Upgraded To 'AAA' On Strengthening Capitalization; Outlook Stable

July 24, 2019

Overview

- KommuneKredit has strengthened its capitalization, benefitting from subdued new lending, more efficient asset allocation, and moderate internal capital generation.
- The agency is also improving its funding and liquidity profile.
- We are raising our long-term rating on KommuneKredit to 'AAA' from 'AA+', and affirming the 'A-1+' short-term rating.
- The outlook is stable.

Rating Action

On July 24, 2019, S&P Global Ratings raised to 'AAA' from 'AA+' its long-term issuer credit rating on Danish public-sector funding agency KommuneKredit. The outlook is stable. In addition, we affirmed our 'A-1+' short-term issuer credit rating on the agency.

Outlook

The stable outlook reflects our expectation that KommuneKredit will maintain its capital position while continuing to strengthen its funding and liquidity profile. It also reflects our expectation that the guarantee structure will remain unchanged and that the agency will continue to benefit from unwavering membership support. Moreover, we expect that KommuneKredit will continue to manage risk so that its lending services, and ultimately the execution of its public policy role, are not affected.

Downside scenario

We could downgrade KommuneKredit over the next two years if the agency's capitalization

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declined, with its risk-adjusted capital (RAC) ratio decreasing to below 15%. This could result from higher lending book expansion or increased concentration on the top borrowers clients. Furthermore, we could lower the rating if we perceived that the improvement in the agency's liquidity position was not sustainable and the funding gap widened. We could also lower the ratings if we observed a diminishing likelihood of receiving extraordinary support from its members, Danish local and regional governments (LRGs).

Rationale

The upgrade reflects the strengthening in KommuneKredit's capitalization as well as progress in improving its funding and liquidity metrics. This leads to a stand-alone credit profile (SACP) of 'aa-'. Our unchanged expectation that KommuneKredit will benefit from extraordinary support from its highly creditworthy local government shareholders lifts the issuer credit rating to 'AAA'.

KommuneKredit's RAC metrics, both before and after adjustments, improved during 2018 and reached about 17.2% as of March 2019--comfortably above the 15.1% seen at end-April 2018. The RAC ratio has benefited from a more efficient allocation of KommuneKredit' securities portfolio, only modest new lending, and moderate internal capital generation. These developments have helped the agency to absorb slightly greater concentration of its loans book. We believe that this trend will continue in the coming years, enabling KommuneKredit to sustain its RAC ratio after adjustment comfortably above 15%.

KommuneKredit's funding and liquidity position is also gradually improving, though still slightly weaker than peers'. Our calculation of the agency's one-year liquidity ratio (including disbursements) increased to 1.3x as of June 30, 2019, from slightly below 1.0x as of end-April 2018. This ratio factors in potentially stressed market conditions, under which we assume the agency wouldn't have access to the capital markets. Our static one-year funding gap also improved and was about 1.1x at end-June 2019. Maturing assets did not sufficiently cover all the maturing debt below one-year, indicating that KommuneKredit will not be able to fully cover its scheduled liabilities without access to the capital markets. We believe the weakness in the funding ratios are somewhat counterbalanced by an average maturity of 5.8 years for its funding; this points to some leeway for adjusting the structural mismatch.

KommuneKredit's very strong market position, its important public policy mandate, and creditworthy borrowers also underpin the agency's creditworthiness.

Enterprise risk profile: A very strong market position as a key lender to low-risk municipal sector and an important public policy mandate

- A very competitive loan offer underpins the agency's strong public policy role and impressive market position.
- Denmark's wealthy, resilient economy and well-developed financial sector, reflected in our strong public industry risk assessment (PICRA), and the agency's strong ties to the 'AAA' rated sovereign are credit strengths.

KommuneKredit's public-sector mandate is to provide funding solely to its members, the Danish LRGs. The agency provides funding directly to its member municipalities and regions, or to companies with a municipal guarantee. As a result, KommuneKredit's loan book contains only Danish LRG risk. KommuneKredit holds a very strong market position with a market share of 99% of total lending to the LRG sector.

KommuneKredit has a pronounced public policy mandate based on its ownership, support structure, niched lending, and non-profit mission. As such, KommuneKredit plays a very important role in supplying financing to the Danish LRG sector by ensuring stable and advantageous funding in national and international capital markets. KommuneKredit's public policy relevance is further accentuated by its long-term engagement in the LRG sector. A distinguishing feature of the Danish LRG sector is its target of long-term borrowing. The average maturity of KommuneKredit's lending is 7.7 years, which shows the agency's long-term commitment to the sector. KommuneKredit has call options on its lending, although we do not expect it will exercise them, due to its public policy role and very close ties to the LRG sector.

We view KommuneKredit's overall financial management and governance as strong but not as robust as its Nordic peers' when focusing on KommuneKredit's liquidity and funding profile. Also, in contrast to Kommunalbanken (KBN), Municipality Finance, and Kommuninvest (KI), KommuneKredit does not perform its own credit analysis of individual borrowers. Instead, the Danish Ministry for Economic Affairs and the Interior performs monitoring of the LRG sector and thereby de facto sets KommuneKredit's lending strategy.

KommuneKredit's risk management principles (including policies for liquidity risk, currency risk, interest rate risk, and credit risk) are defined in the operating policies approved by the board of directors.

The Danish LRG sector exhibits key structural features that support its high credit standing and our view of a strong PICRA. For example, the economy is wealthy, the financial system is advanced, the LRG sector benefits from low leverage and a strong institutional framework, and there are close links between the LRG sector and the 'AAA' rated sovereign. In addition, the economy displays very strong resilience.

Financial risk profile: Very Strong capitalization combined with adequate liquidity and neutral funding ratios

- The agency's very strong capital ratios are benefiting from subdued lending growth.
- We believe the agency's liquidity position has improved, based on our stressed liquidity ratio having strengthened to above 1x.

Our RAC ratio for KommuneKredit before adjustments is one of the highest on our capital adequacy scale, at a very strong 41% as of March 31, 2019 (versus 34.7% at April 30, 2018). After applying adjustments specific to public-sector funding agencies, to account for single-name concentration on Danish municipalities, the RAC ratio reduces to 17.2% (15.1% as of April 30, 2018), but continues to exceed the 15% threshold. The increase in the RAC ratio is driven by moderate internal capital generation and more efficient allocation of its liquid portfolio, which offset some lending growth and moderate increase in exposure concentration. We expect this trend to continue in the coming years and now view KommuneKredit's capital adequacy as very strong.

In our view, due to KommuneKredit's significant market share and lending strategy's dependence on general borrowing trends in the Danish LRG sector, the agency is exposed to possible higher lending concentration. However, we think that the agency has some buffer to absorb some increase in lending concentration.

KommuneKredit's funding moderately improved to 1.1x as of end-June 2019, and we expect to remain around that level. We acknowledge the funding gap gradually improved compared with last year but we think a structural enhancement will take time to be implemented, and

KommuneKredit funding and liquidity profiles appear slightly weaker than peers'. The average maturity of funding is over five years, which is shorter than 7.7 years for lending, but longer than for security investments (about 2.5 years); there is therefore still some headroom for adjusting the mismatch. As a result, the agency's funding is a neutral rating factor.

KommuneKredit's funding strategy focuses on benchmark issuance in strategic markets, including green bonds. All markets are open to KommuneKredit as a result of its excellent name recognition and deep investor base. It issues primarily standard funding instruments, with any structured instruments typically comprising Japanese retail Uridashi with index-linked options.

We consider KommuneKredit to have an adequate liquidity position. We calculate KommuneKredit's liquidity ratio to be 1.31x as of June 30, 2019. This ratio indicates that KommuneKredit can meet its financial obligations over a one-year period. We factored into our calculations stressed market conditions, under which we assume the agency would not have access to the capital markets. KommuneKredit has adapted to the change to bilateral credit support annexes (CSAs), which supports its liquidity assessment in our view.

By law, KommuneKredit can prefinance up to 25% of lending and, in December 2018, this amounted to about 19.3% of lending. KommuneKredit's liquidity portfolio is invested in liquid fixed-income securities issued by governments, states, regional governments, multilateral development banks, and financial institutions rated 'AA-' or higher.

We do not foresee risks not captured in our RAC calculations and funding and liquidity metrics, since KommuneKredit hedges risk through derivatives, which, however, creates material counterparty exposures to financial institutions. Importantly, the agency follows prudent counterparty limitations and risk-reducing contracts--such as International Swaps and Derivatives Association master agreements and CSAs--to handle these exposures.

We observe that securities issued by KommuneKredit are eligible as collateral in the Danish central bank's monetary policy operations, and its foreign currency issues are eligible as collateral at the European Central Bank. However, KommuneKredit's lending book is not eligible as collateral; therefore, the eligibility of its securities does not enhance its liquidity position, in our view.

Likelihood of extraordinary support: Extremely high, via a joint and several guarantee and the agency's mutual structure, resulting in a three-notch uplift to the SACP

- KommuneKredit's highly creditworthy members are liable for its obligations under a joint and several liability scheme, and we expect that the largest members will support the agency if needed.
- We assess the likelihood of KommuneKredit receiving extraordinary government support to be extremely high, owing to what we view as the agency's integral link to, and very important role for, its municipal government members.

KommuneKredit's members are responsible for its obligations through a joint and several liability mechanism. This translates into an explicit, statutory liability of all municipalities and regions, and ultimately of the central government. We assess the guarantee structure as predictable and immediately enforceable by law, under which members have to inject capital if the capital ratio falls below 1%. We understand that any investor, without a court order, can call upon any guaranteeing member to pay a claim on KommuneKredit. This gives the largest LRG members, whose creditworthiness we assess as slightly below the sovereign's, an extremely strong incentive

to provide support to KommuneKredit before the guarantees are called. The legal enforceability of the guarantee underpins our assessment of an integral link between KommuneKredit and its members. At the same time, we consider that KommuneKredit has a very important role in providing cost-efficient funding to its members. We therefore believe there is an extremely high likelihood that the members would support KommuneKredit should it experience financial distress, before any guarantees are called.

Moreover, we believe that KommuneKredit's other LRG members would also be liable and able to support it in a stress scenario. This underlines our view of sector support in addition to extraordinary support from the largest owners. All together, we add three notches of uplift to KommuneKredit's 'aa-' SACP, leading to the issuer credit rating of 'AAA'. By comparison, we add a two-notch uplift for KI and KBN.

Key Statistics

KommuneKredit Selected Indicators

(Mil. DKK)	--Year ended Dec. 31--				
	2018	2017	2016	2015	2014
Business position					
Total adjusted assets	226,609	222,564	223,938	213,199	201,413
Customer loans (gross)	177,454	173,580	168,589	157,693	152,085
Growth in loans (%)	2	3	7	4	7
Net interest revenues	441	634	656	674	450
Noninterest expenses	127	123	106	96	95
Capital and risk position					
Total liabilities	218,873	215,231	217,094	206,852	195,169
Total adjusted capital	7,736	7,333	6,844	6,347	6,244
Assets/capital	29	30	33	34	32
RAC ratio before diversification (%)*	41	34.7	N.A.	N.A.	N.A.
RAC ratio after diversification (%)*	17.2	15.1	N.A.	N.A.	N.A.
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity§					
Liquidity ratio with loan disbursement (1 year)	1.3	0.6	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (1 year)	1.4	0.96	N.A.	N.A.	N.A.
Funding ratio (1 year)	1.1	0.67	N.A.	N.A.	N.A.

*RAC ratios for 2017 are as of end-April 2018 and for 2018 are as of end-March 2019. §Funding and liquidity ratios for 2018 are as of end-June 2019. RAC--Risk-adjusted capital. DKK--Danish krone. N.A.--Not available.

Ratings Score Snapshot

Issuer Credit Rating	AAA/Stable/A-1+
SACP	aa-
Enterprise Risk Profile	Strong (2)
PICRA	Strong (2)
Business Position	Very Strong (1)
Management & Governance	Strong (2)
Financial Risk Profile	Strong (2)
Capital Adequacy	Very Strong (1)
Funding and	Neutral (0) and
Liquidity	Adequate (3)
Support	(+2)
GRE Support	(+2)
Group Support	(0)
Additional Factors	(+1)

Related Criteria

- Criteria | Governments | International Public Finance: Public-Sector Funding Agencies: Methodology And Assumptions, May 22, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Danish Public-Sector Funding Agency KommuneKredit Ratings Lowered To 'AA+'; Off UCO; Outlook Stable, July 26, 2018
- Assumptions For Liquidity Gap Analysis Under "Public-Sector Funding Agencies: Methodology And Assumptions", May 22, 2018
- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018

Ratings List

Upgraded; Ratings Affirmed

	To	From
KommuneKredit		
Issuer Credit Rating	AAA/Stable/A-1+	AA+/Stable/A-1+
Senior Unsecured	AAA	AA+

Ratings Affirmed

KommuneKredit		
Commercial Paper	A-1+	

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