

# MOODY'S

## INVESTORS SERVICE

### CREDIT OPINION

30 July 2020

#### Update

 Rate this Research

#### RATINGS

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 reflects the institution's close links to Danish regional and local governments (RLGs) and ultimately the [Danish sovereign](#) (Aaa, stable). The main drivers of the ratings are (1) the support offered by the joint-and-several guarantee provided by its RLG members; (2) the agency's close association with the central government; (3) its public policy mandate and dominant franchise in Denmark; and (4) prudent financial management.

#### Credit strengths

- » Benefits from a joint and several guarantee provided by all Danish regional and local governments
- » Direct oversight by the sovereign
- » Excellent asset quality
- » Very solid capitalization

#### Credit challenges

- » Some lending concentration, although mitigated by very strong asset quality
- » Low profitability, albeit 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 senior unsecured debt ratings is stable, in line with the Government of Denmark.

#### 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 a 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]

	12-19 <sup>2</sup>	12-18 <sup>2</sup>	12-17 <sup>2</sup>	12-16 <sup>3</sup>	12-15 <sup>3</sup>	CAGR/Avg. <sup>4</sup>
Total Assets (DKK Million)	236,935.0	226,609.0	222,564.0	223,938.0	213,199.0	2.7 <sup>5</sup>
Total Assets (USD Million)	35,591.9	34,713.7	35,895.1	31,766.3	31,034.2	3.5 <sup>5</sup>
Tangible Common Equity (DKK Million)	8,184.0	7,754.0	7,333.0	6,844.0	6,347.0	6.6 <sup>5</sup>
Tangible Common Equity (USD Million)	1,229.4	1,187.8	1,182.7	970.8	923.9	7.4 <sup>5</sup>
Tangible Common Equity / Risk Weighted Assets (%)	68.7	56.0	41.8	--	--	55.5 <sup>6</sup>
Net Interest Margin (%)	0.2	0.2	0.3	0.3	0.3	0.3 <sup>6</sup>
PPI / Average RWA (%)	4.5	3.2	3.6	--	--	3.7 <sup>6</sup>
Net Income / Tangible Assets (%)	0.2	0.2	0.2	0.2	0.0	0.2 <sup>6</sup>
Cost / Income Ratio (%)	18.9	20.4	17.9	14.2	43.0	22.9 <sup>6</sup>
Market Funds / Tangible Banking Assets (%)	96.0	96.1	96.2	96.5	96.5	96.3 <sup>6</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	16.8	16.5	19.0	15.9	16.3	16.9 <sup>6</sup>

[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 because of the scale of reported amounts. [5]Compound annual growth rate (%) based on the periods for the latest accounting regime. [6]Simple average of Basel III periods. [7]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 and was established over 120 years ago as a credit association (a membership organization). Membership is voluntary but currently all Danish regions and municipalities are members. KommuneKredit has no separate ownership organization. As of year-end 2019, all Denmark's (98) municipalities and (5) regions are 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.

Following the general elections in Denmark on 5 June 2019, the responsibility for KommuneKredit was transferred to the Danish Ministry of Industry, Business and Financial Affairs from the Ministry of Economic Affairs. The framework governing KommuneKredit's operations remains unchanged, however.

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.

## Recent developments

We [expect](#) advanced economies collectively to contract in 2020. We expect a gradual recovery beginning in the second half of the year, but that outcome will depend on whether governments can reopen their economies while also safeguarding public health. A rebound in demand will determine the ability of businesses and labour markets to recover from the shock. Even with a gradual recovery, we expect 2021 real GDP in most advanced economies to be below pre-coronavirus levels.

We have [changed](#) our outlook for the Danish banking system to negative from stable. Coronavirus-related disruption is expected to lead to a decline in GDP growth in 2020, and an uptick in unemployment. The full extent of the economic impact will be unclear for some time. A broad package of government support measures, including time-limited financial assistance for affected businesses' payroll and fixed expenses, support for the self-employed, loan guarantee schemes for companies and tax payment deferrals, will help limit the impact in the short term.

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](http://www.moody's.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 the 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 (rather than the Danish financial supervisory authority), and lending is restricted to Danish regional and local authorities and institutions benefiting from a full guarantee from a 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 the 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 as the agency can offer very competitive funding costs, but is also supported by its long track-record.

The government's spring 2018 proposal to expose the utilities sector to more competition was updated in the first half of 2019, which could have prevented KommuneKredit from granting loans to this sector. However, KommuneKredit commissioned a competition analysis on waste energy and waste incineration in Denmark, which resulted in the agency being able to continue lending to the utilities sector as long as such facilities are within the regulatory framework.

### 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. The Ministry has determined that KommuneKredit may build up liquidity of up to 25% of total lending at the end of the preceding quarter, and as of year-end 2019 the upper limit was set at DKK47.1 billion, while the agency's liquidity resources stood at DKK35.9 billion. 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, equating to DKK368 million as of year-end 2019.

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

Although the economic impact from the coronavirus-induced economic disruption will be negative for Danish lenders in general, we expect KommuneKredit's asset quality to remain resilient as it lends to the Danish RLG sector. KommuneKredit has never incurred a credit loss on any of its loans in its 120-year history. Its creditworthiness rests on the RLG sector. We consider the sub-sovereign financially strong as Danish regions and municipalities can increase revenues through 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 the grants from the central government. In addition, 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.

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

In 2019, the value of lending and leasing increased to DKK185.0 billion, an increase of DKK7.5 billion, of which DKK2.4 billion was due to new lending. The association had a strong demand for the 25-year fixed-rate loans, which represented around 60% of all new loans during the same period.

Although KommuneKredit has never incurred a credit loss, the introduction of IFRS9 in January 2018, resulted in the municipal lender having to take a DKK2.1 million higher impairment charge linked to the leasing portfolio.

### Very solid capitalisation

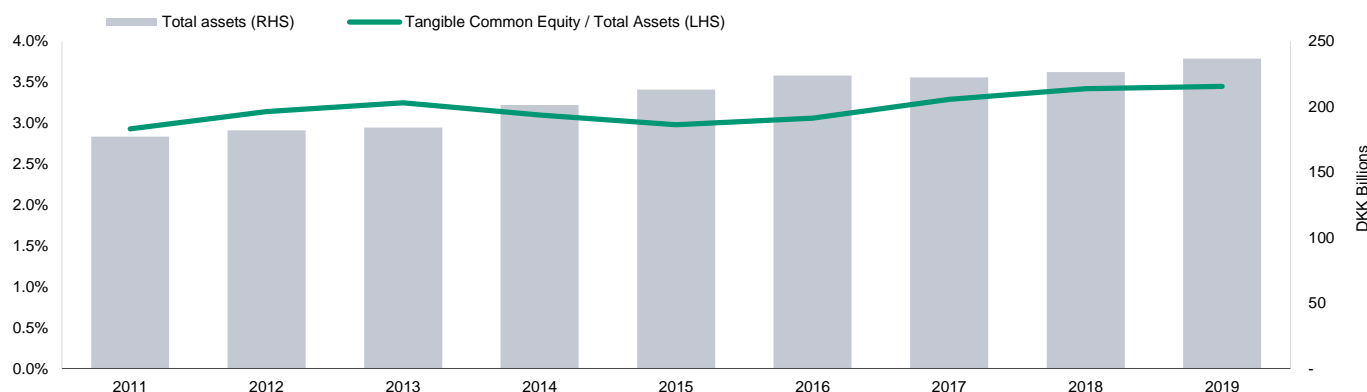
KommuneKredit is not required to report a Tier 1 capital ratio, but has indicated that its capital ratio (capital base divided by risk-weighted assets) was 67% as of year-end 2019, which is mainly due to the zero risk weights assigned to its RLG lending.

KommuneKredit's leverage ratio (Moody's: tangible common equity to total assets) stood at 3.5% as of year-end 2019. 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 (see Exhibit 2), and we expect it to remain so going forward.

Exhibit 2

### Leverage has remained stable while assets have grown

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



Source: Moody's Financial Metrics

### Low profitability, but relatively stable and linked to its public policy mandate

Like 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 as predictable as 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 as membership is limited to Danish regional and local governments and all of them are 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. However, the coronavirus' outbreak will have implications for public health across Denmark, as well as an adverse impact on the collection of local tax and service fee revenues due to weaker economic growth and higher unemployment.

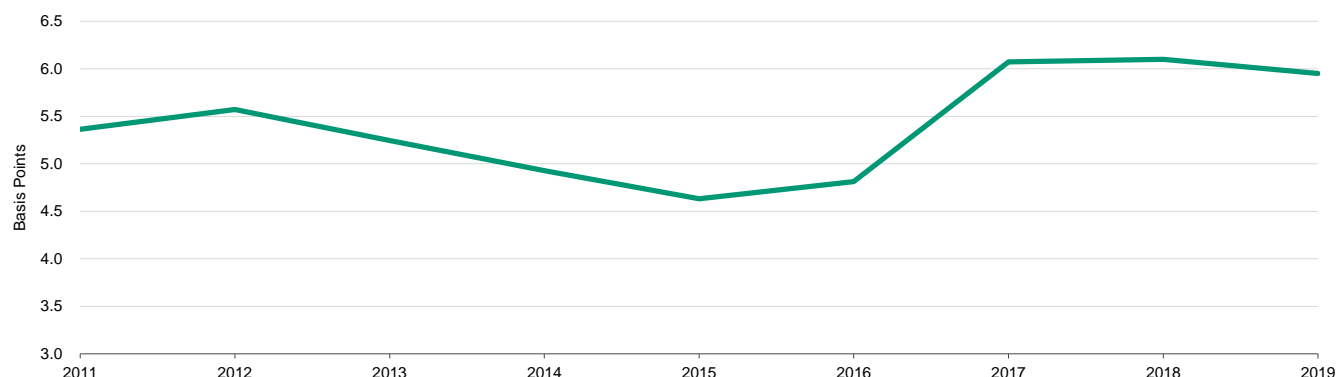
In 2018, KommuneKredit implemented a new method for fixing interest rates on new loans called the Funds Transfer Pricing model, with the aim of aligning the interest rate on an individual loan to the costs and risks attached to it.

KommuneKredit's monoline business model and efficient distribution channels allow the association to keep operating expenses at very manageable levels. The lender employed 76 people in year-end 2019, had total assets of DKK236.9 billion (approximately €31.7 billion) at year-end 2019. Its ratio of operating expenses to total average assets has remained low at slightly over 5 basis points as of December 2019 (see Exhibit 3).

Exhibit 3

### Operating expenses are low at slightly over 5 basis points as of year-end 2019

KommuneKredit's operating expenses to average total assets "basis points"



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 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.

Most of the outstanding funding before currency hedging is in Euro, US dollars and Danish kroner as of year-end 2019.

As of year-end 2019 funding due to credit institutions and debt securities issued stood at DKK219 billion, an increase by DKK10.7 billion compared to year-end 2018 due to the increase in lending and leasing. In June 2020, KommuneKredit issued a new 5-year USD1 billion benchmark, which was oversubscribed and offered as a switch and tender offer to existing investors in two outstanding USD benchmarks.

Similar to its peers, KommuneKredit has issued three green bonds (€500 million in May 2017, €750 million issuance in June 2018, and €500 million in November 2019) to fund sustainable lending across Denmark, and by the year-end 2019 the value of disbursed loans amounted to DKK13.0 billion.

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), with the bulk of investments in supra-nationals, agencies and covered bonds. As of year-end 2019 the size of the liquidity 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.

## ESG considerations

We consider KommuneKredit to have a low exposure to Environmental risks in line with how we view the banking sector. See our Environmental risks [Environmental heatmap](#) for further information.

Due to KommuneKredit's role as one of Denmark's largest credit institution specialising in the financing of Danish municipalities, it is susceptible to politically and socially motivated decisions that could affect its financial profile. Its borrowers are exposed to the challenges of providing services to an aging population leading to increasing dependency ratios. Over time, these challenges can add pressure on municipalities' finances, even though 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 member organisations are responsible for each other's commitments in proportion to their population figures. Overall, we consider the issuer to have a moderate exposure to Social risk.

We also regard the coronavirus outbreak as a social risk under our 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 [Social heatmap](#) for further information.

Governance is highly relevant to 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
<b>KOMMUNEKREDIT</b>	
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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