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## Research Update:

# Danish Local Government Funding Agency KommuneKredit Ratings Affirmed At 'AAA/A-1+'; Outlook Stable

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## Research Update:

# Danish Local Government Funding Agency KommuneKredit Ratings Affirmed At 'AAA/A-1+'; Outlook Stable

## Overview

- Danish local government funding agency KommuneKredit continues to benefit from very solid operations, thanks to excellent asset quality, capitalization, and asset-liability management, as well as a joint and several liability structure from the Danish local government sector.
- We are affirming our 'AAA/A-1+' long- and short-term issuer credit ratings on KommuneKredit.
- The stable outlook reflects our expectation that, over the coming two years, KommuneKredit's joint and several member liability structure will remain intact, and that the agency will continue to pursue prudent risk-management practices and excellent asset quality, and maintain its liquidity policies and liquidity position.

## Rating Action

On Nov. 17, 2017, S&P Global Ratings affirmed its 'AAA' long-term and 'A-1+' short-term issuer credit ratings on Danish local government funding agency KommuneKredit. The outlook is stable.

## Rationale

We use our "Principles of Credit Ratings" to assess KommuneKredit. KommuneKredit's enterprise risk profile is benchmarked from our multilateral lending institutions (MLI) and other supranational institutions ratings methodology, which is based on a combination of policy importance and governance and management expertise. The financial risk profile is benchmarked against the MLI methodology, with a combination of capital adequacy and funding and liquidity. We then factor in the joint and several liability to KommuneKredit from its members, which results in a 'AAA' rating.

The ratings also reflect our view of KommuneKredit's prudent risk management, excellent asset quality, and very strong capitalization. KommuneKredit's special status as a lending agency under government law limits its exposure to regulatory risks and is a rating strength. Conversely, under a stressed scenario, we see potential funding risks from the agency's dependence on wholesale funding, its lack of explicit central bank access, and some concentration risks from lending and derivative counterparty exposures.

KommuneKredit benefits from a supportive legal framework and a special status and operational mandate, formalized by law. Thereby, KommuneKredit is exempt from the proposed Basel III regulations, which it could nevertheless currently accommodate.

KommuneKredit has a very strong capital base. The agency does not have to comply with regulatory capital ratios, but we note that our risk-adjusted capital ratio was a very strong 39% on June 30, 2017, compared with 32% on June 30, 2016. In addition, KommuneKredit's equity-to-assets ratio (leverage ratio) was a strong 3.1%, above the proposed Basel III requirement of 3%. Furthermore, the agency has stated in its financial policy that its internal goal is to maintain a ratio above 3% in the long term, although the agency is only legally required to keep its equity capital at more than 1% of total liabilities. KommuneKredit's capitalization consists solely of core equity with no need for hybrid instruments.

On June 30, 2017, KommuneKredit's total loans amounted to Danish krone (DKK) 166 billion (approximately €22.3 billion), 96% of total lending, and leasing stood at DKK6.2 billion, accounting for 4% of lending. KommuneKredit grants loans only to Danish local and regional governments (LRGs) or public-sector companies backed by municipal guarantees. The Danish LRG sector has a very supportive grant and equalization system that ensures LRGs have sufficient financing and are largely unaffected by economic downturns. Consequently, we consider the asset quality of KommuneKredit's loan book to be excellent.

KommuneKredit's credit portfolio is concentrated in the LRG sector, but we believe this is mitigated by Danish LRGs' very strong credit quality. All loans carry a zero risk weight according to the Bank for International Settlement's guidelines. KommuneKredit has never recorded loan losses or nonperforming loans from the Danish LRG sector. Consequently, the joint and several liability has never been called.

KommuneKredit's asset-liability management is prudent, and the agency strives to eliminate duration mismatches between assets and liabilities. Consequently, the agency 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 credit support annexes (CSAs)--to handle these exposures. The switch to bilateral CSA agreements could impact liquidity positions if KommuneKredit had to pledge large amounts of its securities as collateral for counterparties' derivatives claims at KommuneKredit. However, KommuneKredit has increased its prefunding to strengthen its overall liquidity position, taking into account the liquidity drain that could take place because of a collateral outflow for derivatives trading in a worst-case scenario.

Overall, KommuneKredit has limited exposure to market risks. Currency risk is minimal because all lending is typically in Danish krone and all funding in other currencies is swapped into Danish krone. Similarly, the agency reduces virtually all interest rate risk through extensive use of derivatives, whereby all fixed-rate funding of a certain size is swapped into floating rates as of the agreement date. KommuneKredit has a fixed exposure limit for interest rate risk (4.5% of equity), derived using a 1% parallel shift of the interest curve based on market values. In 2016, KommuneKredit utilized 13% of the interest rate limit, equivalent to DKK38 million of the interest rate limit of DKK299 million.

On June 30, 2017, comprehensive income amounted to DKK269 million (€35 million), down 13% from DKK308 million on June 30, 2016, due to a decrease in net interest income. Total lending amounted to DKK172 billion at the end of June 2017, compared with DKK169 billion in June 2016. Over the coming years, KommuneKredit forecasts continued lending in line with the LRG sector. For full year 2017, we expect that KommuneKredit will record comprehensive income of DKK495 million, against DKK498 million in 2016.

On June 21, 2017, the Danish government announced that it would be introducing a law reform which makes it possible to use government loans to finance social housing. Today, these schemes are financed through subsidized mortgage loans from Danish mortgage banks and through municipality-guaranteed loans from KommuneKredit. The social housing sector holds subsidized loans amounting to DKK180 billion, of which KommuneKredit has total lending of about DKK25 billion. The proposal to use government loans for social housing will be part of a future proposal to amend the Social Housing Act. If the reform is passed, we expect existing loans to finance social housing to the elderly to remain in KommuneKredit's balance sheet until maturity. However, KommuneKredit would likely not finance new loans to the sector. Consequently, banks and KommuneKredit's exposure will gradually decrease as existing loans mature.

## **Liquidity**

KommuneKredit uses only wholesale funding (in the bond and commercial paper market, but not via deposits), so it is fully dependent on reliable access to capital markets. Hence, KommuneKredit is exposed to changed liquidity in these markets and risk appetite among institutional investors. However, KommuneKredit has access to several funding markets, very strong name recognition, prudent liquidity policies, and significant volumes of prefunded highly rated securities. Furthermore, even if KommuneKredit does not have direct central bank access, securities issued by KommuneKredit are, for banks with central bank access, eligible as collateral in the Danish central bank's monetary policy operations. At the same time, KommuneKredit's foreign currency issues are eligible as collateral at the European Central Bank, while its Danish krone issues are not eligible. This could boost KommuneKredit's liquidity in a stressed scenario as long as banks are able and willing to engage in repurchase transactions. At the same time, KommuneKredit can issue unlimited volumes of its own securities, which are eligible as collateral.

By law, KommuneKredit can hold prefunding only within a limit set by the Ministry for Economic Affairs and the Interior. The maximum is 25% of lending, and, in June 2017, it amounted to 24% of lending compared with 18% in June 2016. KommuneKredit's treasury investments are highly liquid, typically bank deposits or investments in securities rated 'AA-' or higher.

KommuneKredit monitors liquidity daily and carries out stress tests to verify that there is sufficient liquidity to sustain a prolonged funding interruption. Under a simulated worst-case scenario in September 2017, assuming all funding with call options were called simultaneously and no lending was called, KommuneKredit's

liquidity buffers were sufficient to cover 496 days of operations before resorting to equity capital, against 364 days in our worst-case scenario in September 2016.

## Outlook

The stable outlook reflects our expectation that, over the coming two years, KommuneKredit's joint and several member liability structure will remain intact. It further reflects our expectation that KommuneKredit will continue its prudent risk management and maintain its excellent asset quality, as well as sustaining its liquidity policies and positions.

Downward pressure on the ratings could arise if KommuneKredit's liquidity position weakened significantly, if its funding capacity deteriorated, or if our view of its management and risk-management practices were to weaken. A substantial deterioration of the quality of loans or securities investments, or a downward revision of our assessment of the member liability structure, could also lead to a negative rating action.

### KommuneKredit Key Statistics

(Mil DKK)	--Year ended Dec. 31--			
	2016	2015	2014	2013
Adjusted assets	223,938	213,199	201,413	184,239
Customer loans (gross)	168,589	157,693	152,085	142,711
Adjusted common equity	6,844	6,347	6,244	5,995
Operating revenues	745	223	433	428
Noninterest expenses	106	96	95	96
Core earnings	498	104	254	279
<b>CAPITAL AND EARNINGS (%)</b>				
Net interest income/operating revenues	88.1	302.2	103.9	117.5
Noninterest expenses/operating revenues	14.2	43.0	21.9	22.4
Provision operating income/average assets	0.3	0.1	0.2	0.2
Core earnings/average managed assets	0.2	0.1	0.1	0.2
<b>RISK POSITION (%)</b>				
Growth in customer loans	6.9	3.7	6.6	4.7
Total managed assets/adjusted common equity (x)	32.7	33.6	32.3	30.7
<b>FUNDING AND LIQUIDITY (%)</b>				
Long term funding ratio	79.1	69.2	59.9	70.9
Short-term wholesale funding/funding base	21.6	31.8	41.4	30.1
Broad liquid assets/short-term wholesale funding (x)	0.6	0.4	0.3	0.5
Short-term wholesale funding/total wholesale funding	21.6	31.8	41.4	30.1

DKK--Danish krone.

## Related Criteria And Research

### Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology - November 26, 2012
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions - November 09, 2011
- General Criteria: Principles Of Credit Ratings - February 16, 2011
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

### Related Research

- Research Update: Kingdom of Denmark 'AAA/A-1+' Ratings Affirmed; Outlook Stable - September 15, 2017

## Ratings List

	Rating	
	To	From
KommuneKredit		
Issuer Credit Rating		
Foreign and Local Currency	AAA/Stable/A-1+	AAA/Stable/A-1+
Senior Unsecured		
Foreign and Local Currency	AAA	AAA
Short-Term Debt		
Foreign and Local Currency	A-1+	A-1+
Commercial Paper		
Foreign Currency	A-1+	A-1+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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