

Research Update:

Danish Public-Sector Funding Agency KommuneKredit Affirmed At 'AAA'; Outlook Stable

July 3, 2020

Overview

- We expect Danish local and regional governments to uphold very strong credit quality despite setbacks from the COVID-19 pandemic, thanks to central government support and automatic stabilizers.
- KommuneKredit is committed to maintaining its strong liquidity coverage, leading us to revise up our assessment of the agency's funding and liquidity profile.
- We are affirming our 'AAA/A-1+' long- and short-term issuer credit ratings on KommuneKredit.
- The outlook is stable.

Rating Action

On July 3, 2020, S&P Global Ratings affirmed its 'AAA/A-1+' long- and short-term issuer credit ratings on Danish public-sector funding agency KommuneKredit. The outlook on the long-term rating is stable.

Outlook

The stable outlook reflects our expectations that the underlying Danish municipal sector will maintain its strong credit quality despite COVID-19 fallout, thanks to robust support from the central government. It also reflects our expectations that the guarantee structure will remain unchanged and that KommuneKredit will maintain its solid capital position and strong funding and liquidity profile. 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 declined, with its risk-adjusted capital (RAC) ratio decreasing to below 15%. This could result from

PRIMARY CREDIT ANALYST

Alexander Ekblom
Stockholm
(46) 8-440-5911
alexander.ekblom
@spglobal.com

SECONDARY CONTACT

Johanna Melinder
Stockholm
+ 46 84 40 5926
johanna.melinder
@spglobal.com

ADDITIONAL CONTACT

EMEA Sovereign and IPF
SovereignIPF
@spglobal.com

higher lending book expansion or increased concentration on the top borrowers. 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) or a structural deterioration of the creditworthiness of the underlying sector.

Rationale

The ratings reflect KommuneKredit's very strong market position, its important public-policy mandate, and highly creditworthy borrowers and members. Sustained high capitalization, solid funding, strong liquidity, and our expectation that KommuneKredit will benefit from extraordinary support from its highly creditworthy LRG shareholders also support the ratings.

Enterprise risk profile: A very strong market position as a key lender to the 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, and the LRG sector's strong ties to the 'AAA' rated sovereign are credit strengths.
- Danish LRGs have shown resilient financial performance despite subdued economic activity due to the COVID-19 pandemic.

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 and it holds a very strong market position, with a market share of close to 100% of total lending to the LRG sector.

The agency has a pronounced public-policy mandate based on its ownership, support structure, niche lending, and nonprofit 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. About 40% of KommuneKredit's loans mature after five years, which shows the agency's long-term commitment to the sector. Although the agency has call options on its loans that could potentially provide additional flexibility, 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', particularly when focusing on the internal credit assessment of its members. In contrast to Kommunalbanken, Municipality Finance, and Kommuninvest, 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 that KommuneKredit then incorporates.

The Danish LRG sector exhibits key structural features that support its high credit standing and our view of a strong Public Sector Industry Risk and Country Risk Assessment. 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. We expect the central government to compensate Danish LRGs for lost revenue and

increased costs linked to the COVID-19 pandemic so that they will uphold its sound financial positions.

Financial risk profile: Very strong capitalization and recently strengthened liquidity coverage provide important financial buffers

- KommuneKredit's very strong capital ratios result from institutionalized low lending growth.
- We believe the agency's liquidity position has improved and that it can consistently maintain scheduled loan disbursements to members without access to external funding in a stressed scenario.
- Broad access to diversified funding and the track record of a positive funding gap support a positive funding profile.

At a very strong 54.5% as of Dec. 31, 2019 (versus 41% at March 31, 2019), our RAC ratio for KommuneKredit, before adjustments, is one of the highest on our capital adequacy scale. After applying adjustments specific to public-sector funding agencies, to account for single-name concentration on Danish municipalities, the RAC ratio reduces to 19.2% (versus 17.2% at March 31, 2019), but continues to exceed the 15% threshold for the current capital assessment. The increase in the RAC ratio is spurred by more efficient allocation of its liquid portfolio and moderate internal capital generation, which offset some lending growth and a moderate increase in exposure concentration. We expect KommuneKredit to maintain its capitalization levels in the coming years. In our view, due to its significant market share and the 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 it has a buffer to absorb some increases in lending concentration.

KommuneKredit's funding strategy focuses on benchmark issuance in strategic markets, including green bonds. All markets are open to KommuneKredit because of its excellent name recognition and deep investor base. Since early 2018, KommuneKredit issues primarily standard funding instrument in contrast to the practice earlier when structured notes were common. We expect this to continue. Moreover, the agency's funding ratios have continued to improve and stood at 1.4x as of March 31, 2020, and we expect funding sources to adequately cover maturing debt in a given time period going forward. As a result, we now consider the agency's funding profile positive.

In our view, the agency has also improved its liquidity coverage and we now consider it to have a strong liquidity position. We calculate KommuneKredit's liquidity ratio to be 1.4x as of March 31, 2020, and we observe that it has been consistently above 1x for more than 15 months. This ratio indicates that KommuneKredit can meet its financial obligations over a one-year period. We factor into our calculations stressed market conditions, under which we assume the agency would not have access to the capital markets. In our view, KommuneKredit has also over the past couple of years adapted to the change to bilateral credit support annexes (CSAs), which supports its liquidity assessment.

By law, KommuneKredit can pre-finance up to 25% of lending, with the metric standing at 19% at Dec. 31, 2019. The agency'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 forecast risks not captured in our RAC calculations and funding and liquidity metrics, since KommuneKredit hedges risk through derivatives, although this does create material

counterparty exposure 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.

Extremely high likelihood of extraordinary support via a joint and several guarantee from its highly creditworthy member

- 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.
- Additional uplift for what we regard as support mutualization from other members with strong investment-grade credit profiles leads to the rating of 'AAA'.

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 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 the 'aa-' stand-alone credit profile, leading to the issuer credit rating of 'AAA'.

Key Statistics

Table 1

KommuneKredit Selected Indicators

(Mil. DKK)	--Year ended Dec. 31--				
	2019	2018	2017	2016	2015
Business position					
Total adjusted assets	236,935	226,609	222,564	223,938	213,199
Customer loans (gross)	184,967	177,454	173,580	168,589	157,693
Growth in loans (%)	4	2	3	7	4
Net interest revenues	495	441	634	656	674
Noninterest expenses	126	127	123	106	96
Capital and risk position					
Total liabilities	228,756	218,873	215,231	217,094	206,852
Total adjusted capital	8,179	7,736	7,333	6,844	6,347
Assets/capital	29	29	30	33	34
RAC ratio before diversification (%)*	54.5	41	34.7	N.A.	N.A.
RAC ratio after diversification (%)*	19.2	17.2	15.1	N.A.	N.A.
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity§					
Liquidity ratio with loan disbursement (1 year)	1.4	1.3	0.6	N.A.	N.A.
Liquidity ratio without loan disbursement (1 year)	1.5	1.4	0.96	N.A.	N.A.
Funding ratio (1 year)	1.4	1.1	0.67	N.A.	N.A.

*RAC ratios for 2017 are as of end-April 2018, for 2018 are as of end-March 2019 and 2019 as of end-December 2019. §Funding and liquidity ratios for 2018 are as of end-June 2019 and for 2019 as of end-March 2020. RAC--Risk-adjusted capital. DKK--Danish krone. N.A.--Not available.

Ratings Score Snapshot

Table 2

KommuneKredit 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)

Table 2

KommuneKredit Ratings Score Snapshot (cont.)

Funding and Liquidity	Positive and Strong (2)
Support	2
GRE Support	2
Group Support	0
Additional Factors	1

PICRA--Public-Sector Industry Risk And Country Risk Assessment.

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 Upgraded To 'AAA' On Strengthening Capitalization; Outlook Stable, July 24, 2019
- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018

Ratings List

Ratings Affirmed

KommuneKredit

Issuer Credit Rating AAA/Stable/A-1+

KommuneKredit

Senior Unsecured AAA

Commercial Paper 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

Research Update: Danish Public-Sector Funding Agency KommuneKredit Affirmed At 'AAA'; Outlook Stable

criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at 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.

Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.