

Research Update:

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

June 18, 2021

Overview

- We expect Danish local and regional governments (LRGs) to uphold very strong credit quality despite setbacks from the COVID-19 pandemic, thanks to central government support and automatic fiscal stabilizers built into their budgets.
- KommuneKredit is committed to maintaining its strong liquidity coverage, leading us to revise upward our assessment of the agency's funding and liquidity profile, and its stand-alone credit profile to 'aa'.
- We affirmed our 'AAA/A-1+' long- and short-term issuer credit ratings on KommuneKredit.
- The outlook is stable.

Rating Action

On June 18, 2021, 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 is stable.

Outlook

The stable outlook reflects our expectations that the underlying Danish municipal sector will maintain its strong credit quality, thanks to robust support from the central government and gradual economic recovery. It also reflects our expectations that the guarantee structure will remain unchanged and that KommuneKredit will maintain its solid capital position and very 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

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declined to the extent that that 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. We could also lower the ratings if we observed a diminishing likelihood of receiving extraordinary support from its members, Danish 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, very 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, 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. More than 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, KommuneKredit relies on the monitoring of the LRG sector by the Danish Ministry for Economic Affairs and the Interior.

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. The aforementioned close oversight from government is incorporated into our assessment of the institutional framework of the Danish LRG sector as extremely strong. We note that Danish LRGs have experienced limited financial impact from the COVID-19 pandemic, largely thanks to central government support and automatic fiscal stabilizers built into the Danish financing system for LRGs. We expect the central government will continue to compensate Danish LRGs for lost revenue and increased costs if the pandemic-induced recession continues beyond our current base case.

Financial Risk Profile: Very strong capitalization and structurally strengthened liquidity coverage provide 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.

Our RAC ratio for KommuneKredit, before adjustments, is one of the highest on our capital adequacy scale, at a very strong 59.5% on Dec. 31, 2020 (versus 54.5% a year earlier). After applying adjustments specific to public-sector funding agencies, to account for single-name concentration on Danish municipalities, the RAC ratio declines to 20.0% (versus 19.2% on Dec. 31, 2019), but continues to exceed the 15% threshold for the current capital assessment. The increase in the RAC ratio is spurred by moderate lending growth coupled with internal capital generation. We expect KommuneKredit will maintain its capitalization 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 sufficient buffer to absorb such an increase.

KommuneKredit's funding strategy focuses on benchmark issuance in strategic markets, including green bonds. All markets are open to KommuneKredit because of its excellent brand recognition and deep investor base. Since early 2018, KommuneKredit has issued primarily standard funding instruments, in contrast to the practice earlier when structured notes were common. We expect this will continue. Moreover, the agency's funding ratio have continued to improve and stood at 1.5x on Dec. 31, 2020, and we expect funding sources will adequately cover maturing debt in a given time period. As a result, we 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 very strong liquidity position. We calculate KommuneKredit's liquidity ratio to be 1.7x as of March 31, 2021, and we observe that it has been consistently above 1.2x since 2018. This ratio indicates that KommuneKredit can meet its financial obligations over a one-year period, including a buffer. We factor into our calculations stressed market conditions, under which we assume the agency would not have access to the capital markets. Moreover, KommuneKredit uses bilateral credit support annexes (CSAs), which support its liquidity position in our view.

By law, KommuneKredit can pre-finance up to 25% of lending, with the metric standing at 13% on Dec. 31, 2020. 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.

KommuneKredit hedges risk through derivatives, although this creates material counterparty

exposure to financial institutions, we believe risks are adequately captured in our RAC calculations and funding and liquidity metrics. 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 members

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

Table 1

KommuneKredit Selected Indicators

| (Mil. DKK) | --Year ended Dec. 31-- | | | | |
|--------------------------|------------------------|---------|---------|---------|---------|
| | 2020 | 2019 | 2018 | 2017 | 2016 |
| Business position | | | | | |
| Total adjusted assets | 233,872 | 236,935 | 226,609 | 222,564 | 223,938 |
| Customer loans (gross) | 192,459 | 184,967 | 177,454 | 173,580 | 168,589 |

Table 1

KommuneKredit Selected Indicators (cont.)

| (Mil. DKK) | --Year ended Dec. 31-- | | | | |
|--|------------------------|---------|---------|---------|---------|
| | 2020 | 2019 | 2018 | 2017 | 2016 |
| Growth in loans (%) | 4 | 4 | 2 | 3 | 7 |
| Net interest revenues | 440 | 495 | 441 | 634 | 656 |
| Noninterest expenses | 130 | 126 | 127 | 123 | 106 |
| Capital and risk position | | | | | |
| Total liabilities | 225,475 | 228,756 | 218,873 | 215,231 | 217,094 |
| Total adjusted capital | 8,397 | 8,179 | 7,736 | 7,333 | 6,844 |
| Assets/capital | 28 | 29 | 29 | 30 | 33 |
| RAC ratio before diversification (%)* | 60 | 55 | 41 | 35 | N.A. |
| RAC ratio after diversification (%)* | 20 | 19 | 17 | 15 | N.A. |
| Gross nonperforming assets/gross loans | 0 | 0 | 0 | 0 | 0 |
| Funding and liquidity§ | | | | | |
| Liquidity ratio with loan disbursement (1 year) | 1.7 | 1.4 | 1.3 | 0.6 | N.A. |
| Liquidity ratio without loan disbursement (1 year) | 2.3 | 1.5 | 1.4 | 1.0 | N.A. |
| Funding ratio (1 year) | 1.5 | 1.4 | 1.1 | 0.7 | N.A. |

*RAC ratios for 2017 are as of end-April 2018, for 2018 as of end-March 2019, and 2019 and 2020 as of end-December. §Funding and liquidity ratios for 2018 are as of end-June 2019, and for 2019 and 2020 as of end-March 2020 and 2021, respectively. Funding ratio is without loan disbursements. 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 | Very Strong (1) |
| Capital Adequacy | Very Strong (1) |
| Funding and Liquidity | Positive and Very Strong (1) |
| Support | 1 |
| GRE Support | 1 |
| Group Support | 0 |

Table 2

KommuneKredit Ratings Score Snapshot (cont.)

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: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Institutional Framework Assessment: Danish Regions And Municipalities, Feb. 3, 2021

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 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.

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