

CREDIT OPINION

23 June 2021

Update

✓ Rate this Research

RATINGS

KommuneKredit

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

Credit strengths

- » Benefits from a joint and several guarantee provided by all Danish RLGs
- » Direct oversight by the sovereign
- » Excellent asset quality
- » Very solid capitalisation

Credit challenges

- » Some lending concentration, although mitigated by very strong asset quality
- » Low profitability, although 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 that on the ratings of the Government of Denmark.

Factors that could lead to a downgrade

Although currently unlikely, downward pressure on KommuneKredit's ratings could arise as a result of any 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]

	12-20 ²	12-19 ²	12-18 ²	12-17 ²	12-16 ³	CAGR/Avg. ⁴
Total Assets (DKK Million)	219,675.0	227,633.0	226,609.0	222,564.0	223,938.0	(0.5) ⁵
Total Assets (USD Million)	36,110.0	34,194.5	34,713.7	35,895.1	31,766.3	3.3 ⁵
Tangible Common Equity (DKK Million)	8,395.0	8,184.0	7,754.0	7,333.0	6,844.0	5.2 ⁵
Tangible Common Equity (USD Million)	1,380.0	1,229.4	1,187.8	1,182.7	970.8	9.2 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	73.0	68.7	56.0	41.8	--	59.9 ⁶
Net Interest Margin (%)	0.2	0.2	0.2	0.3	0.3	0.2 ⁶
PPI / Average RWA (%)	2.2	4.5	3.2	3.6	--	3.4 ⁶
Net Income / Tangible Assets (%)	0.1	0.2	0.2	0.2	0.2	0.2 ⁶
Cost / Income Ratio (%)	34.1	18.9	20.4	17.9	14.2	21.1 ⁶
Market Funds / Tangible Banking Assets (%)	95.7	95.9	96.1	96.2	96.5	96.1 ⁶
Liquid Banking Assets / Tangible Banking Assets (%)	11.6	15.6	16.5	19.0	15.9	15.7 ⁶

[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. It was established more than 120 years ago as a credit association (a membership organisation). Membership is voluntary; however, currently, all Danish regions and municipalities are members. KommuneKredit does not have any separate ownership organisation. As of the end of December 2020, all Denmark's municipalities (98) and regions (5) were 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 Interior. However, the framework governing KommuneKredit's operations remains unchanged.

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

In March 2021 we changed our [outlook](#) for the Danish banking system to stable from negative. The change reflects the Danish economy's return to growth in 2021 after a coronavirus-related contraction in 2020.

[Furthermore](#), we expect real GDP in all G-20 countries to grow compared with last year, but some countries will take longer than others to return to full capacity. Fiscal and monetary policy response, as well as pandemic management, will continue to play a key role.

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 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 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, and lending is restricted to Danish regional and local authorities and institutions benefiting from a full guarantee from an 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 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 because the agency can offer very competitive funding costs and is also supported by its long track record.

In June 2020, a political agreement was reached regarding the future structure of the waste management sector. This led to a decision to allow KommuneKredit to continue to grant loans for the management of incinerable waste within the auspices of EU state aid regulation.

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 approval. 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 pre-finance of up to 25% of total lending at the end of the preceding quarter, and as of end December 2020, the upper limit was set at DKK47.8 billion, while the agency's pre-financing was DKK24.4 billion. The total holding of liquidity stood at DKK 33.6bn end of December 2020. 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, equivalent to DKK378 million as of end December 2020.

KommuneKredit has signed standardised swap and collateral documentation with all its largest counterparties. Terms include daily valuation and collateral transfer to and from KommuneKredit, and eligible collateral is limited to mortgage bonds and government bonds.

Excellent asset quality, although there is some lending concentration

Although the economic impact from the pandemic-induced economic disruption will be negative for Danish lenders in general, we expect KommuneKredit's asset quality to remain resilient because 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 because Danish regions and municipalities can increase revenue by 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 grants from the central government. In addition, Danish municipalities participate in a financial redistribution

system, under which revenue is spread so that all citizens, irrespective of their 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, that is, the Danish regions and municipalities, which also vary in size.

As of year-end 2020, the value of lending and leasing stood at DKK192.5 billion, an increase of DKK7.5 billion from year-end 2019, of which DKK5.1 billion was new lending. Overall, in 2020, the issuer disbursed over 800 new loans for DKK41 billion, which consisted of remortgaging of floating-rate loans and interest margin into fixed-rate loans accounted for DKK10 billion due to low interest rates.

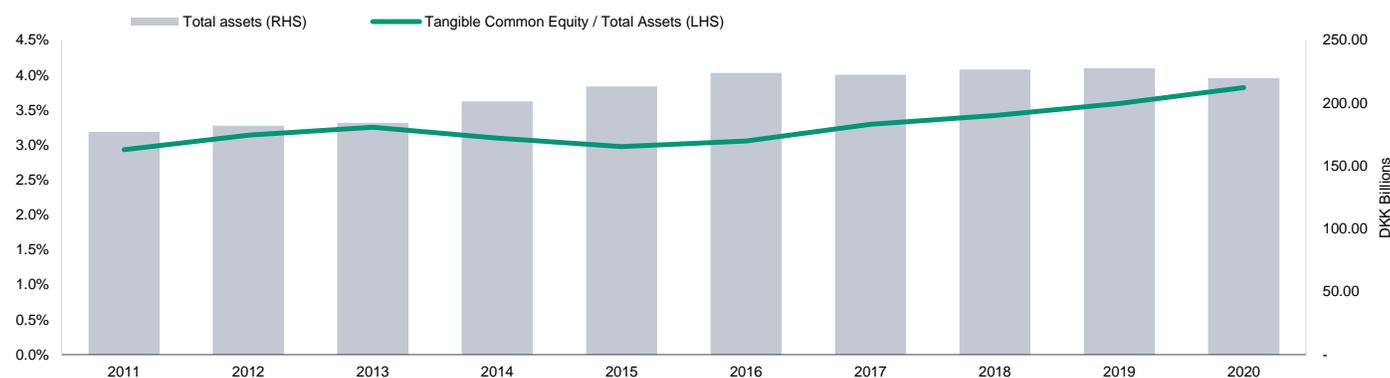
Very solid capitalisation

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 72% as of the end of December 2020, which is mainly because of the zero risk weights assigned to its RLG lending.

KommuneKredit's leverage ratio (Moody's adjusted: tangible common equity/total assets) was 3.8% as of the end of December 2020. This ratio is higher than the 1% (defined as equity divided by total obligations) requirement specified in its articles of association and also higher than those of other Nordic specialised lenders. KommuneKredit's leverage ratio has remained broadly unchanged at around 3% over the past eight years (see Exhibit 2), and we expect it to remain so over the outlook period of 12-18 months.

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, although relatively stable and linked to its public-policy mandate

Like that of 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 predictable because 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 because membership is limited to Danish RLGs and all of them are members. In addition, demand for KommuneKredit's loans is likely to remain predictable as RLGs continue to invest in the infrastructure required to deliver key services as mandated by the Danish central government. The creditworthiness of its customer base is closely linked to the Aaa-rated Danish sovereign with a stable outlook. However, the pandemic will have implications for public health across Denmark, as well as an adverse impact on the collection of local tax and service fee revenue because of weaker economic growth and higher unemployment.

However, if the pandemic were to become more severe and last longer than expected, this would have [clear negative implications for growth and unemployment](#). Denmark is vulnerable to a potential downturn in the global trade environment, given the sizeable contribution of exports to economic activity. These risks will remain until an effective vaccine is widely administered globally. Denmark

is an open economy, and the country's growth performance is closely related to global trade developments and economic performance in the euro area.

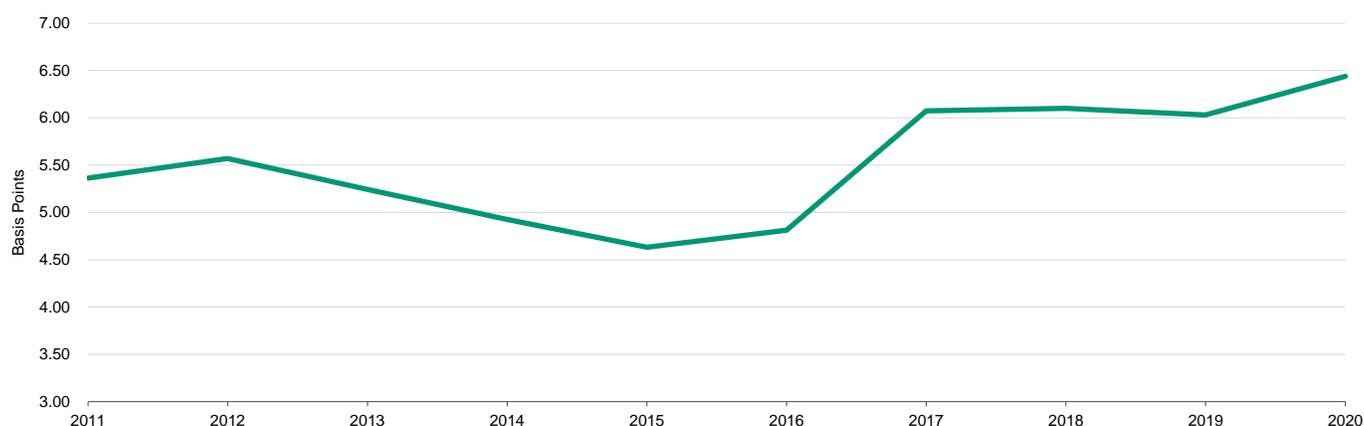
In 2018, KommuneKredit implemented a new method for fixing interest rates on new loans called the funds transfer pricing model, with the aim of aligning the interest rate on an individual loan to the costs and risks associated with it.

KommuneKredit's monoline business model and efficient distribution channels allow the association to keep operating expenses at very manageable levels. The lender employed 82 people and reported total assets of DKK233.9 billion (around €31.5 billion) as of the end of December 2020. Its operating expenses/total average assets remained at a low 6.4 basis points as of the end of December 2020 (see Exhibit 3).

Exhibit 3

Operating expenses were low at 6 basis points as of the end of December 2020

KommuneKredit's operating expenses/average total assets



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 because of 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 was in euros, US dollars and Danish kroner as of end June 2020.

As of the end of December 2020, funding from credit institutions and debt securities issued was DKK212.7 billion, a DKK6.2 billion drop from year-end 2019, in spite of the increase in lending and leasing. In June 2020, KommuneKredit issued a new five-year \$1 billion benchmark, which was oversubscribed and offered as a switch and tender offer to existing investors in two outstanding US dollar benchmarks. Furthermore, in connection to this issuance, KommuneKredit bought back outstanding EMTN notes with maturities less than 12 months for a total amount of \$191 million.

Similar to its peers, KommuneKredit has issued three green bonds (€500 million in May 2017, €750 million in June 2018, €500 million in November 2019 and another €500 million in August 2020) to fund sustainable lending across Denmark, and as of year-end 2020, the value of disbursed loans amounted to DKK171 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 supnationals, agencies and covered bonds. As of the end of December 2020, the size of the liquidity portfolio amounted to 15.3% of tangible banking assets. KommuneKredit's liquidity portfolio is comparable with the portfolios of its peers in terms of size and credit quality. However, unlike some peers, KommuneKredit does not have direct access to central bank liquidity.

ESG considerations

KommuneKredit has low exposure to environmental risks, in line with our view of the banking sector. In 2020, the issuer's Green Bond Committee approved 94 loans as being green, with total lending of a little more than DKK3.0 billion. The majority of the approved green loans were granted for projects in district heating and water and wastewater management, but a small part of the green loans were granted for projects within energy-saving initiatives. See our [Environmental risks heat map](#) for further information.

Because of KommuneKredit's role as one of Denmark's largest credit institutions specialising in the financing of Danish municipalities, it is susceptible to politically and socially motivated decisions, which could affect its financial profile. Its borrowers are exposed to the challenges of providing services to an ageing population, leading to increasing dependency ratios. Over time, these challenges can add pressure on municipalities' finances, although 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 each member is responsible for others' commitments in proportion to their individual commitment to KommuneKredit. Overall, the issuer has moderate exposure to social risks.

We also regard the pandemic as a social risk under our environmental, social and governance (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 heat map](#) for further information.

Governance is highly relevant for 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
KOMMUNEKREDIT	
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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