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Research Update:

Danish Public-Sector Funding Agency KommuneKredit Ratings Lowered To 'AA+'; Off UCO; Outlook Stable

Primary Credit Analyst:

Abril A Canizares, London (44) 20-7176-0161; abril.canizares@spglobal.com

Secondary Contact:

Carl Nyrrerod, Stockholm (46) 8-440-5919; carl.nyrrerod@spglobal.com

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Overview

- Following our review of KommuneKredit under our new public-sector funding agencies criteria, we believe the agency's financial risk profile is less strong than that of higher rated Nordic peers.
- KommuneKredit has adequate liquidity, with coverage slightly below 1x over the next 12 months, and a structural asset-liability mismatch that is somewhat counterbalanced by funding maturities of more than five years.
- We are therefore lowering our long-term rating on KommuneKredit to 'AA+' from 'AAA', affirming our 'A-1+' short-term rating, and removing both ratings from under criteria observation (UCO).
- The stable outlook reflects our expectation that KommuneKredit's guarantee structure will remain unchanged and the agency will continue to benefit from its members' unwavering support

Rating Action

On July 26, 2018, S&P Global Ratings lowered its long-term issuer credit rating on Danish public-sector funding agency KommuneKredit to 'AA+' from 'AAA'. The outlook is stable.

We affirmed our 'A-1+' short-term issuer credit rating on the agency.

At the same time, we removed our ratings on KommuneKredit from UCO, where we placed them on May 22, 2018, following the publication of our criteria for public-sector finance agencies.

Rationale

The downgrade reflects our combined view of KommuneKredit's strong enterprise risk and adequate financial risk profiles, which leads to a stand-alone credit profile (SACP) of 'a+'. We factor in our assessment of KommuneKredit's joint and several liability mechanism, which we consider very predictable, supportive, and immediately enforceable. This, in addition to the agency's highly creditworthy local government shareholders, lifts the issuer credit rating to 'AA+'.

Our funding and liquidity ratios indicate that KommuneKredit would not be able to cover its scheduled one-year term debt liabilities without access to the capital markets. Under extremely stressed market conditions ('AAA' stress scenario), without access to the capital markets, we estimate KommuneKredit's one-year liquidity ratio to be slightly below 1x, which compares unfavorably with that of its 'AAA' rated peers. Our calculated static one-year funding gap for KommuneKredit is 0.7x, but this is counterbalanced to some extent by an average maturity of 5.5x for its funding, indicating some leeway for adjusting the structural mismatch.

Furthermore, we see a negative trend in KommuneKredit's capital adequacy, since a buildup of its top 20 lending exposures could increase pressure from single-name concentration on our risk-adjusted capital (RAC) metric, which after adjustments now stands slightly above 15%.

Counterbalancing these risks is KommuneKredit's very strong market position, which together with its creditworthy borrowers, still underpin its strong enterprise risk profile. The strength of KommuneKredit's members supports our strong public industry risk assessment (PICRA) for Denmark and the agency's important public policy mandate.

Enterprise risk profile: A very strong market position as a key lender to low-risk municipal sector and an important public policy mandate

- Extensive lending and a very competitive loan offer underpin the agency's strong public policy role and impressive market position.
- Strong PICRA, reflecting Denmark's wealthy, resilient economy and well-developed financial sector, and the agency's strong ties to the 'AAA' rated sovereign.

KommuneKredit's public-sector mandate is to provide funding solely to its members, which form part of the Danish local and regional government (LRG) sector. It provides funding directly to its member municipalities and regions, or to companies with a municipal guarantee. As such, KommuneKredit's loan book contains only Danish LRG risk. KommuneKredit holds a very strong market position with a market share of 99% of total lending to the LRG sector.

KommuneKredit has a pronounced public policy mandate based on its ownership, support structure, niched lending, and non-profit 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. The average maturity of KommuneKredit's lending is 7.7 years, which shows the agency's long-term commitment to the sector. KommuneKredit has call options on its lending, although 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. However, its liquidity and funding ratios are weaker than those of its Nordic peers. In contrast to Kommunalbanken (KBN), Municipality Finance, and Kommuninvest (KI), 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 and thereby de facto sets KommuneKredit's lending strategy.

KommuneKredit's risk management principles (including policies for liquidity risk, currency risk, interest rate risk, and credit risk) are defined in the operating policies approved by the board of directors.

The Danish LRG sector exhibits key structural features that support its high credit standing and our view of a strong PICRA. For example, 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. In addition, the economy displays very strong resilience.

Financial risk profile: Strong capitalization combined with adequate liquidity and neutral funding ratios

- Strong capital adequacy, as reflected in a RAC ratio slightly above 15% after adjustments, and our view of a negative trend in terms of capitalization.
- Under extremely stressed market conditions and without access to the capital markets we estimate a KommuneKredit's one-year liquidity ratio to be slightly below 1x.
- Our calculated static one-year funding gap of 0.7x is counterbalanced by an average maturity of 5.5 years.

Our RAC ratio for KommuneKredit before adjustments is one of the highest on our capital adequacy scale, at a very strong 35%. After applying adjustments specific to public-sector funding agencies, to account for single-name concentration on Danish municipalities, the RAC ratio reduces to a borderline 15%. This compares somewhat unfavorably with peers', since KI's and KBN's adjusted RAC ratios are 17% and 31% respectively, above our 15% threshold. A RAC ratio of 15%, combined with our view of a negative trend for capitalization arising from a risk that single-name concentration could increase, leads to our assessment of overall strong capital adequacy. For example, considering that KommuneKredit's lending strategy depends on general borrowing trends in the Danish LRG sector, we do not believe it has much leeway to adjust its lending concentration. This, when combined with its significant market share, could in our view result in an increase in single-name exposure, which in the following 24 months could weigh on the RAC ratio after adjustments.

We see a risk stemming from KommuneKredit's funding gap of 0.7x, which indicates a structural mismatch between assets and liabilities. The average

maturity of funding is over five years, which is shorter than 7.7 years for lending, but longer than for security investments (2.5 years), and therefore still provides some headroom for adjusting the mismatch. As a result, the agency's funding is a neutral rating factor, which is not the case for Municipality Finance, whose funding profile we assess as negative and includes structured debt.

KommuneKredit's funding strategy focuses on benchmark issuance in strategic markets, including green bonds. All markets are open to KommuneKredit as a result of its excellent name recognition and deep investor base. It issues primarily standard funding instruments, with any structured instruments typically comprising Japanese retail Uridashi with index-linked options.

We consider KommuneKredit to have only an adequate liquidity position. Our ratio of liquidity sources to uses of 0.96x indicates that KommuneKredit can just meet its financial obligations over a one-year period. This ratio is weaker than 1.2x for KBN and 1.05x for KI. We factored into our calculations stressed market conditions, under which we assume the agency would not have access to the capital markets. KommuneKredit's adequate liquidity and neutral funding weigh on its financial risk profile, which we assess as adequate. KommuneKredit has adapted to the change to bilateral credit support annexes (CSAs).

By law, KommuneKredit can prefinance up to 25% of lending and, in May 2018, this amounted to 23% of lending. KommuneKredit'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 foresee risks not captured in our RAC calculations and funding and liquidity metrics, since KommuneKredit 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 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.

Likelihood of extraordinary support: Extremely high, via a joint and several guarantee and the agency's mutual structure, resulting in a three-notch uplift to the SACP

- 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.

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 the members would support KommuneKredit should it experience financial distress, before any guarantees are called.

In addition, 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 KommuneKredit's 'a+' SACP, leading to the issuer credit rating of 'AA+'. By comparison, we add a two-notch uplift for KI and one notch for Municipality Finance.

Outlook

The stable outlook reflects our expectation that KommuneKredit's guarantee structure will remain unchanged and that the agency will continue to benefit from unwavering membership support. 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.

We could lower the long-term rating over the next two years if KommuneKredit's liquidity position remains below 1x, the funding gap widens further, or the average maturity of funding falls below five years. In addition, the long-term rating could come under pressure if the lending book expands significantly, with increased concentration on the top borrowers, leading us to revise our capital adequacy assessment downward. We could also lower the ratings if we change our view of the likelihood of extraordinary support from the LRG members.

We could raise the long-term rating if KommuneKredit consistently maintains a

stronger funding and liquidity position, with liquidity ratios under stressed market conditions exceeding 1x, and if the agency is able to consistently strengthen its capitalization, suggesting a neutral trend for capital adequacy, while preserving its strong enterprise profile.

Key Statistics

KommuneKredit Selected Indicators					
	--Year ended Dec. 31--				
(Mil. DKK)	2017	2016	2015	2014	2013
Business position					
Total adjusted assets	230,199	223,938	213,199	201,413	184,239
Customer loans (gross)	172,271	168,589	157,693	152,085	142,711
Growth in loans (%)	4	7	4	7	5
Net interest revenues	269	498	104	254	279
Noninterest expenses	58	106	96	95	96
Capital and risk position					
Total liabilities	215,231	217,094	206,852	195,169	178,244
Total adjusted capital	7,333	6,844	6,347	6,244	5,993
Assets/capital	34.7	38	42	55	46
RAC ratio before diversification (%)	34.7	N.A.	N.A.	N.A.	N.A.
RAC ratio after diversification (%)	15.1	N.A.	N.A.	N.A.	N.A.
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity					
Liquidity ratio with loan disbursement (1 year)	0.6	N.A.	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (1 year)	0.96	N.A.	N.A.	N.A.	N.A.
Funding ratio (1 year)	0.67	N.A.	N.A.	N.A.	N.A.

DKK--Danish krone. N.A.--Not available.

Ratings Score Snapshot

Issuer Credit Rating AA+/Stable/A-1+

SACP a+

Enterprise Risk Profile Strong (2)
 PICRA Strong (2)
 Business Position Very strong (1)
 Management and Governance Strong (2)

Financial Risk Profile Adequate (3)
 Capital Adequacy Strong (2)
 Funding Neutral (0)

and Liquidity	Adequate (3)
Support	+2
GRE Support	+2
Group Support	0
Additional Factors	+1

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

- Assumptions For Liquidity Gap Analysis Under "Public-Sector Funding Agencies: Methodology And Assumptions", May 22, 2018
- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018
- 10 Public-Sector Funding Agencies Placed Under Criteria Observation On Publication Of New Criteria, May 22, 2018

Ratings List

Downgraded; Ratings Affirmed

	To	From
KommuneKredit		
Issuer Credit Rating	AA+/Stable/A-1+	AAA/Stable/A-1+
Senior Unsecured	AA+	AAA
Short-Term Debt	A-1+	A-1+
Commercial Paper	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 for further information. 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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