

Global Credit Research - 29 Oct 2015

Copenhagen, Denmark

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Aaa
Senior Unsecured	Aaa
Commercial Paper	P-1
Other Short Term	(P)P-1

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Opinion

SUMMARY RATING RATIONALE

KommuneKredit's Aaa rating reflects (1) the support offered by the joint-and-several liability provided by its public sector members; (2) the agency's close association with the national government; (3) its public policy mandate and dominant franchise in Denmark; and (4) prudent financial management.

RATING DRIVERS

- KommuneKredit is closely linked to government and benefits from a joint and several liability provided by all Danish RLGs
- Excellent asset quality albeit with some lending concentration
- Direct oversight by sovereign, with prudent counterparty risk policies
- KommuneKredit's financial performance is stable as a result of its public policy mandate
- Strong funding and liquidity and solid capitalisation relative to peers

RATING OUTLOOK

The outlook on KommuneKredit's senior unsecured debt ratings is stable.

WHAT COULD CHANGE THE RATING - DOWN

Although not currently anticipated, downward pressure on KommuneKredit's rating could arise over time as a result of sustained weak financial performance, a weakening of its public policy mandate, or a deterioration of the joint-and-several liability it benefits from.

DETAILED RATING CONSIDERATIONS

KOMMUNEKREDIT IS CLOSELY LINKED TO GOVERNMENT AND BENEFITS FROM A JOINT AND

SEVERAL LIABILITY PROVIDED BY ALL DANISH RLGs

KommuneKredit's government-related footprint is significant. Originally established through special legislation, the association's activities are supervised by the Ministry of Social Affairs and Interior (rather than the Danish financial services authority), and lending is restricted to Danish local and regional authorities and any semi-municipal institutions benefiting from a full guarantee from a local or regional authority.

KommuneKredit benefits from a very high market share of regional and local government financing which we understand is consistently above 90%. Competition is limited because of the agency's low funding cost and not-for-profit mandate, combined with its long track-record.

The Danish municipalities and regions are jointly and severally liable for KommuneKredit's liabilities. A creditor can claim payment from any of them in the currently unlikely event of failure. 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 liability is unique in that it is backed by every single RLG in Denmark.

EXCELLENT ASSET QUALITY ALBEIT SOME LENDING CONCENTRATION

KommuneKredit's has never incurred a loss on any of its loans in its 116-year history. Its creditworthiness rests on the RLG sector that we consider financially strong because of the supportive system that underpins the sector, as Danish municipalities have unlimited powers to levy income taxes. These powers are balanced against their obligation to deliver services such as healthcare, social security and education. Grants from the central government form an additional significant revenue source for the municipalities. Moreover, we note that Danish municipalities participate in a financial redistribution system under which revenues are spread so that all citizens, irrespective of geographical location, are guaranteed the above mentioned public services.

Prudential regulations imposed by the central government provide strict controls and effectively limit regional and local governments from accumulating debt beyond agreed levels. Effective powers of intervention by the central government ensure prudence, balanced budgets and highly infrequent cases of financial distress. Moreover, regional and local governments are prohibited by law from declaring bankruptcy.

Loan exposures are inevitably concentrated because the size of Danish municipalities vary and KommuneKredit's customer base is small.

DIRECT OVERSIGHT BY SOVEREIGN, WITH PRUDENT COUNTERPARTY RISK POLICIES

The Danish Ministry of Social Affairs and Interior supervises KommuneKredit and is responsible for approving any changes to the association's bylaws. The ministry sets limits for liquidity, pre-financing and approves the agency's rules for the management of financial risks and the use of financial instruments. 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 agency's guidelines include an interest rate risk limit of 4.5% of its DKK6.4 billion total equity base, equating to DKK288 million at end-June 2015.

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

KOMMUNEKREDIT'S FINANCIAL PERFORMANCE IS STABLE AS A RESULT OF ITS PUBLIC POLICY MANDATE

Like other specialised lenders, KommuneKredit's profitability depends primarily on the spread between its lending rates and funding costs. KommuneKredit has continued to access markets at favourable rates.

We consider KommuneKredit's profitability as very predictable because the association is effectively in a monopoly position, as its customer base is likely to remain unchanged in the long term because membership is limited to Danish regional and local governments and all of them are already members. In addition, demand for KommuneKredit's loans is likely to remain predictable as regional and local governments continue to invest in the infrastructure required to deliver key services as mandated by the Danish central government; and the creditworthiness of its customer base is closely tied to the Aaa-rated Danish sovereign that has a stable outlook.

KommuneKredit's mono-line business model and efficient distribution channels allow the association to keep operating expenses at very manageable levels. The agency employed 62 full time employees at year end-2014, although its total assets were in excess of DKK207 billion (approximately EUR28 billion) at end-June 2015. Its ratio of operating expenses-to-total average assets is normally around five basis points.

KommuneKredit has maintained a strong funding position throughout the European sovereign debt crisis. In our view, investors have perceived the Danish public sector as a safe haven during periods of turmoil in the wider European financial markets, which means that the association has been able to issue debt at very advantageous rates compared with commercial banks.

The maturity of the agency's liabilities is typically at least as long as the maturity of its assets. However, similar to peers, some funding comes with option-like features, which suddenly could shorten its liability profile. This relates to funding in Japanese Yen, accounting for 4% of the agency's total funding at end-2014, where we understand that the majority are callable Uridashi bonds. For its liquidity planning, KommuneKredit assumes that all such funding is called at first call date. The association maintains a substantial liquidity portfolio, with its Liquidity Coverage Ratio (LCR) exceeding 500% on a regular basis, and has ample ability to refinance called funding.

The liquidity portfolio consists of highly rated securities with short maturities (around 75% of securities have a maturity of less than one year), with the bulk of investments in supra-nationals, agencies and covered bonds. Moreover, investments are mainly in Northern Europe in countries including Germany, Denmark and Sweden. KommuneKredit's liquidity portfolio is comparable with the portfolios of its peers in terms of size/total assets and credit quality. Unlike some peers, KommuneKredit does not have access to Central Bank liquidity.

At 3.1% at end-June 2015, KommuneKredit's (Moody's calculated) leverage ratio is in excess of the 3% that is likely to become a requirement for similar institutions under Basel III (which the institution itself is exempt from). This is higher than the 1% (defined as equity divided by total obligations) requirement specified in its articles of association and also higher compared with the other Nordic specialised lenders. The leverage ratio has hovered around 3% over the past five years, although total assets increased by approximately 40% during the same period.

KommuneKredit does not pay dividends, nor does it forecast extraordinary balance sheet growth, which should enable it to maintain its leverage ratio at around 3%. The agency is not required to report a Tier 1 capital ratio, but nevertheless indicated that its Tier 1 ratio was 90% at year-end 2014, the latest available figure, which is high compared with its Nordic peers and reflects the zero risk weights assigned to its lending.

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