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## Research Update:

# Norwegian Funding Agency Kommunalbanken AS (KBN) Affirmed At 'AAA/A-1+' After Criteria Revision; Off UCO; Outlook Stable

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## Research Update:

# Norwegian Funding Agency Kommunalbanken AS (KBN) Affirmed At 'AAA/A-1+' After Criteria Revision; Off UCO; Outlook Stable

## Overview

- We have completed our review of the ratings on Kommunalbanken AS (KBN), a public sector funding agency that lends to the Norwegian local and regional government sector, following the release of our "Public-Sector Funding Agencies: Methodology And Assumptions" criteria.
- We had placed the ratings under criteria observation (UCO) on May 22, 2018, in conjunction with the criteria release.
- After our review, we are affirming our 'AAA/A-1+' long- and short-term issuer credit ratings on KBN and removing the ratings from UCO.
- The stable outlook reflects that, in the next two years, KBN's ownership structure and the implicit support from the Norwegian government (AAA/Stable/A-1+) will remain unchanged and that KBN's management will maintain low risk tolerance and continue to contain risks associated with the wholesale-funded nature of its activities, while maintaining very strong liquidity and prudent management practices.

## Rating Action

On June 28, 2018, S&P Global Ratings affirmed its 'AAA' long-term and 'A-1+' short-term issuer credit ratings on Norwegian public sector funding agency Kommunalbanken AS (KBN). We also removed the ratings from UCO, where we placed them on May 22, 2018. The outlook is stable.

At the same time, we affirmed the 'AA+' rating on KBN's subordinated bond and the 'A+' rating on its hybrid bond.

## Outlook

The stable outlook reflects our expectation that KBN's ownership structure and the implicit support from the Norwegian government (AAA/Stable/A-1+) will remain unchanged. We expect KBN's management to maintain low risk tolerance and continue to contain risks associated with the wholesale funded nature of its activities. Moreover, we expect that KBN will successfully navigate instances of regulatory risk so that its lending services, and ultimately the execution of its public policy role, are not affected.

We could lower our rating over the next two years if KBN's stand-alone credit profile (SACP) came under significant pressure, for example if risk management faltered to the extent that KBN's liquidity position significantly deteriorated through for instance a widening funding gap and a sharply reduced liquidity position. Such financial pressure would likely spill-over onto the agency's ability to fulfil its public policy mandate, which combined with lowered confidence in the agency's risk management culture, could put pressure on the SACP. We could also consider a downgrade if we believed the likelihood of extraordinary support from KBN's owner, the Norwegian government, was weakening.

We consider our downside scenarios to be unlikely in the next two years.

## **Rationale**

KBN was established in 1926 by an act of parliament and gained its current organizational form in 1999 by a conversion act. It was for some time 20% owned by KLP and 80% by the Norwegian government. In 2009, The Norwegian government bought up the KLP shares and it became 100% central government owned. We consider KBN has an integral link with the central government. KBN has a very strong public policy role to provide stable and low-cost financing to Norwegian local and regional governments (LRGs), intermunicipal companies, or others backed by a municipal guarantee.

KBN has a strong business position as one of the main providers of funding to LRGs in Norway. Its market share of close to 50% is intentional as part of the government policy to promote the domestic capital market. We consider that Norwegian LRGs have low credit risk, owing to their predictable and well-balanced institutional framework, but the sector's leverage ratio shows some risks. The high income level supports significant economic resilience, partly offset by moderate risks in the Norwegian financial system. Management is competent and prudently handles risk associated with expanding activities and regulatory requirements, in our view, while adhering to the public policy mandate. These factors underpin KBN's strong enterprise risk profile. On the financial side, KBN's very strong risk-adjusted capitalization, both before and after concentration adjustment, positive funding position from strong name recognition, and very strong liquidity underpin our assessment of the agency's very strong financial risk profile.

We combine our assessments of KBN's strong enterprise risk profile and very low financial risk profile to arrive at an SACP of 'aa'. Taking into account our view that in the event of financial stress there is an extremely high likelihood of extraordinary financial support from the Norwegian government, we assess the issuer credit rating on KBN at 'AAA/A-1+'.

### **Enterprise Risk Profile: Low-risk municipal sector supported by very strong management and an important public policy mandate**

- A continued stable market share on strong lending offer underpins a

strong public policy role.

- Strong public industry country risk assessment, reflecting a wealthy and resilient economy, a well-developed financial sector, and a low-risk but moderately leveraged LRG sector.
- Management policies and practices are prudent.

KBN's public-sector mandate is to provide funding solely to Norwegian LRGs or companies backed by guarantees from Norwegian LRGs. KBN provides funding directly to the municipalities, county councils, or companies backed by a municipal guarantee. As such, KBN's loan book holds only Norwegian LRG risk. We believe KBN holds a very strong market position as its market share is stable and currently stands at about 50% of the total lending to the sector.

Adhering to its public policy mandate, KBN plays a very important role in supplying low-cost financing to the Norwegian LRG sector, by ensuring stable and advantageous borrowing in national and international capital markets. It aims at having a market share close to 50% in order to promote competition in the market for municipal loans and support a domestic capital market.

The Norwegian LRG sector exhibits key structural features, which supports high credit standing. For example, the economy is wealthy, the financial system is advanced, and the linkages between the local government sector and the 'AAA' rated sovereign is very tight. Balancing these factors are the moderate indebtedness of the LRG sector and the sector's average access to external liquidity as measured by our Banking Industry Country Risk Assessment (BICRA) on Norway. Therefore, our public industry country risk assessment is "strong."

Management policies and practices are prudent and contribute to our view of KBN's management and governance as very strong. KBN's business plan sets out the organization's annual goals, both financial and nonfinancial. The board tracks progress on outcomes in regular meetings with senior staff. Risk management policies and practices are sensible. Asset-liability matching is a key risk management practice. The management team is experienced and key members generally have long tenure with the funding agency.

We observe that uncertainties regarding regulatory mandated leverage ratios in the EU are being gradually lifted. We note that Norwegian parliament in its legislative bill to implement BRRD in Norway proposed to treat KBN as a promotional bank under the directive, due to its special nature and limited risk in lending operations. The bill was adopted in March 2018 by Norwegian parliament. There are ongoing discussions both in the EU and Norway on the supervisory treatment by national supervisory authorities of promotional banks licensed as credit institutions under BRRD, including the relevance of the general Minimum Requirement for own funds and Eligible Liabilities (MREL) for promotional banks. The Norwegian regulator has noted, however, that regardless of how the MREL provisions are implemented in EU and Norway, KBN already has

reserves that would be eligible against the requirement well above the minimum levels mandated by the BRRD, and that such a requirement would therefore in any case not affect KBN in any way.

**Financial Risk Profile: Very strong capitalization and very strong liquidity provide financial buffers**

- Very solid capital ratios.
- Tight matching of assets and liabilities, comprehensive treasury portfolio, and broad access to diversified funding underpin strong funding and liquidity.

KBN posts a very strong capital position. At end of first-quarter 2018, KBN was fully compliant with the minimum Tier 1 capital ratio of 15.4%, standing at 17.91%. In order to maintain a sufficient capital level, KBN can, depending on market conditions, reduce or increase its total assets or enter into a dialogue with the owner regarding changing its capital structure by changes in dividend policy or issue of share capital. KBN has recently adapted its capital structure to new capital requirements and issued additional Tier 1 capital in the form of a subordinated bond in June 2017.

KBN's risk-adjusted capital (RAC) ratio is very strong at 59% before adjustments. When factoring in our adjustments, in particular from single-name concentration on underlying borrowers, KBN's RAC after adjustments declines to 31%, but remains very strong. An absence of loss experience, prudent risk management, and more stringent asset-liability matching all support its very strong capital assessment. Exposure to the 20 largest borrowers, as a percentage of total lending, stands at about 30% in 2018, similar to peers. We expect our adjusted RAC ratio to comfortably surpass 15% in the next two years and remain a key support to KBN's financial risk profile.

KBN's funding strategy is focused on benchmark issuance in strategic markets. All markets are open to KBN, given its very strong name recognition and deep investor base. Funding instruments are kept a majority plain vanilla, but some structures exist typically conducted on Japanese retail Uridashi funding where call and index-linked options are typically embedded. Callable funding stands at 14% but is set to decrease. KBN is also currently reducing its exposure to the Uridashi funding market as a step to reduce complexity and focus more on plain vanilla. Over the past couple of years, KBN has added green bonds to its funding portfolio, which has allowed for a further expansion of the investor base.

KBN holds a high level of expertise with regards to liquidity portfolio management and execution. This has allowed the agency to employ more stringent asset-liability matching to a higher degree of cost efficiency. The liquidity portfolio is primarily held in zero-risk-weighted investments, and primarily in foreign currencies. As a result of the Norwegian krone strengthening against the U.S. dollar in 2017, the value of the liquidity portfolio at year-end 2017 slightly weakened from year-end 2016, to NOK107.5 billion from NOK 116.4 billion. The average duration is below 0.7 years (excluding the U.S.

treasury liquidity buffer, 1.12 years when included), highlighting the liquidity portfolio nature of the holdings.

At the same time, we observe that KBN remain proactive in its liquidity management execution, which we view as important in light of the agency's ongoing move to two-way credit support annexes (CSAs) on its derivatives counterparty portfolio. This move is underway and KBN is set to continue to adapt its liquidity portfolio to a situation with changes in collateral requirements in a forward-looking manner. Taking this into account, our liquidity ratio indicates that KBN will be able to meet its financial obligations over more than a one-year period. Our liquidity ratio factors in stressed market conditions, under which we assume the agency would not have access to the capital markets.

### Extremely high likelihood of support from Norwegian government

We view the likelihood that Norway would provide timely and sufficient extraordinary support to KBN in the event of financial distress as extremely high. This assessment is based on our view of KBN's:

- Very important role for the Norwegian government as a vehicle to limit the cost of debt for Norway's LRG sector. Acting largely as a state instrument, KBN performs an important public policy function in providing low-cost funding to the Norwegian LRG sector and in promoting competition in the municipal loan market; and
- Integral link with the Norwegian government, which has fully owned KBN since 2009. Through a letter of support, the central government has formalized its relationship with KBN and expressed its clear intention of extending timely support should the company find itself in financial distress. The central government confirmed its supportive stance toward KBN in November 2011 to avoid negative reputational effects associated with Eksportfinans losing its government mandate to provide state-subsidized export credit, and it was again confirmed in 2017.

## Key Statistics

KBN Kommunalbanken Selected Indicators					
(Mil. NOK)	--Year ended Dec. 31--				
	2017	2016	2015	2014	2013
<b>Business Position</b>					
Total adjusted assets	412,729	418,189	449,236	455,386	361,884
Customer loans (gross)	283,396	267,521	256,815	249,928	243,114
Growth in loans (%)	6	4	3	3	N.M.
Net interest revenues	2,162	2,087	1,642	1,515	1,634
Noninterest expenses	193	177	151	123	105
<b>Capital &amp; Risk Position</b>					
Total liabilities	398,187	405,875	437,159	447,130	353,702

## KBN Kommunalbanken Selected Indicators (cont.)

(Mil. NOK)	--Year ended Dec. 31--				
	2017	2016	2015	2014	2013
Total adjusted capital	14,099	11,924	11,660	8,256	7,825
Assets/capital	35	38	42	55	46
RAC ratio before diversification (%)	59	N.A.	N.A.	N.A.	N.A.
RAC ratio after diversification (%)	31	N.A.	N.A.	N.A.	N.A.
Gross nonperforming assets/gross loans	0	0	0	0	0
<b>Funding &amp; Liquidity</b>					
Liquidity ratio with loan disbursement (1 year)	1.2	N.A.	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (1 year)	1.5	N.A.	N.A.	N.A.	N.A.
Funding ratio (1 year)	1.5	N.A.	N.A.	N.A.	N.A.

NOK--Norwegian krone. N.A.--Not available. N.M.--Not meaningful.

## Ratings Score Snapshot

Issuer Credit Rating      AAA/Stable/A-1+

SACP                              aa

Enterprise Risk Profile    Strong (2)

    PICRA                        Strong (2)

    Business Position        Strong (2)

    Management & Governance    Very Strong (1)

Financial Risk Profile      Very strong(1)

    Capital Adequacy        Very strong (1)

    Funding                    Positive

    and Liquidity            Very strong (1)

Support                        2

    GRE Support              2

    Group Support            0

Additional Factors            0

## 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
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related Research

- Guidance - General Criteria - 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

### Ratings Affirmed

#### Kommunalbanken AS

Issuer Credit Rating	AAA/Stable/A-1+
Senior Unsecured	AAA
Subordinated	AA+
Junior Subordinated	A+
Commercial Paper	A-1+

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