S&P Global Ratings

RatingsDirect®

Research Update:

Norwegian Funding Agency KBN Kommunalbanken Affirmed At 'AAA/A-1+'; Outlook Stable

June 18, 2021

PRIMARY CREDIT ANALYST

Abril A Canizares
London
+ 44 20 7176 0161
abril.canizares@spglobal.com

SECONDARY CONTACT

Carl Nyrerod
Stockholm
+ 46 84 40 5919
carl.nyrerod@spglobal.com

Overview

- The most recent capital injection from the central government of Norway strengthened KBN Kommunalbanken Norway's (KBN) financial position.
- We think KBN has a very important role and integral link with Norway's central government, resulting in an extremely high likelihood of receiving extraordinary support in the unlikely event of financial distress.
- We affirmed our 'AAA/A-1+' long- and short-term issuer credit ratings on KBN.
- 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 Norwegian public sector funding agency KBN. The outlook is stable.

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

Rationale

The rating on KBN is supported by our view that the bank will continue aligning to its strategy and remain a key lender in the Norwegian local government sector. We expect KBN will maintain a very strong financial position thanks to the April 2020 capital injection from the Norwegian government and our view that local governments will remain resilient to the long-lasting effects of the COVID-19 pandemic.

KBN operates under a relatively strict regulatory framework in Norway, but we expect the bank will remain compliant with all regulatory requirements, which will further support its very strong financial risk profile.

The 'AAA' rating on KBN is two notches higher than its stand-alone credit profile (SACP) because we think the bank has a very important role and integral link with the Norwegian government.

Therefore, we think there is an extremely high likelihood that Norway would provide timely and sufficient extraordinary support to KBN in the event of financial distress.

KBN has a long track record of fulfilling its public policy role and has been active under adverse market conditions, as demonstrated last year during the pandemic. Despite the economic effects of the pandemic, the bank managed to increase its lending activity and sustain very strong capital and liquidity ratios. The strong support from the central government toward the Norwegian local and government sector throughout the pandemic buttressed KBN's resilience and helped maintained its robust asset quality. KBN's management has considerable expertise, prudently handles risks, and consistently complies with the regulatory requirements under which it operates, which we consider stricter when compared to its Nordic public sector funding agency peers. These factors support our assessment of KBN's strong enterprise risk profile.

Sustained high levels of capitalization, positive funding position from strong name recognition, and very strong liquidity support our assessment of KBN's very strong financial risk profile.

Enterprise risk profile: Low-risk municipal sector, even throughout the pandemic; very strong management and governance standards accompanied by a strong record of fulfilling an important public policy mandate

- KBN operates in a low-risk public industry. The unwavering support from the central government to the Norwegian local government sector strengthened its resilience throughout the pandemic.
- KBN has been a countercyclical lender and we expect it to continue fulfilling its important policy mandate.
- Compliance with relatively strict regulatory requirements, tight central government oversight, and prudent risk policies support of our view of KBN's very strong management and governance.

KBN was established in 1926 by an act of parliament and took its current organizational structure in 1999 via a conversion act. KBN was 80% owned by the Norwegian government and 20% owned by Kommunal Landspensjonskasse (KLP) until 2009, when the Norwegian government bought the KLP shares and became the sole owner.

Over the years, the Norwegian government has ratified its support toward KBN via the Ministry of Local Government and Modernization. It made capital injections in 2008, 2012, and 2015 to strengthen KBN's capital position, and it made a further injection in April 2020 following the outbreak of COVID-19. This demonstrated the government's support and confirmed our view that KBN is a key agent for the government in terms of dealing with economic and financial crises.

Strong fiscal compensation from the central government to the Norwegian local and regional sector (LRG) has strengthened the sector's resilience throughout the pandemic and supports our view that it is low-risk overall. The sector exhibits key structural features that support high credit standing, and it has a low-risk Public Industry Country Risk Assessment. Norway has a wealthy economy that contracted by 0.8% in 2020, which is less than most European peers, largely thanks to substantial government support packages and strong net exports. Furthermore, our view of the Norwegian LRG sector's low risk is supported by its advanced financial system and the tight link between the local government sector and the 'AAA' rated sovereign.

That said, the Norwegian LRG sector has slightly higher leverage than peers, although it remains adequate. We forecast the sector's direct debt will reach about 105% of its operating revenue by

2021 but that low interest rates would support an interest to operating expense stable ratio of 2%. We also view the sector as having average access to external liquidity, as measured by our Banking Industry Country Risk Assessment on Norway.

KBN's public-sector mandate is to provide long-term funding to or guaranteed by Norwegian LRGs. It has been a countercyclical lender, maintaining an active role throughout the pandemic: It increased its lending by 2.7% in 2020, reaching a market share of 47%. We expect KBN's target to remain above 45% but we think it will remain below 50% because it aims to promote competition for municipal loans and support the domestic capital market.

KBN's capacity to act as a countercyclical lender further demonstrates its broad access to markets. Its innovative product offering, which responds to changing market and customer needs, has allowed KBN to remain relevant to its customers. The bank was also well supported by its owner, the central government, which forewent dividend distributions in 2019 and 2020.

We note that KBN has kept a strong focus on sustainable financing, which is one of the key pillars of its 2020-2022 strategy and is in line with national climate goals. During 2019, KBN's portfolio continued increasing its allocation on green projects.

Management policies and practices are prudent and generally demonstrate a low risk appetite, which contributes to our view of KBN's management and governance as very strong. Oversight from the Norwegian Financial Supervisory Authority (FSA Norway) ensures continuity of managerial practices and mitigates key risks, a distinctive feature of KBN when compared to most of its global peers. KBN's organizational structure allows it to respond appropriately to stakeholder's needs and requirements. The board of directors tracks progress on outcomes in regular meetings with the executive team, and it is the ultimate decision maker.

We note that Jannicke Trumpy has taken the permanent position as Kommunalbanken's chief executive officer. Therefore, we expect continuity in KBN's strategy and prudent financial policies. Additionally, the Ministry of Local Government and Modernization's participation in supervisory board meetings increases oversight.

In our view, KBN's management team is experienced and key members generally have long tenure with the funding agency, further supporting our very strong management and governance assessment. Superior risk-management policies and practices mitigate key risks in KBN's operations.

We observe that uncertainties regarding regulatory mandated leverage ratios in the EU are being gradually lifted. We note that the Norwegian Ministry of Finance, in its legislative bill to implement the Bank Recovery and Resolution Directive (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. Norwegian parliament adopted the bill in March 2018. There are ongoing discussions in the EU and in Norway on the relevance of the general minimum requirement for own funds and eligible liabilities (MREL) for banks with a public policy mandate that are fully owned by governments. Although all credit institutions with a license are, in principle, subject to MREL requirements that must be set in accordance with the Norwegian implementing legislation, an MREL requirement would not affect the ability of the central government to support a fully owned credit institution as owner. Norway, as KBN's sole owner, confirmed its support when the legislative bill was presented in 2017.

However, FSA Norway has noted that KBN already has reserves that would be eligible against the requirement, well above the minimum levels mandated by the directive, regardless of how the MREL provisions will be implemented in EU and Norway. The MREL for KBN is still pending approval by the Ministry of Finance of FSA Norway's resolution plan for KBN. In May 2020, FSA Norway announced that compliance date for fulfilling an MREL requirement would be postponed to Jan. 1, 2024. Consequences of the requirement should therefore be very limited for KBN, although national implementation of the MREL-provisions could require KBN to issue senior non-preferred instruments.

Additionally, FSA Norway's Supervisory Review and Evaluation Process introduced an increase in the bank's Pillar 2 requirement from 1.4% to 2.3%, in effect from March 31, 2020, primarily due to an increase in the systemic risk buffer.

Financial risk profile: Very strong capitalization and very strong liquidity provide financial buffers

- Very strong and stable capitalization levels, supported by compliance with regulatory requirements and a capital injection from the central government.
- Reduced agency risk since borrowers are not owners of KBN.
- Broad and diversified access to capital markets and robust asset liability management ensure very strong liquidity buffers.

As of end-March 2021, KBN's risk-adjusted capital (RAC) ratio was very strong, increasing to 67% from 46% before adjustments. The strong increase is largely down to higher total adjusted capital after the Norwegian krone 750 million received from the central government in April 2020 and the decision to forego dividends. This offset lower profitability during 2020.

When factoring our adjustment for single-name concentration on underlying borrowers, KBN's RAC after adjustments declines but remains at a very strong 29%. As of March 2021, exposure to the 20 largest borrowers stands at about 28% of total lending, similar to peers'. KBN has not experienced losses and maintains prudent risk management, further supporting the very strong capital adequacy assessment.

KBN's compliance with regulatory capital requirements support our expectation that its S&P Global Ratings-adjusted RAC ratio will be comfortably above our 15% threshold in the next two years and remain a key support to its financial risk profile. As of December 2020, KBN's Tier 1 capital ratio of 17.0% was fully compliant with the minimum regulatory Tier 1 capital ratio of 15.4%, with ample headroom. We note that risk weights applicable under FSA Norway are significantly higher than those applied under our methodology and therefore KBN's adjusted RAC ratio is higher than its Common Equity Tier 1 ratio.

KBN has adapted its capital structure to new capital requirements, and it issued additional tier 1 (AT1) capital notes in June 2017. Our RAC ratios include capital from these notes because these are perpetual and have a call date that we expect will be approximately 10 years from issuance. The instruments do not contain a coupon step-up and have loss-absorption features on a going-concern basis. Although we expect the Norwegian government would prevent a conversion into equity of these AT1 capital notes, they are available to KBN to provide equity if triggered.

KBN's very strong name recognition and deep investor base further support its financial risk profile. KBN's funding strategy is focused on benchmark issuance in strategic markets. Over the past couple of years, KBN has actively issued green bonds, which has allowed it to further expand its investor base.

As of March 2021, KBN's funding ratios remain robust and have strengthened, even taking into consideration its undrawn lending commitments. The funding gap excluding scheduled loans for one year stood at 1.47x. Including undrawn loan commitments, the funding ratio increased to 1.89x from 1.43x in the previous year. The majority of KBN's funding instruments are plain vanilla, and it has taken steps to reduce its exposure to callable funding and Japanese retail Uridashi funding.

At the same time, we note that KBN remains proactive in its liquidity management execution. KBN's liquidity policy is to hold minimum liquidity equal to the projected payment obligations over the coming 12 months without access to funding. In line with our expectations, all of KBN's derivative counterparties have now moved to bilateral credit support annexes with daily exchange of collateral.

Our 12-month liquidity ratio increased to 1.9x as of March 2021 from 1.56x, including undrawn loan commitments. This indicates that KBN would be able to cover all committed lending and debt repayments for at least one year, even under extremely stressed market conditions and without 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 and ratified it in 2017 to avoid negative reputational effects associated with Eksportfinans losing its government mandate to provide state-subsidized export credit.

Outlook

The stable outlook reflects our view there is little risk that KBN's market relevance, ownership structure, or implicit support from the Norwegian government will change in the next few years.

Downside scenario

We could lower our rating if we thought KBN's public policy role was subsiding, or if there were a change to its ownership, resulting in a lower likelihood of extraordinary support from the Norwegian government. The ratings could also come under pressure if KBN's financial indicators weakened significantly, or if management failed to achieve its strategy and experienced a structural reduction of its market share, limiting its ability to fulfill its mandate.

Issue Ratings--Subordination Risk Analysis

The affirmation of the 'A+' issue rating on KBN's AT1 capital notes issuance, and our 'AA+' issue rating on KBN's subordinated bond, follow our "General Criteria: Hybrid Capital: Methodology And Assumptions," published July 1, 2019. The starting point on both issue ratings is KBN's 'AAA' issuer credit rating, given our view of the extremely high likelihood of KBN receiving extraordinary support from its owner. This is further supported by our expectation that the Norwegian government would provide financial support in order to prevent loss absorption and that it could step in at early stages to prevent a conversion, as per the instrument's procedure.

We derive the four-notch difference between the 'A+' issue rating on the AT1 notes and the issuer credit rating on KBN as follows:

- One notch for subordination;
- Two notches for Tier 1 regulatory capital status; and
- One notch because the instruments allow for a full or partial temporary write-down.

The affirmation of our 'AA+' issue rating on KBN's subordinated bond reflects the bond's subordination to KBN's senior unsubordinated debt. We do not apply further notching for a full or partial temporary write-down because we regard this as contradicting our view of government support for KBN.

Key Statistics

Table 1

KBN Kommunalbanken Norway -- Selected Indicators

	--Year ended Dec. 31--				
(Mil. NOK)	**2020**	**2019**	**2018**	**2017**	**2016**
Business Position					
Total adjusted assets	498,088	460,652	457,585	412,729	418,189
Customer loans (gross)	321,900	310,923	303,582	283,396	267,521
Growth in loans (%)	4	2	7	6	4
Net interest revenue	1,672	1,874	1,885	2,162	2,087
Noninterest expenses	256	251	210	193	177
Capital & Risk Position					
Total liabilities	479,681	444,377	442,279	398,187	405,875
Total adjusted capital*	16,577	15,639	15,561	14,099	11,924
Assets/capital	31	33	36	35	38
RAC ratio before diversification (%)*	67.2	46.0	51.0	59.0	N.A.
RAC ratio after diversification (%)*	29.5	25.0	29.0	31.0	N.A.
Funding and Liquidity					
Liquidity ratio with loan disbursement (one year)*	2.0	1.6	1.3	1.2	N.A.
Liquidity ratio without loan disbursement (one year)*	2.0	1.7	1.3	1.5	N.A.
Funding ratio (one year)*	1.9	1.5	1.1	1.5	N.A.

*As of the first quarter of the fiscal year. NOK--Norwegian krone. N.A.--Not available. RAC--Risk-adjusted capital.

Ratings Score Snapshot

Table 2

KBN Kommunalbanken Norway -- 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 and Governance	Very Strong (1)
Financial Risk Profile	Very Strong(1)
Capital Adequacy	Very Strong (1)
Funding and Liquidity	Positive and Very Strong (1)
Support	(2)
GRE Support	(2)
Group Support	(0)
Additional Factors	(0)

PICRA--Public-Sector Industry Risk And Country Risk Assessment. SACP--Stand-alone credit profile.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- 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: Norwegian Municipalities And Counties, Feb. 8, 2021
- Public-Sector Funding Agencies Risk Indicators: May 2019, May 13, 2019
- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018

Ratings List

Ratings Affirmed

KBN Kommunalbanken Norway	
Issuer Credit Rating	AAA/Stable/A-1+
Senior Unsecured	AAA
Subordinated	AA+
Junior Subordinated	A+
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.