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Research Update:

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

September 23, 2024

PRIMARY CREDIT ANALYST

Linus Bladlund

Stockholm

+ 46-8-440-5356

linus.bladlund@spglobal.com

SECONDARY CONTACT

Abril A Canizares

London

+ 44 20 7176 0161

abril.canizares@spglobal.com

ADDITIONAL CONTACT

Sovereign and IPF EMEA

SOVIPF@spglobal.com

Overview

- The Norwegian local government sector exhibits key structural features that support high credit quality, although high and rising debt burdens point to a weakening trend.
- Kommunalbanken (KBN) maintains a significant market share in the low-risk Norwegian local and regional (LRG) sector, while upholding high levels of capitalization and a strong liquidity position.
- We think KBN has a very important role and integral link with Norway's central government, resulting in an extremely high likelihood of it 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 Sept. 23, 2024, 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 subordinated bond issue and our 'A+' issue rating on its two rated hybrid bonds.

Outlook

The stable outlook reflects our view that KBN will be able to uphold its robust market position and that the LRG sector will remain a low-risk lending exposure, despite the weakening trend related to the sector's debt burden. At the same time, we expect KBN's experienced management will continue to mitigate risks by maintaining high levels of capital and robust liquidity, supported by reliable and diversified funding channels.

Downside scenario

We could lower our ratings in the unlikely event that KBN's stand-alone credit profile deteriorated markedly, and its public policy role subsided, or if there were a change to its ownership, resulting in a lower likelihood of extraordinary support from the Norwegian government.

Rationale

The rating on KBN is supported by our assumption that the bank will remain a key financier of the Norwegian local government sector. KBN has a long track record of fulfilling its public policy role and has been active under adverse market conditions, as demonstrated most recently during the pandemic.

KBN operates under a regulatory framework that we consider stricter than those in other Nordic countries. We expect the bank will remain compliant with all regulatory requirements. KBN's management has considerable expertise, prudently handles risks, and consistently complies with the regulatory requirements under which it operates.

Following our criteria update, KBN's stand-alone credit profile (SACP) has improved to 'aaa' from 'aa'. Still, we believe the bank has a very important role and integral link with the Norwegian government. Therefore, we think there is an extremely high likelihood that the Norwegian government would provide timely and sufficient extraordinary support to KBN in the event of financial distress.

Sector risk profile: The high and growing debt burden is pressuring Norwegian LRGs, although their strong fundamentals mitigate risks

KBN has a long track record of fulfilling its public policy role of providing affordable financing to Norwegian local governments. KBN was established in 1926 by an act of parliament and assumed its current organizational structure in 1999 via a conversion act. The bank was 80% owned by the Norwegian government and 20% owned by Kommunal Landspensjonskasse (KLP) until 2009, when the Norwegian government bought KLP's shares and became the sole owner. Over the years, the Norwegian government has made capital injections into the bank several times, most recently during the pandemic, to ensure that the bank can fulfil its mandate.

Kommunalbanken's public-sector mandate is to provide long-term funding to, or guaranteed by, Norwegian LRGs. Consequently, the sector risk profile is based on the credit quality of the LRG sector, which is reflected in our institutional framework assessment. We see a weakening trend for the Norwegian institutional framework, triggered by a persistent mismatch between revenues and total expenditures, particularly in the capital accounts. Consequently, LRG sector debt has been increasing for more than a decade as capital projects often require recourse to debt. Debt as a percentage of the sector's revenues increased to 105% in 2022 from 95% in 2015, and we project continued debt uptake will cement the ratio at or around this high level in the medium term.

Despite this weakening trend, we continue to regard the institutional framework as extremely predictable and supportive, with key responsibilities supported by automatic revenue stabilizers in the central government grant framework, and a far-reaching equalization system. We view the balanced budget requirement as a strength, as it steers toward operating surpluses. This is supported by central government grants, and a far-reaching equalization system that balances the otherwise weak financial flexibility. We also view as positive the central government's extensive control framework and its intervention mechanisms preventing defaults.

Individual credit profile: Strong and experienced management, a robust market position, and strong financials support KBN's credit quality

Kommunalbanken's public-sector mandate is to provide long-term funding to, or guarantees by, Norwegian LRGs. KBN aims to complement market participants and, as a result, tries to maintain its market share at about 50%. Lending from banks to the LRG sector is decreasing, while funding from the capital markets has increased in the last five years. Husbanken (the state housing bank), which directly funds social housing, is also becoming more active. We expect KBN's market share will remain stable at around 50%.

KBN's capacity to act as a countercyclical lender further demonstrates its broad access to the markets. Its innovative product offering, which responds to changing market and customer needs, has enabled KBN to remain relevant to its customers. The bank strives to be a leading financial institution for sustainable financing solutions and, at the end of 2023, just over 15% of its total lending portfolio was green loans. Moreover, in April 2024, S&P Global Ratings published a second party opinion on KBN's green bond framework (see "Kommunalbanken Green Bond Framework"). Shortly thereafter, KBN issued its most oversubscribed Euro trade to date under the updated framework.

In our view, KBN's management team is experienced. Key members generally have long tenure with the funding agency. Robust risk-management policies and practices mitigate the main risks to the bank's operations. Management's policies and practices are prudent and oversight from the Norwegian FSA ensures continuity of managerial practices and mitigates key risks, a distinctive feature when compared with most of its global peers. KBN's organizational structure allows it to respond appropriately to stakeholder needs and requirements. Additionally, the Ministry of Local Government and Regional Development's participation in supervisory board meetings increases oversight.

KBN's risk-adjusted capital (RAC) remains very strong; before adjustments the ratio stands at about 70%. When factoring in our adjustment for single-name concentration in underlying borrowers, KBN's RAC ratio remains a very strong 42%.

As with its Nordic peers, concentration is relatively high, with the top 22 largest borrowers representing about 32% of the total loan book. However, the largest single exposure, City of Oslo, represents only about 4.5% of the portfolio and KBN has funded every municipality in Norway.

Its capital position strengthened after the central government's injection of Norwegian krone (NOK) 750 million in April 2020. In June 2023, the bank replaced part of its subordinated loan with additional Tier 1 (ATI) instruments to ensure a margin against regulatory leverage ratio requirements. We assess the hybrid instrument as having intermediate equity content and we therefore include it in our total adjusted capital (TAC) calculation. The instruments are perpetual and have a call date of at least five years from issuance. In addition, they 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 to equity of these AT1 capital notes, they are available to KBN to provide equity if triggered.

As of December 2023, KBN's common equity Tier 1 capital adequacy (CET1) ratio of 17.4% was well above the minimum regulatory Tier 1 capital ratio of 14.8%. The risk weights applied in the Norwegian FSA framework are significantly higher than those used under our RAC methodology. Therefore, KBN's adjusted RAC ratio is higher than its CET1 ratio.

KBN has never experienced any losses and has no past due or impaired exposures. Risk management remains very robust and KBN uses internal models for capital requirements for market, liquidity, and operational risks. The bank also implements strong credit risk monitoring of all its customers and processes for granting loans, and is gradually incorporating environmental, social, and governance (ESG) considerations. It introduced a new credit assessment model in March 2024.

KBN's funding ratio remains very solid at above 2x and is still very strong after including its undrawn lending commitments. KBN benefits from strong funding access through a set of reliable and diversified channels, underpinned by excellent name recognition. The majority of its funding instruments are plain vanilla and it has reduced its exposure to callable funding, including the Japanese Uridashi market.

KBN remains proactive in its liquidity management and has very strong liquidity buffers. Its policy is to hold minimum liquidity equal to its projected payment obligations over the coming 12 months without access to funding. In line with our expectations, all KBN's derivative counterparties have now moved to bilateral credit support annexes with a daily exchange of collateral.

Our 12-month liquidity ratio was 2.3x as of March 2024 after including undrawn loan commitments. This indicates that KBN, with a comfortable margin, 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.

Extraordinary support: Extremely high likelihood of support from the Norwegian government

The 'AAA' rating on KBN is supported by its very important role and integral link with the Norwegian government. Therefore, we foresee an extremely high likelihood that the central government would provide timely and sufficient extraordinary support to KBN. The government has shown willingness to support KBN several times over the years, although KBN not has experienced financial distress because the government has made capital injections--in 2008, 2012, and 2015. Most recently, in 2020 KBN's mandate was reinforced by a capital injection from the government to support its capacity to respond to municipalities' funding needs during the pandemic.

Our 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, its sole owner 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.

Issue Ratings: Subordination Risk Analysis

We rate two of KBN's AT1 capital notes 'A+' and its subordinated bond 'AA+'. The starting point for these issue ratings is our 'AAA' issuer credit rating on KBN given our view of the extremely high likelihood of KBN receiving extraordinary support from its owner in case of financial distress. We also note that the above-mentioned letter of support, which states that the government will support KBN to fulfill its financial obligations, does not exclude hybrids. As such, we believe that the Norwegian government would provide financial support to prevent loss absorption and especially that it could step in early to prevent a conversion.

We derive the four-notch difference between the 'A+' issue ratings 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 '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.

Table 1

KBN Kommunalbanken Norway -- Selected Indicators

	--Year ended Dec. 31--				
(Mil. NOK)	**2023**	**2022**	**2021**	**2020**	**2019**
Business Position					
Total adjusted assets	522,041	492,307	472,924	498,088	460,652
Customer loans (gross)	352,267	324,584	323,696	321,900	310,923
Growth in loans (%)	9.00	0.27	0.56	4.00	2.00
Net interest revenue	2,105	1,866	1,585	1,672	1,874
Noninterest expenses	325	270	255	256	251
Capital & Risk Position					
Total liabilities	500,520	473,547	453,983	479,681	444,377
Total adjusted capital*	20,470	17,832	16,484	16,577	15,639
Assets/capital	30	30	30	31	33
RAC ratio before diversification (%)*	70.4§	70.5	69.9	67.2	46.0
RAC ratio after diversification (%)*	41.8§	31.1	30.7	29.5	25.0
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity					
Liquidity ratio with loan disbursement (1 year)*	2.3§	2.3	2.2	2.0	1.6
Liquidity ratio without loan disbursement (1 year)*	2.4§	2.4	2.2	2.0	1.7

Table 1

KBN Kommunalbanken Norway -- Selected Indicators (cont.)

	--Year ended Dec. 31--				
(Mil. NOK)	**2023**	**2022**	**2021**	**2020**	**2019**
Funding ratio (1 year)*	2.1§	2.1	2.3	1.9	1.5

*As of the first quarter of the subsequent fiscal year. §As of June 2024. NOK--Norwegian krone. N.A.--Not available. RAC--Risk-adjusted capital.

Ratings Score Snapshot

Issuer credit rating	AAA/Stable/A-1+
Sector risk profile	Very Strong
Individual credit profile:	
Business position	Strong
Management & governance	Very Strong
Capital adequacy	Very Strong
Funding & liquidity	Very Strong
Anchor	aaa
Overriding factors and caps	0
Holistic analysis	0
Stand-alone credit profile	aaa
Extraordinary support	0

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Non-U.S. Public-Sector Funding Agencies, July 26, 2024
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, April 30, 2024
- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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

- Rising Debt Points To A Weakening Trend For Norwegian LRGs, March 21, 2024
- Norway, Sept 9, 2024

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+