Research Update:

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

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Overview

- KBN Kommunalbanken (KBN) maintains a significant market share in the low-risk Norwegian municipal sector, and upholds 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 receiving extraordinary support in the unlikely event of financial distress.
- In our view, this extraordinary support applies to all KBN's financial obligations, including its hybrid bonds.
- We affirmed our 'AAA/A-1+' long- and short-term issuer credit ratings on KBN. The outlook is stable.

Rating Action

On June 22, 2023, 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 two rated hybrid bonds.

Outlook

The stable outlook reflects our view that 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 ratings 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.

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. 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 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. KBN's management has considerable expertise, prudently handles risks, and consistently complies with the regulatory requirements under which it operates, which we consider stricter than those of its Nordic public sector funding agency peers.

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

The 'AAA' rating on KBN is two notches higher than the 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.

In June 2023, Kommunalbanken issued another Additional Tier 1 (AT1) notes to allow for a buffer against regulatory leverage ratio requirements. We rate the junior subordinated issues at 'A+', four notches below its issuer credit rating. The starting point of the issuer credit rating reflects our view of extremely high likelihood that KBN would receive timely extraordinary support from its owner, the Kingdom of Norway, in case of financial distress. We assess the hybrid to have intermediate equity content and hence include it in our total adjusted capital (TAC).

Enterprise risk profile: Low-risk municipal sector, very strong management and governance, and a significant market share

- Very strong management and governance is supported by compliance with banking regulatory standards.
- The Norwegian local government sector exhibits key structural features that support high credit standing.
- Significant market share with a diversified revenue base.

KBN has a long track record of fulfilling its public policy role and has been active under adverse market conditions, as demonstrated during the pandemic and recent market volatility. 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 the KLP 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.

While rising interest rates and high inflation could weigh on local government finances, the sector exhibits key structural features that should continue supporting its high credit standing.

Norwegian local and regional governments (LRGs) show a high degree of institutional stability and there are mechanisms in place to ensure they do not suffer financial distress. For example, the central government has provided unwavering support to the sector.

Our assessment of Norway's low risk Public Industry Country Risk Assessment is supported by its wealthy economy. Although we expect GDP to slow in 2023 because of still-elevated inflation and tighter financing conditions, wealth levels remain among the highest in Europe. Our view is supported by the advanced financial system in Norway and the tight link between the local government sector and the 'AAA' rated sovereign. Moreover, the central government's close oversight of LRGs enables timely mitigating actions before the sector enters financial distress.

The Norwegian LRG sector has slightly higher leverage than peers, although it remains modest. We forecast the sector's direct debt will increase to about 110% of its operating revenue by 2025, driven by high investment needs in the sector and somewhat weaker revenue growth due to slowing economic activity. Still, its interest-to-operating-expense ratio will stay comfortably below 5%.

KBN's public-sector mandate is to provide long-term funding to, or guaranteed by, Norwegian LRGs. It has been a countercyclical lender and played an active role throughout the pandemic. KBN aims to complement market participants and, as a result, tries to maintain a market share at about 50%. Lending from banks to the LRG sector is decreasing, while funding from the capital markets is increasing. Husbanken (the state housing bank), which directly funds social housing, is also becoming more active. This has resulted in KBN's market share (excluding Husbanken- the Norwegian State Housing Bank) declining slightly to 49.7% in 2022, from 51.4% in the previous year.

The bank's very strong management and governance is underpinned by its robust compliance with banking regulatory requirements, the central government's tight oversight of its activities, its prudent risk management with a low-risk appetite, and its robust record of fulfilling its public-policy mandate through credit cycles.

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 enabled KBN to remain relevant to its customers. The bank has also been well supported by its owner, the central government, which forewent dividend distributions in 2019, 2020 and 2022, and provided a capital in 2020.

KBN has kept a strong focus on sustainable financing, as one of the key pillars of its 2022-2024 strategy, and in line with national climate goals.

In our view, KBN's management team is experienced, and key members generally have long tenure with the funding agency. Superior risk-management policies and practices mitigate key risks in 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 of KBN 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.

We expect KBN to remain compliant after the upcoming banking reform packages come into force. In May 2020, the FSA announced that the deadline for fulfilling the minimum requirement for own funds and eligible liabilities (MREL) would be postponed to Jan. 1, 2024. We understand that there is no decision to exclude KBN from MREL requirement, so national implementation of MREL provisions could require KBN to issue senior nonpreferred instruments. KBN has also stepped up its internal processes to align with the upcoming ESG disclosure requirements, which was implemented in July 2022, with reporting in 2023.

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

- Sustained high levels of capitalization supported by compliance with regulatory requirements.
- Excellent name recognition supports strong market access and a deep investor base.
- Robust risk management supports strong liquidity buffers.

KBN's risk-adjusted capital (RAC) ratio before adjustments remained very high at 70.5% at March 31, 2023. For fiscal year ending Dec. 31, 2022, there are no dividend pay-outs proposed, because large unrealized losses led to a negative result. During the pandemic, the government waived these payments despite positive results. KBN's capital position has strengthened after the central government's capital 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 to ensure a margin against regulatory leverage ratio requirements. We assess the hybrid instrument to have intermediate equity content and will therefore include it in our TAC calculations. We estimate that this will increase TAC by close to 7% and add about 4.5 percentage points (pps) to total RAC, and 3 pps after adjustments.

When factoring in our adjustment for single-name concentration in underlying borrowers, KBN's S&P Global Ratings-adjusted RAC ratio remains at a very strong 31%. As with its Nordic peers, concentration is relatively high, with the top 20 largest borrowers representing about 40% of the total loan book. However, the largest single exposure (Municipality of Oslo) is less than 4% of total and KBN has funded every municipality in Norway. We have not observed any major increase in single name concentration following the municipal reform in 2020, and do not expect this to happen.

KBN has not 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. It 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.

KBN's compliance with regulatory capital requirements supports 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 feature of its financial risk profile. As of December 2022, KBN's common equity Tier 1 capital adequacy (CET1) ratio of 19% was well above the minimum regulatory Tier 1 capital ratio of 16.1%. Risk weights applicable under FSA Norway are significantly higher than those applied under our RAC framework methodology; therefore, KBN's adjusted RAC ratio is higher than its CET1 ratio.

KBN has adapted its capital structure to new capital requirements and issued its third AT1 notes in June 2023. Our RAC ratios include capital from these notes because these meet the conditions for intermediate equity content under our hybrid criteria. 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.

KBN's excellent name recognition and deep investor base further supports our view of its funding profile. Its funding strategy is focused on benchmark issuance in strategic markets. It also has a record of more than 10 years of green bond issuance, which has further expanded its investor base. During 2022 the bank issued approximately NOK7.5 billion through three green bonds in three currencies.

As of March 2023, KBN's funding ratio remains very solid at 2.1x and is still very strong after including its undrawn lending commitments, at 2.0x. The majority of KBN's funding instruments are plain vanilla and it has reduced its exposure to callable funding and Japanese retail Uridashi funding.

KBN remains proactive in its liquidity management and has very strong liquidity buffers. Its 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 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 2023 after 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 the Norwegian government

The 'AAA' rating on KBN is two notches higher than the 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 the central government would provide timely and sufficient extraordinary support to KBN in the event of financial distress. This has been illustrated several times over the years as the Norwegian government has made capital injections to the bank in 2008, 2012, and 2015. In 2020, the bank's mandate was reinforced by a capital injection from the government, which increased KBN's 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, 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.

Key Statistics

Table 1

KBN Kommunalbanken Norway--Selected Indicators

	--Year ended Dec. 31--				
(Mil. NOK)	**2022**	**2021**	**2020**	**2019**	**2018**
Business position					
Total adjusted assets	492,307	472,924	498,088	460,652	457,585
Customer loans (gross)	324,584	323,696	321,900	310,923	303,582
Growth in loans (%)	0.27	0.56	4.00	2.00	7.00
Net interest revenue	1,866	1,585	1,672	1,874	1,885
Noninterest expenses	270	255	256	251	210
Capital and risk position					
Total liabilities	473,547	453,983	479,681	444,377	442,279
Total adjusted capital*	17,832	16,484	16,577	15,639	15,561
Assets/capital	30	30	31	33	36
RAC ratio before diversification (%)*	70.5	69.9	67.2	46.0	51.0
RAC ratio after diversification (%)*	31.1	30.7	29.5	25.0	29.0
Funding and liquidity					
Liquidity ratio with loan disbursement (one year)*	2.3	2.2	2.0	1.6	1.3
Liquidity ratio without loan disbursement (one year)*	2.4	2.2	2.0	1.7	1.3
Funding ratio (one year)*	2.1	2.3	1.9	1.5	1.1

*As of the first quarter of the fiscal year. NOK--Norwegian krone. RAC--Risk-adjusted capital.

Ratings Score Snapshot

Table 2

KBN Kommunalbanken Norway--Ratings Score Snapshot

Issuer credit rating	**AAA/Stable/A-1+**
Stand-alone credit profile	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

Table 2

KBN Kommunalbanken Norway--Ratings Score Snapshot (cont.)

Issuer credit rating	AAA/Stable/A-1+
Additional factors	0

GRE--Government-related entity. PICRA--Public Sector Industry Risk And Country Risk Assessment.

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.

The AT1 issued in June 2023 is partly replacing the outstanding subordinated loan issued in 2016 (classified as Tier 2 capital) to similar long-term investors. This will help Kommunalbanken maintain a leverage ratio above the regulatory requirement of 3% (plus an administrative buffer of 0.6% set by the board of governors) in a period of potentially volatile Norwegian krone and increased lending.

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.

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions , March 2, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021
- 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

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+