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Research Update:

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

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Overview

- Kommunalbanken AS (KBN's) long record of fulfilling its public policy mandate, as well as its prudent risk management, support its very strong financial risk profile.
- We believe KBN has a very important role and integral link with Norway's central government, resulting an extremely high likelihood of receiving extraordinary support in the case of financial distress.
- Therefore, we are affirming our 'AAA/A-1+' long- and short-term issuer credit ratings on KBN.
- The stable outlook reflects our expectation that KBN's ownership structure and the support from the Norwegian government will remain unchanged, and that it will maintain very strong financial indicators while complying with regulatory requirements.

Rating Action

On June 21, 2019, S&P Global Ratings affirmed its 'AAA/A-1+' long- and short-term issuer credit ratings on Norwegian public sector funding agency Kommunalbanken AS (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.

Outlook

The stable outlook reflects our expectation that KBN's ownership structure and the support from the Norway (AAA/Stable/A-1+) will remain unchanged. We expect KBN's management will maintain a very strong financial risk profile, supported by very robust risk management policies. Additionally, we expect that KBN will continue complying with upcoming potential changes in regulatory requirements.

Downside scenario

We could lower our rating over the next two years if KBN's intrinsic characteristics came under significant pressure, for example if its financial indicators deteriorated materially, its market share reduced significantly, or if it failed to fulfil its public policy mandate. We could also consider a downgrade if we believed the likelihood of extraordinary support from KBN's owner had weakened.

Rationale

In our view, KBN has a very important role and integral link with Norway's central government, which has ratified its support to KBN over the years. KBN was established in 1926 by an act of parliament and gained its current organizational form in 1999 by a conversion act. For some time it was 20% owned by Kommunal Landspensjonskasse (KLP) and 80% owned by the Norwegian government. In 2009, the Norwegian government bought up the KLP shares and it became 100% central government owned.

KBN has a long record of fulfilling its public policy role, has proven to be active under adverse market conditions, and has aligned its product offer with market and customer needs. We consider that the Norwegian local and regional government sector is low risk, owing to its extremely predictable and well-balanced institutional framework, although this is counterbalanced by the sector's leverage. The high-income level supports significant economic resilience, partly offset by moderate risks in the Norwegian financial system. Management is competent and prudently handles risks associated with expanding activities, while complying with regulatory requirements. These factors support our assessment of KBN's strong enterprise risk profile. 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.

We combine our assessments of KBN's strong enterprise risk profile and very strong financial risk profile to arrive at a stand-alone credit profile (SACP) of 'aa', further supported by a more robust financial profile than peers. 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'.

Enterprise Risk Profile: Low risk municipal sector; 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, demonstrated by its wealthy and resilient economy, a well-developed financial sector, and moderately leveraged local and regional government (LRG) sector.
- Compliance with regulatory requirements, tight central government oversight, prudent risk management, and a robust record of fulfilling its public policy role support our view of KBN's very strong management and governance.
- KBN's strong access to capital markets ensure LRGs' stable and low-cost access to financing throughout the economic cycle. It has adapted its lending offer to market and customer needs, enabling it to maintain a stable market share backing its strong public policy role.

KBN's public-sector mandate is to provide long-term funding to or guaranteed by Norwegian LRGs. KBN's lending portfolio continues to expand, and accelerated to 7.3% in 2018 from 5.7% in 2017. However, KBN aims at a market share below 50% in order to promote competition for municipal loans and support the domestic capital market.

Furthermore, KBN has proven to be a countercyclical lender, with its loan book expanding significantly during financial crisis. This 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. During 2018, KBN's portfolio significantly increased its focus on green projects, which has become an important focus area for KBN, aligned with national climate goals. As such, KBN has been working on a "Green Framework" to demonstrate to shareholders that its green bonds fund project aligns with national targets. KBN's framework has achieved the highest rating from the Centre for International Climate Research, further proving management's ability to achieve its operational targets.

The Norwegian LRG sector exhibits key structural features, which supports high credit standing and a low risk public industry country risk assessment. For example, its economy is wealthy, it has an advanced financial system, and there is a tight link between the local government sector and the 'AAA' rated sovereign. Balancing these strengths is the LRG sector's slightly higher leverage than peers. We forecast the sector's direct debt will reach about 104% of its operating revenues by 2020, and view the sector as having average access to external liquidity as measured by our Banking Industry Country Risk Assessment (BICRA) on Norway.

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 Financial Supervisory Authority ensures continuity of managerial practices and mitigates key risks. 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 is the ultimate decision maker. Additionally, the Ministry of Local Government and Modernization participation in Supervisory Board meetings increases oversight. In our view, the management team is experienced and key members generally have long tenure with the funding agency, further supporting our management and governance assessment. Superior risk-management policies and practices mitigate key risks in its operations.

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 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. 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 with license 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 Financial Supervisory Authority has noted, however, that regardless of how the MREL provisions will be implemented in EU and Norway, KBN already has reserves that would be eligible against the requirement well above the minimum levels mandated by the Directive. 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 by the end of 2022.

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.
- Broad and diversified access to capital markets and robust asset liability management ensure very strong liquidity buffers.

As of end of March 2019, KBN's risk-adjusted capital (RAC) ratio was very strong at 51% before adjustments. When factoring in our adjustment for single-name concentration on underlying borrowers, KBN's RAC after adjustments declines but remains at a very strong level of 29%. Exposure to the 20-largest borrowers, stands at about 30% in 2018 as a percentage of total lending, similar to that of peers. KBN has not experienced losses and maintains a prudent risk management, further supporting the very strong capital adequacy assessment.

KBN's compliance with regulatory capital requirements support our expectation that its adjusted RAC ratio will be comfortably over our 15% threshold in the next two years and remain a key support to its financial risk profile. As of December 2019, KBN's Tier 1 capital ratio of 17.4% was fully compliant with the minimum regulatory Tier 1 capital ratio of 15.4%.

KBN has adapted its capital structure to new capital requirements and issued additional Tier 1 capital notes in June 2017. Our RAC ratios include capital from these notes because they meet the conditions for intermediate equity content under our criteria. The notes are perpetual and have a call date expected to 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.

Further supporting its financial risk profile is KBN's very strong name recognition and deep investor base. 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. In August 2018, KBN issued its first green kangaroo bond in the Australian dollar market, further broadening its investor base

KBN's funding ratios as of March 2019 were robust, even considering its undrawn lending commitments. The funding gap without scheduled loans for one year stood at 1.12x, and was 1.08x after including undrawn loan commitments. The majority of its funding instruments are plain vanilla, and KBN has taken steps to reduce its exposure to callable funding and Japanese retail Uridashi funding.

At the same time, we observe that KBN remain proactive in its liquidity management execution, ensuring maintains a very strong position in the next 12-18 months. 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 expectations, all of KBN's derivative counterparties have now moved to bilateral credit support annexes (two-way CSAs).

Our 12-month liquidity ratio at 1.28x including undrawn loan commitments indicate 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 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

The affirmation of the 'A+' long-term issue rating on KBN's additional Tier 1 capital notes issuance (AT1), and our 'AA+' long-term issue rating on KBN's subordinated bond follow our Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions. 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.

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+' long-term 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 Selected Indicators

	--Year ended Dec. 31--				
(Mil. NOK)	2018	2017	2016	2015	2014
Business Position					
Total adjusted assets	457,585	412,729	418,189	449,236	455,386
Customer loans (gross)	303,582	283,396	267,521	256,815	249,928
Growth in loans (%)	7	6	4	3	3
Net interest revenues	1,885	2,162	2,087	1,642	1,515
Noninterest expenses	210	193	177	151	123
Capital & Risk Position					
Total liabilities	442,279	398,187	405,875	437,159	447,130
Total adjusted capital**	15,561	14,099	11,924	11,660	8,256
Assets/capital	36	35	38	42	55

Table 1

KBN Kommunalbanken Selected Indicators (cont.)

	--Year ended Dec. 31--				
(Mil. NOK)	2018	2017	2016	2015	2014
RAC ratio before diversification (%)**	51	59	N.A.	N.A.	N.A.
RAC ratio after diversification (%)**	29	31	N.A.	N.A.	N.A.
Funding and Liquidity					
Liquidity ratio with loan disbursement (1 year)**	1.28	1.2	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (1 year)**	1.33	1.5	N.A.	N.A.	N.A.
Funding ratio (1 year)**	1.12	1.5	N.A.	N.A.	N.A.

**as of March 2019. NOK--Norwegian krone. N.A.--Not available.

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

PICRA--Public-Sector Industry Risk And Country Risk Assessment.

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

- Public-Sector Funding Agencies Risk Indicators: May 2019, May 13, 2019
- 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

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