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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) has fulfilled its policy mandate through credit cycles, and we expect it to be a key agent for dealing with the economic effects of COVID-19.
- Operating within a relatively strict regulatory framework in Norway, we expect KBN to maintain prudent risk management and its very strong financial risk profile. We believe KBN has a very important role for, and integral link with, Norway's central government, resulting in an extremely high likelihood of it 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 navigating through the current crisis and while complying with regulatory requirements.

Rating Action

On June 9, 2020, 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.

Outlook

The stable outlook reflects our expectation that over the next two years, KBN's ownership structure and the implicit support from the Norwegian government will remain unchanged. We expect KBN's policy mandate to strengthen as it is a key agent in the government's strategy to deal with the economic impact of the COVID-19 pandemic, by providing affordable funding to Norwegian local governments. We forecast that its capital adequacy and funding and liquidity ratios will remain very strong, further supported by the recent capital injection and robust risk management policies. We also expect that KBN will successfully navigate instances of regulatory risk so that the execution of its public policy role is not affected.

We could lower our rating if KBN's financial indicators weaken significantly, or if it experiences a structural reduction of its market share limiting its ability to fulfil its anticyclical public policy mandate. If we believed KBN's public policy role subsides, or if there is change to its ownership, the ratings could also come under pressure.

Rationale

Underpinning the 'AAA' ratings on KBN is our view of its very important role for, and integral link with, the Norwegian government. Therefore, we believe that in the event of KBN experiencing financial stress, there is an extremely high likelihood of extraordinary financial support from the central government. This provides a two-notch uplift from KBN's stand-alone credit profile (SACP) of 'aa'.

KBN has a long track record of fulfilling its public policy role and has proven to be active under adverse market conditions. We expect it to be a key partner for dealing with the economic effects of the COVID-19 outbreak, further supported by the capital injection from the central government in April 2020. We consider that the Norwegian local and regional government sector is overall low risk and well supported by the central government to navigate the economic impact arising from the COVID-19 outbreak. KBN's management is competent and prudently handles risks, while complying with stricter regulatory requirements than its Nordic peers. These factors support our assessment of KBN's strong enterprise risk profile.

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.

Enterprise Risk Profile: Low-risk municipal sector even amid COVID-19; 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. In our view, the Norwegian local government sector has a wealthy and resilient economy, a well-developed financial sector, and is moderately leveraged.
- KBN has proven to be a countercyclical lender and we expect it to continue fulfilling its important policy mandate amid the economic slowdown stemming from the COVID-19 outbreak.
- Compliance with relatively strict regulatory requirements, tight central government oversight, and prudent risk management support our view of KBN's very strong management and governance.

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 became the sole owner.

Over the years, the government of Norway through the Ministry of Local Government and Modernization has ratified its support toward KBN, as well as making capital injections in 2008, 2012, and 2015 to strengthen its capital position. More recently, a capital injection in April 2020 following the COVID-19 outbreak is a testament of such support, and it confirms our view that KBN is a key agent for the government to deal with the economic and financial impact unfolded by the containment of the COVID-19 outbreak.

We consider that the Norwegian local and regional government (LRG) sector is overall low risk and is well supported by the central government to navigate the economic impact of the COVID-19 outbreak. When local government finances came under pressure previously, due to either financial or oil market turbulences, they were compensated financially by the central government.

The 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. On the other hand, the Norwegian LRG sector has slightly higher leverage than peers. We forecast the sector's direct debt will reach about 104% of its operating revenues by 2021, and view the sector as having average access to external liquidity as measured by our Banking Industry Country Risk Assessment (BICRA) on Norway.

KBN's public-sector mandate is to provide long-term funding to, or guaranteed by, Norwegian LRGs. It has proven to be a countercyclical lender and under the current economic stress we expect it will continue fulfilling its important mandate. Moreover, the central government injected capital in April 2020, mainly for local governments to secure funding to refinance short-term maturities under the capital markets turmoil.

Therefore, we expect KBN's lending portfolio to continue expanding. However, market share would remain at KBN's target of lower than 50% in order 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.

KBN has kept a strong focus on sustainable financing, one of the key pillars of its 2020-2022 strategy, and one which aligns with the national climate goals. During 2019, KBN's portfolio continued increasing its allocation on green projects. KBN's green framework has achieved the highest rating from the Centre for International Climate Research, further proving management's ability to achieve its operational targets.

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, a distinctive feature of KBN when compared with most of its global peers. KBN's organizational structure allows it to respond appropriately to stakeholders' needs and requirements. The board of directors tracks progress on outcomes in regular meetings with the executive team, and is the ultimate decision maker.

In March 2020, the CEO Kristine Falkgård stepped down after seven years of service. The process for recruiting a new CEO has not yet concluded, and acting as interim CEO is CFO Jannicke Trumpy. We expect continuity in KBN's strategy and prudent financial policies because, in our view, there is no "key man" risk. Additionally, the Ministry of Local Government and Modernization's 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 very strong 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. The 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, owing to its special nature and limited risk in lending operations. The bill was adopted in March 2018 by parliament. There are ongoing discussions in both 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 the 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.

Additionally, the Supervisory Review and Evaluation Process (SREP) from the Financial Supervisory Authority of Norway introduced an increase in the bank's pillar 2 requirement from 1.4% to 2.3% with effect from March 31, 2020, primarily due to an increase in the systemic risk buffer.

We view positively the central government's decision to forgo dividend distribution for 2019, in order to support financial resilience at KBN and to robustly meet the increasing capital regulatory requirements.

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 the recent capital injection from the central government.
- Reduced agency risk as 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, 2020, KBN's risk-adjusted capital (RAC) ratio was very strong at 46% before adjustments. The RAC before adjustments reduced from the previous 51% due to large unrealized losses and larger balance sheet due to volatility in exchange rates.

When factoring our adjustment for single-name concentration on underlying borrowers, KBN's RAC after adjustments declines but remains at a very strong level of 25%. As of March 2020, exposure to the 20-largest borrowers stands at about 27% 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.

These ratios do not include the capital injection, because this was paid in April 2020. While the capital increase will enable KBN to lend an additional Norwegian krone (NOK) 20 billion-NOK25 billion, we do not expect pressures on its RAC ratios to move to a lower assessment. This is further supported by dividends retention.

KBN's compliance with regulatory capital requirements support our expectation that its S&P Global Ratings-adjusted RAC ratio will be comfortably over our 15% threshold in the next two years, and will 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%. We note that risk weights applicable under the Financial Supervisory Authority in Norway are significantly higher than those applied under S&P Global Ratings' methodology, and therefore S&P Global Ratings' RAC ratios are higher than the Common Equity Tier 1 ratio of KBN.

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.

KBN's funding ratios as of March 2020 are robust even considering its undrawn lending commitments. The ratios have increased from the previous year as the amount of collateral received from derivatives was significantly higher in this quarter. The funding gap without scheduled loans for one year stood at 1.47x, and was 1.43x 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 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 expectations, all of KBN's derivative counterparties have now moved to bilateral credit support annexes (two-way CSAs) with daily exchange of collateral.

Our 12-month liquidity ratio at 1.56x 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 the 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.

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.

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 Hybrid Capital: 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)	2019	2018	2017	2016	2015
Business Position					
Total adjusted assets	460,652	457,585	412,729	418,189	449,236
Customer loans (gross)	310,923	303,582	283,396	267,521	256,815
Growth in loans (%)	2	7	6	4	3
Net interest revenues	1,874	1,885	2,162	2,087	1,642
Noninterest expenses	251	210	193	177	151
Capital & Risk Position					
Total liabilities	444,377	442,279	398,187	405,875	437,159
Total adjusted capital*	15,639	15,561	14,099	11,924	11,660
Assets/capital	38	36	35	38	42
RAC ratio before diversification (%)*	46	51	59	N.A.	N.A.
RAC ratio after diversification (%)*	25	29	31	N.A.	N.A.
Funding and Liquidity					
Liquidity ratio with loan disbursement (1 year)*	1.38	1.28	1.20	N.A.	N.A.
Liquidity ratio without loan disbursement (1 year)*	1.65	1.33	1.50	N.A.	N.A.
Funding ratio (1 year)*	1.47	1.12	1.50	N.A.	N.A.

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

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: 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

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+