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Credit Opinion: Kommuninvest i Sverige Aktiebolag

Global Credit Research - 27 Mar 2015

Orebro, Sweden

Ratings

Category	**Moody's Rating**
Outlook	Stable
Issuer Rating	Aaa
Senior Unsecured	Aaa
Bkd Commercial Paper	P-1
Bkd Other Short Term	(P)P-1

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Opinion

SUMMARY RATING RATIONALE

Kommuninvest i Sverige AB's (Kommuninvest) Aaa rating with a stable outlook reflect (1) its public policy mandate to act as the debt management office for the regional and local government (RLG) sector in Sweden, (2) a joint and several guarantee by all RLGs that are members in Kommuninvest Cooperative Society (Kommuninvest's owner organisation), (3) predictable financial performance, and (4) low risk appetite.

RATING DRIVERS

-100% RLG ownership reflects importance of Kommuninvest to Swedish RLG sector

- Strong asset quality rests on RLG's predictable revenues and government oversight

- Kommuninvest's liabilities are guaranteed by all members of Kommuninvest Cooperative Society

- Financial performance is predictable as a result of public policy mandate

- Diverse funding, maturity of assets and liabilities matched and good liquidity

- Capitalisation is good but some uncertainty persists due to new regulatory rules

- Prudent risk management is comparable with peers

RATING OUTLOOK

The outlook on Kommuninvest's senior unsecured debt ratings is stable.

WHAT COULD CHANGE THE RATING - DOWN

Downward pressure on the rating could result if (1) asset quality deteriorates, which currently is unlikely, (2) Kommuninvest's public policy mandate is diluted, (3) its ability to access debt capital markets is weakened, and/or (4) its financial performance deteriorates over the longer term, which we currently deem unlikely.

DETAILED RATING CONSIDERATIONS

The ratings assigned to Kommuninvest reflects the application of Moody's Banks and Government-Related Issuers (GRIs) methodologies. In accordance with these methodologies, Moody's first establishes the baseline credit assessment (BCA) for the entity and then considers the likelihood of support coming from the Swedish local and regional governments - its members - and the national government in order to avoid an imminent default by Kommuninvest, should this extreme event ever occur.

While we currently rate Kommuninvest using both our GRI and Bank rating methodologies, in the coming months, we are likely to consider solely using the former methodology to better capture the institution's profile, as its liabilities are guaranteed by the entire regional and local government sector in Sweden. Consequently, we are likely to maintain the current debt ratings and outlook whilst at the same time (i) withdrawing the institution's baseline credit assessment (BCA) and (ii) basing Kommuninvest's ratings solely on a notching framework related to its guarantee, as also outlined in our GRI methodology.

100% RLG OWNERSHIP REFLECTS IMPORTANCE OF KOMMUNINVEST TO SWEDISH RLG SECTOR

Kommuninvest is closely tied to the Swedish RLG sector. The company is fully owned by the RLG sector, and acts as the sector's debt management office. Only Swedish municipalities and county councils can become members in its ownership organisation, and the board of Kommuninvest Cooperative Society (Kommuninvest's ownership organisation) consists exclusively of representatives from the RLG sector.

Kommuninvest's market share of RLG borrowing is 44% at year end-2014 which makes it the market leader. We consider its market share sufficiently large in order for us to conclude that Kommuninvest has a national public policy mandate. Its ability to further strengthen that mandate will depend on its ability to attract some large RLGs which may have other (standalone) funding options, such as the City of Stockholm, to join its membership organisation.

STRONG ASSET QUALITY RESTS ON RLG'S PREDICTABLE REVENUES AND GOVERNMENT OVERSIGHT

Kommunivest's asset quality is strong as a result of (1) Swedish RLG's have authority to raise income taxes, (2) grants from the central government forms another important source of revenues, (3) a revenue equalisation principle which enables all RLG's to deliver key public services irrespective of the economic conditions in each municipality, (4) legislation states that Swedish RLG's budget imbalances cannot persist for more than three years, and (5) the Swedish central government bears ultimate financial responsibility for the Swedish RLG sector.

The five components above are in place in order to ensure that Swedish RLG's remain creditworthy over the long-term, in order to allow continuous delivery of key public services such as education, healthcare, care for the elderly and housing. We also note that Swedish RLG's cannot be declared bankrupt and have never defaulted on any obligation.

Similar to its Nordic peers, Kommuninvest has a small number of customers and this inevitably translates into lending concentration.

KOMMUNINVEST'S LIABILITIES ARE GUARANTEED BY ALL MEMBERS OF KOMMUNINVEST COOPERATIVE SOCIETY

All liabilities of Kommuninvest are guaranteed by its owners on a joint and several basis. In the currently unlikely event of a default, a creditor can claim full payment from any local government that is a member of Kommuninvest's ownership organisation, Kommuninvest Cooperative Society, thus having recourse to 94% of Sweden's municipalities (year end-2014).

FINANCIAL PERFORMANCE IS PREDICTABLE AS A RESULT OF PUBLIC POLICY MANDATE

Kommuninvest's financial performance is moderate because its mandate is to offer cost-effective lending to the Swedish RLG sector. Its ability to deliver under this mandate is largely determined by its funding cost, which has remained stable in recent years in spite of significant volatility in the financial markets.

Kommuninvest's profitability is predictable as a result of its mandate to lend exclusively to the Swedish RLG sector and related entities guaranteed by Swedish RLGs and leading market position with a market share of 44% at year end-2014. In addition, its customers are financially stable for the reasons outlined in the section above.

Operating expenses are low due to Kommuninvest's monoline business model. For example, in 2014 total expenses were SEK284 million, including a SEK111 million stability fee which authorities also impose on commercial banks, compared to operating income of SEK1,013 million. We expect operating expenses to remain low because we think the institution's business model will remain unchanged for the foreseeable future.

DIVERSE FUNDING, MATURITY OF ASSETS AND LIABILITIES MATCHED AND GOOD LIQUIDITY

Kommuninvest issues various types of debt, in multiple markets, in several currencies, to a diverse investor base. We view this approach as prudent because it reduces dependence on a single funding source. That said, we understand that Kommuninvest in the future intends to source a greater proportion of funds from Sweden. Although this is likely to translate into lower credit counterparty risks, due to a lesser need for currency hedging, it will inevitably translate into a less diverse funding profile.

Kommuninvest is match-funded which means that the maturity of its liabilities is generally at least as long as the maturity of its assets.

Similar to peers, some of Kommuninvest's funding comes with option-like features, which suddenly could shorten its liability profile. For its liquidity planning, Kommuninvest assumes that all such funding is called at first call date. We also note that Kommuninvest's funding profile is more domestically orientated than its peers and as a result it is less reliant on callable funding which is mainly sourced from Japan.

Kommuninvest maintains a large liquidity portfolio, which size amounted to 30% of lending at year end-2014. The bulk of the portfolio is of very strong asset quality and the exposure is mainly to sovereigns in Northern Europe and Swedish covered bonds. Kommuninvest also has central bank access which is not the case for all its peers.

CAPITALISATION IS GOOD BUT SOME UNCERTAINTY PERSISTS DUE TO NEW REGULATORY RULES

Kommuninvest is adequately capitalised relative to its risks. The institution reported a 34.6% Tier 1 ratio at year end-2014, which is very high namely because a zero risk-weight is applicable on its lending. In comparison, its Norway based peer, Kommunalbanken, applies a 20% risk-weight on its lending. We also note that Kommuninvest has never recorded a loss on its lending.

Kommuninvest's leverage ratio of 0.76% (excluding subordinated debt that will not in the future qualify as capital) is below that of its peers and well below 3% that might become a requirement from 1 January 2018. The institution is targeting a 1.5% ratio in light of the current uncertainty if 3% indeed will become a requirement. We think Kommuninvest is likely to request a capital injection from its owners or issue hybrid debt if 3% were to become a requirement in 2017, as we don't think that one year will be sufficient to organically grow its leverage ratio to 3%.

PRUDENT RISK MANAGEMENT IS COMPARABLE WITH PEERS

Kommuninvest has very limited appetite for risk which is consistent with its peers. The institution mitigates currency risks by using hedging agreements and interest rate risk is limited to SEK8.5 million, assuming a one percentage point parallel yield curve shift, and that is a small exposure compared to equity of SEK2.4 billion at year end-2014.

Kommuninvest's extensive use of derivatives for hedging purposes gives rise to credit counterparty risks which the institution mitigates against by entering into standard international swaps and derivatives association agreements (ISDAs) and credit support annex agreements (CSAs) which, however, also increasingly require Kommuninvest to post collateral. All counterparties are required to have a rating of at least A2.

SUPPORT CONSIDERATION

Moody's assigns a very high likelihood of support from the Swedish local and regional governments - its members - and the national government in order to avoid an imminent default by Kommuninvest, should this extreme event ever occur.

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