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## Research Update:

# Swedish Local Government Funding Agency Kommuninvest i Sverige AB Ratings Affirmed At 'AAA/A-1+'; Outlook Stable

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## Research Update:

# Swedish Local Government Funding Agency Kommuninvest i Sverige AB Ratings Affirmed At 'AAA/A-1+'; Outlook Stable

## Overview

- Kommuninvest's capitalization is set to strengthen further on the back of shareholder capital contributions and sound internal capital generation from robust earnings.
- In addition, Kommuninvest continues to benefit from excellent asset quality, robust liquidity, and a joint and several guarantee on its financial obligations extended from its vast membership base of Swedish local and regional governments, which in turn have close ties to the central government through an extremely predictable and supportive institutional framework.
- We are affirming our 'AAA/A-1+' long- and short-term issuer credit ratings and our 'K-1' short-term Nordic regional scale rating on Kommuninvest.
- The stable outlook reflects our expectation that Kommuninvest's guarantee structure will remain unchanged and that the agency will maintain robust liquidity, prudent risk management, excellent asset quality, and a continuously strengthening capitalization benefitting from unwavering membership support.

## Rating Action

On June 25, 2015, Standard & Poor's Ratings Services affirmed its 'AAA' long-term and 'A-1+' short-term issuer credit ratings on Swedish local government funding agency Kommuninvest i Sverige AB (Kommuninvest). The outlook is stable.

At the same time, we affirmed our 'K-1' short-term Nordic regional scale rating on Kommuninvest.

## Rationale

We base our ratings on Kommuninvest on our assessment of its robust joint and several guarantee structure signed by all member local governments and covering all the agency's financial liabilities. In addition, additional rating support stems from Kommuninvest's access to central bank financing, the excellent asset quality of its loan book and securities investments, strong financial risk management, and strengthening capitalization on the back of member capital contributions.

Although members have agreed to capital contributions in 2015 that will significantly boost Kommuninvest's equity, the agency's current non-risk-weighted leverage ratio is thin. This exposes the agency to some regulatory risks should its capital build-up not materialize according to plan. Our ratings also incorporate the added funding risk derived from the agency's dependence on wholesale funding, in addition to a degree of concentration risk in its regionally concentrated lending portfolio.

Kommuninvest is a subsidiary of Kommuninvest Cooperative Society (KCS). The local governments that belong to KCS must sign a joint and several guarantee to cover Kommuninvest's financial commitments if they want to become a member of the agency. The guarantee, last updated in 2011, passes on all financial risks to Kommuninvest's member local governments, including exposures in Kommuninvest's derivatives portfolio. No court order or board decision by the guarantors is needed for a payment to be made under the guarantee. A pro rata right of recourse agreement reduces a member's ultimate responsibility to its own share of any liability on which Kommuninvest defaults. In our opinion, the joint and several guarantee commitment from Kommuninvest's member local governments underpin the ratings on the agency.

We acknowledge Kommuninvest's progress in its strategy to build capital to comply with the Basel III leverage ratio requirement, which is set to be introduced in 2018. Internal capital generation continues to be sound, but the agency is increasingly turning to its municipal members for capital contributions. In essence, we consider that it will primarily be the responsibility of the member municipalities to ensure that Kommuninvest holds adequate capitalization to continue with its desired scope of funding activities.

Importantly, we expect Kommuninvest's member municipalities will follow through on their intention to make meaningful capital contributions in 2015 in line with the agency's strategy to prepare for the 2018 Basel III leverage ratio requirements. In practice, the agency has revised its thresholds for the initial capital contribution levels paid on membership. These currently hold a minimum level at Swedish krona (SEK) 200 per inhabitant and rise to a maximum SEK900 per inhabitant. When the members approach the maximum level of capital contribution they will be entitled to keep a greater portion of the refund of yearly profits. We understand that a large number of members will commit to increasing their initial capital contribution to Kommuninvest and therefore significantly boost the core capital of the agency. We assume that Kommuninvest's leverage ratio will likely improve to about 1.5% by 2015 from a thin 0.78% in 2014. We do not include Kommuninvest's SEK1 billion debenture loan as primary capital in this ratio, as we do not think that the current loan satisfies the requirements for inclusion.

In addition, at KCS' annual general meeting in April 2015, the member local governments confirmed its 2014 decision to adopt a contingency plan if the Basel III leverage ratio reaches 3% in 2018, introducing in the KCS's statutes the possibility to strengthen Kommuninvest's capital base via the subscription of core capital instruments. We view it as positive that Kommuninvest is proactively preparing an action plan for the most conservative scenario of Basel's leverage ratio.

Kommuninvest's risk-weighted capital ratios are solid. Given the zero risk weighting of Swedish local government lending, Kommuninvest's risk weighted Tier 1 capital adequacy was strong at 34.6% at year-end 2014, down from 37% at year-end 2013. The decrease in the Tier 1 capital ratio relates from different regulatory requirements on the capital charge on the counterparty exposures of Kommuninvest's derivatives. According to our calculations, Kommuninvest's risk-adjusted capital (RAC) ratios were 14% (before concentration adjustments). In our view, this is a sound level of

capitalization. In addition, we expect Kommuninvest's capitalization to strengthen further in 2015 as members provide supplementary capital contributions.

Kommuninvest's public sector mandate instructs it to provide funding solely to its members, which comprise entities within the Swedish local government sector. Kommuninvest provides funding directly to its member municipalities, county councils, or companies under their control, in which case a municipal guarantee is required. As such, Kommuninvest's loan book holds only Swedish local government risk. We assess the credit quality of the Swedish local and regional government (LRG) sector as robust, and we consequently consider that the asset quality of Kommuninvest's LRG sector loan book represents very limited credit risk. Although the mandate ensures that the agency's lending mirrors the overall credit quality of the Swedish public sector, it imposes certain constraints, primarily on concentration risk in its lending activities. However, we consider the overall stability and predictability of Kommuninvest's business position to be important mitigating factors that support and underlie our assessments.

In 2014, Kommuninvest's lending grew by 7%, largely in line with the sector trend, but a pickup from the 4% increase registered in 2013. Capital market funding has represented an increasingly attractive funding alternative over the past two years as the agency has worked to strengthen profitability to build equity through retained earnings. We note that this strategy has resulted in continued sound profitability in 2014, with net interest income coming in at SEK915 million in 2014 compared with SEK970 million in 2013. While we expect Kommuninvest's profitability to remain sound, we acknowledge that the agency could likely moderate its loan margins as members' support strengthens capital. As such, we consider the agency to be well placed to provide competitive lending terms and to enforce its position as the leading lender to Swedish public authorities over the coming two years.

We have a positive view of Kommuninvest's funding strategy to increasingly rely on funding in Swedish kronas through its domestic benchmark program. By year-end 2014, 53% of Kommuninvest's funding had been sourced from the domestic market, significantly reducing the need for derivatives on asset-liability matching. In addition, we observe that the agency enjoys excellent name recognition throughout the international markets. Over the past three years, while its funding in Swedish krona has increased, Kommuninvest has reduced the funding sourced from the Japanese Uridashi market. There is currently a very low degree of callability on Kommuninvest's funding, standing at about 5% of total funding at year-end 2014.

## **Liquidity**

Kommuninvest has a robust liquidity position, in our view. Even though the agency is exposed to risks through its dependence on wholesale market funding, we consider this risk to be mitigated by its prudent liquidity policies, substantial high quality prefunding, and importantly through the agency's access to funding operations with the Swedish Riksbank (central bank). In addition, we view favorably Kommuninvest's focus on long-term wholesale funding with a duration of assets shorter than that of liabilities.

Since 2010, Kommuninvest has held the status of a central bank counterparty, which has added a backstop mechanism for liquidity management. Specifically, Kommuninvest can participate in the Riksbank's credit facilities as well as borrow directly from Riksbank against collateral to the extent allowed by pledgeable assets.

We consider Kommuninvest's liquidity policies as prudent. The agency stipulates that it should at all times hold a liquidity reserve amounting to 20%-40% of total lending. In April 2014, Kommuninvest held prefunding invested in highly rated liquid securities at about SEK67 billion, equivalent to a high 30% of total lending. In addition, about 85% of the assets held in the liquidity reserve was eligible as collateral in the European Central Bank (ECB) or the Riksbank, with 80% of the securities repo-eligible in the Riksbank alone. This is in line with the minimum level outlined in Kommuninvest's policy, which dictates that that a minimum of 65% of the liquidity reserve should be eligible for repo transactions in the Swedish central bank or with the ECB.

According to Kommuninvest's policy, its liquidity level should sustain a market shutdown of six months without a disruption in its lending activities, including forecast new lending. In April 2014, the liquidity reserve would allow Kommuninvest to continue its operations for 14 months of funding market shutdown without new loan disbursement and normal calls on funding.

## **Outlook**

The stable outlook reflects our expectation that Kommuninvest's guarantee structure will remain unchanged and that the agency will maintain robust liquidity, prudent risk management, excellent asset quality, and a continuously strengthening capitalization benefitting from unwavering membership support.

A negative rating action could result from a weakening of Kommuninvest's guarantee structure. In addition, pressure on the ratings would build if we observed a significant deterioration in the asset quality of the agency's lending operations or securities investments or if its risk management processes were to loosen.

## **Related Criteria And Research**

### **Related Criteria**

- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- General Criteria: Principles Of Credit Ratings - February 16, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010

### **Related Research**

## **Ratings List**

|                            | Ratings         |                 |
|----------------------------|-----------------|-----------------|
|                            | To              | From            |
| Kommuninvest i Sverige AB  |                 |                 |
| Issuer credit rating       |                 |                 |
| Foreign and Local Currency | AAA/Stable/A-1+ | AAA/Stable/A-1+ |
| Nordic Regional Scale      | --/--/K-1       | --/--/K-1       |
| Senior Unsecured           |                 |                 |
| Foreign and Local Currency | AAA             | AAA             |
| Commercial Paper           |                 |                 |
| Foreign and Local Currency | A-1+            | A-1+            |
| Nordic Regional Scale      | K-1             | K-1             |

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