

Research Update:

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

December 1, 2020

## Overview

- Unprecedented central government support will help Swedish local and regional governments (LRGs) uphold very strong credit quality, despite setbacks from the COVID-19 pandemic.
- Although Kommuninvest' rapid expansion in lending will weigh on its capital ratios, a new capitalization policy will lead to somewhat stronger and more stable ratios.
- We are therefore affirming our 'AAA/A-1+' and 'K-1' ratings on Kommuninvest.
- The stable outlook reflects our view that Kommuninvest will maintain an important both market share and role in funding Swedish LRGs, while preserving its solid capital and liquidity positions over the next two years.

## Rating Action

On Dec. 1, 2020, S&P Global Ratings affirmed its 'AAA' long-term and 'A-1+' short-term issuer credit ratings on Swedish local government funding agency Kommuninvest i Sverige AB. The outlook is stable.

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

## Outlook

The stable outlook reflects our expectation that the underlying municipal sector will maintain high creditworthiness, Kommuninvest's guarantee structure will remain unchanged, and the agency will continue to benefit from unwavering support from its members. We expect Kommuninvest's management to maintain low risk tolerances and continue to contain risks associated with the wholesale-funded nature of its activities. Moreover, we expect that Kommuninvest will maintain prudent risk policies so that its lending services--and ultimately the execution of its public policy role--will stay on track.

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We could lower our rating over the next two years if we observed a structural deterioration in the credit quality of Kommuninvest's members. This could stem from either general weakening of the LRG sector's creditworthiness or developments that lead us to negatively reassess the institutional framework for Swedish LRGs.

We could also consider a downgrade if Kommuninvest's stand-alone credit profile (SACP) came under significant pressure, for example if risk management faltered to the extent that its liquidity and capital position notably deteriorated. This scenario could materialize through a widening funding gap, substantial stress on the agency's liquidity position, and further weakening capital adequacy. Such financial pressure could hinder the agency's ability to fulfil its public policy mandate, which, combined with reduced confidence in the agency's risk management culture, would weigh on its SACP.

## **Rationale**

The rating reflects our view of Kommuninvest's competent management, which has fostered the agency's public policy role by remaining responsive to members' requirements. The highly creditworthy position of Kommuninvest's borrowers and members, supported by key structural underpinnings, confirms our assessment of its very low risk business profile. In addition, its positive funding position from diversified funding, efficient funding techniques, excellent name recognition, and adequate liquidity enable the agency to withstand most conceivable shocks. Recent rapid loan growth at low margins has constrained capitalization, but we expect the agency's newly approved capitalization plan, agreed by members in April, will strengthen and stabilize its capital ratios, which keeps our view of the financial risk profile strong.

At the same time, we regard Kommuninvest's guarantee structure as predictable, supportive, and immediately enforceable, which, combined with the numerous and highly creditworthy LRG members, lifts our long-term rating on Kommuninvest to 'AAA'.

## **Enterprise risk profile: Very strong management and status as a key lender to the LRGs underline a strong market position and public policy role**

- Strong public policy role underpinned by increasing market share and importance, further illustrated during the pandemic.
- A strong public industry country risk assessment, owing to the wealthy and resilient national economy, well-developed financial sector, and the LRG sector's strong ties to an 'AAA' rated sovereign.
- Swedish LRGs show financial resilience, despite subdued economic activity due to the pandemic, thanks to unprecedented central government support.

Kommuninvest's public sector mandate is to provide funding solely to its members, which comprise entities in the Swedish LRG sector. Kommuninvest provides funding directly to its member municipalities and regions, and to companies under their control (in which case a municipal guarantee is required). As such, Kommuninvest's loan book is exposed only to Swedish LRG risk. We believe the agency holds a strong market position, given that its market share is steadily increasing and stood at 58% of total lending to the sector as of June 30, 2020.

Kommuninvest's lending growth has remained consistently around 15% over the past two years, outpacing the sector average and suggesting a competitive offer.

Kommuninvest has a clear public policy mandate based on its ownership, support structure, niche

lending, and nonprofit mission. As such, it plays a very important role in financing the Swedish LRG sector by ensuring stable and advantageous borrowing in national and international capital markets. Kommuninvest's role as a supplier of stable financing to the LRG sector has been especially notable during the pandemic as many LRGs have increasingly turned to Kommuninvest for their funding needs, given its more stable and favorable role than the alternatives.

Kommuninvest has also supported the sector during the pandemic by providing a loan to the sector to buy protective equipment for the health care sector.

The Swedish Central government has proposed a risk tax for all credit institutions from 2022. There is not yet a final decision on the scope of the tax, but based on the proposed wording it would also apply to Kommuninvest. This could increase costs for Kommuninvest and thereby increase borrowing costs for its members. We would not expect a noticeable deterioration in Kommuninvest's financial profile if such a tax is implemented, but we could see a decrease in its market share, from the current very high level, as other sources of financing become more competitive in comparison. Nevertheless, in our view, their public policy role, in particular for small and midsize LRGs, would remain important.

In preparation for a regulatory leverage ratio requirement and internal targets for capitalization, Kommuninvest has actively engaged with its members to secure a significant increase in core capital through higher contributions, redistribution of dividends, capital injections, and the replacement of a subordinated loan from the members. The model for capital contributions has been reworked over the past few years and a new model for capitalization was agreed in April 2020. This will allow for a more predictable and stable capitalization, both for the members and the agency, as it covers four years. We believe these developments highlight the constructive dialogue between Kommuninvest and its members, and strengthens our view of the agency's management, relationship with members, and overall capitalization.

The Swedish LRG sector exhibits high credit standing, with some recently weakening features. For example, the national economy is wealthy, the financial system is advanced, and links between the LRG sector and the 'AAA' rated sovereign are very tight. However, there are some structural demographic challenges and deteriorating performance in the Swedish LRG sector. This is owing to intensifying expenditure pressure and inadequate compensation from the central government or counter measures from the LRGs in certain areas. Although the central government has implemented permanent support packages throughout the year and provided generous support in light of the pandemic, we still believe that many of the sector's structural issues remain unresolved. Consequently, we continue to assess the institutional framework trend for LRGs as weakening. "Public Finance System Overview: Swedish Municipalities And Regions," published Dec. 3, 2019).

### **Financial risk profile: New model for capitalization provides predictability in times of rapid lending growth and pressure on capital ratios**

- The recently approved capitalization plan will provide predictability and stability to Kommuninvest's capital adequacy, but we expect it to remain below that of its Nordic peers.
- Benchmark funding in domestic currency limits the use of nonstandard derivatives, which lowers market risk and counterparty exposure.
- Funding and liquidity is supported by tight matching of assets and liabilities, a very liquid treasury portfolio, and broad access to diversified funding, although a short maturity profile of lending results in continuous high funding volumes needed.

Kommuninvest maintains a strong capital position. In a regulatory context, its Tier 1 capital ratio, at 153%, is impressive. This is largely thanks to the zero risk-weighting of Kommuninvest's lending, and counterparty risk in derivatives are covered by a guarantee from its members. All of Kommuninvest's equity is eligible as Tier 1 capital, and we incorporate it into our total adjusted capital ratio. Our projected risk-adjusted capital (RAC) ratio before adjustments for Kommuninvest remains very strong, and we project it around 39%. After our adjustments for single-name concentration relating to LRGs, the RAC ratio reduces to about 14%. The reduction primarily reflects the rapid increase in lending, which grew 14% over the 12 months ended June 30, 2020, while the capital base marginally decreased due to negative net profit.

However, we expect a stagnation in lending growth, owing to the high liquidity in the sector and Kommuninvest's already high market share. This will support our capital ratios, as will the increased capital base following the new capitalization plan agreed in April. Decisions are made for four-year periods and the current plan suggests that the agency's capital base will increase by about 65% by 2024. We anticipated that our RAC ratio after adjustments will increase to about 14%-15% by year-end 2020 and remain around those levels.

Kommuninvest's funding profile is a rating support. We expect that all major funding markets are open to Kommuninvest, thanks to excellent name recognition and its deep investor base even in a stressed scenario, which has been proven during the COVID-19 crisis. In Sweden, securities issued by Kommuninvest are considered among those of highest quality in the calculation of the liquidity coverage ratio and have been included in the Swedish Riksbank's asset purchase program during the pandemic. The agency focuses on plain vanilla benchmark issuance and has recently added euros as one of its strategic currencies, together with the Swedish krona (SEK) and U.S. dollar. Over the past few years, Kommuninvest has added green bonds to its funding portfolio, which has allowed further expansion of its investor base.

We view as positive Kommuninvest's strategy of closely matching assets with liabilities and predominantly relying on funding in SEK. This strategy limits the need for derivatives and contributes to Kommuninvest's stable funding profile, with cumulative maturing assets covering about 120% of cumulative maturing liabilities for the next 12 months. With the growth of the Swedish benchmark program, transparency and liquidity in the secondary market have improved. This progress has led to gradual tightening of the spread between Kommuninvest's issuances and Swedish government bonds, apart from a temporary deviation in March 2020 as financial turbulence started to build. However, both lending and borrowing are shorter term than peers', creating a mismatch of lending and funding to the investment cycle of the underlying capital investment and high roll-over rate. Although there is no legal obligation to roll over loans, municipalities expect Kommuninvest to do so and any significant failure would likely damage the franchise. We believe this limits the benefit of having shorter-term exposure, instead creating a roll-over risk in volatile markets.

Kommuninvest has a high level of expertise concerning liquidity portfolio management and execution, which enables more stringent asset-liability management and greater cost efficiency. The liquidity portfolio comprises very liquid and short-term securities issued solely by highly rated government-related entities. The average duration is below 0.5 years, highlighting the very liquid nature of the holdings. In addition, we believe Kommuninvest exercises proactive liquidity management, which we view as important, in light of its shift to two-way credit support annexes in its derivatives counterparty portfolio.

Our liquidity ratio of about 1.1x for Kommuninvest indicates that the agency can meet its financial obligations over a one-year period. This ratio factors in potentially stressed market conditions, under which we assume the agency wouldn't have access to the capital markets. However, we understand that most loans to its members typically are renewed before maturity date and

thereby do not necessarily result in a liquidity inflow for the agency. Given Kommuninvest's relatively short maturity profile in its lending, we believe this aspect is more burdensome to its liquidity position than for peers with longer average lending, which we incorporate into our overall view of Kommuninvest's liquidity position.

## Extremely high likelihood of support via a joint and several guarantee from all members

- Expected support, if needed, from the largest members, with credit quality at about 'aa+' on average, under the joint and several guarantee mechanism.
- Extremely high likelihood of extraordinary support from members, thanks to the agency's integral link with and very important role for those members, which uplifts Kommuninvest's SACP and results in an indicative long-term rating of 'aa+'.
- Further uplift from the support mutualization of additional members outside the group of supporting members, and their strong investment-grade credit profiles, leads to the 'AAA' issuer credit rating.

Kommuninvest has a vast membership base that is bound to it by a joint and several guarantee mechanism. We assess Kommuninvest's guarantee structure as predictable and immediately enforceable by law. Any investor, without a court order, could call upon any guaranteeing member to make good on a claim on Kommuninvest. The legal enforceability of the guarantee underpins our assessment of an integral link between the members and Kommuninvest. At the same time, we consider Kommuninvest holds a very important role in terms of providing cost-efficient funding to its members.

In addition, we believe that many of the other members outside the group of guaranteeing supporting members would also be liable and able to support Kommuninvest in a situation of distress. These member governments' aggregate revenue represents more than 20% of the entire LRG sector, underpinning our assessment of support mutualization. Therefore, we include an additional notch of uplift in the long-term issuer credit rating on Kommuninvest.

## Key Statistics

Table 1

### Kommuninvest i Sverige AB -- Selected Indicators

(Mil. SEK)	--Year ended Dec. 31--					
	2020H1	2019	2018	2017	2016	2015
<b>Business position</b>						
Total adjusted assets	537,420	471,299	417,186	356,932	361,712	340,611
Customer loans (gross)	441,482	408,218	355,710	310,147	276,982	254,422
Growth in loans	13.6*	14.8	14.7	12	8.9	14.2
Net interest revenues	360	828	886	881	762	799
Non interest expenses	117	242	266.5	265	228	293
<b>Capital and risk position</b>						
Total liabilities	530,004	463,719	409,599	349,332	355,211	336,282

Table 1

### Kommuninvest i Sverige AB -- Selected Indicators (cont.)

(Mil. SEK)	--Year ended Dec. 31--					
	2020H1	2019	2018	2017	2016	2015
Total adjusted capital	7,416	7,581	7,588	7,599	6,491	4,363
Assets/capital				47	56	78
RAC before diversification (%)	39.3§	38.2§	41§	40.5	N.A.	N.A.
RAC after diversification (%)	13.9§	14.8§	17§	16.8	N.A.	N.A.
Gross nonperforming assets/gross loans	0		0	0	0	0
<b>Funding and liquidity</b>						
Liquidity ratio with loan disbursement (1 year)	1.1§	1.1§	1.1§	1	N.A.	N.A.
Liquidity ratio without loan disbursement (1 year)	1.1§	1.1§	1.1§	1.1	N.A.	N.A.
Funding ratio (1 year)	1.2§	1.3§	1.2§	1.2	N.A.	N.A.

\*Year-on-year. §As of end-June. RAC--Risk-adjusted capital. SEK--Swedish krona. N.A.--Not available. Source: S&P Global Ratings.

## Ratings Score Snapshot

Table 2

### Kommuninvest i Sverige AB -- 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	Strong (2)
Capital Adequacy	Very Strong (1)
Funding and	Positive and
Liquidity	Adequate (3)
Support	(+2)
GRE Support	(+2)
Group Support	0
Additional Factors	(+1)

## 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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

## Ratings List

### Ratings Affirmed

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#### Kommuninvest i Sverige AB

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Issuer Credit Rating	AAA/Stable/A-1+
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Nordic Regional Scale	--/--/K-1
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Senior Unsecured	AAA
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceld/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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