

Kommuninvest credit follow-up model

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INTRODUCTION

As a credit institute, Kommuninvest i Sverige AB (“Kommuninvest”) is required by law to identify, measure, control, internally report and maintain control over the risks with which its operations are associated. This includes the credit risks in its lending activities.

The ownership directives formulated by the members of the Kommuninvest Cooperative Society also underscore the need to monitor members’ financial development. It is in the interests of the members of the Society, as guarantors of Kommuninvest’s commitments, that financial challenges in a particular municipality or county council be addressed proactively and constructively.

Kommuninvest’s lending is concentrated entirely on Swedish municipalities and county councils who are members of the Kommuninvest Cooperative Society and, against sureties¹ from a member or members of the Kommuninvest Cooperative Society, to majority-owned municipal companies and foundations, or municipal associations.

All of Kommuninvest’s lending is zero risk-weighted in accordance with existing capital adequacy rules, meaning that no capital need be maintained to cover credit risk exposures in the lending activities.

The creditworthiness of Swedish municipalities and county councils is considered very strong, since municipalities and county councils have the right to levy taxes, cannot be declared bankrupt, and cannot cease to exist other than by merging, while, at the same time, the Swedish central government holds the ultimate responsibility for their operations. However, the conditions of the municipalities and county councils vary, for example in terms of their tax base, and financial strength and liquidity readiness may thus vary between them.

The members of the Kommuninvest Cooperative Society and their companies are analysed both in advance of membership approval and subsequently. The purpose is to

¹Guarantee signed “as if for own liabilities”. The creditor may demand repayment directly from the guarantor, without issuing a demand to the debtor.



identify which members face, or may come to face, financial challenges and to obtain a better overview of the financial challenges facing the Swedish local government sector in general. This document describes the on-going follow-up that takes place once a municipality or county council has become a member of the Kommuninvest Cooperative Society.

Access to credit provided by Kommuninvest is generally restricted for members for whom Kommuninvest has identified financial challenges. In individual cases, Kommuninvest also initiates a forward-looking dialogue with the member to ensure a long-term sustainable financial position.

KOMMUNINVEST'S CREDIT FOLLOW-UP MODEL

Kommuninvest lends only to member municipalities and county councils, and, against sureties, to member's wholly-owned companies and foundations, and to municipal associations.

To assess the financial strength of individual members of the Kommuninvest Cooperative Society, Kommuninvest has developed its own quantitatively based analysis model. The quantitative analysis forms the basis for an overall assessment by Kommuninvest of individual members' capacity to meet their future financial commitments.

The follow-up focuses primarily on the municipal members, since lending to county councils accounts for less than 1 percent of Kommuninvest's total lending. For further information regarding follow-up on county councils, please see the Questions and Answers section.

The municipalities are always assessed from a consolidated perspective, that is, including municipal companies, and they are analysed at least twice annually. The point of departure is the quantitative model, in which the income statement, balance sheet, demographics and risks in the municipal operations are reviewed.

Once a quantitative analysis has been made, it is, if necessary, followed by a qualitative analysis. This scrutinises and analyses the local government corporation and its financial conditions in more detail.

Kommuninvest's analysis model is based on 11 key figures:

- population growth
- net cost
- solvency including pension commitments
- current ratio
- consolidated net debt including pension commitments
- level of tax levy

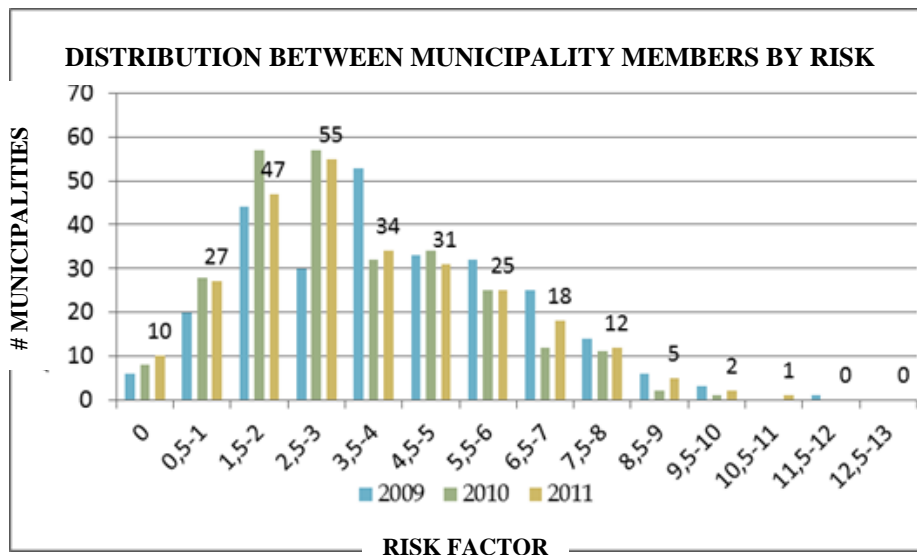


- results before extraordinary items
- equalisation contributions & government grants
- commitments
- loan debt
- vacancy rates in the municipal housing company.

For each member, the model generates a risk factor on a scale of 0 to 13. A higher risk factor indicates that the municipality faces, or could face, considerable financial challenges. However, for the reasons named above, creditworthiness is very good regardless of the risk factor.

The graph below shows the outcome of the quantitative model distributed among the municipalities that were members of the Kommuninvest Cooperative Society at the ends of 2011, 2010 and 2009 respectively. (The distribution for 2012 is made in the second half of 2013 when the annual reports for 2012 are available.)

Most of the members have a relatively low risk factor – that is, higher relative financial strength. For the 2011 financial year, 139 municipalities had a risk factor between 0 and 3, 90 municipalities had a risk factor between 3.5 and 6, 30 municipalities had a risk factor between 6.5 and 8. Eight municipalities had a risk factor above 8.5 – the level at which Kommuninvest initiates a dialogue on the individual municipality’s financial conditions.²



² A dialogue is to be initiated with an individual municipality in the event it has a risk weight of more than 8.5, although a dialogue may be initiated with members with a lower risk weight if Kommuninvest deems it suitable.

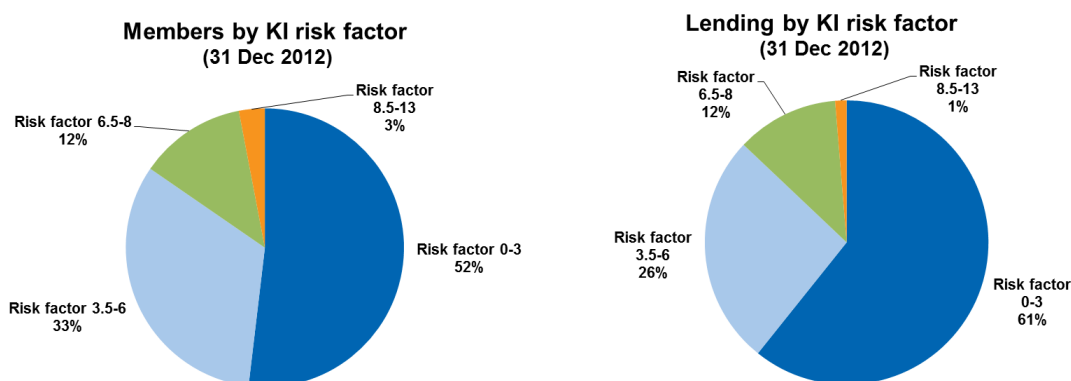
Setting of loan limits

Each year, the Board of Directors of Kommuninvest sets a general loan limit for all members. The general loan limit corresponds to the total external debt that the Board considers each member able to bear, including liabilities “below the line”. The general limit should not be confused with the member’s credit facility with Kommuninvest – see below.

Before setting the general loan limit, a general analysis is made of the sector’s combined financial capacity. This analysis is primarily based on growth factors such as GDP, taxation power and tax base, but also other factors that affect the municipalities’ balance sheets and income statements. An example is the basis on which pensions are calculated.

For 2013, the general loan limit for municipalities amounts to SEK 118,000 per inhabitant. Depending on their financial capacity, individual municipalities may have a higher or lower loan limit. The municipality may, for example, have extensive operations and revenues in its municipal companies or surplus values in its housing stock. For 2013, Kommuninvest’s loan limits vary between SEK 83,700 and SEK 196,000 per inhabitant. An individual decision by Kommuninvest is required to obtain a higher, special loan limit. Members with a special limit are subject to more frequent follow-up than other members.

The graphs below illustrate the distribution of Kommuninvest’s members and lending volumes by risk factor at the end of 2012. As can be seen, lending is to a large extent distributed among members with a lower risk factor. On 31 December 2012, 61 percent of lending was to members with a risk factor between 0 and 3, while the number of members with a risk factor between 0 and 3 amounted to 52 percent of the total.

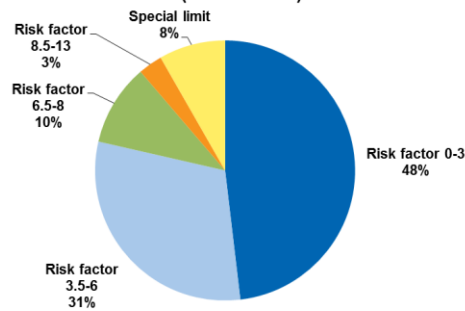


Members with special loan limits are listed separately in the graphs below. From the graphs, it can be seen that members with special loan limits accounted for 24 percent of lending on 31 December 2012, while such members only accounted for 8 percent of the

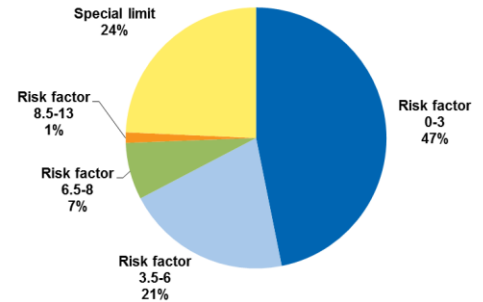


total number. Members with special loan limits generally have greater financial strength than other members.

**Members by KI risk factor and special limit
(31 Dec 2012)**



**Lending by KI risk factor and special limit
(31 Dec 2012)**



Calculation of credit facility with Kommuninvest

A particular member's credit facility with Kommuninvest is defined as the difference between the member's loan limit and its net debt. Example: A member with a loan limit of SEK 118,000 per inhabitant and a net debt of SEK 50,000 per inhabitant has a credit facility with Kommuninvest amounting to SEK 68,000 per inhabitant.

Restriction to the credit facility

The risk factor assigned to a member in Kommuninvest's quantitative risk model indicates the degree of access to the member's credit facility with Kommuninvest.³

Risk factor: 0 – 3.0	Scope of loans = 100 percent of credit facility
Risk factor: 3.5 – 6.0	Scope of loans = 75 percent of credit facility
Risk factor: 6.5 – 8.0	Scope of loans = 50 percent of credit facility
Risk factor: 8.5 – 13	Scope of loans = 50 percent of credit facility
	Member is placed under special monitoring and a dialogue is initiated
	Access to new credits may be restricted.

³Members with special loan limits are exempt from an automatic restriction to the credit facility since they are subject to more frequent follow-up. Special testing of whether access to the credit facility should be restricted is made from case to case.

**QUESTIONS AND ANSWERS – KOMMUNINVEST’S CREDIT FOLLOW-UP MODEL****Question: How has the analysis model developed over time? Is the weighting of the key figures in the model dynamic?**

Answer: The analysis model is reviewed annually and developed to better highlight the challenges identified by Kommuninvest and that could affect the members of the Kommuninvest Cooperative Society. The weighting of different key figures is reconsidered – with regard to the key figure “population growth”, for example. Previously, the weighting of this key figure caused high risk factors among some rural municipalities. A deeper analysis showed that high risk factors did not necessarily correspond to low financial capacity and the weighting was subsequently adjusted.

Municipal companies are tending to have an increasing impact on the individual member’s risk factor. Consequently, the model is gaining an increasing company focus. In recent years, this has meant that the key figures having the greatest bearing on financial capacity, such as earnings and indebtedness have had an increasing impact in the model.

In general, the model is moving in the direction of members being compared with their own trend rather than against an average for similar local government authorities (according to the SALAR⁴ classification of local government authorities). However, the assessment in relation to the average is of importance when it comes to analyses for special limits. Members with weaker financial conditions have less extensive opportunities to be granted raised limits.

Q: What are the foremost purposes of the analysis model?

A: Identifying members requiring deeper analysis and those in need of a dialogue regarding their financial conditions. An individual member’s current risk factor is of interest, as well as the trend in that factor.

The analysis model also acts as a tool for analysing the local government sector and its trends.

⁴ Swedish Association of Local Authorities and Regions, www.skl.se. Classification of municipalities: Major cities; Municipalities that are suburbs of the major cities; Larger town and cities; Municipalities that are suburbs of the larger town and cities; Commuter municipalities; Tourism and visitor sector municipalities; Goods producing municipalities; Rural municipalities; Municipalities in densely populated regions; Municipalities in rural regions.

Q: How are the county councils followed up?

A: Of Kommuninvest's 277 members on 30 April 2013, eight were county councils. Lending to the county councils accounted for less than 1 percent of total lending, of which one borrower accounted for more than half of the total lending to county councils. For these reasons, the follow-up of the county councils is conducted from a more sector-wide perspective. Kommuninvest's general limit for lending to county councils is 50 percent of the general limit for municipalities.

In the longer term, however, Kommuninvest expects that lending to county councils will increase, primarily as a consequence of increasing needs for new and re-investment in buildings, as well as increasing demands on municipal transport. At the same time, net costs are increasing, driven to a large extent by demographic factors and increased demands on healthcare services and their quality.

Q: What is the foremost difference between Kommuninvest's analysis model and other models for the assessment of municipalities' "financial risk factor"?

A: An important aspect of Kommuninvest's analysis model is that it focuses on the combined municipal corporation. The intention is also that Kommuninvest's analysis model, and in particular the part that is communicated to members, should be recognisable and that the areas of analysis should be easy to understand and relate to.

The model has been developed to capture challenges characteristic of local government finances and to take into account their distinctive features in terms of distribution of revenues and expenses, and of assets and liabilities.

Q: What components does Kommuninvest's analysis of a member comprise?

A: The quantitative risk factor model forms the initial analysis. The next stage comprises a special analysis based on principles regarding financial capacity, assets and professionalism. The final qualitative assessment takes into account factors including capacity for adaptation, demographic conditions and the degree to which the municipality upholds its budget. The overall assessment considers the member's capacity to cope with increased indebtedness.