

## SPECIAL COMMENT

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# Nordic Specialised Lenders: a model for public sector financing agencies in France and the UK

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**Summary**

In October 2013, 11 local governments in France created the Agence France Locale (AFL), an agency to borrow funds and on-lend to its shareholder regional and local governments (RLGs). One month later, the Local Government Association in the UK voted to establish a municipal bond agency<sup>1</sup> to undertake the same financing activities for its members. Both of these entities are modelled off the Specialised Lenders (SLs) for RLGs in the Nordic countries<sup>2</sup>.

This Special Comment provides an overview of those key characteristics that underlie our view of the creditworthiness of Nordic SLs. In particular, we highlight the following:

- » **Public policy mandates, which restrict loans to low-risk entities.** The simple business models of Nordic SLs result in portfolios of low-risk loans to a closely monitored and highly regulated sector.
- » **Robust liquidity positions,** which provide buffers against the risk of disruptions in capital market activities or missed loan repayments by members.
- » **Healthy risk management,** reflecting fiscal conservatism which is linked to their public policy mandates and lack of a profit motive.

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<sup>1</sup> See Special Comment: [UK Local Governments Would Benefit from a Municipal Bond Agency](#), December 2013

<sup>2</sup> The most significant of the Nordic SLs are KommuneKredit (Denmark) (Aaa stable), Kommunalbanken AS (Norway) (Aaa stable), Kommuninvest i Sverige AB (Sweden) (Aaa stable) and Municipality Finance plc (Finland) (Aaa stable).

## Features that underpin the credit strength of Nordic specialised lenders

The business model of Nordic SLs is relatively simple: borrowing in the wholesale market and on-lending to their members (i.e. public sector entities), and in the process passing along the costs of borrowing and administration. Profits are kept to a minimum by design and expansion reflects only a growing number of borrowing entities and the increasing needs of members. They do not take deposits. While their assets and liabilities are not perfectly matched, they maintain high levels of liquidity to guard against the risk of market disruption (see “Robust liquidity positions” below).

All four Nordic SLs (KommuneKredit, Kommunalbanken, Kommuninvest i Sverige and Municipality Finance) were set up by national or RLGs to allow them to offer low-cost financing to their members by attaining economies of scale through large joint issuances. Although other financing options are available to RLGs (including bank loans or individual bond issuances), the benchmark size of issuances from SLs can generate significant savings for participating RLGs.

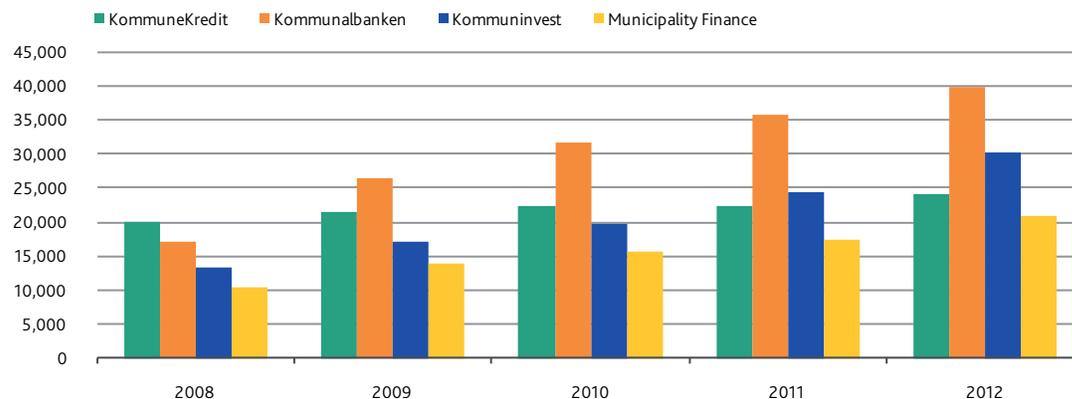
As a result, SLs have gained moderate to very high market shares in RLG lending in their respective markets, varying from 46% for Kommuninvest i Sverige to around 90% for KommuneKredit (see Appendix). The instances of moderate market shares are seen where some non-participating RLGs are not eligible to borrow from the SL as they are not members (e.g., in Sweden), or where some RLGs are able to tap the capital markets directly with their own bond issuances (e.g., in Norway: City of Oslo, Aaa stable).

All Nordic SLs display a strong ability to access the wholesale capital markets cost effectively. We believe this is driven by their strong creditworthiness, which is in turn based on the following key factors:

### **(1) Public policy mandates, which restrict loans to low-risk entities**

The credit strength of Nordic SLs is underlined by their role as the preferred lender to the RLG sector, having been established either by the sovereign or the RLG sector itself. By maintaining focus on serving their local RLG markets, they do not need to generate high returns to finance their expansion. As a result, their loan books, while concentrated, are very low risk. No default has ever been recorded for a borrower from any of these Nordic SLs and non-performing loans are non-existent. This in turn reflects the following characteristics of the Nordic RLG sector: (1) high regulation by their respective sovereigns, with features such as balanced budget requirements, debt limits and transparent reporting; (2) fiscal flexibility to adjust budgets as required to meet financing obligations; and (3) fiscal equalisation programmes that aim to provide weaker RLGs with transfers to meet local needs.

EXHIBIT 1

**Specialised Lenders' Loan Books (in US\$ million)****(2) Robust liquidity positions**

While an SL has never missed a loan payment from an RLG, SLs maintain high levels of cash and liquid reserves to guard against the potential for missed payments or a disruption in capital market access. These liquidity levels ensure that the SLs can time market access and remain opportunistic borrowers. In addition to these buffers, both Municipality Finance and Kommuninvest i Sverige can borrow from their respective central banks as lenders of last resort.

**(3) Risk management**

Risk management of these entities is considered robust, reflecting fiscal conservatism linked to their public policy mandates and lack of profit motive. We observe that these entities are not match-funded (i.e., the maturity of liabilities does not equal that of assets). However, in order to mitigate re-financing risks, they aim to maintain liquid and highly rated securities in amounts sufficient to continue normal operations, including new lending, for a certain period without new funding.

**The Nordic model could take hold in France and the UK****France**

The Agence France Locale (AFL) was established by 11 founding local governments in France to borrow on their behalf, and we expect more local governments to join the group. RLGs wishing to borrow through the AFL need to apply for membership and meet certain solvency criteria, as well as make an initial capital contribution. If implemented successfully, the AFL would play a key role in meeting the sector's funding needs. Over a five-year horizon, the AFL aims to provide a quarter of RLGs' annual borrowing needs, or from €4-€5 billion annually.

The growth of joint issuances by French RLGs observed in recent years highlights the desire of smaller RLGs to reduce their exposure to bank de-leveraging, and to diversify their funding sources by tapping the capital market. For example, in 2012, a group of 44 French RLGs issued a €610 million joint bond. This is a significantly large issuance compared to pre-crisis issuances, when smaller groups of between 11 and 22 RLGs jointly issued bonds ranging from €89 million to €120 million. The AFL should enable RLGs to access financing at lower interest rates and provide market access to local governments that lack the critical budget size to issue on their own.

The AFL was modelled on Nordic specialised lenders. In line with these Nordic entities, it is 100% owned by sub-sovereign entities via a parent company, and bond issuance will comprise most of its funding. Similar to the Finnish model, the liability for participating entities will be limited to a pro-rata share.

#### UK

On 22 November 2013, the UK's Local Government Agency proposed setting up a specialised lender that would borrow from the capital market and in turn provide loans to local authorities. Eighteen local government councils made formal expressions of interest in creating an entity modelled on the specialised lenders operating in the Nordic countries and the Netherlands. This reflects the desire of local authorities to reduce their exposure to changes in the terms of trade provided by the Public Works Loan Board (PWLB), which provides 75% of the sector's £5 billion annual funding needs with the lowest rate of 80 basis points over gilts.<sup>3</sup>

The proposal assumes that local authorities would still assess their borrowing capacity in line with the Prudential Code for Capital Finance, the institutional framework that governs borrowing limits. Although the PWLB has provided a stable lending pool to the local authorities sector to date, its dominant role and lack of competition expose RLGs to changes in the terms of trade. Overall, creating this entity would expand options for local government financing in the UK.

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<sup>3</sup> See [UK Local Governments Would Benefit from a Municipal Bond Agency](#), 2 December 2013.

## Appendix

	KommuneKredit	Kommunalbanken AS	Kommuninvest i Sverige AB	Municipality Finance plc
<b>Issuer Rating</b>	Aaa/stable/P-1	Aaa/stable/P-1	Aaa/stable/P-1	Aaa/stable/P-1
<b>Country</b>	Denmark (Aaa stable)	Norway (Aaa stable)	Sweden (Aaa stable)	Finland (Aaa stable)
<b>Institutional Framework</b>				
Year established	1899	1926	1986	1989/1993
Ownership/control	Danish RLGs	100% Norway (sovereign)	Swedish RLGs	16%: Finland (sovereign) 53%: Finnish RLGs 31% Keva (formerly Local Government Pensions Institution)
Support	Joint and several guarantee from each of the Danish RLGs	Letter of support from the Norwegian government (100% owner)	Joint and several guarantee from each of the (participating) RLGs	All Finnish local governments on a pro-rata basis (through the Municipal Guarantee Board); in addition, implicit support from sovereign as a co-owner
Relevant law	Special law: Act on KommuneKredit	General law on credit institutions	General law on credit institutions	General law on credit institutions; in addition, special law: Act on Municipal Guarantee Board (MGB)
<b>Activities/Market</b>				
Purpose	Provide low-cost funding to its members (Danish RLGs)	Provide low-cost funding to Norwegian RLGs	Provide low-cost funding to participating members (Swedish RLGs)	Act as the debt management office and provide competitive funding to Finnish municipalities and the social housing sector
Relevant geographical market	Municipalities and regions (RLGs); entities owned or guaranteed by RLGs; exclusively in Denmark	Municipalities and regions (RLGs); entities owned or guaranteed by RLGs; exclusively in Norway	Municipalities and regions (RLGs); entities owned or guaranteed by RLGs; exclusively in Sweden	Municipalities and regions (RLGs); entities owned or guaranteed by RLGs; social housing (sovereign guaranteed); exclusively in Finland
Market share	~ 90%	~ 50%	~ 46%	~ 80%
<b>Figures (December 2012)</b>				
In USD million				
Avg. Liquid assets (% of avg. total assets)	17.1%	31.9%	23.8%	26.6%
Avg. Liquid assets (% of avg. market debt)	18.6%	34.8%	25.9%	36.6%
Avg. Liquid assets (% of avg. loans)	23.1%	52.8%	33.4%	44.8%
Loan book (in USD million)	24,150	39,937	30,345	20,813
10 largest borrowers (% of total loans)	24%	23%	23%	21%
Single largest borrower (% of total loans)	4%	3.3%	3%	4%
Total capital (in USD million)	1,013	1,631	295	576
Total assets (in USD million)	32,227	62,777	42,778	33,747
Equity (% of tot. assets)	3.1%	2.12%	0.34%	1.4%
Net interest margin (%)	0.37%	0.62%	0.31%	0.67%

## Moody's Related Research

### Credit Opinions:

- » [Kommunalbanken AS](#)
- » [KommuneKredit](#)
- » [Kommuninvest i Sverige Aktiebolag](#)
- » [Municipality Finance Plc](#)
- » [Municipal Guarantee Board](#)
- » [Norway, Government of](#)
- » [Denmark, Government of](#)
- » [Sweden, Government of](#)
- » [Finland, Government of](#)

### Credit Focus:

- » [Denmark, Finland, Norway and Sweden: Peer Comparison, September 2013 \(157683\)](#)

### Special Comment:

- » [UK Local Governments Would Benefit from a Municipal Bond Agency, December 2013 \(161041\)](#)

### Analyses:

- » [Kommunalbanken AS, June 2013 \(155500\)](#)
- » [KommuneKredit, June 2013 \(154869\)](#)
- » [Kommuninvest i Sverige Aktiebolag AB, June 2013 \(153603\)](#)
- » [Municipality Finance Plc, November 2013 \(159839\)](#)
- » [Municipal Guarantee Board, February 2013 \(149335\)](#)
- » [Norway, March 2013 \(151455\)](#)
- » [Denmark, December 2013 \(148527\)](#)
- » [Sweden, October 2013 \(161526\)](#)
- » [Finland, May 2013 \(154474\)](#)

### Rating Methodology:

- » [Government Related Issuers: Methodology Update, July 2010 \(126031\)](#)

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