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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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## Overview

- Sweden's Kommuninvest's capitalization has strengthened further, thanks to shareholder capital contributions and sound internal capital generation from robust earnings.
- In addition, Kommuninvest continues to benefit from excellent asset quality, sound liquidity, and a joint and several guarantee on its financial obligations 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+' and 'K-1' ratings 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 continuously strengthening capitalization thanks to unwavering membership support.

## Rating Action

On May 24, 2017, 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.

## Rationale

We use our Principles of Credit Ratings to assess Kommuninvest. Kommuninvest's enterprise risk profile is derived from our multilateral lending institutions (MLI) and other supranational institutions ratings methodology, which is based on a combination of policy importance and governance and management expertise. The financial risk profile is benchmarked against the MLI methodology, with a combination of capital adequacy and funding and liquidity. We then incorporate the extraordinary support provided by the joint and several liability from its members to Kommuninvest's stand-alone credit profile (SACP), which results in a 'AAA' rating. Hence, our ratings on Kommuninvest are underpinned by its very strong public policy role and the credit strength of the Swedish local government sector through the joint and several liability structure, signed by all member local governments, which covers all the agency's financial liabilities.

The ratings also reflect 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 members' capital contributions. 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 focused lending portfolio.

Members have agreed to capital contributions to boost Kommuninvest's equity. As a result, the agency's non-risk-weighted leverage ratio has increased beyond 1.5%, a level being discussed within the European Parliament as a minimum requirement for low-risk credit institutions in the upcoming EU Capital Requirements Regulation and Capital Requirement Directive under Basel III. Should the minimum leverage ratio requirement be higher, Kommuninvest would have to consider ways to further increase its capitalization. Currently, Kommuninvest is not compliant with a 3% leverage requirement. Kommuninvest henceforth expects to be exempted from the 3.0% leverage ratio and only be compliant with 1.5% as a minimum. However, the European Commission has opened up the possibility of a lower requirement for public lending by public development banks. To date, no formal decision has been taken, either about a possible requirement relaxation or whether Kommuninvest will be labeled a public development bank. If either of these two issues were to be decided to Kommuninvest's disadvantage, the requirement would be 3%, i.e., above Kommuninvest's current standing.

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 to become a member of Kommuninvest. The guarantee, last updated in 2011, passes on all financial risks to Kommuninvest's member local governments. 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. The joint and several guarantee commitment from Kommuninvest's members underpins our ratings on the agency.

As such, we regard as positive that Kommuninvest's member municipalities have followed through on their intention to make meaningful capital contributions, in line with the agency's strategy to prepare for the 2018 Basel III leverage ratio requirements. The agency has revised its thresholds for the initial capital contribution paid upon membership; the minimum is Swedish krona (SEK) 200 (approximately €20) per inhabitant, increasing to a voluntary maximum SEK1,800 (about €184) per inhabitant in 2017. If a member reaches the maximum capital contribution level, it is entitled to keep a greater portion of the refund of yearly profits. A large number of members have committed to increasing their initial capital contribution, thereby significantly boosting Kommuninvest's core capital. As a result, Kommuninvest's leverage ratio improved to about 1.6% in 2016 from a thin 0.9% in 2015. We do not include Kommuninvest's SEK1 billion debenture loan as primary capital in this ratio, since it does not satisfy our requirements for inclusion.

In addition, the member local governments confirmed their decision to adopt a contingency plan, if the Basel III leverage ratio reaches 3% in 2018, by introducing in KCS's statutes the possibility to strengthen Kommuninvest's capital base via the

subscription of core capital instruments. We view as positive that Kommuninvest is proactively preparing an action plan for the most conservative scenario regarding the Basel III leverage ratio.

Kommuninvest is developing its strategy to build capital to comply with the Basel III leverage ratio requirement. Internal capital generation remains sound, but the agency is turning to its municipal members for capital contributions. In essence, we consider that it will primarily be with the help of the member municipalities to ensure that Kommuninvest has adequate capitalization to continue its desired scope of funding activities. Currently, Kommuninvest is not compliant with the 3% leverage ratio which may be proposed in Basel III.

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 103.7% at year-end 2016, up from 44.6% at year-end 2015. The reason for the high capital ratio is the buildup of capital having taken place prior to the introduction of a leverage ratio. According to our calculations, Kommuninvest's risk-adjusted capital ratio was 41.5% (before concentration adjustments) in December 2016, which, in our view, indicates a sound level of capitalization. Given the strength of Sweden's local and regional government (LRG) sector, Kommuninvest has concentration risk in its lending portfolio, whereby the adjusted ratio is lower at 32.6%.

Kommuninvest's public-sector mandate is to provide funding solely to its members, which comprise entities within the Swedish LRG 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 LRG risk. We assess the credit quality of the Swedish 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 our assessments.

Despite increased lending, net interest income decreased to SEK762 million. The decrease is primarily due to the effects of the reduction in lending margins implemented as of the third quarter of 2014, following the change in strategy for capital-building. The reduction, which had relatively little impact on net interest income over much of 2015, had a greater impact in 2016, as an increasing proportion of lending was gradually affected by the margin reduction. As such, Kommuninvest has relaxed its loan margin requirements to regain competitiveness. Its lending grew significantly over the past few years and increased its market share to 48% in 2016 from 46% in 2015.

We have a positive view of Kommuninvest's strategy of increasingly relying on funding in Swedish krona through its domestic benchmark program. By year-end 2016, 33% of Kommuninvest's funding came from U.S. dollars. At the same time, 53% of

Kommuninvest's funding had been sourced from the domestic market, significantly reducing the need for derivatives for asset-liability matching. In addition, the agency enjoys excellent name recognition in international markets. In 2013-2015, while its funding in Swedish krona increased, Kommuninvest reduced funding from the Japanese Uridashi market. However, in 2016, funding from the Uridashi market increased to 6% from 4% in 2015. There is currently a very low degree of callability on Kommuninvest's funding, representing about 2% of total funding at year-end 2016.

## **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, and it is transitioning toward bilateral collateral agreements with counterparties on its derivatives, we consider this risk to be mitigated by its prudent liquidity policies, substantial high-quality prefunding, and access to funding operations with Sweden's central bank, Sveriges Riksbank. In addition, we view as positive 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. Kommuninvest can participate in the Riksbank's interbank scheme, as well as borrow directly from Sveriges Riksbank against collateral to the extent allowed by pledgeable assets.

We consider Kommuninvest's liquidity policies as prudent. The agency has committed to holding a liquidity reserve of 19%-27% of total lending at all times. At year-end 2016, Kommuninvest held prefunding invested in highly rated liquid securities totaling about SEK60 billion, equivalent to a high 23% of lending. In addition, about 86% of these assets were eligible as collateral at the European Central Bank (ECB) or Sveriges Riksbank, and 84% were eligible for repurchase transactions (repos) with Sveriges Riksbank. This is in line with Kommuninvest's policy, which states that a minimum of 65% of the liquidity reserve should be eligible for repos with Sveriges Riksbank or the ECB.

According to Kommuninvest's policy, its liquidity reserve should sustain its operations during a market shutdown of six months, without a disruption of any of its lending activities. In April 2017, the liquidity reserve would allow Kommuninvest to continue its operations during a 10-month funding market shutdown, without new loan disbursements and normal calls on funding.

## **Outlook**

The stable outlook reflects our expectation that, over the next two years, Kommuninvest's guarantee structure will remain unchanged and that the agency will maintain robust liquidity, prudent risk management, excellent asset quality, and continuously strengthening capitalization, thanks to unwavering membership support.

A negative rating action could result from a weakening of Kommuninvest's guarantee structure or its role and relevance for its shareholders. 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 loosening of management processes.

## Kommuninvest i Sverige AB Key Statistics

(Mil. SEK)	--Fiscal year ended Dec. 31--				
	2016	2015	2014	2013	2012
Adjusted assets	361,712	340,611	312,051	277,459	283,284
Customer loans (gross)	276,982	254,422	222,804	208,644	200,951
Adjusted common equity	6,491	4,363	2,361	1,710	930
Operating revenues	630	998	1,013	990	477
Noninterest expenses	228	293	284	245	252
Core earnings	314	593	568	580	159
<b>CAPITAL AND EARNINGS (%)</b>					
Tier 1 capital ratio	103.7	44.6	34.6	37.0	N/A
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	75.2
Net interest income/operating revenues	120.9	80.0	90.3	98.0	161.9
Fee income/operating revenues	(0.8)	(0.5)	(0.5)	(0.6)	(1.8)
Market-sensitive income/operating revenues	(20.7)	20.3	10.0	2.6	(61.1)
Noninterest expenses/operating revenues	36.2	29.4	28.0	24.8	52.8
Provision operating income/average assets	0.1	0.2	0.2	0.3	0.1
Core earnings/average managed assets	0.1	0.2	0.2	0.2	0.1
<b>RISK POSITION (%)</b>					
Growth in customer loans	8.9	14.2	6.8	3.8	19.6
Total managed assets/adjusted common equity (x)	55.7	78.1	132.2	162.2	304.7
New loan loss provisions/average customer loans	N.M.	0	N.M.	N.M.	N.M.
Gross nonperforming assets/customer loans + other real estate owned	0	0	0	0	0
<b>FUNDING AND LIQUIDITY (%)</b>					
Core deposits/funding base	0	0	0	0	0
Long term funding ratio	73.4	70.9	71.8	66.7	68.6
Stable funding ratio	88.4	85.6	90.4	82.4	N/A
Short-term wholesale funding/funding base	27.1	29.5	28.5	33.5	31.7
Broad liquid assets/short-term wholesale funding (x)	0.5	0.5	0.6	0.5	N/A
Short-term wholesale funding/total wholesale funding	27.1	29.5	28.5	33.5	31.5
Narrow liquid assets/3-month wholesale funding (x)	1.6	1.6	1.6	1.2	N/A

SEK--Swedish krona. N.M.--Not meaningful. N/A--Not applicable.

## Related Criteria And Research

### Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - June 01, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology - November 26, 2012
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions - November 09, 2011
- General Criteria: Principles Of Credit Ratings - February 16, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Financial Institutions - Finance Companies: Rating Finance Companies - March 18, 2004

## Ratings List

	Rating	
	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
Foreign Currency	AAA	AAA
Commercial Paper		
Foreign and Local Currency	A-1+	A-1+
Nordic Regional Scale	K-1	K-1

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. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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