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Research Update:

Sweden-Based Kommuninvest i Sverige AB Ratings Affirmed At 'AAA/A-1+' After Criteria Revision; Off UCO; Outlook Stable

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Research Update:

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Overview

- We have completed our review of the ratings on Kommuninvest i Sverige AB (Kommuninvest), a Sweden-based public sector funding agency that lends to the Swedish local and regional government sector, following the release of our "Public-Sector Funding Agencies: Methodology And Assumptions" criteria.
- We had placed the ratings on the agency Under Criteria Observation (UCO) on May 22, 2018, in conjunction with the criteria's release.
- After our review, we're affirming our 'AAA' and 'A-1+' issuer credit ratings on Kommuninvest and removing them from UCO.
- The outlook is stable.

Rating Action

On July 2, 2018, S&P Global Ratings affirmed its 'AAA' long-term and 'A-1+' short-term issuer credit ratings on Kommuninvest i Sverige AB. At the same time, we affirmed our 'K-1' short-term Nordic regional scale rating on Kommuninvest. We also removed the ratings from UCO, where we placed them on May 22, 2018. The outlook is stable.

Outlook

The stable outlook reflects our expectation that Kommuninvest's guarantee structure will remain unchanged and that the agency will continue to benefit from unwavering membership support. 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 successfully navigate instances of regulatory risk and continue to pre-empt situations so that its low risk profile, lending services, and ultimately the execution of its public policy role, are not impacted.

We could lower our rating over the next two years if Kommuninvest's stand-alone credit profile (SACP) came under significant pressure for example if risk management faltered to the extent that its liquidity position notably deteriorated. Such a scenario could manifest itself through a widening funding

gap and a sharply reduced stressed liquidity position. Such financial pressure could hinder the agency's ability to fulfil its public policy mandate, which combined with lowered confidence in the agency's risk management culture, would add downside momentum to the SACP.

We could also consider a downgrade if we reassessed the creditworthiness of Kommuninvest's underlying municipal shareholders or if we considered a risk that the joint and several guarantee structure could lose its stringency or be unwound.

We consider both our downside scenarios to be unlikely at this stage.

Rationale

The ratings reflect our view of Kommuninvest's competent management, which has fostered the agency's public policy role, by remaining responsive to shareholder requirements, while prudently catering for financial risks, associated with expanding activities and regulatory requirements. The highly creditworthy position of Kommuninvest's borrowers and shareholders, supported by key structural underpinnings, confirms our assessment of its very low risk business profile. In addition, on the financial side, Kommuninvest's excellent risk-adjusted capitalization levels, positive funding position from excellent name recognition, and a large reliance on domestic funding and strong liquidity provide the entity buffers to weather most conceivable shocks and underpin our assessment of the agency's very strong financial risk profile.

We combine our assessments of Kommuninvest's enterprise risk profile and financial risk profile to arrive at a SACP of 'aa'. The agency's favorable position to peers, notably with regards to an extremely strong capital adequacy, prudent risk management, and arrangement to tap into central bank liquidity, support our assessment of the SACP. Furthermore, we assess Kommuninvest's guarantee structure as predictable, supporting and immediately enforceable, which in combination with the numerous and highly creditworthy local government shareholders, lifts Kommuninvest's issuer credit rating to 'AAA'.

Enterprise Risk Profile: Very strong management and position as key lender to highly creditworthy sector secures strong market position and enforces public policy role

- Management is set to sail through period of uncertain leverage ratio regulation with a notably improved capital position, enhanced shareholder awareness, and with additional contingency plans in place.
- Growing market share on strong and further improving lending offer is set to entrench strong public policy role.
- Strong public industry country risk assessment (PICRA) on wealthy and resilient economy, well-developed financial sector, and strong sector ties to 'AAA' rated sovereign.

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, county councils, or 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 very strong market position given that its market share is steadily growing and currently stands at about 50% of the total lending to the sector. Kommuninvest's lending growth has remained consistently in the double-digit area, outpacing the sector's average, suggesting a competitive offer. Moreover, we observe that Kommuninvest has taken the decision to revise its profitability target, removing the requirement to cater for impact of IFRS swings. Such unrealized market value movements have typically added 8-10 basis points (bps) onto the profitability requirement. A revised focus on the underlying operating cash flow will thus allow for lowered lending margins, which will provide scope for further lending expansion and entrenchment of its public policy role. However, this will also lead to somewhat weaker profitability. We continue to monitor any potential impact on liquidity coverage and capital adequacy this could have.

Kommuninvest has a pronounced public policy mandate based on its ownership, support structure, niched lending, and non-profit mission. As such, Kommuninvest plays a very important role in supplying financing to the Swedish LRG sector by ensuring stable and advantageous borrowing in national and international capital markets. History suggests that Kommuninvest's role as a supplier of financing to the LRG sector increases in importance in periods of financial distress, such as in 2008 and 2009, when the agency was called upon to assume large local government financing portfolios from commercial banks.

The Swedish LRG sector exhibits key structural features, which supports a high credit standing. For example, the economy is wealthy, the financial system is advanced, and the linkages between the local government sector and the 'AAA' rated sovereign are very tight. Therefore, we assess our PICRA to be strong.

We observe that uncertainties regarding regulatory mandated leverage ratio requirements are gradually diminishing. In a 2017 proposal, the European Commission has revised the requirements for the requirement to be labelled a public development credit institution (PDCI), most notably relaxing the requisite for any such institution to be established under public law. Furthermore, the revised proposal states that even indirect exposures (e.g. lending to municipal companies) would be subject to exemption from the leverage regulation for PDCIs in which case Kommuninvest's leverage ratio would surpass 10%, comfortably above the 3% regulatory level. While the Swedish Financial Supervisory Authority (FSA) will hold the authority to determine which institutions are labelled PDCI, we believe Kommuninvest, through its business model and structure, is well positioned to be granted such a status. This is set to allow Kommuninvest pursue expansion without further extraordinary capital injections.

In preparation for the leverage ratio requirement, Kommuninvest has actively engaged with its shareholders to secure a notable increase in core capital through increased contributions, re-distribution of dividends, capital injections, and the replacement of a subordinated loan from the shareholders to Kommuninvest. A revamped model for capital contribution is now on stream, which holds possibilities for to further ramp-up in capital from the shareholders if required. We believe these developments highlight the constructive dialogue between the company and its shareholders and strengthens our assessments of the agency's management as well as the relationship with shareholders.

With regards requirements for minimum required eligible liabilities (MREL), the Swedish National Debt Office, which is the appointed resolution authority in Sweden, has concluded that Kommuninvest, despite its role as a systemically important domestic financial institution, is not required to adhere to MREL requirements due to its special nature and limited risk in lending operations. We view this exemption as credit positive because it precludes any risk of private capital, through holders of MREL securities, as potential shareholders in the organization.

Financial Risk Profile: Very strong capitalization and strong liquidity provide notable financial buffers

- Very solid capital ratios thanks to notable recent capital support from shareholders.
- Tight matching of assets and liabilities, treasury portfolio, and broad access to diversified funding underpin strong funding and liquidity.
- Benchmark funding in domestic currency limits the use of derivatives.

Kommuninvest boasts a very strong capital position. In a regulatory context, the agency's Tier 1 capital ratio is impressive, exceeding 200%. This is largely due to the zero risk weighting of Kommuninvest's lending, and counterparty risk in derivatives are covered by member guarantee. Nevertheless, Kommuninvest's equity has strengthened notably in recent years due to capital contributions from its members, healthy retained earnings, in addition to the redemption of a SEK1 billion subordinated loans, which were replaced with a share issue subscribed by the members in 2017. As such, all equity is eligible as Tier 1 capital and we incorporate it into our total adjusted capital (TAC) ratio.

We compute our risk-adjusted capital (RAC) to an extremely strong 40.5% before adjustments. When factoring in our adjustments, in particular from important single-name concentration on municipalities, Kommuninvest's RAC after adjustments reduces but still stands at a very strong 17%. However, over the past 10 years, the concentration has steadily decreased due to the expansion of membership and lending. Exposure to 20 largest borrowers, as a percentage of total lending, is down to less than 30% in 2018 from 45% in 2007. We expect our adjusted RAC ratio to continue to comfortably surpass 15% and remain a key support to Kommuninvest's financial risk profile.

Kommuninvest's funding strategy is focused on benchmark issuance in strategic markets. All markets are open to Kommuninvest thanks to its excellent name recognition and deep investor base. Securities issued by Kommuninvest are, in Sweden, among those considered to be of the highest quality in the calculation of the Liquidity Coverage Ratio (LCR). Funding instruments are kept primarily plain vanilla with any structures typically conducted on Japanese retail Uridashi funding where call- and index-linked options are typically embedded. The limit for callable funding stands at 10% with the current level at approximately 1.5%. Over the past couple of years, Kommuninvest has added green bonds to its funding palette, which has allowed for a further growing investor base.

We view positively Kommuninvest's strategy of predominantly relying on funding in Swedish krona through its domestic benchmark program, because this limits the need for derivatives and allows for close asset liability management (ALM) matching. This strategy contributes to Kommuninvest's stable funding profile, with cumulative maturing assets covering 115% of cumulative maturing liabilities for the next 12 months. With the growth of the Swedish benchmark program, the transparency and liquidity in the secondary market has improved, which has allowed for a gradual tightening against the Swedish government bond. The outstanding amount under the SEK benchmark program is SEK170 billion or roughly little more than half of total funding.

Kommuninvest holds a high level of expertise with regards to liquidity portfolio management and execution. This has allowed the agency to employ a more stringent ALM to a higher degree of cost efficiency. As such, Kommuninvest has undergone somewhat of a strategic change with regards to its liquidity holdings. While the amount of the liquidity portfolio has gradually declined, the nature of the exposures has changed, whereby the portfolio comprises very liquid and short-term securities solely directed towards highly rated government-related securities. The average duration is below 0.5 years, highlighting the liquidity portfolio nature of the holdings.

At the same time we observe that Kommuninvest remains proactive in its liquidity management execution, which we view as important in light of the agency's ongoing move to two-way CSAs on its derivatives counterparty portfolio. This move is underway and Kommuninvest is set to adapt its liquidity portfolio to a situation where it will be required to post collateral. Taking this into account, our liquidity ratio, which we calculate at 1.05, indicates that Kommuninvest will be able to meet its financial obligations over a one-year period. Our liquidity ratio factors in stressed market conditions, under which we assume the bank wouldn't have access to the capital markets. We also observe that Kommuninvest, as a distinguishing feature to most PSFAs, is an approved monetary counterparty to its domestic central bank, meaning that it can participate in credit facilities from the Swedish Riksbank and can borrow directly from the Riksbank against collateral from its liquidity portfolio. However, in this regard we observe that its lending book is not eligible as collateral.

Extremely strong likelihood of support by a joint and several guarantee mechanism from all its members

- Under the joint and several guarantee scheme, we expect a group of largest potential supporting members estimated at 'aa+' on average will effectively provide support in case of need.
- We assess the likelihood of extraordinary support provided by the group of supporting entities to be extremely high thanks to what we view as the agency's integral link to, and very important role for, the municipal government shareholders.
- We factor the support mutualization by one notch-up to the indicative issuer credit rating due to the number of additional members and their credit profile as strong investment grade.

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

In addition, we believe that a large number of other members, outside the group of potential supporting members, would also be liable and able to support Kommuninvest in situation of distress. These member governments account for aggregate revenues representing notably above 20% of the entire sector and add support to our assessment of support mutualization. Therefore, we give an additional notching to the indicative issuer credit rating on Kommuninvest.

Key Statistics

Table 1

| Kommuninvest Selected Indicators | | | | | |
|----------------------------------|-----------------------------|---------|---------|---------|---------|
| | -- Year ended December 31-- | | | | |
| (Mil. SEK) | 2017 | 2016 | 2015 | 2014 | 2013 |
| Business Position | | | | | |
| Total adjusted assets | 356,932 | 361,712 | 340,611 | 312,051 | 277,459 |
| Customer loans (gross) | 310,147 | 276,982 | 254,422 | 222,804 | 208,644 |
| Growth in loans | 12.0 | 8.9 | 14.2 | 6.8 | 3.8 |
| Net interest revenues | 881 | 762 | 799 | 915 | 970 |
| Non interest expenses | 265 | 228 | 293 | 284 | 245 |

Table 1

| Kommuninvest Selected Indicators (cont.) | | | | | |
|--|-----------------------------|---------|---------|---------|---------|
| | -- Year ended December 31-- | | | | |
| (Mil. SEK) | 2017 | 2016 | 2015 | 2014 | 2013 |
| Capital & Risk Position | | | | | |
| Total liabilities | 349,332 | 355,211 | 336,282 | 309,677 | 275,731 |
| Total adjusted capital | 7,599 | 6,491 | 4,363 | 2,361 | 1,710 |
| Assets/capital | 47 | 56 | 78 | 132 | 162 |
| RAC before diversification (%) | 40.5 | N.A. | N.A. | N.A. | N.A. |
| RAC after diversification (%) | 16.8 | N.A. | N.A. | N.A. | N.A. |
| Gross nonperforming assets/gross loans | 0 | 0 | 0 | 0 | 0 |
| Funding & Liquidity | | | | | |
| Liquidity ratio with loan disbursement (1 year) | 1.04 | N.A. | N.A. | N.A. | N.A. |
| Liquidity ratio without loan disbursement (1 year) | 1.05 | N.A. | N.A. | N.A. | N.A. |
| Funding ratio (1 year) | 1.15 | N.A. | N.A. | N.A. | N.A. |

Ratings Score Snapshot

| | |
|-------------------------|------------------------|
| Issuer Credit Rating | AAA/Stable/A-1+ |
| Anchor | 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 Liquidity | Positive Strong (2) |
| Support | 1 |
| GRE Support | 1 |
| Group Support | 0 |
| Additional Factors | +1 |

Related Criteria

- Criteria - Governments - International Public Finance: Public-Sector Funding Agencies: Methodology And Assumptions, May 22, 2018
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, Aug. 14, 2017
- 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: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Assumptions For Liquidity Gap Analysis Under "Public-Sector Funding Agencies: Methodology And Assumptions", May 22, 2018
- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018
- 10 Public-Sector Funding Agencies Placed Under Criteria Observation On Publication Of New Criteria, May 22, 2018

Ratings List

Ratings Affirmed

Kommuninvest i Sverige AB

| | |
|-----------------------|-----------------|
| Issuer Credit Rating | AAA/Stable/A-1+ |
| Nordic Regional Scale | --/--/K-1 |
| Senior Unsecured | AAA |
| Commercial Paper | A-1+ |
| Commercial Paper | 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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at 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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