

Research Update:

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

December 11, 2019

Overview

- Our assessment of Kommuninvest's stand-alone credit quality has weakened because we have amended our view of the agency's liquidity position and observed a slight weakening of capitalization ratios following rapid expansion in lending, as well as a negative performance trend among Swedish local and regional governments (LRGs).
- Still, Kommuninvest displays a solid and marginally increasing market position, prudent risk management policies, declining but still very strong overall capital adequacy, and steady support from its highly creditworthy members.
- 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 market share and its role in funding Swedish LRGs, while preserving its very strong capital position over the next two years.

Rating Action

On Dec. 11, 2019, 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 high creditworthiness of the underlying municipal sector will sustain, 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

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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, stay on track.

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 via sustained 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 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 ratings reflect 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, Kommuninvest's strong risk-adjusted capitalization levels, positive funding position from diversified funding, efficient funding techniques, excellent name recognition, and adequate liquidity enable the agency to withstand most conceivable shocks. These factors also underpin our assessment of the agency's strong financial risk profile.

However, recent rapid loan growth at low margins has constrained capitalization, and we see potential risk stemming from a more active capital management and pressure on our risk-adjusted capital ratio following recent clarification on regulatory capitalization requirement. This, together with a comparably short maturity profile of its lending portfolio compared to peers and weakening performance trend in the Swedish LRG sector, has led us to revise down the SACP to 'aa-' from 'aa'. At the same time, we regard Kommuninvest's guarantee structure as predictable, supportive, and immediately enforceable, which combined with the numerous and highly creditworthy local government members, lifts our long-term rating on Kommuninvest to 'AAA'.

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

- Strong public policy role underpinned by increasing market share on competitive lending.
- A strong public industry country risk assessment (PICRA), owing to the wealthy and resilient national economy, well-developed financial sector, and the LRG sector's strong ties to 'AAA' rated sovereign.
- Signs of flagging performance in the underlying municipal sector.

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/regions, 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 increasing and stood at 57% of total lending to the sector as of June 30, 2019.

Kommuninvest's lending growth has remained consistently in the double-digit area, outpacing the sector average, suggesting a competitive offer.

Moreover, Kommuninvest revised its profitability target during 2018, removing the requirement to cater for the impact of swings in International Financial Reporting Standards (IFRS). Such unrealized market value movements have typically added eight basis points (bps) to 10 bps to the profitability requirement. The new focus on underlying operating cash flow allows for lower lending margins, providing scope for further lending expansion and entrenchment of Kommuninvest's public policy role. However, this will also lead to somewhat weaker profitability, and we note that the rapid expansion is weighing on the agency's capital adequacy.

Kommuninvest has a clear public policy mandate based on its ownership, support structure, niche lending, and non-profit 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. 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 it was called upon to assume a large local government loan portfolio from one of the largest Swedish banks.

In preparation for regulatory leverage ratio requirement, Kommuninvest has actively engaged with its members to secure a notable 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 contribution has been reworked over the past few years and offers possibilities for a further increase in members' capital contribution if required. We believe these developments highlight the constructive dialogue between Kommuninvest and its members, and strengthens our view of the agency's management and relationship with members.

The Swedish LRG sector exhibits key structural features that support its high credit standing. 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, we have some concerns over weakening performance in the Swedish LRG sector and increased number of LRGs not compliant with the regulatory balanced budget requirement. This is owing to intensifying expenditure pressure and inadequate compensation from central government or counter measures from the LRGs. As such, we recently reassessed our view of the trend for the Swedish institutional framework for LRGs as weakening, versus from stable previously (Public Finance System Overview: "Swedish Municipalities And Regions," published Dec. 3, 2019).

Financial risk profile: Very strong capitalization and adequate liquidity provide important financial buffers

- Funding and liquidity supported by tight matching of assets and liabilities, a very liquid treasury portfolio, and broad access to diversified funding underpin the agency's, although a short maturity profile of lending results in continuous high funding volumes needed.
- Very strong capital ratios, thanks notably to recent capital support from members.
- Benchmark funding in domestic currency limits the use of non-standard derivatives which lowers market risk and counterparty exposure.

Kommuninvest maintains a very strong capital position. In a regulatory context, its Tier 1 capital

ratio is impressive at 156%. 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 risk-adjusted capital (RAC) ratio before adjustments for Kommuninvest remain very strong at 38% but has weakened somewhat from the 41% in the last review. After our adjustments, in particular for important single-name concentration relating to municipalities, the RAC ratio reduces to 15%. The reduction primarily reflects the rapid increase in lending, which had grown 17% over the 12 months ended June 30, 2019.

Kommuninvest is now officially labelled a public development credit institution, which mean that its lending is exempted from EU leverage ratio calculation and hence that the agency lies comfortably above the 3% limit at more than 8%. Also, the Swedish FSA has lowered its leverage ratio requirement for Kommuninvest from 1.5% to 1.0%. These clarification and amendments have lifted uncertainties related to regulatory capital requirement and will allow the agency to focus on its business plan without having to factor worst case scenarios for regulatory capitalization. We will monitor how Kommuninvest undertakes a more active capital management and the potential impacts on our RAC ratio.

At the same time, we note that Kommuninvest could increase the capital contribution from its members if needed, and that they are looking into setting up a capital buffer with the Cooperative Society to facilitate a more stringent capitalization process. We consider these aspects to be mitigating factors for the agency's overall capital adequacy, which remain a key support to Kommuninvest's financial risk profile.

Kommuninvest's funding strategy focuses on benchmark issuance in strategic markets. 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. Securities issued by Kommuninvest are, in Sweden, among those considered to be of the highest quality in the calculation of the liquidity coverage ratio. Funding instruments are primarily non-structured, with any structures typically conducted via Japanese retail Uridashi funding, where call- and index-linked options are typically embedded. The limit for callable funding stands at 10.0%, compared with the outstanding amount of approximately 3.2% as of June 30, 2019. Over the past few years, Kommuninvest has added green bonds to its funding portfolio, which has allowed further expansion of its investor base. The agency has also recently added euros as one of its strategic currencies together with the Swedish krona (SEK) and U.S. dollar.

We view as positive Kommuninvest's strategy of close matching assets with liabilities and predominantly relying on funding in Swedish krona through its domestic benchmark program, because this limits the need for derivatives. This strategy contributes to Kommuninvest's stable funding profile, with cumulative maturing assets covering 125% 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. The outstanding amount under the local currency benchmark program is SEK232 billion, more than half of total funding.

However, both lending and borrowing are shorter term compared with peers, and creating a mismatch of lending and funding to the investment cycle of the underlying capital investment. Therefore, the vast majority of loans are rolled over. While there is no legal obligation to roll over loans, municipalities expect Kommuninvest to do so and any significant failure could likely lead to a franchise damage. 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 has a 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 1.13x 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 a majority of 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. We have therefore incorporated this into our overall view of Kommuninvest's liquidity position, which we now assess as adequate.

An extremely strong 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 that group of members, thanks to what we view as the agency's integral link with and very important role for, the municipal government members. This leads to an uplift to Kommuninvest's SACP, resulting in an indicative long-term issuer credit rating (ICR) of 'aa+'.
- Addition uplift from what we regard as support mutualization from additional members, outside the group of supporting members, and their strong investment-grade credit profiles, which leads to the final rating of 'AAA'.

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. We observe that 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 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 a situation of distress. These member governments' aggregate revenues represent 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--					
	2019H1	2018	2017	2016	2015	2014
Business position						
Total adjusted assets	469,278.9	417,186.4	356,932.0	361,712.0	340,611.0	312,051.0
Customer loans (gross)	388,465.6	355,710.0	310,147.0	276,982.0	254,422.0	222,804.0
Growth in loans	17.2*	14.7	12.0	8.9	14.2	6.8
Net interest revenues	284.7	591.4	881.0	762.0	799.0	915.0
Non interest expenses	116.1	266.5	265.0	228.0	293.0	284.0
Capital and risk position						
Total liabilities	461,411.5	409,598.7	349,332.0	355,211.0	336,282.0	309,677.0
Total adjusted capital	7,867	7,588	7,599	6,491	4,363	2,361
Assets/capital	54		47	56	78	132
RAC before diversification (%)	38.2	41§	40.5	N.A.	N.A.	N.A.
RAC after diversification (%)	14.8	17§	16.8	N.A.	N.A.	N.A.
Gross nonperforming assets/gross loans	0	0	0	0	0	0
Funding and liquidity						
Liquidity ratio with loan disbursement (1 year)	1.1	1.1§	1.0	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (1 year)	1.1	1.1§	1.1	N.A.	N.A.	N.A.
Funding ratio (1 year)	1.3	1.2§	1.2	N.A.	N.A.	N.A.

*Year-on-year. §As of end-June 2018. 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 and 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)

Table 2

Kommuninvest i Sverige AB--Ratings Score Snapshot (cont.)

Group support	(0)
Additional factors	(+1)

SACP--Stand-alone credit profile. PICRA--Public industry country risk assessment.

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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Public Finance System Overview: Swedish Municipalities And Regions, Dec. 3, 2019
- Summary: Sweden, Aug. 23, 2019

Ratings List

Ratings Affirmed

Kommuninvest i Sverige AB

Issuer Credit Rating	AAA/Stable/A-1+
Nordic Regional Scale	--/--/K-1
Senior Unsecured	AAA

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. 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/sourceId/504352 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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