

CREDIT ANALYSIS

Kommuninvest i Sverige Aktiebolag AB

Orebro, Sweden

Table of Contents:

SUMMARY RATING RATIONALE	1
PEER COMPARISON	1
RATING OUTLOOK	2
WHAT COULD CHANGE THE RATING - DOWN	2
ISSUER OVERVIEW	2
KEY RATING CONSIDERATIONS	2
Institutional Framework	2
Financial Position and Performance	4
Capital Adequacy	5
Liquidity	5
Asset Quality	6
Risk Positioning	7
RATING HISTORY	9
ANNUAL STATISTICS	10
MOODY'S RELATED RESEARCH	14

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Summary Rating Rationale

The Aaa rating of Kommuninvest i Sverige AB (Kommuninvest), with stable outlook, is underpinned by its strong franchise, with a solid and growing market share in lending to its local member governments. The rating also reflects:

- » Kommuninvest's strong asset quality and prudent asset liability management throughout the global financial crisis.
- » The joint and several guarantee of Kommuninvest's assets from a large number of local governments who form the wider Kommuninvest Cooperative Society (the Society) including 254 municipalities and 8 counties as of mid-2011.
- » Kommuninvest's solid financial fundamentals and its plans to significantly strengthen its equity base.

Peer Comparison

Like other Nordic specialised lenders, Kommuninvest has a stable core lending market to local governments and is restricted from expanding into higher risk markets. Unlike the guarantors of similar entities in Finland and Denmark, the Society does not include all local governments within the country, although its resources remain proportionate to Kommuninvest's exposures. Whilst total equity and equity-like funds have strongly increased, total equity remains well below Basel III targets.

This Credit Analysis provides an in-depth discussion of credit rating(s) for Kommuninvest i Sverige Aktiebolag and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on [Moody's website](#).

Rating Outlook

The Aaa rating is stable.

What Could Change the Rating - Down

The strength of the joint-and-several pledge makes it difficult to see a weakening of the Aaa rating, although any change in the support mechanisms for Kommuninvest's liabilities would result in downward rating pressure. No such change has been discussed.

Issuer Overview

Kommuninvest was established in 1986 to provide low-cost financing to Swedish local governments. It is a wholly owned subsidiary of the Kommuninvest Cooperative Society, which is a collective of Swedish municipalities and counties that form both Kommuninvest's borrowers and guarantors.

Kommuninvest serves as the debt office for its members and also provides advisory and training services. Its sector-wide role is reinforced by its representation of the Swedish municipal sector on public funding policies within discussions of broader governmental finances. Kommuninvest also acts as an intermediary for loans from the Council of Europe Development Bank (CEB) to finance infrastructure, healthcare, education and environmental projects as well as accommodation for senior citizens.

Registered as a joint-stock credit company, Kommuninvest is subject to supervision from the Financial Supervisory Authority of Sweden (*Finansinspektionen*).

In early 2010, Kommuninvest became a counterparty of the Swedish Riksbank and was approved as a member of the Riksbank payment system, RIX. Closer links with the central bank have improved the firm's access to liquidity in difficult market conditions and underscore the role it plays in the national financing system.

Key Rating Considerations

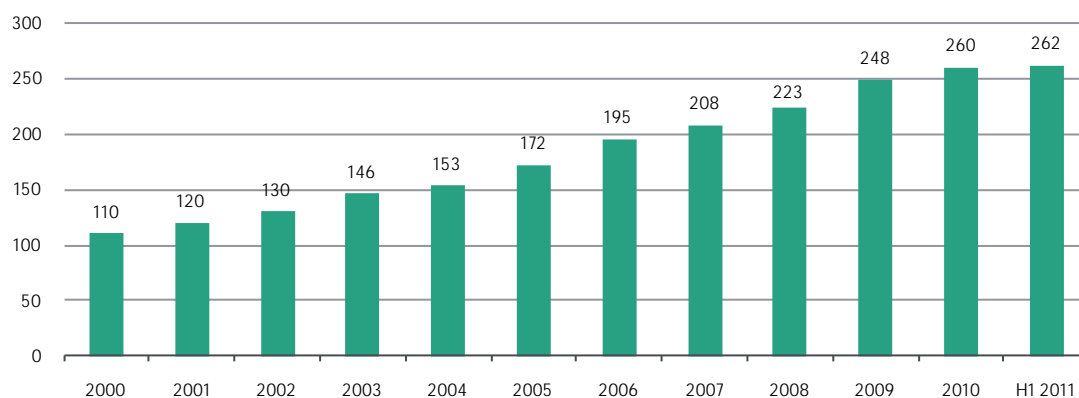
Institutional Framework

[Membership has expanded during the financial crisis](#)

The society acquired 14 new members since December 2009. As of June 2011, the Kommuninvest Cooperative Society had 262 members (comprising 254 municipalities and eight counties) of a national total of 290 municipalities and 20 counties, accounting for 88% of all municipalities and counties and approximately 62% of Sweden's population (see Exhibit 1, below).

EXHIBIT 1

Growth In Membership



Source: Kommuninvest AB

Joint and several liability underpins Kommuninvest's creditworthiness

The members of the society are jointly and severally liable for Kommuninvest's commitments and liabilities.¹

- » Kommuninvest's members have unlimited taxing authority and ample liquidity, estimated at SEK31 billion for 2010
- » New members become liable for current and future liabilities, whilst any member leaving the society is liable for liabilities outstanding as of the date of departure
- » The legality of the joint and several guarantee was challenged and ultimately confirmed by the Supreme Administrative Court (*Regeringsrätten*) in 1994

The pricing and security conditions of Kommuninvest's loans are offered equally to all members, regardless of the loan's size or the financial profile of the borrower. This helps to reinforce the collective nature of the firm's activities and support within the society.

Competition for municipal lending has fallen since the collapse of Lehman Brothers

Kommuninvest provides approximately 51% of its members' total borrowing (approximately 37% of the total Swedish RLG-related market), and approximately 90% of all new lending to its members. Kommuninvest has improved its net interest margins in recent years (see *Financial Position and Performance*, below).

We expect Kommuninvest's market strength to continue in the near-to-medium term, in the relative absence of commercial banking competition.

In August 2005, Kommuninvest received permission to use the Lesser Coat of Arms of the Kingdom of Sweden on its international presentation material, indicating its importance as a funding vehicle for local governments in the country.

¹ Kommuninvest Cooperative Society Articles of Association, Article 7.

Financial Position and Performance

Strong risk management has helped to preserve surpluses during market volatility

Results from 2010 and the first half year of 2011 indicate pricing power from Kommuninvest's strong lending franchise. The volatility (including unrealised gains and losses on assets and liabilities) from certain line items also underscores the scale of risks that it must hedge to preserve profits within low-margin sector.

- » Net interest income during 2010 rose to SEK432 million from SEK382 million in 2009. Net interest income continued its strong performance in the first half of 2011, totalling SEK266 million and comparing favourably to SEK214 million over the same period in 2010.
- » The operating profit for 2010 amounted to SEK275.7, down by 17.7% from SEK335 million in 2009 largely due to unrealised market value changes of SEK-86.5 million (SEK-9.4 million in 2009). In the first half of 2011 operating profit of SEK110.9 million rose by 5.3% over the same period a year before, suggesting continuing good fundamental results.
- » The 2010 results includes an SEK102.5 million gain on the buyback of Kommuninvest's own securities, which helped offset SEK-86.5 million in unrealised market value changes.

As shown in exhibit 2 below, net interest margin has strengthened to 28% in the first half of 2011. Kommuninvest aims to keep its lending spreads at sufficient levels to support anticipated growth in both membership and lending levels.

EXHIBIT 2
Net interest margin from 1999 to H1 2011 (%)



Source: Kommuninvest

Operating expenses remain low and proportionate to Kommuninvest's balance sheet

As lending margins have at times been extremely narrow, cost control is essential for the viability of Kommuninvest's business model. In the first half of 2011, operating costs remained approximately within historical ranges at 0.09% of average assets, up from 0.08% in 2009. The increase in absolute costs to SEK126.6 million in the first half of 2011 from SEK80.1 million over the same period in 2010 is largely due to the introduction of the "stability charge" associated with new financial regulation as well as increased staff, IT and other consultancy expenses, and has been absorbed by the growth in lending. Kommuninvest has 62 full-time employees, up from 37 in 2007, which remains proportionate to its activities.

Capital Adequacy

Kommuninvest has increased its equity and equity-like funds through solid earnings and increased contributions and commitments by the members of the Society. Kommuninvest is compliant generally well ahead of the new risk-based capital requirements of Basel III but remains below the 3% leverage ratio target.

In 2010, Kommuninvest completed the sale of a SEK1.0 billion hybrid loan to the members of the Society, with the flexibility to create maximum equity-like features. The Kommuninvest board intends to modify or replace the loan with other structures as necessary so as to maintain the 1.0% target in light of any changes to financial policies regarding equity value or calculation.

- » Kommuninvest has improved its equity ratios by reducing its market- and counterparty-risk exposure, by building up its retained earnings and by raising additional capital from new members. By the end of 2010, Kommuninvest's total capital ratio (total capital base in relation to risk-weighted assets) rose to 80.5% (46.6% Tier-1 equivalent, as calculated by Moody's) from 45.9% (28.4% Tier-1 equivalent) at year-end 2009. Recent developments in the first six months of 2011 has seen Kommuninvest increase its liquidity portfolio in order to enable them to meet expected future financing needs from existing and new members. As a consequence, the total capital ratio was 45.8% as of 30 June 2011.
- » Total equity, although improving in recent years, remains low compared with similar Nordic and Dutch specialised lenders. As of 30 June 2011 Kommuninvest's ratio of total equity to assets increased to 0.52% from 0.39% at year end 2009. Existing levels, even after giving effect to full conversion of the hybrid loan to equity remain considerably below the Basel III total equity target.

Liquidity

Prudent liquidity management to meet lending needs

Kommuninvest has maintained ample liquidity throughout the global financial crisis, allowing it to assert its role as lender of last resort to its clients. 100% of the primary reserve is repo eligible with the Swedish Riksbank. Since March 2010, Kommuninvest's membership in the RIX system adds further assurance that it can meet its liquidity needs under difficult circumstances.

Kommuninvest projects all cash flows from lending and investment activities in multi-month analysis. This analysis incorporates an estimate of any potential additional lending and excludes any cash benefit from the two-month call of its short-term lending programmes. The analysis also looks at the conservative case of all calls on its own financing (approximately 5% of its borrowing) being exercised. The key features of Kommuninvest's liquidity management are listed below:

- » Kommuninvest's internal guidelines state that surplus liquidity must constitute at least 24% of the total balance sheet plus estimated result of outstanding tenders, but never less than 50% of outstanding tenders.
- » The securities portfolio is divided into three categories depending on liquidity, primary reserve (14%), secondary reserve (67%) and the investment portfolio (19%). The primary reserve is set to

a minimum of 4% of the total balance sheet plus outstanding tenders, and should be invested in assets with minimal credit and liquidity risk.²

- » The securities portfolio totalled SEK60.7 billion in June 2011, equal to 27.4% of total assets (26.4% at year-end 2009). Kommuninvest also had SEK5.1 billion in deposits, listed as loans to credit institutions, as part of its liquidity reserve.
- » The securities portfolio held to a short average maturity of 1.8 years as of December 2010, against an internally set maximum of 5.5 years.
- » As of June 2011, 85% of the liquidity reserve was distributed in Aaa and Aa level entities. Of the investments, 80% was in securities issued by Nordic and German issuers. Kommuninvest has no exposure to US sub-prime investments, nor does it have positions in CDOs or ABSs.

Asset Quality

Sound credit risk supported by well-diversified asset quality

Kommuninvest's credit rests on the high quality of the local government sector that it serves. We view the Swedish local government sector as a stable, well-managed and appropriately funded sector.

- » *Reliable and flexible revenues.* The major revenues of local governments are income tax (which governments set independently), fees (generally at cost of services) and central government grants.
- » *Government oversight of sector promotes stability.* The equalisation of resources within the local government sector is strongly managed at the national level. Accounting standards are high and government oversight has historically been thorough. Reforms follow thorough consultation, with a principle of balancing funding and responsibilities noted in the constitution.
- » *Intervention when necessary.* The central government has acted strongly in periods of financial difficulty. There are no restrictions on the borrowings of local governments other than meeting prudential guidelines; in practice, borrowing is limited to capital expenditure and speculative financial activities are understood to be forbidden under the Local Government Act requiring 'economic management'.

Kommuninvest's loan exposures are well managed.

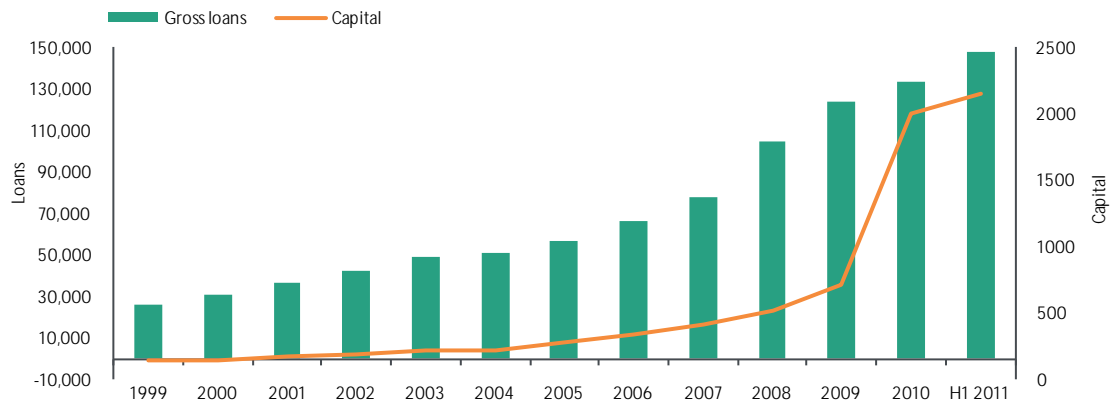
- » *Loans only within the sector.* Kommuninvest's bylaws require that it lend only to local governments that are members of the society or to entities guaranteed by such local governments. Around 38% of its portfolio consists of loans to members. Municipal housing companies account for around 39% and other companies with municipal guarantees account for 22%. In cases of privatisation, any outstanding loans must be repaid.
- » *Good diversification within the sector.* The largest individual borrower constitutes 3.3% of total lending, signifying limited concentration risk. The top 10 borrowers make up 24% of the loan portfolio.
- » *Credit reviews.* Kommuninvest reviews members' credit at least twice a year and may expel a member for not meeting its credit requirements; to date this has not proved necessary.

² The size of the secondary reserve is residual to the primary reserve and the investment portfolio. 50% of the assets in the secondary reserve should be repo eligible with the Swedish Riksbank. The investment portfolio is limited to a maximum of 10% of the total balance sheet and 25% of the portfolio should be repo eligible with the Swedish Riksbank.

- » *Direct charges to many members.* Kommuninvest can draw scheduled payments directly from the accounts of around 78% of its members.

Kommuninvest's outstanding loans totalled SEK147.9 billion at mid-year 2011, a 15.0% increase from SEK128.8 billion in June 2010. Since year-end 2007, lending has increased 89.8%.

EXHIBIT 3
Gross loans and capital (SEK millions)



Source: Kommuninvest AB

Risk Positioning

Governance structure is effective

The Kommuninvest Cooperative Society appoints eight members of the Board of Directors as well as the Chairman and Vice-Chairman. It also appoints the Audit Committee, which has the power to institute audits in addition to the statutory audit.

The board sets objectives and strategies for Kommuninvest's operations as well as its risk management (including market, liquidity, credit-related, counterparty and operational risks), its objectives for capital coverage and liquidity reserves. The board sets specific reporting against these objectives.

The President, as the Chief Executive Officer, is required to provide monthly written reports to the board, to supply information for board decisions and to inform the board continually about regulatory structures, audit reports and other significant events. The risk analysis department reports daily to the President and monthly to the board on market, liquidity, credit and counterparty risk.

Comprehensive asset-liability management

Kommuninvest's policies for hedging and for the diversification of counterparty risks have withstood unprecedented market volatility and preserved lending surpluses.

- » *Tightly limited interest rate exposure.* Exposure is managed on a portfolio basis and is limited to SEK10 million (equal to 1.7% of equity as of June 2011) for up to three days, produced by a 100bp shift in the yield curve. As of December 2010, the *ex ante* risk to the entire portfolio amounted to SEK8.3 million (0.9% of equity) as a 100bp parallel shift. Shorter duration exposures on investments has helped protect against the impact of spread changes in the balance sheet. See impact of market volatility in *Financial Position and Performance*, above.

- » *Highly rated investment counterparties.* Investments are limited to highly liquid government securities, financial institutions with government guarantees and financial borrowers with risk weightings of 0%, 10% or 20%. Ratings can be no lower than A level.
- » *Derivative contracts hedge investment and lending portfolios and cancel market risks on Kommuninvest's own borrowing.* Kommuninvest may not maintain open currency positions; foreign currency returns are converted to Swedish kronor, to match kronor lending. Hedging positions are regularly marked to market.
- » *Derivative counterparty ratings are high.* 51% of counterparties are rated Aa or above and all must be systemically important in the countries in which they are legally domiciled. As of June 2011, Kommuninvest has 20 credit support annexes (CSA) with its derivative counterparties, covering 68% of the credit risk exposure related to these CSA's.

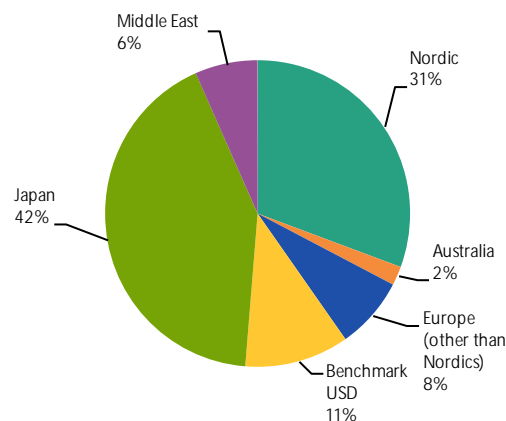
Market funding is derived from diversified sources

Kommuninvest has managed to lower its financing costs and provide substantial lending growth throughout the global financial crisis. In November 2010 Kommuninvest issued the first Swedish local government bonds, issuing a total of SEK15 billion through two bonds. We view this broadening of the investor base as a credit positive.

Like other specialised lenders, we view positively Kommuninvest's focus on diversified market funding sources. At times however, funding activities may be highly concentrated in specific countries, which could, were those markets to experience a downturn, narrow options.

EXHIBIT 4

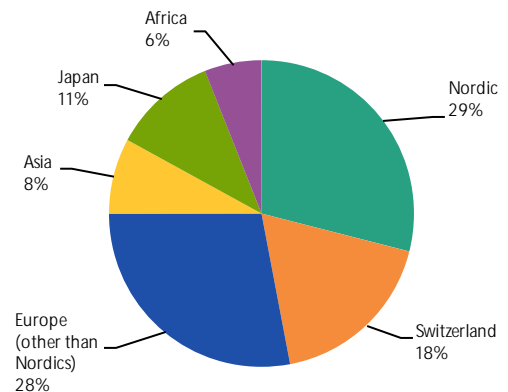
Borrowing per market, 2010



Source: Kommuninvest AB

EXHIBIT 5

Borrowing per market, 2009



Source: Kommuninvest AB

We regard Kommuninvest's global recognition as a borrower as its major strength and therefore believe that it must protect its standing in the market. Like most other specialised lenders, Kommuninvest can issue notes with more variable payments and widely changing market values, which may only be appropriate for sophisticated investors.

Operational risk management is adequate

Since Kommuninvest is a small monoline organisation, it has standardised most of its procedures and loan agreements to reduce risk and to promote efficiency. In order to provide more robust IT systems

and to reduce costs, Kommuninvest and its Norwegian counterpart Kommunalbanken have undertaken a joint venture, which has helped to reduce key person dependence.

Rating History

Kommuninvest i Sverige Aktiebolag AB

Date	Rating	
19-Jun-95	Aa3	Rating Assigned
04-Jun-98	Aa2	Rating Raised
24-Aug-99	Aa1	Rating Raised
11-Apr-02	Aaa	Rating Raised

Annual Statistics

Kommuninvest Cooperative Society Group

	31/12/2010	31/12/09	31/12/08	31/12/07	31/12/06
Summary Balance Sheet (SEK million)					
Cash & central bank	0	0	0	0	0
Due from banks	1,698	1,851	2,440	2,514	2,703
Securities	41,648	46,517	19,512	23,348	27,943
Gross loans	133,729	123,624	104,658	77,938	67,344
Loan loss reserves (LLR)	0	0	0	0	0
Insurance assets	0	0	0	0	0
Fixed assets	7	4	4	3	3
Other assets	13,119	11,001	16,124	6,115	4,545
Total assets	190,200	182,997	142,738	109,918	102,538
Total assets (USD million) [1]	27,960	25,372	18,412	16,995	14,920
Demand deposits	0	0	0	0	0
Savings deposits [2]	0	0	0	0	0
Due to banks	3,439	7,348	5,390	4,627	3,618
Market funds	173,852	164,696	126,106	93,561	88,212
Insurance liabilities	0	0	0	0	0
Other liabilities	10,906	10,232	10,729	11,316	10,367
Total liabilities	188,197	182,276	142,226	109,505	102,198
Subordinated debt	1,003	0	0	0	0
Shareholders' equity	1,000.7	720.7	512.8	413.0	340.2
Total capital funds	2,004	721	513	413	340
Total liabilities & capital funds	190,200	182,997	142,738	109,918	102,538
Derivatives - notional amount	295,240	282,959	237,351	198,606	169,733
Derivatives - replacement value	--	--	--	2,133	8,368
Contigent liabilities	--	--	--	514	1,185
Risk weighted assets (RWA)	2,346	1,488	1,516	2,714	1,569
Assets under management (SEK million) [3]					--
Number of employees	53	49	41	37	38

Kommuninvest Cooperative Society Group

	31/12/2010	31/12/09	31/12/08	31/12/07	31/12/06
Summary Income Statement					
+Interest income	3025.0	3339.7	4727.2	3792.7	3216.4
-Interest expense	2593.0	2957.6	4575.1	3713.1	3116.2
=Net interest income	432.0	382.1	152.1	79.6	100.2
+Trading income	0.0	0.0	0.0	0.0	0.0
+Fees & commissions	-4.4	-3.5	-3.6	-3.1	-4.1
+Insurance income (net)	0.0	0.0	0.0	0.0	0.0
+Other operating income	17.5	-50.7	13.9	34.8	13.7
=Operating income	445.1	327.9	162.4	111.3	109.8
-Personnel expenses	58.4	49.7	44.3	36.5	32.9
-Other operating expenses	108.3	82.9	41.5	42.5	45.3
= Operating funds flow	278.4	195.3	76.6	32.3	31.6
-Amortisation/depreciation	2.7	1.8	1.6	1.6	2.1
(Total operating expenses)	169.4	134.4	87.4	80.6	80.3
=Preprovision income (PPI)	275.7	193.5	75.0	30.7	29.5
-Loan loss provisions (LLP)	0.0	0.0	0.0	0.0	0.0
+Other non operating adjustments [4]	-83.2	-82.5	-11.6	0.5	-3.6
+Extraordinary profit / loss	0.0	0.0	0.0	0.0	0.0
=Pretax income	192.5	111.0	63.4	31.2	25.9
-Taxes	51.9	44.7	19.2	7.1	8.0
=Net income	140.6	66.3	44.2	24.1	17.9
-Minority interests	0.0	0.0	0.0	0.0	0.0
=Net income (group share)	140.6	66.3	44.2	24.1	17.9
Growth Rates (%)					
Gross loans	8.17	18.12	34.28	15.73	18.69
Total assets	3.94	28.20	29.86	7.20	12.50
Customer deposits (demand and savings)	--	--	--	--	--
Net interest income	13.05	151.28	91.02	-20.56	-14.71
Fee and commission income	--	--	--	--	--
Operating expenses	26.03	53.82	8.47	0.32	30.36
Preprovision income	42.50	157.98	144.28	4.06	-47.29
Net Income	112.16	49.92	83.22	34.92	-43.37
Income Statement In % Average Risk Weighted Assets					
Net interest income	22.54	25.44	7.19	3.72	6.29
Trading income	0.00	0.00	0.00	0.00	0.00
Fee and commission income	-0.23	-0.23	-0.17	-0.15	-0.26
Insurance income	0.00	0.00	0.00	0.00	0.00
Operating income	23.22	21.83	7.68	5.20	6.89
Operating expenses	8.84	8.95	4.13	3.76	5.04

Kommuninvest Cooperative Society Group

	31/12/2010	31/12/09	31/12/08	31/12/07	31/12/06
Preprovision income	14.38	12.88	3.55	1.43	1.85
Loan loss provisions	0.00	0.00	0.00	0.00	0.00
Extraordinary profit	0.00	0.00	0.00	0.00	0.00
Net income	7.33	4.41	2.09	1.13	1.12
Liquidity, Funding & Balance Sheet Composition					
Avg. liquid assets % avg. total assets	24.58	21.59	18.92	26.60	32.21
Avg. gross loans % avg. total assets	68.96	70.08	72.27	68.38	64.06
Avg. customer deposits % avg. total funding	0.00	0.00	0.00	0.00	0.00
Avg. interbank funds % avg. total funding	3.08	4.20	4.36	4.34	3.91
Avg. market funds (excl. interbank) % avg. total funding	96.63	95.80	95.64	95.66	96.09
Avg. sub debt % total funding	0.29	0.00	0.00	0.00	0.00
Avg. liquid assets % avg. customer deposits	--	--	--	--	--
Avg. gross loans % avg. customer deposits	--	--	--	--	--
Avg. market funds reliance [5]	95.84	96.81	93.19	86.17	89.44
Avg. RWA % avg. total assets	1.03	0.92	1.67	2.02	1.65
Breakdown of Operating Income In %					
Net interest income % operating income	97.06	116.54	93.65	71.55	91.26
Trading income % operating income	0.00	0.00	0.00	0.00	0.00
Fees & commissions % operating income	-0.99	-1.07	-2.24	-2.81	-3.72
Insurance income % operating income	0.00	0.00	0.00	0.00	0.00
Other operating income % operating income	3.93	-15.48	8.59	31.26	12.45
Profitability					
Yield on avg. earning assets (%)	1.73	2.24	4.10	3.76	3.45
Cost of interest bearing liabilities (%)	1.48	1.95	3.98	3.91	3.46
Net interest margin (%)	0.25	0.26	0.13	0.08	0.11
Recurring earning power (PPI % avg. assets)	0.15	0.12	0.06	0.03	0.03
Risk-weighted recurring earning power (PPI % avg. RWA)	14.38	12.88	3.55	1.43	1.85
Return on average assets (%)	0.08	0.04	0.03	0.02	0.02
Return on avg. RWA (%)	7.33	4.41	2.09	1.13	1.12
Return on equity (period end) (%)	14.05	9.19	8.62	5.84	5.26
Net interest income coverage of loan loss provisions	--	--	--	--	--
Loan loss provisions % preprovision income	0.00	0.00	0.00	0.00	0.00
Internal capital growth (%)	19.51	12.92	10.70	7.09	6.23
Dividend payout ratio (%)	0.00	0.00	0.00	0.00	0.00
Efficiency					
Cost/total assets	0.09	0.07	0.06	0.07	0.08
Cost/income ratio (operating expenses / operating income)	38.1	41.0	53.8	72.4	73.1
Operating expenses % average assets	0.09	0.08	0.07	0.08	0.08
Operating income / employee (SEK thousand)	8,398	6,692	3,961	3,007	2,890

Kommuninvest Cooperative Society Group

	31/12/2010	31/12/09	31/12/08	31/12/07	31/12/06
Operating expenses / employee (SEK thousand)	3,196	2,743	2,131	2,177	2,113
PPI / employee (SEK thousand)	5,202	3,949	1,829	830	776
Total assets / employee (SEK million)	3,589	3,735	3,481	2,971	2,698
Capital Adequacy (Period End)					
Tier 1 ratio (%)	46.6	28.4	26.8	15.0	18.8
Total capital BIS ratio (%)	80.5	45.9	32.9	14.8	21.0
Shareholders' equity % total assets	0.53	0.39	0.36	0.38	0.33
Equity participations % shareholders' equity	1.1	0.0	0.0	0.0	0.0

[1] USD figure uses historical exchange rate against the SEK.

[2] Full disclosure may not be available for all years. The amount is then included in "demand deposits".

[3] As reported by the bank

[4] This may include value adjustments of securities.

[5] Avg. [(market funds-liquid assets) % (earning assets-liquid assets)]

Moody's Related Research

Banking System Outlook:

- » [Sweden, March 2010 \(123463\)](#)

Banking Statistical Supplement:

- » [Sweden, July 2009 \(119136\)](#)

Special Comments:

- » [Specialised Lenders To Nordic Local Governments, August 2006, \(98800\)](#)
- » [Government Related Issuers: May 2007 Update, March 2005 \(102945\)](#)
- » [Rating Impact of 'GRI' Methodology for Non Depository Financial Institutions in the EMEA Region, June 2005 \(93349\)](#)

Analysis:

- » [Sweden, Government of, 5 December 2008 \(112502\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Report Number: 135840

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