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Municipality Finance And Municipal Guarantee Board

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Municipality Finance And Municipal Guarantee Board

Credit Highlights

Issuer Credit Rating
AA+/Stable/A-1+

Overview

Enterprise risk profile	Financial risk profile
The enterprise risk profile of Municipality Finance (MuniFin) and the Municipal Guarantee Board (MGB), creating a de facto group, is supported by a clearly defined public policy mandate and a strong market position.	The group's risk-adjusted-capital (RAC) ratio remains very robust in a Nordic peer comparison.
The implementation of the Social and Healthcare (SOTE) reform has had a significant impact on the local and regional government sector in Finland, but the group's lending exposure risks remain low.	The liquidity position remains strong, supported by ample buffers and broad access to external funding channels.
We believe the group's credit quality is supported by a highly competent management team, demonstrated by comprehensive risk management policies and sophisticated funding strategies.	The structural funding gap we observed before 2021 has disappeared, as demonstrated by the one-year assets-to-liabilities ratio being above 1.0x

The group's strong public-policy mandate and competitive market position remains intact after the implementation of the SOTE reform. As of Jan. 1, 2023, the responsibility for organizing health care and social services has been transferred to the newly created wellbeing services counties, which are classified as zero risk-weight exposures according to the Finnish Financial Supervisory Authority (FIN-FSA). Consequently, we do not believe that risks in MuniFin's lending have increased. For now, the central government is responsible for financing the counties, but they might be granted taxation powers in the future. However, this would require a major overhaul of the current taxation system. Overall, the reform itself does not materially affect MuniFin's strong market position and favorable business prospects.

Excellent risk capitalization, diversified funding sources, and central bank access support the group's financial risk profile. The group remains very well capitalized, demonstrated by an adjusted RAC ratio of 37.4% as of June 2023. Its funding and liquidity position is supported by the close matching of assets and liabilities, ample liquidity buffers, and central bank access. Furthermore, MuniFin benefits from a strong presence in the capital markets, allowing for a broad and reliable funding strategy.

We believe that the group would receive timely and extraordinary support from its municipal owners if needed. The group enjoys municipal sector support through a joint and pro rata guarantee commitment from the MGB. The guarantee rests on an extensive and permanent membership base and the members are bound by a joint pro rata liability mechanism.

Outlook

The stable outlook reflects our expectation that the guarantee mechanism will not change. In addition, we expect that the creditworthiness of the underlying municipal and social housing sectors will remain high, as long as MuniFin upholds its solid financial risk profile. Our view of the group's strong public policy mandate will likely remain unchanged.

Downside scenario

We could lower the ratings over the next 24 months if the credit quality of the underlying municipal stakeholders deteriorates materially. Pressure on the ratings would also build if MuniFin's business position weakened, for instance from a reduced ability to execute its public policy mandate efficiently throughout the economic cycle.

Upside scenario

We could raise the ratings if the underlying credit quality of the Finnish municipalities constituting the supporting group were to improve. In addition, an upgrade would require a similar rating action on the sovereign.

Rationale

Enterprise risk profile: Strong market position combined with low-risk lending activities

- MuniFin's critical policy role as funding provider to the municipal sector remains intact amid macroeconomic headwinds and volatile market conditions.
- The public sectors to which MuniFin lends have very strong credit quality owing to Finland's strong economic fundamentals and well-developed financial sector, and the government guarantees the group's social housing lending.
- In our view, the group benefits from proactive, competent, and risk-averse management, which ensures compliance with regulatory requirements and continued execution of the public-policy mandate.
- Despite structural demographic challenges in Finland, illustrated by a weakening dependency ratio, combined with inflationary pressure, we expect the local and regional government sector will maintain sound budgetary performance, underpinning the strong credit quality of MuniFin's lending portfolio.

MuniFin and MGB comprise the funding system for Finnish local and regional governments (LRGs). Given the institutionalized links and close integration between the two, we consider them a de facto group. MuniFin's lending and funding activities dominate the group's operations, so our assessment of the group's enterprise risk is primarily based on MuniFin's credit features.

We consider MuniFin core to the group because it carries out all lending and funding activities, and plays an important role in providing financing to Finland's municipalities, wellbeing services counties, and non-profit housing organizations, the latter of which benefit from guarantees extended by Finland's central government. MuniFin has close links with the LRG sector, as well as the central government, illustrated by its lending mandate and the statutes that govern it. We also consider MGB core to the group, and a crucial component of Finland's joint LRG and social housing funding system. The LRG sector's guarantees of MuniFin's financial liabilities are provided through MGB.

MuniFin's market position has gradually strengthened in recent years, especially since the outbreak of the pandemic, while other credit institutions have had limited presence in local government financing. We expect MuniFin's competitiveness vis-à-vis other financiers in the market will remain strong.

On Jan. 1, 2023, the Social and Healthcare (SOTE) reform was implemented after many years of discussion and preparation, bringing to life a third tier of government comprising 21 wellbeing services counties and the city of Helsinki. Financially, the reform has had a significant impact on the local government sector's financial statements as cash flows, assets, and debt have been transferred between entities.

Notably, the municipal sector's revenue base has been roughly halved whereas the aggregated loan stock has not decreased to the same extent. Consequently, the relative debt burden in the sector has structurally increased. That said, the transfer of health care and social services to the counties means that municipalities will no longer be exposed to spending pressures within these responsibility areas.

We expect the municipalities' operating margins will remain relatively stable as the revenue base shrinks, translating into structurally improved performance metrics across the board. Overall, the Finnish LRG sector exhibits structural features that support a high credit standing, such as the wealthy economy, advanced financial system, and strong links between the LRG sector and the sovereign. Because of this, and the clarity we now have on the financial impact of this reform on the local government sector, we have revised the trend for the institutional framework for Finnish municipalities to stable from weakening.

That said, the wellbeing services counties have struggled financially during the first months of their existence, partly due to inflationary cost pressure and a healthcare backlog related to the pandemic. Given that the central government is responsible for funding the newly created entities, the counties have limited flexibility to raise revenue to reach a balanced budget. We believe, though, that the central government is committed to supporting the sector, and that the relatively weak financial performance is a result of external factors rather than underlying structural or organizational deficiencies.

As a result of the reform, about 10% of the loan portfolio is now linked to the wellbeing services counties. That said, given that these exposures are also classified as having a zero risk-weight, this has not increased risks in the portfolio. Furthermore, because the counties are not members of the MGB at this stage and therefore remain outside the guarantee system, the MGB has imposed an annual cap on MuniFin's lending to these entities. For 2023, the cap for long-term loans was €400 million earmarked for new investments and €900 million for short-term liquidity needs. As part of its budget for 2024, the MGB does not suggest any changes to the annual lending caps.

MuniFin's role as primary financier of the Finnish municipal sector has strengthened further in 2023. In light of the challenging market environment, other credit institutions have played a limited role in financing LRGs and the state-subsidized housing sector. Municipal finances have remained relatively strong, bolstered by extraordinary tax benefits partly related to the SOTE reform. On the other hand, higher inflation and interest rates have put pressure on the sector's performance margins. Investment needs for core infrastructure remain sizeable and, despite challenging times ahead, there are no indications of a significant slowdown in capital expenditure. Many municipalities view their planned investments as more or less mandatory, meaning that demand for financing remains high.

For state-subsidized housing, inflated construction costs led to a significant slowdown in new construction between fourth-quarter 2022 and second-quarter 2023. Since then, construction costs have started to come down, leading to more project approvals and ultimately demand for MuniFin's services. About 49% of MuniFin's loans are directed to the housing sector, carrying central government deficiency guarantees. This gives uplift to our public sector industry and country risk assessment (PICRA), attributable to MuniFin's lending operations to the housing sector.

We view MuniFin's overall risk and financial management, and by extension, that of the group, as very strong. European Central Bank (ECB) supervision and bank regulation play an important role in forming the agency's internal risk management policies, and MuniFin is proactive in managing its regulatory requirements. MuniFin also has robust frameworks for assessing the credit quality of its lending counterparties, and managing other risks.

Financial risk profile: Very strong capitalization and comprehensive access to the Eurosystem

- The group has very strong capital ratios, both in a regulatory context and according to our risk-adjusted capital (RAC) ratios.
- Central bank access supports MuniFin's strong liquidity position.
- The one-year assets-to-liabilities funding ratio remains above 1.0x.

The group has a very strong capital position with almost all capital reported on MuniFin's balance sheet. Our RAC ratio before adjustments for the group has increased to 75.2% as of June 2023, compared to a year before. After adjustments, in particular for single-name concentrations, the RAC ratio is still extremely strong at 37.4% and comfortably above our 15% threshold. MuniFin also has a robust CET1 capital ratio of 101.3% as of June 2023. This is largely due to the zero-risk weight applied to MuniFin's loans. Overall, we believe the group has a very robust capital position, and stronger than that of Nordic peers.

We view the group's liquidity position as strong. Although MuniFin is exposed to risks through its dependence on wholesale market funding, this is mitigated by prudent liquidity policies, significant levels of high-quality pre-funding, and access to financing from the Finnish central bank, which is a part of the Eurosystem. We continue to assess MuniFin's status as a central bank counterparty and its access to liquidity from the central banking system as a distinguishing strength. In August 2019, the ECB revised its guidelines for collateral eligible for repurchase agreement purposes, which restored a significant part of MuniFin's municipal lending assets as eligible collateral. In addition to a large part of its municipal loan book, the vast majority of its securities portfolio is eligible as collateral for repurchase agreement transactions with the central bank.

MuniFin conducts active asset and liability management, but the size of its balance sheet and strategies to optimize its financial position result in occasional volatility of its liquid assets. MuniFin has recently maintained higher liquidity buffers as a precaution. Consequently, we believe the coverage ratios could be somewhat inflated. That said, MuniFin has taken steps to structurally improve its liquidity position, partly by extending the survival horizon. Our liquidity sources-to-uses ratio indicates that MuniFin will comfortably meet its financial obligations over a one-year period, factoring in stressed market conditions.

MuniFin has established debt programs and is a regular benchmark issuer, with a well-diversified funding profile in terms of markets, currencies, regions, maturities, and investor types. Since 2016, MuniFin has also issued green bonds, which has further expanded its investor base. In 2020, MuniFin also ventured into the themed bond space and issued its inaugural social bond, becoming the first Nordic entity in the sovereigns, supranationals, and agencies category to do so. We expect green and social bonds will play an increasingly important role in MuniFin's funding strategy. The Finnish Financial Supervisory Authority considers bonds issued by MuniFin to be high-quality Level 1 liquid assets.

We view MuniFin's management of its structured funding portfolio as prudent and note that the agency accepts no market risk. Derivative contracts include stipulations for a two-way credit support extension, and the agency prudently accounts for collateral flows in its regular funding activities. However, the importance of structured funding has decreased in recent years and in 2023 only 3% of new funding can be considered structured, due to the possibility of early redemption. This drop can partly be attributed to MuniFin's decision to, at least temporarily, leave the structured Japanese Uridashi market. In 2023 it has focused instead on plain vanilla benchmark funding, a trend that we expect will continue in 2024. In our view, the diminishing share of structured funding is positive because it allows the agency to focus more on its core markets.

In the years leading up to 2021, MuniFin operated with a funding gap as illustrated by our one-year assets-to-liabilities ratio of below 1.0x. Since then, the funding ratio has stabilized above the 1.0x threshold. The average maturity of the funding portfolio has increased somewhat and we expect it could increase further, supporting our neutral assessment.

Likelihood of extraordinary support: Extremely high via a joint and pro rata sector guarantee mechanism

- Under the joint guarantee scheme that operates through MGB, we expect that potential supporting members, with creditworthiness in line with that of the sovereign, will have a strong incentive to provide timely extraordinary support to the group if needed.
- Our view of an extremely high likelihood of extraordinary support from the main supporting entities stems from our assessment of the group's integral link with and very important role for local governments.
- The newly created wellbeing services counties are now up and running, but have not become MGB members yet despite being classified as zero-risk-weight exposures.

The group benefits from a joint and pro rata guarantee commitment from the municipal sector through MGB. The guarantee rests on an extensive and permanent membership base, and the members are bound by a joint pro rata liability mechanism. MGB was set up by law, which ensures its long-term existence, and its sole purpose is to guarantee funding to the municipal sector and affiliates. Since the inception of the joint funding system for Finnish municipalities, MuniFin has been the only entity to meet the criteria set out in the MGB Act, and we do not expect this will change.

The Finnish Financial Supervisory Authority (FIN-FSA) has established that the counties be classified as zero-risk weight exposures. As a result, no central government guarantee is required to finance these entities. That said, the newly created counties have not become members of the MGB at this stage and so are not part of the guarantee system. Consequently, the MGB has imposed an annual lending cap on MuniFin's funding to these entities. As part of its budget for 2024, the MGB does not suggest any changes to the annual lending caps. Furthermore, as long as the counties remain non-members of the MGB, and hence remains outside the joint guarantee system, we expect lending caps will remain in place.

Future MGB membership for the counties is under consideration by the Ministry of Finance and the MGB. We believe the counties could become MGB members at some point.

We assess the guarantees as predictable and immediately enforceable by law, which underpins our assessment of an integral link between the group and its municipal stakeholders. We believe MuniFin has a very important role in providing cost-efficient funding to the sector.

Although the main group of supporting members is ultimately liable for only a portion of the group's debt, the initial claims on the guarantees are unlimited. We therefore believe there is a very strong incentive for these supporting members to provide extraordinary support to the group if it experiences financial stress, and before the guarantees are called, preventing a default.

In addition to the extraordinary support from MGB members, the central government is another possible support channel. Furthermore, there are ongoing discussions, albeit at an early stage, about creating a model in which new government-controlled entities could be established to carry out large-scale infrastructure investments, mainly related to the railway network. In connection with this initiative, the program outlines the possibility of MuniFin taking part in the financing of these entities via amendments to the MGB Act.

We consider these statements an indication of the central government's recognition of the efficiency and importance of the joint funding system for municipalities and its benefits for the central government. Nevertheless, we believe the infrastructure projects will only materialize over the medium to long term. However, it could eventually strengthen the group's link to the central government.

Key Statistics

Municipality Finance PLC--Selected Indicators

(mil. €)	2023 H1	2022 H1	2021 H1	2020 H1	2019 H1
Business position					
Total adjusted assets	48,377	47,491	45,658	41,288	36,956
Customer loans (gross)	30,130	28,831	28,582	26,743	23,719
Growth in loans (%)	4.50	0.87	6.88	12.70	3.30
Net interest income	124	122	138	123	117
Non interest expenses	41	40	31	29	29
Capital and risk position					
Total liabilities	46,753	46,010	43,865	39,678	35,450
Total adjusted capital	1,627	1,532	1,427	1,235	1,125
RAC before diversification (%)	75.20	68.90	69.10	54.7%	50.6%
RAC after diversification (%)	37.40	37.80	36.30	31.4%	31.2%
Gross nonperforming assets/gross loans (%)	0.10	0.10	0.10	0.1%	0.1%

Municipality Finance PLC--Selected Indicators (cont.)					
(mil. €)	**2023 H1**	**2022 H1**	**2021 H1**	**2020 H1**	**2019 H1**
Funding and liquidity (x)					
Liquidity ratio with loan disbursement (1 year)	1.06	1.25	1.27	0.97	0.78
Liquidity ratio without loan disbursement (1 year)	1.16	1.28	1.32	1.21	1.04
Funding ratio (1 year)	1.0	1.08	1.08	0.99	0.84

*Ratio computed with data as per June 30

Ratings Score Snapshot

Municipality Finance PLC

Issuer Credit Rating: AA+/Stable/A-1+

Group credit profile: aa+

Enterprise risk profile: Very strong (1)

- PICRA: Very strong (1)
- Business position: Strong (2)
- Management and governance: Very strong (1)

Financial risk profile: Strong (2)

- Capital adequacy: Very strong (1)
- Funding and Liquidity: Neutral and strong (2)

Support: +1

- GRE support: +1
- Group support: 0

Additional factors: 0

SACP: aa

- Group status: Core
- Likelihood of support: Extremely high (+1 notch)

Municipal Guarantee Board

Issuer Credit Rating: AA+/Stable/A-1+

- Group Credit Profile: aa+
- Group status: Core

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- 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: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Finland 'AA+/A-1+' Ratings Affirmed; Outlook Stable, Oct. 27, 2023
- Institutional Framework Assessment: Finnish Municipalities, Dec. 13, 2022

This report does not constitute a rating action.

Ratings Detail (As Of December 12, 2023)*		
Municipality Finance PLC		
Issuer Credit Rating		AA+/Stable/A-1+
Senior Unsecured		AA+
Issuer Credit Ratings History		
30-Sep-2016	*Foreign Currency*	AA+/Stable/A-1+
13-Oct-2015		AA+/Negative/A-1+
14-Oct-2014		AA+/Stable/A-1+
30-Sep-2016	*Local Currency*	AA+/Stable/A-1+
13-Oct-2015		AA+/Negative/A-1+
14-Oct-2014		AA+/Stable/A-1+
Related Entities		
Municipal Guarantee Board		
Issuer Credit Rating		AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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