Research Update:

Ratings On Finland-Based Municipality Finance And Municipal Guarantee Board Affirmed At 'AA+/A-1+'; Outlook Stable

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Overview

- The Social and Healthcare (SOTE) reform, the implementation of which will bring about a third tier of government in Finland, was approved by the Parliament in June 2021.
- The ratings on Municipality Finance and Municipal Guarantee Board are supported by the robust risk-adjusted capital position, reliable access to the central bank, and very competent management.
- In light of an extended maturity profile in the debt portfolio, the one-year assets-to-liabilities funding ratio has strengthened above 1.0x.
- We affirmed our 'AA+/A-1+' long- and short-term issuer credit ratings on Municipality Finance and Municipal Guarantee Board.
- The outlook is stable.

Rating Action

On Dec. 17, 2021, S&P Global Ratings affirmed its 'AA+' long-term and 'A-1+' short-term issuer credit ratings on Finnish local government funding agencies Municipality Finance PLC (MuniFin) and Municipal Guarantee Board (MGB). The outlook on each is stable.

At the same time, we affirmed our 'A-' long-term issue rating on MuniFin's subordinated debt.

Rationale

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, and assess the group credit profile (GCP) at 'aa+'. MuniFin's lending and funding activities dominate the group's operations, so our assessment of the group's enterprise risk is primarily based on the organization's credit features. Our financial risk profile analysis covers the combined entity.

We believe the group has a very strong enterprise risk profile and a strong financial risk profile. These assessments reflect our view of the group's strong market position, supported by highly creditworthy borrowers. In addition, the group has excellent risk-adjusted capitalization (RAC) and strong liquidity, underpinned by reliable central bank access. Moreover, we see an extremely high likelihood of the group receiving extraordinary financial support from its local government shareholders via MGB, should it experience financial stress. This lifts the GCP to 'aa+'.

We consider MuniFin core to the group, because it conducts all lending and funding activities and plays a key role in the joint municipal funding system for Finland's local governments. Its primary function is to provide cost-efficient funding to the Finnish municipal and social housing sectors, with the latter benefitting 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 municipal funding system for municipalities. The LRG sector's guarantees of MuniFin's financial liabilities are provided through MGB.

We continue to assess MuniFin's stand-alone credit profile (SACP) at 'aa'. The 'A-' rating on the entity's subordinated additional Tier 1 (AT1) instrument continues to stand four notches below MuniFin's SACP.

Enterprise risk profile: MuniFin's critical policy role as funding provider to the LRG sector has remained intact throughout the pandemic, while extensive central government support has mitigated the financial pressure on Finnish municipalities.

- 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.
- The group has proactive, competent, and risk-averse management, which assures compliance with regulatory requirements and continued execution of the public-policy mandate.
- The Finnish municipal sector faces structural demographic challenges, illustrated by a weakening dependency ratio, while the implementation of the SOTE reform will test the financial performance of municipalities since largely similar debt stocks will be serviced on the back of a reduced tax base.

Since MuniFin's activities dominate the group's operations, our enterprise risk profile analysis is based on the credit features of that organization. MuniFin's mission is to ensure reliable and cost-efficient funding to Finnish municipalities and joint municipal authorities, municipal companies, and state- and municipality-guaranteed housing entities. The organization's market position has gradually strengthened in recent years and we estimate that the entity's lending accounts for about 65% of its eligible markets. Furthermore, in the fall of 2021, MuniFin implemented changes to the conditions of its long-term loans with variable interest rates so that customers will benefit from negative reference rates more than previously. These revisions will likely further strengthen MuniFin's competitiveness vis-à-vis other financiers present in the market.

On June 23, 2021, after many years of discussion, the SOTE reform was passed in the Finnish

Parliament with a margin of 105 votes to 77 and no abstentions. The reform will introduce a third tier of government, comprising 21 wellbeing service counties plus the city of Helsinki, and enter into force by early 2023. The aim of the reform is to address nationwide inequalities in access to quality health, social, and rescue services. The creation of a new tier of government will have a significant impact on the LRG sector's financial statements since cash flows, assets, and debt will be transferred between entities. At this point, it is difficult to assess how the reform will affect the financial position of the sector once it is fully implemented, but we expect that the central government will put the sector's financial sustainability at the top of the political agenda. That said, we believe Finnish municipalities face structural challenges to their long-term budgetary performance. These include underlying mismatches in revenue and expenditure that emanate from urbanization patterns, coupled with an aging population, aspects that present systemic challenges, partly through eroded local tax bases. Consequently, we assess our institutional assessment for Finnish LRGs as on a weakening trend. Prolonged negative budgetary deviations, if unaddressed, could put into question the framework's robustness and add pressure on our public industry country risk assessment (PICRA) and the enterprise risk profile.

For MuniFin and MGB, an important part of the reform concerns the risk weight that will be applied for the lending to wellbeing service counties. A zero-risk weight would imply the new entities could be easily admitted as members of the MGB group, and allow all of MuniFin's services to be available for the new counties. The Finnish Financial Supervisory Authority (FIN-FSA) has recently put forward a proposal to treat the counties as zero-risk weight exposures, in line with those in the municipal sector. The deadline for submitting feedback is Dec. 22, 2021, and we expect resolution shortly thereafter.

MuniFin's role as primary financier of the Finnish municipal sector has been on display since the pandemic took hold in the first half of 2020, when demand for financing grew rapidly as a result of municipalities proactively acquiring their budgeted 2020 loan volumes in advance. However, in line with the relatively speedy economic recovery in Finland, the municipal sector's demand for new financing has returned to more moderate levels. At the same time, the central government has implemented unprecedented support packages to combat the financial impact of the pandemic, mitigating the borrowing needs in the municipal sector. That said, when the temporary COVID-19-related support comes to an end, we expect the borrowing projections will return to the long-term debt trajectory, underpinned by high investment needs, a significant share of which stems from changing demographic structures and a deteriorating dependency ratio. 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.

In contrast to the volatile demand for municipal sector financing, the demand for state-subsidized housing financing has remained stable throughout the pandemic, reflecting the limited impact of COVID-19 on these organizations' financial operations. About 47% of MuniFin's loans are directed to the housing sector, carrying central government deficiency guarantees. This gives an uplift in our PICRA attributable to MuniFin's lending operations to the housing sector. Furthermore, the competition in the housing sector is limited, and in October 2021 Handelsbanken, one of the active funding providers in the sector, announced its intention to withdraw from the market.

Following the outbreak of COVID-19, MuniFin experienced a temporary surge, albeit from low levels, in requests for payment holidays coming almost exclusively from municipal-owned companies. Since then, the number of requests has returned to pre-pandemic levels; in 2021, the group has only granted a few concessions and the expected credit loss according to the IFRS 9 framework is negligible. Consequently, we do not believe the increase in payment holiday requests during the second quarter of 2020 represents a structural deterioration in asset quality, but rather a temporary spike caused by extraordinary circumstances.

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. In this regard, we observe that the entity issued an additional tier 1 (AT1) instrument in 2015 to address the potential effect of the proposed leverage ratio requirement. We consider it important that this instrument does not allow for conversion into equity.

In June 2021, the Capital Requirements Regulation II (CRR II) entered into force, introducing a binding leverage ratio requirement of 3%. Under the updated framework, MuniFin fulfills the requirements for being categorized as a public development credit institution, meaning that all credit receivables from the central government and municipalities can be deducted in the leverage ratio computation. Consequently, MuniFin's leverage ratio increased dramatically overnight to 12.6%, which can be compared with 3.9% 12 months prior. In contrast, as a result of the regulation's updated approach for measuring counterparty credit risk and credit valuation adjustment risk, MuniFin's common equity Tier 1 (CET1) and total capital ratios deteriorated somewhat. That said, in comparison with minimum capital requirements, the group's capital adequacy remains very strong.

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

- The group has very strong capital ratios on the back of capital strengthening in recent years.
- Central bank access supports MuniFin's strong liquidity position.
- The one-year assets-to-liabilities funding ratio has strengthened and now exceeds 1.0x.

The group has a very strong capital position, as almost all capital is reported on MuniFin's balance sheet. MuniFin has a robust CET1 capital ratio, which stood at 91.1% as of June 2021. This is largely due to the zero-risk weight applied to its loans, but also strong levels of retained earnings. Our RAC ratio before adjustments for the group has strengthened since the previous review and amounted to a very strong 69.1% on June 30, 2021. After adjustments, in particular for single-name concentration, the RAC ratio is still extremely strong at 36.3%. Going forward, we expect both ratios will remain comfortably above our 15% threshold.

We assess the residual life of MuniFin's €350 million AT1 instrument at less than four years. We believe it has limited equity content according to our methodology, and therefore exclude it from our total adjusted capital (TAC) figure. As we perform the analysis on a group basis, we include MGB's equity in our TAC calculation. However, the added equity has little effect due to the dominance of MuniFin's financial operations within the group.

We view the group's liquidity position as strong. Although MuniFin is exposed to risk through its dependence on wholesale market funding, this is mitigated by prudent liquidity policies, significant levels of high-quality prefunding, and comprehensive access to financing from the Finnish central bank. 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 eligibility guidelines for collateral eligible for repurchase agreement purposes, which has 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. The size of its balance sheet and strategies to optimize its financial position result in occasional volatility in liquid assets. In June 2021 (our latest data for the liquidity coverage ratio), MuniFin held a higher share of short-term liquidity--almost exclusively central bank deposits--compared with the end of 2020. In the first half of the year, MuniFin maintained higher cash holdings than expected due to the low spread environment, resulting in stronger liquidity ratios compared with 12 months ago. However, we believe that the improvement could be temporary since short-term liquidity is set to decrease toward the end of 2021. Our liquidity sources-to-uses ratio indicates that MuniFin will 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, it 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. Going forward, we expect green and social bonds will play an increasingly important role in MuniFin's funding strategy. The Finnish Financial Supervisory Authority regards bonds issued by MuniFin as high-quality Level 1 liquid assets.

MuniFin's diverse funding options also benefit from central bank options. In June 2021, the company participated in the ECB's third series of targeted long-term refinancing operations (TLTRO III), acquiring €750 million, bringing the total amount of such funding to €2 billion (about 5% of total funding in June).

Although MuniFin primarily issues standard funding instruments, structured funding represents about 23% of its debt portfolio. Between 2015 and 2019, the share of structured funding diminished significantly, and has remained relatively stable since then. We view MuniFin's management of its structured funding portfolio as prudent, and 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.

We now assess MuniFin's funding position as neutral rather than negative. In the last 12 months, the funding gap for MuniFin, as illustrated by our one-year assets-to-liabilities ratio of below 1.0x, has disappeared. In recent years, the ratio has shown a positive trend and sat at 1.08x in June 2021. The average maturity of the funding portfolio has increased somewhat and the internal target for 2022 is to extend the maturities even further.

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 legislated county tier is on track for zero-risk weighted status, enabling frictionless entrance into the MGB framework.

The group enjoys municipal sector support through 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 Act on MGB, and we do not expect this will change in the near future.

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. At the same time, 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 liabilities, 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 terms of the SOTE reform, the issue regarding risk weighting associated with exposures to wellbeing service counties is key for determining their future membership of MGB. In a regulatory context, a zero-risk weight is a requisite for being able to become a member of MGB and borrow from MuniFin. The Finnish Financial Supervisory Authority (FIN-FSA) has recently put forward a proposal to treat the counties as zero-risk weight exposures, in line with municipalities, and we expect the issue will be resolved shortly.

In addition to the extraordinary support coming from the local government and MGB members, the central government's direct ownership in the group limits risk by providing an additional prospective support channel. Finland's government, in office since June 2019, has moved the ownership steering of MuniFin from the Ministry of Finance to the Prime Minister's Office. Furthermore, the government program outlines plans for creating a model in which new government-controlled entities could be established for the purposes of large-scale infrastructure investments, in practice railways. In connection with this initiative, the program outlines the possibility of financing 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 relevant infrastructure project will only materialize over the medium term, because the portfolio of the projects is large and will require government preparation. However, it could eventually strengthen the group's link to the central government.

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 while MuniFin upholds its solid financial risk profile. At the same time, we expect that our view of the group's strong public policy mandate will 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. This deterioration could emanate from lessened central government engagement to the sector leading to a lowered institutional framework assessment. 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.

Key Statistics

Municipality Finance PLC--Selected Indicators

				-- Year ended Dec. 31--	
(Mil. €)	**2021 H1**	**2020 H1**	**2019 H1**	**2018**	**2017**
Business position					
Total adjusted assets	45,658	41,288	36,956	35,677	34,738
Customer loans (gross)	28,582	26,743	23,719	22,968	21,651
Growth in loans (%)	6.88	12.70	3.30	6.10	2.15
Net interest revenues	138	123	117	236	229
Non interest expenses	31	29	29	47	41
Capital and risk position					
Total liabilities	44,213	40,025	35,450	34,538	33,746
Total adjusted capital	1,472	1,235	1,125	1,103	962
RAC before diversification (%)	69.1	54.7	50.6	39.2*	34.1*
RAC after diversification (%)	36.3	31.4	31.2	24.5*	21.1*
Gross nonperforming assets/gross loans (%)	0.1	0.1	0.1	0	0
Funding and liquidity (x)					
Liquidity ratio with loan disbursement (1 year)	1.27	0.97	0.78	0.83*	0.84*
Liquidity ratio without loan disbursement (1 year)	1.32	1.21	1.04	1.02*	1.01*
Funding ratio (1 year)	1.08	0.99	0.84	0.80*	0.75*

*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
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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, Sept. 6, 2021
- Institutional Framework Assessment: Finnish Municipalities, Dec. 21, 2020

Ratings List

Ratings Affirmed	
Municipal Guarantee Board	
Municipality Finance PLC	
Issuer Credit Rating	AA+/Stable/A-1+
Municipality Finance PLC	
Senior Unsecured	AA+
Subordinated	A-
Commercial Paper	A-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. 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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