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Ratings

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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 ratings on Municipality Finance and Municipal Guarantee Board are supported by the very strong risk-adjusted capital position, comprehensive access to the central bank, their strong market position, and very strong management.
- Despite a weakening financial trend for Finnish municipalities, the sector's credit quality remains high.
- We continue to assess both organizations as core entities in the joint Finnish public-sector funding system.
- We are therefore affirming 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. 20, 2019, 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 outlooks are 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 these two entities, we consider them to be a de facto group, and we assess the group credit profile (GCP) at 'aa+'. MuniFin's lending and funding activities dominate the group's operations, hence our assessment of the group's enterprise risk relies mainly on MuniFin's credit features. Our view of the financial risk profile stems from our analysis of the combined entity.

We believe the group has a very strong enterprise risk profile and a strong financial 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, complemented by comprehensive central bank access, which alleviate our concerns about a recurring structural funding gap.

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 to be core to the group, since it conducts all lending and funding activities and plays a key role in the joint municipal funding system for Finland's local governments. Its chief function is to provide efficient funding to the Finnish municipal sector and the social housing sector, guaranteed by the central government of the Republic of Finland. MuniFin has close links with the LRG sector, as well as with the central government, as shown by its lending mandate and the statutes that govern it.

We also consider MGB to be core to the group, and a crucial component of Finland's joint municipal funding system for LRGs. The LRG sector's guarantees of the group's financial liabilities are all provided through MGB.

In our review, we have also affirmed our assessment of MuniFin's stand-alone credit profile (SACP) at 'aa'. We have affirmed our issue rating on the junior subordinated debt at 'A-', which continues to stand four notches below MuniFin's SACP.

Enterprise risk profile: Competent execution of policy mandate ensures a solid market position, but underlying financial imbalances in the local government sector are building

- A very strong public industry country risk assessment (PICRA), thanks to Finland's wealthy economy and well-developed financial sector, and the government guarantees on the group's social housing lending.
- Proactive, competent, and risk-averse management, which assures compliance with regulatory requirements and continued execution of the public-policy mandate.
- Weakening financial trend for Finnish municipalities as structural revenue and expenditure mismatches become increasingly pronounced.

The group's operations are dominated by MuniFin's activities; hence our enterprise risk profile analysis focuses on MuniFin. MuniFin's mission is to ensure reliable and cost-efficient funding to Finnish local governments, municipal companies, and state- and municipality-guaranteed housing entities. We estimate that MuniFin's lending accounts for about 60% of its eligible market. However, we observe meaningful competition, for example, from multilateral lending institutions offering attractive pricing. Those entities, however, mainly target certain large municipalities and their largest projects, so we do not think their activities will threaten MuniFin's strong market position and public-policy role.

The Finnish LRG sector exhibits key 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. About 45% of MuniFin's loans are to social housing entities, and carry central government deficiency guarantees. We take this into account in our PICRA assessment attributable to MuniFin's lending operations.

In first-half 2019, MuniFin's lending increased by about 3.3% to €23.7 billion, compared with a growth rate of 1.7% over the same period in 2018. We expect the financing requirements of the municipal sector to remain meaningful over the next three years. Specifically, we foresee the loan stock for the municipal sector, absent firm adjustment efforts to restore budgetary positions, could increase by almost €10 billion from 2019 through 2023, equivalent to a 45% increase. This increase is prompted by significant investment needs in combination with a strained budgetary situation in the municipal sector.

In 2019, we observe accelerating growth in local governments' operating expenditure, in particular within health and social services, while tax revenue is falling short of expectations due to the slowing economy in addition to technical changes introduced under the income tax card reform that led to a misalignment of tax income. Central government measures through temporary grants have been deployed to remedy the situation alongside local decisions to increase the municipal tax rates. For 2020, we observe that 53 municipalities will increase their local tax rate, including several of the larger cities.

Although we observe a deteriorating trend in the aggregate budgetary balance of the Finnish municipal sector, we believe its institutional framework, including the sector's close ties to the central government and its significant flexibilities, will allow it to digest and counter the rising revenue and expenditure discrepancies without a meaningful effect on the sector's credit quality. That said, any prolonged negative deviation could test the robustness of the framework and worsen our PICRA assessment and MuniFin's enterprise risk profile.

Over the longer term, however, we believe the sustainability of Finnish public finances will likely require more tangible success on structural reforms. These have recently underwhelmed, particularly the recurring failure to push through social and health care (SOTE) reform after a decade of discussions. We observe strong political consensus on the need to push it forward to ensure the sustainability of public finances, as evidenced by recent trends in municipal finances. Therefore, we believe that the social and health care reform will stand as a top priority and return to the government agenda in the early days of its legislative term.

We view MuniFin's overall risk and financial management, and by extension, that of the group's, as very strong. Prudent internal risk management policies are enhanced by European Central Bank (ECB) supervision and bank regulation, and MuniFin is proactive in managing its regulatory requirements. In this regard, we observe that MuniFin 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.

The Capital Requirements Regulation II, including the binding leverage ratio, is now in force and will be applicable in 2021. The regulation includes a binding leverage ratio requirement of 3% that will be applicable as of June 28, 2021. The regulation contains specific exemptions for promotional banks. We consider it highly likely that MuniFin will fulfill the requisites of a public development credit institution, which will mean that its lending is exempted from the leverage ratio calculation. These clarifications and amendments have lifted uncertainties related to regulatory capital requirements. MuniFin's leverage ratio stood at 3.99% at June 30, 2019, and is set to increase well beyond 10%, according to our estimates. This illustrates the group's very comfortable capital position.

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

- Very strong capital ratios on the back of capital strengthening in recent years.
- Central bank access that underscores strong liquidity.
- A structural funding gap weighs on our funding assessment.

The group has a very strong capital position, with the majority of capital on MuniFin's balance sheet. MuniFin has an impressive Tier 1 capital ratio of 91.4% as of June 30, 2019. This is largely due to the zero risk weight applied to its loans, but also strong levels of retained earnings.

Our RAC ratio for the group was a very strong 50.6% on June 30, 2019, before adjustments. After our adjustments, in particular for single-name concentration, the RAC ratio is still extremely strong at 31.2%. We expect it will stay comfortably above our 15% threshold, thereby remaining a key support to the group's financial risk profile.

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

We consider the group to have a strong liquidity position. Although MuniFin is exposed to risk through its dependence on wholesale market funding, we consider that 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. We note that the ECB in August 2019 revised its eligibility guidelines for collateral eligible for repurchase agreement purposes, which has restored a notable 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.

We observe that 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 its liquid assets. In our computation of the liquidity coverage ratio with data as of June 30, 2019, we include contracted bond inflows of €500 million that were paid in on July 5, 2019. Our liquidity sources-to-uses ratio indicates that MuniFin will be able to meet its financial obligations over a one-year period, factoring in stressed market conditions. We believe that recent internal policy changes will sustain MuniFin's liquidity such that it can cover commitments over the next 12 months, taking into account 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, geographies, maturities, and investor types. Since 2016, MuniFin has also issued green bonds, which has further expanded its investor base. The Finnish Financial Supervisory Authority regards bonds issued by MuniFin as high-quality Level 1 liquid assets.

Although MuniFin issues mainly standard funding instruments, we note that legacy structured funding represents about 15% of its funding mix, which is higher than for its Nordic peers. Specifically, a majority of its structured funding instruments hold call options that are typically callable at three months' notice under certain circumstances, which we believe adds potential refinancing risks. That said, the structured funding component has decreased in recent years, and is hedged. We view MuniFin's management of its structured funding portfolio as prudent and the agency accepts no market risks. All MuniFin's derivative contracts include stipulations for a two-way credit support annex, and the agency prudently accounts for collateral flows in its regular funding activities.

We see a structural funding gap for MuniFin and therefore for the group, with our one-year assets-to-liabilities ratio at 0.80x, and a persistent funding gap for up to two years. The funding gap is largely due to the very long average tenor of lending, the majority of which matures after two years, combined with a funding instruments containing callable features. The risks are partly mitigated by the generally long-dated nature of the funding, which provides some headroom for adjusting the structural mismatch. We observe, however, that the group's funding ratio has the potential to improve further as adopted policy changes are set to lead to a lengthening of funding tenures.

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 similar to the sovereign's, 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 the local government sector.
- Central government reform ambitions could tie the MuniFin and MGB group closer to the central level by extending the group's funding scope to national infrastructure projects.

The group enjoys municipal sector support through a joint and pro rata guarantee commitment from the LRG 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 all the funding provided 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 guarantee as predictable and immediately enforceable by law. The legal enforceability of the guarantee underpins our assessment of an integral link between the group and its municipal stakeholders. At the same time, we consider that MuniFin has a very important role in providing cost-efficient funding to the sector.

Although the main group of supporting members are 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 is in financial stress, and before the guarantees are called, thereby preventing a default.

Aside from extraordinary support from the local government and MGB members, the group's direct ownership by central government adds reassurance by providing an additional prospective support channel. Finland's new government that entered office in 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 where new government-controlled entities could be established for the purposes of large-scale infrastructure investments, in practice railways. In connection with this initiative, the Government Programme outlines the possibility of financing these entities via amendments to the Act of the MGB.

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. That said, we foresee that the relevant infrastructure project will only materialize over the medium term, since the portfolio of the projects is large and will require preparation by the government. Over time, however, it could strengthen the group's link to the central government.

Outlook

The stable outlook reflects our expectation that the guarantee mechanism will remain unchanged. In addition, we expect that the creditworthiness of the underlying municipal sector will remain high, that MuniFin's financial risk profile will remain solid, and that any structural reform of the municipal sector is unlikely to materially alter our view of the group's public-policy mandate.

Downside scenario

We could lower the ratings over the next 24 months if the credit quality of the underlying municipal stakeholders materially deteriorates. Such a deterioration could emanate from lessened central government engagement to the sector that could manifest in a lowered institutional framework assessment. We could also lower the ratings if MuniFin's business position weakened, for example, due to a reorganization of the Finnish LRG sector, or a reduced ability to execute its public-policy mandate efficiently through the economic cycle. Moreover, downward rating pressure could build if the group's funding gap widens or liquidity position weakens.

Upside scenario

We could raise the ratings if the underlying credit quality of the Finnish LRGs supporting the group were to improve, alongside that of the sovereign.

Key Statistics

Municipality Finance Plc Selected Indicators

		-- Year ended December 31--					
(Mil. €)	**2019 H1**	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**
Business Position							
Total adjusted assets	36,956	35,677	34,728	34,045	33,883	30,005	26,152
Customer loans (gross)	23,719	22,968	21,651	21,196	20,276	19,338	17,882
Growth in loans (%)	3.30	6.10	2.15	4.54	4.85	8.14	13.44
Net interest revenues	117	236	229	206	172	160	149
Non interest expenses	29	45	39	31	25	22	21
Capital & Risk Position							
Total Liabilities	35,450	34,538	33,746	32,868	32,845	29,415	25,686
Total Adjusted Capital	1125	1103	962	1,078	903	559	443
Assets/capital (%)	33	32	36	32	38	54	59
RAC before diversification (%)	50.6	39.2*	34				

Municipality Finance Plc Selected Indicators (cont.)

		-- Year ended December 31--					
(Mil. €)	2019 H1	2018	2017	2016	2015	2014	2013
RAC after diversification (%)	31.2	24.5*	21				
Gross nonperforming assets/gross loans (%)	0.1	0	0	0	0	0	0
Funding & Liquidity							
Liquidity Ratio with loan disbursement (1 year)	0.78	0.83*	0.84				
Liquidity Ratio without loan disbursement (1 year)	1.04	1.02*	1.01				
Funding Ratio (1 year)	0.84	0.80*	0.75				

*Ratio computed with data as per June 30, 2018. H1--First half.

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: Negative 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: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- 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
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

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+