

## CREDIT OPINION

21 December 2021

### Update

 Rate this Research

#### RATINGS

##### Municipal Guarantee Board

Domicile	Finland
Long Term Rating	Aa1
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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## Municipal Guarantee Board

### Update to credit analysis

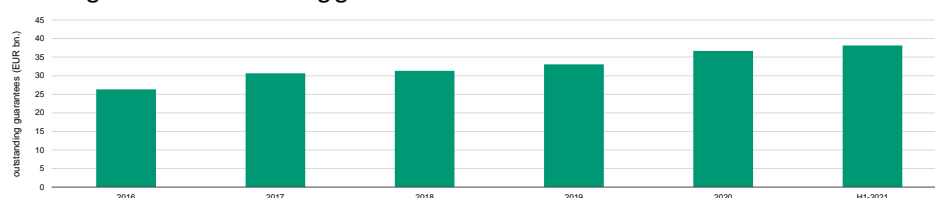
#### Summary

The credit profile of the [Municipal Guarantee Board](#) (MGB, Aa1 stable) reflects the strong linkages between the [Government of Finland](#) (Aa1 stable) and MGB's member municipalities. The interlinks, controls and importance of services provided by the local government sector indicate that the ultimate support provider in the unlikely event of an acute liquidity stress would be the Government of Finland.

MGB was set up by the Finnish parliament in 1996 under a special law aiming to safeguard and develop the joint funding of Finnish municipalities. MGB can grant guarantees for funding by public sector credit institutions that will be used for lending to municipalities, municipal entities and government guaranteed social housing entities. [Municipality Finance Plc](#) (MuniFin, Aa1 stable) is the only entity benefiting from MGB's guarantees.

Exhibit 1

#### Increasing volume of outstanding guarantees



Source: MGB, Moody's Investors Service

#### Credit strengths

- » Strong linkages between the local government sector and the central government
- » Joint guarantee issued by all municipalities on the Finnish mainland
- » MGB plays an important role in the Finnish local government funding system
- » Governance structure brings in central and local governments affirming low risk tolerance
- » MuniFin's asset quality is a strong element in assessing MGB's risk
- » Robust risk management framework and multitiered guarantee structure

#### Credit challenges

- » Limited stand-alone liquidity is mitigated by strong municipalities' cash reserves
- » Untested guarantee mechanism

## Rating outlook

The rating outlook is stable. This reflects the outlook of its support provider, the Government of Finland. It also reflects our expectation that the current joint municipal funding system will remain unchanged ensuring that the creditworthiness of the local government sector will be preserved in the medium term.

## Factors that could lead to an upgrade

An upgrade in Finland's sovereign rating could lead to an upgrade of MGB's rating.

## Factors that could lead to a downgrade

Negative pressure on the rating could result from one or a combination of the following: (1) a downgrade of Finland's sovereign rating, (2) a weakening of the ties between the local government sector and the sovereign, (3) a weakening of the MGB Act and the joint guarantee, or (4) a weakening of MGB public policy mandate and its importance for lower-tier governments.

## Detailed credit considerations

In June 2021, the Finnish parliament approved the health and social services (SOTE) reform legislation. The reform aims to create 21 self-governing service counties, which will provide healthcare, social welfare and rescue services throughout Finland. SOTE responsibilities, currently assigned to municipalities and hospital districts, will be transferred to the new wellbeing service counties in January 2023. The legislation change includes amendments to the MGB Act to allow the joint funding system of MGB and MuniFin to temporarily supply the new wellbeing service counties regarding the transferred loans.

The Government also intends to amend the MGB Act so that the joint funding system of municipalities would be able to fund the new wellbeing service counties on a permanent basis. The bill on new loans will enter the parliamentary procedure soon and we expect the Act to be adopted and enter into force by 1 March 2022. This reform marks a significant step towards reducing inequalities in provision of healthcare and social welfare as well as improving efficiency and curbing the growth of costs.

The credit profile of MGB, as expressed in its Aa1 issuer rating reflects the support from the central government and in our view, it is not significant to distinguish between MGB and Government of Finland. MGB's credit strength is inextricably linked with that of the Government of Finland because of its status as public policy entity and MGB's mandate to safeguard and develop joint funding for Finnish municipalities. MGB members' close linkages with the central government lead to an expectation of ultimate support from the central government to provide liquidity in the unlikely event that the local government sector and MGB would require this support.

## Baseline credit assessment

### Strong linkages between the local government sector and the central government

We see the average credit quality across the Finnish local government sector as high. Beside a strong, decentralised self-governed municipal sector, the credit quality reflects the high level of control exercised by the Government of Finland through the Ministry of Finance, which performs on-going monitoring of operational and financial performance of municipalities. The sector is further supported by a strong institutional framework evidenced by: 1) the legal requirement for municipalities to set a balanced budget over a four-year period; 2) a history of intervention in cases of failed service provision and financial distress; 3) well developed equalisation system, which ensures a provision of equitable services across the country; and 4) strong market access through MuniFin.

Finnish municipality sector is characterized by a high level of devolved powers with local authorities having a full autonomy to levy municipal income tax and property tax. The Finnish municipalities are represented at the highest level of parliament debates via the Finnish Local and Regional Authority, collaborating on all matters affecting the municipal sector. Local finances and services are assessed every year and should a municipality be flagged as distressed, the municipal council would immediately start a recovery plan to address any highlighted issues. The creditworthiness of the municipality sector stems from a high level of revenue predictability, modest, although increasing, levels of debt, and close operational, financial and institutional linkages between the central and local governments. Around 55% of local governments' operating revenue is generated from their own tax revenue, additional 25% comprises the central government transfers and while the remainder is made up of non-tax operating income.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

The new reform on the organization of health and social services will impact the setup and tasks of local governments. We understand that the new reform is an important step forward, after the previous government's proposal failed in front of the constitutional law committee in early 2019. We understand that implementation of the current reform proposal is aimed from 2023 onwards and includes setting up 21 counties. The counties geographically comprise the area of several local governments and take over responsibilities for health care, social welfare and rescue services, currently operated by local governments.

As part of the implementation, the Finnish Supervisory Authority (FSA-FIN) has put forward a change in its guidelines so that the exposure to wellbeing service counties and joint county authorities would be treated similarly to exposure to the central government. Zero-risk will create an opportunity for new counties to become members of MGB. The right of taxation is undergoing further evaluation and will be effective from 2026 at the earliest. Under the SOTE reform, part of assets and liabilities of municipalities and joint municipal authorities will be transferred to new counties. It is estimated that around €2 billion of debt backed by the MGB and financed by MuniFin will be transferred to new authorities. We will monitor the developments around the Finnish health care reform and its potential impact on MGB's credit profile.

Despite the challenging economic environment driven by the coronavirus pandemic the implication on Finnish local governments was very limited primarily thanks to the robust support from the central government. In addition to the €3 billion subsidies intended to offset the coronavirus effect, the municipal tax revenues were better-than-expected driving the positive financing results of the sector in 2020. We forecast that Finland's real GDP will recover to 2.8% in 2021 and 3% in 2022 after contraction of 2.8% last year. This will translate into growing proceeds from income tax, the main revenue source for Finnish local governments. In 2021, the central government has also taken steps to mitigate the impact by granting additional transfers to local governments, which will further support the improvement in financial performance of the municipal sector.

#### **Joint guarantee issued by all municipalities on the Finnish mainland**

The MGB's credit strength reflects the support of Finland's robust local government sector, through a joint guarantee extended by MGB's member municipalities representing almost all of the Finnish population (except for the Åland Islands). Consequently, MGB guarantees are backed by the entire nations' municipal tax base. If one municipality fails to meet its obligations to MGB, then all peers are required to cover the shortfall on a joint basis based on population size. The island of Åland, which represents 0.5% percent of the Finnish population, is not an MGB member because of its self-governance status.

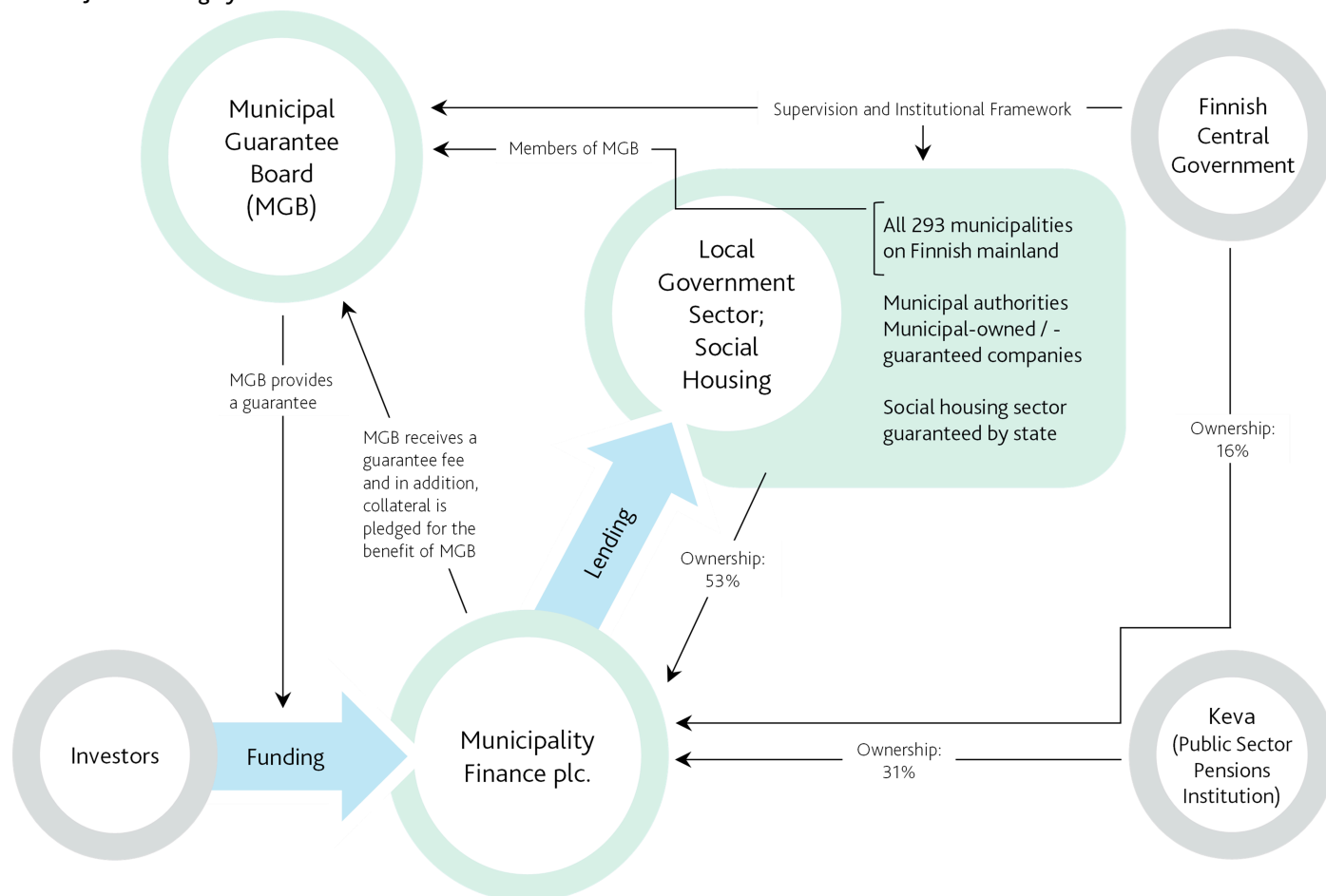
The payment obligation can be used without a court order and the MGB Act allows MGB to support government-owned credit institutions even before the latter fails to make a payment to its creditors. Since MGB's inception, the only credit institution to meet the criteria set out in the Act was Municipality Finance Plc. Therefore, MGB is likely to support MuniFin without going through complex procedures.

#### **MGB plays an important role in the Finnish local government funding system**

MGB was established by law in 1996 aiming to complement the credit institution activities serving the local government sector. The legislation highlights its special public policy role, which along with the MuniFin safeguard and develop the joint funding for municipalities. The MGB Act allows it to extend guarantees to any credit institution that is (a) owned or controlled by municipalities; and (b) in the business of lending to municipalities and their associated entities, and government guaranteed social housing companies. MGB, however, only guarantees MuniFin's debt (and payments from hedging counterparties to MuniFin) because MuniFin is the only credit institution owned by municipalities in Finland. In effect, MGB ensures that MuniFin meets its obligations and allows it to function as the debt management office for the Finnish local government sector.

Exhibit 2

## Finnish Joint Funding System



Source: MGB, Moody's Investors Service

Funds borrowed from MuniFin are used for investments in public services such as education, social housing and elderly care. The municipalities are in continuous dialogue with the central government about the legislation concerning the services to be provided by the municipal sector.

### Governance structure brings in central and local governments affirming low risk tolerance

The strong ties between MGB and the central government are also underlined by its governance. The Ministry of the Finance appoints MGB's council of 15 members at the recommendation of the Association of Finnish Local and Regional Authorities. Members serve four-year terms. The council appoints a board of seven members and the board in turn appoints the managing director for MGB. MGB has its own auditor as well as one appointed by the Ministry of Finance.

By law, MGB must invest its surplus liquidity with regard to safety, yield, and liquidity; in practice investments are investment grade and held to maturity. The investment policy of MGB allocates 50% (+/- 10%) of investments to investment-grade debt instruments issued by governments and banks and 50% (+/- 10%) to debt instruments issued by banks and companies listed on Helsinki Stock Exchange and other investments, which range from capital secured debt to equities and fund investments.

### MuniFin's asset quality is a strong element in assessing MGB's risk

The Finnish local government sector is regarded as one of the most sound in Europe. MuniFin's asset quality remains very strong and its lending is restricted to the following types of borrowers (with share of lending as of June 2021):

- » Local Governments (34% of the total loan portfolio)

- » Local Government Corporations – entities' loans guaranteed by local governments that are members of MGB (13% of the total loan portfolio),
- » Joint Municipal Authorities (6% of the total loan portfolio),
- » Social Housing Corporations - loans guaranteed by the Finnish Government (47% of the total loan portfolio)

As of 30 June 2021, 53% of MuniFin's lending carried local government risk, while the remaining 47% was exposed to national government risk. All local governments and their guarantees are weighted at zero risk by FSA-FIN.

MuniFin's underlying credit strengths makes the likelihood of MGB needing to action the guarantee very remote. MuniFin has a history of a strong and predictable financial performance, an important national and public mandate, diverse funding resources and a low risk appetite. Thus, MGB will only be required to exercise the guarantee in the remote and unlikely event that MuniFin faces acute financial distress and a long-term loss of access to wholesale funding.

#### **Robust risk management framework and multitiered guarantee structure**

Were MuniFin to encounter any difficulty in meeting its obligations, the MuniFin investor or a derivative counterparty can immediately claim payments from MGB. Claims by the MGB to its members for contributions for their share of contributions to satisfy any calls on the guarantee of the MGB can be collected without a court order.

If the municipal member was unable to pay its share of such call, other members would be jointly liable in proportion for this shortfall as well, in proportion to their respective population. In addition to providing security by demand for bondholders, MGB has the discretion under its standing orders to provide funds to MuniFin as needed, in advance of a distress scenario crystallising.

To avoid the need for such action, MuniFin and MGB have put in place several layers of protection, before needing to call additional capital under the guarantee. MuniFin reported total liquid assets of €11.7 billion as of June 2021 (€10.1 billion at year-end 2020) compared with total assets of €44.9 billion. MuniFin holds debt securities that are very highly rated and sufficient to cover obligations for a minimum of six months, assuming uninterrupted lending. MuniFin also has access to Central Bank liquidity facility whereby it can pledge eligible loans as collateral, giving it access to additional liquidity in case of need.

#### **Limited stand-alone liquidity is mitigated by strong municipalities' cash reserves**

As of June 2021, MGB's has a standalone liquidity portfolio of €20.5 million and also benefits from a committed revolving credit facility of €200 million with Nordic Investment Bank. This is considered low compared with its outstanding guarantee stock, which at year-end 2020 amounted to €36.7 billion. From a credit perspective, MGB's liquidity profile is limited but moreover, we take comfort from the sizable reserves held by MuniFin and the Finnish local government sector's financial strength. The Finnish local government sector holds around €7.9 billion in cash reserves (as of 31 December 2020) up from €6.3 billion a year before, representing around 18% of sector operating revenue. Municipalities could use its cash reserves to support MGB in unlikely event of need. Projections from the Ministry of Finance suggest that the level of local government sector's liquidity will remain around €7.4 billion over the next four years.

#### **Untested guarantee mechanism**

The MGB guarantee has never been triggered, but practical procedures for delivering financial support to MuniFin has been documented. MGB can claim payment from its member municipalities to support MuniFin without a court order.

A mitigating factor is the financial health of Finnish local government sector, which despite the coronavirus pandemic, maintained its strength thanks to comprehensive financial support packages from the central government in 2020 and 2021. In addition, MuniFin and MGB could take several early steps to prevent triggering the MGB guarantee mechanism.

## ESG considerations

### How environmental, social and governance risks inform our credit analysis of MGB

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of MGB, we assess the materiality of ESG to the credit profile as follows:

Environmental risks are not material for MGB's rating. MGB's members (local governments) are exposed to environmental risks, including severe weather conditions or rising sea levels, could have an impact. Nevertheless, these risks are not material for the rating of MGB.

Social risks are not material for MGB. However, MGB's members are exposed to the challenges of providing services to an ageing population with higher dependency ratios. Over time, these challenges can add pressure on municipalities' finances, even though central government plays a significant role in mitigating some of those pressures as well as the fact that the sector's institution framework is established to mitigate some of those pressures. Overall, we consider the issuer to have a moderate exposure to social risk, in line with the Finnish local governments.

Governance risk is material for MGB, as it has to abide by the mandate set by the law. It is also subject to close oversight by the central government.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology [General Principles for Assessing ESG Risks](#).

## Rating methodology

We use the [Government-Related Issuers](#) rating methodology, published in February 2020.

The significance of the joint and pro-rata guarantee, involving all Finnish municipalities, ultimately leads to an expectation of support from the Government of Finland in the unlikely event of financial distress.

## Ratings

Exhibit 3

Category	Moody's Rating
<b>MUNICIPAL GUARANTEE BOARD</b>	
Outlook	Stable
Issuer Rating - Dom Curr	Aa1

Source: Moody's Investors Service

## Moody's related publications

- » [Municipality Finance Plc : Update to credit analysis](#), November 2021
- » [Government of Finland – Aa1 stable: Annual credit analysis](#), June 2021
- » [Government of Finland – Aa1 stable: Regular update](#), July 2021

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