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Update

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Municipality Finance Plc

Update to credit analysis

Summary

The Aa1 senior debt and issuer ratings assigned to Municipality Finance Plc (MuniFin), as assessed by our Government-Related Issuers (GRIs) methodology, reflects the institution's close links to Finnish regional and local governments (RLGs) and ultimately the sovereign, because of (1) its role as the main provider of funding to the municipal sector and to the central government subsidised housing sector; (2) its public policy mandate to act as the de-facto debt management office for the RLGs; and (3) the joint guarantee by RLGs in Finland (Aa1, Stable) with income tax levying power, provided through the Municipal Guarantee Board (MGB, Aa1, stable). They also reflect the institution's predictable financial performance, as well as its low risk appetite which is consistent with its peers. We also assign a Aa1(cr)/P-1(cr) Counterparty Risk Assessment.

Credit strengths

» Ownership and market share reflect MuniFin's importance to the Finnish regional and local government sector

» MuniFin's funding is guaranteed by the Aa1 rated Municipal Guarantee Board

» Strong sovereign and healthy RLG sector result in good asset quality

» Predictable financial performance due to public policy mandate

» Diverse funding and good liquidity

» Capitalisation and low risk appetite, consistent with peers

Credit challenges

» Borrower concentration

» Mismatches between assets and liabilities mitigated by ample liquidity portfolio, diverse funding and the liquidity line facility from the Finnish central bank (thanks to its status as a central bank counterparty)

Outlook

The stable outlook on MuniFin's issuer and backed senior unsecured ratings reflects the stable outlook on the government of Finland's rating.

Factors that could lead to an upgrade

Although unlikely in the short-term, MuniFin's ratings could be upgraded as a result of an upgrade of the government of Finland.

Factors that could lead to a downgrade

Although not expected in the short-term, MuniFin's ratings could be downgraded if the government of Finland is downgraded. Downward pressure on the ratings could also arise over time as a result of: (1) asset quality deterioration; (2) a diluted public policy mandate; (3) a weaker standing in debt capital markets; and (4) a weakening in the MGB guarantee.

Key indicators

Exhibit 1

Municipality Finance Plc (Consolidated Financials) [1]

	12-18[2]	12-17[2]	12-16[2]	12-15[2]	12-14[2]	CAGR/Avg.[3]
Total Assets (EUR million)	33,497	32,663	31,456	31,195	28,250	4.4[4]
Total Assets (USD million)	38,292	39,222	33,178	33,887	34,184	2.9[4]
Tangible Common Equity (EUR million)	1,104	953	811	678	558	18.6[4]
Tangible Common Equity (USD million)	1,262	1,144	855	737	675	16.9[4]
Problem Loans / Gross Loans (%)	-	0.0	0.0	0.0	0.0	0.0[5]
Tangible Common Equity / Risk Weighted Assets (%)	68.7	53.4	48.2	41.0	30.0	48.3[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	-	0.1	0.0	0.0	0.0	0.0[5]
Net Interest Margin (%)	0.7	0.7	0.6	0.6	0.6	0.6[5]
PPI / Average RWA (%)	10.8	11.6	10.6	8.6	7.8	9.9[6]
Net Income / Tangible Assets (%)	0.5	0.5	0.4	0.4	0.4	0.4[5]
Cost / Income Ratio (%)	19.2	16.4	15.1	14.1	13.1	15.6[5]
Market Funds / Tangible Banking Assets (%)	82.9	83.4	92.3	92.4	93.1	88.8[5]
Liquid Banking Assets / Tangible Banking Assets (%)	16.5	27.8	22.3	23.4	21.1	22.2[5]
Gross Loans / Due to Customers (%)	591.9	577.9	2,428.1	2,125.3	2,006.7	1,546.0[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully-loaded or transitional phase-in; IFRS. [3] May include rounding differences due to scale of reported amounts. [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [5] Simple average of periods presented for the latest accounting regime. [6] Simple average of Basel III periods presented.

Source: Moody's Financial Metrics

Profile

MuniFin is the only financial institution in Finland which specialises in providing financing to the Finnish municipal and social housing sector. The institution provides loans to local and regional governments for a wide range of investments, including environmental projects, local infrastructure, education, healthcare and central government subsidized housing. The total assets of MuniFin were EUR33.5 billion as of Year-end 2018 (Moody's adjusted).

MuniFin has being growing its personnel in the last few years and increased the number of employees to 151 from 134 in 2018 due to business development and greater regulatory requirements.

MuniFin is jointly owned by the Finnish RLGs (53%), the Finnish public sector pension fund (Keva, 31%) and the government of Finland (16%).

Detailed credit considerations

Ownership and market share reflect MuniFin's importance to the Finnish regional and local government sector and to the central government subsidised housing sector

MuniFin is closely associated with the Finnish regional and local government sector. The institution is owned by the Finnish municipal sector, a Finnish local government pension institution (Keva) and the Republic of Finland. MuniFin effectively acts as the debt management office for Finnish RLGs, and lends exclusively to Finnish public sector customers or entities guaranteed by the Finnish public sector.

MuniFin's importance to the Finnish RLG sector is also reflected by its leading market share. Munifin's dominant position is likely to persist since its public policy mandate is to lend at cost-effective rates to RLGs rather than maximising profits. We note that MuniFin's regional peers in other Nordic countries also report high market shares, assisted by their not-for-profit mandate.

MuniFin's funding is guaranteed by the Aa1 rated Municipality Guarantee Board

Munifin's funding is guaranteed by the Municipal Guarantee Board, a public body established by law for the sole purpose of safeguarding the funding of Finnish municipalities. The MGB's strong credit strength (Aa1 stable) reflects that all municipalities in Finland (except for the Åland Islands) are permanent MGB members, and these municipalities are closely linked to the Finnish sovereign. If one municipality fails to meet its obligations towards the MGB, then all remaining municipalities are obliged to cover the shortfall in proportion to their population size.

Strong sovereign and healthy RLG sector result in good asset quality

MuniFin's creditworthiness rests on the RLG sector that we consider financially strong because of the supportive system that underpins the sector: (1) Finnish RLGs have full authority to levy income taxes on their inhabitants (2) RLGs' other revenue sources include grants from the central government, (3) Finnish RLGs benefit from an equalisation principle to ensure provision of public services across the country, (4) RLGs are required by law to balance their finances over a four-year horizon, (5) lending for the purpose of public housing construction (around 45% of lending at year-end 2018) is guaranteed by the Aa1 rated Finnish government, and (6) the Ministry of Finance is responsible for the oversight of local governments. Moreover, Finnish law does not allow for a municipality to be declared bankrupt and this is consistent with other Nordic countries.

These components are in place to ensure that RLGs remain creditworthy in the long-term so that they can deliver key public services, such as education and health-care, as mandated by the central government. The extensive social and healthcare reform was deferred ahead of the elections in March this year. The proposed reform relating to the Finnish RLG sector where "Counties" were to be introduced as a new layer of government between the RLGs and the central government has been postponed. According to the new government programme, the reform work will continue with the previous proposition as a base.

Although MuniFin's asset quality is good, we believe that following the health-care reform the risk profile of some municipalities might increase due to the real estate assets currently used for health-care activities which are located in less liquid parts of Finland. Nevertheless, we do not expect any changes in MuniFin's asset risk, even if reported NPLs increase from current levels, due to the supportive mechanisms currently in place on the RLG sector.

Similar to peers, MuniFin's lending book is somewhat concentrated due to its customer base which is small in number. MuniFin does comply with all banking regulatory requirements, including those on large exposures.

Predictable financial performance due to public policy mandate

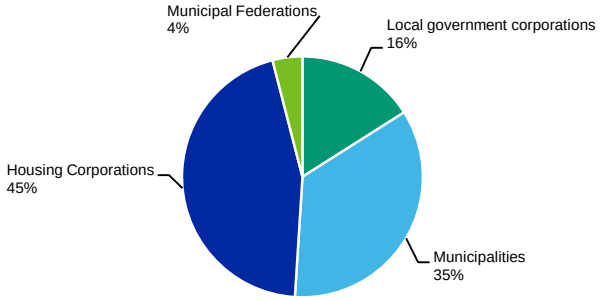
Like its peers, MuniFin has a not-for-profit mandate consisting in providing cost effective lending to the Finnish RLG sector. The institution has a good track-record of fulfilling its mandate even during times when debt capital markets were under severe pressure. Net income over tangible assets declined slightly to 0.45% in 2018, from 0.49% as in 2017.

MuniFin's profitability is predictable because (1) it lends exclusively to the Finnish municipal sector and the central government subsidised housing sector (see Exhibit 2), (2) we consider the Finnish RLG sector financially stable for the reasons outlined above, and (3) its dominant market position.

Exhibit 2

MuniFin's Lending Broken Down By Type at year-end 2018

MuniFin's lending is diversified within the RLG sector



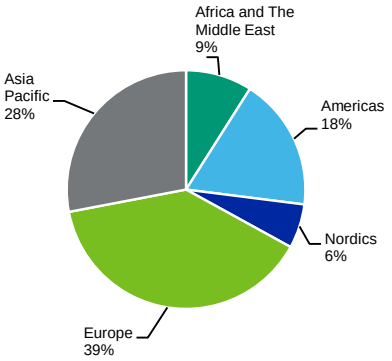
Source: Company reports

Diverse funding and good liquidity, but mismatches between assets and liabilities

Like its peers, MuniFin issues various types of debt in several geographies, in multiple currencies to a diverse investor base (see Exhibit 3-5) and in many different product segments in the international capital markets. We view this diversification as positive because it means that MuniFin is not dependant on a single source for funding.

Exhibit 3

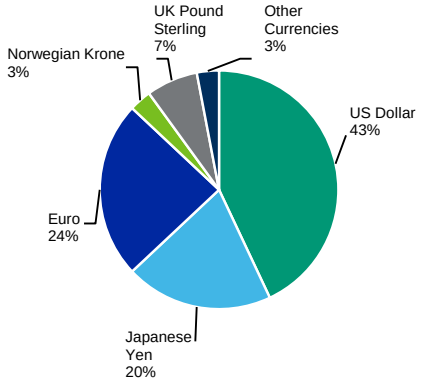
Funding By Region in 2018



Source: Company reports

Exhibit 4

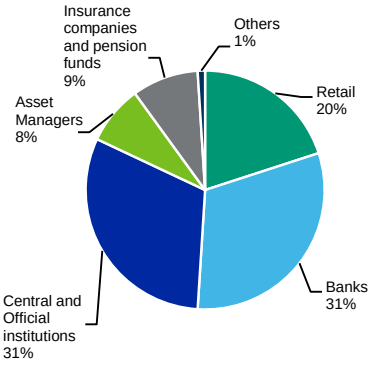
Funding By Currency in 2018



Source: Company reports

Exhibit 5

Funding By Investor Type in 2018



Source: Company reports

MuniFin is not match-funded, meaning that the maturity of its liabilities are shorter than the maturity of its assets. Also, a proportion of MuniFin's funding comes with callable features (although proportions have come down significantly compared to a few years ago), which could suddenly shorten the maturity of MuniFin's liability profile. MuniFin is managing this risk by analysing the likelihood of funding being called and maintaining a large liquidity reserve as well as having good access to funding in various markets and holding a liquidity facility with Bank of Finland.

MuniFin's customers have become more aware of green finance, which has been launched in 2016. Decisions on projects that are eligible for green finance are made by an independent evaluation team of external experts. Green finance increased the municipal sector's environmental investments, as the customer costs of green lending and leasing are in most cases lower than the costs of other financial instruments. In May 2018, Nasdaq Helsinki launched sustainable bond market, and MuniFin listed two green bonds in Helsinki, and was the first issuer to do so. As of year-end 2018 MuniFin's green finance accounted to EUR1,143 million, which has increased from EUR 803 million as of year-end 2017.

The institution's liquidity portfolio is of good quality and large in size. At year-end 2018 MuniFin had liquid assets of EUR 5.5 billion compared to total assets of EUR 33.5 billion (Moody's adjusted). The portfolio is very highly rated, which is also the case for MuniFin's Nordic peers. However, unlike some of its peers, MuniFin has access to Central Bank liquidity and the majority of the assets in the liquidity portfolio are eligible collateral for the Central Bank.

Capitalisation consistent with peers, but some uncertainty due to planned regulatory rules

MuniFin is adequately capitalised relative to its risks. At year-end 2018 the institution reported a common equity Tier 1 (CET1) ratio of 66.34% Although this ratio is far higher compared to most commercial banks in the region, we recognise that this is largely as a result of the zero risk weights applicable on MuniFin's lending. This ratio nonetheless represents 7.9 times the minimum CET1 ratio of 8.45% required by the ECB. The minimum capital requirements are inclusive of a capital conservation buffer of 2.5%, an other systemically important credit institutions (O-SII) requirement of 1.0% and an institution-specific countercyclical buffer based on geographical distribution of exposures of 0.45%.

MuniFin reported a leverage ratio of 4.06%, as at year-end 2018 (year-end 2017: 3.84%), which is higher than 3% which has become a regulatory requirement from January 2018 under CRR/CRDIV regulation.

Going forward, the leverage ratio will likely improve as exposures to municipalities will be excluded from the it. Following amendments to the Capital Requirements Regulation (CRR) (the EU Commission published its proposal for the CRR amendments in November 2016 and the European Parliament adopted the amended CRR in April 2019), public development institutions' exposures to "regional governments, local authorities or public sector entities in relation to public sector investments" can be excluded from the denominator of the leverage ratio.[1] The amended leverage ratio is expected to come into effect no earlier than in 2021. Based on Munifin's current capital base, the amended leverage ratio will be substantially in excess of the 3% threshold in the likely scenario that Munifin is able to exclude municipal exposures. [2]

Support and structural considerations

The A3(hyb) rating assigned to Munifin's perpetual fixed rate resettable AT1 securities issued on 1 October 2015 reflects the application of Moody's Banks methodology updated in August 2018. The AT1 rating is derived using our implied baseline credit assessment (BCA) of a1, which reflects MuniFin's high standalone creditworthiness based on its (1) strong asset quality, (2) predictable financial performance due to public policy mandate, (3) sound liquidity, (4) adequate capital and (5) low risk appetite. We then considered the volume of liabilities eligible for bail-in, under our advanced loss-given-failure analysis, and assessed the likelihood of support coming from the Finnish local and regional governments - its members - and the national government in order to avoid an imminent default by MuniFin, should this extreme event ever occur.

Our advanced loss given failure analysis confirms a high level loss-given-failure for the AT1 securities, given the small volume of debt and limited protection from residual equity, resulting in one negative notch adjustment. We also incorporate one additional notch reflecting our assessment of the risk of coupon skips on non-viability AT1 securities balanced against the expectation of support from MuniFin's owners and guarantors to prevent such an event from occurring. This results in a rating on these instruments of A3(hyb), two notches below MuniFin's implied BCA. The rating of the AT1 securities was initiated by Moody's and was not requested by MuniFin.

Counterparty Risk Assessment

Counterparty Risk (CR) Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default, and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (for example, swaps), letters of credit, guarantees and liquidity facilities.

MuniFin's CR Assessment is positioned at Aa1(cr)/ P-1(cr).

The CR Assessment, prior to government support, is positioned three notches above the implied BCA of a1. The main difference with our Advanced LGF approach used to determine instrument ratings is that the CR Assessment captures the probability of default on certain senior obligations, rather than expected loss, therefore we focus purely on subordination and take no account of the volume of the instrument class.

We assume a very high support assumption from the government for the CR Assessment but due to the proximity between the sovereign rating and the CR Assessment prior to government support, this support no longer results in any uplift. The very high support assumption reflects our view that any support provided by governmental authorities to a bank which benefits senior unsecured debt or deposits is very likely to benefit operating activities and obligations reflected by the CR Assessment as well, consistent with our belief that governments are likely to maintain such operations as a going-concern in order to reduce contagion and preserve a bank's critical functions.

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 http://www.moodys.com for the most updated credit rating action information and rating history.

Ratings

Exhibit 6

Category	Moody's Rating
MUNICIPALITY FINANCE PLC	
Outlook	Stable
Counterparty Risk Assessment	Aa1(cr)/P-1(cr)
Issuer Rating	Aa1
Pref. Stock Non-cumulative -Dom Curr	A3 (hyb)

Source: Moody's Investors Service

Endnotes

1 Article 429a(d) of the EC's proposal for a Regulation of the European Parliament and the Council dated 23 November 2016, amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012

2 For more details, please refer to Moody's issuer in-depth "European lenders to local governments: adequate capitalisation despite expected relaxation in leverage requirements" published in March 2017.

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