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Research Update:

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

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Overview

- In our view, the liquidity position of Finnish local government funding agencies Municipality Finance PLC (MuniFin) and Municipal Guarantee Board (MGB) will remain strong. Policy refinements and active asset liability management are set to strengthen the agencies' liquidity positions and they will maintain comprehensive access to the central banking system despite recent changes to the European Central Bank's collateral policy.
- The ratings on MuniFin and MGB continue to be supported by a strong market position, highly creditworthy borrowers, and a very strong risk-adjusted capital position.
- We continue to assess MuniFin and MGB as core entities in the joint Finnish public-sector funding system.
- We are therefore affirming our long- and short-term 'AA+/A-1+' issuer credit ratings on MuniFin and MGB.
- The stable outlook reflects our expectation that the structure of Finland's municipal funding system will remain unchanged, that MuniFin will remain the sole recipient of MGB's guarantees, and that local government sector reform is unlikely to weaken the group's public policy mandate materially in the next two years.

Rating Action

On Jan. 11, 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 long-term issue rating on MuniFin's subordinated debt at 'A-'.

Rationale

The affirmation reflects our view that policy refinements and active asset liability management are set to sustain MuniFin's and MGB's strong liquidity position and that they will maintain comprehensive access to the central banking system despite recent changes to the European Central Bank's (ECB's) collateral policy.

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 and strong liquidity, complemented by comprehensive central bank access, which alleviates 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 MuniFin 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 government of Finland. MuniFin has close links with the LRG sector, as well as with 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. We observe that the first call date of this additional Tier 1 (AT1) instrument is in April 2022, which indicates a residual life of less than four years, resulting in minimal rather than intermediate equity content in MuniFin's AT1 instrument.

Enterprise risk profile: Competent execution of policy mandate, and low-risk lending activities

- 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 public housing lending.
- Proactive, competent, and risk-averse management, which assures compliance with regulatory requirements and continued execution of the public policy mandate.

- Upcoming reform of the social and health care sector that could increase the credit risk from municipalities, alter the group's market position, and impede loan growth.

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-guaranteed housing entities. We estimate that MuniFin's lending accounts for about 60% of its eligible market. However, we observe increased competition, for example, from multilateral lending institutions offering attractive pricing. However, those entities mainly target certain large municipalities and their sizable projects, so we do not think their activities will threaten MuniFin's strong market position and public policy role.

In the first half of 2018, MuniFin's lending increased by about 1.4% to €21.5 billion, compared with 1.5% growth in 2017. The subdued increase in net lending is primarily attributable to the municipalities' stronger financial results, as municipal finances continue to benefit from the strong growth momentum in the national economy, which has reduced their need for debt financing. Other factors are the pronounced competition for financing, and uncertainties surrounding the upcoming social and health care reform, which have led local governments to postpone investments in this area.

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 ECB supervision and bank regulation, and MuniFin is proactive in managing its regulatory requirements. In this regard, we observe that MuniFin issued an AT1 instrument in 2015 to address the potential impact of the proposed leverage ratio requirement. We consider it important that this instrument does not allow for conversion into equity.

The regulatory authorities are yet to take a firm decision on the leverage ratio requirement for promotional banks such as MuniFin. However, in mid-2018, MuniFin's leverage ratio stood at 3.97%, suggesting that it has buffers to comply with the upcoming regulation. We observe that the supervisory and resolution authorities are yet to take a decision on the requirements for resolution plans and the minimum requirement for own funds and eligible liabilities (MREL) for promotional banks. Therefore, we cannot exclude the possibility that MuniFin could be required to issue Tier 3 instruments to comply with the MREL. We note that the statutes governing MuniFin allow only public bodies to be stakeholders, suggesting that hybrid instruments will not under any circumstance dilute the agency's public ownership base.

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 on Finland.

Financial risk profile: Very strong capitalization and strong liquidity, boosted by comprehensive access to the European central banking system

- Very strong capital ratios on the back of capital strengthening in recent years.
- Conservative liquidity policies and active central bank access that underscores strong liquidity.
- A structural funding gap from existing levels of callable structured funding and long-term assets.

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 83.2%. This is largely due to the zero risk weight applied to its loans, but also to strong levels of retained earnings. 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.

Our risk-adjusted capital (RAC) ratio for the group was a very strong 39.2% on June 30, 2018, before adjustments. After our adjustments, in particular for single-name concentration, the group's RAC ratio is still a very strong 24.5%. We expect it will stay comfortably above our 15% threshold, thereby remaining a key support to the group's financial risk profile.

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. This is in spite of the recent amendment to the eligibility guidelines from the ECB, which disqualified a notable part of MuniFin's eligible municipal lending assets from being collateral. Even so, we consider the remaining amount meaningful and believe that the actions that MuniFin has taken will help to restore its level of lending asset collateral over the short term.

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 liquid asset data as of June 30, 2018, we include contracted bond inflows of $1 billion that was paid out on July 5, 2018. 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, and taking into account stressed market conditions.

In addition to the vast majority of its securities portfolio, parts of MuniFin's municipal loan book are eligible as collateral for repurchase agreement transactions with the central bank.

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 been issuing 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 callable structured funding represents about 20% 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 and that we believe add 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.

Nevertheless, the use of structured products implies some risk to the overall funding profile, with early redemptions of callable funding adding to planned funding needs. 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 recurring proportion of funding 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 improved over the past six months and we believe it has the potential to improve further as adopted policy changes are set to lead to a lengthening of funding tenures and an increased focus on public trades.

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, 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.

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 is ultimately liable for only a proportion 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.

Outlook

The stable outlook reflects our expectation that the structure of Finland's municipal funding system will remain in its current form, including the guarantee mechanism, meaning that MuniFin will remain the sole recipient of MGB's guarantees. In addition, we expect that the coming reform of the municipal sector is unlikely to materially alter our view of the group's public policy mandate or our assessment of the risk from its customer base in the next two years. In addition, we expect that MuniFin's management will manage to control the risks associated with the agency's wholesale funding, keep its structural funding gap in check, and sustain strong liquidity.

We could lower the ratings if the municipal funding system unwinds and the credit quality of the underlying municipal stakeholders deteriorates, with credit risk from local government and state-subsidized social housing sector borrowers increasing significantly. 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 persists or liquidity position weakens.

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.

Municipality Finance PLC Selected Indicators

	--Year ended Dec. 31--					
(Mil. €)	**2018 H1**	**2017**	**2016**	**2015**	**2014**	**2013**
Business position						
Total adjusted assets	35,508	34,728	34,045	33,883	30,005	26,152
Customer loans (gross)	22,019	21,651	21,196	20,276	19,338	17,882
Growth in loans	2	2	5	5	8	13.44
Net interest revenues	118	229	206	172	160	149
Non interest expenses	26	39	31	25	22	21
Capital and risk position						
Total liabilities	33,399	33,746	32,868	32,845	29,415	25,686
Total adjusted capital	1,053	962	1,078	903	559	443
Assets/capital	34	36	32	38	54	59
RAC before diversification	0	0				
RAC after diversification	24.5%	21.1%				
Gross nonperforming assets/gross loans	0	0	0	0	0	0
Funding and liquidity						
Liquidity ratio with loan disbursement (1 year)	0.83	0.84				
Liquidity ratio without loan disbursement (1 year)	1.02	1.01				
Funding ratio (1 year)	0.8	0.75				

Ratings Score Snapshot

Municipality Finance PLC

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Issuer Credit Ratings      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               Negative and (2)
 Liquidity                 Strong

Support                    +1
 GRE support               +1
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Group support	0
Additional factors	0
SACP	aa
Group status	Core
Likelihood of support	Extremely high (+1 notch)

Municipal Guarantee Board

Issuer Credit Ratings	AA+/Stable/A-1+
Group Credit Profile	aa+
Group status	Core

Related Criteria

- 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
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- 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+

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. 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.