Research Update:

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

December 22, 2020

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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, and very strong management.
- Comprehensive central government support will help Finnish municipalities navigate the stormy COVID-19 seas in 2020, but structural imbalances will require long-term reform commitment.
- We are 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. 22, 2020, 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 relies mainly 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, complemented by comprehensive central bank access, which alleviate risks from 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 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 chief function is to provide efficient funding to the Finnish municipal and social housing sectors, with social housing benefiting from guarantees by Finland's central government. 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 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 not changed our assessment of MuniFin's stand-alone credit profile (SACP) at 'aa'. The 'A-' rating on the entity's subordinated debt continues to stand four notches below MuniFin's SACP.

Enterprise risk profile: COVID-19 stress accentuates MuniFin's critical policy role as funding backstop for municipal sector while unprecedented central government support sustains sector credit quality amid the pandemic's fallout

- The very strong credit quality of the public sectors that MuniFin serves, 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.
- A weakening underlying financial trend for Finnish municipalities on structural revenue and expenditure mismatches that will need to be addressed after COVID-19.

MuniFin's activities dominate the group's operations; therefore, our enterprise risk profile analysis focuses on the entity. 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 the entity's lending accounts for about 60% of its eligible market and is steadily increasing.

MuniFin's role as key financier to the Finnish municipal sector was on display as the pandemic took hold in first-half 2020, infusing uncertainty into markets and directly hitting municipal finances. The organization experienced record loan demand from municipalities through June 2020, with lending volume up by 7.8%, compared with 3.3% in the same period in 2019. The heightened level of requests came almost exclusively from municipalities proactively acquiring their budgeted 2020 loan volumes in advance. In addition, loan demand was heightened as commercial banks withdrew or were priced out from the market. While borrowing requirements from municipalities has tempered in second-half 2020, following unprecedented central government support, we foresee that MuniFin will experience elevated lending volume to the municipal sector through 2021 as financing needs in the public sector, including the municipal sphere, remain significant. This is in part because of fiscal stimulus that we expect will continue supporting the fragile economic rebound.

The most pronounced medium-term competition will likely come from multilateral lending institutions, which offer attractive pricing. Those entities, however, mainly target certain large municipalities and municipal federations, 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 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 account for this in our public industry country risk assessment (PICRA) attributable to MuniFin's lending operations.

While municipalities to date have largely weathered COVID-19, some municipal-owned companies have requested payment holidays from MuniFin. However, the increase in requests for payment holidays comes from a very low starting point, and we do not think it represents a deterioration in overall asset quality. In particular, due to the specific and temporary nature of the distress, only very few exposures have been moved into stage 2 or 3 under MuniFin's IFRS 9 accounting. In addition, any payment distress deemed reflective of long-term solvency issues would put the guarantee from the respective municipal owner into play.

Although the central government has deployed significant support to the municipal sector through COVID-19, we believe Finnish municipalities face structural challenges to their long-term financial sustainability. These include underlying mismatches in revenue and expenditure that emanate, as we view it, from increasing urbanization patterns coupled with an aging population, aspects that present systemic challenges, for example, through eroded local tax bases. We assess that the sustainability of Finnish public finances will likely require more tangible success on structural reforms that have to date underwhelmed, as illustrated by the recurring failure to push through social and health care (SOTE) reform after a decade of discussions. We assess our trend on Finland's institutional framework assessment as negative, capturing the lack of predictability of future reform execution and its timing. Underwhelming reform ability or prolonged negative budgetary deviations could test the framework's robustness and worsen our PICRA assessment and MuniFin's enterprise risk profile.

We view MuniFin's overall risk and financial management, and by extension, that of the group, as very strong. Enhancing prudent internal risk management policies are European Central Bank (ECB) supervision and bank regulation, 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.

The Capital Requirements Regulation II, including the binding leverage ratio, will be applicable in 2021. The regulation includes a binding leverage ratio requirement of 3% that will apply 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 exempt from the leverage ratio calculation. These clarifications and amendments have removed uncertainty related to regulatory capital requirements. MuniFin's leverage ratio stood at 3.8% at June 30, 2020, 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 Eurosystem

- Very strong capital ratios on the back of capital strengthening in recent years.
- Central bank access that underpins 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 a comfortable CET1 capital ratio of 87.8% as of June 30, 2020. This is largely due to the zero-risk weight applied to its loans, but also strong levels of retained earnings. The entity's excellent capitalization allowed it to comfortably digest the heightened lending demand over the first half of 2020. Our RAC ratio for the group was a very strong 54.7% on June 30, 2020, before adjustments. After our adjustments, in particular for single-name concentration, the RAC ratio is still extremely strong, at 31.4%. We expect it will stay comfortably above our 15% threshold, remaining a key support to the group's financial risk profile.

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 exclude it from our total adjusted capital (TAC) measure. As we perform the analysis on a group basis, we include MGB's equity in our TAC calculation. Still, 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, prudent liquidity policies, significant levels of high-quality prefunding, and comprehensive access to financing from the Finnish central bank mitigate this. 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 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.

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 our computation of the liquidity coverage ratio with data as of June 30, 2020, we include contracted bond inflows that were paid in early July 2020. 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 pioneered the issuance of social bonds on the Nordic capital markets, adding depth to its investor base. 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. The entity, alongside eligible eurozone supranationals and agencies, over 2020, have taken part in the ECB's targeted long-term refinancing operations (TLTROs). MuniFin used a portion of its pre-pledge municipal loans as collateral to take part in this exercise, which featured very favorable pricing terms.

Although MuniFin issues mainly standard funding instruments, legacy structured funding represents about 20% of its funding mix. Nevertheless, the structured funding component has decreased recently, and is hedged. 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 see a structural funding gap for MuniFin, and therefore for the group, with our one-year assets-to-liabilities ratio of below 1.0x, 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 funding instruments containing callable features. Partially mitigating the risks is the funding's generally long-dated nature, which provides some headroom for adjusting the structural mismatch. However, the group's funding ratio could improve as adopted policy changes are set to lead to longer 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 local governments.
- 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 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 guarantee 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 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, preventing a default.

In terms of SOTE, the central government is working on a revised bill that we expect will reach Parliament shortly. The scope of the reform is now more limited than the original proposition. Conscious of the lengthy setbacks in pushing this reform, the government has initiated a separate parliamentary working group, in which all parties in parliament are involved, that is looking into providing the upcoming regions with taxation rights. Taxation autonomy is a key issue for MGB because the prevalence of this would award the entities with a zero-risk weight in a regulatory context, which is a requisite for being able to join MGB as members and borrow from MuniFin. Considering the heightened financing requirements for upcoming health care investments, we consider it likely that officials will take steps to award the regions the ability to join the MGB structure and enjoy the benefits of MuniFin's long-term function as a stable price anchor to the sector.

Aside from extraordinary support from the local government and MGB members, the group's direct ownership by central government 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 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 program 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. 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, MuniFin's financial risk profile will remain solid, and 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 deteriorates materially. This deterioration could emanate from lessened central government engagement to the sector that lead 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 through the economic cycle.

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.

Municipality Finance PLC--Selected Indicators

			--Year ended Dec. 31--					
(mil. €)	2020 H1	2019 H1	2018	2017	2016	2015	2014	2013
Business position								
Total adjusted assets	41,288	36,956	35,677	34,728	34,045	33,883	30,005	26,152
Customer loans (gross)	26,743	23,719	22,968	21,651	21,196	20,276	19,338	17,882
Growth in loans (%)	7.80	3.30	6.10	2.15	4.54	4.85	8.14	13.44
Net interest revenues	123	117	236	229	206	172	160	149
Non interest expenses	29	29	45	39	31	25	22	21

Municipality Finance PLC--Selected Indicators (cont.)

			--Year ended Dec. 31--					
(mil. €)	2020 H1	2019 H1	2018	2017	2016	2015	2014	2013
Capital and risk position								
Total liabilities	40,025	35,450	34,538	33,746	32,868	32,845	29,415	25,686
Total adjusted capital	1,235	1,125	1,103	962	1,078	903	559	443
RAC before diversification (%)*	54.7	50.6	39.2	34				
RAC after diversification (%)*	31.4	31.2	24.5	21				
Gross nonperforming assets/gross loans (%)	0.1	0.1	0	0	0	0	0	0
Funding and liquidity (x)								
Liquidity ratio with loan disbursement (one-year)*	0.97	0.78	0.83	0.84				
Liquidity ratio without loan disbursement (one-year)*	1.21	1.04	1.02	1.01				
Funding ratio (one-year)*	0.99	0.84	0.8	0.75				

*2018 ratio calculated with data at June 30 of the year.

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: 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

- Institutional Framework Assessment: Finnish Municipalities, Dec. 21, 2020
- Research Update: Finland 'AA+/A-1+' Ratings Affirmed; Outlook Stable, Sept. 4, 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,