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CREDIT OPINION
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Update

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Municipality Finance Plc

Update following ratings affirmation

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.

MuniFin's ratings were affirmed on 23 September 2020.

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 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 is in line with the stable outlook on the government of Finland's rating.

Factors that could lead to an upgrade

MuniFin's senior unsecured and issuer ratings could be upgraded as a result of an upgrade of the government of Finland.

Factors that could lead to a downgrade

MuniFin's senior unsecured and issuer 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]

	06-20[2]	12-19[2]	12-18[2]	12-17[2]	12-16[2]	CAGR/Avg.[3]
Total Assets (EUR Million)	40,151.4	36,897.5	33,497.3	32,663.0	31,455.7	7.2[4]
Total Assets (USD Million)	45,096.2	41,417.4	38,292.2	39,221.6	33,178.0	9.2[4]
Tangible Common Equity (EUR Million)	1,212.2	1,177.7	1,104.1	952.8	810.6	12.2[4]
Tangible Common Equity (USD Million)	1,361.5	1,322.0	1,262.1	1,144.2	854.9	14.2[4]
Problem Loans / Gross Loans (%)	0.2	0.2	0.0	0.0	0.0	0.1[5]
Tangible Common Equity / Risk Weighted Assets (%)	90.8	84.1	68.7	53.4	48.2	69.1[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	3.7	5.2	0.0	0.1	0.0	1.8[5]
Net Interest Margin (%)	0.6	0.7	0.7	0.7	0.6	0.7[5]
PPI / Average RWA (%)	9.1	8.6	10.8	11.6	10.6	10.1[6]
Net Income / Tangible Assets (%)	0.2	0.3	0.5	0.5	0.4	0.4[5]
Cost / Income Ratio (%)	31.9	29.9	19.2	16.4	15.1	22.5[5]
Market Funds / Tangible Banking Assets (%)	88.6	83.8	82.9	83.4	92.3	86.2[5]
Liquid Banking Assets / Tangible Banking Assets (%)	13.6	17.8	16.5	27.8	22.3	19.6[5]
Gross Loans / Due to Customers (%)	1149.3	640.8	591.9	577.9	2428.1	1077.6[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 because of the scale of reported amounts. [4] Compound annual growth rate (%) based on the periods for the latest accounting regime. [5] Simple average of periods for the latest accounting regime. [6] Simple average of Basel III periods.

Sources: Moody's Investors Service and company filings

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 €40.2 billion at the end of June 2020 (Moody's adjusted).

MuniFin has being growing its personnel in the last few years and increased the number of employees to 167 in June 2020 from 151 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%).

Recent developments

We have revised our growth forecasts downward for 2020 as the coronavirus has caused an unprecedented shock to global economy. Business activity has fallen sharply across advanced economies in the first half of 2020 and we expect real GDP in the global economy to contract in 2020, followed by a recovery in 2021.

On 16 April 2020, we changed our outlook for the Finnish banking system to negative from stable. This reflects our expectation that business closures designed to contain the coronavirus outbreak will weigh on Finland's economy, leading to an uptick in problem loans, and increased pressure on banking sector profitability. The Finnish government's policy response has been comprehensive, encompassing financial support for the self-employed, as well as businesses and their employees. However, it will not be sufficient to entirely offset the coronavirus induced drop in growth, which will become more severe the longer the outbreak lasts. MuniFin's senior ratings are assessed by our GRI methodology and reflects the institution's close links to Finnish RLGs and ultimately the sovereign, and therefore are not expected to face the same challenges as commercial banks.

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 100% owned by the Finnish public sector, a Finnish local government pension institution (Keva) and the Republic of Finland. Following, its appointment, the Finnish government altered the oversight of Munifin from the Ministry of Environment to the Prime Minister's Office. This shift was driven by the aim to have all government owned companies steered by a dedicated department. 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 despite the challenging economic environment

MuniFin's strong creditworthiness reflects the supportive framework that underpins the RLG 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 48% of lending at the end of 2019) 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 characteristics ensure that RLGs remain creditworthy in the long-term, and are able to deliver key public services, such as education and health-care, as mandated by the central government. The Finnish government has recently announced that it will continue the preparation of the health care and social services reform and the new plans related to the reform are under political discussion. Previously the social and health care reform failed in the first half of 2019 and uncertainty over investments in health and social services continues in municipalities and hospitals. There is a great need for investments in infrastructure and schools in the growing regions in Finland.

Although MuniFin's asset quality is very strong, we believe that the coronavirus outbreak will increase the solvency risks, given the substantial implications for public health and safety across Finland, as well as the adverse impact the virus will have on the collection of locally generated tax due to weaker economic growth. Nevertheless, we do not expect any changes in MuniFin's asset risk, even if reported NPLs increase from current levels, given the support mechanisms that underpin the RLG sector.

As of June 2020, the lending portfolio grew by 7.7% compared to the year-end 2019 especially in the municipal sector due to the lower-than-anticipated recognition of tax revenues. The total amount of the total green financing stood at €1,436 million as of end-July 2020, which was a 14% increase compared to year-end 2019. 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 Finnish RLGs. 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 increased to 0.25% in the first half of 2020, from 0.16% during the same period in 2019. Although the net interest

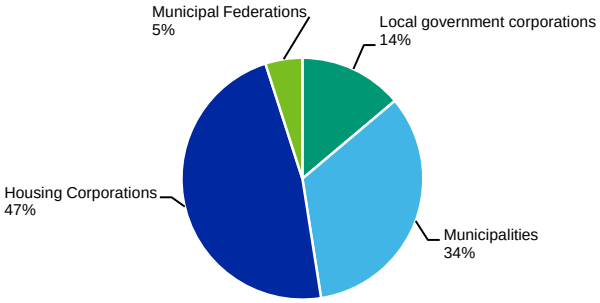
income improved slightly by 5% and total operating expense grew 2% year-on-year, the unrealised fair value changes weakened the net operating profit.

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 in 2019

MuniFin's lending is diversified within the RLG sector



Source: Company reports

However, the coronavirus' outbreak will have a substantial implications for public health and safety across Finland, as well as the adverse impact the virus will have on the collection of locally generated tax and service fee revenues due to weaker economic growth.

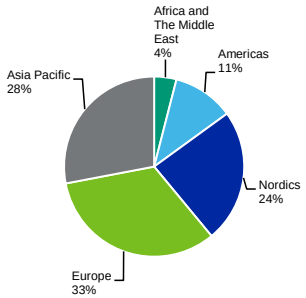
Diverse funding and good liquidity, but mismatches between assets and liabilities

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.

MuniFin was the first credit institution to launch green finance onto the Finnish market and the first Finnish green bond issuer. As of 31 December 2019, the total amount of green bond was €1.478 billion. In February 2020, MuniFin published a social bonds framework, introduced a social finance product targeted at investments that provide benefits for the society, and in September 2020 issued the first Finland's social bond, which was oversubscribed by nearly four times.

Exhibit 3

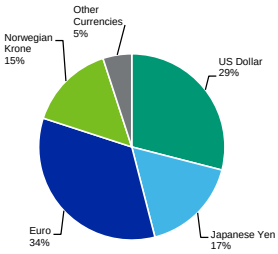
Funding By Region as of YE2019



Source: Company reports

Exhibit 4

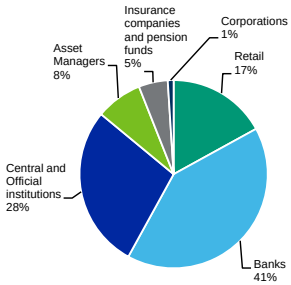
Funding by Currency as of YE2019



Source: Company reports

Exhibit 5

Funding by Investor Type as of YE2019



Source: Company reports

MuniFin is not match-funded, as the average maturity of its liabilities are shorter than the maturity of its assets. Also over 10% of MuniFin's funding comes with callable features (although proportions have come down significantly compared to a few years ago), which could further shorten the maturity of MuniFin's liability profile, if the calls were triggered. MuniFin manages this risk by maintaining a large liquidity reserve as well as having good access to funding in various markets and maintaining a liquidity facility at the Bank of Finland.

At the end of June 2020, MuniFin reported total liquid assets at €8.3 billion. As of year-end 2019 79% of the liquid assets were HQLA Level 1 (72%) and Level 2 (10%) assets. The debt securities in the portfolio are very highly rated, which is also the case for MuniFin's Nordic peers. 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.

Relaxation in capital requirements will mitigate coronovirus' negative effects

MuniFin is currently well capitalised relative to its risks. At the 30 June 2020 the institution reported a common equity Tier 1 (CET1) ratio of 87.8%. We recognise that the very high CET1 ratio is a result of the zero risk weights applicable on MuniFin's lending. This ratio nonetheless represents 11.5 times the minimum CET1 ratio of 7.63% required by the ECB. As of 30 June 2020, the minimum capital requirements were inclusive of a capital conservation buffer of 2.5%, an other systemically important credit institutions (O-SII) requirement of 0.5% and an institution-specific countercyclical buffer based on geographical distribution of exposures of 0.13%. However, on 6 April 2020, the Finnish Financial Supervisory Authority (FIN-FSA) has decided to remove the systemic risk buffer requirement for MuniFin (Finnish regulators implement measures to mitigate coronavirus' negative effects on banks), which lowers MuniFin's capital requirement by 1% since the systemic risk buffer and MuniFin's 0.5% O-SII buffer requirement are overlapping capital requirements. In June 2020 FIN-FSA decided to not impose countercyclical capital buffer requirement. After the changes, MuniFin's minimum Tier 1 Capital and Total own funds requirements as of June 2020 are 9.13% and 11.13% respectively.

The adoption of CRR II and CRD V will require credit institutions to maintain a minimum Tier 1 leverage ratio of 3%, at the earliest in 2021. While MuniFin already fulfills the 3% requirement (3.8%, as at end-June 2020), we expect that as a public development credit institution under CRR II, it will be able to exclude the bulk of its loan book, i.e. its exposures to municipalities and social housing loans, from the leverage ratio. This is a significant relaxation in the company's regulatory capital ratios, which are an important input into the assessment of the A3(hyb) rating assigned to the lender's Additional Tier 1 (AT1) contingent capital securities. Please see section on support and structural considerations below.

ESG considerations

We consider MuniFin to have a low exposure to Environmental risks in line with how we view the banking sector. See our Environmental risks Environmental heatmap for further information.

Due to MuniFin's role as one of Finland's largest credit institution specialising in the financing of Finnish municipalities, it is susceptible to politically and socially motivated decisions that could affect its financial profile. Its borrowers are exposed to the challenges of providing services to an aging population leading to increasing dependency ratios. Over time, these challenges can add pressure on municipalities' finances, even though the sector's institutional framework overlying MuniFin's clients help manage these risks. The framework includes municipalities constitutional right to set local level tax rates independently, an equalisation mechanism supporting financially weaker municipalities, and the joint guarantee where member organisations are responsible for each others commitments in proportion to their population figures. Social considerations are material to Munifin's credit profile due to the credit institution's exposure to the social service and health care provision that must be delivered by its clients, Finnish local governments.

We view the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety across Finland, as well as the adverse impact the virus will have on the collection of locally generated tax and service fee revenues due to weaker economic growth. Overall, we consider the issuer to have a moderate exposure to Social risk.

Other social risks in terms of customer relations or change in consumer preferences, which are generally relevant for the banking industry, are less important for MuniFin, given that the bank does not engage in retail activities. See our Social risks Social heatmap for further information.

Governance is highly relevant to MuniFin's creditworthiness. Corporate governance weaknesses can lead to a deterioration in a company's credit quality, while governance strengths can benefit its credit profile. Governance risks are largely internal rather than externally driven. We do not have any particular concern around MuniFin's corporate governance, which is regulated by law and influenced by its public ownership structure.

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 November 2019. 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.

The company may decide to re-finance the AT1 partially or entirely if the Capital Requirements Regulation permits this based on an improvement in the company's finances. The company has the right but not the obligation to call the instrument on 1 April 2022 or, after that, annually on the interest payment date, as long as the buy-back is approved in advance by the issuer's regulator. An eventual designation as a public development credit institution would enable MuniFin to fulfill the leverage requirement without refinancing the AT1.

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. The CR Assessment assigned to MuniFin also reflects the application of Moody's Banks methodology.

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

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CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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