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Municipality Finance And Municipal Guarantee Board

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Credit Highlights

Issuer Credit Rating
AA+/Stable/A-1+

Overview	
Enterprise risk profile	**Financial risk profile**
The enterprise risk profile of Municipality Finance (MuniFin) and the Municipal Guarantee Board (MGB), creating a de facto group, is supported by a clearly defined public policy mandate and a strong market position.	The group's risk-adjusted capital (RAC) ratio remains very robust in a Nordic peer comparison.
The Social and Healthcare (SOTE) reform will have a significant impact on the local and regional government sector in Finland, but the group's lending exposure risks will remain low.	The liquidity position remains strong, supported by ample buffers and broad access to external funding channels.
We believe the group's credit quality is supported by a highly competent management team, demonstrated by comprehensive risk management policies and sophisticated funding strategies.	The structural funding gap we observed before 2021 has disappeared, as demonstrated by the one-year assets-to-liabilities ratio above 1.0x

The group's strong public policy mandate and competitive market position will remain intact after the implementation of the SOTE reform. In 2023, the responsibility for organizing health care and social services will be transferred to the newly created wellbeing services counties, which are classified as zero risk-weight exposures according to the Finnish Financial Supervisory Authority (FIN-FSA). Initially, the central government will be responsible for the financing of these entities and the municipalities will likely experience diminished spending pressures as a result of the transfer, translating into stronger budgetary performance. At the same time, despite the creation of a new tier of government, we expect MuniFin's strong market position and favorable business prospects will remain.

Excellent risk capitalization, diversified funding sources, and central bank access support the group's financial risk profile. The group remains very well capitalized, demonstrated by an adjusted RAC ratio of 37.8% as of June 2022. At the same time, its funding and liquidity position is supported by close matching of assets and liabilities, ample liquidity buffers, and central bank access. Furthermore, MuniFin benefits from a strong presence in the capital markets, allowing for a broad and reliable funding strategy.

We believe that the group would receive timely and extraordinary support from its municipal owners if needed. The group enjoys municipal sector support through a joint and pro rata guarantee commitment through MGB. The guarantee rests on an extensive and permanent membership base and the members are bound by a joint pro rata liability mechanism.

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 while MuniFin upholds its solid financial risk profile. At the same time, our view of the group's strong public policy mandate will likely remain unchanged.

Downside scenario

We could lower the ratings over the next 24 months if the credit quality of the underlying municipal stakeholders deteriorates materially. 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 throughout the economic cycle.

Upside scenario

We could raise the ratings if the underlying credit quality of the Finnish municipalities constituting the supporting group were to improve. In addition, an upgrade would require a similar rating action on the sovereign.

Rationale

Enterprise risk profile: Strong market position combined with low-risk lending activities

- MuniFin's critical policy role as funding provider to the municipal sector has remained intact throughout the pandemic, while extensive central government support has mitigated the financial pressure on Finnish municipalities.
- The public sectors to which MuniFin lends have very strong credit quality, owing to Finland's strong economic fundamentals and well-developed financial sector, and the government guarantees the group's social housing lending.
- The group has proactive, competent, and risk-averse management, which assures compliance with regulatory requirements and continued execution of the public-policy mandate.
- Despite structural demographic challenges in Finland, illustrated by a weakening dependency ratio, combined with inflationary pressure, we expect the local and regional government sector will maintain sound budgetary performance, underpinning the strong credit quality of MuniFin's lending counterparties.

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. MuniFin's lending and funding activities dominate the group's operations, so our assessment of the group's enterprise risk is primarily based on the organization's credit features.

We consider MuniFin core to the group because it conducts all lending and funding activities, and plays a key role in providing financing to Finland's municipalities and non-profit housing organizations, with the latter benefitting from guarantees extended by Finland's central government. MuniFin has close links with the municipal sector, as well as the central government, illustrated 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 municipalities. The LRG sector's guarantees of MuniFin's financial liabilities are provided through MGB.

MuniFin's mission is to ensure reliable and cost-efficient funding to Finnish municipalities and joint municipal authorities, municipal companies, and state- and municipality-guaranteed housing entities. The organization's market position has gradually strengthened in recent years, especially since the outbreak of the pandemic, during which other credit institutions have had limited presence in local government financing. Furthermore, in the fall of 2021, MuniFin implemented changes to the conditions of its long-term loans with variable interest rates so that customers would benefit from negative reference rates more so than previously. These revisions will likely further strengthen MuniFin's competitiveness vis-à-vis other financiers present in the market.

On June 23, 2021, after many years of discussion, the Social and Healthcare (SOTE) reform was passed in the Finnish Parliament by 105 votes to 77 and no abstentions. The reform will introduce a third tier of government, comprising 21 wellbeing services counties plus the city of Helsinki, and enter into force in 2023. Once implemented, the newly established counties will take over responsibility for health, social, and rescue services. The aim of the reform is to address nationwide inequalities in access to quality health, social, and rescue services. We also believe efficiency gains and economies of scale could be achieved in the process, as a result of streamlined organizational structures across the country.

The creation of a new tier of government will have a significant impact on the local government sector's financial statements because cash flows, assets, and debt will be transferred between entities. Notably, the municipal sector's revenue base will be roughly cut in half whereas the aggregated loan stock will not decrease to the same extent. Consequently, we expect the relative debt burden in the sector will structurally increase in 2023 and beyond. That said, we expect the debt accumulation will be moderate as some investment needs will be transferred to the counties. Moreover, the transfer of health care and social services to the counties means that municipalities will no longer be exposed to spending pressures within these responsibility areas. Given Finland's changing demographic structure, characterized by an aging population, expenditure growth in these budgetary units will remain notable.

At the same time, we expect the municipalities' operating margins will remain relatively stable as the revenue base shrinks, translating into structurally improved performance metrics across the board. As a result, we expect the budgetary performance in the sector will improve after the reform has been implemented. Overall, 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. Because of this, and the clarity we now have on the financial impact of this reform on the local government sector, we have revised the trend for the institutional framework for Finnish municipalities to stable from weakening.

As a result of the reform, about €3 billion-€4 billion of MuniFin's loans and other liabilities will be transferred to the wellbeing service counties. We do not view this transfer as adding additional risk in terms of MuniFin's lending exposure. Initially, the counties will be funded almost exclusively by central government transfers, and there will be mechanisms for compensating entities afterwards if it turns out that distributed funds are insufficient to cover operating expenditure. Overall, we expect there will be a strong commitment from the central government to support the counties financially. At the same time, the counties will fall under the same legal framework and reporting standards as municipalities, while benefitting from the robustness of the Finnish LRG system.

At the onset, the newly created counties will not become members of the MGB and so will not be part of the guarantee system. Therefore, the MGB has imposed an annual lending cap on MuniFin's lending to these entities. As for the counties eventually becoming members of the MGB, questions remain regarding the funding of these entities and their right to levy taxes. Still, we expect the counties will be allowed to become members further down the line. Regardless, we believe MuniFin's market position will remain strong as the agency will remain an important financier of the counties.

MuniFin's role as primary financier of the Finnish municipal sector has remained throughout the pandemic. Initially, funding to the sector grew rapidly as a result of municipalities proactively acquiring funding in advance. However, in line with the relatively speedy economic recovery in Finland, the municipal sector's demand for new financing has returned to more moderate levels. The central government implemented unprecedented support packages to combat the financial impact of the pandemic, boosting budgetary performance and mitigating borrowing needs in the municipal sector. That said, investment needs in the LRG sector remain significant, partly driven by infrastructure projects and maintenance backlog. Consequently, we expect the demand for MuniFin's financing will remain solid in the coming years.

In contrast to the volatile demand for municipal sector financing, the demand for state-subsidized housing financing has remained more stable throughout the pandemic. That said, supply chain issues and material shortages caused by the pandemic, and further exacerbated by the military conflict in Ukraine, have impacted the demand for financing in 2022. About 48% of MuniFin's loans are directed to the housing sector, carrying central government deficiency guarantees. This gives an uplift in our PICRA attributable to MuniFin's lending operations to the housing sector. Furthermore, MuniFin's market position remains very strong as there is limited competition from other credit institutions.

On Oct. 7, 2022, the European Commission approved the notification submitted by the MGB and MuniFin, granting MuniFin license to fund municipal energy companies. This funding setup can be attributed to the high and volatile energy prices seen across Finland and the rest of Europe. The arrangement means that MuniFin can direct funding to energy companies controlled by municipalities only for the purpose of collateral requirements in derivative contracts. In other words, borrowings under this scheme cannot be used for the purpose of funding capital expenditure. At the same time, MuniFin requires that loans to the energy companies are fully covered by a municipal guarantee, meaning that the risk of the agency's lending portfolio does not change. So far, no loans have been issued under this arrangement. However, the future financing needs are difficult to predict since they are linked to energy markets developments.

We view MuniFin's overall risk and financial management, and by extension, that of the group, as very strong. European Central Bank (ECB) supervision and bank regulation play an important role in forming the agency's internal risk management policies, and MuniFin is proactive in managing its regulatory requirements. In this regard, MuniFin issued an additional tier 1 (AT1) instrument in 2015 to address the potential effect of the proposed leverage ratio requirement. These securities, amounting to €350 million, were redeemed on April 1, 2022, but MuniFin's capital adequacy ratios and leverage ratio remain comfortably above the minimum requirements. Previously, we did not include it in our total adjusted capital (TAC), meaning that the redemption does not have an impact our RAC calculations.

Financial risk profile: Very strong capitalization and comprehensive access to the Eurosystem

- The group has very strong capital ratios on the back of capital strengthening in recent years.
- Central bank access supports MuniFin's strong liquidity position.

- The one-year assets-to-liabilities funding ratio remains above 1.0x.

The group has a very strong capital position with almost all capital reported on MuniFin's balance sheet. Our RAC ratio before adjustments for the group has decreased marginally since the previous review but remains very strong at 68.9% as of June 2022. After adjustments, in particular for single-name concentration, the RAC ratio is still extremely strong at 37.8%, which is somewhat higher compared to one year before. MuniFin also has a robust CET1 capital ratio of 83.8% as of June 2022. This is largely due to the zero-risk weight applied to MuniFin's loans, but also to strong levels of retained earnings. We expect both ratios will remain comfortably above our 15% threshold.

We view the group's liquidity position as strong. Although MuniFin is exposed to risks through its dependence on wholesale market funding, this is mitigated by prudent liquidity policies, significant levels of high-quality pre-funding, and access to financing from Finland's central bank, which is a part of the Eurosystem. 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 guidelines for collateral eligible for repurchase agreement purposes, which has restored a significant 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, but the size of its balance sheet and strategies to optimize its financial position result in occasional volatility in liquid assets. Following the outbreak of the military conflict in Ukraine, MuniFin decided to increase its liquidity buffers as a precaution. Consequently, we believe the coverage ratios could be somewhat inflated as a result. That said, MuniFin has taken steps to structurally improve its liquidity position, partly by extending the survival horizon. Our liquidity sources-to-uses ratio indicates that MuniFin will comfortably 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 issued its inaugural social bond, becoming the first Nordic entity in the sovereigns, supranationals, and agencies category to do so. We expect green and social bonds will play an increasingly important role in MuniFin's funding strategy. 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. In June 2021, the company participated in the ECB's third series of targeted long-term refinancing operations (TLTRO III), acquiring €750 million to bring the total to €2 billion (about 5% of total funding in June).

Although MuniFin primarily issues standard funding instruments, structured funding remains key to its strategy. Between 2015 and 2019, the share of structured funding diminished significantly, but the percentage has since been relatively stable at 20%-23%. 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.

In the years leading up to 2021, MuniFin operated with a funding gap as illustrated by our one-year assets-to-liabilities ratio of below 1.0x. Since then, the funding ratio has stabilized above the threshold at 1.08x in June 2022. The average maturity of the funding portfolio has increased somewhat and we expect it could increase further, supporting our neutral assessment.

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 in line with that of the sovereign, 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.
- The newly created wellbeing services counties will soon be fully operational but they will not become MGB members at this stage despite being classified as zero-risk weight exposures.

The group enjoys municipal sector support through a joint and pro rata guarantee commitment from the municipal 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.

The Finnish Financial Supervisory Authority (FIN-FSA) has established that the counties should be classified as zero-risk weight exposures. As a result, no central government guarantee is required in order to finance these entities. That said, the newly created counties will not become members of the MGB at this stage and so will not be a part of the guarantee system. Therefore, the MGB has imposed an annual lending cap on MuniFin's funding to these entities. As for the counties eventually becoming members of the MGB, questions remain regarding their funding and right to levy taxes. Still, we expect the counties will become members at some point.

We assess the guarantees as predictable and immediately enforceable by law, which underpins our assessment of an integral link between the group and its municipal stakeholders. We believe 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 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 experiences financial stress, and before the guarantees are called, preventing a default.

In addition to the extraordinary support coming from the local government and MGB members, the central government's direct ownership in the group 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 in which new government-controlled entities could be established for the purposes of carrying out large-scale infrastructure investments, mainly related to the railway network. In connection with this initiative, the program outlines the possibility of MuniFin taking part in the financing of these entities via amendments to the MGB Act.

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 infrastructure projects will only materialize over the medium to long term. However, it could eventually strengthen the group's link to the central government.

Key Statistics

Municipality Finance PLC--Selected Indicators

	--Year ended December 31--					
(Mil. €)	**2022 H1**	**2021 H1**	**2020 H1**	**2019 H1**	**2018**	**2017**
Business position						
Total adjusted assets	47,491	45,658	41,288	36,956	35,677	34,738
Customer loans (gross)	28,831	28,582	26,743	23,719	22,968	21,651
Growth in loans (%)	0.87	6.88	12.70	3.30	6.10	2.15
Net interest revenues	122	138	123	117	236	229
Non interest expenses	40	31	29	29	47	41
Capital and risk position						
Total liabilities	46,010	44,213	40,025	35,450	34,538	33,746
Total adjusted capital	1,532	1,427	1,235	1125	1103	962
RAC before diversification (%)	68.9	69.1	0.5	50.6	39.2*	34.1*
RAC after diversification (%)	37.8	36.3	31.4	31.2	24.5*	21.1*
Gross nonperforming assets/gross loans (%)	0.1	0.1	0.1	0.1	0	0
Funding and liquidity (x)						
Liquidity ratio with loan disbursement (1 year)	1.25	1.27	0.97	0.78	0.83*	0.84*
Liquidity ratio without loan disbursement (1 year)	1.28	1.32	1.21	1.04	1.02*	1.01*
Funding ratio (1 year)	1.08	1.08	0.99	0.84	0.80*	0.75*

H1--First half. *Ratio computed with data as per June 30.

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: Neutral 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: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, 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. 13, 2022
- Finland, Oct. 31, 2022

This report does not constitute a rating action.

Ratings Detail (As Of December 19, 2022)*		
Municipality Finance PLC		
Issuer Credit Rating		AA+/Stable/A-1+
Senior Unsecured		AA+
Issuer Credit Ratings History		
30-Sep-2016	*Foreign Currency*	AA+/Stable/A-1+
13-Oct-2015		AA+/Negative/A-1+
14-Oct-2014		AA+/Stable/A-1+
30-Sep-2016	*Local Currency*	AA+/Stable/A-1+
13-Oct-2015		AA+/Negative/A-1+
14-Oct-2014		AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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