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Research Update:

Finnish Public-Sector Lending Agency Municipality Finance 'AA+/A-1+' Ratings Affirmed; Outlook Stable

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Table Of Contents

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Overview

- Finland-based Municipality Finance continues to have very strong capitalization, further supported by continued robust earnings and waiving of dividends.
- The ratings on Municipality Finance are underpinned by the high creditworthiness of the Finnish local government sector, which provides a joint and pro rata guarantee to the agency's investors through Municipal Guarantee Board (MGB).
- We are therefore affirming our 'AA+/A-1+' ratings on Municipality Finance.
- The stable outlook partly reflects that on the sovereign. If we lowered our ratings on Finland, we would also lower our ratings on Municipality Finance. If we raised our ratings on Finland, a possible upgrade of Municipality Finance would hinge on our view of Municipality Finance's and MGB's joint creditworthiness.

Rating Action

On Dec. 21, 2017, S&P Global Ratings affirmed its 'AA+/A-1+' long- and short-term issuer credit ratings on Finland-based Municipality Finance PLC. The outlook is stable.

At the same time, we affirmed our 'BBB+' long-term issue rating on Municipality Finance's subordinated debt. We also affirmed our 'A-1+' short-term issue rating on the agency's commercial paper.

Rationale

To analyze Municipality Finance, we use "Principles Of Credit Ratings," published Feb. 16, 2011, on RatingsDirect. We assess the agency's business risk profile as very strong, based on its business position, management, and governance; and its financial risk profile as strong, due to our assessment of its funding, liquidity, and capital adequacy. We then incorporate extraordinary support, provided by a joint and pro rata municipal guarantee from the Finnish local government sector to Municipal Guarantee Board (MGB; AA+/Stable/A-1+), which in turn extends guarantees exclusively to Municipality Finance.

Municipality Finance is the primary credit institution for Finnish local governments and the central government's subsidized housing sector. The ratings on Municipality Finance therefore reflect our view of the local government sector's robust creditworthiness, which is underpinned by strong systemic support features and the institutionalized and unlimited ability of municipalities to increase local income tax rates. Furthermore, the agency displays strong risk management, very strong liquidity, excellent asset quality, and a healthy capital position. That said, the ratings ultimately hinge on the support of the Finnish local government sector via

MGB's joint and pro rata municipal guarantee. MGB is a special public-policy entity through which all Finnish mainland municipalities (that is, excluding the autonomous Åland Islands) are jointly liable (pro rata according to population size) for bonds issued and guaranteed by the Municipal Guarantee Board.

The ratings also incorporate funding risk arising from Municipality Finance's dependence on wholesale funding, together with a large volume of callable liabilities that could subject the agency to occasional short-term refinancing needs. Municipality Finance's public policy mandate also leads to a degree of concentration risk in its lending.

Municipality Finance's loan book contains only Finnish municipal and central government risk. All lending carries a 0% risk weight, per Bank for International Settlements' calculations. The agency provides funding directly to municipalities or municipal federations, or to companies majority owned by the municipalities and to central government subsidized housing production, backed by a municipal or--for public housing--a state deficiency guarantee. We assess the credit quality of the Finnish local and regional government (LRG) sector as robust and consequently consider the asset quality of Municipality Finance's LRG sector loan book to represent very limited credit risk. Furthermore, all loans to the central government's subsidized-housing sector, 46% of the agency's loan book (as of September 2017), contain deficiency guarantees (guarantees that can be exercised after sale of collateral) from the sovereign (Finland, AA+/Stable/A-1+).

Municipality Finance maintained its position as the leading lender to the Finnish public sector in 2016, with total lending rising 4% year on year to €20.9 billion. This high growth rate is similar to 2015's, which in our view reflects Municipality Finance's strong competitiveness in its lending operations, even though competition from multilateral institutions has increased. We note that lending growth slowed so far in 2017, and we estimate it at 0.3%, with total lending of €21 billion at year-end. We note, however, that the decreased lending growth this is related to the improved financial situation of the municipalities, which have reported strong operating performance during the year, and somewhat to the proposed healthcare and county council reform, and the uncertainties surrounding the division of responsibilities between municipalities and county councils.

We observe a continuation of the agency's strategy of maintaining strong profitability to build equity, so as to align itself with future regulatory requirements. In 2016, Municipality Finance's net interest income increased to €206.1 million from €172.2 million the previous year, partly due to healthy loan margins introduced in previous years to strengthen the capital base via the income statement. Municipality Finance's 2016 operating profit (that is, profit before taxes and appropriations) amounted to €174.2 million, up from €151.8 million in 2015.

Municipality Finance's leverage ratio (equity to assets) was 3.7% as of June 30, 2017, compared with 3.2% on June 30, 2016. Therefore, Municipality Finance is compliant with proposed future regulatory capital requirements for leverage ratios. Due to the low-risk nature of Municipality Finance's loan portfolio, our riskadjusted capital ratio for the agency stood at a very healthy 38% (before concentration adjustments) on June 30, 2017, signaling, in our view, very strong capitalization. We note concentration risk in the lending operations, however, which somewhat limits our overall assessment of Municipality Finance's capitalization, although we understand that the concentration is related to limitations set by the Act on the Municipal Guarantee Board.

Municipality Finance's asset-liability management is prudent, and we understand the agency strives to optimize the duration of assets and liabilities, even though it does not conduct loan-to-loan funding of its lending, and an overall structure with liabilities having shorter tenors than assets. Consequently, the agency hedges risk through derivatives, which creates significant counterparty exposures to financial institutions. In our view, the agency conducts prudent and sophisticated risk management with conservative counterparty limitations and risk-reducing credit support annexes in place to handle these exposures. Municipality Finance's funding operations are well diversified in all major relevant financial markets and with regards to its investor base. Some of its funding instruments have callable features which, if exercised, could shorten the maturity profile. To our knowledge, this risk exposure is continuously monitored and managed by setting liquidity reserves at an appropriate size.

We note the ongoing discussions about reorganization of Finland's public sector by establishing county councils whose main responsibility will be health care. We will monitor these developments and assess possible implications for Municipality Finance, with regards to asset quality and market position, among other factors.

Liquidity

Municipality Finance has a very strong liquidity position, in our view. Even though the agency 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. In addition, we view favorably Municipality Finance's focus on long-term wholesale funding.

In addition to a liquidity line with the central bank, Municipality Finance also benefits from an important mechanism for liquidity management, since it can use its entire municipal loan book and most of its securities portfolio as eligible collateral for repurchase agreement transactions. This is possible because of its status as a central bank counterparty and represents a significant strength in terms of the volume of eligible collateral. We understand that Municipality Finance does not intend to use this option on an ongoing basis, although we note that routines and procedures have been tested.

Municipality Finance has ample prefunding, which is invested in highly-rated liquid securities that in total amounted to about €7.3 billion in June 2017. We consider Municipality Finance's liquidity policies to be prudent. They stipulate that the agency should, at all times, carry enough liquidity to sustain a market shutdown of six months without disruption to its lending activities, including forecast new lending and an assumed normal call rate of liabilities.

Outlook

The stable outlook on Municipal Finance partly reflects that on the sovereign. If we were to lower our ratings on Finland, we would also lower our ratings on Municipality Finance. However, if we were to raise our ratings on Finland, a possible upgrade of Municipality Finance would hinge on our view of Municipality Finance's and MGB's joint creditworthiness.

Our ratings on Municipality Finance continue to reflect our two-year expectation that the structure of Finland's joint municipal funding system will remain in its current form, and that Municipality Finance will remain the sole recipient of MGB's guarantees. In addition, we anticipate that the creditworthiness of the Finnish municipal sector, even after a possible reform of the LRG structure, will remain stable and that the current legislative structure--including the MGB Act and MGB's status as a special public-policy agency--will remain broadly unchanged.

Furthermore, we could lower the ratings on Municipality Finance if its stand-alone creditworthiness were to weaken. This could happen if we saw a deterioration in the asset quality of the agency's lending operations or security investments, if its funding capacity deteriorated, or if its management practices loosened. We could also lower our ratings on Municipality Finance if we believed that MGB's guarantee would weaken.

Related Criteria And Research

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions - January 29, 2015
- Criteria - Governments - International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign - December 15, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions - November 19, 2013
- Criteria - Governments - General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology - November 26, 2012
- General Criteria: Principles Of Credit Ratings - February 16, 2011
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Finland Ratings Affirmed At 'AA+/A-1+'; Outlook Stable - September 15, 2017

Ratings List

	Rating	
	To	From
Municipality Finance PLC		
Issuer Credit Rating		
Foreign and Local Currency	AA+/Stable/A-1+	AA+/Stable/A-1+
Senior Unsecured		
Foreign and Local Currency[1]	AA+	AA+
Foreign Currency[1]	AA+	AA+
Foreign and Local Currency	AA+	AA+
Subordinated		
Local Currency	BBB+	BBB+
Short-Term Debt		
Foreign and Local Currency[1]	A-1+	A-1+
Commercial Paper		
Local Currency[1]	A-1+	A-1+

[1] Dependent Participant(s): Municipal Guarantee Board

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.

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