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Research Update:

Ratings On Finnish Public-Sector Funding Group Affirmed At 'AA+/A-1+'; MuniFin Off UCO; Outlook Stable

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Overview

- We have now reviewed Municipality Finance (MuniFin) and Municipal Guarantee Board (MGB) under our new criteria for public-sector funding agencies.
- We regard MuniFin and MGB as a part of a de facto group forming a key pillar of Finland's municipal funding system, with very strong enterprise and financial risk profiles.
- We are affirming our 'AA+/A-1+' ratings on MuniFin and MGB and removing the ratings on MuniFin from under criteria observation (UCO), where we placed them on May 22, 2018, after publishing the new criteria.
- The stable outlook reflects our expectation that the current structure of Finland's municipal funding system will remain intact, that MuniFin will remain the sole recipient of MGB's guarantees, and coming municipal sector reform won't weaken the group's public policy mandate.

Rationale

On July 19, 2018, 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.

We removed the ratings on MuniFin from UCO, where they were placed on May 22, 2018.

At the same time, we raised our long-term issue rating on MuniFin's subordinated debt to 'A-' from 'BBB+'.

Rationale

Together, MuniFin and MGB currently 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 very strong enterprise risk relies mainly on

MuniFin's credit features. Our view of the financial risk profile as strong stems from our analysis of the combined entity.

The ratings 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 alleviate our concerns about a recurring structural funding gap. Overall, we believe the group has a very strong enterprise risk profile and a strong financial profile.

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 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 revised our assessment of MuniFin's stand-alone credit profile (SACP) to 'aa' from 'aa-'. This led us to raise our rating on the junior subordinated debt to 'A-', which is four notches below the SACP. We observe that the first call date of this instrument is in April 2022, which indicates a residual life of less than four years. We now regard the equity content in MuniFin's AT1 instrument as minimal rather than intermediate.

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 social 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 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- and municipality-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 are mainly targeting certain large municipalities and their sizable projects, so we don't think their activities would threaten MuniFin's strong market position and public policy role. Nevertheless, this could somewhat dampen MuniFin's lending growth over the coming two years.

In 2017, MuniFin's lending increased by about 1.5% to €21.2 billion, compared with 4.1% growth in 2016. The lower net increase in lending was primarily attributable to the municipalities' stronger financial results, which reduced their need for debt financing. Another factor was stronger 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 regulatory requirements. In this regard, we observe that MuniFin issued an additional Tier 1 (AT1) instrument in 2015 to cater for the potential impact of the proposed leverage ratio requirement. We consider it important that this instrument does not allow for conversion into equity. Nevertheless, the statutes governing MuniFin allow only public bodies to be stakeholders.

In 2016, the European Commission proposed a requirement for public development credit institutions, relaxing the requisite for any such institution to be established under public law, which if approved would further cement MuniFin's comfortable capital position. We observe that the supervisory and resolution authorities are yet to take a decision on requirements for resolution plans and the minimum requirement for own funds and eligible liabilities (MREL) for promotional banks, such as MuniFin. Therefore, we cannot exclude the possibility that MuniFin could be required to issue Tier 3 instruments to comply with the MREL.

The Finnish local government 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 46% 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 central bank access

- Very strong capital ratios on the back of capital strengthening in recent years.
- Comprehensive treasury portfolio and central bank access that underscores strong liquidity.
- A structural funding gap from the high proportion 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 a very impressive Tier 1 capital ratio of 76%. This is largely due to the zero risk weight applied to its loans, but also thanks 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 measure. Our risk-adjusted capital (RAC) ratio for the group is an extremely strong 35%, and 34.1% for MuniFin alone, before adjustments. After our adjustments, in particular for single-name concentration, the group's RAC ratio is still a very strong 21.6% (21.1% for MuniFin), and 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. In addition, we view MuniFin's focus on long-term wholesale funding as positive. 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. 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, when we assume the agency would not have access to capital markets.

In addition to access to liquidity from the Finnish central bank, MuniFin's entire municipal loan book and most of its securities portfolio are eligible as collateral for repurchase agreement transactions. This is possible because of MuniFin's status as a central bank counterparty, and represents a significant strength of its liquidity profile.

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 structured funding represents about 20% of its funding mix, which is higher than for its Nordic peers.

We see a structural funding gap for MuniFin and therefore for the group, with our one-year assets-to-liabilities ratio at 0.75x, and a persistent funding gap for up to two years. This is largely due to the very long average tenor of lending, the majority of which matures after two years, combined with a material 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.

The structured funding component has decreased in recent years, and is hedged. However, the use of structured products implies some risk to the overall funding profile, with early redemptions of callable funding adding to planned funding needs. Given MuniFin's broad and diversified access to funding markets and instruments, and the current high demand for MuniFin's bonds, parts of these risks are mitigated under the currently positive global funding environment.

Likelihood of extraordinary support: Extremely high, via a joint and pro rata sector guarantee mechanism

- Under the joint guarantee scheme embodied in 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 is 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 the 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 are ultimately liable only for a proportion of the group's liabilities, the initial claims on the guarantees are unlimited. We therefore believe there is 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 will not materially alter our view of the group's public policy mandate or our assessment of risk from its customer base. In addition, we expect MuniFin's management will manage to control 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 were to unwind and the credit quality of 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 reduced ability to efficiently execute its public policy mandate through the economic cycle. Moreover, downward rating pressure could build if weaker risk management led to an erosion the group's funding and liquidity positions.

We could raise the ratings if the underlying credit quality of Finnish LRGs supporting the group were to improve, alongside that of the sovereign.

Key Statistics

Municipality Finance PLC Selected Indicators

	--Year ended Dec. 31--				
(Bil. €)	**2017**	**2016**	**2015**	**2014**	**2013**
Business position					
Total adjusted assets	34,728	34,045	33,883	30,005	26,152
Customer loans (gross)	21,651	21,196	20,276	19,338	17,882
Growth in loans	2.15	4.54	4.85	8.14	13.44
Net interest revenues	229	206	172	160	149
Non interest expenses	39	31	25	22	21
Capital and risk position					
Total liabilities	33,399	32,868	32,845	29,415	25,686
Total adjusted capital	1,267	1,078	903	559	443
Assets/capital (%)	27	32	38	54	59
RAC before diversification	34.10	--	--	--	--
RAC after diversification	21.10	--	--	--	--
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity (%)					
Liquidity ratio with loan disbursement (one year)	0.84	--	--	--	--

Municipality Finance PLC Selected Indicators (cont.)					
	--Year ended Dec. 31--				
(Bil. €)	**2017**	**2016**	**2015**	**2014**	**2013**
Liquidity ratio without loan disbursement (one year)	1.01	--	--	--	--
Funding ratio (one year)	0.75	--	--	--	--

Note: The data and ratios in the table reflect financial accounts of Municipality Finance PLC only.

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
 Group support             0

Additional factors         0

SACP                       aa
 Group status              Core
 Likelihood of support     Extremely high (+1 notch)
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Municipal Guarantee Board

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

Group Credit Profile       aa+
Group status               Core
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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

Related Research

- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018
- 10 Public-Sector Funding Agencies Placed Under Criteria Observation On Publication Of New Criteria, May 22, 2018
- Finland's Proposed Reform Of Government Tiers And Health Care Casts Some Clouds Over Public Sector Predictability, Feb. 28, 2017

Ratings List

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Ratings Affirmed

Municipal Guarantee Board
Municipality Finance PLC
 Issuer Credit Rating                   AA+/Stable/A-1+

Municipality Finance PLC
 Senior Unsecured                       AA+
 Commercial Paper                       A-1+

Upgraded
                                        To                  From
Municipality Finance PLC
 Subordinated                           A-                  BBB+
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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.