Additional key questions and more…

Lars M Andersson

Reducing risks in financing activities

Local Government borrowing, like any other borrowing, includes a number of risks. There is a danger of not getting access to funding in times of crises or any other disturbance in the market that is predominantly used. Another risk is that, in the case only one market or type of financial instrument is used, that local government could suddenly experience sharp interest rate increases (in refinancing or new borrowing). These risks are mitigated by diversification in borrowing activities. Diversification means that you spread the borrowing to different markets, different financial instruments (bonds, private placements etc.) and have a number of loan programmes in place. The key to diversification is volume. The yearly borrowing size needs to be big enough that it enables you to spread the borrowing in the way described above. And it is not only a question of, for example, single bond issues in the different markets. You need to have a presence in each market that you use, so that you are properly recognised when a new bond issue is presented. Even very big local authorities do not have the amount of yearly borrowing to diversify its borrowing in the way an agency can. An agency has a far better possibility to diversify its funding than a single local authority, because of the size of its operations.

The possibility of diversification for a Municipal Bond Agency gives reason, not only for small local authorities, but also for larger cities to join such an entity. The local government funding agencies of Scandinavia and the Netherlands had a steady access to funds in the market during the recent financial crisis. This was the result of their excellent ratings and the fact that the agencies had a real diversification of their borrowing. Another reason was the prudential way of conducting their operations. In the case of Sweden, Kommuninvest was able to help commercial banks by taking over their loan stock of local authorities. Private entities that focused on lending to local authorities had in some cases severe problems. As examples, Dexia and the Austrian Kommunalkredit are noteworthy. In the case of Dexia, it led to a total dismantlement, which was caused by short-term borrowing and long term lending and investments in non-performing assets

Higher creditworthiness for local authorities

A Municipal Bond Agency needs to implement a system of monitoring the activities of local authorities. The reason for this is, of course, that the agency is directly dependent on the creditworthiness of their clients, just as any credit institution. However, the agency only has one category of client. This is both advantageous and disadvantageous. It is advantageous because it the agency can be very knowledgeable about the sector; its challenges and possibilities. It is disadvantageous because it does not spread credit risks to different sectors. This is why an agency has to be even stricter in their appraisal of loan applications than other institutions. Without a good credit rating and a good reputation among investors, an agency will not work. An agency owned and backed by a considerable number of creditworthy local authorities is destined to reach the best possible rating. The reliance on the creditworthiness of the local authorities involved in the Agency's activities also show why an agency would not give incentives to local authorities to take on excessive borrowing.

Let us look at the system for monitoring local authorities, used by Kommuninvest. The are two aspects to this:

1. A thorough investigation of the local authority creditworthiness before it gains membership in Kommuninvest.
2. A yearly assessment of the each member's situation.

If the creditworthiness of a members has dropped substantially, there is a possibility that it was be expelled from the Agency. It is very important that the prerequisites for entering into the Agency are strict and transparent. The Agency should always have the possibilities to refuse membership to local authorities with poor creditworthiness and also to exclude members with financial problems. In the case of Kommuninvest, existing members (local authorities) has the full power to set the criteria for joining the Agency, which assures that every new member has an acceptable creditworthiness. The fact that the members, with their knowledge about the sector, set the criteria also ensures that the quality of the credit quality assessment is excellent.

If high quality supervision of local authorities is combined with a reduction of borrowing costs and reduced risks in the funding activities (diversification), it gives very powerful incentives for councillors and financial directors to improve their authorities creditworthiness, in order to gain membership in the Agency. In my experience, peer pressure is much stronger than central government pressure. Kommuninvest's important role as gatekeeper, as well as giving incentives to improve creditworthiness, is recognised by the Swedish central government.

A centre of expertise

Local authorities main objectives are to provide basic services for their residents. These services could, for example, be water and sewage, solid waste disposal, transportation, education, care of the elderly and other types of local infrastructure. The focus of the local politician is to produce the "right" local services in the "right way", and the evaluation of that is up to the voters in the local elections. The focus of the Financial director in a local authority is to organise proper accounting, to produce a budget and an annual report. The head of economic administration is generally not recruited for skills in financing, but more for extensive experience in budgeting and accounting. This leads normally to a situation where municipalities lack the necessary skills to handle external funding efficiently without excessive risk. An agency has the possibility to employ financial experts to run these activities. However, this does not rule out the fact that an agency also needs people with a thorough understanding of the local government sector.
Both Kommuninvest and Agence France Locale have implemented a structure of governance that takes these matters into consideration. This is illustrated below: Kommuninvest has also taken on a role to support research in matters related to local government financing and related questions. Universities and other research institutions can once a year apply for grants to specific projects. The result of the supported research is communicated to Swedish local authorities.

A centre for transfer of knowledge

A very important role for an agency is to transfer knowledge to local authorities and Kommuninvest works actively in this regard. The transfer of knowledge takes place both in daily activities and at various events. At the level of the board of the cooperative society

The board of Kommuninvest Cooperative Society, consisting of local politicians, receives a training program from Kommuninvest. Discussion within the board provides additional knowledge of the possibilities and conditions of the financial markets. The board is also an arena for exchange of knowledge on best market practices and solutions for the local authorities that the board members represent.

Credit Research & Financial Committee

The members of the Credit Research & Financial Committee are appointed by the Yearly General Meeting of the Cooperative Society. The Committee is responsible for monitoring the financial status of member municipalities as well as developments in the municipal sector as a whole. It is also tasked by the Society's Board to process new membership applications. The committee is made up of financial directors in local authorities that are members of Kommuninvest. The Committee's instructions state that it shall represent different parts of Sweden, have experience from different types of municipalities and knowledge of funding operations.

The Committee's Tasks:

- Screen municipalities and county councils that apply for membership of Kommuninvest Cooperative Society, and give an opinion on the applications.
- Review each member of Kommuninvest Cooperative Society at least twice a year.
- Follow economic and financial developments in the municipal sector.
- Develop the analysis model used to review municipalities and county councils.
- Consider issues of primary economic and financial importance to the municipal sector.
- Deal with issues regarding future assessments relating to the financial position of the municipal sector, and national economic developments.
- Assist the Society's Board in preparing statements on specially referred issues.
- Otherwise performing tasks set by the Society's Board.

This Committee is an important instrument for the activities of Kommuninvest, but also a way to spread knowledge and awareness of questions related to financial markets and instruments, risks and creditworthiness.

Seminars

Annualy, Kommuninvest arranges a number of seminars on subjects related to itsactivities. Both local politicians and officials attend these seminars.
Eight financial seminars were arranged in different parts of Sweden during the autumn of 2013. Kommuninvest are to arrange 18 Member Consultations in 2014. These are conferences, in all parts of Sweden, where the overall strategy for Kommuninvest, as well as current issues, are discussed.

The General Meeting is also organised as a conference to which speakers from central government and other organisations are invited.

Consultancy

In the first part of Kommuninvest's history, consultancy was a part of its activities. The agency carried out loan stock reviews, and consulted on routines and procedures.

General communication - publications

Communication is one of the most important areas for an agency. One could look at an agency as the interpreter between the international financial markets and the local government sector. It is obvious that great efforts have to be applied to inform investors of the Agency, its clients and its activities. An extensive programme of road shows has to be implemented. But, it is also crucial to inform local authorities and to teach them about financial markets, financial instruments and, maybe above all, risk management.

Kommuninvest issues the following publications

Dialog; A magazine with 4 – 5 issues a year aimed at councillors and financial directors, as well as others interested in public finance

Perspektiv; three issues a year with in-depth articles about financial questions, aimed at Financial Directors

Veckobrev; weekly newsletter distributed as e-mail. Include a market up-date and information of rates, currencies etc. Aimed at Financial Directors.

Graphs & charts updated every month
Examples for appropriate wording of council decisions related to finance

Apart from the above-mentioned publications, Kommuninvest, of course, makes the annual report, the interim report and other relevant documents available to members and non-members.

Furthermore, Kommuninvest arranges a number of meetings with the members. What could be specially mentioned are the so-called member consultations. During 2014, these kinds of meeting were arranged in 20 local authorities in Sweden, to which all members were invited to discuss Kommuninvest and its operations.

Investors need to be reached, in different ways, by the message of the merits of the LGFAs and their bond issues. The most important is meetings with investors, either through one-to-one meetings or larger so-called "road shows", where a number of investors are invited. The Scandinavian LGFAs have successfully joined forces to arrange joint road shows in different markets.

Local Authorities and Risk

The role of local authorities is to supply the citizens with local public services of good quality at a low cost. It is not to show good financial results, but to produce services as cost-effective as possible. The resources that local authorities use for their operations are the taxpayers' money, regardless if it comes from local taxes or from state grants. Local Authorities, for that reason, should not speculate with their resources and keep the risks involved in their activities at a low level.

Of course, risk is present everywhere and a part of life that can't be excluded. No matter if you do something or not, risk is involved. Local authorities meet many types of risks in their everyday operations. They could range from the risk of not doing an infrastructure investment, which would slow economical development in the region, to a risk taken in the financial markets, such as choosing between fixt rate loans or floating rate loans.

The more you understand about risks involved in what the local authority is doing, the better you can handle risk. Knowledge is key. Many problems that local authorities have faced in the capital markets derive from them not fully understanding the implications of their actions. A simple rule is that you have to understand the risks in what is planned well enough to be able to evaluate the risk and, equally important, to be able to explain the risk to others, as for example the political leadership of a local authority.

So, in meeting risks, there are certain questions that you should ask yourself, for example:

- How does the risk involved in the project work?
- Can you price the risk?
- How big is the risk of failing?
- Do you know any risk-mitigation techniques that could be applied?

When local authorities are present in the capital markets, they are also exposed to close scrutiny from investors. Investors are, of course, cautious about where they place their money and have often very little time to make their decisions. This leads to a situation where the investors often overreact to bad news from an issuer. If we combine this with the fact that local authorities sometime tent to use media in their negotiations with central government, often describing the situation in gloomy colours to get more support from central government. An example of this is when in the late 90s, the Swedish city of Malmö told the newspapers (and the central government) that their economy was close to a total "melt-down", without being anywhere close to bankruptcy, the capital markets reacted immediately with questions from all over the world.

When there are real financial problems, like in the cases of Orange County in the US and Hammersmith & Fulham in the UK, the effects in the financial markets lingers on for a very long time and also spreads to all related entities in other countries.

Council of Europe has, in the report Local Government in Critical Times (2011) proposed some measures concerning financial risks:

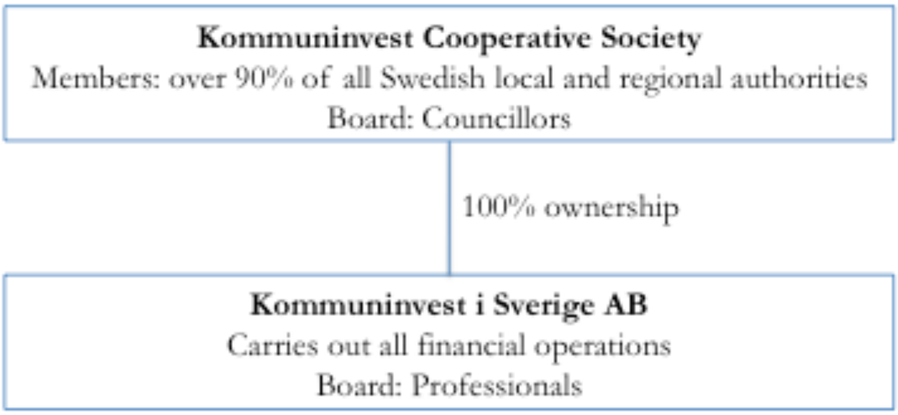
- The assessment of financial risk should comprise prior monitoring and warning mechanisms as well as intervention and supervisory procedures.
- Speculative investment by local and regional authorities should be prohibited.
- Any financing techniques, which have the object or the effect of concealing the level of debt of the local or regional authority, should be prohibited.
- Legislation should exclude or limit the possibility of using buildings and assets indispensable to the fulfilment of the local or regional authority's mandatory or related tasks as collateral for guaranteeing borrowing.
- In general, local and regional authorities should have the right to incur debts only for the funding of investment expenditure and not for current expenditure.[1]

[1] Local Government in Critical Times, CoE, 2011

Political governance of the Nordic local government funding agencies

Kommuninvest

The Swedish local government funding agency has a two-tier organisation, illustrated below



In the cooperative society the Board consists of 15 mayors and councillors appointed by the General Assembly. A nomination committee, consisting of 7 mayors and councillors (other than those in the Board), prepares this appointment. The politicians in the Board represent members of the cooperative society.

According to the Article of Association the Board shall have at least two meetings annually. In practice the Board has 4-5 meetings every year.

The main tasks for the Board of the Cooperative society are to take decisions in membership question. They try and decide on applications for membership, monitor the creditworthiness of the local authorities and take actions if the creditworthiness of individual members were compromised. Such an action could, in the worst case, lead to a proposition to the General Meeting to exclude a member from the Cooperative Society.

The Board have also to decide on the participation capital that should be paid by new members.

The Board is also functioning as referral body for parliamentary propositions in questions concerning local authorities and their financing.

Furthermore the Board propose shall the General Assembly to decide on owner's directive concerning Kommuninvest i Sverige AB. These directives shall include general targets and guidelines for the operations in the limited company. The Board also follows the activities in the limited company through frequent reports.

The Board shall once a year establish rules of procedure for their work.

Within the Board, a Working (Executive) Committee is elected, consisting of the chairman and 3 other members of the Board. Their mission is to prepare decisions in the Board and to function as a nominee committee for proposing members of the Board of the limited company. They meet approx. 8 times annually.

Kommunekredit

Kommunekredit has a one-tier system, with a Board of Director, consisting of 10 mayors and councillors. Eight of these are elected by the municipalities and two by the regions.

According to the Articles of Associations no less than four Board meetings shall be held annually.

According to the Act of Kommunekredit (the latest version was passed by the parliament in 2006) the Board shall ensure that the Institution's (Kommunekredit's) activities are managed properly, while the management is in charge of the day-to-day operations of the institution. The Board of the Institution shall issue written guidelines on the Institution's most significant areas of activity, specifying the distribution of responsibilities between the Board and the Management. For example, the Board issues guidelines on risk exposures.

The Board also follows the activities through reports given on their meetings by the CEO. Another important issue for the Board is to discuss and determine the strategy for Kommunekredit. Annual reports and interim reports are, naturally, also questions for the Board.

Municipality Finance

Municipality Finance has a one-tier system. The Board of the agency consists of eight directors. One restriction that is to be found in the Articles of Association states that Members of the Board of Directors may not belong to the management of another credit institution or another company engaging in competitive activities.

The Board consists of representatives from central government (owns 16 %), KEVA (pension fund owns 30,66%) and local authorities.

The Board has around 10 meetings annually. Two committees are elected within the Board: Audit Committee and Remuneration Committee.

The main duties of the Board include confirming the Company's strategy and budget, monitoring the Company's financial situation and ensuring through supervision that the Company's management, and risk management in particular, is properly arranged by management. The Board also maintains adequate contact with and creates reporting channels for the internal audit and the Company's auditor. The Board will follow the development of the Company by means of monthly management reports and other information supplied by the management. Within the scope of these duties, the Board may set specific limits or restrictions, the exceeding of which is subject to the Board's approval.

Discussion regarding competition

Financial institutions owned by the public sector are viewed with suspicion from the point of view of a free competition. EU-directives set an extensive and detailed framework for keeping the public sector from distorting free markets. It is therefore important to consider whether an agency distorts competition. Firstly, it is essential to discuss the specific regulations of an agency. Experience has shown that the most cost-efficient funding for local authorities occurs when the agency does not have a monopoly and local authorities are free to borrow from any credit supplier in the market. It is essential that all borrowing should be open to fair and transparent competitive bidding. An agency should not be given any specific advantages or privileges such as exemption from taxes, although it can be argued that local government is a part of the country's government that indeed levies taxation. It is an important conclusion that the Agency should, as far as possible, adapt to market practices.

Some argue that a publicly owned financial institution, with or without a guarantee from its owners, distorts the free markets. However, this is a weak argument since the only purpose of a municipal bonds agency s to service its members, local authorities, with financing solutions. An agency does not lend in an open market. It does not lend money to any third party in the competitive sector.

An agency's role is to create advantages for the involved groups, which is identical to the underlying principle behind the whole cooperative movement. In its funding operations an agency works in full competition with other market players and it is only natural that the stakeholders of a funding entity would explore every possible way (such as guarantees) to lower the costs of funding. In lending operations, the Agency must be cost efficient in full competition with banks and other parties in the financial markets.

In conclusion, if a Municipal Bond Agency is operating in a free market competition is boosted. The absence of an Agency often leads to markets characterised by oligopoly consisting of a few suppliers of credit.

Matters relating to competition were taken to both the domestic courts and the EU Commission respectively in complaints lodged by banking interests. The results were rulings that Kommuninvest and Municipality Finance were not distorting competition.

The claim that local government guarantees constitutes so-called State-Aid was resolves for Agence France Locale during 2014, when the EU-commission ruled that this was not the case.

The journeys taken by Kommuninvest and Munifin

This paper is concentrated on the start-up period of Kommuninvest and Municipality Finance. Although these agencies also were created in a different environment from today, many aspects of their developments still shine a light on the challenges involved in these kinds of projects.

Kommuninvest

Timeline

1986
Creation of a regional agency

1988
First private placement in Japan (1.3bn yen)

1989
Questions about the legal status were resolved by a government decision to categorise Kommuninvest as a Credit Market Company.
First Swiss Bond issue (75m Swiss francs)

1991
The first rating (Moody's) at the same level as the Kingdom of Sweden.

1992
Established a euro-commercial paper programme
Initiative to cooperate with the other Nordic agencies

1993 The creation of Kommuninvest Cooperative Society and expansion to a national agency
First Bond issue in Japan (so called Samurai-bond)
Established a Euro-Medium-Term-Note programme

1993
Yearly road-shows in Japan

1994
56 members – 10 employees

1994
Present at the yearly World Bank meetings

1995
A magazine with 5-6 issues per year was introduced, targeted to local authorities
An agreement with EIB (a framework agreement for borrowing and on-lending to Swedish local authorities)

Background to the creation of the agency

The most important means of financing capital investments for the Swedish local authorities has for a long time been borrowing. The last remains of the central government interference in municipal borrowing were removed at the end of the 1970s. This led to some changes of in terms of who supplied municipal credits. Entities like the state pension funds became less active in this market. The effect of this was that big commercial banks became the most active lenders to local authorities. The money market developed rapidly in Sweden during the first part of the 1980s. For a few of the largest cities this meant that they had a way of independently achieving cost-efficient short-term borrowing through different money market programmes. However, the rest of the municipal sector had to turn to the big banks for municipal credits. These banks were not inclined to compete among themselves. For the banks a very convenient market had developed; low risk to great margins without inconvenience. The margins on municipal loans could now be raised to several percentage points. In conclusion there were clear and significant imbalances between risk and margins in municipal credits.

Kommuninvest i Örebro län was formed

In the abovementioned environment, the idea of municipal cooperation was born and developed within a group of civil servants and politicians in the county of Örebro in south central Sweden. Lars Anderrsen presented the first idea to this group in February 1986 and the company "Kommuninvest i Örebro län AB" was formally launched in November the same year. This was a regional initiative and cooperation that included nine municipalities and the county council in the County of Örebro (Örebro län). The cooperation was organised within a joint-stock company. This was at the time a legal requirement rather than the first choice of the founders. Since this was a cooperation project with only public sector participants a public law form would have been preferred. The advantages, though, with a joint-stock company were that this form was recognised internationally.The central government applied, after lengthy discussion, a status of a credit market company for Kommuninvest, which meant that the company was under the supervision of the Financial Supervisory Authority (Finansinspektionen).

Collateral arrangements

One of the crucial tasks was to find ways of "transporting" the municipal risk of the transactions to be used in Kommuninvest's borrowing. Originally, this was done by entering into a REPO-agreement with the financier, where the municipal loan agreements were used. This worked, but the whole handling of these agreements proved burdensome. When international markets started to be used, this method was even more difficult to use. After some years of operations, a system with a joint and several guarantee entered into by the participating municipalities was introduced. This change was inspired by the system used by Kommunekredit in Denmark.

Kommuninvest - from regional project to a national LGFA

In the last few years of the 1980s the agency developed its borrowing operations in the international capital markets. This benefited the owning municipalities as it gave cost-efficient funding. Over time the oligopoly situation of the commercial banks was becoming more widely acknowledged by more and more of the local politicians and civil servants. Still, the question of cooperating was not easy. "To mind one's own business" is one of the basic principles of the whole legal structure of municipalities. That competition between neighbouring municipalities was natural did not work in favour of cooperation.

In the early 1990s Kommuninvest continued to develop its operations successfully despite that the commercial banks trying, as they had from the start, every trick in the book to disturb or even to stop the project. Other municipalities saw both the success of Kommuninvest and the actions taken by the banks. In 1993 the financial crises resulted in great difficulties for the banks to be able to supply the municipalities with both new funding and refinancing. Kommuninvest, on the contrary, worked well during the length of the crises. As a result a large group of municipalities from all over the country turned to the agency with a desire to join. After lengthy discussions Kommuninvest i Örebro län AB changed its name to Kommuninvest i Sverige AB (1993) and became a national agency. There was also another important change: the municipalities were no longer to be direct shareholders in the joint-stock company. A cooperative society, Kommuninvest Cooperative Society, was formed and it was made the sole owner of the company. In the cooperative society the municipalities were members with equal voting rights, irrespective of the size of the municipality. On the board of the Cooperative Society the chairs were held by local politicians, while the board of the company consisted of professionals. Membership of the cooperative society was, and still is, granted to Swedish municipalities and county councils that have a good creditworthiness. Every applicant is thoroughly reviewed before membership is granted. A member can be expelled from the society is the creditworthiness deteriorates. This system gives a clear incentive for all Swedish municipalities to strive to be better in terms of their creditworthiness.

The capitalisation of Kommuninvest works in the way that new members in the cooperative society pay a participation fee based on the population of the municipality to the society, which yearly (if not otherwise is decided by the yearly meeting) is transferred to the joint-stock company as equity.

Municipality Finance Plc. (Finland)

(Source: interview with Nicholas Anderson, the first CEO of Municipality Finance, 1990 – 2000)

Timeline

1990
Creation of Municipality Finance Plc (Munifin), owned by the Local Government Pensions Institution, which also guarantees its funding.

1992
Established a Euro-Medium-Term-Note programme

1996
The Municipal Guarantee Board was established to guarantee Munifin's funding.

2001
Munifin was merged with Municipal Housing Finance Plc.
Alongside of the Pension Institution, a number of cities became shareholders.

2004
A financial advisory services unit was established within Munifin.
European Commission confirmed that guarantees put up by the Municipal Guarantee Board for Munifin's funding acquisition programmes are in line with EU regulations on state subsidies.

Rationale and Objectives, Market Determinants

Prior to the creation of Munifin as a financial institution in 1990, Finnish municipalities faced numerous difficulties in accessing the financial markets for appropriately priced debt. They also faced other problems regarding the efficient management of their financial activities. This situation was unacceptable because of the following facts:

- Municipalities have an unlimited right to tax residents to finance the provision of the basic services. Municipalities also receive subsidies and grants from central government to finance the provision of the basic services.
- Municipalities enjoy a zero risk weighting for the purposes of capital adequacy and thus should be able to borrow at the same level as the Republic of Finland.

There were several reasons for this state of affairs:

- The domestic banking market was an effective oligopoly, where there was little pressure to reduce margins.
- Small and medium-sized municipalities had limited access to the financial markets. Finland has a relatively small population covering a large geographical area with many small municipalities. This means that deal size on average for each municipal loan is low and inefficient.
- Loans to all but the largest municipalities were too small for foreign banks and for the public bond markets. Only a handful of the larger cities ventured into the foreign debt markets due to insufficient expertise.
- Municipalities and their central organisations did not have the necessary competence and expertise in the financial markets to create a more competitive environment for funding.
- Municipalities and their central organisations lacked expertise in asset and liability management of their financial affairs.
- Banks were offering a variety of domestic and foreign currency loans when interest rates and currency movements were extremely volatile.

It was against this background that Munifin was established to lower financing costs for all municipalities, to better secure funding for small and medium sized municipalities and to assist municipalities in the management of their financial assets and liabilities. This was achieved by the creation of the professionally managed funding agency guaranteed first by the Local Government Pension Fund and, subsequently, by the Municipal Guarantee Board (MGB), an institution established under special legislation of which most (98.4%) Finnish municipalities became members. Membership was based on voluntary application at the time the legislation was promulgated. A small number of small municipalities chose not to apply for membership based on fears that they may be subjected to onerous liabilities. This proved not to be the case.

The successful creation of Munifin required a simultaneous combination of the following prerequisites:

- Sufficient equity to satisfy the requirements for capitalisation of financial institutions under the BIS regulations for capital adequacy.
- A minimum number of ten qualified professionals to launch the company as an operating financial institution with appropriate risk and financial management procedures and systems, accounting, loan marketing and lending capacity and sufficient skills to deal with investment banks, banks, brokers and rating agencies for funding.
- Appropriate hardware and software for accounting and financial risk management.
- A joint guarantee system together with sufficient share capital to support capital adequacy requirements.
- The ability to support municipalities in developing their skills in financial asset and liability management.

The above prerequisites succeeded because five important entities supported the creation of MF. These were the Local Government Pensions Institution (LGPI), the Association of Finnish Local and Regional Authorities (AFLRA), the Ministry of the Interior (MoI), the largest cities and the Finnish Parliament.

The LGPI supported the process because they needed to reduce the pressure on direct borrowing by municipalities from the pension funds. Their support was important because they had the funds to invest in the start-up equity of Munifin and provide the necessary guarantees in the first years of operation between 1991 and 1996. They also had the necessary professional management to man the board of directors of Munifin during these early years.
The AFLRA, MoI and Parliament support was forthcoming because of the need to ensure that investments in the infrastructure for the basic services were made efficiently. Lower funding costs and better financial management for municipalities mean substantial costs savings for the public sector. Municipalities are responsible for creating and maintaining this capital-intensive infrastructure. Support from the big cities was motivated by more motives to promote more efficient and disciplined funding within the sector as a whole. The large cities tend to bear the brunt of inefficiencies or any accidents incurred by smaller municipalities in the financial markets. A joint and centralised system made all municipalities to improve efficiency in financial affairs through peer pressure.

The initial start-up period only lasted a few months during which the agency set up a basic risk management system, accounting and marketing system. The rating was announced at the end of this six-month period and was the same as the Republic of Finland. The final risk management system was finally developed during the following three years along side the much-improved accounting system.

The Finnish Banking Association, led by Nordea and OKO Bank, raised many objections to the creation of Munifin and later to the creation of the MGB. The MGB had been created after the Financial Supervision in 1994 raised informal objections to the granting of guarantees by LGPI for debt issued by Munifin. This objection was understandable since it is unusual for any pension institution to grant such guarantees on behalf of its members. The creation of the MGB under special legislation in 1996 resolved the situation. The legislation was supported unanimously by all the political parties. The guarantee ensures competitive funding for municipalities based on the creditworthiness of the whole municipal sector. According to the legislation, each member municipality is severally liable, pro rata their population, for any losses borne by the MGB.

As with the guarantee of LGPI, the guarantee of the MGB was awarded the best possible rating, as well as enjoying a zero risk weighting for the purposes of capital adequacy. After the passing of the legislation in 1996, the Finnish Banking Association subsequently lodged a complaint with the European Commission stating that such legislation whereby the MGB grants guarantees for MF amounts to illegal State Aid. The Commission ultimately rejected this complaint on the grounds that this is an internal guarantee arrangement within the public sector.

Particular Success Factors and External Enabling Conditions

The following factors were essential for success of the operations of Munifin:

- Unanimous support from all political parties from central and regional government for the maintenance of a strong and self-governing municipal system.
- Legislation relating to MGB that provides an unequivocal base that both simplifies and

supports the fact that the municipal sector can secure funding based on the creditworthiness of the whole municipal sector.
- Munifin ownership is concentrated with the large cities and central organisations. This enhances credibility since they represent the largest areas of population. Furthermore, the board is made up of municipal representatives who have some degree of experience in financial markets. Their selection is based on a political basis.
- Munifin and MGB are staffed by professional specialists.
- Munifin operate without having to maximise profits, but in the same fashion as other mutual businesses it seeks to earn a return that enables it to support growth of the balance sheet. Its original aim was to maintain low margins for the direct benefit of its municipal members. However in recent years margins are kept lower because of intense competition from foreign and domestic banks.

Munifin and MGB do not depend on direct sovereign guarantees for funding as a long tradition of self governance between central and regional government exists in Finland. Although this is an important practical principle, central government remains tightly integrated with the municipal sector in as much as their financial interdependence is intense.

Governance

Munifin has applied normal solutions for financial institutions in its choice of corporate governance. The legislation relating to the MGB restricts lending to member municipalities and liquidity and risk management rules are conservative and risk adverse. Munifin seeks to maintain the highest possible rating. This means that risk avoidance is more important than profits. Munifin has actively sought out commissions as a financial consultant from within the municipal sector and they have also conducted education training programs for advanced and more basic asset/liability management. Munifin has increased public awareness of the importance of efficient finance for the municipal sector in Finland by actively promoting such interests in the media. This has been an important counter balance to the banks who have not hesitated in criticising Munifin and MGB in the media.

Another important development was the creation of the domestic municipal bond market. Such bonds have been branded and offered to investors since 1993 as a low risk high yielding investment to bank bonds. Since banks are able to restrict competition, there exist opportunities to offer investors more competitively priced products directly without having the banks as intermediaries.