# KUNTARAHOITUS
MUNICIPALITY FINANCE

ANNUAL REPORT 1996

# TABLE OF CONTENTS

KUNTARAHOITUS
MUNICIPALITY FINANCE

Yrjönkatu 9,

00120 Helsinki, Finland

P.O.BOX 744, 00101 Helsinki

Tel. +358-9-6803 5666

Telefax +358-9-6803 5669

http://www.munifin.fi

# MUNICIPALITY FINANCE LTD.

Municipality Finance Ltd. represents the Finnish municipal sector on domestic and international capital markets.

The company's main objective is to arrange finance for municipalities at the lowest possible cost. The company grants loans exclusively to municipalities, municipal federations and municipality-controlled companies whose loans are guaranteed by a municipality. Municipality Finance Ltd. was established in 1989 and has been wholly owned by the Local Government Pensions Institution from the very beginning.

The company started lending operations at the beginning of 1991. It operates as a credit institution under the Act on Credit Institutions.

Through Municipality Finance Ltd., municipalities are able to reap the benefits of the sector's excellent credit rating and influence their own loan costs.

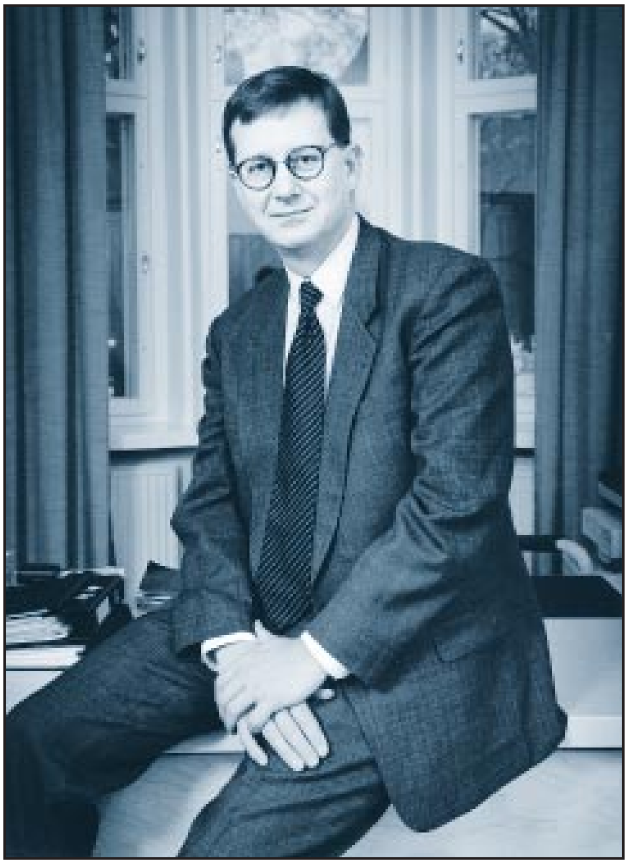
Funds are mainly raised by issuing bonds on the domestic or international capital markets. Domestic funding has clearly increased since Municipality Finance Ltd. launched the first Municipal Bonds® four years ago. This has become the company's most important form of funding. By the end of 1996, the company had executed seven issues.

In order to safeguard and develop the joint funding of municipalities, the Municipal Guarantee Board commenced operations in the fall of 1996. The Guarantee Board may grant guarantees for such funding of credit institutions directly or indirectly owned or controlled by municipalities. The Act on the Municipal Guarantee Board came into force on 1 July 1996.

Municipality Finance Ltd. debt is included in the zero risk category in capital adequacy calculations for banks and credit institutions in Finland.

Municipality Finance Ltd's credit ratings Feb 11th 1997:

| | Domestic currency | Foreign currency |
|---|---|---|
| Standard & Poor's | AA+ | AA |
| Moody's | Aaa | Aa1 |



# THE REVIEW OF THE MANAGING DIRECTOR

We had a good result for the year which was seen both in our figures and in our operations. The latter part of the year saw a return of loan demand but that did not prevent our balance sheet from dropping by more than ten percent. The Municipality Guarantee Board, MGB, started its operations and we were able to launch the first Municipal Bonds® issues in December.

We have continued to develop our loan and short-term facilities for the municipal sector and we will see some new developments in 1997 which will be announced at the beginning of the year.

Throughout the year we were able to offer both large institutional investors and retail clients our debt instruments both in Finland and in the foreign markets. In both markets the response continues to be very positive.

## Improved funding packages and new short term facilities

Our competitive position was strengthened in 1996 by new implementation of loan packaging where we can offer municipalities virtually any type of loan, fixed rate and floating rate, for the whole maturity spectrum from one month to fifteen years.

We have not been charging any management fees and our indicated interest rates has been the market leader for the whole of the year. The only constraint was our inability to issue Municipal Bonds® before the passage of the new Act in Parliament.

We have been planning the development of new short-term facilities in the new year for our municipal clients. They will improve the cost of funding and create higher levels of flexibility for large and small municipal clients.

During the year we introduced a new and successful product in co-operation with the European Investment Bank. Municipality Finance now offers credits based on a Global Loan Agreement with the European Investment Bank to all municipalities.

## The Municipality Guarantee Board takes off

The creation of the MGB, at the end of the year was a big step forward for the municipal sector. It created a clearly defined organization for granting guarantees for municipal debt which is effectively backed by almost all the mainland Finnish municipalities. The new body allows our shareholder to concentrate on their main duties for the next decades during which time the volume of pension liabilities will increase significantly.

The creation of the MGB was not easy given the breadth of the municipal sector and the opposition within some parts of the financial sector.

The result is similar to those constructions elsewhere in Europe and in Japan, where they have been used for many years. The creation of MGB does not involve any public support nor do we anticipate dipping into the public coffers for support in the future. The new entity basically resembles any normal guarantee syndicate where the beneficiaries themselves are responsible for their own liabilities.

## December sales of Municipal Bonds® was encouraging

We were pleased to start the issuance of Municipal Bonds®, once more, after a gap of exactly two years. Investor response was excellent and we were pleased to be able to offer a competitively priced bond once more directly through our own sales group. I expect the sales of this product to be significant in 1997, which is especially important now that debt demand is increasing and the date for a single European currency is coming even closer.

The rating agencies have made their judgment on the debt guaranteed by MGB - Moody's maintained the same ratings for the new senior debt denominated in both, currency Aa1, and Finnish markka Aaa. Standard & Poor's lowered the Finnish markka rating by one notch to AA+ while maintaining the currency rating at the same level of AA–. However we enjoyed the benefit of a currency rating improvement a few days later from Standard & Poor's to AA.

Kommuninvest of Sweden was able to issue bonds which our sales group sold to Finnish retail investors. The results were also excellent and filled the gap due to our absence from the local retail market as an issuer.

## The Single European Currency represents a challenge

One of my main concerns throughout the year has been the impact on and readiness of the municipal sector for the single European currency. We can expect that there will be greater competition for funding when trading commences in securities denominated in Euro at the beginning of 1999. We can expect that there will be a flood of issuers in this new currency both in our domestic market and elsewhere. We will see greater competition for investment funds in markets where we have had some competitive advantage. To balance this we can expect to see greater stability of interest rates - more than we have seen with the Finnish markka over the last six years during which the company has been operating. There will also be increased competition for lending to the municipalities but this may not be altogether positive. One of the reasons for the creation of Municipality Finance was to counteract the effective cartel that the banks have created during the 1980's and early 1990's.

In Finland and outside the country there are a number of financial entities receiving support from the public sector. The are lending to the municipalities and this clearly distorts competition. The creation of a single European currency will make this playing field more distorted in their favor.

The municipalities and our own company have started preparations for the introduction of a single currency. The wholesale financial markets will no longer be denominated in Finnish markka from January 1999. This means that our accounts and financial management and those of the municipalities must reflect these changes as of that date. Delay will serve no useful purpose.

## Conclusions

The year was rich in content - we enjoyed many fruitful meetings with our clients. In the fields of finance, training and consulting we expect these developments to continue along the basic same lines. May I thank staff, our shareholder and many other associates who expended much effort and time in making 1996 such a good year. Our main objective, to achieve the lowest possible cost of funding for the municipalities, has been successfully joined with another important objective - that of giving a high quality investment alternatives to both private retail investors and institutional investors alike. We remain grateful for their continued support.

# MUNICIPAL FINANCE AT A CROSSROADS

Despite the expansion of municipal operations and financial pressures, operating expenses in the municipalities have been held in check. This has been possible mainly because, on the expenditure side, municipalities have carried out their own retrenchment programmes and have made decisions on cutting costs, and on the revenue side, the municipalities have benefited from wage settlements and corporate taxation. The financial position of municipalities has been good up until last year.

However, uncertainties remain present at all times. Despite the positive economic outlook, pressures on expanding municipal duties, a tax revenue base, and a decrease in state grants will make it necessary for municipalities to evaluate thoroughly their own duties and modes of operations and the resources that are needed to maintain them.

## Development of operating expenses in the municipalities

Operating expenses of municipalities were approximately FIM 105 billion in 1995. The new public utility companies increased operating expenses by about FIM 5 billion.

The elimination of supplementary parts of national pensions at the end of the year 1996 decreased operating expenses by over FIM 4 billion. The decrease in employers' unemployment insurance payments also reduced expenditure. On the other hand, operating expenses rose as a result of the increase in municipal earnings, the municipalization of vocational schools, the expansion of the obligation to provide day care services, and the increase in basic subsistence expenditure.

Operating expenses will be lower in 1997 due to a decrease in municipal social security payments and the withdrawal from the obligation to pay a proportion of pensioners' housing allowances. However, these savings have been deducted from the state grants of the municipalities. In the education sector, the realization of a so-called "maintenance model" will substantially lower operating expenses, operating revenues and state grants. The realization of this model will have virtually no effect on municipalities.

In 1997, operating expenses will grow due to the following factors: an increase in municipal earnings, the municipalization of vocational schools, and the growing demand for municipal services. Additionally, reimbursement of VAT returns will be paid back in full.

## Tax revenues and state grants

Municipal tax revenues totalled some FIM 58.3 billion in 1995 and, in 1996, some FIM 61 billion. In 1997 tax revenues are estimated to grow by 3 per cent, (FIM 2 billion). Unfortunately much uncertainly surrounds the accrual of corporate taxes.

State grants for current expenditure totaled approximately FIM 38 billion in 1995. Cuts in state grants and the netting of elimination of supplementary portions in national pensions resulted in a decrease in state grants of some FIM 8 billion in 1996. State grants increased slightly as a result of the municipalization of vocational schools and the expansion of the obligation to provide day-care services.

In 1997, state grants for current expenditure will fall sharply, by approximately one third, from current levels. State grants for current expenditure totaled approximately FIM 30 billion in 1996, but in 1997 they will fall to approximately FIM 22 billion. The sharp decrease in state grants is due to the Government's financial quandary and across-the-board cuts of state grants by FIM 2.5 billion, the lowering of social security payments and also because the municipalities are no longer obliged to pay for pensioners' housing allowances. The latter two reasons mean that expenditure will fall. State grants will also decrease as a result of the "maintenance model" within the education sector and because the employment support will be transferred from state grants to operating revenues. Due to the changes in the state grant model for the education sector, the figures of 1996 and 1997 will not be comparable with one another.

State grants for current expenditure in relation to the operating expenses of the municipalities have decreased dramatically from 1995 to 1997. In 1995 about one third of operating expenses were covered by state grants for current expenditure, whereas in 1997 the corresponding ratio will be one fifth of operating expenses. Supplementary parts of national pensions and housing allowances paid by the municipalities have been deducted from these figures.

## Annual operating results of municipalities

The operating results of the municipal sector totalled approximately FIM 11.5 billion in 1995 and in 1996 the operating results are estimated to be approximately FIM 8 billion. In 1997, operating results will be falling to levels which, at least in some municipalities, may mean cutbacks in necessary basic services and investments. Maintaining the desired level of investments will probably result in many municipalities having to take substantial loans or cutting operating expenses. The slight increase in estimated tax revenues will not be enough to compensate for the decrease in state grants nor an increase in the reimbursement of VAT returns.

## Long-term financial prospects

The Association of Finnish Local Authorities has evaluated the development of municipal finance also in the long run, up until the year 1999. The evaluations are based on two alternative models; a "basic" model and a "slow growth" model.

In the basic model, annual growth of GDP is estimated to be 3.5 per cent on average, and unemployment is estimated to fall to 13 per cent by 1999. In the slow growth model annual GDP growth is 2 per cent on average with unemployment falling to 15 per cent by 1999.

In both models, municipal expenditure in relation to GDP would decrease during the evaluation period. The structure of revenues would change such that the share of tax revenues would increase and state grants would decrease.

According to the basic model the operating results would be lower than net investments. This trend would start in 1997 and by 1999 operating results would be approximately FIM 3.1 billion. In the slow growth model operating results would show a deficit in 1998 and would be FIM 2.8 billion in deficit at the end of the evaluation period.

The preparation of the 1997 budgets was rather problematic in many municipalities. The problems will be brought to a head if the financial assumptions fail. Variations in the financial positions between municipalities would increase and the financial situation of some municipalities could become critical.

## Structural decisions

In order to perform their obligations it will be necessary for municipalities to re-evaluate their finances, services and municipal structure thoroughly. It is essential to evaluate whether municipal obligations and operations are in balance with available resources. Municipalities must also evaluate their financial structures thoroughly.

Client awareness, operational efficiency and networking will be important keywords in the future. The power to make independent financial and operational decisions and increased responsibility will bring stability to municipal activities. Internationalization, membership in the European Union and the potential membership in the EMU will require a new policies and financial abilities to operate efficiently. The State must encourage municipalities to succeed in these aspirations through supporting measures.

*Pekka Alanen, Deputy Managing Director*
*Association of Finnish Local Authorities*

# REVIEW OF OPERATIONS IN 1996

The year 1996 was significant for the future operations of Municipality Finance Ltd. The new debt of the company will now be guaranteed by the Municipal Guarantee Board under an Act which came into force on July 1, 1996. According to the Act, the Municipal Guarantee Board may grant guarantees for the debt of credit institutions owned or controlled by municipalities.

After December 2, 1996 all funding of Municipality Finance Ltd. will be guaranteed by the Municipal Guarantee Board. All funding guaranteed by the Local Government Pensions Institution, which on December 2, 1996 totaled some FIM 6 billion will be remained unchanged until the date of its final maturity.

The borrowing requirements of the municipal sector increased considerably in 1996 because of further cuts in state grants and the repayment of bullets loans.

Close co-operation with the other Nordic finance institutions continued and Municipality Finance Ltd. managed and sold a FIM 60 million bond issue of Kommuninvest of Sweden to Finnish retail investors.

At the end of the year, the balance sheet stood at FIM 6,647 million which was FIM 887 million less than in 1995. Two large bond issues matured during the year, one for FIM 891 million and the other for ECU 240 million.

The company's capital adequacy ratios in the years 1992 - 1996 were as follows:

| | |
|---|---|
| 1992 | 23% |
| 1993 | 33% |
| 1994 | 35% |
| 1995 | 45% |
| 1996 | 44% |

According to the Act on Credit Institutions, the minimum capital adequacy ratio is set at 8 %. There have not been any non-performing loans, nor credit losses in the company's history. Share capital, including tier one reserves, now stands at FIM 50.2 million. The Local Government Pensions Institution holds 100% of the equity of Municipality Finance Ltd.

## Lending

Municipality Finance Ltd. grants loans mainly to municipalities and municipal federations. If a municipality or a municipal federation acts as guarantor, loans can also be granted to municipality-controlled companies and foundations.

The loan portfolio totalled FIM 6,154 million at the end of 1996. Of all loans granted, 76 % were denominated in markka and 24 % in foreign currencies. The amount of new borrowings by municipalities from Municipality Finance Ltd. totalled FIM 1,484 million in 1996. Lending was five times bigger than in 1995. All new loans were denominated in markka. The majority of the loans had annual repayment structures. The total of loans which finally matured during the accounting period totalled FIM 2,092 million. The number of long-term loan agreements was 768 at the end of 1996. The number of borrowers was 363 against 373 at the end of 1995. The company did not grant any short-term loans.

Five new municipal commercial paper programmes were signed. The total number of such programmes was 93 at the end of the year, totalling FIM 1,987 million. Trading in municipal paper remained active.

The book value of leased property stood at FIM 553,000 at year end.

## Funding

The company launched a new Programme for the issuance of Municipal Bonds®. According to this programme, the maximum total of bonds which may be issued is FIM 1,500 million. This is the first programme in Finland which has been listed on the Helsinki Stock Exchange. Municipal Finance Ltd. issued two new issues of Municipal Bonds® through this programme in December.

Municipality Finance Ltd. commenced co-operation with the European Investment Bank by signing a Global Credit Agreement, in June for FIM 200 million. Based on this agreement the company now offers credits to the municipal sector for projects of infrastructure, environmental protection and energy production. Financing has already been provided for the first projects, and negotiations are under way in order to find new targets.

The company has a FIM 4 billion Medium Term Note programme. During the year, the company issued debt under the EMTN programme totalling FIM 1,163 million and other long-term debt was issued totalling FIM 98 million. The company's short-term funding totalled FIM 611 million at the end of 1996. The amount of debt falling due during the year totalled FIM 2,687 million. Total funding at the end of the accounting period was FIM 6,222 million of which 57% was denominated in markka and 43% in foreign currencies.

## Risk management

The prime objective of Municipality Finance Ltd. is to satisfy the financing requirements of the municipal sector at the lowest possible costs. Because the company is indirectly owned and guaranteed by municipalities, it does not seek to maximize profits and therefore all risks have been minimized.

The company has very little open foreign currency or interest rate risks. Risks are hedged with interest rate swaps, currency rate swaps and forward rate agreements. Other derivative instruments may also be used for hedging.

The company uses risk management software for monitoring foreign currency risks, interest rate risks, as well as counterparty risk. Rating limits and internal risk limits have been set for counterparties. The company's portfolio of loans carries no real credit risks, as it lends exclusively to municipalities, municipal federations and municipality-controlled companies whose loans are guaranteed by a municipality. The same prudent policies are also followed for investment activity. The majority of liquid assets is always being invested in Finnish government treasury bills or bonds. The company reports regularly on its activities to the Bank of Finland and the Financial Supervision.

## Personnel and administration

Personnel numbered fourteen at the end of 1996. According to the Articles of Association, the Board of Directors comprises at least four and at most six members. On March 5, 1996 the Annual General Meeting appointed a Company Board.

**The Board of Directors:**

*Mr. Simo Lämsä*, Chairman
Managing Director, The Local Government Pensions Institution

*Mr. Pekka Alanen*
Deputy Managing Director, Association of Finnish Local Authorities

*Mr. Leif Engfelt*
Director, Association of Finnish Local Authorities

*Ms. Marja Kauppila*
Credit Manager, The Local Government Pensions Institution

*Mr. Erkki Pekkarinen*
Director of Finance, The Local Government Pensions Institution

*Mr. Seppo Perttula*
Deputy Managing Director, The Local Government Pensions Institution

The company has a 12-member Advisory Council, the function of which is to supply advice and recommendations, and to guide and direct the company in matters connected with its operating conditions and their development. The Council met once during 1996.

**The Advisory Council**

*Mr. Arto Laitinen*, Chairman
Manager, Municipal Finance
Association of Finnish Local Authorities

*Ms. Christel von Martens*
Deputy Chairman, Development Manager
Association of Finnish Local Authorities

*Mr. Håkan Fant*
Finance Manager, Municipality of Mustasaari

*Ms. Riitta Hallberg*
Municipal Secretary, City of Viitasaari

*Mr. Aaro Honkola*
City Treasurer, City of Seinäjoki

*Mr. Hannu Horto*
Finance Director, City of Kotka

*Ms. Marjatta Keisu*
Municipal Manager, Municipality of Liminka

*Mr. Tapio Korhonen*
Finance Director, City of Helsinki

*Mr. Mika Mäkinen*
Financing Manager, City of Turku

*Mr. Karl-Gustaf Lindström*
Controller, Municipality of Kirkkonummi

*Mr. Simo Paassilta*
Municipal Manager, Municipality of Halikko

*Mr. Matti Tölli*
City Treasurer, City of Kemi

The auditors of the company are Arthur Andersen Kihlman Oy, Authorized Public Accountants, Mr. Erkki Mitro, APA, as the auditor with the main responsibility and Mr. Jaakko Pohtio, APA and as the deputy auditor Mr. Eero Prepula, APA, Chartered Public Finance Auditor.

# BALANCE SHEET

(FIM 000's)

| | 31 December 1996 | | 31 December 1995 | |
|---|---|---|---|---|
| ASSETS | | | | |
| LIQUID ASSETS | | | | |
| Cash in hand | | 3 | | 6 |
| CLAIMS ON CREDIT INSTITUTIONS AND CENTRAL BANKS | | | | |
| Claims on credit institutions | | | | |
| Repayable on demand | 533 | | 612 | |
| Other | 8,701 | 9,234 | 4,600 | 5,212 |
| CLAIMS ON THE PUBLIC AND PUBLIC SECTOR ENTITIES | | 6,154,090 | | 6,758,379 |
| LEASING ASSETS | | 553 | | 897 |
| DEBT SECURITIES | | | | |
| On public sector entities | 219,572 | | 112,038 | |
| Other | 40,619 | 260,191 | 361,287 | 473,325 |
| SHARES AND PARTICIPATIONS | | 60 | | 60 |
| INTANGIBLE ASSETS | | 444 | | - |
| TANGIBLE ASSETS | | | | |
| Machinery and equipment | | 1,510 | | 1,018 |
| OTHER ASSETS | | | | |
| Cash items in the process of collection | | 2 | | - |
| ACCRUED INCOME AND PREPAYMENTS | | | | |
| Interest | 219,307 | | 291,910 | |
| Other | 1,856 | 221,163 | 3,558 | 295,468 |
| TOTAL ASSETS | | 6,647,250 | | 7,534,365 |

# BALANCE SHEET

(FIM 000`s)

| | 31 December 1996 | | 31 December 1995 | |
|---|---|---|---|---|
| LIABILITIES | | | | |
| LIABILITIES: | | | | |
| LIABILITIES TO CREDIT INSTITUTIONS AND CENTRAL BANKS | | | | |
| Credit institutions | | | | |
| Other | | 189.631 | | 157.967 |
| DEBT SECURITIES ISSUED TO THE PUBLIC | | | | |
| Bonds | 5.421.192 | | 6.758.107 | |
| Other | 611.013 | 6.032.205 | - | 6.758.107 |
| ACCRUED EXPENSES AND DEFERRED INCOME | | | | |
| Interest | 198.848 | | 271.119 | |
| Other | 176.410 | 375.258 | 299.372 | 570.491 |
| VOLUNTARY PROVISIONS | | | | |
| Fund for general banking risks | | 9.819 | | 7.619 |
| EQUITY CAPITAL: | | | | |
| Restricted equity: | | | | |
| Share capital | 38.000 | | 38.000 | |
| Reserve fund | 2.335 | 40.335 | 2.335 | 40.335 |
| Distributable equity: | | | | |
| Loss brought forward | -154 | | -169 | |
| Profit for the financial year | 156 | 2 | 15 | -154 |
| TOTAL LIABILITIES | | 6.647.250 | | 7.534.365 |

# PROFIT AND LOSS ACCOUNT

(FIM 000's)

| | 1 January-31 December 1996 | | | 1 January-31 December 1995 | | |
|---|---|---|---|---|---|---|
| INTEREST INCOME | | | | | | |
| Claims on credit institutions | | 2,238 | | | 958 | |
| Claims on the public and public sector entities | | 525,081 | | | 638,579 | |
| Debt securities | | 30,642 | | | 29,813 | |
| Other interest income | | 898 | 558,859 | | 218 | 669,568 |
| NET INCOME FROM LEASING OPERATIONS | | | 180 | | | 347 |
| INTEREST EXPENSES | | | | | | |
| Liabilities to credit institutions | | 5,687 | | | 6,987 | |
| Debt securities issued to the public | | 567,385 | | | 630,736 | |
| Other interest expenses | | -29,284 | -543,788 | | 18,206 | -655,929 |
| NET INCOME FROM FINANCIAL OPERATIONS | | | 15,251 | | | 13,986 |
| COMMISSION INCOME | | | 444 | | | 35 |
| COMMISSION EXPENSES | | | -4,589 | | | -4,018 |
| NET INCOME FROM SECURITIES TRANSACTIONS AND FOREIGN EXCHANGE DEALING | | | | | | |
| Net income from securities transactions | | | | | | |
| Debt securities | | 1,891 | | | 1,758 | |
| Net income from foreign exchange dealing | | 365 | 2,256 | | -358 | 1,373 |
| OTHER OPERATING INCOME | | | 11 | | | - |
| ADMINISTRATIVE EXPENSES | | | | | | |
| Staff costs | | | | | | |
| Salaries | 2,971 | | | 2,634 | | |
| Pension costs | 508 | | | 429 | | |
| Social security costs | 130 | | | 313 | | |
| Other staff-related costs | 284 | 3,893 | | 113 | 3,489 | |
| Other administrative expenses | | 3,867 | -7,760 | | 3,186 | -6,675 |
| DEPRECIATION | | | -562 | | | -457 |
| OTHER OPERATING EXPENSES | | | -2,599 | | | -3,054 |
| NET OPERATING PROFIT | | | 2,452 | | | 1,190 |
| INCREASE IN VOLUNTARY PROVISIONS | | | | | | |
| Increase in fund for general banking risks | | | -2,200 | | | -1,150 |
| DIRECT TAXES | | | -96 | | | -25 |
| PROFIT FOR THE FINANCIAL YEAR | | | 156 | | | 15 |

# SOURCE AND APPLICATION OF FUNDS

(FIM 000's)

| **SOURCE OF FUNDS** | **1996** | **1995** |
|---|---|---|
| FUNDS GENERATED FROM OPERATIONS | | |
| Profit for the year | 156 | 15 |
| Depreciation on fixed assets | 1,132 | 1,491 |
| Change in reserves | 2,200 | 1,150 |
| CHANGE IN LIABILITIES | | |
| Short-term liabilities | 415,781 | 67,708 |
| Long-term domestic liabilities | -982,097 | 12,686 |
| Long-term foreign liabilities | -323,155 | -321,136 |
| TOTAL | -885,983 | -238,086 |
| **APPLICATION OF FUNDS** | | |
| CHANGE IN RECEIVABLES | | |
| Cash and receivables from domestic banks | 4,019 | -28,970 |
| Lending to customers | 583,411 | 198,396 |
| Public bond issues | -1.187,700 | -268,067 |
| Other domestic receivables | -2,416 | 3,367 |
| Foreign receivables | -11,551 | -7,892 |
| CHANGE IN INVESTMENTS | | |
| Trading assets | -273,471 | -134,109 |
| Fixed assets and other assets | 1,725 | -811 |
| TOTAL | -885,983 | -238,086 |

# NOTES ON THE ACCOUNTS

**1.** Debt securities under assets in the balance sheet and debt securities issued to the public under liabilities, itemized.

| | |
|---|---|
| Assets: | |
| Certificates of deposit | 4,955,811 |
| Treasury bills | 170,589,652 |
| Municipal bonds | 10,174,973 |
| Other bonds | 74,470,840 |
| | 260,191,276 |
| Liabilities: | |
| Bonds | 5,421,191,941 |
| Others | 611,012,866 |

**2.** Maturity breakdown of claims and liabilities on the basis of remaining maturity

| | 0-3 months | 3-12 months | 1-5 years | over 5 years |
|---|---|---|---|---|
| Claims on credit institutions | 9.234.256 | - | - | - |
| Claims on the public and public sector entities | 299.963.935 | 821.317.464 | 2.839.794.393 | 2.193.014.658 |
| Debt securities | 65.908.865 | 120.818.968 | 69.088.443 | 4.375.000 |
| Liabilities to credit institutions | - | - | 151.931.040 | 37.700.000 |
| Debt securities issued to the public | 911.069.207 | 787.647.162 | 2.859.126.381 | 1.474.362.057 |

**3.** Assets and liabilities broken down into items denominated in domestic and foreign currency

| | FIM | Foreign currency |
|---|---|---|
| Claims on credit institutions | 8,968,614 | 265,642 |
| Claims on the public and public sector entities | 4,684,869,213 | 1,469,221,237 |
| Debt securities | 260,191,276 | - |
| Liabilities to credit institutions | 37,700,000 | 151,931,040 |
| Debt securities issued to the public | 3,539,085,850 | 2,493,118,957 |

**4.** Claims on the public and public-sector entities broken down by sectors

| | |
|---|---|
| Corporations | 458,972,284 |
| Public sector entities | 5,673,161,215 |
| Non-profit organizations | 21,956,951 |

All lending to corporations, public sector entities and non-profit organizations is guaranteed by a municipality or a city.

**5.** All debt securities under assets in the balance sheet are transferable.

**6.** Municipality Finance Ltd. does not have any non-performing nor other zero interest assets.

**7.** Municipality Finance Ltd. has no debentures nor other claims of less priority in comparison with the debtor's other debts.

**8.** Municipality Finance Ltd. has not granted any loans or guarantees to the members of the Board, to the Managing Director or to the auditors.

**9.** Leasing assets

| | |
|---|---|
| Machinery and equipment | 552,868 |

**10.** All debt securities in the Municipality Finance Ltd. balance sheet are transferable.

**11.** The total amount of the difference between the market value and the lower book value of “debt securities”: FIM 1,278,000.

**12.** Tangible assets and intangible assets in the balance sheet

| | Tangible assets | Intangible assets |
|---|---|---|
| Book value at the beginning of the accounting period | 1,017,839 | 0 |
| + acquisition costs during the accounting period | 1,050,366 | 448,078 |
| - depreciation made during the accounting period | 558,378 | 3,734 |
| Book value at the end of the accounting period | 1,509,827 | 444,344 |

**13.** Commitments and security given

| | |
|---|---|
| Counter-collateral to the Local Government Pensions Institution | 6,310,402,285 |
| Counter-collateral to the Municipal Guarantee Board | 58,980,000 |

**14a)** Total amount of the nominal value and the lower book value of liabilities

| | |
|---|---|
| Bonds | 9,283,378 |
| Others | 3,987,134 |

**14b)** Total amount of the book value and the lower nominal value of liabilities

| | |
|---|---|
| Bonds | 6,949,319 |

**15.** The business area of Municipality Finance Ltd. is to operate as a credit institution. The company’s market area is Finland.

**16.** Net income on leased assets

| | |
|---|---|
| Rental income | 716,186 |
| Gains from the sale of leased assets | 34,027 |
| Planned depreciation | -570,387 |
| Total | 179,826 |

**17.** Other operating income and operating expenses in the profit and loss account itemized as follows:

| | |
|---|---|
| Other operating income | |
| Other income | 11,270 |
| | |
| Other operating expenses | |
| Rental expenses | 610,396 |
| Other expenses | 1,988,730 |

**18.** Municipality Finance Ltd. has not got any credit losses nor guarantee losses.

**19.** Off-balance sheet commitments and liabilities

| | |
|---|---|
| Binding stand-by facilities | 252,155,000 |

| | Underlying instruments For hedging purposes |
|---|---|
| Interest rate derivatives | |
| Written options | 150,000,000 |
| Interest rate swaps | 1,084,019,000 |
| | |
| Currency derivatives | |
| Forward rate contracts | 46,160,000 |
| Interest rate and currency swaps | 2,627,006,000 |

| | Equivalent credit value of contracts |
|---|---|
| Interest rate derivative contracts | 32,671,000 |
| Currency derivative contracts | 489,450,000 |

**20.** The company is subject to the Local Government Officials' and Municipal Employees' Pensions Act.

**21.** Municipality Finance Ltd. asset management services

Municipality Finance Ltd. provides its Municipal Bond customers with free safe custody, which includes the custody of the physical securities by the company and payment of interest and principal directly to customers' accounts.

**22.** The Local Government Pensions Institution has a 100 % holding in Municipality Finance Ltd.

**23.** Claims on and liabilities to the Local Government Pensions Institution (the owner).

| | |
|---|---|
| Accrued income | 5,500 |
| Accrued expenses | 3,547,085 |

**24.** Items denominated in foreign currencies

Receivables and liabilities have been converted into Finnish markkas at the Bank of Finland middle rate on the balance sheet date. Exchange rate differences arising in the valuation process are included under Net income from foreign exchange operations' in the Profit and Loss Account.

**25.** Division of asset items into transferable securities and other securities

Municipality Finance Ltd's own bond issues repurchased temporarily for trading purposes are included under trading assets. Other transferable negotiable instruments, such as treasury bills, government bonds and CDs, are financial assets. Items are valued in accordance with Financial Supervision instructions.

**26.** Depreciation principles

Machinery and equipment are depreciated according to a plan on the straight-line principle over five years, computer hardware and software straight-line over four years, and other long-term expenses straight-line over ten years. The planned depreciation was made on leased equipment, based on the length of the relevant leasing agreements.

# KEY FINANCIAL INDICATORS OF MUNICIPALITY FINANCE LTD.

| | 1996 | 1995 | 1994 | 1993 | 1992 |
|---|---|---|---|---|---|
| Turnover, FIM million | 562 | 672 | 647 | 634 | 436 |
| Net Operating Profit / Loss | 2.5 | 1.2 | 0.2 | -0.2 | 6.0 |
| % of turnover | 0.5 | 0.2 | - | - | 1.4 |
| Return on equity % (ROE) | 4.8 | 2.5 | - | - | 9.8 |
| Equity ratio % | 0.8 | 0.6 | 0.6 | 0.6 | 0.7 |
| Yield-expense ratio % | 1.2 | 1.1 | 1.0 | 1.0 | 1.6 |

Turnover consists of both income from interests, leasing operations, commissions, securities trade, currency operations and of the total value of other operating income.

Net operating profit / loss can directly be seen in the profit and loss account.

Return on equity ratio (ROE) is calculated as follows:

$$\frac{\text{Net operating profit / loss - taxes}}{\text{Equity capital + voluntary provisions (average of year beginning and year end)}} \times 100$$

Equity ratio is calculated as follows:

$$\frac{\text{Equity capital + voluntary provisions}}{\text{Balance sheet total}} \times 100$$

Yield - expense ratio is calculated as follows:

$$\frac{\text{Net income from financial operations + commission income + net income from securities transactions and foreign exchange dealing + other operating income}}{\text{Commission expenses + administrative expenses + depreciation + other operatiing expenses}}$$

# RESULT FOR THE ACCOUNTING PERIOD AND DISTRIBUTION OF PROFIT

The financial statements show a profit of FIM 156,086.98.

The Board of Directors proposes that the profit of the year be retained under non-restricted equity capital and that no dividend be distributed.

Helsinki, 28 January 1997

MUNICIPALITY FINANCE LTD.

Simo Lämsä
Chairman of the Board

Erkki Pekkarinen
Member of the Board

Leif Engfelt
Member of the Board

Pekka Alanen
Member of the Board

Seppo Perttula
Member of the Board

Marja Kauppila
Member of the Board

Nicholas Anderson
Managing Director

# AUDITORS' REPORT

**To the shareholders of Municipality Finance Ltd.**

We have audited the accounting, the financial statements and the corporate governance of Municipality Finance Ltd. for the period 1 January-31 December 1996. The financial statements, which include the report of the Board of Directors, income statement, balance sheet and notes to the financial statements have been prepared by the board of Directors and the Managing Director. Based on our audit we express as opinion on these financial statements and on corporate governance.

We have conducted the audit in accordance with the Finnish Standards on Auditing. Those standards require that we perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining on a test basis evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by the management as well as evaluating the overall financial statement presentation. The purpose of our audit of corporate governance is to examine that the members of the Board of Directors and the Managing Director have legally complied with the rules of the Companies' Act.

In our opinion the financial statements have been prepared in accordance with the Accounting Act and other rules and regulations governing the preparation of financial statements. The financial statements give a true and fair view, as defined in the Accounting Act, of the company's result of operations as well as of the financial position. The financial statements can be adopted and the members of the Board of Directors and the Managing Director can be discharged from liability for the period audited by us. The proposal by the Board of Directors regarding the distribution of retained earnings is in compliance with the Companies Act.

Helsinki, 30 January 1997

ARTHUR ANDERSEN KIHLMAN OY
Authorized Public Accountants

Erkki Mitro
Authorized Public Accountant

Jaakko Pohtio
Authorized Public Accountant

LAYOUT BY NANDO MALMELIN
PHOTOS BY TERO RUUTUVAARA
AND MARKKU OJALA (p. 6)
PRINTED BY FRENCKELL 1996