MOODY'S INVESTORS SERVICE

CREDIT OPINION
11 June 2019

Update

Rate this Research

RATINGS

First Nations Finance Authority

Domicile	British Columbia, Canada
Long Term Rating	A2
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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First Nations Finance Authority (Canada)

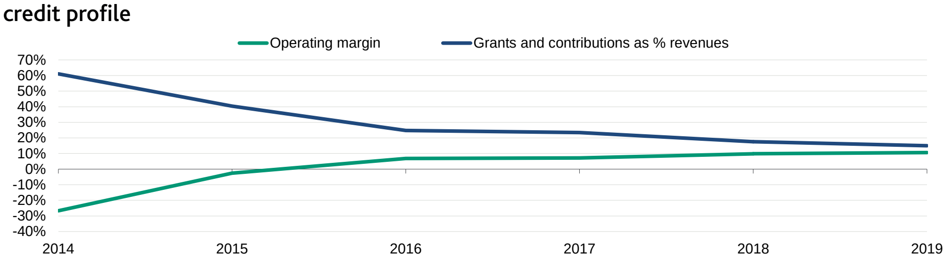
Update to credit analysis

Summary

The credit profile of First Nations Finance Authority (FNFA, A2 stable) reflects continued strong operating performance, sound institutional framework and governance and sound credit quality of borrowing members. FNFA's institutional framework and governance and management structure provide significant debenture holder security, including structural mechanisms from a debt reserve fund (5% of outstanding borrowing), credit enhancement fund and sinking fund, and the joint and several obligation of borrowing members to replenish the debt reserve fund in case of a shortfall. FNFA's credit profile remains constrained by some, although improving, geographic and single-name concentration of the loan portfolio, and only a modest history of borrowing and operations.

Exhibit 1

Declining reliance on federal grants and contributions and positive operating margin benefit credit profile



Source: Moody's Investors Service, FNFA financial statements

Credit strengths

» Strong oversight, member qualification process, and intervention power support loan portfolio quality

» Additional credit protection from growing reserve funds

» Solid governance and management structure

» Strong operating performance and increasing diversification of the loan portfolio

Credit challenges

» Relative reserve levels remain pressured by rapid growth

» Modest track record of operations as FNFA transitions to a mature organization

Rating outlook

The outlook is stable, reflecting our expectations of FNFA's continued stable institutional framework, continued solid operating performance and ongoing diversification of the borrowing base.

Factors that could lead to an upgrade

Material improvements in the credit quality, size and diversity of the participant pool, or an improvement in liquidity (with cash and investment holdings significantly exceeding current levels on a sustained basis) would result in upward pressure on the rating.

Factors that could lead to a downgrade

A deterioration of the size and diversity of the participant pool, leading to increased geographic or single name concentration, or lower credit quality of the pool members would put downward pressure on the rating. A reduction in liquidity and reserves (with cash and investment holdings below 20% of net debt on a sustained basis) or indications of lower support from the federal government would also result in downward rating pressure.

Key indicators

First Nations Finance Authority

(Year Ending 3/31)	2014	2015	2016	2017	2018	2019
Total Direct Debt (C$000)	54,049	107,736	249,840	315,978	469,663	619,470
Loans Outstanding to Clients (C$000)	54,143	103,367	246,022	308,569	453,504	585,977
Total Cash and Investments (C$000)	13,597	19,820	33,008	59,319	88,476	137,268
Interest Income as % of Revenues	33.4	56.4	69.8	71.5	74.5	76.4
Net interest margin (%)	0.11	0.16	0.21	(0.03)	0.03	0.17
Operating Margin as % of Revenues	(26.7)	(2.6)	6.8	7.2	9.9	10.6
Cash and Investments as % of Net Debt	30.9	21.4	14.7	22.1	22.3	26.3

Source: Moody's Investors Service, FNFA financial statements

Detailed rating considerations

The credit profile of FNFA, as expressed in its A2 stable rating, combines a baseline credit assessment (BCA) of baa1, and a strong likelihood of extraordinary support from the Government of Canada (Aaa stable) in the event that FNFA faced acute liquidity stress, should this unlikely scenario occur.

Baseline credit assessment

Strong oversight, member qualification process, and intervention power support loan portfolio quality

The First Nations Finance Authority (FNFA) is a non-profit organization that serves First Nation governments. It is one of three First Nation-led national institutions legislated under the First Nations Fiscal Management Act by the Government of Canada. The First Nations Fiscal Management Act (FNFMA) came into force on 1 April 2006 and established three institutions (1) First Nations Finance Authority (FNFA), (2) First Nations Tax Commission (FNTC) and (3) First Nations Financial Management Board (FMB).

FNFA acts as a central borrowing agency for financing capital requirements and economic and social development projects of member First Nations. In addition to providing long-term capital financing for member First Nations, the stated objectives of the Authority include the provision of interim financing and short-term investment opportunities for First Nations. FNFA is not an agent of the crown nor a crown corporation; obligations of FNFA are not obligations of Canada and are not guaranteed by the federal government.

The quality of FNFA's loan portfolio is supported by a stringent qualification process for becoming a borrowing member, a revenue interception mechanism and debt coverage ratio covenants as well as strong intervention powers granted to the authority under the FNFMA.

Once a borrowing agreement is signed with a borrowing member, an irrevocable intercept mechanism, a Secured Revenues Trust Account (SRTA), is put in place to capture the revenue stream used to support the First Nation's loan. The trust account diverts the gross revenues of those revenues that will be used against borrowing following minimum debt coverage ratios (DCR); anything in excess of that needed for the borrowing is then diverted back to the First Nation.

These DCRs depend on the type of pledged revenues in support of the loan, i.e. higher debt coverage ratios are required for higher risk revenues such as land benefit agreements versus government transfers. Invoicing is also based on revenue frequency, so if revenue streams are received monthly, monies toward repayment will be collected monthly and prior to debt service payments. This allows extra time to resolve any issues prior to any debt service payments.

Stringent qualification process for membership and strong oversight of members

A First Nation must first request to the Minister of Indigenous Services Canada to be scheduled to the FNFMA, which sets out its obligations including obligations to FNFA. A potential member must then pass a band council resolution to apply to become a member and satisfy certification requirements with the FMB, which is responsible for financial management system certification for First Nations. As part of this certification process, FMB analyzes the financial performance of the First Nation. FMB also aids the First Nation in developing a Financial Administration Law, which outlines the decision making, management, monitoring and reporting with respect to financial administration of the First Nation. Moreover, a First Nation must also gain unanimous approval of the FNFA board before becoming a member. This multi-step membership process aids in maintaining the credit quality of borrowing members and by extension, the loan portfolio.

The FMB conducts regular monitoring and oversight of borrowing members and has the power to intervene and arrange a co-management arrangement or third-party management of a First Nation's revenues if necessary. The FNFA also has the power to request intervention by the FMB if the First Nation fails to make a payment or fulfill an obligation under its Borrowing Agreement. The FMB has the power to take control over the treasury functions of a borrowing member that has received a loan and can access all revenue streams of that borrowing member.

Furthermore, the FNFMA outlines the uses for which a First Nation can borrow. Namely, it states that members can borrow for capital infrastructure when borrowing is supported by property tax, and for economic and community infrastructure when borrowing is supported by other revenues, such as for capital infrastructure and land.

Additional credit protection from growing reserve funds

FNFA maintains two important reserve funds which provide credit protection to bond investors: five percent of all loan requests are held in the Debt Reserve Fund (DRF) and the Canadian government has provided funding to a Credit Enhancement Fund (CEF) which acts as a backstop to the DRF.

The DRF grows in proportion with the loan portfolio growth, having reached CAD32.6 million at March 31, 2019, with continued increases projected as the aggregate loan amount increases. The DRF provides liquidity in the event of non-payment by a borrowing member. Assets in the DRF are invested mostly in liquid securities. Should there be a non-payment on an obligation, FNFA would first work to recover the payment but can also tap into the DRF. In case of a shortfall in the DRF, a joint and several obligation of borrowing members requires them to replenish the DRF without limit. As debt coverage ratios are set above required debt service payments, this allows FNFA to replenish the DRF directly from the SRTA.

The CEF has grown to CAD30.5 million at March 31, 2019 following multiple contributions by the Government of Canada. The CEF can be used to temporarily offset shortfalls in the DRF, which provides additional protection to bondholders. The explicit federal support benefits FNFA's credit profile and we anticipate that the federal government would provide additional funding to the CEF as the loan portfolio grows. However, as the DRF continues to grow in line with the growth of the borrowing portfolio, the relative importance of the CEF may gradually decline.

In addition to the liquidity provided by these two reserve funds, FNFA also earns income through its pooled investment activities and has access to CAD220 million revolving credit facility syndicated across several Canadian chartered banks for financing loans to borrowing members.

Solid governance and management structure

FNFA's Board of Directors currently consists of nine directors. The board is elected by borrowing and investing members, but only borrowing members can be elected to the Board. The terms are one year and renewable. With the latest election in July 2018, geographical representation of the board continued to be diversified, which is a key objective of FNFA.

Borrowing members are First Nations that have applied to and have been accepted by the Authority's board as a borrowing member. Investing Members are First Nations that have invested in the Authority's Pooled Investment Funds.

The Act restricts the spectrum of allowed investments to fixed-income securities issued or guaranteed by Canadian governments or Canadian chartered banks or savings institutions. No equity investments are allowed. FNFA has conservative debt and investment management policies, which limits its exposure to market-related risks.

Furthermore, there is an extensive credit approval process. First Nations borrowing through the Authority must meet financial certification requirements and each loan requested from the Authority must receive unanimous board approval prior to funding. The annual operating budget is also approved by the board.

Strong operating performance and increasing diversification of the loan portfolio

FNFA's operating margin (surplus relative to revenues) rose to 10.6% of revenue in 2018/19 from 9.9% in 2017/18 and is above the average of 6.4% over the last 5 years, due to strong interest and investment income and federal grants and contributions. We anticipate that the operating margin will remain strong around 10-15% of revenue over the next two years from ongoing strong federal funding and rising interest, investment and management fee income.

The distribution of borrowing composition continues to diversify with the growth of FNFA's loan portfolio, exhibiting solid credit quality of the pool of borrowing members. Loans to members grew to CAD586 million at March 31, 2019, a remarkable rate of growth which is more than 5.5 times its loan portfolio value of CAD103 million in 2015. We expect that the loan portfolio could grow between CAD120-150 million annually to support strong demand for capital from first nations. Participating borrowing members reached 50 at March 31, 2019, up from 13 in the original 2014 debenture issuance. FNFA now has 87 approved members (borrowing and non-borrowing) with more than 268 scheduled and pending members. The continued increase in FNFA's borrower base and lending activity will help it realize strong operating performance over the next few years.

Although some geographic and single-name concentration remains with the largest share of members in British Columbia, this concentration risk has eased in recent years. FNFA now has scheduled or approved members across all ten Canadian provinces and one territory, with especially robust growth expected in Ontario, Saskatchewan and Manitoba.

Relative reserve levels remain pressured by rapid growth

FNFA targets continued strong growth of its loan portfolio and debenture issues over the next several years. Since completing its first debenture issue (CAD90 million in 2014), aggregate debenture sizes has consistently risen, reaching CAD515 million notional value following the Authority's fall 2018 issuance. However, the rapid growth of its borrowing portfolio imposes some challenges in maintaining adequate reserve levels relative to total outstanding borrowing.

By structure, FNFA will continue to transfer 5% of all loan proceeds into the DRF. As a result, the DRF will increase as FNFA's loan portfolio increases. In addition, we expect that the CAD34 million sinking fund will increase over the medium-term as borrowers continue to repay principal under their amortizing loans well in advance of the first debenture maturity in 2024. However, as the loan portfolio grows, the CAD30.5 million CEF will represent a gradually declining portion of borrowing unless the CEF receives additional federal infusions.

Modest track record of operations as FNFA transitions to a mature organization

FNFA has a limited track record of operations as a specialized lender. FNFA only issued its first debenture in 2014, a relatively short borrowing history for a pooled borrower. Its short operating history and lack of scale to generate meaningful interest from members and investment income resulted in consolidated deficits prior to 2015/16.

Further, FNFA receives a portion of its revenues through federal grants and contributions from Indigenous Services Canada. Grants and contributions remain an important component of revenues (average 24% over the last 5 years), and reflects FNFA's continued reliance on these funds for its operations.

However, as FNFA continues its transition to a mature organization, it will be able to realize greater efficiencies with the expansion of its loan portfolio and will continue to benefit from economies of scale in its revenues (interest, investment income, management fees) and expenses (fees and operating costs). In addition, the relative share of federal grants as a component of total revenue has been gradually falling, from over 70% in 2012/13 to 15% in 2018/19 - a trend we expect will continue as the loan portfolio grows - while at the same time the importance of interest revenue from borrowing members has grown.

Extraordinary support considerations

Moody's assigns a strong likelihood of extraordinary support from the Government of Canada to prevent a default by the FNFA and the creation and support of FNFA and supporting institutions by Canada through legislation as well as the important government-defined mandate of the FNFA in providing financing for First Nations in Canada. Moody's also assigns a very high default dependence level between FNFA and the Government of Canada, reflecting the two entities' shared exposure to common economic and financial risks.

Ratings

Exhibit 3

Category	Moody's Rating
FIRST NATIONS FINANCE AUTHORITY	
Outlook	Stable
Issuer Rating -Dom Curr	A2
Senior Unsecured -Dom Curr	A2

Source: Moody's Investors Service

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