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First Nations Finance Authority

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Table Of Contents

Rationale

Outlook

Moderately High Likelihood Of Extraordinary Support

Business Profile

Lender To First Nations' Councils

Good Asset Quality

Leverage

Asset-Liability Management Is Good

Profitability Is Weak But Likely To Improve

Related Criteria And Research

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First Nations Finance Authority

Rationale

Issuer Credit Rating
A-/Stable/--

The rating on First Nations Finance Authority (FNFA) reflects Standard & Poor's Ratings Services' view of the authority's solid competitive position in a niche market, good asset quality that prudent structural mechanisms enhance, support for operations from the federal government, and low leverage. We believe that the current low profitability and concentration of the loan portfolio in a relatively small number of borrowing members somewhat offset these strengths.

We believe that the FNFA has a solid competitive position in a niche market because of its ability to provide longer loans. Historically, access to long-term fixed-rate capital has been a challenge for many First Nations. Access has improved in recent years, but some impediments to lenders remain, such as security or lenders' mandates. By statute, land or buildings on First Nations territories cannot be pledged as collateral. The authority is mandated to lend to councils, which other lenders are not. Furthermore, some First Nations have capital needs (and debt repayment capacity) that exceeds lenders' ability or willingness to supply capital. Total capital needs from 634 Canadian First Nations are estimated to easily exceed C$5 billion. Those needs are typical of all Canadian communities: infrastructure (water and roads), community-owned housing, equipment, and economic development. Because of these favorable demand and supply conditions, we believe that the authority does not and will not face pricing pressures. We also do not expect an influx of new lenders into this part of the loan market.

Prudent structural mechanisms protect asset quality, in our opinion. Those structural elements include a rigorous qualification process for all borrowing members, revenue interception, prudent discounting of pledged revenues, and the authority's intervention powers. For example, on intervention powers, the First Nations Fiscal Management Act (FNFMA) authorizes the authority, where loan repayment is in question, to replace the chief and council, thereby assuming full treasury and budgetary powers over that community. As well, the credit quality of the pledged revenue streams is good, in our view, because the majority consists currently of provincial revenue-sharing agreements, land lease contracts, and federal right-of-way agreements.

The FNFA was created by federal statute and the government has supported it since its inception. Owing to its small loan portfolio size and start-up costs, the authority has produced operating deficits in the past two fiscal years. Grants from the federal government have covered the deficits, and we expect the government will continue to do so until the loan portfolio grows to achieve self-sufficiency.

Leverage metrics are what we view as favorable. At the end of fiscal 2014, the FNFA's capital base was about C$10.7 million, consisting of equity of C$300,000 and reserves of C$10.4 million. Borrowing, at that time, stood at C$54.4 million or 5.2x the capital base. The authority's leverage metrics are more favorable than those of other non-profit peers. We expect its leverage will increase as its loan portfolio expands. We do not expect any significant sustained increase in reserves until the loan portfolio reaches self-sufficiency. As well, we believe a substantial increase in equity is unlikely during our two-year outlook horizon.

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Owing to the size of its loan portfolio, the FNFA's profitability is weak, in our opinion. The revenues from administrative charges on loans to members are not large enough to support operations. For the 2014 fiscal year, the authority incurred a deficit of C$659,411, up from the previous fiscal year's deficit of C$469,409. Net interest income, however, was positive in 2014 and double that of the previous fiscal year. For fiscal 2014, net income was negative 1.3% of average assets, which was an improvement from the negative 2.6% the previous fiscal year. As well, the FNFA has been incurring one-time start-up expenses. We expect that profitability measures, however, will improve as the loan portfolio expands. For fiscal years 2015 and 2016, we expect the authority to balance its operations.

The FNFA does face concentration risk. With a mandate to lend to First Nations, the authority's loan book is and will be very concentrated by type of borrower, namely First Nations' councils. Borrowing members' financial strength and sound financial practices mitigate this risk somewhat, in our view. Geographically, loans are concentrated in British Columbia because the majority of members are in the province. We expect that geographical concentration will improve in the future as more councils in other provinces become members. Currently, 147 First Nations across Canada have become scheduled to the FNFA Act, of which 84 are in British Columbia.

In accordance with our government-related entity criteria, we view the likelihood of the FNFA receiving extraordinary government support as "moderately high" based on our assessment of the "strong" link with the federal government, which the government's funding support demonstrates. We believe that the FNFA plays an "important" role because of the need for First Nations' access to capital to fund infrastructure renewal, the authority's statutory mandate to lend to approved First Nations, and the political importance of First Nations issues, including natural resource development.

We have also used our "Principles Of Credit Ratings" in conjunction with Financial Institutions' "Rating Finance Companies" and "Rating Government-Related Entities: Methodology And Assumptions" as our criteria foundation for our analysis of FNFA's creditworthiness. We believe the Rating Finance Companies criteria cover all the fundamental aspects of the authority's credit profile because the criteria's rating factors line up well with the FNFA's key credit characteristics.

Liquidity

We believe that authority's liquidity is more than adequate. At fiscal year-end 2014, the FNFA's credit enhancement fund stood at C$10 million and its debt reserve fund was C$2.7 million. Both funds are held in cash or cash equivalents. Borrowing members prepay their loan obligations as pledged revenues that are owed to members are paid into a trusteed account before debt service payments are made, limiting the need for liquidity. In addition, FNFA has a revolving credit facility with a major Canadian bank totaling C$100 million, of which C$45 million is unused.

Outlook

The stable outlook reflects our expectation that the FNFA will continue to build its loan book in the next two years, which will add fee revenues and ultimately eliminate its operating losses; and that it will maintain its solid competitive market position. We also expect that the federal government will continue to support the authority. We could downgrade the FNFA if we were to downgrade Canada, or if the likelihood of extraordinary support changed to "moderate" or "low," material credit losses happen, or increased competition eroded the authority's market position. We could raise the rating if the likelihood of extraordinary support changed to "high" or greater or the FNFA

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profitability improved such that it was able to retain earnings and increase its capital.

Moderately High Likelihood Of Extraordinary Support

In accordance with our government-related entity criteria, we view the likelihood of FNFA receiving extraordinary government support as moderately high, based on our assessment of the strong link with the federal government, which the funding support from the government for the authority's operations demonstrates. Owing to the small size of the FNFA's loan portfolio, two federal grants support most of the FNFA's operating costs: a base operating grant and a comprehensive funding arrangement transfer. We believe that the authority plays an important role because of the need for First Nations' access to capital to fund infrastructure renewal, the statutory mandate to lend to approved First Nations, and the political importance of First Nations issues.

We believe that the plan has a strong link with the federal government. The authority was established by the FNFMA, which specifies the FNFA's powers and purpose; the governance structure, including the roles of the chair and directors, their tenures, and responsibilities; and corporate status. The Act requires the authority to produce annually a report on its operations and to submit the report to members and the government. The government's annual operating grants represent about 60% of the FNFA's revenues. The authority receives two grant streams: a base operating grant, which supports core activities; and a comprehensive funding arrangement transfer, which supports specific programs and activities detailed in the arrangement. As the FNFA's loan portfolio and net interest income increase, we expect that total grants from the federal government will fall in magnitude and the share of those revenues in total revenues will also decline. Nevertheless, we believe that federal grants to the authority will continue to constitute a substantial proportion of revenues for the foreseeable future.

We believe that the FNFA's role is important to the federal government because under the Canadian constitution the welfare of First Nations' peoples is a federal government responsibility. More specifically, we feel the role is important because of the need for First Nations to access to capital to fund infrastructure renewal. The authority's statutory mandate is to lend to approved First Nations. Furthermore, First Nations issues are important politically, especially their role in natural resource development. This is important to the country's economic growth and of development frequently occurs on or requires access to First Nations lands.

Business Profile

The FNFA develops borrowing capacity for First Nations governments and provides investment pooling arrangements for its investing members. It is a not-for-profit, non-share capital corporation that is exempt from income taxes. The authority is headquartered in Kelowna B.C., and has six employees.

FNFA borrows money in public markets and lends those funds to qualified First Nations for a variety of purposes including infrastructure development, community-owned housing, social development, land purchases, economic development (including equity investments in projects, and vehicles and equipment). A nine-member board of directors, all of whom are either First Nations councilors or chiefs, governs the authority.

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The FNFA has 38 borrowing members currently. A borrowing member must receive unanimous approval from the board before it is allowed to borrow from the authority. Currently, 14 members have received loans that total close to C$90 million.

Lender To First Nations' Councils

We believe that the FNFA has a solid competitive position in a niche market because of its ability to provide loans of longer duration. Historically, access to long-term fixed-rate capital has been a challenge for many First Nations. Access has improved in recent years. Major banks and Aboriginal capital corporations (ACCs) provide some access for some First Nations, especially for short-term loans. Nevertheless, some obstacles to lenders remain, such as security or lenders' mandates. By statute, land or buildings on First Nations territories cannot be pledged as collateral, which has been a significant impediment for the major banks. By mandate, FNFA is authorized to lend to councils -- other lenders, such as ACCs, are not so authorized.

Furthermore, some First Nations have capital needs (and debt repayment capacity) that exceeds the ability or willingness of existing lenders to supply capital. Total capital needs from Canadian First Nations are estimated to easily exceed C$5 billion. Those needs are typical of all Canadian communities, infrastructure (water and roads), community-owned housing, equipment, and economic development.

We do not expect an influx of new lenders into this part of the loan market and, accordingly, we believe that the authority does not and will not face pricing pressures. We do not expect this to change. Accordingly, we feel that the FNFA is positioned well in its niche and expect that its market position could strengthen as the authority's book and membership increases.

The FNFA does face concentration risk. With a mandate to lend to First Nations, the authority's loan book is and will be very concentrated by type of borrower, namely First Nations' councils. Borrowing members' financial strength and sound financial practices mitigate this somewhat, in our view. Geographically, loans are concentrated in British Columbia. We expect that geographical concentration will improve as more councils in other provinces become members.

Good Asset Quality

We believe the FNFA's assets are of good quality thanks to the structural mechanisms the authority has put in place. Those structural elements include a rigorous qualification process, revenue interception, prudent discounting of pledged revenues, and the authority's intervention powers.

Structural mechanisms

All potential borrowers must pass a rigorous qualification process before they can become borrowing members. Qualifying members must go through a six-step qualification process, including the following:

- The applicant First Nation applies to the federal government to be added to the FNFMA schedule of First Nations willing to use own source and tax revenues to secure financing for defined projects.

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- The applicant submits five years of audited financial statements to the financial management board (FMB). The statements are subjected to standardized ratio tests.
- The applicant must pass a financial administration law.
- The applicant submits other revenue stream contracts to the FNFA for evaluation as loan security.
- The applicant must receive unanimous board approval before joining.
- The applicant establishes a secured revenue trust account (SRTA) and instructs the payor of other revenue streams to deposit them directly into the SRTA.

Borrowing members pledge other revenue streams to support their debt service obligations. These revenues do not include the base grants the federal government pays to all First Nations to fund health care, education, protective services, housing, and community services. The payor of the other revenue stream makes payments to the trustee directly for deposit into the SRTA. The trustee withholds the amount required to meet that First Nation's upcoming debt service obligation and remits the balance back to the respective First Nation.

The FNFA will only allow a member to borrow up to a debt capacity limit that the authority determines, by calculating the amount of debt service that the discounted cash flow of pledged revenues streams could support for a given loan term. Pledged revenues are subject to two levels of discounting. First, all revenues regardless of payor are discounted 25%. A second discount applied varies dependent on the origin and nature of the pledged revenue stream, which is very broadly correlated with payor credit quality. Other revenues from the federal or provincial governments are discounted the least; conversely, other revenues coming from commercial leases or businesses owned by a First Nation receives the highest discount.

As an example, a pledged revenue stream of C$10.0 million annually from a province or the federal government would be able to support about C$6.1 million of debt service payments. The remainder (about C$3.9 million in this example) is remitted back to the respective First Nation. The trustee, however, could withhold the remainder under certain circumstances, such as debt service reserve replenishment.

The FNFA is empowered under its statute with intervention powers. If a First Nation is unable or unwilling to meet its debt service obligations under its loan agreement, the authority can invoke the statutory intervention provision. A number of other events, including material adverse changes or draws on funds, will also lead to intervention. If invoked, the FNFA, together with the FMB, can remove and replace the council of the defaulting First Nation, thereby gaining access to all that nation's revenues, including those that cannot be pledged.

The authority is required by statute to maintain a debt reserve fund (DRF). At fiscal year-end 2014 (March 31), the DRF stood at C$2.7 million. The DRF ensures timely debt service payment should there be insufficient funds flowing from the SRTAs. From each loan to a borrowing member, 5% of the loan value is deposited into the DRF and invested in eligible investments. Investment returns remain in the DRF. Each member receives its original 5% contribution and investment earnings upon the loan's maturity and discharge. The FNFA does not need the approval of any other party, including members, to draw on the DRF. A draw triggers the trapping of the balance of funds in the SRTAs that would normally be remitted to the members. If trapped funds from the SRTAs are insufficient, the credit enhancement fund (CEF) can be drawn upon.

Due to the portfolio's relatively small size, reserve levels are what we view as very healthy. The CEF stands at C$10

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million, which is large relative to the C$88 million loan portfolio. This level will diminish as the portfolio expands. We expect that the administrative charges the authority levies on each loan will be able to support the FNFA's operations. As the portfolio expands further, we expect that the authority will generate excess cash flow that will then be used to augment reserves. It is also possible that the federal government could further augment the CEF.

Asset quality

Currently, the FNFA has loans outstanding with 14 First Nations totaling about C$88.3 million. The annual debt service obligations for these loans total about C$5.7 million. The pledged revenues flowing to the trustee through the SRTA, however, amounts to about C$18.2 million annually, leaving almost C$12.6 million available for debt service reserve replenishment. Debt service obligations represent only 31% of pledged revenues the trustee receives.

Overall, 62% of pledged revenues come from the federal government, the provinces or their hydroelectric utilities. The balance comes from contracts and leases with various third parties (including major banks, national grocery chains, amongst others) and businesses First Nations run. Furthermore, if the authority were to have to use its intervention powers, it would be able to access all 14 First Nations' revenues, which totals close to C$190 million (excluding the intercepted revenues of about C$18.2 million).

The portfolio of loans is not what we consider diverse. All loans have been made to First Nations councils in keeping with the FNFA's mandate and all are secured by pledged revenues. The pledged revenues are more diverse, in our view. The contracts with the governments and their electric utilities (about two-thirds of all loans) are for a variety of purposes, such as water, mineral and logging rights, and electricity sales. Revenues from contracts and leases with third parties, such as banks and supermarkets, and by income from council-owned businesses, support the remaining loans

Growth prospects for the portfolio are what we view as healthy because of First Nations' considerable need for capital and their historically constrained access to capital. We expect the portfolio increase C$50 million to C$100 million annually for the foreseeable future. We believe geographic diversification should improve with an expanding loan portfolio as more councils in other provinces become members. Concentration by individual councils should also improve as the portfolio grows.

Thanks to all the structural features and the borrowing members' credit quality, no member has failed to make required payments. There have been no delinquencies, charge-offs, recoveries, or provisions for losses to date.

Leverage

We believe the authority's leverage metrics are favorable. At fiscal year-end 2014, the FNFA's capital base was about C$10.7 million, consisting of equity of C$300,000 and reserves of C$10.4 million. Borrowing at that time stood at C$54.4 million or 5.2x the capital base. The authority's leverage metrics are more favorable than those of its nonprofit peers such as The Housing Finance Corp. and New Zealand Local Government Finance Agency. We expect that the FNFA's leverage ratio will increase as its loan portfolio expands. We do not expect any significant sustained increase in reserves until the loan portfolio reaches self-sufficiency in size. We believe that a substantial increase in equity is unlikely during our two-year outlook horizon.

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Asset-Liability Management Is Good

The authority matches its liabilities with its assets minimizing its market risks. Fixed-rate borrowings from public bond markets are match-funded with fixed-rate loans to borrowing members, removing interest rate risk. The term of bond issues are matched with the duration of pledged revenue streams, eliminating refinancing risk. We expect that most bond issues will have 10-year terms, although longer terms might be possible if pledged revenues support them. Bond issues will be bullets that are amortized by the sinking fund components of debt service amounts retained by the trustee from all pledged revenue streams. All borrowing and lending will be done in Canadian dollars, eliminating currency risk.

We expect that funding risk will be modest. The FNFA will lend to members upon receiving the proceeds from bond issuance. The authority maintains a floating-rate revolving credit facility sized at C$100 million with a major Canadian bank. In the periods between bond issuances, the authority may make some short-term floating-rate interim loans (using the facility as funding) to its members, which would then be termed out in a bond issue with the interim loan and facility repaid. We expect that the FNFA will combine its approved loan requests, then lend to members after securing long-term funding in the bond market; short-term interim lending will be minor. The authority's funding sources will likely be what we consider relatively diversified because it intends to source long-term funding through public bond markets and short-term financing from major banks. Nevertheless, Canada's capital markets are deep and diversified with active secondary markets for debt securities.

As a nonprofit, the FNFA marks up its loans to members to recover its operating costs (and in time to build reserves). As a result, it does not face pricing risk, because it passes funding costs on to members. Furthermore, the authority does not face pricing pressure from other lenders.

Profitability Is Weak But Likely To Improve

Owing to the size of its loan portfolio, the FNFA's profitability is weak currently. The revenues from administrative charges on loans to members are not large enough to support operations. As well, the authority has been incurring one-time start-up expenses. We expect that profitability measures, however, will improve as the loan portfolio expands.

For fiscal 2014, the authority incurred a deficit of C$659,411, which was an increase in the previous fiscal's deficit of C$469,409. Net interest income was positive in 2014 and double that of the previous fiscal year. For fiscal 2014, net income as a share of average assets was negative 1.3%, which was an improvement on negative 2.6% the previous fiscal year. Federal government grants have covered the deficits, and we expect the government will continue to do so until the FNFA achieves self-sufficiency. For fiscal years 2015 and 2016, we expect the authority to balance its operations.

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Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Rating Finance Companies, March 18, 2004

Ratings Detail (As Of January 16, 2015)	
First Nations Finance Authority	
Issuer Credit Rating	A-/Stable/--
Issuer Credit Ratings History	
18-Dec-2014	A-/Stable/--

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