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Ratings

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Research Update:

First Nations Finance Authority Ratings Affirmed at 'A+'; Outlook Stable

August 14, 2019

Overview

- We expect First Nations Finance Authority (FNFA), a public-sector funding agency that lends to Canadian First Nations, to maintain its very high capitalization amid increasing borrowers and loans.
- Prudent risk management and assistance from the federal government will also continue to support the FNFA's creditworthiness.
- As a result, we are affirming our 'A+' ratings on the FNFA.
- The stable outlook reflects our expectation that the authority's lending portfolio to First Nations in Canada will continue growing, supporting the FNFA's important public policy role to the federal government, while sustaining a strong financial profile.

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Rating Action

On Aug. 14, 2019, S&P Global Ratings affirmed its 'A+' long-term issuer credit and issue-level ratings on public-sector funding agency First Nations Finance Authority (FNFA). The outlook is stable.

Outlook

The stable outlook reflects our view that the FNFA will continue increasing its loans to First Nations in Canada in the next two years, as it has since the authority began lending in 2012. We believe that First Nations' financing needs, which far surpass the FNFA's current lending capacity, will facilitate this growth well beyond the outlook horizon. In turn, this expansion will reaffirm the authority's policy role, and its strong and supportive relationship with the Government of Canada, without jeopardizing the FNFA's strong financial profile. During this period, we expect the authority's liquid assets to increase in line with liabilities such that the FNFA maintains strong liquidity ratios and continued access to Canada's deep and diversified bond market.

Downside scenario

We could lower the ratings over the next two years if we revised the likelihood of extraordinary support from the federal government to low if the importance of the authority's policy role to the government diminished, or if the government's oversight of the authority lessened. Significantly deteriorating asset quality that suggests persistently weak underwriting decisions and management practices could lead us to lower our management and governance assessment to weak, which would also lead to a lower rating. However, we view these scenarios as unlikely over the outlook horizon.

Upside scenario

We could raise our ratings over the next two years if the FNFA's lengthening track record of lending to the First Nations sector led to a stronger business profile or stronger self-generated income, eliminating the authority's ongoing dependence on the federal government and improving its stand-alone credit profile (SACP). As well, we could raise the ratings if we were to revise the likelihood of extraordinary support from the federal government to high or greater because of the increased importance of the FNFA's public policy role or strong direction by the federal government in the authority's strategy development and day-to-day operations.

Rationale

The 'A+' rating on the FNFA reflects our view of the authority's high levels of capital, prudent structural mechanisms, and strong risk management. In our view, these strengths enhance asset quality despite the FNFA operating in a sector that has an evolving institutional framework and its shorter track record of operations compared with that of other rated public-sector funding agencies. At the same time, the FNFA's low profitability has caused the authority to depend on the federal government for ongoing support, including operational funding and capital transfers. These factors underpin the 'a' SACP on the authority.

The ratings further reflect our belief that the FNFA benefits from a moderately high likelihood of receiving extraordinary support from the federal government, resulting in a one-notch uplift to the SACP for the final 'A+' rating. We believe the authority has a strong link with the federal government, which the government's funding support for its operations demonstrates. We also believe the FNFA plays an important role for the government via its statutory mandate and public policy role to facilitate access to capital by First Nations. Also supporting our assessment of the authority's important role is the political visibility of First Nations' issues generally, and the considerable need for capital in First Nations' communities.

The FNFA is a financial intermediary that supports access to credit for First Nations in Canada. It borrows in the capital markets and on-lends the proceeds to its borrowers, who are exclusively First Nations. Borrowers use the loan proceeds for capital infrastructure on their lands, and secure the loan with a pledged revenue stream. The authority began lending to First Nations in 2012 and issued its inaugural bond in 2014. Although it was created via federal legislation, the FNFA is not an agent of the Government of Canada. Nevertheless, we believe the authority benefits from a strong and supportive relationship with Canada.

Enterprise risk profile: Strong revenue streams and risk management will provide credit strength as the First Nations sector and business position evolve

- The FNFA's pledged revenue streams originate from entities with low financial system risk, which will continue to offset risks posed by economic disparities and the historically unbalanced, although improving, institutional framework of the Canadian First Nations sector.
- We expect that the FNFA will continue to have strong loan and customer growth, supporting revenue stability, despite a shorter lending history.
- The FNFA's growing staff will continue to implement strong risk management policies and sufficient strategic positioning, in our view.

We believe that the FNFA will continue to benefit from solid underlying asset quality. The authority lends exclusively to First Nations communities in Canada. There are over 600 First Nations in the country, with capital needs that some have estimated at more than C$20 billion. Those needs are typical of all Canadian communities: infrastructure (water and roads), community-owned housing, equipment, and economic development.

In our view, the institutional framework under which First Nations in Canada operate has historically been weaker than that of other local and regional governments in the country. The frequency and extent of reforms affecting the division of responsibility and revenues between First Nations and other levels of government in Canada have been evolving for over a century. The historical and existing fiscal and legal structures have led to large socioeconomic gaps between First Nations and Canada, in part, due to weak equalization mechanisms. Therefore, in our view, the sector's economic resilience is somewhat weaker than that of Canada overall, particularly given the disparities in income per capita across First Nations.

Nevertheless, we believe the institutional framework for First Nations is improving. Reflecting this improvement, the federal government established longer-term 10-year grants available to First Nations as of April 2019, which, when implemented, should provide funding that is more predictable than the previous one- and five-year funding agreements. This initiative is part of the new fiscal relationship between the federal government and the Assembly of First Nations that seeks to address some of the system's historical weaknesses. At the same time, there is a prudent legislative framework in place for FNFA borrowers. Under this framework, First Nations that would like to borrow from the authority must receive a Financial Performance Certificate from the First Nations Financial Management Board indicating compliance with certain financial ratios, among other requirements. In addition, borrowers pledge revenue streams to support loan repayments. The sources of these streams directly deposit them in a secured revenues trust account that the FNFA uses to repay debt. The authority discounts pledged revenues according to the type of revenue. Over 70% of these revenues come from either the federal or provincial governments. In our view, these entities are subject to low financial system risk, in part, due to strong regulatory standards and supervision in Canada.

The FNFA's business position continues to be limited by the authority's shorter track record relative to that of more established public-sector funding agencies; and small, although rapidly growing, loan book. The FNFA's loans to First Nations reached C$586 million as of March 31, 2019, up from C$454 million one year earlier. Nevertheless, we believe that the authority's solid competitive position will support healthy customer base growth over the next several years, continuing a trend that began when the FNFA started lending. Historically, access to capital has been a challenge for many First Nations. In recent years, access has improved, 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. In addition, we believe that the authority has a strong price position relative to competitors.

We expect the FNFA's strategic positioning and organizational effectiveness to remain satisfactory, and good risk management practices and solid governance represent management strengths, in our view. The authority's management prepares an annual budget and internal loan portfolio and liquidity forecasts. While the FNFA is not subject to banking regulations or equivalent regulatory oversight, we believe that management has instituted strong financial and risk management policies that mitigate key risks.

Financial risk profile: Very high capital levels and strengthened liquidity and funding minimize financial risks

- We expect the FNFA's capitalization to remain very strong over the next two years.
- Stronger liquidity levels and the structural stability of funding balance some funding concentration.
- Positive risk management practices will continue to minimize potential losses.

Despite the authority's rapidly growing loan portfolio, we expect capitalization to remain very strong over the next two years. In fiscal 2019, the FNFA's loan book grew at a faster pace than its capital. Nevertheless, the authority's risk-adjusted capital before capital adjustments remained extremely high at 97.4%, and 30.8% after adjustments. The main adjustment we make to the after-adjustment capital ratio is for concentration given that the FNFA's 10 largest borrowers represent 52% of its loan portfolio, while its 20 largest borrowers represent 79%. Nevertheless, even after this adjustment, the authority's capital ratios remain very high and compare very favorably with those of other rated public-sector funding agencies. One of the FNFA's main sources of capital is its C$30.5 million Credit Enhancement Fund, a loss-absorbing fund that the federal government has supported through multiple capital injections. We also consider the authority's C$33 million debt reserve fund (DRF) to be loss-absorbing. The FNFA withholds 5% of each member's loan request in the DRF, such that the fund is larger than the FNFA's annual interest obligations at current interest rates.

We expect the FNFA's strengthened liquidity levels to continue to support its creditworthiness over the outlook horizon. In addition to its other liquid funds and about C$9 million in cash and cash equivalents, the authority held about C$34 million in sinking funds as of March 31, 2019, which contribute to the strong, and improved, levels of liquidity. The FNFA's one- and two-year liquidity ratio stood at 1.19x in fiscal 2019. At the same time, the authority's funding ratio was about 1.4x. The Canadian bond market, which we consider deep and diversified, provides 100% of the FNFA's funding, making the authority's funding sources somewhat concentrated. Investor diversification is improving, however, based on investor type and domicile. As well, in our view, the FNFA's funding versus lending commitments are relatively stable. Although loan terms extend as long as 30 years while bonds mature in a shorter timeframe, the authority mitigates this mismatch through its revenue-intercept mechanisms, adjustments to relending rates upon debt refinancing, and sinking funds, among other mechanisms. Furthermore, the FNFA's larger C$220 million revolving credit facility boosts its liquidity position. While the FNFA's long-term borrowing and lending is conducted at fixed interest rates, its interim financing is borrowed at variable rates. The FNFA negotiates and renegotiates interest rates on interim financing loans to First Nations in relation to these rates.

We believe that the FNFA will continue to benefit from strong risk management practices that will minimize potential losses. The authority has never experienced defaults or arrears by borrowing members. Its intercept mechanisms, conservative risk tolerances, solid underwriting standards, and intervention powers enhance asset quality, in our opinion. The FNFA has intervention power under The First Nations Fiscal Management Act. If a First Nation is unable or unwilling to meet its debt service obligations under its loan agreement or replenish any shortfalls in the DRF, the authority can invoke the statutory intervention provision. If the provision is invoked, the FNFA, together with the First Nations Financial Management Board, can remove and replace the council of the defaulting First Nation, thereby gaining access to the nation's revenues, including those that cannot be pledged. While we believe this mechanism contributes to FNFA's strong risk management, the process has not yet been tested in practice, and there is some uncertainty regarding the timeliness of such a mechanism.

Moderately high likelihood of support from the federal government in a stress scenario

We view the likelihood that the Canadian federal government would provide timely and sufficient extraordinary support to the authority in the event of financial distress to be moderately high. We base this assessment on our view of the FNFA's:

- Strong link with the federal government, which the government's ongoing financial support for the authority's operations demonstrates, in our view.
- Important role via the FNFA's statutory mandate and public policy role to facilitate access to capital by First Nations. Also supporting our assessment of the authority's important role is the political visibility of First Nations' issues generally, and the considerable need for capital in First Nations' communities. This supports the FNFA's role as contributing to the federal government's social policies for First Nations. While we expect the FNFA to continue to play an important role through changes in government, the visibility of First Nations' issues may evolve depending on federal government priorities.

First Nations Finance Authority--Selected Indicators

		--Fiscal year ended March 31--			
(Mil. C$)	**2019**	**2018**	**2017**	**2016**	**2015**
Business position					
Total adjusted assets	723.9	542.5	368.2	279.3	123.4
Customer loans (gross)	586	453.5	308.7	246	103.4
Growth in loans (%)	29.2	47	25.4	138	90.9
Net interest revenues	1.1	0.1	(0.10)	0.4	0.2
Noninterest expenses	4.2	2.8	2.5	2.6	2.5
Capital and risk position					
Total liabilities	687.6	509.6	346.7	268.4	113
Total adjusted capital	63.1	54.5	36.2	22.5	15.2
Assets/capital	11.5	10	10.2	12.4	8.1
RAC ratio before diversification	97.4	118.7	N.A.	N.A.	N.A.
RAC ratio after diversification	30.8	32	N.A.	N.A.	N.A.

First Nations Finance Authority--Selected Indicators (cont.)

	--Fiscal year ended March 31--				
(Mil. C$)	2019	2018	2017	2016	2015
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity					
Liquidity ratio with loan disbursement (one year)	1.19	0.8	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (one year)	1.46	1.3	N.A.	N.A.	N.A.
Funding ratio (one year)	1.4	1.1	N.A.	N.A.	N.A.

RAC--Risk-adjusted capital. N.A.--Not available.

Ratings Score Snapshot

First Nations Finance Authority

Key rating factors	Scores
Issuer credit rating	A+/Stable/--
Stand-alone credit profile	a
Enterprise risk profile	Adequate (3)
PICRA	Adequate (3)
Business position	Moderate (4)
Management and governance	Adequate (3)
Financial risk profile	Strong (2)
Capital adequacy	Very Strong (1)
Funding and liquidity	Strong (2)
Support	
GRE support	+1
Group support	0
Additional factors	0

Related Criteria

- Criteria | Governments | International Public Finance: Public-Sector Funding Agencies: Methodology And Assumptions, May 22, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Public-Sector Funding Agencies Risk Indicators: May 2019, May 13, 2019
- Assumptions For Liquidity Gap Analysis Under "Public-Sector Funding Agencies: Methodology And Assumptions"
- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018

Ratings List

Ratings Affirmed	
First Nations Finance Authority	
Issuer Credit Rating	A+/Stable/--
Senior Secured	A+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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