Research Update:

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

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Overview

- Very high capitalization levels, strong liquidity, and prudent risk management are the anchors of our ratings on the First Nation Finance Authority (FNFA), a public sector funding agency (PSFA) that lends to the Canadian First Nations.
- Support from the federal government and a steady growing loan book and market position offset a public sector industry and country risk assessment (PICRA) that is weaker than those of other rated PSFAs.
- Accordingly, we are affirming our 'A+' ratings on FNFA.
- The stable outlook reflects our expectation that the authority will maintain high levels of capitalization and prudent risk management practices, and that FNFA's growing loan book will continue to reinforce the importance of its public policy role to the federal government.

Rating Action

On Aug. 14, 2020, S&P Global Ratings affirmed its 'A+' long-term issuer credit and issue-level ratings on public sector funding agency First Nations Finance Authority. The outlook is stable.

Outlook

The stable outlook reflects our expectation that the authority's loan book and market position will continue to grow steadily in the next two years and reinforce the importance of its public policy role to the federal government. We believe the federal government will continue to support FNFA lending activities, injecting capital as required so that FNFA's capitalization levels remain high. We also expect that the authority's liquid assets will continue to cover maturing liabilities even in a stress scenario without market access, and that access to Canada's deep and diversified bond market will remain unfettered. We believe that risk management practices will remain prudent.

Downside scenario

We could lower our ratings over the next two years if we revised the likelihood of extraordinary support from the federal government to low in scenarios where the importance of the authority's policy role to the government diminished, or the government's oversight of the authority lessened. A material decline in capitalization levels or significantly deteriorating asset quality that suggests persistently weak underwriting decisions and a lower management and governance assessment could also lead to a downgrade. However, we view these scenarios as unlikely over the outlook horizon.

Upside scenario

On the other hand, we could raise our ratings over the next two years if FNFA's growing loan book leads to the authority financing a substantial portion of the First Nations sector's funding needs and a lengthening record of fulfilling its public policy mandate of lending to the sector in Canada and if higher net income materially reduces the authority's ongoing dependence on the federal government. As well, we could raise our 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 reflects our belief that FNFA's high levels of capitalization, strong liquidity cushion, and prudent risk management and structural mechanisms will anchor its credit quality over the two-year outlook horizon. The authority's growing loan book will continue to strengthen its market position and record of fulfilling its public policy mandate despite it operating in a sector that has an evolving institutional framework, and its shorter record of operations compared with those of other rated PSFAs. Annual surpluses should continue to grow and lessen FNFA's dependence on the federal government for ongoing support, including operational funding and capital transfers.

The ratings incorporate our belief that the likelihood of FNFA receiving extraordinary support from the federal government will remain moderately high and provide a one-notch uplift from the 'a' stand-alone credit profile on the authority to the final 'A+' rating. We believe the authority has a strong link with the federal government, which the government's funding support for FNFA's operations demonstrates. We also believe that 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 on First Nations' land.

The FNFA is a financial intermediary that supports access to credit for First Nations in Canada. The authority 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: A growing loan book and market position together with continuing prudent risk management practices will anchor FNFA's business profile as the as First Nations sector evolves institutionally

- Canada's low financial system risk and the sector's low leverage risk will continue to offset somewhat the risks posed by economic disparities and the historically unbalanced, although improving, institutional framework of the Canadian First Nation sector.
- We expect that FNFA's growing loan book and market position will continue to strengthen its revenue stability and bolster its business position, despite a shorter lending history.
- 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 more than 600 First Nations in the country with capital needs that some have estimated are 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 and strengthen fiscal self-sufficiency. A prudent legislative framework is 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 that FNFA prudently discounts 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. Over 80% of these revenues come from the federal or provincial governments.

FNFA's business position continues to improve, although we feel it is still somewhat limited by the authority's shorter record relative to that of most other PSFAs. The authority loan book and market position grew in 2020 (year ended March 31) and we expect that this will continue, leading ultimately to the authority's dominance as a lender to the sector. The FNFA's loans to First Nations reached C$710 million as of March 31, 2020, and we expect that they will reach almost C$1 billion by the end of 2021. The authority's solid competitive position will support healthy customer base growth over the next several years, continuing a trend that began when 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 will remain satisfactory. Prudent risk management policies and practices plus 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: High capitalization levels and an adequate funding and liquidity assessment anchor our favorable view of FNFA's financial profile

- FNFA's capital adequacy strengthened in 2020 on higher levels of capital and lower portfolio concentration.
- Strong liquidity ratios and the structural stability of funding offset some funding concentration.
- A borrower-funded debt service reserves continues to bolster liquidity while providing a first-loss cushion for debt service nonpayment.

FNFA's capitalization levels were very strong in 2020 and we expect them to remain so over the next two years. The 2020 risk-adjusted capital ratio (RAC) before capital adjustments was 110.7%, which was close to last year's level. The RAC ratio after adjustment was 35.0%, which was up slightly from the previous year. Loan growth was strong in 2020 at 21% but it was outpaced by growth in capital. The main adjustment we make to the after-adjustment capital ratio is for concentration and that adjustment shrank in 2020 as portfolio concentration fell moderately: FNFA's 10 largest borrowers represented 48% of the loan portfolio in 2020, down from 52% the previous year. FNFA's capitalization levels compare favorably with those of its peers.

The federal government injected C$12 million into FNFA's credit enhancement fund (CEF) in 2020, following an injection of C$530,000 the year previous. FNFA's CEF, one of the two main sources of capital, stood at C$42.5 million at the end of 2020, up from C$30.5 million a year earlier. We expect that the federal government will continue to provide capital to FNFA approximately commensurate with the growth of the loan book. We also consider the authority's C$40.8 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 funding has risen faster annually than the FNFA's interest obligations at current interest rates.

We expect FNFA's strong liquidity levels will continue to support creditworthiness over the rating horizon. In addition to its other liquid funds and about C$14.3 million in cash and cash equivalents, the authority held about C$49.5 million in sinking funds as of March 31, 2020. The undrawn portion of FNFA's committed C$220 million revolving credit facility further boosts liquidity levels and lifts the funding and liquidity ratios. With the undrawn portion of the facility included, FNFA's one- year liquidity ratio with disbursement of all scheduled loans was 1.80x in 2020; with only 50% of loans disbursed, the ratio was 2.34x and; 3.34x with no loan disbursement. FNFA uses the credit facility to bridge timing differences and make loan aggregation more efficient--the undrawn amount of the facility can vary substantially throughout the year as a result.

At the same time, the funding ratio stood at 3.59x. 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 time frame, the authority has sought to mitigate this mismatch through its revenue intercept mechanisms, adjustments to relending rates upon debt refinancing, and sinking funds, among other mechanisms.

We believe that the FNFA will continue to benefit from strong risk management practices that will minimize potential losses in the future. 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 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.

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 FNFA's:

- Strong link with the federal government, which the government's ongoing financial support for the authority's operations demonstrates, in our view; and
- 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 on First Nations' land.

First Nations Finance Authority -- Selected Indicators

		--Year ended March 31--			
(Mil. C$)	**2020**	**2019**	**2018**	**2017**	**2016**
Business position					
Total adjusted assets	884.3	723.9	542.5	368.2	279.3
Customer loans (gross)	711.0	586	453.5	308.7	246
Growth in loans (%)	22.2	29.2	47	25.4	138
Net interest revenues	1.2	1.1	0.1	(0.1)	0.4
Noninterest expenses	4.6	4.2	2.8	2.5	2.6
Capital and risk position					
Total liabilities	832.2	687.6	509.6	346.7	268.4
Total adjusted capital	83.4	63.1	54.5	36.2	22.5
Assets/capital	17.0	11.5	10	10.2	12.4
RAC ratio before diversification	110.7	97.4	118.7	N.A.	N.A.

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

		--Year ended March 31--			
(Mil. C$)	2020	2019	2018	2017	2016
RAC ratio after diversification	35.0	30.8	32	N.A.	N.A.
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity					
Liquidity ratio with loan disbursement (one year) *	1.80	1.19	0.80	N.A.	N.A.
Liquidity ratio without loan disbursement (one year) *	3.34	1.46	1.30	N.A.	N.A.
Funding ratio (one year) *	3.59	1.40	1.10	N.A.	N.A.

RAC--Risk-adjusted capital. N.A.--Not available. * Includes undrawn portion of credit facility.

Ratings Score Snapshot

First Nations Finance Authority -- Ratings Score Snapshot

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

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", May 22, 2018
- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018
- COVID-19: Emerging Market Local Governments And Non- Profit Public- Sector Entities Face Rising Financial Strains, April 6, 2020
- S&P Global Ratings Definitions, Aug. 7, 2020

Ratings List

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