Research Update:

First Nations Finance Authority Outlook Revised To Positive From Stable On Operating Growth; 'A+' Ratings Affirmed

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Overview

- We expect First Nations Finance Authority (FNFA) will continue to expand on its 10-year track record of lending to First Nations communities in Canada, further strengthening its interest income and business position, and building a longer track record of operational independence. This will solidify its role and public policy mandate as a public sector funding agency (PSFA).
- Very high capitalization levels, strong liquidity, and prudent risk management also anchor our rating on FNFA.
- As a result, S&P Global Ratings revised the outlook on FNFA to positive from stable and affirmed its 'A+' long-term issuer credit and issue-level ratings.
- The positive outlook reflects our expectation that FNFA will continue to increase its market position, interest revenue, and customer base over the next two years, leading to decreased reliance on ongoing support from the federal government.

Rating Action

On Aug. 22, 2022, S&P Global Ratings revised the outlook to positive from stable and affirmed its 'A+' long-term issuer credit and issue-level ratings on First Nations Finance Authority (FNFA).

Outlook

The positive outlook reflects our view that there is at least a one-in-three possibility that we could raise our rating on FNFA in the next one-two years if the authority continues to build its track record of operational independence and a strengthening business position, while maintaining the importance of its public policy role to the federal government. We believe the federal government will continue to support FNFA's lending activities, injecting capital if required so that its 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 its access to Canada's deep and diversified bond market will remain unfettered. We believe that risk management practices will remain prudent.

Upside scenario

We could raise our rating over the next 12-24 months if FNFA's increasing loan book leads the authority to finance a substantial portion of the First Nations sector's funding needs, and it lengthens its track record of fulfilling its public policy mandate and demonstrates higher net income and lower dependence on the federal government. As well, we could raise our rating if we revised the likelihood of extraordinary support from the federal government to high or greater because of the increased importance of FNFA's public policy role or strong direction by the federal government in the authority's strategy development and day-to-day operations.

Downside scenario

We could revise the outlook to stable over the next two years if growth in FNFA's loan book and customer base stabilizes, and the authority fails to reduce its reliance on the federal government for operating support. At the same time, we could lower our rating in the same time frame if we revised the likelihood of extraordinary support from the federal government to low in scenarios where the importance of FNFA's policy role to the government diminished, or the government's oversight of the authority decreased. 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 during the outlook horizon.

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 increasing loan book will continue to strengthen its market position and record of fulfilling its public policy mandate despite operating in a sector that has an evolving institutional framework; and its somewhat shorter, although growing, record of operations compared with those of other rated PSFAs. Annual surpluses should continue to increase and reduce FNFA's dependence on the federal government for ongoing support, including operational funding and capital transfers.

The rating incorporates our belief that the likelihood of FNFA receiving extraordinary support from the federal government will remain moderately high and this provides 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 through its statutory mandate and public policy role to facilitate access to capital for 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, 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: Growing market position, customer base, and revenues together with prudent risk management and creditor protection support the enterprise profile

- We expect FNFA will further expand its position as the majority lender of debt held by its borrowers, and that the number of communities scheduled to the First Nations Fiscal Management (FNFM) Act, which is the first step in becoming a FNFA borrower, will continue to increase, having already surpassed 50% of First Nations communities.
- FNFA's growing market position will strengthen the authority's revenue stability and own-source revenues, reducing its reliance on the federal government.
- We believe that the authority's increasing staff will continue to implement strong risk management policies and sufficient strategic positioning.

We believe that 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 at more than C$20 billion for infrastructure (water and roads), community-owned housing, equipment, and economic development.

FNFA's business position will likely continue to improve despite its shorter track record of lending compared with that of other PSFAs. The authority's loan book and market position increased in 2022 (year ended March 31) and we expect this will lead to its dominance as a lender to the sector. The FNFA's loans to First Nations reached C$1.5 billion as of March 31, 2022, and we believe that they will continue to increase, following more than five years of over 20% growth. The authority is now the creditor of more than 60% of the debt of its members, compared with less than a third five years ago. At the same time, a growing number--more than half--of the more than 600 First Nations communities in Canada have been scheduled to the FNFM Act, which is the first step to becoming a FNFA borrower. As the authority's customer base and lending book increase, we expect FNFA's own-source revenue will continue to grow, led by net interest income. This will further solidify FNFA's operational self-sufficiency after experiencing the first year of the operating surplus exceeding operational funding from the federal government in the fiscal year ended March 31, 2022. This will make FNFA less dependent on the federal government for its operations, and therefore less subject to potential political risk, should government funding priorities shift.

The authority's solid competitive position will support healthy customer base growth in the next several years, continuing a trend that began when FNFA started lending. Historically, access to capital has been difficult 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 compared with that of competitors.

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 more than 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, the federal government has begun to provide more predictable funding. In 2019, the government established 10-year grants available to First Nations, which is longer 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 want 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. More than 75% of these revenues come from the federal or provincial governments.

We expect FNFA's strategic positioning and organizational effectiveness will remain satisfactory as its staff increases. 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. Although 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: A new commercial paper program will continue to support FNFA's favorable financial profile, with very strong capitalization levels and a strong funding and liquidity assessment

- FNFA's capital adequacy remained strong in 2022 despite high loan growth, reflecting a proportionate rise in the debt reserve fund (DRF) to $86.8 million.
- A borrower-funded DRF bolsters liquidity while providing a first-loss cushion for debt service nonpayment.
- Strong liquidity ratios, the structural stability of funding, and new sources of short-term funding offset some funding concentration.

FNFA's capitalization was very strong in 2022 (year ended March 31) and we expect it will remain so over the next two years. As of the year ended March 31, 2022, the risk-adjusted capital (RAC) ratio before capital adjustments was 164.8%, which was close to last year's level. The RAC ratio after adjustment was 27.8%, which was also similar to the previous year. The main adjustment we make to the after-adjustment RAC ratio is for concentration and that adjustment increased in 2022 as portfolio concentration rose. FNFA's 10 largest borrowers represented 55% of the loan portfolio in 2022, up slightly from 53% in the previous year. Still, FNFA's capitalization levels compare favorably with those of other PSFAs.

The federal government injected C$7.7 million into FNFA's credit enhancement fund (CEF) in 2022, following an injection of C$2.9 million in 2021 and C$12 million in 2020. FNFA's CEF, one of the two main sources of capital, stood at C$53.1 million, up from $45.5 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$86.8 million DRF to be loss absorbing. FNFA withholds 5% of each member's loan request in the DRF. At the same time, although we do not consider it in FNFA's measure of total adjusted capital for the purposes of our RAC ratio, the federal government created a C$32.5 million contingency fund in fiscal 2022, with funding provided by Crown-Indigenous Relations and Northern Affairs Canada. The fund was created to provide repayable financial support for FNFA's borrowing members, should they face difficulties due to the COVID-19 pandemic or related restrictions. Although no loans have been made from the fund to date, it could serve as an additional source of loss absorption, if drawn. At the same time, we believe that the establishment of this fund further solidifies the federal government's support of FNFA.

We expect FNFA's strong liquidity levels will support the authority's creditworthiness during the outlook horizon. In late 2021, FNFA launched its first commercial paper program, for a maximum amount outstanding of C$400 million, which is fully backed by a revolving credit facility with a syndicate of Canadian chartered banks. The program will be used to finance FNFA's interim loans and allowed the authority to lower its funding costs. In addition to its other liquid funds and cash and cash equivalents, the authority held about C$110.9 million in sinking funds as of March 31, 2022. FNFA's one-year liquidity ratio with disbursement of all scheduled loans was 1.45x in 2022, and 1.49x with no loan disbursement. At the same time, the funding ratio was 1.35x. These ratios suggest strong liquidity, but are lower than last year, given the timing of FNFA's debt issuances and outstanding commercial paper program.

The Canadian bond market, which we consider deep and diversified, provides 100% of 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, 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 adjustments to its relending rates upon debt refinancing, sinking funds, and revenue intercept mechanisms, among other measures.

We believe that FNFA will 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. FNFA has intervention power under The FNFM 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; and
- Important role through the FNFA's statutory mandate and public policy role to facilitate First Nations' access to capital. 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$)	2022	2021	2020	2019	2018
Business position					
Total adjusted assets	2,292	1,475	884	724	543
Customer loans (gross)	1,541	1,235	711	586	454
Growth in loans (%)	24.8	73.7	21.3	29.2	47
Net interest revenues	4.4	1.8	1.2	1	0
Noninterest expenses	7.0	4.9	4.6	4.2	2.8
Capital and risk position					
Total liabilities	2,190	1,420	832	688	510
Total adjusted capital	140	114	83	63	55
Assets/total adjusted capital	16.4	12.9	11.0	11.9	10.3
RAC ratio before diversification	164.8	184.4	110.7	97.4	118.7
RAC ratio after diversification	27.8	29.1	35	30.8	32
Gross nonperforming assets/gross loans	-	-	-	-	-
Funding and liquidity					
Liquidity ratio with loan disbursement (one year)*	1.5	1.2	1.8	1.2	0.8
Liquidity ratio without loan disbursement (one year)*	1.5	4.2	3.3	1.5	1.3
Funding ratio without scheduled loans(one year)*	1.4	4.2	3.6	1.4	1.1

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+/Positive/--
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)

First Nations Finance Authority--Ratings Score Snapshot (cont.)

Key rating factors	Scores
Support	
GRE support	1
Group support	0
Additional factors	0

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- S&P Global Ratings Definitions, Nov. 10, 2021
- Public-Sector Funding Agencies Risk Indicators: May 2019, May 13, 2019
- Guidance | Criteria | Governments | International Public Finance: 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

Ratings List

Ratings Affirmed		
First Nations Finance Authority		
Senior Secured	A+	
Ratings Affirmed; Outlook Action		
	To	**From**
First Nations Finance Authority		
Issuer Credit Rating	A+/Positive/--	A+/Stable/--

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