Research Update:

First Nations Finance Authority 'A+' Ratings Affirmed; Outlook Remains Positive

September 11, 2023

PRIMARY CREDIT ANALYST

Julia L Smith
Toronto
+ (416) 507-3236
Julia.Smith@spglobal.com

SECONDARY CONTACT

Amanpreet Kaur
Toronto
+1 416 507 2580
Amanpreet.Kaur@spglobal.com

Overview

- We expect First Nations Finance Authority (FNFA) will continue to steadily grow the number of First Nations community borrowers in Canada over the next two years, as well as widen the pool of borrowers in its loan book following recent legislative enhancements to its act.
- This growth will continue FNFA's 11-year lending and 17-year operational track record of steady expansion as the preeminent public-sector funding agency lender to First Nations communities in the country and solidify its operational independence.
- At the same time, we believe that there are mitigating factors to the risks that the unprecedented number of wildfires across Canada pose to FNFA and that the authority will remain resilient in the face of these physical environmental risks.
- We affirmed our 'A+' ratings on FNFA, and the outlook remains positive, indicating our expectation that FNFA will increase its market position, interest revenue, and customer base over the next two years.

Rating Action

On Sept. 11, 2023, 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 remains positive.

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 to two years if the authority:

- Builds its track record of operational independence,
- Continues to strengthen business position,
- Maintains the importance of its public policy role to the federal government, and

- Demonstrates resilience in the face of heightened environmental physical risks.

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 continue to finance a substantial portion of the First Nations sector's funding needs. We would also look for FNFA to continue to fulfill its public policy mandate and demonstrate higher net income and lower dependence on the federal government, while remaining resilient to heightened environmental physical risks.

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 if the authority fails to reduce its reliance on the federal government for operating support. At the same time, we could lower our rating if we revised the likelihood of extraordinary support from the federal government to low--owing to the importance of FNFA's policy role to the government diminishing--or if the government's oversight of the authority decreased.

A material decline in capitalization or significantly deteriorating asset quality that suggests higher underlying risks of borrowers or 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 next two years.

Rationale

The 'A+' rating reflects our belief that FNFA's growing loan book and market position as the most important lender to First Nations communities in Canada for infrastructure, economic, and social development financing needs will support the institution's creditworthiness over the next two years.

With recent enhancements to the act under which FNFA operates, FNFA will also expand its pool of potential borrowers, further solidifying its importance in the sector. This growth will enable FNFA to maintain its operational independence and ensure that it will not depend on operational support from the federal government.

At the same time, we expect that FNFA's high levels of capitalization, strong liquidity cushion, and prudent risk management and structural mechanisms will anchor its credit quality over the next two years. Also underpinning the rating are the ability of FNFA's employees to work remotely, its remote data storage, insurance coverage, and high level of loan repayment revenue streams that do not depend on local economic conditions. We believe that these factors will make the authority resilient to the physical environmental risks that the wildfires across Canada pose.

The rating also incorporates our assessment that the likelihood of FNFA receiving extraordinary support from the federal government, if required, will remain moderately high. This provides a one-notch uplift from the 'a' stand-alone credit profile on the authority to the final 'A+' rating.

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 profile: Supported by growing market position, customer base, and revenues, along with prudent risk management and creditor protection

- We expect FNFA will continue to strengthen its market position as the largest lender to First Nations communities in Canada, particularly following recent enhancements to its act.
- FNFA's growing market position will underpin the authority's revenue stability and own-source revenues, ensuring that it will not need to rely on external operating support.
- We believe that the authority's increasing staff will continue to implement strong risk management policies and sufficient strategic positioning.

Over the next two years, we believe that FNFA's borrowers, loans, and revenues will continue to grow. This growth will solidify FNFA's strengthened market position and lengthen its 11-year lending and 17-year operational track record.

The authority's loan book and market position expanded in 2023, supporting its dominance as a lender to the sector. The FNFA's loans to First Nations reached C$1.8 billion as of June 30, 2023, following annual growth of over 30%, on average, over the last five years. The authority is now the creditor of more than two-thirds of the debt of its members, compared with less than one-third six years ago. At the same time, a rising 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 an FNFA borrower.

In addition, recent enhancements to the legislative act under which FNFA operates will enable the authority to broaden its market position and mandate. On June 20, 2023, the federal government's Bill C-45, which included these amendments, received royal assent. The amendment makes borrowing through FNFA accessible to a larger pool of borrowers, including:

- Modern treaty and self-governing First Nations,
- Tribal councils, and
- Nonprofit organizations that provide public services to Indigenous groups or Indigenous persons.

The federal government's volunteering of funds to cover the costs associated with this amendment demonstrates the government's ongoing support of the authority, in our view.

As the authority's customer base and lending book increase, we expect FNFA's own-source revenue will continue to rise, led by net interest income. This will further solidify FNFA's operational self-sufficiency. In the fiscal year ended March 31, 2023, the authority's operating surplus exceeded operational funding from the federal government for the second year, and we expect this self-sufficiency to continue. This will ensure that FNFA does not depend on the federal government for its operations, and therefore will be less subject to potential political risk, should government funding priorities shift.

We believe that FNFA will continue to benefit from solid underlying asset quality. The authority lends exclusively to First Nations communities in Canada. The First Nations in the country have capital needs that the Assembly of First Nations now estimates are $349 billion more than non-First Nations communities given historical impediments. Infrastructure needs include water and roads projects, community-owned housing, equipment, and economic development.

First Nations 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 70% of these revenues come from the federal or provincial governments. In our view, the broad geographic source of these revenue streams limits the risk that any local wildfire would pose to a particular First Nation community.

The authority's solid competitive position will support healthy customer 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 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 owing 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. Over the past several years, the government established 10-year grants available to First Nations--longer than the previous one- and five-year funding agreements. This initiative is part of the 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 also 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.

Finally, we expect FNFA's strategic positioning and organizational effectiveness will remain satisfactory as its staff increases. 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.

Additionally, while the large McDougall Creek wildfire has been burning near FNFA's head office over the past several weeks, the fire has not directly affected the office to date. FNFA's remote information storage and employee work capabilities, as well as its insurance coverage and presence across Canada, limit the risks that the fire poses to the authority's operations, in our view.

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

- We expect FNFA's capital adequacy to remain very strong despite a recent increase in operational risk given revenue growth, and higher loan concentration.
- A borrower-funded Debt Reserve Fund bolsters liquidity while providing a first-loss cushion for debt service nonpayment.
- Strong liquidity ratios, the structural stability of funding, and short-term funding sources offset some funding concentration.

FNFA's capitalization was very strong in 2023, and we expect it will remain so over the next two years. As of the year ended March 31, 2023, the risk-adjusted capital (RAC) ratio before capital adjustments was 127%, which was lower than last year's 165% but still well above the 15% threshold for our very strong capital adequacy assessment.

At the same time, the RAC ratio after adjustment was 21%, also below the ratio of the previous year. The main adjustment we make to the RAC ratio is for concentration, and that adjustment increased in 2023 as portfolio concentration rose.

FNFA's 10 largest borrowers represented 57% of the loan portfolio in 2023, up slightly from 55% in the previous year. Still, FNFA's capitalization levels compare favorably with those of other public-sector funding agencies.

We expect the federal government will continue to provide funding for FNFA's credit enhancement fund (CEF), one of the two main sources of capital, over the next two years commensurate with the growth of FNFA's loan book. In 2023, while the government did not inject money into the CEF, it directed funds that it had historically used to support the CEF to finance the costs associated with amending the act under which FNFA operates. Over the past three years, the federal government has injected nearly $23 million into the CEF. The CEF stood at C$53.2 million as of March 31, 2023. We also consider the authority's C$101 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 contingency fund in fiscal 2022. The fund now holds C$33 million 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 from the COVID-19 pandemic or subsequent widespread economic shock.

Although no loans have been made from the fund to date, it could serve as an additional source of loss absorption, if drawn. We also 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 over the next two years. In addition to its other liquid funds and cash and cash equivalents, the authority held about C$160 million in sinking funds as of March 31, 2023. FNFA's one-year liquidity ratio with disbursement of all scheduled loans was 1.46x in 2023, and 1.47x with no loan disbursement. While these ratios could indicate a more robust liquidity assessment, they have not been consistently elevated, and we don't believe that they are underpinned by a formal policy targeting specific entity-wide ratios, as is the case with some peers.

At the same time, the funding ratio was 1.28x. These ratios suggest strong liquidity. In addition to other sources of liquidity, FNFA has, since late 2021, operated a 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 is used to finance FNFA's interim loans.

The Canadian bond market, which we consider deep and diversified, provides 100% of FNFA's long-term funding, making the authority's funding sources somewhat concentrated. Investor diversification is improving, however, based on investor type and domicile. FNFA's funding versus lending commitments also are relatively stable, in our view. 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. It has done so through adjustments to its relending rates upon debt refinancing, sinking funds, and revenue intercept mechanisms, among other measures.

We also consider in our rating that FNFA's strong risk management practices 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 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.

Key Statistics

First Nations Finance Authority--selected indicators

	--Fiscal year ended March 31--				
(Mil. C$)	**2023**	**2022**	**2021**	**2020**	**2019**
Business position					
Total adjusted assets	2,335	2292	1475	884	724

First Nations Finance Authority--selected indicators (cont.)

	--Fiscal year ended March 31--				
(Mil. C$)	**2023**	**2022**	**2021**	**2020**	**2019**
Customer loans (gross)	1,677	1541	1235	711	586
Growth in loans (%)	8.83	24.8	73.7	21.3	29.2
Net interest revenues	5	4.4	1.8	1.2	1
Noninterest expenses	11	7	4.9	4.6	4.2
Capital and risk position					
Total liabilities	2,226	2,190	1,420	832	688
Total adjusted capital	154	140	114	83	63
Assets/total adjusted capital (%)	15.1	16.4	12.9	11	11.9
RAC ratio before diversification (%)	127.2	164.8	184.4	110.7	97.4
RAC ratio after diversification (%)	20.6	27.8	29.1	35	30.8
Gross nonperforming assets/gross loans (%)	--	--	--	--	--
Funding and liquidity					
Liquidity ratio with loan disbursement (one year) (x)*	1.5	1.5	1.2	1.8	1.2
Liquidity ratio without loan disbursement (one year) (x)*	1.5	1.5	4.2	3.3	1.5
Funding ratio without scheduled loans(one year) (x)*	1.3	1.4	4.2	3.6	1.4

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

Ratings Score Snapshot

First Nations Finance Authority--ratings score snapshot

Issuer Credit Rating	A+/Positive/--
SACP	a
Enterprise Risk Profile	Adequate (3)
PICRA	Adequate (3)
Business Position	Moderate (4)
Management & 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

- 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

Ratings List

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