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Ratings

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Research Update:

New Zealand Local Government Funding Agency Ltd. Ratings Raised After Similar Action On New Zealand; Outlook Stable

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PRIMARY CREDIT ANALYST

Martin J Foo
Melbourne
+ 61 3 9631 2016
martin.foo
@spglobal.com

SECONDARY CONTACT

Sharad Jain
Melbourne
+ 61 3 9631 2077
sharad.jain
@spglobal.com

Overview

- On Feb. 22, 2021, we raised our long-term ratings on New Zealand to 'AA+' foreign-currency (FC) and 'AAA' local-currency (LC) and affirmed the short-term ratings at 'A-1+'.
- We believe there is an extremely high likelihood the New Zealand government would provide LGFA with extraordinary support in a stress scenario, if needed.
- We are consequently raising our long-term FC rating on LGFA to 'AA+' and long-term LC rating to 'AAA', with a stable outlook. We are affirming our short-term ratings at 'A-1+'.
- LGFA's stand-alone credit profile remains 'aa-'. We assess that its strengths, including its dominant market position as a source of debt finance for highly rated New Zealand local councils, continue to offset its relatively modest risk-adjusted capital ratio.

Rating Action

On Feb. 22, 2021, S&P Global Ratings raised its long-term FC issuer credit rating on New Zealand Local Government Funding Agency Ltd. (LGFA) to 'AA+' from 'AA' and its long-term LC issuer credit rating to 'AAA' from 'AA+'. The outlook on the long-term ratings is stable. We also affirmed our short-term ratings at 'A-1+'. LGFA is a New Zealand-based public-sector funding agency.

Outlook

The stable outlook on LGFA reflects that on the New Zealand sovereign, and our view that the likelihood of LGFA receiving extraordinary support from the sovereign in a stress scenario is unlikely to change.

Downside scenario

We could lower our ratings on LGFA during the next two years if we perceive its public policy role or links to the New Zealand government to be weakening. We could also lower our ratings on LGFA if we were to do the same for New Zealand.

In addition, downward ratings pressure could emerge if we consider LGFA's stand-alone credit profile (SACP) to be weakening. This could occur if, for instance, we were to observe larger asset-liability mismatches without mitigating factors, LGFA's dominant market position wanes, access to funding markets or liquidity falls markedly, or there is a significant decline in the underlying creditworthiness of LGFA's borrowers and guarantors.

Upside scenario

We could raise our FC rating on LGFA during the next two years if we were to do the same for New Zealand, all else being equal.

Rationale

We raised our long-term ratings on LGFA after taking a similar action on the New Zealand sovereign (see "New Zealand Ratings Raised To 'AA+' FC And 'AAA' LC As Pandemic Risks Moderate; Outlook Stable," published Feb. 22, 2021). Our ratings on LGFA reflect its SACP of 'aa-', and our view that there is an extremely high likelihood that extraordinary financial support from the New Zealand government (the Crown) would be forthcoming in a stress scenario.

Our ratings are underpinned by New Zealand's excellent institutional settings and wealthy economy, as well as LGFA's dominant market position and robust management and governance. We consider LGFA's borrowers to be highly creditworthy because those to which we assign ratings have an average long-term issuer credit rating in the 'AA' category. In addition, LGFA has access to a diverse set of domestic and offshore investors and a standby liquidity facility with the New Zealand Debt Management Office (NZDMO), the borrowing arm of the Crown. Partially offsetting these strengths, in our view, is LGFA's highly concentrated lending portfolio, which leads to a weaker capital adequacy assessment than many international peers.

LGFA was established in December 2011, following the enactment of the Local Government Borrowing Act 2011, to provide debt finance to New Zealand local and regional governments (i.e., councils). Its main objective is to raise debt on behalf of councils on terms more favorable than if they had raised that debt directly. LGFA is 20% owned by the Crown and 80% owned by 30 council shareholders. At the time of writing, LGFA counted 71 of New Zealand's 78 councils as members. Together, these councils account for most of the local government debt in New Zealand.

Enterprise Risk Profile: Ratings underpinned by very strong management, dominant market position, and New Zealand's excellent institutional settings

- LGFA has a strong public policy mandate and growing base of highly rated council borrowers.
- LGFA's borrowers benefit from New Zealand's excellent institutional settings and wealthy economy, though councils are quite leveraged relative to international peers.
- Risk management is robust and bolstered by an experienced management and governance

team.

The credit quality of councils in New Zealand is high. We currently assign long-term issuer credit ratings to 24 councils in New Zealand, including most of LGFA's largest borrowers, predominantly in the 'AA' category.

The local government sector is supported by New Zealand's excellent institutional settings and wealthy and resilient economy, with GDP per capita of about US$42,500 in 2021. The country is recovering strongly from a COVID-19 induced recession. We expect real GDP to expand 4.3% year-over-year in 2021 (see "Economic Research: Asia-Pacific Forecasts Stabilize, Risks Now Balanced," published Nov. 30, 2020). The upturn is aided by New Zealand's relative success to date in containing the spread of coronavirus.

We view domestic financial system risk as intermediate, with conservative regulations and risk appetite settings balanced against the banking system's high share of net external borrowings. Leverage in New Zealand's local government sector is elevated compared with other jurisdictions, with direct council debt standing at around 140% of operating revenues.

LGFA has had a strong record since 2011 in fulfilling its public policy mandate, despite being younger than many of its international peers. It has a dominant market position in New Zealand, accounting for 82% of all councils' borrowing in the 12 months to December 2020. Its customer base is expanding, with three new members joining in the December quarter, taking the total to 71.

New Zealand's largest council, Auckland Council, accounts for roughly 38% of the national economy and half of the sector's gross debt. LGFA limits its lending to Auckland Council to reduce concentration risk, and Auckland Council has large offshore and wholesale bond programs of its own, which means that LGFA's share of aggregate local government debt is limited to about two-thirds. Dunedin City Council is the only council of substantial size that does not borrow through LGFA, though it is in the process of joining as a member. LGFA is now the near-monopoly lender to councils outside of Auckland.

LGFA is able to lend on terms that are more attractive than if councils opted to borrow in their own name or through the banking system, as evidenced by secondary market spreads between LGFA bonds and New Zealand-dollar bonds issued by Auckland Council, Dunedin City Council (via Dunedin City Treasury Ltd.), and the major banks. LGFA has also helped councils to lengthen the average tenor of their borrowings.

While we previously expected growth in LGFA's balance sheet to decelerate, we now expect councils to step up their borrowing to finance post-pandemic infrastructure stimulus. LGFA has recorded roughly stable or growing net interest income and positive net profit in every year except its first (partial) year of operation. We expect earnings to remain modest, reflecting its central objective of reducing funding costs for councils.

We consider LGFA's management and governance to be a key strength, and one that mitigates potential risks. The organization is governed by a six-member board of which five members, including the chairperson, are independent directors. The board is responsible for strategic direction and control. LGFA also has a shareholders' council, made up of five to 10 appointees, that recommends appointments to the board and coordinates shareholders on governance decisions. LGFA's management team is highly qualified. Its senior executives have experience from previous roles in council treasury operations, debt management, and private financial institutions.

Like many of its international peers, LGFA is not subject to banking regulation. However, its bonds are quoted on the NZX Debt Market and LGFA is therefore required to comply with continuous disclosure obligations. In addition, securities issued to retail investors are regulated under the

Financial Markets Conduct Act 2013. LGFA produces annual financial statements, with external auditors appointed by the Auditor-General of New Zealand. It also publishes half-year reports and annual "statements of intent". LGFA pays dividends to its shareholders, but payment is always discretionary and subject to board approval.

Financial Risk Profile: Risks from borrower concentration are partly offset by sound access to capital markets and strong liquidity

- The two largest borrowers account for around 43% of the lending book, resulting in concentration risk.
- LGFA benefits from a joint and several guarantee from 60 council guarantors, and its lending is secured over property rates revenue.
- LGFA funds itself only in domestic capital markets. Liquidity is buttressed by a Crown-committed standby facility of up to NZ$1.5 billion (the limit is currently set at NZ$600 million) and a central bank asset purchase program.

LGFA's lending portfolio is concentrated compared with most of its overseas peers, and this constrains its capital adequacy assessment. We calculate its risk-adjusted capital ratio to be 15.7% before diversification and 2.3% after adjustments for single-name concentration, as of June 30, 2020 (the end of the most recent financial year). Its two largest borrowers, Auckland Council and Christchurch City Council, represent 43% of the loan book, while its 20 largest borrowers account for around 83%.

We expect LGFA's capitalization to slowly improve. From July 2020, LGFA increased the percentage of borrower notes that councils must subscribe for, to 2.5% from 1.6% of their long-term borrowing. LGFA also increased its onlending margin by 10 basis points. Its capital structure comprises NZ$25 million of paid-in shareholder capital, about NZ$59 million in retained earnings, and about NZ$182 million in borrower notes, which we view as equity-like. LGFA also has NZ$20 million of uncalled shareholder capital, which we exclude from our calculations, but note could be called to support its financial position in a stress scenario.

We consider risk management to be excellent, which helps to mitigate lending concentration risk. LGFA's investments are restricted to approved financial instruments, such as term deposits and highly rated bonds, as specified in a board-approved treasury policy. LGFA fully hedges any foreign-currency exposures back to New Zealand dollars. Credit risk on derivative contracts is minimized by using NZDMO as counterparty to all such contracts.

The credit history of LGFA's loan portfolio is exceptional, reflecting the fact that it has not experienced any arrears on payments or loan impairments since inception. Council borrowers must comply with various covenants relating to their net debt, interest expenses, and liquidity. In 2020, LGFA relaxed one of its foundation policy covenants. To give councils extra buffer to deal with the fallout of the COVID-19 pandemic, those rated 'A' or higher will be permitted to have net debt up to 300% of their revenues, up from 250%. This higher limit will taper back to 280% by 2026. To address concentration risk, Auckland Council is limited to a maximum of 40% of LGFA's total loan book.

Supporting its financial profile is the fact that all LGFA's borrowers must provide debenture security by way of a charge over council property rates and rates revenues. We view this positively because rates revenue is the largest and most stable source of income for New Zealand councils, and because rates collection ranks ahead of all other claimants on residents, including mortgages and New Zealand's Inland Revenue Department.

A recent change to LGFA's foundation policies will allow it, going forward, to lend to a council-controlled organization (CCO) if that CCO's parent council provides a guarantee or sufficient uncalled capital to meet obligations. We do not anticipate this change having any material impact on LGFA's credit metrics. Historically, LGFA had only provided debt finance to New Zealand councils and not any CCO, joint venture, or other entity.

In addition, our assessment of LGFA is strengthened by the joint and several guarantee of its obligations. Other than the New Zealand government, each of LGFA's shareholders must be a guarantor, and, if the principal amount of a council's borrowing exceeds NZ$20 million, that council must also become party to a deed of guarantee. LGFA currently has 60 such guarantors.

We believe that LGFA has sound access to capital markets, though its funding is concentrated in New Zealand. Its bonds are issued domestically in New Zealand dollars and, since 2015, have been listed on the NZX Debt Market, allowing participation by retail investors. LGFA is the second-largest New Zealand-dollar borrower, behind only the sovereign. Following a bout of market dysfunction at the onset of the pandemic, the Reserve Bank of New Zealand (RBNZ) announced that it would start outright purchases of LGFA bonds as part of its Large-Scale Asset Purchase program.

Bonds are spread across 10 maturities, largely matching those of benchmark New Zealand government bonds. They are mostly in series of NZ$1 billion or more to promote secondary market liquidity. Demand for LGFA's bonds is supported by their repo-eligibility with RBNZ at a low haircut. According to LGFA's surveys, about 20% of its debt is held by offshore investors. Since 2015, LGFA has also issued short-dated bills via tender and private placement. In November 2017, LGFA established an Australian-dollar medium-term notes program, which it has not yet opted to utilize.

We consider LGFA's liquidity to be strong, reflecting its portfolio of liquid financial assets and access to a committed facility with NZDMO. The facility has a maximum size of NZ$1.5 billion; its actual limit is adjusted by LGFA from time to time and currently set at NZ$600 million. In 2020, the Crown agreed to extend the facility for another 10 years, to 2031. We believe that LGFA would generally be able to meet its obligations even under stressed market conditions without calling on additional resources from members. We also believe that, in practice, New Zealand councils would be able to cut back their borrowing requirements in such an environment.

We don't, at present, expect LGFA's new standby facility product for councils to affect its liquidity metrics. LGFA began offering standby facilities of its own in late 2020, entering into one agreement with a council in the December 2020 quarter for NZ$100 million. We expect these offerings to grow over the next 12 months, and to be backed by additional liquid financial assets.

Extremely high likelihood of support from the New Zealand government in a stress scenario

We view the likelihood that the New Zealand government would provide timely and sufficient extraordinary support to LGFA in the event of financial stress to be extremely high. This assessment is based on our view of LGFA's:

- Very important role in meeting the New Zealand government's objectives. LGFA is the near-monopoly source of debt finance for most local authorities. It offers cost savings and access to longer-term borrowings to participating councils, and it has helped to deepen domestic capital markets. A default by LGFA would likely lead to substantial delays in or cancelations of local government projects—across such areas as transport, water, and sewerage infrastructure—to the major detriment of New Zealand's economy.

- Integral link with the New Zealand government. LGFA's enabling legislation allows the Crown to lend it money if it is in the public interest to do so, or to meet a temporary shortfall in a timely manner. LGFA enjoys a special public status in New Zealand. This is evidenced by its committed liquidity facility with NZDMO, which was recently expanded to NZ$1.5 billion and extended for another 10 years.

Key Statistics

	--Year ended June 30--				
(Mil. NZ$)	**2020A**	**2019A**	**2018A**	**2017A**	**2016A**
Business position					
Total adjusted assets	13,174	10,382	8,835	8,491	7,257
Customer loans (gross)	10,900	9,311	7,976	7,784	6,451
Growth in loans (%)	17	17	2	21	28
Net interest revenues	18	19	19	18	16
Noninterest expenses	8	8	7	6	6
Capital and risk position					
Total liabilities	12,908	10,154	8,635	8,306	7,105
Total adjusted capital	266	228	199	185	153
Assets/capital (x)	50	46	44	46	48
RAC ratio before diversification (%)	15.7	17.5	19.2	19.0	N.A.
RAC ratio after diversification (%)	2.3	2.2	1.8	1.5	N.A.
Gross nonperforming assets/gross loans (%)	0	0	0	0	0
Funding and liquidity (x)					
Liquidity ratio with loan disbursement (1 year)	1.31	1.12	0.89	N.A.	N.A.
Liquidity ratio without loan disbursement (1 year)	1.31	1.14	1.61	N.A.	N.A.
Funding ratio (1 year)	1.80	1.31	1.65	N.A.	N.A.

NZ$—New Zealand dollars. N.A.-Not available. E—Estimate. A—Actual.

Ratings Score Snapshot

Issuer credit rating	
Local currency	AAA/Stable/A-1+
Foreign currency	AA+/Stable/A-1+
SACP	aa-
Enterprise risk profile	Very Strong (1)
PICRA	Strong (2)
Business position	Very Strong (1)
Management and governance	Very Strong (1)

Financial risk profile	Adequate (3)
Capital adequacy	Moderate (4)
Funding	Neutral
and liquidity	Strong (2)
Support	2
GRE support	2
Group support	0
Additional factors	0

SACP-Stand-alone credit profile. PICRA-Public-Sector Industry And Country Risk Assessment.

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: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- New Zealand Ratings Raised To 'AA+' FC And 'AAA' LC As Pandemic Risks Moderate; Outlook Stable, Feb. 22, 2021
- Default, Transition, and Recovery: 2019 Annual International Public Finance Default And Rating Transition Study, Dec. 8, 2020
- Economic Research: Asia-Pacific Forecasts Stabilize, Risks Now Balanced, Nov. 30, 2020
- Public Finance System Overview: New Zealand's Institutional Framework For Local And Regional Governments, Oct. 28, 2020
- Banking Industry Country Risk Assessment: New Zealand, July 22, 2020
- Bulletin: New Zealand Local Government Funding Agency Ltd. Ratings Can Tolerate Higher Council Leverage Limits, May 5, 2020
- COVID-19's Effects Will Pressure New Zealand Council Ratings, May 24, 2020
- Public-Sector Funding Agencies Risk Indicators: May 2019, May 14, 2019

Ratings List

Ratings Affirmed		
New Zealand Local Government Funding Agency Ltd.		
Upgraded		
	To	**From**
Senior Unsecured	AAA	AA+
Upgraded; CreditWatch/Outlook Action; Ratings Affirmed		
Issuer Credit Rating		
Foreign Currency	AA+/Stable/A-1+	AA/Positive/A-1+
Local Currency	AAA/Stable/A-1+	AA+/Positive/A-1+

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.