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Research Update:

New Zealand Local Government Funding Agency Ltd. Ratings Affirmed After Criteria Revision; Off UCO; Outlook Stable

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Research Update:

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Overview

- We have completed our review of the ratings on the New Zealand Local Government Funding Agency Ltd. (LGFA), a public-sector funding agency that lends to the New Zealand local government sector, following the release of our "Public-Sector Funding Agencies: Methodology And Assumptions" criteria.
- We placed the ratings on all public-sector funding agencies under criteria observation (UCO) on May 22, 2018, in conjunction with the criteria release.
- After the review, we are affirming our 'AA+/A-1+' local-currency and 'AA/A-1+' foreign-currency issuer credit ratings on LGFA and removing the ratings from UCO.
- The outlook on the long-term ratings is stable.

Rating Action

On July 13, 2018, S&P Global Ratings affirmed its 'AA+/A-1+' long- and short-term local-currency and 'AA/A-1+' long- and short-term foreign-currency issuer credit ratings on the New Zealand Local Government Funding Agency Ltd. (LGFA), a New Zealand public-sector funding agency. S&P Global Ratings also removed the ratings from under criteria observation (UCO), where they had been placed on May 22, 2018. The outlook on the long-term ratings is stable.

Outlook

The stable outlook reflects our view that LGFA's strengths, which include its dominant market position as a source of funding for high-quality New Zealand local and regional governments, will continue to outweigh its relatively modest, albeit gradually improving, capital adequacy.

Downside scenario

We could lower our ratings on LGFA if its stand-alone credit profile were to weaken. This could occur, for instance, if we observed a deterioration in LGFA's risk management, such as the development of large asset-liability mismatches without mitigating factors. It could also occur if LGFA's dominant market position wanes, if access to funding markets or liquidity fall markedly, or if we observe a significant decline in the underlying creditworthiness of borrowers.

Negative ratings action on the New Zealand sovereign would result in that action being mirrored in our ratings on LGFA. In addition, a weakening of LGFA's public policy role or links to the New Zealand sovereign could cause us to lower our assessment of the likelihood of extraordinary support from the sovereign, which would result in downward pressure on the ratings.

Upside scenario

Our ratings on LGFA are equal to those on the New Zealand sovereign. We could raise our ratings on LGFA if we were to raise our ratings on the New Zealand sovereign, and if our view of expected extraordinary support from the sovereign in a distress scenario remained unchanged, all else being equal.

Rationale

Our ratings on LGFA reflect its stand-alone credit profile (SACP) of 'aa-', and our view that there would be an extremely high likelihood of extraordinary financial support for LGFA from the New Zealand government (the Crown) in a distress scenario.

The ratings on LGFA 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 the borrowers that we rate have an average long-term issuer credit rating of approximately 'AA-'. In addition, LGFA has access to a diverse set of domestic and overseas investors and a NZ$1 billion standby facility with the New Zealand Debt Management Office (NZDMO, the debt management 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 funding 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. As of June 30, 2018, LGFA counted 56 of New Zealand's 78 councils as members. Together, these councils account for most of the local government debt within 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, high market share, and growing base of highly rated council borrowers.
- LGFA's borrowers benefit from New Zealand's excellent institutional settings and wealthy economy, although financial system risk and council debt levels are moderately high relative to peers.
- Risk management is robust, and bolstered by an experienced management and governance team.

The credit quality of councils in New Zealand is high. S&P Global Ratings currently assigns ratings to 23 councils in New Zealand, including most of LGFA's largest borrowers, all of which have long-term issuer credit ratings between 'AA' and 'A+' and an average rating of approximately 'AA-'. 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$42,000 in 2018. The country's economic growth has been solid during the past few years at more than 3% per annum, resulting in rising wealth levels. We expect growth to continue over the next few years. We view the domestic financial system as being moderately high risk, in part due to strong house price growth, particularly in the nation's largest city, Auckland. We also note that leverage in the local government sector is relatively high compared to other jurisdictions, standing at about 140% of operating revenues.

LGFA has a solid record of accomplishment since 2011 in fulfilling its public policy mandate, despite being younger than most of its peers. It has a dominant market position in New Zealand, accounting for about 84% of all council borrowing on a rolling one-year average. Its customer base continues to grow, with three new council members joining LGFA in the 2017-18 financial year, and with several prospective new members in the pipeline. New Zealand's largest council, Auckland Council, accounts for roughly 37% of the national economy and half of the local government sector's gross debt. LGFA limits its lending to Auckland Council to reduce concentration risks, which means that LGFA's share of aggregate local government debt is also limited to about two-thirds. Dunedin City Council is the only council of substantial size that does not borrow through LGFA.

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 market spreads between LGFA bonds and New Zealand dollar bonds issued by Auckland Council, Dunedin City Council, and the major banks. LGFA has also helped councils to lengthen the average tenor of their borrowings. We expect growth in LGFA's lending book to flatten over the next few years as it has now amassed the majority of council borrowers in New Zealand, and as high-growth councils turn to potential Crown sources of infrastructure finance, like the NZ$1 billion Housing Infrastructure Fund. LGFA has recorded growing net interest income and positive profit levels in every year except its first (partial) year of operation. We expect LGFA's 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 reduces potential risks. LGFA is governed by a six-member board, of which five members (including the chairperson) are independent directors. The board is responsible for the strategic direction and control of LGFA's activities. LGFA also has a shareholders council, made up of 5-10 appointees, that recommends appointments to the board and coordinates shareholders on governance decisions. LGFA's management team is highly qualified. Its senior executives bring many years of experience from previous roles in council treasury operations, debt management, and private financial markets.

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 subject to continuous disclosure obligations. In addition, securities issued to retail investors are regulated under the Financial Markets Conduct Act 2013. LGFA produces annual financial statements that are audited by external auditors appointed by the Auditor-General of New Zealand.

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

- LGFA's two largest borrowers account for around 47% of its lending book, resulting in concentration risk, though we expect this to gradually decline.
- LGFA benefits from a joint and several guarantee from 45 council guarantors, and its lending is secured over property rates revenue.
- LGFA funds itself only in domestic capital markets. Liquidity is buttressed by a NZ$1 billion standby facility from the Crown.

LGFA's lending portfolio is concentrated compared with most of its peers, and this constrains its capital adequacy assessment. We estimate LGFA's risk-adjusted capital (RAC) ratio to be 19.2% before diversification and 1.8% after adjustments for single-name concentration, as of June 30, 2018. LGFA's two largest borrowers, Auckland Council and Christchurch City Council, represent 47% of its loan book, while its 20 largest borrowers account for around 85%. LGFA's capital structure includes NZ$25 million of paid-in shareholder capital, about NZ$40 million in retained earnings, and about NZ$135 million in borrower notes (which we view as equity-like) inclusive of accrued interest. LGFA also has NZ$20 million of uncalled shareholder capital, which we exclude from our calculations but note could be called to support LGFA's financial position in a stress scenario. We expect LGFA's capitalization to slowly improve as retained earnings grow and borrower concentration gradually declines, particularly as Auckland Council accesses alternative sources of funding.

We consider LGFA's financial risk management to be excellent, which helps to mitigate its 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 the use of NZDMO as the counterparty to all such contracts. Similar to many of its international peers, LGFA's credit quality 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 financial covenants relating to their net debt, interest expenses, and liquidity. To minimize concentration risk, LGFA requires that no more than NZ$100 million or 33% of a council's borrowings mature in any 12-month period, and Auckland Council is limited to a maximum of 40% of LGFA's total lending book.

Supporting its financial profile is the fact that all of LGFA's borrowers must provide debenture security by way of a charge over council property rates and rates revenues. We view this security as being extremely strong because rates revenue is the largest and most stable source of income for New Zealand councils, and because rate collection ranks ahead of all other claimants, including mortgages and New Zealand's Inland Revenue Department. LGFA can only provide debt funding to New Zealand councils, and not any council-controlled organization, joint venture, or partially owned entity.

In addition, our assessment of LGFA is strengthened by the joint and several guarantee of LGFA's 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. As of June 30, 2018, LGFA had 45 council guarantors.

We believe that LGFA has sound access to domestic capital markets. Unlike some of its peers, LGFA does not diversify its funding sources by accessing foreign capital markets. LGFA's bonds are issued domestically in New Zealand dollars and, since 2015, have been listed on the NZX Debt Market, allowing participation by retail investors. Bonds are spread across eight maturities, largely matching those of benchmark New Zealand government bonds. They have mostly been in tranches of NZ$1 billion or greater in order to promote liquidity and cater to investor demand. Tenders are spread throughout the year to ensure consistency of supply. Demand for LGFA's bonds is supported by their repo-eligibility with the Reserve Bank of New Zealand with a low haircut. According to LGFA's surveys, about 40% of its debt is held by offshore investors. Since 2015, LGFA has also issued short-dated bills via tender and private placement.

We consider LGFA's liquidity to be strong, reflecting its portfolio of liquid financial assets and access to a NZ$1 billion standby facility with the NZDMO. We believe that LGFA would generally be able to meet its short-term obligations even in an extreme stress scenario in which all maturing council loans must be rolled over while LGFA's own access to market funding is cut off. We also believe that, in practice, New Zealand councils would be able to reduce their borrowing requirements in such an environment. All rated New

Zealand councils post strong operating surpluses and use debt only to fund capital expenditure, which is likely to be postponed in such a scenario.

Extremely strong 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 distress 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 primary source of capital funding for the New Zealand local government sector. LGFA helps to deepen New Zealand's capital markets, and offers cost savings and access to longer-term borrowings to participating councils. Therefore, a default by LGFA would likely lead to substantial delays or cancelations of local investment projects, thereby having a major impact on 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. In addition, we believe LGFA enjoys a special public status in New Zealand, as evidenced by its NZ$1 billion committed liquidity facility with the NZDMO.

Key Statistics

Table 1

Selected Indicators

	--Year ended June 30--				
(mil. NZ$)	**2018E**	**2017A**	**2016A**	**2015A**	**2014A**
Business position					
Total adjusted assets	N.A.	8,491	7,257	5,412	3,918
Customer loans (gross)	7,974	7,784	6,451	5,032	3,742
Growth in loans (%)	2	21	28	34	49
Net interest revenues	N.A.	18	16	14	10
Noninterest expenses	N.A.	6	6	5	3
Capital and risk position					
Total liabilities	N.A.	8,280	7,105	5,290	3,827
Total adjusted capital	200	186	153	121	91
Assets/capital	N.A.	46	48	45	43
RAC ratio before diversification (%)	19.2	19.0	N.A.	N.A.	N.A.
RAC ratio after diversification (%)	1.8	1.5	N.A.	N.A.	N.A.
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity					
Liquidity ratio with loan disbursement (one year)	0.89	N.A.	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (one year)	1.61	N.A.	N.A.	N.A.	N.A.

Table 1

Selected Indicators (cont.)					
	--Year ended June 30--				
(mil. NZ$)	2018E	2017A	2016A	2015A	2014A
Funding ratio (one year)	1.65	N.A.	N.A.	N.A.	N.A.

N.A.--Not available. E--Estimate. A--Actual.

Ratings Score Snapshot

Issuer Credit Rating	
Local Currency	AA+/Stable/A-1+
Foreign Currency	AA/Stable/A-1+
SACP	aa-
Enterprise Risk Profile	Strong (2)
PICRA	Strong (2)
Business Position	Strong (2)
Management & Governance	Very strong (1)
Financial Risk Profile	Adequate (3)
Capital Adequacy	Moderate (4)
Funding	Neutral
Liquidity	Strong (2)
Support	+2
GRE Support	+2
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: 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Guidance - General Criteria - 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
- 10 Public-Sector Funding Agencies Placed Under Criteria Observation On Publication Of New Criteria, May 22, 2018

Ratings List

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Ratings Affirmed

New Zealand Local Government Funding Agency Ltd.
 Issuer Credit Rating
  Foreign Currency                      AA/Stable/A-1+
  Local Currency                        AA+/Stable/A-1+
 Analytical Factors
  Local Currency                        aa-

New Zealand Local Government Funding Agency Ltd.
 Senior Unsecured                       AA+
 Short-Term Debt                        A-1+
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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.