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Research Update:

New Zealand Local Government Funding Agency Ratings Affirmed; Outlook Stable

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Overview

- The ratings on New Zealand Local Government Funding Agency Ltd. (LGFA) reflect its exceptional asset quality and market position, and our assessment that there is an extremely high likelihood of extraordinary support would be forthcoming from the New Zealand government, in a distress scenario.
- We are affirming our 'AA+/A-1+' local currency long- and short-term ratings and 'AA/A-1+' foreign currency long- and short-term ratings on LGFA.
- The stable outlook reflects our view that LGFA's critical role and very important link to the New Zealand Government will remain unchanged.

Rating Action

On Sept. 25, 2017, S&P Global Ratings affirmed its 'AA+/A-1+' local currency long- and short-term ratings and 'AA/A-1+' foreign currency long- and short-term ratings on New Zealand Local Government Funding Agency Ltd. (LGFA). The outlook remains stable.

Rationale

Our ratings are based on LGFA's stand-alone credit profile (SACP) of 'aa-' and our view of the extremely high likelihood that the New Zealand government (the Crown) will provide extraordinary support to LGFA in a stress scenario.

Our ratings reflect LGFA's sole focus on lending to the high credit-quality New Zealand local government sector, its strong market position, exceptional credit quality, and increasing borrower base. Offsetting these factors are LGFA's reliance on wholesale funding, with some maturity concentration, and borrower concentration in its loan portfolio.

In accordance with our criteria on government-related entities, we base our view of there being an extremely high likelihood of extraordinary support in a stress scenario on our assessment of LGFA's:

- Very important role in meeting the Crown's key economic objectives; LGFA is the main capital funding source for the New Zealand local government sector. LGFA also deepens New Zealand's capital markets, provides an additional source of liquidity for domestic banks, and delivers cost savings for participating local governments. Therefore, a default by LGFA

would have a major impact on the Crown and the New Zealand economy.
- Integral link with the Crown. LGFA's enabling legislation allows the Crown to lend money to LGFA 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, with the Crown extending a committed liquidity facility to LGFA.

LGFA was established in December 2011 to provide debt funding to New Zealand local councils. It does so by raising debt funding in the wholesale capital markets. Its main objectives are to provide more favorable pricing than what councils can achieve individually, and to enable councils to access longer-dated borrowings. LGFA's single purpose of providing debt funding to New Zealand local councils is enshrined in its shareholder agreement. The New Zealand government holds 11% of LGFA's share capital and participating New Zealand local councils hold the rest.

We view New Zealand's institutional framework, which governs the relationship between the Crown and the local councils, to be extremely predictable and supportive, and one of the strongest in the world (see "New Zealand Councils' High Governance Standards Ensure Strong Financial Management, Transparency, And Long-Term Planning," published Nov. 30, 2015). The Crown's audit office audits New Zealand local governments' financial plans and annual reports, and the Crown monitors the financial sustainability of the sector.

LGFA's credit quality is exceptional, reflecting all loans being neither past due nor impaired since the agency's inception. The aggregate credit quality of New Zealand local governments is strong, underpinned by the institutional framework. LGFA's borrower base has become more granular over the years, as more local councils join. However, borrower concentration exists, with the two largest borrowers making up more than half of the loans outstanding. The largest borrower, Auckland Council, accounts for about a third of the loans outstanding.

LGFA is entirely wholesale-funded and therefore is exposed to disruptions to the capital markets. LGFA has only issued domestically in New Zealand dollars and therefore is not exposed to offshore and foreign-currency risk. There is some maturity concentration in LGFA's funding profile due to existing issues being conducted in the same maturities as New Zealand government bonds to tap liquidity. Refinancing risk is low because LGFA's bonds are eligible for repurchase with the Reserve Bank of New Zealand and attract a low haircut.

We expect LGFA's earnings to remain modest, reflecting its objective of reducing funding costs for New Zealand local councils, and the overlap between LGFA's borrower base and shareholders. LGFA aims to minimize its net interest margin to a level that will cover its cost base while paying a return to shareholders.

LGFA's capital levels are low and reflective of its earnings profile and purpose. A large portion of its core capital base consists of uncalled capital held by existing local council shareholders and can be paid up if LGFA requests. In addition, notes are issued to each local council that borrows from LGFA. The notes are subordinated debt instruments that can be converted into redeemable shares at LGFA's request.

Liquidity

Liquidity risk generally has been managed through broadly matching on-lending to New Zealand local councils with LGFA's debt issuance; however, bespoke lending does increase asset-liability mismatches and potential liquidity risk. The LGFA is well placed to manage these risks because it has sufficient balance-sheet liquidity to meet anticipated drawdowns, as well as debt and operational costs. Also, it can access a committed liquidity facility provided by the New Zealand Debt Management Office.

Outlook

The stable outlook reflects our view that LGFA's role and link to the Crown remains broadly stable and its SACP will not detoriate. This will ensure that there will be at least a very high likelihood of extraordinary government support in a stress scenario.

Downside scenario

Downward momentum is unlikely in the next two years, but could arise from a weakening in either LGFA's SACP or its role or link to the Crown. Specifically, LGFA's SACP could weaken and lead to a lowering of its rating if its credit risk rises. Such a scenario could occur if we were to downgrade a major borrower. Further, the rating could come under pressure if we assess a substantial weakening of LGFA's link with the Crown if the Crown withdraws its committed liquidity facility to the LGFA. Negative ratings action on the sovereign would also result in the action being mirrored on our ratings and outlook on LGFA.

Upside scenario

Our ratings on LGFA are equalized with those on the sovereign, and so we consider a higher rating to be remote within the next two years.

Related Criteria

- 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

- Criteria - Financial Institutions - Finance Companies: Rating Finance Companies, March 18, 2004

Related Research

- Public Finance System Overview: New Zealand's Institutional Framework For Local And Regional Governments, Dec. 11, 2016

Ratings List

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+