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Ratings

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New Zealand Local Government Funding Agency Ltd.

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This report does not constitute a rating action.

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Credit Highlights

Overview

Enterprise profile	Financial profile
Very strong management and dominant market position underpin credit quality.	Risks from borrower concentration partly offset by good access to capital markets and strong liquidity.
--Strong public policy mandate and near-monopoly lender to highly-rated New Zealand councils.	--Guarantees from 65 councils, jointly and severally. Lending is secured over their property rates revenue.
--Council borrowers benefit from the country's excellent institutional settings and wealthy economy, though they are quite leveraged relative to international peers.	--Liquidity buttressed by a growing portfolio of liquid assets and committed standby facility from New Zealand sovereign of up to NZ$1.5 billion (current limit is NZ$500 million).
--Robust risk management, bolstered by an experienced executive team.	--Concentrated lending portfolio results in modest risk-adjusted capitalization. The two largest borrowers account for 44% of loan book.

Our long-term issuer credit ratings on New Zealand Local Government Funding Agency Ltd. (LGFA) are 'AA+' for foreign currency and 'AAA' for local currency. They reflect our assessment of LGFA's stand-alone credit profile (SACP) of 'aa-', and our view that there is an extremely high likelihood that extraordinary financial support from the New Zealand government would be forthcoming in a stress scenario.

LGFA has a dominant market share. The agency counts 74 of New Zealand's 78 local councils as its members. Together, these councils account for the bulk of local government debt in New Zealand. Rated councils have an average credit rating in the 'AA' category. Sixty five councils jointly and severally guarantee LGFA's obligations, with 30 councils holding equity in LGFA.

Partially offsetting these strengths is LGFA's highly concentrated lending portfolio. This leads to weaker capital adequacy than many international peers.

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 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, its access to funding markets or liquidity falls markedly, or there is a significant decline in the underlying creditworthiness of the agency's borrowers and guarantors.

Upside scenario

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

Rationale

Enterprise Risk Profile: Very strong management and dominant market position underpin credit quality

The high credit quality of LGFA's borrowers supports the agency's creditworthiness. We currently assign long-term issuer credit ratings to 25 councils in New Zealand. These include most of the largest borrowers from LGFA, which are predominantly in the 'AA' category (see "25 Ratings In 25 Years: New Zealand Councils Prove Their Staying Power," published Feb. 1, 2022).

New Zealand's excellent institutional settings and wealthy and resilient economy (we forecast GDP per capita of about US$49,300 for 2022) support the local government sector. The country is recovering well from a COVID-19-induced recession in 2020. We expect real GDP to expand 2.9% in 2022 (see "Tight Labor Market And Inflation Firm Up New Zealand's Monetary Policy," published Feb. 23, 2022). While rising COVID-19 cases could modestly affect economic activity in the first quarter of 2022, we expect a limited financial impact on councils.

We view domestic financial system risks as intermediate. Conservative regulations and risk-appetite settings help to offset risks associated with the banking system's high share of net external borrowings. Leverage in New Zealand's local government sector is more elevated than in other advanced economies, with direct council debt standing at 170%-180% of operating revenue. In comparison, sector-wide debt ratios for municipal governments in northern Europe are generally below 100%.

LGFA has a strong record of fulfilling its public policy mandate since its establishment in 2011. This is despite the agency's shorter history than many other public-sector funding agencies worldwide. The agency has a dominant market position in New Zealand, accounting for 79% of all councils' local-currency borrowings over the 12 months to December 2021. Its customer base has expanded to encompass 74 of the country's 78 local authorities. LGFA is 20% owned by the New Zealand government and 80% owned by 30 council shareholders.

We view LGFA as the near-monopoly lender to councils, excluding New Zealand's largest subnational borrower, Auckland Council. LGFA limits its lending to Auckland Council to reduce concentration risks. Auckland Council accounts for about half of the sector's gross debt and also has large offshore and wholesale bond programs of its own. This means that LGFA's share of aggregate local government debt is limited to about two-thirds. Dunedin City Council is the only local authority of substantial size that does not borrow through LGFA, though it is in the process of joining as a member.

LGFA lends on terms that are generally more attractive than if councils were to borrow in their own names or through the banking system. This can be seen in 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 lengthen the average tenor of their borrowings.

Councils in New Zealand will likely continue to increase their borrowings to finance new infrastructure and renewals. LGFA has enjoyed stable or rising net interest income and net profits every year except its first (partial) year of operation. We expect earnings to remain modest, reflecting the agency's central objective of reducing funding costs for councils.

We consider LGFA's management and governance to be among its key strengths. The organization is governed by a six-member board. Of these, five, 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. This council recommends appointments to the board and coordinates governance decisions among the shareholders. The agency's management team is well qualified. Its senior executives bring experience from previous roles in council treasury operations and private financial institutions.

Like many of its international peers, LGFA is not subject to banking regulations. However, the agency must comply with continuous disclosure obligations because its bonds are quoted on the NZX Debt Market. 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. The agency also publishes half-yearly reports and annual statements of intent. It pays dividends to shareholders, but payment is always discretionary and subject to board approval.

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

LGFA has a more concentrated lending portfolio than most of its overseas peers. This constrains the agency's capital adequacy. We calculate its risk-adjusted capital ratio to be 18.3%, and 2.3% after adjustments for single-name concentration, as of June 30, 2021 (financial year-end). LGFA's two largest borrowers, Auckland Council and Christchurch City Council, represent 44% of its loan book. The agency's 20 largest borrowers account for around 83%.

We expect capitalization to be roughly stable. 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 borrowings. We consider these notes to be equity-like. The improvement is counterbalanced by the agency's more recent decision to reduce, from July 2021, its base lending margin to 15 basis points (bps) from 20 bps. Its capital structure comprises NZ$25 million of paid-in shareholder capital, about NZ$70 million in retained earnings, and about NZ$224 million in borrower notes. LGFA also has NZ$20 million of uncalled shareholder capital, which we exclude from our calculations of its capital ratio. Nevertheless, we note that uncalled capital could be called to support the agency's financial position in a stress scenario.

We consider risk management to be very good, which helps to mitigate lending concentration risks. 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. The agency fully hedges its foreign-currency exposure. The New Zealand Debt Management Office (NZDMO) is the counterparty to all derivative contracts, minimizing LGFA's credit risk.

LGFA has an exceptional loan portfolio credit history. The agency has not experienced any arrears or impairments since inception. Its 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 an extra buffer to deal with the fallout from COVID-19, councils rated 'A' or higher can have net debt up to 300% of their revenue, up from 250%. The higher limit will taper back to 280% by 2026. To mitigate concentration risks, LGFA's foundation policies also limit Auckland Council to a maximum of 40% of its total loan book.

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

We do not anticipate lending to council-controlled organizations (CCOs) to have any material impact on LGFA's credit metrics. Historically, LGFA only provided debt finance to New Zealand councils. A recent change to its foundation policies allows it to also lend to CCOs like Invercargill City Holdings Ltd., so long as each CCO's parent council provides a guarantee or sufficient uncalled capital to meet obligations. In another recent development, LGFA now offers green, social, and sustainable (GSS) loans to councils at a discount of 5 bps to its usual lending margin. The agency has approved GSS loan applications totaling NZ$407 million.

The joint and several guarantees of LGFA's obligations strengthen its creditworthiness, in our view. Other than the New Zealand government, each LGFA shareholder is a guarantor. If the principal amount of a council's borrowing from LGFA exceeds NZ$20 million, that council must also become party to this guarantee. LGFA currently has 65 such guarantors.

We believe LGFA has good access to capital markets, though its funding is concentrated in New Zealand. The agency issues its bonds domestically in New Zealand dollars. Since 2015, its bonds have also 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) began purchasing LGFA bonds in the secondary market as part of its Large-Scale Asset Purchase (LSAP) program. The LSAP program ended in July 2021.

LGFA's bonds are spread across 12 maturities. These are mostly in series of NZ$1 billion or more to promote secondary market liquidity. Their repo eligibility with RBNZ at a low haircut supports demand for these bonds. The investor base is reasonably diverse, with about 30% of LGFA's debt held by offshore investors. Since 2015, LGFA has also issued short-dated bills via tender and private placements. In November 2017, the agency established an Australian-dollar medium-term note program, which it has yet to utilize.

We consider liquidity to be strong, reflecting LGFA's NZ$1.8 billion portfolio of liquid financial assets as of June 30, 2021. The agency also has access to a committed facility with NZDMO. The facility has a maximum size of NZ$1.5 billion. LGFA adjusts its actual limit from time to time; this is currently set at NZ$500 million.

In 2020, the New Zealand government agreed to extend the facility for another 10 years, to 2031. We believe LGFA can generally meet its obligations under stressed market conditions without calling on additional resources from its members. We also believe that councils would be able to cut back on their borrowings in such an environment.

Recent growth in LGFA's liquid asset portfolio, to backstop its new standby facility offering, supports its liquidity metrics. Since late 2020, the agency has offered standby facilities of its own to member councils. Nine councils had signed up for these facilities, with an aggregate limit of NZ$515 million as of June 30, 2021.

Our base case excludes the potential effect of the New Zealand government's proposed 'three waters' reforms. The reform program could potentially take away responsibility for drinking water, wastewater, and stormwater assets from councils. Responsibility would be amalgamated under four new regional water service entities from mid-2024. The reforms are still under development. We intend to incorporate their effects in our assessment when greater certainty and details emerge.

We see an extremely high likelihood of support from the New Zealand government in a stress scenario

Our 'AAA' long-term local-currency issuer credit rating on LGFA is three notches above our assessment of LGFA's SACP of 'aa-'. This is because we see an extremely high likelihood that the New Zealand government would provide timely and sufficient extraordinary support to LGFA in the event of financial stress. This assessment is based on our view of LGFA's:

- Very important role in meeting the New Zealand government's objectives. The agency has a near-monopoly in financing the debt of most local authorities. It offers cost savings and access to longer-term borrowings to participating councils. It has helped to deepen domestic capital markets. A default by LGFA could substantially delay or lead to the cancelation of local government projects in such areas as transport, water, and sewerage infrastructure. This would be to the major detriment of New Zealand's economy.
- Integral links 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. The agency enjoys a special public status in New Zealand. This is evident from its committed liquidity facility with NZDMO, which was recently expanded to a maximum limit of NZ$1.5 billion and extended for another 10 years.

Key Statistics

	--Year ended June 30--				
(Mil. NZ$)	2021A	2020A	2019A	2018A	2017A
Business position					

Total adjusted assets	14,485	13,174	10,382	8,835	8,491
Customer loans (gross)	12,066	10,900	9,311	7,976	7,784
Growth in loans (%)	11	17	17	2	21
Net interest revenues	20	18	19	19	18
Noninterest expenses	9	8	8	7	6
Capital and risk position					
Total liabilities	14,166	12,908	10,154	8,635	8,306
Total adjusted capital	319	266	228	199	185
Assets/capital (x)	45	50	46	44	46
RAC ratio before diversification (%)	18.3	15.7	17.5	19.2	19.0
RAC ratio after diversification (%)	2.3	2.3	2.2	1.8	1.5
Gross nonperforming assets/gross loans (%)	0	0	0	0	0
Funding and liquidity (x)					
Liquidity ratio with loan disbursement (1 year)	1.21	1.31	1.12	0.89	N.A.
Liquidity ratio without loan disbursement (1 year)	1.47	1.31	1.14	1.61	N.A.
Funding ratio (1 year)	1.58	1.80	1.31	1.65	N.A.

Mil.--Million. NZ$—New Zealand dollars. RAC—Risk-adjusted capital. N.A.—Not available. A—Actual.

Rating Component Scores

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 (local-currency)	+3
GRE support (local-currency)	+3
Group support	0

Additional factors	0

SACP--Stand-alone credit profile. PICRA--Public-sector industry and country risk assessment. GRE--Government-related entity.

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

- Banking Industry Country Risk Assessment, Feb. 26, 2022
- Tight Labor Market And Inflation Firm Up New Zealand's Monetary Policy, Feb. 23, 2022
- 25 Ratings In 25 Years: New Zealand Councils Prove Their Staying Power, Feb. 1, 2022
- Default Transition and Recovery: 2020 Annual International Public Finance Default And Rating Transition Study, Sept. 14, 2021
- New Zealand Councils' Infrastructure Spending Could Erode Rating Headroom, April 11, 2021
- Credit FAQ: Why We Upgraded 11 New Zealand Public Entities, Feb. 22, 2021
- Public Finance System Overview: New Zealand's Institutional Framework For Local And Regional Governments, Oct. 28, 2020

Ratings Detail (as of March 02, 2022)*

New Zealand Local Government Funding Agency Ltd.		
Issuer Credit Rating		
Foreign Currency		AA+/Stable/A-1+
Local Currency		AAA/Stable/A-1+
Senior Unsecured		AAA
Issuer Credit Ratings History		
21-Feb-2021	*Foreign Currency*	AA+/Stable/A-1+
03-Feb-2019		AA/Positive/A-1+
06-Dec-2011		AA/Stable/A-1+
21-Feb-2021	*Local Currency*	AAA/Stable/A-1+
03-Feb-2019		AA+/Positive/A-1+
06-Dec-2011		AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings credit ratings on the global scale are comparable across countries. S&P Global Ratings credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.