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Ratings

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Research Update:

New Zealand Local Government Funding Agency Ltd. Ratings Affirmed; Outlook Stable

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Overview

- New Zealand Local Government Funding Agency Ltd. (LGFA) has a dominant market position as a source of debt financing for highly rated New Zealand local councils.
- We believe this continues to offset the agency's relatively modest, albeit gradually improving, risk-adjusted capital ratio.
- Our ratings on LGFA reflect its very important role and integral link with the New Zealand sovereign.
- We affirmed our long-term issuer credit rating on LGFA at 'AA+' for foreign currency and 'AAA' for local currency, with a stable outlook. We also affirmed our short-term foreign- and local currency issuer credit ratings at 'A-1+'. At the same time, we affirmed our long-term issue ratings on the company's senior unsecured debt at 'AAA' for local currency and 'AA+' for foreign-currency debt.

Rating Action

On Feb. 27, 2024, S&P Global Ratings affirmed its long-term 'AA+' foreign currency and 'AAA' local currency issuer credit ratings on New Zealand Local Government Funding Agency Ltd. (LGFA). The outlook on the long-term ratings is stable. We also affirmed our short-term ratings at 'A-1+'. LGFA's stand-alone credit profile (SACP) remains 'aa-'. LGFA is a New Zealand-based public-sector funding agency.

At the same time, we affirmed our long-term issue ratings on LGFA's senior unsecured debt at 'AAA' for local-currency and 'AA+' for foreign-currency debt.

Outlook

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

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 downgrade 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, 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 foreign-currency issuer credit rating on LGFA during the next two years if we were to do the same for New Zealand, all else being equal.

Rationale

Our ratings on LGFA reflect its SACP of 'aa-', and our view of 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 (NZDM) office--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. LGFA counts 77 of New Zealand's 78 councils as members.

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 stable 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 25 councils in New Zealand, with an average rating in the 'AA' category.

We consider LGFA to be 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.

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 more elevated than in that of other advanced economies, with direct council debt standing at 186% of operating revenue in fiscal 2023. In comparison, sector-wide debt ratios for municipal governments in northern Europe are generally below 100% for the same institutional framework assessment.

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 90% of all councils' domestic borrowing for 2023.

LGFA lends on terms that are generally 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.

Councils in New Zealand will likely continue to increase their borrowings to finance new infrastructure and renewals. We expect LGFA's earnings to remain modest, reflecting the agency's central objective of reducing funding costs for councils. LGFA's net interest income and net profit have generally grown over time, though both metrics weakened in fiscal 2023 (ended June 30) due to the cost of carry of its large liquid asset portfolio.

We consider LGFA's management and governance to be a key strength 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

- LGFA's two largest borrowers account for about 34% of the lending book, resulting in concentration risk.
- The agency benefits from a joint and several guarantee from 72 council guarantors, and its lending is secured over property rates revenue.

LGFA's lending portfolio is concentrated compared with most of its overseas peers, and this constrains our assessment of its capital adequacy. However, concentration has declined in recent years as smaller councils borrow proportionally more than larger ones, improving our assessment. We calculate LGFA's risk-adjusted capital ratio to be 18.8% before diversification and 4.0% after adjustments for single-name concentration, as of June 30, 2023 (the end of the most recent financial year). Its two largest borrowers, Auckland Council and Christchurch City Council, represent 34% of the loan book, while its 20 largest borrowers account for about 78%.

LGFAs capital structure comprises NZ$25 million of paid-in shareholder capital, about NZ$81 million in retained earnings, and about NZ$360 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. We note that this amount could be called to support its financial position in a stress scenario.

We consider risk management to be very good, 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.

The credit history of LGFA's loan portfolio is exceptional. The agency 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 had been permitted to have net debt up to 300% of their revenues, up from 250%. This higher limit will taper back to 280% by 2026.

Supporting its financial profile is the fact that all LGFA's council 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.

We do not anticipate lending to council-controlled organizations (CCOs) will have a material impact on LGFA's credit metrics. Historically, the agency had only provided debt finance to New Zealand councils and not any CCO, joint venture, or other entity. Since 2021, five CCOs have joined LGFA, although total exposures to CCOs remain very small.

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 72 such guarantors.

We believe that LGFA has sound access to capital markets, though its funding has been historically concentrated in New Zealand. The agency debuted two Australian dollar issuances in 2023. It intends to be a regular issuer in the Australian market for diversification purposes. LGFA is the second-largest New Zealand-dollar borrower, behind only the sovereign. In December 2023, the Reserve Bank of New Zealand (RBNZ) confirmed that LGFA bonds will count as "level two" liquid assets, which will support demand for these bonds on bank balance sheets.

LGFA's bonds are spread across 13 maturities. 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 surveys, about 30% 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, potentially, access to a committed facility with NZDM. The facility has a maximum size of NZ$1.5 billion. At the moment, we assume LGFAs ability to draw from the facility is temporarily encumbered. This is because under the standby facility rules, the agency's out-of-the-money derivative contracts are offset against the balance of the facility. In 2021, 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 New Zealand councils would be able to cut back their borrowing requirements in such circumstances.

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. 16 councils had signed up for these facilities, with an aggregate limit of NZ$747 million as of January 2024.

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 cancellations 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 indicated by its committed liquidity facility with NZDM, which was extended for another 10 years in 2021.

Selected Indicators

Table 1

Selected indicators--New Zealand Local Government Funding Agency Ltd.

	--Year ended June 30--						
(Mil. NZ$)	2023a	2022a	2021a	2020a	2019a	2018a	2017a
Business position							
Total adjusted assets	18,175	16,250	14,485	13,174	10,382	8,835	8,491
Customer loans (gross)	16,314	14,042	12,066	10,900	9,311	7,976	7,784
Growth in loans (%)	16	16	11	17	17	2	21
Net interest revenues	10	18	20	18	19	19	18
Noninterest expenses	9	8	9	8	8	7	6

Table 1

Selected indicators--New Zealand Local Government Funding Agency Ltd. (cont.)

	--Year ended June 30--						
(Mil. NZ$)	2023a	2022a	2021a	2020a	2019a	2018a	2017a
Capital and risk position							
Total liabilities	17,708	15,862	14,166	12,908	10,154	8,635	8,306
Total adjusted capital	466	388	319	266	228	199	185
Assets/capital (x)	39	42	45	50	46	44	46
RAC ratio before diversification (%)	18.8	21.9	18.3	15.7	17.5	19.2	19
RAC ratio after diversification (%)	4.0	2.9	2.3	2.3	2.2	1.8	1.5
Gross nonperforming assets/gross loans (%)	0	0	0	0	0	0	0
Funding and liquidity (x)							
Liquidity ratio with loan disbursement (1 year)	0.96	1.14	1.21	1.31	1.12	0.89	N.A.
Liquidity ratio without loan disbursement (1 year)	1.19	1.42	1.47	1.31	1.14	1.61	N.A.
Funding ratio (1 year)	1.26	1.48	1.58	1.8	1.31	1.65	N.A.

a--Actual. N.A.--Not available.

Ratings Score Snapshot

Table 2

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	3
GRE support	3
Group support	0
Additional factors	0

*GRE support uplift is based on local currency ratings. SACP--Stand-alone credit profile. PICRA--Public-sector industry and country risk assessment. GRE--Government-related entity.

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: 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

Ratings List

Ratings Affirmed	
New Zealand Local Government Funding Agency Ltd.	
Issuer Credit Rating	
Foreign Currency	AA+/Stable/A-1+
Local Currency	AAA/Stable/A-1+
New Zealand Local Government Funding Agency Ltd.	
Senior Unsecured	AA+
Senior Unsecured	AAA
Commercial Paper	A-1+