

Research Update:

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

September 8, 2024

Overview

- New Zealand Local Government Funding Agency Ltd. (LGFA) has a dominant market position in the debt financing of highly rated New Zealand local councils.
- The agency's financial profile is improving on the back of broadened access to capital markets, a gradual dilution of borrower concentration, and a growing capital base. All were historical constraints on its credit profile.
- We revised upward our assessment of the agency's stand-alone credit profile (SACP) to 'aa+' from 'aa-'.
- We affirmed our 'AA+' long-term foreign currency and 'AAA' long-term local currency issuer credit ratings on LGFA. At the same time, we affirmed our short-term foreign and local currency issuer credit ratings at 'A-1+'.
- The stable outlook on the long-term ratings reflects our expectation of an extremely high likelihood of support from the New Zealand sovereign for the agency.

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Rating Action

On Sept. 9, 2024, S&P Global Ratings affirmed its 'AA+' long-term foreign currency and 'AAA' long-term local currency issuer credit ratings on LGFA. We also affirmed our short-term foreign and local currency issuer credit ratings at 'A-1+'. At the same time, we affirmed our 'AA+' long-term foreign currency and 'AAA' long-term local currency issue ratings on the agency's senior unsecured debt.

The outlook on the long-term ratings is stable.

Outlook

The stable outlook on LGFA reflects that on the New Zealand sovereign and our view of an extremely high likelihood of extraordinary support from the sovereign for the New Zealand public-sector funding agency in a stress scenario over the next two years.

The stable outlook also reflects our expectation that LGFA will maintain its strong credit profile. The agency's dominant market position, strong governance, improved capital adequacy, and broadened access to funding sources offset rising indebtedness in New Zealand's local government sector.

Downside scenario

We could lower our ratings on LGFA over the next two years if we perceive that its policy role or links to the New Zealand government are weakening. We could also lower our ratings if we were to downgrade New Zealand.

Downward pressure could emerge if we consider LGFA's SACP to be weakening. This could occur if we observe a weakening of management, such as lending to water council-controlled organizations (CCOs) that are not supported by councils without any measures to offset increased risks.

Upside scenario

We could raise our foreign currency issuer credit rating on LGFA over the next two years if we were to do the same for New Zealand, all else being equal.

Rationale

Our ratings on LGFA reflect our 'aa+' assessment of its SACP 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.

LGFA has access to a diverse set of domestic and offshore investors. The agency has broadened its issuances to Australia's capital markets and established a euro commercial paper (ECP) program to diversify its funding sources. We now view its funding profile as positive, from neutral previously. LGFA's liquidity position remains strong.

Our view of LGFA's capital adequacy improves to adequate for several reasons. The drivers are: (1) less single-name concentration as smaller councils borrow at a faster pace than the largest; (2) a growing capital base through higher borrower notes and retained earnings; and (3) a refinement of our operational risk measure. Underpinning our ratings are New Zealand's excellent institutional settings and wealthy economy, as well as LGFA's dominant market position and robust management and governance.

LGFA benefits from shareholder support via its joint-and-several guarantee mechanism. We reflect this in a positive notch to its SACP.

Separately, we expect the credit quality of councils to weaken further as the government and LGFA explore increasing debt limits for high-growth councils. This will generally be negative for the credit quality of the sector, which is already highly indebted by international standards. We reflect this through a downward holistic notch to its SACP. The developments could see a weakening of our sector risk profile assessment. The agency's average loan asset quality could also diminish if it starts lending to highly indebted water CCOs.

LGFA was established in December 2011 to provide debt finance to local and regional governments (councils), following the enactment of the Local Government Borrowing Act 2011. The agency's main objective is to raise debt on behalf of councils on more favorable terms than if

the councils were to raise debt on their own.

The Crown owns 20% of LGFA. Thirty council shareholders own the remaining 80%.

LGFA counts 77 of New Zealand's 78 councils as members.

Sector Risk Profile: Rapidly rising debt in the local government sector weighs on excellent institutional settings.

LGFA currently lends about 97% of its portfolio to local councils. Councils have high, albeit weakening, credit quality.

We currently assign long-term issuer credit ratings to 25 councils in New Zealand. Of these, 20 are on negative outlook.

In February 2024, we revised our assessment of the institutional framework trend to weakening from stable. This was given councils' growing indebtedness. Recent announcements on potential increases to debt covenants for high-growth councils could exacerbate growing indebtedness in the sector.

New Zealand's local government sector has more leverage than other advanced economies. Direct council debt is above 180% of operating revenue in fiscal 2024. In comparison, sectorwide debt ratios for municipal governments in northern Europe are generally below 100% for the same institutional framework assessment.

LGFA announced in August that it would start to lend to supported water CCOs. The leverage of these public water utilities could be up to twice that of councils that the agency currently finances. The stand-alone credit profiles of water CCOs are likely to be weaker than the average council rating of roughly 'AA'.

Any materialization of the above developments could result in a weaker sector risk profile assessment.

Individual Credit Profile: Dominant market position and strong risk management, backed by diversified funding and liquidity and improving capital adequacy.

We consider LGFA to be a near-monopoly lender to councils, excluding New Zealand's largest subnational borrower, Auckland Council. The agency limits its lending to Auckland Council to reduce concentration risks. Auckland Council accounts for about 35% of the sector's gross debt and has large offshore and wholesale bond programs of its own.

LGFA has had a strong record since 2011 in fulfilling its policy mandate. This is despite the agency's shorter operating history than many international peers. The agency has a dominant market position in New Zealand, accounting for 90% of all the domestic borrowings of councils in 2024.

LGFA lends on terms that are generally more attractive than if the councils borrowed in their own names or through the banking system. Evidence of this includes the secondary market spreads between LGFA's bonds and the New Zealand dollar-denominated bonds that Auckland Council, Dunedin City Council (via Dunedin City Treasury Ltd.), and the major banks issue. The agency has also helped councils lengthen the average tenor of their borrowings.

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

risks. A six-member board governs the agency, of whom five are independent directors, including the chairperson. The board is responsible for strategic direction and control.

LGFA also has a shareholders' council, comprising five to 10 appointees. This council recommends appointments to the board and coordinates governance decisions. The agency has a highly qualified management team, which has experience in council treasury operations, debt management, and private financial institutions.

Like many of its international peers, LGFA is not subject to banking regulations. However, given that the agency's bonds are quoted on the NZX Debt Market, the agency is required to comply with continuous disclosure obligations.

In addition, the Financial Markets Conduct Act 2013 regulates the securities that LGFA issues to retail investors. The agency produces annual financial statements, with external auditors appointed by the auditor-general of New Zealand. It also publishes half-yearly reports and annual statements of intent. LGFA pays dividends to its shareholders, although such payments are discretionary and subject to board approval.

LGFA's lending portfolio has gradually become less concentrated over the past few years. This improves the agency's capital adequacy assessment. Smaller councils are borrowing proportionally more than the larger ones, diluting concentration.

We estimate a risk-adjusted capital ratio of 39.0% for LGFA before diversification and 9.3% after adjustments for single-name concentration, as of end-fiscal 2024 (year-end June 30). The agency's two largest borrowers, Auckland Council and Christchurch City Council, represent less than 30% of its loan book. Its 20 largest borrowers account for about 80%.

We believe the increase in LGFA's borrower note margin to 5.0% from 2.5% will help LGFA increase its capital base over time. The agency's capital structure comprises NZ\$25 million of paid-in shareholder capital, about NZ\$89 million in retained earnings, and about NZ\$493 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. The agency could call on this amount 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 restricts its investments to approved financial instruments such as term deposits and highly rated bonds, under its board-approved treasury policy. The agency fully hedges any foreign-currency exposure back to New Zealand dollars.

LGFA's loan portfolio has not experienced any arrears in payments or loan impairments since inception. Council borrowers must comply with various covenants on their net debt, interest expenses, and liquidity.

In 2020, LGFA relaxed one of its foundation policy covenants to give councils an extra buffer during COVID-19. The agency allowed councils rated 'A' or higher to have net debt up to 300% of their revenues, up from 250%. It will reduce this limit back to 280% by 2026. LGFA's proposed increase for high-growth councils could see a rise in net debt to a maximum 350% of revenues in some circumstances.

Supporting the financial profile of LGFA is the fact that all council borrowers must provide debenture security by way of a charge over council property rates and rates revenues. We view this positively because: (1) rates revenue is the largest and most stable source of income for New Zealand councils; and (2) rates collection ranks ahead of all other claimants on residents, including mortgages and New Zealand's Inland Revenue Department.

Lending to CCOs could affect LGFA's credit metrics. Historically, the agency only provided debt finance to councils and not any CCO, joint venture, or other entity. Since 2021, five CCOs have joined LGFA. However, the agency's total exposure to these remains very small, and borrowing by CCOs must be backed by uncalled capital provided by parent councils.

Under the Crown's Local Water Done Well initiative, councils could shift water-related assets and operations to water-specific CCOs. Exposure to CCO lending could increase when LGFA lends to these entities. To date, the agency has announced that it will lend only to supported water CCOs (i.e., those backed by uncalled capital or guarantees from parent councils).

Further strengthening our credit assessment of LGFA is the joint and several guarantee of its obligations. Other than the New Zealand government, each LGFA shareholder must be a guarantor of the agency's obligations. Also, if the principal amount of a council's borrowing exceeds NZ\$20 million, that council must become party to a deed of guarantee. LGFA currently has 72 such guarantors.

LGFA is broadening its access to capital markets. In the last year, the agency debuted four Australian dollar-denominated issuances for maturities ranging from three to 10 years. It intends to be a regular issuer in Australia for diversification purposes.

LGFA has established an ECP program, under which it has issued just over US\$500 million. The agency historically concentrates its funding in New Zealand. It is the second-largest borrower in the New Zealand dollar market, behind only the sovereign.

In December 2023, the Reserve Bank of New Zealand (RBNZ) confirmed that LGFA's bonds will count as "level two" liquid assets. This will support demand for the bonds from banks.

LGFA's domestic bonds are spread across 10 maturities. They are mostly in series of NZ\$1 billion or more to promote secondary market liquidity. Their repurchase eligibility with RBNZ at a low haircut provides demand support for the bonds. Surveys by the agency suggest that offshore investors hold about 35% of its debt. Since 2015, the agency has also issued short-dated bills via tenders and private placements.

We consider LGFA's liquidity to be strong. This reflects the agency's portfolio of liquid financial assets and potential access to a committed facility from the New Zealand Debt Management (NZDM) office. The facility has a maximum size of NZ\$1.5 billion.

At the moment, we assume LGFA's ability to draw from the facility is temporarily encumbered. This is because under the standby facility rules, the agency's out-of-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 LGFA can generally meet its obligations even under stressed market conditions, without the need to call on additional resources from members. New Zealand councils can also cut back their borrowing requirements in such circumstances, in our view.

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. Sixteen councils signed up for these facilities with an aggregate limit of NZ\$747 million as of June 2024.

Extremely high likelihood of support from government in a stress scenario

We view the likelihood of timely and sufficient extraordinary support from the government to LGFA in the event of financial stress to be extremely high. We base our assessment on LGFA's:

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- Critical role in meeting the New Zealand government's objectives. The agency is a near-monopoly source of debt finance for most local authorities. It offers cost savings and access to longer-term borrowings to participating councils. LGFA has also helped to deepen domestic capital markets. A default by the agency could substantially delay or lead to the cancellation of local government projects in transport, water, and sewerage infrastructure, to the major detriment of the economy.
- Very strong link with the New Zealand government. The agency'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 has access to a committed liquidity facility from NZDM, which NZDM extended for another 10 years in 2021 and will be reviewing again in December 2024.

Key statistics

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

	--Year ended June 30--						
(Mil. NZ\$)	2024A	2023A	2022A	2021A	2020A	2019A	2018A
Business position							
Total adjusted assets	23508	18175	16250	14485	13174	10382	8835
Customer loans (gross)	20549	16314	14042	12066	10900	9311	7976
Growth in loans (%)	26	16	16	11	17	17	2
Net interest revenues	19	10	18	20	18	19	19
Noninterest expenses	12	9	8	9	8	8	7
Capital and risk position							
Total liabilities	22902	17708	15862	14166	12908	10154	8635
Total adjusted capital	607	466	388	319	266	228	199
Assets/capital (x)	39	39	42	45	50	46	44
RAC ratio before diversification (%)	39.0	18.8	21.9	18.3	15.7	17.5	19.2
RAC ratio after diversification (%)	9.3	4.0	2.9	2.3	2.3	2.2	1.8
Gross nonperforming assets/gross loans (%)	0	0	0	0	0	0	0
Funding and liquidity (x)							
Liquidity ratio with loan disbursement (1 year)	0.92	0.96	1.14	1.21	1.31	1.12	0.89
Liquidity ratio without loan disbursement (1 year)	1.08	1.19	1.42	1.47	1.31	1.14	1.61
Funding ratio (1 year)	1.11	1.26	1.48	1.58	1.8	1.31	1.65

a--Actual.

Ratings Score Snapshot

Issuer credit rating

Foreign currency	AA+/Stable/A-1+
Local currency	AAA/Stable/A-1+
Sector risk profile	Very Strong (1)
Individual credit profile:	
Business position	Very Strong (1)
Management & governance	Very Strong (1)
Capital adequacy	Adequate (3)
Funding & liquidity	Strong (2)
Anchor	aa+
Overriding factors and caps	+1
Holistic analysis	-1
Stand-alone credit profile	aa+
Extraordinary support	0 (foreign currency) / +1 (local currency)

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Non-U.S. Public-Sector Funding Agencies, July 26, 2024
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, April 30, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- New Zealand's Water Infrastructure Reshuffle Could Alter Local Government Funding Agency's Lending Mix, Aug. 12, 2024
- Economic Outlook Asia-Pacific Q3 2024: Exporters And EMs Are Outperforming, June 24, 2024
- New Zealand Councils Will Lean Into Rising Credit Risk, May 6, 2024
- New Zealand Councils' Extremely Predictable and Supportive Institutional Settings Are At Risk, Feb. 18, 2024
- Various Rating Actions Taken On New Zealand Local Councils On Weakening Institutional

Framework Trend, Feb. 18, 2024

- New Zealand Local Government Outlook 2024: Bridge Over Troubled Waters, Nov. 19, 2023

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+

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