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Research Update:

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

March 17, 2025

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.
- LGFA's strengthening capital position is counteracting rising risk associated with its lending book. On Feb. 24, 2025, we lowered the institutional framework assessment for New Zealand local councils. Consequently, we have lowered LGFA's sector risk profile.
- 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 LGFA's strong credit profile and dominant position, and our expectation of an extremely high likelihood of support from the New Zealand sovereign for the agency.

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Rating Action

On March 18, 2025, 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 and dominant market position.

Downside scenario

We could lower our ratings on LGFA over the next two years if we consider the agency's stand-alone credit profile (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 credit risk.

Downward pressure could emerge if we perceive that LGFA's policy role or links to the New Zealand government are weakening. We could also lower our ratings if we were to downgrade New Zealand.

Upside scenario

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

Rationale

Our credit rating on LGFA reflects its SACP of 'aa+', and our view of an extremely high likelihood that extraordinary financial support from the Crown (the New Zealand government) would be forthcoming in a stress scenario. The SACP reflects the agency's dominant market position, robust management and governance, and strengthening funding and liquidity and capital positions. We expect that the weakening credit quality of borrowing councils will be countered by the agency's risk management, including its measures to improve capitalization and diversify its funding base.

LGFA's capital adequacy is improving, with its risk-adjusted capital ratio, after adjustments for single-name concentration, moving above 10% in December 2024. LGFA's borrower base has expanded, which has reduced its single-name concentration. Further, LGFA's capital base has grown because management doubled its borrower note requirement for new lending to 5%.

LGFA has also diversified its access to global capital markets in recent years. This supports its funding profile and strong liquidity position.

The sector risk profile assessment has weakened this year. On Feb. 24, 2025, we lowered the institutional framework assessment for New Zealand local governments to very predictable and well-balanced from extremely predictable and supportive.

The credit quality of councils could weaken further as the government and LGFA explore increasing debt limits for high-growth councils. The agency's loan asset quality, on average, could also diminish if it starts lending to water CCOs with higher leverage. We believe these developments will generally be negative for the credit quality of the sector, which is already highly indebted by international standards.

Sector Risk Profile: New Zealand institutional framework has weakened due to increasing revenue and expenditure mismatches and less predictable policy settings.

LGFA currently lends about 97% of its portfolio to local councils. Councils have high, albeit weakening, credit quality. The remaining lending is to council-backed organizations. We currently have credit ratings on 25 of the largest borrowing councils in New Zealand.

On Feb. 24, 2025, we lowered our assessment of the sector's institutional framework by one category to very predictable and well-balanced from extremely predictable and supportive. This was because of growing revenue and expenditure mismatches, and less predictable policy settings.

Rapid repeals and passing of water-related and resource management legislation, cancellation of various grant programs, and a rise in unfunded mandates can materially affect council financial outcomes. This can make it challenging to produce accurate financial forecasts (see "Institutional Framework Assessment: New Zealand Local Governments Face Rising Fiscal Imbalances And Less Certain Policy Settings," published March 17, 2025).

New Zealand's local government sector is more leveraged than that of many other advanced economies. Council debt was close to 200% of operating revenue in fiscal 2024 (ended June 30). In comparison, sectorwide debt ratios for municipal governments in northern Europe and Canada are generally below 100% for the highest institutional framework assessment.

LGFA announced in August 2024 that it would in future be able to lend to water CCOs that are financially backed by councils. The leverage of these public water utilities could be up to twice that of councils that the agency currently finances. The SACPs of water CCOs are likely to be weaker than the average rating on councils.

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 has a dominant market position in New Zealand, accounting for 90% of all the domestic borrowings of councils in 2024. 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.

LGFA was established in December 2011 to provide debt finance to councils, following the enactment of the Local Government Borrowing Act 2011. The Crown owns 20% of LGFA. Thirty council shareholders own the remaining 80%. LGFA counts 77 of New Zealand's 78 councils as members.

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. Historically, 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 seven-member board governs the agency, of which six 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 that 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 has improved the agency's capital adequacy assessment. Smaller councils are borrowing proportionally more than the larger ones, diluting concentration.

We estimate the risk-adjusted capital ratio for LGFA to be 34.2% before diversification and 10.5% after adjustments for single-name concentration, as of Dec. 31, 2024. 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 75%.

The increase in LGFA's borrower note margin to 5.0% from 2.5% will help the agency raise its capital base over time. As of Dec. 31, 2024, the agency's capital structure comprises NZ$25 million of paid-in shareholder capital, about NZ$89 million in retained earnings, and about NZ$603 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 capital calculations because it is not paid in. The agency could call on this amount to support its financial position in a stress scenario.

We consider LGFA's risk management to be very good, which helps to mitigate lending concentration risk and weakening credit quality of its lending book. 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.

In early fiscal 2025, LGFA approved an increase to its net debt covenant for high-growth councils at board discretion to a maximum 350% of revenues. This could increase the indebtedness of the sector over time, and potentially weaken the credit quality of LGFA's lending book somewhat, in our assessment.

All council borrowers must provide debenture security by way of a charge over council property rates and rates revenues. This supports the financial profile of LGFA. We view this as a positive factor 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. Since 2021, seven CCOs have joined LGFA. These are financially backed by their parent councils with uncalled capital. The agency's exposure to these entities remains very small.

Under the Crown's Local Water Done Well initiative, councils could shift water-related assets and operations to water-specific CCOs. If this occurs, the LGFA's exposure to CCO lending could increase quickly. 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 continuing to broaden its access to capital markets. Since fiscal 2024, 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 and has since issued twice in fiscal 2025 into existing Australian lines. In January 2025, LGFA established a euro medium-term note program; it will settle its first issuances under this program in March and April 2025.

LGFA also has about US$500 million borrowed through its ECP program.

The agency historically concentrated 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 11 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. 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.

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 with the Crown are offset against the balance of the facility.

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 could also cut back their borrowing requirements in such circumstances, in our view.

Recent growth in LGFA's liquid asset portfolio to backstop its 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$752 million as of December 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:

- 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 has agreed to extend the term and increase the size from the current NZ$1.5 billion.

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	23,508	18,175	16,250	14,485	13,174	10,382	8,835
Customer loans (gross)	20,549	16,314	14,042	12,066	10,900	9,311	7,976
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	22,902	17,708	15,862	14,166	12,908	10,154	8,635
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	0.0	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	1.80	1.31	1.65

a--Actual.

Ratings Score Snapshot

Issuer credit rating

Local currency	AAA/Stable/A-1+
Foreign currency	AA+/Stable/A-1+
Sector risk profile	Strong
Individual credit profile:	

Business position	Very Strong
Management and governance	Very Strong
Capital adequacy	Strong
Funding & liquidity	Strong
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 Local Governments Face Rising Fiscal Imbalances And Less Certain Policy Settings, March 17, 2025
- New Zealand Councils' Institutional Framework Lowered On Rising Debt, Feb. 26, 2025
- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., Feb. 24, 2025
- New Zealand's Water Infrastructure Reshuffle Could Alter Local Government Funding Agency's Lending Mix, Aug. 12, 2024
- New Zealand Councils Will Lean Into Rising Credit Risk, May 6, 2024

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+