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Research Update:

New Zealand Local Government Funding Agency Ratings Affirmed; Outlook Stable

Primary Credit Analyst:

Anthony Walker, Melbourne (61) 3 9631 2019; anthony.walker@spglobal.com

Secondary Contact:

Craig R Michaels, Melbourne (613) 9631 2082; craig.michaels@spglobal.com

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Research Update:

New Zealand Local Government Funding Agency Ratings Affirmed; Outlook Stable

Overview

- The ratings on New Zealand Local Government Funding Agency Ltd. (LGFA) reflect our assessment that there would be an extremely high likelihood of extraordinary support from the New Zealand government in a distress scenario.
- We are affirming our 'AA+/A-1+' local currency long-term and short-term ratings and 'AA/A-1+' foreign currency long-term 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 Oct. 18, 2016, S&P Global Ratings affirmed its 'AA+/A-1+' local currency long-term and short-term ratings and 'AA/A-1+' foreign currency long-term and short-term ratings on New Zealand Local Government Funding Agency Ltd. (LGFA). The outlook remains stable.

Rationale

The rating affirmation on LGFA reflects our view of the extremely high likelihood that the New Zealand government (the Crown) will provide extraordinary support to the LGFA in a stress scenario.

The ratings are also based on LGFA's stand-alone credit profile (SACP) of 'aa-', which reflects LGFAs solefocus on lending to New Zealand local governments, very 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.

We have used our "Principles Of Credit Ratings" in conjunction with "Rating Finance Companies" as our criteria to determine the SACP of LGFA. There is a sufficient degree of similarity between LGFA's operations and criteria for rating finance companies such as analyzing its mandate, asset quality, asset-liability management, and profitability.

Our view of an extremely high likelihood of extraordinary support in a stress scenario is based on our assessment of LGFA's:

- Very important role in meeting key economic objectives of the Crown. 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 economy.
- Integral link with the Crown. LGFA's enabling legislation allows the Crown, along with its internal mechanisms, 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 consider that LGFA enjoys a special public status in New Zealand evidenced by a committed liquidity facility the Crown extends to LGFA.

Over the past year, LGFA focused on implementing the key changes to its operations and product offerings it undertook in 2015. During 2015, LGFA brought its treasury management system in house and no longer relies on the governmental New Zealand Debt Management Office (NZDMO) to execute its debt issuance. This new system is hosted by an external nongovernment provider.

In addition, LGFA began bespoke lending to its members and issuing short-term bills. LGFA had lent about NZ\$550 million with bespoke maturities, and NZ\$160 million of short-term bills to local councils. While these new products have marginally increased LGFA's asset-liability mismatches and liquidity risk, we consider LGFA is well placed to manage these risks with its experienced team, liquid asset holdings, funding strategies, and its NZ\$1 billion liquidity facility from NZDMO.

LGFA was established in December 2011, to provide debt funding to New Zealand local councils 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. Its single purpose of providing debt funding to New Zealand local councils is enshrined in LGFA's shareholder agreement. The New Zealand government holds 20% of LGFA's share capital while the 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, on RatingsDirect). New Zealand local governments' financial plans and annual reports are audited by the Crown's audit office, while the financial sustainability of the sector is closely monitored by the Crown.

LGFA's credit quality is exceptional, reflecting all loans being neither past due nor impaired since LGFA'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 still exists within

the two largest borrowers, which comprise over half, and the largest borrower comprising roughly a third, of the loans outstanding.

LGFA is entirely wholesale-funded, and as such, is exposed to disruptions to the capital markets. At present, LGFA has only issued domestically in New Zealand dollars, and is therefore 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, due to LGFA's bonds being eligible for repurchase with the Reserve Bank of New Zealand and attracting a very 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 may be paid up if requested by the LGFA. In addition, notes are issued to each local council that borrows from LGFA, which are subordinated debt instruments that may be convertible into redeemable shares at LGFA's request.

Liquidity

Liquidity risk has generally been managed through broadly matching of on-lending to New Zealand local councils with LGFA's debt issuance. However, with bespoke lending, the LGFA has introduced some asset-liability mismatch and potential liquidity risk. LGFA is well placed to manage these risks as it has sufficient balance-sheet liquidity to meet anticipated drawdowns, as well as debt and operational costs; and can access a committed liquidity facility provided by the NZDMO.

Outlook

The stable outlook reflects our view that LGFA's role and link remains broadly stable and its SACP will not deteriorate within the next two years. 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, and 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 a major borrower were to be downgraded. Further, the rating could come under pressure if our assessment of LGFA's link with the Crown substantially weakens. This could occur 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 the ratings and outlook on LGFA.

Upside scenario

As the ratings on LGFA are equalized with those on the sovereign, we consider a higher rating to be unlikely within the next two years as the sovereign rating is stable.

Related Criteria And Research

Related Criteria

- Criteria - Financial Institutions - Finance Companies: Rating Finance Companies - March 18, 2004
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Principles Of Credit Ratings - February 16, 2011

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+

Senior Unsecured

AA+

Short-Term Debt

A-1+

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