Research Update:

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

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Overview

- The ratings on LGFA reflect our assessment that LGFA's strengths, including its dominant market position as a source of debt funding for highly rated New Zealand local councils, continue to offset its relatively modest, albeit gradually improving, risk-adjusted capital ratio.
- The ratings also reflect our view of LGFA's very important role and integral link with the New Zealand sovereign.
- We are affirming our 'AA+/A-1+' local-currency and 'AA/A-1+' foreign-currency ratings on LGFA.
- The outlook on the long-term ratings remains positive, reflecting that on the New Zealand sovereign.

Rating Action

On Feb. 27, 2020, S&P Global Ratings affirmed its 'AA+/A-1+' long- and short-term local-currency and 'AA/A-1+' long- and short-term foreign-currency issuer credit ratings on the New Zealand Local Government Funding Agency Ltd. The outlook on the long-term ratings remains positive.

Outlook

The positive 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.

Upside scenario

We would raise our ratings on LGFA if we were to do the same for New Zealand, all else being equal.

Downside scenario

We would revise our outlook on LGFA to stable if we were to take similar action on New Zealand. In addition, a weakening of LGFA's public policy role or links to the New Zealand government could cause us to lower our assessment of the likelihood of extraordinary support from the sovereign, which would result in downward pressure on the ratings.

Downward ratings pressure could also emerge if we consider LGFA's standalone credit profile (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 fall markedly, or there is a significant decline in the underlying creditworthiness of LGFA's borrowers and guarantors.

Rationale

Our ratings on LGFA reflect its SACP of 'aa-', and our view that there is an extremely high likelihood that extraordinary financial support from the New Zealand government (the Crown) would be forthcoming in a stress scenario.

The ratings on LGFA 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 Office (NZDMO), the debt management 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 funding 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. At the time of writing, LGFA counted 66 of New Zealand's 78 councils as members. Together, these councils account for most of the local government debt in New Zealand.

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, high market share, and growing 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, and on a generally improving trend. S&P Global Ratings currently assigns ratings to 23 councils in New Zealand, including most of LGFA's largest borrowers, all of which have long-term issuer credit ratings between 'AA' and 'A+'.

The local government sector is supported by New Zealand's excellent institutional settings and wealthy and resilient economy, with GDP per capita of about US$40,700 in 2020. The country's real economic growth has been solid during the past few years at around 3% per annum, resulting in rising wealth levels. We expect growth to continue over the next few years. 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 relatively high compared with other jurisdictions, with direct council debt standing at about 140% of operating revenues.

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 88% of all councils' local-currency borrowing in the 12 months to December 2019. Its customer base continues to expand, with one new member joining in the December quarter, taking the total to 66. New Zealand's largest council, Auckland Council, accounts for roughly 38% of the national economy and half of the local government sector's gross debt. LGFA limits its lending to Auckland Council to reduce concentration risk, and Auckland Council has large offshore and wholesale bond programs of its own, which means that LGFA's share of aggregate local government debt is limited to about two-thirds. Dunedin City Council is the only council of substantial size that does not borrow through LGFA, though we understand that it intends to join later in 2020. LGFA is becoming the near-monopoly lender to most councils outside of Auckland.

LGFA is able to lend on terms that are 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. We expect growth in LGFA's lending book to decelerate during the next few years because it has now amassed the vast majority of council borrowers in New Zealand. LGFA has recorded stable or growing net interest income and positive profit levels in every year except its first (partial) year of operation. We expect earnings to remain modest, reflecting its central objective of reducing funding costs for councils.

We consider LGFA's management and governance to be a key strength, and one 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 the strategic direction and control of LGFA's activities. LGFA also has a shareholders' council, made up of 5-10 appointees, that recommends appointments to the board and coordinates shareholders on governance decisions. LGFA's management team is highly qualified. Its senior executives bring many years of 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 at all times the payment is 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 around 45% of its lending book, resulting in concentration risk.

- LGFA benefits from a joint and several guarantee from 53 council guarantors, and its lending is secured over property rates revenue.
- LGFA funds itself only in domestic capital markets. Liquidity is buttressed by a Crown-committed standby facility of up to NZ$1 billion; the limit is currently set at NZ$600 million.

LGFA's lending portfolio is concentrated compared with most of its overseas peers, and this constrains its capital adequacy assessment. We calculate its risk-adjusted capital (RAC) ratio to be 17.5% before diversification and 2.2% after adjustments for single-name concentration, as of June 30, 2019. Its two largest borrowers, Auckland Council and Christchurch City Council, represent 45% of the loan book, while its 20 largest borrowers account for around 84%. LGFA's capital structure includes NZ$25 million of paid-in shareholder capital, about NZ$49 million in retained earnings, and about NZ$154 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 but note could be called to support its financial position in a stress scenario. We expect LGFA's capitalization to slowly improve as retained earnings grow and borrower concentration gradually declines, particularly as Auckland Council seeks to access non-LGFA sources of funding.

We consider LGFA's financial risk management to be excellent, which helps to mitigate its 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. Credit risk on derivative contracts is minimized by the use of NZDMO as the counterparty to all such contracts. The credit history of LGFA's loan portfolio is exceptional, reflecting the fact that it 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. To address concentration risk, LGFA requires that no more than NZ$100 million or 33% of a council's borrowings mature in any 12-month period, and Auckland Council is limited to a maximum of 40% of LGFA's total lending book.

Supporting its financial profile is the fact that all of LGFA's borrowers must provide debenture security by way of a charge over council property rates and rates revenues. We view this security as being extremely strong 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. At present, LGFA only provides debt funding to New Zealand councils, and not any council-controlled organization (CCO), joint venture, or partially owned entity. A recent change to LGFA's foundation policies will allow it, going forward, to lend to a CCO if its parent council provides a guarantee over such lending or sufficient uncalled capital to meet that CCO's obligations. We do not anticipate this change having any material impact on LGFA's credit metrics.

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 53 council guarantors.

We believe that LGFA has sound access to capital markets, though its funding is concentrated in New Zealand. Its bonds are issued domestically in New Zealand dollars and, since 2015, have 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. Bonds are spread across nine maturities, largely matching those of benchmark New Zealand government bonds. They are mostly in series of NZ$1 billion or more in order to promote secondary market liquidity. Tenders are spread throughout the year to ensure consistency of supply. Demand for LGFA's bonds is supported by their repo-eligibility with the Reserve Bank of New Zealand with a low haircut. According to LGFA's surveys, about 29% of its debt is held by offshore investors. Since 2015, LGFA has also issued short-dated bills via tender and private placement. In November 2017, LGFA established an Australian-dollar medium-term notes program, which it has not yet opted to utilize.

We consider LGFA's liquidity to be strong, reflecting its portfolio of liquid financial assets and access to a committed facility with the NZDMO. The facility has a maximum limit of NZ$1 billion; its actual limit is adjusted from time to time and currently set at NZ$600 million. 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, in practice, New Zealand councils would be able to cut back their borrowing requirements in such an environment.

While LGFA has not entered into facility arrangements with councils in the past, it intends to start offering such facilities (only to members that are also guarantors) in 2020. At present, we do not expect this change in policy to weaken LGFA's liquidity metrics. However, the impact will depend on the extent to which such facilities are backed by additional liquid financial assets.

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 funding for most local authorities. LGFA offers cost savings and access to longer-term borrowings to participating councils, and it has helped to deepen New Zealand's capital markets. A default by LGFA would likely lead to substantial delays in or cancelations of local government projects—across such areas as transport, water, and sewerage infrastructure—thereby having a major impact on 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, as evidenced by its committed liquidity facility with the NZDMO.

Key Statistics

Table 1

Key Statistics

	--Year ended June 30--				
Selected indicators (mil. NZ$)	**2019A**	**2018A**	**2017A**	**2016A**	**2015A**
Business position					
Total adjusted assets	10,382	8,835	8,491	7,257	5,412
Customer loans (gross)	9,311	7,976	7,784	6,451	5,032

Table 1

Key Statistics (cont.)

	--Year ended June 30--				
Selected indicators (mil. NZ$)	**2019A**	**2018A**	**2017A**	**2016A**	**2015A**
Growth in loans (%)	17	2	21	28	34
Net interest revenues	19	19	18	16	14
Noninterest expenses	8	7	6	6	5
Capital and risk position					
Total liabilities	10,154	8,635	8,306	7,105	5,290
Total adjusted capital	228	199	185	153	121
Assets/capital (x)	46	44	46	48	45
RAC ratio before diversification (%)	17.5	19.2	19.0	N.A.	N.A.
RAC ratio after diversification (%)	2.2	1.8	1.5	N.A.	N.A.
Gross nonperforming assets/gross loans (%)	0	0	0	0	0
Funding and liquidity (x)					
Liquidity ratio with loan disbursement (one year)	1.12	0.89	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (one year)	1.14	1.61	N.A.	N.A.	N.A.
Funding ratio (one year)	1.31	1.65	N.A.	N.A.	N.A.

RAC--Risk-adjusted capital. N.A.--Not available. E--Estimate. A--Actual.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot

Issuer credit rating	
Local currency	AA+/Positive/A-1+
Foreign currency	AA/Positive/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	+2
GRE support	+2
Group support	0

Table 2

Ratings Score Snapshot (cont.)

Additional factors	0

SACP--Standalone credit profile. PICRA--Public-Sector Industry And Country Risk Assessment.

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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- New Zealand Ratings Affirmed At 'AA' FC And 'AA+' LC; Outlook Positive, Feb. 27, 2020
- New Zealand Councils Can Carry Growing Debt, Feb. 16, 2020
- Banking Industry Country Risk Assessment: New Zealand, Sept. 19, 2019
- Public-Sector Funding Agencies Risk Indicators: May 2019, May 14, 2019
- Public Finance System Overview: New Zealand's Institutional Framework For Local And Regional Governments, Nov. 12, 2018

Ratings List

Ratings Affirmed	
New Zealand Local Government Funding Agency Ltd.	
Issuer Credit Rating	
Foreign Currency	AA/Positive/A-1+
Local Currency	AA+/Positive/A-1+
Senior Unsecured	AA+
Short-Term Debt	A-1+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.