New Zealand Local Government Funding Agency

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This report does not constitute a rating action.

Credit Highlights

Overview

Enterprise risk profile	Financial risk profile
Very strong management and dominant market position underpin credit quality.	Risks from borrower concentration partly offset by good access to capital markets and strong liquidity.
--Strong public policy mandate and monopoly lender to highly-rated New Zealand councils.	--Guarantees from 71 councils, jointly and severally. Lending is secured over their property rates revenue.
--Council borrowers benefit from the country's excellent institutional settings and wealthy economy, although they are quite leveraged relative to international peers.	--Liquidity buttressed by a growing portfolio of liquid assets.

We rate the long-term issuer credit ratings on New Zealand Local Government Funding Agency Ltd. (LGFA) 'AA+' for foreign currency and 'AAA' for local currency. The ratings reflect our assessment of LGFA's stand-alone credit profile (SACP) of 'aa-', and our view of an extremely high likelihood of extraordinary financial support from the New Zealand government in a stress scenario.

LGFA has a dominant market share. Seventy seven of New Zealand's 78 local councils are now members of the agency. These councils account for virtually all local-government debt in New Zealand.

Rated councils have an average credit rating in the 'AA' category. Seventy-one councils jointly and severally guarantee LGFA's obligations, with 30 councils holding equity in LGFA.

Partially offsetting these strengths is LGFA's highly concentrated lending portfolio. This leads to weaker capital adequacy than for many international peers.

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Outlook

The stable 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.

Downside scenario

We could lower our ratings on LGFA over 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 do the same for New Zealand.

In addition, downward rating 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, its access to funding markets or liquidity falls markedly, or there is a significant decline in the underlying creditworthiness of the agency's borrowers and guarantors.

Upside scenario

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

Rationale

Enterprise Risk Profile: Very strong management and dominant market position underpin credit quality

The high credit quality of LGFA's borrowers supports the agency's creditworthiness. We currently assign long-term issuer credit ratings to 25 councils in New Zealand.

Dunedin City Council (via Dunedin City Treasury Ltd.) joined LGFA as a member in the past year. Up until then, the council was the largest council borrower that had not joined LGFA. We anticipate a gradual transition of some of its borrowings to LGFA. As such, there should be no immediate significant impact on LGFA's concentration metrics.

We view LGFA as 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. This means that LGFA's share of aggregate local government debt is limited to about two-thirds.

New Zealand's excellent institutional settings and wealthy and resilient economy support the local government sector.

We consider domestic financial system risks as intermediate. Conservative regulations and risk-appetite settings help to offset risks associated with the banking system's high share of net external borrowings.

Leverage in New Zealand's local government sector is more elevated than in other advanced economies, with direct council debt standing at 170%-180% of operating revenue. In comparison, sector-wide debt ratios for municipal governments in northern Europe are generally below 100%.

LGFA has a strong record of fulfilling its public policy mandate since its establishment in 2011. This is despite the agency's shorter history than many other public-sector funding agencies worldwide.

LGFA has a dominant market position in New Zealand. The agency accounted for 80% of the local-currency borrowings of all councils in 2022. Its membership base has expanded to 77 of the country's 78 local authorities.

LGFA is 20% owned by the New Zealand government and 80% by 30 council shareholders.

LGFA lends on terms that are generally more attractive than if the councils were to borrow in their own names or through the banking system. This can be seen in the 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 the councils lengthen the average tenor of their borrowings.

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Councils in New Zealand will likely continue to increase their borrowings to finance new infrastructure and renewals. LGFA has enjoyed stable or rising net interest income and net profits every year except its first (partial) year of operation. We expect earnings to remain modest, reflecting the agency's central objective of reducing funding costs for councils.

LGFA offers green, social, and sustainable (GSS) loans to councils at a discount of 5 basis points (bps) to its usual lending margin. The agency has approved GSS loan applications totaling NZ$543 million, of which NZ$101 million has been drawn to date.

Recently, LGFA has also been rolling out climate action loans. These are similar in concept to sustainability-linked loans.

We consider LGFA's management and governance to be among its key strengths. The organization is governed by a six-member board. Of these, five are independent directors, including the chairperson. The board is responsible for strategic direction and control.

LGFA also has a shareholders' council, made up of five to 10 appointees. This council recommends appointments to the board and coordinates governance decisions among the shareholders.

LGFA has a well-qualified management team. The senior executives bring experience from previous roles in council treasury operations and private financial institutions.

Like many of its international peers, LGFA is not subject to banking regulations. However, the agency must comply with continuous disclosure obligations. This is because its bonds are quoted on the NZX Debt Market. In addition, securities issued to retail investors are regulated under the Financial Markets Conduct Act 2013.

LGFA produces annual financial statements. The agency's external auditors are appointed by the Auditor-General of New Zealand. The agency also publishes half-yearly reports and annual statements of intent. Although it pays dividends to shareholders, such payments are always discretionary and subject to board approval.

Financial Risk Profile: Risks from borrower concentration partly offset by good access to capital markets and strong liquidity

LGFA has a more concentrated lending portfolio than most of its overseas peers. This constrains the agency's capital adequacy. We calculate its risk-adjusted capital ratio at 21.9%, and 2.9% after adjustments for single-name concentration, as of fiscal 2022 (year-end June 30).

LGFA's two largest borrowers, Auckland Council and Christchurch City Council, represent 37% of its loan book. The agency's 20 largest borrowers account for about 80% of this book.

We expect capitalization to be roughly stable. LGFA has increased the percentage of 'borrower notes' that councils must subscribe for, to 2.5% from 1.6% of their long-term borrowings from July 2020 onward. We consider these notes to be equity-like.

LGFA has a capital structure that comprises NZ$25 million of paid-in shareholder capital, NZ$79.5 million in retained earnings, and about NZ$283 million in borrower notes. The agency also has NZ$20 million of uncalled shareholder capital, which we exclude from our calculations of its capital ratio.

LGFA can likely call on the uncalled capital to support its financial position in a stress scenario, in our view.

We consider risk management to be very good. The latter helps to mitigate lending concentration risks. 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 its foreign-currency exposure. The New Zealand Debt Management Office (NZDMO) is traditionally the counterparty to all derivative contracts. This minimizes LGFA's credit risk.

From 2023, LGFA will switch derivative counterparties to commercial banks and away from NZDMO. This is for diversification purposes and strengthening relationships with other financial market participants.

LGFA has an exceptional loan portfolio credit history. The agency has not experienced any arrears or impairments since inception. Its 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 an extra buffer to deal with the fallout from COVID-19, councils rated 'A' or higher could have net debt up to 300% of their revenue, up from 250%.

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LGFA will scale back the limit to 280% by 2026. To mitigate concentration risks, the agency's foundation policies also limit Auckland Council to a maximum of 40% of its total loan book.

All borrowers from LGFA must provide debenture security by way of a charge over council property rates and rates revenue. We view this positively. This is because rates revenue is the largest and most stable source of income for New Zealand’s councils. 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) to have any material impact on LGFA’s credit metrics. Historically, LGFA only provided debt finance to New Zealand councils. A recent change to the agency's foundation policies allows it to also lend to CCOs like Invercargill City Holdings Ltd. This is so long as the parent council for each CCO provides a guarantee or sufficient uncalled capital to meet the obligations.

The joint and several guarantees of LGFA’s obligations strengthen its creditworthiness, in our view. Other than the New Zealand government, each LGFA shareholder is a guarantor. If the principal amount of a council’s borrowing from LGFA exceeds NZ$20 million, that council must also become party to this guarantee. LGFA currently has 71 such guarantors.

We believe LGFA has good access to capital markets, although its funding is concentrated in New Zealand. The agency issues its bonds domestically in New Zealand dollars. Since 2015, its bonds have also 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.

LGFA’s bonds are spread across 11 maturities. These are mostly in series of NZ$1 billion or more to promote secondary market liquidity. Their repurchase eligibility with the Reserve Bank of New Zealand at low haircuts supports demand for these bonds. The bonds also have a reasonably diverse investor base. Offshore investors hold about 30% of LGFA’s debt.

Since 2015, LGFA has also issued short-dated bills via tender and private placements. In November 2017, the agency established an Australian-dollar medium-term note program, which it has yet to utilize.

We consider liquidity to be strong. LGFA has access to a committed facility with NZDMO, capped at NZ$1.5 billion. At the moment, we assume LGFA’s ability to draw from the facility is temporarily and partly encumbered. This is because under the standby facility rules, the agency's derivative contracts with NZDMO are currently out of the money. We have given no benefit for the committed facility in our liquidity stress tests.

In 2021, the New Zealand government agreed to extend the facility for another 10 years, to 2031. We believe LGFA can generally meet its obligations under stressed market conditions without calling on additional resources from its members. We also believe councils will be able to cut back on their borrowings in such an environment.

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. Nine councils had signed up for these facilities, with an aggregate limit of NZ$662 million as of June 30, 2022.

Our base case excludes the potential effect of the New Zealand government's proposed 'three waters' reforms. The reform program could potentially take away responsibility for drinking water, wastewater, and stormwater assets from councils. Responsibility would be amalgamated under four new regional water services entities from mid-2024.

Councils could be relieved of their water-related debts and receive cash settlements from the water services entities to repay LGFA. The reforms are still under development. We intend to incorporate their effects in our assessment when greater certainty and details emerge.

We see an extremely high likelihood of support from the New Zealand government in a stress scenario

Our 'AAA' long-term local currency issuer credit rating on LGFA is three notches above our assessment of its SACP at 'aa-'. This is because we see an extremely high likelihood that the New Zealand government would provide timely and sufficient extraordinary support to LGFA in the event of financial stress.

We base this assessment on our view of LGFA's:

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- Very important role in meeting the New Zealand government's objectives. The agency has a near-monopoly in financing the debt of most local authorities. It offers cost savings and access to longer-term borrowings to participating councils. LGFA has helped to deepen domestic capital markets. A default by the agency could substantially delay or lead to the cancelation of local government projects in such areas as transport, water, and sewerage infrastructure. This would be to the major detriment of New Zealand's economy.
- Integral links with the New Zealand government. LGFA's enabling legislation allows the Crown to lend it money if it is in public interest to do so, or to meet a temporary shortfall in a timely manner. The agency enjoys a special public status in New Zealand. This is evident from its committed liquidity facility with NZDMO, which has been expanded to a maximum limit of NZ$1.5 billion and extended for another 10 years until 2031.

Key Statistics

	--Year ended June 30--					
(Mil. NZ$)	2022A	2021A	2020A	2019A	2018A	2017A
Business position						
Total adjusted assets	16,250	14,485	13,174	10,382	8,835	8,491
Customer loans (gross)	14,042	12,066	10,900	9,311	7,976	7,784
Growth in loans (%)	16	11	17	17	2	21
Net interest revenues	18	20	18	19	19	18
Noninterest expenses	8	9	8	8	7	6
Capital and risk position						
Total liabilities	16,146	14,166	12,908	10,154	8,635	8,306
Total adjusted capital	388	319	266	228	199	185
Assets/capital (x)	42	45	50	46	44	46
RAC ratio before diversification (%)	21.9	18.3	15.7	17.5	19.2	19.0
RAC ratio after diversification (%)	2.9	2.3	2.3	2.2	1.8	1.5
Gross nonperforming assets/gross loans (%)	0	0	0	0	0	0
Funding and liquidity (x)						
Liquidity ratio with loan disbursement (1 year)	1.14	1.21	1.31	1.12	0.89	N.A.
Liquidity ratio without loan disbursement (1 year)	1.42	1.47	1.31	1.14	1.61	N.A.
Funding ratio (1 year)	1.48	1.58	1.80	1.31	1.65	N.A.

Rating Component Scores

Issuer credit rating	
Local currency	AAA/Stable/A-1+
Foreign currency	AA+/Stable/A-1+

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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

SACP—Stand-alone credit profile. PICRA—Public-sector industry and country risk assessment. GRE—Government-related entity.

*GRE Support uplift is based on local currency ratings.

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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Credit FAQ: Lifting The Lid On New Zealand's "Three Waters" Reforms, Oct. 13, 2022
- Default Transition and Recovery: 2021 Annual International Public Finance Default And Rating Transition Study, Oct. 4, 2022
- COVID Contained But Symptoms Linger For New Zealand Governments, Banks, And Insurers, Sept. 19, 2022
- Bulletin: Credit Implications Of New Zealand's Proposed "Three Water" Reforms, May 10, 2022
- Banking Industry Country Risk Assessment: New Zealand, May 5, 2022
- Institutional Framework Assessment: New Zealand Local Governments, April 28, 2022
- 25 Ratings In 25 Years: New Zealand Councils Prove Their Staying Power, Feb. 1, 2022
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Ratings Detail (as of March 01, 2023)*

New Zealand Local Government Funding Agency Ltd.		
Issuer Credit Rating		
Foreign Currency		AA+/Stable/A-1+
Local Currency		AAA/Stable/A-1+
Senior Unsecured		AAA
Issuer Credit Ratings History		
21-Feb-2021	*Foreign Currency*	AA+/Stable/A-1+
03-Feb-2019		AA/Positive/A-1+
06-Dec-2011		AA/Stable/A-1+
21-Feb-2021	*Local Currency*	AAA/Stable/A-1+
03-Feb-2019		AA+/Positive/A-1+
06-Dec-2011		AA+/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings credit ratings on the global scale are comparable across countries. S&P Global Ratings credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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