September 2018

First Nations Finance Authority (FNFA) —A continuing credit improvement story

S&P: A+, "Stable" outlook

Moody's: A2, "Stable" outlook

Bloomberg ticker: FNFACA / Website: fnfa.ca

Enabling legislation: The FNFA came into effect in 2006 following passage of the federal *First Nations Fiscal Management Act, 2005 (FNFMA)*.

Purpose: The FNFA is a not-for-profit organization providing financing to qualifying First Nations (FNs) via a pooled borrowing model similar to certain municipal authorities. Qualifying FNs utilize existing revenue streams to secure financing for eligible projects, including: equity participation in certain projects, infrastructure investment, community housing, land purchases, and economic/social development projects. FNFA provides short-term loans (below bank prime), long-term funding (out to 30 years) and advisory services to participating FNs.

Membership: Participating FNs are subjected to a stringent vetting process. FNs must voluntarily agree to abide by fiscal rules set down in the FNFMA. Prior to applying for membership in the FNFA, a federally established Financial Management Board (FMB) scrutinizes and conducts tests on five years of audited financial statements, and also reviews the governance framework and risk management controls. The FNFA then conducts a review of the FNs revenue streams, applying variable discount rates in order to determine a given FNs borrowing capacity. Following unanimous approval from the FNFA Board, each FN must establish a Secured Revenue Trust Account (SRTA), into which intercepted revenue streams are directed. Borrowing members are subjected to annual reviews by the FNFA and FMB.

Investor safeguards:

1. Notable discounting of eligible revenue streams to determine borrowing capacity
   - FNFA identifies eligible contractual revenues for each borrowing FN and calculates maximum borrowing capacity based upon each payor's discount factor;
   - Discount factors vary by revenue stream, with less stable/secure revenues discounted at a higher rate: federal/provincial transfers 1.23; independent power projects 1.25; municipal transfers 1.3; provincial gaming revenues 1.6; contracts & leases and band business: 1.75; land benefit agreements $1.23 when contracted with the local province or $2.25 when contracted with a private sector proponent (no loans have been secured with private sector revenue streams to date).
2. Revenue intercept mechanism
   - Contractual revenue is redirected from the payor directly to SRTA. The FNFA has irrevocable priority access to SRTA funds in order to immediately satisfy each FNs loan obligations. The term of posted contractual revenues equals or exceeds the debt term;
   - Currently 81% of intercepted revenues are from federal/provincial governments;
   - Against an $18.7 million annual interest obligation, FNFA boasts $87.3 million of annual cash flows/intercepted revenues;
   - Interest coverage (ICR) is 4.67X and P&I liability coverage is 3.50X (as at September 1st, 2018).
3. Fully funded Debt Reserve Fund (DRF) of $25.06 million as at September 1st, 2018
   - 5% of a loan's value is deposited into the DRF, with all borrowing members obligated to maintain the fund. At current interest rates, the DRF is growing faster than the interest obligation;
   - The DRF is maintained at 100% prior to any surplus funds in the SRTA being distributed to the FNs. Draws on the DRF are replenished from all borrowing members' SRTAs, on a proportional basis.
4. Federally funded Credit Enhancement Fund (CEF) of $30 million as at September 1st, 2018
   - CEF was increased from $10 million via 2016 federal budget;
   - If SRTA funds are insufficient to replenish the DRF, the separate and federally funded CEF serves as a backstop.
5. Intervention rights ($548 million as at September 1st, 2018 of joint and several revenues are accessible)
   - Existing borrowing members have total surplus revenue in excess of expenditures of approximately $232 million (equivalent to 42.3% of expenditures);
   - The FNFA can require the FMB to assume management of all of a FNs revenue streams in order to satisfy its bond obligations.

Potential credit rating upgrade goalposts:

1. Grow and diversify FNFA member base
   - As of September 2018, there are 84 FNFA members, up from 33 members in June 2014;
   - Given a healthy pipeline of FNs on the list to be certified as part of the FMB evaluation process (currently 265 scheduled and pending), FNFA expects to have in the range of 95 members by June 2019;
   - Members are increasingly diversified geographically across the provinces.
2. Grow joint and several debenture borrowers
   - FNFA's first debenture, in June 2014, had 13 FN participants;
   - As of today, there are 50 FNs that have accessed the FNFA's bond loan program, with further steady growth anticipated.
3. Sustained positive financial performance and reduced dependence on federal government for operating cost contribution
   - The FNFA returned to an operating surplus in F2015-16. Liquidity/sinking fund assets scheduled for steady growth though 2019-20;
   - Prior to its first debenture in June 2014, FNFA received 100% of its operating budget from the federal government. Currently, FN borrowers cover one third of operating costs, with the FNFA moving towards fully self-funded status (expected within 3 years).
4. Increased likelihood of extraordinary support or growing importance of FNFA's public policy role.

Federal government's commitments to First Nations Communities: The 2018 federal budget included a net fiscal investment of $4.8 billion over six years ($1.4 billion in 2018-19) in the area of "reconciliation". These investments are generally designed to support better results for Indigenous Peoples and the building of renewed relationships between the government and Indigenous Peoples, based on rights and self-determination.

Of particular note, the 2018 federal budget included $189 million over five years for "Strengthening First Nations Institutions and Community Capacity". Specifically, that amount included $50 million over five years (and $11 million/year in ongoing support) to strengthen the FMB, the FNFA and the First Nations Tax Commission. An additional $189 million has also been provided in 2018-19 to implement fiscal policy reforms with self-governing Indigenous governments.

Other noteworthy federal budget investments included:

- $400 million to help fulfill significant gaps in health outcomes between Indigenous and non-Indigenous people;
- $230 million to ensure FNs children are safe and supported within their communities;
- $200 million for distinctions-based housing strategies support (less existing funds in the fiscal framework);
- $100 million for clean and safe drinking water on reserve.

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