Research Update:

First Nations Finance Authority Ratings Raised To 'AA-' From 'A+' On Strengthened Market Position; Outlook Stable

August 21, 2024

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Overview

- First Nations Finance Authority (FNFA) has continued to build its track record of operational independence and strengthened its business position as the preeminent public sector funding agency lender to First Nations communities in Canada with steady growth in the number of First Nations community borrowers.
- We expect this momentum will continue over the next two years, along with growth in the pool of borrowers following the legislative amendments to the First Nations Fiscal Management Act, expected to be completed in 2024.
- As a result, S&P Global Ratings raised its long-term issuer credit and issue-level ratings on FNFA to 'AA-' from 'A+'.
- The stable outlook reflects our expectation that the authority's lending portfolio to First Nations in Canada will continue rising, thus maintaining the importance of FNFA's public policy role to the federal government.

Rating Action

On Aug. 21, 2024, S&P Global Ratings raised its long-term issuer credit and issue-level ratings on public-sector funding agency First Nations Finance Authority (FNFA) to 'AA-' from 'A+'. The outlook is stable.

Outlook

The stable outlook reflects our view that a strong intercept mechanism, the importance of FNFA's public policy role to the government, and prudent risk management practices balance the risk of FNFA's exposures to First Nations in Canada, which operate under an institutional framework that we view as weaker than that of other local and regional governments in the country.

Downside scenario

We could lower our rating over the next two years if there is material deterioration in risk mitigation mechanisms, including a substantial decrease in the federal or provincial portion of secured revenue streams with ongoing growth in borrowing members, without being replaced by equally stable revenue streams; or if the asset quality significantly deteriorates, indicating higher underlying risks of borrowers or persistently weak underwriting decisions suggesting weaker management and governance.

Upside scenario

We could raise our rating over the next two years if the management effectively strengthens its strategic positioning with a sustained track record of success in operating its business, suggesting stronger management and governance, while maintaining a strong liquidity position and robust asset quality.

Rationale

The 'AA-' rating reflects our view that FNFA's expanding loan book and strengthened market position as the most important lender to First Nations communities in Canada for infrastructure, economic, and social development financing needs, will support the institution's creditworthiness over the next two years. The rating also reflects our view of the authority's prudent risk management, conservative structural mechanisms, and strong liquidity cushion.

We expect FNFA's large and widening market share will continue to strengthen each year. This is demonstrated by the authority's increasing number of borrowing members as well as rising amounts of FNFA-issued debt of its members over the past few years. We expect that the assent of Bill C-45 last year to amend the First Nations Fiscal Management (FNFM) Act under which FNFA operates will lead to more expansion in the pool of potential borrowers, further solidifying its importance in the First Nations sector. This growth will also enable FNFA to maintain its operational independence.

Also underpinning the rating are the high level of loan repayment revenue streams that do not depend on local economic conditions but are federally or provincially tied, FNFA's remote data storage, its insurance coverage, and the ability of the authority's employees to work remotely. We believe that these factors will make the authority resilient to physical environmental risks, such as wildfires, that may be present in some areas of Canada where First Nations communities are located.

Sector risk profile: FNFA's creditor protection and risk mitigation mechanisms offset some of the weaknesses in the evolving institutional framework for First Nations in Canada.

We believe FNFA's structure of intercepted revenues mitigates the risk of lending exclusively to First Nations in Canada. First Nations borrowers pledge revenue streams that flow directly from the source to FNFA to cover loan payments, which FNFA prudently discounts to support loan repayments. More than 75% of these intercepted revenues come from the federal or provincial governments. They include provincial gaming revenue, provincial tobacco tax revenue and rebates, provincial forestry agreements, federal fishery agreements, and provincial petroleum royalties. In our view, this structure of intercepted revenues offsets some of the weaknesses in the institutional framework for First Nations in Canada and is a positive factor for the overall creditworthiness of the authority, given that the Canadian federal government and provinces operate in a stronger institutional framework than First Nations in Canada.

In our view, the institutional framework under which First Nations in Canada operate has historically been weaker than that of other local and regional governments in the country. The frequency and extent of reforms affecting the division of responsibility and revenues between First Nations and other levels of government has been evolving for more than a century. The historical and existing fiscal and legal structures have led to large socioeconomic gaps between First Nations and Canada, in part owing to weak equalization mechanisms. Therefore, in our view, the sector's economic resilience is somewhat weaker than that of Canada overall, particularly given the disparities in income per capita across First Nations. Nevertheless, reforms during the past decades all share the same goal to address some of the system's historical weaknesses and strengthen fiscal self-sufficiency.

Individual credit profile: Enhanced market position and prudent risk management are backed by robust liquidity and effective risk mitigation mechanisms.

We believe FNFA's market position continues to solidify with consistent growth in revenues, borrowers, and loans to members. In our view, the growth in the authority's loan book and market position reinforces FNFA's importance as a lender to the sector. The authority's loans to First Nations exceeded C$2.2 billion as of June 13, 2024, following annual growth of about 28% in the past five years. The authority is now the creditor of more than two-thirds of the debt of its members, compared with less than one-third in 2017. At the same time, a rising number--more than half--of over 600 First Nations communities in Canada has been scheduled to the FNFM Act, which is the first step to becoming an FNFA borrower. Of these, about 48% have now completed the process to become an FNFA borrowing member.

FNFA is a financial intermediary facilitating credit access for First Nations in Canada. It borrows in the capital markets and on-lends the proceeds exclusively to borrowing member First Nations. Created by federal legislation, FNFA is not an agent of the Government of Canada. Nevertheless, the authority benefits from a strong and supportive relationship with Canada, in our view. In addition, we expect recent enhancements to the FNFM act will further support its business position, as it will expand its borrower pool to include modern treaty and self-governing First Nations, tribal councils, and nonprofits serving Indigenous communities. The federal government also funded the costs associated with this amendment in 2023, showing continued support for FNFA, in our view.

We expect FNFA will continue to strengthen its operational self-sufficiency through ongoing expansion of its lending base. This is evidenced by its rising own-source revenue, led by net interest income and investment income. In the fiscal year ended March 31, 2024, the authority's operating surplus exceeded operational funding from the federal government for the third consecutive year. This reduces its reliance on federal operational support, thereby making the authority less exposed to potential political risk, should government funding priorities shift.

We expect that the authority's strong price position relative to its competitors will support healthy customer growth in the next several years, continuing a trend that began when FNFA started lending. Historically, access to capital has been difficult for many First Nations. Although it has improved in recent years, some impediments to lenders still exist, such as security or lenders' mandates. By statute, land or buildings on First Nations territories cannot be pledged as collateral.

We also believe FNFA's strong risk management policies and practices and solid governance represent management strengths. We expect that the authority's strategic positioning and organizational effectiveness will remain adequate as its staff increases. Management prepares an annual budget and internal loan portfolio and liquidity forecasts. Although FNFA is not subject to banking regulations or equivalent regulatory oversight, we believe that management has instituted robust financial and risk management policies that mitigate key risks.

FNFA's prudent legislative framework mitigates lending risk, in our view. Under this framework, First Nations that want to borrow from the authority must receive a financial performance certificate from the First Nations Financial Management Board (FMB) indicating compliance with certain financial ratios, among other requirements. In addition, legislation is in place concerning the mechanism used to intercept revenues that secure loan payments. Borrowers irrevocably pledge revenue streams to support their debt service obligations. These revenues do not include the base grants that the federal government pays to all First Nations to fund essential services. The broad geographic source of these revenue streams limits the risk of physical environmental events affecting any single First Nations community. FNFA's remote information storage, virtual work capabilities, insurance coverage, and nationwide presence further mitigate the environmental risks to operations, in our view. If necessary, a member must substitute a performing revenue stream for a nonperforming stream.

We view FNFA as a pass-through vehicle. As a result, given its not-for-profit nature, we view the authority's initial capital adequacy as adequate. Nevertheless, we view FNFA's strong risk mitigation mechanisms positively. The authority has never experienced defaults or arrears by borrowing members. Its intercept mechanisms, conservative risk tolerances, solid underwriting standards, and intervention powers enhance the asset quality, in our opinion.

FNFA has intervention power under the FNFM Act. If a First Nation is unable or unwilling to meet its debt service obligations under its loan agreement or replenish any shortfalls in the debt reserve fund (DRF), the authority can invoke the statutory intervention provision. If the act is invoked, the FNFA, together with the First Nations FMB, can remove and replace the council of the defaulting First Nation, thereby gaining access to the nation's revenues, including those that cannot be pledged.

FNFA has two main sources of capital: a borrower-funded DRF and the federal government-provided credit enhancement fund (CEF). As of March 31, 2024, the DRF and CEF stood at C$119 million and C$53.2 million, respectively. The DRF is the first-loss cushion for debt service nonpayment. FNFA withholds 5% of each member's loan request in the DRF. The federal government did not contribute to the CEF in 2023 or 2024 but injected nearly C$23 million over the three years preceding 2023.

In fiscal 2022, the federal government created a contingency fund to provide repayable financial support for FNFA's borrowing members, should they face difficulties due to the pandemic or subsequent widespread economic shock. The fund now holds C$35.5 million, with funding provided by Crown-Indigenous Relations and Northern Affairs Canada. In our view, the fund might not be available to absorb all losses, but only losses due to some events. Nevertheless, although no loans have been made from the fund to date, it could serve as an additional source of loss absorption, if drawn upon. We also believe that the establishment of this fund further solidifies the federal government's support of FNFA.

We view FNFA's overall funding and liquidity as strong, underpinned by structural stability of funding and strong liquidity ratios, which will continue to support the authority's creditworthiness.

The Canadian bond market, which we consider deep and diversified, provides 100% of FNFA's long-term funding. Although this somewhat concentrates the authority's funding sources, we believe it is offset by relatively stable funding versus lending commitments. Investor diversification is also improving based on investor type and domicile. Although loan terms extend as long as 30 years, the bonds mature in a shorter time frame. The authority has sought to mitigate this mismatch through adjustments to its relending rates upon debt refinancing, sinking funds, and revenue intercept mechanisms, among other measures.

In addition to its other liquid funds and cash and cash equivalents, the authority held about C$213.5 million in sinking funds as of March 31, 2024. However, FNFA's one-year liquidity and funding ratios weakened from historical levels to 1.0x and 0.86x, respectively, as of March 31, 2024. The decline in the ratios was due to the timing of issuance of its latest debenture and refinancing the outstanding debenture of C$251 million, which was due to mature this year. Therefore, we expect the ratios to structurally improve and remain well above 1.0x, each, in line with historical levels.

FNFA issued its 11th debenture, the largest to date, on June 11, 2024, for C$452 million in financing for First Nations communities, which indicates continued successful access to the market. This also marks the refinancing of its inaugural debenture issued in 2014. FNFA's liquidity is also bolstered by the borrower-funded DRF.

In addition, since late 2021, FNFA has operated a commercial paper program for a maximum amount outstanding of C$600 million, which is fully backed by a revolving credit facility with a syndicate of Canadian chartered banks. The program was sized up to C$600 million from C$400 million effective June 20, 2024. It is used to finance FNFA's interim loans.

Moderately high likelihood of support from the federal government in a stress scenario

The rating also incorporates our assessment that the likelihood of FNFA receiving timely and sufficient extraordinary support from the federal government, in the event of financial distress, will remain moderately high. This provides a one-notch uplift from the 'a+' stand-alone credit profile on the authority to the final 'AA-' rating.

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

- Strong link with the federal government, which the government's ongoing support for the authority's operations demonstrates; and
- Important role through the FNFA's statutory mandate and public policy role to facilitate First Nations' access to capital. Also supporting our assessment of the authority's important role is the political visibility of First Nations' issues generally, and the considerable need for capital on First Nations' land.

Table 1

First Nations Finance Authority--Selected indicators

	--Fiscal year ended March 31--					
(Mil. C$)	**2024**	**2023**	**2022**	**2021**	**2020**	**2019**
Business position						
Total adjusted assets	2,773	2,335	2,292	1,475	884	724
Customer loans (gross)	1,908	1,677	1,541	1,235	711	586
Growth in loans (%)	13.8	8.8	24.8	73.7	21.3	29.2

Table 1

First Nations Finance Authority--Selected indicators (cont.)

	--Fiscal year ended March 31--					
(Mil. C$)	**2024**	**2023**	**2022**	**2021**	**2020**	**2019**
Net interest revenues	5.5	5.0	4.4	1.8	1.2	1.0
Noninterest expenses	10.0	8.5	4.9	3.6	4.6	4.2
Capital and risk position						
Total liabilities	2,656	2,226	2,190	1,420	832	688
Total adjusted capital	172	154	140	114	83	63
Assets/capital	16.1	15.1	16.4	12.9	11	11.9
Funding and liquidity*						
Liquidity ratio with loan disbursement (one year)	1.0	1.5	1.5	1.2	1.8	1.2
Liquidity ratio without loan disbursement (one year)	1.0	1.5	1.5	4.2	3.3	1.5
Funding ratio (one year)	0.9	1.3	1.4	4.2	3.6	1.4

*Includes undrawn portion of credit facility. Funding ratio is without loan disbursements.

Table 2

First Nations Finance Authority--Ratings score snapshot

Issuer credit rating	AA-/Stable/--
Sector risk profile	Adequate (3)
Individual credit profile:	
Business position	Adequate (3)
Management & governance	Adequate (3)
Capital adequacy	Strong (2)
Funding & liquidity	Strong (2)
Anchor	a+
Overriding factors and caps	0
Holistic analysis	0
Stand-alone credit profile	a+
Extraordinary support	1

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Non-U.S. Public-Sector Funding Agencies, July 26, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015

- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded

	To	From
First Nations Finance Authority		
Senior Secured	AA-	A+

Upgraded; CreditWatch/Outlook Action

	To	From
First Nations Finance Authority		
Issuer Credit Rating	AA-/Stable/--	A+/Positive/--

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.spglobal.com/ratings for further information. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.