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New Zealand Local Government Funding Agency Ltd.

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New Zealand Local Government Funding Agency Ltd.

Major Rating Factors

Counterparty Credit Rating
Foreign Currency
AA/Stable/A-1+
Local Currency
AA+/Stable/A-1+

Strengths:

- "Extremely high" likelihood of extraordinary support from the New Zealand government
- Single-purpose focus in lending to New Zealand's local government sector
- Sound aggregate credit quality
- Good liquidity position

Weaknesses:

- Weak earnings, reflecting its not-for-profit role

Rationale

The ratings on New Zealand's Local Government Funding Agency (LGFA) reflect our view of the entity's "extremely high" likelihood of extraordinary support from the New Zealand government, arising from the LGFA's "integral" links to the New Zealand government, combined with its "very important" role under our government related entity (GRE) criteria. The ratings on LGFA also reflect the organisation's strong stand-alone credit profile, arising from its sole role of providing debt finance to the New Zealand local and regional government (LRG) sector, the sound aggregate credit quality of that sector, and LGFA's prudent liquidity policies. These strengths are moderated by the organisation's wholesale funding profile and our expectation that risk-weighted capitalisation will progressively decline from initially strong levels as lending increases against a backdrop of a small capital base.

In accordance with our GRE criteria, our view of an "extremely high" likelihood of extraordinary support is based on our assessment of LGFA's:

- "Very important" role. LGFA is expected to become the main funding source for the LRG sector. Additionally, LGFA provides several benefits to the central government, including the deepening of the New Zealand capital markets and an additional source of liquidity for New Zealand banks, as well as providing greater efficiency at the local government level.
- "Integral" link with the New Zealand government. This link stems from LGFA's very close operational links with the New Zealand government's Debt Management Office (DMO), which executes funding and investing functions (on instructions from LGFA). LGFA's enabling legislation allows the New Zealand government to lend money to LGFA if it is in the public interest to do so or if it is necessary to meet a temporary shortfall. The debts of LGFA will not, however, be guaranteed by the New Zealand government. While not specifically a government agency, LGFA's special purpose is encoded in its shareholder agreement, which we view as further reinforcing its linkage to the government.

LGFA has been established to provide a central point for financing the New Zealand LRG sector, and is expected to provide better funding margins and greater efficiencies. This single purpose has been enshrined in the company's shareholder agreement. The initial group of nine New Zealand councils that formed the steering group holds the majority of LGFA's share capital. The New Zealand government holds a further 20% and other councils the remainder.

The institutional framework in which the New Zealand LRG sector is considered by Standard & Poor's to be predictable and transparent, and underpins the sector's overall credit quality. A financial planning framework is enshrined in legislation, including the need for long-term financial planning. Financial plans and reports are audited by the central government's audit office, including for their financial sustainability.

LGFA does not hold a banking license, and all funding is expected to be raised from domestic and international debt capital markets. It will use both retail and wholesale funding, and we believe demand will be sound, particularly given the favorable regulatory treatment of government debt and its (typically) repo-eligibility. Liquidity risk will be alleviated through the broad matching of asset and liability maturities, while LGFA will have access to a liquidity line from New Zealand's DMO, initially NZ$500 million in size but increasing to NZ$1 billion over four years. The DMO will also be LGFA's sole hedge counterparty. Finally, we expect that a sizeable proportion of its loan portfolio will be repo-eligible with the Reserve Bank of New Zealand.

Although LGFA's earning are expected to be weak, this reflects its not-for-profit role. LGFA is not a profit-maximizing entity, but rather is focused on lowering the funding costs for LRGs. LGFA expects to minimize its net interest margin to a level that will cover its cost base and allow it to pay out a capped return to shareholders.

Outlook

The stable outlook reflects our expectation that the will be no change in the New Zealand Government's support of LGFA. Downward pressure on the rating is unlikely, and would only occur if there were a change in LGFA's relationship with the New Zealand government. This would likely only occur if the New Zealand government withdrew its capital or cancelled LGFA's backstop liquidity line. LGFA's ratings are linked to the sovereign's ratings, and therefore a lowering in the sovereign ratings could also result in a lower rating for LGFA.

Comparative Analysis

LGFA is comparable with: Kommuninvest (Sweden) , KommuneKredit (Denmark) , KBN Kommunalbanken Norway (Norway), Municipality Finance PLC (Finland), Japan Finance Organization for Municipalities ("JFM", Japan), and to some extent two Dutch public-sector banks: Bank Nederland's Gemeenten N.V. and Nederlandse Waterschapsbank N.V. These municipal funding agencies all supply low-cost funding to the LRG sector in their respective countries, providing them with low-risk assets. All of the municipal funding vehicles have very strong credit profiles, in our view, with similarly high asset quality, prudent asset-liability management, and strong liquidity. In terms of liquidity access, LGFA, Kommuninvest, and Municipality Finance have access to repos with their central banks. LGFA also has a committed liquidity facility with the New Zealand DMO. JFM's liquidity position is relatively modest compared to LGFA and the Nordic agencies, as it does not have the same level of access.

We consider the ownership and support structure of LGFA to be as strong as the Nordic agencies, although the structures are different. Ownership of Kommuninvest and KommuneKredit rests with their respective LRG members, which have signed joint and several guarantees. KBN Kommunalbanken Norway receives support from its owner, the central government of Norway. By contrast, the municipalities that own Municipality Finance are jointly liable for its liabilities on a pro rata basis via Finland's Municipal Guarantee Board, which provides a last-resort guarantee. LGFA has the best of both, with a joint-and-several guarantee between its guarantors (the LRG shareholders and/or borrowers who borrow more than NZ$20 million from LGFA) as well as strong support from the central government.

LGFA's concentration risk ratios are in line with those of its peers in the Nordic region (see table 1).

Table 1

LGFA Peer Comparison

	New Zealand Local Government Debt Vehicle	KBN Kommunalbanken Norway	KommuneKredit	Kommuninvest Sverige AB	Municipality Finance PLC	Japan Finance Organization for Municipalities
Issuer credit rating	AA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AA-/Negative/A-1+
Country	New Zealand	Norway	Denmark	Sweden	Finland	Japan
Sovereign credit rating	AA/Stable FC; AA+/Stable LC	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AA-/Negative/A-1+
Establishment date	2011	1926	1898	1986	1989/1993	1957
Guarantee structure	Joint and several guarantee from local and regional governments	100% owned by the Norwegian government. Letter of support from owner.	Joint and several guarantee from local and regional governments	Joint and several guarantee from local and regional governments	Municipalities on a joint basis through municipal guarantee board	Direct guarantee to the qualified bonds (issued before 2000 and its refinancing) from the central government; ultimate guarantee collectively from LRGs
Market share (%)	Forecast ~30% within 3 years	47	More than 90	40	About 50	9%~13% in recent 5 yrs
Competition	Limited	Limited	Very limited	Limited	Limited	Competitive but segmented, dominant in longer tenure
Adj. equity/adj. assets (%)	2.7 in 2014F*	2	3.1	0	1.2	0.2
Adj. equity/customer loans (%)	3.0 in 2014F*	3	3.9	0	1.8	0.2
Default	None known in sector	None	None	None	None	None

*Adjusted equity comprises principal equity, subordinated debt securities, and retained earnings.

Profile

LGFA is a single-purpose entity created to provide a central funding vehicle for New Zealand's local governments. Its single purpose is enshrined in its shareholder agreement, as are many of its risk policies. We understand that of the nine sponsoring councils, eight have committed to sourcing 80% of their funding needs through LGFA, with the residual sourcing 30% for three years; we also expect other New Zealand LRGs to source the majority of their term funding needs through LGFA, which is likely to result in LGFA exhibiting a strong market position.

The bulk of LGFA's operational activities are outsourced to the New Zealand DMO, which is responsible for central government funding. As well as its expertise in capital markets and liquidity management, the DMO will execute LGFA's funding and investing functions (on instruction from LGFA). The operational support provided by the DMO is covered by an outsourcing agreement.

Support and Ownership

LGFA is owned by New Zealand local governments (about 80%) and the Crown (about 20%). It is majority owned by the nine sponsoring councils. Ownership is restricted to New Zealand councils and the Crown. In addition to equity ownership, the LRG shareholder borrowers in excess of NZ$20 million are party to a joint-and-several guarantee. LGFA is defined as a "council-controlled organization" under the Local Government Act.

Standard & Poor's rates LGFA in accordance with our criteria for rating government-related entities (GREs). Under this criteria, we believe that enhancement to LGFA's rating can be derived from an "extremely high" likelihood of extraordinary government support to LGFA in a distress scenario. This is based on our view that LGFA has a "very important" role in the New Zealand market and "integral" links with the New Zealand government.

LGFA's "extremely high" likelihood of extraordinary support stems from its:

- "Very important" role. LGFA is expected to become the main funding source for the LRG sector. Additionally, LGFA provides several benefits to the central government, including the deepening of the New Zealand capital markets and an additional source of liquidity for New Zealand banks, as well as providing greater efficiency at local government level.
- "Integral" link with the New Zealand government. This link stems from LGFA's very close operational links with the New Zealand government's DMO, which will execute LGFA's funding and investing functions (on instruction from LGFA). LGFA's enabling legislation allows the New Zealand government to lend money to LGFA if it is in the public interest to do so or if it is necessary to meet a temporary shortfall. The debts of LGFA will not, however, be guaranteed by the New Zealand government. While not specifically a government agency, LGFA's special purpose is encoded in its shareholder agreement, which we view as further reinforcing its linkage to the government.

Strategy

LGFA is intended to provide local governments with better access to funding at cheaper rates than LRGs can source individually, while maintaining a low risk profile. By centralizing funding, LGFA benefits from asset diversification and reduces aggregate credit risk. Its higher rating than several individual local governments should provide it with better funding rates, while larger debt issuance sizes are expected to attract a greater range of investors. Additionally, it will have the ability to raise foreign-currency funding (which it will swap back to domestic currency), further deepening the investor pool. Over time, LGFA will also result in broadening and deepening New Zealand's capital markets.

Credit risk

We view LGFA's credit risk as low, based on the good credit quality of New Zealand's LRGs combined with LGFA's policy of securing loans to local government against their rates income. There is, however, geographic concentration in the portfolio, as LGFA is restricted to lending to New Zealand local governments. Each holder of voting shares (other than the New Zealand government and Auckland Council, Taupo District Council, and Waipa District Council) will commit to borrowing 80% of their funding requirements from LGFA for three years. There is also some single-name concentration, as 30%-50% of its loans are expected to be to Auckland Council--this is in line with Auckland's proportion of New Zealand LRG debt, however. After three years, Auckland Council will be limited to a maximum of 40% of LGFA's total local government assets.

We consider New Zealand LRGs generally as having fairly stable credit quality. This is due to our view of the strong institutional framework in New Zealand around LRGs. Local governments are required to undertake long-term financial planning--out to 10 years--including capital expenditure and funding sources. Long-term plans are audited by Audit New Zealand, as are LRGs' annual reports. This transparent and predictable framework provides some protection, in our opinion, against sharp deterioration in the fiscal position of a local government in New Zealand. There are no known local government defaults in New Zealand.

LGFA's loan growth is expected to be very strong initially, as it anticipates building significant market share in the local government sector. LGFA will have credit policies in place that prohibits lending to local governments that do not meet certain covenants unless they seek approval from the board in the first instance and from other shareholders in the second instance. Further, councils are required to have security over rates.

Market risk

LGFA intends to have minimal risk. Foreign currency funding will be swapped back to New Zealand dollars, and LGFA intends to run a largely matched loan portfolio to funding, reducing interest rate risk. The majority of both assets and liabilities will re-price quarterly.

Funding and liquidity risk

We view LGFA's liquidity position as adequate, and expect it to have good access to wholesale markets. We believe LGFA funding and liquidity policies are appropriate.

We believe liquidity risk will be alleviated to an extent through the broad matching of asset-and-liability maturities. We also understand LGFA intends to hold about liquid assets equivalent to at least 10% of LRG assets, while LGFA will also have access to a liquidity line from New Zealand's DMO, initially NZ$500 million in size before increasing to NZ$1 billion over four years. Finally, we expect that a sizeable proportion of its loan portfolio will be repo-eligible with the Reserve Bank of New Zealand; based on our liquidity estimations, which include a conservative 'haircut' on repo-eligible loans, we believe LGFA's liquidity position is adequately positioned to manage a series of adverse scenarios in the short-to-medium term.

LGFA will source funding from wholesale and retail debt markets, and intends to issue both local-and foreign-currency funding. Despite the confidence-sensitive nature of wholesale funding, we believe demand will be sound, particularly given the favorable regulatory treatment of government debt and the (typically) repo-eligibility. The maturity profile of debt is intended to largely match the maturity profile of loans to local governments and so will be mostly long-term in nature. The intent of the LGFA is to allow local governments to extend the maturity profile of liabilities so they better match the long-term infrastructure projects they are funding.

Profitability

LGFA is not a profit-maximizing entity, focused as it is on lowering the funding costs for LRGs. LGFA expects to minimize its net interest margin to a level that will cover its cost base and allows it to pay out a capped return to shareholders.

Pricing is to be differentiated on the basis of an assessment of the borrower's credit quality, and whether the borrower is a party to the joint-and-several guarantee. Credit quality and borrowed amount both affect the overall efficiency of LGFA and the price at which it can attract funds, while the greater the number of parties to the guarantee, the greater the enhancement to security and liquidity of LGFA.

Capital

LGFA's capitalisation is sound, predominantly reflecting the financial flexibility inherent within LGFA's capital structure. Although principal equity is expected to remain unchanged at NZ$25 million, this will be supplemented by the issuance of subordinated debt securities, which increase proportionally as the utilisation of LGFA by local governments increases. The subordinated notes can be converted into redeemable shares--to be issued to the LRGs--in the event that the board of LGFA deems necessary to avoid default. Further, we believe LRGs would be supportive of providing additional equity--noting that all earnings are repatriated back to local governments--particularly if LGFA is successful in meeting its objectives.

We understand LGFA intends to maintain its capitalization at or above an amount equivalent to 1.6% of its loan portfolio, which would approximate a 8% regulatory capital ratio based on the Basel II Standardised approach, although we note that based on supplied forecasts, LGFA's capitalisation will be closer to 2% and 10%, respectively. Based on Standard & Poor's framework for assessing capitalisation of financial institutions, LGFA's risk-adjusted capital ratio is forecast to commence strongly at 19.0% at end-2012, before progressively declining to an estimated 13.5% in fiscal 2014. That said, our opinion on LGFA's capitalisation is focused on its flexible structure and our expectation that additional capital would be forthcoming from LRGs if necessary.

Ratings Detail (As Of December 6, 2011)		
New Zealand Local Government Funding Agency Ltd.		
Counterparty Credit Rating		
Foreign Currency		AA/Stable/A-1+
Local Currency		AA+/Stable/A-1+
Counterparty Credit Ratings History		
06-Dec-2011	*Foreign Currency*	AA/Stable/A-1+
06-Dec-2011	*Local Currency*	AA+/Stable/A-1+
Related Entities		
Earthquake Commission		
Financial Strength Rating		
Local Currency		AA+/Stable/--
Issuer Credit Rating		
Local Currency		AA+/Stable/--
Genesis Power Ltd.		
Issuer Credit Rating		BBB+/Stable/NR
Senior Unsecured (7 Issues)		BBB+

Ratings Detail (As Of December 6, 2011) **(cont.)**	
Subordinated (1 Issue)	BB-
Kiwibank Ltd.	
Issuer Credit Rating	AA-/Stable/A-1+
Certificate Of Deposit	
Local Currency	A-1+
Subordinated (2 Issues)	A+
Kiwi Capital Securities Ltd.	
Preference Stock (1 Issue)	BB+
Meridian Energy Ltd.	
Issuer Credit Rating	BBB+/Stable/A-2
Commercial Paper	
Local Currency	A-2
Senior Unsecured (1 Issue)	A-2
Senior Unsecured (9 Issues)	BBB+
Senior Unsecured (1 Issue)	BBB+/Stable
Mighty River Power Ltd.	
Issuer Credit Rating	BBB+/Stable/NR
Senior Unsecured (7 Issues)	BBB+
Senior Unsecured (1 Issue)	BBB+/Stable
New Zealand	
Issuer Credit Rating	
Foreign Currency	AA/Stable/A-1+
Local Currency	AA+/Stable/A-1+
Transfer & Convertibility Assessment	AAA
Senior Unsecured (26 Issues)	AA
Senior Unsecured (11 Issues)	AA+
New Zealand Post Ltd.	
Issuer Credit Rating	AA-/Stable/A-1+
Certificate Of Deposit	
Local Currency	A-1+
Commercial Paper	A-1+
Senior Unsecured (1 Issue)	AA
Senior Unsecured (2 Issues)	AA-
Subordinated (1 Issue)	A

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.