MOODY'S
INVESTORS SERVICE

Credit Opinion: First Nations Finance Authority

Global Credit Research - 07 Aug 2015

Kelowna, British Columbia, Canada

Ratings

Category	**Moody's Rating**
Outlook	Negative
Issuer Rating -Dom Curr	A3
Senior Unsecured -Dom Curr	A3

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Key Indicators

First Nations Finance Authority (Year Ending 3/31)	**2011**	**2012**	**2013**	**2014**	**2015**
Total Direct Debt (C$000)			**20,776**	**54,049**	**104,821**
Loans Outstanding to Clients (C$000)			**20,778**	**54,143**	**103,367**
Total Cash and Investments (C$000)	**10,690**	**11,638**	**12,237**	**13,597**	**19,820**
Interest Income as % of Revenues			**19.2**	**33.4**	**56.4**
Net interest margin (%)			**0.10**	**0.11**	**0.16**
Operating Margin as % of Revenues	**85.9**	**33.9**	**-30.1**	**-26.7**	**-2.5**
Cash and Investments as % of Net Debt			**119.1**	**30.9**	**22.1**

Opinion

SUMMARY RATING RATIONALE

FNFA's A3 ratings reflects (1) the slightly improved diversification of the loan portfolio in terms of borrowers and geography following the successful placement of the reopening of the debenture which has increased the number of participating borrowing members to 24 from 14 previously; (2) solid debt service coverage ratios; (3) a sound institutional framework and governance and management structure, (4) the oversight of borrowing members by the First Nations Financial Management Board (FMB) and (5) strong likelihood of extraordinary support from the federal government. The rating remains constrained by marginal profitability (net interest margin of 0.16% in 2014-15), still relatively high concentration of borrowing members and short operating history given the nascent status of FNFA as an organization.

FNFA's institutional framework and governance and management structure provide debenture holder security, including structural mechanisms such as debt reserve funds (5% of outstanding debenture debt), a CAD10 million credit enhancement fund, a CAD3.35 million sinking fund which is expected to increase in the next few years, as well as a debt reserve fund replenishment requirement of all borrowing members. This is supported by extensive requirements that need be fulfilled in order for a First Nation to become a borrowing member and be granted a loan from FNFA.

Credit Strengths

- Strong oversight and monitoring power support quality of loan portfolio

- Debt reserve fund and credit enhancement fund provide additional security to bondholders

- Solid governance and management structure

- Improving concentration of loan portfolio

Credit Challenges

- Rapid growth adds pressure on operations and relative reserve levels

- Relatively new organization with limited track record and marginal profitability

Rating Outlook

The negative rating outlook reflects our concern that that the expected rapid rate of growth of FNFA's loan portfolio could impose challenges to an entity with a short-term operating history in terms of maintaining adequate lending practices as well as improving operating performance despite a stringent qualification process for new borrowers to become a borrowing member. It also reflects the risk that a higher amount of secured debt outstanding under its CAD100 million revolving credit facility could potentially weaken the senior unsecured bondholder's position, if not refinanced in a timely manner.

What Could Change the Rating - Up

Material and sustained improvement in the credit quality, size and diversity of the participant pool along with an increase in liquidity relative to outstanding debt could put upward pressure on the rating.

What Could Change the Rating - Down

A deterioration of lending practices, credit quality of the loan portfolio or a reduction in reserves could put downward pressure on the rating. Indications of lower support from the federal government could also put downward pressure on the rating. In addition, material drawings under the senior secured credit facility for more than a few months that weaken the structural position of senior unsecured bondholders could lead to a downgrade of its senior unsecured debenture ratings.

Issuer Profile

The First Nations Finance Authority (FNFA) is a non-profit organization without share capital that serves First Nation governments. It is one of three First Nation led national institutions legislated under the First Nations Fiscal Management Act by the Government of Canada. The First Nations Fiscal Management Act (FNFMA) came into force on 1 April 2006 and established three institutions (1) First Nations Finance Authority (FNFA), (2) First Nations Tax Commission (FNTC) and (3) First Nations Financial Management Board (FMB).

FNFA acts as a central borrowing agency for financing capital requirements and economic and social development projects of member First Nations. In addition to providing long-term capital financing for member First Nations, the stated objectives of the Authority include the provision of interim financing and short-term investment opportunities for First Nations. FNFA is not an agent of the crown nor a crown corporation; obligations of FNFA are not obligations of Canada and are not guaranteed by the federal government.

DETAILED RATING CONSIDERATIONS

The A3 ratings of FNFA reflect the application of Moody's Joint Default Analysis rating methodology for government-related issuers. In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) of baa2 for FNA, and then considers the likelihood of extraordinary support from the Government of Canada (Aaa, stable) in the event that FNFA faced acute liquidity stress, should this extreme situation occur.

Baseline Credit Assessment

STRONG OVERSIGHT AND INTERVENTION POWER SUPPORT QUALITY OF LOAN PORTFOLIO

The quality of FNFA's loan portfolio is supported by a stringent qualification process for becoming a borrowing member, a revenue interception mechanism and debt coverage ratio covenants as well as strong intervention powers granted to the authority under the First Nations Fiscal Management Act (FNFMA).

A First Nation must first request to the Minister of Aboriginal Affairs and Northern Development Canada (AANDC) to be scheduled to the FNFMA, which sets out its obligations including obligations to FNFA. A potential member must then pass a band council resolution to apply to become a member and satisfy certification requirements with the FMB, which is responsible for financial management system certification for First Nations. As part of this certification process, FMB analyzes the financial performance of the First Nation. FMB also aids the First Nation in developing a Financial Administration Law, which outlines the decision making, management, monitoring and reporting with respect to financial administration of the First Nation. Moreover, in addition to the requirement of FMB certification, a First Nation must also gain unanimous approval of the FNFA board before becoming a member. This multi-step membership process aids in maintaining the credit quality of borrowing members and by extension, the loan portfolio.

The FMB conducts regular monitoring and oversight of borrowing members and has the power to intervene and arrange a co-management arrangement or third-party management of a First Nation's revenues if necessary. The FNFA also has the power to request intervention by the FMB if the First Nation fails to make a payment or fulfill an obligation under its Borrowing Agreement. The FMB has the power to take control over the treasury functions of a borrowing member that has received a loan and then has access to all revenue streams of that borrowing member.

Furthermore, the FNFMA outlines the uses for which a First Nation can borrow. Namely, it states that members can borrow for infrastructure when borrowing supported by property tax and for economic and community infrastructure tied to social and economic development when borrowing supported by other revenues, such as for capital infrastructure and land. Currently all outstanding borrowing is only supported by other revenues and not property tax revenue.

Once a borrowing agreement is signed with a borrowing member, an irrevocable intercept mechanism, a Secured Revenue Trust Account (SRTA), is put in place to capture the revenue stream used to support the First Nation's loan. The trust account diverts the gross revenues of those revenues that will be used against borrowing following minimum debt coverage ratios (DCR); anything in excess of that needed for the borrowing is then diverted back to the First Nation. These DCRs depend on the type of pledged revenues in support of the loan, i.e. higher debt coverage ratios are required for higher risk revenues such as land benefit agreements versus government transfers. Invoicing is also based on revenue frequency, so if revenue streams are received monthly, monies toward repayment will be collected monthly and prior to debt service payments. This allows extra time to resolve any issues prior to any debt service payments.

DEBT RESERVE FUND AND CREDIT ENHANCEMENT FUND PROVIDE ADDITIONAL SECURITY TO BONDHOLDERS

As of March 31, 2015, FNFA had cash and investments on balance sheet of CAD19.8 million (around 22% of direct debt). Cash and investments include the Credit Enhancement Fund (CEF) of CAD10 million received from the Government of Canada as well as a Debt Reserve Fund (DRF) of CAD5.2 million. Following the re-opening of the existing debenture due 2024 by CAD50 million in July 23, 2015 we expect the DRF to increase to around CAD7 million (5% of total outstanding debentures).

The DRF provides liquidity in the event of non-payment by a borrowing member. Assets in the DRF are invested mostly in liquid securities. Should there be a non-payment on an obligation, the FNFA would first work to recover the payment but can also tap into the DRF. In case of a shortfall in the DRF all borrowing members would be required to replenish the DRF without limit. As debt coverage ratios are set above required debt service payments, this allows FNFA to replenish the DRF directly from the Secured Revenue Trust Account.

The CEF can be used to temporarily offset shortfalls in the DRF, providing additional protection to bondholders.

In addition to the liquidity provided by FNFA's reserve funds (DRF and CEF), the Authority also earns income through its pooled investment activities that could be used and has access to a secured revolving credit facility with a Canadian chartered bank in the amount of CAD100 million for the financing of interim loans.

SOLID GOVERNANCE AND MANAGEMENT STRUCTURE

FNFA's Board of Directors currently consists of nine directors, including a Chair and Deputy Chair. The Board is elected by borrowing and investing members, but only borrowing members can be elected to the Board. The terms are one year and renewable. With the latest election in July 2015, geographical representation of the Board continued to be diversified, which was a key objective of FNFA.

Borrowing members are First Nations that have applied to and have been accepted by the Authority's Board as a borrowing member. Investing Members are First Nations that have invested in the Authority's Pooled Investment Funds.

The Act restricts the spectrum of allowed investments to fixed-income securities issued or guaranteed by Canadian governments or Canadian chartered banks or savings institutions. No equity investments are allowed. FNFA has conservative debt and investment management policies, which limits its exposure to market-related risks.

Furthermore, there is an extensive credit approval process. First Nations borrowing through the Authority must meet financial certification requirements and each loan requested from the Authority must be reviewed by the Board and Members of the Authority and receive unanimous approval prior to funding. The annual operating budget is also approved by the Board.

IMPROVING CONCENTRATION OF LOAN PORTFOLIO

The concentration of FNFA's loan portfolio has improved with the recent CAD50m reopening of the debenture. The total outstanding debenture now amounts to CAD140 million and includes 24 participating borrowing members up from 14 previously. In addition, FNFA expects to nearly fully draw under its CAD100 million senior secured revolving credit facility in order to finance interim loans. We assumes that outstanding amounts under the revolving credit facility will be refinanced with senior unsecured debentures over the next few months.

The majority of current borrowing members that received loans benefit from positive operating results. The 24 borrowing members that participated in the CAD140 million debenture recorded a median consolidated surplus/revenue of 8.7% in 2013-14 (average median of 4.8% for the period 2010-2014).

RAPID GROWTH ADDS PRESSURE ON OPERATIONS AND RELATIVE RESERVE LEVELS

While rapid growth of the loan portfolio increases portfolio diversification it also imposes challenges to FNFA's relatively young organization in terms of maintaining adequate lending practices, improving operating performance as well as maintaining healthy reserve levels relative to total outstanding debt. The loan portfolio has doubled since rating assignment and FNFA targets continued strong growth of its loan portfolio over the next 12 months.

As the growth in FNFA's debt outpaces the growth in reserves, the current security to the bondholders (Debt Reserve Fund, Credit Enhancement Fund and sinking fund) will represent a decreasing share of debt if borrowings continue to grow at a rapid pace going forward. The Debt Reserve Fund will be maintained at 5% of outstanding debenture debt. The Credit Enhancement of CAD10 million will remain constant and the CAD3.35 million sinking fund will only increase gradually over the next few years when borrowers begin to repay principal under their amortizing loans.

RELATIVELY NEW ORGANIZATION WITH LIMITED TRACK RECORD AND MARGINAL PROFITABILITY

FNFA has a limited track record of operating as a specialized lender, which is reflected in its small loan portfolio, a marginal net interest margin of around 0.16% and consolidated deficits over the last three years. In its start-up phase as a lender FNFA has received most of its revenues through grants and contributions from Aboriginal Affairs and Northern Development Canada (AANDC). The share of federal grants relative to total revenue (40% in 2013-15) has declined and interest on client loans now account for the majority of revenue (56% in 2014-15).We anticipate that FNFA will continue to benefit in the intermediate term from grants from AANDC, highlighting the support from the federal government to FNFA. Furthermore, we project FNFA to post a similar net interest margin in 2015-16 as in the prior two years. However, as FNFA continues to build its loan portfolio, we expect that higher initial operating costs should decline, supporting modest improvements in its operating performance and small surpluses going forward.

STRUCTURAL CONSIDERATIONS

As of July 21, 2015 and following a CAD50 million reopening of the debenture, FNFA's outstanding debenture debt was comprised of 140 million senior unsecured debenture due June 2024. In addition, we expect that FNFA will nearly fully draw under its secured revolving credit facility of CAD100 million maturing in October 2016 for the financing of interim loans. The CAD140 million senior unsecured debenture is effectively subordinated to FNFA's CAD100 million secured revolving credit facility, to the extent of the value of the assets securing the revolving credit facility. The senior secured revolving credit facility benefits from a lien on all of FNFA's assets, present and future. The current senior unsecured rating assumes that the outstanding amounts under the credit facility will be refinanced with debenture borrowings in the next few months.

Extraordinary Support Considerations

The Joint-Default Analysis methodology also considers the likelihood of extraordinary support coming from the Government of Canada (Aaa, stable) to prevent a default by the FNFA. Moody's assigns a strong likelihood of support, reflecting the creation and support of FNFA and supporting institutions by Canada through legislation as well as the important government-defined mandate of the FNFA in providing financing for First Nations in Canada.

Moody's also assigns a very high default dependence level between FNFA and the Government of Canada, reflecting the two entities' shared exposure to common economic and financial risks.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a Government Related Issuer (GRI) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0 - 30%), moderate (31 - 50%), strong (51 -70%), high (71 - 90%) and very high (91 - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to GRIs, default dependence reflects the tendency of the GRI and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the government to provide extraordinary support and prevent a default by a GRI is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' credit profiles, the lower the benefits achieved from joint support. In most cases GRIs demonstrate moderate to very high degrees of default dependence with their supporting governments, which reflects the existence of institutional linkages and shared exposure to economic conditions that draw credit profiles together.

Default dependence is described as either low (30%), moderate (50%), high (70%) and very high (90%).