STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

First Nations Finance Authority

Primary Credit Analyst:
Stephen Ogilvie, Toronto (1) 416-507-2524; stephen.ogilvie@standardandpoors.com

Secondary Contact:
Bhavini Patel, CFA, Toronto (1) 416-507-2558; bhavini.patel@standardandpoors.com

Table Of Contents

Rationale

Outlook

Moderately High Likelihood Of Extraordinary Support

Business Profile

Lender To First Nations' Councils

Good Asset Quality

Leverage

Asset-Liability Management Is Good

Profitability Is Improving But Still Weak

Related Criteria And Research

First Nations Finance Authority

Rationale

Issuer Credit Rating
A-/Stable/--

The ratings on First Nations Finance Authority (FNFA) reflect Standard & Poor's Ratings Services' view of the authority's solid competitive position in a niche market, prudent structural mechanisms that enhance asset quality, support for operations from the federal government, and moderate leverage. We believe that the FNFA's low-but-improving level of profitability and the concentration of its loan portfolio somewhat offset these strengths. We have assessed the authority's stand-alone credit profile (SACP) as 'bbb'.

In accordance with our government-related entity criteria, we view the likelihood of the FNFA receiving extraordinary government support as moderately high, resulting in an uplift of two notches from the SACP, based on our assessment of the strong link with the federal government, which the government's funding support for the authority's operations demonstrates. We also believe the FNFA plays an important role because of the need for access to capital by First Nations, the authority's statutory mandate to lend to approved First Nations, the political visibility of First Nations issues generally, and the condition of infrastructure on First Nations territories specifically.

We believe the FNFA has a solid competitive position in its niche market. Historically, access to capital has been a challenge for many First Nations. In recent years, access has improved but some impediments to lenders remain, such as security or lenders' mandates. By statute, land or buildings on First Nations territories cannot be pledged as collateral. By mandate, the FNFA is authorized to lend to councils for tax-supported debt requirements -- other lenders are not. Furthermore, some First Nations have capital needs (and debt repayment capacity) that exceed the ability or willingness of existing lenders to supply capital in our opinion. We estimate total capital needs for Canadian First Nations to easily exceed C$5 billion. Those needs are the typical needs of all Canadian communities: infrastructure (water and roads), community-owned housing, equipment, and economic development. Because of these favorable demand and supply conditions, we believe that the authority does not and will not face pricing pressures and we do not expect this to change. We do not expect an influx of new lenders into this market, although existing lenders will likely increase their lending.

The FNFA was created by federal statute and the government has supported the authority since its inception. Owing to its small loan portfolio size and start-up costs, the authority has produced operating deficits in the last three fiscal years. In response, the government increased its grants to the FNFA in the past two fiscal years (year ended March 31) and will again in fiscal years 2016 and 2017. We expect the government will support the authority until it achieves self-sufficiency.

At fiscal year-end 2015, the FNFA's capital base was about C$10.3 million, consisting of equity of C$300,000 and reserves (credit enhancement fund [CEF]) of C$10.0 million. Borrowing (long-term and interim) was about C$107.7 million, or 10x the capital base. Long-term lending increased to about C$230 million as of October 2015. For fiscal 2016 and beyond, we expect the FNFA to issue more than C$100 million annually. Total debt and loans outstanding could exceed C$600 million by fiscal year-end 2018. The consequences of continuing issuance at this level are that

FNFA's capital base will become inadequate relative to its leverage. However, the loan portfolio's projected expansion will increase management fees and net interest income and make the authority profitable. Achieving profitability will ultimately bolster capital reserves, which should mitigate the increase in leverage somewhat. We believe the FNFA could also receive an equity injection from the federal government over our two-year outlook horizon.

The authority's profitability is improving steadily but results remained weak at fiscal year-end 2015. In fiscal 2015, it reduced its shortfall to C$127,379 on higher government grants and management fees, which was a big improvement from the C$659,349 loss a year earlier. Net income as a share of average assets improved to negative 0.13% from negative 1.30%; and return on equity strengthened, to negative 1.2% from negative 5.9% a year earlier. We expect the authority will produce balanced results at a minimum or a modest surplus in fiscal 2016 thanks to increases in continuing federal grants and management fees. As well, previous one-time start-up expenses will not weigh on results. Accordingly, we expect that profitability measures will improve as the loan portfolio continues to grow.

The FNFA faces concentration risk. With a mandate to lend to First Nations, the authority's loan book is and will be very concentrated by type of borrower, namely First Nations' councils. However, the financial strength and sound financial practices of Borrowing Members will mitigate this risk somewhat. Geographically, loans are concentrated in British Columbia (B.C.), but we expect this concentration to diminish as it did in fiscal 2015, to 61% from 63%. Single-name concentration has also fallen as more Borrowing Members have been added. The largest obligor represented only 12% of total loans in fiscal 2015, down from 24%. We expect that geographical and single name concentration will improve as more councils in other provinces become Borrowing Members.

We have also used our "Principles Of Credit Ratings" in conjunction with "Rating Finance Companies" and "Rating Government-Related Entities: Methodology And Assumptions" as our criteria foundation for our analysis of the FNFA's creditworthiness. We believe rating finance companies criteria covers all the fundamental aspects of the authority's credit profile as the rating factors line up well with the FNFA's key credit aspects.

Liquidity

We believe that authority's liquidity is adequate. As of Nov. 30, 2015, the FNFA had cash and cash equivalents of C$1.2 million and its credit enhancement fund stood at C$10 million. Balances in the debt deserve fund (DRF) of C$12.0 million and the secured revenue trust account (SRTA; C$17.3 million) more than meet upcoming debt service requirements. With the FNFA withholding 5% of each member's loan request in the DRF, the DRF is growing faster annually than the FNFA's interest obligations at current interest rates. Both funds are held in cash or cash equivalents. Borrowing Members prepay their loan obligations as pledged revenues that are owed to members into a trusteed account before debt service payments are made, which reduces the risk that liquidity might not be sufficient to meet debt service obligations. In addition, the FNFA has a revolving credit facility with a major Canadian bank totaling C$100 million, which is close to being fully used, but will become unused after the next debt issuance.

Outlook

The stable outlook reflects our expectation that the authority will continue to expand its loan portfolio and interest income, achieving profitability in the next two years. We expect that asset quality will remain good, the loan portfolio will diversify further geographically, and single-name concentration will continue to fall. Sustained operating deficits, increasing concentration of its loan portfolio, or debt issuance beyond our expectations could place downward pressure on FNFA's SACP. We could lower the rating if we were to downgrade Canada, or revise the likelihood of extraordinary support to moderate or low if the federal government's oversight of the authority lessened or the importance of its policy role diminished. Profitable operations, coupled with earnings retention, increasing portfolio diversification, and a stronger capital base could put upward pressure on the SACP. We could upgrade the authority if we were to revise the likelihood of extraordinary support to high or greater because of increased importance of the authority's public policy role or strong direction by the federal government in the FNFA's strategy development and day-to-day operations.

Moderately High Likelihood Of Extraordinary Support

In accordance with our government-related entity criteria, we view the likelihood of the FNFA receiving extraordinary government support as moderately high based on our assessment of the strong link with the federal government, which the funding support from the government for the authority's operations demonstrates. Owing to the small size of the FNFA's loan portfolio, two federal grants support most of its operations. We believe that the authority's role is important to the government because of the need for access to capital by First Nations, the FNFA's statutory mandate to lend to approved First Nations, and the political visibility of First Nations issues generally and the condition of infrastructure on First Nations territories specifically.

We believe that the plan has a strong link with the federal government. The authority was established by federal statute, which specifies its powers and purpose; the governance structure, including the roles of the chair and directors, their tenures, and responsibilities; and corporate status. The legislation requires the authority to produce annually a report on its operations and to submit the report to members and the government. The government's annual operating grants represent more than 80% of the FNFA's revenues. The authority receives a base operating grant, which supports core activities; and a comprehensive funding arrangement transfer, which supports specific programs and activities detailed in the arrangement. As the FNFA's loan portfolio and net interest income increase, we expect the total grants will decrease and the share of those revenues of total revenues will decline. Nevertheless, we believe that federal grants to the authority will continue to constitute a substantial proportion of revenues for the foreseeable future.

We believe that the FNFA's role is important to the federal government because under the Canadian constitution, the welfare of First Nations peoples is a federal government responsibility. Specifically, we view the role as important because of the considerable need for access to capital by First Nations, the authority's statutory mandate to lend to approved First Nations, and the political visibility of First Nations issues generally. The condition of infrastructure on First Nations territories lags that of non-aboriginal communities. The stark difference between the state of the infrastructure in northern communities and those of southern communities, aboriginal or non-aboriginal, has frequently been a political embarrassment for the government. The FNFA's role might increase in importance over the next two years. The new government has made commitments to the Assembly of First Nations, some of which could involve the authority.

Business Profile

The FNFA was created in 2006 by The First Nations Fiscal Management Act to develop borrowing capacity for First Nations governments and provide investment pooling arrangements for its investing members. It is a not-for-profit, nonshare capital corporation that is exempt from income taxes. The authority is headquartered in Kelowna, B.C., and has seven employees.

The FNFA borrows money in public markets and lends those funds to qualified First Nations for a variety of purpose including infrastructure development, community owned housing, social development, land purchases, economic development (including equity investments in projects, and vehicles and equipment. The authority is governed by a nine-member board of directors. All directors and the chair are either First Nations councilors or chiefs.

The FNFA has 50 members. A Borrowing Member must receive unanimous approval from the board before it can borrow from the authority. Currently, 25 members have received long-term loans, totaling almost C$230 million.

Lender To First Nations' Councils

We believe that the FNFA has a solid competitive position in niche market. Historically, access to capital has been a challenge for many First Nations, especially for long-term lending. In recent years, access to long-term lending has improved. Major banks and aboriginal capital corporations (ACCs) provide access for some First Nations. Nevertheless, impediments to lenders remain, such as security, or lenders' mandates. By statute, land or buildings on First Nations territories cannot be pledged as collateral, which has impeded lending by the major banks somewhat. By mandate, the FNFA is authorized to lend to councils for their taxation-supported lending -- other lenders, such as ACCs, are not so authorized.

Furthermore, some First Nations have capital needs (and debt repayment capacity) that exceeds the ability or willingness of existing lenders. Total capital needs from Canadian First Nations is estimated to easily exceed C$5 billion. Those needs are typical of all Canadian communities: infrastructure (water and roads), community-owned housing, equipment, and economic development.

Because of these favorable demand and supply conditions, we believe that the FNFA will not face pricing pressures and we do not expect this to change. Owing to the impediments described above, we do not expect an influx of new lenders into this part of the loan market. Accordingly, we believe that the authority is positioned well in its niche and we expect that its market position will strengthen as its loan portfolio and membership expands. Furthermore, the federal government's recent commitments to the Assembly of First Nations raise the possibility of increased lending opportunities.

Good Asset Quality

Structural mechanisms enhance the FNFA's asset quality, in our opinion. Those structural elements include rigorous qualification process required of all borrowing members, revenue interception, prudent discounting of pledged revenues, and the authority's intervention powers.

All potential borrowers must pass a rigorous qualification process before they can become Borrowing Members and receive loans. Qualifying members must go through a six-step qualification process. The six steps include the following:

- Applicant First Nation applies to the Federal Government to be added to the First Nations Fiscal Management Act (FNFM Act) schedule of First Nations willing to use own source and tax revenues to secure financing for defined projects.
- Applicant submits five years of audited financial statements to the First Nations Financial Management Board (FNFMB) and must pass six strict ratio tests.
- The applicant must pass a financial administration law in its council.
- It submits other revenue stream contracts to the FNFA for evaluation as loan security.
- The board must unanimously approve the applicant.
- Applicant establishes an SRTA and instructs the payor of other revenue streams to deposit directly into this account.

Borrowing Members pledge other 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 health care, education, protective services, housing, and community services. The payor of the other revenue stream makes payments directly to the trustee through the SRTA. The trustee withholds the amount required to meet that First Nation's upcoming debt service obligation and remits the balance back to the respective nation.

The FNFA will only allow a Borrowing Member to borrow up to debt capacity limit that the authority determines by calculating the amount of debt service that could be supported by the discounted cash flow of pledged revenues streams for a given loan term. Pledged revenues are subject to two levels of discounting. First, all revenues regardless of payor are discounted by 25%. A second discount applied varies dependent on the origin and nature of the pledged revenue stream, which is very broadly correlated with payer credit quality.

The FNFA has intervention power under the Act. If a First Nation is unable or unwilling to meet its debt service obligations under its loan agreement, the authority can invoke the statutory intervention provision. If invoked, the FNFA, together with the FNFMB, can remove and replace the council of the defaulting First Nation, thereby gaining access to the nation's revenue, including those that cannot be pledged.

At the end of fiscal 2015, the authority had loans outstanding with 14 First Nations totaling C$103.4 million, of which C$85.6 million were long-term and debenture funded and the remaining C$17.7 million was interim funded with the FNFA's credit facility. With the authority's second debt issue in July 2015, loans increased to C$227.0 million. The annual debt service obligations for these loans total about C$10.3 million. The pledged revenues flowing to the trustee through the SRTA amounts to C$40.7 million annually, leaving about C$30.4 million available for debt service reserve replenishment. Debt service obligations represent only 25% of pledged revenues received by the trustee.

Growth prospects for the portfolio are what we consider healthy because of First Nations' considerable need for capital and their historically constrained access to capital. Currently, the portfolio is small but it we expect it to increase by more than C$100 million annually. The authority expects that it will have more than 100 Borrowing Members, including more than 50 members with loans outstanding by the end of 2016.

The CEF is unchanged at C$10 million. Although adequate at start-up, in our view, the CEF will become inadequate at its current level. We expect that retained earnings will augment it as the FNFA becomes profitable. With the loan portfolio's growth, administrative charges the authority levies on each loan will support FNFA operations and generate excess cash flow that will then augment reserves. The federal government might augment the CEF to maintain adequacy of capital before retained earnings are sufficient.

The debt reserve fund (DRF) augments the CEF. At fiscal year-end 2015 (March 31), the DRF stood at C$5.2 million (C$2.7 million at the end of fiscal 2014). At Oct. 31, 2015, the DRF stood at C$11.1 million, or more than 100% of current debt service. The DRF ensures timely debt service payment when there are insufficient funds flowing in from the SRTAs. From each loan to a Borrowing Member, 5% of the loan value is deposited into the DRF and invested in eligible investments. Investment returns remain in the DRF. Each Borrowing Member receives its original 5% contribution and investment earnings upon the maturity and discharge of its loan. The authority does not need the approval of any other party, including Borrowing Members, to draw on the DRF. A draw on the DRF triggers the trapping of the balance of funds in the SRTAs by the trustee that would normally be remitted back to the Borrowing Members. If trapped funds from the SRTAs are insufficient, the CEF can be drawn upon.

Intervention is the next line of defense. A number of events, including material adverse changes and draws on funds, will lead to intervention. Under the FNFM Act, the authority will notify the FNFMB of a failure of a Borrowing Member to make the required payment. The board will then investigate and report back to the authority, which will then require the board to impose a co-management arrangement on the Borrowing Member or assume management of the Borrowing Members finances directly. In intervention, all revenues of the Borrowing Member are available.

There have been no delinquencies, charge-offs, recoveries, or provisions for losses to date.

Diversification

The authority's loan book is and will continue to be very concentrated by type of borrower. As a lender to First Nations by statute, the loan portfolio will always have 100% exposure to this sector.

Geographically, loans are concentrated in B.C. as the majority of Borrowing Members are in the province. Of long-term loans outstanding, 61% of loans were in B.C., 12% in Nova Scotia, 9% in both Saskatchewan and Manitoba, 7% in Ontario, and 2% in Quebec. B.C. represented 64% of the portfolio after the first debt issuance. Saskatchewan and Quebec became new jurisdictions in the second debt issuance and loan dispersement. We expect that geographical concentration will continue to improve as councils in other provinces become Borrowing Members.

Single-name concentration is improving. Membertou, the FNFA's biggest obligor, represents 12% of total loans, down from 24% a year earlier. The top five largest obligors represent 42% of total loans, which is also down considerably from 65% fiscal 2014. We expect name concentration to diminish as the number of Borrowing Members increases and existing borrowers reach the limit of revenues that can be pledged.

The loan obligors' credit quality remains what we consider good. All but a few obligors have mid-to-high investment grade credit quality, in our opinion. Approximately, 41% of loans outstanding are with obligors in the 'aa-' category;

48% are in the 'a+' category.

The pledged revenues that support the repayment of those loans are more diverse. About two-thirds of total loans are supported by revenues from contracts with the federal government, the provinces, and their wholly-owned electric utilities. Those contracts are for a variety of purposes, including water, mineral, logging rights, and electricity sales. The remaining one-third of total loans is supported by revenues from contracts and leases with third parties, such as banks and supermarkets, and by income from council-owned businesses. As of Oct. 31, 2015, 60% of pledged revenues came from the federal government, the provinces, or their hydroelectric utilities. About 15% of pledged revenues comes from contracts and leases with various third parties (including major banks, national grocery chains, amongst others) and 25% comes from businesses run by First Nations.

We expect that geographic diversification should continue to improve as the loan portfolio expands. Obligor credit quality should remain concentrated in the 'a' and 'aa' categories. We expect that the credit quality of pledged revenues will remain good thanks to the preponderance of revenues from federal and provincial governments and their electric utilities.

Leverage

At the end of fiscal 2015, the FNFA's capital base was about C$10.3 million, consisting of equity of C$0.3 million and reserves (CEF) of C$10.0 million. Borrowing (long-term and interim) was about C$107.7 million, or 10x the capital base, which subsequently increased to about C$230 million as of October 2015. We expect the authority to issue more than C$100 million annually. The FNFA believes that total debt and loans will exceed C$600 million by the end of fiscal 2018. We believe that this forecast is somewhat optimistic as the FNFA's operations and those of the FNFMB will have to scale up to support issuance and lending of this magnitude. The consequences of continuing issuance at this level are that the authority's capital base will become inadequate relative to its leverage. However, the projected expansion of the loan portfolio will increase management fees and net interest income and make the FNFA profitable. Achieving profitability will ultimately bolter capital reserves as earnings are retained, which should mitigate the increase in leverage somewhat.

The possibility exists that the federal government may augment the CEF to maintain adequacy of capital before retained earnings are sufficient.

Asset-Liability Management Is Good

The authority matches its liabilities with its assets minimizing its market risks. Match-funding its fixed-rate borrowings from public bond markets with its fixed-rate loans to Borrowing Members removes interest rate risk. The term of bond issues will match the duration of pledged revenue streams, eliminating refinancing risk. We expect that most bond issues will have 10-year terms, although longer terms may be possible if pledged revenues support such terms. Bond issues will be bullets that are amortized by the sinking fund components of debt service amounts retained by the trustee from all pledged revenue streams. All borrowing and lending will be done in Canadian dollars, eliminating currency risk.

We expect that funding risk will be modest. Loans to Borrowing Members will be made upon the receipt of the proceeds from bond issuance. The authority maintains a C$100 million floating-rate revolving credit facility with a major Canadian bank. In the periods between bond issuances, the FNFA may make short-term floating-rate interim loans to its members, which are then termed out in a bond issue with the interim loan repaid. We expect that authority will combine its approved loan requests and then lend to Borrowing Members after long-term funding is secured in the bond market: short-term interim lending will be minor. The authority's funding sources will likely be relatively focused because it intends to source long-term funding through public bond markets and short-term financing from major banks. Nevertheless, Canada's capital markets are deep and diversified with active secondary markets for debt securities.

As a non-profit, FNFA marks up its loans to Borrowing Members to recover its operating costs (and in time to build reserves). As a result, it does not face pricing risk because it fully passes on funding costs to Borrowing Members. Furthermore, the authority does not face pricing pressure from other lenders.

Profitability Is Improving But Still Weak

Thanks to increased management fees and a substantial increase in federal government grants, the authority significantly reduced its loss in fiscal 2015. The shortfall was about C$127,000, a big improvement on the C$659,000 loss a year earlier. We expect that the FNFA will produce near-balanced results at a minimum in fiscal 2016 thanks to increases in federal grants and management fees. As well, one-time start-up expenses will not weigh on results. Accordingly, we expect that profitability measures will improve as the loan portfolio continues to grow.

Net interest income remained positive in fiscal 2015 and rose sharply on the expansion of the loan portfolio. For the same reason, management fees also jumped dramatically. For fiscal 2015, net income as a share of average assets improved to about negative 0.1% from negative 1.3% a year earlier. Net income has been strengthening since start-up and we expect this to become positive in fiscal 2016 or 2017. Grants from the federal government continue to cover deficits; grants increased in fiscal 2015 by about a third and will rise again in fiscal 2016.

Similarly, the authority's return on equity also strengthened, improving to negative 1.2% in fiscal 2015 from negative 5.9% a year earlier. We also expect this ratio to become positive in fiscal 2016 or 2017. The pre-tax profit margin improved as well strengthening to negative 5.3% in fiscal 2015 from negative 37% a year earlier.

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Rating Finance Companies, March 18, 2004
- Principles Of Credit Ratings, Feb. 16, 2011

Ratings Detail (As Of February 3, 2016)	
First Nations Finance Authority	
Issuer Credit Rating	A-/Stable/--

Ratings Detail (As Of February 3, 2016) (cont.)	
Senior Unsecured	A-
Issuer Credit Ratings History	
18-Dec-2014	A-/Stable/--

*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. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.