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First Nations Finance Authority (Canada)

Loan growth highlights critical social role without compromising credit quality

The First Nations Finance Authority (FNFA, Aa3 stable) has increased its loan activity and borrower pool significantly in the last few years to support social and environmental projects within First Nations communities. Continued support from the Government of Canada (Aaa stable) as well as the institution's own credit-protection mechanisms and strict onboarding and monitoring practices limit the credit risks from this increase in lending.

» **FNFA plays a crucial social role in the development of First Nations' communities across Canada.** 60% of FNFA's lending activity is geared toward financing social-development projects in education, community health, community social infrastructure, housing projects, and safety and protection infrastructure. Low interest costs and a lack of collateral requirements help borrowers reduce their reliance on more costly bank lending and ensures progress on projects that would otherwise not be financially viable. FNFA loans are estimated to have created 9,000 new jobs since 2014.

» **Support from the federal government highlights FNFA's social importance while strengthening its credit profile**. FNFA plays a significant role in the federal government's policy of strengthening its relationship with and improving the socio-economic development of indigenous communities across Canada. To help achieve FNFA's goals, the federal government provides it with annual operating funding and a liquidity backstop facility. It is also highly likely that the federal government would provide extraordinary support if FNFA experienced significant financial distress.

» **Structural protection mechanisms and continued borrower diversification limit risks from a growing loan portfolio**. Robust structural credit-protection mechanisms have ensured that the average credit quality of borrowing members has remained consistently strong. These strong quality checks and limits on the amount of lending based on a First Nation's borrowing capacity ensured that the FNFA has never reported a nonperforming or delinquent loan to date. They also limit the risk to bondholders and allow FNFA to continue to grow and expand its services to an ever increasing set of borrowing members.

» **Stringent oversight and monitoring of pool participants also strengthen its credit profile**. FNFA maintains a stringent onboarding, approval and monitoring process, including reviewing member First Nations' financial statements, ensuring that borrowers maintain strong interest and debt-coverage ratios, and a stringent certification and onboarding process. FNFA also has intervention powers to actively manage the affairs of a defaulting First Nation.

FNFA plays a crucial social role in First Nations' communities across Canada

The FNFA provides long-term capital financing, interim financing and short-term investment opportunities for member First Nations. The costs on FNFA's loans are low and borrowers do not need to post collateral. This provides increased access to affordable funding and ensures progress on projects that support social and economic development that would otherwise not be financially viable.

Most of its lending supports social (60% of total loans) and environmental (30%) development projects. Its funding of social infrastructure is wide ranging but includes education (day cares, elementary schools), community health and safety (safe houses, wellness centres, water projects), community social infrastructure (community services building, cemeteries, pow wow spaces), housing, and protection infrastructure (fire and emergency services buildings, flood protection). Exhibit 1 provides a detailed breakdown of major social infrastructure project types:

Exhibit 1
FNFA loans support a wide range of social infrastructure projects critical for First Nations

Education	Community - health and safety	Community - social	Sports	Housing	Protection infrastructure
Aboriginal pre kindergarten	Community health and wellness centre	Band office	Recreation centre	Housing - new units	Flood protection barrier
Daycare centre	Community shelter/safe house	Cemetery	Sports field with facilities	Housing - renovations	Emergency services building
Schools - elementary	Construction of water and hydro projects	Community store		School additions and renovations	Fire hall
Schools - teacher facilities		Elders and community complexes		Student rental housing	Wharf project
		Pow wow spaces			
		Public works service centre			

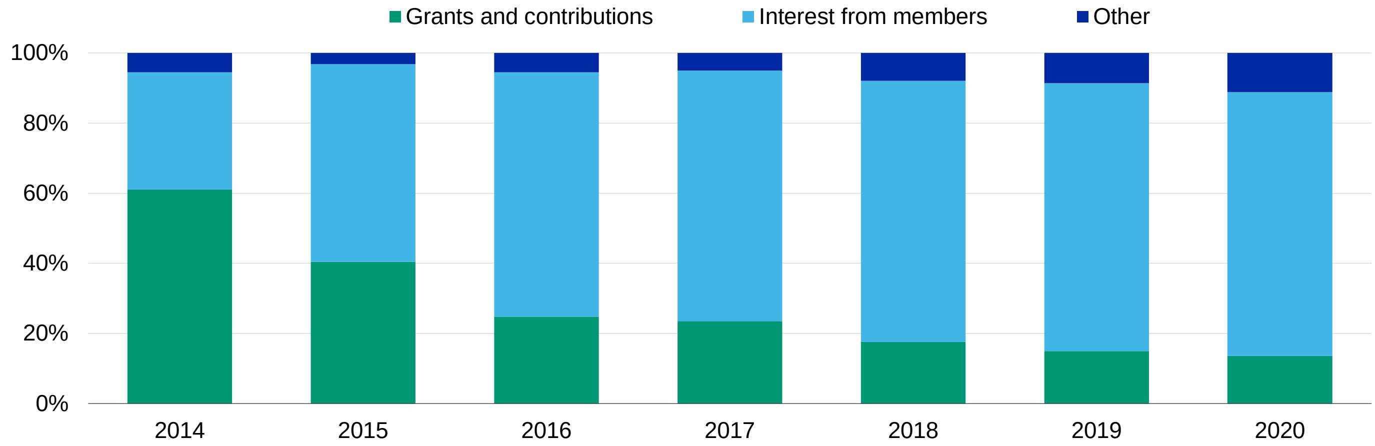
Source: FNFA

Financing available through FNFA can be assigned to single projects or put toward multiple projects that support First Nations' long-term capital needs and economic growth. For example, proceeds from FNFA's first debenture proceeds in 2014 supported multiple projects for the Tzeachten First Nation, including construction of a new multipurpose community building and the expansion to its existing community centre, new housing development, and water, sewer mains, and septic system infrastructure. From loans received between 2014 and 2018, the Membertou First Nations constructed several projects including a sports and wellness centre and a gaming and business centre, while the Fisher River Cree Nation constructed an office complex, a hotel, and a new high school. Since 2014, FNFA loans are estimated to have created 9,000 new jobs.

Support from the federal government highlights FNFA's social importance while strengthening its credit profile

FNFA's support for First Nations communities across Canada ties in with the federal government's support of indigenous development and self-governance. To help achieve FNFA's goals and given the authority's relatively young age, the federal government provides both direct and indirect support to FNFA. In terms of direct support, FNFA receives an annual operating grant from the federal government through Indigenous Services Canada, for the delivery of programs and services and to offset operating costs. The relative share of federal funding has declined from 61% of revenue in 2014/15 to 14% in 2019/20, as FNFA now derives most of its revenues from interest from members.

Exhibit 2
FNFA continues to receive federal operating grants, but their relative importance is declining
(Proportion of total revenue)



Fiscal years ended March 31
Source: Moody's Investors Service, FNFA audited financial statements

The federal government also contributes toward a liquidity backstop facility called the Credit Enhancement Fund (CEF). The CEF has benefitted from multiple increases over the last few years, increasing from CAD10 million in 2011 to CAD42.5 million in 2020. Although growth in the CEF has not matched the pace of FNFA's loan growth, the slower growth is consistent with our expectation that the CEF will gradually decline in importance as FNFA matures as an institution and its reserve and sinking funds continue to grow.

In response to the coronavirus pandemic, in June 2020 the federal government announced that it will provide CAD17.1 million in interest payment relief to FNFA's existing loan borrowers for 2020. Our assessment of FNFA's credit profile also incorporates a strong likelihood of extraordinary support from Canada if FNFA experienced significant financial distress given the essential social role it fulfills.

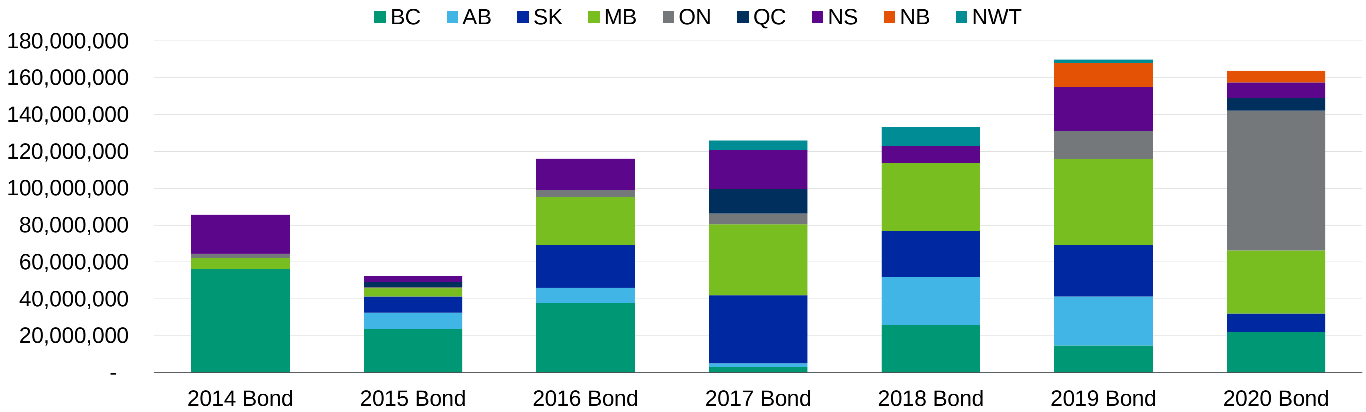
Structural protection mechanisms and continued borrower diversification limit risks from a growing loan portfolio

FNFA's lending portfolio grew significantly between 2014 to 2020, with total loans rising from CAD54 million at 31 March 2014 to CAD898 million at 31 May 2020. As a result, there is a risk that it could start lending to borrowers with lower credit quality. However, robust structural credit-protection mechanisms have ensured that the average credit quality of borrowing members has remained consistently strong. These strong quality checks and limits on the amount of lending based on a First Nation's borrowing capacity ensured that to date there have been no nonperforming or delinquent loans. These robust structural mechanisms also limit the risk to bondholders and allow FNFA to continue to grow and expand its services to an ever increasing set of borrowing members.

Each loan to a First Nation is supported by an irrevocable pledge of various eligible revenue streams (including leases, royalties, and government transfers) to FNFA for the term of the loan. This structure provides credit protection to FNFA's bondholders because revenue is diverted into a secured trust account before flowing to the First Nation and therefore it gives FNFA priority over these cash flows. Because FNFA requires a higher level of pledged revenue than needed to cover interest and debt payments, these revenue streams should always exceed the First Nations' contractual interest and debt obligations, supporting continued loan growth while limiting the risk to FNFA.

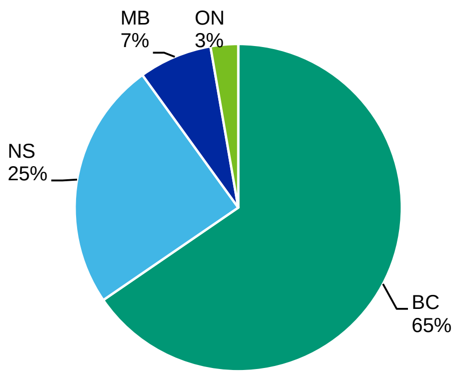
This structure also allows First Nations to participate in multiple rounds of financing by FNFA, supporting continued growth and development. Sustained loan growth has also led to a wider distribution of loan borrowing member composition, ensuring borrower diversification. The continued diversification of the loan book reduces concentration risk and strengthens credit quality.

Exhibit 3
Loan growth has helped to diversify its borrowers by geography
(Debenture size, in Canadian dollars)



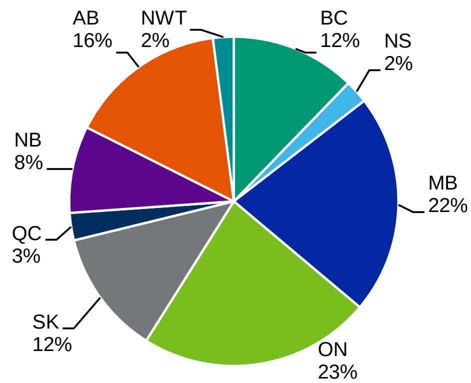
Source: Moody's Investors Service, FNFA

Exhibit 4
Borrower concentration was elevated in 2014...
Borrower concentration at June 2014



Source: FNFA

Exhibit 5
...but has since improved greatly
Aggregate borrower diversification at May 2020



Source: FNFA

The structural credit-protection mechanisms that support our assessment include an irrevocable revenue intercept mechanism, a dedicated debt reserve fund (DRF) provides liquidity in the event of nonpayment by a borrowing member, a joint and several obligation of borrowing members to replenish the DRF without limit, and a credit enhancement fund (CEF) which was set up by the federal government to enhance FNFA's creditworthiness and act as a backstop to the DRF. On a combined basis, the DRF and CEF account for nearly 10% of the outstanding loan amount.

Stringent oversight and monitoring of pool participants further supports credit quality

FNFA maintains a very stringent onboarding, approval and monitoring process. Pool borrower financial statements are audited and vetted by FNFA and borrowers maintain strong interest and debt-coverage ratios. This process not only enhances FNFA's credit quality, but First Nations directly benefit from FNFA's oversight and expertise in reviewing their financial practices. Prospective borrowing members must undergo a certification and comprehensive onboarding process and FNFA's regularly monitor of the pool participants' credit quality to ensure borrowers' timely cash flow payment of debt-service obligations. FNFA also has intervention powers granted to the authority under the First Nations Fiscal Management Act (FNFMA) to actively manage the affairs of a defaulting First Nation. To date, there have been no nonperforming or delinquent loans. In addition, the growth of the borrowing pool continues to help reduce any concentration risk.

The vetting process to become a borrowing member involves a comprehensive qualification and onboarding process and continuous post-onboarding monitoring. A First Nation must pass a band council resolution, apply to the federal government to be scheduled to the FNFMA, must satisfy certification requirements by the First Nations Financial Management Board (FMB), and receive unanimous approval by FNFA's Board. Post-approval, each First Nation is subject to continued monitoring and reporting. This process ensures that a high credit quality of borrowing members and loan portfolio is maintained.

Moody's related publications

Issuer research

» First Nations Finance Authority (Canada): Update following rating upgrade, May 2020

Sector research

» Sub-Sovereign – Canada: FAQ on pandemic-driven credit pressures facing public-sector entities. July 2020

» Sub-Sovereign – Canada: Public-sector entities face differing risks from coronavirus and oil price shocks, March 2020

» Canada's fiscal support package will help blunt coronavirus shock to the economy, March 2020

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