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Research Update:

Municipal Finance Authority of British Columbia Ratings Affirmed At 'AAA'; Outlook Is Stable

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Overview

- We view the enterprise risk profile of the Municipal Finance Authority of British Columbia (MFABC), a Canadian-based public sector funding agency that lends to the British Columbia (B.C.) municipal sector, as very strong, owing to its very strong market position and public policy mandate and supported by a very strong management as well.
- While increasing concentration on MFABC's lending portfolio has weakened our capital adequacy assessment, the strong financial risk profile is underpinned by our assessment of its strong funding and liquidity profile.
- Accordingly, we are affirming our ratings, including our 'AAA' long-term issuer credit rating, on MFABC.
- The stable outlook reflects our expectation that, in the next two years, the authority will retain its status as the exclusive lender of long-term debt to B.C. municipalities, with legislatively enshrined taxing powers to backstop its capital against unforeseen losses, strong funding and liquidity position and adequate capital adequacy, supported by prudent risk management practices.

Rating Action

On May 30, 2019, S&P Global Ratings affirmed its 'AAA' long-term issuer credit rating on Municipal Finance Authority of British Columbia (MFABC). At the same time, S&P Global Ratings affirmed its 'A-1+' short-term issuer credit rating, and its 'A-1+' global scale and 'A-1 (High)' Canada scale commercial paper ratings on the authority. The outlook is stable.

Outlook

The stable outlook reflects MFABC's long history of prudent management practices and conservative risk policies mainly on asset-liability matching to continue. We expect that the strengthening of the authority's capital policies and growing capital will support MFABC's adequate capital adequacy. We also expect that the authority will maintain its ready access to Canada's deep and diverse capital markets and its diversified investor base; and that its funding and liquidity position will stay strong in the next two years. MFABC will remain the exclusive lender of long-term debt to British Columbia (B.C.) municipalities. We also expect the authority to retain its legislatively enshrined ability to levy a province-wide tax to replenish any potential draw on its debt reserve fund (DRF).

Although we do not expect it, we could lower the rating in the next two years if MFABC were to have its taxing powers constrained, or if capital adequacy ratios fell significantly due to a fall in capital following sustained operational losses or a full or partial distribution of the strategic retention fund (SRF) to members. We could also consider a negative rating action if the authority was no longer the exclusive lender to B.C. municipalities or in the case of a sustained decline in the credit quality of the B.C. local government sector.

Rationale

MFABC has a very strong public policy role and business position as the exclusive lender of long-term debt to B.C. municipalities. We deem the sector low risk, owing to its predictable and well-balanced institutional framework and very high economic resilience. Funding and liquidity levels are strong, given prudent risk management practices that result from retaining liquid investments in its sinking funds, which as of December 2018 added up to C$3.7 billion. Supported by low-risk appetite policies, we consider MFABC has very strong management that, combined with robust governance, mitigates the risk that can arise from being a moderate-size organization relative to peers. While MFABC's capital adequacy has weakened to adequate from strong, due to increasing concentration on its loan book, the pass-through nature of its operations, plain-vanilla funding, and robust cash and liquid investments held within the SRF and DRF support a strong overall financial risk profile.

The authority, unlike any of its peers, has taxing powers. It has the unfettered ability to impose a province-wide levy on all taxable land and improvements to replenish its DRF, if needed. MFABC is already a claimant on annual local tax bills, which we believe would expedite its ability to collect on a special levy. We consider this taxing power a key strength underpinning the 'AAA' rating.

MFABC was established in 1970 to provide low-cost financing to B.C.'s municipal sector except to the City of Vancouver and South Coast British Columbia Transportation Authority. It is a not-for-profit tax-exempt corporation without share capital controlled by its member municipalities. Despite its establishment by provincial statute, the authority has an arm's length relationship with the government, with minimal direct linkages and no provincial guarantee on its debt. As a result, we do not view it as a government-related entity.

Enterprise risk profile: Very strong market position and public policy mandate and very strong management complement the low-risk municipal sector

- The public-sector industry and country risk assessment is strong thanks to the B.C. municipal sector's well-balanced and predictable institutional framework, very high economic resilience, moderate leverage levels, and low financial system risk.
- The authority has a very strong public policy mandate and business position as the exclusive lender to the sector.
- With well-established and prudent management policies and practices, especially concerning asset-liability matching, we consider MFABC's management and governance very strong.

MFABC has a strong public policy mandate as the exclusive lender of long-term debt to the municipal sector in B.C. The policy objective at the foundation of its mandate is the provision of low-cost borrowing to municipalities by pooling bond issues and creating liquidity in bond markets. The authority is one of the biggest municipal lenders in the country. Its status as the exclusive lender stabilizes its revenues because revenues are tied to the sector's capital funding needs, which have been steadily rising and predictable in the long term. Unlike many of its peers, MFABC does not face competition from other lenders, which makes its customer base very stable.

Management policies and practices are prudent with low-risk appetite, which contributes to our view of MFABC's management and governance as very strong. The authority's business plan sets out the organization's annual goals, both financial and nonfinancial. The board tracks progress on outcomes in regular meetings with senior staff. Committees must approve both loan and investment decisions. Risk management policies and practices are a reflection of the organization's low-risk appetite. Policies cover all key aspects of their operations, including asset-liability matching as a key risk management practice. The management team is experienced; key members have long tenure with the authority. Management has a board-approved succession plan. In terms of personnel, MFABC is a relatively small organization but the pass-through nature of its business and plain-vanilla funding mitigate potential risks when compared with larger and more complex peers that compete for borrowers and whose funding practices expose them to higher market risks.

We view the B.C. municipal sector as low risk. Our public-sector industry and country risk assessment is favorable because of the sector's well-balanced and predictable institutional framework, very high economic resilience, moderate leverage levels, and low financial system risk. Provincial-municipal intergovernmental arrangements continue to be stable. Leverage levels in the sector are moderate: debt levels are forecast to remain below 80% of operating revenues and interest expense to be at about 2% of operating revenues. As well, and like the rest of the country, B.C. has very high economic resilience thanks to the province's high GDP per capita levels of about US$44,000. Canada's banking system is sound and we view financial system risk as low.

Financial risk profile: Strong funding and liquidity levels mitigates an adequate capital adequacy

- Our view of the authority's adequate levels of retained earnings and the loss-absorbing nature of the DRF complements the virtual absence of asset-liability management risks.
- Increased concentration on the lending book resulted in a decline of risk-adjusted capital (RAC) after adjustments in fiscal 2018.
- Funding and liquidity levels remained strong in 2018, supported by the authority' considerable holdings of liquid investments in its sinking funds of C$3.7 billion at year end.

In fiscal 2018, the relative growth on the MFABC's capital (including the DRF, provided its loss-absorbing nature) outpaced the growth of its lending activity resulting in an RAC ratio before adjustments of 14.8% for 2018, up from 14.3% a year earlier. However, increasing concentration on MFABC's top borrowers increased the single-name concentration charge, which resulted in an after-concentration ratio of 6.8% falling from 7.4% the year before. We expect concentration on top exposures to remain a challenge but the RAC ratio to remain close to the 7% threshold.

MFABC does not take on any transformation risk because it uses fixed-rate domestic bonds to fund its lending, which supports our capital adequacy assessment of adequate. Risk management practices, which include very strict asset-liability matching, are sound in our view. The SRF and

DRF, which make up MFABC's loss-absorbing capital, totaled C$181 million in 2018, up from C$173 million a year earlier.

The authority holds considerable levels of liquid investments in its sinking funds of C$3.7 billion at the end of 2018 and they underpin the authority's strong funding and liquidity levels. MFABC's ratio of adjusted assets-to-liabilities is 1.2x. The one-year liquidity ratio stood at 1.79x and the two-year ratio at 1.07x. The Canadian bond market, which we consider deep and diversified, provides 100% of MFABC's funding, making the authority's funding sources somewhat concentrated. While investor diversification is much stronger and continues to improve, we view its investor base as weaker relative to that of peers. In addition, the authority's liquidity position is boosted by lines of credit totaling C$350 million.

MFABC, unlike any of its peers, has taxing powers, which we consider a significant credit strength. It has the unfettered ability to impose a province-wide levy on all taxable land and improvements if needed to replenish its DRF. The board can immediately invoke taxing powers at its discretion, and needs no approval from municipal members or any higher level of government. MFABC is already a claimant on annual local tax bills, which provided about C$400,000 in revenues in 2018, and we believe this expedites its ability to collect on a special levy. MFABC has not suffered a loan book default in its close to 50-year history, nor has it experienced a DRF deficiency. It also has never had to enact a special levy. We consider this taxing power a key strength underpinning the 'AAA' rating.

Municipal Finance Authority of British Columbia -- Selected Indicators

	--Year ended March 31--				
(Mil. C$)	**2018**	**2017**	**2016**	**2015**	**2014**
Business position					
Total assets*	9,244.0	8,844.7	8,507.3	8,128.5	7,765.5
Customer loans (gross)	4,972.3	4,681.1	4,606.3	4,603.2	4,615.6
Growth in loans (%)	6.22	1.62	0.07	(0.27)	N/A
Net interest revenues	118.5	115.4	123.7	110.0	103.9
Noninterest expenses	3.4	3.2	3.5	3.4	3.0
Capital and risk position					
Total liabilities*	8,953.8	8,494.2	8235.1	7816.5	7455.8
Total adjusted capital	180.6	172.9	163.1	154.0	144.1
Assets/capital (%)	51.2	51.7	52.2	52.8	53.9
RAC ratio before diversification	14.8	14.3	N/A	N/A	N/A
RAC ratio after diversification	6.8	7.4	N/A	N/A	N/A
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity (x)					
Liquidity ratio with loan disbursement (1 year)§	1.8	1.2	N/A	N/A	N/A
Liquidity ratio without loan disbursement (1 year)§	1.8	1.7	N/A	N/A	N/A
Funding ratio (1 year)§	1.2	0.5	N/A	N/A	N/A

*As per balance sheet. §2018 figures includes sinking funds. RAC--Risk-adjusted capital. N/A--Not applicable.

Ratings Score Snapshot

Municipal Finance Authority of British Columbia -- Ratings Score Snapshot

Issuer Credit Rating	AAA/Stable/A-1+
SACP	aa+
Enterprise Risk Profile	Very strong (1)
PICRA	Strong (2)
Business Position	Very strong (1)
Management & Governance	Very strong (1)
Financial Risk Profile	Strong (2)
Capital Adequacy	Adequate (3)
Funding	Neutral
Liquidity	Strong (2)
Support	0
GRE Support	0
Group Support	0
Additional Factors	1

Related Criteria

- Criteria - Governments - International Public Finance: Public-Sector Funding Agencies: Methodology And Assumptions, May 22, 2018
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed	
Municipal Finance Authority of British Columbia	
Issuer Credit Rating	AAA/Stable/A-1+
Senior Unsecured	AAA
Commercial Paper	
Global Scale	A-1+
Canada Scale	A-1(High)