FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Municipal Finance Authority of British Columbia, Canada at 'AAA'; Outlook Stable

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Fitch Ratings - New York - 20 Dec 2022: Fitch Ratings has affirmed the Issuer Default Rating (IDR) of the Municipal Finance Authority of British Columbia, Canada (MFABC, or the Authority) at 'AAA' with a Stable Rating Outlook. Fitch has also affirmed the long-term ratings on outstanding senior unsecured debentures of approximately CAD9.3 billion (as of Dec. 31, 2021) at 'AAA'. The Outlook is Stable.

The 'AAA' IDR is based on MFABC's independent and unlimited property taxing authority, which supports its mission of providing access to capital for local and regional governments within the province of British Columbia (AA+/Stable). The affirmation reflects a standalone credit profile (SCP) of 'aaa', based on MFABC's risk profile, at 'Stronger', and a debt sustainability assessment in the 'aaa' category.

KEY RATING DRIVERS

Risk Profile: 'Stronger'

MFABC's 'Stronger' risk profile is based on its broad taxation power, narrow and predictable expense profile and solid liquidity and debt profile, which support its mission of issuing debt for the capital financing needs of local governments, and result in 'Strong' assessments for all six categories assessed by Fitch under its local and regional government (LRG) criteria.

Revenue Robustness: 'Stronger'

MFABC's smallest, but most important revenue source is a property tax levied on the province's massive property tax base, which is assessed at CAD2.17 trillion as of the 2022 assessment by BC Assessment, an independent provincial authority that reassesses property tax values each year. Every property owner's annual tax bill includes a very small MFABC levy, which totaled CAD440,000 in 2021. Maintaining the levy ensures a functioning mechanism that would allow MFABC to increase its levy if needed to address a borrower's failure to pay.

Fitch does not expect the housing market downturn now underway to be a material risk to MFABC's ability to levy sufficient property taxes, given the small size of the levy that would be necessary to ensure payment of debt service compared to the total value of the provincial assessment roll. Over the long-term, property market fundamentals are expected to remain strong, consistent with Fitch's view of British Columbia's economy.

Although the pandemic resulted in a 2.9% dip in assessed value, in 2020, the 10-year CAGR through 2022 for the assessment roll total value has been 8.2%; this includes a 21.3% gain in the 2022 assessment. Assessments for 2023 will not be released until January 2023, although the BC Assessment expects increases between 5% and 15%.

MFABC's largest sources of annual revenue is interest on loans to clients, which generated CAD230 million in 2021 (CAD232 million in 2020). The second largest source is investment income from the portfolio of assets, mainly sinking funds, managed by MFABC, which generated CAD144 million in 2021 (CAD141 million in 2020). Total revenue stood at CAD399 million in 2021 (CAD398 million in 2020). The operating levy generated only CAD440,000.

Revenue Adjustability: 'Stronger'

The authority has the ability by a vote of its governing board of trustees to levy a province-wide property tax base following any draw on its debt reserve fund (DRF), if it determines that loan repayments will be insufficient to restore the DRF within a reasonable period. If the DRF is drawn down by more than 50% from its required level, MFABC is statutorily required to levy a province-wide tax to restore it.

The size of the levy is limited to restoring the DRF to its required level of half of the average annual principal and interest payments on borrower loans for all regional districts and half of the average annual principal and interest payments on borrowings by districts' member municipalities. There is no other limitation on the rates the Authority can levy, and no approvals are necessary from provincial or local authorities.

Expenditure Sustainability: 'Stronger'

MFABC's operating profile consists primarily of servicing market-issued debt with loan repayments from borrowing governments, managing pools of invested sinking funds and providing secondary financial services to client governments, including asset management. Rising interest rates on debt over time are passed through to borrowers in the form of higher loan repayments, insulating MFABC from interest rate risk.

MFABC provides no direct program services to citizens and does not perform capital planning or construction services. Within its narrow scope of activity, MFABC regularly runs small annual surpluses and has built up a sizable strategic retention fund (SRF) at CAD102 million in 2021 (CAD96 million in 2020), indicating a track record of tight control over expenditure growth.

Expenditure Adjustability: 'Stronger'

The authority's primary expenses for interest on debt are matched over time by incoming borrower loan repayments. Secondary services for client governments, such as pooled fund offerings and financial risk training (including cyber risk), are demand based and impose limited additional operating costs on MFABC. There is a small staff of 17.

Liabilities & Liquidity Robustness: 'Stronger'

MFABC debt is issued at fixed rates and benefits from excellent access to capital markets, as demonstrated through consistently favorable spreads to provincial debt in the highly liquid Canadian domestic market. Long-term debt outstanding totals CAD9.3 billion in 2021 (CAD8.5 billion in 2020), consisting of debentures with bullet maturities typically at 5, 10 and 20 years. The weighted average maturity calculated by Fitch is between 4 and 5 years. In 2022, MFABC has issued CAD1.33 billion.

Commercial paper (CP) notes (not rated by Fitch) with maturities from 35 or 91 days are limited by policy to a maximum of CAD700 million as of 2021; the balance stood at CAD500 million as of Dec. 31, 2021 (CAD610 million in 2020), the FYE; CP notes are backstopped by two Canadian chartered banks. CP notes provide liquidity to MFABC and interim financing for local governments, including for the initial phases of capital projects until taken out by long-term MFABC debentures. MFABC retains strong market access for the CP note program, implying limited rollover risk.

The authority's loan assets are matched with its debenture liabilities such that interest payments from client governments meet the annual interest obligations on debentures. Loans are fully amortized with principal payments deposited in dedicated sinking funds invested by MFABC and used to retire debentures upon maturity. Loan maturities are not always matched to the corresponding maturities of debt issued by MFABC, although the loan rates reset to reflect the rate on refunding debt.

Borrowers are compensated for sinking funds accumulated and invested before the associated debenture matures, with the application of an actuarial reduction applied to each principal payment. The discount is covered through the earnings on sinking fund investments. The authority sets actuarial rates (between 1.75% and 5%) at the commencement of each loan and reviews it against actual investment performance.

The MFA retains the right to adjust the actuarial assumption and has done so regularly. Earnings in excess of the actuarial rate are recorded as a surplus and are available to MFABC as liquidity until associated debenture maturity when the authority distributes them to participating borrowers.

Liabilities & Liquidity Flexibility: 'Stronger'

MFABC has considerable flexibility in managing its liquidity, with recourse to a range of internal and external sources of liquidity if needed. In the unexpected event that a borrowing government fails to make its loan payments, MFABC would cover interest first by drawing on the DRF, which held CAD123 million in 2021 (CAD120 million in 2020). If the DRF is drawn on, the MFABC can unilaterally impose a property tax as described above to restore the draw; a tax must be levied if the DRF balance is drawn to less than 50% of the required level.

Beyond the DRF balance, additional sources of liquidity include the SRF, noted earlier, which held CAD102 million in 2021 (CAD95 million in 2020), and a CAD100 million revolving line of credit with Canadian Imperial Bank of Commerce (AA-/Stable). Finally, MFABC can also draw on the core sinking fund balance, which stood at CAD4.3 billion in 2021 (CAD4.4 billion in 2020), equal to 47% of outstanding long-term debt.

Sinking fund assets are invested under statutory requirements which limit holdings to Canadian or provincial securities or those guaranteed by them; securities of a local, municipal or regional government in Canada; investments guaranteed by a chartered bank; or deposits in a savings institution or non-equity or membership shares of a credit union. Statutory restrictions on the DRF are similar, except that those cannot be invested in securities of Canadian local, municipal or regional governments. MFABC has developed investment policies to provide further guidance in managing DRF and SRF assets.

Debt Sustainability: 'aaa category'

The 'aaa' category debt sustainability assessment is based on the criteria variation, under which the unlimited taxing power of MFABC provides substantially more protection than captured in the debt sustainability metrics under a scenario in which borrowers fail to pay interest.

Under the rating case projection through 2026 that assumes the pledge of province-wide property taxes is triggered by successive draws on the DRF, the payback ratio (net adjusted debt/operating balance) gradually falls to 8x. The synthetic debt service coverage ratio (operating balance-to-a mortgage like payoff of debt service) rises to 1.4x. The fiscal debt burden (net adjusted debt/operating revenue) remains weak through the period, although is not as relevant to the overall assessment given the matched nature of MFABC's liabilities and assets over time.

Although this combination of factors suggests an assessment at the 'aa' category level, additional liquidity beyond the DRF and the availability of an essentially unlimited property tax levy offsets the potential impacts of any reasonable stress that the rating case is intended to capture. This factor is incorporated in a criteria variation, as detailed below.

Fitch views MFABC as a 'Type B' LRG under its criteria, reflecting its taxation powers but limited operating mission as authorized by the province.

DERIVATION SUMMARY

MFABC maintains ample sources of liquidity internally, which are available to support its obligations until taxes are levied and collected. These factors support a risk profile that Fitch assesses as 'Stronger' and robust debt sustainability metrics in Fitch's through-the-cycle scenario analysis. Within the broad constitutional and statutory framework of Canadian LRGs, the authority functions autonomously; its liquidity and debt are not supported by the province.

Short-Term Ratings

Fitch does not rate the short-term debt of MFABC.

Criteria Variation

The analysis supporting MFABC's 'AAA' rating includes a variation from the International LRG Rating Criteria dated Sept. 3, 2021. A variation was made to the debt sustainability analysis because of the overarching strength provided by the statutory requirement to levy an unlimited property tax on a broad economic base to restore draws on the authority's DRF.

This fiscal rebalancing strength is difficult to reflect in criteria metrics. Additionally, the matched nature of the MFABC's long-term debentures by loans made to borrower governments is unusual in the context of local governments. These factors result in MFABC being capable of adjusting its financial performance in a manner that offsets all potential stresses envisaged by Fitch under the rating scenario that underlies the debt sustainability assessment, leading to the 'aaa' debt sustainability assessment.

KEY ASSUMPTIONS

Risk Profile: 'Stronger'

Revenue Robustness: 'Stronger'

Revenue Adjustability: 'Stronger'

Expenditure Sustainability: 'Stronger'

Expenditure Adjustability: 'Stronger'

Liabilities and Liquidity Robustness: 'Stronger'

Liabilities and Liquidity Flexibility: 'Stronger'

Debt sustainability: 'aaa'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Sovereign Cap (LT IDR): 'N/A'

Sovereign Cap (LT LC IDR) 'N/A'

Sovereign Floor: 'N/A'

Quantitative assumptions - Issuer Specific

Fitch's rating case is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on 2017-2021 actual figures and 2022-2026 projected ratios. The key assumptions for the scenario include:

--Base case nominal GDP growth uses data from Fitch's December 2022 GEO (for Canada), and assumes the identical rate of growth for British Columbia. Rating case nominal GDP growth is modestly weaker both for Canada and British Columbia.

--Base case and rating case long-term debt rise approximately 5% annually beginning in fiscal 2023; additionally, short-term debt is increased to CAD700 million in 2023, from CAD500 million, and remains at that level.

--Base case cost of debt relies on the province's Budget 2022 forecast, while the rating case approximates the province's 2022 forecast revision with the spread over the base case diminishing thereafter.

--Interest rates on debt also provide the basis for calculating revenues, both loan repayments from borrowers and earnings on sinking funds, which equaled about 47% of outstanding debt as of 2021.

--The rating case assumes unprecedented draws on combined balance of the DRF and SRF, equal to 100%, 50% and 25% in 2023-2025, triggering property tax levies on a lagged basis over the 2024-2026 period to replenish internal liquidity.

Liquidity and Debt Structure

Under Fitch's calculation, direct debt stood at CAD9.8 billion in 2021, consisting of CAD9.3 billion in long-term debentures and CAD500 million in short-term CP notes at YE. Net adjusted debt stands at just under CAD5 billion, after netting CAD4.8 billion in cash, cash equivalents, and investments, chiefly the sinking funds noted above. MFABC has no contingent liabilities.

MFABC's direct debt is used solely to fund loans to borrower governments. While direct debt is forecast to increase in the rating case, which is similar to the base case and the Authority's projections for 2022 and 2023, it will be matched with borrower loans, with debt service and loan payment dates and amounts also aligned.

Loans outstanding, both long- and short-term, typically represent a 55%-58% of outstanding debt, with the balance consisting of investments, typically accumulated sinking fund deposits and earnings. Loan terms often exceed the maturity of associated debt, with loan repayments subject to reset when maturing debt is refunded.

Issuer Profile

Created in 1970, MFABC is the authorized capital financing entity for most municipalities and regional districts in the Province of British Columbia. MFABC provides loans to local and regional governments primarily for capital purposes, issuing long-term debentures to fund those loans. Borrowers' loan repayments support MFABC's debt service. The failure to pay by a borrower triggers a requirement that MFABC levy a province-wide property tax to support debt repayment. Over MFABC's 53-year history there have been no instances of local government failure to repay loans. More recently, pandemic disruptions in 2020-2021 and the severe fires and floods in 2021 in the province's interior had no impact on MFABC.

MFABC is governed by regional governments in the province. While authorized under provincial law, MFABC operates autonomously, its financial statements and debts are not consolidated with the province's, and there is no provincial guarantee of MFABC borrowing. MFABC benefits from a strict system of oversight of local governments by British Columbia. Local governments may not budget for deficits, have broad operating flexibility to adjust their finances, and are subject to borrowing limits that include capping principal and interest at 25% of recurring revenues and requiring voter, regional government and MFABC approval for new issuance.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Erosion of the currently sizable unrestricted liquidity that is at least equal to one year of debt service, in the form of cash, cash equivalents and credit facilities from highly-rated counterparties, sufficient to bridge the time between a borrower's failure to pay and the receipt of MFABC tax levies.

Any changes in the robust institutional framework, including to the authority's independent and unlimited taxing power, or a structural shift in the long-term growth trajectory of British Columbia's economy and MFABC's property tax base could affect the credit quality.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Not applicable for a 'AAA' rating.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

References for Substantially Material Source Cited as Key Driver Rating

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Municipal Finance Authority of British Columbia	LT IDR	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
senior unsecured	LT	AAA	Affirmed	AAA

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

International Local and Regional Governments Rating Criteria (pub. 03 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Municipal Finance Authority of British Columbia	EU Endorsed, UK Endorsed

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