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Research Update:

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

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Overview

- The Municipal Finance Authority of British Columbia's (MFABC) new capital policy will support strengthened capital levels, while the authority's mandate will be reinforced by enhanced revenue anticipation lending as a result of the COVID-19 pandemic.
- 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 municipalities in British Columbia (B.C.), with legislatively enshrined taxing powers to backstop its strong capital against unforeseen losses, strong funding and liquidity position, and prudent risk management practices.

Rating Action

On May 15, 2020, S&P Global Ratings affirmed its 'AAA' long-term issuer credit and senior unsecured debt ratings 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 ratings on the authority's commercial paper. The outlook is stable.

Outlook

The stable outlook reflects MFABC's long history of prudent management practices and conservative risk policies through asset-liability matching, which we expect will continue. We believe that the strengthening of the authority's capital policies and enhancement of its lending mandate will support creditworthiness throughout the credit cycle. We also expect that the authority will maintain its ready access to Canada's deep and diverse capital markets and its diversified investor base, as demonstrated recently amid heavy market volatility; and that MFABC's funding and liquidity position will stay strong in the next two years. MFABC will remain the exclusive lender of long-term debt to B.C. municipalities. We also expect the authority will retain its legislatively enshrined ability to levy a provincewide 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 decline 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 province's local government sector.

Rationale

MFABC, which we group with other public sector funding agencies, 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 MFABC's sinking funds, which as of December 2019 reached C$3.9 billion. We believe that, supported by low-risk appetite policies, MFABC has very strong management that, combined with robust governance, mitigates the risk that can arise from being a moderate-size organization from being smaller than peers. Capital adequacy has strengthened following the introduction of a capital framework policy, and the pass-through nature of the 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. MFABC has the unfettered ability to impose a provincewide 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 MFABC as a government-related entity.

Enterprise risk profile: Very strong public policy mandate and management will continue to complement the low-risk municipal sector

- We expect the municipal sector will remain low risk because of its well-balanced and predictable institutional framework, very high economic resilience, average leverage levels, and low financial system risk.
- The authority's very strong public policy mandate as the exclusive long-term lender to the sector will be enhanced by revenue anticipation lending.
- Management policies and governance will remain very strong with well-established and prudent management policies and practices, especially concerning asset-liability matching.

We expect MFABC will maintain its 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 the authority's mandate is the provision of low-cost borrowing to municipalities by pooling bond issues and creating liquidity in bond markets. While its core business will remain the provision of long-term lending, we expect MFABC's mandate will be enhanced by the temporary expansion of its ancillary revenue anticipation lending activity in 2020. Under this lending program, municipalities may borrow against their future anticipated revenues for the year. Although this borrowing may temporarily rise due to the impact of COVID-19 on local governments' revenue collection, we believe that legislative requirements for municipalities to produce balanced budgets, which have not changed; extremely high tax collection rates over a three-year cycle; and appropriate margins charged on such lending, limit credit risk. Furthermore, we believe that MFABC's ability to provide this lending will strengthen its already very strong public policy role for local governments, and enhance its position as one of the largest subnational lenders in the country, particularly in the municipal realm. The authority's status as the exclusive long-term lender to this sector in B.C. stabilizes its revenues because these are tied to the sector's capital funding needs, which are large and predictable. We do not expect these needs will materially change as a result of the pandemic. Unlike some of its peers, MFABC does not face competition from other lenders, which makes its customer base very stable.

Management policies and practices are prudent, and contribute to our view of the authority's management and governance as very strong. MFABC'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. Risk management policies and practices reflect the organization's low-risk appetite, most recently indicated in the approval of a new capital policy and framework. Committees must approve both loan and investment decisions. Policies cover all key aspects of MFABC's 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, plain-vanilla funding, and standardized risk management policies and procedures 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 continue to 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 remain stable. B.C., like all other provinces, imposes a prudent fiscal policy framework on its municipalities. Although social distancing requirements to mitigate the spread of COVID-19 will likely reduce municipal fee-based revenues, the requirements to run balanced budgets and to address shortfalls, will continue to bolster municipalities' ability to prevail beyond the current circumstances with relatively strong financial standing, in our view. Leverage levels in the sector are moderate: debt levels are forecast to remain below 85% of operating revenues and interest expense to be about 2% of operating revenues. As well, and like the rest of the country, the municipal sector has very high economic resilience thanks to the province's high GDP per capita levels of about US$45,600. Canada's banking system is sound and we view financial system risk for the B.C. municipal sector as low.

Financial risk profile: Strengthened capital levels will support MFABC's financial position

- Strengthened retained earnings and the loss-absorbing nature of the DRF complement the virtual absence of asset-liability management risks.
- The authority's new capital management policy will support strong risk-adjusted capital (RAC)

levels.

- Funding and liquidity levels are supported by the authority's considerable holdings of liquid investments in its sinking funds of C$3.9 billion at year-end 2019, and its unfettered access to capital markets.

We expect MFABC's new capital adequacy policy and framework, adopted in September 2019, will support strong capital levels. Growth in the authority's capital, which includes the DRF, given its loss-absorbing nature, outpaced growth in its risk-weighted assets in 2019. Capital grew as a result of MFABC's retained income, investment earnings, and short-term debt fund earnings. At the same time, the authority's loan portfolio shrunk slightly, given the speed of clients' capital investments and financing needs. This resulted in a RAC ratio before adjustments of 16.1% in 2019, up from 14.8% a year earlier. At the same time, despite MFABC's continued concentration in its top borrowers, the after-concentration ratio reached 7.9%, up from 6.8% the year before.

MFABC does not take on any transformation risk because it uses fixed-rate domestic bonds to fund its lending, which supports our strong capital adequacy assessment. 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$195 million in 2019, up from C$181 million a year earlier.

MFABC holds considerable levels of liquid investments in its sinking funds of C$3.9 billion at the end of 2019, and they underpin the authority's strong funding and liquidity levels. MFABC's funding ratio of assets-to-liabilities is 1x. The one-year liquidity ratio stood at 1.6x. 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 MFABC's investor diversification is much stronger and continues to improve, we view its investor base as slightly weaker relative to that of peers. Nevertheless, MFABC has unfettered access to the Canadian capital market, as was further demonstrated by its broadly syndicated, oversubscribed debt issuance in March 2020, during extreme market uncertainty related to the COVID-19 outbreak, and at a time when other domestic public issuers were only conducting private placements. The authority's liquidity position is also boosted by committed lines of credit totaling C$350 million, and recently, by its access to the Bank of Canada's Contingent Term Repo Facility.

MFABC, unlike any of its peers, has taxing powers, which we consider a significant credit strength. The authority has the unencumbered ability to impose a provincewide 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, and we believe this expedites its ability to collect on a special levy. MFABC has not suffered a loan book default in its 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.

Table 1

Municipal Finance Authority of British Columbia -- Selected Indicators

	--Year ended March 31--				
(Mil. C$)	**2019**	**2018**	**2017**	**2016**	**2015**
Business position					
Total assets*	9358	9244	8845	8507	8129
Customer loans (gross)	4914	4972	4681	4606	4603
Growth in loans (%)	(1.20)	6.2	1.6	0.1	(0.27)

Table 1

Municipal Finance Authority of British Columbia -- Selected Indicators (cont.)

	--Year ended March 31--				
(Mil. C$)	**2019**	**2018**	**2017**	**2016**	**2015**
Net interest revenues	120.7	118.5	115.4	123.7	110
Noninterest expenses	3.5	3.3	3.2	3.5	3.4
Capital and risk position					
Total liabilities*	8866.0	8953.8	8494.2	8235.1	7816.5
Total adjusted capital	195	181	173	163	154
Assets/capital (%)	48.0	51.2	51.7	52.2	52.8
RAC ratio before diversification	16.1	14.8	14.3	N/A	N/A
RAC ratio after diversification	7.9	6.8	7.4	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)§	1.6	1.8	1.2	N/A	N/A
Liquidity ratio without loan disbursement (1 year)§	2.5	1.8	1.7	N/A	N/A
Funding ratio (1 year)§	1	1.2	0.5	N/A	N/A

*As per balance sheet. §2018 + 2019 figures includes sinking funds. RAC--Risk-adjusted capital. N/A--Not applicable.

Ratings Score Snapshot

Table 2

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	Strong (2)
Funding	Neutral
Liquidity	Very strong (1)
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+
Municipal Finance Authority of British Columbia	
Senior Unsecured	AAA
Commercial Paper	A-1(HIGH)
Commercial Paper	A-1+