Fitch Affirms Province of British Columbia's IDR at 'AAA'; Outlook Revised to Negative

Thu 30 Jul, 2020 - 5:22 PM ET

Fitch Ratings - New York - 30 Jul 2020: Fitch Ratings has affirmed the following ratings on the Province of British Columbia, Canada:

--Long-Term Foreign Currency Issuer Default Rating (IDR) at 'AAA';

--Long-Term Local Currency IDR at 'AAA';

--Senior unsecured debt at 'AAA';

--Short-Term IDR at 'F1+'.

The Rating Outlook on the long-term ratings has been revised to Negative from Stable.

The affirmation of British Columbia's ratings are based on its Standalone Credit Profile (SCP), which remains at 'aaa'. Canada's IDR, rated at 'AA+/Stable following Fitch's downgrade on June 24, 2020, neither directly constrains nor supports the rating on British Columbia. The SCP indicates Fitch's assessment of the province's
credit quality based on two analyses. First, the province's risk profile is assessed as 'Stronger', reflecting its intrinsic economic and institutional characteristics as analyzed within the revenue, spending, liability and liquidity factors considered under Fitch's criteria for local and regional governments (LRGs). Second, the province's debt sustainability is assessed in the 'aa' category. The debt sustainability assessment is derived from a rating case scenario that posits the possible trajectory of an LRG's fiscal and debt performance from the present through fiscal 2025. Fitch's scenario considers the current severe economic and fiscal stress, and potential offsetting policy responses by the province.

The revision of the Rating Outlook to Negative from Stable reflects the possibility of the debt sustainability assessment falling into the 'a' category under Fitch's rating case. A sharp increase in the province's debt burden is all but certain in the coming years, as calculated by Fitch, potentially rising to a level, in the absence of sufficient offsetting actions, that would be incompatible with the current rating. The province's July 2020 economic and fiscal update anticipates a sharp economic contraction and a yawning deficit in fiscal 2021 relative to the tabled budget, triggered both by revenue losses and by the twin needs of responding to the pandemic and restarting the economy. The size of the potential deficit, if it materializes, far exceeds the province's experience in the Great Recession, and could have a longer lasting impact on outstanding debt.

The July update was confined specifically to the situation in fiscal 2021, and Fitch expects both an economic rebound and an eventual budgetary consolidation plan to curb growth in the debt burden, possibly within the timeline outlined in the Economic Stabilization (Covid-19) Act, passed in June, which permits deficits through fiscal 2024. In the meantime, borrowing for operations is expected to raise outstanding debt, adding to the steady forecast rise in borrowing to support the province's ambitious multiyear capital plan.

Although Fitch does not directly link British Columbia's 'AAA' IDR to the 'AA+' IDR for Canada, the national recession and the federal policy response to it are contributing to our view of British Columbia's weakening debt sustainability. Higher expected federal borrowing, when combined with provincial borrowing for operations and capital, would further raise British Columbia's economic liability burden, a metric that measures provincial debt and a pro-rata share of federal debt to GDP. The rise in federal borrowing, combined with expected provincial borrowing for operating deficits and capital projects, is reducing the leeway for additional borrowing that the province can carry while remaining within the 'aa' debt
sustainability assessment. The economic liability burden is a primary metric for assessing debt sustainability for LRGs with sovereign-like powers and responsibilities, such as provinces.

The Negative Rating Outlook does not necessarily mean that Fitch views a downgrade of British Columbia’s IDR as inevitable, and the context of the economic and fiscal recovery and future budget plans, both in British Columbia and Canada, will influence the resolution of the Negative Rating Outlook. Based on the scenario assumptions outlined below, Fitch’s rating case scenario anticipates an economic liability burden of 69% in fiscal 2025, growing from 45% in fiscal 2020. The ratio would rise over 70% through most of the scenario period, even as policy responses are implemented to narrow potential deficits.

Fitch expects policy responses to be unveiled once the public health crisis recedes and the outlines of the recession and fiscal gap become clearer. However, the uncertainties going forward are significant, and the size of necessary actions to balance are well beyond what the province had to implement following the last recession. An extended health crisis, slower economic and revenue rebound, higher spending needs and higher capital spending could delay recovery and lead to a higher debt burden, and would likely lead to a downgrade. Offsetting these factors are the inherent strengths of British Columbia’s economy and finances, which could ultimately position it for a solid recovery assuming the pandemic remains under control.

**KEY RATING DRIVERS**

Risk Profile: 'Stronger'

Fitch assesses the underlying risk profile for British Columbia as 'Stronger', reflecting the stronger assessments assigned by Fitch in five of six risk categories. The six risk categories are detailed below:

Revenue Robustness: 'Stronger'

British Columbia’s diverse revenue base, including income and sales taxes, is closely correlated to the province’s healthy economic performance, and supports the 'Stronger' revenue robustness assessment. The province's growth prospects are strong and in line with economic growth prospects for Canada overall. Although
British Columbia's diverse economy is subject to cyclicalities, Fitch anticipates it will continue over time to grow faster than most other provinces, driven by steady population gains, favorable labor market conditions and strong international linkages.

Revenue Adjustability: 'Stronger'

Like all Canadian provinces, British Columbia has unlimited legal control of own-source revenue under Canada's constitutional framework, and, thus, Fitch assesses its revenue adjustability as stronger by default. Own-source revenues are the vast majority of the revenue base, with a well-established system of federal transfers providing additional stability.

Expenditure Sustainability: 'Midrange'

As with other provinces, British Columbia's spending responsibilities are broad. The largest areas of spending are education (generally non-cyclical and stable) and healthcare (counter-cyclical and prone to rise more quickly over time). During economic downturns, British Columbia typically maintains steady spending on programs and accelerates capital outlays for economic stimulus. The 'Midrange' assessment, identical to other Fitch-rated provinces, reflects the broad spending mandate and track record of stimulus spending, which exposes the province to a higher risk that spending exceeds revenue over time.

Expenditure Adjustability: 'Stronger'

As with revenue, British Columbia retains extensive control over spending, supporting the 'Stronger' assessment. British Columbia's flexibility with regards to program spending is somewhat constrained by service demands from residents, although the province otherwise retains substantial control of spending given collective bargaining for the large civil service. Fixed costs are relatively modest, including for servicing debt, and spending mandates are not a significant constraint on the province's spending control.

Liabilities and Liquidity Robustness: 'Stronger'

British Columbia manages its debt profile independent of the federal government, and within its own robust provincial framework. The provincial treasury maintains close oversight of liquidity and borrowing, with risks stemming from variable-rate,
foreign exchange and debt refinancing carefully managed. Robust access to global capital markets supports liquidity and provides flexibility for supporting operating needs, financing deficits and refinancing bullet maturities.

Liabilities and Liquidity Flexibility: 'Stronger'

As with all provinces, British Columbia has extensive power under Canada's federal framework to manage its own internal liquid resources or mobilize external resources as needed, leading to the 'Stronger' assessment. As of March 31, 2020, Fitch estimates the province carried CAD6.8 billion in relatively liquid cash and temporary investments that could be liquidated as needed to support emergency cash flow needs.

Debt sustainability: 'a' category

Under Fitch's criteria for rating LRGs, British Columbia is classified as a Type A LRG with sovereign-like powers and responsibilities. As a Type A entity, its primary debt sustainability metric is the economic liability burden (net adjusted debt plus a proportional share of the sovereign's debt relative to the province's GDP). Secondary metrics including the fiscal debt burden (net adjusted debt to operating revenue) and actual debt service coverage (operating balance to debt service) are also considered in assigning the score.

Fitch anticipates the economic liability burden will rise over the rating case period. The affirmation of the IDR considers the province's ability to apply policy options to prevent debt from rising over the long term to a level exceeding 70% of GDP, the threshold for an 'a' category assessment. The path of future borrowing will be influenced by the size of budgetary deficits the province is likely to carry, additional borrowing to execute a sizable planned capital program, and the increase in central government debt stemming from the recession and the federal fiscal policy response.

In fiscal 2020 (estimated), Fitch calculates net adjusted debt of approximately CAD38 billion, consisting primarily of senior unsecured general debt. The economic liability burden measures 45% as of fiscal 2020, well within the 'aa' category for debt sustainability. Fitch's calculation includes public-private partnerships and leases, and nets out sinking funds for taxpayer-supported debt, cash and temporary investments. Pensions are effectively fully funded, and Fitch considers the liability for other future employee benefits and debt of the self-supporting crown
corporations (primarily BC Hydro) as contingent obligations and excludes them from net adjusted debt.

In the rating case scenario, Fitch includes revenue and spending policy responses phased in over the period through fiscal 2025, equivalent to approximately 1.2% of GDP in that year, and assumes that capital spending peaks following the pandemic and falls as the economy strengthens, consistent with past capital spending cycles. Based on these assumptions, the province's economic liability burden jumps to 74% by fiscal 2023 before beginning to decline; in fiscal 2025, it measures 69%. The fiscal debt burden metric remains within the 'aa' category for debt sustainability through the period. Debt service coverage remains below 1x through the period, typical for Canadian provinces. Given the province's ability to carry deficits, its ample liquid resources and ready access to provincial debt markets, Fitch relies less on debt service coverage ratios to assess debt sustainability.

**DERIVATION SUMMARY**

British Columbia's SCP is assessed at 'aaa', reflecting a 'Stronger' risk profile and debt sustainability metrics in the 'aa' category. Since no other factors affect the ratings, British Columbia's IDR is equal to the SCP. The province's 'aaa' SCP is one notch above Canada's sovereign rating. In Fitch's view, provinces with an SCP above the sovereign have the ability to meet the conditions under Fitch’s criteria that are necessary to be rated above the sovereign IDR, including institutional recognition and financial and fiscal autonomy; these factors also inform the 'Stronger' risk profile assessment. However, factors affecting Canada's credit quality may also affect the credit quality of individual provinces, tempering the degree to which Fitch would recognize the potential for a province to be rated above the sovereign, including British Columbia.

With broad powers devolved to the provinces under Canada's federal structure, negotiation and consensus among the provinces and federal government are necessary to initiate most changes. The powers and responsibilities of provinces limit the ability of Canada's government to unilaterally impose changes, notably on matters that fall exclusively to the provinces. Direct taxation for provincial purposes and the power to borrow on their own credit are the basis for these expansive fiscal powers. Federal transfers to provinces are material, but are likewise based on negotiation and compromise and historically have not been subject to disruptive shifts. British Columbia is among the provinces less dependent on such transfers,
and would not be constrained based on current tax rates in raising taxes from its large, diverse and wealthy economic base. Other financial flows between the provinces and the federal government are significant, such as tax collection agreements intended to simplify tax administration, but such factors do not significantly constrain our view of British Columbia's financial autonomy.

**KEY ASSUMPTIONS**

Qualitative Assumptions and Assessments:

--Risk Profile: Stronger.

--Revenue Robustness: Stronger.

--Revenue Adjustability: Stronger.

--Expenditure Sustainability: Midrange.

--Expenditure Adjustability: Stronger.

--Liabilities and Liquidity Robustness: Stronger.

--Liabilities and Liquidity Flexibility: Stronger.

--Debt sustainability: 'a' category.

--Support: none.

--Asymmetric Risk: none.

Quantitative Assumptions - Issuer Specific

Fitch's rating case scenario incorporates a combination of revenue, cost and financial risk stresses and potential policy responses through a stress scenario. It is based on the 2016-2019 actual results, preliminary results for fiscal 2020 in the February 2020 tabled budget, figures for fiscal 2021 provided in the Economic and Fiscal Update 2020-2021, released on July 14, and Fitch's projections for fiscal years 2021-2025. The key assumptions for the scenario include:
--An expected decline in nominal GDP for 2020 of 4.6% for the province and 6.2% for Canada, followed by 7.0% provincial and 4.6% national growth in 2021. The forecast assumptions for British Columbia are informed by recent publicly available forecasts published by Canadian banks; the forecasts for Canada are based on Fitch's Global Economic Outlook. Nominal GDP growth for both the province and the nation is assumed to be 4.7%, 3.7% and 3.7% in the following three years.

--The deficit in fiscal 2021 is based on the combination of revenue impacts and spending responses outlined in the July 2020 update, as modified by Fitch.

--Provincial and federal nominal GDP are the basis for growing own-source revenues and federal transfers through fiscal 2025. Federal transfers in fiscal 2021 assume a per capita apportionment of the recently announced CAD19 billion federal safe restart funding. Growth of revenues in the fiscal 2022-2025 period is adjusted by Fitch's assumptions for potential policy actions.

--Full use of the contingencies built into the province's February 2020 tabled budget.

--Removal of extraordinary pandemic expenditures in fiscal 2022, with baseline growth in operating spending through fiscal 2025 approximating the levels in the February 2020 tabled budget, partly offset by savings from potential policy actions.

--Capital spending in fiscal 2020 below the February 2020 budget level.

--3% cost of debt over the next five years.

**RATING SENSITIVITIES**

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

--Stronger Performance Reducing Debt: The Rating Outlook could be revised back to Stable in the event that the economic and fiscal recovery is more pronounced at the federal and provincial levels, resulting in more robust GDP growth and reducing the expected growth in the province's debt burden.

Factors that could, individually or collectively, lead to negative rating action/downgrade:
Prolonged or Deeper Fiscal Imbalance: Provincial economic and fiscal performance during the current recession that is significantly weaker than current Fitch expectations and that leads to more severe deficits, a prolonged period of consolidation and a greater reliance on borrowing.

Federal Fiscal Weakness: More severe deterioration in the federal fiscal outlook, including a lengthier national downturn, more severe deficits and a higher debt burden, which pushes up the pro-rata share of central government debt recognized in the province's economic liability burden metric.

Challenges in Achieving Consolidation: Evidence of difficulties in successfully carrying out the revenue and expenditure measures necessary to return to fiscal balance and resume debt reduction.

BEST/WORST CASE RATING SCENARIO

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].

CRITERIA VARIATION

The analysis supporting the 'AAA' IDR on the Province of British Columbia includes a variation from the "Rating Criteria for International Local and Regional Governments," dated September 2019. A variation was made to the limitation on rating leeway for an LRG's Long-Term Foreign-Currency IDR relative to the sovereign's Long-Term Foreign-Currency IDR. The variation recognizes that the expansive fiscal powers of provinces under Canada's constitutional framework
provide British Columbia with additional leeway to meet its financial obligations allowing for a one-notch distinction relative to Canada's 'AA+' IDR.

**SUMMARY OF FINANCIAL ADJUSTMENTS**

Minor adjustments have been made to the province's accrual based financial statement and budgetary data to calculate cash-based metrics under Fitch's criteria and to facilitate comparisons across Canadian and international LRGs.

**SOURCES OF INFORMATION**

In addition to the sources of information identified in Fitch's "International Local and Regional Governments Rating Criteria," this action was additionally informed by information from Statistics Canada.

**REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

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

**ESG CONSIDERATIONS**

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

**RATING ACTIONS**

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APPLICABLE CRITERIA

Rating Criteria for International Local and Regional Governments (pub. 13 Sep 2019) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

ENDORSEMENT STATUS

British Columbia, Province of EU Endorsed

ADDITIONAL DISCLOSURES FOR UNSOLICITED CREDIT RATINGS

British Columbia, Province of (Unsolicited)
With Rated Entity or Related Third Party Participation Yes
With Access to Internal Documents No
With Access to Management Yes

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