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INVESTMENT POLICY UPDATE

The following report, April 27, 2006, from the Commissioner of Finance, is submitted to Council without a committee recommendation:

1. RECOMMENDATIONS

It is recommended that:

1. The Investment Policy, shown as *Attachment 1,* be adopted for the management of all surplus funds and investments, including the following specific amendments:

   a) The addition of the following securities as eligible investments:

      i. Debt of supranational agencies;
      ii. Long-term debt of Schedule II and debt of Schedule III banks;
      iii. Debt of Canadian corporations rated 'AA-' or higher for a term of greater than one year but less than 5 years;
      iv. Debt of public hospitals, non-profit housing corporations, local housing corporations, post secondary educational institutions and colleges of applied arts;
      v. Debt issued by the Ontario Strategic Infrastructure Financing Authority;
      vi. Debt of Canadian corporations for a term longer than 5 years with a credit rating of 'A' or higher provided such investments are made through the ONE Fund; and
      vii. Shares of Canadian corporations provided such investments are made through the ONE Fund.

   b) The use of Forward Rate Agreements as a tool for managing interest rate uncertainty.

   c) The extension of the weighted average term of investments in the General Portfolio from a maximum of 4 years to a maximum of 8 years.

2. The Commissioner of Finance and Treasurer, the Regional Clerk and the Regional Chair be authorized to execute on behalf of the Region any documents necessary to participate in the new investment pools operated by the ONE Fund.

3. The Commissioner of Finance report back to the Finance and Administration Committee on the proposed investment guidelines to be used by the ONE Fund Equity Fund prior to any investments being made in it by the Region.

4. Staff be authorized to take all actions necessary to implement these recommendations.

2. PURPOSE

The purpose of this report is to update the Region's policy governing the management of its surplus funds and investments.

3. BACKGROUND

3.1 Investment Policy

The Investment Policy (the 'Policy') provides the framework by which staff are able to prudently and effectively manage the Region's surplus funds and investments which totalled approximately $953 million as at December 31, 2005. The Policy identifies and prioritizes the investment objectives, which in turn help staff in developing and implementing appropriate investment strategies. The Policy was last updated and approved by Council in October 2002. This update proposes to maintain the current investment objectives which, in order of priority, are as follows:

- adherence to statutory requirements;
- preservation of capital;
- maintaining liquidity; and,
- earning a competitive rate of return.

Ontario Regulation 438/97 s.7 requires that "before a municipality invests in a security prescribed under this Regulation, the Council of the municipality shall, if it has not already done so, adopt a statement of the municipality's investment policies and goals." The updated Policy will continue to meet the requirements of this regulation.

3.2 Recent Events

Since the Policy was last approved by Council, there have been several recent events which have led to the need to update the Policy again.

3.2.1 Provincial Regulatory Changes

The Provincial Debt and Investment Policy Advisory Committee (the "Committee") is comprised of representatives from provincial ministries and agencies, financial institutions as well as several municipalities, including the Region of York. During 2004 and early 2005 the Committee was asked to consider and recommend a number of potential changes to Ontario regulation 438/987 including the list of eligible investments. As a result, an updated investment regulation was filed by the Province in December of 2005. Among the more significant changes to the list of eligible investments included in the regulation was the addition of shares and long-term debt of Canadian corporations provided investments in these securities were made through the ONE Fund.

In addition, the new regulation authorized the use of hedging instruments called Forward Rate Agreements to enable municipalities to manage the costs or risks associated with fluctuations in interest rates.

3.2.2 Internal Audit Recommendations

In 2005, Internal Audit completed its normal review of all treasury operations managed by the Policy, Risk and Treasury Branch. As a result, the auditor has made several suggestions to further strengthen internal controls and clarify roles and responsibilities. These recommendations have been incorporated into the updated Policy and are described in more detail in Section 4 below.

3.2.3 Change in Strategic Focus

Over the past five years the Region's investment program has changed its focus from just providing liquidity for the day-to-day operations to a long-term reserve management and asset replacement strategy.

This change in strategic focus has transformed the portfolio from a short-term money market portfolio to one that is more diversified in terms of credit and term exposure. This transformation, which is still in the development stage, has provided significant opportunities for the Region to realize enhanced investment returns over the past four years. With the new investment powers authorized by the Province and incorporated in the updated Policy, further progress is anticipated in the development of this long-term strategic focus.

4. ANALYSIS AND OPTIONS

4.1 Provincial Regulatory Changes – Eligible Investments

The new investment regulation filed in December 2005 addressed several municipal concerns relating to investment diversity and credit exposures, while providing new opportunities to responsibly enhance portfolio yields.

The following sections further describe each of these new eligible investments included in the updated Policy.

4.1.1 Supranationals

Supranationals are agencies (financial and governmental) which raise money to fund large infrastructure projects or investments in developing countries. These institutions are typically owned and/or guaranteed by a consortium of national governments.

Although Ontario municipalities were previously allowed to invest in debt issued by the International Bank of Reconstruction and Development (IBRD), the updated regulation allows for investment in any supranational that is rated 'AAA'. Debt denominated in Canadian dollars and issued by, but not limited to, the Inter-American Development Bank and the Asian Development Bank are now part of the eligible investment list. Although no term restrictions are proposed by the Regulation, staff consider it prudent to limit the maturity of these investments to 15 years. The solid track record of these organizations in honouring their debt, backed by strong 'AAA' credit ratings, justifies a term limit of longer than 10 years. The exposure limit proposed in the Policy is set at 20% of the total portfolio.

4.1.2 Schedule II & III Banks

The Bank Act classifies banks as Schedule I, II or III banks dependent upon their status and purpose. Schedule I banks are domestic banks authorized under the Bank Act to accept deposits which may be eligible for deposit insurance provided by the Canadian Deposit Insurance Corporation (CDIC). Schedule II banks are foreign bank subsidiaries authorized to accept deposits which may also be eligible for deposit insurance provided by the CDIC. Schedule III banks are foreign bank branches that have been authorized to do banking business in Canada subject to certain restrictions.

Schedule II banks were previously authorized as eligible investments and Schedule III banks were added to the list during the most recent update to the regulation (O.Reg 655/05). However, in the banking category, the current Policy only allows for investments in securities issued by Schedule I banks with restrictions to debt of Schedule II banks. Given the benefits of diversification to the portfolio, the Policy is updated to include debt of all three tiers of Banks (i.e. Schedule I, II and III). The term limited of Schedule I banks is increased to 10 years and term limits for Schedule II and III banks are set at 10 and 5 years respectively. Only 5% (maximum) of the value of the portfolio may be invested in long-term debt of Schedule III banks. The credit risk will be limited to investment in bank paper that is rated 'AA-' or higher.

4.1.3 Canadian Corporations

In addition to Canadian banks new provincial regulations authorize municipalities to directly invest in securities issued by a Canadian corporation for a term of more than 1 year but less than 5 years provided the securities are rated 'AA-' or higher. This type of debt therefore represents securities with above average quality and low risk to default. Again, this class of securities offers more opportunities to help diversify the portfolio and enhance investment returns.

In order to limit risk exposure a limit of 25% has been set for these securities as a category with individual limits set at 5%.

4.1.4 Public hospital, non-profit housing corporations, local housing corporations, post secondary educational institutions and a college of applied arts

The inclusion of these investments is an extension of the previous eligible list of investments in specific corporations and institutions that might be considered important to municipalities. Given the focus on liquidity in the portfolio, investments in these securities are anticipated to occur infrequently and will be evaluated on a case by case basis. Exposure to this category is limited to 25% of the total portfolio, the term limit is set at 10 years and the minimum acceptable credit rating will be 'AA.'

4.1.5 Ontario Strategic Infrastructure Financing Authority (OSIFA)

OSIFA is added to the list of eligible investment as a result of a new entity that was formed to borrow on behalf of Ontario municipalities. Although OSIFA may borrow on behalf of municipalities with a lower or even no credit rating, OSIFA itself carries a credit rating of 'AA' and it is unlikely that small amounts borrowed on behalf of non-rated municipalities will affect the broader rating for the total OSIFA pool of borrowings. Investments in debt issued by OISFA will fall under the category "Municipal – 'AA'rated investments and as such is governed by an exposure limit of 25% and a term limit of 15 years.

4.1.6 ONE Fund

The ONE Fund is a municipal pooled investment program operated by two municipal organizations - the Local Authority Services Limited (a subsidiary of the Association of Municipalities of Ontario and CHUMS Financing Corporation (a subsidiary of the Municipal Finance Officers Association of Ontario). The ONE Fund currently operates two investment funds managed by professional investment firms - a money market fund and a bond fund. New provincial regulations have now authorized the development of two new classes of funds to be operated by the ONE Fund - a long-term corporate bond fund and equity funds. Each of these types of funds may present value-added investment opportunities for the Region.

4.1.6.1 ONE Fund Corporate Bond Fund

Provincial regulations restrict municipalities from investing in securities of Canadian corporations for terms longer than five years and in securities whose credit ratings are less than 'AA-'. New regulations however, do allow for such investments as long as they are part of an investment fund operated by the ONE Fund and each security is rated 'A' or higher.

Dependant on market circumstances and rates available, it may be beneficial for the Region to invest in such a fund from time to time. Such a fund would be professionally managed with term and risk exposures appropriately diversified. To further control risk exposure, any investment in such a fund would be limited to 10 percent of the overall portfolio.

4.1.6.2 ONE Fund Equity Fund

Shares or equities issued by a Canadian corporation are now included as eligible investments for Ontario municipalities, provided that any such investment is done through the ONE Fund.

In a report to Council in February 2006, the Commissioner of Finance identified the need for a Capital Asset Management Plan to establish a long-term plan for the rehabilitation and/or replacement of capital assets and associated funding requirements. The report estimated the current value of the Region's capital asset inventory at approximately $6.3 billion. Capital reserves for the refurbishment and replacement of assets including water and wastewater, roads , transit infrastructure, buildings and equipment will need to be more focussed on long-term growth as will the strategies relating to the investing of those funds set aside for them.

The ability to invest in shares of Canadian corporations provides the Region with an asset class that can provide opportunities to enhance investment returns over the long-term and support growth in capital reserves to meet future replacement/refurbishment needs. Investing in shares will increase the diversification and therefore reduce reliance on fixed income securities alone and the portfolio will be less vulnerable to adverse interest rate changes. Investments in shares will be part of the long-term portfolio and would therefore be considered longer term investments. This will reduce the risk associated with short-term fluctuations in share prices. By way of example, the TSX overall index returned 7.2% per annum between 1990 and 2005 despite the major correction in global stock markets experienced between 2000 and 2002.

Again, such a fund would be professionally managed and in order to limit risk exposures investments in Canadian shares will be limited to only 10% of the portfolio value. Furthermore, all such investments will be transacted by means of an agreement with the ONE Fund.

4.1.7 Debt Securities of Sovereign Countries

The updated Policy also includes debt securities of other high-rated sovereign countries. Investment in these securities will also promote diversification without altering the overall credit (risk profile) of the portfolio. Investments in Canadian denominated sovereign (government) debt will be restricted to 25% of the portfolio value and to a minimum credit rating of “AA-“. The latter limit will restrict investment to Canadian denominated debt issued by countries such as Australia, France, Germany, UK, USA (all ‘AAA’-rated) and Iceland, Italy, Japan, New Zealand (all ‘AA’-rated). ‘AAA’ countries carry an term exposure limit of 20 years, compared to a term exposure of 10 years for ‘AA’-rated countries and individual limits will be set at 10% for ‘AAA’ rated countries and 5% for ‘AA’ rated entities.

4.2 Provincial Regulatory Changes - New Hedging Instruments

Ontario regulation 655/05 introduced the use of instruments to manage the cost or risk associated with the fluctuations in interest rates. “Forward Rate Agreements” (FRAs) are contracts where two parties (eg. TD Bank and the Region) agree today on the interest rate level that will apply to a certain amount of investment in the future. By entering into this agreement the risk of lower interest rates between “today” and the “future” date when the actual investment occurs, is eliminated. Essentially, forward rate agreements allow the Region to “lock in” future rate of returns.

Although the interest rate is known at the time of the agreement, the Region runs the risks of opportunity losses. Since the Region has already agreed on a future interest rate based on today’s interest rate, the Region might have to forgo a higher interest rate at the actual time of investment should the interest rate increase between the time of the agreement and the time the money is invested.

In order to balance the benefits and opportunity risks of FRAs, the following guidelines would be adhered to:

- Contracts should only be used on a cash-match basis (i.e. entering into a FRA in anticipation of cash known to be received by the Region).
- Contracts cannot exceed 12 months as permitted by Ontario regulation 655/05.
- The forward amount may not exceed the lesser of the expected principal amount or 25% of the previous year's cash inflows.

4.3 Internal Audit Recommendations

As a result of the internal audit of the treasury operations completed in 2005, the following recommendations have been incorporated into the updated Policy:

a) Enhanced delieneation of treasury responsibilities and functions between front office (Treasury Division) and back office (Financing Reporting).
b) Explicit authority for the Commissioner of Finance and/or Director of Policy Risk and Treasury to delegate day-to-day investment management to the Manager of Treasury and Reserves.
c) Identifying the responsibility for and the frequency of limit monitoring, exception reporting and remediation requirements when limits have been breached.
d) Identifying the responsibility for monitoring credit rating changes on investments and how these changes can be communicated on a timely basis to Treasury and Financial Reporting staff.

The auditor also suggested that the use of a performance benchmark should vary from time to time to be reflective of the Region's current investment objectives and risk approach.

In the past, due to the short term profile of the Region's investment portfolio, investment returns have been only compared to the ONE Fund's Money Market Fund. During the last few years, the portfolio size has not only increased significantly, but has become a more diversified portfolio in terms of duration and credit exposures. Due to the change in the overall profile of the portfolio, the auditor felt that the benchmarks used to compare the performance of the portfolio also warranted change. While the portfolio will continue to evolve over time, the benchmark will require ongoing adjustments. Two sets of performance benchmarks are currently incorporated in the updated Policy based on the composition and average term of investments held – an index benchmark and a managed portfolio benchmark.

The index benchmark reflects the investment returns of a group of debt market index funds as calculated by Scotia Capital as a recognized independent service provider. The index benchmark will be set as a blend of the following indices:

- 91 day Canada Treasury Bill Rate
- Scotia Capital's All Government Short-Term Bond Index
- Scotia Capital's All Government Medium-Term Bond Index
- Scotia Capitals All Government Long-Term Bond Index

The managed portfolio benchmark will be set as a blend of the fixed income portfolio returns derived from the following funds managed by the ONE Fund:

- ONE Fund Money Market Fund
- ONE Fund Bond Fund

4.4 Change in Strategic Focus

As previously noted, the majority of the funds held in the investment portfolio are derived from corporate and capital reserves, including development charge levies. These reserves provide the Region with an important source for funding future capital needs and provide a buffer for unanticipated expenditures. The size and availability of reserves are referenced by the credit rating agencies as important considerations in the Region's overall fiscal position and contribute to maintaining its 'AAA' credit rating. Not only have the reserves grown substantially over the past several years, but analyses have shown that they have longer life cycles than originally assumed. The average term of the reserves are forecast at approximately five years currently with certain reserves exhibiting much longer time lines.

In addition, the Long Range Fiscal Planning Strategy Report highlighted that the need for providing for the replacement of the Region's assets will increase significantly in the future. With a capital asset base of more than $5 billion, the ability to match future asset replacements as far out as 50 years with current investments has become essential. The updated Policy therefore recommends that the allowable weighted average term limit for the portfolio be increased to 8 years from 4 years. To achieve this, changes to the term limits of all the current categories were made and the new proposed limits are set out in Appendix 1 of the Policy.

This will not only provide for superior matching between long-term capital expenditures and investment maturities, but will also create increased opportunities to enhance portfolio returns.

5. FINANCIAL IMPLICATIONS

Revenue earned by the investment portfolio is for the most part credited to the underlying reserve and reserve funds. As a result there is only limited direct impact to the Region's operating budget from the recommendations contained in this report.

The changes being proposed to the updated Policy, such as the expansion of the list of eligible investments and the extension of the allowable weighted term of the portfolio, will provide substantially more opportunities to both diversify portfolio holdings and enhance returns. These enhanced returns will augment the levels of the Region's reserves and reserve funds which may indirectly lessen the impact to property tax and user rates over time.

Over the past few years, interest rates generally and short-term rates in particular have been trending lower. Although interest rates recently have been increasing, the ability to diversify the portfolio into different terms, credits and asset classes has become more important. By utilizing these new investment vehicles, the Region could increase returns on funds invested by an average of 5 basis points on the overall portfolio. As an example, in 2005 the investment portfolio earned income of $33.7 million on average investments of $875 million for a net rate of return of 3.86%. If the investment program had been able to utilize the powers recommended in the new Policy, investment returns could have been increased by approximately $440,000.

Additionally, Forward Rate Agreements can be used to successfully mitigate the risk and uncertainty of cash inflows during a period of volatile interest rates.

6. LOCAL MUNICIPAL IMPACT

There is no direct impact from this recommendation on local area municipalities.

7. CONCLUSION

By approving the revised investment policy, Council is putting in place appropriate and comprehensive guidelines to promote best practices in the administration of the Region's investments. This policy specifies the goals, responsibilities, methods and parameters of the investment program. Furthermore, it ensures the effective and prudent use of the Region's investable assets while enabling staff to maximize investment returns.

This report has been reviewed by the Senior Management Group.

(The attachment referred to in this clause is attached to this report.)