3
CAPITAL FINANCING AND DEBT POLICY UPDATE

The Finance and Administration Committee recommends the adoption of the recommendations contained in the following report, May 18, 2006, from the Commissioner of Finance:

1. RECOMMENDATIONS

It is recommended that:

1. The Capital Financing and Debt Policy, shown as Attachment 1, be adopted for the purpose of all capital financing and debt activities including the use of bond forward agreements to reduce interest rate risk exposure when appropriate.

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 implement the use of bond forward agreements.

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

2. PURPOSE

This report updates the policy governing the capital financing and debt activities of the Corporation.

3. BACKGROUND

The Capital Financing and Debt Policy (the “Policy”) provides the framework by which staff administer both the short and long term financing requirements of the Corporation. It also prioritizes the financing objectives that staff will use in determining its funding strategies and financing vehicles. This Policy was last up updated and approved by Council in January 2003.

3.1 Capital Financing and Debt Policy

As at December 31, 2005 the long-term debt outstanding for Regional purposes totalled $702.8 million compared to $264.8 million at December 31, 2002, the time of the last policy update. This rapid growth in debt is forecasted to continue over the next several years as the Region invests in significant new infrastructure to enable growth and replace aging assets. It is therefore necessary for the Region to maintain an up-to-date and comprehensive policy to guide it in the administration of its capital financing and debt program.

This update proposes to maintain the best practice procedures found in earlier policies in order to fulfill Council's previously stated financing objectives, which in order of priority are:

- Adhere to statutory requirements;
- Ensure long-term financial flexibility;
- Limit financial risk exposure;
- Minimize long-term cost of financing; and
- Match term of financing to the useful life of the related asset.

These objectives also reflect the philosophy of the Financial Mission Statement and its principles that were adopted by Council in 1999.

3.2 Events Leading to Current Policy Update

Since the Policy was last approved by Council there have been several events which have led to the Policy being updated at this time.

3.2.1 Provincial Regulatory Changes

All municipal financing activities are governed by the Municipal Act and its regulations. A Provincial Debt and Investment Policy Advisory Committee (the "Committee"), which is comprised of representation from provincial ministries and agencies, financial institutions as well as several municipalities, including the Region of York, provides advice to the Province on this matter. During 2004 and 2005, the Committee considered, among other things, the use of bond forward agreements as a means to manage in-year changes to interest rate exposure on debt financing. As a result, an updated regulation was filed by the Province in December 2005 authorizing the use of bond forward agreements which are described more fully in Section 4.1 below.

3.2.2 Internal Audit Review

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 suggested that the Policy be updated to provide an expanded description relating to the use of variable interest rate debentures and bank loans.

3.2.3 Standard & Poor's Rating Review

In late 2005, the Standard & Poor's Rating Agency completed its annual review of the debt issued by the Region of York. As a result of this review, the Region's AAA rating was assigned a "negative" outlook pending future reviews.

4. ANALYSIS AND OPTIONS

4.1 Provincial Regulatory Change – Bond Forward Agreements

The new provincial regulation (0.R. 653/05) filed in December 2005 addressed the need of municipalities to mitigate costs or risks associated with debenture financing due to detrimental interest rate fluctuations.

The mechanism used to accomplish this is referred to as a bond forward agreement. A bond forward agreement is a financial contract between a municipality and an approved financial institution that allows the municipality to effectively fix the interest rate of a prospective debenture issue in advance of the issue date.

In the past, once a municipality passed a by-law authorizing the issue of debentures, it was exposed to changes in interest rates until the time of issue. Municipalities borrowing costs are primarily a function of movements in Government of Canada or Province of Ontario bond yields. These yields are of course subject to the impact of developments in the financial markets. By using bond forward contracts, a municipality now has the ability to lock in the yields on the underlying Government of Canada or Province of Ontario bonds at any period in time for part or all of its borrowing requirements thereby reducing or eliminating the effect of their movements on its financing cost. While debentures are still issued at the prevailing market rate, payments resulting from the bond forward agreement are received from or made to the financial institution which will effectively fix the cost at the interest rate that was negotiated.

The Policy has been updated to include bond forward agreements as an eligible method to mitigate interest rate risk. The Policy sets out a number of guidelines for the use of these instruments including the following:

- Bond forward agreements cannot exceed seventy-five percent of the approved amount of debenture financing authorized by Council.
- The settlement date for bond forward agreements shall not be more than 60 days after the date the agreement is executed.
- Bond forward agreements must be transacted with eligible Schedule I, II or III banks only.

Any outstanding bond forward agreements will be regularly monitored by appropriate staff and reported to Council as required by Provincial regulations.

4.2 Internal Audit Review

As a result of the internal audit of the treasury operation, the following recommendations of the auditor have been incorporated into the updated Policy:

- Expanded detail on current practices and responsibilities.
- Enhanced descriptive detailing the condition and procedures for entering into variable rate debentures and variable rate bank loan.

- Clarification of criteria for entering into interest rate exchange agreements as a hedging tool for variable interest rate loan.

Additionally, the updated policy provides an enhanced section detailing the procedures for borrowing in a foreign currency.

4.3 Standard & Poor's Rating Review

The 2005 rating review by Standard & Poor's demonstrated the need to highlight Council's commitment through this Policy to prudently finance its capital requirements including its pay-as-you-go philosophy, appropriate financing terms and reserving practices.

5. FINANCIAL IMPLICATIONS

There are no direct costs associated with this report however the update to the Policy will ensure that future risks and costs associated with capital financing are minimized.

6. LOCAL MUNICIPAL IMPACT

If a bond forward agreement relates to debentures to be issued for the purposes of a local municipality, that municipality may enter one or more agreement relating to the costs of the bond forward agreement and related matters arising from it.

7. CONCLUSION

The revised Capital Financing and Debt Policy, puts in place appropriate and comprehensive guidelines to promote best practises in the administration of the Region's capital financing and debt program.

The Senior Management Group has reviewed this report.

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