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The Regional Municipality of Durham Report

To: Finance & Administration Committee
From: Commissioner of Finance
Report: #2023-F-28
Date: November 14, 2023

Subject:

Debt Strategy update

Recommendation:

That the Finance & Administration Committee recommends to Regional Council:

- a) That Council approve the transition to the issuance of Sinking Fund debentures, where warranted, to support borrowing needs of the Region and local municipalities;
 - b) That staff report back on a Debt Management Policy to formalize the standards and controls of the capital financing and debt issuance activities for the Region of Durham; and
 - c) That staff report back on an updated Statement of Investment Policy and Goals which incorporates investment objectives for Sinking Fund investments managed internally by the Region.
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Report:

1. Purpose

- 1.1 This report evaluates the merits of alternative debenture structures and other changes required for the Region's current borrowing program to support larger debt issuances and recommends next steps to reflect best practices moving forward. Utilizing different debt structures can enhance debt issuance capabilities, improve marketing to potential investors and decrease borrowing costs.

2. Background

- 2.1 Sections 401 and 403 of the Municipal Act, 2001 (the “**Act**”) provide municipalities with the ability to incur debt for municipal purposes, including the issuance of debentures and prescribed financial instruments. The Act further requires that lower-tier (“**local**”) municipalities issue long-term debt through their upper-tier municipalities, except in the case of counties.
- 2.2 Section 408 of the Act provides that a municipality may issue debentures for long-term borrowing only to provide financing for a capital work. Sections 409 and 410 of the Act establish the guidelines to issue Sinking and Retirement Fund debentures for municipalities. Requirements include, but are not limited to, having a fixed principal payment date, estimating an annual contribution amount which, with interest compounded annually, will be sufficient to pay the principal of the debentures at maturity, and the option to establish a sinking fund committee to manage sinking fund investments.
- 2.3 Debenture capital financing may only be undertaken if compliant with the relevant sections of the Act, the Local Improvement Act, or the Tile Drainage Act, and their related regulations. Requirements include, but are not limited to, the following:
 - a. Local and Regional Council approval is required in order to issue debentures;
 - b. The term of the capital financing will not exceed the lesser of 40 years or the useful life of the underlying asset;
 - c. Long-term debt (term exceeding the current fiscal year) will only be issued for capital projects;
 - d. The total annual financing charges after a proposed debt issue will not exceed the Annual Repayment Limit (“**ARL**”) for the municipality responsible for repaying the debt, unless otherwise approved by the Ontario Land Tribunal;
 - e. Prior to passing a debenture by-law which provides that installments of principal or interest, or both, are not payable during the period of construction of an undertaking, Council will have considered all financial and other risks related to the proposed construction financing;
 - f. Long-term debt will be the joint and several obligations of the Region and its local municipalities.
- 2.4 Sources of financing include reserves, reserve funds, external borrowing in the capital markets accessed through a Debt Syndicate and other authorized financial agreements in connection with long-term borrowing offered through governments, their agencies and others, e.g., Canada Infrastructure Bank, Federation of Canadian Municipalities (“**FCM**”), Infrastructure Ontario, Ontario Ministry of Agriculture, Food and Rural Affairs.
- 2.5 As at December 31, 2022, the total long-term debt outstanding for the Region was \$265.8 million. This consisted of \$113.5 million in external debt financing for Regional purposes and \$152.3 million issued on behalf of local municipalities.

- 2.6 The Region supports the use of accumulated funds for capital financing when feasible and appropriate, supplemented with debt if necessary. Debt is considered when beneficial to the Region (e.g., incremental revenue stream over multiple years partially offset capital costs for Long-Term Care Homes) and can be supplemented by access to additional senior government financing (e.g., FCM loans regarding Durham Regional Local Housing Corporation energy retrofits).
- 2.7 The Region of Durham is one of eight municipalities in Canada currently maintaining a AAA credit rating with stable outlook from Moody's. The Region's credit strengths continue to reflect exceptional liquidity and low debt levels, strong population growth, economic diversity, and a positive operating profile with conservative fiscal and debt management. Maintaining a high credit rating is critical to supporting access to capital markets and obtaining attractive borrowing rates.

3. Previous Reports and Decisions

- 3.1 On June 29, 2022, Council authorized the issuance of external debentures not to exceed \$57.9 million on behalf of the City of Pickering, the Municipality of Clarington and The Regional Municipality of Durham ([Report #2022-F-17](#)).
- 3.2 Confirmation of the Region's Triple "A" credit rating with a stable outlook by Moody's Investors Service was provided in the May 26, 2023 Council Information Package ([Report #2023-INFO-45](#)).
- 3.3 On June 28, 2023 Council authorized the establishment of a Debenture Committee and delegated to it the authority to enact debenture, other long-term borrowing and temporary borrowing by-laws ([Report #2023-F-12](#)).

4. Methods of Issuing Debentures

External Debentures

- 4.1 The use of a Debt Syndicate, also referred to as Fiscal Agent(s), will be the primary method by which debentures will be sold by the Region to acquire capital project financing for the Region and local municipalities. The Debt Syndicate oversees the issuance of external debentures in the capital markets, including marketing and selling debentures to investors.
- 4.2 Considerations used for membership in the syndicate will include, among other things: the demonstrated ability of the Fiscal Agent(s) to underwrite and/or sell debentures in the Canadian capital markets; its commitment to provide an active and robust "secondary market" for municipal debt; and its support for maintaining and developing new investors for municipal debentures. The composition of the Debt Syndicate will be reviewed as required to address the borrowing needs of the Region and local municipalities.
- 4.3 For over 30 years, CIBC World Markets Inc. and RBC Dominion Securities Inc. have acted as the Region's Debt Syndicate/Fiscal Agent(s). In this role, they have

provided advice to staff on an on-going basis and have successfully marketed the Region's debenture issues.

Internal Debentures

- 4.4 The Region and local municipalities have the general power pursuant to section 417 of the Act, to apply reserve funds to a purpose other than that for which the fund was established. This includes utilizing reserve funds to finance capital projects.
- 4.5 Borrowing from internal reserve funds is permitted, provided that excess funds are available and the use of these funds will not adversely affect the intended purpose of the originating reserve fund. Interest should be paid to the lending reserve fund at a prescribed rate appropriate for the respective municipality.
- 4.6 A local municipality has the authority to issue a promissory note for a term that does not exceed the term of council and borrow from its own reserve fund(s) (subject to any restrictions that may apply to any reserve fund(s)) for a capital work. Borrowing of this nature by the local municipalities does not require debenture documents to be issued by the Region.
- 4.7 Internal borrowing from reserve fund(s) for capital works for a term beyond the term of council, constitutes long-term borrowing and is to be long-term financed through the issuance of debentures. The Region has received confirmation from external legal counsel that its current practice of issuing a formal debenture certificate and by-laws for internal debentures undertaken at either the regional or local level complies with the provisions of the Act.

5. Debenture Structures

Serial Debentures

- 5.1 Serial Debentures refer to a type of debt of which a portion of the principal matures each year throughout the life of the debenture issue and interest is paid on the unpaid balance in one or more instalments in each year.
- 5.2 Serial debentures are highly utilized by municipalities in terms up to 20 years, support borrowing amounts up to approximately \$75 million and are typically more cost-effective than issuing Sinking Fund and amortizing debentures.
- 5.3 In a normal, upward sloping yield curve, serial debentures can offer the lowest cost of financing given that pricing is spread across the curve. However, in the current inverted yield curve environment this may not always be true. They appeal to investors employing a buy and hold strategy and incorporate a principal pay-down feature, eliminating the need for sinking funds.

Sinking Fund Debentures

- 5.4 Sinking Fund debentures are long-term debt instruments that contain a sinking fund provision pursuant to which the issuer has undertaken to annually pay on a fixed date funds into a sinking fund for the repayment of the principal at maturity.
- 5.5 Sinking Fund debentures are another common structure used by larger municipalities to issue debt in the capital markets. They are appropriate for large capital projects with useful lives up to 40 years and transaction sizes in the area of \$100 million and more.
- 5.6 Sinking Fund debentures can accommodate terms up to 30 years, offer the broadest investor base and highest liquidity of all debt structures. However, Sinking Fund debentures are best suited for large capital projects with expected useful lives coinciding with benchmark borrowing terms of 5, 10, 20 and 30 years. Smaller projects, with varying maturities between benchmark terms (e.g., 7 or 9 years) may require alternative funding sources or debt structures.
- 5.7 A unique characteristic of Sinking Fund debentures is the requirement to establish and maintain sinking fund investment portfolios. Funds must be contributed by all participants in the Sinking Fund and invested annually to ensure sufficient funds are available to retire the debt at maturity. Contributions made to a sinking fund may result in annual surpluses or deficits based on the investments chosen.
- 5.8 Sinking fund investment portfolios also require several additional administrative duties such as maintaining separate sinking fund financial statements and audits.

Amortizer Debentures

- 5.9 Amortizer Debentures refer to debentures for which the total annual payment (principal plus interest) is approximately even throughout the life of the debt as the interest paid decreases and principal paid increases over the term.
- 5.10 Amortizer debentures are utilized less frequently in the municipal sector as they tend to be the most expensive debt structure due to their illiquidity and have a smaller investor base. However, they can support borrowing terms up to 30 years and incorporate a principal pay-down feature which eliminates the need for a sinking fund.

Retirement Fund Debentures

- 5.11 Retirement Funds are a hybrid structure which can incorporate elements of Serial, and Sinking Fund debentures where the issuer agrees to annually contribute into a retirement fund for the repayment of the principal at maturity only after the principal of other debentures issued under the same debenture by-law becomes payable. This structure is used infrequently to issue external debentures by Ontario municipalities as few issuers utilize both Serial and Sinking Fund debentures.

Please see *Appendix A: Debenture Structures* for additional details on Serial, Sinking Fund and Amortizer formats.

6. Debenture Issuance Process

- 6.1 The Debenture issuance process is complex, requiring significant collaboration and information exchange between the Region, local municipalities, Debt Syndicate, external legal counsel and investors to ensure regulatory requirements are met and securities are sold in a timely manner prior to settlement in the market.
- 6.2 Frequent communication between Finance divisions is also required throughout the process and post issuance to ensure supporting documentation is provided to enable the payment of legal fees, receipt and disbursement of interest and/or principal payments, assignment of bond ratings and recordkeeping.
- 6.3 Although some procedures may differ between external and internal debenture issuances, in general the processes are comparable.

Please see *Appendix B: Example Debenture Issuance Process* for more details on the steps required to obtain debt financing in the capital markets.

7. Discussion

- 7.1 The Region and local municipalities are going through a period of rapid growth and significant cost inflation and recent forecasts by the locals shows a need for borrowing in excess of \$250 million through the capital markets each year from 2024 to 2026. Moreover, the Region's ten-year capital forecast projects a total of \$1.2 billion in debenture financing required over the next 10 years. This level of annual debt financing is unprecedented for the Region and alternative debt securities and strategies are required to cope with increased borrowing volumes.
- 7.2 Debt capital markets continue to be extremely volatile into late 2023 with higher rates expected until the middle of 2024, at the earliest. The Region and local municipalities have made a collaborative effort to defer long-term borrowing until 2024 in an effort to minimize interest costs.
- 7.3 The Region has traditionally utilized Serial debentures to execute its borrowing program based on the size and liquidity requirements of the Region and eight local municipalities. Going forward, Sinking Fund debentures are also required to enhance debt issuances and ensure access to sufficient capital financing in the capital markets.
- 7.4 Transitioning into Sinking Fund debentures is consistent with best practices utilized by other municipal debt issuers. Staff obtained borrowing program details from several large municipalities, including the Regions of York, Peel and Waterloo and Cities of Ottawa and Toronto. From 2017 to 2022, their average annual debt issuance was \$167 million, with most issuers going to market about twice a year

and utilizing six Debt Syndicate members on average to improve marketing of debenture issuances.

8. Recommendation

- 8.1 To support the capital infrastructure needs of the Region and local municipalities, Staff recommend the development and enhancement of policies, procedures and debt issuance and investment capabilities to facilitate the issuance of Sinking Fund debentures.

9. Next Steps

- 9.1 Staff will review and determine the frequency and structure of external debenture issuances required to accommodate growth in the region and support debt requests of the local municipalities. It is anticipated that Sinking Fund debentures will be required as early as 2024 to satisfy capital financing needs estimated to be in excess of \$250 million. Serial debentures may be considered for issuance sizes below \$75 million or for projects with varying maturities between benchmark terms.
- 9.2 The composition of the Debt Syndicate will be reviewed to assess the need to appoint additional Fiscal Agent(s) to improve marketing and issuance capabilities in the capital markets.
- 9.3 A unified Debt Management Policy is required to establish financial guidelines and appropriate standards for the capital financing and debt issuance activities of the Region. The policy should be developed to help guide the effective management of debt to ensure the delivery of infrastructure and services to the residents and businesses within the Region in a sustainable manner. This is a key deliverable supporting the Long-term Financial Planning Framework for the Region of Durham as reflected in [Report 2019-F-33](#).
- 9.4 The Region's Statement of Investment Policy and Goals will also need to be updated to include objectives for Sinking Fund investments managed internally to support Sinking Fund debentures issued for the Region and local municipalities.
- 9.5 As a new Sinking Fund debenture issuer, the Region will need to develop its investor relations activities in collaboration with members of the Debt Syndicate. This may include participating on national investor calls or presenting at industry events to convey the financial strengths of the Region in the investment community.

10. Conclusion

- 10.1 Regional staff have explored options to implement best practices to support significantly larger debt issuances and leverage the Region's AAA credit rating to improve marketability of future transactions with potential investors.
- 10.2 To manage increased borrowing volumes and obtain the financing required to maintain and build new capital infrastructure, the Region will need to enhance its

debt issuance capabilities by venturing into Sinking Fund debentures and/or increasing the number of debenture issuances undertaken annually.

- 10.3 Effective management of sinking fund investment portfolios will require enhanced collaboration between the Region and local municipalities to ensure contributions are made in a timely manner and that excess balances and funding shortfalls are managed effectively. Regional staff are currently working on preparing documentation which can be shared with municipal staff at the local level and the Manager, Investment Portfolio will also be providing an update at the Area Treasurers meeting in November.
- 10.4 Sinking Fund debentures are typically associated with larger Debt Syndicates to support and market debt issuances over \$100 million. The Region will likely need to expand membership in its Debt Syndicate to include additional financial institutions to facilitate large debt issuances.
- 10.5 Utilizing Sinking Fund debentures sets the foundation for the Region to establish a framework to issue debentures such as sustainable and green bonds in the future to fund projects with positive environmental, social, and governance impacts.
- 10.6 As the debt strategy evolves and new financing structures are utilized, an update of existing debt management policies and procedures is required to ensure the Region adheres to statutory requirements, maintains a superior credit rating, attains long-term financial sustainability and flexibility, mitigates financial risk and minimizes the long-term cost of borrowing.
- 10.7 Recommendations proposed in this report are consistent with the Region's long-term financial planning principle of maintaining financial flexibility as noted in its [Long-term Financial Planning Framework](#). A dynamic debt strategy exemplifies a commitment to addressing and adapting to changes (both in the internal and external environment), uncertainties and liabilities by managing a cost-effective borrowing program and avoiding potentially negative impacts to multi-generational taxpayer and user rate affordability.

11. Relationship to Strategic Plan

- 11.1 This report aligns with/addresses the following strategic goals and priorities in the Durham Region Strategic Plan:
 - a. Goal 5.4 Service Excellence – This report demonstrates the commitment to effective, responsible financial management and provision of exceptional value to Durham taxpayers by identifying opportunities to drive organizational success through innovation, a skilled workforce, and modernized services.

12. Attachments

Attachment #1: Appendix A: Debenture Structures

Attachment #2: Appendix B: Example Debenture Issuance Process

Respectfully submitted,

Original Signed By

Nancy Taylor
Commissioner of Finance/Treasurer

Recommended for Presentation to Committee

Original Signed By

Elaine C. Baxter-Trahair
Chief Administrative Officer

Appendix A: Debenture Structures

Structure Highlights – Bullets / Serials / Amortizers				
	<i>Structure</i>	<i>Sinking Fund/Bullet</i>	<i>Serial</i>	<i>Amortizer</i>
1	Size	Typically min. C\$50 million; C\$100-400 million common size range	Suitable for smaller sizes, typically ranging from C\$25-75 million	Historically \$20-100 million, similar to serials
2	Term	5 / 10 / 20 / 30yrs	1-10 / 1-15 / 1-20yrs	20-30yrs
3	Principal Paydown	No – interest only till maturity	Yes – a line matures every year, bringing down the total deal size every year	Yes – principal and interest each year; customizable payments
4	Sinking Fund	Yes, sinking fund to be maintained to pay down maturity	No sinking fund required	No sinking fund required
5	Investors	Traditional muni buyers, broadest investor base	Subset of the muni buyers; niche investor base who participate in serials	Private placement buyers, primarily life insurance companies
6	Liquidity	High – significant trading activity	Medium – mostly buy and hold	Low – rarely traded; buy and hold, tucked away till maturity
7	Pricing	Pricing at one point on the curve	Lowest cost of financing given pricing across the curve	In between bullets and serials; pricing depends on weighted-average life maturity + amortizer premium
8	Documentation	Streamlined documentation	Similar to sinking fund debentures; includes repayment schedules	Very similar to serials; not onerous
9	CDS Fees	Lowest given fewer “events”	Typically higher than bullets and could vary depending on term (1-10 / 1-15)	Slightly higher than serials due to a new CDS event management fees

Appendix B: Example Debenture Issuance Process

Prior to Issuance

- a. Local municipalities provide a letter to the Region Treasurer advising of their intentions to obtain long-term debt through a debenture including estimated timing, amount, term and passes a borrowing by-law;
- b. Local municipalities provide authorizing documents to the Region e.g., by-laws, council reports, resolutions and meeting minutes, confirmation of capital works, compliance with ARL etc.;
- c. Regional staff and external legal counsel review authorizing documents for compliance with the Act;
- d. The Region consolidates borrowing requests, determines a suitable debt structure and submits a Council Report to approve the debenture issue;
- e. After approval, the Region confirms the desired settlement date of the debenture issuance with the Debt Syndicate and external legal counsel;

Issuance Period

- f. Notify local(s) of debenture timeline and key dates;
- g. Region completes pricing call and provides locals with final pricing details;
- h. Final pricing and purchase letter are provided by the lead Fiscal Agent;
- i. The purchase letter is executed by the engaged parties, as appropriate;
- j. Debenture documents are provided to the municipalities for signature (e.g., certificates of Clerk, Treasurer);
- k. Local(s) to provide executed documentation e.g., certificates of Clerk, Treasurer;
- l. The Debenture Committee approves the debenture certificates and numerous other debenture documents and by-law(s) are passed;

Between Issuance and Settlement:

- m. Debenture documents from local(s) and Region are provided to external legal counsel e.g., all approved certificates, debentures, by-law(s), etc.;
- n. Region to provide repayment schedules from Debt Syndicate lead to local(s);
- o. Region and local(s) to coordinate disbursement of funds and payment of future coupon and maturities;
- p. Debenture certificates are distributed to the Canadian Depository for Securities for registration;

Settlement Date:

- q. Confirmation of no changes to the conditions for the issuance of the debenture by the Region and issuance of the legal opinion;
- r. Net proceeds are disbursed to the Region by the Debt Syndicate lead;
- s. Region confirms receipt and transfers funds to the local municipality(ies);
- t. Local(s) confirm receipt of debenture proceeds.