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The Regional Municipality of Durham Information Report

To: Finance and Administration Committee
From: Commissioner of Finance
Report: #2023-F-4
Date: February 14, 2023

Subject:

Investment Portfolio Update

Recommendation:

That the Finance and Administration Committee recommends to Regional Council that:

Staff continue to investigate alternatives for transitioning to the prudent investor standard to assess its suitability for the Region's portfolio.

Report:

1. Purpose

1.1 This report is a second in a series to update Committee on current and future activities pertaining to Durham Region's investment portfolio. The purpose of this report is to provide information on the legislation governing municipal investments, eligible investments, investment policy and reporting requirements. This report also describes recent initiatives and discusses next steps for improving the ability to earn better returns on the investment portfolio.

2. Background

2.1 For all municipalities in Ontario, except for the City of Toronto, investment powers are governed by the Municipal Act, 2001 (Act). Section 418 of the Act clarifies that municipalities can only invest in prescribed securities according to the rules and conditions established by regulation. On March 1, 2018, the Municipal Act, 2001, Ontario Regulation 438/97 (Regulation) was amended to update Section 418 for new eligible investments and add Section 418.1 to provide municipalities with the option to invest under the prudent investor standard. Prior to this change municipalities were only allowed to invest in a prescribed list of securities, often referred to as the legal list.

- 2.2 The legal list approach represents the default set of provincial guidelines for all municipalities and restricts investment to a prescribed list of securities. The ability to invest is limited to the institutions and securities that are considered eligible under the Regulation. For example, Guaranteed Investment Certificates (GICs) issued by a Schedule I bank are considered eligible investments, whereas direct ownership in shares of a Canadian corporation is not considered an eligible investment. For a full list of permitted securities, please refer to [Part I: Eligible Investments](#) of the Regulation.
- 2.3 Qualifying municipalities who elect to become prudent investors can invest in any asset insofar as the portfolio is considered prudent for its circumstances. For a full description of the applicable rules for obtaining prudent investor status, please refer to [Part II: Prudent Investment](#) of the Regulation.
- 2.4 Durham Region's investments are currently restricted to the legal list of eligible investments permitted under the Regulation. The Region's Investment Policy sets a low to moderate risk tolerance level depending on investment terms, and the overall investing approach prioritizes compliance with legislation, capital preservation and liquidity when considering investment opportunities to maximize returns within the stated risk tolerance.

3. Previous Reports and Decisions

- 3.1 The Act states that before a municipality invests in a security prescribed under the regulation, the Council of the municipality shall adopt a statement of its Investment Policy and goals. The Region's current [Statement of Investment Policy and Goals](#) (Investment Policy) was approved by Council on January 26, 2022 (Confirming By-law #02-2022).
- 3.2 In accordance with the Municipal Act, 2001, Ontario Regulation 438/97, and the Region's Statement of Investment Policy and Goals, an investment report is prepared annually by the Treasurer to report on the performance of the investment portfolio for the prior fiscal year and compliance with the Region's Investment Policy. The 2021 investment report ([2022-INFO-68](#)) was included in the August 19, 2022 CIP package.
- 3.3 Council approved, through the 2020 annual budget, dedicated resources (Manager, Investment Portfolio and Senior Investment Analyst). The Manager, Investment Portfolio is now in place and recruitment for the Senior Investment Analyst is underway.

4. Discussion

Legal List

- 4.1 The legal list permits investment in a range of securities for municipalities that are ineligible for, or choose not to implement, the prudent investor standard.

4.2 Examples of investment options permitted under the legal list include:

- Canadian federal, provincial and municipal government or government-guaranteed bonds
- Short-term deposit and fixed-income securities issued by Schedule I, II or III banks, loan or trust corporations and credit unions
- Canadian corporate debt maturing in under 5 years
- Other prescribed investments such as commercial paper and arrangements for the sale of assets that entitle the purchaser to an undivided beneficial interest in a pool of assets (previously referred to as asset-backed securities)
- Shares of a Canadian corporation or Canadian corporate debt maturing in over five years accessed through ONE Investment portfolios

4.3 Issuing financial institutions for all deposit and debt related securities must satisfy the ratings and financial indicators identified in the legislation to be considered eligible investments. For example, Schedule I bank deposits or debt with maturities over two years must be ranked as “A-” or higher.

4.4 Under the legal list approach, no formal governance model is required under Ontario Regulation 438/97. Municipalities maintain full control and management of all investments purchased with public funds and no delegation of investment powers or duties to investment boards are required.

Prudent Investor Standard

4.5 Section 418.1 of the Municipal Act, 2001 that authorizes municipalities (other than the City of Toronto) to opt into the prudent investor regime was proclaimed in force, effective March 1, 2018. This included regulatory amendments that set out the requirements around eligibility criteria, the governance framework, and the rules for municipalities investing together as a group. Municipalities that opt into the prudent regime will no longer be restricted to a prescribed list of investments.

4.6 Municipalities utilizing, or in progress of accessing prudent investor powers using an independent investment board, include the Cities of Toronto, Ottawa and Barrie. There are currently nine municipalities accessing the prudent investor standard through the ONE Joint Investment Board: The Cities of Kenora, Thunder Bay and Quinte West, District Municipality of Muskoka, Municipality of Neebing and Towns of Bracebridge, Huntsville, Innisfil, and Whitby. It should be noted that the current ONE Joint Investment Board is more appropriate for smaller municipalities as its portfolios could be distorted by larger municipalities such as Durham Region.

4.7 As an entity that satisfies all eligibility criteria, the Region can transition to the standard under one of three approaches:

- I. Establish an independent investment board (IB);

- II. Establish a joint investment board (JIB) with one or more other municipalities;
or
 - III. Invest through an existing IB or JIB (e.g., ONE Investment).
- 4.8 Adoption of the prudent investor standard requires the passage of a new irrevocable by-law. A municipality is only required to satisfy the eligibility criteria at the time of adoption and approval of the by-law. To opt out of the prudent investor standard, a municipality would require a regulation of the Lieutenant Governor in Council. If alternative service providers exist, there is also the option to switch investment boards to achieve investment objectives more effectively.
- 4.9 A qualifying municipality can invest in any security insofar as the portfolio is considered prudent for its circumstances, as opposed to the prescribed legal list of investments permitted by the province. There are no restrictions on securities but requires investors to construct a portfolio with the care, skill, diligence and judgment of a prudent investor. Example investments could include global bond or equities and even illiquid assets such as real estate.
- 4.10 As a prudent investor, a municipality must delegate its control and management over funds deemed not required immediately (i.e., long-term funds) to a professionally managed investment board. The Region would continue to have investment oversight for short-term funds required for operating purposes.
- 4.11 Council retains strategic direction over assets managed by the investment board and guides the activities of the professional fund managers through its Investment Policy which defines risk and return objectives and liquidity requirements for long-term funds. Council must review and, if necessary, amend the policy at least annually.

5. 2022 Highlights

Investment Policy update

- 5.1 The Investment Policy adopted in January 2022 allows access to a broader range of securities, providing staff with additional flexibility and guidance when choosing investments. It also supports the goal of diversifying investments to improve portfolio returns, enhances the ability to achieve stated objectives, and facilitates the implementation of a more active investment strategy, subject to the legality, capital preservation and liquidity objectives within the policy.

Active Investing

- 5.2 The volume of transactions has increased significantly in the last year to capitalize on investment and redemption opportunities. This includes a return to the capital markets after a four-year hiatus. On average, the number of transactions for 2022 is more than double the amount from the pre-pandemic period.

Environmental, Social, and Governance (ESG) investing

- 5.3 ESG securities are employed to increase exposure to organizations that demonstrate high ethical and environmental standards and respect for their employees, human rights, and the communities in which they do business. Global ESG assets are expected to exceed \$53 trillion USD in 2025, more than a third of projected assets under management¹. In a 2022 survey of global investors, over 45% of respondents, representing over \$42 trillion USD, indicated that they incorporated ESG considerations in their investment decisions². ESG securities represent approximately 1.6% of the portfolio and are allocated amongst Social (0.3%) and Green bonds (1.3%). ESG bond issuers in the portfolio include the City of Toronto, CPP Investment Board, Ontario Teachers Pension Trust and Government of Canada (Ukraine Sovereignty bond).

Increased Equity exposure

- 5.4 Equity exposure through the ONE Canadian Equity fund increased to 3.6% in 2022 from 1.6% at the end of 2021. The equity allocation was increased using a disciplined dollar cost averaging strategy to mitigate the impact of market volatility. Committing funds to equities enhances long-term returns over 10 years or more.

GIC Ladder

- 5.5 Surplus cash and maturing funds were used to implement a 5-year GIC ladder during the year. This approach enhances cash flow flexibility, mitigates the impact of interest rate fluctuations and encourages diversification by issuer to improve returns or lower risk. The average rate or return across all terms is approximately 4.1%.

Average Term to Maturity (Duration)

- 5.6 Strategic decisions to implement a GIC ladder, increase equity exposure and incorporate longer term bonds have extended the average term to maturity for assets held in the portfolio, allowing staff to lock in returns over longer periods of time. The average duration of the portfolio increased by half a year in 2022.

Increased Diversification

- 5.7 Staff were able to source investments from several new issuers to mitigate concentration risk in the portfolio from being exposed to a few large entities. This involved shifting funds to high credit quality municipal, provincial and federal bonds from Schedule I banks.

1 <https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/>

2 https://www.rbccm.com/assets/rbccm/docs/insights/rbc_capital_markets_global_esg_credit_investor_survey.pdf

Liquidity Optimization

- 5.8 Deposits held in High Interest Savings Accounts (HISA's) at banks were minimized to achieve better returns while maintaining liquidity. This involved utilizing short-term GIC's, redeemable securities and government bonds to generate higher returns.

Enhanced Returns

- 5.9 Capital markets were extremely volatile throughout 2022 but fixed income investment yields were boosted by a 4.0% increase in the Bank of Canada overnight rate. Taken into consideration with a more active investing approach and trading strategies, the average rate of return on the portfolio increased by approximately 0.70%, or \$25.5M in value.

Collaboration with Local Municipalities

- 5.10 Investment and networking opportunities continue to be shared with Area Treasurers. Investment Portfolio Division staff are willing to offer advice and support as a subject matter expert to local municipalities on issues related to investments or debt issuances.

New Accounts & Relationships

- 5.11 Several new relationships were established to improve knowledge and access to investment securities and market research. While not all resulted in new business, staff were successful in opening an account with BMO Nesbitt Burns to gain access to structured products which may offer enhanced return potential in the future.

6. Next Steps

Cash Flow Forecast Enhancement

- 6.1 Investment staff have already updated calculation methodologies and initiated discussions within Finance with a view to improving the accuracy of short and long-term cash forecasts. This is an integral step in developing reliable estimates of surplus cash which will inform investment decisions and match cash flows with growth capital, asset management and debenture repayment requirements. Reserve and reserve fund forecasts and long-range financial plans will be consulted throughout the process to ensure all relevant data is considered.

Trading Efficiencies

- 6.2 To streamline trade execution and settlement processes, investment staff will acquire a Bloomberg terminal and enable online custodial transactions, respectively. These endeavours will not only significantly decrease the amount of

time spent negotiating and settling trades, but also improves the safety and security of transactions and investments.

Prudent Investor Analysis

- 6.3 Investment staff will consider alternatives for transitioning to the prudent investor standard to assess its suitability for the Region's portfolio and update Council. This analysis will assess the merits and limitations of creating a new investment board or joint investment board or joining an existing investment board. There are numerous requirements for adoption and creating and operating an IB or JIB so careful consideration will be paid to potential resourcing constraints of developing an independent investment board. Investment staff are aware that efforts are currently underway by ONE Investment to establish a joint investment board with a limited number of large municipalities and will evaluate that potential solution as more details become available. As a general ballpark, it is estimated that costs to implement a full prudent investor investment regime are in the vicinity of \$1 million. There are also ongoing costs for the JIB, compliance costs with the Ontario Securities Commission, custodial and audit fees as examples.

Durham Investment/Debt Forum

- 6.4 Investment Division staff will work with local municipal staff to implement a monthly forum to discuss and review topics related to investments and debenture issuances. The goal is to provide a forum for collaboration, information gathering and knowledge sharing amongst members. The Region, specifically, can offer feedback on investment policies, networking opportunities with contacts, facilitate enrollment in the ONE Investment program or assist with evaluating investment ideas or service providers etc. Regional staff will also continue to assess further opportunities, outside of the prudent option, to support and assist local municipalities to maximize their investment returns.

7. Relationship to Strategic Plan

- 7.1 This report aligns with/addresses the following strategic goals and priorities in the Durham Region Strategic Plan:
- i. 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.

8. Conclusion

- 8.1 The update to the Region's Investment Policy was a significant step towards implementing a more active investment strategy and improving the ability to generate new revenues by implementing a more diversified portfolio. Changes to the policy facilitated the optimal use of available funds within the overarching

objectives of the Investment Policy to generate increased investment income, subject to other external factors, such as market conditions.

- 8.2 Municipal investments are an important source of financing and as Durham Region continues to grow and ratepayer needs increase, additional revenues will be required to mitigate tax increases and balance long-term cash flow needs and funding challenges with future capital budgeting requirements. Cash flows generated from investments can be structured to match expected capital expenses in the future by aligning investment life cycles with municipal asset management plans for repair, replacement, and creation of local infrastructure.
- 8.3 Establishing a process that is reflective of best practices where long-term financial plans inform investment decisions will require a coordinated effort between Finance and departmental business partners. Ideally, this exercise would include the forecasting of anticipated cash flows associated with approved growth capital projects, debt repayment or asset management requirements. An enhanced reserve and reserve fund forecast to identify long-term funds will be a prerequisite for transitioning to the prudent investor standard.
- 8.4 Finance staff are committed to collaborating with the local Area Treasurers to determine effective partnership/support opportunities and will include updates in future reports.
- 8.5 Efforts to creatively diversify the portfolio within the parameters of the Investment Policy to improve returns and mitigate risk are ongoing and investment staff are continuously researching new securities, establishing relationships with investment providers and reviewing best practices with municipal peers. Portfolio activities and investment strategies will continue to be communicated to Council on a regular basis.

Respectfully submitted,

Original Signed By

Nancy Taylor, BBA, CPA, CA
Commissioner of Finance

Recommended for Presentation to Committee

Original Signed By

Elaine C. Baxter-Trahair
Chief Administrative Officer