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Item No. 6

Halifax Regional Council
September 8, 2009

TO: Mayor Kelly and Members of Halifax Regional Council

SUBMITTED BY: Cathie O'Toole, CGA Director of Finance / CFO

DATE: August 24, 2009

SUBJECT: **Review of HRM Debt Issue Options**

INFORMATION REPORT

ORIGIN

Discussion at the March 31, 2009 meeting of Regional Council on how HRM currently issues long term debt.

BACKGROUND

In considering the staff recommendations for the Spring Debenture issue, there were a number of questions related to whether the current practice of issuing debt through the Nova Scotia Municipal Finance Corporation (NSMFC) represented the best option for HRM. While current Provincial Legislation generally requires that all Nova Scotia Municipalities borrow through NSMFC, should more attractive options be available to HRM then a change in Legislation could be pursued. The purpose of this report is to inform Council of the results of the review of HRM's current debt issue practices and whether there may be other options that may be more beneficial to HRM.

DISCUSSION

Capital Market Overview

Capital Markets, of which debt issuance is but a part, is a very specialized area of Finance. Currently HRM directly participates in the Capital Markets primarily as a lender under the HRM Investment Policy. Many of the principles and analytical processes are the same whether from the perspective of lender as the buyer of debt, or borrower as the issuer of debt. The main considerations are Credit Risk, Liquidity Risk, Interest Rate or Market Risk and Diversification.

Credit Risk is the risk that interest and principal payments won't be made as promised in the debt instrument. An inability or unwillingness to pay by the borrower can result in expensive litigation and losses for the lender. In the case of secured debt, debt which is backed by a particular asset, the lender can have a financial asset unexpectedly become a physical asset. For example a default on a mortgage often results in a bank taking ownership of a house which it must then maintain and resell to recover its original loan amount. The issuance of secured debt by a Municipality can be somewhat problematic as many Municipal Assets cannot be readily resold as their ability to produce a stream of income to the owner may be questionable.

Liquidity Risk is the ease with which a bond or other debt instrument can be sold to another market participant. Key factors here are the stability of the Credit Risk of the issuer as well as the size and market demand for the particular instrument.

Interest Rate or Market Risk refers to the risk that interest rates may go up or down after a debt instrument has been issued by the borrower or purchased by the lender. There is always a risk that a 'better deal' could be available in the future after a commitment has been made. Diversification is a risk management technique whereby investments and borrowing is spread among a number of parties to reduce the potential negative impacts in the case of a default by one particular party.

The government bond market in Canada is well established. The Government of Canada has some $487 billion of bonds and treasury bills outstanding while the total for the Province of Ontario as at March 31, 2009 was $177 billion. According to the May 4, 2009 Debt Management Plan, the Province of Nova Scotia has some $12.3 billion of debt outstanding.

Canadian Bond Market norms are well entrenched. For example, Government of Canada bonds are generally the benchmark bonds off of which other bonds are priced. As a sovereign government that can create money, Government of Canada bonds are seen as having the least Credit Risk of all Canadian government bonds. Relative to other Canadian government bond issuers, the large size of Government of Canada bond issues make them the most liquid. As a result bond investors demand to be paid premiums over what the Government of Canada can borrow at for any particular term to compensate for greater relative Credit and Liquidity Risk. These premiums vary by issuer according to the market's perceptions of these risks at any given time.

Municipalities that issue bonds under their own name always pay higher rates than their home Province even if they have a higher credit rating than their Province. This is because of the relatively smaller size of Municipal bond issues, making them relatively less liquid, as well as the fact that Municipalities are subject to Provincial Legislation. Changes in Provincial Legislation can have negative impacts on a Municipality's financial situation and the Bond Market participants want to be paid for this risk.

The vast majority of the buyers of Government bonds are institutional investors like Insurance Companies, Bond Fund Managers, etc. that have a fiduciary responsibility over the funds they manage. As such they are accountable to others for the decisions they make and therefore tend to follow the Bond Market norms.

How HRM Currently Issues Debt

The Municipal Finance Corporation Act of Nova Scotia requires all Nova Scotia Municipalities to issue bonds to the NSMFC or to the Government of Canada, the Province or another municipality. The NSMFC pools the requests of Nova Scotia Municipalities and other eligible entities and borrows on their behalf. The Province of Nova Scotia guarantees this debt and maintains the right of first refusal to purchase bonds issued by the NSMFC. The Provincial guarantee is critical from the Market's perspective and outweighs any considerations of the financial position of any of the borrowers using the services of the NSMFC. The Provincial guarantee not only directly impacts the interest rates that will be paid on this debt but also helps ensure an appetite for this debt when market conditions are difficult.

The NSMFC charges a fee of approximately of 3/4% on top of the market determined interest rates. Roughly half of this fee is to create a Reserve to fund the ongoing operations of the NSMFC while the balance covers actual costs incurred in the issuance of debt such as commission expenses and other related fees. Staff are advised that the NSMFC is able to piggyback on Province of Nova Scotia commission rates leading to savings of some 50% on these fees. There is no explicit fee for the Province of Nova Scotia guarantee.

The primary drawback for HRM using the NSMFC is a lack of control over the timing of debenture issues. The NSMFC usually does two bond issues a year around May / June and October / November. There is typically a 6 week lag between when HRM must indicate the amount of funds desired from a bond issue and when the funds are actually received. The timing of NSMFC bond issues generally works reasonably well as the Fall issue can potentially capture expenditures from the Spring and early Summer construction season while the Spring issue can cover expenditures for the balance of the year. NSMFC is open to feedback on the general timing of their debenture issues. However they also must consider the needs of all of their clients. NSMFC is also willing to do special issues and in fact did so at HRM's request for Harbour Solutions. The drawback for a special issue for HRM is that all of the issue costs must be absorbed by HRM versus being shared by the other participants. In the case of the special Harbour Solution issue of $110,000,000 this was acceptable. However for smaller issues the costs can be relatively higher as some of the issue costs are fixed dollar amounts versus a percentage.

The right of first refusal that has been frequently exercised by the Province of Nova Scotia is worthy of some discussion. When market conditions are difficult this helps ensure that the bond issue is completed which avoids the negative stigma of a failed issue and ensures that HRM and other participants receive their funds as expected. For the Province the liability created by the Provincial guarantee is effectively extinguished as they are holding the debt. Because of their senior Legislative position to the participants in NSMFC bond issues, they are virtually assured payment as they can produce Legislation to enforce payment should it ever be in doubt. The net result is that they are receiving interest payments at Province of Nova Scotia borrowing rates, which as previously discussed reflect a risk premium, for what is substantially a risk free investment. It should be noted that HRM, or the other NSMFC clients for that matter, are not bearing any additional costs for this arrangement and gain the benefit of a dramatically reduced potential for failed issues.

As part of the Harbour Solutions Project (the Project) HRM received approval by Provincial Legislation to pursue financing for the Project outside of the normal NSMFC process. An exhaustive search for alternative sources of financing was conducted. After detailed discussions and negotiations with a number of parties it was concluded that the NSMFC offered the most cost effective financing. One exception to this was financing offered through the Federation of Canadian Municipalities Green Fund. This Fund offered limited financing at below market interest rates as an incentive for Municipalities to undertake environmentally friendly projects. HRM secured $20 million, the maximum amount available, as part of the Project financing. In the future there may be other opportunities to access other cost effective financing as part of Federal Government initiatives.

What Other Canadian Municipalities Do

In reviewing what other Canadian Municipalities do staff consulted both industry sources as well as other Canadian Municipalities. There are differences in approach across the country. In some Provinces Municipalities are required to borrow through a Provincial Agency as in Nova Scotia. In other Provinces certain Municipalities are exempted from this requirement while others are not. In some Provinces the Municipalities have the option of going to the Bond Market on their own or through a Provincial Agency. Of particular interest were those Municipalities that had the option to use a Provincial Agency but chose instead to borrow on their own.

For the most part Municipalities that choose to go to the bond market on their own had a credit rating of AA or AAA. Despite such high credit ratings, we could find no cases where a Municipality could borrower cheaper than its Province no matter what the difference in credit rating between the Province and the Municipality. Some of these more highly rated Municipalities, however, could borrow at rates competitive with those offered by their respective Provincial Agency after all fees were considered. From discussions with colleagues in some of these Municipalities the primary motivations for borrowing on their own was the flexibility in the timing of debt issuance, the desire to avoid the administrative and reporting requirements of some Provincial Agencies and the preservation of the ability to access Capital Markets on an independent basis. They believe that these advantages offset the requirement to maintain staff expertise in this area as well as the need to maintain a current credit rating, Investment Dealer relationships, etc.

Conclusion

Staff believe that the current arrangement of borrowing through the NSMFC is beneficial to HRM as well as the other participating Municipalities in Nova Scotia. However, in the future should HRM attain a credit rating of AA or higher then the option of HRM issuing bonds directly to the market should again be reviewed. Should a review at that time result in the potential for cost savings for HRM versus the use of NSMFC then a change in Provincial Legislation could be pursued.

Recognizing that this is a very specialized area, staff have attached a number of Frequently Asked Questions (FAQs) pertaining to debt issuance as Appendix A.

BUDGET IMPLICATIONS

There are no budget implications arising from this Information Report.

FINANCIAL MANAGEMENT POLICIES / BUSINESS PLAN

This report complies with the Municipality's Multi-Year Financial Strategy, the approved Operating, Capital and Reserve budgets, policies and procedures regarding withdrawals from the utilization of Capital and Operating reserves, as well as any relevant legislation.

ATTACHMENTS

Appendix A - Frequently Asked Questions

A copy of this report can be obtained online at http://www.halifax.ca/council/agendasc/cagenda.html then choose the appropriate meeting date, or by contacting the Office of the Municipal Clerk at 490-4210, or Fax 490-4208.

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Appendix A

Frequently Asked Questions

1) Q: The staff report for the HRM Spring bond issue included a Resolution for Pre-Approval of Debenture Issuance Subject to Interest Rate with an interest rate of 6.5%. What were the actual rates for the Spring bond issue?

A: The interest rate stated in the Resolution for Pre-Approval of Debenture Issuance Subject to Interest Rate is deliberately set at a very high level compared to the actual rates anticipated. This is to avoid the need to come back to Council should rates increase from the time Council approves a borrowing and the debenture issue is priced. By setting a high upper limit, staff and the NSMFC can be secure that the debenture issue can proceed under most market conditions and funds be received by HRM when anticipated. Setting this rate at a high level has no impact on actual borrowing costs.

Below is a summary of the "All in" interest rates from the Spring Debenture issue. "All in" rates include all issue costs.

"All-in" Costs	
Breakdown by term:	
Term	**"All-in" Costs**
5 years	2.78%
10 years	4.01%
15 years	4.75%
20 years	5.09%
25 years	5.26%
30 years	5.36%

2) Q: I think the interest rate on my Personal Bank Line of Credit is lower than the rates that HRM pays for bond interest. Is that possible?

A: A Personal Bank Line of Credit is a type of floating rate debt. In other words the interest rate will change over time. In most cases the interest rate on a Bank Line of Credit is set at the Bank's Prime Rate plus an additional spread. This spread depends on the creditworthiness of the borrower as well as whether the Line of Credit is secured or unsecured. While an unsecured Line of Credit depends solely on the creditworthiness of the borrower, a secured line of credit will have some type of asset that can be seized by the bank if the Line of Credit is not repaid. The interest rate on a Line of Credit will change as the Bank's Prime Rate changes or should the bank reassess the creditworthiness of the borrower or usefulness of the collateral. Currently Bank Prime Rates are at historic lows and as a result have the potential to go up in the future.

HRM has the option under the banking contract to borrow on a short term basis using a Bank Prime Rate formula. This option has not been used in the past as active cash management has mitigated the need for any short term borrowing. Staff do not believe that attempting to use this type of short term borrowing to provide permanent financing for long term capital assets is prudent as it exposes HRM to Interest Rate Risk. The interest rates that HRM pays on bonds issued by NSMFC are fixed at the time of issuance of these bonds and will not change no matter what happens to the bank Prime Rate or any other interest rate changes in the future.

3) Q: I think the interest rate on my mortgage is less than what HRM pays for bond interest. Is that possible?

A: A mortgage is a secured type of loan with the house pledged as collateral. Should the mortgage payments not be made then the house can be seized by the mortgage holder and sold to recover the loan amount. There are well established legal frameworks for doing this and most houses can be sold at a price that would cover the mortgage amount. In addition, many mortgages carry Canada Mortgage and Housing Corporation insurance that can reimburse the mortgage holder in the case of default. This insurance allows the mortgage holder to take less risk which in turn may serve to lower the interest rate. Interest rates on mortgages and new bond issues are constantly changing so if making a comparison it is important to do this on the same date. Also, when making a comparison the terms or time frames must be equal. For example comparing a three year mortgage to a ten year bond is not particularly valid.

The dynamics of the bond market versus the mortgage market can sometimes be different. There can be competitive pressures on mortgage lenders that can serve to lower rates in this market where in the bond market a sense of risk aversion by institutional investors can serve to raise rates. If it may be possible to occasionally get a mortgage at lower rates than HRM can borrow in the bond market this does not represent a lost opportunity to HRM as the two markets are different.

4) Q: Why don't we just issue bonds directly to our taxpayers who may see this as a good investment opportunity?

A: While this may sound appealing, when considered in some detail it does not take long to become complex and costly. Ignoring the Legislative issues, bonds would need to be either issued in physical form as bond documents with coupons to be clipped and redeemed or through an electronic registry. Physical form bonds could be either registered in the name of the bond holder or in bearer form. Assuming these bonds were issued in $1,000 denominations it would take 5,000 of them to raise $5,000,000, a fairly modest amount compared to normal HRM borrowing requirements. With physical form bonds there would be legitimate cases where these bonds could be inadvertently destroyed, lost or stolen. Addressing these issues would expose HRM to fraud. Semi-annual interest on 5,000 bonds would require 10,000 interest payments a year. In other than pure bearer form, which would open the risk of counterfeit, a registration and re-registration process would need to be established when the bonds were initially sold and as they were passed from one person to another by sale, gift or as part of an estate. Should early redemption be permitted then there is the risk that these bonds would be put back to HRM when interest rates have risen as the holders seek higher yielding opportunities requiring HRM to re-finance in this higher interest rate environment. With 5,000 bonds there will be unanticipated events requiring resolution. All of the above suggest a cost of funds well in excess of borrowing through established channels.