REPORT TO GOVERNANCE AND FINANCE COMMITTEE
MEETING OF WEDNESDAY, OCTOBER 02, 2019

SUBJECT **Debt Term Guidelines**

ISSUE

The report provides an overview of optimal financing terms and related guidelines.

BACKGROUND

In response to a request from the Board, this report summarizes optimal financing terms balancing the cost of debt with overall cost of the desired service levels. Guidelines are deployed as a standard approach in evaluating all debt issuances across all services. Guidelines support an organization-wide approach to balancing these critical criteria.

Before debt funding is considered, other funding sources are pursued to balance costs of service delivery. Sources such as grants, partnering agreements, third-party contributions and reserves are all examples of alternatives to debt funding which help to manage overall cost of service delivery. If debt funding is required, the debt term guidelines contain principles to mitigate exposure to interest costs and interest rate risks while balancing the ability to pay annual debt servicing.

ALTERNATIVES

Alternative 1

That the Governance and Finance Committee recommend to the Capital Regional District Board:
That the Debt Term Guidelines report be received for information.

Alternative 2

That this report be referred back to staff for additional information.

DISCUSSION

Although financial leverage is not explicitly constrained by legislation, the cost of debt is inherently constrained by each service. Debt within each service is approved through the approval process by way of a loan authorization bylaw. The bylaw process includes review of proposed debt and cost of borrowing both at the service and the organization level. In addition, all planned debt funding must be included in the Five-Year Financial Plan.

Debt is then monitored through financial health indicators both in financial planning and financial reporting. Examples of financial health indicators and the credit worthiness of the CRD are debt-to-equity ratio, investment funded by new debt ratio and debt servicing costs to total revenue ratio.

LEGISLATIVE ENVIRONMENT

Long-term debt for all BC municipalities, including regional districts, must be arranged through the Municipal Finance Authority of British Columbia (MFA). The MFA offers member financing by pooling the borrowing requests across the province, then issuing bonds in financial markets with a fixed initial term of 10 years and 5 year renewals thereafter. The maximum term is 30 years. All debt is guaranteed by regional districts, thereby reducing the credit risk of all MFA issues. The pooled approach combined with the short, fixed term structure is attractive to lenders garnering lower lending rates.

The Capital Regional Hospital District (CRHD) debt limits are also not explicitly constrained within legislation. However, current legislation allows the CRHD to borrow from lending institutions other than the MFA, providing access to other rates and term borrowing structures. The Capital Region Housing Corporation (CRHC) is a government not-for-profit organization that is not subject to the same legislation as the CRD or CRHD. The CRHC is not able to borrow directly from MFA but is able to borrow through the CRD Land, Banking and Housing Service as well as from other lending institutions. Debt limits are set in line with current loan covenants and the target debt-to-equity ratio.

LONG-DEBT TERM GUIDELINES

Long-term debt is issued individually by service. Staff consider the following guidelines on each issue with respect to term maturity:

- The term maturity of debt issue is limited to the estimated useful life of the asset.
- Borrowing terms should be limited to a maximum of 15 years as both interest costs and interest rate risk increase with increasing time to maturity.
- Terms to maturity greater than 15 years will be considered for infrastructure where the life of the asset supports longer term to maturity. However, the overall impact of both the annual costs and total cost of borrowing should be considered.
- Current MFA indicative rates are risk-adjusted in modelling the ability to pay by service in terms longer than 15 years.

COSTS OF BORROWING

Interest Rate Risk

MFA issues debenture debt for an initial term of only 10 years, irrespective of the total term of the debt. If the total term to maturity selected exceeds 10 years, the principal and interest would be subject to renewal in 5 year increments thereafter the first 10 year term.

While this is attractive to lenders garnering a lower rate to borrow, this exposes the debt to future interest rate risk. A subsequent 5 year term renewal could result in higher than expected interest rates similar to that a conventional residential mortgage could experience. The extent of risk depends greatly on the prevailing economic conditions, but the renewal could result in higher costs of service delivery. A debt term of 15 years mitigates interest rate risk to only one subsequent renewal period.

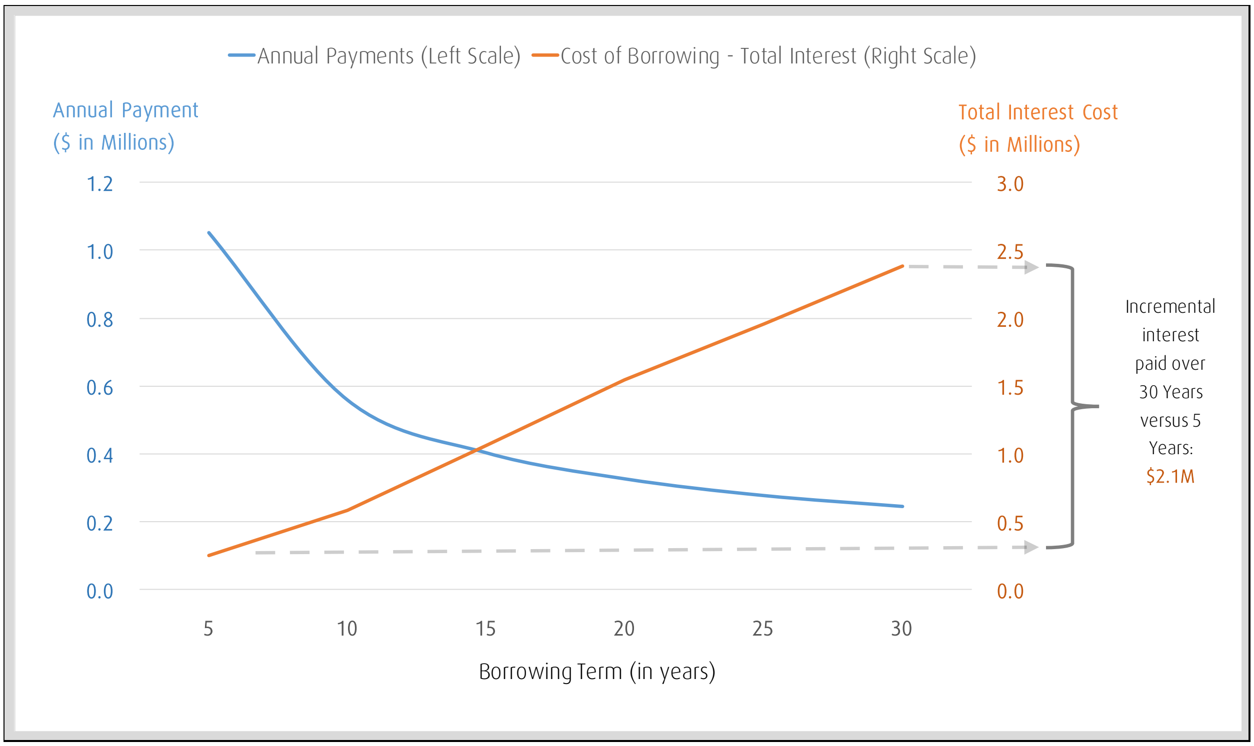
<u>Term to Maturity</u>

Regardless of the lender, as the term to debt maturity increases, the total cost of interest paid over the life of the debt rises. The actual 'cost' paid for an asset can be 40%-50% higher over the long-term to maturities of 25 and 30 years.

The maximum term of a debt borrowing is the lesser of thirty years or the reasonable life expectancy of the capital asset being funded or the term of any related agreement (whichever is less). However, the current debt guidelines establish a maximum term of 15 years to optimize the annual revenue requirement while minimizing costs of borrowing.

Financial analysis shows that the term of 15 years is where the annual debt payments are minimized while still also minimizing costs of borrowing.

Figure 1: Optimal Term to Maturity
Example: Payments and costs of a $5M debt issue



The gap between the trend lines grows as costs continue to rise while the ability to lower payments flattens. This demonstrates diminishing returns when lowering payments for terms beyond 15 years. Moreover, containing debt payback timelines to 15 years lessens the outstanding commitment over the long term in many cases avoiding the necessity to stack debt. The term to maturity of 15 years is encouraged in all cases, where possible, to encourage cost containment on delivery of services.

<u>CAPITAL REGIONAL HOSPITAL DISTRICT (CRHD)</u>

For reference, the CRHD Board approved funding guidelines were last amended in 2009. (See Appendix B for the May 2009 report and subsequent June 2009 CRHD Minutes)

Generally, in order to minimize interest costs and interest rate risk, the CRHD guidelines support terms to maturity ranging between 5 to 15 years. The term to maturity is correlated to the value of the asset purchase. The guidelines look to deploy shorter terms for assets with a lower purchase price/project cost. This principle leverages debt, mitigates sharp increases in revenue while also mitigating costs of borrowing.

The strategy takes into consideration the amount of the CRHD share of the total project cost and analyzes the scope of the project and its relative financing over a period not exceeding the estimated useful life of the project to be financed.

An exception to these guidelines, as directed by the CRHD Board, was the issuance of a fixed 25-year term debt through MFA related to the Summit project. This exception to both the guidelines for CRHD and a departure for MFA from their typical term structure. This would not form part of the general guidelines as it requires large lump sum debt issuances higher than can be expected on the majority of CRD and CRHD debt funding requirements.

CONCLUSION

The debt term guidelines recommend optimization of the term to maturity. The target term of 15 years, supported through financial analysis, is considered the optimal point where use of debt is supported while minimizing costs and mitigating interest rate risk. The ultimate selection of the term to maturity takes into consideration overall impact of both the annual costs and total cost of borrowing over the term.

RECOMMENDATION

That the Governance and Finance Committee recommend to the Capital Regional District Board:
That the Debt Term Guidelines report be received for information.

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Attachments:

Appendix A: Graph Data
Appendix B: CRHD Debt Guidelines (2009 Board minutes and staff report)