

MA-132

For Information

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DATE: May 15, 2010

REPORT TITLE: **OPTIONS FOR ISSUING DEBENTURES**

FROM: Norma Trim, Chief Financial Officer and Commissioner of Corporate Services

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## **OBJECTIVE**

To provide Council with the options available to the Region of Peel with respect to issuing debentures.

## **REPORT HIGHLIGHTS**

- Municipalities can issue debentures for generally all types of capital works in the Capital (Bond) Market by utilizing an underwriting syndicate, to Infrastructure Ontario, or directly to purchasers over-the-counter (OTC)
- Due to time constraints in issuing debentures to Infrastructure Ontario, the forecast that interest rates will increase and the Region of Peel's desire to market a portion of any new debenture issuance to local retail investors, the proposed approach for the Region to issuing debentures in 2010 is through a capital market debenture issuance utilizing a debt issuance syndicate

## **DISCUSSION**

### **1. Background**

The issuance of debt by Governments is a global occurrence and Canada and Ontario are frequent market participants that issue debt in the capital market. Over time, an efficient system of issuing debt via electronic clearing and depository services that is fairly standardized across the world today has evolved. This electronic book-based system is transparent and spreads risk evenly.

One of the advantages of issuing debt through an electronic book-based system is that it can be done quickly to take advantage of moves in interest rates and investor demand. For example, after having Council authorization to negotiate one or more debenture issues in 2010, for a certain amount and term, the actual timing of any one or more debenture issues in 2010 can be decided when interest rates have hit a certain level, at which point, some or all of the authorized debentures may be issued in a matter of a few days. This provides the greatest flexibility to time the debenture issue at the most beneficial rate of interest and when investor demand is at a peak.

Prior to the book-based system of issuing debentures, debentures were issued in what is now called definitive form using a certificated fully registered paper based system. At that

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time, the size of debenture issues was generally quite small and there were several large trust companies that acted as depository agents to hold and exchange numerous paper-based definitive debentures. In Canada, CDS Clearing and Depository Services Inc. ("CDS") is now the only electronic clearing and depository service for issuers of debt securities. When CDS became the only provider of electronic clearing and depository services, the efficiency and transparency of issuing debt electronically basically eliminated any need for the numerous paper-based definitive debentures. As existing debt issues matured, issuers converted to an electronic book-entry only system. The companies that acted as transfer agents and offered depository services abandoned the business, as CDS became the only provider that issuers would use, due to costs and efficiencies.

**2. Sources of Financing for Municipal Debentures**

A municipality can choose to issue debentures for generally all types of capital works in the capital market by utilizing a debt issuance syndicate, to Infrastructure Ontario, or directly to purchasers OTC.

**Capital (Bond) Market**

As highlighted earlier, the capital market in Canada, as in much of the global markets, operates efficiently and with great transparency. The capital market allows issuers to quickly set terms of debenture issues and provides maximum flexibility in choosing the right mix of debentures issued, the term of the debentures and the ability to await favourable interest rate conditions. In addition, unlike Infrastructure Ontario debentures, as capital market debentures are traded within an open market system, the Region is always able, should its financial capability permit, to buy-back such debentures and actually retire some or all before the actual maturity date, thereby saving interest costs.

Municipalities issue debentures in the capital market utilizing a debt issuance syndicate. The debt issuance syndicate is a group of investment bankers appointed for the purpose of purchasing and reselling new debentures issued by a municipality in the capital market at a negotiated price. For an agreed fee the syndicate assumes the risks related to promoting, marketing and underwriting the debentures issued by the municipality to investors. The structure of a debt issuance syndicate needs to be approved by Council.

Several years ago, a coalition of Ontario municipalities approached the main participants of the Canadian Debt Issuance Syndicate to negotiate improved commissions. An arrangement was agreed to that fixes the commissions at rates that are close to those of the smaller provinces. Only Ontario and Quebec are charged lower commissions. It is expected that issuing debentures through this method will be at least as cost-effective as issuing to Infrastructure Ontario given the Region's strong credit rating.

As well, to address retail clients, the Region was able to negotiate a commitment from the proposed lead managers of the Canadian Debt Issuance Syndicate that they will commit to market Region of Peel debentures for retail clients. They will hold back a specified portion of the debentures up to 10 business days past the normal closing date, at their retail outlets in Peel, to allow Peel residents additional time to purchase these debentures. This may give the Region of Peel an opportunity to test the market to see what the take-up might be should the Region want to issue OTC debentures at a later time.

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### Infrastructure Ontario

Infrastructure Ontario is a Crown corporation dedicated to managing some of the Province's large and more complex infrastructure renewal projects and to providing financing to prescribed entities. All Ontario municipalities are eligible to apply for a loan from Infrastructure Ontario. Infrastructure Ontario only offers amortizing or serial debentures. Such debentures require higher annual principal payments to occur (as compared to a sinking fund debenture issued through the capital market), resulting in greater cash outflows in the years ahead.

There is a due diligence component to the borrowing, which means that there may be audits by Infrastructure Ontario in subsequent years. Furthermore, the interest rates offered by Infrastructure Ontario are quoted on a blended basis. While the rates may look competitive, in reality these rates may actually be higher than what the Region may pay by issuing a 30 year debenture in the capital market. This could result in a higher overall interest cost to the Region.

To qualify for an Infrastructure Ontario loan, an application process must be followed. The application, review, financing agreement and debenture issuance under Infrastructure Ontario is a process that would take approximately two to three months and includes the following steps.

- First, registering with Infrastructure Ontario and completing an online application form.
- Second, Infrastructure Ontario will undertake a legal and credit review. The entire application process typically takes four to eight weeks from Infrastructure Ontario's receipt of a completed application, including all supporting documentation.
- Third, a Financing Agreement is drafted for review and execution by both parties. After the Financing Agreement has been executed, clients may wish to begin the debenture process. Infrastructure Ontario has established reporting requirements for capital construction projects only. Municipalities are responsible for submitting project reports according to an estimated project start date.

Due to the interruption of the Council schedule in the fall, July 8<sup>th</sup> may be the last regularly scheduled Regional Council meeting at which a debenture by-law can be approved this year. The Infrastructure Ontario borrowing process may not be completed in time to meet that deadline.

### Over-the-Counter (OTC) Debentures

We understand that several Ontario municipalities have considered issuing debentures directly, in what the industry refers to as "over-the-counter" or "OTC" debentures. The appeal of this method is to provide residents with a stable interest rate while also allowing them to demonstrate pride in their community. Staff are continuing to research this approach to see if we can find a municipality that is active in this market. To the best of our knowledge, no municipality has undertaken such an approach in recent years.

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Other municipalities like Halton Region and Toronto that have recently investigated the OTC approach chose not to issue debentures in this manner for the following reasons:

- Cost of issuing debentures in this manner is higher since it would require a manual, manpower intensive and paper-based model especially when compared to the streamlined electronic book entry only services of CDS.
- There are costs to issue, advertise and administer the debentures and there are many more transactions necessary to raise the same amount of funds since purchasers tend to be small individual investors rather than large institutional investors like pension plans.
- Need to set up secure locations to sell debentures.
- Uncertainty around take-up by residents since majority of investors today do so electronically based on the advice of their investment advisors.
- Laws and rules governing the sale and marketing of investment products to the public have increased significantly. Conflict of interest, privacy, freedom of information, anti-money laundering, specific "know your client" investment rules and other legislative and business practices would need to be researched by legal and regulatory authorities.

OTC would appear to be a costly approach, with an outcome that would be impossible to estimate with accuracy. The one-time start-up costs would be significant. Hiring contract staff, purchasing or developing a business system to maintain records, printing certificates on paper that is fraud proof and legal approvals would be both costly and time-consuming. In addition, there would be ongoing costs to maintain a debentureholder registry, issue bi-annual interest cheques, issue annual tax slips and to have staff available to respond to ongoing queries. These costs would exist for at least as long as the debentures remain outstanding. These costs would be incurred again if the Region decides to issue OTC debentures in subsequent years. Another Region reported that its estimate was that it would take no less than six full time staff members to operate an OTC debenture issue.

The risk/reward balance is such that the Region could expend a great deal of time and money, without achieving the desired result of raising the required funds.

Given the appeal of giving residents the opportunity to invest in their communities, staff will continue to research this opportunity to see if any municipality has developed a more cost effective approach of raising funds in this manner.

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**CONCLUSION**

Due to time constraints in issuing debentures to Infrastructure Ontario, the forecast that interest rates will increase and the Region of Peel's desire to market a portion of any new debenture issuance to retail investors, the proposed approach to issuing debentures in 2010 is through a capital market issuance utilizing the Canadian Debt Issuance Syndicate.



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**Approved for Submission:**



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