Clause 6 in Report No. 21 of Committee of the Whole was adopted, without amendment, by the Council of The Regional Municipality of York at its meeting held on December 17, 2015.

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# Annual Report on 2014 Debenture Issuance Hedging

**Committee of the Whole recommends adoption of the recommendation contained in the report dated November 18, 2015 from the Commissioner of Finance:**

## 1. Recommendation

It is recommended that Council receive this report for information.

## 2. Purpose

This report summarizes the debenture issuance hedging activities that were undertaken during 2014 in accordance with Ontario Regulation 653/05 of the *Municipal Act*, 2001

## 3. Background

### The Capital Financing and Debt Policy allows debenture hedging to achieve greater cost certainty for its debenture issues

In 2003, Council approved a Capital Financing and Debt Policy (the "Debt Policy") that permits the use of bond forward ("hedging") agreements where, in the opinion of the Treasurer, it is financially prudent to hedge a portion of a planned debt issue against the risk of a rise in interest rates. Under this policy, a hedging agreement can be used to hedge no more than 75% of a debenture issue. Hedges must be settled within 180 days. The results of hedging activities are reported to the Debenture Committee at the time of issue and a report to Council is also required.

### Hedging agreements are contracts with financial institutions that fix the interest cost of a future debenture issue

A hedging agreement is a contract with a financial institution that provides protection against the impact of rising interest rates on the Region’s long-term borrowing program. When the Region enters into a hedging agreement, it does so at prevailing interest rates. The hedging agreement is for an agreed-upon length of time. At the end of that period there is a cash settlement between the Region and its counterparty. If rates go up, the Region receives money; if rates decline, the Region pays money to the counterparty. The amount of the cash settlement depends on the amount hedged and the change in interest rates.

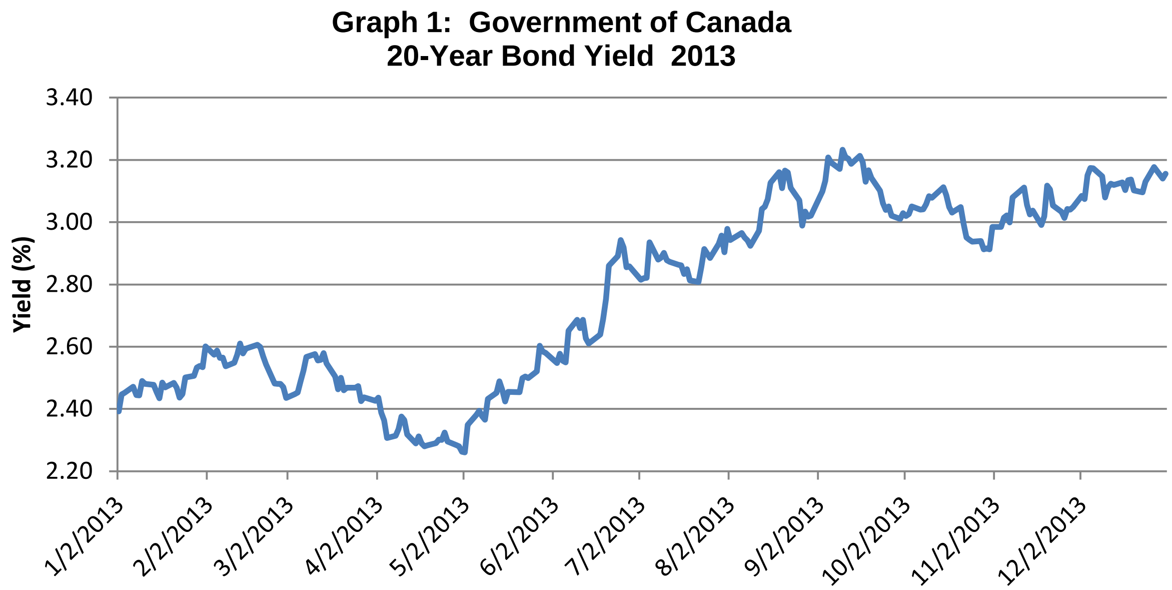
Hedging agreements are not used to speculate on the movement of interest rates, but rather to lock-in the cost of financing to provide greater cost certainty for debenture issues. Hedging functions like insurance against spikes in interest rates at times when the Region needs to issue debt.

Before entering into a hedging agreement, staff obtain quotes from several Canadian financial institutions and enter into an agreement with the institution offering the lowest cost.

## 4. Analysis and Options

### Interest rates were expected to continue to rise throughout 2014, resulting in higher financing costs for the Region

The interest rate environment was very volatile during 2013, first declining and then rising sharply (see Graph 1). From May to September interest rates rose approximately 1% and remained elevated through year end.




Entering into 2014, most economists and other market participants forecast improving economic conditions, with a further winding down of the quantitative easing program by the United States Federal Reserve. Combined with the quiet political landscape in North America and elsewhere, interest rates were widely expected to rise throughout the year.

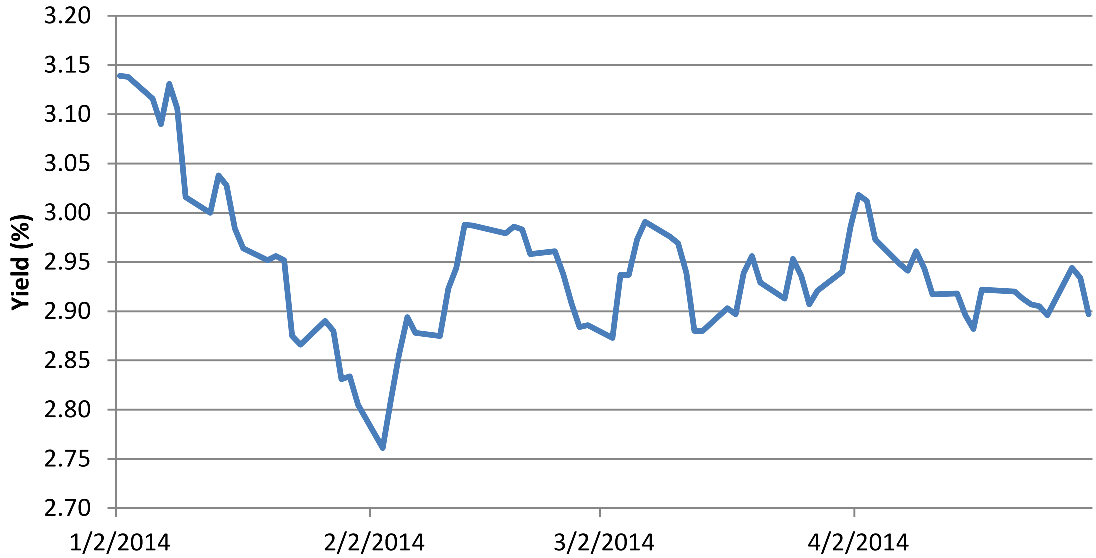
Given the size of the Region's borrowing program in 2014 at $450 million, a similar rise in interest rates would have had a significant impact on the Region's borrowing costs. A 1% rise would have meant an increase in annual debt servicing costs of approximately $3 million - $60 million over the term of the debenture financing.

Considering the potential cost of rising interest rates, staff looked for hedging opportunities to lock-in the interest rates on the planned 2014 debenture issues. The objective was to hedge at interest rates below the 2013 Fall debenture issue rate of 4.52%.

## 2014 Spring debenture issue was the first time a hedging program was used for a debenture issue

As the year began, investors saw an initial drop in interest rates, as events such as geopolitical risks in Ukraine and the Middle East kept the fixed income markets nervous and off balance, even in the face of continuing good news on the US economy. Interest rates on Government of Canada 20-year bonds, which began the year at 3.14 %, fell to less than 2.80% by the end of January 2014 (Graph 2).

**Graph 2: Government of Canada 20-Year Bond Yield**
**January to May 2014**




When interest rates declined at the beginning of 2014, it was seen as a short-term event by most economists. Therefore, it was deemed to be a good opportunity to initiate the hedging program. In January and February, the Region entered into $100 million in hedging agreements with two major Canadian banks, which effectively hedged 50% of the anticipated $200 million debenture issue.

Graph 3 reflects the implied interest rates for 20-year York Region debentures over the course of the first half of 2014. Highlighted on the graph are the points where hedging agreements were transacted and also the date of the actual $200 million debenture issue on April 16th. All hedges were transacted at rates significantly lower than the Fall 2013 debenture issue and therefore locked-in interest rates that would substantially lower the Region's debt servicing costs.

**Graph 3: York Region 20-Year Debt Cost of Funds**
**January to May 2014**

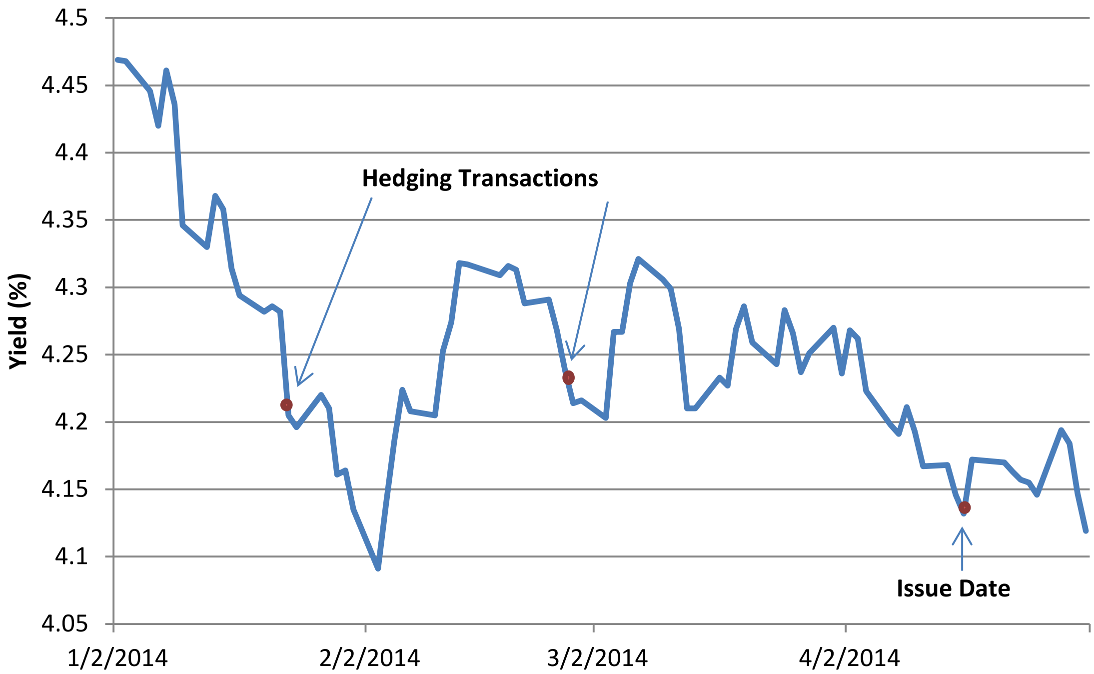



Table 1 below sumarizes the interest rate for the Spring debenture issue and the impact of the hedging program.

**Table 1**
**Summary of 2014 Spring Debenture Issuance with Hedges**
**York Region 4.05% Sinking Fund Debentures due 01-May-2034**

| Amount Issued | Yield Before Hedge | Cost % of Hedge | Yield After Hedge | Yield Savings vs 4.52% |
|---|---|---|---|---|
| $200,000,000 | 4.134% | .0049 | 4.183% | (0.337%) |

The cost of the hedge settlement was $1,313,000 (or approximately 5 basis points), which represented the difference in interest rates locked-in versus what was available at the time of the debenture issue. After hedging costs, the interest rate on the Spring debenture issue (4.18%) was still 34 basis points below the previous Fall's debenture rate of 4.52%.

## As interest rates were substantially lower in the Fall, there was less need to implement a full hedging strategy

Subsequent to the Spring debenture issue, interest rates continued to decline, as depicted in Graph 4 below. The debt issuance strategy for the Fall debenture issue set a target of keeping interest costs below the Spring debenture issue rate of 4.18%.

As interest rates showed a steady decline over the summer, market participants were no longer calling for a significant rise in rates. Therefore, staff limited the size of the hedging program to less than 25% of the expected $250 million issue.

To that end, a total of $60 million in hedging agreements were transacted in June and July. The cost of settling these agreements totaled $220,000. After hedging costs, the interest rate savings when compared to the rate used for the Spring debenture issue was 31 basis points or $15.5 million over the term of the debenture.

**Graph 4: York Region 20-Year Debt Cost of Funds**
**June to October 2014**

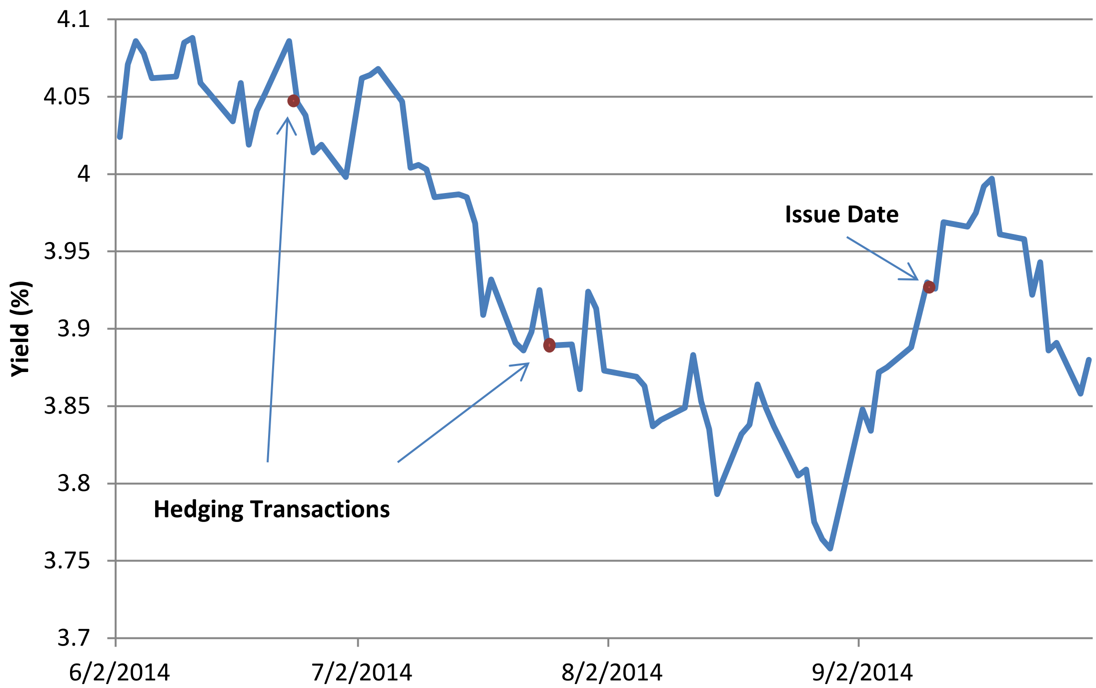


Table 2 below summarizes the interest cost for the Fall debenture issue and the impact of the hedging program on the cost of the issue.

**Table 2**
**Summary of 2014 Fall Debenture Issuance with Hedges**
**York Region 4.05% Sinking Fund Debentures due 01-May-2034**

| Amount Issued | Yield Before Hedge | Cost % of Hedge | Yield After Hedge | Yield Savings vs 4.183% |
|---|---|---|---|---|
| $250,000,000 | 3.865% | .0007 | 3.872% | (0.311%) |

### Link to key Council-approved plans

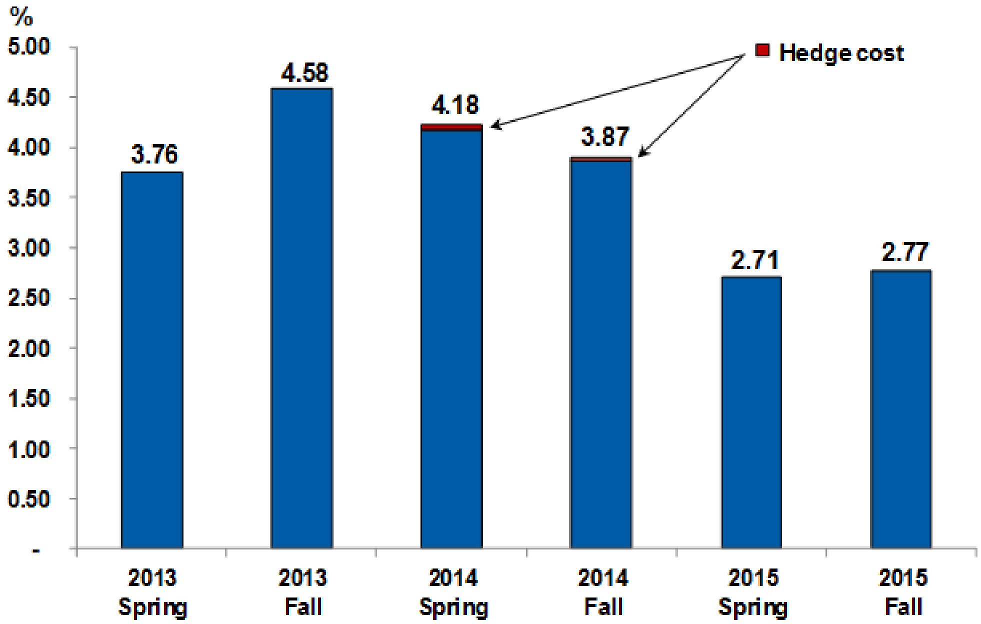
Debenture issuance hedging, under the Capital Financing and Debt Policy, assists the Region in managing its debt prudently. This is a strategic priority area identified in the 2015 to 2019 Strategic Plan.

## 5. Financial Implications

The use of hedging agreements allowed the Region to manage the interest rate risk of its 2014 debt issuance program at a time when interest rates were expected to increase. Since interest rates fell after the Region entered into the hedging contacts, the Region incurred a cost of $1,533,000 for its entire 2014 hedging program.

The cost of the hedging program was embedded in the cost of the debenture. Graph 5 shows a three-year history of the interest rates on the Region's debenture issues.

**Graph 5: York Region's all-in rate on debt over the past 3 years**




*2015 debt issues were for 10 year term. Prior years were for 20 year term.

## 6. Local Municipal Impact

There is no impact to local municipalities arising from the debenture issuance hedging undertaken in 2014.

## 7. Conclusion

During 2014, York Region entered into four hedging agreements. All of the hedging agreements entered into during 2014 were consistent with the Capital Financing and Debt Policy.

For more information on this report, please contact Edward Hankins, Director, Treasury Office, at ext. 71644.

The Senior Management Group has reviewed this report. November 18, 2015

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