REPORT FOR ACTION

City of Toronto Debt Limit

Date: February 17, 2021
To: City Council
From: Chief Financial Officer and Treasurer
Wards: All

SUMMARY

This report discusses the potential impacts on the City's borrowing costs from increasing the debt ceiling and the potential corresponding credit rating downgrade to an "A" rating.

Credit rating agencies will assess the financial risk factors of an entity by using key ratios relating to debt management. These key ratios are Net Tax-Supported Debt per Capita ("debt ratio"), Net Tax-Supported debt per Total Tax Assessment, and Interest Costs per Revenue.

In addition to these financial risk factors, credit rating agencies also consider other critical risk factors in the areas of economic structure, fiscal management, budgetary performance, debt and liquidity management, as well as relations with senior levels of government. In most cases, these critical risk factors have greater weight than the financial risk factors alone.

Increasing the City of Toronto debt ceiling in 2021 that would trigger a credit rating downgrade to "A" rating category will have significant impact to annual Debt Service Charges (includes both Sinking Fund contribution plus interest charges), by at least 20% increase in the following years. Also, the tax-supported debt service ratio could spike to around 18% over the 10-year capital plan period.

A downgrade in City of Toronto's credit rating that has been in place for almost 20 years will have significant reputational and spin-off effects. City of Toronto would be the lowest rated Canadian municipality should it be downgraded to "A" rating. The pool of investors for City of Toronto bonds would drop significantly as there will be material loss of interest from international investors and other investors from major Canadian financial institutions due to these lower ratings.

RECOMMENDATIONS

The Chief Financial Officer and Treasurer recommends that the City Council receive this report for information.

FINANCIAL IMPACT

There is no financial impact from the receipt of this report.

DECISION HISTORY

At the Executive Committee held on February 11, 2021, 2021 Capital and Operating Budgets were considered with recommendations.
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2021.EX21.2

COMMENTS

Background

This report discusses the potential impacts on the City’s borrowing costs from increasing the debt ceiling and the potential corresponding credit rating downgrade to an "A" rating.

The key ratios relating to debt management that credit rating agencies use to assess financial risk are mainly Net Tax-Supported debt per Capita (debt ratio), Net Tax-Supported Debt per Total Tax Assessment, and Interest Costs per Revenue.

In addition to financial risk factors, credit rating agencies also consider other critical risk factors as shown in Table 1 below. In most cases, these critical risk factors have greater weight than financial risk factors alone.

Table 1 - Critical Risk Factors

1. Economic Structure	
	Economic diversification and volatility
	Population & taxable assessment growth
	Income & weather of local economy
	Labour market

2. Fiscal Management	
	Fiscal sustainability and performance
	Budget management & prudence
	Tax competitiveness
	Transparency & reporting
3. Debt & Liquidity Management	
	Capital investment outlook
	Debt and liquidity Management practices
	Access to capital markets
	Debt structure and maturity profile
	Liquidity profile
	Pension and benefits liabilities
4. Relations with Senior Levels of Government	
	Municipal legislative framework
	Senior government funding
	Historical relations with senior governments

Analysis and Results:

Table 2 below demonstrates the ratings on debt burden of the four major Canadian municipalities.

Table 2: Debt Burden Rating

S&P Credit Rating	Major Cities	Rating Factor: Debt Burden Rating, (1 - Best, 5 - Worst)
AAA	City of Vancouver	1
AA	City of Toronto	3
AA-	City of Montreal	4
AA	City of Ottawa	3

Source: S&P Global published on July 23, 2020

Debt management policies of major Canadian municipalities have different debt ceiling limit measures which are often derived from the different financial regulation mandated by their respective provinces, as demonstrated in Table 3 below.

Table 3: Municipal Debt Management Policy

	Self-imposed Key Debt Service Limits	Derived based on Provincial Regulation
City of Vancouver	Annual Debt Service Cost as a % of Operating Expenditure < 10%	Province of B.C. Vancouver Charter: Total debt < 20% of total assessed value of such real property calculated upon the average assessment for the two year prior
City of Toronto	Annual Tax-supported Debt Service Cost as a % of Property Tax Revenue < 15%	Province of Ontario (No debt limit for the City of Toronto)
City of Montreal	Annual Debt Service Cost as a % of City All Expenditure < 16%	Province of Quebec Supervised by the Ministère des Affaires Municipales et de l'occupation du Territoire (MAMOT). Any request for new debt must be analyzed and approved by the MAMOT and submitted to the MFQ.
City of Ottawa	Annual Tax-supported Debt Service Cost as a % of tax revenue < 7.5%	Province of Ontario - debt service payments were limited to 25% of a municipality's own-source revenue

For comparison purposes, the Total Debt Service Cost as a percentage of Property Tax Levy ratio of the four major Canadian municipalities are compared in Table 4 below. Total Debt Service Cost is used here because data for tax-supported debt service cost is not publicly available for the other municipalities.

Table 4: Estimated Debt ratio

Credit Rating	Total Debt Service Cost as a % of Property Tax Levy	2019	2018
AAA	City of Vancouver	4.6%	4.6%
AA	City of Toronto*	13.7%	13.4%
AA-	City of Montreal	31.9%	31.2%

Credit Rating	Total Debt Service Cost as a % of Property Tax Levy	2019	2018
AA	City of Ottawa	8.5%	8.9%

*Unconsolidated debt (e.g exclude CMHC),

Overall, it is not recommended to increase the City's debt level to a point that would trigger a credit rating downgrade. With an "A" rating, the City of Toronto will be the lowest rated Canadian municipality. Currently the lowest rated Canadian municipality is St John's which is rated A+. As a reference, City of Montreal is rated AA-.

It is very rare to see Canadian municipalities get credit rating downgrades and in fact most are looking to have their rating increased as it results in lower borrowing costs.

Other risk factors to consider:

- Reputational risk – the current credit rating of "AA" has been in place for 20 years and has given the City a reputation of a "solid credit" with investors, however a drop in rating would indicate to investors that the City is "weaker" and has some serious underlying issues with a loss of financial control.

- Some investors will have minimum rating criteria and the pool of available investors becomes smaller as the rating deteriorates (less demand for City's bonds), especially the international investor base that the City has built in recent years. International investors tend to require higher rated foreign issuers.

- When a municipality trades below AA-, it loses its regulatory BASEL HQLA (high quality liquid assets) Level 2A treatment, meaning some investors of City's bonds such as bank treasuries would have a much higher capital charge to own the product (less demand for City's bonds).

- Insurance companies run actuarial models and have default assumptions – a lower rating would have a higher default assumption and would result in insurance companies having to hold more capital. There is lower incentive to hold a lower-rated product. It is hard for City's bond to compete against higher yielding options (Corporate bonds) that have the same rating.

- The outstanding bonds in the secondary market is likely to result in capital loss as a result of a rating downgrade. Investors of City of Toronto's bonds might lose confident with the City. When investors purchase City's bonds, they have expectation that the City will be able to maintain its credit rating.

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SIGNATURE

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