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2025 OPERATING BUDGET BRIEFING NOTE – Overview of Debt Financing and City of Toronto Debt Summary

Issue/Background:

At its meeting on January 17, 2025, Budget Committee requested that the Chief Financial Officer and Treasurer provide a briefing note on a) an explanation of how debt financing works; and b) a summary of the overall debt carried by the City.

Key Points:

- In the context of a Canadian municipality like the City of Toronto, “funding” refers to the financial resources allocated to cover the costs of a specific project or initiative, often derived from taxes, grants, user fees, or reserve funds. These sources represent money the municipality has or receives without an obligation to repay.
- The City’s capital projects in ten-year capital budget and plan are funded by a variety of sources such as grant funding from other orders of government or the issuance of debt or debt financing. Unlike funding, debt financing creates a liability, as the municipality must repay the borrowed amount with interest over time.
- Debt financing involves borrowing funds to support capital projects, typically through issuing debentures or accessing direct loans.
- Debt financing provides the City with affordable financing for large-scale capital projects by spreading the repayment term over a longer term while matching to the economic useful life of the project.
- Without debt financing, the City may be hindered from taking on large capital projects and would leave present taxpayers to pay for infrastructure that provide long-term benefits for future residents.

A. Explanation of How Debt Financing Works

1. Legislative Framework Governing Debt Financing

Debt financing or borrowing is a way to fund capital projects and maintain infrastructure in the ten-year capital budget and plan over a longer term. Municipalities in Ontario are governed by provincial legislation that restrict municipalities from issuing debt for operating budget expenses but are permitted to issue debt for capital projects. Additionally, the term of any issued debt must not exceed the useful life of the asset being financed. In the City of Toronto, debt is typically issued with terms of ten, twenty, and thirty years. Annual repayments of principal are mandatory, and the City uses a Sinking Fund mechanism to meet this obligation in compliance with provincial rules.

2. Council-Adopted Policies

In addition to provincial legislation, the City of Toronto adheres to policies adopted by City Council to manage debt financing responsibly. The *Financing of Capital Works Policy and Goals* establishes guidelines, including the setting of a debt service ratio to ensure fiscal discipline.

Debt issuance requires Council approval at two instances. Firstly, at the start of each Council term, annual debt limits are determined, and the Debenture Committee is established, authorizing the Mayor and Chief Financial Officer to execute debt transactions through the *Multi-Year Debenture and Temporary Borrowing Authorities – Current Term of Council 2022 to 2026*. For the 2022-2026 term, City Council has established an annual debt amount not to exceed $2.0 billion issued per year.

Secondly, individual capital projects to be financed through debt must also receive specific approval from Council. This step is completed as part of the annual budget process whereby Council considers projects in the 10-Year Capital Plan and their recommended funding sources, including debt financing.

More information:

- Annual Debt Authority (2023.CC1.3): https://secure.toronto.ca/council/agenda-item.do?item=2023.CC1.3
- Financing of Capital Works Policy and Goals (2011.BU9.4): https://secure.toronto.ca/council/agenda-item.do?item=2011.BU9.4

3. Debt Issuance Process

The City of Toronto accesses the public bond market to finance its capital needs - a practice it has followed since 1954. Due to the size and complexity of its debt structure, the City works with a syndicate of seven investment banking institutions (BMO, CIBC, National Bank Financial, RBC, TD Bank, Scotiabank, and Casgrain). External legal counsel ensures compliance with all legislative and regulatory requirements by providing a legal opinion certifying the validity of each issuance. The City's credit rating, determined by independent agencies, plays a critical role in influencing investor confidence and interest rates. The issuance process is designed to secure the most competitive terms, thereby minimizing borrowing costs for the City of Toronto. Institutional investors, including pension funds, asset managers, insurance companies, and central banks, are the primary purchasers of the City's debt.

4. Practical Considerations for Debt Issuance

Debt issuance is carefully planned within an eight-month window to align with market conditions. Typically, there is a five to six-week gap between issuances to ensure optimal timing and pricing. Economic indicators, credit ratings, and investor sentiment significantly influence the process. Market conditions and timing are carefully evaluated to minimize borrowing costs and maximize investor interest.

As a practical matter, the City issues debt *after* a capital project is completed and invoices are finalized and paid. The City's working capital is leveraged as an interim funding source rather than pre-financing projects. This avoids the situation of pre-financing a project which may be in the capital plan but has yet to begin or be completed. Pre-financing is avoided as it otherwise would create unnecessary interest and principal payments should the project be delayed or changed.

5. Allocation of Debt Financing Across City Programs and Agencies

Debt financing is not pre-allocated to Divisions or Agencies, rather the City's 10-Year Capital Plan is developed based on the prioritization of capital needs across the following categories:

i. Health and Safety;
ii. Legislated;
iii. State-of-Good Repair
iv. Service Improvement; and
v. Growth Related.

Health and Safety and Legislated projects are considered the highest priority, followed by State-of-Good Repair (SOGR). SOGR investments are further influenced by the City's Capital Asset Management Plan and the current repair backlog for City assets.

A Capital Prioritization Framework and a Carbon Budget Prioritization Process were developed in 2024 to further assist in the consideration and prioritization of primarily Service Improvement and Growth-Related projects.

Lastly, consideration is also given to availability of non-debt funding or intergovernmental funding programs, the readiness of a project to proceed and the capacity of a Division or Agency to spend allocated capital funds.

Debt financing is the final source of funding allocated to the Capital Program consistent with debt policies and prudent fiscal management, following consideration of capital needs and the review of outstanding unfunded projects.

B. Summary of the City's Debt

1. Overview of Debt Composition and Net Obligations

The City of Toronto's total debt outstanding is composed of two main components. The first is public debt issued, which amounts to approximately $11.052 billion. The second component includes private debt obligations from sources such as Infrastructure Ontario (IO), the Federation of Canadian Municipalities (FCM), and the Canada Mortgage and Housing Corporation (CMHC), which collectively total approximately $89.408 million. The total debt outstanding, including both public and private obligations, is approximately $11.141 billion.

Additionally, the City's Sinking Fund, which is utilized to repay the principal on its debt upon maturity, is projected to have a balance of $2.869 billion at the end of 2024. By subtracting the Sinking Fund balance from the total public debt of $11.141 billion, the City's net debt is calculated to be approximately **$8.272 billion**. This net debt reflects the City's remaining obligations after accounting for the Sinking Fund reserve.

2. Implications and Challenges of Rising Debt Levels

The increase in debt issuance has important implications for the City. Higher debt levels may attract heightened scrutiny from credit rating agencies and investors, underlining the importance of sound fiscal policies to preserve the City's creditworthiness. The rising cost of debt servicing, which includes principal and interest payments, necessitates a focus on sustainable revenue growth to ensure these obligations are met without undue strain on municipal finances.

Increases in tax supported debt also add pressure to the City's operating budget to support debt servicing costs in the form of principal and interest payments. The City's debt service ratio policy provides fiscal discipline and ensure no more than 15% of property tax revenue generated (excludes City Building Fund) will be used to support borrowing costs, and conversely no less than 85% of property tax revenue generated is available to support the costs of City operations.

Conclusion

The City of Toronto employs a well-defined and rigorous framework for debt financing, combining compliance with provincial legislation and adherence to Council-adopted policies. By accessing the public bond market, the City secures the capital necessary to support its infrastructure and other long-term initiatives to ensure the most competitive terms, thereby minimizing borrowing costs. However, the growing debt levels underscore the need for continued vigilance to maintain credit quality and manage borrowing costs effectively.

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