quarterly newsletter

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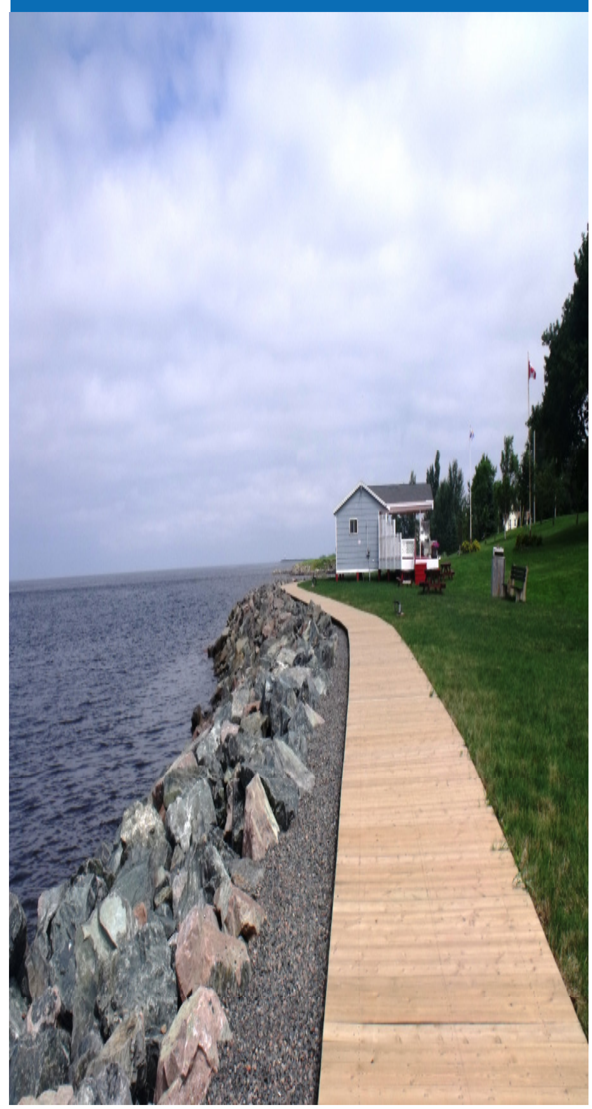

Spring is almost here!

As many of you are aware, the current Order in Council of our Board of Directors expires on June 30th. Two of our members come from the UNSM, and one from the AMANS. We have asked both these organizations to submit names to be considered for the next three year term appointment.

Since April 1, 2015, here are some of the projects we have been working on. To date, the Corporation has assisted 12 municipal units in completing the Debt Affordability Model to help other units evaluate future trending and potential cash flow issues, as well as to assist in the dissolution process.

On the best practice front, we have assisted one municipality with their Capital Investment policy. We are currently working with another municipality to help identify any internal control weaknesses in their various processes.

And finally, we are currently exploring going paperless for the debenture process. Pending the appropriate approvals, we would be looking at going paperless for the Fall 2016 Debenture Issue .

Thank you for taking the time to read this newsletter.

Paul Wills

CEO/Treasurer

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Nova Scotia Municipal Finance Corporation

MFC Mission Statement:

To utilize credit enhancement and debt pooling techniques to meet clients approved funding requirements at the lowest possible cost.

This is achieved through the issuance of debentures. The Corporation pools municipal borrowing requirements which eliminate the need for individual municipalities to negotiate and administer their own debenture issues. Under the MFC arrangement, the debt issuance function remains in the public sector domain.

Why the MFC?

The Nova Scotia Municipal Finance Corporation (MFC) was established by an Act of the Legislature of the Province of Nova Scotia in 1979 (*Municipal Finance Corporation Act, Chapter 301*). The MFC concept is widely used in Canadian provinces and American states as a cost effective, efficient means of raising long term debenture funds to finance municipal capital projects. Studies have shown that smaller municipalities with lower credit ratings receive the greatest interest savings from MFC participation and that all municipalities can benefit from savings in the cost of administration on outstanding debenture issues. In addition, two of the five Board of Directors are appointed based on the recommendation of the Union of Nova Scotia Municipalities (UNSM), which ensures a strong municipal representation in the MFC.

Who must finance capital projects through the MFC?

The objective of the Corporation is to provide financial assistance to its clients, including municipalities, villages, municipal enterprises, school boards and hospitals (*MFC Act, S7*). All municipalities, villages, and municipal enterprises must finance their external capital requirements through the Corporation through the issuance of a debenture (*MFC Act*, *S16 (1) and S16(2)*). The MFC utilizes credit enhancement and debt-pooling techniques to meet clients' approved funding requirements at the lowest possible cost.

Long-Term Loans For Capital Infrastructure

Pooled debenture issues are the most utilized product that the MFC offers its clients. The MFC regularly goes to market with two debenture issues each fiscal year, a spring issue and a fall issue.

Debenture Issue Process

The debenture issue process is initiated when the Chief Executive Officer of the MFC sends out letters regarding participation in an upcoming debenture issue. These letters are normally sent out in mid-February and mid-July of each year to all fifty-one municipalities in the province, plus municipal enterprises and incorporated villages. Interested clients are requested to provide a written letter of commitment in order to be included in the upcoming debenture issue.

Advice on Loan Features, Term and Structure

MFC staff can normally accommodate a client's request to structure a loan to their requirements. A municipal client may finance for a shorter period than the project's amortization period in anticipation of accessing funds for early loan repayment, or to take advantage of the lower interest rates that are associated with the earlier years of a debenture issue. The risk associated with this method is the possibility of interest rates increasing when the loan matures requiring the project to be refinanced. Most municipal clients avoid this uncertainty by locking into rates as long as possible in order to know what their long-term debt servicing commitments will be.

In special circumstances (as in the case of homes for special care) due to budgetary limits and cash flow management, an exact net proceeds amount is requested on behalf of a debenture participant. MFC staff works with the client to accommodate the request. The approach is to calculate the "gross" loan amount that would be required under the current bond market conditions at the time of the request.

Net proceeds are calculated as the total municipal loan, underwriting commissions, and expenses associated with the loan.

The Early Loan Repayment Policy

The MFC does not allow early loan repayment because the term and structure of all MFC debentures mirror the term and structure of the pooled loans provided for by that debenture issue. Therefore, the MFC would be hit with a penalty by its creditor which would have to be passed on to the requesting payout client. This in effect cancels out any interest savings the client might realize.

Short and Long-Term Municipal Financing Strategies

Short-term versus long-term interest rates

It is inappropriate to compare short-term rates (prime) with long-term borrowing rates as they represent different types of financing for different purposes. A short-term rate is a floating rate that is subject to change on a daily basis, whereas a long-term rate is fixed for a specified period. Generally the longer the term, the higher the interest rate because the investor is committing to a longer period of time at a fixed rate. A MFC debenture issue costs reflect a weighted average of borrowing costs for each debenture maturing. For example, a fifteen year MFC serial debenture issue has fifteen interest rates that when averaged, can appear to cost more than the short-term rates (prime) that are quoted by the various Canadian Chartered Banks. However, the 15 year MFC rate is fixed for the life of the loan. The current prime rate will change over the life of the loan and there is increased risk in using this alternative. The rates of a MFC debenture issue carry lower interest rates in the early years (that are comparable to prime), and as the further out in time that the debenture issue goes the bond market adjusts interest rates upward for this time risk factor.

A participant in a MFC debenture issue is not required to finance over the full life of the debenture. The participant can finance for a shorter time period than the project's amortization period thus taking advantage of the lower interest rates in the debenture issue's earlier years. Traditionally, municipalities have locked in rates for as long a period as possible because they want to know with certainty what their long-term debt service commitments will be. There are arguments on both sides of this debate. It is important when comparing MFC and bank rates that a comparable term is used. Short-term rates quoted by the Canadian Chartered Banks are normally lower but more volatile because the prime interest rate may change several times over the course of the financing period, based upon scheduled announcements by the Bank of Canada. Long-term rates provide certainty with respect to future debt service costs.

Straight serial versus blended serial debenture payments

The MFC and Municipal Services staff will work together in advising a municipal client/enterprise on structuring a debenture issue repayment. The two most common types of repayment structures used by municipal clients are straight serial and blended serial debentures. There are advantages and disadvantages to both of these types of repayment methods.

The most commonly used repayment method is the straight serial method where an equivalent amount of principal is repaid each year over the life of the loan. The main advantages to this type of repayment is that of the amount of interest expense paid each year decreases, and the total interest paid over the full term of the loan is minimized. A straight serial also frees up capacity for future borrowing more quickly than the blended payment structure. A potential disadvantage to this type of repayment is that more cash is required in the earlier years to service the loan.

The use of the blended serial method has the advantage of being able to have a relatively consistent yearly debt service payment. This method can be advantageous to those clients that have a fixed cash flow (e.g., nursing homes receiving government subsidies, or smaller municipalities with large single projects). The disadvantage to this type of repayment is that the client would pay more in interest expense over the life of the debenture issue than with a straight serial type repayment.

Frequently Asked Questions

How is interest calculated?

Interest on a MFC debenture is not calculated by taking the outstanding principal balance multiplied by the outstanding interest rate at that point in time. Each annual principal maturity has its own interest rate (or coupon rate). The semi-annual interest to be paid to MFC has to take each principal amount, times its own interest rate (coupon rate), divided by “2”, to capture the 6-month interest payment.

How is my net proceeds calculated?

Why is my loan request different from the funds deposited into my bank account? This is your net proceeds. Each MFC debenture passes on the costs of issuing the debenture, based proportionally on how much is borrowed. Your net proceeds is calculated by subtracting the MFC administration fee, issuance costs, and commissions from the loan request (based on XX cents/$100 borrowed). For budget purposes, MFC suggests grossing up your loan request by 0.70% of 1% in order to receive the funds you actually require.

How is the “all-in” cost calculated?

It is simpler to quote a loan using one interest rate, hence the use of the “all-in” cost. The all-in cost is a finance calculation called Internal Rate of Return (IRR). Since the MFC has different interest rates for each maturity, how would a client know that they are getting the lowest rate possible – hence the use of the “all-in” rate. Your all-in rate is calculated by using you net cash flows, which is the total principal and interest payments over the life of the loan less your net proceeds, to come back to an average interest rate.

MFC Best Practice Profile

Appropriate Minimum Level of Operating Reserves and Accumulated Surpluses

The original recommended practice was developed by the Government Finance Officers Association (GFOA). Some aspects of the practice have been revised by the Financial Management Capacity Building Committee (FMCBC) for use by Nova Scotia municipal governments. The original GFOA recommended practice is *Appropriate Level of Unreserved Fund Balance in the General Fund*, approved by GFOA Executive Board in 2002.

Recommendation

GFOA recommends that municipal governments create a formal policy to establish the level of unreserved fund balance that should be maintained in the general fund. GFOA also encourages the adoption of similar policies for other types of governmental funds. The "unreserved fund balance" terminology used in GFOA's recommended practice is replaced by "accumulated surplus" in the FMCBC version because the latter term is more commonly used by municipalities in Nova Scotia.

Purpose

The purpose of maintaining adequate levels of accumulated surplus and operating reserves is to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. Accumulated surplus and operating reserves are a significant consideration in long-term financial planning and management.

Background

The operating fund accumulated surplus and the operating reserve refer to a fund balance that the council has available for contingencies and/or other purposes, defined by the council.

The operating fund accumulated surplus is intended to serve as a measure of the financial resources that have accumulated over a number of years. This surplus might be allocated or unallocated. Allocated accumulated surplus refers to a fund balance that the council has assigned a specific purpose, such as contingencies or appropriations in future years.

The fund balance, which includes operating fund accumulated surplus and the operating reserve, can be measured as a percentage of the regular general fund operating revenues, or as a certain number of months' operating expenditures. The choice of revenues or expenditures as a basis of comparison may be dictated by what is more predictable in a municipality's particular circumstances. Unusual items that would distort trends (e.g., one-time revenues and expenditures) should be excluded, whereas recurring transfers should be included. Once the decision has been made to compare the operating fund accumulated surplus to either revenues or expenditures, that decision should be followed consistently from period to period.

MFC Best Practice Profile Continued

Unlike a capital reserve, which is required under legislation, the operating fund accumulated surplus and the operating reserve can be established at the discretion of council and are more flexible than a capital reserve. Municipalities are legally required to maintain a capital reserve fund according to the *Municipal Government Act*. Utilization of the capital reserve is also limited to certain areas (see *Municipal Government Act* Section 99). Unallocated operating fund accumulated surplus can be utilized for different kinds of contingencies that may arise.

An operating fund accumulated surplus and an operating reserve might generate debate between those who prefer that the municipality use the reserve for temporary tax cuts or increased provision of services and those who prefer a long-term stable tax rate and consistent level of service provision. Stability in tax rate and service delivery is important for long term financial planning. Fluctuating tax rates create uncertainty for both citizens and businesses.

Government Finance Officers Association Conference Sponsorship

As many of you are aware, the Government Finance Officers Association is holding its annual conference this year in Toronto, Ontario. The Corporation sponsors a financial professional working in municipal government in Nova Scotia to attend. This year, I am proud to announce we will be sponsoring two financial professionals to the conference - Doug Armstrong from the Town of Windsor and Bonnie Coulter from the Town of New Glasgow. Congratulations to both of you!

2016 Spring Debenture Update

And with that MFC staff is currently working towards the Spring 2016 Debenture issue. By now, you all would have received your Debenture Package. Just a reminder, in order to participate in the Spring Debenture issue, we require your Commitment Letter, Pre-Approval Form and a copy of your approved Temporary Borrowing Resolution by April 18th. Templates for both the Commitment Letter and Pre-Approval Form can be found on our website at: http://www.nsmfc.ca/the-debenture-issue-process.html