

Credit Analysis

Municipal Finance Authority of British Columbia, Canada

Ratings

Long-Term Obligations AAA

Rating Outlook

Stable

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Related Research

- *Province of Quebec, July 2, 2008*
- *Fitch Revises Ontario's Rating Outlook to Positive; Affirms 'AA' Ratings, Jan. 8, 2008*

Rating Rationale

- The joint and several, unlimited property tax pledge of all municipal borrowers provincewide provides a great degree of bondholder security on the Municipal Finance Authority of British Columbia's (MFABC, or the authority) debenture issues.
- The authority retains sizable financial reserves, including both MFABC resources and the reserves held by constituent municipalities.
- Investment returns on sinking funds and debt reserve funds reduce borrowing costs for municipal borrowers.
- Financial oversight of clients and the credit approval process promote sound capital project planning.

Key Rating Drivers

- While market weakening may pressure investment returns, the authority is somewhat insulated from its borrowers' economic circumstances due to stringent limits on levels of borrowing and the legal framework for the debt approval process.

Credit Summary

MFABC maintains the unconditional power to levy ad valorem taxes provincewide, without external approval, if a municipal borrower fails to meet its debt service payments. While the authority is not immune to the effects of the global economic downturn, manifested economically through slightly higher provincial unemployment rates and financially in dampened investment earnings, the authority has stepped up its already vigilant monitoring of municipal credit quality and maintains an impeccable record of debt repayment. The authority has never had a payment default from one of its borrowers nor has it needed to draw on property taxes or fiscal reserves to cure a debt service deficiency in its 39-year history.

MFABC's board and regional administrative districts consist of municipal representatives that carefully manage capital project planning and debt issuance to achieve low borrowing costs for local governments. Additionally, MFABC returns all excess earnings on investments to its borrowers, once sinking funds have earned enough to satisfy associated debt service requirements. This strategy effectively reduces borrowing costs, as sinking funds typically are large enough to cover one-third of principal.

MFABC is the borrowing vehicle for all municipalities and regional districts in the province and provides financing for general municipal projects, water and sewer infrastructure, and transportation. The joint and several pledge supporting MFABC's debt issuance requires all member governments to satisfy the obligations of a deficient borrower and ultimately requires the borrower to repay the authority for the deficiency. MFABC's sizable available liquidity includes C\$1.1 billion from sinking funds and debt reserve funds of approximately C\$104 million to deal with temporary payment interruptions should they arise. If any municipality cannot meet its payments, MFABC will draw on these debt reserve funds. Although these debt reserves are relatively modest, the authority also

maintains a C\$200 million line of credit available for any short term disruption and its taxing ability provincewide ultimately counters any related risk.

Each debenture issuance creates a sinking fund dedicated to repayment of that specific offering. The authority's debt reserve fund retains 1% of all borrowings in cash plus accumulated interest to date and represents a security against all municipalities' loans. If any municipality cannot meet its payments, MFABC will draw on this debt reserve fund which stood at C\$104 million as of Dec. 31, 2008. In addition, the authority may levy an unlimited ad valorem tax on all properties within the province in an amount equal to any deficiency that may arise in the debt reserve fund balance.

A key component supporting MFABC's financial capacity is the economic strength of British Columbia, particularly within the Greater Vancouver region. With a 2008 estimated population of 4.4 million, provincial population growth was 5.5% since 2004, compared with 4.3% for Canada over the same period. After declining to 4.6% in 2006, at the time the lowest unemployment rate for the province in three decades, unemployment increased to 6.1% by January 2009, up from 4.1% in January 2008. The province has experienced some softness in construction-related activity and development cost charges with the global economic downturn. However, the housing market remains relatively resilient to date in part due to conservative lending practices of Canadian institutions, qualification requirements to home ownership, and continued strong housing values.

Although the forestry product industry remains an important economic sector, rapid growth in health care, financial, and other services has diversified the region and helped British Columbia's economic output grow to 12% of Canadian gross domestic product. The province has led Canadian housing starts, with the average home price in the Vancouver area nearly doubling since 2000. Provincewide taxable assessed valuation grew at double digit rates in the past several years and now exceeds C\$800 billion. Per capita market value of the provincial tax base is over \$187,000.

Municipal Finance Authority of British Columbia

MFABC, created in 1970 by the Municipal Finance Authority Act, provides both long- and short-term financing for regional districts and their constituent municipalities. While facilitating debt issuance, the authority, in conjunction with the Provincial Ministry of Community Development, also monitors the financial performance of its borrowers, sets financial management parameters, and determines the debt capacity for each individual government. It is the primary general purpose borrowing conduit for local governments in British Columbia and transportation projects, while the provincial government directly finances education and hospital capital needs.

MFABC serves 210 local governments, ranging in size and sophistication, and operates as the borrowing vehicle for all municipalities and regional districts in British Columbia. MFABC provides financing for general municipal projects, water and sewer improvements, and transportation needs. Its clients include regional districts; municipalities; regional hospital districts; water, sewer, and drainage districts; and TransLink, the Vancouver area's regional transportation system. While Vancouver is the only municipality authorized to issue debt on its own behalf, the city finances most of its larger sewer and water capital needs through the Greater Vancouver regional district and MFABC to utilize the authority's capital finance expertise and ensure low borrowing costs.

The members of the authority are elected officials appointed by the regional boards in each regional district in the province. The number of members (currently 38) is based on the population of the regional districts and they represent all 28 regional districts in

British Columbia. The members are responsible for review of all requests for financing (municipal loans) and approval of the annual tax levy and operating budget. The members also appoint 10 trustees (including a chair and vice-chair) to oversee the executive and administrative duties of the authority. The trustees are delegated by the members of the authority to issue and sell securities sufficient to fund loan requests. Of the trustees, four must be from the Greater Vancouver regional district, at least one from the capital district, and another five from the remaining regional districts. The full board of members meets twice annually and the 10 trustees meet monthly to set policy, review the loan portfolio, and discuss mutually beneficial financing opportunities.

Security

The superior credit strength of MFABC is exemplified by its ability to levy an unlimited ad valorem tax on all properties within the province to satisfy debt obligations if loan payments fall short. Due to strict administrative controls, no municipal client has ever defaulted on a loan from MFABC, and consequently, the authority has never needed to draw on the property tax levy. Nonetheless, the board of trustees may levy a provincewide property tax without additional or provincial approvals. This tax can be levied by a resolution of the board of trustees.

Each borrower, upon receiving a loan from MFABC, must deposit 50% of the average annual loan servicing payment into a debt reserve fund, either in full or with a deposit equaling 1% of borrowed principal and a non-interest-bearing demand note, payable to MFABC to secure the balance. Aggregating all borrowers' deposits, the debt reserve fund's cash and investments equaled C\$104 million as of Dec. 31, 2008.

If a borrower fails to make its loan payment to MFABC, the authority first draws on the debt reserve fund to make principal and interest payments. The debt reserve fund provides bondholders with a great degree of security, as the current balance in the fund is set to cover the authority's largest single-day interest payment exposure more than 2.0x. Because MFABC continually monitors the financial condition of its borrowers, the authority has never needed to use its debt reserve fund balances. Any withdrawal due to an unpaid loan is subsequently recouped from the defaulting borrower, allowing the authority to reimburse the other municipalities for the deficiency.

The size of the debt reserve fund provides the financial flexibility to meet debt service payments on any outstanding loan. It provides the authority with ample time to levy an unlimited ad valorem tax on all property within the province. To further offset any liquidity issues, the authority maintains a C\$200 million line of credit with local banks.

Imposition of the provincewide property tax levy is mandatory when the balance in the debt reserve fund falls below 50% of expected combined municipal loan payments to MFABC in the current year. Although the authority has never levied taxes due to loan delinquencies, it annually collects a small notional amount of property taxes, to ensure the levy-raising system remains active and functioning, and essentially rebates these funds back at the end of the fiscal period.

Property taxes are due July 2 of each year. Delinquent taxes receive a 10% penalty after the due date, and by December additional penalties are accrued. By December of the following year, overdue payments are officially deemed delinquent, and by September of the third year, subject to property seizure.

Credit Approval Process

Local governments undergo a rigorous and lengthy process to secure capital financing through MFABC. The objective is not only to structure an affordable borrowing, but also to protect the municipal governments against unnecessary financial risks. The process

requires approval from regional and provincial representatives, the electorate, and the authority. MFABC structures the credit approval process and ensures that all requisite authorizations are in place before issuing any debt. Only approved projects deemed both necessary and affordable for each local government can be candidates for capital financing.

Before approving any project financing, MFABC first evaluates the debt affordability for each specific borrower. The authority manages debt issuance by determining each municipality's borrowing capacity by gauging the strength of revenue sources. For most governments, loan payments cannot exceed 25% of available revenues, but actual borrowing levels tend to be much less. In the aggregate, local governments have used less than one-quarter of total borrowing capacity.

The regional district, the provincial inspector of municipalities, and the authority's members must each approve a proposed borrowing. The borrower must first ask its senior government, typically the regional district to which it belongs, to borrow funds on its behalf. MFABC then drafts a loan agreement between itself and the regional district, signed by the chair and treasurer of the district and the provincial deputy inspector of municipalities. This agreement stipulates loan terms, including payment dates and deposit requirements. A second agreement between the regional district and its member municipality reflects the same terms. Signed by the mayor or treasurer of the local government, this second agreement establishes that loan payments pass through the regional district to the authority. The two agreements bind all parties to loan repayments through final maturity and preserve the joint and several pledges of all borrowers.

MFABC bundles several borrowings into periodically issued debentures. The authority's board of trustees approves the issuance of securities, and each borrower receives the same interest rate, regardless of size. MFABC typically issues its debentures twice annually. Individual loan terms may extend to a maximum maturity of 30 years, although debentures typically mature in 10 years.

Debt and Borrower Composition

The authority's modest outstanding debt imposes an affordable debt burden on its provincewide tax base. In 2008, MFABC's gross debt equaled about C\$6.0 billion, with net debt representing C\$4.7 billion after deducting sinking and reserve funds. Including all MFABC borrowers, including debt supported through user fees, per capita debt equaled C\$744. Debt issuances on behalf of user fee-supported enterprises, such as water and sewer systems, represent about one-half of outstanding debt.

In the past 20 years, British Columbia provided substantial water and sewer grants to municipalities outside the Vancouver area in the relatively less developed regions known collectively as the hinterlands. As these grants financed much of the hinterlands' infrastructure needs, the municipal needs of the hinterlands are relatively low, compared with those of the Vancouver area, and relate primarily to recreational projects and essential infrastructure, such as roadway improvements. The borrowings of hinterland municipalities and regional districts constitute about one-third of total MFABC debt, a proportion likely to decline in the coming years with greater borrowing requirements in the high-growth Vancouver area.

The Greater Vancouver area's regional transportation system is the authority's largest single borrower, alone accounting for one-third of total MFABC debt. Created in 1998 by the Greater Vancouver Transportation Authority Act to address long-standing transit needs, the system is responsible for public transportation development and local roadway infrastructure. TransLink, as the system is better known, began operating in

April 1999 and serves the region with a network of buses, trains, ferries, and extensive roadways. A combination of fare box revenues, motor fuel taxes, and property taxes finances the system's operations.

MFABC's unique role among the municipalities places it in a pivotal position to facilitate long-term financing. TransLink has an extensive capital plan of more than C\$2 billion, which, with the continued pace of regional expansion, may grow to 50% of MFABC's total loan portfolio by 2015. However, as with all MFABC borrowers, the system's available revenues constrain its borrowing capacity. By statute, the TransLink system cannot budget a deficit, ensuring that its revenue streams support any proposed debt issuance.

The city of Vancouver represents about 10% of municipal outstanding debt. Although the city is the only municipality that can issue debt on its own behalf, it typically uses the authority to finance its larger, more regionally significant projects. Separately, the Greater Vancouver Water District and the Greater Vancouver Sewer and Drainage District, represented about one-quarter of total debt, reflecting substantial regional investment in utilities. Future borrowing for utilities in the Vancouver area is expected to remain stable, averaging about C\$120 million annually through 2015 and potentially increasing to 25% of MFABC's loan portfolio.

MFABC Financial Performance

MFABC has a superior record of financial performance, largely due to its stringent credit controls and loan performance monitoring. Combined with the authority's steadily growing investment returns, the typical municipal borrower only needs to repay about two-thirds of its loan principal, as sinking funds earn enough to cover the balance. MFABC reduces its interest rate risk by matching the duration of investments with its liabilities.

The authority provides a variety of financing options for its local governments, including long-term capital, short-term bridge financing, and lease financing. With the exception of capital financing, participation in any or all of its programs is voluntary. Operating without direct tax support, the authority relies on self-generated revenues derived from management fees on its programs.

MFABC's historically strong financial performance has yielded consistently healthy fiscal reserves and steady investment returns. Its audited results tend to reflect fluctuations in balances related to loan disbursements. While final audited results are not available for all funds for 2008, estimates of consolidated financial results show that MFABC's investments and cash positions were approximately C\$1.6 billion for all funds. In 2008, total revenues exceeded expenditures by about C\$50.6 million, as debt servicing costs remained carefully balanced, slightly below the level of interest revenue from borrowers. The authority's combined net asset position equaled an estimated C\$109.5 million at year-end 2008, a slight decline from C\$158.1 million in 2006 due to the distribution of a portion of excess investment earnings to borrowers and the tighter investment returns.

In 2008, in response to the global economic downturn and a more challenging borrowing environment, the authority took proactive steps to remain in front of investors and increased its liquidity position. Unencumbered cash grew to C\$99.2 million from about C\$10.3 million in the prior year. The authority entered the market for short-term borrowing twice a week, compared to once a week in prior years, to maintain steady investor demand and ensure continued strong market access with good interest rates. The authority also increased its monitoring of local government credit quality to stay on top of any developing deterioration in borrower creditworthiness. Credit repayment remains excellent and no delinquencies have occurred to date.

Consolidated Financial Results

(C\$000, Audited Years Ended Dec. 31)

	2004	2005	2006	2007	2008 ^a
Balance Sheet					
Assets					
Loans to Clients (Including Short-Term Borrowing)	3,475,043	3,406,685	3,574,009	4,227,789	4,582,352
Investments (Net of Holdings)	1,122,924	1,051,810	1,294,111	1,327,491	1,456,908
Cash and Cash Equivalents	8,326	10,849	15,297	10,277	99,202
Other Assets	463,919	411,821	193,020	121,656	93,072
Total Assets	5,070,212	4,881,165	5,076,437	5,687,213	6,231,534
Liabilities					
Long and Short-Term Debt	4,260,329	4,275,333	4,697,525	5,401,270	5,933,135
Due to Clients (Including Investments under Management)	431,689	391,761	159,005	98,405	104,292
Other Liabilities	39,944	40,290	59,545	57,954	83,855
Total Liabilities	4,731,962	4,707,384	4,916,075	5,557,629	6,121,282
Equity in Capital Assets	805	780	755	730	705
Appropriated Surplus	504	1,405	1,498	0	0
Surplus and Other Net Assets	336,941	171,596	158,109	128,854	109,547
Total Liabilities, Equity, and Net Assets	5,070,212	4,881,165	5,076,437	5,687,213	6,231,534
Income Statement					
Revenue					
Interest from Loans to Clients	253,649	258,067	271,051	284,738	302,490
Investment Income	73,261	77,637	65,326	67,097	67,191
Other Revenue	1,290	1,738	1,896	2,114	2,303
Total Revenue	328,200	337,442	338,273	353,949	371,984
Expenditures					
Interest on Long- and Short-Term Debt	245,870	252,670	245,724	258,993	274,986
Amortization of Issue and Other Costs	5,451	5,544	10,642	13,217	38,408
Other Spending	11,576	10,813	9,022	5,769	7,982
Total Spending	262,897	269,027	265,388	277,979	321,376
Excess of Revenue Over Expenditure	65,303	68,415	72,885	75,970	50,608
Beginning Year Surplus	397,355	336,941	171,596	174,781	128,854
Accrued and Other allocations to Clients	(125,426)	(232,284)	(85,704)	(120,318)	(87,000)
Other Uses	(291)	(1,476)	(668)	(1,579)	17,085
Net Assets, End of Year	336,941	171,596	158,109	128,854	109,547

^aPreliminary. Note: Numbers may not add due to rounding.

MFABC utilizes three major funds to account for its financing activities — operating, debt, and debt reserve. The operating fund facilitates the administration of capital financing and collects all management fees. It also serves as the temporary repository of fully returned property tax levies. The fund's expenditures relate to administrative costs and distribution of its annual dividend, which equaled C\$700,000 in 2008. It retained approximately C\$5.6 million of unappropriated equity in 2008. The debt fund is the largest fund, with C\$101.2 million in equity in 2008; it records all disbursement and repayment activity. The debt reserve fund retains all borrower reserve deposits, held as assets in the form of cash, investments, and demand notes, which are kept as collateral and eliminated upon receipt of final loan payments.

Municipal Financial Performance

Ultimately supporting MFABC's unconditional taxing authority provincewide, the local municipal borrowers' full faith and credit pledge provides a high degree of bondholder security. The pledge's joint and several structure places an obligation on the municipalities' general revenues if loan performance dilutes the authority's own reserves. However, the authority's financing capacity has expanded exponentially in

recent years as the province's large tax base experienced rapid tax base growth in the past several years, producing taxable property values of C\$810 billion in 2008.

Local borrowers are financially sound and hold a significant level of their own fiscal reserves. The authority monitors total municipal revenue and expenditure performance and evaluates the local debt burden as part of its ongoing efforts to assess the total financial commitments of the municipal sector. Aggregated municipal revenues equaled an estimated C\$8.8 billion in 2008, growing at a rapid 8.6% annually in the past five years. Locally held reserves equaled about C\$5.1 billion in the same period, fully covering net MFABC debt of C\$4.7 billion.

MFABC also prepares five-year financial model estimates of local municipal financial performance, incorporating uniform conservative assumptions and growth in debt issuance. Using a 5% assumption of reserve balances, compared with the five-year history of nearly 8% annual growth, general municipal reserves are projected to rise more than C\$6 billion by 2010. Increased debt issuance may reduce debt service coverage to a low of 1.2x, assuming modest revenue growth.

Provincial Economy

Representing 13% of the Canadian population with a residential base of 4.4 million, British Columbia is the third largest Canadian province. Its population growth has accelerated since 2001, as average annual growth expanded at a 5.3% rate, compared with 4.9% annual growth between 1996–2001. Reflecting an internationally influenced local economy and proximity to U.S. and Asian trading partners, the province has diversified from its resource-based origins in lumber, paper production, and minerals to manufacturing and service-sector development.

While per capita personal income of C\$34,664 equaled 98% of the sovereign average, the province's total income is growing at a more rapid rate than that of Canada, indicating increasing residential affluence. Migration from other parts of Canada and other countries has enhanced wealth levels.

Although British Columbia had historically been a center of lumber production, its economy has diversified in recent years. Financial services, primarily within the Vancouver region, now dominate the local economy. The services, trade, and manufacturing industries lead employment, with the bulk of job growth related to expansion in financial and business services. After declining to 4.6% in 2006, at the time the lowest unemployment rate for the province in three decades, unemployment increased to 6.1% in January 2009, up from 4.1% in January 2008. Employment contraction has been the greatest in construction related jobs as well as manufacturing employment. Trade-related employment, an important 16% of the total provincial jobs base, is also down, as import and export activity has cooled considerably.

The global economic slowdown has had an effect on the province. While stringent credit standards for homeownership have insulated the province from the U.S. mortgage crisis, the provincial economy is experiencing softness in home sales and residential construction. While median home values remain very strong at over C\$350,000 provincewide, and well over C\$500,000 in the Vancouver area, the average residential property price declined about 5% in 2008. Housing starts are projected to drop about 20% from the 2007 peak and business investment is expected to slow as well. Real gross domestic product growth slowed to an estimated 1.5% in 2008 from double that level in 2007. Modest recovery in GDP, employment, and housing construction is expected to begin in 2010.

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