

Credit Analysis

**Municipal Finance Authority of  
British Columbia, Canada**

**Ratings**

Long-Term Obligations AAA

**Rating Outlook**

Stable

**Analysts**

Melanie A.J. Shaker  
+1 312 368-3143  
[melanie.shaker@fitchratings.com](mailto:melanie.shaker@fitchratings.com)

Roger Scher  
+1 212 908-0240  
[roger.scher@fitchratings.com](mailto:roger.scher@fitchratings.com)

Steven Shevoley  
+1 416 703-4824  
[stephen.shevoley@fitchratings.com](mailto:stephen.shevoley@fitchratings.com)

**Related Research**

- *Fitch Revises Quebec's Rating Outlook to Positive; Affirms Province at 'AA-', Jan. 9, 2008*
- *Fitch Revises Ontario's Rating Outlook to Positive; Affirms 'AA' Ratings, Jan. 9, 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, providing strong debt service coverage.
- 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 debt issuance and narrow approved borrowing purposes.

**Credit Summary**

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. The authority is deliberate and cautious in its credit approval process, tailoring structurally and financially sound projects to suitable financing methods. 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. Created in 1970 by the Municipal Finance Authority Act, the authority works closely with its member municipalities to guide debt issuance and monitor financial performance of individual governments to ensure timely debt service payments. 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 reserves include C\$1.2 billion of sinking funds plus debt service reserves. Each debenture issuance creates a sinking fund dedicated to repayment of that specific offering. The authority's debt service reserve fund holds 1% of all borrowings in cash, representing a reserve paid by all clients. If any municipality cannot meet its payments, MFABC will draw on the debt service reserve account, equaling C\$94.5 million in 2007. The debt service reserve account is equivalent to 2.5 times (x) the largest single-day interest expense. In addition, the authority will levy an unlimited ad valorem tax on all properties within the province in an amount equal to the deficient debt service payment.

**Rating History**

Rating	Action	Outlook/ Watch	Date
AAA	Affirmed	Stable	3/13/08
AAA	Assigned	Stable	3/15/07

A key component supporting MFABC’s financial capacity is the economic strength of British Columbia, particularly within the Greater Vancouver region. With an estimated population of 4.1 million, provincial population growth averaged 5.7% annually since 2001, compared with 5.2% on average annually for Canada. 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 two years and now exceeds C\$800 billion.

Strong provincial economic prospects are demonstrated by a diverse employment base, with low unemployment rates, and population gains, along with greater per capita income levels. With a slightly older and better educated residential base than the Canadian average, per capita personal income equals 98% of the Canadian average but is growing more rapidly than that of the nation. The province’s 2006 unemployment rate of 4.8% was the lowest in three decades, as employment opportunities centering on finance, health care, and retail trade increased. In 2007, its unemployment rate declined further, equaling just 4.2% in November 2007 compared to Canada’s 5.9%.

**The Authority**

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 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 capital needs through MFABC to utilize the authority’s capital finance expertise and ensure low borrowing costs.

The board of trustees, headed by a chairman and administered by the executive director and director of finance, governs the authority. Representing each of the province’s 27 regional districts by population, the board has 35 members, consisting of local mayors and councilors, who elect 10 trustees, a chairman, and a vice chairman. Four of the trustees 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 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 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\$94.5 million as of Dec. 31, 2007.

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\$300 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 amount of property taxes, sized to cover annual interest payments to keep the levy-raising system active and functioning, and fully remits the funds 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 board of trustees 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

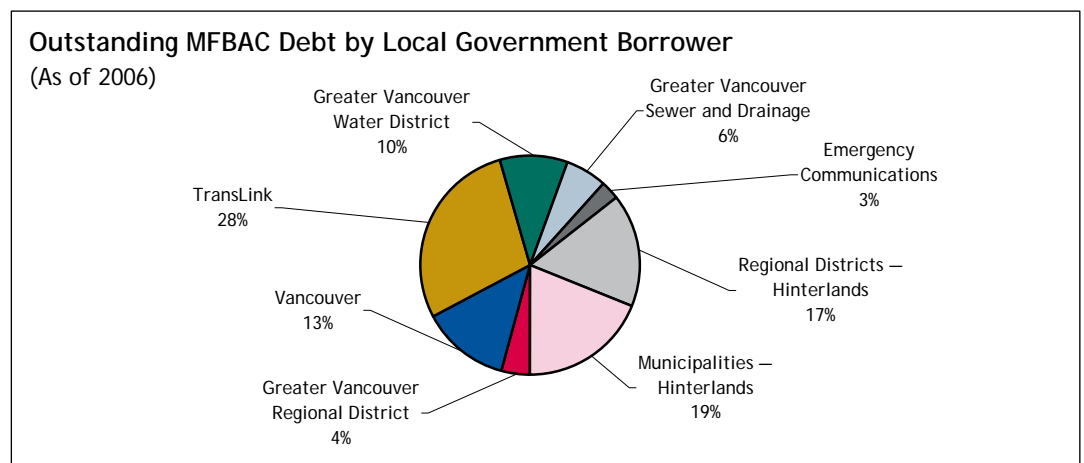
deputy inspector of municipalities. This agreement stipulates loan terms, including payment dates and deposit requirements. A second agreement between the regional district and its member municipality reflects the same terms. Signed by the mayor or treasurer of the local government, this second agreement 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 sets all the rates, terms, and conditions for sale, 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 2007, MFABC's gross debt equaled about C\$5.4 billion, with net debt representing C\$4.1 billion after deducting sinking and reserve funds. Including all MFABC borrowers, per capita debt equaled C\$805. Debt issuances on behalf of user fee-supported enterprises, such as water and sewer systems, represent about one-half of outstanding debt. If self-sustaining enterprise debt is excluded from the tax-supported debt burden, net per capita debt equals about C\$403.

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. As of Dec. 31, 2006, the borrowings of hinterland municipalities and regional districts constituted 36% 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, accounting for 28% 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 represented 13% of municipal outstanding debt as of year-end 2006. 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 represented 10% of borrowed principal, and the Greater Vancouver Sewer and Drainage District, 6%, 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 maturing the duration of investments with its liabilities. Guided by its preference to safeguard investment holdings, MFABC purchases mostly governmental or chartered bank securities. Its largest holdings are of chartered bank securities, accounting for 47% of the 2007 gross book value of all MFABC consolidated funds, and provincial securities, representing 39% of the securities held.

The authority provides a variety of financing options for its local governments, including capital and short-term 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 2007, estimates of consolidated financial results show that MFABC's investments and cash positions were approximately C\$1.3 billion for all funds. In 2007, total revenues exceeded expenditures by about C\$76.0 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\$128.9 million at year-end 2007, a slight decline from 2006's C\$158.1 million due to the distribution of a portion of excess investment earnings to borrowers.

MFABC utilizes three major funds to account for its financing activities — the operating, debt, and debt reserve funds. 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 2007 and C\$600,000 in 2006. It retained approximately \$2.6 million of unappropriated

## Consolidated Financial Results

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

	2004	2005	2006	2007 <sup>a</sup>
<b>Balance Sheet</b>				
Loans to Clients, Including Short-Term Borrowing	3,475,043	3,406,685	3,574,009	4,227,789
Investments, Net of Holdings	1,122,924	1,051,810	1,294,111	1,327,491
Cash and Cash Equivalents	8,326	10,849	15,297	10,277
Other Assets	463,919	411,821	193,020	121,656
<b>Total Assets</b>	<b>5,070,212</b>	<b>4,881,165</b>	<b>5,076,437</b>	<b>5,687,213</b>
Long and Short-Term Debt	4,260,329	4,275,333	4,697,525	5,401,270
Due to Clients <sup>b</sup>	431,689	391,761	159,005	98,405
Other Liabilities	39,944	40,290	59,545	57,954
<b>Total Liabilities</b>	<b>4,731,962</b>	<b>4,707,384</b>	<b>4,916,075</b>	<b>5,557,629</b>
Equity in Capital Assets	805	780	755	730
Appropriated Surplus	504	1,405	1,498	—
Surplus and Other Net Assets	336,941	171,596	158,109	128,854
<b>Total Liabilities, Equity, and Net Assets</b>	<b>5,070,212</b>	<b>4,881,165</b>	<b>5,076,437</b>	<b>5,687,213</b>
<b>Income Statement</b>				
Interest from Loans to Clients	253,649	258,067	271,051	284,738
Investment Income	73,261	77,637	65,326	67,097
Other Revenue	1,290	1,738	1,896	2,114
<b>Total Revenue</b>	<b>328,200</b>	<b>337,442</b>	<b>338,273</b>	<b>353,949</b>
Interest on Long- and Short-Term Debt	245,870	252,670	245,724	258,993
Amortization of Issue and Other Costs	5,451	5,544	10,642	13,217
Other Spending	11,576	10,813	9,022	5,769
<b>Total Spending</b>	<b>262,897</b>	<b>269,027</b>	<b>265,388</b>	<b>277,979</b>
<b>Excess of Revenue Over Expenditure</b>	<b>65,303</b>	<b>68,415</b>	<b>72,885</b>	<b>75,970</b>
Beginning Year Surplus	397,355	336,941	171,596	17,4781 <sup>c</sup>
Accrued and Other Allocations to Clients	(125,426)	(232,284)	(85,704)	(120,318)
Other Uses	(291)	(1,476)	(668)	(1,579)
<b>Net Assets, End of Year</b>	<b>336,941</b>	<b>171,596</b>	<b>158,109</b>	<b>128,854</b>

<sup>a</sup>Preliminary. <sup>b</sup>Includes investments under management. <sup>c</sup>Audited results are restated annually to include the effect of accounting changes.

equity in 2007. The debt fund is the largest fund, with C\$121 million in equity in 2007; 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 2006 and 2007, producing taxable property values in excess of C\$800 billion.

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\$8.6 billion in 2006, 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\$4.1 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 4.1 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.

The province's median home values grew an average 15.8% annually since 2000 to reach an estimated C\$390,760 in 2006. Even more rapid housing appreciation in the Greater Vancouver area resulted in median home values of about C\$518,000, or roughly 134% of the provincial average, in 2006. While per capita personal income of C\$32,734 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 and exerted strong upward pressure on real estate values.

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. While financial activities expanded at 14.9% annually since 2002 to account for 22.1% of the province's real 2006 gross domestic product (GDP), manufacturing's relative importance has declined slightly, representing just 11.2% of its GDP versus the 15.6% average for Canada. The services, trade, and manufacturing industries lead employment, with the bulk of job growth related to expansion in financial and business services. With an unemployment rate of 4.2% in November 2007, British Columbia is experiencing the lowest unemployment in decades and solid labor force growth.

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