Chapter 1

Section

1.06

Ministry of Infrastructure (formerly the Ministry of Economic Development, Employment and Infrastructure

Infrastructure Ontario's Loans Program

Follow-Up on VFM Section 3.06, *2014 Annual Report*

RECOMMENDATION STATUS OVERVIEW					
	# of	Status of Actions Recommended			
	Actions Recommended	Fully Implemented	In Process of Being Implemented	Little or No Progress	Will Not Be Implemented
Recommendation 1	1	1			
Recommendation 2	1	1			
Recommendation 3	1	1			
Total	**3**	**3**	**0**	**0**	**0**
%	**100**	**100**	**0**	**0**	**0**

Background

Ontario Infrastructure and Lands Corporation, commonly referred to as Infrastructure Ontario, is a Crown corporation established by the *Ontario Infrastructure and Lands Corporation Act, 2011* (Act). Infrastructure Ontario is governed by a board of directors that is appointed by the Lieutenant Governor in Council and accountable to the Minister of Infrastructure (at the time of our audit in 2014, the Minister of Economic Development, Employment and Infrastructure).

Infrastructure Ontario has four main lines of business that deal with both government and non-government clients: Major Projects—managing large, complex public infrastructure projects through the alternative financing and procurement model; Real Estate Services—managing the Province's real estate and lands portfolio; Infrastructure Lending—administering the Loans Program; and Commercial Projects—leveraging private-sector partnerships and investments for efficiency in government services and investments.

Through the Loans Program, Infrastructure Ontario has been lending money to municipalities, the broader public sector and the not-for-profit sector in Ontario for the development of infrastructure. Infrastructure Ontario's Loans Program employs 26 full-time-equivalent staff, including loan officers, commercial underwriters, client-relations personnel, credit risk analysts, project managers, treasury analysts and legal advisers. The Program's 2015/16 expenditures amounted to $7.1 million for salaries and administration costs.

Loans Program

The Loans Program had been lending infrastructure funds to municipalities under several other corporate structures before Infrastructure Ontario was created in 2011. In 2004, the Ontario Strategic Infrastructure Financing Authority (OSIFA) was formed to manage municipal loans formerly granted under the Ontario Municipal Economic Infrastructure Financing Authority (OMEIFA). OSIFA was established to expand the OMEIFA's mandate from one of lending strictly to Ontario municipalities to one that included borrowers in the broader public and not-for-profit sectors as well. Between 2006 and 2011, OSIFA and several other Crown agencies were amalgamated, ultimately creating the Ontario Infrastructure and Lands Corporation (referred to as Infrastructure Ontario throughout the report).

When OSIFA was formed and took over the Loans Program in 2004, it was administering a portfolio of approximately $514 million in municipal loans. Since then, the types of borrowers eligible for the Program have grown from solely municipalities to 10 eligible sectors. The eligible sectors, which are outlined in the Act and further detailed in Ontario Regulation 210/11 of the Act, are as follows:

- municipalities;
- universities and affiliated colleges;
- municipal corporations (including power generation and local energy-distribution companies and district energy corporations);
- local services boards;
- not-for-profit long-term-care homes and hospices;
- not-for-profit social and affordable housing providers;
- Aboriginal health access centres;
- community health and social services hubs;
- not-for-profit arts training institutes; and
- not-for-profit sports and recreation organizations.

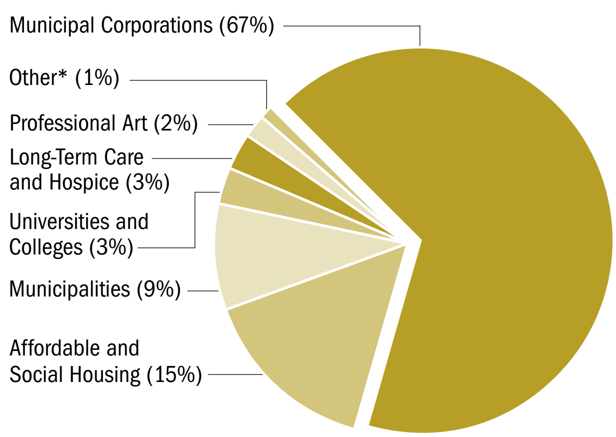
Entities that fall into one of the above sectors are eligible to borrow money from Infrastructure Ontario. In addition, certain other entities (such as the 2015 Pan American Games Organizing Committee and MaRS Discovery District) have been named eligible borrowers under the Act and its regulations.

The expansion of the Loans Program to the broader public and not-for-profit sectors has given borrowers who previously may not have had an external credit rating access to affordable financing through the province's high credit rating and low cost of capital. Under the Loans Program's expanded mandate, Infrastructure Ontario has a portfolio of 1,310 loans advanced to 379 borrowers, and it has approved loans totalling more than $7.7 billion since the inception of the Program. As of March 31, 2016, Infrastructure Ontario's balance of outstanding loans receivable totalled approximately $5.3 billion. **Figure 1** shows this balance by sector.

In managing credit risk for its portfolio—defined as "the potential for default or non-payments of loan principal and interest by borrowers of scheduled interest or principal repayments"—Infrastructure Ontario has developed a general credit risk policy as well as an individual credit risk policy/guideline for each of the 10 eligible borrowing

Figure 1: Total Outstanding Loan Advances by Eligible Sector, March 31, 2016

Source of data: Infrastructure Ontario



* Includes community health and social services hubs, Aboriginal health access centres, sports and recreation organizations, and local services boards.

sectors. Each sector policy/guideline outlines the sector's general credit strengths and risks, as well as common individual risks within the sector. The policies/guidelines also outline Infrastructure Ontario's maximum exposure limits for individual loans and for each sector overall, debt service coverage ratio limits for potential borrowers within the sector according to their risk class, and other sector-specific limitations.

Our 2014 audit found that Infrastructure Ontario needed to enhance its credit-risk assessment models (particularly for non-municipal borrowers), and update and strengthen its credit-risk policies. In addition, Infrastructure Ontario needed to formalize its loan-monitoring procedures, which were not well documented at the time of our audit. We found as well that Infrastructure Ontario should have a monitoring tool to track and monitor compliance with non-standard loan covenants within certain loan agreements.

Other significant observations from the 2014 audit included the following:

- Generally, Infrastructure Ontario had policies and procedures for lending and approval in place to ensure that loans to borrowers in the eligible sectors were made at terms commensurate with the associated risk. The vast majority of borrowers were making payments as required, and loan losses were historically quite low. However, the higher-risk loans were loans that did not fall into the eligible borrowing sectors but had been made eligible through other means in order to support the government's plans and priorities, such as support for the arts and for research and innovation.
- In one case, a loan for up to $235 million ($216 million was outstanding as of March 31, 2014) to a subsidiary of MaRS Discovery District, a not-for-profit organization that would not otherwise have been eligible for the Loans Program, was made possible by a regulatory amendment. The loan was to provide financing to complete the construction of a commercial office and research tower—which was to be built, owned and operated by a private-sector developer—after the developer was unable to secure financing to complete the construction. As part of the loan, the Ministry of Research, Innovation and Science (at the time of our audit in 2014, the Ministry of Research and Innovation) also provided a 15-year debt service guarantee for up to $7.1 million per year to cover the financial risk posed by the lack of committed tenants for the project.
- By December 2013, further difficulties on this project meant that the Ministry of Research and Innovation had to honour the guarantee it provided to facilitate the loan, as the amount of space leased out was not sufficient to support the loan-interest payments that were coming due in January 2014. Our audit noted that the lack of transparency around the policy objectives and intended benefits to be obtained in return for the significant risks assumed in providing the loan and guarantee created the perception of a bailout of a private-sector developer. We noted that it was still uncertain whether the benefits realized from this transaction will ultimately outweigh the risks and costs assumed.
- Also on the troubled loan list were two older loans made to not-for-profit organizations with a combined balance of approximately $75 million outstanding as of March 31, 2014. Both loans were approved based on optimistic assumptions about donation revenues that have not materialized to date. Approval by Order-in-Council was required for one of these borrowers to become eligible for the Loans Program. Neither borrower would have qualified for loans under Infrastructure Ontario lending policies regarding donation revenues that were in place at the time of our audit. Neither loan was in default at the time of the audit.

We made a number of recommendations for improvement and received commitments from Infrastructure Ontario that it would take action to address our recommendations.

Standing Committee on Public Accounts

On September 23, 2015, the Standing Committee on Public Accounts (Committee) held a public hearing on Section 3.06 of our *2014 Annual Report*, Infrastructure Ontario's Loans Program. Subsequent to the hearing, in October 2015, the Committee wrote a letter to the Ministry of Infrastructure (at the time, the Ministry of Economic Development, Employment and Infrastructure), endorsing the findings and recommendations in our report and acknowledging Infrastructure Ontario's responses to our recommendations and the additional information provided at the hearing. The Committee was satisfied with the information provided at the hearing and had no further recommendations.

Status of Actions Taken on Recommendations

Infrastructure Ontario has implemented all three recommendations in our *2014 Annual Report*, which were aimed at ensuring sufficient monitoring and tracking of the loans made under the Program.

For instance, with respect to the monitoring of loans, Infrastructure Ontario has revised its Credit Risk Management Policy by updating the individual credit risk policies (now called Sector Lending Guidelines and Procedures) for five eligible borrowing sectors covering most of its portfolio. In addition, Infrastructure Ontario also fully implemented 34 out of the 36 recommendations from an external review of its credit and lending processes, and implemented a new loan system that became operational in September 2014, where all non-standard loan covenants have been recorded in the system for tracking and monitoring.

The status of the actions taken on each recommendation is described in the following sections.

Municipal Loans

Recommendation 1

To ensure that outstanding municipal loans are effectively monitored, Infrastructure Ontario should formalize and document its monitoring procedures regarding municipal loans.

Status: Fully implemented.

Details

Infrastructure Ontario monitors municipal loans through an annual review of the municipalities' audited financial statements; through data collected in the annual Financial Information Return from the municipalities—the main tool for collecting financial and statistical information on municipalities—which is managed by the Ministry of Municipal Affairs and Housing (MMAH); and through discussions with MMAH, where appropriate. Infrastructure Ontario's Credit Risk Department uses the annual review to identify borrowers with low credit scores and assess any potential impact this may have on debt repayment.

Our 2014 audit noted that although Infrastructure Ontario had sufficient procedures in place to monitor municipal loans, they could be better documented.

Since our audit, Infrastructure Ontario in September 2015 updated its Credit Risk Management Policy and its Sector Lending Guidelines and Procedures for municipalities, which document the monitoring procedures for municipal loans. The Credit Risk Management Policy now defines Infrastructure Ontario's responsibility for ensuring appropriate credit management planning and risk measurement, and for monitoring and reporting on existing and potential credit risks and environmental risks in its portfolio of loans.

The updated Sector Lending Guidelines and Procedures for municipalities now has a section dedicated to analysis and due diligence required for municipal loans, and lists specific areas such as the mandatory completion of the Municipal Scoring Model that should be checked against Infrastructure Ontario's minimum requirements. Infrastructure

Ontario will actively monitor municipalities that score below these minimum requirements to understand the causes contributing to their drop in creditworthiness and how to best address these.

Review of Infrastructure Ontario's Credit and Lending Review Process

Recommendation 2

To ensure that loans issued to eligible borrowers reflect the associated risks, and that outstanding loans are effectively monitored, Infrastructure Ontario should implement all components of its action plan to address the deficiencies identified in the 2013 consultant's review of its credit and lending processes.

Status: Fully Implemented.

Details

In June 2013, Infrastructure Ontario hired an external consulting firm to conduct a review of its lending and credit review processes. The review had 36 recommendations, including:

- refining the Credit Risk Policy to be more prescriptive and to cover all relevant loan processes;
- enhancing existing policies and procedures to facilitate the consistent use of underwriting and credit assessment;
- establishing a minimum global debt service coverage ratio requirement;
- formalizing the current monitoring process to identify potential problem accounts in a systematic way; and
- implementing an annual loan review process.

In March 2014, Infrastructure Ontario management presented an implementation plan to address all 36 of the report's recommendations to its board of directors, with an April–September 2014 timeline.

Since our 2014 audit, Infrastructure Ontario has fully implemented 34 of the recommendations through the updates to its Credit Risk Management Policy and its Lending Guidelines and Procedures.

Infrastructure Ontario will not be implementing the other two remaining recommendations, relating to adjusting the loan interest rate in relation to borrower creditworthiness and incorporating additional information and conditions on the borrowing rate within the Term Sheet. This is because the vast majority of borrowers are making their payments as required, and loan losses have been historically low.

Recommendation 3

To ensure all loan covenants are being monitored and appropriate action is taken when associated risks warrant it, Infrastructure Ontario should develop a tracking tool to record and monitor all non-standard covenants that are included in signed loan agreements.

Status: Fully implemented.

Details

Infrastructure Ontario's Credit Risk department is responsible for credit application review and loan monitoring. At the time of our audit in 2014, the department was in the process of developing and refining a number of loan-monitoring tools and other reporting tools, but its loan-monitoring policies and procedure were still informal. In addition, our audit found a number of instances where non-standard restrictions or covenants had been included in loan-financing agreements to address specific risk areas. However, we did not see evidence that Infrastructure Ontario was monitoring compliance with these covenants.

Since our audit in 2014, Infrastructure Ontario has implemented a new loan system that became operational in September 2014 with the functionality to track and monitor loan covenants. All non-standard covenants in the loan agreements have been entered into the system, and reports are generated weekly for the loan officers to monitor the due dates for the submission of the necessary information to assess compliance with the covenants. Loans with covenant breaches are identified for further follow-up and are reported quarterly to senior management and the board of directors. As of March 31, 2016, there were six loans ($108 million) on the Loan Watch List identified for further monitoring.

MaRS Phase 2 Inc. Loan Update

In May 2010, the Credit and Risk Management Committee of Infrastructure Ontario's board approved a loan for up to $235 million ($216 million was outstanding as of March 31, 2014) to a subsidiary of MaRS Discovery District, a not-for-profit organization that would not otherwise have been eligible for the Loans Program. The loan was made possible by a regulatory amendment. Its purpose was to provide financing to complete the construction of a commercial office and research tower—which was to be built, owned and operated by a private-sector developer—after the developer was unable to secure financing to complete the construction. Infrastructure Ontario approved the loan with a debt service guarantee from the Ministry of Research and Innovation in lieu of a condition requiring 80% of the building to be pre-leased, which Infrastructure Ontario required the developer to meet before any funds could be advanced on the loan. This guarantee transferred the loan default risk from Infrastructure Ontario's Loans Program to the Ministry.

In December 2013, the construction of the tower was completed and an occupancy permit was issued; however, only just over 30% of the space available had been leased. As well, MaRS Discovery District did not have the required funds to service lease commitments it had made and the interest payments on the loan. On February 3, 2014, Infrastructure Ontario notified the Ministry of Research and Innovation that it would be requesting a draw on the debt service guarantee to service the loan. At the same time, the Minister of Infrastructure also asked Infrastructure Ontario to explore options to preserve both the project and the loan while reducing the government's exposure.

Negotiations with stakeholders continued through August 2014, and a conditional agreement to buy out the developer's residual interest was announced in September 2014. The loan was also converted from a construction loan to a long-term debenture on September 30, 2014. Total draws on the guarantee from February 2014 to January 2015 were $7.9 million.

Our audit noted that the lack of transparency around the policy objectives and intended benefits to be obtained in return for the significant risks assumed in providing the loan and guarantee created the perception of a bailout of a private-sector developer. We noted that it was still uncertain whether the benefits realized from this transaction will ultimately outweigh the risks and costs assumed.

Since our audit, the MaRS debenture and financing agreement was assigned to and fully paid out by the Ministry of Research and Innovation, thus making Infrastructure Ontario whole.

An amended and restated credit agreement was signed between MaRS Discovery District, MaRS Phase 2 Inc. and the Province of Ontario on March 30, 2015, to cover the existing debenture of $223.3 million (comprised of $217.5 million from Infrastructure Ontario and $5.8 million drawn on the existing term facility immediately prior to the closing date) and to provide a new term facility up to $155 million. This new term facility is to be used to draw upon until 2019 to support the project until the building has enough tenants and cash flow for the project to stabilize. The Ministry has set up a number of measures to oversee this amended agreement. They include monitoring construction costs, appointing an expert supervisory committee and appointing an independent member to the MaRS board of directors.

As of March 31, 2016, the outstanding balance of the total credit facility is $290 million. This loan is reported in the Province's Public Accounts.