Chapter 3

Section 3.06

Ministry of Economic Development, Employment and Infrastructure

Infrastructure Ontario's Loans Program

Background

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

IO's role is to manage Ontario's public infrastructure, real estate and government facilities, and to help finance public infrastructure renewal. It has four main lines of business that deal with both government and non-government clients: Real Estate Management, Ontario Lands, Project Delivery, and Lending (the Loans Program).

IO lends money to municipalities, the broader public sector and the not-for-profit sector in Ontario for the development of infrastructure. The Loans Program's 2013/14 budget was $9.85 million. IO's Lending department employs 28 full-time-equivalent staff, including loan officers, commercial underwriters, client-relations personnel, credit risk analysts, project managers, treasury analysts and legal advisors (see **Figure 1**).

History of Infrastructure Ontario and the Loans Program

The Loans Program had been lending infrastructure funds to municipalities under several other corporate structures before IO 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, first forming the Ontario Infrastructure Projects Corporation and ultimately creating the Ontario Infrastructure and Lands Corporation (referred to as IO throughout the report).

Expansion of Loan Portfolio

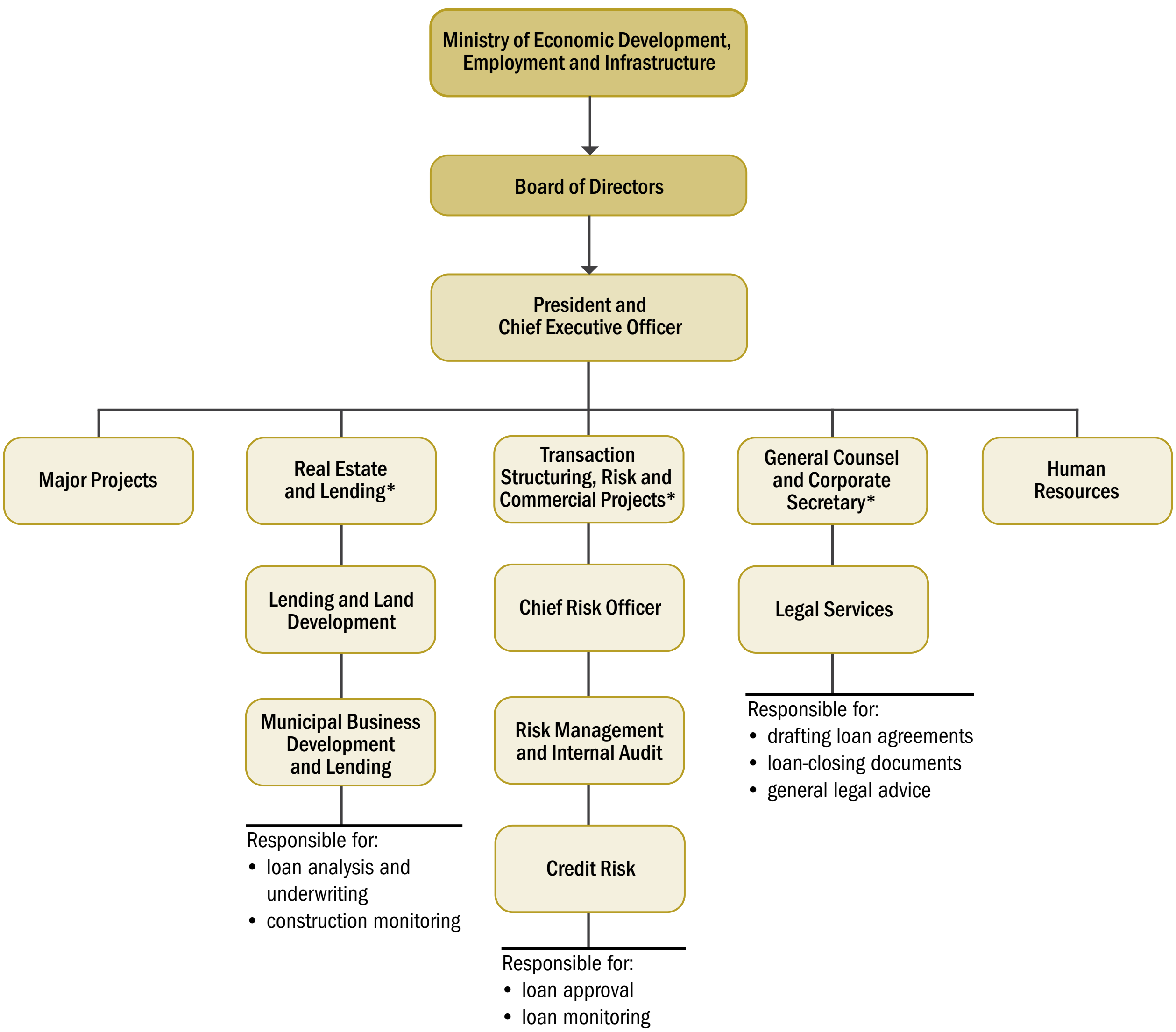
When OSIFA was formed and took over the Loans Program in 2004, it was administering a portfolio of approximately $514 million in municipal loans. Since then, the types of borrowers eligible for the program have grown from solely municipalities to 10 eligible sectors. The eligible sectors, which are outlined 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 service 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 IO. 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 Royal Conservatory of Music was made an eligible borrower through an

Figure 1: Infrastructure Ontario Organization Chart

Source of data: Infrastructure Ontario



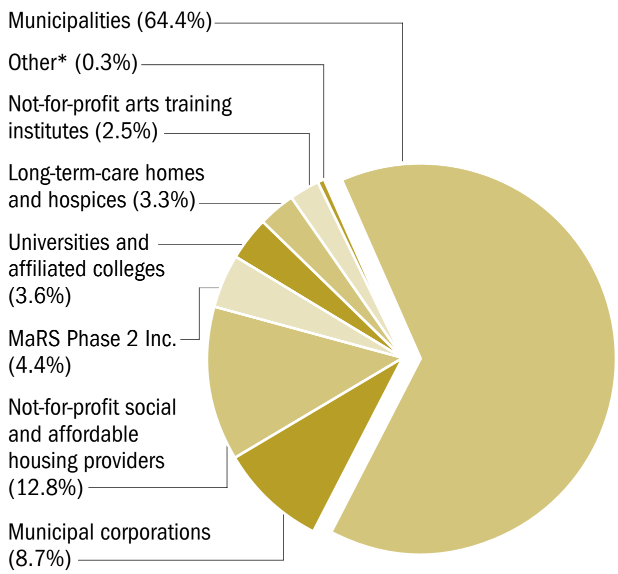
* Divisions typically involved in administering the Loans Program.

Order in Council (OIC), under a section of the Act that allows the government to specify other activities in which IO may engage based on Cabinet approval.

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, IO has a portfolio of 806 loans advanced to 353 borrowers and has approved loans totalling more than $7 billion since the inception of the Program. As of March 31, 2014, IO's balance of outstanding loans receivable totalled approximately $4.9 billion. **Figure 2** shows this balance broken down by sector.

Figure 2: Total Outstanding Loan Advances by Eligible Sector, as at March 31, 2014 (%)

Source of data: Infrastructure Ontario



* Includes the following sectors: Aboriginal health access centres; community health and social service hubs; not-for-profit sport and recreation organizations; local services boards.

Credit Risk Framework

IO's Credit Risk Policy outlines a credit risk management strategy, roles and responsibilities, internal controls, and requirements for reporting to its board of directors.

This policy defines credit risk as "the potential for default or non-payment by borrowers of scheduled interest or principal repayments." In addition to this general policy, IO has policies on credit risk and lending for each of the 10 eligible borrowing sectors. Each policy outlines the sector's general credit strengths and risks as well as common individual risks within it. The policies also outline IO'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.

IO classifies its borrowers into three risk tiers that are based on the borrowing entity's relative level of government oversight and funding. Borrowers rated "primary" include municipalities, universities and affiliated colleges, and local services boards (who provide municipal-level services outside of incorporated municipalities, in rural areas, for example). Loans to these borrowers are considered the least risky because they have ongoing, consistent revenue streams that allow them to service debt on a long-term basis. Borrowers rated "secondary" include some municipal corporations (for example, local energy-distribution companies), long-term-care homes, not-for-profit social housing providers and Aboriginal health access centres. These borrowers are in the secondary risk tier because, although they have some government oversight and financial support, the government has no legislative requirement to support them. Borrowers rated "tertiary" include some municipal corporations (for example, power generators), district energy corporations, not-for-profit arts training institutes, hospices, and not-for-profit sports and recreation organizations. Tertiary borrowers are considered the highest credit risk because they generally receive little or no government capital funding and must rely on self-generated revenues to service their debt.

Audit Objective and Scope

The objective of our audit was to assess whether Infrastructure Ontario (IO):

- issues loans to eligible borrowers at terms that reflect the associated risks; and
- effectively monitors the ongoing performance of outstanding loans and takes appropriate actions when risks warrant.

Senior management at IO reviewed and agreed to our audit objective and associated audit criteria.

Our audit work was conducted primarily at IO's two main Toronto offices between January and June of 2014. We reviewed relevant documents and administrative policies and procedures, analyzed pertinent information and statistics, and interviewed appropriate staff from IO as well as other key stakeholders. We examined the loan approval process for a sample of loan application files approved within the last five years and reviewed the monitoring process for a sample of municipal and non-municipal loans issued, focusing mainly on higher-risk, non-municipal loans. We also examined IO's loan-monitoring reports, including its Loan Watch List. In addition, we looked at relevant internal audit reports and an external consultant's report on the results of a review on IO's lending and credit review processes that was conducted from June to November of 2013, along with management's action plan to address the report's findings.

Summary

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

Generally, we found that IO's policies and procedures for lending and approval were reasonable and sufficient for ensuring that loans to eligible borrowers are made at terms commensurate with the associated risk. IO has strengthened its monitoring over the past couple of years through the separation of the monitoring function from the underwriting and credit review functions, and through the development of various loan portfolio monitoring reports and tools, including its Loan Watch List for troubled loans. The vast majority of borrowers are making their payments as required, and loan losses have historically been rare and quite low. The higher-risk loans in IO's portfolio were loans that did not initially fall into IO's eligible borrowing sectors.

Higher-risk Loans

The higher-risk, non-municipal loans that we examined were being monitored by IO, and it had actions underway for borrowers who were having difficulty meeting the conditions of their loan agreements. At the time of our audit, IO was using its Loan Watch List to track four loans experiencing difficulties. The combined outstanding balance of these loans as of March 31, 2014, was approximately $300 million. The two most significant high-risk loans on the Watch List had been made to borrowers who did not fall into any of IO's 10 eligible borrowing sectors, but who had been made eligible through other legal means to support the government's plans and priorities, such as support for the arts and for research and innovation.

MaRS Phase 2 Loan

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. MaRS Discovery District sought the loan to help restart 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, which was then halted during the economic downturn in 2008.

IO approved the loan request in May 2010. Construction resumed in August 2011 after MaRS Discovery District made favourable concessions to the developer to avoid further construction delays and a debt service guarantee from the Ministry of Research and Innovation was signed in lieu of an 80% pre-leasing loan condition. IO monitored the project throughout construction in accordance with its policies and procedures for managing construction risk.

The project is now complete and the building ready for occupancy, but the amount of space leased out so far is not sufficient to support loan-interest payments, which started to become due in January 2014. The most significant third-party leases signed so far are both with publicly funded organizations (Public Health Ontario and the Ontario Institute for Cancer Research). These leases were committed to before construction began in 2007 at rates that exceed current market rents for this type of property. MaRS has not been able to find additional tenants at these rates, which could not be lowered because of the concessions made to the developer to enable MaRS to recommence construction in 2011.

With the Ministry of Research and Innovation's having to honour a guarantee it provided to facilitate the loan along with the risk that MaRS may require additional funding to support its operations, the Minister of Infrastructure asked IO to explore options that would preserve both the project and the loan while reducing the government's exposure. In April 2014, the Ministry of Research and Innovation and the Ministry of Infrastructure prepared a joint submission to Treasury Board that analyzed each option under consideration and concluded that the best option was for the Ministry of Infrastructure to acquire the property if it could do so economically. Negotiations with stakeholders were ongoing as of August 2014 when we completed our audit work, and a conditional agreement to buy out the developer's residual interest was announced on September 23, 2014.

The lack of transparency around the policy objectives and intended benefits to be obtained for the significant risks assumed in providing the loan and guarantee creates the perception of a bailout of a private-sector developer. Whether the benefits realized from this transaction will ultimately outweigh the risks and costs assumed remains to be seen.

Other Higher-risk Loans

Also on IO's Loan Watch List are 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 aggressive assumptions about donation revenues that have not materialized to date. Approval by Order-in-Council was required in order for one of these borrowers to become eligible for the Loans Program. Neither borrower would have qualified for loans under IO lending policies regarding donation revenues that were in place at the time of our audit. Neither loan is currently in default.

The remaining loan on the Watch List, with an outstanding balance of approximately $12 million as of March 31, 2014, was being tracked because revenues from the infrastructure project funded by the loan were less than the amount projected by an engineering study conducted at the project proposal stage.

Majority of Loans are to Low-risk Municipalities

Around 64% of the Loans Program's portfolio comprises loans to municipalities—relatively low-risk borrowers whose financial condition is also monitored annually by the Ministry of Municipal Affairs and Housing. We found that the procedures in place were being followed for the municipal loans we examined, and that further enhancements to the program's lending policies were underway.

OVERALL INFRASTRUCTURE ONTARIO RESPONSE

Infrastructure Ontario (IO) appreciates the hard work and insights of the Auditor General's Office in examining IO's Loans Program. Our management team is also grateful for the recognition of the contribution the Program makes to many communities (big and small) across the province. Modern and efficient public infrastructure is key for building and maintaining a strong economy, prosperous communities and a clean, healthy environment.

Together with our clients, IO has helped finance more than 1,000 projects—from the construction of roads, bridges and facilities to the acquisition of assets, such as vehicles and equipment, as most capital expenditures are eligible. IO subjects borrowers to detailed loan underwriting and an independent credit review that confirms the financial soundness of the loan application. In addition to reviews of loans in the operational phase, we also closely monitor the delivery of projects in construction through the use of independent project monitoring and project reporting requirements. For any loans at risk identified in the construction or operating phases, IO works proactively with borrowers to develop viable solutions to allow the project to continue to deliver important services to Ontarians and ensure that the loan is paid back in full.

IO will undertake the Auditor General's recommendations to further improve our Loans Program. We will act on each and every recommendation in our commitment to continuously improve the services we provide the province.

In the spirit of continuous improvement, IO engaged a reputable external accounting firm through a competitive process in June 2013 to review the Loans Program. The consultant examined the Loans Program from an end-to-end perspective and assessed IO's practices against leading practices throughout the industry. Since then, we have been working to address the improvements identified by the external review and will complete that action plan by the end of the 2014/15 fiscal year.

Detailed Audit Observations

Municipal Loans

Over the past 10 years, 231 of Ontario's 444 municipalities have entered into financing agreements under the Loans Program administered by Infrastructure Ontario (IO). As of March 31, 2014, IO's outstanding loans to municipalities totalled approximately $3.1 billion, accounting for roughly 64% of its total outstanding loans.

Municipalities are subject to regulatory limits on borrowing, are required by legislation to present annual balanced budgets, and have the ability to generate revenue from their tax bases. For these reasons, IO assesses municipal loans as having the highest credit quality (or lowest risk) of all its loans.

We examined a sample of municipal loan files and risk-assessment tools along with loan performance to date and found that IO's general risk assessment for municipal loans appears appropriate. To date, there have been no defaults on municipal loans.

There was a structured risk-assessment process in place for the municipal loans we examined. IO has a credit-rating model for municipalities that was developed by the Ontario Financing Authority and that uses data collected by the Ministry of Municipal Affairs and Housing (MMAH), the government of Ontario's main liaison with municipalities in the province. MMAH manages the annual Financial Information Return (FIR) process, the main tool for collecting financial and statistical information on municipalities. IO's credit-rating model involves calculating seven key financial ratios using data derived from the FIR and then assigning a credit rating based on the cumulative average score of those ratios. We found that the credit-rating model had been used in the credit analysis for all the municipal loans that we examined.

In addition to IO's internal credit ratings, larger municipalities are rated by external debt-rating services. IO's municipal underwriting process also includes MMAH reviews of borrower applications, in which MMAH provides feedback on the municipality's financial status, any impediments to the loan and any concerns regarding the loan application.

Currently, IO monitors municipal loans through an annual review of audited financial statements, data collected in the FIR and discussions with MMAH, where appropriate. IO'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. We found that although IO had sufficient procedures in place to monitor municipal loans, they could be better documented.

RECOMMENDATION 1

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

INFRASTRUCTURE ONTARIO RESPONSE

Infrastructure Ontario (IO) monitors the loan portfolio across all sectors through a quarterly loan portfolio review. The objectives of the loan review are to identify negative trends so that timely action can be taken to minimize potential credit loss and escalate borrowers identified as having potential loan payment difficulties to our Loan Watch List to receive a more thorough review. IO thanks the Auditor General for this recommendation and agrees with the need to document our current monitoring procedures directly in our Credit Policies. All loan monitoring activities will be documented in IO's Credit Policies and Operating Standards and Procedures in 2014.

Non-municipal Loans

Analysis and Approval

IO does not have a standard credit-risk assessment model in place for non-municipal borrowers because the organizational structures, financial reporting requirements, and financial capabilities and risks of these borrowers vary widely.

When a potential non-municipal borrower submits a loan application to IO, it is assigned to an underwriter for credit analysis. The underwriter prepares a summary memo for IO's Credit Review Committee (CRC), a senior management committee whose members include IO's Chief Risk Officer, Chief Financial Officer and Senior Vice President of Transaction Finance, General Counsel, plus a representative from the Ontario Financing Authority.

The summary memo outlines the credit analysis, including a summary of the loan application's financial details, the applicant's credit-risk score, a summary of the infrastructure project details, an outline of both the applicant's and the project's governance structures, and a recommendation on whether to approve the application or not, which includes a summary of its strengths and challenges. This information is followed by a detailed risk analysis (credit and otherwise) prepared by the underwriter in accordance with IO's credit risk policies (last updated November 2012) and underwriting guidelines (last updated September 2011), with input from legal, project-management, environmental and appraisal experts within IO. The summary memo recommends general security requirements and loan covenants plus any additional security or covenants deemed appropriate. For construction projects worth more than $50 million, IO requires that a due diligence report on the project be prepared by a third party, such as an architectural or civil engineering firm. We found that the required project reports were on file for all loans over $50 million that we examined in our sample.

IO's Credit Risk department reviews the summary memo to ensure that IO's credit policies have been adhered to before presenting it for approval.

Loans of up to $2 million are approved by the Chief Risk Officer, loans of up to $25 million are approved by the CRC and loans of more than $25 million are approved by the board of directors. Approval of the loan is recorded in the applicable committee meeting minutes.

We found that the appropriate delegated authority had properly approved all of the loans in the sample we examined. We also found that the loan applications and risk analyses in our sample were generally well-documented, both in the loan files and the summary memos. In some of the older files we examined, we noted that the assessed credit-risk score was not always evident in the summary memo and certain financial analyses were not as comprehensive as those carried out for more recent loans. In one of the files in the sample we examined, a $7-million loan approved in 2011, we found deficiencies in the underwriting process that accepted overly optimistic revenue projections. This loan's risk rating was not adequately supported by the information and sensitivity analysis in the summary memo. It is currently on IO's Loan Watch List.

Monitoring

To provide an independent review and challenge of its underwriting process, IO transferred the responsibility for credit application review and loan monitoring from its Underwriting department to its Credit Risk department in April 2013. The Credit Risk department is developing and refining a number of loan-monitoring tools and other reporting tools, but its loan-monitoring policies and procedures were still informal at the time of our audit.

The Credit Risk department's current loan-monitoring function includes the following:

- assessing the ongoing financial viability of the borrower throughout the term of the loan;
- ensuring compliance with the financing agreement's payment terms, restrictions and covenants;
- identifying negative trends in the borrower's financial performance in order to facilitate early intervention when it is required; and
- identifying borrowers with potential loan repayment difficulties and adding them to the Loan Watch List (introduced in early 2012).

IO's Lending department is still responsible for monitoring projects under construction. It reviews the project reports it receives from borrowers each month when their loan money is advanced. Depending on the project's complexity, monitoring is performed by a project manager in the Lending department, a third-party project monitor engaged by the Lending department but paid for by the borrower, or a combination of the two.

The Credit Risk department tracks the status of all of IO's non-municipal borrowers. Standard loan agreement reporting requirements (for example, audited financial statements) are tracked through a spreadsheet that is also used to assess basic covenants and ratios (debt service coverage ratio, current ratio and debt-to-capital ratio) against established limits. However, IO did not have a formal monitoring process in place to track and monitor compliance with those covenants.

In our examination of the loan analysis and approval processes, we found a number of instances in our sample 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 IO was monitoring compliance with those covenants.

In addition to the monitoring spreadsheet, IO has developed loan-monitoring reports to keep senior management and the board of directors up-to-date. The Quarterly Review Report summarizes the performance of all non-municipal loans in four categories: construction project status (where applicable), financial review, payment compliance and covenant compliance. Loans for which serious financial deterioration or concerns over debt servicing have been noted in the Quarterly Review Report are escalated to the Loan Watch List. Borrowers on the Loan Watch List may not be in default, but are considered to have a high level of uncertainty for future debt repayment.

As of March 31, 2014, four loans were on IO's Loan Watch List. Their combined outstanding balances totalled approximately $300 million—approximately 15% of IO's total non-municipal loans.

Two loans on the Watch List were to borrowers that did not fall into any of IO's 10 eligible borrowing sectors, but had been made anyway because they supported the government's plans and priorities, such as support for the arts and for research and innovation. One of the borrowers, the Royal Conservatory of Music, was made eligible for the Loans Program by Order-in-Council in July 2007. The other, MaRS Phase 2 Inc. (discussed in more detail in a later section), was made eligible through the amendment of a regulation in February 2010. As we have already noted, IO's lending policies for the 10 eligible sectors outline specific risks and loan thresholds for each; loans to borrowers outside the eligible sectors are inherently riskier.

In addition, we noted that loans, totalling $75 million, to the Royal Conservatory of Music and another not-for-profit organization were approved based on projected fundraising donations that have fallen below expectations. In January 2012, IO adopted a donation/fundraising underwriting guideline that limits the amount that can be borrowed based on fundraising projections. Neither of the loans would have qualified under the new donation revenue limits. Although neither of these loans is in default, both are being tracked on IO's Loan Watch List.

The remaining loan on the Loan Watch List, with an outstanding balance of approximately $12 million, was being tracked because revenues from the infrastructure project funded by the loan were less than the amount projected by an engineering study conducted at the project proposal stage.

IO's October 2012 *Valuation Allowance Policy* outlines the establishment of a general allowance provision for its loans. This is based on financial industry statistics on non-government-organization default and loan-loss rates published by Moody's, an external debt-rating agency. In addition, IO establishes specific allowances for problem loans according to the borrower's ability to service the loan within its current financial structure. IO's Finance department determines allowance amounts through an analysis of the loans on the Watch List and discussions with the Credit Risk department, the Credit Review Committee and the board's Credit and Risk Management Committee. As of March 31, 2014, general and specific allowances for doubtful accounts totalled $11 million. Based on the information available at the time of our audit, we found no evidence suggesting that IO needed to increase its allowances.

Review of IO's Credit and Lending Review Process

In June 2013, IO hired an external consulting firm to conduct a review of its lending and credit review processes. The purpose of this review was to help IO "formalize the objectives of the lending program and define the program's target state with respect to governance, processes, credit risk management, organizational structure and portfolio management."

The consulting firm reported its findings and made 36 recommendations to IO's board in November 2013. Several of the recommendations related to our audit scope and findings, with many of them focusing on refining, enhancing and formalizing processes, policies and procedures. These recommendations included the following:

- refining the Credit Risk Policy to be more prescriptive and to cover all relevant loan processes (risk assessment, adjudication, and loan monitoring and reporting);
- enhancing existing policies and procedures to facilitate the consistent use of underwriting and credit assessment, including detailed procedures covering risk-rating assessments and financial analysis to ensure the rating model is replicable;

- establishing a minimum global debt service coverage ratio requirement and considering a maximum loan-to-value requirement driven by IO's level of risk for each sector;
- formalizing the current monitoring process to identify potential problem accounts in a systematic way, including identifying actions to be taken when a covenant is breached or a loan is in default; and
- implementing an annual loan review process that includes reassessing the risk profiles of borrowers.

In March 2014, IO 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.

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.

INFRASTRUCTURE ONTARIO RESPONSE

As part of Infrastructure Ontario's (IO) commitment to continuous improvement, we initiated an external review in June 2013 in an effort to further improve our Loans Program. As noted in the report, IO immediately began to address all issues identified in the review. IO agrees with the importance of completing its action plan relating to the 2013 external review of its lending practices. Many action plan items are now complete, with the remaining in progress and planned for completion by the end of the 2014/15 fiscal year.

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.

INFRASTRUCTURE ONTARIO RESPONSE

Infrastructure Ontario (IO) agrees with the importance of improved monitoring of non-standard covenants. IO currently monitors financial covenants through our quarterly loan portfolio review and escalates loans in line with risk to the Loan Watch List report. At the time of the Auditor General's review, IO had procured a new loan system capable of tracking and monitoring compliance of standard and non-standard loan covenants by way of checklists. The checklists include all covenants per the financing agreement and due dates associated with each for tracking covenants via the reports.

The new loan system became operational on September 4, 2014, and all covenants (standard and non-standard) will be tracked through a full loan Annual Review Process to be implemented in the 2014/15 fiscal year.

Loan to MaRS Phase 2 Inc.

MaRS Discovery District (MaRS) is a not-for-profit corporation formed in 2000 by a group of prominent business leaders and researchers. "MaRS" was originally an acronym for "medical and related sciences." The corporation's objective was to establish a large research and innovation hub focusing on technology commercialization in a downtown area of Toronto that is home to the University of Toronto and numerous research hospitals. This hub was to be built over several phases using private-sector donations along with federal and provincial contributions.

Phase 1 included the construction of three new buildings and the retrofit of the former Toronto General Hospital building to form the MaRS Centre, a research tower and "convergence centre/incubator." The MaRS Centre was completed in late 2005. Its construction was partially debt-financed along with the assistance of the federal government, the MaRS founders, the University of Toronto, and approximately $55 million in contributions from the province to help with land acquisition, construction costs and an initial operating grant. The province also contributed just over $16 million toward the acquisition of the lands that Phase 2 is built on, which it announced in the 2006 budget. The University Health Network occupies much of the research tower of the Phase 1 buildings.

In August 2007, following a competitive selection process, MaRS entered into an agreement with a private-sector developer for the construction of Phase 2 of its downtown research and innovation hub. Phase 2 would include a 20-storey commercial office building and laboratory space next to the MaRS Centre on former Toronto General Hospital lands that had been sold, with conditions, to MaRS by the University Health Network for $7.525 million (see **Figure 3** for a timeline of the events discussed in this section). Phase 2 was to be 100% financed, built and operated by the private-sector developer, but when the global economic crisis hit in late 2008, the developer was no longer able to obtain the necessary financing, and construction came to a halt. At this point, the complex had been built up to street level and about $90 million had been invested, according to the developer.

In December 2008, MaRS approached IO about the possibility of obtaining financing to complete the construction of Phase 2, and submitted a formal financing proposal to the Ontario Infrastructure Projects Corporation, a predecessor agency to IO, in January 2009. In the initial analysis of the proposal, Loans Program staff outlined that MaRS would need to show that it could meet the minimum debt service coverage ratio of 1:1 (the ratio of cash available for debt servicing to total interest and principal payments—in this case a breakeven level) to minimize the loan's default risk. (This ratio increased to 1.2:1 after year 1.) In addition, MaRS would be required to pre-lease 80% of the building's available space at an average rent of $29 per square foot before any construction funds could be advanced. The purpose of this requirement was to minimize the tenancy risk associated with the project by demonstrating that MaRS could attract enough tenants with high-quality credit to sign long-term leases at the proposed rate of $29 per square foot (operating costs were estimated at an additional $31 per square foot). Although $29 per square foot was approximately $4 more per square foot than the Toronto market average for renting office space at the time, and $6–$9 more per square foot more than the rents at other MaRS buildings, an external real estate advisor assessed it as a reasonable rate as of March 2010 for a special-purpose building designed to accommodate modern research laboratories.

When MaRS originally approached IO in December 2008, it had secured two "anchor tenants" to commit to leasing space in Phase 2. Both tenants, the Ontario Agency for Health Protection and Promotion (Public Health Ontario) and the Ontario Institute for Cancer Research (OICR), are provincially funded organizations. The government had already approved negotiations to move Ministry of Health and Long-Term Care staff that would be joining the newly formed Public Health Ontario from another downtown Toronto location, along with the Ministry's central public health labs from inadequate and deteriorating facilities in Etobicoke to the proposed MaRS Phase 2 building in June 2007 (see Appendix). OICR was already leasing lab space in MaRS Phase 1, but was looking for more space to meet the demands of an expanding mandate. When MaRS submitted its financing proposal to IO in January 2009, the lease commitments for these two tenants represented approximately 40% of the building (Public Health

Ontario's lease was eventually signed for $29 per square foot; OICR's for $30 per square foot).

The other risks that Loans Program staff looked at in the initial analysis of MaRS's financing proposal related to the 2008 suspension of construction. These risks were assessed as "minimal" since 90% of the project had been tendered, construction plans had been approved by the municipality,

Figure 3: MaRS Phase 2 Inc. Loan Timeline

Prepared by the Office of the Auditor General of Ontario

Mar. 2006	In its 2006 budget, government announces support for the MaRS Phase 2 project with a $16.2 million grant for the acquisition of the land to be developed.
May 2006	Treasury Board approves negotiations to more PHO offices and central public health laboratories to proposed MaRS Phase 2 building.
Aug. 2007	MaRS Discovery District enters into development agreement with private-sector developer for construction of commercial office building dedicated to scientific research.
Nov. 2008	Private-sector developer's project financing dries up as a result of global economic crisis; building construction halted.
Dec. 2008	MaRS Discovery District approaches IO about financing loan.
Jan. 2009	MaRS Discovery District submits formal financing proposal and IO performs initial financial assessment.
Feb. 2010	Amendment made by Ontario Regulation 220/08 to the *Ontario Infrastructure Corporation Act, 2006*, naming MaRS Discovery District and its subsidiaries as eligible borrowers.
Mar.–May 2010	IO performs detailed underwriting analysis of MaRS Discovery District's proposal.
May 19, 2010	IO Credit Risk Committee recommends to IO board Credit and Risk Management Committee that a $235-million loan be approved.
May 28, 2010	Credit and Risk Management Committee approves $235-million loan (including restriction that 80% of the building must be pre-leased before first instalment of loan can be advanced).
July 2011	MaRS Phase 2 Inc. formed as subsidiary of MaRS Discovery District, to become named developer and borrower.
Aug. 2011	Ministry of Research and Innovation (Ministry) signs Debt Service Guarantee with MaRS Phase 2 Inc. to begin in September 2014 as required, in lieu of IO's 80% pre-lease restriction being met.
Sept. 2011	Construction recommences.
Sept. 2011–Dec. 2013	Construction continues with regular management reports and monitoring reports submitted to IO.
Sept. 2013	IO sends letter to MaRS Phase 2 Inc. inquiring about delays in lease-up of building.
Dec. 2013	Construction completed and occupancy permit received.
Dec. 16, 2013	IO sends letter to MaRS Phase 2 Inc. outlining first interest-only payment due in January 2014.
Dec. 19, 2013	MaRS Phase 2 Inc. responds to IO's letter with request to modify terms and increase amount of loan to fund tenant inducements (fitting-up of space, etc.).
Dec. 31, 2013	Ministry signs amendment to Debt Service Guarantee making it effective January 2, 2014, instead of September 2014 to cover MaRS' payment obligations as required.
Jan. 2014	MaRS Phase 2 Inc. makes first interest payment
Feb. 2014–Present	MaRS Phase 2 Inc. interest payments due to IO covered by Ministry's Debt Service Guarantee.
Feb. 3, 2014	Minister of Infrastructure sends letter to IO directing it to provide financial and strategic advice to Ministry regarding MaRS Phase 2 Inc.
Apr. 2014	IO receives preliminary Treasury Board approval to pursue its recommended option of buying out private-sector developer and acquiring the MaRS Phase 2 building.
May 2014	Final approval of negotiated settlement with developer and acquisition of building delayed as a result of provincial election call.
Sept. 2014	Agreement to buy out the developer's residual interest announced.

permits were in place and the project had already been built up to street level. The main construction risks that IO identified at this time were that any further delays could lead to deterioration of the building's foundation and put at risk the significant amount of funds that had already been invested. As well, further delays might cause the two committed anchor tenants to seek space elsewhere.

When it submitted its formal financing proposal to the Loans Program, MaRS did not fit into any of the 10 eligible borrowing sectors identified in Ontario Regulation 220/08 to the *Ontario Infrastructure Corporation Act, 2006*. In February 2010, the Ministry of Energy and Infrastructure (since split into two separate ministries) submitted a request to Cabinet's Legislation and Regulations Committee to name MaRS (and its subsidiaries) an eligible borrower under the Loans Program. The reasons for the request included the following: complementing the government's previous grant support of over $70 million for the MaRS project; supporting the government's commitment to Ontario's research and innovation agenda; supporting the government's priority of job creation in the construction and knowledge-based sectors; and addressing a shortage of laboratory space in Toronto at the time (which included addressing the research laboratory-space needs of Public Health Ontario and OICR). Later in February 2010, the requested regulatory change was made, and MaRS and its subsidiaries became eligible for financing from IO for capital expenditures relating to infrastructure projects and acquisitions.

With MaRS now officially eligible to borrow, Loans Program staff performed a formal underwriting analysis for a proposed $235-million loan to MaRS and presented it to IO's Credit Review Committee (CRC) in May 2010. The analysis highlighted various risks relating to the loan, which were as follows:

- **Low budgets for "tenant inducements"**—The space for lease was newly constructed and essentially bare down to the concrete. Tenants would have to pay to custom-finish and equip the space they were to lease (for example erecting walls, installing floor coverings, and connecting to the building's central HVAC and water systems). There were limited funds available to offer tenants at least partial finishing as an inducement to sign a lease, and with the proposed rent of $29 per square foot and additional operating costs of $31 per square foot, both of which are still much higher than the market average, finding tenants willing to spend that kind of money might be difficult.
- **Competition from other research facilities**—Because the project had already been delayed, interested tenants could already be looking or have found space available elsewhere.
- **Limited alternative uses for the building because of lease restrictions**—The University Health Network's land-lease to MaRS states that the land may only be used for medical or other scientific research purposes.
- **An overly-optimistic projected vacancy rate**—The vacancy rate for the Phase 2 building was projected to be 3.1% (based on the vacancy rate at Phase 1) versus the average vacancy rate for commercial space in Toronto at the time, which was 6.1%.

To deal with the risks identified, the analysis suggested a number of restrictions and covenants for the proposed loan, including the 80% pre-leasing condition along with a debt-service and cost-overrun guarantee from MaRS that would have to be met before any loan money could be advanced.

IO's board Credit and Risk Management Committee approved a $235-million loan to MaRS later on in May 2010. The file remained relatively idle for more than a year while MaRS renegotiated its sub-lease with the private-sector developer, formed a subsidiary to manage the completion of construction of MaRS Phase 2 and attempted to meet the loan agreement's 80% lease-up condition.

In July 2011, MaRS Phase 2 Inc. was formed as a subsidiary of MaRS Discovery District. In August 2011, a restructured sub-lease agreement was signed and the newly formed subsidiary took over constructing and leasing-up the MaRS Phase 2 building from the private-sector developer. The restructured sub-lease agreement facilitated the recommencement of construction and shifted the risks associated with Phase 2 (for example, construction, tenancy and loan-default risks) from the private-sector developer to MaRS Phase 2 Inc. and the Loans Program. However, to reduce further potential delays in construction, concessions were made to the private-sector developer in the final agreement, granting the developer the right to approve or reject proposed leases at rates that were lower than the established minimum rate of $29 per square foot. The developer also retained a residual interest in the project, which gave it the potential to recover all or part of its original investment in the project after debt service payments, operating expenses and land-lease payments had been covered.

By August 2011, MaRS still had lease commitments from Public Health Ontario and OICR, but, having secured more economical space for its head office and other central operations at a different downtown Toronto location in 2008, Public Health Ontario had reduced the amount of space it would need in Phase 2 to cover just the relocation of its central public health laboratories. In addition to these lease commitments, MaRS Discovery District signed a lease with MaRS Phase 2 Inc. for approximately 15% of the available space, intending to later divide it up and sub-lease it to other tenants (i.e., MaRS Discovery District would absorb the tenancy risk related to this 15% of the rental space). However, these lease commitments only added up to 43% of the building's available space—still nowhere near the Loans Program's 80% pre-lease requirement.

To avoid delaying the project any longer and to support the government's research and innovation priority, the proposed debt-service and cost-overrun guarantees from MaRS were not included in the final financing agreement (MaRS did not have the means to service these guarantees from its other operations). Instead, the Ministry of Research and Innovation (Ministry) signed a 15-year debt service guarantee for up to $7.1 million/year with MaRS Phase 2 Inc. to cover the financial risk posed by the lack of committed tenants. The purpose of the debt service guarantee was to allow funding to begin to flow from the Loans Program to MaRS Phase 2 Inc. so that construction could recommence, and suitable tenants were to be sought out during the construction phase. In its submission for Treasury Board approval for the debt service guarantee, the Ministry noted that the amount of the guarantee could be reduced if additional government funding was allocated to other public entities for moving into the relatively expensive space in Phase 2.

Although the Ministry's debt service guarantee minimized the amount of default risk the construction loan posed to IO and allowed construction of Phase 2 to recommence, the original purpose of the proposed 80% pre-leasing condition—that is, reducing uncertainty and risks around MaRS Phase 2 Inc.'s ability to attract high-credit-quality tenants to sign long-term leases at the proposed rate of $29 per square foot—was not realized. Instead, the debt service guarantee merely transferred the loan default risk from IO's Loans Program to the Ministry. Any loan default costs would be considered Research and Innovation Program expenditures instead of IO expenditures.

Construction recommenced in August 2011 and continued for the next 28 months. IO (recently re-formed as the Ontario Infrastructure and Lands Corporation) managed the project's construction risk through its standard construction-monitoring procedures, such as reviewing monthly project-monitoring reports prepared by a third-party loan monitor along with monthly project-management reports prepared by MaRS and the general contractor. In September 2013, as construction was coming to a close, with still only about 30% of the building pre-leased, MaRS Phase 2 Inc. requested additional loan financing of $40 million from IO to go towards tenant inducements (such as offering tenants various finishes to the newly constructed but still bare space) and to assist in finding tenants. IO declined this request.

In December 2013, the construction of the Phase 2 tower was completed within budget at just over $212 million at the time (subsequent work increased this amount to $224 million), and an occupancy permit was issued. At this point, the majority of the building should have been leased out, with tenants fitting out their spaces and preparing to move in, but still only just over 30% of the space available had been leased, to the two anchor tenants. Leases for both anchor tenants were at the higher-than-market-average prices that they had previously committed to. Since both organizations receive the majority of their funding from the government of Ontario, the additional rent over market prices would in effect be a subsidy in support of the government's medical research agenda and the MaRS vision. In the case of Public Health Ontario, the net present value of this subsidy is at least $7 million over the 25-year lease, based on an appraisal done in 2010 that indicated a $27-per-square-foot net market rental rate for specialized laboratory space in downtown Toronto.

No other tenants were coming forward to sign leases at these rates. At the same time, MaRS Discovery District did not have the required funds available to service the lease commitment it had made for 15% of the available space, and that space remained unleased as well.

The concessions granted to the private-sector developer to get construction restarted in 2011 now proved to be a roadblock to leasing available space when construction was completed. The developer has no financial incentive to approve any leases at rates lower than the $29 established minimum. Had this concession not been made, MaRS Phase 2 Inc. would have been able to lower its asking lease rate to match the going rate, fill the vacant space and thereby cover its debt service costs.

In mid-December 2013, IO sent a letter to MaRS Phase 2 Inc. outlining details of the first interest-only payment due in January 2014. MaRS Phase 2 Inc. again responded with a request to modify the loan terms and increase the amount of the loan to fund tenant inducements, which IO again turned down.

On December 31, 2013, the Ministry signed an amendment to its debt service guarantee that made it effective earlier—on January 2, 2014, instead of in September 2014. MaRS Phase 2 Inc. made its interest-only payment for the month of January, but the Ministry has been covering the debt service payments per the debt service guarantee since February 2014. However, with sufficient lease commitments still not in place, the Ministry's $7.1 million annual debt service guarantee limit will not cover the entire year's debt service obligation of $8 million for 2014 or the $14.6 million annual obligation for 2015 onwards, and the loan is still at risk of default.

In early February 2014, the Minister of Infrastructure wrote to IO's board directing it to provide advice and assistance regarding MaRS Phase 2 Inc. and the debt service guarantee, and to analyze various options for the building, including its acquisition by the Ministry. The options and related analysis presented included the following:

- acquiring the building for government use, to lease to innovation-oriented clients, or to sell and use the proceeds of the sale to repay the loan; or
- providing funds to MaRS with a restructured loan to acquire the private-sector developer's interest and to offer tenant inducements.

In April 2014, IO received preliminary Treasury Board approval to pursue its recommended option, which was to negotiate a buyout of the private-sector developer's interest in the project at a discounted amount reflecting the building's high vacancy rate at the current, restricted rental rates and to have the Ministry of Infrastructure acquire the MaRS Phase 2 building at a price that makes economic sense. More specifically, the price paid, including the outstanding loan balance and the buyout of the developer's interest, should not exceed the value of the building. Final approval of the negotiated settlement with the developer and acquisition of the building were delayed as a result of an election call in Ontario in early May of 2014.

Negotiations with stakeholders were ongoing as of August 2014 when we completed our audit work, and a conditional agreement to buy out the developer's residual interest was announced on September 23, 2014.

With respect to the MaRS Phase 2 construction loan, we conclude that the government assumed significant risks in order to support MaRS's mission and vision and to preserve, through this support, a key component of the government's research and innovation agenda. By choosing to deliver support to the research and innovation agenda through IO's Loan Program, provincial monies were put at risk. This was done in several ways: through bypassing IO's established risk framework to facilitate the loan (for example, the change in legislation to make MaRS an eligible borrower under the Loans Program); through the Ministry of Research and Innovation's debt service guarantee that bypassed IO's requirement for an 80% building pre-lease commitment before funds could be advanced; and through committing two government-funded tenants to pay higher-than-market rates.

Further, there was a lack of transparency surrounding the government's support for its research and innovation agenda through this loan. No related performance measures were established for the government to determine whether its intended research and innovation outcomes were, or will be, achieved with this project. The lack of transparency regarding the policy objectives and outcomes to be achieved from this loan creates the perception that this transaction was a "bailout" of a non-government organization.

If the conditional agreement with the developer and acquisition of MaRS Phase 2 is executed, the loan-default risk and provincial guarantee will be eliminated. In addition, the above-market rents for the Public Health Ontario and OICR leases will no longer be an issue. However, as the owner of the property, the province will have new risks to manage, such as the following:

- funding any necessary tenant inducements to encourage faster lease-up of the building;
- obtaining rental rates sufficient to cover the full costs of ownership; and
- ensuring the building is a cost-effective option for addressing other government accommodation needs.

Whether the benefits realized from this transaction will ultimately outweigh the risks and costs assumed remains to be seen.

Appendix—Relocation of Public Health Ontario's Central Public Health Laboratory to MaRS Phase 2 Building

In May 2006, the Ministry of Health and Long Term Care (Ministry) sought and in June 2006 received Treasury Board approvals for an exemption to the Management Board Directive on Real Property and Accommodation, which allowed it to single-source procurement of space, and to pursue non-binding negotiations with MaRS Discovery District for accommodation space in the proposed MaRS Phase 2 building to co-locate the province's Central Public Health Laboratory (Laboratory) and the proposed Ontario Agency for Health Protection and Promotion (Public Health Ontario). The exemption request was based on a number of factors: the existing Laboratory building's age and state of deterioration (facilities were experiencing power outages, flooding, heating problems and required major repairs, including asbestos abatement); the need to reconfigure and improve ventilation to perform advanced diagnostic and molecular testing post-SARS; the proximity to academic and research centres that the downtown Toronto location offered; the ability to recruit and retain specialized staff to a modern downtown location; and the opportunity to be an anchor tenant in the proposed building before the MaRS Phase 2 building contract was awarded, which the Ministry stated would place the government in a stronger position to negotiate favourable lease and financing arrangements. Treasury Board's approval was accompanied by a requirement that the Ministry report back to it outlining the range of financing models for the MaRS relocation and providing financial analysis of other comparable options for accommodation in the downtown core.

In March 2007, the Ministry reported back to Treasury Board with further details and analysis of the options to be considered and the costs that would be incurred under the various options. The Ministry noted that moving to MaRS Phase 2 was the second-most expensive option of the various options analyzed, involving full moves, partial moves or remaining at the Laboratory site; that it would mean leaving behind a newly built Level 3 laboratory; and that the existing building and property would be left mostly vacant, leaving the special-purpose space to fill. Although about $40 million had already been spent on or committed to the existing labs for asbestos abatement and required building system upgrades to meet operational needs, the Ministry concluded that the existing Laboratory facility could not meet its program needs. (It lacked the open-concept design necessary to improve workflow, additional sealed laboratory space with advanced airflow, and a freight elevator.) The submission stressed an urgency to approve the lease negotiations, as the developer for Phase 2 was actively seeking tenants and negotiating leases while the already limited laboratory space in downtown Toronto was quickly disappearing. As well, reports analyzing the province's response to the SARS outbreak identified an urgent need to modernize the province's testing labs and improve linkages with academic researchers.

The submission called for moving almost all Laboratory operations to Phase 2 except the warehouse storage, which would remain at the existing location. This meant that, along with the agency's head office and other program-staff accommodation needs, approximately 229,000 square feet would be needed. The MaRS Phase 2 option that the Ministry outlined gave as a best estimate a rental cost of $248.9 million for a 20-year lease (assuming a rental rate starting at $20 per square foot plus another $20 per square foot in operating costs).

The legislation that created Public Health Ontario was passed in late 2007, and the agency began operating in July of 2008. The responsibility for the province's public health labs was transferred from the Ministry to Public Health Ontario in December 2008. When the construction of MaRS Phase 2 was halted in 2008, the relocation of Public

Health Ontario's head office and program staff became an issue. Given that it was going to cost more to use laboratory space as office space, as well as the uncertainty at the time as to whether Phase 2 would ever be completed, the Ministry supported Public Health Ontario's request to obtain alternative space in downtown Toronto. Around this same time, stop-gap maintenance and repairs were done at the existing Laboratory facility.

In April 2011, the Ministry, as part of a joint Treasury Board submission with the Ministry of Research and Innovation regarding a proposed debt service guarantee to facilitate the recommencement of construction on MaRS Phase 2, requested approval to increase the lease negotiation ceiling for the proposed Public Health Ontario lease for space in MaRS Phase 2 (for the Laboratory portion only) by $131 million over 25 years. The Ministry's request stated that most of the requested increased costs resulted from the additional five-year lease term obligation. However, this was only one contributing factor. The main reason for the increase is that most of the assumptions that were used in the 2007 cost projection had changed. In particular, there was an increase in the assumed gross rent from $40 per square foot ($20 base rental rate plus $20 in operating costs) to $59 per square foot ($29 base rental rate plus $30 in operating costs), rents required by MaRS Phase 2 Inc. Both of these factors were partially offset by a reduction of 69,000 square feet in the proposed total rental space required, due to a combination of accommodating agency head office and program staff elsewhere, and operational efficiencies in the new lab's design.

A plan for the former property has not yet been put forth for approval; however, the Laboratory's warehouse space is to be amalgamated with the Ministry's main supply warehouse, which will leave the entire former space vacant once the Laboratory is relocated to MaRS Phase 2 in fall/winter 2014 and the warehouse is relocated in late 2015.

According to Public Health Ontario, the benefits of moving the Laboratory to the MaRS Phase 2 downtown location are as follows: "The relocation will help achieve operational efficiencies, faster turnaround times, and allow for the full implementation of new laboratory technologies. It also means that health care providers will have timely clinical results to inform patient care."

The lease that was ultimately signed with MaRS Phase 2 was at least 50% more expensive than what had been assumed in the Ministry's original submission to obtain Treasury Board approval to negotiate with MaRS Phase 2 on a single-source basis. Given that other proposed tenants of the MaRS Phase 2 building have been unwilling to rent space at the same rates, the premium paid on this lease represents an additional cost that the government was willing to pay to strengthen its ties to the broader medical research community and to support the MaRS vision and mission.