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Quick Hit — In defense of pre-funding

There may still be five months to go in fiscal 2017-18, but Québec is already chipping away at next fiscal year's borrowing program. Québec pre-funding towards 2018-19 currently amounts to $2.2 billion and will only mount as proceeds from future deals up to March 31 get added to the till. If you're familiar with Québec, you know that pre-financing is well ingrained in the province's debt management DNA, averaging almost $6 billion/year over the past decade. Notwithstanding prospective tweaks to official funding requirements for 2017-18, we wouldn't be surprised if the final amount of pre-funding completed by Québec this fiscal year attains or even breaches the prior trend. Moreover, we expect some other provinces to get in on the action, notably Ontario.

Pre-funding then, is increasingly topical. And we've been asked more than once about the effective cost of pre-emptive financing; in other words, is pre-financing really worth it? Let's conduct a quick cost-benefit analysis, shall we. We'll start off by stating that if an issuer is regularly pre-funding (i.e., doing it year in and year out), it's less about trying to time the market. Rather, it's more about taking advantage of favourable market conditions when/where they exist in order to get in front of future funding needs, thereby ensuring financing flexibility down the road. In that case, here's how we tend to think about the cost of pre-financing:

Cost of pre-funding (for a given period) = Net borrowing rate x amount of pre-funding conducted, where

Net borrowing rate = Weighted average borrowing cost less proceeds/return on pre-funded cash

Since Québec is a habitual pre-funder, we'll use this province as part of an illustration. In terms of simplifying assumptions, let's say that (1) pre-financing is conducted in the domestic market and (2) the weighted average term of pre-financed debt is no different from the rest of the province's borrowing, which in recent years has been around a dozen years or so. Well, Québec's re-offer yield on 10- to 15-year funding is no more than 3% today. (It was lower early in the fiscal year, and could well move higher from here, assuming the Bank of Canada isn't done hiking rates.) What, pray tell, might the province earn on its excess cash? For starters, let's assume overnight, which is currently 1% (but as just noted, would step up on any future BoC hikes). So Québec currently borrows for term at a blended rate of <3% and earns at least 1%, implying a *net* pre-funding cost of no more than 2%. Assuming the province was always, consistently $6 billion ahead of schedule (the prior ten-year average, rounded up), then the annualized cost might be something like $120 million.

How significant is such an amount? Well, $120 million in annualized pre-funding costs would equate to 0.03% of Québec's nominal GDP. Alternatively, it would be a direct interest bite of barely one tenth of one percent of current provincial revenue. Looked at still another way, pre-funding costs might account for just 1% of Québec's current full-year interest bill, which runs a bit under $10 billion/year. All that to say, I'm not sure I would label this a *material* fiscal cost for a province as large as Québec. Moreover, the true cost of pre-financing is likely lighter that what we've set down here, perhaps considerably so.

First off, what's to stop the province from moving down the curve for its pre-financing activities, which could notably lessen the weighted average cost of funds. Funding capital works, be it a public transit project or a hydro dam for example, with long-term money makes imminent sense, but it's not so obvious that pre-financing need be of equivalent duration. And rather than sticking excess cash under the proverbial mattress, a province could always place it in ultra-safe/uber-liquid GoC T-bills or their own short-dated paper. Depending on the expected rate path, an issuer might also swap into floaters a portion of pre-financing. These strategies have the potential to bolster returns and lower the cost of carry. Additionally, pre-financing might enable a province such as Québec to get a jump start on special deposits to certain sinking funds (e.g., those linked to public sector pension plans). Invested in a diversified portfolio, these sinking funds typically return more than the average borrowing cost (i.e., it's a positive carry trade on average, albeit not a risk-free proposition). The point is, the real cost of pre-financing is likely less significant than meets the eye.

And what of the benefits? Well, there are a number. There's the simple mathematical reduction to future year funding needs that goes hand in hand with pre-financing. Again, guided by Québec's pre-funding track record, six billion dollars borrowed today is technically six billion dollars you *don't* need to raise tomorrow. While admittedly tough to quantify, the extra liquidity and/or financial flexibility that's directly or indirectly linked to pre-borrowing is something investors and credit rating agencies tend to look favourably upon, which you might legitimately argue translates into tighter credit spreads, all else equal. After all, being nicely ahead of your underlying borrowing need not only eases "green banner" anxiety but provides the luxury to ride out unfavourable market conditions, obviating the need to force a deal into a shaky market purely to secure needed liquidity. (Granted, Canada's large provincial issuers have long proven adept at selecting optimal issuance windows.)

In the end, we tend to think of pre-funding as a highly defensible insurance policy. For a relatively modest premium, pre-funding affords some of our largest provincial issuers piece of mind; protection should market tone sour, and positive vibes from investors if things stay rosy. Moreover, in times such as this, when provincial borrowing rates could finally be embarking on a sustained push higher, when future year funding needs are fairly elevated, and when 2018 general elections loom in the two largest provinces, the case for pre-financing gets even more compelling. (Note that before adjusting for pre-funding, aggregate provincial borrowing needs for the 2018-19 fiscal year were north of $90 billion—a heady sum to be sure.) So go ahead Québec, Ontario and others, get a sizeable jump start on next year's borrowing program… subject to favourable market conditions of course. To us, the cost-benefit analysis supports pre-financing, perhaps now more than ever.

Fixed Income Trading Desk Research

Public Sector Research
Warren Lovely
+1 416-869-8598 | Warren.Lovely@nbc.ca

Corporate Credit
Connor Sedgewick
+1 514-879-3182 | Connor.Sedgewick@nbc.ca

Relative Value Models
Drew Lloyd
+44 (0)20-7488-9379 | Drew.Lloyd@nbc.ca

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