

BACKGROUND

- 5.1** Pension, retirement and other obligations are a significant liability to the Province. On a consolidated basis, the net accrued liability was \$1.3 billion at March 31, 2004 (2003 - \$1.3 billion). Interest costs related to these obligations (included in debt servicing costs on the Province's statement of operations) totaled \$86 million in 2004 (2003 - \$65 million). These interest costs were offset by a net expense recovery (or pension valuation adjustment, as it is described on the statement of operations) of \$14 million in 2004 (2003 - \$152 million).
- 5.2** Note 6 to the Province's March 31, 2004 consolidated financial statements describes the various pension, retirement and other obligations included in the liability. The table in Exhibit 5.1 lists the more significant of these obligations, and provides details of related legislation or authority, and benefit recipients.
- 5.3** Note 6 also details financial activity throughout the year, summarized between activity in pension benefit plans, and activity in other benefit plans. Exhibit 5.2 summarizes the obligations and assets of the plans as at March 31, 2004, as well as the net obligation as at March 31, 2003.
- 5.4** In Chapter 2 of the 2003 Report of the Auditor General, we provided an introduction to the administration of and accounting for these obligations. In accordance with the Office's 2004 Business Plan, we initiated an examination of selected aspects of pension, retirement and other obligations. This examination was conducted under Section 8 of the Auditor General Act.

RESULTS IN BRIEF

- 5.5** The following are the principal observations from this assignment.
- Assets available to fund the Province's pension plans totaled \$7.3 billion at March 31, 2004. A Statement of Investment Policies and Goals (Statement) was established several years ago to provide guidance on the management of these assets. Changes to the Statement should be formally approved by the Minister of Finance as Trustee.
 - An Investment Advisory Committee (IAC) has been in existence since as early as the 1980s to provide advice on asset mix and management of funds to the Minister of Finance as the plans' Trustee. Recent changes in asset mix approved by the IAC indicate that the role of the committee has moved beyond that of advisory. We have recommended that the IAC adhere to its role as advisor to

the Trustee. We have also recommended that the committee consider expanded use of external consultants to corroborate its suggested changes to investment strategies.

- We tested internal controls over the recording and monitoring of transactions. We found no errors in our testing.
- External investment managers manage the entire equity portfolio and a portion of the fixed income portfolio of the plans. Individual contracts with these managers specify their mandates. We have recommended that a formal system be established to monitor compliance with these mandates.
- There is a well-established system for reporting investment performance. We tested the support for this system and found no errors. Finance management should continue its efforts to establish a performance management system for all aspects of pension administration.
- Governance arrangements for the two most significant pension plans (Teachers' Pension Plan and Public Service Superannuation Plan) are under review. Protocols established as a result of these reviews should include sufficient, appropriate reporting to the plan trustee or administrator.

AUDIT SCOPE

- 5.6** Our summary objective was to assess the overall governance, accountability, management and control arrangements as they relate to aspects of the administration of pension and other retirement benefits, in order to conclude on the adequacy of:
- compliance with statutory and other enabling authorities or requirements;
 - control systems, procedures and practices; and
 - due regard for economy and efficiency.
- 5.7** Specific objectives and criteria were identified for each of the selected areas. These criteria were provided to and reviewed with Department of Finance management. The period covered by our audit testing was January to December 2003.
- 5.8** Subsequent to initiating this examination, we were informed that Finance was contracting with a private sector firm to audit the governance and control frameworks for treasury and pension-related areas of the Department. The results of that audit were to be released in fall 2004 along with the Department's action plan to address various recommendations.
- 5.9** In light of the scope of Finance's own audit initiative, we agreed to make appropriate adjustments to our plans and schedule. The results of our examination included in this chapter should be considered in conjunction with the audit results and recommendations of the private sector firm.

PRINCIPAL FINDINGS

Asset Management

- 5.10** As at March 31, 2004 the market related value of assets included in the consolidated financial statements of the Province available to fund pensions and other retirement benefits was \$7.3 billion (\$6.6 billion as at March 31, 2003). As can be seen in Exhibit 5.2, \$7.2 billion, or 98% relates to two pension plans (\$3.2 billion to Public Service Superannuation Plan and \$4.0 billion to Teachers' Pension Plan). We focused our attention on systems, controls and practices related to these amounts.
- 5.11** Exhibit 5.3 is extracted from the most recent audited financial statements of the funds related to each of the plans, and details the composition of these assets.
- 5.12** **Roles and responsibilities** - A Statement of Investment Policies and Goals was established several years ago by senior management at the Department of Finance to provide guidance for those involved in asset management for the plans. The groups identified in the Statement are the Investment Advisory Committee (IAC), Pensions and Investment Branch staff, internal and external investment managers, the asset custodian, and consultants.
- 5.13** These groups, as well as their roles and responsibilities, are defined in the Statement. Comments related to these groups are noted beginning in paragraph 5.14 below. With respect to the Statement of Investment Policies and Goals we have the following observations.
- Management noted that the document is constantly under review, and changes were made to the Statement during the period of our examination. We noted that the minutes of the Investment Advisory Committee (IAC) reflect discussion of changes to be made to the Statement, but no formal approval of the revised policy for recommendation and approval by Trustee, is noted.
 - The Statement reflects decisions made on asset management matters, such as rates of return and asset mix, but not on overall risk tolerance for the Plans' assets. It was indicated to us that the risk tolerance can be inferred from the approved asset mix.

Recommendation 5.1

We recommend that changes to the Statement of Investment Policies and Goals should be formally approved by the Investment Advisory Committee for recommendation to and approval by the Trustee. In addition, the Statement should explicitly state the overall risk tolerance or refer to an overall risk management plan.

5.14 The role of the IAC is defined in the Statement of Investment Policies and Goals as advisory. Overall primary fiduciary responsibility for each of the plans rests with its Trustee (i.e., the Minister of Finance). We have the following comments regarding the IAC.

- A recommendation was made and approved by the Committee in February 2003 to allocate 7% of the plans' assets to real estate. This represents a significant change in the asset mix (approximately \$420 million). There is no indication that the Minister of Finance was advised of, or approved, this decision at the time it was made.
- Formal terms of reference for the Committee need to be developed and approved. Draft terms of reference were developed in 1992, and the intent of these appears to be captured in the Statement of Investment Policies and Goals, but there is no indication that these were approved. The terms of reference should address roles and responsibilities as well as administrative matters such as quorums, voting privileges, etc.
- The Statement notes that the IAC is to provide an annual report to the Minister, although the content of such a report is not noted. An annual report has not been prepared for several years (most recent was in 1999). Senior management indicated that the plans' annual reports released in July 2004 satisfy this requirement. If this is the case, the Statement should be updated to remove this requirement.
- Suggestions regarding alternative investments are being presented to the IAC by Finance staff, or are initiated by the IAC itself and investigated by staff. External consultants are used infrequently to support the suggested strategies. One example where the advice of a consultant could have been sought was in January 2003. At that time, the IAC approved a staff recommendation to invest in fixed income derivatives. This decision was made by the IAC, contrary to its role as an advisory committee.

Recommendation 5.2

We recommend the Investment Advisory Committee adhere to its role as an advisory committee to the Minister. Formal terms of reference should be developed and approved for the Committee, and updated periodically as appropriate.

Recommendation 5.3

We recommend the Investment Advisory Committee should consider increased use of external consultants to corroborate changes to investment strategies suggested by Department of Finance staff.

- 5.15** **Internal controls** - In the 2001 Report of the Auditor General, we reported on the results of a review of the Treasury Management System (TMS) at the Department of Finance. This focused specifically on the Millennium software package which was purchased "... to assist Branch staff in the management of the cash, investments and debt ...".
- 5.16** The Millennium system is used to record fixed income and money market transactions related to the pension plans. Transactions posted to the Millennium system must also be manually posted to government's central SAP financial system, since there is no electronic interface between the two systems.
- 5.17** During this year's assignment, we tested internal controls over the authorization, processing and recording of fixed income and money market transactions for the pension plans. Our procedures focused on transactions recorded on TMS, and we found no errors in the processing and recording of the transactions we tested. However, because transactions are authorized subsequent to their input into TMS, it is possible that an improper transaction could be processed. We recognize that this situation may not be entirely avoidable given the real-time nature of most investment market transactions, but suggest that controls be established to ensure proper and timely authorization. An example of such a control may be pre-authorization of transactions over a certain limit.
- 5.18** In addition, we tested the results of the monthly reconciliation process between TMS and statements provided by the asset custodian. Again, there were no errors noted in our sample items.
- 5.19** Although we found no errors in our testing, we reiterate the suggestion made in the 2001 Report of the Auditor General that improvements could be made in the transaction processing cycle by implementing a direct link to SAP. This would limit errors inherent in manual transcription of data.
- 5.20** Finally, we conducted tests to determine the accuracy of the reconciliations performed by the asset custodian. These reconciliations compare the custodian's balances with those of the external investment managers, and are prepared by the custodian on a periodic basis throughout the year. We found no errors in our testing.
- 5.21** **Performance management** - There is an established system for monitoring and reporting overall and total asset performance of the plans and investment manager.
- 5.22** Several reports detailing various aspects of performance are provided to members of the Investment Advisory Committee each month. For example, one report details individual investment manager results, including related benchmark information. We tested the support used to prepare this report for several months during 2003, and found no errors.
- 5.23** In addition to the internal monitoring and reporting system, the Branch also uses the services of an external consultant to evaluate the performance of the pension asset portfolio against other similarly-sized portfolios. A formal evaluation is

performed bi-annually which compares the plans' results with those of other participants. Data on the other participants is provided every year. Management informed us that there is only one consultant providing this service and consequently the service is not tendered.

- 5.24** We reviewed the executive summary provided in the most recent report dated September 2003 from this consultant and noted the plans' assets performed as well as or better than their peer group in three of four categories. The plans measured considerably lower than the peer group in one category which was implementation risk (i.e., the risks associated with active vs. passive portfolio management). Management informed us this is consistent with the overall conservative philosophy of the Branch and the IAC, which is reflected in the portfolio.
- 5.25** **Service providers** - The equity portfolios of the pension plans (about \$3.9 billion) are managed by external investment managers. Approximately 20% of the fixed income portfolios (about \$450 million) is managed by an external manager with the remainder (about \$1.6 billion) managed by a fixed income manager on staff at Finance. An outside consultant is used by the Branch in the selection of the external investment managers. The other significant service provider involved in asset management is the asset custodian.

- 5.26** We have the following observations with respect to the arrangements with the service providers.

- **Compliance** - In addition to what is noted in the Statement of Investment Policies and Goals, the mandate and responsibilities of the external managers are detailed in the contracts with them. We understand a standard contract is provided to each manager, modified in each case to reflect the specifics of the related mandate (e.g., Canadian equities). There is also a contract in place between the Province and the asset custodian.

There was no formal system in place to monitor contractual compliance for either the asset custodian or the external managers. During the course of the audit we noted compliance with significant aspects of the contracts (e.g., monthly reports being provided as of a certain date). However, our procedures did not cover whether the external managers are making investments in accordance with each of their mandates.

There was no formal system to monitor compliance with individual external investment manager mandates (e.g., that transactions occur only within the specified mandate). Although some managers provide periodic representation that they are in compliance with their individual contracts, this representation is not used as part of a control system at Finance to monitor compliance.

Management noted that a system to monitor compliance has been implemented during 2004. We have not verified the existence or components of this system.

- **Procurement** - It was indicated that an external consultant has been used in the past during the process to select an external manager. We tested the process used in the hiring of the most recent managers and found that the external consultant's services were used in only one of five instances. Finance management indicated that there were mitigating circumstances in each situation where the external consultant was not used. In each instance, the IAC approved the selection recommended by staff.

We also discussed the process used to hire the asset custodian. This contract has been in place for several years and management indicated there are no plans to tender the custodian services at this time.

- **Performance** - The mandate of each external manager includes a benchmark (e.g., TSX 300) and an investment return objective. This information is tracked as part of the overall monthly performance reporting provided to the IAC. External managers not meeting the specified investment return objective are placed on a watch list. Management should consider establishing guidelines to specify when a manager is to be replaced due to poor performance or removed from the watch list due to improved performance.

Recommendation 5.4

We recommend that a system to formally monitor compliance with contractual requirements and mandates of external investment managers should be established.

Governance Arrangements

- 5.27** **Roles and responsibilities** - In the 2003 Report of the Auditor General (see Chapter 2, paragraphs 2.26 to 2.39), we provided a brief description of the groups involved in the governance and administration of the Teachers' Pension Plan (TPP) and the Public Service Superannuation Plan (PSSP). In Exhibit 5.4, we expand that description to include details related to other retirement obligations.
- 5.28** Our current audit focused on the most significant of these plans. As can be seen in Exhibit 5.2, these are the Public Service Superannuation Plan (PSSP), Teachers' Pension Plan (TPP) and retirement health benefits related to each of these plans.
- 5.29** The role of the Investment Advisory Committee (IAC) relates only to asset management for the two funded plans (TPP and PSSP). Our observations and recommendations on this Committee are noted in paragraph 5.14. With respect to other groups, we note the following.
- We understand the governance arrangements for the TPP are under review as part of an overall review of funding arrangements for the plan. This review is required under the 1993 agreement between the Province and the Nova Scotia Teachers' Union (NSTU).

The Teachers' Pension Partners' Board is the entity through which the terms of the agreement between the NSTU and the Province are exercised. One purpose of the Board is to make recommendations for changes to the plan to the Minister (as the plan's trustee). There are terms of reference for the Board but these do not include any regular reporting to the Minister.

- Governance arrangements have not been formally established for the Public Service Superannuation Plan. The Public Service Pension Forum was formed in 2003 to serve as a communication vehicle for plan stakeholders. Members of the Forum are representatives from the Province (as plan sponsor), and current and retired representatives from the Nova Scotia Government Employees Union (NSGEU) and the Canadian Union of Public Employees (CUPE). Members of the Forum meet infrequently and are not involved in recommending plan changes to the Minister. We understand a working committee of the Forum has been established within the past year with the intent of reviewing current governance arrangements.
- Day-to-day administration of retirement health benefits provided to retired civil servants and various other PSSP recipients is through an external service provider. Overall administration is through the Public Service Commission (PSC). An informal inter-departmental committee (Health and Dental Committee) meets during the year to discuss rate changes. Revised rates are to be approved by a Pension and Benefits Committee. The purpose of this Committee is to review and recommend on administrative aspects of pensions and other benefits to the Deputy Ministers of Finance and the PSC, who are both members of the Committee. A recommendation approving proposed rate changes was made to the Deputy Ministers in a memo from the Committee members dated July 2003.
- The oversight function for retirement health benefits for teachers is performed by the NSTU Group Insurance Trustees. There are six trustees appointed by the Union. Two limited trustees can be appointed from the Department of Education; at present, only one of these appointments is currently filled. The Trustees meet each month to discuss and vote on changes such as additional approved drugs for both active and retired members. It should be noted that the Province funds 100% of retirement health benefits for retired teachers (versus the 65%/35% Provincial/retiree contributions for PSSP-related retirement health benefits).
- Job descriptions for management at the Department of Finance involved in the administration of pension plans appear to adequately describe roles although some need to be updated to reflect current Departmental structure. Job descriptions should also be updated to reflect reporting responsibilities.
- Quarterly reporting to the Minister of Finance detailing the funded status, membership, investment returns and the status of governance discussions with stakeholders of the pension plans has recently been initiated by senior management. Management and staff informed us there is regular, informal reporting of pension activities within the Division.

Recommendation 5.5

We recommend that the control framework related to pension and other retirement obligations should be formalized as required. Committees involved in the monitoring and/or approval of benefits should provide regular reports to the plan trustee or administrator.

- 5.30** **Performance management** - We discussed objectives and performance measures for components of pension plan administration with management of the Pensions and Investment Branch of the Department of Finance. Our comments on each of these components are as follows.
- **Legislative compliance** - Management indicated this is to be nothing less than 100%. One area of non-compliance which has been resolved in the past year is the preparation of an annual report for the PSSP as required by its Act. An annual report has also been prepared as at December 31, 2003 for the TPP. The annual reports for both plans were released in July 2004.
 - **Plan funding** - The Department of Finance Business Plan for the current and preceding two fiscal years notes the target of the plans is to be 100% funded. The plans' annual reports note that the funded ratio of the TPP and PSSP are 81% and 86%, respectively, at December 31, 2003, the date of the most recent actuarial valuations. We suggest that targets for funding of the plans be set over a number of years toward achieving the ultimate goal of 100% funding. These targets should be included in annual or other reporting of the plans.
 - **Benefits administration** - Objectives and performance measures have not been established for this component. An external consultant completed a benchmarking analysis on benefit administration in April 2004. Management indicated the results of this analysis will be used to develop objectives and measures in this area.
 - **Asset management** - An expected or planned rate of return on assets is established as input to the actuarial review processes for the plans. We noted that management and staff of the investment side of the Pensions and Investment Branch had not been involved in determining this assumption. The rate had been determined by the pension administration side of the Branch. We were told that recent administrative changes within the Branch should lead to input by investment personnel in determining this rate in the future.

Recommendation 5.6

We recommend that management should continue to develop a sufficient and appropriate performance management system for the administration of pension and other retirement obligations.

CONCLUSION

- 5.31** The magnitude of the financial obligations and assets associated with the various pensions and other retirement benefit plans warrants improvements being made to, and formalization of, governance and management control processes.
- 5.32** In addition to matters discussed in this chapter, government needs to ensure the results and recommendations of the audit commissioned separately by Department of Finance management, of the governance and controls in the pension and treasury areas of its operations, are appropriately addressed on a timely basis.
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Details of Pension, Retirement and Other Obligations, and Recipients

Exhibit 5.1

Benefit plan	Related Legislation or Authority	Recipient
Pensions:		
Teachers' Pension Plan (TPP)	Teachers' Pension Act	Public school and some community college teachers
Public Service Superannuation Plan (PSSP)	Public Service Superannuation Act	Employees of the Province and certain other public sector entities
Various pension plans of the former Sydney Steel Corporation (SYSCO)	Sydney Steel Corporation Sale Act	Individuals covered under the former SYSCO pension plans
Members' Retiring Allowances Accounts (MRAA)	Members' Retiring Allowances Act	Members of the House of Assembly
Other pension plans or other programs	Various	Judges, deputies, and public sector employees retiring under early retirement plans
Retirement and Other Obligations:		
Retirement health benefits	Various	Recipients under TPP, PSSP, SYSCO, MRAA, and employees of the Capital District Health Authority
Retiring allowances	Various	Public sector employees including those of district health authorities and regional school boards
Other	Various Authorities including: - Nova Scotia Public Service Long Term Disability Plan Trust Agreement - Workers' Compensation Act	Various qualifying employees

Net Benefit Obligation

Benefit	Accrued Benefit Liability March 31, 2004 (\$ thousands)	Accrued Benefit Assets March 31, 2004 (\$ thousands)	Net Obligation March 31, 2004 (\$ thousands)	Net Obligation March 31, 2003 (\$ thousands)
Teachers' Pension Plan (TPP)	\$4,242,524	\$(4,023,986)	\$ 218,538	\$ 197,243
Public Service Superannuation Plan (PSSP)	3,131,921	(3,233,979)	(102,058)	(134,773)
Other pension plans	352,514	(15,189)	337,325	346,428
TPP – related retirement health benefits	357,213		357,213	326,376
PSSP – related retirement health benefits	155,155		155,155	170,178
Other retirement health benefits	62,318		62,318	58,625
Retiring allowances	246,324		246,324	278,671
Other retirement benefits	337,222	(34,488)	302,734	295,272
Sub-total	8,885,191	(7,307,642)	1,577,549	1,538,020
Net unamortized actuarial (losses)*			(259,219)	(205,633)
Total	\$8,885,191	\$(7,307,642)	\$1,318,330	\$1,332,387

* The original printing of this Report read "(gains)" which was in error and had not been corrected prior to going to print.

Composition of Assets

Asset Class	TPP*		PSSP*	
	Dec 31, 2003 (\$ thousands)	Dec 31, 2002 (\$ thousands)	March 31, 2004 (\$ thousands)	March 31, 2003 (\$ thousands)
Money market	\$ 343,644	\$ 97,419	\$ 298,296	\$ 72,278
Fixed income	1,096,223	1,229,884	906,666	964,767
Equities:				
Canadian	1,316,372	1,084,296	1,079,231	867,192
US	578,837	530,382	457,792	402,586
Other foreign	279,114	253,346	236,508	176,080
Real estate:				
Canadian	9,356		21,803	
Pooled fund	37,537	35,409	49,325	36,001
Total	\$3,661,083	\$3,230,736	\$3,049,621	\$2,518,904

* These details are taken from the most recent audited financial statements of the fund for each plan. Differences between above totals and those reported in the Province's March 31, 2004 consolidated financial statements are due to differences in timing (i.e., TPP fund is as at December 31, 2003) and accounting methods.

Roles and Responsibilities

Action	Prepare/Propose/ Inform	Review/Advise/ Recommend to Deciding Authority	Approve/Decide	Execute/Perform
Legislative Changes	Current and retired members	TPPB Staff	Trustee	Staff
Changes to Pension Benefits	Current and retired members	TPPB Staff	Trustee	Staff
Changes to Post-Retirement Benefits	Current and retired members	Service Provider Health and Dental Committee (Re: civil servants) ⁽¹⁾	NSTU Trustees Pension and Benefits Committee ⁽¹⁾	Service Provider PSC (through service provider)
Changes to Asset Mix	Staff IAC	IAC	Trustee	Staff External investment managers
Monitoring of Compliance	Staff PSC	Staff PSC		Staff PSC
Annual Report	Staff		Trustee	Staff

TPPB - Teachers' Pension Partners Board
 NSTU Trustees - NSTU Group Insurance Trustees
 PSC - Public Service Commission
 Staff - Staff of the Pension and Investment Branch, Department of Finance
 Trustee - Minister of Finance
 IAC - Investment Advisory Committee

⁽¹⁾ Rate changes only