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FINANCE - DEBT MANAGEMENT - UPDATE REVIEW

BACKGROUND

13.1 According to the Province's traditional non-consolidated *Financial Statements* for the year ended March 31, 1997, net debt servicing costs (i.e., gross debt service costs, net of sinking fund earnings and public debt retirement fund earnings) were \$687.2 million, 16.2% of the government's expenditures. Debt servicing costs remain the third largest category of Provincial government expenditure, after health and education.

13.2 Exhibit 13.1 on page 138 provides a summary of the debt and related funds reported on the Province's *Statement of Financial Position* as at March 31, 1997. The debts and obligations of a number of crown agencies, approximately \$1 billion guaranteed by the Province (see note 7 to the Province's March 31, 1997 financial statements), are not yet specifically covered by the Department of Finance's *Debt Management Plan* which is published each year as part of *Government By Design*.

13.3 The Provincial Finance Act and the annual Appropriations Act establish the statutory requirements, authorities and limits for Provincial borrowing. Under these Acts, Executive Council has the delegated authority and responsibility for approving Provincial borrowing, including any guarantees of borrowing by crown agencies.

13.4 The Department of Finance, through its Investments, Pensions and Treasury Services Branch, is responsible for the ongoing management and control of the Province's debt and related sinking funds and the Public Debt Retirement Fund (PDRF). Finance develops and maintains cash flow plans identifying the funds required to be borrowed during a fiscal year to support government's programs and to meet its other obligations. To meet cash requirements, the Province issues a variety of debt obligations in a number of capital markets including lines of credit with major Canadian banks.

13.5 Our 1994 and 1995 Reports included chapters on the results of our review of Finance's policies and practices for managing the Province's debt and debt-related activities. During 1996 and 1997, we continued to monitor Finance's plans and progress in this significant area.

RESULTS IN BRIEF

13.6 The following are the major observations resulting from our update review procedures.

- Cost-effective management of the Province's debt and debt-related costs remains a priority for government. The size of the Province's total debt together with the significant proportion of the debt payable in foreign currencies (more than 50% as at March 31, 1997 - see Exhibit 13.1) warrants a high level of reporting to and attention by government, the House of Assembly, and the public.
- The objectives, strategies and initiatives outlined in the *Debt Management Plan* included in the government's *Government By Design* publication are significant and continue to provide a formal and improved basis to hold Finance accountable for debt

management activities and results. To achieve the goals and targets set out in the *Debt Management Plan* and *Government By Design*, government must ensure that the resources available are sufficient to support implementation of necessary improvements and to ensure monitoring and reporting are timely, accurate and effective.

- Action has been taken or is planned to address many of the comments and suggestions included in our previous Reports. However, continued effort will be required to fully implement the policies, maintain plans, and implement systems necessary to support improved and continued control of the Province's debt and debt management activities on an ongoing basis.

Draft policy statements on debt management and on the use of derivatives were prepared and substantially implemented by Finance in 1997. Finance indicated these will be finalized and presented to the Public Accounts Committee in 1998. We recommend such policy statements be subject to Executive Council approval prior to being finalized.

SCOPE OF REVIEW

13.7 The objective for this update review was to obtain current status information on the action taken or planned by Finance to improve the Province's debt management policies and practices. We also wanted to provide summary information on the Province's debt and debt management function in order to support increased awareness and understanding by the Members of the Legislative Assembly (MLAs).

13.8 Our approach included meetings with Finance management and review of available supporting documentation to determine the status of action taken or planned for the debt management related comments and suggestions included in our previous Reports.

PRINCIPAL FINDINGS

Introductory Comments

13.9 Exhibit 13.2(a) on page 139 provides a summary of the governance, accountability and management organization for the control of the Province's debt and debt-related activities.

13.10 The overall roles and responsibilities of the Executive Council, the Minister and the Deputy Minister with respect to the Province's debt and related activities are defined in the Provincial Finance Act and the annual Appropriations Act.

13.11 The Director of Liability Management and Treasury Services is responsible for monitoring the market and making recommendations to the Executive Director, the Deputy Minister and the Minister on the timing, terms, costs and sources of new borrowing. The Executive Director and his staff collaborate in the completion of negotiations with the underwriter(s) for new debenture issues, and in the completion of other significant debt-related transactions. The accounting and related activities associated with the reporting of the Province's debt in its financial statements are the responsibility of the Controller, who also reports to the Deputy Minister of Finance.

13.12 Since 1993 there has been a turnover of almost 100% of the senior staff at Finance responsible for the administration and ongoing management of the Province's debt. The Liability

Management and Treasury Services division was at full staff complement in November 1997 for the first time in a number of years.

Historical Overview

13.13 *Debenture and other commercial debt* - Exhibit 13.3 on page 140 shows the total commercial debt reported in the Province's financial statements from 1985 to 1997. As at March 31, 1997 commercial debt was \$10.514 billion, up from \$4.263 billion in 1985, but down from a reported high of \$10.744 billion as at March 31, 1995. The Exhibit also shows the net commercial debt (i.e., total commercial debt less sinking funds and the Public Debt Retirement Fund). It is important to note that some of the change in reported debt relates to changes in foreign exchange rates from one year to the next.

13.14 The Minister of Finance's annual *Financial Report - Hitting the Targets*, which was released in August, and the *Debt Management Plan* included in the 1997-98 *Government By Design* publication provide trend information on selected measures.

13.15 *Debt servicing costs* - Exhibit 13.4 on page 141 shows the annual cost of servicing the Province's debt (i.e., debenture interest and other debt charges) for the last eight years on the same basis used for the Province's March 31, 1997 non-consolidated financial statements. The Exhibit also shows debt charges net of income from both sinking funds and the Public Debt Retirement Fund.

13.16 Debt servicing costs have increased at a higher rate than total government expenditures. During the eight-year period ended March 31, 1997, the net debt servicing costs reported in the Province's financial statements have risen 56% from \$440 million to \$687 million. For the same period, expenditures (current and capital) increased 6% from \$3.982 billion to \$4.238 billion. Net debt servicing costs absorbed 16% of total revenue for the year ended March 31, 1997 compared to 11% in 1989-90, but down from a peak of 20% in 1994-95.

13.17 Finance's *Debt Management Plan* includes information on the sensitivity of the Province's debt servicing costs to changes in interest and foreign exchange rates. The following information is extracted from the *Debt Management Plan* (per page 37 of the 1997-98 *Government By Design* publication) from a section entitled *Debt Servicing Cost Sensitivity Analysis*.

<i>Change in Financial Market Variable</i>	<i>Change in Debt - Servicing Cost (C\$ Millions)</i>
<i>1% Change in Canada 3-Month Treasury Bill</i>	18.2
<i>1% Change in Canada 10-Year Bond</i>	4.0
<i>1% Change in U.S. 3-Month Treasury Bill</i>	4.5
<i>1 Canadian Cent Change versus 1 US Cent</i>	3.4
<i>1 Japanese Yen Change</i>	1.6

13.18 It should be noted that the impact of small shifts in interest or foreign exchange rates on the costs to the Province can be larger than the total annual costs of some departments and agencies of government.

13.19 Due to a combination of lower interest rates, fluctuations in foreign exchange rates and more active debt management, the Province's debt servicing costs have been under budget in recent years. Within the context of government's fiscal targets, positive budget variances for debt servicing costs in recent years have offset certain over-expenditures in other program areas.

13.20 *Foreign exchange exposure* - Foreign exchange exposure is the proportion of debt outstanding in foreign currencies to the total debt outstanding from all sources. The foreign exchange exposure differs depending on whether it is calculated on the basis of gross debt or net debt (i.e., gross debt less sinking funds and public debt retirement funds).

13.21 The Provincial Finance Act, Section 52A, includes the terms "*public debt*" and "*total public debt*", however neither term is defined in legislation. The *Debt Management Plan* defines the term "*gross debt*" (page 41 of the 1997-98 *Government By Design* publication) as:

"Outstanding debentures, short term promissory notes net of related investments, debt associated with hospitals and public schools, and debt assumed for Teachers' Pension Fund, and Members' Retiring Fund. The amount does not include the deficiency in net assets of the Crown Corporations, Nova Scotia Resources Limited and Sydney Steel, nor certain pension liabilities."

13.22 The Department of Finance's *Debt Management Plan* measures foreign exchange exposure on the basis of gross debt adjusted for foreign currency swap contracts and certain pension liabilities. On this basis, as used by the Department of Finance, foreign currency exposure was 52% at March 31, 1997.

13.23 Exhibit 13.1 provides a summary of debt, sinking funds, public debt retirement funds and net debt together with the proportion in foreign currency in various categories. Using the net debt basis, the foreign exchange exposure would be 59% compared to 52% on the gross debt basis.

13.24 Exhibit 13.5 on page 141 shows the Province's foreign exchange exposure on both a gross and net basis over the last eight years. The Province's foreign exchange exposure at March 31, 1997 was 59% - net (52% - gross), up from 50% - net (50% - gross) in 1990 and down from a 1995 peak of 71% - net (64% - gross).

Summary of Key Initiatives Taken or Planned since our 1995 Report

13.25 The 1994 chapter included a number of comments and suggestions for improvements to the debt management function and related activities. In 1995 we provided detailed follow-up comments on the action taken or planned by Finance to address the concerns and suggestions included in our 1994 Report. Based on information provided to us in 1997 by senior management at Finance responsible for Liability Management and Treasury Services, further progress has been achieved, as outlined below.

13.26 Draft policies related to debt management and derivatives have been prepared and are being used. It is anticipated that these policies will be finalized early in 1998, and Finance indicated that they will then be presented to the Public Accounts Committee. It should be acknowledged that these are working policies, and as such will continue to evolve over time. This notwithstanding, in our view the policies should be subject to review and approval by the Executive Council.

13.27 There has been an increase in the use of alternative financial instruments (i.e., derivatives), as part of Finance's plans which call for more active management of the Province's debt. Finance management has informed us that all of these transactions have been conducted within the context of the draft policy on derivatives.

13.28 An internal committee structure outlined in the draft debt management policy (see Exhibit 13.2(b) on page 140) has been put in place. The individual committees are in various stages of implementation of their respective roles and responsibilities, and it was indicated to us that certain sub-committees, such as the Cash Forecasting Sub-committee, have been functioning for over two years.

13.29 In November 1997, all key management positions within the Liability Management and Treasury Services Division had been filled for the first time in a number of years. It was indicated that this will allow for more efficient management and more appropriate task delegation, including further improvements in systems and controls.

13.30 Senior management at Finance indicated that an objective of the Investment, Pensions and Treasury Services Branch is to become a centre of excellence for treasury-related matters within the Provincial government operations. This expertise would be utilized to provide proactive treasury-related support to departments, crown corporations and other public sector entities. In this regard, we note that the draft policies referred to above do not, but should, include comments on applicability to other than government core (i.e., Finance and other departments) treasury activities.

13.31 Recent amendments to the Provincial Finance Act include the following and should serve to support debt management activities and reporting.

- Section 8B - *Quarterly reports* provides that the Minister shall submit to the House of Assembly quarterly financial reports on the state of the public finances, and such other financial or economic reports as the Minister determines
- A goal to limit foreign debt to 20% of total public debt has been defined in Section 52A - *Reduction in foreign current borrowings*. The Section also notes that while the foreign exchange exposure remains above 20% there can be no management-induced increase in foreign exchange exposure.
- Section 60A - *Sale of Crown Assets* provides for net sale proceeds to be used to reduce public debt.
- Proposed public financing by crown corporations must be reported to the House of Assembly under Section 73 - *Annual Reports to House of Assembly*.

13.32 Finance has been investigating its management and information systems requirements related to debt management and other treasury management functions. At the time of this update review, a draft request for proposals for the implementation of necessary Treasury Management systems was being considered.

Highlights of Significant Outstanding Issues or Concerns

13.33 From discussions with Finance senior management and a review of information provided, it is evident that considerable action has been taken or is planned. Additional and ongoing effort will be required to fully implement the policies, maintain plans and implement systems necessary to support improved and continued control of the Province's debt and debt-related activities. Certain of the more significant issues which remain to be fully addressed are discussed below.

13.34 Formal reporting to parties external to the ongoing debt management function (e.g., Executive Council, House of Assembly) on Finance's performance, with respect to the *Debt Management Plan* and compliance with policy, needs to be defined and appropriately incorporated into statutory and/or policy accountability reporting requirements.

13.35 Appendix 8B to our 1995 chapter on debt management summarized key governance questions for the use and control of derivatives (adapted from a booklet entitled *Derivatives for Directors*, published by KPMG - one of a number of available references for debt management practices or guidelines). Not all the issues and concerns raised have been fully dealt with, and because they relate to ensuring appropriate governance over the management of the Province's debt and debt-related activities, these should be subject to further consideration.

13.36 The investment and liability management functions are managed by a small number of qualified and experienced staff at Finance. This poses risks to the Province in the event of staff changes. For example the Executive Director, appointed in 1994, was leaving the employ of the Province at the end of 1997. In an attempt to manage and mitigate such risks, an internal committee structure related to debt management has been formally established at Finance (see paragraph 13.28 and Exhibit 13.2(b)). In addition, senior management have indicated that they will contract necessary resources to cover short-term needs. We acknowledge that the committee structure implemented to support the management of the Province's debt may mitigate some, but not all, such risks, particularly in relation to the more complex or technical treasury product considerations.

13.37 Finance indicated efforts are continuing to establish a benchmark portfolio to assist with the debt (and investment) management activities. Further, policies and guidelines (limits, restrictions, mix, etc.) related to the management and monitoring of the Public Debt Retirement Fund and the sinking fund investments need to be formalized. Overall, control of these activities should benefit from the definition of more detailed policies or guidelines and adherence to them.

CONCLUDING REMARKS

13.38 The size of the Province's total debt, together with the proportion payable in foreign currencies, warrants increased reporting to and attention by government and the House of Assembly. The Department of Finance has taken and continues to take action to enhance its policies and practices relating to the ongoing management and control of the Province's debt and related costs.

13.39 There are significant public policy issues and decisions related to the management of the Province's debt such as the appropriate level of debt, the appropriate mix of foreign and domestic debt, and the level of acceptable risk. It is not the role of this Office to actively participate in such discussions. Our role and focus is on whether policies, plans and systems exist and operate to support the overall governance, accountability and management processes regarding the control of the Province's debt and debt-related costs. It is incumbent on government to ensure that sufficient appropriate resources are allocated to achieve the level of management control necessary in the circumstances. Regardless of which public policy direction or emphasis is taken, the management of the Province's debt will most likely continue to be a matter of significance and interest to the House of Assembly.

Exhibit 13.1

**SUMMARY OF PROVINCE'S DEBT
ON MARCH 31, 1997 STATEMENT OF FINANCIAL POSITION
(NON-CONSOLIDATED)**

	(thousands of Canadian \$)		Foreign %	
	1997	1996	1997	1996
Debentures				
Payable in Canadian Dollars	\$ 4,395,558	\$ 3,722,811		
Payable in US Dollars	4,002,482	3,759,297		
Payable in Japanese Yen	1,230,900	1,785,000		
Payable in Swiss Francs	240,625	492,866		
Payable in U.K. Pounds	79	187,254		
Other capital liabilities	249,083	302,771		
Bank advances and short-term debt	<u>395,132</u>	<u>428,763</u>		
Commerical Debt	10,513,859	10,678,762	57	58
Pension and retirement obligations	<u>866,749</u>	<u>996,780</u>		
Gross Debt (Note A)	11,380,608	11,675,542	52	53
Deficiencies in crown corporations (Note C)	<u>463,911</u>	<u>473,067</u>	(Note B)	(Note B)
Total Debt to be Managed	11,844,519	12,148,609	54	55
Less:				
Sinking funds				
- debentures	1,552,302	1,316,540	25	23
- other capital liabilities	90,068	102,130		
Public Debt Retirement Fund	<u>709,540</u>	<u>648,346</u>	35	35
Funds to be Managed	2,351,910	2,067,016	27	25
Net Debt	\$ 9,492,609	\$ 10,081,593	60	61
Consisting of:				
Net debenture debt	\$ 7,607,802	\$ 7,982,342	70	71
Net other capital liabilities	159,015	200,641		
Bank advances and short-term	<u>395,132</u>	<u>428,763</u>		
Net Commerical Debt	8,161,949	8,611,746	65	66
Pension and retirement obligations (Note A)	<u>866,749</u>	<u>996,780</u>	59	59
Deficiencies in crown corporations	<u>463,911</u>	<u>473,067</u>	(Note B)	(Note B)
Net Debt	\$ 9,492,609	\$ 10,081,593	60	61
Notes:				
A - The <i>Debt Management Plan</i> includes debt to this level.				
B - Included is the net deficiency of a number of crown corporations. The most significant is Nova Scotia Resources Limited which has issued debt in foreign currency.				
C - See note 5 to March 31, 1997 financial statements - Contingent Liabilities and Commitments - for information on debts and obligations of government enterprises guaranteed by the Province but not covered by Finance's current plans.				

Exhibit 13.2(a)

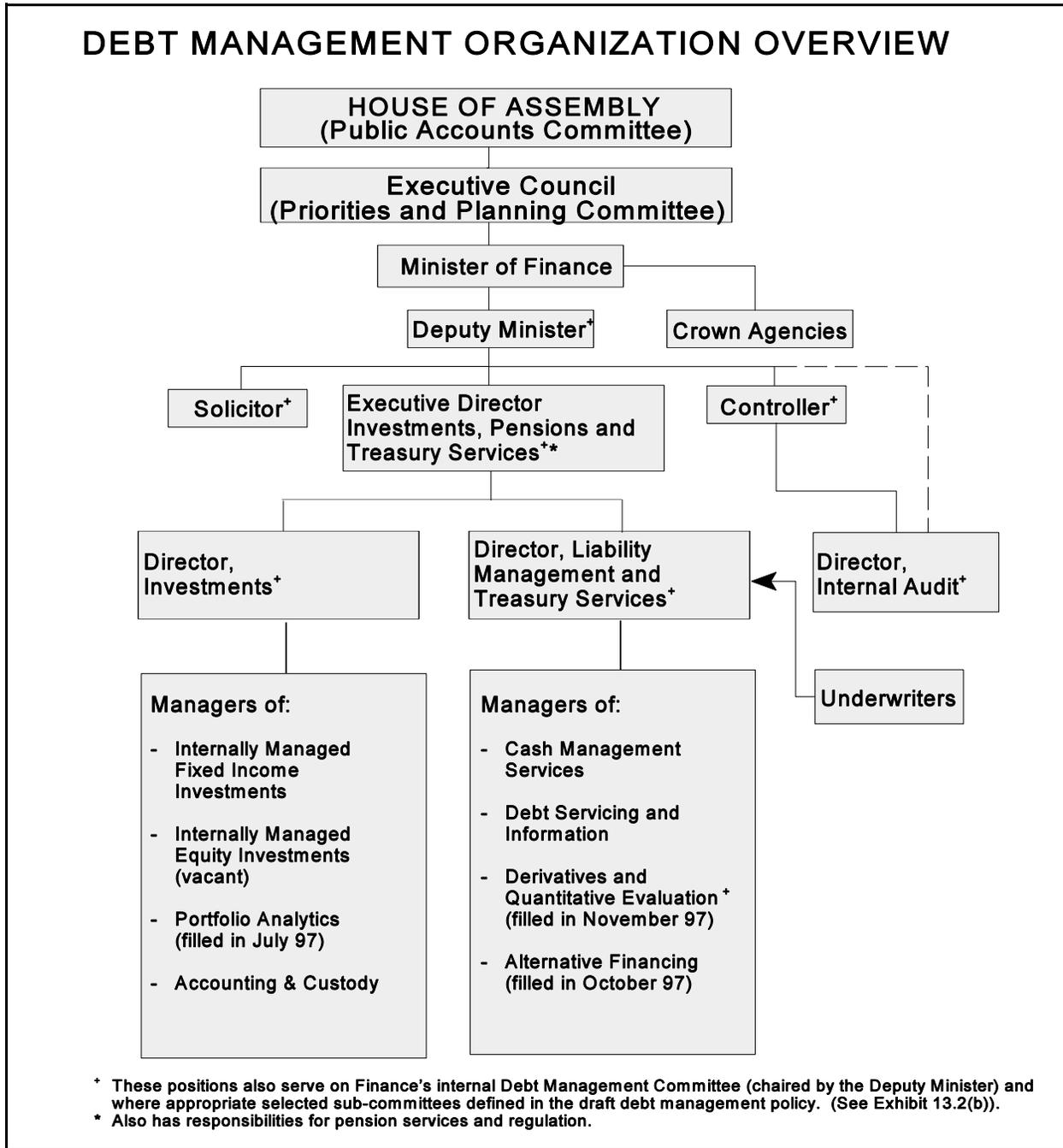


Exhibit 13.2 (b)

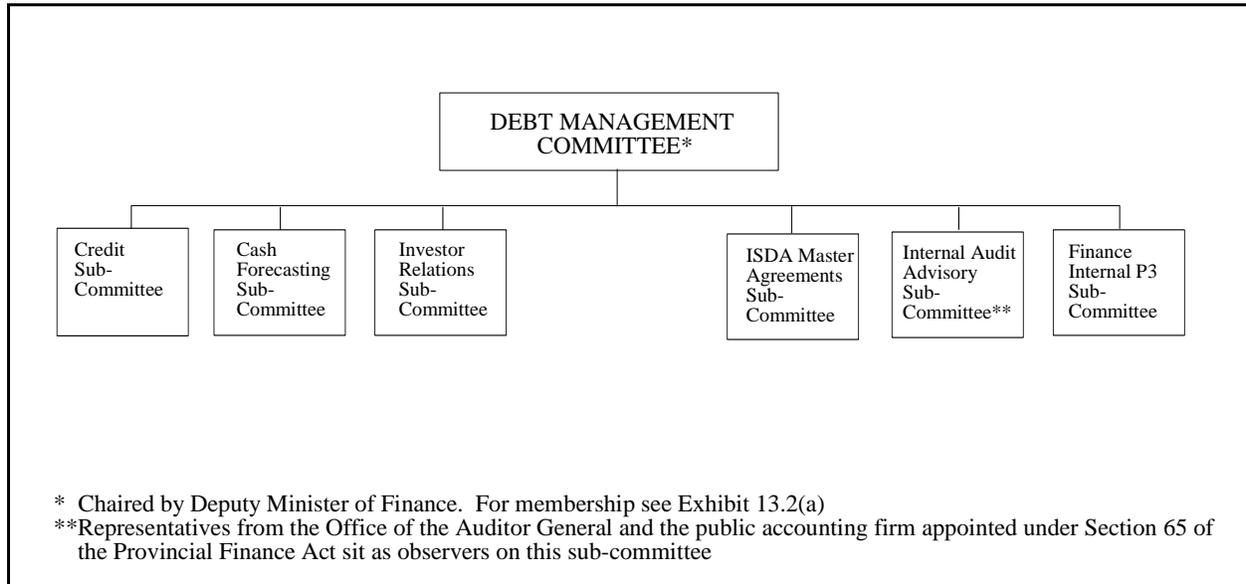


Exhibit 13.3

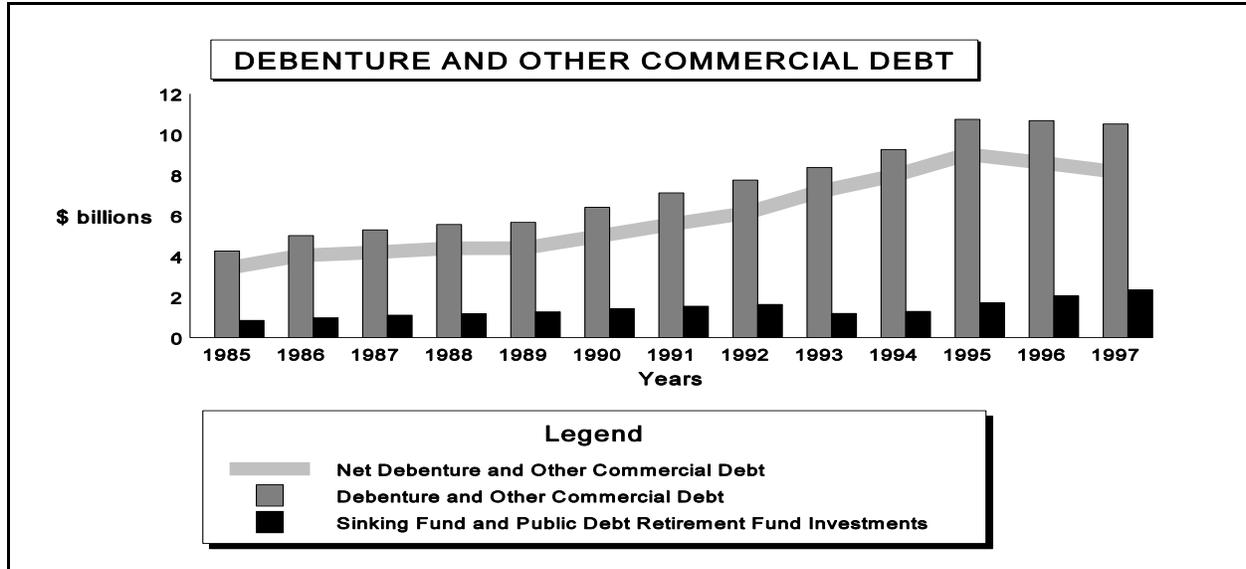
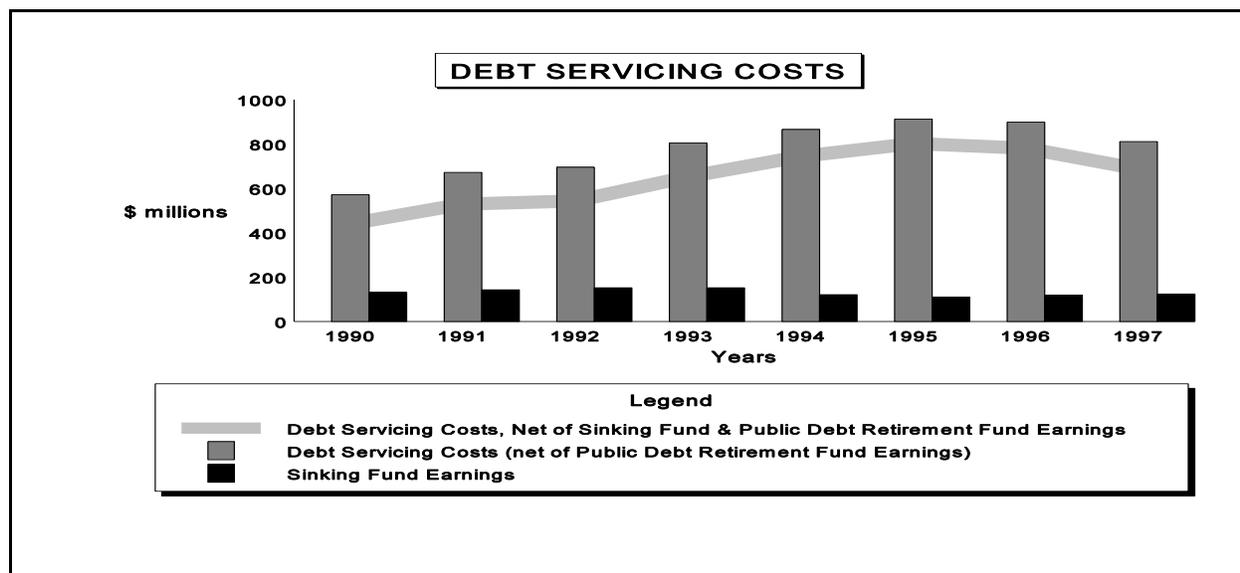


Exhibit 13.4*Exhibit 13.5*

Foreign Exchange Exposure*
as at March 31
(millions of Canadian \$)

	1990	1991	1992	1993	1994	1995	1996	1997
Foreign Debt (Gross)	<u>\$ 3,366</u>	<u>\$ 4,187</u>	<u>\$ 4,488</u>	<u>\$ 4,882</u>	<u>\$ 5,925</u>	<u>\$ 7,554</u>	<u>\$ 6,224</u>	<u>\$ 5,951</u>
Percent of gross debt	50%	57%	57%	55%	59%	64%	53%	52%
Foreign Debt (Net)	<u>\$ 2,638</u>	<u>\$ 3,360</u>	<u>\$ 3,660</u>	<u>\$ 4,624</u>	<u>\$ 5,632</u>	<u>\$ 7,115</u>	<u>\$ 5,702</u>	<u>\$ 5,324</u>
Percentage of net debt	50%	57%	58%	61%	64%	71%	59%	59%

*Excluding foreign debt of crown corporations

