6.

FINANCE - LIABILITY AND RISK MANAGEMENT

BACKGROUND

6.1 Exhibit 6.1 on page 85 provides a summary of the Provincial debt and related funds as at March 31, 1999. The exhibit summarizes the debt burden of Government Service Organizations (see Appendix II, page 214 for list) and Government Business Enterprises (see Appendix II, page 214 for list) including debts and obligations of crown agencies, guaranteed by the Province. Exhibit 6.2(a) on page 86 provides a summary of the governance, accountability and management organization for the control of the Province's debt and debt-related activities. Exhibit 6.2(b) on page 87 illustrates the internal committee structure, outlined in the debt management policy, which has been put into operation. Management indicated to us that all sub-committees have been active and functioning over the past year.

6.2 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.

6.3 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.

6.4 Our 1994, 1995 and 1997 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. We continue to monitor Finance’s plans and progress in this significant area.

6.5 During 1999, the Office of the Auditor General and the Internal Audit Division of the Department of Finance co-sponsored the engagement of an external consultant to undertake a Liability and Risk Management audit of the Liability Management & Treasury Services Division of the Investments, Pensions and Treasury Services Branch of the Department of Finance. The audit was conducted during March and April 1999 and the report released in November 1999. The consultant was assisted by representatives of both the Office of the Auditor General and Internal Audit Division of the Department of Finance

RESULTS IN BRIEF

6.6 The following are the principal observations from our review of the consultant’s work and the status of action taken or planned regarding matters previously reported upon by this Office.

- Action has been taken to address many of the comments and suggestions included in our previous Reports. However, based on the results of the audit work of the external consultants, certain issues raised in past Auditor General Reports dealing with overall governance, accountability and reporting of the Provincial debt and derivative related activities have not been fully addressed.

- 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 45% as at March 31, 1999 - see Exhibit 6.1) 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 *Government By Design* are significant and continue to provide a formal 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.

SCOPE OF REVIEW

6.7 Our overall objective in 1999 was to determine the status of action taken or planned regarding matters previously reported by this Office. This was primarily addressed through the work of the external consultant contracted by the Internal Audit Division of the Department of Finance and this Office.

6.8 The broad objectives of the audit by the external consultant were to determine whether the Division:

- has an effective risk management framework to manage the financial risk of the Provincial Debt and Obligations;

- is properly controlled and provides adequate reporting to the Executive Director, Deputy Minister and Minister of Finance; and

- is properly staffed in terms of expertise and resources.

6.9 The planned areas of audit coverage included, Liability Management & Treasury Services; Cash Management; Finance and Administration; Human Resources; Corporate Governance; and Information Technology.

PRINCIPAL FINDINGS

6.10 Action has been taken to address many of the comments and suggestions included in our previous Reports. However, based on the results of the audit work of the external consultants, certain issues raised in past Auditor General Reports dealing with the overall governance, accountability and reporting of the Provincial debt and derivative related activities have not been fully addressed. The status of certain of these matters is noted in Appendix 6.1 on page 88 (first reported as part of our 1995 chapter on debt management) which summarizes 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). Significant and 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.

6.11 The consultants' report was issued in November 1999. For this chapter, we have reproduced selected sections from the executive summary of the draft report - i.e., 3.0 Overview Of Liability Management And Treasury Services Division, and 4.0 Summary Findings and Recommendations.

3.0 OVERVIEW OF LIABILITY MANAGEMENT AND TREASURY SERVICES DIVISION

The Division's accountability framework flows from the Provincial Finance Act and the Appropriations Act. Under these Acts, the Governor in Council or the Minister of Finance have the delegated authority and responsibly [sic] for approving Provincial indebtedness.

The Division is overseen by the internal Debt Management Committee ("DMC") whose function it is to set strategic objectives and approve broad debt management initiatives and the authorities of its sub-committees.

The operations are overseen by the Executive Director, Investments, Pensions and Treasury Services who reports to the Deputy Minister of Finance who ultimately reports to the Minister of Finance.

3.1 Branch History

The Investment, Pensions and Treasury Services Branch has been going through a dynamic and evolutionary period of change over the last five years. This can be seen through the Auditor General reports. The information from the Auditor General Reports can be categorized into the following: (1) summary of the debt portfolio; (2) governance; (3) derivatives; (4) documentation; (5) management information systems; (6) branch organizational structure and staffing complements; (7) reporting; and (8) Department of Finance senior management plans for future evolutions. The following comments, from various Auditor General Reports, provide a context for the improvement in Liability Management accomplished over the past number of years.

Summary of the Debt Portfolio

- In 1994, the Province had assumed a significant amount of foreign exchange exposure with an expectation of obtaining interest rate savings. The Province's debt position and the burden of servicing the debt were among the least favourable in the Country.
- In 1995, the Province's debt position and the burden of servicing the debt were among the least favourable in the Country. The risks associated with having a substantial part of the outstanding debt issued in foreign currencies compounded this situation.
- The total commercial debt outstanding had increased from $4.263 billion in 1985 to $10.744 billion as at March 31, 1995, and as at March 31, 1997, commercial debt was $10.514 billion.
- Historically, the Province has had significant foreign exchange exposure. For example, between 1976 and 1989, the percentage of net debt in foreign currencies averaged 40%.
- Since March 31, 1994, the Province has moved from having virtually all of its outstanding debentures and other commercial debt at fixed interest rates to having between 20-25% at floating rates.
- Debt servicing costs have generally increased at a higher rate that [sic] 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. 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.

- 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 72% at March 31, 1994, and has declined to 50.5% by March 31, 1999.

Governance

- Changes to the Provincial Finance Act in 1994 provided the Minister of Finance more flexibility to manage investments, including sinking funds.
- In 1995, the objectives, strategies and initiatives outlined in the Debt Management Plan were significant and provided a formal and improved basis to hold Finance accountable for debt management activities and results. However, more detailed and specific policies and procedures in key areas to support the Debt Management Plan had yet to be fully defined.
- In 1995, a clear definition of the Province's policies and limits with respect to the use of debt and other financial instruments, including derivatives, was required. These needed to be consistent with the Province's risk management policies and strategies which, at that date, had not been fully defined and documented.
- In 1995, an effective governance function for the Province's derivative activities had not been put in place.
- In their Management Report as a result of the March 31, 1995 audit of the Province's financial statements, the auditors appointed under Section 65 of the Provincial Finance Act had made a number of summary comments and recommendations relating to the use and control of financial instruments (i.e. derivatives). One of the recommendations was "*that a senior high-level committee be established including both internal and external Finance department members to set appropriate derivatives policies and to monitor the derivative transactions throughout all departments and associated agencies and enterprises.*"

Derivatives

- In 1994, Finance had the authority and planned to expand the nature and extent of its use of alternative instruments (e.g. derivatives) to manage the Province's debt costs and risks.
- The specific policies, plans and procedures for the use and control of derivative transactions had not been fully defined and approved.
- The extent of Finance's use of alternative financial instruments (i.e. derivatives), whether for management of the Province's debt and debt costs or for investment purposes, had increased from 1994 to 1995.
- Draft policy statements on debt management and on the use of derivatives were prepared and substantially implemented by Finance in 1997. Finance indicated these would be finalized and presented to the Public Accounts Committee in 1998.

Management Information Systems

- Finance has been investigating its management and information systems requirements related to debt management and other treasury management functions. At the time of the 1997 review, a draft request for proposals for the implementation of necessary Treasury Management system was being considered.

Organizational Structure and Staff Complement

- During the 1994 audit, Finance was in the midst of a reorganization, and some key positions were not filled.
- Since 1993 there was an [sic] almost a 100% turnover of senior staff involved in the administration and ongoing management of the debenture debt.
- As of January 1996, most but not all positions within Finance's Investments, Pensions and Treasury Services Branch had been filled.
- The Liability Management and Treasury Services division was at full staff complement in November 1997 for the first time in a number of years.
- 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. In an attempt to mitigate such risks, an internal committee structure related to debt management has been formally established at Finance.

Reporting

- In 1994, the objectives, strategies and initiatives outlined in the Debt Management Plan for the first time (emphasis added) provide a formal and improved basis to hold Finance accountable for debt management activities and results.
- The Debt Management Plan published in the 1994-95 Government by Design publication included the following:
  - The department's debt management and investment information systems will be upgraded and enhanced to provide timely data to make debt and investment decisions based on associated risk assessment.
  - The department's analytical capability will be increased to access alternative financing instruments, measure risks, and employ options, swaps and other financial products to manage the liability portfolio.
- Debts and obligations of a number of crown agencies guaranteed by the Province were not reflected in the notes to the financial statements and not covered in the Debt Management Plan.
- The current version of the Debt Management Plan tabled in April 1995, included the government's strategic objectives for the management of the Province's debt. It identified a number of strategies and initiatives adopted by Finance to assist in meeting the debt management objectives. Medium and longer-term targets for the following key objectives/indicators were included in Government by Design:
  - net direct debt as a percentage of GDP;
  - net debt charges as a percent of revenue;
  - Provincial credit rating; and
  - net direct debt per capita.
- The financial statement accounting policies for reporting the Province's derivative positions and the related income or costs have not been fully defined and documented.

Future Plans

- In 1994, it was indicated that the Province's strategy was to use sinking and debt retirement funds to help mitigate foreign currency exposure, reduce refinancing risk, and plan for the orderly retirement of debt.
- In 1994, Finance senior management acknowledged its plans for managing the debt will continue to evolve.
- In 1995, Finance stated they will be developing more detailed plans and specific policies and procedures in a number of key areas to support the Debt Management Plan. The OAG

suggested these be appropriately defined, documented, and submitted for Executive Council approval as soon as possible.

In 1995, Finance had indicated it would continue to expand and enhance its policies, plans and procedures for its debt management activities, including those for the use and control of derivatives. These improvements are to be defined and implemented over time as and when necessary resources become available.

3.2 Overview of Division Mission

The mission of the Division is defined within the Debt Management Plan of the Government by Design document published on an annual basis and is expressed as follows:

3.2.1 Liability Management

To manage the debt portfolio of the province so as to maximise the likelihood of achieving the fiscal objectives of the province, while minimising the debt portfolio's long term cost of carry and to fund cash requirements at a minimum cost to the Province.

The day to day operations of the Division is led by the Director, Liability Management and Treasury Services who reports to the Executive Director, Investments, Pensions and Treasury Services. Those liability management activities that are within the purview of the Division are managed within the parameters set by the Debt Management Policy statement. This statement has been approved by the internal DMC and addresses the risk to which the Province is exposed and the guidelines to which the Division must subscribe.

In this regard, the Division executes transactions on behalf of the Government, the primary goal of which is to meet the financial requirements of the Province and management of the financial risk arising from the Province's debt.

3.2.2 Treasury Services

To manage effectively the banking arrangements of the province, to service outstanding debt, and to estimate and manage cash balances of the consolidated and related funds.

The cash management team carries out cash forecasting for the Government, invests surplus funds and borrows to meet the Province's cash needs, manages the Province's banking arrangements, and completes bank reconciliations and other cash management administrative functions.

Cash management activities are the responsibility of the Manager, Cash Management Services, except completion of bank reconciliations, which is the responsibility of the Manager, Debt Servicing & Information.

Furthermore, the Treasury Services group provides various services to other departments, Crown Corporations and Agencies. In this regard, Treasury Services will execute transactions on behalf of various Crown Corporations and Agencies the primary goal of which is to ensure that financial requirements are met for the Province by ensuring a co-ordinated borrowing and investment program within the marketplace. As well, Treasury Services will undertake to provide financial advice to various departments on alternative financing projects which may include the Public / Private Partnership.

3.2.3 Information Technology

The Division uses purchased software packages to administer divisional information with primary reliance on spreadsheet application software. The IT Division of the Finance CSU (Corporate Services Unit) administers information technology within the Department of Finance.

A new Treasury Management System will be implemented in the near future. We understand that the new system will enhance operational efficiency and risk management modelling capabilities by providing a centralised database where information can be effectively shared while reducing certain manual operations.

6.12 The consultant's draft report contained 67 recommendations. Of these recommendations, 26 were identified as requiring immediate attention and 42 as being less significant. The following comments are extracted from the Summary Findings and Recommendations section in the Executive Summary to the draft report.

4.0 SUMMARY FINDINGS AND RECOMMENDATIONS

"Our summary recommendations to improve the transaction control cycle and to establish an appropriate risk management framework are provided below. These recommendations, where applicable, have been benchmarked to best practice within government and industry.

The resulting recommendations are grouped under two headings: Risk Management and Operational by planned area of audit coverage.

4.1 Risk Management

Effective financial risk management begins with a solid understanding of the organisation's mission, objectives and strategies, and clear identification of the financial risks to be taken and the expected returns associated with those risks. Integral to sound business planning is a formal description of the organisation's "risk appetite" and the nature and level of risks that are acceptable to the organisation.

The risk management infrastructure forms the foundation for the risk management framework. It is the organisational, analytic, operational and systems infrastructure necessary to support the transaction control cycle. Without these "building blocks," the risk management transaction control cycle is unable to operate effectively, controls are diminished, and management will lack the information necessary to monitor performance and evaluate different strategies.

The risk management activities should be supported by an appropriate organisational structure, such as defined and documented roles and responsibilities, and risk management framework, such as defined and documented risk measurement methodology, reporting framework and limit structure.

The Division's mission statement and objective is defined within the Debt Management Plan within the Government by Design document. The Division's identification of the risk exposures is incorporated within the Debt Management Policy statement. However, the Division's, and by extension the Province's, 'risk appetite' has not been explicitly defined nor have the expected 'returns' associated with those risks. However, the Debt Management Committee has recently developed a Risk Table and Policy Statement in response to that issue.

In this regard, the following tasks should be undertaken to further develop a risk management infrastructure:

4.1.1 The Government should establish a risk framework where its tolerances for financial risk and its financial risk management philosophy are formally set and provided to management.

The internal DMC has recently approved a Debt Management Policy statement that sets a number of operational targets for interest rate, liquidity, currency, settlement, counterparty, and operational risks. However, it is not clear whether this Policy Statement is consistent with the risk tolerance and philosophy of the Government.

The Government should issue written risk management guidelines that link the strategies of the Government to its risk tolerance/philosophy. These guidelines should establish the scope of permitted treasury activities, guidelines for acceptable levels of risks and benchmark returns, the structure and independence of the risk management processes, and an accountability framework. Responsibility for overseeing this process should be formally delegated by the House of Assembly to the Debt Management Committee.

4.1.2 The Debt Management Committee should be expanded to include members external to the Finance Department.

We recommend that membership in the Debt Management Committee be expanded to include members external to the Finance Department. The Committee composition should be amended to include members of the Fiscal and Economic Policy Branch as this group may lend its expertise with respect to short and long term economic conditions which may bring to light economic factors which can influence the borrowing/refinancing plan of the Division. These individuals should be at a sufficiently high level to provide adequate interpretation of economic conditions. As well, consideration should be given to include additional high level staff from other departments which can provide additional resources and independent oversight by the Committee to ensure that its fulfilment of its mandate can be objectively monitored.

4.1.3 The Division should enhance its measurement and reporting against the Policy Variables outlined in the Debt Management Policy statement.

The internal DMC recently approved a Debt Management Policy statement defining 14 key financial risks managed by the Division and sets 36 Policy Variables that provide financial risk targets and limits. This Policy represents an excellent step toward improving the measurement of risks and articulation of the 'risk appetite' of the Government. We recommend the following enhancements to this new Policy:

- specific linkage of the detailed Policy Variables to the financial objectives, strategies and risk tolerance of the Government; and
- establishment of a formal measurement and reporting program to report on progress toward meeting financial risk targets or compliance with risk limits.

A number of Policy Variables have been established as operational targets as opposed to hard limits. These operational targets, established in 1998 are compared against the current debt portfolio which has arisen from experience and debt management decisions made over the past number of decades. In some instances actual risk exposures are well in excess of those targets (e.g. average term to maturity of debt, duration, foreign currency risk). In these cases, we recommend that management develop a formal strategy for meeting these targets, and formally review and report on progress toward achieving those targets on a regular basis. This strategy should recognize the existing debt portfolio and the challenges of effectively managing this portfolio to the operational targets.

4.1.4 A benchmark portfolio of debt should be developed to form the basis of performance measurement.

Best practice within Government is to construct a benchmark debt portfolio to allow for performance measurement of the Division's activities and responsibilities. Many provinces have used independent advisors to assist them to construct a model portfolio. Such a model would set parameters for the debt portfolio, such as the duration and repricing of debt and degree of currency risk, in an effort to achieve a theoretical "efficient frontier" for borrowing. This portfolio should be designed in conjunction with management of the Division, and approved by the Debt Management Committee.

This benchmark debt portfolio should be used for assessing the actual performance of Divisional management in achieving the rate level that could have been reached by the benchmark portfolio. Variance to such a rate level should be commented upon by Divisional management. Additionally, the benchmark portfolio provides a threshold against which quantitative risk measures, such as the effect of a rate shock on current debt service cost, can be compared.

4.1.5 All existing and contingent (potential) indebtedness of the Province, including that not currently in the purview of the Division, should be aggregated within the Division and incorporated within the portfolio sensitivity analysis.

The Division does not currently have an oversight responsibility or accurate information for all existing and contingent indebtedness of the Province (e.g. guarantees, leases and performance bonds) and is therefore unable to aggregate all such exposures within its sensitivity analysis. As such, the Division has not formalised its basis for measuring certain exposures. For example, there is no policy that dictates which time period such guarantees, leases or performance bonds should be assigned for purposes of sensitivity analysis nor a policy as to the method of valuation of such (e.g. discounted cashflows, cost less provision, other).

All existing and contingent (potential) indebtedness of the Province should be aggregated within the Division, and policies for measuring such risk within the overall risk profile and sensitivity analysis should be formalised.

4.1.6 The 'counterpart credit exposure report' should include the consolidated exposure to all counterparts and such exposure should be independently calculated and reported by the Division.

The Division relies on its derivative counterparties to provide it with the mark-to-market exposure on its outstanding swap transactions on a monthly basis. Not all counterparties provide this information. If such information is not reported, the Division does not independently calculate and report this amount. The Division does not perform an independent verification of its counterpart's calculation. We understand that the new Treasury Management System will have the functionality to undertake this calculation.

The Division should incorporate all counterparty exposures within the 'counterpart credit exposure report'. Such amounts should be independently calculated by the Division and compared to the amounts reported by each counterparty.

4.1.7 The systems and processes for measurement and reporting of the Provinces' financial risk positioning should be enhanced.

A robust risk measurement methodology would ensure reliability of input data, tested and credible pricing models, a revaluation methodology that accurately reflects the cost of closing out current positions at current market prices and an integrated profile of all market risks.

The Division's formal aggregation, measurement and reporting of risk positions are limited in nature and scope. This factor was one of the reasons the Division has made the acquisition and implementation of the Treasury Management System a high priority. The Division should begin to incorporate all risk exposures within the existing measurement systems for the quantification of the financial risk inherent in the portfolio. As well, the Division should ensure that it begins to carry out scenario analysis and stress testing to ensure that potential movements in the underlying financial risks within the portfolio are understood.

4.1.8 Policy and Procedural documentation for the Division should be enhanced.

Policies and procedures translate the Division's strategy and objectives into operating documents to control the Division's activities. Policies should clearly set out all the parameters within which the risk management strategies are formulated, executed and monitored, and should be formally ratified by the DMC. Procedures act to operationalise the DMC's policies and should be continually amended to reflect the current processes.

Management has demonstrated their understanding of the need for establishment of formal, detailed procedures for key risk management functions. However, management has been reluctant to commit resources to develop and document detailed procedures for key functions that will be replaced by the introduction of the new Treasury Management System. Given the current lack of detailed process documentation we would recommend that each desk create a high level description of processes that will form the precursor for detailed procedures to be documented at a later date (after implementation of the new Treasury Management System). This information will assist the department in designing new controls and processes for the new Treasury Management System.

4.1.9 Succession Planning and Human Resource Development for the Division should be formalised.

Management should devote additional focus to human resource development items and reduction of key person risk through the following:

- Development of a formal succession plan/reduction of key person risk;
- Cross training of staff within each division;
- Focus on development of staff skill sets/knowledge of the liquidity and cash management processes.

Of a total staff complement of 16 full time employees, 7 have less than a full year of experience within the Division (although they have extensive experience in government or the private sector). There are currently no formal training, succession or personal development plans for staff of the Division.

Additionally, there is no policy requiring staff to be removed from their position for a minimum of 5 days. Each individual should be removed from their position for this period of time to allow another individual to re-perform their function. This will provide the Division opportunity to cross-train staff as well as to ensure the job function is being performed in the appropriate manner.

4.1.10 An independent Risk Management function for the Division should be instituted.

Senior management relies extensively on the Manager, Derivative and Quantitative Evaluation to both execute transactions and to monitor and communicate the results of those transactions. The key functions of measurement and management of interest rate and foreign currency risks should be segregated.

Given the broad range and complexity of risks assumed by the Division, on behalf of the Province, we see strong justification for the appointment of an independent risk manager. This position can be a component part of the Division and would be responsible for the identification, measurement and reporting of all financial risk. This would not be simply a policing or audit function, but instead would be key [sic] role in identifying and communicating to the internal DMC the risk profile resulting from the liability positions assumed.

4.1.11 Financial Risk Management Reporting by the Division should be improved.

The current organisational reporting structure is through the Executive Director to the Deputy Minister of Finance, who reports to the Minister of Finance and ultimately the Cabinet. The reporting to the Deputy Minister of Finance is carried out on a regular basis informally, with formal reporting through the bi-monthly Debt Management Committee meeting, while the Minister of Finance is reported to on an ad-hoc basis. We understand that no regular reports which summarise the risks inherent in the Province’s debt are provided to the Minister of Finance, other than the annual Debt Management Plan. Best practice would dictate the need for sufficient and timely reporting of the risks undertaken to those ultimately responsible for the Province's debt.

4.2 Operational

The process for managing individual transaction risks and cumulative portfolio risk is executed via the transaction control cycle. It consists of a structured process by which risks are identified, measured, captured, managed and reported. Additionally, the results of the control cycle are continuously evaluated relative to stated goals and objectives to enable effective performance monitoring and control. The comprehensive development of the control cycle is essential to any risk management program.

4.2.1 Segregation of duties within the Division should be enhanced.

There are various instances that we noted which require enhancements to the level of segregation between certain incompatible functions. Management is aware of the issues and has been accommodating the necessary changes as resources become available within staff complement constraints.

The primary concern is to ensure that back office staff do not have reporting responsibility to an individual who has trading responsibility. Furthermore, an individual with trading responsibility should not be responsible for the creation of risk reports. Finally, in conjunction with the development of the appropriate level of cross training, bank account reconciliation staff should be required to change the accounts which they reconcile at least semi-annually. Bank reconciliation provides a key control to determine the legitimacy of cash transactions and the accounting for those transactions.

4.2.2 Bank account maintenance and banking relationships on behalf of the Province should be enhanced.

The Division has relationships with all five major banks. There is a significant time and resource requirement for administering these banking relationships and to reconcile the bank accounts on a timely basis.

The Department of Finance should assess the cost effectiveness of current banking arrangements. Considerations should be given to consolidating the banking operations with a goal to achieve operational savings to the Province while increasing efficiency. Furthermore, consideration should be given to a more proactive approach to closing inactive and dormant bank accounts in order to reduce the work to maintain and reconcile these accounts.

4.2.3 The accuracy and timeliness of Cash Forecasting data should be improved.

The current cash forecasting process within Liability Management and Treasury Services is formal. However, there is no requirement for other departments to provide timely and accurate cash forecast information. Estimates of cash inflows/outflows rely heavily on the experience of the Manager - Cash Management Services. We determined that there are large recurring variances between actual end of day cash positions and that day's projected closing cash position.

A requirement should be set for all departments to provide timely and accurate cash forecast information. Other departments should be held accountable for the accuracy and timeliness of the cash forecast information (possibly by transfer pricing the cost associated with the additional funds required). Finally, the actual variance from projected end of day cash position should be determined and a threshold amount should be set prior to investigation.

4.2.4 Accounting records and management reports within the Division should be complete.

We noted various instances in which the full processing cycle has not been completed for certain types of transactions within the Division. As such, this would cause the accounting records to be misstated at a point in time. We understand that adjustments are made to the accounting records to ensure that such records are complete on a yearly basis. Furthermore, certain transactions are not being recorded on management reports used within the Division.

The completeness and reliability of accounting and management records ensures that Divisional staff are made aware of the total exposure to which the Province is exposed. Immediate effort should be made to ensuring [sic] that all reports and accounting records are brought up to date and reconciled in a timely fashion as opposed to on a yearly basis.

As a control process, we believe that the Internal Audit Division should undertake regular assessments of the Division on a 12 - 18 month cycle. This regular assessment should encompass all functions within the Division and should be reported upon to the Deputy Minister of Finance.

4.2.5 An implementation plan should be developed for the new Treasury Management System

The Division has not developed an implementation plan for the new Treasury Management System. Management should develop a detailed implementation plan that aligns people, processes and the new system. This plan should provide the detailed process changes and the changes to staff resources. As detailed procedural documentation regarding the current systems and processes is not available, each desk should create a high level description of existing processes that will form the precursor for transforming the Division to the new Treasury Management System. This high level description may then be used as a foundation for development of the detailed implementation plan.

CONCLUDING REMARKS

6.13 Based on the results of the audit work of the external consultants, certain issues raised in past Auditor General Reports dealing with overall governance, accountability and management of the Provincial debt and derivative related activities have not been fully addressed.

6.14 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.

6.15 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 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, management of the Province's debt should likely continue to be a matter of significance and interest to the House of Assembly.

Exhibit 6.1

SUMMARY OF PROVINCE'S DEBT
AS AT MARCH 31, 1999
(Source: Derived from Province's Consolidated Financial Statements)

	(thousands of Canadian $)		Foreign %	
	1999	**1998**	**1999**	**1998**
Gross Long Term Debt				
Government Service Organizations (1)	$ 13,803,074	$ 13,141,728	46.5%	49.1%
Government Business Enterprises	208,776	189,658	0.0%	0.0%
Total Long Term Debt to be Managed	14,011,850	13,331,386	45.9%	48.4%
Sinking Funds (2)				
Government Service Organizations (1)	4,218,955	3,980,976	31.4%	29.2%
Government Business Enterprises	-	-	0.0%	0.0%
Funds to be Managed	4,218,955	3,980,976	31.4%	29.2%
Net Long Term Debt	$ 9,792,895	$ 9,350,410	52.1%	56.5%
Other Debt				
Bank Advances and short-term borrowings	942,001	891,599	9.7%	7.5%
Pensions, retirement and other obligations	810,011	457,994	0.0%	0.0%
Deficiency in government business enterprises	674,110	573,058	53.6%	55.1%
Net Provincial Debt	$ 12,219,017	$11,273,061	45.4%	50.3%

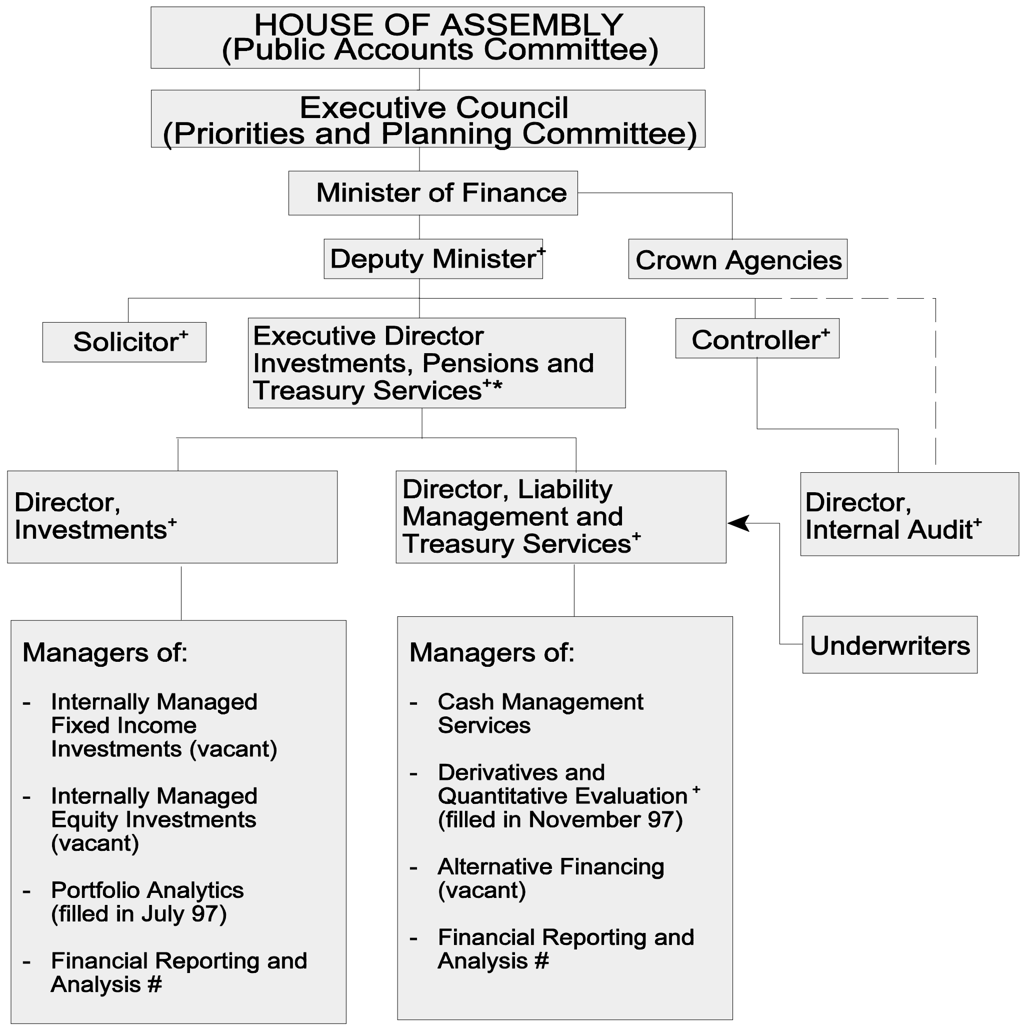
Notes:

(1) The Investments, Pensions and Treasury Services Branch of the Department of Finance is directly responsible for managing 83.5% (82.7% - 1998) of the gross long term debt, 65.0% (63.6% - 1998) of the sinking funds related to Government Service Organizations and 92.8% (92.7% - 1998) of bank advances and short-term borrowings.

(2) Sinking Funds include funds held in Sinking Funds related to debenture debt issues, the Public Debt Retirement Fund and Defeasant Assets.

Exhibit 6.2(a)

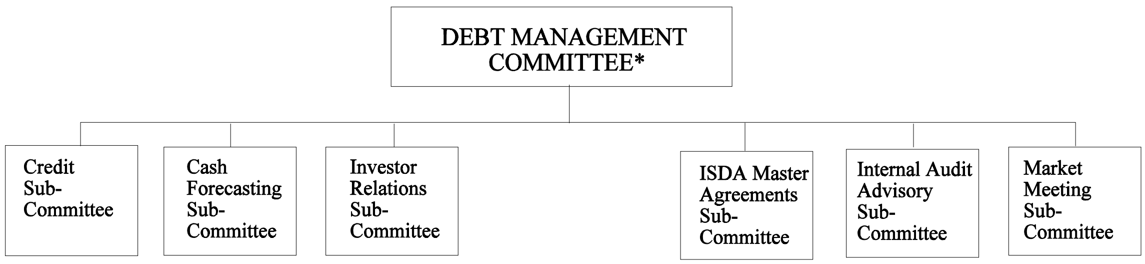
DEBT MANAGEMENT ORGANIZATION OVERVIEW



+ These positions also serve on Finance's Internal Debt Management Committee (chaired by the Deputy Minister) and where appropriate selected sub-committees defined in the draft debt management policy. (See Exhibit 6.2(b)).
* Also has responsibilities for pension services and regulation.
# One Manager services both Divisions.

Exhibit 6.2 (b)

DEBT MANAGEMENT COMMITTEE ORGANIZATION OVERVIEW



* Chaired by Deputy Minister of Finance.

Appendix 6.1

KEY GOVERNANCE QUESTIONS FOR DERIVATIVES			
Questions	**Status 1995**	**Summary Comments**	**Consultant's Comments 1999**
1. Policies (a) Has the government (i.e. Executive Council, Priorities and Planning, and the Minister) established clear and internally consistent risk management policies, and are they communicated clearly?	Needs more action	■ This is a responsibility of the highest level upon which other activities are dependent. ■ This requirement is recognized but there is no timetable for its completion.	■ 1995 status remains valid for the establishment of clear and internally consistent risk management policies and the extent of communication thereof.
(b) If so, are management's strategies and implementation procedures consistent with the authorized policies?	Needs more action	■ Without clearly communicated strategies and policy direction at the senior level this area cannot be fully completed. ■ This is not just a case of documenting transactions that have and are occurring. There are no limits defined for scope of activities, no limits on risk taking, no standards for valuing positions and ensuring performance, etc. ■ Again there is no timetable for completing these responsibilities.	
2. Limits (a) Are comprehensive treasury limits in place that cover various types of risk: i.e. - treasury products, - market risk, - legal risk, - credit risk, - liquidity risk, and - operations risk?	Needs more action	■ Management indicates these will be developed along with the above outstanding items. However, transactions have and will occur for which the Province is responsible without these limits being fully defined and approved.	■ 1995 status remains valid for the monitoring against established limits.
(b) Are procedures in place to monitor treasury's activities against established limits and is appropriate action taken when limits are exceeded?	Needs more action	■ There are very broad portfolio targets established, but no specific limits or policies (re: risk management) established against which to monitor and react.	

Appendix 6.1 (cont'd)

KEY GOVERNANCE QUESTIONS FOR DERIVATIVES			
Questions	**Status 1995**	**Summary Comments**	**Consultant's Comments 1999**
3. Procedures and Systems Support (a) Is there an independent back office function supporting treasury activities?	Needs more action	■ While there is better segregation of duties now, there is still room to improve. ■ The back office reports to those responsible for authorizing and managing the transactions.	■ 1995 status remains valid for the independent reporting function, documentation of procedures and adequacy of information technology.
(b) Are documented procedures and controls in place for: - treasury decision-making and execution, - back office functions, and - accounting and reporting?	Needs more action	■ There are some informal accounting and reporting procedures being followed in dealing with transactions, however there are no documented procedures and controls for the various segments listed.	However, the implementation of the new Treasury Management System should alleviate some of these difficulties.
(c) Does the Province have adequate integrated computer hardware, software, expertise and operations understanding to support the range of treasury's activities?	Needs more action	■ Systems are just adequate for present level and type of activity, however the current systems will not be adequate for future planned activity.	
4. Valuation (a) If computer models are used in treasury, are the models independently validated on a regular basis?	Will need action	■ Sophisticated models are being reviewed but not currently being used. Basic spreadsheets are currently being used.	■ 1995 status remains valid for use of computer models, valuation issues and scenario analysis.
(b) Are the systems capable of performing "what if?" scenarios, in order to determine the Province's potential risk?	Needs action	■ The current systems are not able to efficiently complete these scenarios and as a result potential risk is not being regularly reported.	

Appendix 6.1 (cont'd)

KEY GOVERNANCE QUESTIONS FOR DERIVATIVES			
Questions	**Status 1995**	**Summary Comments**	**Consultant's Comments 1999**
5. Accounting/Disclosure (a) Is there an emphasis on accrual or mark-to-market accounting of all treasury's positions?	Yes, a bit of both	■ Accrual accounting used for external financial statements, with note disclosure of derivatives. ■ Mark-to-market is being completed for internal monthly reports, using information produced externally by the counterparties.	■ No further work carried out.
(b) Is the Province bringing its treasury activities disclosure reporting in line with current regulations and best practices?	Yes, but will evolve	■ However, the specific accounting policies and procedures for derivatives have not yet been fully defined and documented. There is no timetable for this topic, but presumably will be necessary for March 31, 1996 statements. ■ The accounting policies are linked to the overall strategies and policies, and until these are complete it is difficult to complete the accounting policies.	■ No further work carried out.
6. Management (a) Should outside advisors be retained to review the government's risk management policies and practices?	Some action taken	■ Finance has made use of external parties to review selected aspects of its treasury plans and activities.	■ 1995 status remains valid for review of risk management policies and practices.
Does senior management receive useful reporting updates on the treasury function and activities on a regular basis?	Some action taken	■ Treasury management is receiving regular reports which include mark-to-market reporting, but reporting to government is not formalized yet. Further, the back office function is not fully independent or segregated from senior treasury management.	■ 1995 status remains valid for reporting to government and segregation of functions.

Appendix 6.1 (cont'd)

KEY GOVERNANCE QUESTIONS FOR DERIVATIVES			
Questions	**Status 1995**	**Summary Comments**	**Consultant's Comments 1999**
(b) Does the government receive timely and relevant information regarding treasury activities?	Needs more action	■ The Minister is informed of treasury activities on a verbal basis. The reporting to others in government has not yet been formally defined. There is no timetable for the completion of this.	■ 1995 status remains valid.
(c) Does government know the most the Province could lose as a result of treasury risks in a worst-case scenario?	Needs more action	■ Potential risk exposure and stress tests are not reported to government. The policies and procedures have not been established to require this type of reporting, and there is no timetable for the completion of this.	■ 1995 status remains valid.
(d) Is the government aware of the effect of treasury's activities on cash flow and deficit last year?	Yes	■ Government is aware of treasury's activities in general terms and on a selected basis.	■ No further work carried out.
7. Performance Measurement (a) Is the treasury function seen or evaluated as a profit centre? Do treasury staff understand the Province's position in this regard?	No Yes	■ Treasury is aware it is dealing with public monies and does not view itself as a profit centre. ■ However, there are no overall policies and strategies clearly governing this.	■ No further work carried out.
(b) Do treasury staff sign off on the Province's code of ethics?	No	■ No code of ethics defined for Province. However, most treasury staff have professional designations which require they adhere to a defined code of ethics.	■ No further work carried out.
(c) Is the compensation in treasury consistent with the Province's overall objectives?	May need action	■ There is an active market with high demand for skilled treasury personnel. Building and retaining a solid world class treasury team may require additional resources.	■ 1995 status remains valid.

Appendix 6.1 (cont'd)

KEY GOVERNANCE QUESTIONS FOR DERIVATIVES			
Questions	**Status 1995**	**Summary Comments**	**Consultant's Comments 1999**
8. Internal Control (a) Are the staff authorized to engage in and to monitor treasury activities qualified and trained?	Yes, but will continue to evolve	■ The senior staff responsible for treasury activities have various professional qualifications and experience.	■ 1995 status remains valid.
(b) Do key controls exist to ensure that only authorized transactions take place, and that all transactions are completely and accurately recorded, and that unauthorized transactions would be detected quickly and appropriate action taken?	Needs more action	■ Finance has taken some action in the past year, but needs to continue efforts to improve systems and controls, including definition of more detailed plans, policies and procedures. Business plans identify a number of initiatives, but there is not a formal implementation plan or schedule, including definition of resources required.	■ 1995 status remains valid for enhancement of key controls.
(c) Is there adequate independent audit coverage of and reporting on the treasury function?	Needs more action	■ Auditor General's coverage will continue to evolve, and likely be ongoing in certain respects, but will rely on public accounts audit function re: Province's financial statement reporting. ■ Finance's internal audit group has not been (but should be) involved in the auditing of derivative activities.	■ 1995 status remains valid for cyclical audits to be carried out for this division.

Appendix 6.1 (cont'd)

KEY GOVERNANCE QUESTIONS FOR DERIVATIVES			
Questions	**Status 1995**	**Summary Comments**	**Consultant's Comments 1999**
9. Evaluation (a) Is compliance with all policies and procedures evaluated regularly?	Needs more action	■ Being done informally by treasury management. However, without detailed plans and specific policies and procedures defined and documented, such evaluations cannot be formally completed by others independent of treasury. The external parties to Finance's derivative transactions expect compliance with minimum standards and controls for the industry.	■ 1995 status remains valid for independent valuation of the division performance and the need for independent oversights.
(b) Has the government established an investment or risk management committee, composed of knowledgeable people, including senior managers and perhaps outside advisors, who regularly review treasury strategies, controls and performance?	Needs more action	■ There is an advisory committee, chaired by the Finance Deputy Minister, for pension investments, but not for sinking or other debt-related funds and activities. At the present time those responsible for the treasury operations also are responsible for risk management and assessment. Such committees should be appropriately independent of management responsible.	■ 1995 status remains valid for the need for an independent oversight function.
(c) Should government retain outside advisors to review the risk management policies and practices being and/or to be followed?	Will need action	■ The Province's risk management policies and procedures are not formally defined and documented, and there is no timetable for completion. Once completed, policies should be independently reviewed.	■ 1995 status remains valid.