

Chapter 7

General Sinking Fund

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General Sinking Fund

Background

7.1 A sinking fund is a dedicated fund where money is set aside by an organization to help repay a debt when the debt matures or is redeemed.

7.2 Section 12 of the *Provincial Loans Act* (the Act) requires the Minister of Finance to maintain one or more sinking funds for the payment of funded debt either at maturity or upon redemption in advance of maturity. The Act defines “funded debt” as securities issued by the Province of New Brunswick having a term to maturity of more than one year from their date of issue and that are not subject to serial repayment.

7.3 The Province maintains a general investment sinking fund (Sinking Fund) that accumulates fixed income investments on behalf of both the Province and the New Brunswick Electric Finance Corporation (NBEFC) for the purpose of Section 12 of the Act.

7.4 At 31 March 2008, the Province did not have any outstanding securities that are subject to serial repayment. Securities that are subject to serial repayment would not require a sinking fund since the principal would be repaid periodically during the life of the security rather than all on the date of maturity.

Purpose of the Sinking Fund

7.5 The purpose of the Sinking Fund differentiates it from other investment portfolios such as pension and endowment funds, where there may be objectives to grow the capital on an inflation adjusted basis. The purpose of a sinking fund is to accumulate sufficient assets to retire debt as it matures or is redeemed. As such the management of the Sinking Fund is somewhat restricted by the Act.

7.6 Although the purpose of the Sinking Fund is to match fixed income securities to fixed payment debt obligations, the Province does not track specific Sinking Fund assets against specific debt obligations. The Province manages the Sinking Fund assets and funded debt liabilities on a pooling basis considering such factors as the maturity and foreign currency profiles.

7.7 The existence of the Sinking Fund provides increased credit support for bondholders. The Department of Finance has indicated that the Sinking Fund is a debt management tool that can provide liquidity for outstanding New Brunswick bonds and can be used to manage the Province's interest rate and foreign currency exposure.

7.8 Foreign denominated assets are purchased to offset foreign denominated debt. As at 31 March 2008, the Province had issued US\$1,300 million in United States dollar denominated bonds, the earliest of which are due in the year ended 31 March 2013. At 31 March 2008, the Sinking Fund held US\$404 million in United States dollar denominated assets. The Province also uses other financial instruments to manage its foreign currency exposure outside of the Sinking Fund.

Financial information

7.9 The following table provides a history of the value of the Province's total Funded Debt, including Funded Debt issued for NBEFC; and the book value of the Sinking Fund for the past eight years.

Year	Total Funded Debt (\$ millions)	Book Value of Sinking Fund (\$ millions)	Sinking Fund as % of Total Funded Debt
2008	\$13,064.3	\$4,471.3	34.2%
2007	12,981.9	4,268.7	32.9%
2006	12,203.9	4,320.4	35.4%
2005	11,713.6	4,165.4	35.6%
2004	11,583.8	4,079.9	35.2%
2003	11,391.5	3,894.3	34.2%
2002	11,126.4	3,686.2	33.1%
2001	10,717.3	3,427.5	32.0%

7.10 The Sinking fund has consistently been kept at a value that is approximately one third the value of the Province's total Funded Debt outstanding.

7.11 The Sinking Fund is accumulated for the purpose of providing funds to repay all Province of New Brunswick debt issues, whether they were issued for Provincial purposes or for the NBEFC. The following table compares the book value of NBEFC's share of the Sinking Fund to the value of the Funded Debt issued for NBEFC.

Year	Funded Debt Issued for NBEFC (\$ millions)	NBEFC Share of Sinking Fund (\$ millions)	NBEFC share of Sinking Fund as % of Funded Debt Issued for NBEFC
2008	\$3,602.6	\$309.4	8.6%
2007	3,709.1	300.5	8.1%
2006	3,261.5	336.4	10.3%
2005	3,316.6	391.6	11.8%
2004	3,098.0	363.7	11.7%
2003	2,972.8	351.3	11.8%
2002	3,121.7	327.4	10.5%
2001	3,061.1	297.3	9.7%

7.12 Note 2 (b) to the unaudited financial statements of the Sinking Fund discloses that most of the NBEFC share of the Sinking Fund is held in United States dollars.

7.13 The following table compares the book value of the Province's share of the Sinking Fund to the value of the Funded Debt issued for provincial purposes.

Year	Funded Debt Issued for Provincial Purposes (\$ millions)	Provincial Share of Sinking Fund (\$ millions)	Provincial Share of Sinking Fund as % of Funded Debt Issued for Provincial Purposes
2008	\$9,461.7	\$4,161.9	44.0%
2007	9,272.8	3,968.2	42.8%
2006	8,942.4	3,984.0	44.6%
2005	8,397.0	3,773.8	44.9%
2004	8,485.8	3,716.2	43.8%
2003	8,418.7	3,543.0	42.1%
2002	8,004.7	3,358.8	42.0%
2001	7,656.2	3,130.2	40.9%

7.14 There is a significant difference between the value of the Provincial share of the Sinking Fund compared to outstanding provincial debt and the value of the NBEFC share of the Sinking Fund compared to the outstanding debt of NBEFC.

7.15 One reason why there are significant differences in the use of the Sinking Fund between the provincial portion and the NBEFC portion is the nature of the assets that are financed through debt. Most of NBEFC's debt financed assets are long-lived and are expected to directly produce many years of cash flow with which the debt can be paid. Many of the Province's debt financing is for general purposes, and to the extent that it is for long-lived assets, they usually do not have direct cash flows attached to them.

7.16 Another reason for the lower percentage of assets attributed to NBEFC is that historically NBEFC contributes 1% of the value of its debt annually whereas the Province contributes 1.5%.

7.17 The following table compares the market value of the entire sinking fund to its net book value.

Year	Book Value of Sinking Fund (\$ millions)	Market Value of Sinking Fund (\$ millions)	Market Value as a % of Book Value
2008	\$4,471.3	\$4,771.8	106.7%
2007	4,268.7	4,577.3	107.2%
2006	4,320.4	4,636.4	107.3%
2005	4,165.4	4,507.8	108.2%
2004	4,079.9	4,387.9	107.5%
2003	3,894.3	4,024.8	103.4%
2002	3,686.2	3,659.6	99.3%
2001	3,427.5	3,419.2	99.8%

7.18 For the past six years, the market value of the investments held in the Sinking Fund has exceeded the recorded book value. However, since the investments held by the Sinking Fund are not actively traded, but are for the most part held until they mature, the market value of the fund is not particularly important. The difference in market value and book value can be attributed to generally declining interest rates during this period. Over the past three years, only 3.5% of Sinking Fund investments have been sold on an annual basis. The sales were made to better match the sinking fund to the debt.

Sinking Fund earnings

7.19 The unaudited financial statements of the Province's Sinking Fund are contained in Volume 2 of the Province's Public Accounts. The Statement of Activity shows how the entire Sinking Fund changes from year to year, which can be summarized as:

	(\$ millions)							
	2008	2007	2006	2005	2004	2003	2002	2001
Balance Beginning of Year	4,268.7	4,320.4	4,165.4	4,079.9	3,894.3	3,686.2	3,427.5	3,220.6
Income Earned	227.7	226.1	225.1	222.5	219.1	235.5	218.8	213.3
Amortization	(10.0)	21.7	13.7	(3.6)	(12.8)	3.9	33.6	29.4
Installments Received	179.2	160.3	160.3	158.7	150.6	140.3	149.4	142.4
Redemptions Paid	(194.3)	(459.8)	(244.1)	(292.1)	(171.2)	(171.5)	(143.1)	(178.2)
Balance End of Year	4,471.3	4,268.7	4,320.4	4,165.4	4,079.9	3,894.3	3,686.2	3,427.5
Average Rate of Return	5.2%	5.3%	5.3%	5.4%	5.5%	6.2%	6.2%	6.4%

7.20 The annual rate of return on Sinking Fund assets is quite stable, but it has been slowly declining as interest rates have generally fallen during the period.

Sinking Fund installments

7.21 The Act requires the Province pay into the Sinking Fund an installment on or before the anniversary date of each issue of funded debt. The installment payment is required to be not less than one per cent of the then outstanding principal of each issue, and is to be paid in Canadian currency. The Act also stipulates how debt denoted in foreign currencies is to be converted into Canadian currency for the purposes of determining the installment payment.

7.22 Note 1 to the unaudited financial statements of the Sinking Fund says that “Sinking fund installments are paid into the General Sinking Fund on or before the anniversary date of each issue of funded debt, at the prescribed rate.” For most debt issues, the Province makes annual Sinking Fund installments of 1.5% per year for debt issued for provincial purposes, while NBEFC makes annual Sinking Fund installments of 1.0% per year.

Sinking Fund investments

7.23 The Act restricts the types of investments that the Sinking Fund can hold. The only allowable investments are direct obligations of certain governments, obligations guaranteed by certain governments or certain instruments issued by Canadian chartered banks.

7.24 The direct obligations of certain governments is limited to the Government of Canada, any Province of Canada, any municipality of New Brunswick or any national government, other than Canada, if

the Province of New Brunswick has issued securities in that national government's currency and those securities have not yet matured.

7.25 Guaranteed obligations of certain governments is limited to guarantees of the Government of Canada, any Province of Canada, any agency of the Province of New Brunswick, or any national government, other than Canada, if the Province of New Brunswick has issued securities in that national government's currency and those securities have not yet matured.

7.26 Allowable instruments of Canadian chartered banks include deposit receipts, deposit notes, certificates of deposit, acceptances and other similar instruments.

7.27 The notes to the unaudited financial statements of the Sinking Fund provide some details of the investments held by the Sinking Fund. These fall into three categories:

- bonds and debentures issued or guaranteed by Canada;
- bonds and debentures issued or guaranteed by New Brunswick; and,
- other - bonds and debentures issued or guaranteed by other provinces.

7.28 The following table provides this breakdown, using par value. The par values used in this table are significantly different from the year end book values because the year end book values include unamortized discounts or premiums.

(\$ millions)				
Year	New			Total
	Canada	Brunswick	Other	
2008	164.0	2,253.8	2,487.2	4,905.0
2007	198.0	1,891.8	2,664.0	4,753.8
2006	228.0	1,827.6	2,747.6	4,803.2
2005	282.0	1,634.3	2,770.1	4,686.4
2004	249.3	1,561.0	2,570.5	4,380.8
2003	214.2	1,393.9	2,596.7	4,204.8
2002	179.4	1,515.4	2,346.5	4,041.3
2001	205.7	1,570.9	2,023.4	3,800.0

7.29 The following table reports the percentage each investment type has been of the total portfolio based on par value.

(%)				
Year	Canada	New Brunswick	Other	Total
2008	3.0	45.0	52.0	100.0
2007	4.2	39.8	56.0	100.0
2006	4.7	38.0	57.3	100.0
2005	6.0	34.9	59.1	100.0
2004	5.7	35.6	58.7	100.0
2003	5.1	33.2	61.7	100.0
2002	4.4	37.5	58.1	100.0
2001	5.4	41.3	53.3	100.0

7.30 The Sinking Fund investments are carried on the Statement of Financial Position at net book value which is the par value of the investments less the unamortized balance of discounts and premiums and less the unamortized balance of foreign exchange gains or losses.

7.31 The unamortized amount of discounts and premiums changes each year. Each year a portion of the discount or premium is amortized or recognized as income (either positive or negative) so that at maturity, the net book value of the bond will equal the par value of the bond.

7.32 Par value is the amount stated on the bond. It is the amount that will be paid by the issuer of the bond to the holder of the bond on maturity. Because the amount that a purchaser is willing to pay to own a bond will change depending upon the rates of return available from alternative investments, bonds will usually sell for a discount or a premium. For example, if market interest rates are higher than the interest rate of a bond, the bond will sell below its par value at a discount. In this way the investor is able to acquire an investment that will provide a market rate of return even though its stated interest rate may differ from market interest rates.

7.33 For strategic reasons the Province of New Brunswick may borrow directly from the Sinking Fund. The reasons may be the particular term of the assets being financed, the size of the issue and market conditions. At 31 March 2008 there are two outstanding Province of New Brunswick debt issues that were sold directly to the Sinking Fund totaling \$220 million.

7.34 For similar reasons, the New Brunswick Municipal Finance Corporation (NBMFC), whose objective is to provide financing for municipalities and municipal enterprises through a central borrowing authority, will also borrow directly from the Sinking Fund. NBMFC bonds are guaranteed by the Province of New Brunswick. The NBMFC bonds also pay a higher interest rate, which enhances the Sinking Fund earnings. At 31 March 2008 the Sinking Fund owns a total of \$274.2 million of NBMFC privately issued serial bonds. Additionally, the Sinking Fund owns \$19.8 million of publicly issued NBMFC serial bonds.

Redemptions

7.35 The Act does not direct that funds have to be withdrawn from the Sinking Fund to redeem a funded debt issue on maturity. The current practice for provincial purpose debt that has an original life of at least twenty years is to redeem the full principal value of the debt from the Sinking Fund. Nothing is redeemed from the Sinking Fund if the term to maturity of the bond issue was less than twenty years. For debt issued for NBEFC, when the debt matures, NBEFC withdraws up to the amount that was accumulated in the Sinking Fund for that particular debt issue.

7.36 During the year ended 31 March 2008, the Province had Funded Debt issues of \$892.6 million mature. \$194.3 million was withdrawn from the Sinking Fund to be used to redeem these maturities; this represented 21.8% of the total principal amount paid.

Series	Interest Rate (%)	Sinking Fund Withdrawal (\$ millions)	% of Funded Debt Issue Redeemed By the Sinking Fund
CP-264	9.12	7.9	100
CP-265	11.07	13.9	100
CP-266	9.88	14.5	100
CP-267	9.83	6.0	100
CP-268	9.72	3.5	100
CP-269	10.42	2.7	100
CP-270	10.79	2.4	100
CP-271	11.07	6.6	100
CP-272	9.62	4.9	100
GA	4.78	130.3	16
GH	3.82	1.6	4
Total		194.3	21.8%

Funding status study

7.37 We have been told that the Department of Finance is in the process of conducting a funding status study of the Sinking Fund. We agree that such a study is necessary. It should address such issues as:

- explicitly stating the purpose of the Sinking Fund and specifically addressing the Sinking Fund's role as a purchaser of New Brunswick and NBMFC debt and providing additional investor confidence;
- the determination of the amount of investments to be held in the Sinking Fund;
- the mix of investments that should be held in the Fund; and
- the level of installments that should be made each year and the amortization period of the debt.

7.38 The last three items would all be determined in a way that is tied into the purpose of the Sinking Fund. Furthermore, once these issues have been addressed, the study should also include future cash flow projections using various assumptions, (debt levels, installment rates, etc) over the fiscal framework period and as far into the future as 10 years.