The Department of Finance's Response to the Retail Debt Program Review by Cap Gemini Ernst & Young

Overview

- In the mid-1990s, Canada faced an environment of rising debt and deficits and increasing uncertainty about its ability to continue to borrow money from domestic and international institutional investors, and the cost of this source of funds. To deal with these problems in a prudent and fiscally responsible manner, the Government:

  - increased the fixed-rate portion of its wholesale debt portfolio from one-half to two-thirds to reduce the frequency of refinancing debt and the risks caused by volatile interest rates; and
  - revitalized the Canada Savings Bonds Program to encourage Canadians to buy a share of the country's debt and broaden the investor base.

- Since 1997–98, Canada has undergone a remarkable fiscal turnaround, which has lessened its need to borrow money. At the same time, consumers now have a wider range of choices among investment options.

- As part of the regular treasury management review process, and particularly given these changes, the Government hired Cap Gemini Ernst & Young (CGEY) to review the Retail Debt Program and make recommendations on future directions.

- The report prepared by CGEY concluded the Canada Savings Bonds Program is losing relevance to the Government and Canadians and recommended that it be gradually phased out.

- The CGEY report is one element of the review of the Retail Debt Program. The Government is considering additional factors:

  - meeting the current borrowing needs of government;
  - the need for prudence in our debt management strategy; and
  - the strong views of Canadians in support of the program.

- Within the context of a continuing Canada Savings Bonds Program, efforts are focusing on ways to update the program to meet the evolving needs of the Government and Canadians. These changes will be announced in the months to come as part of the Government's ongoing expenditure review process.

- The new series of Canada Savings Bonds will go on sale as scheduled on October 4, 2004.

About the Department of Finance's Treasury Evaluation Program

Through its Treasury Evaluation Program, the Department of Finance regularly conducts external evaluations of policy and operational initiatives in the area of treasury management (debt, cash balances and international reserves). Since the evaluation program was launched 12 years ago, 20 evaluations have been conducted. Reports and departmental responses to recommendations made by evaluators are shared with the Auditor General of Canada and the Standing Committee on Public Accounts.

As part of the Treasury Evaluation Program, the Department of Finance hired CGEY in September 2003 to assess the Retail Debt Program and to provide advice on strategic options for the future. CGEY concluded that the Retail Debt Program faces challenges and is losing relevance to the Government and investors, owing to the decreased need for government borrowing and increased competition from new products from the financial services sector. CGEY identified four options for the future, ranging from relaunching an expanded effort to running the program down. Of the four options they reviewed, they recommended that the Government adopt the "run down" option.

Departmental Response to the CGEY Report

Background

The fundamental objective of the debt management strategy is to raise stable, low-cost funding to meet the Government's financing needs. The public debt program has two main components: wholesale debt and retail debt.

Wholesale debt is made up of Government of Canada bonds and Treasury bills, which are sold to large institutional investors such as large domestic and foreign banks, pension funds and mutual funds.

Retail debt is made up of Canada Savings Bond products, which are sold to individual Canadians through financial institutions, over the telephone, on the Internet and through payroll deductions.

Today, wholesale debt accounts for 95 per cent of the outstanding debt portfolio and retail debt accounts for the remaining 5 per cent. Currently, more than 3.5 million Canadians hold Canada Savings Bond products.

Historical Perspective

In the early 1990s, the Government faced an environment of large deficits, rising debt and growing concerns from the financial markets about the nation's dependency on domestic and foreign institutional investors. At the same time, the number of Canadians purchasing Canada

Savings Bond products was declining because of increased competition from a broader array of instruments available from the private sector and because there had been no changes to Canada Savings Bond products in some time.

By 1995 the debt situation was critical. The debt was high and rising, and interest rates had moved sharply higher. There was growing concern that if debt continued to increase institutional investors would require large premiums to lend to Canada or, worse still, would become unwilling to take on any more Canadian debt. In this context, the Government took action to stabilize debt costs and to ensure access to funds in order to reduce risks to the Government's borrowing program and to the fiscal situation. This was part of a larger strategy to put Canada's fiscal house in order.

Through 1994 and 1995, the target share of wholesale debt in fixed-rate or longer-term instruments was raised from one-half to two-thirds to reduce exposure to volatility in interest rates and to changes in investor sentiment.

At the same time, the decision was also taken to revitalize the Retail Debt Program to maintain a diversified investor base and ensure access to funds by providing greater opportunity for federal debt to be held directly by individual Canadians. A new agency, Canada Investment and Savings, was formally launched in 1996 with the mandate to design, market and support savings and investment products for individual Canadians.

Since the mid 1990s, Canada's debt situation has changed dramatically. The Government's success in managing the budget has led to seven consecutive budgetary surpluses and a $52-billion reduction in federal debt. Reduced borrowing requirements and increasing investor confidence have reduced borrowing costs in the wholesale market and lessened the need to sustain a broad investor base.

At the same time, Canada Savings Bonds faced even more competition from financial products offered by banks, credit unions and other financial institutions. Low interest rates and the strong North American equity markets of the late 1990s made other investment options more attractive to investors.

As part of our regular reviews of the various elements of treasury management, and particularly given the tremendous improvement in the fiscal situation and the broader array of investment opportunities for Canadians, a review of the Retail Debt Program was timely and appropriate.

Review of the Retail Debt Program

Such a review of the Retail Debt Program involves several elements. The CGEY report is one element. CGEY was commissioned to provide an independent assessment of the program and to provide advice on strategic options for the future.

(a) CGEY Analysis

CGEY concluded that the Retail Debt Program faces challenges and is losing relevance to the Government and investors, owing to the decreased need for government borrowing and increasing competition from the financial services sector. They assess that retail debt was an expensive source of funds and estimate the cost of the Retail Debt Program was about $1 billion from 1997 to 2003.

It is important to understand the nature of this estimate. The CGEY estimate is based on a comparison of the cost of Canada Savings Bond products with the cost of relatively short-term wholesale debt. Furthermore, this comparison is made after the fact, with the benefit of perfect hindsight.

To provide a simple analogy to the CGEY analysis, consider the decision of an individual choosing between a fixed-rate and a floating-rate mortgage. If the individual chooses the fixed-rate mortgage and interest rates subsequently decline, the floating-rate mortgage would, in hindsight, have been the lower-cost choice. However, the extra cost of the fixed-rate mortgage was the price for certainty about the cost of mortgage payments and protection that interest rates could have risen over the period.

In a similar vein, it is clear that in hindsight, Canada Savings Bond products with multi-year interest rate commitments set in a higher interest rate environment were more costly than shorter-term wholesale debt. This is because interest rates subsequently declined through the later part of the 1990s, reaching extraordinarily low levels by 2002.

Of course, in reality, governments and individuals must make decisions without knowledge of the future, and in 1995 there was a great deal of uncertainty about the future. In this environment, the Government's decision to take a more prudent approach to fiscal and debt management and to guard against negative surprises was the right one. The outcome has been a remarkable fiscal turnaround. Indeed, the improvement in the fiscal situation and the decline in wholesale borrowing costs was considerably faster than market participants and most people expected.

(b) Further Elements of the Review

Going forward, there are a number of elements to the review of the Retail Debt Program. The Department is conducting public opinion research to assess the attitudes of Canadians towards the program and potential changes to it. The research conducted thus far indicates that a majority of Canadians continue to be attached to the program as a convenient and secure savings vehicle. At the same time, the research also shows that a majority of bondholders and non-bondholders agree that the program should be adjusted to current circumstances.

The Department is also undertaking analysis of expected future costs and benefits of the program over the next 10 years under a number of different program designs. Even if wholesale markets are adequate to deal with the Government's funding needs in the current environment, the Retail Debt Program offers the Government an alternative and diversified source of funds. There is an insurance value in keeping this channel open. There are also benefits to providing Canadians with a secure investment vehicle that helps them save. These benefits must be weighed against the costs.

With the tremendous improvement in Canada's fiscal situation, the appropriate balance between low cost and stable or less risky funding is shifting. With renewed fiscal credibility, the Government can take greater advantage of financing options that are lower cost on average, though less stable through time.

For the wholesale debt program, in the 2003 budget the Government announced a reduction in the target share for fixed-rate or longer-term debt from two-thirds to 60 per cent to be achieved over five years. Once this new target is reached, savings in debt charges of up to $500 million per year are expected on average.

For the Retail Debt Program, the move from deficits to surpluses has already resulted in a change in the mandate to allow the size of the retail debt portfolio to decline, consistent with the decline in Canada's overall debt. Combined with an emphasis on finding cost efficiencies in the delivery of the Retail Debt Program, this has resulted in a 22-per-cent decline in operational costs from 2000 to 2004.

Going forward, the challenges facing the Retail Debt Program suggest a need to update the program and adjust it to better meet the current needs of the Government. With lower financing and fiscal risks, there is less need for insurance. Nonetheless, prudence remains an important principle. Canadians have also indicated they continue to support the concept of a retail debt product that provides them with a secure savings vehicle and the opportunity to hold a direct stake in the debt of Canada. Within the context of a continuing Canada Savings Bonds Program, the focus of the Department is on ways to design and deliver a program that meets the evolving needs of both the government and Canadians.

Once the program review is complete, further information on the outcome will be made available to the Expenditure Review Committee, the House of Commons Standing Committee on Finance and the public.