## Updating Quebec Financial Requirements – How will the Province pay back $10 billion of debt?

With an updated financial framework in the Pre-Election Report on Quebec's Public Finances and a promise by the new Government of the Coalition Avenir Québec (CAQ) to use $10B of the Generation Funds (the Fund) to pay back the debt before the end of this fiscal year, we re-estimated the near and medium term borrowing requirements of the Province. We find that Quebec's financing program could be significantly smaller than the 2018 budget estimates. Our revised requirement estimates are $6.7B lower for 2018-19 (from $13.4B to $6.7B) and $5.6B lower for 2019-20 (from $18.6B to $13B). However, 2020-21 financing requirements could be higher than previously budgeted to the tune of $747M (from $18.1B to $18.8B). Below, we also discuss how selling assets of the Generation Funds to meet year-end deadline could potentially be challenging.

In its platform, the CAQ committed to use $10B of the Generations Funds, which book value is expected to reach $13.3B by the end of FY 2018-19, to pay back Quebec's public debt. The first thing worth highlighting is that the intention of the new Government is merely a shift in the timing of the drawdown. Indeed, the previous Government had already planned for a $10B debt reduction over the next five years, starting with $2B in FY 2018-19. Therefore, excluding interests on the debt, the debt reduction over a five year horizon is the same and is unlikely to create major market disruptions or alter Quebec's ratings profile.

The *net* financial benefit of this policy will depend on how the foregone realised returns on the reduced investment in the Fund over the next five years will compare with the interest savings of lower borrowing requirements by the Quebec government. Since inception, the return on the investments of the Fund has been higher than the marginal average cost of borrowings by the Quebec government. However now that benchmark interest rates are rising and the business cycle is ageing, these excess returns might not materialize again; at least in the near future. Moreover, any leverage strategy which may bring potential financial benefits carries a cost as taxpayers are supporting the risk of such strategy. The risk premium associated to the investment in the funds are not merely excess returns, they represent the cost of the risk taken by the Fund and ultimately the taxpayers.

## Retiring Existing Maturities

The timetable established by the Government-Elect would give the Ministry of Finance about five months before March 31st 2019 to implement its debt reduction plan. As of October 1st, the Government of Quebec and its subsidiaries had around $193B of market debt outstanding. However, it is unlikely that the Government would elect to buy back issues currently trading in the secondary markets. Signalling its intent to do so could lead to an increase in the price of such securities and thus would cost the government more to buy back its debt than it would otherwise. Implementing the simpler strategy of not refinancing debt reaching maturity is more optimal in our view. Assuming that the Ministry of Finance is not altering its domestic Treasury Bill and U.S. commercial paper programs, its debt retirement options by the end of FY 2018-19 are somewhat limited. Some options are presented in Table 1 below:

| Table 1: Possible Redemptions | | | |
|---|---|---|---|
| **Description** | **Outstanding ($)** | **ISIN** | **Type / Coupon** |
| **QUE 4.5 01/12/18** | 4,500,000,000 | CA74814ZDU45 | Domestic / Fixed |
| **QUE 3.875 11/12/18** | 259,363,032 | CH0049484618 | CHF MTN / Fixed |
| **QUE 2.174 19/12/18** | 2,994,000,000 | CA74814ZET62 | Domestic / Float |
| **Subtotal 2018-19** | **7,753,363,032** | | |
| **QUE 5 29/4/19** | 2,214,925,380 | XS0425413209 | Euro MTN / Fixed |
| **Subtotal 2019-20** | **2,214,925,380** | | |
| **Total** | **9,968,288,412** | | |

By selling assets of the Fund to retire two domestically issued securities and a Swiss Medium-Term Note (MTN), the Government could manage to reduce its debt by $7.8B before the end of the fiscal year (see Table 1). The Government could reimburse another $2.2B by not refinancing a Euro MTN maturing in late April 2019 for a rounded total of $10B.

### Lower Financial Requirements

Because $2B of debt reduction was already included in the 2018 budget, we estimate the resulting reduction in the borrowing program to be $5.8B ($7.8B minus $2.0B) in 2018-19 and $215M ($2.2 minus $2.0B) in 2019-20. Paying down that debt will also eliminate the interest payments on those securities, with minimum savings of $303M in 2019-20 and 2020-21. Finally, we also include in the calculation a $950M upward revision to the expected surplus for each year as disclosed in the Pre-Electoral Report. This should reduce the General Fund financial requirements by an equivalent amount. However, based on our calculations, because Quebec has already completed 81% ($10.9B out of $13.4B) of its 2018 budget borrowing program, the reduction in financial requirements this year would result in pre-financing of $4.1B in FY 2018-19. This would not be out of line with the average annual pre-financing of $6.6B observed over the past decade. All in all, keeping everything else constant, the aforementioned changes would reduce financial requirements by $6.7B (from $13.4B to $6.7B) in FY 2018-19 and by $5.6B (from $18.6B to $13B) in FY 2019-20(see Table 2); in FY 2020-21, however, financing requirements would increase by $747M (from $18.1B, to $18.8B) .

With interest rates poised to rise, pre-financing is not a bad option from a public finance standpoint. The actual savings from lower interest on debt are also a net positive for Québec's fiscal stance especially if the returns on the assets of the Funds are forecast to underperform.

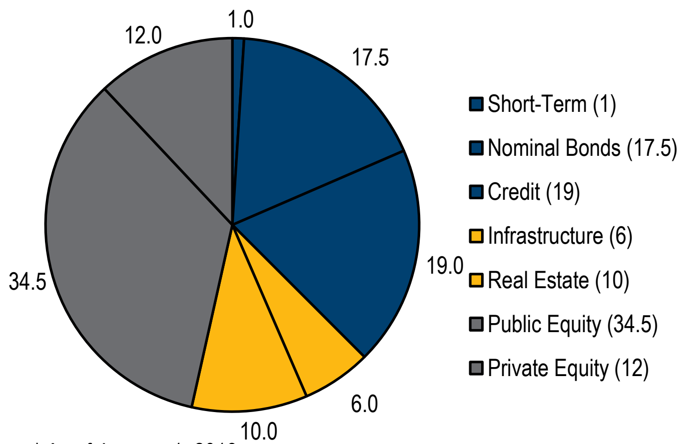
| **Table 2: Québec Financing Program Budget 2018** | **2018-19** | **2019-20** | **2020-21** |
|---|---|---|---|
| General Fund | | | |
| Net financial requirements | 5,012 | 2,556 | 3,628 |
| Repayment of borrowings | 8,252 | 8,215 | 7,674 |
| Use of the Generations Fund to repay maturing borrowings | -2,000 | -2,000 | -2,000 |
| Change in cash織posititon | -9,342 | | |
| **General Fund** | 1,922 | 8,771 | 9,302 |
| **Financing Fund** | 10,100 | 7,500 | 7,400 |
| **Financement-Québec** | 1,400 | 2,300 | 1,400 |
| Total | 13,422 | 18,571 | 18,102 |
| **Modified (LBS)** | **2018-19** | **2019-20** | **2020-21** |
| General Fund | | | |
| Net financial requirements | 5,012 | 2,556 | 3,628 |
| August Surplus | -950 | -950 | -950 |
| Interest on Debt | | -303 | -303 |
| Repayment of borrowings | 8,252 | 8,215 | 7,674 |
| Use of the Generations Fund to repay maturing borrowings | -7,753 | -2,215 | 0 |
| Change in cash posititon | -9,342 | -4,131 | |
| **General Fund** | -4,781 | 3,172 | 10,049 |
| **Financing Fund** | 10,100 | 7,500 | 7,400 |
| **Financement-Québec** | 1,400 | 2,300 | 1,400 |
| Total | 6,719 | 12,972 | 18,849 |
| ***Completed YTD*** | *10,850* | | |
| ***Pre-financing 2019-20*** | *-4,131* | | |
| ***Difference*** | *-6,703* | *-5,599* | *747* |

Sources: Gouvernement du Québec and LBS Economic Research and Strategy.

## Selling the assets of the Generation Funds

Finally, let us discuss the opposite side of the operation, which consists of directing la Caisse de Dépôt et Placement du Québec (CDPQ) to sell $10B of assets held in the Generation Funds. Section G.55 of Budget 2018 reveals that 38% of the Fund is comprised of fixed income instruments (nominal bonds, credit and short-term instruments), 16% is real assets (infrastructure and real estate) and the remaining 47% consists of public and private equities (see Chart 1). How the selling of assets will be implemented matters. Indeed, it could be challenging to liquidate 75% of the Fund within 6 months if the Government wants to keep intact its asset allocation and risk profile. For one, a significant portion of the Fund's assets are generally characterised as illiquid (i.e. harder to sell on short notice). For example, while public equities could be sold relatively easily, investments in real estate projects, private equity and infrastructure could be harder to unwind before March 31st 2019. It is unclear if there are $10B of liquid assets in the Funds. And if so, only selling liquid assets would significantly alter the asset allocation of the Fund which could end up, as a result, being riskier and much less liquid. In the situation where both all liquid public equity and safer fixed income products have to be sold to meet the end of year deadline, the Fund would only hold private equity, real estate and infrastructure assets. Finally, while 5% of CDPQ net assets are invested Government of Quebec Bonds[1], as far as we were able to verify, it is unclear if the Generation Funds currently holds any. If it does, selling Government of Quebec bonds to buy back Government of Quebec Bonds would not achieve the objectives pursued by the Government of reducing the risk of the Fund.

Chart 1: Asset Mix of the Generation Funds (%)




* As of January 1, 2018.
Source: Gouvernement du Québec.

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[1] CDPQ 2017 Annual Report.