Department of Finance Canada
Ministère des Finances Canada

Report on the Management of Canada's Official International Reserves

April 1, 2009 – March 31, 2010

Canada

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Purpose of the Report

This edition of the *Report on the Management of Canada's Official International Reserves* provides details on official international reserves operations from April 1, 2009 to March 31, 2010.

As required under the *Currency Act*, the report provides a comprehensive account of the framework within which the Exchange Fund Account (EFA) is managed, its composition and changes during the year and strategic policy initiatives, as well as a statement of whether the strategic objectives established for the EFA have been met.

The accompanying financial statements, audited by the Auditor General of Canada, present the position of the EFA asset portfolio as at the end of the 2009–10 fiscal year.

Unless otherwise noted, in this report the official international reserves are reported in US dollars on a market-value basis. The financial statements that appear at the end of this report are in Canadian dollars, as reported in the *Public Accounts of Canada*.

Exchange Fund Account

The EFA, which is held in the name of the Minister of Finance, represents the largest component of Canada's official international reserves. It is an actively managed portfolio that is primarily made up of liquid foreign currency securities, special drawing rights (SDRs), and a small holding of gold. SDRs are international reserve assets created by the International Monetary Fund (IMF) whose value is based on a basket of international currencies. The official international reserves also include Canada's reserve position at the IMF. This position, which represents Canada's investment in the activities of the IMF, fluctuates according to drawdowns by and repayments from the IMF.

The legislative objective of the EFA, as specified in the *Currency Act*, is to aid in the control and protection of the external value of the Canadian dollar. Assets held in the EFA are managed to provide foreign currency liquidity to the Government and to promote orderly conditions for the Canadian dollar in the foreign exchange markets, if required. Under the *Currency Act*, the Minister of Finance has the authority to acquire, borrow, sell or lend assets held in the EFA in accordance with the *Statement of Investment Policy* (see Annex 1).

The Department of Finance and Bank of Canada jointly develop and implement the investment policy and funding program. As fiscal agent of the Government, the Bank of Canada executes investment and funding transactions and manages EFA cash flows.

A detailed description of the EFA's management framework is provided in Annex 2. The framework includes the objectives, principles and governance structure of the EFA. Annex 2 also describes the policies that pertain to investments, risk management, performance measurement and foreign currency funding activities.

Highlights

Change in the level of the official international reserves: The market value of the official international reserves increased to US$56.7 billion as at March 31, 2010 from $43.5 billion as at March 31, 2009. The change comprised a $12.3-billion increase in EFA assets and an $872-million increase in the reserve position in the IMF. The majority of the increase in EFA assets was attributable to the allocation of SDRs to Canada as part of the IMF's program to supplement SDR positions of member countries in 2009. Canada's allocation was SDR 5 billion, equivalent to $8 billion.

Table 1

The EFA and Official International Reserves

	March 31, 2010	March 31, 2009	Change
	(market value in millions of dollars)		
Securities	44,716	40,176	4,540
Deposits	484	734	-250
Total securities and deposits (liquid reserves)	45,200	40,910	4,290
Gold	122	100	22
SDRs	8,925	964	7,961
Total EFA	54,247	41,974	12,273
IMF reserve position	2,422	1,550	872
Total official international reserves	56,669	43,524	13,145

The financial market environment: Although global economic growth resumed, financial market conditions continued to be unsettled in 2009–10. Credit markets were characterized by disruptions and rating downgrades of a number of issuers, while interest rate swap markets exhibited periods of volatility. Fiscal deficits for many sovereigns widened due to economic stimulus measures and support for their financial institutions.

During this period, the EFA's exposure to financial institutions remained limited, while its exposure to sovereigns and their agencies was prudently managed within the limits of the *Statement of Investment Policy* approved by the Minister of Finance.

EFA funding sources: The foreign currency reserve assets held in the EFA and the foreign currency liabilities financing these assets are managed on a portfolio basis, and are matched as closely as possible in currency and duration, in order to limit the EFA's net exposure to currency and interest rate risk. In 2009–10, cross-currency swaps of domestic obligations and foreign currency bond issues were the primary sources of foreign currency funding.

Cross-currency swaps totalling $6.2 billion, involving the exchange of Canadian-dollar liabilities for US dollars or euros, were transacted at an average cost of 3-month US$ LIBOR (London Interbank Offered Rate) less 17.5 basis points. For a short period of time during the fiscal year, the Canadian interest rate swap market showed signs of dislocated pricing as swap spreads (the spread between the fixed swap rate and comparable maturity Government of Canada yields) were temporarily negative.

After a 10-year absence, Canada returned to the global bond market in 2009–10 with two highly successful, oversubscribed offerings. The global bonds were issued to diversify Canada's sources of foreign currency funding by reducing its reliance on cross-currency swaps, and to take advantage of Canada's strong credit position in international bond markets. In September 2009, a $3-billion 5-year US-dollar-denominated bond was issued at mid-swaps less 15 basis points, and in January 2010, a €2-billion 10-year euro-denominated bond was issued at mid-swaps plus 2 basis points. The level of outstanding short-term commercial paper issued under the Canada bills (US-dollar commercial paper) program decreased to $2.4 billion from $6 billion during the fiscal year. The average cost of funding for Canada bills was US$ LIBOR less 37 basis points.

Portfolio return: In 2009–10, the EFA earned an average positive spread of 42 basis points, up from 31 basis points the previous year. This spread represents the difference between the yield to maturity on foreign currency fixed-income assets and foreign currency fixed-income liabilities used to fund the assets. The spread measures the underlying net return of the portfolio on the assumption that all the assets are held to maturity.

Taking into account changes in the market value of assets and liabilities due to interest rate changes, credit spreads and coupon flows, the EFA reported a total net return of 58 basis points, equivalent to an unrealized mark-to-market gain of $122 million. This compares to a mark-to-market return of 117 basis points (or a gain of $446 million) the previous year. This calculation represents the hypothetical net profit or loss on the portfolio if all assets were liquidated at market rates prevailing at the end of the fiscal year and the proceeds were used to pay down the liabilities at their assumed market rates at that time.

Taking into account only realized gains and losses on actual securities transactions, the EFA portfolio earned 84 basis points (or a gain of $306 million), up from -1 basis point (or a loss of $1 million) the previous year.

Report on Operations in 2009–10

The following sections review market developments, new initiatives, portfolio performance and risk measures in 2009–10. The financial statements that appear at the end of this report are reported in Canadian dollars.

Market Developments

Although the financial situation began to normalize over the course of the fiscal year, governments continued to provide a significant amount of fiscal stimulus and support for the financial sector and implemented a number of financial regulatory initiatives amid continued economic uncertainty. In the second half of the year, liquidity conditions for the sovereign debt of certain Eurozone issuers continued to deteriorate. This resulted in rating downgrades for a number of issuers, which raised concerns about sovereign risk, particularly in the peripheral European jurisdictions.

Interest Rates

US-dollar-denominated holdings in the EFA are mainly composed of short- and long-term fixed-income securities issued by the US government, its agencies, and supranational institutions. During 2009–10, short-term interest rates in the United States remained broadly unchanged as the US Federal Reserve kept policy rates close to zero, while bond rates moved higher as economic activity strengthened and financial market conditions improved. Over the year, the yield on US 3-month Treasury bills fell by 5 basis points while the yield on 5-year Treasury bonds increased by 90 basis points. Euro-denominated holdings in the EFA are mainly composed of bonds. The yield on German government 5-year securities declined by 8 basis points while the yield on 10-year securities increased by 10 basis points. Overall, changes in foreign interest rates over 2009–10 resulted in an increase of $264 million in the market value of the reserves.

Credit Spreads

The vast majority of EFA holdings are fixed-income securities issued by high credit quality sovereigns, government agencies, and supranational institutions. Credit spreads on fixed-income securities generally narrowed in the first half of 2009–10 compared to the previous fiscal year, although spreads widened for a number of Eurozone issuers in the later part of the year. As a result, the EFA's exposure to possible credit events increased somewhat in 2009–10. Despite the challenging environment, which included multiple downgrades, the EFA did not need to undergo large changes in asset allocation as it is a conservatively managed portfolio. Throughout the year, EFA credit exposure was managed within acceptable limits.

Exchange Rates

The euro generally appreciated against the US dollar during the first eight months of 2009–10, then depreciated for the remainder of the fiscal year. From March 31, 2009 to March 31, 2010, the euro appreciated by 2 per cent against the US dollar. As roughly 45 per cent of the official international reserves were held in euro-denominated securities (as at March 31, 2010), these changes in the value of the euro against the US dollar imparted some volatility to the reported monthly market value of the reserves.

Changes in the yen/US-dollar exchange rate had little impact on the market value of the official international reserves as only 0.7 per cent of the reserves were held in yen-denominated assets as at March 31, 2010. Changes in the value of the yen also have a small impact on reserves through their impact on the value of the SDR. Overall, the yen appreciated by 5 per cent against the US dollar during the reporting period.

Overall, exchange rate changes versus the US dollar resulted in a modest decrease of $86 million in the market value of the reserves. Given the foreign asset-liability matching framework, the exchange rate translation of the value of reserves from US dollars to Canadian dollars, for reporting purposes in the *Public Accounts of Canada*, had a relatively minor impact on the Government's financial position.

Initiatives in 2009–10

Investment Policy

During 2009–10, foreign government finances continued to weaken as fiscal stimulus and financial sector support packages significantly raised debt levels. This put downward pressure on sovereign credit ratings and increased the credit risk for a number of sovereign counterparties of the EFA. Liquidity conditions for the sovereign debt of certain Eurozone issuers also deteriorated. Towards the end of the 2009–10 fiscal year, global economic growth showed signs of a recovery, although stresses remained in the Eurozone with the onset of the Greek debt crisis.

EFA portfolio managers continued to prudently manage investments within the limits of the *Statement of Investment Policy*. Short-term investments in commercial paper and certificates of deposits issued by private sector entities were managed at low levels. As well, the use of the EFA's securities lending and tri-party repo programs were limited as demand for short-term EFA assets was greatly reduced due to very low interest rates.

Direct Foreign Currency Issuances

During 2009–10, the Government of Canada issued two global bonds, the first direct foreign obligations in more than a decade. These direct foreign obligations were used to diversify foreign currency funding by reducing reliance on cross-currency swaps. Future direct issuance will depend on market circumstances and EFA funding needs.

US-dollar bond: The first issue (September 2009) was a 5-year $3-billion 2.375-per-cent US-dollar issue. The transaction met very strong demand and was oversubscribed, with orders totalling more than US$15 billion from close to 300 investors from around the world. Pricing for the issue was the tightest to US Treasuries achieved by a sovereign since 2005 and was the first sub-LIBOR issue since the dislocation in markets in October 2008. The re-offer spread on the bonds was equivalent to the rate on 5-year US Treasury bonds plus 23.5 basis points (or LIBOR less 15 basis points).

Euro-denominated bond: The second issue (January 2010) was a 10-year 2-billion 3.5-per-cent euro issue. The transaction also met very strong demand and was several times oversubscribed, with orders totalling close to €11 billion from more than 200 investors from around the world. At the time of issuance, the pricing level, which was equivalent to 19 basis points over German government bonds, or EURIBOR (Euro Interbank Offered Rate) plus 2 basis points, was the tightest syndicate spread since the onset of the financial crisis. Canada was able to price the bond at tighter spreads than similar maturity securities issued by France, the Netherlands and Finland.

Medium-term note programs: The Government is updating the legal documentation for its US and European medium-term note programs. These programs could supplement large global bond issues as a potential source of funding for Canada's foreign exchange reserves. Under the programs, notes can be offered in various amounts in US dollars, euros and other currencies. Notes can be issued for terms of nine months or longer and can have fixed or floating rates of interest. The updated programs are expected to be in place later in the 2010–11 fiscal year.

EFA Asset-Liability Framework

Despite the low and stable interest rate environment during 2009–10, the value of EFA assets, measured in US dollars, varied with the rise and subsequent decline in the value of the euro against the US dollar. In order to maintain the value of reserve assets at planned levels, foreign currency funding levels were adjusted throughout the year. The EFA's asset-liability matching principle was maintained, as the market value of liabilities funding the EFA remained well matched against the market value of EFA assets.

The volatility in the gap between asset and liability market values was lower in 2009–10 than in 2008–09, in part due to the diversification of EFA funding sources. Prior to September 2009, all of the long-term liabilities used to fund EFA assets were in the form of cross-currency swaps. The market value of liabilities, and thus the asset-liability gap, was directly affected by movements in domestic swap spreads, which have exhibited higher volatility over the past two years than previously.

The issuance of foreign currency bonds in September 2009 and January 2010 improved asset-liability matching, as the changes in the value of Canada's fixed-rate global bonds generally move in the same direction as changes in the value of the EFA's fixed-income assets (i.e., changes in asset and liability values are more highly correlated). In addition, in contrast to cross-currency swaps, the issuance of global bonds does not result in counterparty credit risk.

Cross-Currency Swap Funding

Cross-currency swaps allow the Government of Canada to cost-effectively transform domestic liabilities into foreign currency liabilities. Since the first swap for reserves was transacted in 1996, the Government has mainly transacted fixed-to-fixed-rate and fixed-to-floating-rate swaps.

During the fiscal year, Canada experienced negative swap spreads for a short period, during which the Government issued floating Canadian dollar to fixed foreign currency (floating-to-fixed) swaps to fund the EFA. Negative swap spreads across the yield curve are generally deemed to be an anomaly. This anomaly may have been caused by illiquid conditions in the swap market and other temporary factors.

Conducting floating-to-fixed cross currency swaps to fund the EFA allowed the Government to continue to fund reserves cost-effectively without adding to flows that contributed to negative swap spreads in Canada. In addition, the use of long-term swaps rather than short-term funding through Canada bills permitted the EFA's liabilities to be more effectively spread out over time. The Government reverted to regular fixed-to-fixed foreign currency swaps to fund the EFA when Canadian swap spreads returned to more normal and positive levels.

IMF Support and Hedging Foreign Exchange Risk in IMF Loans

As part of the efforts of G-20 countries to combat the financial crisis, Canada committed to provide further support to the IMF and other international financial institutions to help countries in urgent need of assistance. The Government of Canada and the IMF signed a bilateral borrowing agreement providing up to US$10 billion of additional temporary resources for member countries requiring balance of payment assistance during the crisis.

Upon request from the IMF, the Government of Canada raises foreign currency, typically US dollars, and lends these funds to the IMF. The loans to the IMF, however, are denominated in SDRs, which are indexed to the euro, pound sterling, yen and US dollar. Therefore, in lending to the IMF, Canada is exposed to foreign exchange rate risk since the repayment of the loan (denominated in SDRs) could differ from the costs incurred by Canada to raise the money for the IMF (in US dollars). In early 2010–11, Canada implemented a hedging program to mitigate this foreign exchange risk.

Performance Versus Strategic Objectives

The *Currency Act* stipulates that this report provide a statement of whether the strategic objectives established for the EFA have been met during the review period. These objectives—to maintain a high standard of liquidity, preserve capital value and optimize return—were achieved. The planned level of liquidity was maintained for the reserves portfolio throughout the reporting period, and the portfolio's exposure to market and credit risks was managed within acceptable limits. In addition, the underlying coupon return measure was positive (see Annex 5).

Liquidity and Preservation of Capital

In practice, the EFA's liquid reserves (which exclude gold and SDR holdings) are mainly invested in the debt of sovereigns and their explicitly supported borrowing entities (over 84 per cent as at March 31, 2010), as these securities enhance both liquidity and capital preservation (Table 2). The Liquidity Tier mainly consists of US Treasury securities, reflecting their high market liquidity. A more detailed description of the composition, term structure and changes in the level of the Official International Reserves is provided in Annexes 3 and 4.

Table 2

Composition of EFA Liquid Reserves

	March 31, 2010	March 31, 2009	Change
	(market value in millions of dollars, settled basis)		
Sovereigns and agencies	37,822	33,728	4,094
Supranationals	6,365	5,898	467
Private sector investments	529	555	-26
Cash	484	734	-250

Note: Liquid reserves exclude gold and SDR holdings.

The ongoing practice has been to hold a significant portion of the reserves in US dollars because foreign currency needs are mostly in US dollars and, historically, foreign exchange market intervention has mainly consisted of transactions involving the US dollar. The past year has seen a small appreciation of the euro and the yen against the US dollar, resulting in a modest decrease in the share of US-dollar holdings. As well, maturities were refinanced primarily in US dollars. As at March 31, 2010, the US-dollar share of EFA liquid investments was US$24.8 billion or 54.9 per cent, the euro share was equivalent to US$20.1 billion or 44.5 per cent, and the yen portion was equivalent to US$306 million or 0.7 per cent (Table 3). By comparison, the US-dollar share was 55.9 per cent, the euro share was 43.9 per cent, and the yen share was 0.2 per cent as at March 31, 2009.

Table 3

Currency Composition of EFA Liquid Reserves

	March 31, 2010	March 31, 2009	Change
	(market value in millions of dollars, settled basis)		
US dollars	24,800	22,871	1,929
Euro	20,095	17,956	2,139
Yen	306	84	222

Note: Liquid reserves exclude gold and SDR holdings.

To help achieve the objective of preserving capital value, an entity must have a credit rating of at least A-/ A3 to be eligible for investment in the EFA, as specified in the *Statement of Investment Policy*. Counterparty limits are established based on a framework that incorporates external ratings from credit rating agencies, and compliance with counterparty limits is monitored on a real-time basis. The majority of EFA investments are in the AAA category, as indicated in Table 4.

Table 4

Credit Composition of EFA Liquid Reserves

	March 31, 2010	March 31, 2009	Change
	(market value in millions of dollars, settled basis)		
AAA	40,232	37,551	2,681
AA+	1,274	866	408
AA	2,396	225	2,171
AA-	1,298	2,269	-971

Note: Liquid reserves exclude gold and SDR holdings.

Portfolio Returns

The EFA is a financial asset portfolio within *Canada's Public Accounts*. For risk management purposes and to provide transparency on the economic return or cost to the Government of maintaining the EFA, several performance indicators are measured and tracked on a regular basis and reported to management at the Department of Finance and the Bank of Canada. A brief overview of the portfolio's performance is provided below (a more detailed description is provided in Annex 5).

Overview

The assets held in the EFA generated lower revenues in 2009–10 than in 2008–09 as coupons received on both US-dollar and euro-denominated fixed-income securities were lower. The spread between the yield to maturity on fixed-income reserve assets and the foreign fixed-income liabilities used to fund the assets continued to remain positive in 2009–10. The spread measures the underlying return of the portfolio if the assets are held to maturity. Over the year, the portfolio generated a positive spread or coupon return of 42 basis points, up from 31 basis points the previous fiscal year.

The cost of advances to the EFA, which represents the estimated economic cost to the Government of maintaining the EFA, was lower than net revenue earned in 2009–10.

Table 5

Summary of Main Performance Indicators for the Official International Reserves

	April 1, 2009 to March 31, 2010	April 1, 2008 to March 31, 2009
1) Net revenue of the Exchange Fund Account (C$ millions)	1,456	1,853
2) Net return on assets measures		
Coupon return (basis points)	42	31
Carry (basis points)	-2	-30
Carry including net realized gains or losses (basis points)	84	-1
Total return (basis points)	58	117
3) Cost of advances to the EFA (C$ millions)	1,357	1,630
	As at March 31, 2010	**As at March 31, 2009**
4) Risk measures		
Market risk (99% 10-day VaR, US$ millions)	11	11
Credit risk (99% 365-day VaR, US$ millions)	1,319	1,245

There are two carry performance measures used for the portfolio: carry including only interest receipts and payments; and carry including interest receipts and payments as well as net realized gains and losses from the sale or purchase of assets. When net realized gains and losses were included in the carry measure, the carry improved from -2 basis points to +84 basis points. Taking into account the change in the market value of assets and liabilities, the net value of the portfolio increased by 58 basis points. This compares to a gain of 117 basis points in the market value of the portfolio in 2008–09 as Canada's foreign liabilities depreciated more slowly than the value of the assets held in the EFA.

The Value at Risk (VaR) measure of potential losses to the EFA portfolio arising from movements in interest and exchange rates increased somewhat during the financial crisis but continued to remain very low as a result of the asset-liability matching of the foreign reserves. The VaR measure of potential losses due to credit exposure to issuers (Credit VaR) increased slightly as a result of wider credit spreads associated with the market turmoil.

EFA Financing

EFA assets are funded by dedicated foreign currency borrowings from a variety of sources (Table 6). Funding requirements are primarily met through an ongoing program of cross-currency swaps of domestic obligations. Total cross-currency swap funding and maturities during the reporting period were $8.1 billion and $3.2 billion respectively. While swaps have generally been cost-effective in recent years compared to other sources of foreign funds, swap markets have exhibited periods of volatility. During 2009–10, foreign currency was raised through cross-currency swaps at 3-month LIBOR less 17.5 basis points on average. This funding cost was less favourable than rates obtained during the previous fiscal year, which averaged 3-month LIBOR less 58 basis points.

As at March 31, 2010, Government of Canada cross-currency swaps outstanding stood at US$34.8 billion (C$37.5 billion). Swaps of US dollars, euro and yen made up 56 per cent, 43 per cent and 1 per cent of the swap portfolio respectively.

The EFA can also be funded through a short-term US-dollar paper program (Canada bills), medium-term note issuance in various markets (Canada notes and medium-term notes), and international bond issues (global bonds), the use of which depends on funding needs and market conditions. From April 1, 2009 to March 31, 2010, the level of outstanding Canada bills decreased by US$3.6 billion. Canada bills were issued, on average, at an all-in cost of LIBOR less 37 basis points, which was higher than funding levels of prior years. Direct issuance through global bonds increased by $5.7 billion.

The changes shown in Table 6 reflect not only issuance and maturities, but also changes in the exchange rates of the euro and yen versus the US dollar (as the foreign currency issues are reported in US dollars).

Table 6

Outstanding Foreign Currency Issues

	March 31, 2010	March 31, 2009	Change
	(par value in millions of dollars)		
Swapped domestic issues	34,817	31,450	3,367
Global bonds	5,701	0	5,701
Canada bills	2,415	6,046	-3,631
Medium-term notes	0	1,328	-1,328
Canada notes	0	0	0
Total	42,933	38,824	4,109

Note: Liabilities are stated at the exchange rates prevailing on March 31, 2010.

Further information on the management of foreign currency liabilities and the associated credit risks can be found in the *Debt Management Report* at www.fin.gc.ca/dtman/2008-2009/dmr09-eng.asp.

Annex 1: Statement of Investment Policy

1. Purpose of Policy

The *Statement of Investment Policy for the Government of Canada* sets out the policy, approved by the Minister of Finance under the *Currency Act*, governing the acquisition, management and divestiture of assets for the Exchange Fund Account (EFA).

2. Purpose of EFA

The purpose of the Exchange Fund Account (EFA) is to aid in the control and protection of the external value of the Canadian dollar. Assets held in the EFA are managed to provide foreign-currency liquidity to the Government and to promote orderly conditions for the Canadian dollar in the foreign exchange markets, if required.

3. Governance

Part II of the *Currency Act* governs the management of the EFA. As amended in 2005, the act requires the Minister of Finance to establish an investment policy for EFA assets. Responsibility for the implementation of approved policy and strategy is delegated to officials of the Department of Finance and the Bank of Canada.

The *Bank of Canada Act* provides statutory authority for the Bank of Canada to act as the Government's fiscal agent in the management of the Government of Canada's Exchange Fund Account.

The Funds Management Committee (FMC), which comprises senior management from the Department of Finance and the Bank of Canada, is responsible for the oversight of EFA investments. For policy development, the FMC is supported by a Risk Committee (RC) and an Asset-Liability Management Committee (ALMC). The RC is an advisory body to the FMC that reviews and provide opinions on the risk implications while the ALMC is responsible for strategic planning and performance evaluation. The Financial Risk Office (FRO) at the Bank of Canada provides support to the RC and the ALMC on risk issues. Officials from the Department of Finance and the Bank of Canada are responsible for the implementation of the strategic plan and day-to-day management of investment. Further information regarding oversight and governance is available within the *Treasury Management Governance Framework* document (available at http://www.fin.gc.ca/treas/Goveev/TMGF03_-eng.asp).

4. No Inconsistent Business or Activity

This policy prohibits any business or activity that is inconsistent with the investment objectives set forth below or in a manner that is contrary to the *Currency Act*.

5. Investment Objective

There are three investment objectives:

- **Maintain a high standard of liquidity:** Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.
- **Preserve capital value:** Minimize risk of loss of market value by holding a diversified portfolio of high quality assets (in terms of credit rating and type of issuer), managing liquid assets and liabilities on a matched basis[1] (in terms of currency and duration), and using appropriate practices to mitigate risks.
- **Optimize return:** Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

1 Liabilities, which fund EFA assets, are managed outside the EFA.

6. Investment Policy

6.1 Eligible Asset Classes

The EFA may hold the following classes of assets: 1) fixed income securities (including bonds, notes, bills and short-term discount notes/commercial paper) issued by sovereigns (including, central banks, and explicit agencies[2]) or fully-guaranteed by sovereigns, government-supported entities, sub-sovereign entities[3] and supranational institutions; 2) deposits with commercial banks, central banks and the Bank for International Settlements; 3) repurchase agreements; 4) commercial paper and certificates of deposit issued by private sector entities; 5) gold; and 6) IMF special drawing rights. Subject to section 6.9, bonds with embedded options (such as callable bonds) and holdings of securities issued by and deposits with Canadian-domiciled entities (or entities that derive a majority of their revenues from their Canadian operations) are not permitted. All other classes of assets not listed in this policy are prohibited.

6.2 Eligible Investment Ratings

Eligibility for investment in the EFA is based on external credit ratings. To be eligible for investment, an entity[4] must have a senior unsecured debt credit rating in the top seven categories from at least two of the four main rating agencies[5]: Moody's Investors Service, Standard & Poor's (S&P), Fitch Ratings and Dominion Bond Rating Service (DBRS). When credit ratings for an entity differ, the rating of the second highest rating agency will be used to assess eligibility[6], consistent with the Basel II approach.

The only allowable unrated investments are the following: a) securities issued by and deposits with central banks and the Bank for International Settlements and b) investments in special drawing rights created by the IMF.

Ratings agency	Minimum rating
Moody's Investors Service	A3 or better
Standard & Poor's	A- or better
Fitch Ratings	A- or better
Dominion Bond Rating Service	A (low) or better

Note: Rating references in this document use the ratings scale of S&P for illustrative purpose.

6.3 Credit Exposure Limits

Exposure limits are based on credit quality for classes of assets, aggregate and individual counterparties.

6.3.1 Fixed Income Securities

Exposure to fixed income securities issued by sovereigns (including central banks and explicit agencies), government-supported entities, sub-sovereigns, and supranationals are shown in the tables below.

2 An agency is deemed to be explicit, if and only if, the government support is guaranteed by law.
3 Sub-sovereigns are defined as levels of government within a sovereign territory, and hierarchically below the sovereign. For example, this could include, but not limited to, states, provinces or municipalities within a sovereign.
4 Under exceptional circumstances, the credit rating of an entity's issuance may be used, at the discretion of the ALMC.
5 EFA ratings of sovereigns are based on the lower of domestic and foreign currency ratings.
6 Stand-alone credit ratings for commercial banks by Moody's and S&P (Bank Financial Strength Rating (BFSR)) and by DBRS (Intrinsic Assessments) will be used in conjunction with official credit ratings from Fitch to provide the relative credit quality of entities. The use of stand-alone ratings is to remove the assumption of implicit government support embedded in the official ratings of Moody's and DBRS. However, in cases where two or more ratings are the same, for example, Moody's is AA, S&P is AA, DBRS is AA- and Fitch Ratings is AA-, the EFA rating would be AA (not AA-).

Limits on sovereigns in domestic and foreign currency (including central banks, and explicit agencies)

Issuer type	Aggregate limits (% of reserves target level)	Individual counterparty limits (% of reserves target level)
"AAA"	Unlimited	20 (Excluded from above would be direct domestic currency obligations of US, France, Germany and Netherlands)
"AA-" to "AA+"	25	10
"A+"	2	1.67
"A"	(to be included in	0.83
"A-"	the above 25% limit)	0.33

Limits on Government Supported Entities (senior unsecured obligations) and sub-sovereigns

Issuer type	Aggregate limits (% of reserves target level)	Individual counterparty limits (% of reserves target level)
"AAA"	25 (10% sub-sovereign limit)	3
"AA-" to "AA+"		1.5
"A+"	2	0.3
"A"	(to be included	0.2
"A-"	in the above 25% limit)	0.1

Limits on supranationals

Issuer type	Aggregate limits (% of reserves target level)	Individual counterparty limits (% of reserves target level)
"AAA"	25	10.0
"AA-" to "AA+"		5.0
"A+"	2	1.0
"A"	(to be included	0.5
"A-"	in the above 25% limit)	0.2
Bank for International Settlements	10	–

6.3.2 Deposits and Other Short-Term Securities

Individual actual exposure limits to private sector entities in the form of forwards, deposits, commercial paper and certificates of deposit, together with swaps used for funding purposes, are determined by credit rating, as shown in the following table. These limits are cumulative across all lines of EFA business and represent the mark-to-market value for swaps and forwards and the par-value exposure for deposits, commercial paper and certificates of deposit. Total exposure to private sector entities may not exceed 25 per cent of the reserves target level, including a maximum of 2 per cent of the reserves target level for private sector entities rated A+ to A-.

Exposure limits by credit rating of private sector counterparties/issuers[7]

Issuer type	Aggregate limits (% of reserves target level)	Individual counterparty limits (% of reserves target level)
"AAA"	25	1.00
"AA+"		0.67
"AA"		0.50
"AA-"		0.33
"A+"	2 (to be included in the 25% aggregate limit)	0.17
"A"		0.08
"A-"		0.03

6.4 Structure of EFA Holdings

Investments will be held in either a Liquidity Tier or an Investment Tier. Only highly liquid US-dollar-denominated securities are eligible for investment in the Liquidity Tier: 1) sovereign (including explicit agencies and central banks) and "AAA" rated supranational securities; 2) US government-supported entity securities; 3) "AAA" rated US and European government-supported entity discount notes and commercial paper; 4) callable Bank for International Settlement deposits and medium-term investments; 5) overnight commercial bank deposits; 6) commercial paper and certificates of deposit issued by private sector entities; and 7) overnight repurchase agreements. Investment in EFA eligible securities, excluding securities held under the Liquidity Tier, is classified as investment in the Investment Tier.

6.5 Eligible Currencies

The Exchange Fund Account may hold US dollars, euros, and Japanese yen and IMF special drawing rights. The minimum floor for US-dollar-denominated assets is US$12 billion on a market-value basis.

6.6 Terms of Investments

The maximum term to maturity of EFA assets is based on type of instrument, credit rating and currency of issuance, as shown in the following table.

Instrument	Maximum term to maturity
Marketable securities from issuers rated "AA-" or better	10.5 years
Investments from issuers rated from "A-" to "A+"	5 years
Commercial paper and certificates of deposit	1 year
Commercial bank deposits, repurchase agreements and all non-marketable instruments, such as deposits.	3 months

6.7 Permitted Activities

EFA officials may acquire or borrow assets to be held in the EFA and sell or lend those assets. Short sales are prohibited.

7 Exposure limits on deposits, commercial paper, and/or certificate of deposit will be determined at discretion of ALMC.

6.8 Use of Derivatives

EFA officials may use derivatives to mitigate risk and reduce costs. Derivatives shall not be used to establish speculative or leveraged positions.

6.9 Securities Lending and Repurchase Agreements

EFA officials may lend or borrow securities held in the EFA through a securities-lending program or repurchase agreements to enhance portfolio returns, provided it does not compromise liquidity or engender material exposure to loss. Officials are responsible for appointing and supervising agents, determining eligible collateral and setting collateral margins. Eligible collateral may include, but is not limited to, bonds with embedded options. Officials have the authority to either manage themselves or delegate to an agent the authority to select borrowers, negotiate terms to maturity and rates, and invest cash or securities collateral.

Individual exposure limits to private sector entities, in the form of repurchase ("repo") transactions, are determined by credit rating, as shown in the following table.

Exposure limits by credit rating of private sector entities for repurchase transactions (% of the reserves target level)

	EFA Credit Rating		
Individual Counterparty Limits	"AAA"	"AA-" to "AA+"	"A-" to "A+"
Versus US Treasury and US Agency collateral combined	2.50%	1.67%	1.00%

6.10 Exceptions

In exceptional circumstances such as a ratings downgrade or an event of default, the EFA may hold assets (acquired either through direct investment or by taking possession of collateral following an event of default) that do not otherwise meet the criteria for eligible asset classes and/or breach the credit exposure limits, provided that timely efforts are made to divest the EFA of those assets or otherwise bring any such exceptional holdings into compliance.

7. Performance Assessment and Risk Management

Officials are responsible for measuring, monitoring and reporting on the performance and risk exposures of the EFA and tracking these positions against appropriate indices. Performance and risk exposures will be reported on a timely and regular basis to the ALMC, the RC, the FMC, the Minister of Finance and Parliament. Measures should be consistent with leading practices in the private sector and provide information on the returns on EFA assets, the cost of associated liabilities and financial risks. Detailed information on the Government's risk management policies is provided in the *Government of Canada Treasury Risk Management Framework*.

8. Review

The *Statement of Investment Policy* will be reviewed annually and updated as required. Investment programs and practices should be subject to periodic external review to ensure that they contribute effectively to the achievement of EFA objectives.

Annex 2: Overview of the Exchange Fund Account Management Framework

Objective

- The legislative objective of the EFA, specified in Part II of the *Currency Act*, is to aid in the control and protection of the external value of the Canadian dollar. Assets held in the EFA are managed to provide foreign currency liquidity to the Government and to promote orderly conditions for the Canadian dollar in the foreign exchange markets, if required.

Strategic Objectives

- **Maintain a high standard of liquidity:** Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.
- **Preserve capital value:** Minimize risk of loss of market value by holding a diversified portfolio of high quality assets (in terms of credit rating and type of issuer), managing liquid assets and liabilities on a matched basis (in terms of currency and duration), and using appropriate practices to mitigate risks.
- **Optimize return:** Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

Overarching Funds Management Principles

- **Efficiency and effectiveness:** Policy development and operations should take into account, to the extent possible, leading practices of other comparable sovereigns. Regular evaluations should be conducted to ensure the efficiency and effectiveness of the governance framework and borrowing and investing programs.
- **Transparency and accountability:** Information on financial asset and liability management plans, activities and outcomes should be made publicly available in a timely manner. Borrowing costs, investment performance and material exposures to financial risk should be measured, monitored, controlled and regularly reported, as applicable.
- **Risk management:** Risk monitoring and oversight should be independent of financial asset and liability management operations.

Reserves Management Principles

- **Prudence:** The foreign reserves should be managed to limit exposure to financial risk through the matching of foreign-currency-denominated assets and liabilities, the adherence to prudent investment limits, and the diversification of instruments, currencies and maturities held.
- **Cost-effectiveness:** The reserves investment portfolio should be actively managed such that the net cost to the taxpayer, if any, is minimized.

Governance of the EFA

The *Currency Act*

The EFA is governed by the provisions of the *Currency Act*, which allows the Minister of Finance to acquire, borrow, sell or lend assets held in the EFA in accordance with the *Statement of Investment Policy*.

Statement of Investment Policy

An updated *Statement of Investment Policy* (SIP) was approved by the Minister in April 2009. The SIP sets out the policy governing the acquisition, management and divestiture of assets for the EFA and details the investment objectives, eligible asset classes and currencies, and risk exposure limits. The policy is designed to ensure prudent and effective management practices are followed in accordance with reserves management objectives and principles.

Governance Structure

Responsibility for the management of the EFA is shared between the Department of Finance and the Bank of Canada. The Bank of Canada, acting as fiscal agent for the Minister of Finance, executes transactions for the Account. The strategic planning and the operational management of the EFA are conducted jointly by the two organizations.

The Funds Management Committee (FMC), composed of senior management from the Department of Finance and the Bank of Canada, oversees the management of the EFA and is a decision-making body within limits delegated by the Minister. The Committee advises the Minister on policy and strategy, oversees the implementation of approved policy and plans, reviews performance outcome reports and makes decisions related to the management of the reserves.

The FMC is supported by the Risk Committee (RC), whose mandate is to review and provide opinions on the risk implications of policy proposals and recommendations. The Financial Risk Office at the Bank of Canada provides analytical support to the RC and is responsible for monitoring and regularly reporting on the EFA's financial performance and its exposure to credit, liquidity, market and operational risks.

The FMC is also supported by the Asset Liability Management Committee (ALMC), which provides recommendations to the FMC, in its advisory role, on strategic and policy matters affecting the management of foreign reserves, including changes to the limits and guidelines pertaining to the foreign reserves established by the Minister of Finance and the FMC. Within limits delegated by the FMC, the ALMC is also a decision-making body, whose decisions are executed by officials at the Bank of Canada and the Department of Finance.

For more information on the governance framework of the EFA, consult the document entitled *Funds Management Governance Framework* at www.fin.gc.ca/treas/Goveev/TMGF_1-eng.asp.

EFA Management Policy

Management of the EFA follows a set of policies that apply to investments, funding, asset-liability management, risk management and performance measurement.

Investment Policy

The policy governing the management of EFA assets, set out in the SIP, is designed to achieve the strategic objectives of maintaining a high standard of liquidity, preserving capital value and, subject to those objectives, maximizing return. To achieve these goals, the policy permits a range of investments, notably in US-dollar-, euro- and yen-denominated securities (bonds and bills) issued by sovereigns and their agencies, subnational governments or supranational organizations, including government-guaranteed securities. The policy also permits investment in cash deposits with financial institutions, US-dollar tri-party repurchase agreements (repos), commercial paper and certificates of deposit issued by private sector entities, gold and IMF special drawing rights. Lastly, the SIP allows for securities-lending activities to generate incremental returns.

The investment policy splits investments for the EFA into two tiers: the Liquidity Tier and the Investment Tier. The Liquidity Tier serves to meet the core liquidity requirements in foreign currencies and consists of highly rated US-dollar-denominated assets, such as Treasuries, discount notes and overnight bank deposits. The Investment Tier consists of a diversified mix of high credit quality securities denominated in US dollars, euro and yen.

Swap Management Policy

The swap management policy sets out the framework used to manage the liability structure of the Government's marketable debt by governing the use, procurement and execution of swap agreements. The Government can use swaps to mitigate the risk and/or reduce the cost of borrowing by exchanging interest rate and/or principal payments in one currency for another currency and to change the interest payment characteristics, such as fixed versus floating rates, of borrowings. The policy outlines eligibility criteria for swap counterparties and actual and potential exposure levels to counterparties. A collateral management framework is used to mitigate risk arising from the changes in the mark-to-market value of swap contracts beyond pre-set exposure limits.

Risk Management Policy

The risk management policy of the EFA requires identifying, monitoring, mitigating, to the extent required, and the regular and timely reporting of treasury risk exposures. Treasury risk includes currency, interest rate, credit, liquidity, legal and operational risks related to the financing and investment of the foreign exchange reserves. For information on recent risk policy initiatives, see the section entitled "Initiatives in 2009–10."

For more information on the risk management policies that pertain to all of the Government's funds management operations, including foreign reserves, cash and debt management, consult the document entitled *Government of Canada Treasury Risk Management Framework* at www.fin.gc.ca/treas/frame/gctrmf06e.pdf.

Asset-liability management policy: Foreign currency reserve assets held in the EFA and the foreign currency liabilities and swaps that finance those assets are managed on a portfolio basis, and are matched as closely as possible in currency and duration, so that the net exposure to currency and interest rate risks is limited.

Credit risk management policy: The Department of Finance and the Bank of Canada use a variety of tools to assess and manage credit risk, including an external credit ratings–based framework in which judgment is applied, diversification of credit exposures and the use of collateral frameworks.

Liquidity risk policy: Liquidity risk of EFA assets is low due to the high credit quality of eligible investments under the SIP. In addition, liquidity risk is minimized by limiting the portion of the reserve asset portfolio and foreign liabilities that is rolled over at any particular point in time. This ensures that the EFA would be able to meet commitments as they become due under various market conditions.

Legal and operational risks: Legal risk associated with agreements and contracts with external parties, including fiscal agents, mandataries and private sector borrowers and lenders, is managed by the Department of Finance. Operational risk is managed by the Bank of Canada and reported on a regular basis.

Performance Measurement Policy

The EFA's performance measurement policy provides a framework for measuring, analyzing and evaluating the financial performance of EFA investments and associated liabilities. The policy requires regular and timely reporting of the returns on EFA assets and the cost of associated liabilities to senior management within the Department of Finance and the Bank of Canada, the Minister of Finance and Parliament.

Performance measures: The principal performance measures are based on accounting information (investment revenues, coupon return and the net carry measure) while asset-liability matching performance is measured using market-based measures such as total return. Liability benchmarks, external indices and attribution analysis are also used to measure portfolio performance. These performance measures are reported on a monthly basis to management at the Department of Finance and the Bank of Canada. For more information on the performance measures, see Annex 5.

Legislative reporting: As required by the *Currency Act*, the Office of the Auditor General of Canada audits the financial statements of the EFA and reports to the Minister of Finance on a fiscal-year basis on the financial position of the Account and its revenues and cash flows for the year. The *Currency Act* also requires annual reporting to Parliament on whether the financial performance of the portfolio has resulted in the achievement of the EFA's objectives. The section entitled "Report on Operations in 2009–10" fulfils this requirement.

Annex 3: Composition of the Official International Reserves

The *Statement of Investment Policy* permits investments in securities with terms of up to 10.5 years. As at the end of March 2010, the majority of EFA liquid holdings, which are heavily concentrated in US dollars and euro securities, were held in the over five year maturity bucket.

International Monetary Fund Reserve Position

Each member country of the International Monetary Fund (IMF) is assigned a quota that represents the maximum amount of resources that it is obliged to provide to the IMF, upon request. As well, the IMF typically has on deposit with each government holdings in the form of non-interest-bearing notes and non-interest-bearing accounts. Canada's reserve position at the IMF represents the difference between Canada's quota and the IMF's holdings of Canadian dollars, which is equivalent to the cumulative amount of all the money that Canada has advanced to the IMF over the years.

Canada's reserve position at the IMF is an asset that is included as a component of the official international reserves but is not held in the EFA. As such, changes in Canada's reserve position that may result from advances, repayments or revaluations directly impact the Government of Canada's financial statements.

Currency and Term Structure of the Official International Reserves

The following table shows the distribution of investments in the official international reserves by currency and term to maturity as at March 31, 2010. Gold, SDR holdings and the IMF reserve position, which have no terms to maturity, are translated into US dollars.

Table A3.1

Term Structure of the Official International Reserves as at March 31, 2010

Term	Cash and term deposits	Government securities in domestic currency	Other securities	Gold	SDR holdings	Total EFA assets	IMF reserve position	Total official international reserves
			(market value in millions of US dollars)					
US-dollar holdings								
Under 6 months	222	740	6,229	–	–	**7,191**	–	**7,191**
6 to 12 months	–	–	153	–	–	**153**	–	**153**
1 to 5 years	–	122	6,899	–	–	**7,021**	–	**7,021**
Over 5 years	–	4,555	5,879	–	–	**10,434**	–	**10,434**
Indefinite term	–	–	–	122	8,925	**9,047**	2,422	**11,469**
Total US-dollar holdings	222	5,417	19,160	122	8,925	**33,846**	2,422	**36,268**
Euro holdings								
Under 6 months	173	795	267	–	–	**1,234**	–	**1,234**
6 to 12 months	–	806	41	–	–	**847**	–	**847**
1 to 5 years	–	4,112	2,319	–	–	**6,430**	–	**6,430**
Over 5 years	–	9,164	2,419	–	–	**11,584**	–	**11,584**
Total euro holdings	173	14,877	5,046	0	0	**20,095**	0	**20,095**
Yen holdings								
Under 6 months	89	–	–	–	–	**89**	–	**89**
6 to 12 months	–	–	–	–	–	**–**	–	**–**
1 to 5 years	–	217	–	–	–	**217**	–	**217**
Over 5 years	–	–	–	–	–	**–**	–	**–**
Total yen holdings	89	217	0	0	0	**306**	0	**306**
Total	484	20,511	24,206	122	8,925	**54,247**	2,422	**56,669**

Note: Numbers may not add due to rounding. The exchange rates prevailing on March 31, 2010 are used for the euro and yen assets.

Annex 4: Changes in the Level of the Official International Reserves

Unless otherwise noted, in this report the official international reserves are reported in US dollars on a market-value basis.

The level of the official international reserves changes over time due to a variety of factors. As shown in Table A4.1, over the 12-month reporting period the level of reserves increased by $13.1 billion. The increase was due to return on investments ($1.55 billion), reserves management operations ($5.01 billion) and an additional SDR allocation ($8.17 billion), which was partially offset by foreign currency debt charges ($1.50 billion) and revaluation effects ($86 million).

Table A4.1

Sources of Change in Canada's Official International Reserves Between March 31, 2009 and March 31, 2010

	Change
	(market value in millions of dollars)
Official intervention	–
Net government operations	–
Reserves management operations	5,014
Gains and losses on gold	–
Return on investments	1,551
Foreign currency debt charges	-1,501
Revaluation effects	-86
Other	8,166
Total change	13,144

Official Intervention

Official intervention involves buying or selling foreign currencies in exchange for Canadian dollars, and would therefore affect the level of the official international reserves. Intervention in the foreign exchange market for the Canadian dollar might be considered if there were signs of a serious near-term market breakdown (e.g. extreme price volatility with both buyers and sellers increasingly unwilling to transact), indicating a severe lack of liquidity in the Canadian-dollar market. It might also be considered if extreme currency movements seriously threatened the conditions that support sustainable long-term growth of the Canadian economy. The goal would be to help stabilize the currency and to signal a commitment to back up the intervention with further policy actions, as necessary.

Since September 1998 the Bank of Canada, acting as agent for the Government, has not undertaken any foreign exchange market intervention in the form of either purchases or sales of US dollars versus the Canadian dollar.[8]

Table A4.2

Official Intervention

	2003	2004	2005	January 1, 2006 to March 31, 2007	2007–08	2008–09	2009–10
				(millions of US dollars)			
Purchases	–	–	–	–	–	–	–
Sales	–	–	–	–	–	–	–
Net	–	–	–	–	–	–	–

Net Government Operations

Net purchases of foreign currencies for government foreign exchange requirements will affect the official international reserves. There were no net government operations during the reporting period.

Reserves Management Operations

Matched debt issues and maturities and purchases and sales of foreign currency assets affect the level of the EFA. Over the reporting period, funds raised through the issuance of bonds, foreign exchange (FX) swaps, cross-currency swaps and Canada bills, totalling $27.9 billion, were more than the debt maturities totalling $22.8 billion (including Canada bill maturities of $17.5 billion, euro medium-term note maturities of $1.3 billion, FX swap maturities of $0.8 billion and cross-currency swap maturities of $3.2 billion).

Gains and Losses on Gold

This factor reflects the difference between the value of gold holdings at the beginning and the end of the reporting period due to gold sales and the change in the market value of gold. There were no gold transactions during the period, with the last of the Government's gold bullion holdings having been sold in December 2003.

8 Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

Return on Investments

Return on investments comprises interest earned on investments ($1.3 billion) and the increase in the market value of securities resulting from changes in interest rates ($0.3 billion). The overall effect on the official international reserves was a net increase of $1.6 billion.

Foreign Currency Debt Charges

Foreign currency debt charges reduced the level of the official international reserves by $1.5 billion. These expenses are charged to the Consolidated Revenue Fund but paid using foreign assets of the EFA.

Revaluation Effects

Revaluation effects resulting from movements in exchange rates reflect changes in the market value of the official international reserves. Revaluation effects decreased the official international reserves by $86 million, primarily due to the depreciation of the euro versus the US dollar during the last four months of the reporting period.

Other Changes

In August 2009, the IMF approved a general allocation of SDRs to member countries, in proportion to their existing quotas with the IMF, to supplement their foreign exchange reserves and provide liquidity to the global economic system. In September 2009, the IMF also provided a special one-time allocation of SDRs to member countries. Canada's allocations of SDR 5.2 billion were equivalent to $8.2 billion.

More detailed information on monthly levels and changes in Canada's official international reserves is provided in Tables A4.3 and A4.4.

Table A4.3

Canada's Official International Reserves
Month-to-Month Changes

Month-end	Securities	Deposits	Gold[1]	Special drawing rights[2]	Reserve position in the IMF[3]	Total	Total monthly change
			(market value in millions of US dollars)				
2009							
March	40,176	734	100	964	1,550	43,524	331
2009–10							
April	39,128	883	96	965	1,552	42,624	-900
May	40,031	2,129	106	999	1,605	44,870	2,246
June	41,048	700	102	1,001	1,811	44,662	-208
July	41,576	722	102	1,002	2,012	45,414	752
August	42,308	661	104	8,405	2,093	53,571	8,157
September	44,678	1,649	109	9,276	2,450	58,162	4,591
October	43,378	945	113	9,341	2,459	56,236	-1,926
November	43,230	1,111	128	9,461	2,490	56,420	184
December	41,968	634	119	9,212	2,424	54,357	-2,064
January	44,778	546	118	9,132	2,403	56,977	2,620
February	45,104	741	121	9,006	2,370	57,342	365
March	44,716	484	122	8,925	2,422	56,669	-673
Total[4]	n/a	n/a	n/a	n/a	n/a	n/a	13,144

1 Gold valuation is based on the London p.m. fix on the last business day of the reporting month.

2 SDR-denominated assets are valued in US dollars at the SDR rate established by the IMF. A rise in the SDR in terms of the US dollar generates an increase in the US-dollar value of Canada's holdings of SDR-denominated assets.

3 The reserve position in the IMF represents the amount of foreign exchange that Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.

4 Numbers are from the *Official International Reserves* press release.

Table A4.4

Canada's Official International Reserves
Details of Month-to-Month Changes

Month-end	Reserves management operations[1]	Gains and losses on gold sales	Return on investments[2]	Foreign currency debt charges	Revaluation effects	Net government operations[3]	Official intervention	Other transactions[4]	Total monthly change
				(market value in millions of US dollars)					
2009									
March	-711	0	294	-90	838	0	0	0	331
2009–10									
April	-561	0	-174	-110	-55	0	0	0	-900
May	1,119	0	-80	-38	1,245	0	0	0	2,246
June	194	0	198	-470	-130	0	0	0	-208
July	429	0	292	-264	295	0	0	0	752
August	420	0	233	-41	151	0	0	7,394	8,157
September	3,131	0	243	-96	541	0	0	722	4,591
October	-2,076	0	143	-129	136	0	0	0	-1,926
November	-797	0	486	-59	554	0	0	0	184
December	-141	0	-583	-101	-1,239	0	0	0	-2,064
January	2,941	0	522	-60	-783	0	0	0	2,620
February	617	0	300	-27	-525	0	0	0	365
March	-262	0	-29	-106	-276	0	0	0	-673
Total[5]	5,014	0	1,551	-1,501	-86	0	0	8,116	13,144

1 Net change in securities and deposits resulting from foreign currency funding activities of the Government. (Issuance of foreign currency liabilities used to acquire assets increases reserves, while maturities decrease reserves).

2 Return on investments comprises interest earned on investments and changes in the market value of securities resulting from changes in interest rates.

3 Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

4 Related to the securities assumed by the Government of Canada following the privatization of Petro-Canada in July 1991 and the subsequent dissolution of Petro-Canada Limited in 2001.

5 Numbers are from the *Official International Reserves* press release.

Annex 5: Detailed Portfolio Performance

Unless otherwise noted, in this report the official international reserves are reported in US dollars on a market-value basis.

This annex provides detailed, technical information on indicators used to measure the portfolio's performance in four areas: 1) revenues; 2) net return on assets; 3) cost of advances to the EFA; and 4) market and credit risk measures.

1) Revenues

Revenues include income from investments and foreign exchange gains. Data are reported in Canadian dollars, as EFA revenues are reported in Canadian dollars in the attached financial statements. In 2009–10, income totalled C$1.46 billion compared to C$1.85 billion in 2008–09. The main categories of income are summarized in Table A5.1.

Table A5.1

Revenues of the Exchange Fund Account

	April 1, 2009 to March 31, 2010	April 1, 2008 to March 31, 2009
	(millions of Canadian dollars)	
Investment income		
Marketable securities	1,717	1,661
Cash and short-term deposits	1	24
Deposits held under repurchase agreements	-	8
Special drawing rights	16	22
Total investment income	1,734	1,715
Other income		
Foreign exchange gains or losses	-278	138
Total income	1,456	1,853

2) Net Return on Assets

The net return on assets of the EFA is reported using two separate measures. The first is called "carry" and represents the net revenue generated by funding and holding reserve assets from a cash only perspective. The second measure is called "total return." It represents the net return generated by the EFA by including the cash flows as depicted in the carry measure (i.e. interest streams and realized gains or losses), as well as the changes in the market values of the assets and liabilities over the reporting period. By including the market values of the EFA's assets and corresponding liabilities, the total return measure includes unrealized gains or losses, which is the difference between what an asset (or liability) is worth compared to what it cost. In this way, the total return measure depicts the market or fair value of the EFA.

Carry

Carry represents the interest received on the EFA's assets minus the interest paid on the liabilities that fund the assets. The carry measure is also reported including any realized gains or losses stemming from asset sales, which is the difference between the amount for which an asset is sold and the amount it originally cost. A principal reason for using this measure of performance is that it depicts the effect of the EFA's net revenue on the financial results.

Table A5.2 provides an estimate of the carry for the EFA and its constituent currency portfolios. The carry for the 2009–10 fiscal year is estimated at -1.5 basis points, a 28-basis-point improvement over 2008–09. The improvement was mainly caused by a narrowing of the difference between interest earned and paid as older liabilities with high coupons matured.

Taking into account gains or losses on the sale of assets during 2009–10, the EFA incurred net gains of $306 million, or 84 basis points. These sales resulted in a net realized gain of $365 million, which was slightly offset by the loss of interest income of $59 million.The EFA realized $110 million in gains on US asset sales and $255 million in gains on euro asset sales.

Table A5.2

Carry of the Official International Reserves[1]

	April 1, 2009 to March 31, 2010					April 1, 2008 to March 31, 2009	
	Interest earned on assets	Interest paid on liabilities	Net interest earned on assets	Carry	Carry (including net realized gains)	Carry	Carry (including net realized gains)
	(millions of dollars)			(basis points)		(basis points)	
Euro portfolio	633.2	725.2	-92.0	-14.5	45.1	-29.4	-27.9
Yen portfolio	1.4	0.8	0.6	0.1	0.1	-0.2	-0.2
US$ portfolio	581.8	549.4	32.4	12.9	38.7	-0.1	27.0
Total carry[2]	1,216.3	1,275.4	-59.1	-1.5	84.0	-29.7	-1.1

1 The carry figures show the contribution of each currency portfolio to the overall carry.

2 Excludes gold holdings, and IMF reserve position and associated liabilities.

Total Return on a Market-Value Basis

The total return measure is used in several different ways. For instance, it is used to compare the performance of the EFA's assets to its liabilities in order to depict the net return of the portfolio on a market-value basis. The total return of the assets is also compared to an external benchmark index in order to provide an independent measure of the performance of the EFA and to enhance the understanding of performance in relation to broader market developments. Lastly, the EFA's total return is decomposed into the key sources of return. This is done by decomposing the total return measures for both the assets and liabilities into key sources of return through a technique called "performance attribution." This allows management to discern what aspects of total return resulted from controllable influences as compared to those sources that are market-driven. As well, the attribution analysis provides an indication as to how well objectives of the asset-liability management framework of the EFA are being met.

Table A5.3 provides an estimate of the total return on a market-value basis for the EFA as a whole and its key portfolios compared to the corresponding liabilities. The net total return was 58 basis points, or a gain of $122 million, in the fiscal year ending March 31, 2010, compared to 117 basis points, or a gain of $479 million, in the year ending March 31, 2009. This reflects net returns in US-dollar terms of 33 basis points for the US-dollar portfolio, 90 basis points for the euro portfolio and 58 basis points for the yen portfolio. These numbers include interest flows as well as all gains or losses earned over the period, regardless of whether they were realized or not.

Table A5.3

Total Return of the EFA Compared to Liability Benchmarks

	April 1, 2009 to March 31, 2010				April 1, 2008 to March 31, 2009
	US$ portfolio	Euro portfolio	Yen portfolio	Total EFA	Total EFA
EFA asset portfolio					
Return in original currency	1.95%	5.72%	1.31%	**n/a**	**n/a**
Return in US$ (A)	1.95%	7.50%	7.25%	**4.33%**	**-1.76%**
Liability benchmarks					
Return in original currency	1.62%	4.84%	0.77%	**n/a**	**n/a**
Return in US$ (B)	1.62%	6.60%	6.67%	**3.75%**	**-2.93%**
Return vs. liability benchmark in basis points (A – B) in US$	33	90	58	**58**	**117**

Table A5.4 compares the total return of the EFA to a set of Merrill Lynch government securities indices.[9] This provides some insight into how the total return of the EFA compares to a portfolio invested solely in US Treasury and German government securities. While the indices have been combined and weighted to reflect the currency composition and duration of the EFA, they only provide a general indication of its performance because the EFA is invested in a broader range of high quality assets. In the fiscal year ending March 31, 2010, the EFA's total return exceeded the external indices by 244 basis points, compared to an underperformance of 66 basis points in the fiscal year ending March 31, 2009.

9 Merrill Lynch, used with permission. *"MERRILL LYNCH IS LICENSING THE MERRILL LYNCH INDICES 'AS IS,' MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE QUALITY, ACCURACY AND/OR COMPLETENESS OF THE MERRILL LYNCH INDICES OR ANY DATA INCLUDED THEREIN OR DERIVED THEREFROM, AND ASSUMES NO LIABILITY IN CONNECTION WITH THEIR USE."*

Table A5.4

Total Return of the EFA Compared to External Indices[1,2]
April 1, 2009 to March 31, 2010

	US$ portfolio	Euro portfolio	Yen portfolio
EFA asset portfolio			
Return in original currency (A)	1.95%	5.72%	1.31%
Return in US$	1.95%	7.50%	7.25%
External indices			
Return in original currency (B)	-0.56%	3.41%	n/a
Return in US$[3]	-0.56%	5.14%	n/a
Return vs. external indices in basis points (A – B) in original currency	252	231	n/a

[1] Composite index for the US portfolio is constructed as weighted average of the following Merrill Lynch indices: US Treasury Bills (G0BA), US Treasuries 1-3yr (G1O2), US Treasuries 3-5yr (G2O2), US Treasuries 5-7yr (G3O2) and US Treasuries 7-10yr (G4O2). The weights for the composite index are updated on a monthly basis according to the holdings of the EFA US asset portfolio.

[2] Composite index for the euro portfolio is constructed as weighted average of the following Merrill Lynch indices: German Govt Bills (G0DB), German Federal Govts 1-3yr (G1D0), German Federal Govts 3-5yr (G2D0), German Federal Govts 5-7yr (G3D0) and German Federal Govts 7-10yr (G4D0). The weights for the composite index are updated on a monthly basis according to the holdings of the EFA euro asset portfolio.

[3] Return versus external indices is expressed in original currency except for the total EFA, where both assets and index returns are converted to US dollars.

Performance Attribution of Total Return

Table A5.5 summarizes the attribution results for the EFA’s US-dollar and euro portfolios for the fiscal year ending March 31, 2010.

Of the key sources of return, the coupon effect (the difference between the yield to maturity of assets and liabilities) was the main driver of the positive total return in the EFA’s portfolio. The coupon effect generally represents the underlying return of the portfolio if matched assets and liabilities are held to maturity. It helps create a positive return because the EFA’s assets generate more interest income than interest paid on liabilities. Moreover, the coupon effect represents the positive return generated by portfolio managers through their investment and issuance decisions.

The yield curve effect (the impact of changes in the general level of interest rates) demonstrates the extent to which the EFA’s assets and liabilities are matched in terms of their sensitivity to changes in interest rates. Although total returns for both the US-dollar and euro asset portfolios were significantly affected by yield curve movements over the period, similar effects were observed in the corresponding liabilities. This demonstrates the benefit of the asset-liability management framework of the EFA over the reporting period.

The credit spread effect (the change in the market value of EFA assets and foreign liabilities due to credit spreads) played a smaller role in the portfolio. However, the turmoil in the credit markets led to a larger than normal impact from changes in credit spreads, as Government of Canada liabilities benefited more from the flight to quality than the assets held in the US-dollar portfolio, but underperformed relative to euro assets.

The movement in credit spreads of EFA assets, which result from changes in market conditions, can differ in magnitude and direction from the spread movements of Government of Canada's liabilities. For this reason, the asset-liability matching framework does not hedge the credit spread effect. However, the impact of changes in the credit quality of investments is managed at low levels through the EFA's conservative investment policy, mainly AAA-rated counterparties, and diversified holdings.

As well, a component of the total return is generated through securities-lending activities. Any difference between the actual return and the sum of the above effects is the residual return, which reflects the fact that performance attribution approximately explains total return. By using these key sources of return, a clearer picture emerges as to the drivers of the EFA's annual total return.

Table A5.5

Performance Attribution for the US-Dollar and Euro Portfolios Compared to Liability Benchmarks April 1, 2009 to March 31, 2010

	US$ portfolio		Euro portfolio	
	Assets	Liabilities	Assets	Liabilities
	(per cent)			
Coupon effect	2.00	1.65	2.59	2.07
Yield curve effect	-1.09	-1.15	2.26	2.25
Credit spread effect	1.11	1.17	0.84	0.56
Securities-lending activities	0.00			
Residual return	-0.07	-0.05	0.03	-0.04
Return in original currency	1.95	1.62	5.72	4.84
Exchange rate effect			1.77	1.76
Total return in US$	1.95	1.62	7.49	6.60

3) Notional Cost of Advances to the EFA

From the Consolidated Revenue Fund

The cost of advances represents an estimate of the cost of maintaining the EFA by adding the cost of foreign debt payments (including the interest on cross-currency swaps) to the notional amount of foreign interest that would be paid on non-interest-bearing items or items funded in Canadian dollars. The level of foreign currency advances, measured in Canadian dollars, varies with the flow of foreign currencies between the EFA and the Consolidated Revenue Fund (CRF).

Actual foreign interest charges: The proceeds from foreign currency borrowings are remitted to the CRF and concurrently advanced to the EFA. Foreign debt interest and principal repayments are charged to the CRF but paid using the foreign assets of the EFA, reducing the amount advanced to the EFA. Actual foreign interest paid is converted into Canadian currency for the purpose of determining this portion of the notional cost of advances; for 2009–10, this value was C$1,357 million.

Notional interest charged in Canadian dollars: Because domestically funded EFA assets, SDR advances, and the portion of net revenues reinvested in the EFA (i.e. cumulative net revenues of the EFA less cumulative foreign debt interest payments) are not linked to foreign liabilities, an imputed interest cost is utilized to approximate the notional interest charge on the portion of advances from the CRF related to those assets. For 2009–10, a weighted cost of domestic and foreign funding (2.71 per cent) was utilized in calculating notional interest paid in Canadian dollars, resulting in a value of C$155 million.

4) Risk Measures

The risk management framework covers market, credit, liquidity, legal and operational risks related to the financing and investment of the foreign reserves. Risk measures are reported on a monthly basis to management at the Department of Finance and the Bank of Canada. The Minister of Finance receives an annual report on treasury risk management that is prepared in collaboration with the Bank of Canada's Financial Risk Office.

Market Risk

Market risk stems from changes in interest rates and exchange rates. Several industry-standard measures of market risk exposure are employed: scenario analysis, stress testing and Value at Risk (VaR) (Table A5.6). Stress testing and scenario analysis are used to evaluate the portfolio's performance under extraordinary circumstances in the market. VaR is a statistical measure for estimating potential losses to the EFA portfolio arising from extreme but plausible market movements such as changes in interest and exchange rates.

Stress tests are regularly carried out to gauge the sensitivity of the EFA portfolio to large changes in exchange rates and interest rates, including the portfolio impact of a 1-per-cent depreciation of the euro and yen vis-à-vis the US dollar and a 1-per-cent increase in interest rates across the yield curve. The results showed that, on a net basis during the reporting period, the EFA assets and the associated liabilities had very minimal exposure to currency depreciations and upward shifts in the yield curve.

Table A5.6

Market Risk Measures

	March 31, 2010		March 31, 2009	
	EFA	EFA assets less liabilities	EFA	EFA assets less liabilities
	(millions of dollars)			
Single factor stress tests				
1% depreciation of euro/yen	-204	-1	-180	0
1% upward parallel shift in yield curve	-1,950	-5	-1,334	-14
Scenario analyses				
1994 Fed tightening	-4,634	35	-3,569	-7
1997 Asian financial crisis	-991	137	-887	70
1998 Russian default/LTCM collapse	-1,054	229	-1,131	115
2001 terrorist attacks	1,575	105	1,273	47
99% 10-day VaR	1,513	11	1,324	11

In addition, some hypothetical scenario analyses that mimic market conditions during four previous extraordinary market events were regularly conducted: the tightening of monetary policy by the US Federal Reserve in 1994; the 1997 Asian financial crisis; the 1998 Russian debt default and Long-Term Capital Management (LTCM) collapse; and the 2001 US terrorist attacks. The scenario analyses showed that the EFA would generally perform well during such periods of market turbulence. The results were broadly in line with those reported for March 31, 2009. Scenario creation is a dynamic process. New scenarios continue to be considered and will be added when relevant and feasible.

Market VaR is a statistical measure that estimates the possible loss in portfolio value within a specific time period during normal market conditions as a result of interest rate and exchange rate changes. This is regularly reported for the entire EFA portfolio and on the net position between assets and liabilities. As of March 31, 2010, the EFA had a 99–per-cent 10-day VaR of $11 million, which implied that 99 per cent of the time, the value of the portfolio was not expected to decline by more than $11 million, on a net basis, over a 10-trading-day period.

Credit Risk

Credit risk includes the risk that a counterparty or issuer will be unable or unwilling to meet their obligations to pay as well as the risk that the value of an instrument will change as a result of actual or perceived changes in the credit quality of a counterparty or issuer.

Credit risk, which is the most important risk faced by the EFA, is controlled by setting limits on both actual and potential exposures to counterparties and issuers. A collateral management framework is used for managing the credit risk to financial institution counterparties arising from the cross-currency swaps used to fund the EFA. Under this framework, high quality collateral is placed with collateral managers for the EFA when the market value of the swap contracts exceeds specified thresholds. The Credit VaR model and some selected credit risk stress tests were used to measure the EFA's exposure to credit risk during the reporting period (Table A5.7).

Table A5.7

Credit Risk Measures

	March 31, 2010	March 31, 2009
	(millions of dollars)	
Credit VaR and expected shortfall		
99.9% 365-day Credit VaR	1,319	1,245
Expected shortfall	2,139	2,046
Stress test		
Potential loss if counterparties with negative outlook or negative watch are downgraded one notch	16.6	5.6

The Credit VaR model provides an estimate of the maximum expected loss in portfolio value within a year as a result of a credit event, such as a counterparty downgrade or default, under normal market conditions. As of March 31, 2010, the EFA had a 99.9-per-cent 1-year Credit VaR of $1.3 billion, which implied that 99.9 per cent of the time, the value of the portfolio was not expected to decline by more than $1.3 billion over a 1-year period due to credit events. An associated measure, expected shortfall, computes the expected average loss in portfolio value during the same period due to an extreme, unexpected credit event, whose possibility of happening (less than 0.1 per cent) was not captured by the Credit VaR statistic. The expected shortfall measure for the EFA was $2.1 billion as of March 31, 2010. The increase in Credit VaR from the previous year reflects wider credit spreads, which increase the possible losses associated with downgrades and defaults.

Credit risk stress tests were also carried out to evaluate potential losses to the EFA assets and the associated liabilities arising from extraordinary credit events in the market. These tests subjected the EFA to hypothetical scenarios, such as all counterparties with a negative outlook being downgraded by one notch. Due to the financial crisis, several counterparties of the EFA have been downgraded and a number remain on negative outlook. As a result, the potential loss to the EFA under this hypothetical scenario has increased compared to the previous fiscal year.

Annex 6: List of Agents and Mandataries as Defined by the *Currency Act*

The *Currency Act* stipulates that this report include a list of the following agents and mandataries appointed by the Minister under subsection 17.2(3) of the act to perform services concerning the EFA.

Bank of Canada

The Bank of Canada, as specified under the *Bank of Canada Act*, is the fiscal agent for the Government of Canada. As part of its fiscal agency responsibilities, the Bank manages the Government's foreign exchange reserves.

RBC Dexia Investor Services and State Street Corporation

RBC Dexia Investor Services and State Street Corporation manage the securities-lending program for the EFA. As the Government's agents and mandataries, they carry out securities lending on behalf of the Government. The program involves loaning a security from the Government to a counterparty, who must eventually return the same security, in order to earn additional return on the portfolio.

Annex 7: Glossary

basis point: One-hundredth of a percentage point (0.01 per cent).

Canada bill: Promissory note denominated in US dollars and issued only in book-entry form. Canada bills mature not more than 270 days from their date of issue, and are discount obligations with a minimum order size of US$1,000,000 and a minimum denomination of US$1,000. Delivery and payment occur in same-day funds through JP Morgan Chase Bank in New York City. Primary distribution occurs through four dealers: CIBC World Markets, Credit Suisse First Boston LLC, Goldman, Sachs & Co. and RBC Dominion Securities Inc. Rates on Canada bills are posted daily for terms of one to six months. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes are issued in denominations of US$1,000 and integral multiples thereof. At present the aggregate principal amount outstanding issued under the program is limited to US$10.0 billion. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. The interest rate or interest rate formula, issue price, stated maturity, redemption or repayment provisions, and any other terms are established by the Government of Canada at the time of issuance of the notes and are indicated in the Pricing Supplement. Delivery and payment occur through Citibank, N.A. The notes are offered by the Government through Credit Suisse. The Government may also sell notes to other dealers or directly to investors. Canada notes are issued for foreign exchange reserve funding purposes only.

certificate of deposit: Promissory note issued by a bank. It is a time deposit that restricts holders from withdrawing funds on demand. Although it is still possible to withdraw the money, this action will often incur a penalty.

commercial paper: Senior level unsecured short-term debt that is a source of cost-effective short-term financing available to the largest and most creditworthy issuers relative to bank loans.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

euro medium-term note (EMTN): Medium-term note issued outside the United States and Canada. Government of Canada EMTNs are sold either by dealers in the dealer group, or by dealers who are not in the dealer group but who are acting as the Government's agent for the particular transaction (called reverse inquiry). EMTNs are sold on a bought-deal basis (i.e. the dealer purchasing EMTNs is responsible for the sale of the notes) and on an intermittent basis. The arranger for the EMTN program is Morgan Stanley. The maturities of EMTNs are not fixed, and can range from short- to long-term. The EMTN program further diversifies the sources of cost-effective funding for the foreign exchange reserves. Notes issued under this program can be denominated in a range of currencies and structured to meet investor demand. EMTNs are issued for foreign exchange reserve funding purposes only.

global bond: Syndicated, marketable debt instrument issued in a foreign currency with a fixed interest rate. The majority of global bonds issued by Canada are denominated in US dollars. Global bonds are issued for foreign exchange reserve funding purposes only.

repo; repurchase agreement: Repos are transactions in which one party sells securities to another while agreeing to repurchase those same securities at a pre-specified price on a predetermined future date. These transactions are similar to secured loans where the lender receives securities as collateral for protection against default risk. The collateral is marked-to-market with appropriate haircuts to protect the Government from market risk in collateral values.

securities lending: A loan of a security from one counterparty to another, who must eventually return the same security as repayment. The loan is collateralized by other high quality securities. Securities lending allows a counterparty in possession of a particular security to earn enhanced returns on the security.

special drawing right (SDR): An international reserve asset created by the IMF in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of international currencies.

Exchange Fund Account

Financial Statements

31 March 2010

Exchange Fund Account

Statement of Responsibility

Responsibility for the financial statements of the Exchange Fund Account (the Account) and all other information presented in this Annual Report rests with the Department of Finance. The operations of the Account are governed by the provisions of Part II of the *Currency Act*. The Bank of Canada administers the Account, as fiscal agent for the Government of Canada.

The financial statements were prepared in accordance with the accounting policies set out in Note 2 to the financial statements, which are consistent with those used by the Government of Canada, and do not result in any significant differences from Canadian generally accepted accounting principles for the public sector. These policies were applied on a basis consistent with that of the preceding year. The information included in these financial statements is based on the best estimates and judgement of the Department of Finance and the Bank of Canada, with due consideration given to materiality.

The Department of Finance establishes policies for the Account's transactions and investments. It also ensures that the Account's activities comply with the statutory authority of the *Currency Act*.

The Bank of Canada maintains appropriate financial systems and related internal controls to provide reasonable assurance that financial information is reliable, assets are safeguarded and transactions are properly authorized in accordance with the *Currency Act*. The system of internal control is supported by an internal audit department, whose functions include reviewing internal controls, including accounting and financial controls and their application. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

The Auditor General of Canada conducts an independent audit of the financial statements of the Account and reports the results of her audit to the Minister of Finance.

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are also part of the *Public Accounts of Canada*, and are referred to the Standing Committee on Public Accounts, which reports to Parliament on the results of its examination together with any recommendations it may have with respect to the financial statements and accompanying audit opinion.

Mark Carney
Governor
Bank of Canada

Michael Horgan
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

Ottawa, Canada
7 May 2010

Auditor General of Canada
Vérificatrice générale du Canada

Auditor's Report

To the Minister of Finance

I have audited the statement of financial position of the Exchange Fund Account as at 31 March 2010 and the statements of operations and cash flows for the year then ended. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

I conducted my audit in accordance with Canadian generally accepted auditing standards. Those standards require that I plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at 31 March 2010 and the results of its operations and its cash flows for the year then ended in accordance with the accounting policies set out in Note 2 to the financial statements, which conform with Canadian generally accepted accounting principles.

Further, in my opinion, the transactions of the Account that have come to my notice during my audit of the financial statements have, in all significant respects, been in accordance with Part II of the *Currency Act*.

Nancy Y. Cheng, FCA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
7 May 2010

Exchange Fund Account

Statement of Financial Position
as at March 31, 2010

	2010	2009
	(in millions of Canadian dollars)	
Financial assets		
Cash and short-term deposits (note 3)	492	926
	492	926
Investments		
Marketable securities (note 5)	44,137	49,045
Special drawing rights (note 6)	9,066	1,216
Gold	6	7
	53,209	50,268
	53,701	**51,194**
Liabilities		
Due to the Consolidated Revenue Fund (note 7)	**53,701**	**51,194**
Commitments (note 9)		

(The accompanying notes are an integral part of these financial statements.)

Approved:

Mark Carney
Governor
Bank of Canada

Michael Horgan
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

Exchange Fund Account

Statement of Operations
For the Year Ended March 31, 2010

	2010	2009
	(in millions of Canadian dollars)	
Net revenue from investments		
Marketable securities	1,717	1,661
Cash and short term deposits	1	24
Special drawing rights	16	22
Deposits held under repurchase agreements	–	8
	1,734	1,715
Other		
Net foreign exchange (loss) gain	(278)	138
Net revenue for the year	**1,456**	**1,853**

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Statement of Cash Flows
for the Year Ended 31 March, 2010

	2010	2009
	(in millions of Canadian dollars)	
Cash flows from operating activities		
Revenue from investments received		
Marketable securities	1,353	1,334
Short term deposits	–	18
Deposits held under repurchase agreements	–	9
Other	1	11
Purchase of marketable securities	(65,650)	(70,206)
Proceeds from the sale or maturity of marketable securities	61,268	67,185
Increase in foreign currency position	4	137
Decrease in foreign currency position	(2,623)	(3,005)
Cash used in operating activities	**(5,647)**	**(4,517)**
Cash flows from financing activities		
Increase in advances from the CRF	30,568	30,894
Repayment of advances to the CRF	(25,145)	(27,535)
Cash provided by financing activities	**5,423**	**3,359**
Effects of exchange rate changes on cash and cash equivalents	(210)	175
Decrease in cash and cash equivalents	**(434)**	**(983)**
Cash and cash equivalents		
Balance, beginning of year	926	1,909
Balance, end of year	**492**	**926**

(The accompanying notes are an integral part of these financial statements.)

Exchange Fund Account

Notes to the financial statements
For the year ended 31 March 2010

(Amounts in the notes to the financial statements are in millions of Canadian dollars, unless otherwise stated.)

1. Authority and Objective

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account. The majority of Canada's official international reserves reside inside the Account. The Account represents approximately 96 per cent (96 per cent at 31 March 2009) of Canada's official reserves. The remainder of the official reserves reside in the foreign currency accounts of the Minister of Finance.

The legislative mandate of the Account is to aid in the control and protection of the external value of the Canadian dollar. The Minister of Finance empowers the Account to acquire or sell assets deemed appropriate for this purpose, in accordance with the Account's *Statement of Investment Policy*.

Assets held in the Account are managed to provide foreign-currency liquidity to the government and to promote orderly conditions for the Canadian dollar in the foreign exchange markets, if required. Canada's current policy is to intervene in foreign exchange markets on a discretionary, rather than a systematic, basis and only in the most exceptional of circumstances. Since September 1998, no transactions have been aimed at moderating movements in the value of the Canadian dollar.

In accordance with the *Currency Act*, the net revenue for the year is paid to or charged to the Consolidated Revenue Fund (CRF) of the Government of Canada within three months after the end of the fiscal year, and the Minister of Finance reports to Parliament on the operations of the Account within the first 60 days on which Parliament is sitting after the end of the fiscal year.

2. Significant Accounting Policies

As stipulated in the *Currency Act*, the financial statements of the Account are prepared in a manner consistent with the accounting policies used by the Government of Canada to prepare its financial statements. The presentation and results of the Account using these accounting policies do not result in any significant differences from Canadian generally accepted accounting principles for the public sector.

a) Revenue recognition

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts using the straight line method, gains or losses on sales of securities, and revenues from securities lending activities. Interest is accrued on short-term deposits, deposits held under repurchase agreements, marketable securities, and Special Drawing Rights.

b) Expense recognition

The Account's administrative, custodial, and fiscal agency services are provided and paid for by the Bank of Canada and Department of Finance. These costs are not recognized in the financial statements.

In addition, the notional cost specifically identified as related to the funding of the Account's assets and advanced by the CRF are not recognized in the financial statements.

2. Significant Accounting Policies *(continued)*

c) Financial assets

Short-term deposits
Short-term deposits are recorded at cost and are generally held to maturity.

Deposits held under repurchase agreements
Deposits held under repurchase agreements are recorded at cost.

Marketable securities
Marketable securities are recorded at cost and are adjusted for amortization of purchase discounts and premiums on a straight-line basis over the term to maturity of the security. Purchases and sales of securities are recorded at the settlement dates. The securities loaned under the securities lending program continue to be accounted for as investment assets.

Short-term deposits, Deposits held under repurchase agreement and Marketable securities are written down to their recoverable amount in the event of an other than temporary impairment in the fair value. Write-downs to reflect other than temporary impairment are included in *Net revenue from investments* in the *Statement of Operations.*

Special Drawing Rights
SDR's are initially recorded at cost and are subsequently translated into Canadian dollars at market exchange rates.

Gold
Gold is carried in the Account at a value of 35 SDRs per fine ounce, which approximates cost and conforms to the value used in the *Public Accounts of Canada*.

d) Translation of foreign currencies and Special Drawing Rights

Assets and advances denominated in foreign currencies and special drawing rights (SDRs) are translated into Canadian dollar equivalents at rates prevailing on the balance sheet dates, which were as follows:

	2010	2009
US dollars	1.0158	1.2613
Euros	1.3720	1.6755
Japanese yen	0.0109	0.0127
SDRs	1.5422	1.8857

Gains or losses resulting from the translation of assets and advances denominated in foreign currencies and SDRs, as well as on transactions throughout the fiscal year, are recorded as net foreign exchange gains or losses and are included in the *Statement of Operations.*

Investment revenue in foreign currencies and SDRs is translated into Canadian dollars at the foreign exchange rates prevailing on the date the revenue is earned.

2. Significant Accounting Policies *(continued)*

e) Use of estimates and measurement uncertainty

The preparation of the financial statements of the Account requires management to make estimates and assumptions, based on information available as of the date of the financial statements. The most significant use of estimates is in the disclosure of the fair value of assets and disclosure of the notional cost of advances.

3. Cash and Short-term Deposits

	2010	2009
	Carrying Value	Carrying Value
Cash		
US dollars	226	548
Euros	175	272
Japanese yen	91	106
	492	**926**

Short-term deposits are money market transactions where the Account invests funds with designated counterparties.

There were no short-term deposits at 31 March 2010 (nil at 31 March 2009).

4. Deposits Held Under Repurchase Agreements

Deposits held under repurchase agreements are money market transactions where the Account invests funds on a secured basis with designated counterparties at prevailing market rates based on tri-party reverse repurchase agreements. The collateral on these transactions is held by a tri-party custodian.

Deposits held under repurchase agreements are denominated in US dollars. There were no deposits held under repurchase agreements at 31 March 2010 (nil at 31 March 2009).

5. Marketable Securities

Term to maturity

	2010										2009
	Under 6 months		6 months to 1 year		1 to 5 years		Over 5 years		Total Accrued Interest	Total	Total
	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield			
US dollar											
Corporation	183	0.22%	–	–	–	–	–	–	–	183	126
Commercial Banks	354	0.19%	–	–	–	–	–	–	–	354	568
Sovereign	2,066	0.19%	21	1.66%	810	2.48%	4,759	3.67%	53	7,709	8,785
Supra National	213	0.21%	47	0.90%	1,939	3.68%	1,953	4.51%	54	4,206	4,639
Agencies and other	4,262	0.26%	85	2.48%	4,089	3.34%	3,490	4.55%	99	12,025	13,286
	7,078		**153**		**6,838**		**10,202**		**206**	**24,477**	**27,404**
Euro											
Sovereign	713	1.25%	737	1.64%	3,128	2.95%	7,705	3.67%	237	12,520	12,328
Supra National	113	3.97%	–	–	704	4.09%	1,086	3.86%	56	1,959	2,407
Agencies and other	235	2.93%	110	2.73%	2,280	3.96%	2,232	3.89%	107	4,964	6,906
	1,061		**847**		**6,112**		**11,023**		**400**	**19,443**	**21,641**
Japanese yen											
Sovereign	–	–	–	–	217	0.68%	–	–	–	217	–
	–		–		**217**		–		–	**217**	–
Total marketable securities	**8,139**		**1,000**		**13,167**		**21,225**		**606**	**44,137**	**49,045**

The yield in the above table represents the weighted average yield to maturity based on the carrying value at the end of the fiscal year for the respective securities.

5. Marketable Securities *(continued)*

At 31 March 2010, the net unamortized premium on marketable securities amounted to $407 million ($356 million net unamortized premium at 31 March 2009). Sales of marketable securities during the year resulted in a net gain of $395 million (net gain of $135 million at 31 March 2009) and is included in *Net revenue from Marketable Securities* on the *Statement of Operations.*

Under the securities lending program, the Account has agency agreements with two major financial institutions. Loans of securities are effected on behalf of the Account by these agents who guarantee the loans and obtain collateral of equal or greater value from their approved counterparties in these transactions. At 31 March 2010, no US Treasury Bills (US$255 million (par value) at 31 March 2009) and US$569 million (par value) in Treasury Notes (US$698 (par value) at 31 March 2009), were being used in the securities lending program with financial institutions.

6. Special Drawing Rights

The special drawing right (SDR) is an international reserve asset created by the International Monetary fund (IMF) in 1969 to supplement the existing official reserves of member countries. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR serves as the unit of account of the International Monetary Fund (IMF) and its value is based on a basket of key international currencies. In August and September of 2009, the IMF completed allocations of Special Drawing Rights (SDRs) in an effort to boost global liquidity. Canada's share of these allocations was initially recorded at $8,063 million (SDR4,722 million) and $829 million (SDR487 million) in August 2009 and September 2009, respectively.

7. Due to the Consolidated Revenue Fund (CRF)

The Account is funded by the Government of Canada through interest-free advances from the CRF. Advances to the Account from the CRF are authorized by the Minister under the terms and conditions prescribed by the Minister of Finance. Pursuant to Section 19 of the *Currency Act*, these advances are limited to $100 billion by order of the Minister of Finance in September of 2009.

The CRF advances the proceeds of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF to the Account. Subsequent repayments of foreign currency debt are made using the assets of the Account and result in reductions in the level of foreign currency advances from the CRF. Interest payable by Canada on borrowings in foreign currencies and charges on allocations of SDRs to Canada are charged directly to the CRF.

The Account requires Canadian dollar advances to settle its purchases of foreign currencies. Canadian dollars received from sales of foreign currencies are remitted to the CRF. This, together with foreign currency payments made on behalf of the Government of Canada cause reductions in the level of outstanding Canadian-dollar advances, and can result in overall net deposits of Canadian dollars by the Account with the CRF.

7. Due to the Consolidated Revenue Fund (CRF) *(continued)*

At 31 March, advances from the CRF were comprised of the following currencies:

	2010	2009
US dollars	26,689	29,167
Euros	18,810	21,128
Japanese yen	304	102
SDRs	7,092	(1,150)
Subtotal – foreign currencies	52,895	49,247
Canadian dollars	(650)	94
Net revenue	1,456	1,853
Total Due to Consolidated Revenue Fund	**53,701**	**51,194**

For the year ended 31 March 2010, the notional cost specifically identified as related to the funding of the Account's assets and advanced by the CRF to the Account is $1,357 million ($1,630 million for the year ended 31 March 2009). The notional cost of advanced funds is comprised of the actual interest costs on foreign denominated debt and cross currency swaps for foreign currency advances, and an imputed interest cost calculated using the average funding rate of outstanding Government of Canada market debt, applicable to the net of Canadian dollar and SDR currency advances.

8. Financial Instruments

The role of the Account as principal repository of Canada's official international reserves determines the nature of its assets and of its operations, as well as its use of financial instruments.

a) Credit risk

Credit risk is the risk that a counterparty to a financial contract will cause a loss to the Account by failing to discharge its obligations in accordance with agreed upon terms.

To ensure that the Account's asset portfolio is prudently diversified with respect to credit risk, the *Statement of Investment Policy* prescribed by the Minister of Finance specifies limits on holdings by class of issuer (sovereign, agency, supranational, corporation or commercial financial institution) and type of instrument. There are also limits on exposure to any one issuer or counterparty.

8. Financial Instruments *(continued)*

a) Credit risk *(continued)*

With respect to the *Statement of Investment Policy*, the Account may hold fixed income securities of highly rated sovereigns, central banks, government-supported entities and supranational organizations. To be eligible for investment, an entity must have a credit rating in the top seven categories from two of four designated rating agencies (Standard & Poor's, Moody's, Fitch, and Dominion Bond Rating Service). The Account may also make deposits and execute other transactions, up to prescribed limits, with commercial financial institutions that meet the same rating criteria.

As stipulated in the *Currency Act*, the Minister may appoint agents to perform services concerning the Account. Through the securities-lending program, agents can lend securities only up to a prescribed maximum amount and only to a list of approved counterparties. Each borrower must enter into a Securities Loan Agreement with at least one of the agents. Borrowers are also required to provide collateral for securities borrowed, according to a specific list approved by the Government. Collateral is limited to specific security types, terms to maturity, and credit ratings.

The agents also provide an indemnity in the event of default by the borrower. The Account enters into securities lending transactions in order to increase its return on investments.

b) Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk comprises three types of risk: interest rate risk, currency risk, and other price risk. Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in market interest rates. Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices, other than those arising from interest rate risk or currency risk. The Account is not exposed to significant other price risk.

Interest rate and currency risks are managed, with due consideration of the risk to the Government of Canada, through the asset-liability management policy. This policy utilizes a strategy of matching the duration structure and the currency of the Account's assets with the foreign currency borrowings of the Government of Canada that notionally finance the Account's assets. Other price risks are mitigated by holding high quality liquid assets.

c) Liquidity Risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities. Liquidity risk is minimized by limiting the portion of foreign liabilities that needs to be rolled over within a one year period. In addition, liquidity risk is mitigated by holding short-term investments that are matched to maturing liabilities.

8. Financial Instruments *(continued)*

d) Fair value of financial instruments

	2010		2009	
	Carrying Value and Accrued Interest	Fair value	Carrying Value and Accrued Interest	Fair value
Investments				
Cash and short-term deposits	492	492	926	926
Marketable securities				
US dollar	24,477	24,966	27,404	28,299
Euro	19,443	20,237	21,641	22,375
Japanese Yen	217	220	–	–
	44,629	45,915	49,971	51,600
SDRs	9,066	9,066	1,216	1,216
Gold	6	124	7	126
	53,701	**55,105**	**51,194**	**52,942**

The estimated fair value of cash and short-term deposits is deemed equal to their carrying value given their short term to maturity. SDRs are translated into Canadian dollar equivalents at rates prevailing on the balance sheet dates.

Estimated fair values of marketable securities are based on quoted market prices. If such prices are not available, the fair value is determined by discounting future cash flows using an appropriate yield curve. During the year, no marketable securities have been written down to reflect other than temporary impairments in the fair value.

The estimated fair value of gold is based on London fixing of $1,133.12 at 31 March 2010 ($1,155.98 at 31 March 2009) per fine ounce.

Subsequent to 31 March 2010, the fair value of marketable securities and SDRs continued to fluctuate as a result of changes in market conditions. As discussed in notes 8(a) and 8(b), credit and market risks of marketable securities are managed in accordance with the Account's *Statement of Investment Policy* and the asset-liability management policy. These risk management practices mitigate the risk of fair value fluctuations of marketable securities.

9. Commitments

a) Foreign currency swaps

Foreign currency swaps are agreements that exchange one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments. The Account may enter into short-term foreign currency swap arrangements with the Bank of Canada to assist the Bank in its cash-management operations. There were no drawings under this facility during the years ended 31 March 2010 or 31 March 2009, and there were no commitments outstanding at 31 March 2010.

b) Foreign currency contracts

A foreign currency contract is a commitment to purchase or sell a foreign currency at the spot rate, requiring settlement within two days. In the normal course of operations, the Account enters into foreign currency contracts. At 31 March 2010, the Account was under contract to sell $1 million ($8 million at 31 March 2009) of foreign currency. Unrealized gains (losses) on foreign currency contracts are calculated using the 31 March 2010 exchange rates. As of that date, there were no unrealized net gains (losses) included in net revenue (nil at 31 March 2009). Outstanding foreign currency contracts were settled by 1 April 2010.

c) Investment contracts

In the normal course of operations, the Account enters into investment contracts. The following table presents the fair value of investment contracts with contractual amounts outstanding at 31 March 2010. There were no outstanding investment contracts at 31 March 2009.

	2010		2009	
	Contractual value	Fair value	Contractual value	Fair value
Marketable securities				
US Dollars				
Purchases	162	162	–	–
Sales	22	20	–	–
Euro				
Purchases	50	50	–	–
Sales	51	50	–	–

10. Comparative figures

Certain of the 2009 comparative figures have been reclassified to conform to the current year's presentation.