

REPORT ON THE
MANAGEMENT OF CANADA'S
OFFICIAL INTERNATIONAL RESERVES

April 1, 2006 – March 31, 2007



REPORT ON THE
MANAGEMENT OF CANADA'S
OFFICIAL INTERNATIONAL RESERVES

April 1, 2006 – March 31, 2007



©Her Majesty the Queen in Right of Canada (2007)
All rights reserved

All requests for permission to reproduce this document or any part thereof
shall be addressed to Public Works and Government Services Canada.

Available from the

Distribution Centre
Department of Finance Canada
Room P-135, West Tower
300 Laurier Avenue West
Ottawa, Ontario K1A 0G5
Tel: 613-995-2855
Fax: 613-996-0518

Also available on the Internet at
www.fin.gc.ca

Cette publication est également disponible en français.

Cat. No.: F1-31/2007E
ISBN 978-0-662-47147-9



Table of Contents

Purpose of the Report	5
Highlights	7
Overview of the Exchange Fund Account Management Framework	8
Objectives and Principles	8
Governance of the EFA	9
EFA Management Policy	9
Major Initiatives in 2006–07	11
Report on Operations in 2006–07	14
Performance Versus Strategic Objectives	14
Market Developments During the Reporting Period	16
Composition of the Official International Reserves as at March 31, 2007	18
Changes in the Level of the Official International Reserves	21
EFA Financing	22
Portfolio Performance Measurement	24
Risk Measures	28
Annex 1: Statement of Investment Policy	31
Annex 2: Official Intervention	36
Annex 3: Canada’s Official International Reserves	37
Annex 4: List of Agents and Mandataries as Defined by the <i>Currency Act</i>	38
Annex 5: Glossary	39
Financial Statements of the Exchange Fund Account	41



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, primarily the management of the Exchange Fund Account (EFA), from April 1, 2006 to March 31, 2007.

On a market-value basis, the official international reserves stood at US\$39,309 million as of March 31, 2007 (Table 1), including the International Monetary Fund (IMF) reserve position, which is Canada's investment in the activities of the IMF. The IMF reserve position, which is not actively managed, fluctuates according to drawdowns and repayments from the IMF. Special drawing rights (SDRs), which are international reserve assets created by the IMF based on a basket of international currencies, and gold are also not actively managed.

The EFA, which represents the largest component of the official international reserves, is an actively managed portfolio of liquid foreign currency assets. The EFA is funded by liabilities of the Government of Canada denominated in, or converted to, foreign currency. Assets and liabilities are matched as closely as possible in currency and duration to minimize exposure to currency and interest rate risks.

This report provides a comprehensive account of the framework within which the EFA is managed, its composition and changes during the year, and strategic policy initiatives. The accompanying financial statements, audited by the Auditor General of Canada, provide information on the position of the EFA asset portfolio as of fiscal year end.

Table 1

The EFA and Official International Reserves

	March 31, 2007	March 31, 2006	Change
	(market value in millions of US dollars)		
Securities	33,657	28,420	5,237
Deposits	3,882	5,596	-1,714
Total securities and deposits (liquid reserves)	37,539	34,016	3,523
Gold	72	63	9
Special drawing rights (SDRs)	976	917	59
Total EFA	38,587	34,996	3,591
IMF reserve position	722	1,038	-316
Total official international reserves	39,309	36,034	3,275



Highlights

Portfolio Management

- **Change in the level of the official international reserves:** The market value of the official international reserves increased to US\$39.3 billion as of March 31, 2007 from US\$36.0 billion as of March 31, 2006. The change comprised a US\$3.6-billion increase in EFA assets and a US\$0.3-billion decrease in the IMF reserve position.
- **EFA funding sources:** The program of cross-currency swaps of domestic obligations was the primary source of foreign currency funding for the EFA. US\$5 billion was raised at an average cost of 3-month US\$ LIBOR (London Inter-Bank Offered Rate) less 41 basis points, a funding cost better than was obtained in recent years.

Performance and Risk Measurement

- **Asset-liability portfolio performance:** The EFA is a stand-alone asset portfolio within the Public Accounts framework and is audited on this basis. It is managed against a portfolio of Government of Canada foreign currency liabilities in order to provide transparency on the net return to the Government and to minimize risk.

From April 1, 2006 to March 31, 2007, on a mark-to-market or total return basis, including net interest income and all gains or losses earned over the period and the cost of funds, the net total return was a gain of US\$105 million, or +31 basis points.

Although the portfolio returned an underlying profit on a market-value basis, on a book-value basis, the Government experienced net losses. This is captured in the carry measure, which reports the performance of the asset-liability portfolio from a cash flow perspective. Of note, the carry measure is indicative of the impact of the performance of the reserves on the *Public Accounts of Canada*, which are also measured on a book-value basis. For 2006–07, the carry of the portfolio was a loss of US\$110 million, or -32 basis points. This amount includes US\$77.7 million in realized losses on US-dollar and euro asset sales, as well as net interest costs of US\$32 million. The difference between the market or total return measure and the book or carry measure is due to the fact that the total return measure includes both realized and unrealized gains and losses while the carry measure includes only realized gains or losses. During the reporting period unrealized gains more than offset realized losses.

- **Asset-liability portfolio risk:** Market risk measures, such as Value-at-Risk, and various stress tests indicate the EFA portfolio was at all times well positioned to cope with adverse movements in interest and exchange rates. Also, various credit risk measures show that the EFA portfolio is well positioned in terms of its credit risk exposure.

Portfolio Assessment

- **Current practices and management:** An external evaluation of the management of the EFA was conducted as part of the Government's Treasury Evaluation Program. The evaluation, conducted by Fischer Francis Trees & Watts, concluded that the EFA is being managed prudently, effectively and with due regard for its strategic objectives.
- **Suggested recommendations for enhancement of returns:** The recommendations of the external evaluation focused on enhancing portfolio returns at the expense of liquidity. The recommendations of the report will be considered at a later date, given the Government's current desire to maintain a very high standard of liquidity for its reserves portfolio and to mitigate market risk to the greatest extent possible.



Overview of the Exchange Fund Account Management Framework

This section describes the EFA management framework, including the objectives and principles and governance structure. It also summarizes policies governing investment, risk management and performance measurement.

Objectives and Principles

Objective

- The objective of the 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.

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. Information on 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 in 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

A *Statement of Investment Policy* (SIP) was approved by the Minister in September 2006. 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 policies are designed to ensure prudent and effective management practices are followed in accordance with reserves management objectives and principles. The SIP is provided in Annex 1.

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 a 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, please consult the document entitled *Funds Management Governance Framework* at www.fin.gc.ca/treas/Goveev/TMGF_e.html.

EFA Management Policy

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



Investment Policy

The policy governing the management of 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 constraints, 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 or supranational organizations. 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.

Eligibility for investment in the EFA is based on a prudent framework that incorporates external credit ratings. To be eligible for investment, an entity must have a credit rating in the top seven categories from at least two of four rating agencies: Moody's Investors Service, Standard & Poor's, Fitch Ratings and Dominion Bond Rating Service. The only allowable unrated investments are the following: securities issued by and deposits with central banks and the Bank for International Settlements and investments in special drawing rights created by the IMF. Beyond credit ratings, the SIP also sets limits pertaining to issuers and counterparties across all lines of business and defines high liquidity standards of reserve asset classes.

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.

Asset-Liability Management Policy

Foreign currency reserve assets held in the EFA and the Government of Canada foreign currency liabilities and swaps that notionally 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. The policy seeks to minimize the gap between the market value of assets and liabilities, as monitored on a daily basis, to within a target range of +/-US\$300 million.

Risk Management Policy

Risk management policy requires identifying, monitoring, mitigating, to the extent required, and the regular and timely reporting of treasury risk exposures. Treasury risk includes credit, liquidity, legal, market and operational risks related to the financing and investment of the foreign exchange reserves. For more information, see the box entitled "Risk Management Policy Developments" later in this section.

Performance Measurement Policy

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 to senior management within the Department of Finance and the Bank of Canada, the Minister of Finance and Parliament of the returns on EFA assets and the cost of associated liabilities.



The principal measures are based on accounting book-based information (revenues and the net carry measure), as well as an economic market-based measure of asset-liability performance called total return. In addition to economic market-based measures, liability benchmarks, external indices and attribution analysis are also used to measure portfolio performance. For more information on the performance measures, please see the “Portfolio Performance Measurement” section later in this document.

Asset-liability performance is reported monthly to management at the Department of Finance and the Bank of Canada, periodically to the Minister of Finance and annually to Parliament. 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 annually on a fiscal-year basis.

Major Initiatives in 2006–07

During 2006–07, major initiatives focused on implementing a new investment regime as per the EFA's SIP, strengthening the funds management governance and risk management frameworks, and evaluating the effectiveness of the management of the EFA.

Implementation of the New Investment Regime

As required by the *Currency Act*, the SIP governs the acquisition, management and divestiture of assets for the EFA. The SIP allows for the investment in two new short-term asset classes: commercial paper and certificates of deposit. Investment in these new asset classes began in 2006–07.

Commercial paper is a marketable senior level unsecured short-term instrument, typically issued by the largest and most creditworthy issuers as an alternative to bank loans. Only traditional commercial paper issued and fully backed by top-rated financial institutions and financial affiliates of commercial firms is eligible for investment in the EFA. Of note, asset-backed commercial paper does not qualify. As described in the SIP, the amount of funds that may be invested in commercial paper varies according to the credit quality of the issuer. As an example, the maximum amount that may be invested in commercial paper issued by an entity with the highest credit rating is US\$300 million. Further, there is also an aggregate limit on the total amount of commercial paper that may be held within the EFA. Certificates of deposit are marketable deposits issued by banks as an alternative to term deposits.

Investment in commercial paper and certificates of deposit were approved as eligible asset classes for the EFA as their inclusion improves the overall liquidity and investment performance of the EFA with minimal additional risk. Limits as to eligible issuers and the amounts that may be invested are specified in the SIP.

Strengthening of the *Funds Management Governance Framework*

The *Funds Management Governance Framework*, which sets out the decision-making authority for the EFA and ensures accountability through appropriate performance measurement, risk management and reporting, was enhanced to focus the roles, responsibilities and accountability for the management of the EFA. For example, the purpose and role of the Funds Management Committee (FMC), the most senior committee, have been clarified to better reflect its responsibilities and those that it has delegated to subordinate committees. The purpose and responsibilities of the Risk Committee have also been refined to better reflect its relationship with the FMC and coordinating committees. As well, an Asset Liability Management Committee (ALMC) has been incorporated within the governance framework to provide recommendations to the FMC, in its advisory role, on strategic and policy matters affecting the management of the EFA, including changes to the pertinent limits and guidelines. The ALMC is also a decision-making body, within limits delegated by the FMC, whose decisions are executed by officials at the Bank of Canada and the Department of Finance.



Strengthening of the Risk Management Framework

An effective risk management framework requires identifying, measuring, monitoring and managing risks related to the financing and investment of the foreign reserves. It also includes regular and timely reporting of risk exposures. As such, new risk measures and reporting practices were developed to enhance the monitoring and reporting of operational and liquidity risks.

The new operational risk measures and reporting framework provide management with a better understanding of the nature, frequency and severity of operational risks that arise from time to time in the management of the EFA. For instance, the new measures classify each operational risk event according to the risk drivers and resultant consequences. The risk drivers are further classified according to the relevant source, which may involve people, processes, systems or external factors. The consequences of operational risk events are also further classified according to limit breaches, business delays and monitoring/reporting issues. For both the risk drivers and consequences, each event is also classified according to severity using a standardized scale. In terms of monitoring and reporting, monitoring of operational risk events occurs on a real-time basis with formal reports being produced for management at least semi-annually.

The new liquidity stress test measures provide an indication of the EFA's ability to meet commitments as they become due under various market conditions. The latter include circumstances wherein the markets are functioning normally, conditions in which the markets are moderately disrupted and conditions in which the EFA is also being used to support intervention in foreign exchange markets. These measures provide a better understanding of how well the EFA is achieving the key strategic objective of preserving liquidity.

Evaluation of the Management of the EFA

As a component of ongoing reviews that are part of the Treasury Evaluation Program, an external evaluation of the EFA was completed in 2006–07. The evaluation was undertaken to assess the effectiveness of current practices in achieving the objectives of the EFA, as well as seeking recommendations to further enhance the management of the EFA.

The evaluation focused on the EFA portfolio structure, investment guidelines, asset eligibility, performance measurement metrics and reporting. The evaluation process involved a comparison of the EFA's investment framework with the general investment practices of similar large, public sector institutional investors. The evaluation concluded that Canada's investment policies and practices compare well to the practices of other comparable countries and that the EFA is being managed prudently, effectively and with due regard for the three key objectives: liquidity, capital preservation and return enhancement.

The evaluation also suggested that the EFA is managed relatively conservatively and provided recommendations on ways in which the EFA's investment returns could be enhanced. The latter focused on two areas: seeking additional returns by investing in less liquid assets and by adding market risk. Examples of areas identified for consideration include re-evaluating eligible currencies and their allocations, broadening the list of eligible investments and allowing unmatched interest exposure between the EFA's assets and corresponding liabilities. These recommendations will be considered at a later date. For more information on the evaluation of the EFA, please visit www.fin.gc.ca/efa/EFA2006_e.pdf.



Risk Management Policy Developments

The EFA's exposure to market risk is mitigated by matching the financial characteristics of the assets and liabilities of the EFA. A Value-at-Risk (VaR) model and various stress tests that are considered to be industry standards are employed to measure the EFA's exposure to market risk. VaR is a statistical measure for estimating potential losses to the EFA portfolio arising from normal market movements such as changes in interest and exchange rates, while stress tests are used to evaluate the portfolio's performance under extraordinary circumstances in the market.

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. 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 these frameworks, high quality collateral is placed with collateral managers for the EFA when the market value of the swap contracts exceeds specified limits. Along with liquidity and legal risks, credit risk is also controlled through strict guidelines.

Lastly, operational risk is managed by the Bank of Canada and is monitored and reported on a regular basis.

Risk policy issues are reviewed on an ongoing basis, with the current focus in various key areas:

Credit Risk:

The main objective of credit risk policies of the Government is to distribute credit exposures to counterparties in a manner that provides effective control over the Government's exposure to counterparty risk. These policies include guidelines for assessing counterparty credit quality, setting exposure limits to those counterparties and measuring, monitoring and reporting credit exposures.

Credit ratings from four credit rating agencies are used to derive an internal rating to establish the credit quality of each counterparty. This enables the Government to rank counterparties in a transparent manner, with higher-rated counterparties receiving larger exposure limits than those that have lower credit ratings. The methodologies used by rating agencies are monitored on a regular basis to ensure they meet the needs of the Government.

Review of the *Treasury Risk Management Framework*:

The *Treasury Risk Management Framework* is undergoing an external review in 2007–08 to ensure its appropriateness with ongoing risk management developments. The evaluation will consider the effectiveness of the current risk management framework in controlling the risks that have been identified as well as the comprehensiveness and completeness of the framework in identifying, measuring, controlling and reporting on the full range of pertinent risks.



Report on Operations in 2006–07

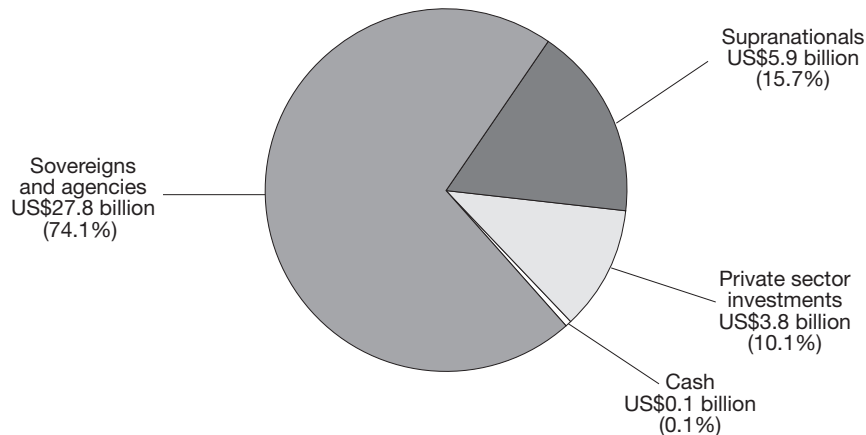
This section reviews operations related to the official international reserves, including the achievement of objectives, changes in the level of reserves, portfolio performance and risk measurements.

Performance Versus Strategic Objectives

The *Currency Act* stipulates that this report provide a statement of whether the strategic objectives have been met during the review period. The three objectives, which are to maintain a high standard of liquidity, preserve capital value and optimize return, have been achieved, as the level of liquidity was maintained for the reserves portfolio throughout the reporting period, and the portfolio's exposure to market and credit risks remained stable (see the section entitled "Risk Measures"). In addition, the total return measure was positive (see the section entitled "Portfolio Performance Measurement").

In practice, the EFA portfolio is mainly invested in sovereign and government-sponsored entity securities (74 per cent), as these securities enhance both liquidity and capital preservation (Chart 1).¹ The share of deposits and repos is small because they offer lower liquidity than other investment options. The Liquidity Tier mainly consists of US Treasury securities, given that they are the most liquid securities in the market.

Chart 1
Composition of EFA Liquid Investments as at March 31, 2007
(market value)



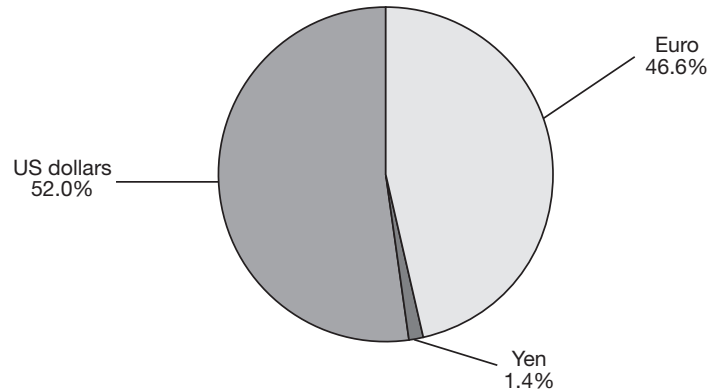
The current practice is to hold a significant portion of the reserves in US dollars because foreign currency needs are mostly in US dollars and, historically, foreign exchange intervention has mainly consisted of transactions involving the US dollar. As at March 31, 2007, the US-dollar share of the EFA liquid investments was US\$19.5 billion or 52 per cent, the euro share was 13.1 billion euros or 46.6 per cent, and the yen portion was 59.5 billion yen or 1.4 per cent (Chart 2).²

¹ Excludes gold and SDR holdings.

² Excludes gold and SDR holdings.



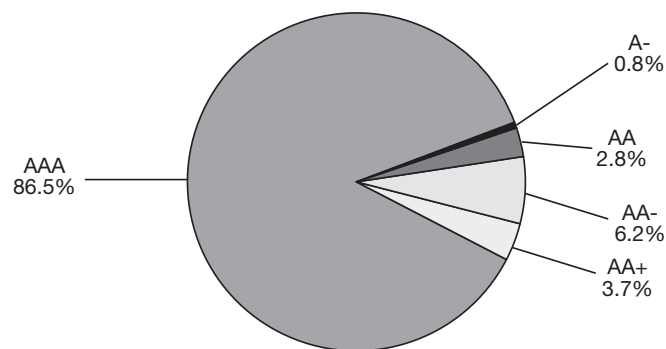
Chart 2
Currency Composition of EFA Liquid Investments
as at March 31, 2007
 (market value)



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 according to the SIP. The majority of EFA investments are in the AAA category, as indicated in Chart 3.³ Of note, repurchase agreements are included and secured by AAA/Aaa securities.

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.

Chart 3
Official Liquid Reserves as at March 31, 2007
 (settled basis)



³ Excludes gold and SDR holdings.

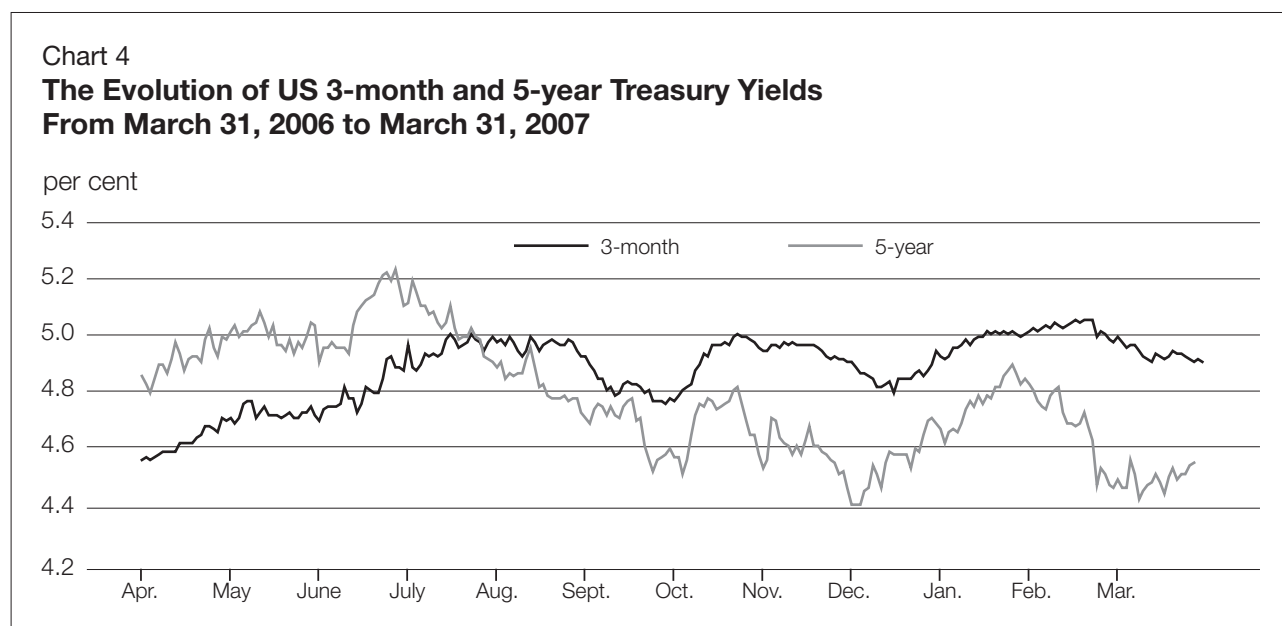


Market Developments During the Reporting Period

The official international reserves are reported on a market-value basis and in US dollars, meaning that changes in interest and exchange rates will affect the market value of the reserves. Overall, changes in exchange rates increased the value of the reserves by US\$1.6 billion and changes in interest rates increased the value of the reserves by US\$192 million.

Interest Rates

As examples of changes over 2006–07, the yield on US 3-month Treasury bills increased by 35 basis points while the yield on US 5-year Treasury bonds decreased by 31 basis points (Chart 4). The changes in interest rates had the effect of slightly increasing the market value of the EFA's assets.



Since the EFA is managed according to an asset-liability matching framework, both the reserves and its associated liabilities increased in similar magnitude. In turn, these effects necessitated modest alterations to the annual funding projections in order to maintain the reserves at close to their target level. As well, the rising short-term US interest rate environment decreased the EFA's funding costs, as the Government was required to pay lower floating interest payments while maintaining fixed interest receipts to match the fixed interest payments on domestic bonds on its cross-currency swaps.

The euro-denominated holdings within the reserves are mainly composed of longer-term issues. As the changes in European longer-term interest rates over 2006–07 were relatively minor, with an increase of only 3 basis points, the impact on the reserves was small.



Exchange Rates

As roughly 47 per cent of the official international reserves were held in euro-denominated securities (as at March 31, 2007), the market value of the reserves was significantly affected by movements in the euro. From March 31, 2006 to March 31, 2007, the euro appreciated 10.3 per cent against the US dollar. The highest level of the US dollar/euro exchange rate during the period was 1.3373 on March 30, 2007, while the low was 1.209 on April 10, 2006 (Chart 5).



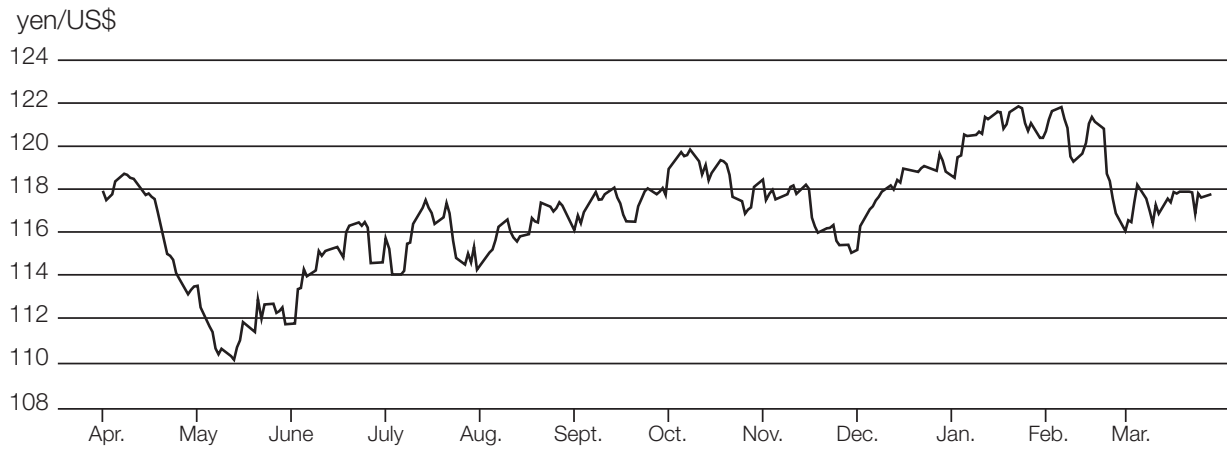
As with changing interest rates, the appreciation of the euro affected the annual funding requirements by increasing the market value of the reserves, measured in dollars, thereby decreasing the annual funding requirements needed to maintain the reserves at close to their target level.

The level of the official international reserves was less exposed to changes in the yen/US-dollar exchange rate (Chart 6) since only 1.4 per cent of the reserves were held in yen-denominated assets (as at March 31, 2007). Overall, the yen appreciated by 0.1 per cent against the US dollar during the reporting period. The highest level of the yen/US dollar exchange rate during the period was 110.202 on May 16, 2006, and the low was 121.81 on January 29, 2007.

Changes in interest rates affect the market value of investments by either increasing (when rates fall) or decreasing (when rates rise) the value of the investments held in the reserves. Over the period from March 31, 2006 to March 31, 2007, movements in interest rates had a smaller effect on the reserves than movements in exchange rates: changes in interest rates increased the market value of the reserves by US\$192 million, while foreign currency revaluations increased their market value by US\$1.625 billion.



Chart 6
The Evolution of the Yen from March 31, 2006 to March 31, 2007



Composition of the Official International Reserves as at March 31, 2007

Table 2 shows the distribution of investments in the official international reserves by currency and term to maturity as at March 31, 2007. US-dollar holdings, which made up more than half of the reserves, were primarily in short-term (i.e. under six months) maturities, as they are held for liquidity purposes. The euro holdings, which are held for investment purposes, were more heavily weighted towards medium-term (i.e. one to five years) investments. Likewise, the yen holdings were mostly invested in securities with medium-term maturities.

For reporting purposes, gold, SDR holdings and the IMF reserve position, which have no terms to maturity, are translated into US dollars. The IMF reserve position is classified as an investment of indefinite term.



IMF Reserve Position

The International Monetary Fund (IMF) is an international organization that is structured as a financial cooperative owned by its member nations whose objective is to promote international monetary cooperation and exchange stability and to help foster economic growth. One of the functions of the IMF is to provide financial assistance to countries experiencing temporary balance of payment difficulties. The IMF also promotes economic growth and poverty reduction by providing loans to countries in need at favourable rates.

Each country (including Canada) that joins the IMF is assigned a quota that represents the maximum amount of resources that a country is obliged to provide to the IMF, upon request. As well, the IMF typically has on deposit with each respective 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 IMF reserve position is an asset that is included as a component of the official international reserves. As such, changes in Canada's IMF reserve position that may result from advances, repayments or revaluations directly impact the Government of Canada's Public Accounts. However, because the IMF reserve position is not actively managed by the Department of Finance or the Bank of Canada, it is not included in the EFA and is instead represented within the wider category of official international reserves. Further, in order to reconcile the holding of the IMF reserve position within the official international reserve's asset-liability matching framework, only US-dollar liabilities are deemed to fund the reserve position.



Table 2
Term Structure of the Official International Reserves as at March 31, 2007

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	3,555	3,635	5,657	-	-	12,847	-	12,847
6 to 12 months	-	-	335	-	-	335	-	335
1 to 5 years	-	-	3,135	-	-	3,135	-	3,135
Over 5 years	-	378	2,854	-	-	3,232	-	3,232
Indefinite term	-	-	-	72	976	1,048	722	1,770
Total US-dollar holdings	3,555	4,013	11,981	72	976	20,597	722	21,319
Euro holdings¹								
Under 6 months	257	264	311	-	-	832	-	832
6 to 12 months	-	106	334	-	-	440	-	440
1 to 5 years	-	8,276	2,218	-	-	10,494	-	10,494
Over 5 years	-	4,343	1,377	-	-	5,720	-	5,720
Total euro holdings	257	12,989	4,240	0	0	17,486	0	17,486
Yen holdings¹								
Under 6 months	71	-	-	-	-	71	-	71
6 to 12 months	-	-	-	-	-	-	-	-
1 to 5 years	-	434	-	-	-	434	-	434
Over 5 years	-	-	-	-	-	-	-	-
Total yen holdings	71	434	0	0	0	505	0	505
Total	3,882	17,435	16,222	72	976	38,587	722	39,309

¹ The exchange rates prevailing on March 31, 2007, are used for the euro and yen assets.



Changes in the Level of the Official International Reserves

The level of the official international reserves changes over time due to a variety of factors. As shown in Table 3, over the 12-month reporting period the level of the reserves increased by US\$3.3 billion due to reserves management operations (US\$1.6 billion), return on investments (US\$1.4 billion) and revaluation effects (US\$1.6 billion). The increase was partly offset by foreign currency debt charges (US\$1.4 billion).

Table 3

*Sources of Changes in Canada's Official International Reserves
(March 31, 2006 to March 31, 2007)*

	Change
	(market value in millions of US dollars)
Official intervention	–
Net government operations	–
Reserves management operations	1,631
Gains and losses on gold sales	–
Return on investments	1,392
Foreign currency debt charges	-1,373
Revaluation effects	1,625
Other	-1
Total change	3,275

Note: Numbers may not add due to rounding.

Official Intervention

Official intervention involves buying or selling foreign exchange currencies in exchange for Canadian dollars, and would therefore affect the level of the official international reserves. Intervention in the Canadian-dollar foreign exchange market has not occurred since 1998 (see Annex 2).⁴

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/maturities and purchases/sales of foreign currency assets affect the level of the EFA. Over the reporting period, funds raised through the issuance of cross-currency swaps and Canada bills, totalling US\$17 billion, more than offset debt maturities (US\$15 billion in total, including a US\$1-billion global bond, Canada bill maturities totalling US\$12 billion and cross-currency swap maturities of US\$2 billion), resulting in a net increase in the level of official international reserves.

⁴ Since that time, the only market intervention was the purchase of euros in 2000 as part of Canada's participation in concerted Group of Seven (G7) intervention in support of the euro.



Gains and Losses on Gold Sales

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 a 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.

Return on Investments

Return on investments comprises interest earned on investments (US\$1.2 billion) and the increase in the market value of securities resulting from changes in interest rates (US\$192 million). The overall effect on the official international reserves was a net increase of US\$1.4 billion.

Foreign Currency Debt Charges

Foreign currency debt charges reduced the level of the official international reserves by US\$1.4 billion.

Revaluation Effects

Revaluation effects resulting from movements in exchange rates reflect changes in the market value of the official international reserves. Revaluation effects increased the official international reserves by US\$1.6 billion, primarily due to the appreciation of the euro versus the US dollar.

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

EFA Financing

As previously noted, the assets in the EFA are managed against a portfolio of dedicated liabilities. The liabilities are Government of Canada foreign currency borrowings from a variety of sources (Table 4).

Funding requirements are primarily met through an ongoing program of cross-currency swaps of domestic obligations. Total cross-currency swap issuance and maturities during the reporting period were US\$5 billion and US\$2 billion, respectively. In recent years, swaps have been particularly cost-effective compared to other sources of foreign currency funds. During 2006–07, foreign currency was raised through cross-currency swaps at 3-month US\$ LIBOR less 41 basis points on average. This funding cost compares favourably with the rates obtained during the previous reporting period, which averaged 3-month US\$ LIBOR less 35 basis points.

In addition to cross-currency swaps of domestic obligations, the EFA is funded by a short-term US-dollar paper program (Canada bills), medium-term note issuance in various markets (Canada notes and euro medium-term notes [EMTNs]) and international bond issues (global bonds), the use of which depends on funding needs and market conditions. From March 31, 2006 to March 31, 2007, the level of outstanding Canada bills decreased by US\$2.5 billion. Canada bills were issued, on average, at an all-in cost of US\$ LIBOR less 20 basis points, which was generally in line with funding levels of prior years. There was no new issuance of Canada notes, euro medium-term notes or global bonds during the period. One US-dollar global bond (US\$1 billion) matured.



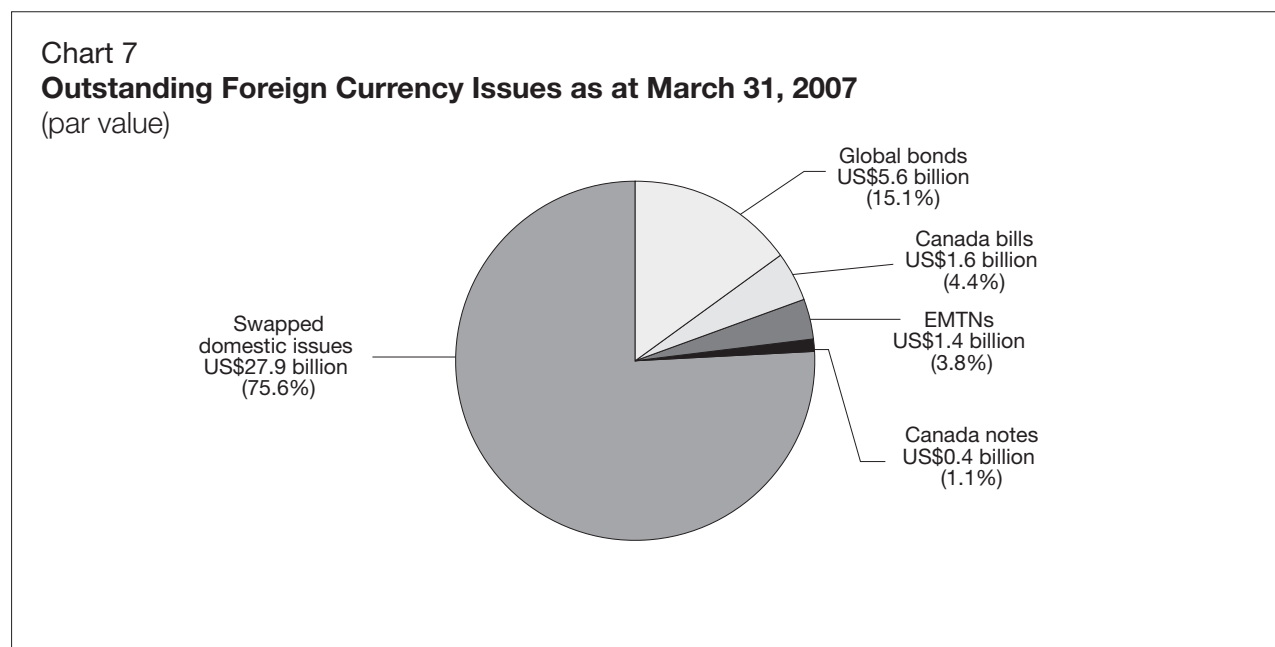
The changes in the outstanding numbers shown in Table 4 reflect not only issuance and maturities, but also changes in the exchange rates of the euro and yen versus the US dollar (as the foreign currency issues are reported in US dollars). Outstanding foreign currency issues are represented in Chart 7.

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/purl/dmr-e.html.

Table 4
Outstanding Foreign Currency Issues as at March 31, 2007

	March 31, 2007	March 31, 2006	Change
	(par value ¹ in millions of US dollars)		
Swapped domestic issues	27,962	22,083	5,879
Global bonds	5,589	6,286	-697
Canada bills	1,600	4,053	-2,453
Euro medium-term notes	1,408	1,284	124
Canada notes	424	425	-1
Total	36,983	34,131	2,852

¹ Liabilities are stated at the exchange rates on March 31, 2007.





Portfolio Performance Measurement

Performance measures are reported on a monthly basis to management at the Department of Finance and the Bank of Canada.

Revenues

The revenues of the official international reserves include income from investments and foreign exchange gains. During the reporting period, income totalled C\$1.77 billion, compared to C\$1.73 billion in the previous reporting period. The main categories of income are summarized in Table 5. Data is reported in Canadian dollars, as EFA revenues, which account for the bulk of the revenues of the official international reserves, are reported in Canadian dollars in the attached financial statements.

Table 5

Revenues for the Official International Reserves as at March 31, 2007

	Official international reserves	
	Total revenue from April 1, 2006 to March 31, 2007	Total revenue from January 1, 2005 to March 31, 2006
	(millions of Canadian dollars)	
Investment income		
Marketable securities	1,368	1,840
Cash and short-term deposits	109	104
Deposits held under repurchase agreements	105	46
Special drawing rights	42	37
Total investment income	1,624	2,027
Other income		
Foreign exchange gains or losses	141	-293
Total income	1,765	1,734

The EFA's securities-lending program enhances the income earned on the portfolio by lending out securities that are highly sought after in the market. Income from securities lending, included in investment income from marketable securities in Table 5, totalled C\$3 million during the period compared to C\$8 million in 2006.



EFA Performance Measures

The performance of the EFA is reported using two separate measures. The first is called “carry” and represents the net revenue generated by the EFA’s assets and corresponding liabilities from a cash-only perspective. For instance, 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 compared to 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 *Public Accounts of Canada*, which currently account for financial assets and liabilities on an accrual basis.

The second measure of performance 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.

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 liability 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 required by the asset-liability management framework of the EFA are being met.

Of the key sources of return, the coupon effect (what would have been earned had interest rates remained unchanged over the period) is the main driver of the EFA’s positive total return. This is because the EFA’s assets generate more interest income than what is required to pay for the EFA’s liabilities. 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. The spread effect (returns due to movements in interest rate spreads) illustrates how the EFA’s assets and liabilities respond to changing interest rate spreads. Typically, movements in interest rate spreads will differ for assets according to their credit quality. 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 called the “residual return,” which is the unexplained portion of total return. By using these key sources of return, a clearer picture emerges as to the drivers of the EFA’s annual total return.



Carry

Table 6 provides an estimate of the carry for the EFA and its constituent currency portfolios. The carry for the 2006–07 fiscal year was estimated at -9 basis points, an improvement over the previous period. The continued negative performance was due to the holding of low-coupon assets relative to the interest paid on older liabilities while this year's improvement was caused by a narrowing of the difference between the interest receipt and payment flows.

Taking into account gains or losses on asset sales recorded during the same period, the EFA accumulated net losses of US\$110 million, or -32 basis points. This reflects US\$78 million in net realized losses on US-dollar and euro asset sales plus net interest costs of US\$32 million. Realized losses were significant due to sales of lower-coupon assets in favour of higher-yielding ones in an environment where interest rates have generally increased since the assets were originally purchased. Regardless of whether capital gains or losses are recorded on these transactions in an accounting sense in the year in which they took place, the EFA benefits in economic terms over the whole period during which the assets are held because it earns more interest income over the remaining life of the new higher-yielding investments than it would have done on the assets sold.

Table 6*Carry for the Official International Reserves¹*

	January 1, 2005 to March 31, 2006		April 1, 2006 to March 31, 2007				
	Carry	Carry (including net realized gains)	Interest earned on assets	Interest paid on liabilities	Net interest earned on assets	Carry	Carry (including net realized gains)
	(basis points)		(millions of US dollars)			(basis points)	
Euro portfolio	-29	41.6	602.0	661.0	-59	-17.1	-17.3
Yen portfolio	0	0	8.1	8.0	0.1	0.1	0.1
US\$ portfolio	-20.1	-17.1	856.5	829.5	27	7.8	-14.4
Total carry²	-49.1	24.5	1,466.7	1,498.5	-31.8	-9.2	-31.7

¹ The carry figures show the contribution of each currency portfolio to the overall carry. Numbers for 2006–07 do not include the IMF reserve position and associated liabilities.

² Excludes gold holdings.

Total Return on Market-Value Basis

Table 7 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.⁵ The net total return was +31 basis points, or US\$105 million, in the fiscal year ending March 31, 2007 compared to +17 basis points, or US\$44 million, in the 15 months ending March 31, 2006. This reflects net returns in US dollar terms of +21 basis points for the US-dollar portfolio, +43 basis points for the euro portfolio and +18 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.

⁵ Excluding gold, SDR holdings and the IMF reserve position as those assets are not actively managed on an integrated asset-liability basis.

**Table 7***Total Return for the EFA Compared to Liability Benchmarks*

	January 1, 2005 to March 31, 2006	April 1, 2006 to March 31, 2007			Total EFA
	Total EFA	US\$ portfolio	Euro portfolio	Yen portfolio	
EFA asset portfolio					
Return in original currency	n/a	5.69%	2.30%	0.93%	n/a
Return in US\$ (A)	-3.42%	5.69%	12.80%	0.82%	8.62%
Liability benchmarks					
Return in original currency	n/a	5.47%	1.92%	0.74%	n/a
Return in US\$ (B)	-3.60%	5.47%	12.36%	0.64%	8.31%
Return vs. liability benchmark in basis points					
(A – B) in US\$	17	21	43	18	31

Table 8 compares the total return for the EFA to a set of Merrill Lynch government securities indices. This provides some insight into how it 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, 2007, the EFA's total return exceeded that of the external indices by 15 basis points, compared to an underperformance of 2 basis points in the 15 months ending March 31, 2006. The EFA's excess return this fiscal year was largely due to the strong performance of its non-US-Treasury US-dollar investments.

Table 8*Total Return for the EFA Compared to External Indices¹*

	April 1, 2006 to March 31, 2007		
	US\$ portfolio	Euro portfolio	Yen portfolio
EFA asset portfolio			
Return in original currency (A)	5.69%	2.30%	0.93%
Return in US\$	5.69%	12.80%	0.82%
External indices			
Return in original currency (B)	5.38%	2.30%	n/a
Return in US\$ ²	5.38%	12.80%	n/a
Return vs. external indices in basis points (A – B) in original currency			
	31	0	n/a

¹ Composite indices are constructed as weighted averages of Merrill Lynch US Treasury and German government indices.

² 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

Table 9 summarizes the attribution results for the EFA's US-dollar and euro portfolios for the fiscal year ending March 31, 2007. They indicate the coupon effects and credit spread changes were the main sources of original currency return for both portfolios. Although total returns on both portfolios were significantly affected by interest rate movements over the period, similar effects were observed in the corresponding liabilities. This demonstrates a central requirement of the asset-liability management framework of the EFA was achieved over the reporting period. The US-dollar portfolio also earned about 1 basis point from securities-lending activities over the period, since some of its securities were in high demand in the market.

Table 9

Performance Attribution for the US Dollar and Euro Portfolios Compared to Liability Benchmarks

	April 1, 2006 to March 31, 2007			
	US\$ portfolio		Euro portfolio	
	Assets	Liabilities	Assets	Liabilities
	(per cent)			
Coupon effect	5.22	5.12	3.81	3.71
Yield curve change	0.30	0.39	-1.68	-1.69
Credit spread change	0.19	-0.07	0.24	-0.15
Securities-lending revenue	0.01			
Residual returns	-0.04	0.04	-0.05	0.04
Return in original currency	5.69	5.48	2.31	1.92

Risk Measures⁶

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

Several industry-standard measures of market risk exposure were employed: scenario analysis, stress testing and Value-at-Risk (VaR) (Table 10).

Stress tests were 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, comparable to their positions as at March 31, 2006.

⁶ These risk measures apply to the EFA only, excluding the SDRs and gold holdings.



In addition, some hypothetical scenario stress tests that mimic the 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 four stress tests showed that the EFA would generally perform well during such periods of market turbulence. The results were similar to those reported for March 31, 2006, and show that on a net basis, the EFA was continuously well positioned to benefit from flight-to-quality effects.

Table 10
Market Risk Measures

Risk measure	March 31, 2007		March 31, 2006	
	EFA	EFA assets less liabilities	EFA	EFA assets less liabilities
	(millions of US dollars)			
Single factor stress tests				
1% depreciation of euro/yen	-180	-3	-138	-2
1% upward parallel shift in yield curve	-963	-27	-801	2
Scenario tests				
1994 Fed tightening	-2,670	75	-2,198	85
1997 Asian financial crisis	-982	30	-713	54
1998 Russian default/LTCM collapse	-1,381	6	-989	45
2001 terrorist attacks	1,100	10	889	14
99% 10-day VaR	643	15	609	14

Market VaR is a statistical measure that estimates the expected 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, 2007, the EFA had a 99 per cent 10-day VaR of US\$15 million, little changed from at March 31, 2006, which implied that 99 per cent of the time, the value of the portfolio was not expected to decline by more than US\$15 million, on a net basis, over a 10 trading-day period.

Credit Risk

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 11).

**Table 11***Credit Risk Measures*

Risk measure	March 31, 2007
	(millions of US dollars)
Credit VaR and expected shortfall	
99.9% 365-day Credit VaR	493
Expected shortfall	1,402
Stress test	
Potential loss if counterparties with negative outlook are downgraded one notch	0.1

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, 2007, the EFA had a 99.9 per cent 1-year Credit VaR of US\$493 million, which implied that 99.9 per cent of the time, the value of the portfolio was not expected to decline by more than US\$493 million 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 US\$1.4 billion as of March 31, 2007.

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. They showed that the EFA would perform well in this type of scenario.



Annex 1: Statement of Investment Policy

1. Purpose of Policy

This document 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 Exchange Fund Account is the principal repository of the Government of Canada's official international reserves. Its purpose is to provide a source of funds, if required, to help promote orderly conditions for the Canadian dollar in the foreign exchange market and to provide foreign currency liquidity for the Government of Canada.

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. Details of the governance framework are provided in the *Treasury Management Governance Framework*.

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 basis⁷ (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.

⁷ 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 directly guaranteed agencies), central banks, government-supported entities 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) International Monetary Fund (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 must have a credit rating in the top seven categories from at least two of the four main rating agencies: Moody's Investors Service, Standard & Poor's, Fitch Ratings and Dominion Bond Rating Service. When there are two or more ratings for an entity, the rating of the second highest rating agency will be used to assess eligibility.⁸

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
Standard & Poor's	A-
Fitch Ratings	A
Dominion Bond Rating Service	A (low)

Notes: The Bank for International Settlements (BIS) and the IMF are deemed to be eligible entities. Rating references elsewhere in this document use the ratings scale of Standard & Poor's.

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 directly guaranteed agencies), government-supported entities and supranational institutions are determined by credit rating and by currency of issuance, as shown in the table below.

⁸ 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-).



Issuer	Aggregate limits (% of reserves target level)	Individual counterparty limits (% of reserves target level)
AAA sovereigns in domestic currency (including directly guaranteed agencies)	Unlimited	Unlimited
AAA sovereigns in foreign currency (including directly guaranteed agencies) and AA- to AA+ sovereigns in domestic and foreign currency (including directly guaranteed agencies)	25	10
A- to A+ sovereigns (including directly guaranteed agencies)	2	See below ¹
Government-supported entities (senior unsecured obligations)	15	3
Suprationals (excluding Bank for International Settlements)	25	10

Note: All amounts are expressed in par values.

¹ Individual exposure limits for single-A sovereigns (including directly guaranteed agencies) are as follows:

Credit rating	Total exposure	Of which home currency	Of which foreign currency
		(millions of US dollars)	
A+	500	500	50
A	250	250	25
A-	100	100	10

Note: All amounts are expressed in par values.

6.3.2 Deposits and Other Short-Term Securities

Aggregate and individual exposure limits exist for deposits and other eligible securities. A maximum of 10 per cent of the reserves target level (based on par values) may be invested in deposits and securities of the Bank for International Settlements. Aggregate limits of US\$1.5 billion and US\$1 billion (based on par values), respectively, are imposed on commercial bank deposits and commercial paper/certificates of deposit issued by private sector entities.

Individual 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 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, with a maximum of 2 per cent of the reserves target level for private sector entities rated A+ to A-.

*Actual exposure limits by credit rating of private sector counterparties/issuers¹*

	AAA	AA+	AA	AA-	A+	A	A-
	(millions of US dollars)						
Individual exposure	300	200	150	100	50	25	10

¹ Represents par value for deposits, commercial paper and certificates of deposit and mark-to-market value for swaps and forwards.

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 directly guaranteed agencies) and supranational securities; 2) US government-supported entity securities; 3) 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.

6.5 Eligible Currencies

The Exchange Fund Account may hold US dollars, euros, Japanese yen and IMF special drawing rights. The minimum floor for US-dollar-denominated securities 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 A+ or lower	5 years if the investment is denominated in domestic currency 1 year if the investment is denominated in foreign currency
Commercial paper and certificates of deposit	1 year
Commercial bank deposits and repurchase agreements	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.

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.

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 a risk committee that has the capacity to provide an independent view of operations, to a management committee, and to senior management from the Department of Finance and the Bank of Canada, 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: Official Intervention

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.⁹

Table 12
Official Intervention

	2002	2003	2004	January 1, 2005 to March 31, 2006	March 31, 2006 to March 31, 2007
	(millions of US dollars)				
Purchases	-	-	-	-	-
Sales	-	-	-	-	-
Net	-	-	-	-	-

⁹ Official intervention is separate from net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.



Annex 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 monthly change	Reserves management operations ⁴	Gains and losses on gold sales	Return on investments ⁵	Foreign currency debt charges	Revaluation effects	Net government operations ⁶	Official intervention	Other transactions ⁷
(market value in millions of US dollars)														
2006														
March	28,420	5,596	63	917	1,038	36,034	-215	0	523	-1,326	-1,122	0	0	0
2006-07														
April	29,606	4,051	70	931	1,058	35,716	-318	0	29	-85	610	0	0	0
May	29,601	3,960	71	949	1,103	35,684	-32	0	125	-70	267	0	0	0
June	30,230	3,584	67	939	1,092	35,912	228	0	22	-375	-49	0	0	-1
July	30,514	3,770	69	942	1,096	36,391	479	0	250	-135	-8	0	0	0
August	29,989	3,748	68	949	1,099	35,853	-538	0	270	-47	42	0	0	0
September	29,161	4,760	65	941	1,090	36,017	164	0	151	-72	-187	0	0	0
October	29,712	3,976	66	944	945	35,643	-374	0	107	-150	121	0	0	0
November	30,284	4,291	70	965	867	36,477	834	0	193	-81	680	0	0	0
December	30,197	3,001	69	963	833	35,063	-1,414	0	-125	-229	-87	0	0	1
January	30,425	3,633	71	954	825	35,908	845	0	32	-13	-220	0	0	-1
February	31,569	2,983	72	966	720	36,310	402	0	288	-12	285	0	0	0
March	33,657	3,882	72	976	722	39,309	2,999	0	50	-104	171	0	0	0
Total⁸	n/a	n/a	n/a	n/a	n/a	n/a	3,275	0	1,392	-1,373	1,625	0	0	-1

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

² Special drawing right (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 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).

⁵ Return on investments comprises interest earned on investments and changes in the market value of securities resulting from changes in interest rates.

⁶ Net government operations are the net purchases of foreign currency for government foreign exchange requirements and for additions to reserves.

⁷ 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.

⁸ Numbers are from the Official International Reserves press release.



Annex 4: 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 5: 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 five dealers: CIBC World Markets, Credit Suisse First Boston LLC, Goldman, Sachs & Co., Lehman Brothers Inc. 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 the Bank of New York. The notes are offered by the Government through five dealers: Credit Suisse First Boston LLC, Goldman, Sachs & Co., Harris Nesbitt Corporation, Lehman Brothers Inc. and Scotia Capital (USA) Inc. 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 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 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 2007



Exchange Fund Account

Management Responsibility for the Financial Statements

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 operation of the Account is governed by the provisions of Part II of the *Currency Act*. The Bank of Canada administers the Account, as fiscal agent of the Government of Canada.

The financial statements were prepared in accordance with the stated accounting policies set out in Note 2 to the financial statements, which are consistent with those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year.

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

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. 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 for their review.

David A. Dodge
Governor
Bank of Canada

Rob Wright
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

Ottawa, Canada
4 May 2007



Auditor General of Canada
Vérificatrice générale du Canada

Auditor's Report

To the Minister of Finance

I have audited the balance sheet of the Exchange Fund Account as at 31 March 2007 and the statements of revenue and cash flows for the year then ended. These financial statements have been prepared to comply with Sections 20 and 21 of the *Currency Act*. 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 2007 and its revenues and its cash flows for the year then ended in accordance with the accounting policies set out in Note 2 to the financial statements.

These financial statements, which have not been, and were not intended to be, prepared in accordance with Canadian generally accepted accounting principles, are solely for the information and use of the Minister of Finance for complying with Sections 20 and 21 of the *Currency Act* as set out in Note 2 to the financial statements. The financial statements are not intended to be and should not be used by anyone other than the specified users or for any other purpose.

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*.

Douglas G. Timmins, CA
Assistant Auditor General
for the Auditor General of Canada

Ottawa, Canada
4 May 2007



Exchange Fund Account

Balance Sheet as at 31 March

	2007	2006
	(millions of Canadian dollars)	
Assets		
Cash and short-term deposits (note 3)	1,925	4,239
Deposits held under repurchase agreements (note 4)	2,540	2,278
Marketable securities (note 5)	38,463	32,855
	42,928	39,372
Other assets		
Special drawing rights	1,119	1,065
Gold	7	6
Accrued interest (note 6)	619	493
	1,745	1,564
	44,673	40,936
Liabilities		
Due to the Consolidated Revenue Fund		
Advances (note 7)	42,908	39,202
Net revenue for the year	1,765	1,734
	44,673	40,936

Approved:

David A. Dodge
Governor
Bank of Canada

Rob Wright
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

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



Exchange Fund Account

Statement of Revenue
For the year ended 31 March

	2007 (12 months)	2006 (15 months)
	(millions of Canadian dollars)	
Revenue from investments		
Marketable securities	1,368	1,840
Cash and short term deposits	109	104
Deposits held under repurchase agreements	105	46
Special drawing rights	42	37
	<u>1,624</u>	<u>2,027</u>
Other revenue		
Net gain (loss) on foreign exchange	141	(293)
Net revenue for the year	<u>1,765</u>	<u>1,734</u>

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



Exchange Fund Account

Statement of Cash flows
For the year ended 31 March

	2007 (12 months)	2006 (15 months)
	(millions of Canadian dollars)	
Cash flows from operating activities		
Interest received		
Marketable securities	995	1,476
Securities lending activities	3	8
Short term deposits	100	85
Deposits held under repurchase agreements	102	37
Other	15	10
Purchase of marketable securities	(60,028)	(63,093)
Proceeds from the sale or maturity of marketable securities	55,937	59,688
Increase in foreign currencies	459	3,407
Decrease in foreign currencies	(1,563)	(2,777)
Cash used in operating activities	(3,980)	(1,159)
Cash flows from financing activities		
Increase in advances	19,418	31,255
Repayment of advances	(17,400)	(26,131)
Cash provided by financing activities	2,018	5,124
Effects of exchange rate changes on cash and cash equivalents	(90)	(116)
Increase (decrease) in cash and cash equivalents	(2,052)	3,849
Cash and cash equivalents		
Balance, beginning of year	6,517	2,668
Balance, end of year	4,465	6,517
Represented by		
Cash and short term deposits	1,925	4,239
Deposits held under repurchase agreements	2,540	2,278
	4,465	6,517

(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 2007

(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 98 per cent (97 per cent as at 31 March 2006) 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, and the Minister of Finance acquires or sells for the Account those assets that are deemed appropriate for this purpose in accordance with the *Currency Act*. The Account is empowered to invest in instruments approved by the Minister of Finance in accordance with the Act.

The objective of the Exchange Fund Account is to aid in the control and protection of the external value of the Canadian dollar. 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 were 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 financial statements of the Account are prepared for the Minister of Finance in compliance with Sections 20 and 21 of the *Currency Act*.

a) Change in Year-end

Amendments to the *Currency Act* came into effect on 30 December 2005 and included changing the reporting year of the Account, which had been the calendar year, to a fiscal year ending 31 March. The amendments included a provision for a 15-month transitional period ending 31 March 2006.



b) Reporting entity

The reporting entity of the Account is limited to those transactions permitted by a policy established by the Minister of Finance. For that purpose, the following operations are recorded in the Account:

All proceeds, earnings, and interest from transactions relating to the assets are credited to the Account, along with all amounts received on the maturity of deposits, securities, and notes held for the Account.

Interest-free advances to the Account from the CRF are authorized by the Minister under the terms and conditions prescribed by the Minister of Finance.

The annual net revenue of the Account is paid to the CRF (or charged to the CRF when net revenue is a negative amount).

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

c) Basis of Presentation

The basis of accounting used in these financial statements differs from Canadian generally accepted accounting principles because it excludes the disclosure of the notional cost of advances.

d) Use of estimates

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 presentation of assets at fair value. Actual results could differ significantly from those estimates.

e) 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:

	2007	2006
US dollars	1.1546	1.1680
Euros	1.5424	1.4153
Japanese yen	0.009799	0.009923
SDR's	1.74367	1.68291

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

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.



f) Revenue

Revenue from investments is recorded on an accrual basis and includes interest earned, amortization of premiums and discounts, 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. Accrued interest is recorded in the category *Other assets* on the *Balance sheet*.

g) Assets

Short-term deposits

Short-term deposits are money market transactions where the Account invests funds with designated counterparties. Short-term deposits are recorded at cost and are generally held to maturity.

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 recorded at the amount originally invested.

Marketable securities

Marketable securities are recorded at cost and are adjusted for amortization of purchase discounts and premiums. Purchases and sales of securities are recorded at the settlement dates.

Write-downs to reflect other than temporary impairment in the fair value of securities are included in *Revenue from investments* in the *Statement of Revenue*.

Special Drawing Rights

The special drawing right (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. SDRs are recorded at fiscal year-end market value.

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*. The Account sold its remaining gold bullion in 2003 and continues to hold gold coins. Net gains on gold sales are recorded at settlement dates.

h) 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. The securities loaned continue to be accounted for as investment assets. Revenue from the securities-lending program is included in *Revenue from investments* in the *Statement of Revenue*.

**3. Cash and Short-term Deposits**

	<u>2007</u>	<u>2006</u>
	Carrying Value	Carrying Value
US dollars	1,548	4,065
Euros	295	91
Japanese yen	82	83
	<u>1,925</u>	<u>4,239</u>

4. Deposits Held Under Repurchase Agreements

	<u>2007</u>	<u>2006</u>
	Carrying Value	Carrying Value
US dollars	2,540	2,278

At 31 March 2007, the term to maturity of deposits held under repurchase agreements was less than 3 months.



52 **5. Marketable Securities**

Term to maturity

	2007										2006
	Under 6 months		6 months to 1 year		1 to 5 years		Over 5 years		Total		Total Carrying value
	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	
US dollar											
Commercial Banks	922	5.24%	-	-	-	-	-	-	922	-	-
Sovereign	4,706	5.53%	-	-	246	4.47%	552	4.68%	5,504	4.68%	6,252
Supra National	1,886	4.84%	23	4.80%	1,146	4.74%	1,522	4.88%	4,577	4.88%	3,977
Agencies and other	3,210	4.87%	363	5.16%	2,165	4.93%	1,626	4.90%	7,364	4.90%	7,113
Carrying value	10,724		386		3,557		3,700		18,367		17,342
Euro											
Sovereign	409	3.58%	120	3.59%	7,178	3.77%	3,369	3.83%	11,076	3.83%	10,261
Supra National	-	-	115	3.70%	577	4.17%	840	3.75%	1,532	3.75%	1,000
Agencies and other	230	4.77%	270	2.64%	4,161	3.78%	2,337	3.89%	6,998	3.89%	3,756
Carrying value	639		505		11,916		6,546		19,606		15,017
Japanese yen											
Sovereign	-	-	-	-	490	1.91%	-	-	490	-	496
Carrying value	-		-		490		-		490		496
Total securities											
Carrying value	11,363		891		15,963		10,246		38,463		32,855

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.



The unamortized premium/discount on marketable securities amounts to \$4 million (\$193 million at 31 March 2006).

At 31 March 2007, a portion of the Account's holdings of US government securities, consisting of US\$2,355 million (par value) in Treasury Bills (US\$1,815 million (par value) at 31 March 2006) and US\$359 million (par value) in Treasury Notes (US\$1,130 million (par value) at 31 March 2006), is being used in securities-lending operations with financial institutions.

6. Accrued Interest

	2007	2006
Accrued interest		
Cash and short-term deposits	7	12
Deposits held under repurchase agreements	11	9
Marketable securities		
US Dollar	114	107
Euro	479	359
SDR's	8	6
	619	493

The fair value of the accrued interest is deemed equal to their carrying value given their short term to maturity.

7. Due to the Consolidated Revenue Fund (CRF)—Advances

The Account is funded by advances from the CRF. These are limited to \$60 billion by order of the Minister of Finance dated 30 December 2005. At fiscal year-end, advances from (deposits with) the CRF consisted of:

	2007	2006
US dollars	23,078	24,698
Canadian dollars	960	349
Euros	19,366	14,606
Japanese yen	568	576
SDR's	(1,064)	(1,027)
	42,908	39,202

The proceeds of Canada's borrowings in foreign currencies and allocations of SDRs by the IMF have been advanced from the CRF 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. Interest payable by Canada on borrowings in foreign currencies and charges on allocations of SDRs to Canada are charged directly to the CRF.



Canadian-dollar advances are required by the Account for the settlement of its purchases of foreign currencies. Sales of foreign currencies result in receipts of Canadian dollars that are remitted to the CRF, causing reductions in the level of outstanding Canadian-dollar advances. Cumulative net sales of foreign currencies can result in overall net deposits of Canadian dollars by the Account with the CRF.

8. Financial Instruments

a) Risk management

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.

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.

With respect to the Statement of Investment Policy, the Account may hold debt issued in the designated currencies by highly rated sovereign governments and their agencies, as well as by supranational organizations. Eligible issues 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.

Through the securities-lending program, agents can lend securities only up to a prescribed maximum amount and only to a list of counterparties approved by the Government. Each borrower must enter into a Securities Loan Agreement with either 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 in order to increase its return on investments.

b) Interest rate and foreign currency risk

Interest rate and foreign currency risks are managed, with due consideration of the risk to the Government of Canada, by adopting 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 fund the Account's assets.



c) Fair value of financial instruments

	2007		2006	
	Carrying Value and Accrued Interest	Fair value	Carrying Value and Accrued Interest	Fair value
Investments				
Cash and short-term deposits	1,932	1,932	4,251	4,251
Deposits held under repurchase agreements	2,551	2,551	2,287	2,287
Marketable securities				
US dollar	18,481	18,466	17,449	17,235
Euro	20,085	19,893	15,376	15,448
Japanese Yen	490	501	496	511
	43,539	43,343	39,859	39,732
SDRs	1,127	1,127	1,071	1,071
Gold	7	83	6	74
	44,673	44,553	40,936	40,877

The estimated fair value of cash, short-term deposits, deposits held under repurchase agreements and SDRs is deemed equal to their carrying value given their short term to maturity.

Estimated fair values of marketable securities are based on quoted market prices. Prevailing market conditions at 31 March 2007 reduced fair values on US dollar and Euro marketable securities below carrying values. As it is uncertain that these conditions reflect other than temporary impairment in the fair value, these securities have not been written-down to fair value.

The estimated fair value of gold is based on London fixing of \$764.06 at 31 March 2007 (\$679.78 at 31 March 2006) per fine ounce.

9. Commitments

a) Currency swaps

The Account may enter into short-term 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 year ended 31 March 2007 or during the 15 month period ended 31 March 2006, and there were no commitments outstanding as at 31 March 2007.

b) Foreign currency contracts

In the normal course of operations, the Account enters into foreign currency contracts. As at 31 March 2007, the Account was under contract to sell \$18 million (\$25 million at 31 March 2006) of foreign currency. Unrealized gains (losses) on foreign currency contracts are calculated using the 31 March 2007 exchange rates. As of that date, there were no unrealized net gains (losses) included in net revenue (nil at 31 March 2006). Outstanding foreign currency contracts were settled by 2 April 2007.



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 2007. Outstanding investment contracts were settled by 12 April 2007.

	2007		2006	
	Contractual value	Fair value	Contractual value	Fair value
Marketable securities				
US Dollars				
Purchases	(115)	(115)	(663)	(663)
Sales	116	116	82	82
Euro				
Purchases	(35)	(35)	(94)	(94)
Sales	36	36	93	93

Certain comparative figures have been reclassified to conform to the presentation adopted in the current year.