Report on the Management of Canada's Official International Reserves

January 1, 2005 – March 31, 2006

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Report on the Management of Canada's Official International Reserves

January 1, 2005 – March 31, 2006

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Ministère des Finances Canada

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The legal framework governing the Exchange Fund Account, the *Currency Act*, was amended in 2005 to enhance the management of the official international reserves. As part of the amendments, the law was changed to stipulate that this report be published on a fiscal-year basis, consistent with the period covered by the *Public Accounts of Canada*. In previous years the report was produced on a calendar-year basis, with the previous report covering the year ending December 31, 2004. The current report contains information spanning the 15-month period beginning January 1, 2005 and ending March 31, 2006.

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 January 1, 2005 to March 31, 2006.

The EFA, which represents the largest component of the official international reserves, is an actively managed portfolio of liquid foreign currency assets, maintained to provide foreign currency liquidity for the Government of Canada and to provide the funds, if required, to help promote orderly conditions for the Canadian dollar in foreign exchange markets. 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.

The 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 fiscal year-end position of the EFA asset portfolio.

On a market-value basis, the official international reserves stood at US$36,034 million as of March 31, 2006 (Table 1), including the International Monetary Fund (IMF) reserve position, which is Canada's investment in the activities of the IMF and an asset in the official international reserves. The IMF reserve position, which is not actively managed, fluctuates according to requests and repayments from the IMF.

Table 1

The EFA and Official International Reserves

	December 31, 2004	March 31, 2006	Change
	(market value in millions of US dollars)		
Securities	27,834	28,420	586
Deposits	2,223	5,596	3,373
Gold	48	63	15
Special drawing rights (SDRs)	925	917	-8
Total EFA	31,030	34,996	3,966
IMF reserve position	3,327	1,038	-2,289
Bank of Canada account[1]	105	–	-105
Receiver General account[1]	5	–	-5
Total official international reserves	34,467	36,034	1,567

[1] In 2005–06, the definition of official international reserves was revised to be consistent with IMF guidelines. As a result, the Bank of Canada and Receiver General accounts are no longer included in the definition of official international reserves.

Highlights

Changes in the Legislative Framework

- Amendments to Part II of the *Currency Act* were introduced and passed in 2005, as part of the *Budget Implementation Act, 2005*. The *Currency Act* was amended to improve the flexibility in managing the EFA. The amended act provides the Minister of Finance with the authority to set investment policy, and requires that an annual report be made to Parliament on the management of the EFA. To fulfill the revised statutory obligations, a *Statement of Investment Policy* was approved by the Minister in December 2005 (with amendments effective as of September 2006), setting out the policies that govern the acquisition, management and divestiture of EFA assets (see Annex 1).

Portfolio Management

- *Change in the level of the official international reserves:* The market value of the official international reserves increased to US$36.0 billion as of March 31, 2006 from US$34.5 billion as of December 31, 2004. The change included a US$4.0-billion increase in EFA assets, a US$2.3-billion decrease in the IMF reserve position, and the removal of unrelated Bank of Canada and Receiver General accounts, totalling US$0.1 billion, from the reserves portfolio.
- *EFA funding sources:* The program of cross-currency swaps[1] of domestic obligations was the primary source of foreign currency funding for the EFA. US$8.0 billion was raised at an average cost of 3-month US$ LIBOR (London Inter-Bank Offered Rate) less 35 basis points, a funding cost comparable to previous 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. However, it is managed against a portfolio of Government of Canada foreign currency liabilities in order to provide transparency on its net return to the Government and to minimize risk. From January 1, 2005 to March 31, 2006, the Government earned net revenues of US$75 million, or 25 basis points, which includes US$227 million in net realized gains on US-dollar and euro asset sales, partially offset by net interest costs of US$152 million. In terms of total return expressed on a yield basis (including net interest income and all gains or losses earned over the period, regardless of whether they were realized or not), the net total return was US$44 million, or 17 basis points.

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1 Cross-currency swaps involve the exchange of Canadian dollars, which have been raised through the issuance of domestic bonds, for foreign currency. The foreign currency is subsequently invested in an eligible asset (e.g. US Treasuries).

- *Enhanced performance and risk measurements:* External asset indices[2] were introduced in 2005 in order to enhance the understanding of the performance of the EFA in relation to broader market developments. The EFA asset portfolio performed in line with the broad index used for comparison purposes during the reporting period. New credit risk measures were also introduced, including a credit Value-at-Risk model and credit risk stress tests, providing better information on risks.
- *Portfolio risk:* Market risk measures (Value-at-Risk and various stress tests) indicate that the EFA portfolio was at all times well positioned to cope with movements in interest rates and exchange rates, and that it would perform well during periods of market turbulence. Similarly, various credit risk measures show that the EFA portfolio was continuously well positioned in terms of its credit risk exposure.

2 External asset indices are based on Merrill Lynch composite indices.

Overview of the Exchange Fund Account Management Framework

This section describes the EFA management framework, including the purpose, objectives and guiding principles; governance structure; and the policies governing investment, asset-liability management, risk management and performance measurement.

Objectives and Principles

Purpose

- The purpose of the EFA is to provide foreign currency liquidity and to provide the funds, if required, to help promote orderly conditions for the Canadian dollar in foreign exchange markets.

Strategic Objectives[3]

- *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

- *Risk management:* Debt and asset management activities should be conducted in line with clear operational and risk guidelines, and risk monitoring and oversight should be independent of treasury management operations.
- *Efficiency and effectiveness:* Policy and operational standards 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, policy initiatives and operations.
- *Reporting:* Information on funds management plans, activities and outcomes should be made publicly available in a timely manner so as to ensure understanding and accountability.

Reserves Management Principles

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

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[3] Section 21(2)(c) of the *Currency Act* stipulates that this report include the objectives of the EFA for the reporting period and the current fiscal year. The strategic objectives in the current fiscal year (2006–07) are unchanged from 2005–06.

Governance of the EFA

The Currency Act

Through the *Budget Implementation Act, 2005*, the *Currency Act* was amended to enhance the management of the EFA portfolio. The amended act improves the flexibility in managing the EFA by allowing investment in asset classes with potentially better risk-return profiles. It also reduces the risk of legal issues arising from antiquated and unclear drafting of some sections of the previous legislation. The amended act, which came into effect on December 30, 2005, 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 December 2005. 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 latest SIP, including amendments effective as of September 2006, is provided in Annex 1.

Governance Structure

Responsibility for the management of assets in accordance with the SIP, including strategic planning and the operational management of the EFA, is shared by 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 oversight of activity is through a Funds Management Committee (FMC), comprised of senior management from the Department of Finance and the Bank of Canada. The Committee advises the Minister on policy and strategy, oversees the implementation of approved policy and plans, and reviews performance outcome reports.

The FMC is supported by a Risk Committee, whose mandate is to oversee and advise on the risk management policy and to report to the FMC on financial risk positions and exposures. The Financial Risk Office at the Bank of Canada provides analytical support to the Risk Committee in this role and is responsible for monitoring and regularly reporting on the EFA's financial performance and its exposure to credit, liquidity, market and operational risks.

For more information on the governance framework of the EFA, please consult the document entitled *Treasury 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.

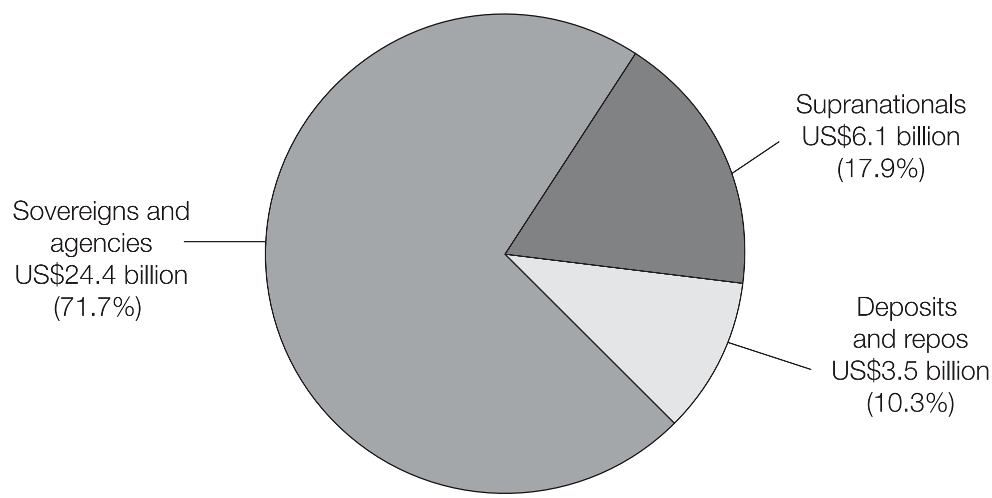
Investment Policy

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 optimizing return. To achieve these goals, the policy is to invest primarily in securities (bonds and bills) issued by sovereigns and their agencies or supranationals denominated in US dollars, euro and yen. Reserves can also be invested in cash deposits with financial institutions and in US-dollar tri-party repurchase agreements (repos). The SIP sets limits pertaining to issuers and counterparties across all lines of business, requires diversification of assets and counterparties, and defines high liquidity standards and the allowable maturities of reserve asset classes.

The investment policy splits investments into two tiers: the Liquidity Tier and the Investment Tier. The Liquidity Tier serves to meet the core liquidity requirements in foreign currencies. It 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.

In practice, the EFA portfolio is mainly invested in sovereign and agency securities (72 per cent), as these securities enhance both liquidity and capital preservation (Chart 1).[4] The share of deposits and repos is small because they offer lower returns 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, 2006
(market value)



Note: Does not add to 100% due to rounding.

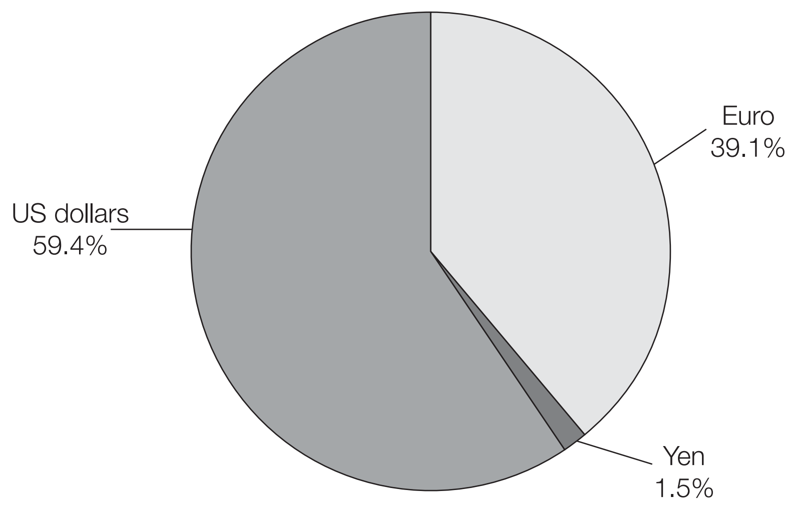
4 Excludes gold, SDR holdings, as well as cash in the Bank of Japan and the Bank for International Settlements (BIS). Deposits with the BIS are included in supranationals in Chart 1.

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, 2006, the US-dollar share of the EFA portfolio was US$20.2 billion or 59.4 per cent, the euro share was 11.0 billion euros or 39.1 per cent, and the yen portion was 59.8 billion yen or 1.5 per cent (Chart 2).[5]

Asset-Liability Management Policy

Foreign currency reserve assets held in the EFA and the Government of Canada foreign currency liabilities identified as financing 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 target is to minimize the gap between the market value of assets and liabilities, as monitored on a daily basis, to within a range of +/- US$300 million.

Chart 2
Currency Composition of the EFA
as at March 31, 2006
(market value)



5 Excludes gold and SDR holdings.

Risk Management Policy

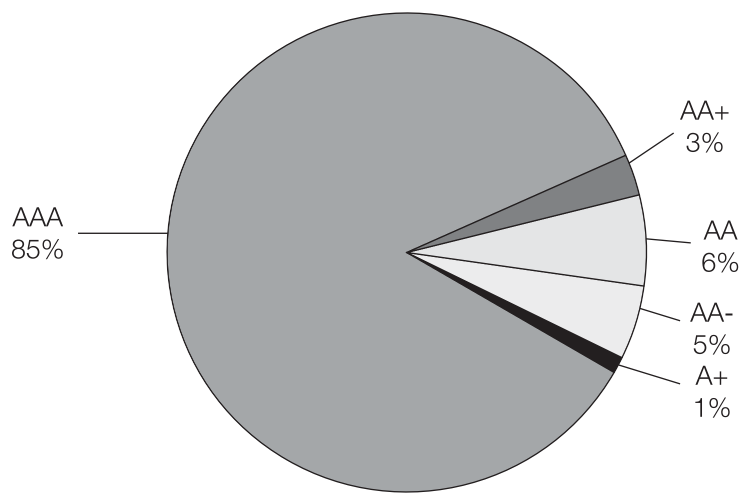
Risk management policy requires identifying and managing treasury risk, including credit, liquidity, legal, market and operational risks related to the financing and investment of the foreign exchange reserves, and regular and timely reporting of risk exposures. For more details, please consult the *Government of Canada Treasury Risk Management Framework* at www.fin.gc.ca/treas/frame/gcfrmf06_e.html.

A number of methods are used for measuring financial risk exposures and to ensure compliance with guidelines and specific risk policies. Credit risk is the most important risk faced by the EFA and is controlled by setting limits on both actual and potential exposures[6] to counterparties. There is an ongoing assessment of the credit status of the counterparties using ratings provided by third-party credit rating agencies.

To be eligible for EFA investments, an entity must have a credit rating of at least A-/A3 (see Annex 1 for details). The majority of EFA investments are in the AAA category, as indicated in Chart 3.[7]

Counterparty limits are established based on external ratings, and compliance with counterparty limits is monitored on a real-time basis. In addition, a number of new credit risk measures were adopted in 2005. They are described in more detail in the box entitled "Enhanced Performance Measurement and New Risk Measures" at the end of this section.

Chart 3
EFA Investments by Credit Rating
as at March 31, 2006



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[6] Actual exposure is a measure of losses that could be incurred if a counterparty defaults today. Potential exposure is a measure of potential losses that would arise from the time of default for a derivatives transaction until that contract could be replaced in the market.

[7] Excludes gold and SDR holdings.

Collateral management frameworks are used for managing the credit risk to financial institution counterparties, taking into account any exposure from unsecured deposits. Under these frameworks, high quality collateral (e.g. cash and US Treasury or Government of Canada securities) is placed with the EFA when the current market value of the contract exceeds specified limits on the 1st and the 15th days of each month.

A Value-at-Risk (VaR) model and various stress tests that are considered to be industry standards are also 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, i.e. changes in interest and exchange rates, while stress tests are used for evaluating portfolio performance under extraordinary circumstances in the market.

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.

Performance Measurement Policy

Performance measurement policy provides a framework for measuring, analyzing and evaluating financial performance of EFA investments and associated liabilities. The policy requires regular and timely reporting to senior management, the Minister and Parliament of the returns on EFA assets and the costs of associated liabilities.

The principal measure is based on accounting information (revenues and the net carry measure), supplemented by an economic yield-based measure of asset-liability performance called total return. In addition, liability benchmarks, external indices and attribution analysis are used to measure portfolio performance.

Asset-liability performance is reported on a monthly basis 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 audits the financial statements of the EFA and reports to the Minister annually on a fiscal-year basis.

Enhanced Performance Measurement and New Risk Measures

New measures and methodologies to enhance performance and risk reporting were introduced during the reporting period. These measures have been adopted based on leading industry standards (see the sections "Portfolio Performance Measurement" and "Risk Measures" for detailed results).

Enhanced Performance Measurement

Until recently, the return on the liability portfolio was the only measure used as a benchmark for the assets (since liabilities fund the assets and assets must match liabilities in currency and duration). To supplement this information, external asset indices for the EFA portfolio have recently been introduced to enhance the understanding of the performance of the EFA in relation to broader market developments, and to provide some insight into additional returns earned from investing in a broader range of assets. The new asset indices for the EFA, based on Merrill Lynch composite indices, provide an independent comparator for the performance of the EFA portfolio broken down by currency denomination.

Performance attribution analysis determines by how much each contributing variable impacts total return, as explained in more detail below. Results are calculated for both assets and liabilities, as well as for each currency, on a net basis.

- *Coupon effect* measures the return that would have been earned had interest rates remained unchanged over the period.
- *Yield curve effect* measures the impact on returns due to changes in the general level of interest rates over the period.
- *Spread effect* measures the impact on returns due to movements in interest rate spreads over the period.
- *Securities-lending revenue* measures the return from lending US Treasury securities held in the EFA.
- *Residual returns* are the difference between the actual return and the sum of the above effects.

New Risk Measures

Credit Value-at-Risk (credit VaR) is a statistical measure that was developed for estimating the maximum expected loss over a specified time period (i.e. one year) as a result of a credit event, such as a counterparty downgrade or default, under normal market conditions. An associated measure, expected shortfall, indicates the potential losses to the EFA due to extreme, unexpected credit events occurring in the same period. The EFA's credit VaR model was validated by a Bank for International Settlements (BIS) expert in October 2005. The expert concluded that the model reflects best practice, input assumptions are appropriately conservative and the results of the model are reliable. Suggestions made by the BIS expert for improving the model have since been incorporated.

Credit risk stress tests are carried out to evaluate potential losses to the EFA arising from serious credit events in the market. They subject the EFA to a range of hypothetical extreme scenarios, allowing risk managers to assess how well the EFA would withstand a ratings downgrade of one notch and other selected credit event scenarios in the market.

Review of Operations

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

Performance Versus Strategic Objectives

The amended *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, both cost of carry and total return measures were positive (see the section entitled "Portfolio Performance Measurement").

Major Initiatives

During this period, major initiatives focused on implementing legislative changes and on setting out the EFA's investment policy in the *Statement of Investment Policy*. Several reviews were also undertaken to ensure that programs continue to operate effectively, to identify areas of improvement, and to ensure that operational practices are in line with industry standards.

Review of the Tri-Party Repo Program

The US-dollar tri-party repo program, introduced in April 2003, is a collateralized short-term US-dollar investment program that provides an alternative to unsecured deposits with financial institutions. A review of the operational parameters of the program identified several adjustments to allow it to better achieve its objectives and to bring it more in line with private sector industry standards. The changes should result in an increase in the number of repo dealers participating in the program and enable the size of the program to be increased, reducing the reliance on unsecured deposits with financial institutions as a short-term investment vehicle.

Review of the Cross-Currency Swap Program

Since its inception in 1995, the cross-currency swap program has been the most cost-effective measure of funding foreign currency investments. As of March 31, 2006, cross-currency swaps of domestic obligations accounted for over 60 per cent of liabilities used for funding the EFA. Due to its growing importance, an overall review of the cross-currency swap program was undertaken. The review examined the effectiveness of several risk guidelines limiting credit risk exposure to swap counterparties, as well as the operational aspects of the program. In addition, a *Swap Management Policy* (SMP) was approved by the Minister in September 2006. The SMP sets out the policy for swaps used to manage the liability structure of the marketable debt and documents the governance of the cross-currency swap program.

External Evaluation of the EFA

An external review of the EFA was launched in December 2005 focusing on the EFA portfolio structure, investment guidelines, asset eligibility, performance measurement metrics and reporting. The evaluation process involves a comparison of the EFA's investment framework with the general investment practices of similar large, public sector institutional investors. The evaluator's report will be released publicly in 2006.

Treasury Risk Management Framework

To further enhance accountability and the transparency of treasury risk management policies and practices, the *Government of Canada Treasury Risk Management Framework* was prepared and posted on the Department of Finance website www.fin.gc.ca/treas/frame/gcfrmf06_e.html. This reference document provides detailed information on the risk management framework within which the Government's liquid financial assets and marketable debt are managed.

Market Developments During the Reporting Period

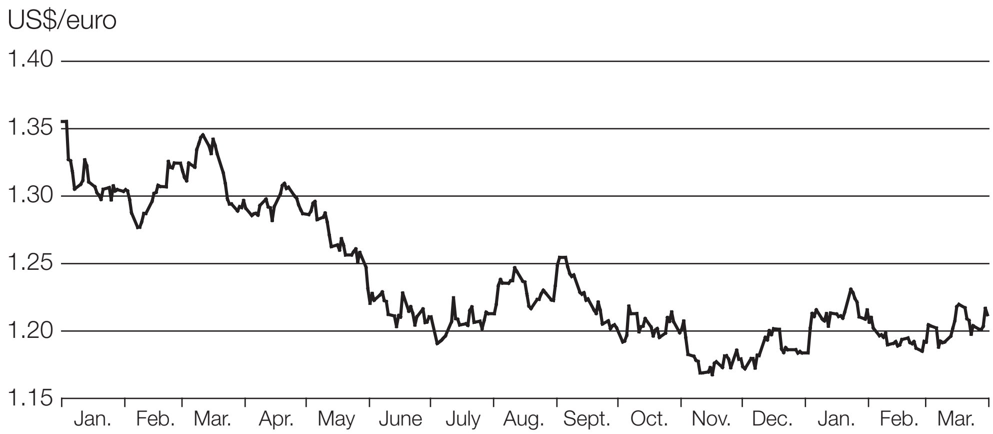
As the official international reserves are reported on a market-value basis and in US dollars, changes in interest and exchange rates (i.e. US-dollar/euro and yen/US-dollar exchange rates)[8] will affect the level of the reserves.

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 15-month period from January 1, 2005 to March 31, 2006, movements in interest rates had a smaller effect on the reserves than movements in exchange rates: changes in interest rates reduced the market value of the reserves by US$706 million, while foreign currency revaluations reduced their market value by US$1.9 billion.

As roughly 39 per cent of the official international reserves were held in euro-denominated securities (as at March 31, 2006), the market value of the reserves was significantly affected by movements in the euro. From January 1, 2005 to March 31, 2006, the euro depreciated 10.6 per cent against the US dollar. The high for the period was 1.3550 (US dollar/euro) on January 1, 2005, while the low was 1.1675 on November 16, 2005 (Chart 4).

[8] Charts 4 and 5 show the US dollar exchange rates for the euro and yen, where in accordance with market practice the euro is quoted in US-dollar terms (i.e. how many US dollars are required to buy 1 euro) and the yen is quoted in yen terms (i.e. how many yen are required to by 1 US dollar). Both charts reflect an increase in the US dollar.

Chart 4
The Evolution of the Euro From January 1, 2005 to March 31, 2006



The official international reserves were less exposed to changes in the yen/US-dollar exchange rate (Chart 5) since only 1.5 per cent of the reserves were held in yen-denominated assets (as at March 31, 2006). Overall, the yen depreciated by 14.8 per cent against the US dollar during the reporting period. The high for the period was 102.04 on January 14, 2005, and the low was 120.98 on December 7, 2005.

Chart 5
The Evolution of the Yen From January 1, 2005 to March 31, 2006

Composition of the Official International Reserves at March 31, 2006

Table 2 shows the term structure of investments in the official international reserves by currency and term to maturity as at March 31, 2006. 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.

Table 2

Term Structure of the Official International Reserves as at March 31, 2006

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	5,447	2,720	5,639	–	–	**13,806**	–	**13,806**
6 to 12 months	–	–	432	–	–	**432**	–	**432**
1 to 5 years	–	–	2,674	–	–	**2,674**	–	**2,674**
Over 5 years	–	1,049	2,242	–	–	**3,291**	–	**3,291**
Indefinite term	–	–	–	63	917	**980**	1,038	**2,018**
Total US-dollar holdings	5,447	3,769	10,987	63	917	**21,183**	1,038	**22,221**
Euro holdings[1]								
Under 6 months	78	368	–	–	–	**446**	–	**446**
6 to 12 months	–	142	64	–	–	**206**	–	**206**
1 to 5 years	–	7,219	1,873	–	–	**9,092**	–	**9,092**
Over 5 years	–	2,915	645	–	–	**3,560**	–	**3,560**
Total euro holdings	78	10,644	2,582	0	0	**13,304**	0	**13,304**
Yen holdings[1]								
Under 6 months	71	–	–	–	–	**71**	–	**71**
6 to 12 months	–	–	–	–	–	**–**	–	**–**
1 to 5 years	–	438	–	–	–	**438**	–	**438**
Over 5 years	–	–	–	–	–	**–**	–	**–**
Total yen holdings	71	438	0	0	0	**509**	0	**509**
Total	5,596	14,851	13,569	63	917	**34,996**	1,038	**36,034**

1 The exchange rates prevailing on March 31, 2006, are used for the euro and yen assets.

Changes in the Level of the Official International Reserves

As shown in Table 3, Canada's official international reserves as at March 31, 2006, were US$36.0 billion (on a market-value basis), up from US$34.5 billion as at December 31, 2004. The sources of changes are provided in the next section.

Table 3

Canada's Official International Reserves Holdings as at March 31, 2006

		Total official international reserves			
	Total official international reserves as at December 31, 2004	**EFA**	**IMF reserve position**	**Total official international reserves as at March 31, 2006**	**Change**
	(market value in millions of US dollars)				
Securities	**27,834**	28,420	–	**28,420**	586
Deposits[1]	**2,333**	5,596	–	**5,596**	3,263
Gold	**48**	63	–	**63**	15
Special drawing rights	**925**	917	–	**917**	-8
IMF reserve position	**3,327**	–	1,038	**1,038**	-2,289
Total	**34,467**	34,996	1,038	**36,034**	1,567

[1] The figure as at December 31, 2004 includes the Bank of Canada and Receiver General accounts, totalling US$0.1 billion.

Sources of Changes

The level of the official international reserves changes over time due to a variety of factors. As shown in Table 4, over the 15-month reporting period the level of the reserves increased by US$1.6 billion due to reserves management operations (US$4.4 billion) and return on investment (US$0.6 billion). The increase was partly offset by foreign currency debt charges (US$1.5 billion) and revaluation effects (US$1.9 billion).

Table 4

Sources of Changes in Canada's Official International Reserves (December 31, 2004 to March 31, 2006)

	Change
	(market value in millions of US dollars)
Official intervention	–
Net government operations	–
Reserves management operations	4,372
Gains and losses on gold sales	–
Return on investments	613
Foreign currency debt charges	-1,513
Revaluation effects	-1,903
Total change	1,567

Note: Numbers do 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).

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 15-month reporting period, funds raised through the issuance of cross-currency swaps and Canada bills, totalling US$10.6 billion, more than offset debt maturities (US$6.2 billion in total, including a US$1.5-billion global bond, a Canada note maturity totalling US$430 million and cross-currency swap maturities of US$4.3 billion), resulting in a net increase in the level of official international reserves.

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$1.3 billion) and the decrease in the market value of securities resulting from changes in interest rates (US$0.7 billion). The overall effect on the official international reserves was a net increase of US$0.6 billion.

Foreign Currency Debt Charges

Foreign currency debt charges reduced the level of the official international reserves by US$1.5 billion.

Revaluation Effects

Revaluation effects resulting from movements in exchange rates reflect changes in the market value of the official international reserves. Revaluation effects reduced the official international reserves by US$1.9 billion, primarily due to the depreciation 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. These are Government of Canada foreign currency borrowings from a variety of sources (Table 5).

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$8.0 billion and US$4.3 billion, respectively. Swaps are particularly cost-effective compared to other sources of foreign currency funds. Foreign currency was raised through cross-currency swaps at 3-month US$ LIBOR less 35 basis points on average.

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) and international bond issues (global bonds), the use of which depends on funding needs and market conditions. From December 31, 2004 to March 31, 2006, the level of outstanding Canada bills increased by US$2.6 billion. Canada bills were issued, on average, at an all-in cost of US$ 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$1.5 billion) and one Canada note (US$430 million) matured.

The changes in the outstanding numbers shown in Table 5 reflect not only issuance and maturities, but also changes in the exchange rates of the euro and yen versus the US dollar (as the foreign currency issues are reported in US dollars).

Table 5

Outstanding Foreign Currency Issues as at March 31, 2006

	December 31, 2004	March 31, 2006	Change
	(par value[1] in millions of US dollars)		
Swapped domestic issues	19,378	22,083	2,705
Global bonds	8,131	6,286	-1,845
Canada bills	1,424	4,053	2,629
Euro-medium term notes	1,434	1,284	-150
Canada notes	976	425	-551
Total	31,343	34,131	2,788

[1] Liabilities are stated at the exchange rates on December 31, 2004 and March 31, 2006.

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.

Portfolio Performance Measurement

Revenues

The revenues of the official international reserves include income from investments and foreign exchange gains. During the reporting period, income totalled C$1.7 billion, compared to C$1.8 billion in 2004. The main categories of income are summarized in Table 6. 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 6

Revenues for the Official International Reserves as at March 31, 2006

		Official international reserves		
	2004 total revenue	**EFA**	**IMF reserve position**	**Total revenue from January 1, 2005 to March 31, 2006**
		(millions of Canadian dollars)		
Investment income				
Marketable securities	**1,588**	1,840	–	**1,840**
Cash and short-term deposits	**34**	104	–	**104**
Deposits held under repurchase aggreements	**3**	46	–	**46**
Special drawing rights	**21**	37	–	**37**
IMF reserve position	**–**	–	–	**–**
Total investment income	**1,646**	2,027	–	**2,027**
Other income				
Net gain on sales of gold	**–**	–	–	**–**
Foreign exchange gains (losses)	**154**	-293	–	**-293**
Total income	**1,800**	1,734	–	**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. At year-end, C$3.4 billion (par value) in US government securities were held by the two financial institutions that act as agents and mandataries (see Annex 4) for lending these securities to market participants. Income from securities lending, included in investment income from marketable securities in Table 6, totalled C$8.4 million during the period compared to C$2.6 million in 2004.

Net Return Measures

As the EFA is managed on an integrated asset-liability basis, from an economic perspective, the key measures of portfolio performance net the performance of assets and liabilities. Two principal measures of performance are used: carry and total return.

Carry is an accounting-based measure expressed in dollar and yield terms estimated by subtracting the interest earned on assets from the interest paid on Canada's foreign currency liabilities (i.e. the net interest earned or paid). Total return, expressed as a yield based on market values, is calculated for both the assets and the liabilities and for each currency, with the return on the liability portfolio being used as a benchmark for the assets (since liabilities fund the assets and assets must match liabilities in currency and duration). Performance of the assets is also compared to an external 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. Performance according to both measures is presented below.

Carry

Table 7 provides an estimate of the carry for the official international reserves and for segments of the reserves. The carry for the 15-month reporting period is estimated at -49 basis points, which is lower than in 2004. The negative performance is due to the holding of low-coupon assets relative to the interest paid on the liabilities.

Taking into account gains/losses on asset sales, during the same period, the Government earned net revenues of US$75 million, or 25 basis points, which reflects US$227 million in net realized gains on US-dollar and euro asset sales, partially offset by net interest costs of US$152 million. The EFA realized US$9 million in gains on US-dollar asset sales and US$218 million in gains on euro asset sales. Realized gains were significant due to sales of high-coupon assets in a low interest-rate environment. As a result, the net carry is estimated at +25 basis points, similar to the net carry achieved in calendar year 2004.

Table 7

Carry for the Official International Reserves[1]

	2004		January 1, 2005 to March 31, 2006				
	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	-7.2	19.7	617.2	706.8	-89.6	-29.0	41.6
Yen portfolio	–	–	13.8	13.8	0	0	0
US$ portfolio	-13.4	5.3	797.5	859.6	-62.1	-20.1	-17.1
EFA[2]	**-20.6**	**25.0**	**1,428.5**	**1,580.2**	**-151.7**	**-49.1**	**24.5**
IMF reserve position	1.5	1.5	–	–	–	–	–
Total carry	**-19.1**	**26.5**	**1,428.5**	**1,580.2**	**-151.7**	**-49.1**	**24.5**

1 The carry figures show the contribution of each currency portfolio to the overall carry. Numbers for 2005–06 do not include the IMF reserve position and associated liabilities. Including the IMF reserve position for the 15-month reporting period would have decreased the carry of the EFA by about 8 basis points.

2 Excludes gold holdings.

In December 2005, the decision was taken to remove the IMF reserve position and the liabilities that fund it from EFA portfolio performance measures, as it is not actively managed. The inclusion of the IMF position in EFA performance measures was also introducing volatility in returns, as the IMF position is not currency matched (i.e. the IMF position is denominated in special drawing rights and funded with US-dollar liabilities), distorting measures of performance of the actively managed portfolio. This segregated reporting approach is consistent with that of other central banks.

Total Return On Market-Value Basis

Table 8 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.[9] The net total return was +17 basis points, or US$44 million, in the 15 months ending March 31, 2006 compared to +20 basis points in 2004. This reflects net returns in US dollar terms of +23 basis points for the US-dollar portfolio, +14 basis points for the euro portfolio and -3 basis points for the yen portfolio. These numbers include interest flows as well as all gains/losses earned over the period, regardless of whether they were realized or not.

9 Excluding gold, SDR holdings and the IMF reserve position as those assets are not actively managed on an integrated asset-liability basis. Including the IMF reserve position and SDRs would have reduced the EFA total return by about 6 basis points in the 15 months ending March 31, 2006.

Table 8

Total Return for the EFA Compared to Liability Benchmarks

	2004	January 1, 2005 to March 31, 2006			
	Total EFA	US$ portfolio	Euro portfolio	Yen portfolio	Total EFA
EFA asset portfolio					
Return in original currency	**n/a**	3.02%	1.78%	-0.45%	**n/a**
Return in US$ (A)	**7.74%**	3.02%	-8.99%	-13.31%	**-3.42%**
Liability benchmarks					
Return in original currency	**n/a**	2.79%	1.62%	-0.41%	**n/a**
Return in US$ (B)	**7.74%**	2.79%	-9.13%	-13.28%	**-3.60%**
Return vs. liability benchmark in basis points (A – B) in US$	**20**	23	14	-3	**17**

Table 9 compares the total return for the EFA to a set of Merrill Lynch government securities indices. This provides insight into how it compares to a portfolio invested strictly 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 provide only a general indication of its performance because the EFA is invested in a broader range of high quality assets. In the 15 months ending March 31, 2006, the EFA's total return was within 2 basis points of the weighted average return of these indices.

Table 9

Total Return for the EFA Compared to External Indices[1]

	January 1, 2005 to March 31, 2006			
	US$ portfolio	Euro portfolio	Yen portfolio	Total EFA
EFA asset portfolio				
Return in original currency (A)	3.02%	1.78%	-0.45%	**n/a**
Return in US$	3.02%	-8.99%	-13.31%	**-3.42%**
External indices				
Return in original currency (B)	2.80%	2.04%	-0.41%	**n/a**
Return in US$	2.80%	-8.75%	-13.28%	**-3.40%** [2]
Return vs. external indices in basis points (A – B) in original currency	22	-26	-4	**-2**

[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

In 2005, a new performance attribution system was introduced that decomposes the total market-value return of the EFA's portfolios into key sources of return. They include: returns that would have been earned had interest rates remained unchanged over the period (coupon effect); the impact of changes in the general level of interest rates (yield curve effect); returns due to movements in interest rate spreads (spread effect); revenue obtained from securities lending; and residual returns. The analysis is performed on the original currency returns of the US-dollar and euro portfolios and their corresponding liabilities.

Table 10 summarizes the attribution results for the EFA's US-dollar and euro portfolios for the 15 months ending March 31, 2006. They indicate the coupon effect was the main source of original currency return for both portfolios. Although total returns on both portfolios were undermined by rising interest rates over the period, similar effects were observed in the corresponding liabilities, confirming that assets and liabilities are closely matched in terms of their sensitivity to movements in interest rates. The US-dollar portfolio also earned 4 basis points from securities-lending activities over the period, since many of its securities were in high demand in the market.

Table 10

Performance Attribution for the US-Dollar and Euro Portfolios[1]
Compared to Liability Benchmarks

	January 1, 2005 to March 31, 2006			
	US$ portfolio		Euro portfolio	
	Assets	Liabilities	Assets	Liabilities
	(per cent)			
Coupon effect	4.97	4.77	3.46	3.32
Yield curve effect	-2.39	-2.13	-1.89	-2.01
Spread effect	0.39	0.10	0.26	0.25
Securities-lending revenue	0.04			
Residual returns	0.01	0.05	-0.05	0.06
Return in original currency	3.02	2.79	1.78	1.62

1 Please refer to the box entitled "Enhanced Performance Measurement and New Risk Measures" earlier in this document for the definitions of the performance attribution variables.

Risk Measures[10]

The risk management framework covers market, credit, liquidity, legal and operational risks related to the financing and investment of the foreign reserves.

Market Risk

Several industry-standard measures of market risk exposure were employed: scenario analysis, stress testing and Value-at-Risk (VaR) (Table 11).

Stress tests were regularly carried out to gauge the sensitivity of the EFA portfolio to 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 December 31, 2004.

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 December 31, 2004, and show that on a net basis, the EFA was continuously well positioned to benefit from flight-to-quality effects.

Table 11

Market Risk Measures

	December 31, 2004		March 31, 2006	
Risk measure	**EFA**	**EFA assets less liabilities**	**EFA**	**EFA assets less liabilities**
	(millions of US dollars)			
Single factor stress tests				
1% depreciation of euro/yen	-157	-2	-138	-2
1% upward parallel shift in yield curve	-797	-5	-801	2
Scenario tests				
1994 Fed tightening	-2,345	12	-2,198	85
1997 Asian financial crisis	-814	48	-713	54
1998 Russian default/LTCM collapse	-1,149	68	-989	45
2001 terrorist attacks	993	38	889	14
99% 10-day VaR	1,103	18	609	14

[10] These risk measures apply to the EFA only, excluding the SDRs and gold holdings.

The market VaR is a statistical measure that estimates the maximum 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 on the entire EFA portfolio and on the net position between assets and liabilities. As of March 31, 2006, the EFA had a 99-per-cent 10-day VaR of US$14 million, slightly lower than at December 31, 2004, which implied that 99 per cent of the time, the value of the portfolio was not expected to decline by more than US$18 million, on a net basis, over a 10-day period.

Credit Risk

The new 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 12).

Table 12

Credit Risk Measures

Risk measure	March 31, 2006
	(millions of US dollars)
Credit VaR and expected shortfall	
99.9% 365-day credit VaR	427
Expected shortfall	1,357
Stress test	
Potential loss if counterparties with negative outlook are downgraded one notch	0.646

The credit VaR estimated 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, 2006, the EFA had a 99.9-per-cent 365-day credit VaR of US$427 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$427 million over a 365-day 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, 2006.

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 continuously perform well in this type of scenario.

Annex 1: Statement of Investment Policy *(Effective as of September 2006)*

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 basis[11] (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.

[11] 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.[12]

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.

[12] 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-).

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.

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
Supranationals (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/issuers[1]

	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.[13] Since that time, the only market intervention was the purchase of euros in 2000 as part of Canada's participation in concerted G7 intervention in support of the euro.

Table 13

Official Intervention

	2001	2002	2003	2004	January 1, 2005 to March 31, 2006
			(millions of US dollars)		
Purchases	–	–	–	–	–
Sales	–	–	–	–	–
Net	–	–	–	–	–

[13] 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	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)								
2004															
December	28,151	2,016	48	925	3,327	34,467	-1,801	-2,963	0	1,176	-1,208	1,193	0	0	1
2005															
January	28,354	2,030	46	905	3,255	34,590	124	715	0	104	-47	-648	0	0	0
February	29,316	2,065	47	925	3,208	35,561	971	813	0	-62	-25	245	0	0	0
March	29,201	2,922	47	916	3,164	36,250	689	1,134	0	48	-115	-378	0	0	0
April	29,398	2,065	47	916	3,176	35,602	-648	-792	0	289	-77	-68	0	0	0
May	29,210	2,058	45	904	2,817	35,034	-568	76	0	160	-55	-749	0	0	0
June	28,909	2,590	48	893	2,484	34,924	-110	278	0	142	-244	-285	0	0	-1
July	27,976	2,314	47	890	2,101	33,328	-1,595	-1,244	0	-110	-242	1	0	0	0
August	27,086	4,146	47	907	2,113	34,299	971	538	0	214	-40	259	0	0	0
September	27,108	3,441	52	900	2,098	33,599	-700	-156	0	-85	-86	-374	0	0	1
October	27,350	3,773	51	898	2,142	34,214	615	906	0	-113	-114	-64	0	0	0
November	26,879	4,333	54	894	2,039	34,199	-15	265	0	63	-65	-278	0	0	0
December	26,741	3,923	56	897	1,401	33,018	-1,181	-1,145	0	107	-228	86	0	0	-1
2006															
January	27,274	3,674	62	907	1,042	32,959	-59	-358	0	-77	-3	379	0	0	0
February	27,125	3,556	61	908	1,034	32,684	-275	-32	0	46	-38	-251	0	0	0
March	28,420	5,596	63	917	1,038	36,034	3,350	3,374	0	-113	-134	222	0	0	1
Total[8]	n/a	n/a	n/a	n/a	n/a	n/a	1,567	4,372	0	613	-1,513	-1,903	0	0	0

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 which 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 may not add due to rounding.

Annex 4: List of Agents and Mandataries as Defined by the Currency Act

The amended *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.

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.

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.

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 Chase Manhattan 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.

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 Dean Witter. 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

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 Account is administered by the Bank of Canada as fiscal agent.

The financial statements were prepared in accordance with the stated accounting policies set out in Note 2 to the financial statements, which conform to those used by the Government of Canada. These policies were applied on a basis consistent with that of the preceding year except, as a result of amendments to the *Currency Act*, the year-end for the Account changed to March 31st.

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
12 June 2006

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 2006 and the statement of revenue for the 15 month period 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 2006 and its revenues and its cash flows for the 15 month period then ended in accordance with the accounting policies set out in Note 2 to the financial statements, which conform to the accounting policies of the Government of Canada.

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 Timmins

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

Ottawa, Canada
12 June 2006

Exchange Fund Account

Balance Sheet as at 31 March 2006

	31 March 2006	31 December 2004
	(millions of Canadian dollars)	
Assets		
Cash and short-term deposits (note 4)	4,239	2,668
Deposits held under repurchase agreements (note 5)	2,278	–
Marketable securities (note 6)	32,855	31,761
	39,372	34,429
Other assets		
Special drawing rights	1,065	1,107
Gold	6	7
Accrued interest and other receivables (note 7)	493	637
	1,564	1,751
	40,936	36,180
Liabilities		
Due to the Consolidated Revenue Fund		
Advances (note 8)	39,202	34,382
Net revenue for the year	1,734	1,798
	40,936	36,180

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 15 month period ended 31 March 2006

	31 March 2006 (15 months)	31 December 2004 (12 months)
	(millions of Canadian dollars)	
Revenue from investments		
Marketable securities	1,840	1,588
Cash and short-term deposits	104	32
Deposits held under repurchase agreements	46	3
Special drawing rights	37	21
	2,027	1,644
Other revenue		
Net gain (loss) on foreign exchange	(293)	154
	(293)	154
Net revenue for the year	1,734	1,798

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

Exchange Fund Account

Notes to the Financial Statements
15 Month period ended 31 March 2006

(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 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 objectives of the Account are to provide general foreign currency liquidity for the government and to provide a source of funds, if required, to help promote orderly conditions for the Canadian dollar in the foreign exchange market. 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.

The net revenue for the year is payable to the Consolidated Revenue Fund (CRF) of the Government of Canada within three months after the end of the fiscal year in accordance with the *Currency Act*.

2. Significant Accounting Policies

As stipulated in the *Currency Act*, the financial statements of the Account are prepared in accordance 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*.

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. The advances are provided interest free under the terms and conditions prescribed by the Minister of Finance and the Account reflects only transactions pertaining to the assets of the Account. The significant accounting policies of the Account are set out below.

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 include a transitional provision stipulating that the 15 month period that ends 31 March 2006 is deemed to be the first fiscal year.

b) Basis of Presentation

The purpose of the financial statements is to report to Parliament on the operations of the Account to comply with the *Currency Act*. 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.

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.

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).

All material changes in cash flows are evident from the financial statements. A separate statement of cash flows has not been prepared.

c) 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.

d) Translation of foreign currencies and Special Drawing Rights

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

	31 March 2006	**31 December 2004**
US dollars	1.1680	1.2020
Euros	1.4153	1.6287
Japanese yen	0.009923	0.011727
SDRs	1.68291	1.86050

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.

e) 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*.

f) 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 rights (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.

g) 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. Official Government Operations

Official government operations involve purchases and sales of Canadian dollars against foreign currencies. These are undertaken to promote orderly conditions in the market for the Canadian dollar or to meet net government requirements for foreign exchange. Since September 1998, no transactions were aimed at moderating movements in the value of the Canadian dollar.

The majority of Canada's official international reserves reside inside the Account. The Account represents approximately 97 per cent (90 per cent as at 31 December 2004) of Canada's official reserves. The remainder of the official reserves reside in the foreign currency accounts of the Minister of Finance.

4. Cash and Short-Term Deposits

	31 March 2006	31 December 2004
	Carrying value	Carrying value
US dollar	4,065	2,529
Euro	91	42
Japanese yen	83	97
	4,239	2,668

5. Deposits Held Under Repurchase Agreements

	31 March 2006	31 December 2004
	Carrying value	Carrying value
US dollar	2,278	–
	2,278	–

At 31 March 2006, the term to maturity of deposits held under repurchase agreements was less than 3 months.

6. Marketable Securities

Term to maturity

	31 March 2006									31 December 2004
	Under 6 months		6 months to 1 year		1 to 5 years		Over 5 years		Total	Total
	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Yield	Carrying value	Carrying value
US dollar										
Sovereign	4,181	4.27%	147	3.72%	352	4.44%	1,572	4.28%	6,252	6,357
Supra National	1,820	4.11%	147	4.05%	1,032	4.49%	978	4.53%	3,977	2,709
Agencies and other	3,768	4.42%	210	4.34%	1,753	4.59%	1,382	4.70%	7,113	5,285
Carrying Value	9,769		504		3,137		3,932		17,342	14,351
Euro										
Sovereign	282	2.38%	163	3.97%	7,396	3.89%	2,420	3.44%	10,261	11,643
Supra National	–		–		716	4.61%	284	3.35%	1,000	989
Agencies and other	143	4.54%	75	2.64%	2,126	3.76%	1,412	3.70%	3,756	3,605
Carrying Value	425		238		10,238		4,116		15,017	16,237
Japanese Yen										
Sovereign	–		–		496	1.91%	–		496	1,173
Carrying Value	–		–		496		–		496	1,173
Total securities										
Carrying value	10,194		742		13,871		8,048		32,855	31,761

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 outstanding unamortized premium/discount on marketable securities amounts to $193 million ($230 million at 31 December 2004).

At 31 March 2006, a portion of the Account's holdings of US government securities, consisting of US$1,815 million (par value) in Treasury Bills (US$1,830 million at 31 December 2004) and US$1,130 million (par value) in Treasury Notes (US$1,165 million at 31 December 2004), is being used in securities-lending operations with financial institutions.

7. Accrued Interest and Other Receivables

	31 March 2006	31 December 2004
Accrued interest		
Cash and short-term deposits	12	4
Deposits held under repurchase agreements	9	–
Marketable securities		
US dollar	107	164
Euro	359	461
Japanese yen	–	4
SDRs	6	4
Other receivables	–	–
	493	637

The fair value of the accrued interest and other receivables is deemed equal to their carrying value given their maturity date.

8. 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:

	31 March 2006	31 December 2004
US dollars	24,698	20,332
Canadian dollars	349	(2,108)
Euros	14,606	16,027
Japanese yen	576	1,266
SDR	(1,027)	(1,135)
	39,202	34,382

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.

9. 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 asset portfolio is prudently diversified with respect to credit risk, the policy and investment guidelines prescribed by the Minister of Finance specify limits on holdings by class of issuer (sovereign, agency, supranational, or commercial financial institution) and type of instrument. There are also limits on exposure to any one issuer or counterparty.

With respect to policy and investment guidelines, 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 minimum long-term rating of A- or A3 from two of four designated rating agencies (Standard & Poor's, Moody's, Fitch, and Dominion Bond Rating Service), one of which must be either Moody's or Standard & Poor's. The Account may also make deposits and execute other transactions with commercial financial institutions that meet the same rating criteria, with the term to maturity of commercial deposits limited to three months or less.

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 earn extra return on investments.

b) Interest rate and foreign currency risk

Interest rate and foreign currency risks are managed by adopting a strategy of matching the duration structure and the currency of the Account's assets with the related foreign currency borrowings of the Government of Canada.

c) Fair value of financial instruments

	31 March 2006		31 December 2004	
	Carrying value and accrued interest	Fair value	Carrying value and accrued interest	Fair value
Investments				
Cash and short-term deposits	4,251	4,251	2,672	2,672
Deposits held under repurchase agreements	2,287	2,287	–	–
Marketable securities				
US dollar	17,449	17,235	14,514	14,685
Euro	15,376	15,448	16,698	17,552
Japanese Yen	496	511	1,178	1,218
	39,859	39,732	35,062	36,127
SDRs	1,071	1,071	1,111	1,111
Gold	6	74	7	57

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 maturity date.

Estimated fair values of marketable securities are based on quoted market prices. Prevailing market conditions at 31 March 2006 reduced fair values on US dollar 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 $679.78 ($526.48 at 31 December 2004) per fine ounce.

10. 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 15 month period ended 31 March 2006 or during the year ended 31 December 2004, and there were no commitments outstanding as at 31 March 2006.

b) Foreign currency contracts

In the normal course of operations, the Account enters into foreign currency contracts. As at 31 March 2006, the Account was under contract to sell $25 million ($8 thousand at 31 December 2004) of foreign currency. Unrealized gains (losses) are calculated using the 31 March 2006 exchange rates. As of that date, there were no unrealized net gains (losses) included in net revenue (nil at 31 December 2004). Outstanding foreign currency contracts were settled by 3 April 2006.

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 2006. Outstanding investment contracts were settled by 6 April 2006.

	31 March 2006		31 December 2004	
	Contractual value	Fair value	Contractual value	Fair value
Marketable securities				
US dollar				
Purchases	(663)	(663)	–	–
Sales	82	82	–	–
Euro				
Purchases	(94)	(94)	–	–
Sales	93	93	–	–

11. Comparative Figures

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