Department of Finance Canada
Ministère des Finances Canada

Report on the Management of Canada's Official International Reserves

April 1, 2007 – March 31, 2008

Canada

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Table of Contents

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 related to the management of the Exchange Fund Account (EFA), from April 1, 2007 to March 31, 2008.

On a market-value basis, the official international reserves stood at US$43,057 million as at March 31, 2008 (Table 1). The EFA, which represents the largest component of the official international reserves, is an actively managed portfolio of liquid foreign currency securities and deposits. The EFA also includes assets that are not actively managed, including special drawing rights (SDRs) and a small holding of gold. SDRs are international reserve assets created by the International Monetary Fund (IMF) based on a basket of international currencies.

The official international reserves also include the IMF reserve position, which is not actively managed. This position, which represents Canada's investment in the activities of the IMF, fluctuates according to drawdowns and repayments from the IMF.

The EFA is funded by liabilities of the Government of Canada denominated in, or converted to, foreign currencies. The interest and principal receipts and payments on EFA assets and foreign-denominated liabilities are matched as closely as possible in currency and timing to minimize the Government's exposure to foreign currency and foreign interest rate risks. Accordingly, the EFA is managed on a portfolio basis, focusing on earning a return on assets slightly in excess of the cost of funding the EFA.

This report provides a comprehensive account of the framework within which the EFA is managed, its composition and changes during the year, and strategic policy initiatives. The accompanying financial statements, audited by the Auditor General of Canada, provide information on the position of the EFA asset portfolio as at the end of the 2007–08 fiscal year.

Table 1
The EFA and Official International Reserves

	March 31, 2008	March 31, 2007	Change
	(market value in millions of US dollars)		
Securities	39,359	33,657	5,702
Deposits	1,866	3,882	-2,016
Total securities and deposits (liquid reserves)	41,225	37,539	3,686
Gold	102	72	30
Special drawing rights (SDRs)	1,062	976	86
Total EFA	42,389	38,587	3,802
IMF reserve position	668	722	-54
Total official international reserves	43,057	39,309	3,748

Highlights

- ✔ **Impact of market turmoil:** Financial market conditions in 2007–08 were marked by major disruptions to credit markets. The EFA was well positioned to cope with the financial market turbulence, reflecting its prudent risk management policies and practices.
- ✔ **Change in the level of the official international reserves:** The market value of the official international reserves increased to US$43.1 billion as at March 31, 2008 from US$39.3 billion as at March 31, 2007. The change comprised a US$3.8-billion increase in EFA assets and a US$54-million decrease in the IMF reserve position.
- ✔ **EFA funding sources:** Cross-currency swaps of domestic obligations were the primary source of foreign currency funding for the EFA in 2007–08. US$4.3 billion was raised using cross-currency swaps at an average cost of 3-month US$ LIBOR (London Interbank Offered Rate) less 56 basis points. The funding cost of swaps was significantly better than that obtained in recent years, generally due to widening in credit spreads.
- ✔ **Portfolio return:** In 2007–08, the EFA continued to earn a positive spread between the coupons on foreign fixed income assets and the fixed income liabilities used to fund the assets. The spread measures the underlying return of the portfolio if the assets are held to maturity. Over the year, the portfolio generated a positive spread or return of 21 basis points, up from 10 basis points the previous year. Short-term lending of US Treasury securities held in the EFA contributed an additional 2 basis points of return during the fiscal year.

  While the asset-liability portfolio returned an underlying profit, it experienced a loss on a mark-to-market or total return basis of 105 basis points or US$394 million, compared to a gain of 31 basis points or US$105 million in the previous year. The total return measure includes coupon flows as well as any realized or unrealized gains or losses from interest rate movements and changes in credit spreads. The turmoil in the credit markets led to larger-than-normal changes in credit spreads, as Government of Canada liabilities benefited more from the flight to quality than the assets held in the EFA. From a cash flow perspective, taking into account only realized gains and losses, the carry of the portfolio was 12 basis points, up from -32 basis points in the previous year.
- ✔ **Credit risk policy review:** An internal review of credit risk policy was undertaken in 2007–08. The review covered the use of credit ratings to assess the credit quality of counterparties with whom the Government transacts and the assignment of limits to credit exposure levels across the various foreign investment and financing programs. It also addressed recent changes in rating methodologies by Moody's Investors Service and Dominion Bond Rating Service, who now include an assessment of the likelihood that government support would be offered to a failing financial institution. Stand-alone credit ratings for commercial banks are now used to assess the relative credit quality of EFA investments.
- ✔ **Treasury Evaluation Program:** An external review of the treasury risk management framework was conducted in 2007–08 as part of the Government's Treasury Evaluation Program. The review concluded that existing risk management policies are in line with leading practices and that the framework is effective in identifying, monitoring and mitigating risks.

Overview of the Exchange Fund Account Management Framework

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

Objectives and Principles

Objective

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

Strategic Objectives

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

Overarching Funds Management Principles

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

Reserves Management Principles

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

Governance of the EFA

The *Currency Act*

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

Statement of Investment Policy

An updated *Statement of Investment Policy* (SIP) was approved by the Minister in January 2008. 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 updated SIP is provided in Annex 1.

Governance Structure

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

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

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

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

For more information on the governance framework of the EFA, see the document entitled *Funds Management Governance Framework* at www.fin.gc.ca/treas/Goveev/TMGF_e.html.

EFA Management Policy

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

Investment Policy

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

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

Swap Management Policy

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

Risk Management Policy

The risk management policy of the EFA requires identifying, monitoring, mitigating, to the extent required, and the regular and timely reporting of treasury risk exposures. Treasury risk includes currency, interest rate, credit, liquidity, legal and operational risks related to the financing and investment of the foreign exchange reserves. For information on recent risk policy initiatives, see the section entitled "Major Initiatives in 2007–08."

For more information on the risk management policies that pertain to all of the Government's funds management operations, including foreign reserves, cash and debt management, see the document entitled *Treasury Risk Management Framework for the Government of Canada* at www.fin.gc.ca/treas/frame/tmrf08_e.html.

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

Credit risk management policy: Eligibility for investment in the EFA is based on a prudent framework to help assess the credit quality of counterparties with whom the Government transacts. The Government and Bank of Canada use a variety of tools to assess and manage credit risk, including an external credit-ratings-based framework in which judgment is applied, diversification of credit exposures, and the use of collateral frameworks.

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

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

Performance Measurement Policy

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

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

Legislative reporting: As required by the *Currency Act*, the Office of the Auditor General of Canada audits the financial statements of the EFA and reports to the Minister on the financial position of the Account and its revenues and cash flows on a fiscal-year basis. The *Currency Act* also requires annual reporting to Parliament on whether the financial performance of the portfolio has resulted in the achievement of the EFA's objectives. The "Report on Operations in 2007–08" section of this document fulfils this requirement.

Report on Operations in 2007–08

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

Market Developments and the Impact on the Portfolio During the Reporting Period

The official international reserves are reported in US dollars on a market-value basis. Changes in interest rates affect the market value of investments by either increasing (when rates fall) or decreasing (when rates rise) the value of the investments held in the reserves. Over the period from March 31, 2007 to March 31, 2008, movements in interest rates had a smaller effect on the reserves than did movements in exchange rates. Changes in interest rates increased the market value of the reserves by US$1.1 billion, while foreign currency revaluations increased their market value by US$3.5 billion.

The Impact of the Credit Market Turmoil on the EFA

The second half of the 2007–08 fiscal year was dominated by the global credit crisis and liquidity crunch, stemming initially from sub-prime lending problems and tumbling real estate prices in the US, and the resulting slowing of the global economy. Defaults of sub-prime mortgages undermined confidence in structured financial products, making it difficult for many global financial institutions to fund their lending through their off-balance-sheet activities. Uncertainty regarding the size and distribution of potential losses related to complex securitized products led to tightening credit conditions and a retrenchment from risk taking. The ensuing deleveraging process resulted in further losses for financial institutions on many structured products, which they recognized in their balance sheets on a timely basis. Lower confidence in bank counterparty credit led to an increase in interbank lending rates. Governments in many countries took action to raise market confidence by helping address liquidity challenges faced by institutions and proceeded to review oversight and regulatory responsibilities.

EFA funding: The global financial market turmoil had a generally positive impact on the value and funding of the EFA. Due to the high credit quality and liquidity of US-dollar-denominated assets held in the EFA, the value of EFA assets benefited from the flight to quality as investors sought safe havens in sovereign issues. Fixed rate euro-denominated EFA assets also increased in value due to the decrease in interest rates and the appreciation of the euro relative to the US dollar. The increase in the market value of the reserves during the reporting period resulted in somewhat lower-than-planned annual funding requirements needed to maintain reserves at planned levels.

Throughout the turmoil, the EFA's asset-liability matching principle proved effective. Some volatility in the asset-liability gap occurred as the market value of Government of Canada liabilities often increased more than the market value of foreign currency assets held in the EFA due to Canada's strong credit profile in the market. During the fall of 2007, the market turmoil temporarily led to less liquidity in the swap market used to fund the EFA.

Portfolio performance: Despite the turbulent environment, the EFA continued to meet its objective of generating small positive net underlying returns for the Government. The Credit VaR of the portfolio, which measures the portfolio's exposure to possible credit events such as a default or downgrade, remained within acceptable limits. The portfolio remained sufficiently diversified and protected from private sector credit exposure following the downgrade of a few private sector investment counterparties. The total return on EFA assets, which includes unrealized gains and losses due to changes in credit spreads, fell slightly short of external benchmarks based on US and German federal government issued securities. This result occurred as the EFA's diversified US-dollar and euro portfolios did not benefit as greatly from the flight to quality during the credit market turmoil as a portfolio composed solely of US Treasury and German government securities.

Interest Rates

Interest rates for US government securities decreased over 2007–08 as the US Federal Reserve cut policy rates by 300 basis points in response to the credit market turmoil. For example, the yield on US 3-month Treasury bills fell 371 basis points while the yield on US 5-year Treasury bonds decreased by 210 basis points (Chart 1), increasing the market value of US-denominated fixed income securities held in the EFA.

The euro-denominated holdings within the EFA are mainly composed of bonds. The yield on European sovereign 5-year securities declined by 42 basis points while that on 10-year securities eased by 16 basis points (Chart 2). The change in European interest rates also contributed to increasing the market value of euro-denominated fixed income securities in the EFA.

Since the EFA is managed according to an asset-liability matching framework, increases in the market value of the reserves were generally offset by a similar magnitude increase in the market value of liabilities used to fund the reserve assets.

Exchange Rates

As roughly 52 per cent of the official international reserves were held in euro-denominated securities (as at March 31, 2008), the market value of the reserves was significantly affected by movements in the euro. The credit and liquidity crisis, which coincided with early signs of a US economic slowdown, led to a relatively rapid depreciation of the US dollar, especially versus the euro. This appreciation of the euro also led to an increase in the reserves when reported in US dollars. From March 31, 2007 to March 31, 2008, the euro appreciated 18.2 per cent against the US dollar. The highest level of the US dollar/euro exchange rate during the period was 1.5846 on March 26, 2008, while the low was 1.3303 on June 12, 2007 (Chart 3).

The level of the official international reserves was less exposed to changes in the yen/US dollar exchange rate (Chart 4) since only 1.4 per cent of the reserves were held in yen-denominated assets (as at March 31, 2008). Overall, the yen appreciated by 18.2 per cent against the US dollar during the reporting period. The lowest level of the yen/US dollar exchange rate (i.e. the highest value of the yen) during the period was 97.3 on March 17, 2008, and the highest level was 123.9 on June 22, 2007.

Given the asset-liability matching framework, some operational adjustments were made during the year, as planned funding requirements decreased due to the appreciation of euro-denominated assets in the portfolio. The appreciation of the euro had a relatively modest impact on the Government's financial position.

Chart 1
Evolution of US 3-Month and 5-Year Treasury Yields From March 31, 2007 to March 31, 2008

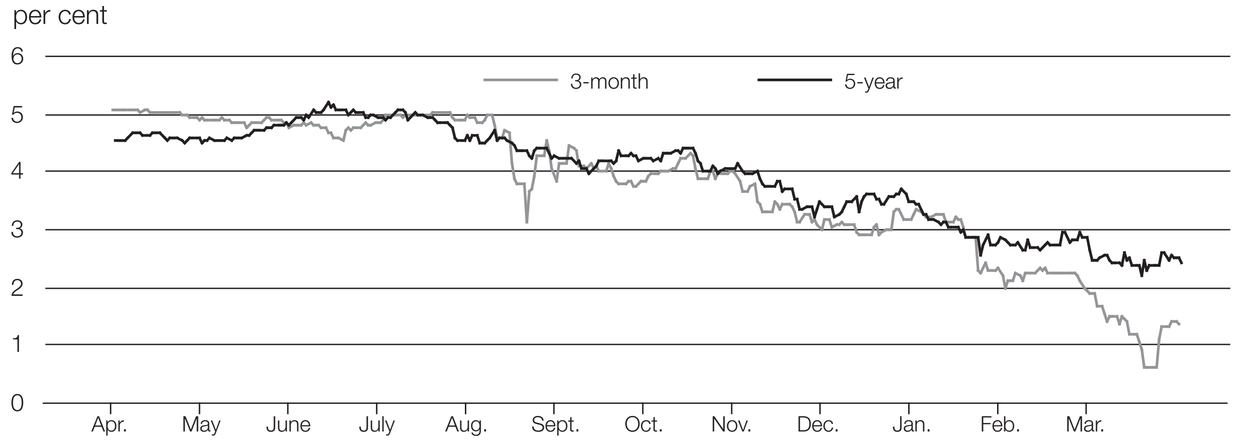


Chart 2
Evolution of Euro 5-Year and 10-Year Sovereign Yields From March 31, 2007 to March 31, 2008

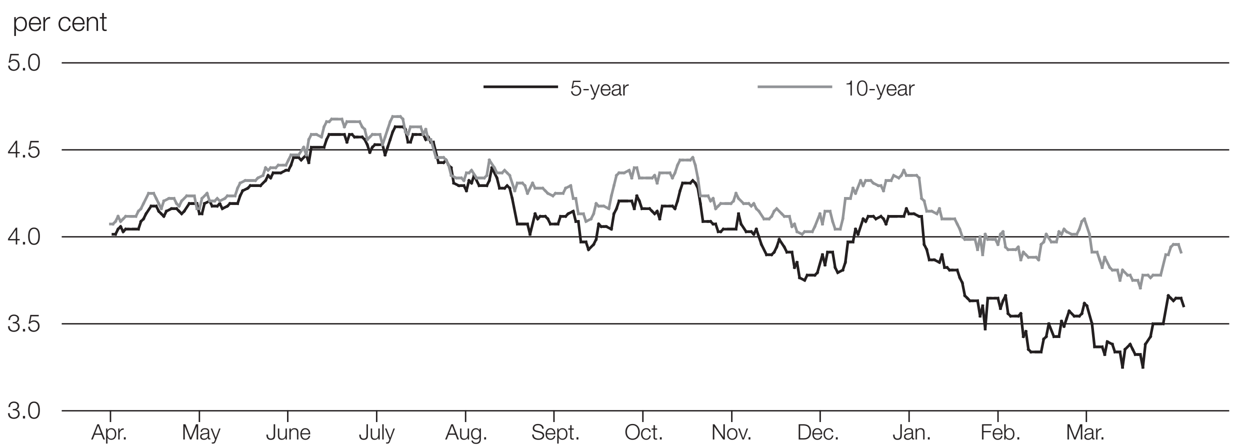
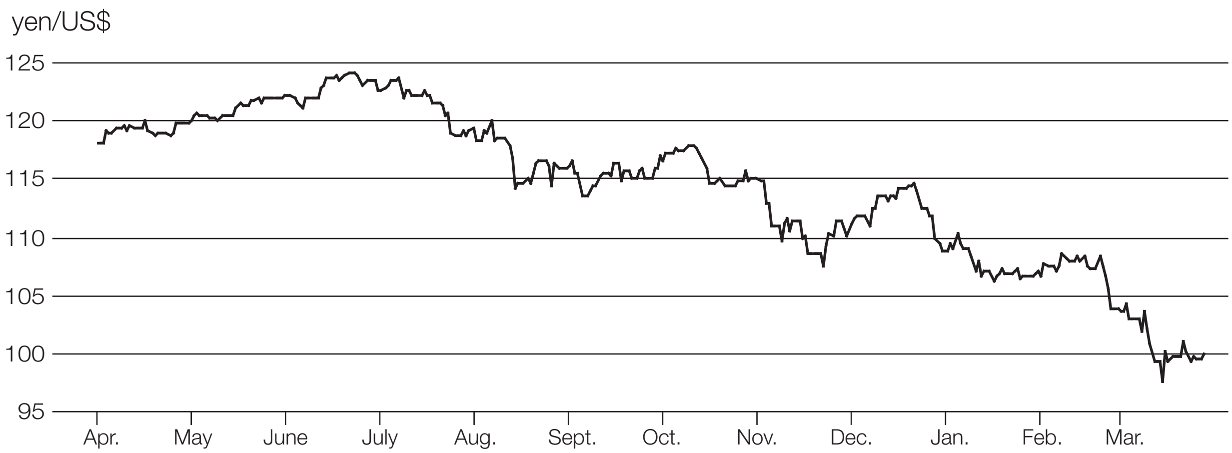


Chart 3

Evolution of the Euro From March 31, 2007 to March 31, 2008

Chart 4

Evolution of the Yen From March 31, 2007 to March 31, 2008



Major Initiatives in 2007–08

During 2007–08, an internal review was undertaken of the Government's credit risk policies. Also, an external evaluation was conducted of its treasury risk management framework.

Strengthening the Credit Risk Policy Framework

An effective credit risk policy framework ensures that counterparty risk exposure is appropriately assessed, that processes are in place to continually monitor credit quality changes and their impacts on the portfolio, and that risk exposures are managed within appropriate limits. An internal review of the Government's credit risk policies evaluated the use of credit ratings as a means to assess the credit quality of counterparties with whom the Government transacts and the assignment of credit exposure limits for various foreign investment and borrowing programs. The review also looked at counterparty risks in other government treasury operations, notably for the auctions of Receiver General (RG) cash balances.

Use of credit ratings: The Government of Canada takes into consideration the assessment of credit quality provided by credit rating agencies. It uses a ranking method, consistent with the Basel II approach, to assign an "internal rating" for an entity that receives ratings from a list of four eligible credit rating agencies (Moody's Investors Service, Standard & Poor's, Fitch Ratings and Dominion Bond Rating Service [DBRS]). To be eligible as an EFA investment counterparty or swap counterparty or to participate in RG auctions with the Government, an entity must have a senior unsecured debt credit rating in the top seven categories from at least two of the four rating agencies. The Government determines an internal rating by taking the second highest rating, or highest paired rating for swaps. The internal rating is used to determine the level of credit exposure to a counterparty that the Government is willing to accept. Although counterparty exposure limits are established in a pre-determined and mechanical fashion based on ratings, portfolio managers monitor exposure to counterparties and use discretion to maintain actual or potential credit exposure within assigned limits.

In March 2007, DBRS and Moody's altered their methodology for assigning credit ratings for financial institutions. Their assessment now includes the likelihood that governments would support failing institutions. This methodological change resulted in higher internal ratings for a number of domestic and foreign commercial banks with no change in underlying credit quality.

In response to the change in credit rating methodologies and to ensure that counterparty credit risk management of the EFA remains centred on objective financial indicators, the Government altered its use of credit ratings in determining internal ratings across all EFA-related investment and intends to revise its use of credit ratings as they apply to RG deposit auction terms and conditions and swap collateral support annex agreements. The "stand-alone" ratings (Moody's Bank Financial Strength Rating and DBRS's Intrinsic Assessment Ratings on banks), which do not include the assumption of government support, are now used to determine counterparty credit ratings, in conjunction with the official credit ratings published by Standard & Poor's and Fitch Ratings.

Updating credit exposure limits: Credit exposure limits to individual counterparties are used to minimize potential financial losses and to ensure the diversification of investments and swap funding sources in the EFA. As a part of the credit risk policy review, credit exposure limits to eligible counterparties were adjusted, from a fixed dollar-based exposure limit to a percentage of the target reserves portfolio size, across all lines of the EFA business.

As the reserves have grown over time, the fixed dollar-based exposure limits, which applied to single-A sovereigns and private sector counterparties, had the potential to impede portfolio diversification and undermine the return of the portfolio. The foreign investment exposure limits were therefore revised and established as a fixed percentage of the reserves level. This change would permit the credit exposure to all investments to scale upward to optimize EFA returns. The potential exposure limits to swap counterparties were also scaled upwards as a fixed percentage of the reserves target level.

To further simplify the credit limit framework and to continue to reflect good credit risk management practices, domestic and foreign currency exposure limits for sovereign counterparties for each sovereign were consolidated into one exposure limit. A fixed percentage counterparty limit for all AAA sovereign counterparties, except the United States, France, Germany and the Netherlands, was introduced in 2007. The allowable unrated investments remained the same following the review: securities issued by and deposits with central banks and the Bank for International Settlements and investments in special drawing rights created by the IMF.

Evaluation of the Treasury Risk Management Framework

An evaluation of the treasury risk management framework was completed in 2007–08 by an external expert as part of the ongoing program evaluations undertaken through the Department of Finance's Treasury Evaluation Program. The evaluation was conducted by Dr. Glen Donaldson, Associate Professor and Chair of the Finance Division of the Sauder School of Business, University of British Columbia.

The evaluation assessed risk management processes and practices in order to ensure that investment objectives were being met. In particular, the evaluation examined the effectiveness of the current risk management framework in controlling the risks that have been identified as well as the comprehensiveness and completeness of the framework in identifying, measuring, controlling and reporting on the full range of pertinent risks. The evaluation compared the Government's risk framework with the best risk practices of similar large, public sector investors and sovereign reserves managers.

The evaluation concluded that most areas of the Government's risk framework are working well and do not need to be adjusted and that most processes within the Department and the Bank of Canada are appropriate, taking into account industry best practices and those of comparable international institutions. The evaluation included recommendations to enhance some treasury risk processes as soon as possible and monitor others for possible changes in the future. Examples of areas identified for improvement include enhancing the readability of risk reports and developing documentation to support the transfer of corporate knowledge during staff changes. The evaluation also recommended that developments in the area of risk models, metrics and views be monitored, with the aim of continually adapting and improving the risk framework.

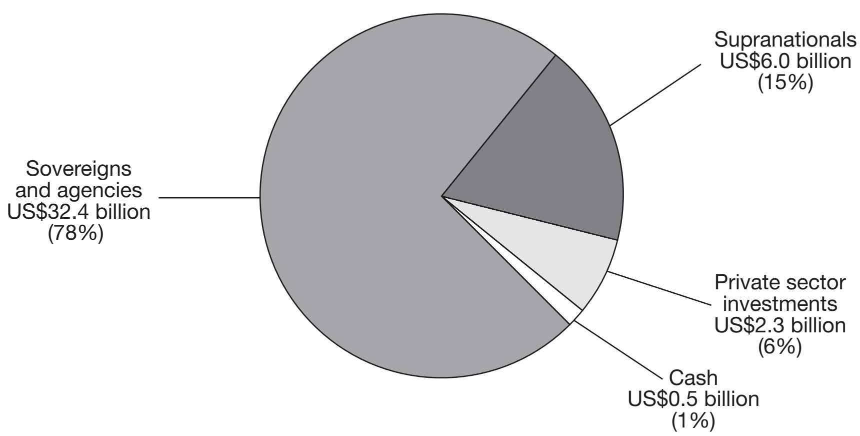
The evaluation has been tabled in Parliament and is available on the Treasury Evaluation Program area of the Department of Finance website (www.fin.gc.ca/access/fininste.html#Treasury).

Performance Versus Strategic Objectives

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

In practice, the EFA liquid reserves (which exclude gold and SDR holdings) are mainly invested in sovereign and government-sponsored entity securities (78 per cent), as these securities enhance both liquidity and capital preservation (Chart 5).[1] The share of deposits and repos with private sector entities is small because they are less liquid than other investment options. The Liquidity Tier mainly consists of US Treasury securities, reflecting their high market liquidity.

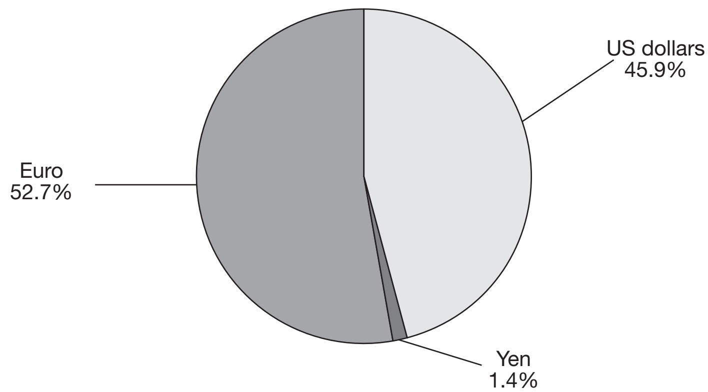
Chart 5
Composition of EFA Liquid Reserves as at March 31, 2008
(market value)



The ongoing practice has been to hold a significant portion of the reserves in US dollars because foreign currency needs are mostly in US dollars and, historically, foreign exchange intervention has mainly consisted of transactions involving the US dollar. Over the past two years, the euro has appreciated versus the US dollar. As the portfolio is denominated in US dollars, the appreciation of the euro has led to a shift in the currency composition of the portfolio. As at March 31, 2008, the US-dollar share of EFA liquid investments was US$18.9 billion or 45.9 per cent, the euro share was 21.7 billion euros or 52.7 per cent, and the yen portion was 0.592 billion yen or 1.4 per cent (Chart 6).[2] By comparison, the US-dollar share was 52.0 per cent and the euro share was 46.6 per cent as at March 31, 2007.

1 Excludes gold and SDR holdings.
2 Excludes gold and SDR holdings.

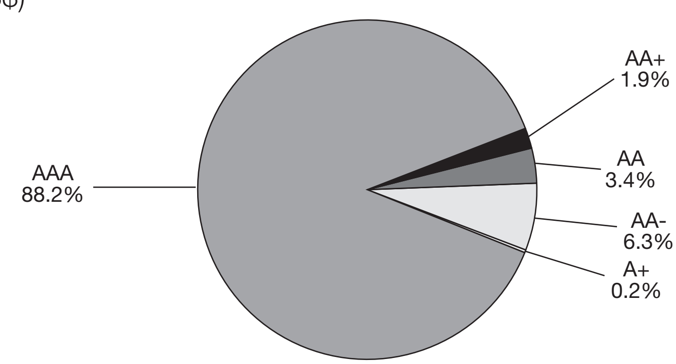
Chart 6
Currency Composition of EFA Liquid Reserves as at March 31, 2008
(market value in US$)



To help achieve the objective of preserving capital value, an entity must have a credit rating of at least A-/A3 to be eligible for investment in the EFA, as according to the SIP. The majority of EFA investments are in the AAA category, as indicated in Chart 7.[3] Of note, repos are included and secured by AAA/Aaa securities.

Counterparty limits are established based on a framework that incorporates external ratings from credit rating agencies, and compliance with counterparty limits is monitored on a real-time basis.

Chart 7
Credit Composition of EFA Liquid Reserves as at March 31, 2008
(settled basis in US$)



[3] Excludes gold and SDR holdings

Composition of the Official International Reserves as at March 31, 2008

Table 2 shows the distribution of investments in the official international reserves by currency and term to maturity as at March 31, 2008. US-dollar holdings made up slightly less than half of the reserves and were primarily short-term (i.e. maturities under six months) securities, as they are held for liquidity purposes. The euro holdings, which are held for investment purposes, were more heavily weighted towards medium- and longer-term investments. Over 75 per cent of euro investments have a maturity of greater than 1 year. All yen holdings have a maturity of 12 months or less.

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

IMF Reserve Position

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

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

Canada's IMF reserve position is an asset that is included as a component of the official international reserves. As such, changes in Canada's IMF reserve position that may result from advances, repayments or revaluations directly impact the Government of Canada's Public Accounts. However, because the IMF reserve position is not actively managed by the Department of Finance or the Bank of Canada, it is not included in the EFA and is instead represented within the wider category of official international reserves. Further, in order to reconcile the holding of the IMF reserve position within the official international reserves' asset-liability matching framework, only US-dollar liabilities are deemed to fund the reserve position.

Table 2

Term Structure of the Official International Reserves as at March 31, 2008

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	1,545	3,784	5,375	–	–	**10,704**	–	**10,704**
6 to 12 months	–	–	336	–	–	**336**	–	**336**
1 to 5 years	–	–	2,328	–	–	**2,328**	–	**2,328**
Over 5 years	–	740	4,788	–	–	**5,528**	–	**5,528**
Indefinite term	–	–	–	102	1,062	**1,164**	668	**1,832**
Total US-dollar holdings	1,545	4,524	12,827	102	1,062	**20,060**	668	**20,728**
Euro holdings[1]								
Under 6 months	238	3,475	241	–	–	**3,954**	–	**3,954**
6 to 12 months	–	271	830	–	–	**1,101**	–	**1,101**
1 to 5 years	–	6,794	2,099	–	–	**8,893**	–	**8,893**
Over 5 years	–	5,438	2,352	–	–	**7,790**	–	**7,790**
Total euro holdings	238	15,978	5,522	0	0	**21,738**	0	**21,738**
Yen holdings[1]								
Under 6 months	84	–	–	–	–	**84**	–	**84**
6 to 12 months	–	508	–	–	–	**508**	–	**508**
1 to 5 years	–	–	–	–	–	**–**	–	**–**
Over 5 years	–	–	–	–	–	**–**	–	**–**
Total yen holdings	84	508	0	0	0	**592**	0	**592**
Total	1,866	21,010	18,349	102	1,062	**42,389**	668	**43,057**

[1] The exchange rates prevailing on March 31, 2008 are used for the euro and yen assets.

Changes in the Level of the Official International Reserves

The level of the official international reserves changes over time due to a variety of factors. As shown in Table 3, over the 12-month reporting period the level of the reserves increased by US$3.7 billion due to revaluation effects (US$3.5 billion) and return on investments (US$2.5 billion). The increase was partially offset by foreign currency debt charges (US$1.7 billion) and reserves management operations (US$0.6 billion).

Table 3
Sources of Changes in Canada's Official International Reserves (March 31, 2007 to March 31, 2008)

	Change
	(market value in millions of US dollars)
Official intervention	–
Net government operations	–
Reserves management operations	-604
Gains and losses on gold	–
Return on investments	2,502
Foreign currency debt charges	-1,660
Revaluation effects	3,510
Other	–
Total change	3,748

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 and maturities and purchases and sales of foreign currency assets affect the level of the EFA. Over the reporting period, funds raised through the issuance of cross-currency swaps and Canada bills, totalling US$14.7 billion, were less than the debt maturities (US$15.3 billion in total, including Canada bill maturities totalling US$10.6 billion and cross-currency swap maturities of US$4.3 billion). The new issuances, combined with the increase in value due to the appreciation of the euro, resulted in a net increase in the level of official international reserves.

Gains and Losses on Gold

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

Return on Investments

Return on investments comprises interest earned on investments (US$1.4 billion) and the increase in the market value of securities resulting from changes in interest rates (US$1.1 billion). The overall effect on the official international reserves was a net increase of US$2.5 billion.

Foreign Currency Debt Charges

Foreign currency debt charges reduced the level of the official international reserves by US$1.7 billion. These expenses are charged to the Consolidated Revenue Fund but are paid using foreign assets of the EFA.

Revaluation Effects

Revaluation effects reflect changes in the market value of the official international reserves resulting from movements in exchange rates. Revaluation effects increased the official international reserves by US$3.5 billion, primarily due to the appreciation of the euro versus the US dollar.

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

EFA Financing

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

Funding requirements are primarily met through an ongoing program of cross-currency swaps of domestic obligations. Total cross-currency swap issuance and maturities during the reporting period were US$4.3 billion and US$2.3 billion, respectively. In recent years, swaps have been particularly cost-effective compared to other sources of foreign currency funds. During 2007–08, foreign currency was raised through cross-currency swaps at 3-month US$ LIBOR less 56 basis points on average. This funding cost compares favourably with the rates obtained during the previous reporting period, which averaged 3-month US$ LIBOR less 41 basis points.

In addition to cross-currency swaps of domestic obligations, the EFA is funded by a short-term US-dollar paper program (Canada bills), medium-term note issuance in various markets (Canada notes and euro medium-term notes [EMTNs]) and international bond issues (global bonds), the use of which depends on funding needs and market conditions. From March 31, 2007 to March 31, 2008, the level of outstanding Canada bills decreased by US$155 million. Canada bills were issued, on average, at an all-in cost of US$ LIBOR less 80 basis points, which was generally lower than funding levels of prior years. There was no new issuance of Canada notes, EMTNs or global bonds during the period.

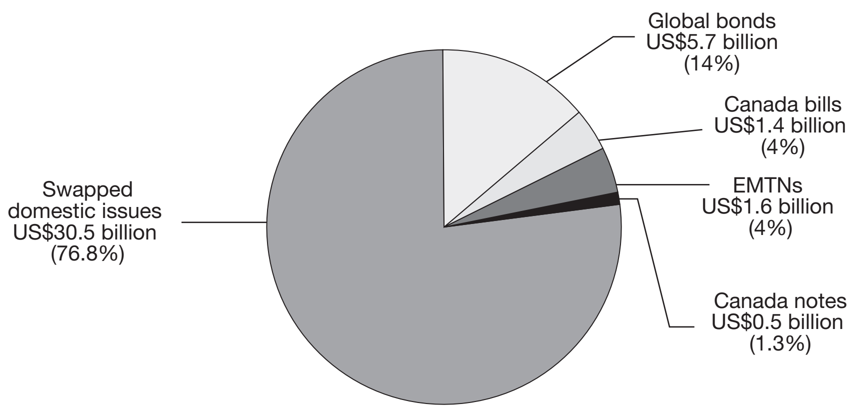
The changes in the outstanding numbers shown in Table 4 reflect not only issuance and maturities, but also changes in the exchange rates of the euro and yen versus the US dollar (as the foreign currency issues are reported in US dollars). Outstanding foreign currency issues are represented in Chart 8.

Table 4
Outstanding Foreign Currency Issues

	March 31, 2008	March 31, 2007	Change
	(par value in millions of US dollars)		
Swapped domestic issues	30,503	27,962	2,541
Global bonds	5,729	5,589	-140
Canada bills	1,445	1,600	-155
Euro medium-term notes	1,579	1,408	171
Canada notes	502	424	78
Total	39,758	36,983	2,495

Note: Liabilities are stated at the exchange rates prevailing on March 31, 2008.

Chart 8
Outstanding Foreign Currency Issues as at March 31, 2008
(par value)



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

The EFA is a financial asset portfolio within the Public Accounts framework. For risk management purposes and to provide transparency on the economic return or cost to the Government of maintaining the Account, several performance indicators are measured and tracked on a regular basis and reported to management at the Department of Finance and the Bank of Canada.

This section of the report provides detailed, technical information on indicators used to measure performance in four areas: 1) revenues; 2) asset-liability matching; 3) cost of advances to the EFA; and 4) market and credit risk measures. A brief overview is provided below to highlight the main performance indicators.

Overview

In 2007–08, the assets held in the EFA generated higher revenues than in 2006–07 as shown in Table 5, reflecting a slightly larger portfolio. Revenues were also higher due to higher coupons received on euro-denominated fixed income securities, which offset lower coupons received on US-dollar fixed income securities. The estimated economic cost to the Government of maintaining the EFA, i.e. the cost of advances to the EFA, was lower than revenues in 2007–08.

The spread between the coupons on fixed income reserve assets and the foreign fixed income liabilities used to fund the assets continued to remain positive in 2007–08. The spread measures the underlying return of the portfolio if the assets are held to maturity. Over the year, the portfolio generated a positive spread or coupon return of 21 basis points, up from 10 basis points in the previous year.

Table 5

Summary of Main Performance Indicators for the Official International Reserves

	April 1, 2007 to March 31, 2008	April 1, 2006 to March 31, 2007
1) Net revenue (C$ millions)	1,828	1,765
2) Asset-liability performance		
Coupon return (basis points)	21	10
Asset-liability matching indicators		
Carry (basis points)	-3.7	-9.2
Carry including net realized gains or losses (basis points)	11.7	-31.7
Total return (basis points)	-105	31
3) Cost of advances to the EFA (C$ millions)	1,792	n/a
	March 31, 2008	**March 31, 2007**
4) Risk measures		
Market risk (99% 10-day VaR, US$ millions)	3	15
Credit risk (99% 365-day VaR, US$ millions)	810	493

The difference between the actual cash flows of interest receipts and payments—the carry of the portfolio—was slightly negative at -3.7 basis points, but improved from 2006–07. The carry, taking into account net realized gains or losses from the sale or purchase of assets, was positive at 11.7 basis points. The difference between the two carry measures resulted from gains realized from selling and repurchasing assets as US interest rates declined. Taking into account the change in the market value of assets and liabilities, the portfolio's total return fell, as Canada's foreign liabilities appreciated faster, due to a flight to quality, than the value of the assets held in the EFA.

The Value-at-Risk (VaR) measure of potential losses to the EFA portfolio from market movements in interest and exchange rates remained very low as a result of the asset-liability matching of the foreign reserves. The VaR measure of potential losses due to the credit exposure to counterparties increased slightly as a result of wider credit spreads associated with the market turmoil.

1) Revenues

Revenues include income from investments and foreign exchange gains. In 2007–08, income totalled C$1.83 billion compared to C$1.77 billion in the previous reporting period. The main categories of income are summarized in Table 6. Data is reported in Canadian dollars as EFA revenues are reported in Canadian dollars in the attached financial statements.

Table 6
Revenues of the Exchange Fund Account

	April 1, 2007 to March 31, 2008	April 1, 2006 to March 31, 2007
	(millions of Canadian dollars)	
Investment Income		
Marketable securities	1,622	1,368
Cash and short-term deposits	72	109
Deposits held under repurchase agreements	89	105
Special drawing rights	38	42
Total investment income	1,821	1,624
Other income		
Foreign exchange gains or losses	7	141
Total income	1,828	1,765

The EFA's securities-lending program enhances the income earned on the portfolio by lending out US Treasury securities that are highly sought after in the market. Income from securities lending, included in investment income from marketable securities in Table 6, totalled C$8.6 million during the period compared to C$3 million in 2006–07.

2) Asset-Liability Matching

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

Carry

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

Table 7 provides an estimate of the carry for the EFA and its constituent currency portfolios. The carry for the 2007–08 fiscal year was estimated at -3.7 basis points, a 5.5-basis-point improvement over the previous period. The improvement was caused by a narrowing of the difference between interest earned and paid as older liabilities with high coupons matured.

Taking into account gains or losses on asset sales recorded during the same period, the EFA accumulated net gains of US$61 million, or 11.7 basis points. This reflects US$60 million in net realized gains on US-dollar and euro asset sales plus net interest income of US$1 million. The EFA realized US$91 million in gains on US asset sales and US$31 million in losses on euro asset sales. Realized losses in the euro portfolio over the whole year were offset by realized gains in the US portfolio in the second part of the year as interest rates generally decreased.

The methodology for computing the 2007–08 cost of carry was slightly changed from that in 2006–07. In 2006–07 the net interest expense (i.e. interest earned on assets less interest paid on liabilities) was divided by the book value of assets. In 2007–08, the ratio of earnings (i.e. interest earned on assets divided by the book value of assets) less the ratio of expenses (i.e. interest paid on liabilities divided by the book value of liabilities) was used to compute the cost of carry (see Diagram 1) as it accounts for small differences in the gap between asset and liability values. The impact of the change in methodology on the carry results was small.

Table 7

Carry for the Official International Reserves[1]

	April 1, 2006 to March 31, 2007		April 1, 2007 to March 31, 2008				
	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	-17.1	-17.3	731.2	779.6	-48.4	-14.3	-22.4
Yen portfolio	0.1	0.1	8.4	8.5	-0.1	-0.1	-0.1
US$ portfolio	7.8	-14.4	933.7	883.8	49.9	10.6	34.1
Total carry[2]	**-9.2**	**-31.7**	**1,673.3**	**1,671.9**	**1.4**	**-3.7**	**11.7**

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

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

Diagram 1

Cost of Carry Methodology

$$\text{Cost of carry} = \left(\frac{\text{Interest earned}}{\text{Average assets}}\right) - \left(\frac{\text{Interest paid}}{\text{Average liabilities}}\right)$$

$$= \left(\frac{\text{US\$1,673.3 million}}{\text{US\$38,989.4 million}}\right) - \left(\frac{\text{US\$1,671.9 million}}{\text{US\$38,620.2 million}}\right)$$

$$= 4.292\% - 4.329\%$$

$$= -3.7 \text{ basis points}$$

Total Return on a Market-Value Basis

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

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. The net total return was -105 basis points, or a loss of US$394 million, in the fiscal year ending March 31, 2008, compared to +31 basis points, or US$105 million, in the year ending March 31, 2007. This reflects net returns in US-dollar terms of -115 basis points for the US-dollar portfolio, -93 basis points for the euro portfolio and -7 basis points for the yen portfolio. These numbers include interest flows as well as all gains or losses earned over the period, regardless of whether they were realized or not.

Table 8

Total Return for the EFA Compared to Liability Benchmarks

	April 1, 2006 to March 31, 2007	April 1, 2007 to March 31, 2008			
	Total EFA	US$ portfolio	Euro portfolio	Yen portfolio	Total EFA
EFA asset portfolio					
Return in original currency	**n/a**	8.28%	4.58%	0.88%	**n/a**
Return in US$ (A)	**8.62%**	8.28%	23.59%	19.25%	**15.71%**
Liability benchmarks					
Return in original currency	**n/a**	9.43%	5.37%	0.93%	**n/a**
Return in US$ (B)	**8.31%**	9.43%	24.52%	19.32%	**16.76%**
Return vs. liability benchmark in basis points (A – B) in US$	**31**	-115	-93	-7	**-105**

Table 9 compares the total return for the EFA to a set of Merrill Lynch government securities indices.[4] This provides some insight into how it compares to a portfolio invested solely in US and German government issued securities. While the indices have been combined and weighted to reflect the currency composition and duration of the EFA, they only provide a general indication of its performance because the EFA is invested in a broader range of high quality assets. In the fiscal year ending March 31, 2008, the EFA's total return fell slightly short of the external indices by 30 basis points, compared to an excess of 31 basis points in the fiscal year ending March 31, 2007. The EFA's underperformance this fiscal year was due to the greater flight to quality to German- and US-issued securities in the indices compared to that for the diversified securities held in the EFA.

Table 9

Total Return for the EFA Compared to External Indices[1, 2]
April 1, 2007 to March 31, 2008

	US$ portfolio	Euro portfolio	Yen portfolio
EFA asset portfolio			
Return in original currency (A)	8.28%	4.58%	0.88%
Return in US$	8.28%	23.59%	19.25%
External indices			
Return in original currency (B)	8.38%	5.10%	n/a
Return in US$[3]	8.38%	24.21%	n/a
Return vs. external indices in basis points (A – B) in original currency	-11	-52	n/a

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

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

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

Performance Attribution of Total Return

Of the key sources of return, the coupon effect (what would have been earned had interest rates remained unchanged over the period) is the main driver of the EFA's positive total return. The coupon effect generally represents the underlying return of the portfolio if matched assets and liabilities are held to maturity. The coupon effect helps create a positive return because the EFA's assets generate more interest income than what is required to pay for the EFA's liabilities. Moreover, the coupon effect reflects the positive return generated by portfolio managers through their investment and issuance decisions.

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

The yield curve effect (returns due to movements in interest rate spreads) demonstrates the extent to which the EFA's assets and liabilities are matched in terms of their sensitivity to changes in interest rates. The yield curve effect illustrates how the EFA's assets and liabilities respond to changing interest rate spreads. Typically, movements in interest rate spreads will differ for assets according to their credit quality, captured by the credit spread effect. The asset-liability matching framework does not hedge the credit spread effect as investment assets and Government of Canada liabilities are of different credit quality. As well, a component of the total return is generated through securities-lending activities. Any difference between the actual return and the sum of the above effects is called the "residual return," which is the unexplained portion of total return. By using these key sources of return, a clearer picture emerges as to the drivers of the EFA's annual total return.

Table 10 summarizes the attribution results for the EFA's US-dollar and euro portfolios for the fiscal year ending March 31, 2008. They indicate the coupon effects were the main sources of original currency return for both portfolios. Although total returns on the US-dollar portfolio were significantly affected by interest rate movements over the period, similar effects were observed in the corresponding liabilities. This demonstrates the benefit of the asset-liability management framework of the EFA over the reporting period. The turmoil in the credit markets led to a larger-than-normal impact from changes in credit spreads, as Government of Canada liabilities benefited more from the flight to quality than the assets held in the US-dollar and euro portfolios. The US-dollar portfolio also earned small positive returns from securities-lending activities over the period.

Table 10
Performance Attribution for the US-Dollar and Euro Portfolios Compared to Liability Benchmarks April 1, 2007 to March 31, 2008

	US$ portfolio		Euro portfolio	
	Assets	Liabilities	Assets	Liabilities
	(per cent)			
Coupon effect	4.66	4.42	4.30	4.12
Yield curve effect	3.66	3.84	-0.02	0.11
Credit spread effect	0.03	1.19	0.42	1.27
Securities-lending activities	0.04			
Residual return	-0.11	-0.03	-0.12	-0.12
Return in original currency	8.28	9.43	4.58	5.37

3) Notional Cost of Advances to the EFA From the Consolidated Revenue Fund

In 2008, disclosure in the Account's financial statements on the notional cost of advances from the Government's Consolidated Revenue Fund (CRF) was enhanced. This disclosure, presented in Note 7 to the financial statements, coupled with the performance measures described above, provides more information on the economic cost to the Government of Canada of maintaining the Account.

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

Actual foreign interest charges: The proceeds from foreign currency borrowings are remitted to the CRF and concurrently advanced to the EFA. Foreign debt interest and principal repayments are charged to the CRF but are paid using the foreign assets of the EFA, reducing the amount advanced to the EFA. Actual foreign interest paid is converted into Canadian currency for the purpose of determining this portion of the notional cost of advances; for 2007–08, this value was C$1,723 million.

Notional interest charged in Canadian dollars: Because domestically funded EFA assets, SDR advances and the portion of net revenues reinvested in the fund (i.e. cumulative net revenues of the Account less cumulative foreign debt interest payments) are not linked to foreign liabilities, an imputed interest cost is used to approximate the notional interest charge on the portion of advances from the CRF related to those assets. For 2007–08, a weighted cost of domestic funding, 4.61 per cent, was used in calculating notional interest paid in Canadian dollars, resulting in a value of C$69 million.

Diagram 2

Cost of Advances Methodology

$$\text{Cost of advances} = \begin{array}{l}\text{Actual foreign}\\ \text{interest paid,}\\ \text{converted to C\\$}\end{array} + \text{Notional interest paid in C\\$}$$

$$= \text{C\\$1,723.4 million} + \left[\left(\begin{array}{l}\text{Average annual domestic}\\ \text{funded (unmatched) assets}\\ +\\ \text{Average annual SDRs}\\ \text{advanced to CRF}\\ +\\ \text{Average annual EFA profits}\end{array}\right) \times \begin{array}{l}\text{Average}\\ \text{annual}\\ \text{domestic}\\ \text{funding cost}\end{array}\right]$$

$$= \text{C\\$1,723.4 million} + [\text{C\\$1,497.8 million} \times 4.61\%]$$

$$= \text{C\\$1,723.4 million} + \text{C\\$69.0 million}$$

$$= \text{C\\$1,792.5 million}$$

4) Risk Measures

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

Market Risk

Several industry-standard measures of market risk exposure were employed: scenario analysis, stress testing and Value-at-Risk (VaR) (Table 11). VaR is a statistical measure for estimating potential losses to the EFA portfolio arising from severe market movements such as changes in interest and exchange rates, while stress testing and scenario analysis are used to evaluate the portfolio's performance under extraordinary circumstances in the market.

Stress tests were regularly carried out to gauge the sensitivity of the EFA portfolio to large changes in exchange rates and interest rates, including the portfolio impact of a 1 per cent depreciation of the euro and yen vis-à-vis the US dollar and a 1 per cent increase in interest rates across the yield curve. The results showed that, on a net basis during the reporting period, the EFA assets and the associated liabilities had very minimal exposure to currency depreciations and upward shifts in the yield curve, comparable to their positions as at March 31, 2007.

Table 11
Market Risk Measures

	March 31, 2008		March 31, 2007	
	EFA	EFA assets less liabilities	EFA	EFA assets less liabilities
	(millions of US dollars)			
Single factor stress tests				
1% depreciation of euro/yen	-223	1	-180	-3
1% upward parallel shift in yield curve	-1,212	9	-963	-27
Scenario tests				
1994 Fed tightening	-3,420	139	-2,670	75
1997 Asian financial crisis	-1,168	73	-982	30
1998 Russian default/LTCM collapse	-1,649	82	-1,381	6
2001 terrorist attacks	1,368	-10	1,100	10
99% 10-day VaR	678	3	643	15

In addition, some hypothetical scenario stress tests that mimic the market conditions during four previous extraordinary market events were regularly conducted: the tightening of monetary policy by the US Federal Reserve in 1994; the 1997 Asian financial crisis; the 1998 Russian debt default and Long-Term Capital Management (LTCM) collapse; and the 2001 US terrorist attacks. The four stress tests showed that the EFA would generally perform well during such periods of market turbulence. The results were similar to those reported for March 31, 2007, and show that on a net basis, the EFA was continuously well positioned to benefit from flight-to-quality effects. Scenario creation is a dynamic process. New scenarios continue to be considered and will be added when relevant and feasible.

Market VaR is a statistical measure that estimates the expected loss in portfolio value within a specific time period during normal market conditions as a result of interest rate and exchange rate changes. This is regularly reported for the entire EFA portfolio and on the net position between assets and liabilities. As at March 31, 2008, the EFA had a 99 per cent 10-day VaR of US$3 million, which implied that 99 per cent of the time, the value of the portfolio was not expected to decline by more than US$3 million, on a net basis, over a 10-trading-day period.

Credit Risk

Credit risk, which is the most important risk faced by the EFA, is controlled by setting limits on both actual and potential exposures to counterparties. A collateral management framework is used for managing the credit risk to financial institution counterparties arising from the cross-currency swaps used to fund the EFA. Under this framework, high quality collateral is placed with collateral managers for the EFA when the market value of the swap contracts exceeds specified limits. Along with liquidity and legal risks, credit risk is also controlled through strict guidelines. The Credit VaR model and some selected credit risk stress tests were used to measure the EFA's exposure to credit risk during the reporting period (Table 12).

Table 12

Credit Risk Measures

	March 31, 2008	March 31, 2007
	(millions of US dollars)	
Credit VaR and expected shortfall		
99.9% 365-day Credit VaR	810	493
Expected shortfall	1,719	1,402
Stress test		
Potential loss if counterparties with negative outlook or negative watch are downgraded one notch	0.5	0.1

The Credit VaR model provides an estimate of the maximum expected loss in portfolio value within a year as a result of a credit event, such as a counterparty downgrade or default, under normal market conditions. As at March 31, 2008, the EFA had a 99.9 per cent 1-year Credit VaR of US$810 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$810 million over a 1-year period due to credit events. An associated measure, expected shortfall, computes the expected average loss in portfolio value during the same period due to an extreme, unexpected credit event, whose possibility of happening (less than 0.1 per cent) was not captured by the Credit VaR statistic. The expected shortfall measure for the EFA was US$1.7 billion as at March 31, 2008. The increase in Credit VaR from the previous period reflects growth in the level of reserves plus wider credit spreads, which increase the possible losses associated with downgrades and defaults.

Credit risk stress tests were also carried out to evaluate potential losses to the EFA assets and the associated liabilities arising from extraordinary credit events in the market. These tests subjected the EFA to hypothetical scenarios, such as all counterparties with a negative outlook being downgraded by one notch. They showed that the EFA would perform well in this type of scenario.

Annex 1: Statement of Investment Policy

1. Purpose of Policy

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

2. Purpose of EFA

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

3. Governance

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

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

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

4. No Inconsistent Business or Activity

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

5. Investment Objective

There are three investment objectives:

- **Maintain a high standard of liquidity:** Hold reserves in assets that mature or can be sold on very short notice with minimal market impact and therefore loss of value.

- **Preserve capital value:** Minimize risk of loss of market value by holding a diversified portfolio of high quality assets (in terms of credit rating and type of issuer), managing liquid assets and liabilities on a matched basis[1] (in terms of currency and duration), and using appropriate practices to mitigate risks.
- **Optimize return:** Achieve the highest possible level of return, while respecting the liquidity and capital preservation objectives.

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[2] must have a senior unsecured debt credit rating in the top seven categories from at least two of the four main rating agencies:[3] Moody's Investors Service, Standard & Poor's (S&P), Fitch Ratings and Dominion Bond Rating Service (DBRS). When credit ratings for an entity differ, the rating of the second highest rating agency will be used to assess eligibility,[4] consistent with the Basel II approach.

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

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

2 Under exceptional circumstances, the credit rating of an entity's issue may be used, at the discretion of the ALMC.

3 EFA ratings of sovereigns are based on the lower of domestic and foreign currency ratings.

4 Stand-alone credit ratings for commercial banks by Moody's (Bank Financial Strength Rating (BFSR)) and by DBRS (Intrinsic Assessments) will be used in conjunction with official credit ratings from S&P and Fitch to provide the relative credit quality of entities. The use of stand-alone ratings is to remove the assumption of implicit government support embedded in the official ratings of Moody's and DBRS. However, in cases where two or more ratings are the same, for example, Moody's is AA, S&P is AA, DBRS is AA- and Fitch Ratings is AA-, the EFA rating would be AA (not AA-).

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

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

6.3 Credit Exposure Limits

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

6.3.1 Fixed Income Securities

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

Issuer	Aggregate limits (% of reserves target level)	Individual counterparty limits (% of reserves target level)
"AAA" sovereigns in domestic and foreign currency (including central banks and directly guaranteed agencies)	Unlimited	20 (Excluded from above would be direct domestic currency obligations of US, France, Germany and Netherlands)
"AA-" to "AA+" sovereigns in domestic and foreign currency (including central banks and directly guaranteed agencies)	25	10
"A+" sovereigns (including central banks and directly guaranteed agencies)		1.67
"A" sovereigns (including central banks and directly guaranteed agencies)	2 (to be included in the above 25% limit)	0.83
"A-" sovereigns (including central banks and directly guaranteed agencies)		0.33
Government-supported entities (senior unsecured obligations)	15	3
Supranationals (excluding Bank for International Settlements)	25	10
Bank for International Settlements	10	–

6.3.2 Deposits and Other Short-Term Securities

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

Exposure limits by credit rating of private sector counterparties/issuers (% of the reserves target level)

	EFA Credit Rating						
Type of Exposure	**“AAA”**	**“AA+”**	**“AA”**	**AA-”**	**“A+”**	**“A”**	**“A-”**
Individual actual exposure	1.00%	0.67%	0.50%	0.33%	0.17%	0.08%	0.03%
Total actual exposure		N/A				2%	
Deposits			At discretion of ALMC				
Commercial paper/certificate of deposit			At discretion of ALMC				

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 assets is US$12 billion on a market-value basis.

6.6 Terms of Investments

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

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

6.7 Permitted Activities

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

6.8 Use of Derivatives

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

6.9 Securities Lending and Repurchase Agreements

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

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

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

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

6.10 Exceptions

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

7. Performance Assessment and Risk Management

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

8. Review

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

Annex 2: 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.[5]

Official Intervention

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

[5] 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	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)								
2007															
March	33,657	3,882	72	976	722	39,309	3,275	1,631	0	1,392	-1,373	1,625	0	0	-1
2007–08															
April	34,106	4,311	74	978	714	40,183	874	490	0	85	-91	390	0	0	0
May	32,751	5,608	72	972	693	40,096	-87	383	0	-115	-81	-274	0	0	0
June	33,451	4,222	71	974	695	39,413	-683	-212	0	15	-585	98	0	0	1
July	34,068	4,493	73	984	685	40,303	890	464	0	348	-146	225	0	0	-1
August	35,059	3,524	73	985	660	40,301	-2	-286	0	371	-24	-63	0	0	0
September	36,620	2,609	81	1,001	671	40,982	681	-245	0	131	-90	885	0	0	0
October	36,636	2,388	86	1,010	677	40,797	-185	-582	0	240	-157	314	0	0	0
November	36,621	2,439	85	1,022	685	40,852	55	-484	0	406	-92	225	0	0	0
December	37,156	2,158	91	1,015	661	41,081	229	500	0	54	-253	-71	0	0	-1
January	37,721	2,745	101	1,026	668	42,261	1,180	92	0	670	-11	428	0	0	1
February	38,722	3,096	106	1,035	654	43,613	1,352	622	0	281	-22	471	0	0	0
March	39,359	1,866	102	1,062	668	43,057	-556	-1,346	0	16	-108	882	0	0	0
Total[8]	n/a	n/a	n/a	n/a	n/a	n/a	3,748	-604	0	2,502	-1,660	3,510	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 that Canada is entitled to draw from the IMF on demand for balance of payments purposes. It equals the Canadian quota, less IMF holdings of Canadian dollars, plus loans to the IMF.

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

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

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

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

[8] Numbers are from the Official International Reserves press release.

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

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

Bank of Canada

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

RBC Dexia Investor Services and State Street Corporation

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

Annex 5: Glossary

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

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

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes are issued in denominations of US$1,000 and integral multiples thereof. At present the aggregate principal amount outstanding issued under the program is limited to US$10.0 billion. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. The interest rate or interest rate formula, issue price, stated maturity, redemption or repayment provisions, and any other terms are established by the Government of Canada at the time of issuance of the notes and are indicated in the Pricing Supplement. Delivery and payment occur through the Bank of New York. The notes are offered by the Government through five dealers: Credit Suisse First Boston LLC, Goldman, Sachs & Co., Harris Nesbitt Corporation, Lehman Brothers Inc. and Scotia Capital (USA) Inc. The Government may also sell notes to other dealers or directly to investors. Canada notes are issued for foreign exchange reserve funding purposes only.

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

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

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

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

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

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

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

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

Exchange Fund Account

Financial Statements

31 March 2008

Exchange Fund Account

Management Responsibility for the Financial Statements

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

The financial statements were prepared in accordance with the accounting policies set out in Note 2 to the financial statements, which are consistent with those used by the Government of Canada, and do not result in any significant differences from generally accepted accounting principles in the public sector. These policies were applied on a basis consistent with that of the preceding year.

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

The Bank of Canada effects transactions for the Account and maintains records, as required to provide reasonable assurance regarding the reliability of the financial statements. The Bank reports to the Department of Finance on the financial position of the Account and on the results of its operations.

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

The Annual Report of the Account is tabled in Parliament along with the financial statements, which are also part of the Public Accounts of Canada and are referred to the Standing Committee on Public Accounts for their review.

Mark Carney
Governor
Bank of Canada

Rob Wright
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

Ottawa, Canada
27 June 2008

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 2008 and the statements of revenue and cash flows for the year then ended. These financial statements are the responsibility of the Account's management. My responsibility is to express an opinion on these financial statements based on my audit.

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

In my opinion, these financial statements present fairly, in all material respects, the financial position of the Account as at 31 March 2008 and its revenues and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

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

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

Ottawa, Canada
27 June 2008

Exchange Fund Account

Balance Sheet as at 31 March

	2008	2007
	(millions of Canadian dollars)	
Assets		
Cash and short-term deposits (note 3)	1,570	1,925
Deposits held under repurchase agreements (note 4)	339	2,540
Marketable securities (note 5)	39,262	38,463
	41,171	42,928
Other assets		
Special drawing rights	1,085	1,119
Gold	7	7
Accrued interest (note 6)	641	619
	1,733	1,745
	42,904	**44,673**
Liabilities		
Due to the Consolidated Revenue Fund (note 7)	**42,904**	**44,673**

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

Approved:

Mark Carney
Governor
Bank of Canada

Rob Wright
Deputy Minister
Department of Finance

Sheila Vokey, CA
Chief Accountant
Bank of Canada

Exchange Fund Account

Statement of Revenue
For the year ended 31 March

	2008	2007
	(millions of Canadian dollars)	
Revenue from investments		
Marketable securities	1,622	1,368
Cash and short term deposits	72	109
Deposits held under repurchase agreements	89	105
Special drawing rights	38	42
	1,821	1,624
Other revenue		
Net gain on foreign exchange	7	141
Net revenue for the year	**1,828**	**1,765**

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

Exchange Fund Account

Statement of Cash flows
For the year ended 31 March

	2008	2007
	(millions of Canadian dollars)	
Cash flows from operating activities		
Revenue from investments received		
Marketable securities	1,177	998
Short term deposits	59	100
Deposits held under repurchase agreements	97	102
Other	14	15
Purchase of marketable securities	(57,949)	(60,028)
Proceeds from the sale or maturity of marketable securities	56,614	55,937
Increase in foreign currency position	275	459
Decrease in foreign currency position	(1,843)	(1,563)
Cash used in operating activities	**(1,556)**	**(3,980)**
Cash flows from financing activities		
Increase in advances	15,415	19,418
Repayment of advances	(15,888)	(17,400)
Cash (used in) provided by financing activities	**(473)**	**2,018**
Effects of exchange rate changes on cash and cash equivalents	(527)	(90)
Decrease in cash and cash equivalents	**(2,556)**	**(2,052)**
Cash and cash equivalents		
Balance, beginning of year	4,465	6,517
Balance, end of year	**1,909**	**4,465**
Represented by		
Cash and short term deposits	1,570	1,925
Deposits held under repurchase agreements	339	2,540
	1,909	**4,465**

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

Exchange Fund Account

Notes to the financial statements
For the year ended 31 March 2008

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

1. Authority and Objective

The Exchange Fund Account (the Account) is governed by Part II of the *Currency Act*. The Account is in the name of the Minister of Finance and is administered by the Bank of Canada as fiscal agent. The *Financial Administration Act* does not apply to the Account. The majority of Canada's official international reserves reside inside the Account. The Account represents approximately 98 per cent (98 per cent as at 31 March 2007) of Canada's official reserves. The remainder of the official reserves reside in the foreign currency accounts of the Minister of Finance.

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

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

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

2. Significant Accounting Policies

As stipulated in the *Currency Act*, the financial statements of the Account are prepared in a manner consistent with the accounting policies used by the Government of Canada to prepare its financial statements. The financial statements of the Account are prepared for the Minister of Finance in compliance with Sections 20 and 21 of the *Currency Act*. The presentation and results of the Account using these accounting policies do not result in any significant differences from Canadian generally accepted accounting principles in the public sector.

a) Reporting entity

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

(i) 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.

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

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 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.

b) 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 and disclosure of the notional cost of advances.

c) 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:

	2008	2007
US dollars	1.0265	1.1546
Euros	1.6205	1.5424
Japanese yen	0.0103	0.0098
SDR's	1.6881	1.7437

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

d) 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.

e) 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 on a straight-line basis over the term to maturity of the security. Purchases and sales of securities are recorded at the settlement dates.

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

Special Drawing Rights

The special drawing right (SDR) serves as the unit of account of the International Monetary Fund (IMF) and its value is based on a basket of key international currencies. SDRs are recorded at fiscal year-end market value.

Gold

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

f) 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 marketable securities* in the *Statement of Revenue*.

3. Cash and Short-term Deposits

	2008 Carrying Value	2007 Carrying Value
Cash		
US dollars	214	238
Euros	244	295
Japanese yen	86	82
Short-term deposits		
US dollars	1,026	1,310
	1,570	1,925

At 31 March 2008, the weighted-average yield to maturity on short-term deposits was 3.30% (5.21% at 31 March 2007), and the term to maturity was less than 3 months (less than 3 months at 31 March 2007).

4. Deposits Held Under Repurchase Agreements

Deposits held under repurchase agreements are denominated in US dollars. At 31 March 2008, the weighted-average yield to maturity on deposits held under repurchase agreements was 3.16% (5.21% at 31 March 2007), and the term to maturity was less than 3 months (less than 3 months at 31 March 2007). The fair value of collateral held on these transactions was $346 million ($2,591 million at 31 March 2007).

5. Marketable Securities

Term to maturity

	2008									2007
	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										
Corporation	77	3.08%	–	–	–	–	–	–	77	–
Commercial Banks	948	3.23%	–	–	–	–	–	–	948	922
Sovereign	4,135	2.68%	–	–	–	–	927	4.34%	5,062	5,504
Supra National	430	3.37%	66	4.92%	611	4.89%	2,098	4.84%	3,205	4,577
Agencies and other	3,777	2.97%	267	4.87%	1,594	4.68%	2,191	4.87%	7,829	7,364
	9,367		**333**		**2,205**		**5,216**		**17,121**	**18,367**
Euro										
Sovereign	3,096	3.56%	387	3.83%	3,955	3.68%	3,888	4.00%	11,326	10,844
Supra National	81	4.05%	–		986	4.31%	1,483	4.13%	2,550	1,532
Agencies and other	560	3.92%	745	3.33%	3,996	3.90%	2,449	4.04%	7,750	7,230
	3,737		**1,132**		**8,937**		**7,820**		**21,626**	**19,606**
Japanese yen										
Sovereign	–	–	515	1.91%	–	–	–	–	515	490
	–		**515**		**–**		**–**		**515**	**490**
Total securities	**13,104**		**1,980**		**11,142**		**13,036**		**39,262**	**38,463**

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.

At 31 March 2008, the unamortized premium/discount on marketable securities amounts to $6 million ($4 million at 31 March 2007).

At 31 March 2008, a portion of the Account's holdings of US government securities, consisting of US$2,182 million (par value) in Treasury Bills (US$2,355 million (par value) at 31 March 2007) and US$713 million (par value) in Treasury Notes (US$359 million (par value) at 31 March 2007), is being used in securities-lending operations with financial institutions.

6. Accrued Interest

	2008	2007
Accrued interest		
Cash and short-term deposits	5	7
Deposits held under repurchase agreements	2	11
Marketable securities		
US Dollar	160	114
Euro	469	479
SDR's	5	8
	641	**619**

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

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

The Account is funded by the Government of Canada through advances from the CRF. These advances are limited to $60 billion by order of the Minister of Finance dated 30 December 2005.

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

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

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

	2008	2007
US dollars	18,904	23,078
Euros	21,489	19,366
Japanese yen	598	568
SDR's	(1,030)	(1,064)
Subtotal – foreign currencies	39,961	41,948
Canadian dollars	1,115	960
Net revenue	1,828	1,765
Total Advances	**42,904**	**44,673**

For the year ended 31 March 2008, the notional cost of funds advanced by the CRF to the Account is $1,792 million ($1,813 million for the year ended 31 March 2007). The notional cost of advanced funds is comprised of the actual interest costs on foreign denominated debt and cross currency swaps for foreign currency advances, and an imputed interest cost calculated using the average funding rate of outstanding Government of Canada market debt, applicable to the net of Canadian dollar and SDR currency advances.

8. Financial Instruments

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

a) Credit risk

Credit risk is the risk that a counterparty to a financial contract will fail to discharge its obligations in accordance with agreed upon terms.

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

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

Through the securities-lending program, agents can lend securities only up to a prescribed maximum amount and only to a list of counterparties approved by the Government. Each borrower must enter into a Securities Loan Agreement with either of the agents. Borrowers are also required to provide collateral for securities borrowed, according to a specific list approved by the Government. Collateral is limited to specific security types, terms to maturity, and credit ratings. The agents also provide an indemnity in the event of default by the borrower. The Account enters into securities lending in order to increase its return on investments.

b) Interest rate and foreign currency risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in market interest rates. Foreign currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

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

c) Fair value of financial instruments

	2008		2007	
	Carrying Value and Accrued Interest	Fair value	Carrying Value and Accrued Interest	Fair value
Investments				
Cash and short-term deposits	1,575	1,575	1,932	1,932
Deposits held under repurchase agreements	341	341	2,551	2,551
Marketable securities				
US dollar	17,281	17,811	18,481	18,466
Euro	22,095	22,070	20,085	19,893
Japanese Yen	515	522	490	501
	41,807	42,319	43,539	43,343
SDRs	1,090	1,090	1,127	1,127
Gold	7	104	7	83
	42,904	**43,513**	**44,673**	**44,553**

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

Estimated fair values of marketable securities are based on quoted market prices. Prevailing market conditions at 31 March 2008 reduced fair values on Euro marketable securities below carrying values. As it is uncertain that these conditions reflect other than temporary impairment in the fair value, these securities have not been written-down to fair value.

The estimated fair value of gold is based on London fixing of $958.24 at 31 March 2008 ($764.06 at 31 March 2007) per fine ounce.

9. Commitments

a) Currency swaps

Currency swaps are interest rate swaps in different currencies involving the exchange of principal amounts at inception and at maturity. The Account may enter into short-term currency swap arrangements with the Bank of Canada to assist the Bank in its cash-management operations. There were no drawings under this facility during the year ended 31 March 2008 or during the year ended 31 March 2007, and there were no commitments outstanding as at 31 March 2008.

b) Foreign currency contracts

A foreign currency forward contract is a commitment to purchase or sell a foreign currency at a fixed rate for delivery on a specified future date. In the normal course of operations, the Account enters into foreign currency contracts. As at 31 March 2008, the Account was under contract to sell $15 million ($18 million at 31 March 2007) of foreign currency. Unrealized gains (losses) on foreign currency contracts are calculated using the 31 March 2008 exchange rates. As of that date, there were no unrealized net gains (losses) included in net revenue (nil at 31 March 2007). Outstanding foreign currency contracts were settled by 1 April 2008.

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 2008. Outstanding investment contracts were settled by 3 April 2008.

	2008		2007	
	Contractual value	Fair value	Contractual value	Fair value
Marketable securities				
US Dollars				
Purchases	(22)	(22)	(115)	(115)
Sales	22	22	116	116
Euro				
Purchases	(495)	(494)	(35)	(35)
Sales	499	498	36	36

10. Comparative figures

Certain of the 2007 comparative figures have been reclassified to conform to the current year's presentation.