FINANCIAL DISCUSSION

This section of the annual report presents management's discussion of the financial aspects of our operations, including financial operating highlights, financial risk management, and future accounting changes.

The Bank's Balance Sheet

To understand the finances of a central bank, it is helpful to know how it operates in support of its public policy mandate. The Bank's balance sheet is fairly straightforward, compared with those of major Canadian financial institutions, with its assets and liabilities supporting one or more of its functions.

The most significant single item on the Bank's balance sheet is the liability that is created through the issuance of Canadian bank notes under the Bank's currency function. The face value of the bank notes issued is an asset in the hands of the Canadian public but represents a financial liability to the Bank of Canada. This liability tends to increase over time with the growth in demand for bank notes, which is directly related to the growth in the Canadian economy. The bank note liability is supported by the Bank's financial assets in the form of Government of Canada bonds and treasury bills. Seasonal fluctuations in the demand for bank notes are managed by acquiring treasury bills and other short-term assets, such as term repurchase agreements, that mature when the seasonal demand for bank notes is expected to abate.

The Bank of Canada's financial assets support its operational independence to conduct monetary policy by providing an independent revenue stream outside of the government's budget process. A portion of this revenue is used to fund the Bank's operations; the remaining net revenue is remitted to the federal government periodically throughout the year.

Canada's approach to implementing monetary policy requires that a small portion of the Bank's assets be available as collateral for sale and repurchase operations. Implementing monetary policy based on an inflation target and flexible exchange rate focuses on influencing short-term interest rates through the setting of the overnight rate. On each fixed announcement date, the Bank of Canada announces the target overnight rate, which is the interest rate that financial institutions charge each other for overnight loans. The operating range for this

rate is set by policy, allowing direct-clearing members of the Canadian Payments Association (CPA) to hold deposits with the Bank at the target rate minus 25 basis points, or to take collateralized advances at the target rate plus 25 basis points. When required, the Bank will also offer purchase and resale agreements and sale and repurchase agreements to maintain the overnight rate near the target.

The Bank's financial assets also support the financial system function. Every day, relatively small advances are routinely made under the Bank's standing liquidity facility. Financial intermediaries are usually able to allocate liquidity among themselves without having to make significant use of the Bank's collateralized advance and deposit facilities. However, in exceptional circumstances, advances could become significant if the Bank is required to provide emergency lending assistance to a liquidity-challenged financial institution. The last such event was in 1986. Advances from the Bank can be funded by the outright sales of treasury bills, government securities repurchase agreements (repos), or the issuance of interest-bearing securities.

The Bank's investments, managed through the funds-management function, consist primarily of government securities in a proportion that broadly mirrors the structure of the federal government's domestic marketable debt. This makes the Bank's balance sheet a neutral factor in the government's debt-management and fiscal-planning activities. The Bank also operates a securities-lending program to support the efficiency of the market for Government of Canada securities by providing a temporary secondary source of securities. When specific Government of Canada treasury bills or bonds are in short supply in the secondary market and are trading below a predetermined threshold interest rate in the repo market, the Bank will lend up to 50 per cent of its holdings in these securities on an overnight basis in exchange for other securities.

Unlike most central banks, the Bank does not hold foreign exchange reserves on its balance sheet. Instead, Canada's official international reserves are largely held in a separate entity, called the Exchange Fund Account, which the Bank manages on behalf of the federal government.

Financial Operating Highlights

For a central bank, profit maximization is not an objective. The finances of the Bank of Canada are shaped by the activities it undertakes in support of its public policy responsibilities, as outlined in previous sections of this report.

Balance sheet highlights

At 31 December 2006, the majority of the Bank's $51.6 billion in assets were held in investments totalling $48.3 billion. The Bank's main liability is the bank notes in circulation, valued at $48.8 billion, which rose 6 per cent during the year, reflecting the increased demand for notes by the Canadian public.

Revenue from investments

Total revenue from investments in 2006 was $2.2 billion, an increase of 9 per cent over 2005, primarily because of a larger investment portfolio and higher interest rates. The main source of revenues is interest earned on holdings of federal government securities. After expenses,

the net revenue paid to the Government of Canada in 2006 was $1.9 billion, approximately $160 million more than the amount paid in 2005.

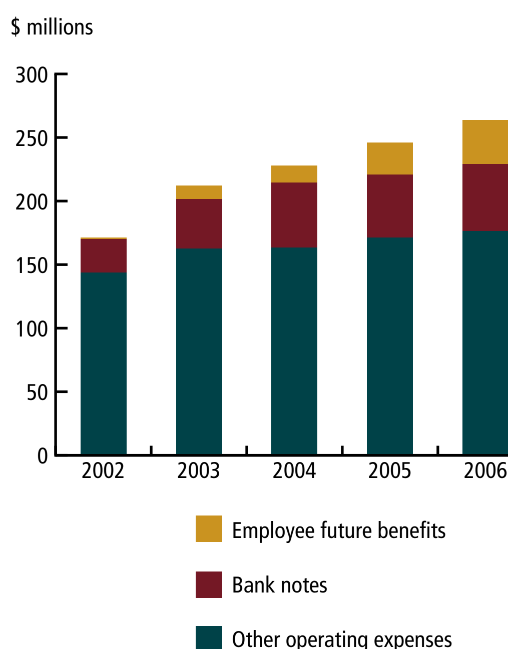
Net revenue is not a good indicator of the Bank's management performance. As noted above, the Bank deals in financial markets to achieve policy goals, not to maximize its revenues. For this reason, the level of operating expenses is a better indicator of the Bank's stewardship of public resources.

Operating expenses

Operating expenses support the Bank's activities in its four main functions: monetary policy, currency, financial system, and funds management. The expenses for these functions in 2006 were $264 million, an increase of $18 million from 2005. Compensation and currency-related costs represent two of the largest expenses by class of expenditure (see note 3, page 62) and also accounted for a significant portion of the year-over-year increase in 2006. Expenses for retail debt operations, which are now reported as part of funds management, are fully recovered from the Government of Canada.

Operating Expenses

Net of retail debt recovery



Compensation

For 2006, the Bank's total compensation expense, made up of salaries, benefits, and other staff expenses, increased by $13 million. The most significant cost driver continues to be employee future benefit costs, which increased by $9 million in 2006, representing more than one-half of the increase in total operating expenses. Most of this change was due to the lower discount rate used to calculate the present value of future obligations. Salaries increased by approximately $3 million, which was mainly attributable to general market adjustments.

Currency costs

Bank notes, which are included in currency costs, increased by slightly more than $3 million in 2006, reflecting the increased volume of notes produced during the year and the higher unit cost of the upgraded $5 note introduced in November. The launch of the $5 note completed the issuance of the *Canadian Journey* series.

Financial Plan for 2007

The year 2007 is the first of the Bank's new medium-term plan, which covers the period 2007–09. The new plan focuses on three strategic priorities: the Bank's operational infrastructure, work environment, and

Financial Profile Over the Period of the 2003–06 Medium-Term Plan

The medium-term plan that ended in 2006 established a number of strategic priorities involving investments in the Bank's research and analytic capabilities, bank note security, and clear communication within the Bank and with Canadians. As we look at the expense profile over the period, the costs were predominately driven by two factors that accounted for two-thirds of the increase: employee future benefit costs and the costs of printing bank notes.

Employee future benefits rose significantly over the four years, increasing by $34 million, which represents 36 per cent of the expense growth during the period. This increase follows updates to demographic, economic, and actuarial assumptions, as well as a period of low discount rates used to calculate the present value of future obligations.

The second significant component of expense growth is attributable to the cost of printing bank notes, which accounts for 29 per cent, or $26 million, of the increase over the period. Bank note costs are the single largest component of operating expenses in the currency function. The medium-term plan focused on launching a new series of bank notes to protect the integrity of Canada's currency. In 2004, the Bank issued the high-denomination notes ($20, $50, $100) in its new series with enhanced security features. The upgraded $10 and $5 notes were issued in 2005 and 2006, respectively.

The average annual increase in the remaining operating expenses was 5 per cent over the period of the plan. The focus here has been on strengthening the Bank's analytic capability and, as a result, a significant investment has been made in attracting and retaining qualified staff. Another major focus during this period, in terms of both financial and human resources, has been the redevelopment of technology systems, in particular the Bank's analytic tools and its systems for essential banking services.

governance. Operational expenses for 2007 (excluding bank note costs and non-current deferred employee benefits) are expected to increase by no more than 5 per cent relative to the 2006 budgeted spending levels. Over the three years, the plan includes an average annual growth in expenses of 4 per cent.

With the recent government decision to consolidate the administration of the retail debt program and wind up the Canada Investment and Savings Agency, the costs to the Bank, along with the associated recoveries for this program, are expected to grow in 2007, as these responsibilities are transferred to the Bank. These operations will continue to be part of the funds-management function.

Financial Risk Management

Financial risk is the risk associated with the Bank's management of its assets and liabilities, including those that appear on and off the balance sheet. The Bank is exposed to two underlying financial risks – interest rate risk and credit risk – both of which are inherently low risks and are described here.

Credit risk

The Bank's portfolio is essentially free of credit risk since the securities held are direct obligations of the Government of Canada. Advances to members of the Canadian Payments Association and securities purchased under resale agreements do not pose material credit risk for the Bank because they are fully collateralized transactions backed by high-quality Canadian-dollar-denominated securities.

Interest rate risk

The Bank is exposed to interest rate risk from fluctuations in interest rates on treasury bills and bonds issued by the Government of Canada. Since the Bank's interest revenues greatly exceed its expenses, changes in underlying interest rates would not affect the ability of the Bank to fulfill its financial obligations.

Future Accounting Changes

The Canadian Institute of Chartered Accountants' new accounting standards will affect the Bank of Canada: *Section 3855: Financial Instruments—Recognition and Measurement* and *Section 1530*: *Comprehensive Income* establish standards for the recognition, measurement, and presentation of financial instruments.

The new standards, described in note 2 (m) on page 62, will apply to the Bank starting in 2007. Under section 3855, the Bank will designate its treasury bill portfolio as available for sale and will therefore measure these assets at fair value, with any unrealized gains or losses being recorded in *other comprehensive income*. The bond portfolio will be designated as held to maturity and will continue to be valued at amortized cost. This designation will still allow bonds to be lent or repoed.

Section 1530 introduces a new component of the balance sheet entitled "Comprehensive Income." This new component is part of shareholder's equity and includes the Bank's net revenue and other comprehensive income. Other comprehensive income includes any gains and losses resulting from the change in the market value of assets that are classified as available for sale. Upon settlement of these assets, any associated gains or losses are removed from other comprehensive income and brought into the current period's income.

The current wording of the Bank of Canada Act requires that the Bank remit all of its net revenues to the Government of Canada. The government has introduced legislation to amend the capital clauses of the Act, which upon royal assent would enable the Bank to retain a maximum of $400 million of its net revenue through the establishment of a special reserve fund. This reserve fund will ensure that the Bank has the ability to maintain a capital base sufficient to manage unrealized investment gains and losses resulting from the fair value valuation of the treasury bill portfolio.