FUNDS MANAGEMENT

The Bank's funds-management activities are related to its role as fiscal agent for the federal government and to the banking activities that it undertakes on its own account and on behalf of other central banks and international financial organizations.

Over the 2003–06 medium-term plan, the Bank improved the cost-effectiveness and efficiency of its operations. Several initiatives have been implemented to maintain the liquidity and efficiency of the market for Government of Canada bonds in the face of declining government debt. Overall, the debt-management program has been strengthened to ensure that it keeps pace with innovation and the evolving roles of intermediaries and investors. The governance and oversight structure for all funds-management activities were significantly enhanced. Systems for monitoring and measuring risk and performance have been steadily upgraded in the management of official international reserves. Partnerships with reserve and risk managers at other central banks, sovereign debt agencies, and private sector institutions have been expanded. Operational costs for retail debt continued to be driven down over much of the period, and a significant restructuring of the business functions that support the retail debt program was begun. With regard to the Bank's own account, the investment activities of its pension fund were reviewed in the context of a comprehensive asset-liability framework, and several improvements were made to its investment policy.

Acting as Fiscal Agent

The Bank's role as fiscal agent to the federal government covers a range of activities: wholesale government debt management, government liquidity management, investment of financial assets, providing related banking services, monitoring risks arising from its fiscal-agent activities, and providing various services to the government's retail debt program.

The objective of the federal government's wholesale domestic debt and cash-management is to raise stable and low-cost funding to meet operational needs. This is facilitated by maintaining a well-functioning market in Government of Canada securities. In 2006, bond buybacks were higher than forecast, with buybacks and switch operations totalling $10.9 billion supporting gross bond issuance. Increased recognition of the degree of substitutability between the newly issued 2-year benchmark bonds and existing bond issues carrying the same maturity date allowed the issuance of more bonds with longer-dated maturities. For bonds with 5-year maturities, changes were introduced to the issuance cycle that will further increase the substitutability between existing bonds and newly issued benchmarks. On a number of occasions in 2006, the Bank lent securities off of its balance sheet on a fully collateralized basis under the securities-lending program. Under this program, which was established in 2002, the Bank supports the liquidity of the market for Government of Canada securities by providing a secondary and temporary source of securities for a specific maturity when there is a strong demand for these securities.

The plan to meet the government's objective of reducing the share of fixed-rate debt to 60 per cent in 2007–08 is on track, and the stock of bonds declined in 2006 by $2.3 billion to $252.4 billion. The stock of treasury bills decreased by $2.4 billion to $124.7 billion. Further efficiency gains in auctions were also realized as turnaround times were reduced from an average of 1.99 minutes in 2005 to 1.89 minutes in 2006 for regular auctions, and from 3.95 minutes to 3.07 minutes over the same period for buybacks and switches.

The Bank's treasury-management operations are directed to ensuring that funds are available to meet the daily operating requirements of the federal government and to minimize the cost of holding unused cash balances. Improvements in cash-management techniques resulted in the average balances of the Receiver General declining from $7.6 billion in 2005 to $6.6 billion in 2006.

Canada's official international reserves, held mainly in the Exchange Fund Account (EFA), are maintained to provide foreign currency liquidity and to provide funds, if required, to help promote orderly conditions for the Canadian dollar in foreign exchange markets. At year-end, official international reserves totalled US$35.1 billion, an increase of US$2.0 billion over the previous year-end. The assets of the EFA are funded principally through an ongoing program of cross-currency swaps of domestic obligations. Securities denominated in foreign currencies are also issued to fund reserves. In 2006, the nominal value of the gross issuance of cross-currency swaps was US$4.8 billion. This was partially offset by maturing debt and maturing cross-currency swaps of US$2.9 billion. The return for the EFA net of its associated liabilities during the calendar year, taking into account all valuation gains or losses whether realized or not, was 52 basis points, reflecting movements in interest rate spreads for both assets and liabilities.

The Bank's risk-management activities involve monitoring and reporting risks that arise from the operations it undertakes as fiscal agent to the government. The Bank uses market-based, risk-measurement tools that are consistent with best practices in the central banking community and the financial sector. In 2006, the Bank enhanced its risk-management tools by implementing a new system to track the frequency and severity of operational risk events and by introducing some new liquidity-risk stress tests. The governance structure, which delineates accountability and decision-making structure, was also strengthened further.

Through 2006, the Bank continued its medium-term objective of increasing research and analysis in support of its fiscal-agent responsibilities. Research included a debt-modelling project. Policy advice was primarily directed at supporting the Crown Corporation Funding

Consolidation study and addressing issues of bond market liquidity.

The Bank was also involved in two Treasury Evaluation Program reviews, which pertained to the EFA and the management of Receiver General cash balances. Both programs were found to be effective in meeting their stated objectives.

Provision of services to the government's retail debt program was directed towards promoting cost reduction. In this respect, the major development in 2006 was the decision by the government to wind down Canada Investment and Savings Agency (CI&S) by 31 March 2007 and to consolidate additional retail debt functions relating to sales, distribution, and marketing within the Bank's fiscal-agent responsibilities. This change is expected to reduce total government expenditures for the retail debt program. In addition, the Bank continued to work with the Canadian Payments Association and its members on the inclusion of retail debt certificates in the cheque-imaging initiative launched by the Canadian Payments Association.

Other Funds-Management Activities

The governance structure for managing the Bank's balance sheet was strengthened through the formalization of an investment policy covering the assets of the Bank (see <www.bankofcanada.ca/en/about/corp.html>).

The assets of the Bank are invested primarily in a range of Government of Canada treasury bills and bonds with a range of maturities that closely matches the maturity profile of the government's debt.

The investment framework of the Bank's Pension Trust Fund continued to be adjusted to reflect a better match of pension assets to pension liabilities, a process that has been under way for the past three years. More use has been made of external managers who direct their trading activities to exceeding the total return of an index on a risk-adjusted basis. This has been associated with a more rigorous review and selection process for external managers.

Banking services to other central banks and to international organizations increased by 3 per cent in 2006. The Bank also undertakes transactions with chartered banks and federally chartered trust and loan companies arising from the requirement that these institutions must transfer to the Bank all unclaimed balances maintained in Canada in Canadian currency that have been inactive for a period of 10 years. The owners of these accounts can have their money returned once they provide the Bank with proof of ownership. In 2006, financial institutions transferred $38 million in unclaimed balances to the Bank. There were approximately 33,000 general enquiries, and the Bank paid out or returned a total of $10.7 million to satisfy 7,000 claims.

The Retail Debt Program

The federal government's two retail debt instruments are Canada Savings Bonds (CSBs), which are redeemable at any time, and Canada Premium Bonds (CPBs), which are typically issued at a higher interest rate but are redeemable only annually. There are several ways to buy these bonds: through a network of sales agents; through organizations sponsoring the Payroll Savings Program; and through direct sales by telephone or via the Internet.

Left to right: Finance Minister James Flaherty; Mrs. Jean Spear, Canadian war bride; and Governor Dodge

The 60th anniversary of the Canada Savings Bond program was celebrated in October 2006 at the Museum of Civilization in Gatineau. New designs for the bond certificates were launched to commemorate the anniversary.