

Swap Management Policy
for the Government of Canada

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1. Purpose of Policy

The *Swap Management Policy for the Government of Canada* sets out the policy on the Government's swap program as it is used in the management of the Exchange Fund Account (EFA). The swap policy outlined herein governs the use, procurement and execution of swap agreements.

2. Purpose of Swap Program

The Government of Canada may use swaps to mitigate risk and/or reduce the cost of borrowing. More specifically, the Government may use swap agreements to exchange interest rate and/or principal payments in one currency for another currency; or to change the interest payment characteristics (i.e. fixed versus floating rate).

3. Governance

Sections 45.1 of the *Financial Administration Act* requires that the Governor in Council authorize the Government to enter into contracts and agreements of a financial nature, such as swaps and other derivatives, on such terms and conditions that the Minister deems necessary. Section 55(d) of the *Financial Administration Act* requires that the Governor in Council authorize the payments out of the Consolidated Revenue Fund of all money required to be paid under such contracts and agreements. Pursuant to the Order in Council made under these sections of the *Financial Administration Act*, the aggregate outstanding principal amount (which includes a notional principal amount) of such contracts and agreements is subject to a ceiling that is reviewed each year as part of the Debt Strategy exercise. The exercise of the Minister's powers under this section is delegated to officials of the Department of Finance pursuant to section 60.1 of the *Financial Administration Act*.

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 swap activity. 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 provide 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 the swap program. 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. Documentation

All swap agreements are executed pursuant to the 1992 International Swaps and Derivatives Association (ISDA) Master Agreement or the 2002 ISDA Master Agreement, including a schedule to the Master Agreements and a Credit Support Annex. Under delegation provided by section 60.1 of the *Financial Administration Act*, officials of the Department of Finance are authorized to execute all Master agreements and confirmations for each swap transaction.

5. Permitted Instruments

The following types of swaps are permitted, after identifying the specific financial objectives to be realized and assessing the attendant risks:

- Cross-currency Swaps – A contract that exchanges a series of interest and principal payments denominated in a different currency for the term of the swap.
- Foreign exchange swaps – A contract that exchanges principal payments denominated in different currencies for the term of the swap.
- Interest Rate Swaps – A contract that exchanges a series of interest rate payments denominated in the same currency for the term of the swap.

6. Use of Swaps

6.1 Strategic Plan

The Minister of Finance approves the estimated amount of swap agreements to be undertaken as identified in the annual Debt Management Strategy (available at <http://www.fin.gc.ca/purl/dms-e.html>).

The strategic plan for the swap program is detailed in an annual funding plan for the EFA, which is approved by the ALMC. The strategic plan shall include the following elements:

- The expected amount of swaps required over the upcoming fiscal year, including:
 - Based on prevailing market conditions, the expected amount of swaps by currency (i.e. US dollars, euro and Japanese yen)
 - the expected amount of fixed-for-fixed swaps,
 - the expected amount of fixed-for-floating swaps
 - the expected amount of floating-for-floating swaps and
 - The expected term to maturities.
- The expected cost of the swap program, based on prevailing market conditions, compared to alternative options.

The strategic plan will be reviewed on a semi-annual basis, or as needed, and adjusted, as necessary, should market conditions or needs change.

6.2 Execution

The execution of the strategic plan depends upon how market conditions evolve over time. The appropriate characteristics and term for each swap agreement shall be determined on a case-by-case basis by swap traders.

The use of swap agreements in relation to the EFA is based upon the cost-effectiveness of raising funds through swaps relative to other funding sources. EFA policy guidelines, such as currency composition and liquidity requirements, guide the determination of the currency and cash flow characteristics (i.e. fixed versus floating rate) of the swap agreement.

The capacity of the swap program, and hence the ability to execute the strategic plan, may be constrained by the depth of the Canadian swap markets, the liquidity of domestic debt issues, which are often used by swap counterparties for hedging purposes, and by individual limits to counterparty exposures.

6.3 Eligibility Criteria and Exposure Limits

The eligibility criteria and exposure limits presented within apply across all lines of the EFA business that a private sector counterparty may have with the Government¹ and are not program specific.

6.3.1 Eligible Swap Counterparties

The eligibility criteria for swap counterparties are based on external credit ratings. To be eligible for participation, a counterparty must have a senior unsecured debt credit rating in the top seven categories from at least two of the four main rating agencies: Moody's Investors Service, Standard & Poor's (S&P), Fitch and Dominion Bond Rating Service (DBRS)². When the credit ratings for a counterparty differ, the rating of the second highest rating agency will be used to assess eligibility³, consistent with the Basel II approach.

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.

¹ The exceptions are Receiver General balances and Crown corporation exposures.

² EFA ratings of sovereigns are based on the lower of domestic and foreign currency ratings.

³ 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 counterparties. The use of stand-alone ratings is to remove the assumption of implicit government support embedded in their official ratings. However, in cases where two or more ratings are the same, for example, Moody's is AA, S&P is AA, DBRS is AA- and Fitch Ratings is AA-, the EFA rating would be AA (not AA-).

6.3.2 Credit Support Annex

All counterparties must sign a collateral management framework, called a Credit Support Annex (CSA), to be eligible for swap business. Under a CSA, high-quality collateral is posted to the Government if individual credit exposures, arising from changes in the mark-to-market values of swap contracts, exceed pre-set limits. No further swap business is permitted with counterparties who have not signed a CSA.

6.3.3 Exposure limits

The Government manages credit risk and roll-over risk through individual and aggregate exposure limits based on measures of actual and potential exposure to swap counterparties. Actual exposure is a measure of the mark-to-market value of the swap contract and represents the amount presently at risk of loss should a counterparty default on its obligation. Potential exposure represents the possible future loss as a result of changes in interest rates and exchange rates over the period between the default event and final settlement. For counterparties that have signed a CSA, potential exposure is used also to ensure diversification across individual counterparties.

Individual Exposure

Individual exposure limits to private sector entities in the form of forwards, deposits, commercial paper and certificates of deposit, together with swaps used for funding purposes, are determined by credit rating, as shown in the following table. These limits are cumulative across all lines of 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.

Exposures limits by credit rating of private sector counterparties

(% of the reserves target level or USD)

Type of Exposure	EFA Credit Rating						
	"AAA"	"AA+"	"AA"	"AA-"	"A+"	"A"	"A-"
Individual actual exposure*	1.00%	0.67%	0.50%	0.33%	0.17%	0.08%	0.03%
Individual potential exposure	0.80%				0.40%	0.20%	0.10%

Potential exposure, which applies to swap contracts, is calculated for each contract individually by multiplying the receive-side notional amount by a multiplier. The multiplier, based on the Basel II add-on approach, depends upon the type of contract (interest rate or currency) and its term to maturity.

Multipliers for calculating potential exposure to swaps

Remaining term to maturity Of derivative contract	Receive-side notional multiplier	
	Interest rate contracts	Currency contracts
Less than one year ⁴	0%	1.0%
One to five years	0.5%	5.0%
Longer than five years	1.5%	7.5%

Aggregate Exposure

Aggregate actual exposure to private sector entities is limited to 25 per cent of the liquid reserves target level. Of this amount, exposure to single-A rated private sector entities is limited to 2 per cent. These limits are cumulative in all lines of EFA business⁵ and represent the mark-to-market value for swaps and forwards and, for foreign reserve investments, the par value exposure for deposits, commercial paper and certificates of deposit.

6.3.4 Eligible Collateral and Haircuts

Eligible collateral under the CSA includes: marketable securities issued by the US Treasury, Fannie Mae, Freddie Mac and Federal Home Loan Bank; Government of Canada Treasury bonds and bills; and Canadian and US dollar cash. Furthermore, all US-dollar denominated securities posted must meet the EFA's eligibility requirements, e.g. no callable bonds and maximum term to maturity of 10 years.

A haircut of 2 per cent is applied to all posted securities with up to one year remaining to maturity, as is industry practice, and 5 per cent beyond one year. There is no haircut applied to cash collateral.

Interest, equivalent to the rate paid on Receiver General deposits, is paid on posted Canadian dollar cash collateral, less withholding tax on foreign counterparties. No interest is paid on posted US dollar cash collateral. Rehypothecation of collateral is not permitted.

6.3.5 Collateral Management

Collateral must be posted to the Government when actual exposure exceeds limit. The responsibility for daily compliance monitoring and reporting for the collateral management framework is delegated to an agent appointed under the terms of a Global Custody Agreement. The degree of under-collateralization is reviewed bi-monthly. Collateral thresholds are defined in nominal terms in Credit Support Annexes. The minimum collateral transfer amount is US\$10 million for counterparties rated "AA-" and better, and US\$1 million for counterparties rated below "AA-". Margin calls are made in accordance with the CSA agreement.

⁴ Swap contracts with a remaining maturity of less than 10 business days are excluded from potential exposure calculations.

⁵ With the exception of Receiver General balances and Crown corporation exposures.

7. Prohibited Activities

Swap contracts shall not be used to establish speculative or leveraged positions.

8. Performance Assessment and Risk Management

Officials are responsible for measuring, monitoring and reporting on risk exposure levels related to the swap program to the ALMC, the RC and the FMC on a regular and timely basis. Officials are also responsible for measuring, monitoring and reporting on the performance of the swap program to the ALMC. Detailed information on the Government's risk management policies is provided in the *Government of Canada Treasury Risk Management Framework*.

9. Review

The *Swap Management Policy* shall be reviewed annually or as required.