Daniel Mminele: Global trends and South African reserves management

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Standard Bank 5th African Central Bank Reserves Management Conference, Sandton, 5 November 2013.

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1. Introduction

Good morning ladies and gentlemen. It is a pleasure to be here and to deliver the opening remarks this morning. I thought it may be useful, given that it is the start of the conference, to share with you some of the changes that we have been observing in the reserves management environment over the past year. I note from the agenda that many of the topics you will be discussing over the next few days are issues that we at the South African Reserve Bank have been dealing with directly over the past few years: we have just completed an external fund manager review and rolled out a new external fund management programme for the next three and a half years, in conjunction with the roll out of a new Strategic Asset Allocation (SAA). We are also nearing the end of the Systems Renewal Programme we embarked on a few years ago, and are currently at an advanced stage of a Custodian Review.

My remarks this morning will focus on trends globally and then touch more specifically on what has been happening at the South African Reserve Bank in the reserves management space, before concluding with some comments on asset purchase tapering and its potential impact on reserves management.

2. Global foreign exchange reserve management

I need not tell an audience such as yourselves about the explosive growth in central bank holdings of foreign exchange reserves over the past decade. The most recent data from the International Monetary Fund's "Composition of Foreign exchange reserves" (COFER) is for the second quarter of 2013, and shows that global foreign exchange reserve holdings stood at US$11 trillion, compared to holdings of just over US$1.4 trillion in 1995. In 1995, approximately 65 per cent of foreign exchange reserves were held by advanced economies with more than 60 per cent of the allocated global foreign exchange reserves held in USD. Fast forward to 18 years later, and we find that 67 per cent of reserves are held by emerging market countries and just a little more than 60 per cent of the allocated global foreign exchange reserves are held in USD. However, the unallocated portion of reserves has grown tremendously, and this makes it difficult to compare the currency composition of reserves over time on a like-for-like basis. The Asian financial crisis in the late 1990s provided the impetus for this growth, as reserve holdings were increased to provide a form of insurance against future Balance of Payments crises. The expansion in global liquidity since the 2008 global financial crisis further provided encouragement to increase reserve holdings, as central banks tried to limit appreciation pressure on exchange rates emanating from the surge in capital inflows, and hence intervened in the foreign exchange markets and by so doing, increased their holdings of foreign currency.

South Africa certainly benefitted from the abundance of global liquidity in many ways, and also used this period to build up our foreign exchange reserve levels. This was done through a combination of direct purchases (mostly related to large FDI transactions) as well as opportunistic purchases in the foreign exchange market. The Bank, together with the National Treasury, considers various formulae when assessing what should be the optimal level of reserves for a country such as ours. We look at both an adjusted Greenspan-Guidotti rule, as well as the Jean-Rancierre model, both tweaked to take into account the specifics of the South African economy. The level which is arrived at provides a guide to what would be an adequate level of reserves to hold to protect against external vulnerabilities, however, this is not considered a hard target which has to be reached at all costs. It is for this reason that we have decided to not publicly release any such indicative levels or ranges. These numbers also tend to change quite a bit from year-to-year, largely influenced by the assumptions made and various forecasts used. The costs involved in accumulating reserves are always considered alongside the benefits of higher reserves, as at some point, the costs of accumulating reserves may far outweigh the benefits to be had.

The composition of reserves assets has also changed over time and reserve managers have become more comfortable with and therefore gradually moved to riskier assets. Bearing in mind the low yielding environment we found ourselves in post-2008, with increased levels and costs associated with holding reserves, asset allocation decisions were influenced towards a greater focus on returns. Reserve managers have explored different avenues to achieve this, including:

- *Diversification in the currency composition towards non-traditional reserve currencies* such as the Korean Won, New Zealand Dollar, Australian Dollar and Canadian Dollar. However, the diversification into alternative currencies as opposed to traditional currencies remains quite small as an overall proportion of reserves, around 3 per cent, given that these non-traditional currencies markets are relatively small and have limited depth and liquidity as compared to that of the USD or EUR, for example. Nonetheless, since 2008, the share of alternative currencies in reserves assets has tripled. The IMF has started showing these currencies separately in the Cofer release, in recognition of the growing role they play in foreign exchange reserves management.
- *Gold has also become a popular diversification strategy*, with quite a few central banks increasing their holdings of gold in recent years following two decades where central banks were net sellers of gold. In the first six months of this year central banks have bought over 180 tonnes of gold, and on average have bought between 70–160 tonnes per quarter for the last couple of years[1].
- *Investing in new asset classes* such as emerging market local currency debt; mortgage-backed securities and equities;
- using *more sophisticated financial instruments to mitigate risk* and at the same time to enhance returns by providing protection against rising interest rates;
- *upgrading information technology and risk management systems* to better manage risk;
- *up-skilling staff* through training, education and knowledge transfer with other central banks and private fund managers; and
- *Following a more sophisticated approach to investment policy making and strategic asset allocation*.

Experiences across central banks in dealing with the challenges of the global environment have been quite similar, although some have perhaps been more courageous than others in terms of the avenues in which they have chosen to diversify. What we of course need to be mindful of is that as central bank reserve managers we are custodians of public funds, and at all times have to be guided by prudent strategies which implies that there must be a limit to “thinking outside the box” in the quest for higher returns.

[1] ETF Daily News, Central Bankers trust gold more than money, 25 October 2013.

3. What has South Africa been up to?

In managing its reserves, the South African Reserve Bank continues to adhere to the three main objectives: capital preservation; liquidity and return, in that order of importance. ***Capital preservation*** is the most important objective as any significant erosion of capital on the reserves will not only dent the general perception of the Bank's ability to manage its reserves, but also harm perceptions about South Africa's external vulnerability position. ***Liquidity*** is important for the Bank to be able to meet its day-to-day foreign-exchange commitments and to manage liquidity within the domestic money market arising from its monetary policy implementation function. Finally, the ***return objective*** has become increasingly important in recent years as reserve levels have grown, and therefore there is a need to enhance returns within an acceptable and prudent risk tolerance so as to help defray the costs of accumulating and holding reserves.

The Bank benchmarked and just recently completed a review of its Investment Policy (IP) and also reviewed the Strategic Asset Allocation (SAA), to take into account the current low-yielding environment and expectations of future monetary policy actions by major central banks. The review and benchmarking of the IP earlier this year proved to be very useful with much of the feedback from various central banks, the World Bank and the Bank for International Settlements (BIS) taken on board. A number of refinements were made to the IP, which largely related to improving on already well-structured governance arrangements.

In order to meet the three objectives of capital preservation; liquidity and return, the Bank structured the reserves into various tranches. Prior to the rollout of the most recent SAA, the Bank had divided the reserves into 3 tranches, being the liquidity, buffer and investment tranches. However, the rollout of the new SAA saw the tranches cut down to two instead, namely the liquidity and investment tranches. This change was really just a simplification of the structure and necessitated by the various scenarios informing assumptions made using the Jean-Rancierre model and the amount of reserves which needed to be held for liquidity purposes. In essence, the structuring remains very similar, as the liquidity tranche is divided into two sub-tranches, namely the buffer tranche and working capital tranche, the latter being held largely for liquidity purposes. The Bank has employed the Jean-Ranciere model in determining the appropriate size of each tranche, and within this, has made various assumptions regarding the probability of a sudden stop in capital flows, which then dictated the amount of reserves which should be held in the liquidity tranche.

In order to determine the appropriate risk profile of the portfolios located within each tranche, the Bank uses a Strategic Asset Allocation (SAA), which it reviews roughly every 3 years or when market conditions necessitate a review. The purpose of the SAA is to maximize returns for each tranche, while being subject to a very low probability of capital loss over a given investment horizon. The new SAA which was rolled out in 2013, has allowed for a diversification in the Bank's currency exposure, while assumptions about credit risk had to be adjusted in light of the dwindling amount of AAA rated paper. For the first time in the Bank's history, a portion of the reserves will be invested in the Chinese interbank bond market. South Africa was the first African central bank to be granted an investment quota for the Chinese onshore market. The Chinese bond market is the world's fifth largest, continues to grow rapidly in both depth and liquidity and the onshore market provides more favorable yields. An agreement between the Bank, and the PBOC allows the Bank to invest approximately US$1,5bn or CNY9,3 billion, which is roughly 3 per cent of South Africa's official gold and foreign exchange reserves.

The Bank has also taken steps to invest in new asset classes and new currencies other than the Renminbi. The Bank will be diversifying into currencies such as the Korean Won, Australian Dollar and New Zealand Dollar. New asset classes that the Bank has begun to invest in include covered bonds and mortgage-backed securities and we have recently began trading in bond futures to mitigate the potentially negative impact of rising bond yields on the reserves as well as for more efficient portfolio management.

Investing in these instruments demands better skilled staff and more sophisticated information technology and risk systems. The Bank has gained a great deal of training through external fund managers, including the two official sector fund managers, being the Bank for International Settlements and the World Bank. The Bank has been part of the World Bank's Reserves Advisory and Management Programme (RAMP) since 2006 and through this engagement Bank staff not only received extensive training but are now also in a position to provide training and engage in knowledge transfer with other central banks within the SADC region. Being a member of the RAMP programme has greatly enhanced our efficiency in managing reserves. We also enjoy a very good relationship with the BIS, with whom we have previously partnered to host conferences around reserves management and also participate in their annual BIS Associate programme.

The Bank has further made changes to the split in the proportion of funds managed internally and those managed externally. South Africa implemented its first External Fund Management Programme in 1999, mainly to build internal capacity through skills and technology transfer and for diversification purposes. As our level of foreign exchange reserves grew, especially in the period since 2004, so did the external fund management programme. In 2004, South Africa's gross reserves amounted to approximately US$8 billion and this had grown to US$50 billion by 2011. However, with the most recent review, which took place this year, we decided that the funds under external management would be reduced, primarily because the latest SAA supported benchmarks and related portfolios that could largely be managed internally.

Currently, we are at an advanced stage of reviewing the custodial arrangements we have in place, including the type of model which we would like to follow going forward. The custodial review entails:

- benchmarking services received from custodians against current world custodial service standards;
- reviewing the current ratings of custodians against minimum ratings standards;
- reviewing services required from custodians against the Bank's business requirements; and
- determining the capabilities of Custodians to provide ancillary services such as accounting, performance attribution, settlements and risk measurement and reporting.

Prior to the Custodial Review, the Bank embarked on a comprehensive systems renewal project in order to upgrade the Bank's IT and risk management systems, so as to create a superior reserve and risk management operational platform. The two projects, the Systems Renewal and Custodian Review, of course have a direct bearing on each other. We hope to make final decisions for the Systems Renewal later this year and hopefully be in a position to start implementing whichever system is chosen by the end of the year or early in 2014. The decision regarding custodial arrangements we also hope to make early next year.

4. Asset tapering and reserves management

What will keep reserves managers up at night? No doubt an important issue for reserves managers going forward is that of asset purchase tapering and the timing of policy tightening after the asset purchasing programme has been completed. The implementation of asset purchases by the US Federal Reserve in a bid to dampen yields on the longer end of the yield curve resulted in significant increases in prices of US Treasuries, and prices of other advanced economy and emerging market bonds. In such an environment, it was not too difficult for reserve managers to earn good returns as yields rallied substantially, albeit with a fair amount of volatility. But as they say, everything that goes up must come down. The mere expectation of tapering by the US Federal Reserve had a significant impact on markets, introducing significant volatility, with practically all markets selling off and a number of emerging market central banks spending some of their reserves trying to defend their currencies. With over 60 per cent of foreign exchange reserves held in US dollars, this has important implications for reserve managers, as it is clear that tapering will remove an important source of support for US Treasuries, mortgages and other asset classes. US Treasuries are the so called “risk free” assets, therefore, any rise in US Treasury yields is likely to push up yields elsewhere in the developed and developing world. Furthermore, most central banks are heavily invested in bond markets, which as we know are highly interest rate sensitive. While there has been some diversification of reserves across assets, this has been quite limited.

JP Morgan[2] constructed several portfolios to highlight the impact of what they call a rates crisis on different portfolios and unsurprisingly found that portfolios extending beyond the fixed income universe performed relatively well in an environment of rising interest rates, showing positive expected returns, and all portfolios that included only fixed income, performing poorly with negative return expectations. Having said this, however, the author found that even central banks whose investment universe is constrained to fixed income assets can improve expected returns through diversification into different markets, credit risk exposures, and having some portion of holdings in cash.

The South African Reserve Bank is acutely aware of the risks facing the global environment emanating from asset tapering, and with this in mind made a strategic decision to diversify its currency exposure so as to help insulate the reserves from this potential rise in US treasury yields. From a more operational perspective, the internal portfolio managers are better equipped with the use of bond futures as a hedging instrument against rising yields.

5. Conclusion

In conclusion, the unique financial environment that we find ourselves in has created many new challenges for us as reserve managers. With the increase in the level of reserves came a much higher level of interest and scrutiny in how these reserves are managed, especially against the rising opportunity cost of holding these reserves. At the same time the yield differential between the cost of holding reserves and the return on the reserves necessitated an increased focus on return enhancement without putting at risk a prudent approach to investing.

Including some non-traditional assets in investment portfolios has meant that reserves management has become more complex, resulting in central bank reserves managers, including ourselves, needing to build capacity by up-skilling staff and investing heavily in sophisticated IT and risk management systems.

While the recent impasse in US politics has passed, many of us realise that this stalemate situation will again cause undue volatility in the months ahead. For reserves managers this once again means huge fluctuations in global financial markets and unfortunately large swings in the valuation of our reserve assets. However, there can be no doubt about the need for investment processes to continue to be guided by sound investment principles and solid risk management policies and good governance and oversight structures.

Conferences such as this one, which provide networking opportunities, facilitate knowledge transfer and capacity building therefore play a critical role. Looking at the agenda for the next few days, I’m sure that you will find this conference worthwhile and have a lot to take away to help strengthen reserves management operations and their oversight in your respective institutions.

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[2] Anticipating the end of easy money: reserve management consideration, Robert Grava, Asset Management Strategy Group.

I wish you a successful conference.

Thank you.