Daniel Mminele: Establishing a proper governance framework for central bank reserves management

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Institutional Investor, Africa Sovereign Funds Roundtable, Cape Town, 7 March 2013.

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1. Introduction

Good morning ladies and gentlemen.

Thank you to Institutional Investor for inviting me to address this roundtable meeting, and for choosing to host it in Cape Town. I trust those of you visiting South Africa or Cape Town for the first time will have an opportunity to see the exceptional beauty that this part our country offers.

Judging by the agenda, I have no doubt that the discussions will be rich, as the topics being covered are all pertinent, and should allow us to exchange views and gain valuable insights to inform the work in our respective institutions in strengthening sovereign funds management operations and their oversight.

I have been asked to talk on the topic of governance for central bank reserves management. With the increase in reserves assets observed in recent years, there has come a higher level of scrutiny with regard to how these assets are managed, in particular heightened interest around proper governance structures. As public investment managers we should welcome this trend, because reserves are public assets, which should be seen to be managed prudently and carefully while achieving appropriate returns.

As some of you may be aware, the South African Reserve Bank (the Bank) has made significant progress in recent years in enhancing our governance framework.

2. Evolution of reserves management in South Africa

Before I talk about the governance aspects of foreign exchange reserves management, I would like to first provide a brief history of the build-up of reserves in South Africa, and the evolution of reserves management activities.

In 1998, South Africa had gross reserves of just US$6 billion, but was running an oversold forward book and consequently had a negative net open foreign currency position (NOFP) of US$25 billion. This huge forward dollar commitment left the country in a precariously dangerous and vulnerable external position and resulted in our currency being deemed a one-way downward bet. The Bank and the National Treasury embarked on a drive to reduce the NOFP to zero, and to build up the reserves of the country, with the former being achieved in March 2003. Subsequently, there was a rapid build-up of reserves over the years, made possible by a combination of purchasing the proceeds of Government’s foreign bond issues; taking advantage of large FDI related inflows; and purchasing foreign exchange in the open market, when conditions were deemed to be favourable. At the end of February 2013, South Africa’s gross gold and foreign exchange reserves amounted to US$50.4 billion and the international liquidity position of US$47.2 billion.

While South Africa does not target a specific optimal level of reserves, we do look at various measures that inform what could be deemed an acceptable level of reserves for the country, taking into account factors such as the balance of payments position and debt dynamics. Much as by international comparison, when looking at other emerging market countries or similarly rated countries, our reserves are still relatively low, the level of foreign exchange reserves exceeds short term foreign exchange commitments of the country, and we broadly satisfy commonly accepted reserve adequacy measures. The build-up of foreign exchange reserves will continue when market conditions are conducive, and taking into account a careful cost/benefit analysis. A higher reserves cushion will not only make South Africa more resilient in crisis situations and in the wake of volatile capital flows, but should also help to increase policy flexibility, for example, if exchange rates are perceived to have deviated significantly from what is considered "fair value" as suggested by macro-economic fundamentals.

It goes without saying then, that with the increase in reserves their efficient management became a key focus area of the Bank. The Bank graduated from being a pure liquidity manager to building what by now has become a relatively sophisticated investment management operation. In the process, our investment objectives have not really changed, still conforming to the old definition contained in the 2001 IMF guidelines, and guided by the ***classical trilogy of objectives***, placing emphasis on *capital preservation*, such that investments are undertaken in a manner that seeks to preserve the capital of portfolios over the investment horizon; *liquidity* to enable the Bank to meet its day-to-day foreign-exchange commitments as well as for unforeseen circumstances, without incurring significant penalties when liquidating the investments; and *return* having a lesser emphasis, but the objective of which is to enhance the returns on the Bank's official reserves within an acceptable risk-return framework and to help defray the costs of acquiring and holding reserves.

The reserves are separated into various tranches, around which specific ***portfolios*** have been constructed, with the abovementioned objectives in mind, to ensure an appropriate balance between them. Each portfolio's objectives have specific liquidity requirements and investment horizons. In determining the size, liquidity requirements and investment horizons of these tranches, foreign exchange liquidity needs of the Bank and the National Treasury are taken into account. While return has always been a lesser objective, it has received more prominence in recent years, given the increase in reserves globally and the low yielding environment in which the reserves are invested in.

The Bank, like many other central banks, complements its internal reserves management activities with a carefully structured ***external fund management programme***. The first group of external fund managers were employed in 1999. We have refined the external fund management programme as we went along, with the most recent review initiated in 2012, with a view to completing this process by September 2013. Apart from delivering excess returns against set benchmarks, this programme also has at its core a skills and technology transfer component. Our staff members have benefited vastly from the knowledge transfer, which now allows them to manage more complex portfolios. But, over time our initial objective changed and we now also look at external fund managers with diversification in mind, allowing them, given their higher level of professional expertise, to do things that we can't do. In this respect, they get more leeway in terms of risk taking and asset classes they can invest in.

The Bank established its first formal Reserves Management ***Investment Policy*** (IP) in 2007, to provide the strategic and operational framework and to define the investment criteria for the management of reserves. The aim of the process was to set investment objectives and related parameters for the reserves portfolios. In this, relevant target durations and benchmarks which are consistent with the Bank's risk tolerance were established. The evolution of the Bank's reserves management activities has necessitated the review and enhancement of the IP. The first such review took place in 2010, and apart from being a governance related review, provided an opportunity to not only take into account some of our own lessons learnt from the crisis, but also to align the policy with emerging best practices. The 2010 IP review led to the strengthening of the governance structure for reserves management and a reconfiguration and strengthening of the Reserves Management Committee (Resmanco). Other initiatives currently under way involve improving our IT infrastructure, and upgrading our risk management tools, monitoring, compliance and reporting systems. The IP has been reviewed again in 2012/2013, during which time we also undertook a benchmarking exercise, the results of which revealed some further areas of improvement, which we are taking on board where appropriate.

To align the investment of reserves with the objectives of holding the reserves, the Bank employs a ***Strategic Asset Allocation (SAA)***. The first SAA programme was developed in 2007, the purpose of which was firstly to calculate/agree on a tracking error consistent with the Bank's risk tolerance, and secondly, to establish strategic benchmarks against which reserves would be managed. The SAA for the various tranches is meant to ensure that the tranches maintain sufficient liquidity while maximizing returns, subject to a low probability of capital loss over a given investment horizon. We are currently in the process of reviewing our SAA to be in line with the IP and to take into account the changing financial markets environment, with a view to greater diversification in terms of investment destinations, so as to improve the risk-return profile of the reserves. It will be rolled out later in the year following the approval of the IP and to coincide with any changes deemed necessary emanating from our external fund management review.

3. Governance, accountability and oversight of investment management

Sound governance and oversight around the management and investment of foreign assets has become a critical discussion point in central banks and governments globally, especially so following the financial crisis. The ability of central banks to make decisions and respond to specific market developments within a sound risk management framework were tested during the 2008 financial crisis, when capital markets malfunctioned and liquidity became a major constraint. At the time, potential systemic risks in the banking sector required a tightening of risk management guidelines, placing greater emphasis on liquidity considerations in terms of the asset classes in which reserves portfolios are invested. Central banks generally have a large proportion of reserves invested in highly liquid fixed income assets which include short-term bank deposits. At the peak of the financial crisis, default risk was high and central banks withdrew their investments in the banking sector, which was in desperate need of funding.[1] Although these actions were plausible from an individual reserve manager's perspective, the collective withdrawal exacerbated the already tight funding situation of commercial banks. This pro-cyclical behaviour of reserves managers during crises may conflict with central bank's objective of maintaining financial stability, which again highlights the need for sound governance and oversight in the investment of reserves. Clarity of mandates and objectives is an important part of the governance framework, especially in more recent times when a balance has to be struck between not taking too much risk, and the expectation of higher returns.

The Bank's reaction to the global financial crisis centred on a risk-averse philosophy and we responded to the deterioration in liquidity by tightening investment guidelines to reduce credit risk by limiting counterparty exposures. When a second wave of the crisis emerged in Europe through potential sovereign defaults, the Bank decided to rebalance its portfolios in order to manage exposures to affected peripheral euro area countries.

Foreign exchange reserves make up a significant component of total assets of central bank balance sheets. Due to this concentration, central banks are subject to stringent reporting requirements from the general public, and more specifically, governments and shareholders. To this end, central banks have been developing sound governance structures, improving accountability through more transparency and introducing a culture of higher risk awareness across all their operational activities. Efficient management of foreign exchange reserves has become vital for maintaining sound perceptions of central bank credibility. Undoubtedly, a

[1] Jukka Pihlman and Han van der Hoorn (2010), *Procyclicality in Central Bank Reserve Management: Evidence from the Crisis*, IMF Working Paper

loss of reputation through bad governance could undermine the ability of a central bank to perform its primary tasks of ensuring price and financial stability.

Good governance and sound functional organisational structures are therefore necessary for the efficient management of reserves. In establishing these structures, clear decision-making processes; appropriate delineation of roles and responsibilities, clear execution guidelines, and accountability through adequately transparent regular reporting, should be well defined, documented, adopted and institutionalised. It goes without saying that there is no one correct way of establishing a governance framework, and that country- and institution-specific circumstance must be taken into account, while not compromising on the principles.

Borio et al note that there are two dimensions to consider in governance – vertical and horizontal governance.[2] Vertical governance ensures that decisions are taken at the right level (senior executives), that is, where the strategic direction of the organisation is established. Senior management of the institution should carry out the responsibility of oversight on the investment process and management of reserves. Horizontal governance ensures that business areas and reporting lines are organised in a way that minimises the potential for conflicts of interest. The senior governing body needs to provide overall strategic direction through an investment management policy, which encapsulates the risk tolerance for the institution, while an investment committee should be responsible for the tactical position and for establishing the investment guidelines, and whereas day-to-day trading activities and taking active positions should be the responsibilities of portfolio managers within a control environment which separates them from middle office functions of risk and reporting, as well as accounting and settlement functions.

What is of critical importance is to insure that investment committee members are competent, have relevant skills, and bring the right level of commitment. This can be a challenge for central banks that are busy building professional investment management operations, and when the traditional skills-set in a central bank has been around macroeconomics, monetary and exchange rate policies. A structured programme needs to be developed to capacitate investment committee members, and which seeks to continuously enhance their expertise as part of making the governance structure more solid. We have found that the external fund management programme provides a good opportunity and can be used very effectively for skilling up investment committee members.

The Bank has a three-tier governance structure where the responsibilities for executive authority, strategic management and the actual portfolio management are clearly segregated. This comprises of the Governors' Executive Committee (GEC), the Reserves Management Committee (Resmanco) and the Financial Markets Department (FMD). The GEC is responsible for making decisions such as the risk tolerance of the organisation and policies on reserves accumulation and management. The Resmanco is the investment committee which functions within the parameters set-out by the GEC, and provides guidelines on the framework of reserves management and approves the SAA. In other words, Resmanco designs the investment policy and guidelines for the portfolio and risk management functions, and submits them for approval by the GEC. Portfolio management activities are carried out in the Financial Markets Department. In line with principles of sound internal governance, the Bank has separated portfolio management activities from those of performance measurement, risk control and compliance, accounting and settlement.

2 Claudio Borio, Jannecke Ebbesen, Gabriele Galati and Alexandra Heath (2008), *FX reserve management: elements of a framework*, Bank for International Settlements Working Paper No. 38

Figure 1

SARB Structure and responsibilities in governance structure

GEC	Review and approve Investment Policy Approve the Terms of Reference of RESMANCO Approves the appointment and removal of external fund managers Approves the appointment of custodians & SLAs Approves benchmarks and guidelines and risk management limits and procedures
Resmanco	Approves target tranche sizes and currency composition of tranches within IP parameters Approves the SAA Approves the investment guidelines Approves deviations from benchmarks within approved risk budget and asset classes Evaluates performance and future strategies
FMD	Portfolio and risk management activities

On an annual basis, the Internal Audit Department provides the GEC with a report on the adequacy of internal policies, procedures and processes around reserves management, while at the same time a report is prepared for the Board of Directors. The latter report focusses on the current investment of the reserves including matters such as duration, credit risk, asset class and currency composition, as well as the results of the investment management activity over the year.

As I mentioned earlier, some very useful contributions were received from the benchmarking exercise undertaken, which may result in some adjustments to the governance structure.

4. Current challenges in reserves management

As I come to the end of my remarks, let me leave you with what could be the challenges that reserves managers will have to deal with going forward, and I am sure some of these issues will feature in the discussions over the next two days of your programme:

(i) Do central banks need to redefine what an acceptable risk-return balance for official reserves is and think differently about risk tolerance?

(ii) As we are central banks, what is an acceptable level of trade-off between risk management and financial stability? A recent IMF paper dealt with this and I alluded to it earlier, pointing to the pro-cyclical behaviour of central banks when withdrawing deposits from commercial banks during the crisis. Do there need to be rules around how central bank reserves managers need to behave in a crisis so as not to make matters worse?

(iii) Should there be a greater segregation between reserves that are held for policy purposes (i.e. monetary policy, intervention, etc.) and those that are purely for investments and who is best placed to manage those, central banks or other dedicated public entities?

The low return environment has exacerbated the opportunity costs of holding reserves and induced a debate amongst central banks about ways of enhancing returns by moving higher on the risk-return frontier. Considerations of seeking excess returns (or alpha) carry with them challenges of balancing central banks trilogy of objectives and the related financial risk management issues which will arise with the inclusion of riskier asset classes in the portfolio.

Added to this is also the potential for global monetary policy normalisation which may cause bond yields to rise and hurt the return on fixed income investments.

Furthermore, there are large carry costs (the interest rate differential between the domestic and foreign economy multiplied by the change in reserves) associated with foreign currency accumulation. Whenever foreign currency is purchased in the domestic foreign exchange market, local currency liquidity is injected into the domestic money market and due to the related potential inflationary impact, in most cases central banks have to sterilise these purchases. Indeed, sterilised purchases of foreign exchange can be expensive when the central bank earns a lower interest rate on the foreign currency reserves than it pays on the instruments that are issued in the sterilisation process.

Finally, the complex and changing regulatory framework in financial markets could make the investment landscape for reserves even more challenging given all the uncertainties related to new requirements and potential impact on asset prices.

What does this all mean? Could the outcome be that the pendulum swings all the way back to the other extreme? Are central banks going to become overly risk-averse? Are we going to find it difficult to retain staff members that were attracted to central banks, because of the increased level of sophistication, which they may feel is going to go into reverse?

5. Conclusion

The pressing need for good governance and oversight in reserves management has been emphasised during this financial crisis. The crisis impacted portfolio performance and as a result tighter risk management frameworks had to be implemented. Given the rising challenges faced by reserves portfolios in this low global interest rate environment, the investment processes must remain guided by sound investment principles and solid risk management policies which are supported by effective information technology platforms.

I trust that you will glean useful information over the next two days and that you will assist your respective institutions in overcoming some of these challenges which are faced by central banks in reserves management.

Thank you.