OeNB conference on
Asset Management in an era of Very Low Interest Rates:

Current issues in Central Bank Reserves Management

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Outline of presentation

- **Structure of central bank reserves management**
  - Objectives
  - Style of RM investment operations
- **Current issues and response to markets**
  - The question of the size of the reserves
  - The search for yield
  - The challenge of complexity
- **Outlook and concerns**

A: Structure of CB RM

- **Reserves Management is a multi-faceted and multi-dimensional operation**

- **It has elements of**

  Policy – eg maintain and defend an exchange rate, maintain creditworthiness, manage FX debt servicing

  Market Liaison – eg oversee and gather information on FX and bond markets, communicate intentions

  Financial Management – eg B/S and risk management, income generation, wealth preservation

- **These are three very different objectives**

  They require different skills at both operational and managerial level

  The respective weights of each of the three will differ for each CB

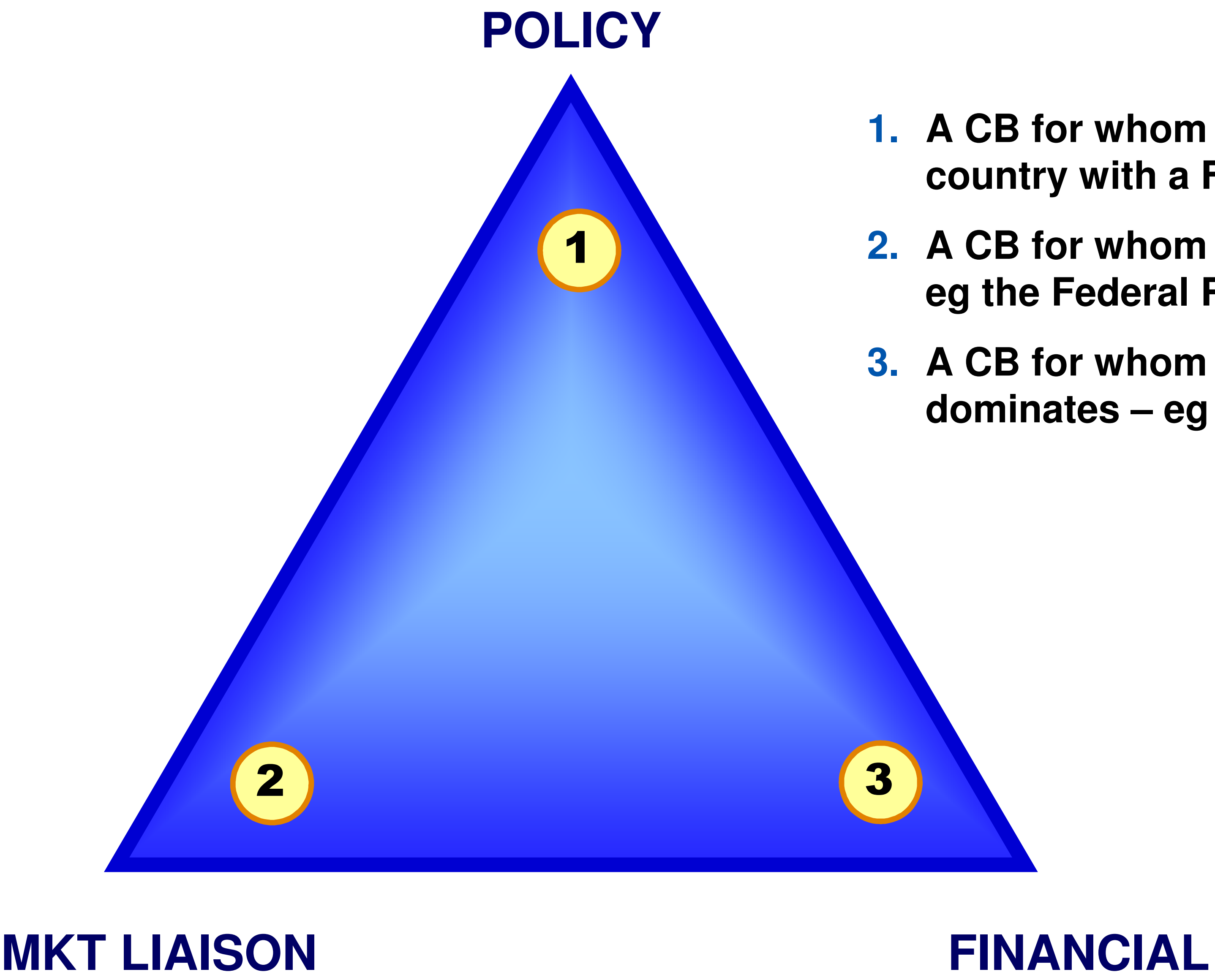
  The impact on the CB, its operations and its reputation will also differ

  Finally they will help determine the CB's investment objectives and style

- **As a result the first question all CBs consider is**

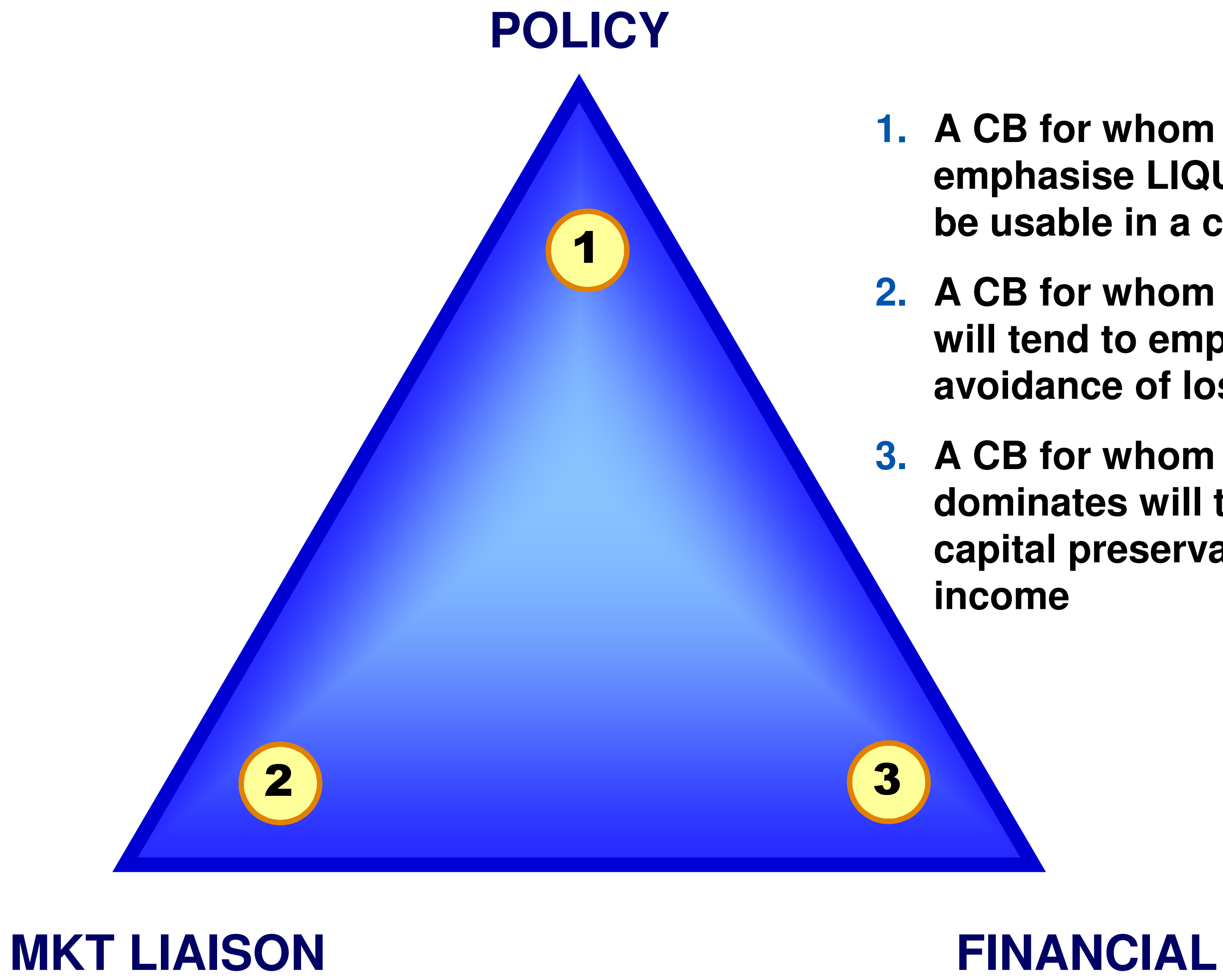
  "What is the respective importance of the three elements of RM?
  What is my RM operation really trying to do?"

The RM Profile triangle



1. A CB for whom Policy dominates – eg a country with a FX peg or currency board
2. A CB for whom Market Liaison dominates – eg the Federal Reserve
3. A CB for whom Financial Management dominates – eg a quasi-SWF

The Policy Triangle and the "Classical Trilogy" of Security, Liquidity, Return



1. A CB for whom Policy dominates will tend to emphasise LIQUIDITY – the reserves have to be usable in a crisis
2. A CB for whom Market Liaison dominates will tend to emphasise SECURITY – the avoidance of loss
3. A CB for whom Financial Management dominates will tend to emphasise RETURN – capital preservation and the generation of income

The style of CB RM

- **There have always been questions as to the appropriate style of reserves management – what activities are acceptable and legitimate, and what activities should be avoided**

- **In the 1980s the big question at most gatherings like this was whether reserves should be managed actively for profit**

  Management of FX reserves had just moved from being an act of custodianship (safe-keeping and administration) to one of management (seeking efficiency and risk minimisation)

  Was it was legitimate for CBs also to seek to manage the reserves for profit?

- **In the 1990s the big question was the CB community's stance on gold**

  Did central banks have the right to trade gold solely with their own objectives in mind, or did they have some responsibility towards the functioning and health of the gold market?

- **In the 2000s the big question was the appropriateness of equities in CB RM**

  And if they were a legitimate diversification, should they be held passively or traded actively?

- **Now one question is how CBs should exercise ownership and governance oversight**

  Passive ownership – abstaining from votes – helps weak management and preserves weak governance

  But there is a thin line between Involvement and Interference

- **CB RM is continually evolving – the current markets are not uniquely forcing change**

B: Current issues facing CB reserves managers

- **Two main types of issue currently face CB reserves managers**

    Internal issues, such as the rationale for holding reserves, the size of reserves portfolios and the interaction with any SWF the country may have

    External issues, most obviously the state of markets and the level of yields

- **It would be wrong to take these in isolation of each other**

    Of course CBs, like any other investors, are challenged by current markets

    Low yields are encouraging CBs to change their investment style, just as others are

    But their responses are conditioned by their institutional framework and in many cases by their size

Issues of size (1)

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The conclusion is that different CBs will have different styles and employ different responses to current market conditions

Relative size of reserves	Implications for Reserves Management style
Inadequate	Liquidity management, rationing of access to foreign exchange (eg via exchange controls), prioritisation of servicing of foreign currency debt, establishment of credit lines, dialogue with official sector finance (IMF etc)
Sufficient	Liquidity management, hedging of foreign currency debt, maintenance of creditworthiness and access to market finance
Comfortable	Liquidity management, hedging of foreign currency debt, interest rate risk management, increased transparency to stakeholders?
Surplus	Interest rate risk management, market selection, asset allocation and diversification, much increased communication with stakeholders
Significant Wealth	Wealth management, market selection, strategic asset allocation, role as shareholder/owner, implications for public profile of the CB, issue of whether or not to split off assets to SWF

Issues of size (2)

- **So far we have just considered the size of a CB's reserves relative to its own circumstances**

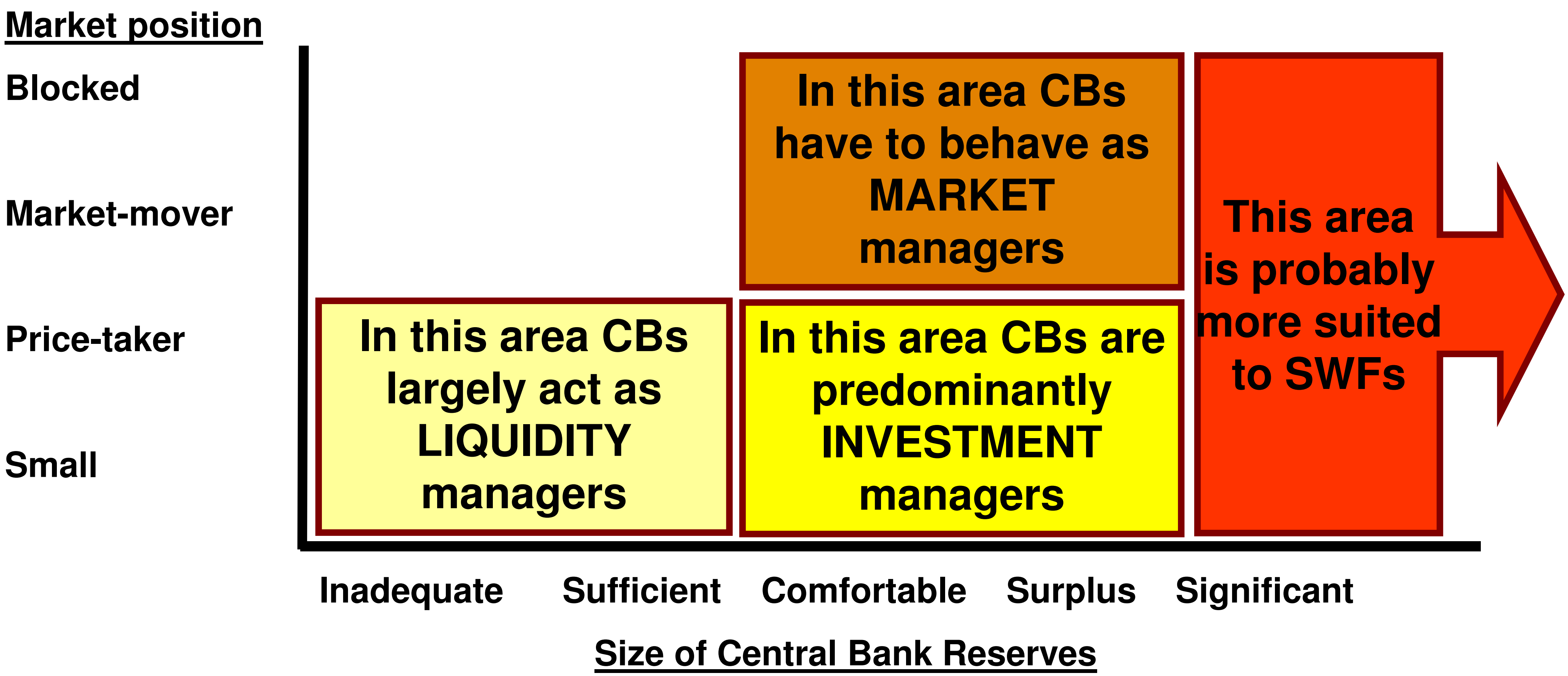
    For most central banks, and in most markets, this is sufficient

- **For the larger and/or wealthier central banks, and for those investing in smaller less liquid markets, there is a second dimension of size – size relative to the market**

Size relative to market	Relationship of CB operations with market	Consequence for RM style	Implications for management
Very small	No significant effect	None	No need to consider market
Small or Medium	Price taker	Able to trade at almost all times	Choice of counterparties important – need a selection but can include second tier players
Large	Price maker, potential market mover	Timing becomes important, need sensitivity to market	Choice of counterparties crucial – should be drawn from the premier houses
Very large	Dominant market player if not largely blocked	Timing and order management crucial	Confidentiality pre-trade and transparency implications post-trade rise in importance

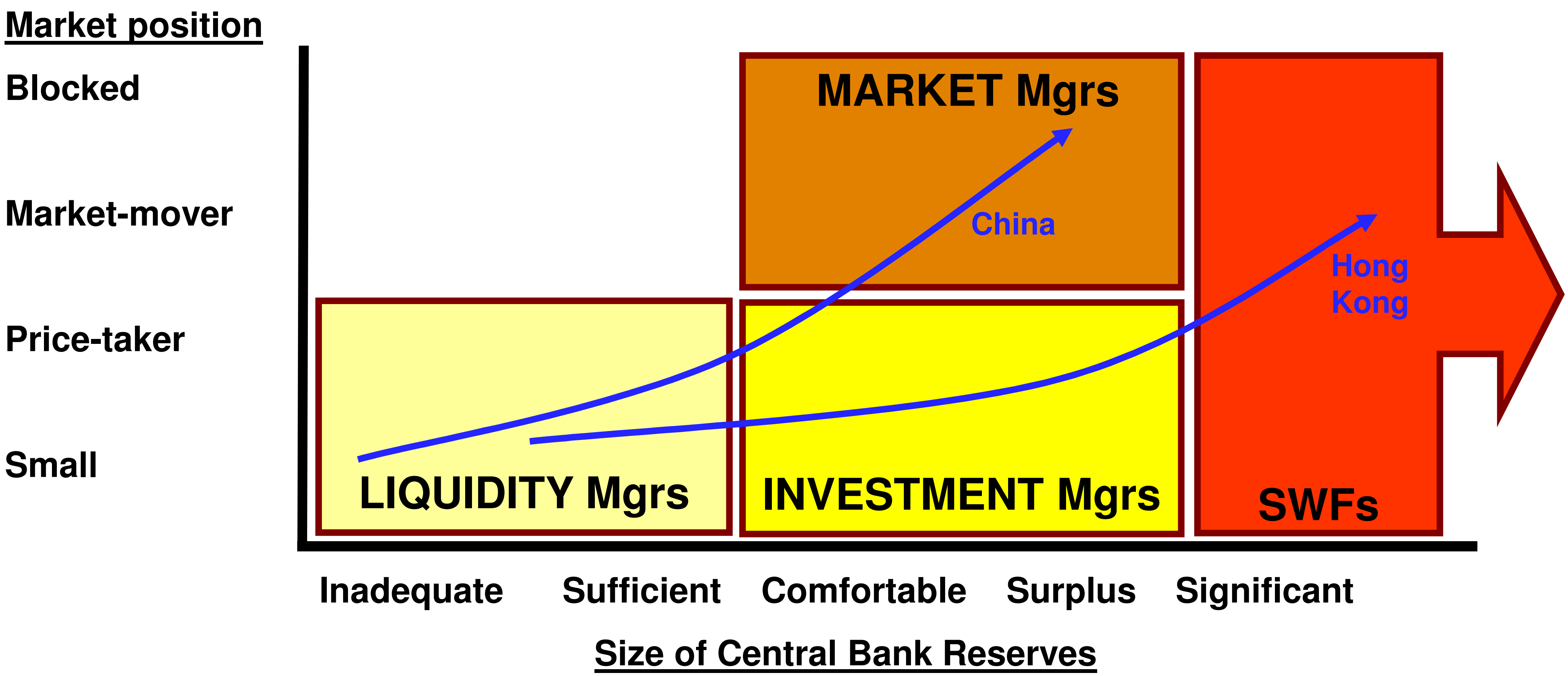
Issues of size – combined chart

- **We can combine these two thoughts on a single chart:**



Issues of size – combined chart

- Many countries have seen growth in reserves which has changed their market position



The challenge of low yields

- **Central banks are faced with the same very low yields as everyone else**
  - Some CBs can ignore this – those for whom return really is a very low priority
  - Most cannot – many CBs need the return on their reserves to fund themselves (or are expected to pay large dividends to Finance Ministries)

- **The solutions CBs are considering are similar to those others have adopted**
  - Diversification into other fixed income asset classes (eg corporate bonds)
  - Diversification into second tier developed markets (eg CAD, AUD, NZD, NOK, SEK, DKK)
  - Consideration of emerging markets (especially RMB)
  - Introduction of equity portfolios, portfolios of alternative assets
  - A renewed consideration of the role of gold
  - Outsourcing non-core portfolios to external managers

- **But although the solutions are similar, the constraints CBs face are not**

Issues of Diversification and Complexity

- **Many alternative asset classes and second tier markets still pose CBs challenges**

  Size, Liquidity, Transparency, Knowledge of market structure, Availability of satisfactory counterparties

  These are common to all investors seeking to diversify away from traditional first tier markets

- **But in addition CBs face some further questions before adding complexity**

  1. **Is it worth it? Does it move the dial?**
     There is no point in adding extra complexity (and, probably, risk) for limited or no extra return
  2. **Do we have the staff to understand it? And can we survive their departure?**
     CBs are vulnerable to key staff risk and should not build portfolios which cannot be maintained if key staff leave
  3. **Does management understand it? Can they explain it to the public?**
     Governance issues are increasingly important as reserves sizes grow. All CBs are now much more aware of the risk of reputational loss from poorly executed operations
  4. **How does this interact with any other official investor of the state?**
     For countries with SWFs or national pension funds, what is optimal for the CB in isolation may not be optimal for the authorities taken as a whole, and the CB may have to step back from diversification
  5. **How will the recipient market (and its authorities) respond?**
     Not all markets welcome large official sector investors. A CB always has to remember that what for it is a foreign market is for a fellow CB their home market

C: Outlook and Concerns

- **Collectively, CBs do not expect yield levels to return rapidly to normal**
  - If any phrase sums up expectations, it is “Lower for Longer”
  - Note that this seems to be largely in keeping with general investor sentiment, and (strangely) in contrast to the Fed’s own expectations as shown in the FOMC’s “Dot charts”

- **But CBs and their reserves managers do have some particular concerns**
  - CBs are responsible for the operation of their own domestic money markets
  - Many reserves managers are part of their bank’s internal analysis of how markets are working under QE and very low or even negative yield environments
  - This colours their outlook on the markets they are investing in as reserves managers

- **Two concerns repeatedly come up in discussions with CBs**
  - The market’s function as a source of signalling and information
  - The changing attitudes of other market participants

The market as a provider of signalling and information

- **CBs and other market participants use markets:**
  - To provide information on the underlying real economy
  - To provide information on the actions and intentions of other market participants

- **As CBs increase the scale and scope of their market operations the ability of markets, particularly money markets, to operate independently of the CB is reduced**
  - In a number of markets the central bank is now the dominant player – the central bank not as LOLR (Lender of Last Resort) but ***FOFR (Funder of First Resort)***
  - Even where financial institutions are not actually dependent on the CB for funds, the CB's operations (eg QE) heavily influence markets
  - Some markets have moved from being a ***window*** for the central bank, showing it the outside world, to a ***mirror***, merely reflecting back its own operations

- **This reduces CB information, and increases the risk of policy uncertainty**

The changing attitude of other market participants

- **Investors' response function to central bank actions is also changing**
  - Market positions have inevitably become more sensitive to the stance of the CB
  - Market participants hold positions not only on their assessment of inherent value but increasingly on their expectations of CB actions
  - As a consequence they may be less tightly held, and a change in policy could produce a bigger response from markets than has hitherto been considered the norm
  - Example: reactions from the US Treasury market and emerging markets to the indications 18 months ago that QE would be reduced (the "taper tantrum")
  - Example: the response to the Swiss National Bank's removal of the cap on the CHF

- **This is compounded by the observed reduction in market-maker capacity and hence liquidity in many bond markets**
  - This is well documented and largely the result of regulatory changes
  - In a number of markets it leads to the risk of periods of elevated volatility
  - Even the largest markets may suffer volatility spikes and liquidity deserts at times of major policy change

- **For CB reserves managers, with their traditional focus on security and liquidity, this further restricts the number of markets that are considered appropriate and investable**

Final observation

- **A quote from a senior central bank reserves manager:**

> **"When I started, most G7 government bond markets provided all three of Security, Liquidity and Return. Now it is increasingly difficult to find all three, and some markets do not guarantee even one of them".**

There is as yet no easy answer for central banks to this conundrum

Presenter biography and disclaimer

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John is an Associate Fellow in the International Economics Department of Chatham House, and also runs his own consultancy company, Laburnum Consulting Ltd, in which capacity he advises a number of governments, central banks, market associations, NGOs and think tanks.

Until October 2013 he was a Senior Managing Director of State Street Global Advisors (SSgA), Head of SSgA's Official Institutions Group and a member of SSgA's Senior Management Group. His responsibilities covered advising SSgA's central bank, sovereign wealth fund and other official sector clients, and consultation on general public policy issues.

Before that he worked in official reserves management for central banks, including spells as the Executive Director in charge of reserves management at the Hong Kong Monetary Authority, and as the Chief Manager, Reserves at the Bank of England. He was also a director of the European Investment Bank and European Investment Fund, an advisor to the European Commission's Working Group of Technical Experts on Markets, a senior lecturer at the Macro-Economic and Financial Management Institute of Africa (MEFMI) and for 15 years a lecturer and technical adviser at the Bank of England's Centre for Central Banking Studies.

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