South African Reserve Bank
90th
Anniversary

Opening remarks by Mr. Daniel Mminele, Deputy Governor, South African Reserve Bank, at the World Bank Treasury's RAMP-Africa Workshop in Cape Town, 13 June 2011

1. Introduction

Ladies and gentlemen, good morning to you all.

Let me take this opportunity to welcome you to our country and the beautiful city of Cape Town. I trust that you will gain much through the interactions at this RAMP-Africa Workshop on Governance and Oversight of Investment Management. I would like to express my gratitude to the World Bank Treasury not only for the great initiative that RAMP-Africa is, but also for choosing South Africa as the host country to bring together central bankers from all over the African continent. The networking opportunities, the transfer of knowledge between participants, capacity building and the deepening of skills in the management, governance and oversight of foreign exchange reserves, are the key benefits provided by workshops such as this one.

My task for now is to provide some general thoughts about governance in reserves management. In a later session, I will share more specifically the particular experiences of the South African Reserve Bank, which has come a long way since the establishment of the Reserves Management Unit in our Financial Markets Department over a decade ago.

2. Significant growth in foreign exchange reserves

The question of reserves management has gathered prominence given the phenomenal growth in global foreign exchange reserves over the past decade, from USD2,8 trillion in 2003 to around USD9,7 trillion in April 2011. Emerging markets have accumulated substantial amounts of reserves and account for US$7,4 trillion of these global reserve assets, with China holding US$3,0 trillion. The surge in foreign exchange reserves in emerging markets has been informed by both the enormous amount of capital flowing into these countries and efforts to stem the tide of currency appreciation, as well as by very deliberate strategies to create buffers that would put countries in a better position to deal with external shocks. Clearly, the traditional motive for holding reserves, namely to offset balance of payments fluctuations, has since become less of a consideration. JP Morgan[1] estimates that countries like China and Brazil have 1,5 to 2 years' worth of import cover, while the largest reserves holders have sufficient reserves to pay off short-term debt five to ten times over.

During the global financial crisis, central banks were in the eye of the storm, challenged not only in our traditional role of monetary policy formulation and implementation, but also as reserves managers. The Governor of the Bank of England, Sir Mervyn King, back in 2003 characterised the 10 years up to the mid-2000s as the "NICE" decade. "NICE" meant: Non-Inflationary Continuous Expansion. He was referring to a relatively comfortable period for policy makers, during which they witnessed relatively stable inflation, good growth rates and few shocks to economies.

He could have just as well used the term "NICE" to describe the space that official sector reserves managers found themselves in, in the aftermath of the Asian financial crisis. The reserves that they had to manage were increasing rapidly, allowing many to accelerate the transition from liquidity management to investment management, facilitating the discovery of new asset classes, and the diversification into riskier assets by way of enhancing returns, managing to attract new skills, and in

[1] Economic Research Note, Global FX reserves on pace to top US$11 trillion in 2011, May 6, 2011

certain cases making it increasingly difficult to tell the difference between official sector managers and private sector managers, given how fast their reserves management practices were converging.

As we know, it did not end very nicely! Many of these assets suffered substantial losses in the wake of the financial crisis starting in 2007, especially at the height of it in 2008 and 2009. In many instances, the risk-return profiles turned out to be somewhat different from what had been anticipated. Many reserves managers found themselves having to answer very difficult questions, and also forced to introduce very drastic risk reduction measures, at a time when it was not going to be only most costly given the frenzy in markets, but also at a time when they would add to already heightened financial stability risks. Whether the crisis will lead to lasting reversals and a fundamental rethink of what official reserves management should be about, very much remains to be seen.

What is clear though, is that the surge in global international reserves, and the most recent financial crisis, have brought central banks to the attention of stakeholders, increasing the level of scrutiny regarding how they manage reserves given the rising opportunity cost of holding these reserves, the high costs of sterilising foreign exchange purchases, and financial stability considerations when investing reserves during financial crises.

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 financial crisis, especially in 2008, when capital markets malfunctioned and liquidity become a major constraint. At the time, potential systemic risks in the banking sector required a tightening of risk management principles and adherence to investment objectives, 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, including in 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.[2] 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, as well as an element of coordination with other functions of the central bank.

Furthermore, foreign exchange reserves make up a significant component of the total assets on the balance sheets of emerging market central banks. Due to this concentration, central banks are subject to stringent reporting requirements from the general public, governments and, where relevant, shareholders. To this end, central banks have been developing sound governance structures, improving accountability 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. One cannot exclude spill over effects that a loss of reputation and credibility through bad governance in reserves management could have on a central bank's primary tasks of ensuring monetary and financial stability.

Good governance and sound functional organisational structures are therefore necessary for the efficient management of reserves. In establishing these structures, accountability, roles and responsibility should be appropriately defined, adopted and institutionalised.

There are two dimensions to consider in governance - vertical and horizontal governance[3]. Vertical governance ensures that decisions are taken at the right level

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

[3] 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

(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 conflict of interest. The senior governing body needs to provide oversight and determine risk tolerance for the institution, while an investment committee should be responsible for establishing the investment policy and guidelines. Consequently, trading activities needs to be separated from middle office functions of risk management and reporting, as well as from the accounting and settlement areas.

4. Current challenges in reserves management

As I come to the end of my remarks, let me leave you with what are generally thought to be the key questions currently facing reserves managers and some of these issues will feature on your programme during the next few days:

- Do we need to need to redefine what is an acceptable risk-return balance for official reserves and think differently about risk tolerance?
- 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, pointing to the pro-cyclical behaviour of central banks when withdrawing deposits from commercial banks during the crisis.
- Does this issue point to the need for greater segregation between reserves that are held for policy purposes (i.e. monetary policy, intervention, etc.) and those that are purely for investments. Should the latter portion be with central banks, or separate investment agencies?
- Does return enhancement need to be again more clearly subordinated to liquidity considerations?

The answers to the above questions could have all manner of implications for central bank reserves management and trigger yet another set of challenges. Could the outcome be that the pendulum swings all the way back to the other extreme, namely that central banks 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 might be going into reverse?

Luckily, all I have to do today is table these questions and leave you to mull over some of them in the next few days.

What is beyond doubt is that proper governance and oversight of investment management, having being highlighted during the crisis, has become even more important. 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, all of that enveloped by good governance and oversight structures.

I trust that you will glean useful information from this workshop, and that it will assist your respective institutions in strengthening reserves management operations and their oversight. The agenda certainly looks very promising in this regard.

Enjoy the workshop.

Thank you