



# MEFMI

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## Governance of Reserves Management

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# Governance

- *Governance is a system for ensuring firstly that the right actions are taken, in the right way, by the right people, and secondly that the wrong actions are prevented, or if nevertheless committed, they are discovered early enough to limit any damage done*
- *Good governance both empowers staff at all levels, by telling them what they are authorised to do, and defends them, in that if they have stayed within their authority they should be protected from unfair criticism or attack*



# Authorizing & Control Environment

Hierarchy

Delegation of  
power

Accountability



**Portfolio Management System and Database**



# Institutional safeguards: IMF Reserve Management Guidelines

- Policy and guidelines
- Clear responsibility and accountability for decisions
- Segregation of duties
- Robust portfolio systems
- Management reporting
- Internal and external IT security
- Accounting
- Internal and external audit



# Beyond the Guidelines: the art of effective reserves management

1. Board/executive challenges
2. Incorporation of reserves adequacy considerations with reserves management
3. Investment committee responsibilities
4. Managing to investment results rather than to accounting
5. Managing reputational and legal risks
6. Corporate culture



## Board/executive challenges

- Capacity Building in formulation of investment policy and oversight of portfolio risk and return outcomes.
- Policy framework for the consideration and approval of the appropriate strategic asset allocation
- Organization that empowers portfolio managers who are closest to the market to make decisions while controlling the risks at the portfolio level
- Organizational structure that provides for segregation of operations and collaboration across functions
- Formulation of risk limits that do not unduly constrain generation of portfolio returns
- Leadership appointments that instill a culture of accountability, transparency and safety



# Incorporating reserves adequacy into reserves management

- For emerging market countries, reserves adequacy and the exchange rate regime are the most important factors for determining the optimal policy portfolio
- But reserves adequacy and reserves management are often divorced because of organizational silos
- Incorporating reserves adequacy is helpful for the formulation of the SAA and communication with external stakeholders
  - New IMF methodology for reserves adequacy vastly improves upon old rules of thumb (3m imports/12m STD)



# Investment committee

- Chair and members
- Tactical asset allocation by committee is problematic (currency, duration, sector decisions)!
- Upward policy proposals and downward implementation
  - Review and propose strategic asset allocation and other policy decisions
  - Assess where, by whom and how much active management to overlay, delegate risk budgets and oversee results
- Executive education in portfolio management is strongly advised



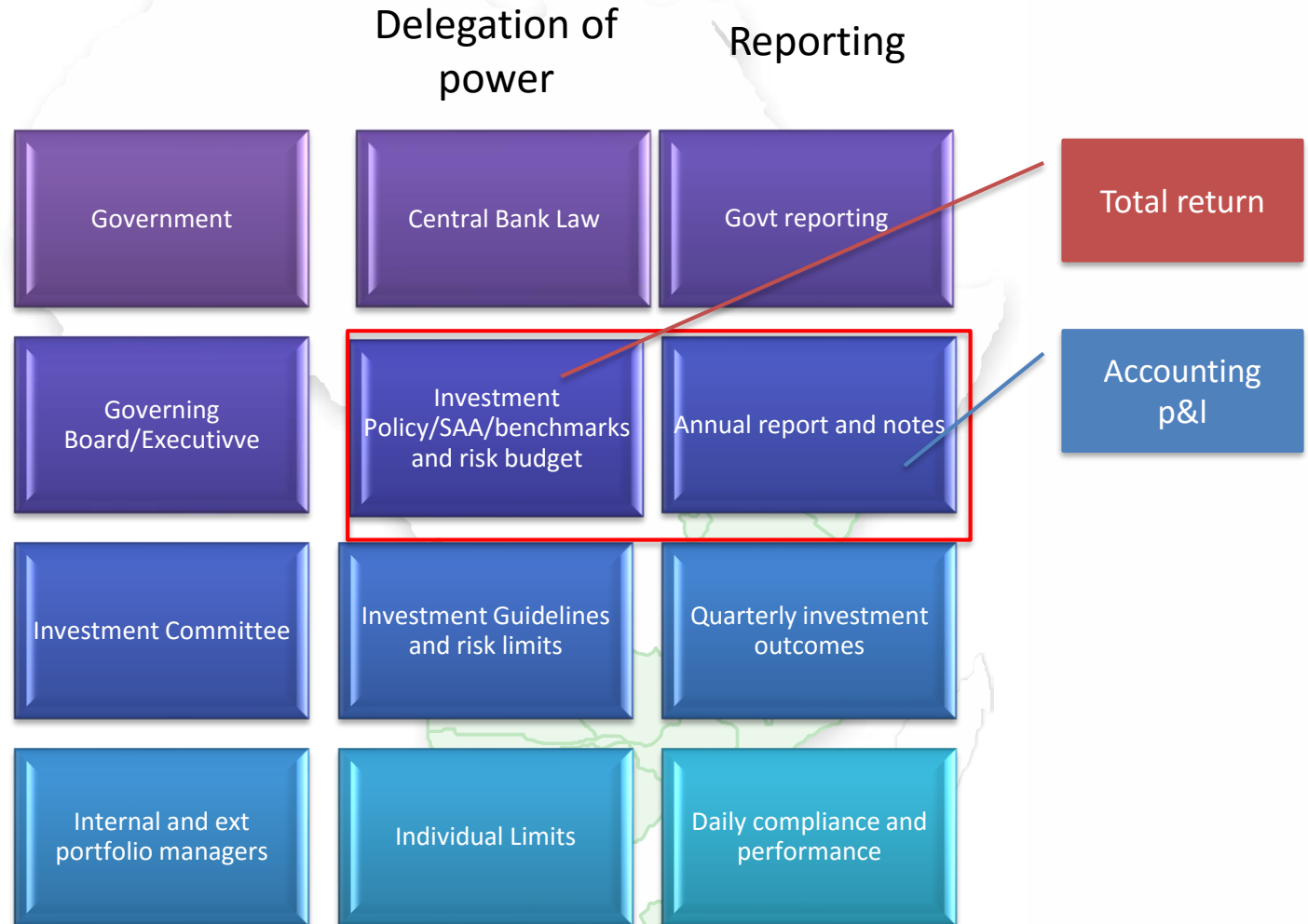


# How accounting can subvert governance

- Accounting should reflect investment management decisions not drive them
- Focus of portfolio management should be on the portfolio's total return
  - Accounting P&L does not coincide with the total return because of timing differences
  - Focus on accounting can lead to “cherry picking” and subvert good governance
- Suggestions:
  - Use financial statement “notes” to report the portfolio total return over multiple horizons (1, 3 and 5 year)
  - Agree with the government to remit profits based on a smoothing formula



# Authorizing & Control Environment





# Reputational and legal risks

- Reputational risk
  - Transparency
  - Strong communication strategy for reserves management rather than risk (return) free portfolio
- Legal risks: adopt standards of care
  - Parametric limits
  - Code of Ethics/behaviour
  - Prudent person rule



# Safety and adaptation: From a bureaucratic to a generative culture

How different organizational cultures handle safety information1/

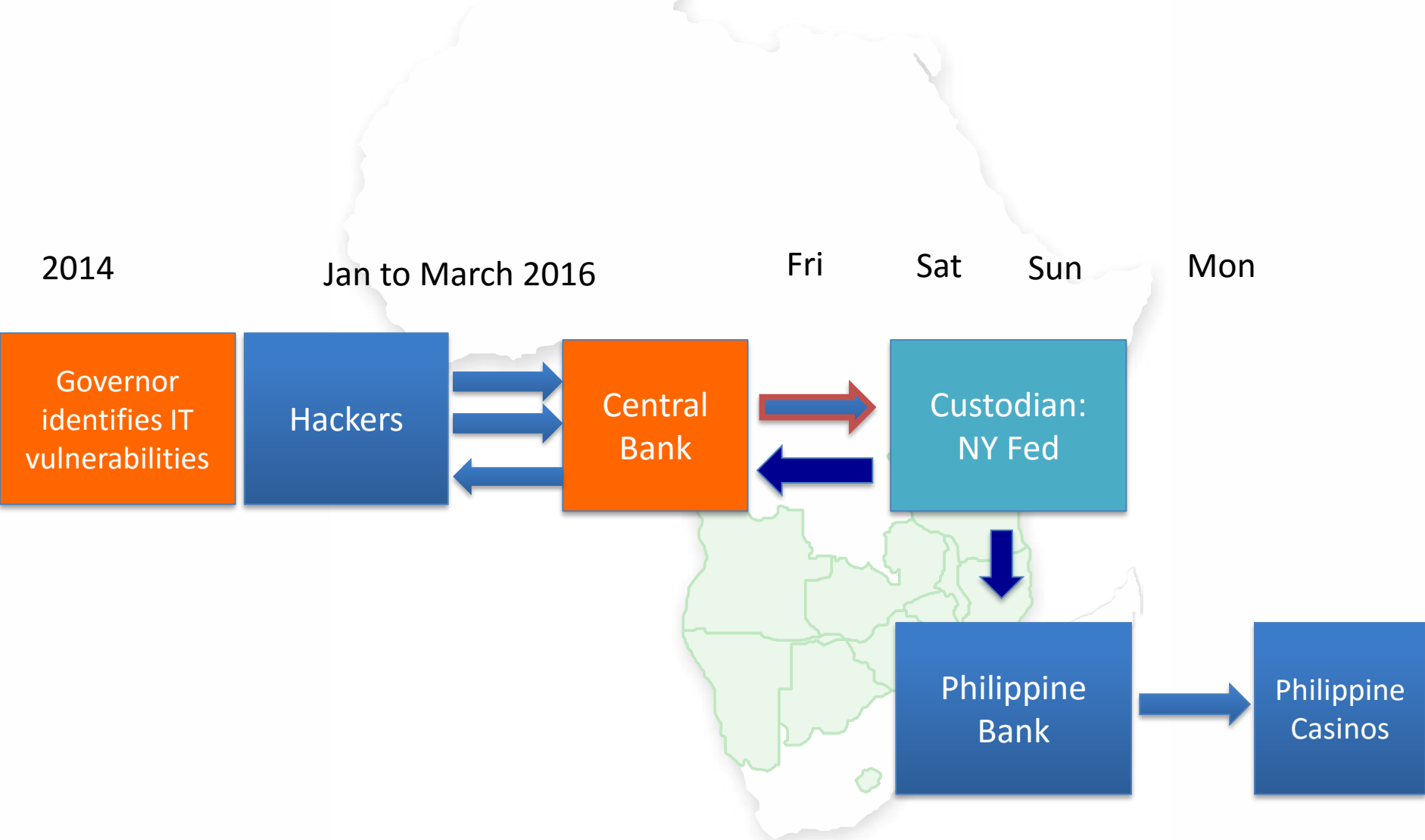
	<b>Pathological culture</b>	<b>Bureaucratic culture</b>	<b>Generative culture</b>
<b>Leaders....</b>	don't want to know	may not find out	actively seek it
<b>Messengers...</b>	are "shot"	are listened to if they arrive	are encouraged and rewarded
<b>Responsibility is...</b>	shirked	compartmentalized	shared
<b>Failure ....</b>	is punished or concealed	leads to local repairs	leads to far-reaching reforms
<b>New ideas...</b>	are actively encouraged	present problems	are welcomed

Luca Celati, The Dark Side Of Risk Management: How People Frame Decisions in Financial Markets



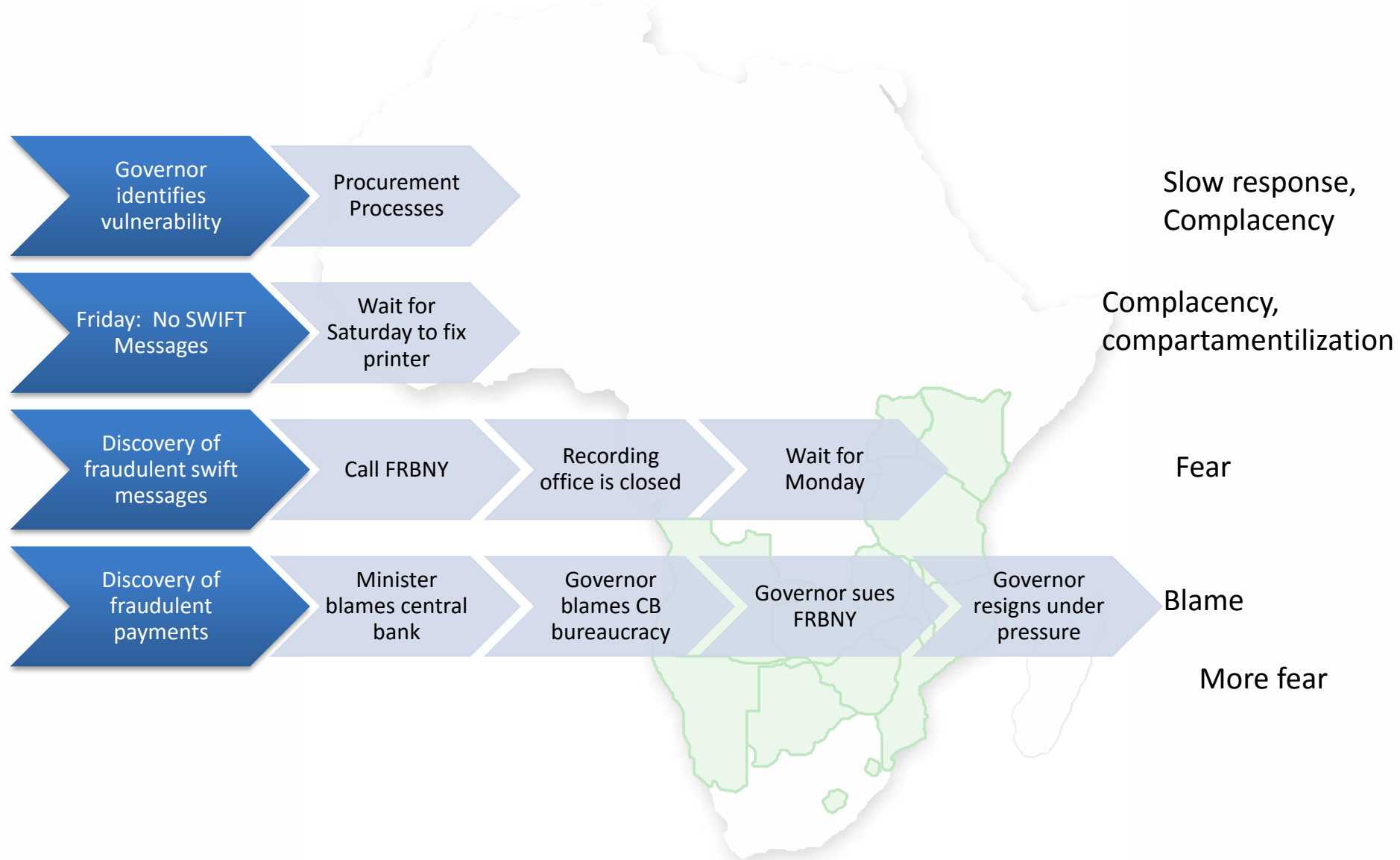
# Corporate Culture Case Study:

## Central Bank of Bangladesh Reserves Heist





# Bureaucratic culture & risk management





# Good Governance

- A process of continuous renewal
- Policies, procedures and limits are important but care that focus is not exclusively on compliance
- Leaders matter in establishing a generative corporate culture
- Communication matters—a lot
- IMF Reserve Management Guidelines are comprehensive but the principles need to be adapted