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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

<table>
<thead>
<tr>
<th>Hierarchy</th>
<th>Delegation of power</th>
<th>Accountability</th>
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<tr>
<td>Legislative delegation of authority</td>
<td>Central Bank Law</td>
<td>Govt reporting</td>
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<tr>
<td>Governing Board</td>
<td>Investment Policy and Strategic Asset Allocation</td>
<td>Annual report and notes</td>
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<td>Investment Committee</td>
<td>Benchmarks Guidelines and risk limits</td>
<td>Quarterly investment outcomes</td>
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<tr>
<td>Internal and ext portfolio managers</td>
<td>Individual Limits</td>
<td>Daily compliance and performance</td>
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</table>

**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

Delegation of power

- Government
- Central Bank Law
- Investment Policy/SAA/benchmarks and risk budget
- Investment Committee
- Investment Guidelines and risk limits

Reporting

- Governing Board/Executive
- Annual report and notes
- Quarterly investment outcomes

- Internal and ext portfolio managers
- Individual Limits
- Daily compliance and performance

- Govt reporting
- Total return
- Accounting p&l
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 information

<table>
<thead>
<tr>
<th></th>
<th>Pathological culture</th>
<th>Bureaucratic culture</th>
<th>Generative culture</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leaders...</td>
<td>don’t want to know</td>
<td>may not find out</td>
<td>actively seek it</td>
</tr>
<tr>
<td>Messengers...</td>
<td>are “shot”</td>
<td>are listened to if they arrive</td>
<td>are encouraged and rewarded</td>
</tr>
<tr>
<td>Responsibility is...</td>
<td>shirked</td>
<td>compartamentalized</td>
<td>shared</td>
</tr>
<tr>
<td>Failure ....</td>
<td>is punished or concealed</td>
<td>leads to local repairs</td>
<td>leads to far-reaching reforms</td>
</tr>
<tr>
<td>New ideas...</td>
<td>are actively encouraged</td>
<td>present problems</td>
<td>are welcomed</td>
</tr>
</tbody>
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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

Governor identifies IT vulnerabilities → Hackers → Central Bank → Custodian: NY Fed → Philippine Bank → Philippine Casinos

Timeline:
- 2014
- Jan to March 2016
- Fri, Sat, Sun, Mon
Bureaucratic culture & risk management

Governor identifies vulnerability

Procurement Processes

Friday: No SWIFT Messages

Wait for Saturday to fix printer

Discovery of fraudulent swift messages

Call FRBNY

Recording office is closed

Wait for Monday

Discovery of fraudulent payments

Minister blames central bank

Governor blames CB bureaucracy

Governor sues FRBNY

Governor resigns under pressure

Slow response, Complacency

Complacency, compartamentalization

Fear

Blame

More fear
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