

MANAGING THE RISE IN CENTRAL BANKING RESERVES

By Terry Beadle, Executive Vice President, Global Markets and Government at Wall Street Systems

In response to the growth in foreign currency reserves during the past few years, many central banks are planning to update reserve management IT systems that manage these funds. According to RBS Reserve Management Trends, of 47 central banks surveyed worldwide this year, nearly half have made major changes to their IT systems in the past 18 months and more than two-thirds say they plan to do so in the near future. Terry Beadle, executive vice president, global markets and governments, Wall Street Systems, examines the drivers behind this investment and how IT systems can help central banks better manage reserves.



The pace of reserve accumulation in central banks has been nothing short of dramatic in the past decade. Since 1995, worldwide reserves have risen from \$1.2 trillion to more than \$4.2 trillion. Central banks anticipate continued rises with reserves reaching up to \$8.2 trillion by 2010. The reasons for this growth vary. Some central banks primarily use reserves for self-insurance. Asian countries in particular are keen to build sufficient amounts to avoid a repeat of the 1997/98 Asian Financial Crisis. Seven Asian central banks each have reserves over \$100 billion dollars, with China's central banks topping \$1 trillion last year.

Another reason, of particular relevance in oil-producing and other resource-rich countries, is that domestic markets are unable to fully absorb current revenues. But the significant increase in central bank reserve levels means they are no longer just a policy tool. The size of reserves exceeds liquidity management purposes and because of this, many central banks are expanding their investment portfolios.

Today, huge central banking reserves inevitably attract greater attention. In the past, the public domain had limited information on how central banks managed these funds. But government and the public are more interested in larger sums of money and the level of returns made. Internal and external benchmarks are set and there is greater transparency into investment

performance. With increased visibility, reporting on activities that have taken place—and in some cases detail of future intentions—it's hardly surprising that central banks are under mounting pressure from both government and the public to deliver the best possible returns.

The problem is that today's low-yield economy offers fewer opportunities to achieve this goal. In the past, central banks accepted lower returns for less risk as part of a traditional trade-off to balance security and liquidity with return. Reserve managers were focused on the efficiency of their portfolio management. They used arbitrage techniques, efficient cash management and securities lending which all sat well within the central bank reserve manager's core competencies. But by limiting risk, they also limited the amount of possible extra return.

Today, asset managers are diversifying their portfolios in pursuit of higher yields, moving away from low-risk, low-yield assets such as government securities and towards new asset classes with higher yields. New sectors in particular include mortgage-backed securities, asset-backed securities, corporate bonds and equities. And as diversification increases, the management of the balance of risk and performance becomes critical.

A SHIFT IN FOCUS

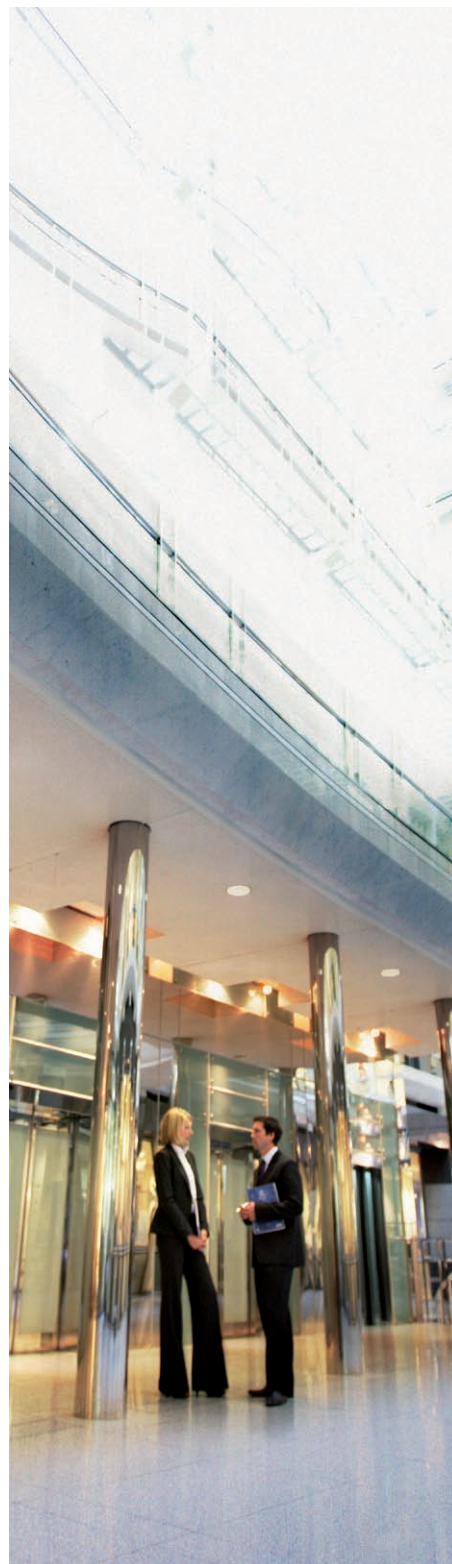
Technology has a critical role to play here. Like commercial banks, over the past decade or so, larger central banks have invested in transaction processing systems to automate trade capture and settlement, improve control and lower the cost of operations. The increase in the size of reserves has accelerated this investment and made central banks focus more on decision support and the middle-office. There is a shift in focus—towards performance and risk management—that demands the application of sophisticated analytical tools so that central banks can more effectively manage risk and return. This shift has changed the systems strategies of almost all central banks, as even the smaller banks now have significant reserves that are above the level where a commercial asset management would consider the use of an enterprise system.

The Bank of Finland, for example, has replaced its mainframe and proprietary solutions with a central banking system that streamlines the operational environment and provides greater control over business processes. Crucially, the bank is now able to work with new instruments on a larger scale than before. The Bank of France has also responded, replacing three disparate system products with a single, integrated central banking solution that lowers the total cost of ownership and reduces operational risk. Of the 47 worldwide central banks surveyed in RBS Reserve Management Trends, three-quarters said they had introduced new asset classes to their investment management processes in the past two years. As diversification continues, central banks need systems to manage increased volumes and risk.

MANAGING RESOURCES

In addition, a central bank faces greater internal resource challenges than commercial banks. The IT department of a large investment bank is a veritable army compared to even a large central bank which might have a team of less than 100 professionals. A key element of central banking systems strategy is an implementation project of reasonable cost and risk, combined with an acceptable total cost of ownership. For most central banks, this rules out the best-of-breed solutions used by the tier-one commercial banks where tens or even hundreds of specialist systems are integrated to provide an overall solution. Almost all central banks now adopt a single-vendor, single-application strategy approach, which minimises the number of technical products and the overall level of risk and complexity.

As central bank reserves continue to rise, reserve managers will look to further diversify investment portfolios. A central banking system with support for all the new asset classes, which also manages risk and performance, can help optimise returns and provide the decision support infrastructure for the central bank's new role as asset manager. With a single-vendor, single-application approach, central banks can reduce the total cost of ownership and improve operational risk while maximising business value.



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