



EUROPEAN CENTRAL BANK

EUROSYSTEM

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# ECB foreign reserves Management

13<sup>th</sup> ECB Central Banking Seminar.

## Overview

- 1 Objectives
- 2 Size and composition
- 3 Governance
- 4 Framework
- 5 Investment universe
- 6 Tactical benchmark recommendation
- 7 Benefits of portfolio management

# 1. ECB foreign reserves Management objectives

## ECB key objectives and tasks

The ECB's primary objective is to maintain price stability. Its main tasks, as described in the Statute of the ESCB, comprise

- the implementation of the monetary policy of the European Union,
- **the conduct of foreign exchange operations,**
- **the management of the official foreign reserves of the euro area countries** and
- the promotion of the smooth operation of payment systems.

## Purpose of the ECB foreign reserves

=> whenever needed, ensure that the ECB has a sufficient amount of liquid resources available for its foreign exchange policy operations, with the main requirements of liquidity, security and return.

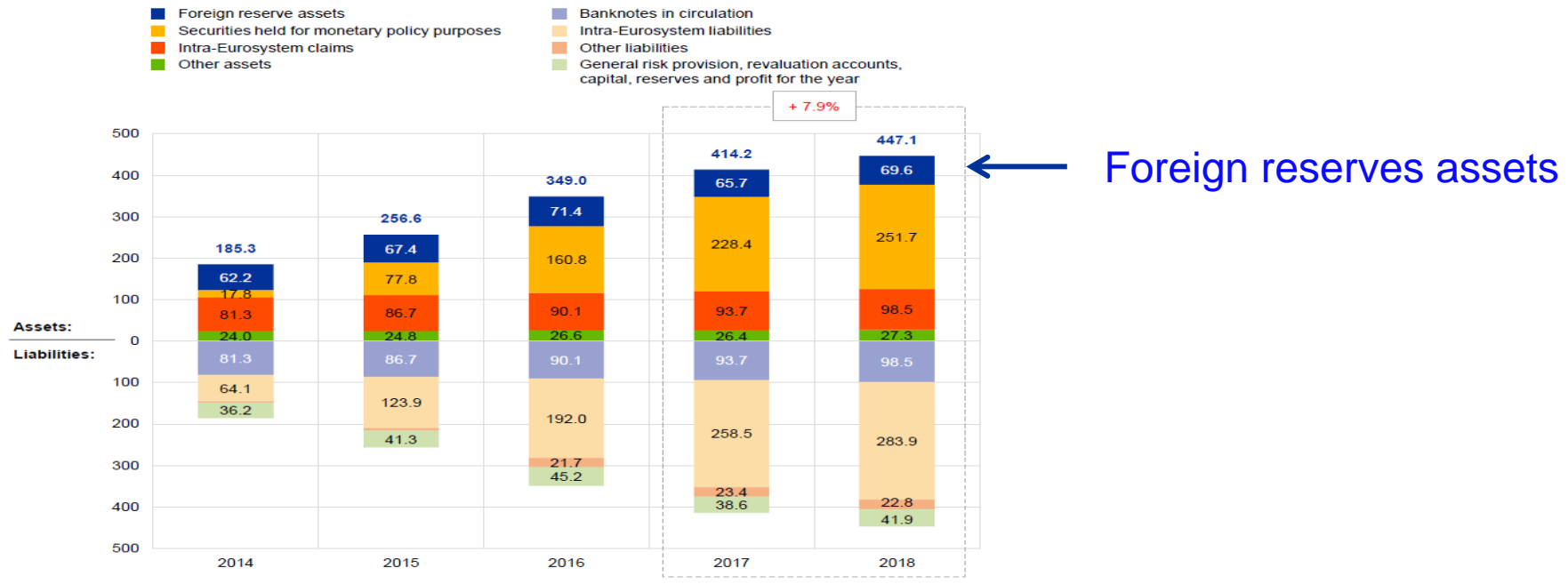
Objective: Maximise portfolio returns subject to portfolio liquidity requirements and risk constraints.

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## 2. ECB foreign reserves size

### Main components of the ECB's Balance Sheet

(EUR billions)



Source: ECB.

#### Conduct of foreign exchange operations and management of the official foreign reserves of the euro area countries

##### Foreign exchange operations and management of foreign reserves

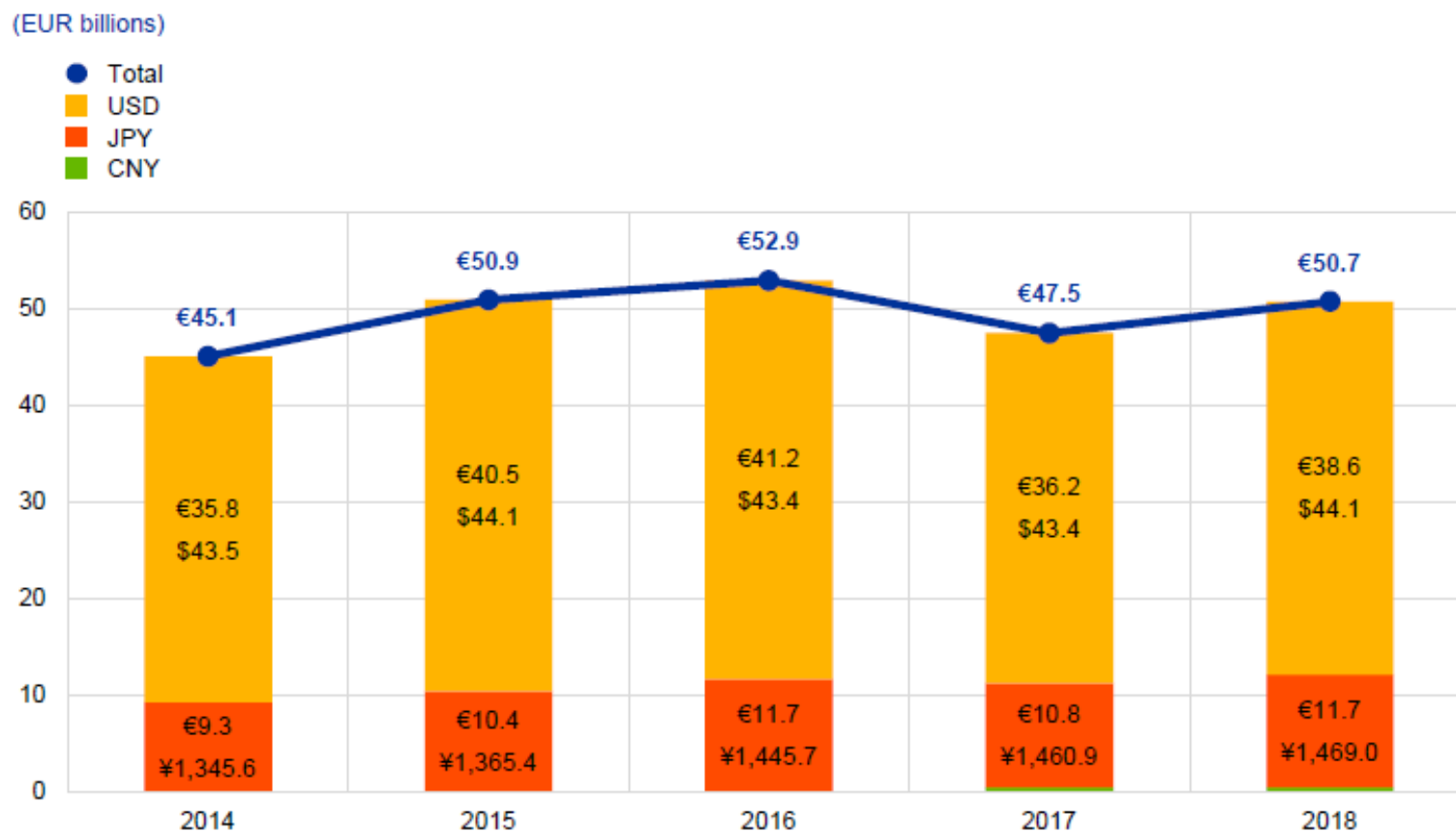
The ECB's foreign reserves are presented on-balance sheet, mainly under "Gold and gold receivables", "Claims on non-euro area residents denominated in foreign currency", "Claims on euro area residents denominated in foreign currency", "Liabilities to euro area residents denominated in foreign currency" and "Liabilities to non-euro area residents denominated in foreign currency". Foreign exchange transactions are reflected in off-balance-sheet accounts until the settlement date.

Net interest income, including coupon accruals and amortised premiums and discounts, is included in the Profit and Loss Account under the item "Interest income on foreign reserve assets".

Unrealised price and exchange rate losses exceeding previously recorded unrealised gains on the same items, as well as realised gains and losses arising from the sale of foreign reserves, are also included in the Profit and Loss Account under the items "Write-downs on financial assets and positions" and "Realised gains/losses arising from financial operations" respectively. Unrealised gains are recorded on-balance sheet under the item "Revaluation accounts".

Source: ECB Annual Account 2018

## 2. ECB foreign reserves size and composition



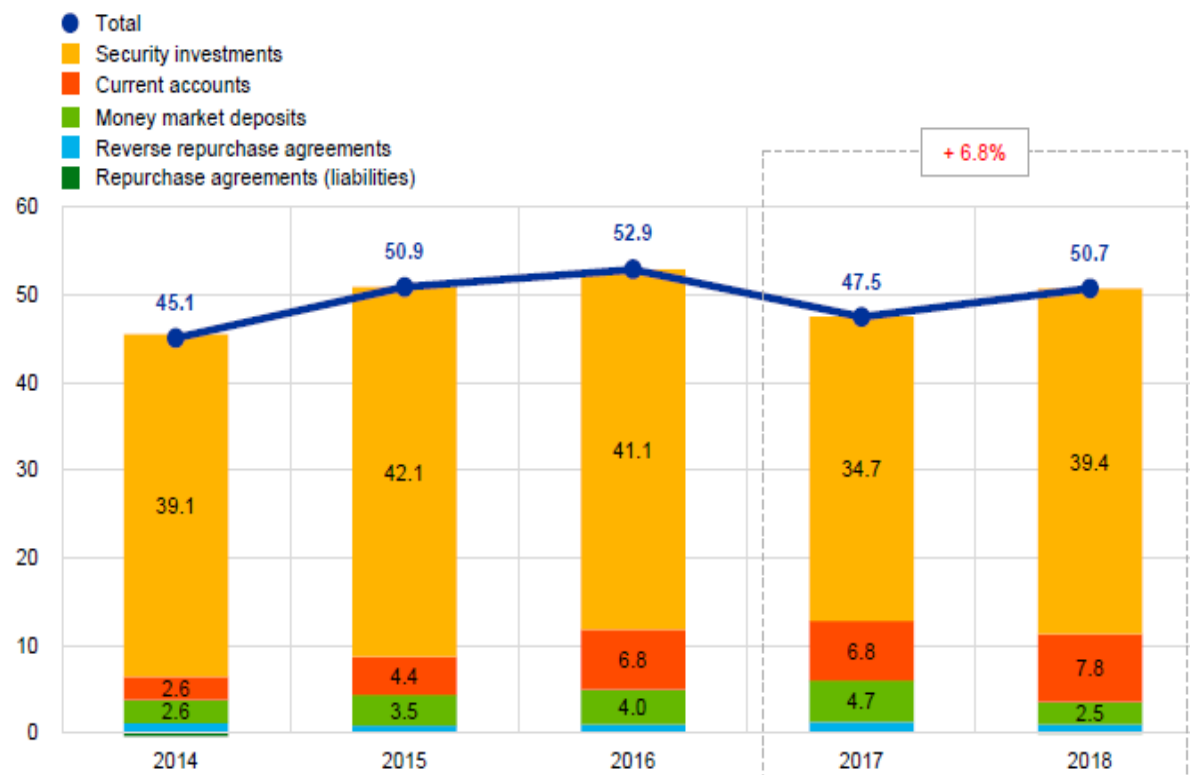
The ECB's net foreign currency holdings composed of USD (76%), JPY (23%) and CNY (1%) increased by €3.2 billion in 2018 to €50.7 billion, (mainly owing to the depreciation of the euro against the US dollar and Japanese yen).

## 2. ECB foreign reserves size

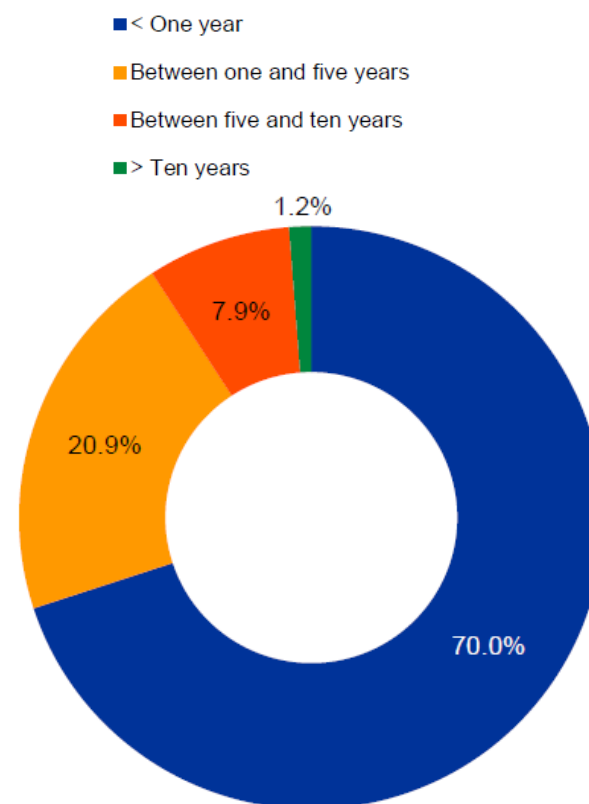
### ECB foreign currency portfolio breakdown per instrument and maturity

Composition of foreign currency investments

(EUR billions)



Maturity profile of foreign currency-denominated securities



Source: ECB Annual Report 2018

<https://www.ecb.europa.eu/pub/pdf/annrep/ecb.annualaccounts2018~cd3eabaa40.en.pdf?76bf8c0bb3ef1f2cff4ba7fd4363abcb>

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### 3. ECB foreign reserves governance

A unique decentralised framework

Involving the ECB and the National Central Banks (NCBs), which are part of the Eurosystem

3 layers approach:

- Strategic benchmark
- Tactical benchmark
- Management of the actual portfolios by NCBs

NCBs' portfolio size in line with capital key

# ECB foreign reserves governance

## A unique decentralised framework

Benchmark	Objective	Review	Rebalancing	Decision Maker
<b>Strategic</b>	<p>"The SB reflects the ECB's long-term risk/return preferences, subject to the principles of liquidity and security. [...]"</p> <p><i>[The investment objective is to maximize expected portfolio return under the constraint that there are no losses at a 99% confidence level in each individual year over the five-year investment horizon.]</i></p>	Annual	Monthly	Governing Council
<b>Tactical</b>	<p>"The TB reflects the ECB's medium-term risk/return preferences against the background of prevailing market conditions. [...]"</p> <p>"The Objective of the TB is to outperform the respective SB within an investment horizon of 3 months. [...]"</p>	Monthly	Monthly	Executive Board (delegation from GovC)

"Quotation" from the ECB Guideline on the management of the ECB's foreign reserves.

### 3. ECB foreign reserves governance

A unique decentralised framework

#### ECB foreign reserves

ECB/GovC/Risk  
Management



ECB  
Investment  
Committee  
BMI



National  
Central  
Banks



USD , JPY , CNY

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## 4. ECB foreign reserves framework

### Currency specialisation for the management of foreign reserves

Normally one portfolio per NCB (11 for USD, 4 for JPY and 1 for CNY)

NCBs choose the currency of specialisation

Allocation of portfolio size according to capital key

### Recent changes to the framework

Before currency specialisation in 2006	After currency specialisation in 2006	Since 2012
<p>Each NCB manages a USD and a JPY portfolio</p> <p>JPY portfolios relatively small</p> <p>12 USD and 12 JPY portfolios</p> <p>No "opt out" from the portfolio management activities of the ECB</p>	<p>Normally one portfolio per NCB</p> <p>Larger JPY portfolios</p> <p>8 USD and 6 JPY portfolios</p> <p>Possibility to "opt out" or to pool reserves with another NCB</p>	<p>Some NCBs mandated the ECB to carry out back office tasks</p> <p>11 USD and 4 JPY portfolios 1 CNY portfolio since 2017</p> <p>Possibility to "opt out" or to pool reserves with another NCB</p>

## 4. ECB foreign reserves framework

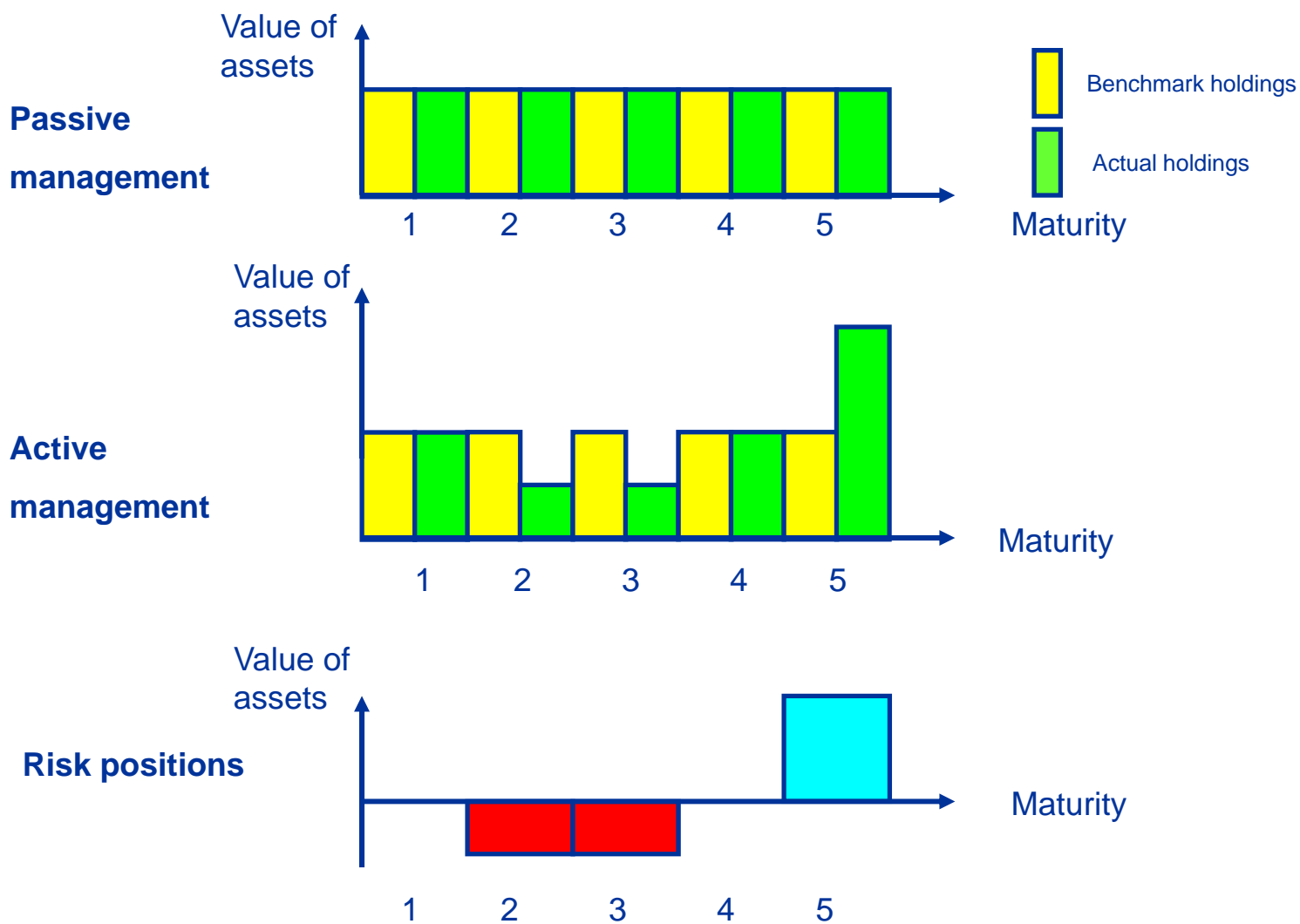
# Active management of the foreign reserves

### Active management, what is it?

- Taking diverging positions from the benchmark positions based on the portfolio managers' view with the aim to outperform the benchmark
- Introduces volatility in the return compare to the benchmark's return
- This volatility is active risk taken by the portfolio managers which can transform with skill into additional return above the benchmark (active return)
- The tactical benchmark's and NCB's portfolio managers perform active management

## 4. ECB foreign reserves framework

### Benchmark philosophy and active management



## 4. ECB foreign reserves framework

### Active management of the foreign reserves

#### **Benefits of active management**

- Generates active return above the tactical benchmark
- Portfolio managers directly contribute by adding performance,
- Creates a competitive environment (league table circulated every month),
- Diversification of management styles,
- Incentive to take risk through the minimum VaR usage

#### **Benefits for the Eurosystem**

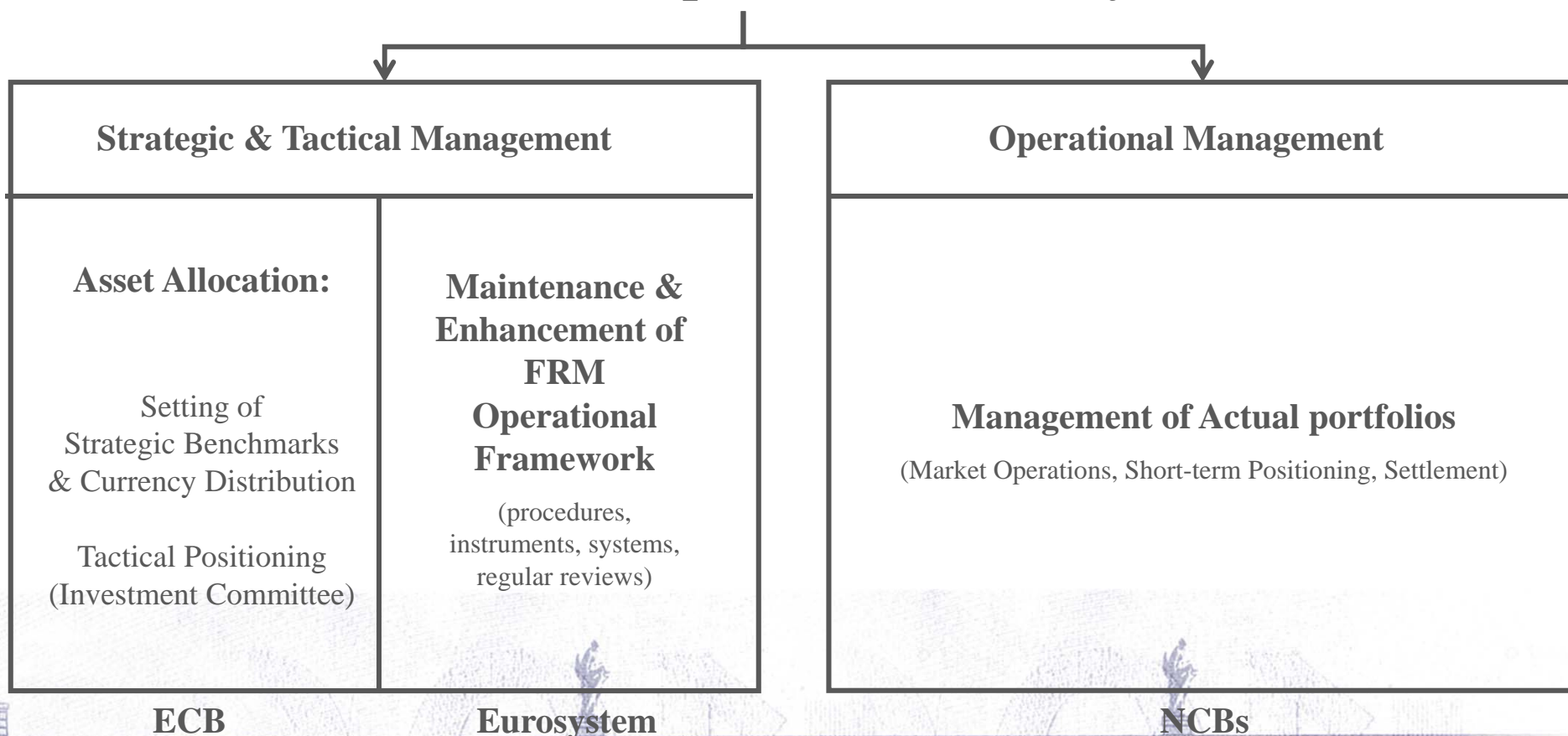
Cross fertilization: sharing knowledge, expertise, exchanging staff, enriching the Eurosystem network of portfolio managers



## 4. ECB foreign reserves framework

### Role of the stakeholders

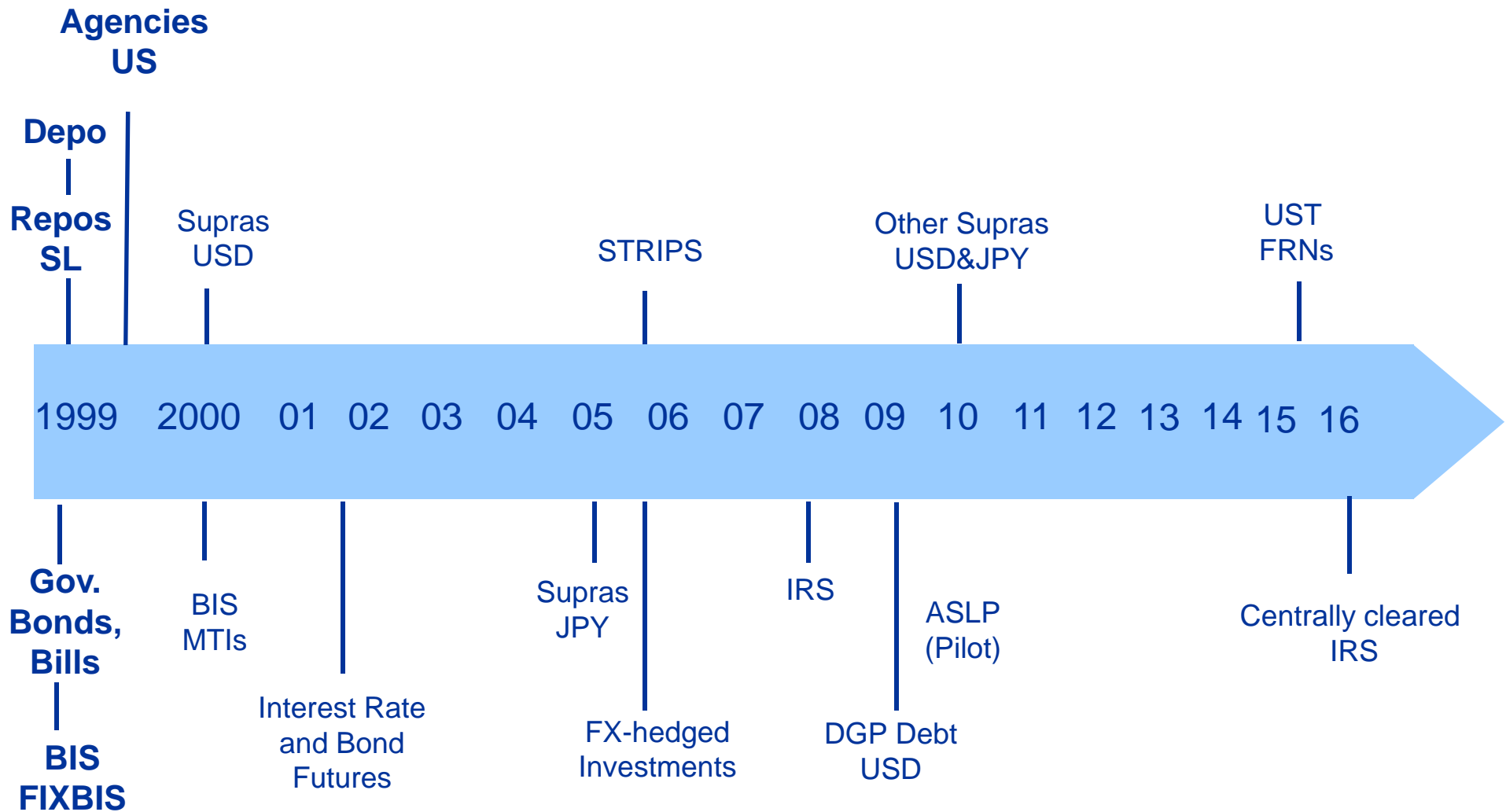
#### Decentralised Set-up within the Eurosystem



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# 5. Investment universe

## Investment Universe of the Foreign Reserves



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## 6. Tactical benchmark recommendation

### A typical tactical benchmark discussion

- 1) Yield scenarios over 3 months (baseline, upside, downside risks)
- 2) Review of i) existing positions and their performance and ii) market developments versus scenarios
- 3) Analysis of macroeconomic, monetary and fiscal policy developments and outlook based on a scenario analysis  
Analysis of market valuations  
Analysis of market conditions (positioning, volatility, external environment)
- 4) Recommendations of positions on the basis of the views on the outlook: expected return and identifying risk factors

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## 7. Benefits of active portfolio management

- Positive performance above the portfolio's benchmark return
- Enhancements of the portfolio management framework
- Operational experience and expertise
- Market intelligence
- Useful expertise for policy programmes



Thank you