USE OF EXTERNAL MANAGERS IN CENTRAL BANK RESERVES MANAGEMENT *

Hong Kong has employed external managers in the management of the Exchange Fund for many years. The first private sector external managers were appointed in the early 1970s, while the Crown Agents in London were involved in the management of the Fund almost from its inception in 1935. However, this usage of external managers for official reserves is unusual, and until very recently the great majority of central banks managed all their reserves internally. In the last year or so, however, there have been growing signs that the central banking fraternity is beginning to reconsider the merits of employing private sector fund managers. There is reason to believe that this is a trend that will continue and grow.

Hong Kong's experience – history

The origins of the Exchange Fund as the assets of a currency board system tied to the pound sterling meant firstly that the assets were themselves held in sterling, and secondly that as the economy recovered sharply after the Japanese occupation in 1941-45 they grew to be a relatively large sum relatively quickly. Both of these facts made management of the great majority of the assets in London and by an agent a logical decision, and the UK Government's Crown Agents were duly appointed at a very early stage in the Fund's history to manage the bulk of the Fund. In this, the Government was merely following the standard procedure of the day for a British colony operating a currency board system.

During the 1950s and 1960s, as more and more of Britain's colonies became independent, enthusiasm for the currency board model waned. Newly independent states converted their currency boards into reserve banks, and repatriated control over their foreign reserves. This move was hastened by the declining role of the Sterling Area, and indeed encouraged by the Bank of England, who were nervous about large sterling balances in London – the 1960s and 1970s equivalent of today's "hot money", able to be withdrawn at short notice and thus a constant threat to sterling.

Hong Kong however maintained its sterling currency board system throughout the 1960s, and partly as a consequence continued to rely heavily on employing external management skills. As late as the end of 1971, 100% of the assets of the Exchange Fund were in sterling and a great proportion of them were managed in London, management of the assets from Hong Kong being limited both in size and sophistication. When in 1972 the HK dollar's link to sterling was abandoned, following the UK Government's decision to allow sterling to float, the consequent rapid diversification of the Fund away from sterling assets (within a very few years the proportion held in sterling was below 20%) highlighted the fact that neither the Government nor its sole manager, the Crown Agents, had the required expertise to manage a large and complex multi-currency fund adequately.

The solution adopted was to appoint a number of private sector fund managers. This overcame the lack of internal resources and expertise, and also allowed the Exchange Fund's portfolios to be actively managed by managers operating in the markets in which the assets were invested. At a time when communications were very much slower and access to overseas markets from Asia difficult if not non-existent, this was a major advantage to be derived from the decision to use external managers.

Despite the obvious advantages, the decision to embrace external managers for the Fund so enthusiastically was at the time highly unusual; indeed, for many of the HKMA's external managers, the Exchange Fund is today one of their oldest and longest-standing institutional accounts. It is difficult at this distance to be sure why exactly the Government was so in favour of external managers at a time when others were much more hesitant, but it is possible that some or all of a long familiarity with having the Fund managed externally, a natural preference for the private sector solution

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which was even then a hallmark of the Hong Kong Government, and the lack of an obvious alternative manager in the form of a central bank all had a part to play.

Hong Kong's experience – the current position

Prior to the setting up of the HKMA, the resources available to its predecessor, the Office of the Exchange Fund, dictated a relatively conservative investment style. Neither the provision of staffing nor the level of management information were commensurate with a more active trading strategy.

Since the formation of the HKMA in 1993, many of the relevant resources for a more active style of fund management, including for example more staff, the necessary economic analysis, portfolio evaluation and performance assessment methods on which to base informed investment decisions, and a more automated settlement system, have been put in place. With these improvements, the HKMA now manages the bulk of the Exchange Fund actively in-house. However, external managers still have a role to play in the management of the Exchange Fund's large reserves. In the Fund's equity market investments, the HKMA still relies entirely on the expertise of external managers. In other areas, the HKMA tends to concentrate on investments in the core currency and bond markets while the external managers are given a wider scope of currencies, markets and investments. In all, about 25% of the assets of the Exchange Fund are currently under external management.

Further benefits arise from the use of the external managers as a valuable yardstick for performance comparison. Each external manager operates under a set of investment guidelines and with a benchmark against which their performance is measured. Although the investment parameters of the internally managed funds are different in detail from those of the external managers, their returns nevertheless provide an objective yardstick against which the returns of the internally managed funds can be compared.

The HKMA conducts regular reviews with all its managers to discuss their performances, and as well as ensuring the managers follow their instructions and guidelines, these meetings enable the HKMA to draw on the knowledge and experience of a diversified group of external opinions. The managers provide a valuable and important source of market information, judgment and technical expertise which complements the HKMA's internal analysis, and as a result the HKMA's management is better informed and less at risk of relying solely on the opinions of the comparatively small in-house staff.

Finally the external portfolios enable the HKMA to invest outside Hong Kong's time zone. Despite the enormous improvements in communications, this remains valuable, as many of the markets in which the Exchange Fund is most heavily invested still show patchy liquidity at best in Asian business hours, and especially given the size of the Fund, it can be quite difficult to conduct significant trades in securities and currencies in Asian time without impacting prices and exchange rates. The use of external managers also helps to mitigate any price risk by placing funds with managers located in the time zones of the markets in which they trade, where liquidity is better.

In conclusion, the external managers have served the Exchange Fund very well. The HKMA's in-house expertise is now greater but the HKMA sees no reason to cease the policy of using external managers for a proportion of the assets of the Exchange Fund, which it finds efficient and effective. The wide global dispersion of the managers adds to the HKMA's ability to read markets (the view of the US economy or global trends as seen from America, for example, is often very different from the view as seen from Hong Kong), and the dialogue that has been established with them, especially since the formation of the HKMA, provides an invaluable private sector view and discipline to the HKMA's own operations.

The experiences of other central banks

Although any statement about the experiences of other central banks is inevitably a generalisation, several themes do stand out. For most central banks, for example, reserves management in the 1970s was little more than liquidity management with a very high emphasis on security. Reserves were largely seen as a policy instrument to facilitate the conduct of monetary or exchange rate policy, and the cost of holding those reserves was seen as an inevitable cost of conducting that policy. As a result most central bank reserves were held

either in gold or in money market instruments in the world's premier markets, and little or no attention was paid to managing the reserves for extra return. Indeed even the concept of a return on the reserves was largely alien.

Some central banks have stuck with this approach largely unchanged to this day; many still hold large gold stocks, and several (and by no means the least advanced) still limit their security holdings to assets of less than a year to maturity. But the majority of central banks began in the 1980s to take an interest in more active management of their reserves especially where the central bank carried the reserves on its own balance sheet. A major impetus to this was the realisation that the typical central bank balance sheet does carry considerable risks, for example currency mismatches (typically between domestic liabilities and foreign assets) and interest rate mismatches (typically between short liabilities and longer maturity assets). These mismatches had always existed, of course, but the more volatile markets in the 1970s had sharply brought them into focus, while at the same time the increasing sophistication of the instruments available enabled central banks for the first time to manage the risks more actively.

Once central banks had begun to take more interest in managing their reserves, they quickly came to appreciate the revenue possibilities. A major catalyst here was the growing Eurodollar market, which seemed to offer almost riskless arbitrage possibilities, especially for investors such as central banks who could afford to take the long view and hold an anomaly position until it moved in their favour. The huge gains to be made from longer-dated fixed income securities in the early 1980s, as the very high interest rates of 1979-81 subsided, also encouraged central banks to look beyond their traditional money market investment universes.

Once this move to more active management had started it gathered adherents. Securities houses, sensing a new class of investors, encouraged central banks to become more active in the markets, with a growing number of training courses and seminars for the increasing numbers of central bank portfolio managers. Banking supervisors and regulators, faced with ever more complex markets, saw benefit in their colleagues' involvement in the markets as investors as a way of increasing the central bank's understanding of the new financial instruments that were being developed. Finally, national treasuries, especially in Europe, became aware of the profits that could be earned and became very keen to turn the reserves management units of their central banks from cost centres to profit centres.

In recent years, however, life has become very much more difficult for central banks. The increased liquidity and sophistication of markets, plus perhaps the actions of the central banks themselves, have greatly reduced the number of low-risk arbitrage opportunities that are available and so the profits to be earned. In order to deliver expected levels of returns, central banks have tended to move to more risky investment strategies, including more position-taking via outright purchases and sales and greater and more active management of their currency allocation. This change of style has enormously increased the requirements for computer support and risk control systems, far more than most central banks expected or in some cases were willing to spend. This trend has been further exacerbated of late by the increasing complexity of the markets themselves.

For those central banks whose systems have not kept pace with the leading edge of the market, the last three years have been a volatile and painful time, as both markets and currencies have confounded analysts and experts alike. The new style of more aggressive position-taking has often delivered losses, and the traditional arbitrage activity has not been able to supply sufficient profits to offset them. Even the few central banks who have maintained their systems have found that the complexity of modern portfolio management demands highly-skilled staff who are difficult either to find from internal resources or to keep even if they can be found. Few central banks can regularly match the salaries offered to good portfolio managers by the private sector.

As a result, whereas the latter part of the 1980s can perhaps be characterised by central banks' levels of sophistication catching up with and narrowing the gap with the market, the 1990s show instead a tendency for them to fall further behind again. When banks and securities houses are finding that the cost of developing value-at-risk models for their balance sheets runs to billions of US dollars, it is perhaps little wonder that many central banks find themselves struggling to keep up.

The move to outside management

Faced on the one hand with the increasing costs of keeping IT systems in tune with modern sophisticated markets, and the increasing difficulty of retaining staff of the calibre required to manage portfolios aggressively, but on the other hand with no desire to return to the low risk and very low return styles of the past, there has been a notable trend for central banks to begin to consider afresh the attractions of employing external managers. In a sense, this is merely a manifestation of the current management trend towards outsourcing: why should central banks try to manage money themselves when it can be outsourced to the market ?

The traditional arguments against external management for central bank FX reserves revolve around three main points. The first of these is security: central banks require their assets to be absolutely secure. The rise of specialist global master custodians, and the resulting ability to split management of funds and custody of assets, has gone a long way towards reassuring central banks that funds placed with external managers can be made sufficiently secure.

The second point is liquidity: central banks often require their funds to be instantly available. The growth of repo markets and other such tools has greatly reduced the time it takes to recall funds from an external manager, while at the same time use of the FX forward and swap markets has increased a central bank's ability to fund itself short term to meet a sudden call for liquidity.

Finally, central banks have always placed very high emphasis on confidentiality. This remains a serious concern, and indeed some central banks will not even consider outside managers for this very reason. However other central banks are increasingly adopting a much more open style in their reserves management, and sharing their objectives with external managers is increasingly seen as not inappropriate or incompatible with overall confidentiality requirements.

With the ability to overcome largely these three main traditional concerns, central banks are more able to focus on the benefits of external management. The traditional benefits that the Exchange Fund has long enjoyed still hold, but to them can be added the two very considerable ones of tapping into the managers' IT and risk control systems, and utilising the managers' professional staff. By using external managers, the pressure on the central bank to keep its own systems abreast of the market and its own staff fully conversant with the latest market developments is much reduced – not eliminated, but the pressure is certainly reduced and a central bank can also call upon its managers to assist in any IT upgrade or staff training. Equally, the central bank is much less affected by the resignation of key portfolio manager personnel; an important point for many central banks where the old-style "40 year career", and with it the expectation that staff will stay at the central bank almost regardless of the outside employment market, is fast becoming a thing of the past. The extra cost of the external managers' fees needs to be considered in the light of this much greater stability of staff and systems that they provide, and not just in monetary terms.

To these major benefits can be added others, such as a greater anonymity in the markets (sometimes very useful, especially in for example the FX markets), a benchmark to assess internal performance, a greater understanding of how the private sector assess the risks and rewards of different investments and investment styles, an opportunity to promote and develop a local fund management industry (particularly attractive to some central banks of emerging markets), and even someone to share the blame for poor results. For all these reasons (and not least among them is a greater focus by the fund management industry itself on the central bank sector as a source of potential clients), the number of central banks who are starting to use or consider external managers is growing and is likely to continue to grow.

Like anyone else who employs outside management for their assets, central banks who do so need to appreciate that while management of the assets can be delegated to an external manager, responsibility for those assets (for example the choice of benchmark) and administration and accounting for them cannot, and it is possible that the resources that a central bank has to devote to running portfolios under external management will surprise some of the newer converts. But despite this, the growth in central bank usage of external managers is likely to continue.