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Latvia

Governance and Institutional Framework

Reserve management objectives and coordination

723. Reserves at the Bank of Latvia are managed according to three primary requirements: stability, liquidity, and income. Clearly, there are trade-offs between income versus stability (or capital protection) and liquidity. In practice, the Bank of Latvia has set an investment benchmark that represents and communicates the Board of Governors' views on these three conflicting goals. The specific aspects of this strategy will be discussed later; but it is important to note at the outset that the Bank of Latvia puts relatively significant emphasis on the income portion of reserves management.

724. Any analysis of appropriate risk/return trade-offs for central bank reserves management needs to incorporate reserves adequacy and potential intervention needs. Latvia's foreign exchange and monetary regime is a quasi-currency board. The bank pursues a fixed exchange rate target (vs. the SDR), with a ±1 percent intervention band. Latvia is a quasi-currency board because we also have and use a number of open market instruments to manage domestic liquidity, which wouldn't be the case in a traditional currency board.

725. On the one hand, automatic interventions at relatively tight intervention bands would necessitate the need for highly liquid reserves. On the other, it is highly unlikely that we would ever see interventions of such size that would entail the sale of the entire money base; and therefore, it would appear that we have a good deal of reserves that would not be necessary for intervention purposes, that could be invested with a higher degree of risk, in exchange for increased expected returns.

726. The use of reserves in Latvia is generally restricted to maintaining the defense of the foreign exchange policy, and generating income for the central bank and the State Budget (through existing profit retention arrangements). Since Latvia has a vibrant banking sector with a large amount of international business, official reserves are rarely needed for current account needs or to provide foreign exchange for local enterprises. The amount of foreign exchange in local bank balance sheets is more than enough to satisfy the needs of importers, exporters, and other financial institutions. All of these factors have been analyzed at the Bank of Latvia, and influence the specific reserves management practices, which will be discussed later.

727. As stated in the law on the Bank of Latvia, the central bank has the sole mandate to manage the foreign exchange reserves of the country (the mandate also permits us to engage external man-

agers to manage a portion of the reserves). As a quasi-currency board, the size of the reserves is entirely dependent on automatic intervention operations, and therefore coordination with monetary policy is not much of an issue. The Bank of Latvia has, at times, offered foreign exchange swap products to the local market, and these operations are always coordinated with monetary policy.

728. The Bank of Latvia works closely with the State Treasury and Finance Ministry to coordinate debt policy, but reserves management is not influenced by the currency composition or maturity of the government's external debt. Each institution is responsible for managing its foreign exchange and interest rate positions. The Bank of Latvia is the fiscal agent for the State Treasury and Finance Ministry, however, and frequently manages money on behalf of these institutions, but these funds are managed in separate portfolios and do not influence the central bank's reserves portfolio. Any non-reserve foreign exchange in the central bank's balance sheet (such as Finance Ministry money or funds from foreign exchange swap operations) is run on a matched-book basis, to minimize any adverse effects on the bank's income statement. While requiring the management of several portfolios with different investment characteristics complicates the foreign exchange management process at the bank, this arrangement allows a very clear understanding of every risk taken on the balance sheet from foreign exchange operations.

Organizational and decision-making structure

729. Investment guidelines for reserves management are set by the central bank's Board of Governors. More specific guidelines (such as allowable risk parameters for other portfolios, for example) are set by the Executive Board. All reserves management operations are undertaken in the Foreign Exchange Department. Great care is taken to ensure that all levels of management are aware of the results of reserves management operations. Monthly performance reports are given to the Executive Board. The Board of Governors analyzes the effects of reserves management on the bank's budget at its meetings, and all management has access to daily accounting reports on the bank's intranet. The central bank is currently installing a new treasury system, which will provide more detailed management information. The system should be live by year-end 2002. Furthermore, the Governor of the Bank of Latvia and the Chairperson of the Executive Board are members of the bank's Investment Committee (along with members of the Foreign Exchange Department), which meets weekly. Therefore, the highest levels of management are always informed of any developments positively or negatively affecting the reserves portfolio.

Transparency and accountability

730. Foreign exchange reserves operations are audited by external auditors and the State Control annually and by internal auditors more frequently. Disclosure of performance and positions is quite transparent. The central bank's published monthly financial statements will reflect all market value changes in all portfolios, and the annual statements are quite specific, offering detailed reports of currency position and also credit quality. While the Bank of Latvia, like most central banks, does not publish results in accordance with International Accounting Standards, the amount of transparency is very high, with footnotes to the financial statements being very detailed, providing any reader of the financial statements possessing a modest amount of accounting knowledge with all the information necessary to analyze the true performance from reserves management. And while relative performance numbers versus the benchmark are not specifically published, the benchmark itself is not confidential, and all of the data that would be needed to make such an analysis are publicly available.

Capacity to Assess and Manage Risk

Risk management and benchmark portfolio

731. As the Bank of Latvia uses reserves to defend a fixed exchange rate target (against the SDR), the neutral currency composition mirrors this target. Specifically, the reserves benchmark consists of the components of the SDR currency

basket, weighted as in the SDR. When the reserves portfolio is invested according to the neutral currency weights, then there are no valuation fluctuations due to currency movements.

732. Regarding interest rate risk, the benchmark consists of the 1–3 year government bond index in each component currency. This maturity sector was chosen for various reasons. First, extending duration, and having a market, not cash, benchmark, markedly increases the return on reserves over the long run. Obviously, increasing expected return leads to an increase in expected volatility. However, the 1–3 year sector was chosen to mirror the risk tolerance of the Board of Governors of the Bank of Latvia. The 1–3 year sector offers notable return enhancement, but volatility is limited—during the time periods available in most financial databases, the 1–3 year maturity sector has never ended a 12-month period with a negative return. Clearly, sub-zero returns can be observed in shorter time periods.

733. Liquidity is, of course, a primary concern. The Bank of Latvia has several liquidity constraints in its reserve management guidelines, which result in the purchase of instruments that can be realized in times of market stress. Unlike other central banks, however, the Bank of Latvia does not maintain separate liquidity and investment tranches in its reserves portfolio. We have found that the addition of extremely liquid short-term instruments for a liquidity portfolio is not economically justified in our case. The instruments we hold in longer-term maturities are more than liquid enough to satisfy any intervention (or even working capital) needs, and any perceived negative effects from increased transaction costs from liquidating market instruments in times of stress are more than offset by increased long-term returns. Maintaining separate liquidity and investment tranches in effect puts the reserves portfolio in a "barbell" strategy. And while such a strategy offers increased portfolio convexity, convexity has a price, and such a portfolio will be suboptimal in the long term, as it will not outperform a duration-neutral "bullet" strategy.

734. Within limits set by the Board of Governors and the Executive Board of the Bank of Latvia, the portfolio managers are allowed to take active positions away from the benchmarks, in the aim of profits from expected rate moves. The long-term strategic benchmark is set by the Board of Governors, and the Investment Committee (comprised of Foreign Exchange Department staff, the Chairperson of the Executive Board, and the Governor of the Bank) meets weekly to set tactical benchmarks. The Investment Committee also holds a quarterly meeting to discuss strategic themes. Individual portfolio managers are free to trade instruments in a range around the tactical benchmark set by the Investment Committee.

Instruments

735. The central bank uses futures, options, swaps, and other derivatives in the management of currency, interest rate, and credit risks. Derivatives can be used for hedging purposes, to quickly and efficiently restructure the risk parameters of the portfolio, and for taking active positions. Leverage limits are set by the Board of Governors' investment guidelines.

736. A certain portion of reserves tends to be invested in "spread product"—agency and supranational paper, corporate bonds, mortgage-backed and asset-backed securities, commercial paper, and similar products. Our studies have shown that greater long-term risk-adjusted expected return can be gained from "moving down the credit curve," than by adding duration, or taking active currency positions. Our investment guidelines limit the amount of credit risk allowable in the portfolio, and limit liquidity and concentration risk as well. With a minimum allowable long-term rating of A-, all of the instruments the Bank of Latvia purchases for its reserves portfolio are safely in the "investment grade" category.

Staff

737. The management of a portfolio with such diverse products requires front, middle, and back office staff that can understand, measure, and manage the various risks involved. The Bank of Latvia has been able to attract and maintain extremely competent staff; turnover in the reserves management department has been limited. The central bank is able to offer its reserve manage-

ment staff sufficient salaries—while not necessarily exceeding those available in the private sector, salaries are at least competitive. It is also possible for reserves management staff in some cases to earn higher salaries than senior management members, or department heads in other bank areas. Furthermore, we have found that allowing more complicated investments tends to keep reserves management staff interested and motivated—it would be much harder to retain our best specialists if the reserves portfolio were limited to, say, only government paper.

738. To maintain a high standard of professionalism in the reserves management staff, every single member of the front and middle offices (and the department head), as well as some back office staff, are enrolled in, or have completed, the Association for Investment Management and Research's (AIMR) Chartered Financial Analyst (CFA) program. This program is a series of annual exams (three years' minimum) that cover all aspects of the investment process, including accounting, taxes, corporate finance, fixed income, equity management, derivatives, portfolio management, ethics, financial analysis, etc. All AIMR members also adhere to a Code of Conduct regarding conflicts of interest in asset management and analysis, and annually sign professional conduct statements.

Risk and performance measurement

739. Information systems are also crucial to the management of these risks. The Bank of Latvia currently has specialized systems covering position management, risk analysis, performance attribution, exception reporting, and accounting requirements for all reserves management operations. Obviously, these systems are capable of processing all the allowable instruments in the bank's reserves and other foreign exchange portfolios. The central bank is currently installing a new bank-wide treasury system, which will further integrate these processes, and a new risk management package will further supplement our existing risk management efforts.

740. The Bank of Latvia employs external asset managers to manage portions of the reserves portfolio. These managers are subject to the same investment guidelines and limits as our internal managers, and every external manager transaction is also entered into our in-house information systems. As a result, the managers provide good external benchmarks for our internal managers, and everyone's performance is measured using the same data and methodology. We have found our external manager program to be quite successful—at first, the managers provided valuable technical assistance and training; now, besides providing external benchmark data, they can be used to discuss investment strategies and ideas. Since every manager has the same goals, in trying to outperform the same benchmark, these discussions can be more fruitful than with some sell-side counterparties that may not know our specific needs at best, or may be trying to sell their specific inventory at worst.

741. Compliance with limits and guidelines is monitored constantly, for both internal and external manager portfolios. Exception reporting is automatic; in the case of a limit breach, the department head, Chairperson of the Executive Board, and Governor are notified electronically. Daily asset mix reports, which show various deviations from strategic and tactical benchmarks (within permissible limits), are also distributed electronically.

742. Portfolio performance is measured on an absolute basis (for accounting purposes), and relative to the benchmark (for investment management purposes). Our performance attribution system disaggregates composite returns into returns from specific strategies, and these reports are always available online in our information systems, and e-mailed weekly to reserves management staff, the Governor, and Chairperson of the Executive Board.

743. Operational risk and legal risk are constantly managed, and also addressed in several department and Executive Board procedures documents. All reserves management operations undergo an annual external audit, and specific aspects are audited more frequently by the Bank's Internal Audit department.

Conclusion

744. The Bank of Latvia places a focus on the return aspect of reserves management, which necessitates excellent staff, excellent systems, and

the willingness of senior management to understand and sanction relatively higher risk levels. We feel the systems and staff at the Bank of Latvia are more than capable of managing the assumed risks, and our performance to date has tended to justify this attitude. The nature of reserves management is always evolving, and the Bank of Latvia will continue to invest resources in staff and systems.