



FOREIGN EXCHANGE RESERVE MANAGEMENT - GOVERNANCE STRUCTURE AND MANAGEMENT STRATEGY

1. OBJECTIVE

The Foreign Exchange Reserves of Pakistan are managed by the State Bank of Pakistan, as mandated by the Central Board:

The Bank directly or indirectly purchase, hold, and sell currencies, financial and capital instruments issued by governments, agencies, local authorities, corporate, and supranational in approved countries and whose currency has been declared as approved foreign exchange. The Bank may appoint managers, custodians, consultants, and any other professional advisors for the effective management of Foreign Exchange Reserves of the country

2. RESERVE MANAGEMENT INVESTMENT PARAMETERS

Management philosophy for reserve management functions is based on three broad investment parameters. These are:

a) Safety

Safety of principal is the foremost objective given Foreign Reserves are a public asset and have strategic role in furthering economic policies and objectives. Investments are undertaken in a manner that seeks capital preservation over the investment horizon subject to the appropriate constraints

b) Liquidity

The management shall seek to ensure that adequate reserves are available to meet obligations as they fall due. In order to maintain sufficient liquidity, investments shall be made primarily in securities with active secondary markets

c) Optimal Returns

Subject to the capital preservation and liquidity constraints, the reserves shall be invested with the objective of maximizing risk adjusted returns.

With the significant accumulation in the Pakistan's reserves over the recent years, the Central Board of the State Bank of Pakistan – the final decision making authority for the Reserves – deemed it necessary to bring the Reserve Management process in line with international best practices. With the institutional reforms taken up at the State Bank, Reserve Management function has acquired a prominent role in the shape of a dedicated International Markets & Investments Department formed within the Financial Markets & Reserve Management (FMRM) Group of the Bank in Nov-2006. The formation of a dedicated department has led to a widening of the scope and dimension of Reserve Management function by acquiring skills and developing expertise, de-layering and institutionalizing decision-making and strengthening risk and controls culture.

In line with Investment Policy approved by the Central Board of State Bank of Pakistan, foreign exchange reserves are invested with highly rated sovereigns & financial institutions,



with average credit quality of invested reserves maintained at AA- or better, while no investment is made below investment grade. The Investment composition of reserves includes deposits and fixed income securities of sovereigns & supranational. Liquid foreign Exchange Reserves held by SBP as on 30th June 2011 were USD 14,784 million (excluding Gold); while following is the detail of liquid Gross Foreign Exchange Reserves of the Country:

USD in Millions

As on	30Jun2009	30Jun2010	30Jun2011
Held by SBP /1	9,117.9	12,958.2	14,783.6
Held by Banks /2	3,307.3	3,792.2	3,460.2
Total Liquid Reserves /3	12,425.2	16,750.4	18,243.8

/1: Liquid FX reserve assets of SBP, excluding gold, SDR, etc

/2: Liquid FX reserve assets of the commercial banks

/3: Gross liquid FX reserves of Pakistan

3. GOVERNANCE STRUCTURE AND MANAGEMENT

Governance structure specifies and designates responsibilities for determining investment parameters, executing investment policy, and monitoring results to various participants in the reserve management process. The following section gives an overview of the governance structure put in place for the effective management of reserves. The governance structure for reserve management at SBP consists of:

- a) Central Board of the State Bank of Pakistan
- b) Sub-committee of the Central Board on Investment
- c) Investment Committee of the Management *and*
- d) Management team

a) Central Board of the State Bank of Pakistan

The Central Board is the highest decision making authority for Management of Reserves. It assumes the primary responsibility of management and performance of reserves. It's responsibilities include:

- Approving Policy Guidelines
- Approving Strategic Asset Allocation (SAA)

b) Sub-Committee of the Board on Investments

The Sub-Committee of the Central Board on Investment provides oversight in the following areas:

- Review & recommend changes in investment policy, strategic asset allocation (SAA) and tactical investment strategy (TIS)
- Operational Guidelines for the investment of the reserves.



- Appointment of asset managers, custodians and investment consultants
- Portfolio Compliance Review & Risk Compliance

c) Investment Committee of the Management

The Investment Committee of the Management is responsible for operational & tactical guidance and supervision for reserves management. Its responsibilities include:

- Develop and recommend to the Sub Committee the investment policies in relation to the management of the Foreign Exchange Reserves.
- Approve the operational & tactical guidelines for the investment of the reserves
- Review investment guidelines for internal and external investments
- Evaluate and recommend to the Sub Committee, the appointment of asset managers, custodians, investment consultants
- Monitor compliance with the Investment Policy and guidelines set out by the Central Board
- Review the performance of the in-house and external managers with respect to the benchmark
- Review new products and asset classes

d) Management Team

Following Departments are responsible to carryout reserve management activities in SBP:

i) International Markets and Investments Department - IMID

The International Markets and Investments Department oversees the day to day operations of reserve management. The Department collaborates the settlement function and risk management and compliance decisions with TOD and RMCD respectively. IMID Departmental responsibilities include:

- Managing international currency exposures
- Managing Cross Currencies cash flows & debt obligations
- Manage the short-term Portfolio to ensure liquidity & optimal return.
- Manage relationship with external Fund Managers, Custodians and Consultants.
- Analyze Active Portfolio Managers' performance & approach in generating alpha
- Global Financial Market Research

ii) Risk Management and Compliance Department - RMCD

RMCD monitors risk exposures in overall reserve. Risk management revolves around setting and monitoring counterparty exposures, measuring systemic risk, concentration risks and contagion risks. It also oversees compliance of externally managed funds with the Board's approved parameters. RMCD also guides external managers on how to reduce or eliminate any unwanted or unexpected exposures



created in the portfolio which may be in excess to the approved benchmarks. Any irregularity/breach is reported directly to the Investment Committee. The department is part of and reports through the Financial Resource Management Group. The reporting line is separate from FMRM Group which is responsible for the investment of reserves - thus ensuring segregation of functions between the Front, Middle and Back Offices.

iii) Treasury Operations Department - TOD

Treasury Operation Department (TOD) is performing all accounting and settlement operations for reserves. It serves as the Back office for Reserves Management. In addition, the back office also performs a variety of other activities including data management and dissemination. It has a reporting line independent of front office and reports to Financial Resource Management Group.

4. RISK MANAGEMENT POLICIES AND PROCEDURES

The foreign reserves portfolio are maintained and managed in accordance with the Bank's policies and procedures, consistent with the following strategic risk management objectives:

a) Liquidity Risk

- To ensure that foreign reserves are available when required on short notice. Reserves comprise assets which are:
 - Diversified across US and other major currencies *and*
 - Include assets in multiple instruments and asset classes which are readily convertible into cash at short notice.

b) Credit Risk

- Reserves are invested under very stringent guidelines and investment parameters including
 - Prudent Obligor Limit Metrics
 - Stringent approval process for Counter-Party selection
 - Managing Concentration Risks
 - Monitoring Contagion Risk

c) Market Risk

- The Bank seeks to minimize the risk of adverse changes to reserves coming from adverse movements in market rates or prices such as interest rates, exchange rates, credit spreads by implementing:
 - Tracking Error limits
 - Performance objectives
 - Conservatively designed customized benchmarks

d) Operational Risk

- Any material damage to the Bank's reputation,
- Any material risk of Legal disputes or
- Any material risk of loss due to fraud, error or oversight