Evaluation of the off-budget treasury and asset management activities managed by ECFIN and in particular its Directorate ECFIN-L ("treasury activities")

Executive summary[1]

A peer review was requested and then agreed upon, between the IBRD and the European Union represented by the European Commission to carry out an evaluation of the off-budget treasury and asset management activities performed by the Directorate Economic and Financial Affairs (ECFIN-L).

<u>Overall assessment</u>

The Treasury of ECFIN-L achieves its objectives in the management of the portfolios under its responsibility, coping well with the different and complex specificities it faces, including the fact that most of the portfolios are characterized by the uncertainty of outflows that follow the inflows, making Asset and Liabilities Management complex, and human and information technology resources' constraints. The peer review has been benchmarked against public financial institutions' practice (i.e. central banks, pension funds, international development banks) and the specificities of the Treasury's activities have been considered.

The set of improvements described below should be considered as medium or low priority. They would need to be gradually implemented given the stretched human resources at ECFIN-L. Two main prerequisites, even for gradual implementation, are additional staff in particular in the Risk Management unit (at least one staff member) and an upgrade of IT tools to better support the development of the activity.

<u>Strategic Asset Allocation</u>

Typically, the most important decision, when managing financial assets, is to define the strategic asset allocation representing the risk/return profile of the institution and translate it into operationalized benchmarks which also are the yardstick against which the management of the assets can be assessed. This process requires the definition of key inputs, investment horizon and risk tolerance, eligible asset classes, and the application of quantitative optimization techniques. The World Bank Team (WBT) has reviewed in detail

[1] The pertinent question in the tender document that is addressed in this Executive Summary is: "To what extent do the Treasury activities achieve their objectives and expected outcomes? Are adjustments needed to improve management performance?" The Peer Review has been conducted by analyzing the operational policies and processes in place at ECFIN-L for the management of the off-budget assets as well as the governance and organizational structure.

the processes used by ECFIN-L for the ECSC and the BUFI portfolios which are compliant with industry standards. It has proposed alternative approaches which could be envisaged for the future. In particular, for the ECSC portfolio, it has analysed the impact of another type of asset allocation based on the fact that this fund does not have liabilities as constraints anymore and can be considered as a long term or endowment fund with a longer investment horizon. This would entail a different asset allocation and asset classes, notably equity holdings. Such an alternative approach has the potential to enhance revenue significantly and thereby support long term goals such as research. Detailed results are presented in an annex of the report[2]. The strategic asset allocation defined for the BUFI portfolio effectively deals with the two strict legal constraints that the fund must comply with, capital protection and Guaranteed Return. For externally managed portfolios, the external asset manager is using approaches that conform to industry standards as well to design the benchmarks, which should be changed only for fundamental events (e.g. large shifts in perceived credit risk).

The key input criteria for the strategic asset allocation (the investment horizon and the risk tolerance) are generally defined by the owners of the assets. Risk tolerance criteria are stated in all the asset management guidelines in broad terms which are consistent with the ones used by similar public financial institutions. The investment horizon is not always explicitly specified. It could be envisaged to make these criteria explicit for all internally and externally managed portfolios, and include them in the asset management guidelines. To avoid overburdening the process, such an improvement could be introduced gradually at the time of the yearly discussion of the investment strategies.

Portfolio management

The portfolio management of internally managed portfolios by ECFIN-L (unit L5/Front Office) can be characterized as a moderately active management performed in a prudent and controlled manner, framed by strict risk budget limits. Investment strategies are defined yearly, reviewed every 6 month and overseen by the Treasury Management Committee (TMC) during its monthly meetings. Processes and procedures are fully documented in the Front Office Manual. The Front Office duly conducts market intelligence in its daily work, using traditional information sources such as Bloomberg and commercial banks' analysis. The WBT has reviewed the historical excess performance resulting from the Treasury's active management for the ECSC and BUFI portfolios. Results are good and consistent with the amount of risks that the portfolio managers are allowed to take. For externally managed portfolios, an annual investment strategy is defined with ECFIN-L. Positions are reviewed monthly by the external manager. The investment style for these portfolios too can be

[2] A similar detailed analysis of the strategic asset allocation and benchmark has been carried out for the new H2020 portfolio that ECFIN-L is going to take under management, even if this portfolio was not directly in the scope of the peer review. The results also are presented in an annex of that report.

characterized as moderately active management, in a controlled and prudent manner and excess return has generally been positive.

Risk management

Sound risk management is a key requirement in all asset management activities, be it in public or private institutions. Risk management is duly framed in a Financial Risk Policy and Financial Risk Manual document which covers best practice.

For internally managed portfolios, risk management is performed by unit L6 (which functions as the Risk Management unit). In terms of risk measures, duration and VaR (Value at Risk) indicators are calculated as is common practice. Performance indicators are calculated monthly and a performance attribution model has been implemented according to state of the art practice for institutions with the same investment universe. These different measures are presented both in absolute and relative terms (against the benchmark). The credit risk limit system is very comprehensive. The Risk Management unit is producing a comprehensive set of reports for the different stakeholders (Director of ECFIN-L, TMC, Director General of ECFIN, and the Council for the ECSC portfolio), with the right frequency. The limit compliance function is also performed by the risk management unit L6. Compliance is an important function of oversight of the management of assets to ensure that all investments comply with the guidelines. It is done for both the internally and externally managed portfolios on a regular basis.

As far as operational risk is concerned, a qualitative assessment is performed in conjunction with DG-BUDG and Secretariat General using industry standards of operational risk management. The risk management unit participates in that assessment, also conducting a regular additional review of incidents which occurred, drawing up action plans and ensuring their follow-up.

The recommendations below are targeted to further enhance the risk management function but are highly dependent on the availability of adequate human resources and IT tools:

- Complement the actual risk indicators with sensitivity analysis such as key rate and spread key rate duration as well as Conditional Value at Risk on a weekly basis;
- Compute performance indicators on a weekly basis: more frequent performance indicators are an additional and useful tool of risk control on how the portfolios are managed;
- When these new indicators are available, build a weekly report on risk and performance for the management of ECFIN-L, an example of which is provided in an annex of the report.

For externally managed portfolios, risk and performance measurement indicators used by the external asset manager are well documented and compliant with market practices. Reporting is done on a monthly basis for holdings and quarterly basis for risks and performance results. Compliance is performed and reported on a quarterly basis too. Compared to standard practices observed for similar institutions using external managers, ECFIN-L would be entitled to ask their external manager to provide the following:

- Monthly reporting on the risk and performance of the managed portfolios;
- Additional risk measures such as relative and not only absolute risk measures, tracking error and information ratio;
- historical excess performance computations on longer horizons (e.g. rolling I year, rolling 3 years and inception to date);

These requirements, to be discussed with the external asset manager, would help ECFIN-L to refine its own analysis of the performance of its external asset manager.

<u>Settlement, Accounting and Information Technology</u>

Settlement processes, as reviewed, are compliant with best practices in terms of messaging and payments processes, account's management, and escalation procedures in case of fails. Furthermore all procedures are properly documented.

Accounting procedures follow the rules applied by the Accountant of the European Commission and rely on international public sector standards (IPSAS) and, where pertinent, IFRS. Relevant reporting is performed and shared with the various stakeholders

Information technology support is a key in any asset management activities which should support efficient and robust processes.

The treasury IT systems offers functionalities for asset management in the Asset Management Module such as deal entry functions with 4-eyes principles both at the front and back-office level, SWIFT message generation, monitoring of credit risk limits, static data maintenance, accounting, and supports those functionalities for a quite large set of instruments (bonds, shares, money market instruments, repos). However, some desirable features of a fully-fledged portfolio management system are missing, at the current time.

The improvements suggested above, especially in terms of risk and performance measurement, require an enhancement of the IT tools available in ECFIN-L. Two alternatives are proposed: either to capitalize on the existing system or on the already developed functionalities used for performance attribution model. Each option would require ECFIN-L to define their business requirements according to the improvements suggested above, with their priorities.

<u>Governance</u>

The governance structure complies with best practice with adequate delegation of authority[3].

Some proposals to further strengthen the governance structure, to be discussed internally are: (i) the Director General of ECFIN-L or the Deputy Director General could be charged more explicitly with approving the key parameters of the strategic asset allocation gathered into an Investment Policy in the same way as they are responsible for approving the Risk Management Policy; (ii) the TMC could be an explicit decision making body rather than a consultative body in charge of approving the investment guidelines; (iii) the composition of the TMC could be enlarged and include more external members such as representatives of the Economic and Research Department, Financial Stability Department, in an observer capacity.

Staffing

ECFIN-L does have competent and skilled staff but there is a shortfall in the numbers to fulfil the important tasks of investing. Implementing the improvements suggested above will require reinforcing the Risk Management unit with at least one staff member (preferably two). Financial asset management requires investing in specialized skills and reduced turnover. It should be reviewed if the general mobility rules of the European Commission could accommodate the business needs of ECFIN-L. Financial asset management requires very technical skills which need to be available and updated constantly to cope with the constantly changing environment in which markets function. This necessitates adequate training of the staff.

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[3] The Council gives strategic orientations and delegates to the Commission and in particular the Directorate General ECFIN the implementation. SLAs are established with the different owners of the funds. For BUFI, DG-BUDG, as the owner of the fund, has delegated the management to ECFIN-L and this delegation is duly documented in a SLA too. The Treasury Management Committee, whose terms of reference are duly documented, is an advisory body in charge of reviewing the investment strategies and the oversight of the management of the different portfolios. The operational units of ECFIN-L (L5/L4/L6) are responsible for the day to day management and proper segregation of functions is applied as is best practice, in order to avoid any conflict of interest.