

Session 4:

Governance, Risk Management, and Strategic Asset Allocation for Central Banks

Risk management and SAA Frameworks for Central Banks

Mr. Thomas Vellacott
Bank of England

**2026 ASIAN REGIONAL FORUM
ON INVESTMENT MANAGEMENT
OF FOREIGN EXCHANGE RESERVES**

Bank of England

Risk management and SAA Frameworks for Central Banks

Hanoi, Vietnam 7-9 October 2026

Session 4 – Asian Regional Forum on
Investment Management of Foreign Reserves

Tom Vellacott



Contents

Background

- Overview of the Exchange Equalisation Account (EEA)
- Risk Management for Strategic Asset Allocation (SAA)

In practice

- Setting risk tolerance – An organisational decision
- Dynamic and Integrated - Attributes of our desired risk culture

Case study – Stress testing

- How Central Banks can consider the role of stress testing in managing reserves

Introducing the EEA



Established in 1932 to help manage sterling's exchange rate. Its remit was updated in 1979 (after the collapse of Bretton Woods system) and last amended in 2000



The Bank manages the EEA on behalf of HM Treasury (HMT), executing FX transactions and investing reserves within an agreed framework.

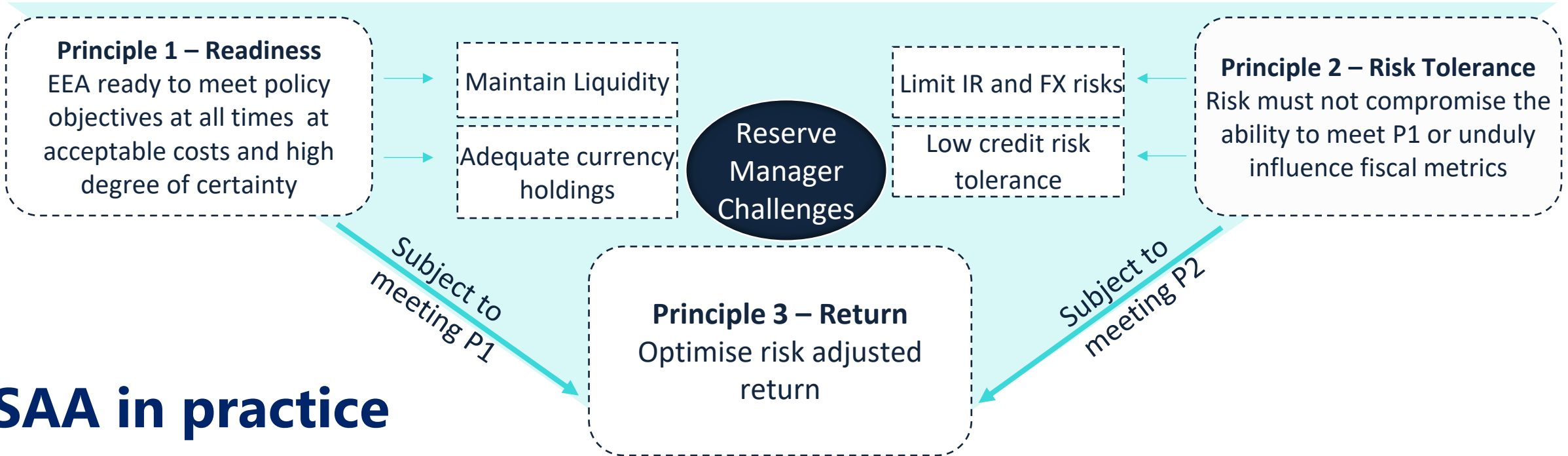


An Investment Policy Statement (IPS) and a Service Level Agreement (SLA) between HMT and the Bank, specifies how the reserves are allocated and managed.



As of the 2024-2025 annual report, the EEA holds UK's reserves of gold, foreign currency assets and IMF Special Drawing Rights (SDRs) amounting to a total of £153bn.

EEA's Investment Objectives



SAA in practice



* We constrain the available solutions to ensure all Investment Policy Statement constraints are met

Portfolio constraints – policy driven



- Liquidity
- Target a minimum of 50% Grade 1 assets
- Liquidity tranching
- Concentration limits and purchase pace



- Currency composition
- 75%: USD and EUR
- 30% each: USD, EUR
- 5% each: JPY, CAD
- No minimum for AUD



- Credit risk
- Maintain minimum internal rating level for purchases;
- Existing credit limit framework to apply



- Duration risk
- Maximum maturity 10 years (credit dependent), while ensuring smooth maturity profile
- Depending on credit and liquidity we cap duration

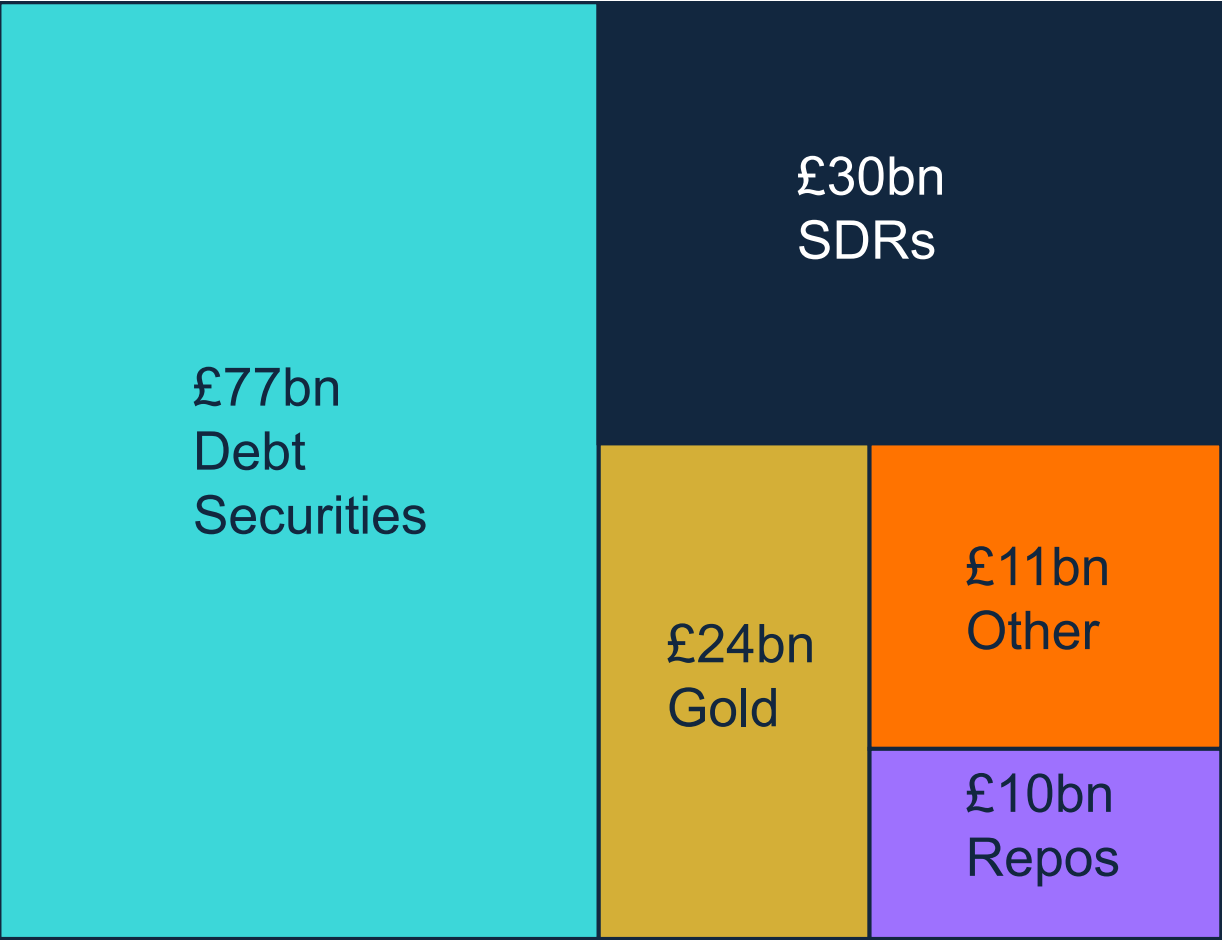


- FX risk
- Seek FX risk exposure (by reducing hedging), subject to HMT volatility tolerance
- Market risk monitored with historical VaR

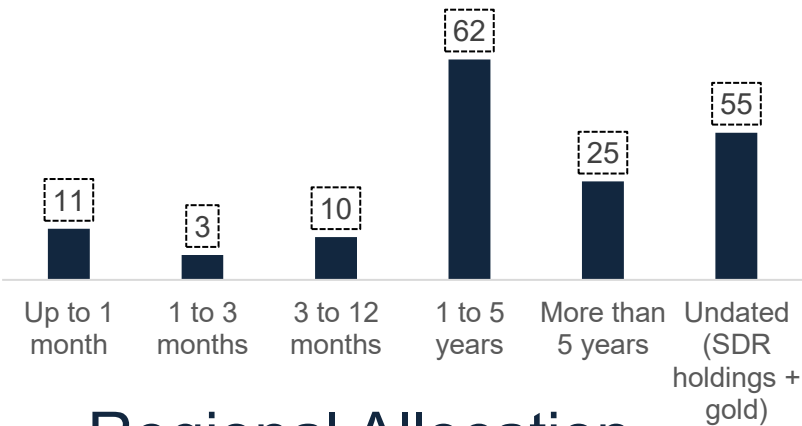
These portfolio constraints are the primary method for satisfying **Principle 1** (readiness) and **Principle 2** (risk)

EEA's 2024-2025 Allocation

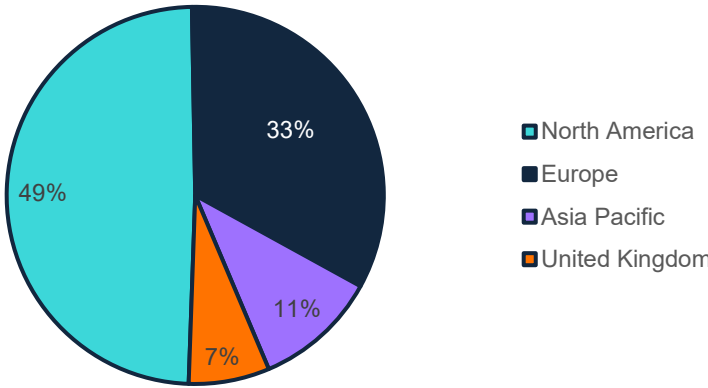
Assets breakdown



Maturity profile £bn



Regional Allocation



* Excluding gold and IMF SDRs

Source: 2024-2025 Annual Report

Three Lines of Defence

COURT

- Risk management strategy
- Risk Tolerance “Enable the Bank to take risk confidently by managing it within tolerances”
- Delegates monitoring and oversight to the Audit & Risk Committee

FIRST LINE: BUSINESS AREA

- Owns and manages risks to functions and objectives
- Implements and monitors controls
- Works within risk tolerance

SECOND LINE: RISK DIRECTORATE

- Sets the risk management framework
- Provides risk management tools
- Oversees and challenges
- Provides risk reporting to the Executive & Court

THIRD LINE: INTERNAL AUDIT

- Independently assures the framework design and operation

Risk Custodians

Subject matter experts for each Key Risk type in Bank's Risk Taxonomy

Setting risk tolerance



Operational: Prioritise mitigation of operational risks that could disrupt business-critical services, particularly high-availability payment, settlement and banking systems.



Legal: Zero tolerance for deliberate breaches of legal or regulatory requirements. Maintain robust controls to monitor and mitigate legal risk.



Conduct: Expect the highest standards of behaviour from staff and leaders, supported by strong financial crime controls.



Climate: Build resilience to climate-related risks and support the transition to net zero through active risk management aligned to published targets.

Dynamic and Integrated risk culture



RISK DENIAL

- Group think
- Over-confidence
- Optimism bias
- Incomplete/selective information
- Limited Knowledge
- Rejection of facts and evidence
- Neglecting issues
- Tolerating issues
- Risk only relevant to others, not us!



RISK AVERSE

- Avoids discussions /responsibility for, risks
- Avoids action due to fear of failure
- No tracking or analysis of failures or successes
- Can't learn from mistakes
- Assign blame, don't share risks
- Enterprise can't take on important risks



RISK AWARE

- Actively consider risk inherent day-to-day
- Okay to talk about, and take, risk
- Okay to fail (if managed appropriately)
- Success and failures tracked, analysed and learnt from
- Actively share risks and risk management
- Enterprise can potentially take on bigger risks.



RISK SEEKING

- Voluntary risk taking
- Risk activity seen to have positive moral value
- Pessimistic bias
- Unsubstantiated perception of control
- Competitiveness
- Early adoption of new ideas
- High risk, high reward mindset

Why do stress testing?

**To assess the
adequacy of financial
resources**

**To articulate risk
tolerance**



**To test readiness for
a range of scenarios**

**To enable the Bank to
take risk confidently**

Using stress tests in reserve management

What should a central bank stress testing framework allow us to do?

- Agree with Government the optimum balance sheet size and how to maintain it (eg income retention)
- Ask questions about central bank facilities and collateral in the context of a range of scenarios
- Provide the liquidity required through a range of economic scenarios and idiosyncratic events
- Assess idiosyncratic shocks against risk tolerance & existing capital resources
- Communicate to stakeholders what balance sheet support is available and what events would require Government agreement / risk sharing
- Provide quantified answers to a series of “what if” questions, both for crystallising risks and for horizon scanning purposes
- Compare core “severe but plausible” stress scenarios, which define risk tolerance, against a range of potential events, to understand balance sheet resilience

Bringing stress testing to life

What scenarios do we want to be able to tolerate, and how do we translate that into a balance sheet stress?



Stress scenarios

- What do we want to be able to withstand?
- Numerical or descriptive?



Balance sheet expansion

- Increase in BAU facility usage
- Activation of contingent facilities
- Firm behaviour



Counterparty default

- Assumptions about default behaviour & collateral management
- Large firms vs multiple small

- There are no facts about the future, only probabilities.
- How do we observe our tolerance for a fatal risk – one that would Bankrupt the organisation (reputationally, financially, operationally, culturally). Ensure the probability and impact of such events are minimal. Invest time and approach with continuous debate and refinement.
- Many of us must self-insure Financial Stability risks, there is no one to risk share with except government...
- **Where to focus on the scale of tolerating to eliminating risks?**
- **How good is the understanding and communication of risks internally? Do you have a consistent approach**