Relations between Treasury, Central Bank and the Banking Sector

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International Monetary Fund
Fiscal Affairs Department

Holger van Eden

Deputy Division Chief

Public Expenditure Management Division II

Fiscal Affairs Department

E-mail: hvaneden@imf.org

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Outline of Presentation

- Traditional relationship Treasury-CB-Banks
- Consequences of traditional relationship
- The Modern Institutional Framework
- Requirements of Modern Treasury Management
- Short- and Long-term Impacts on CB + Banks
  - TSA development
  - Active cash management
- New relationship Treasury - Banks
- New relationship Treasury-CB
- Two special institutional issues

Traditional Roles/Relations Treasury-CB-Banking Sector

- State Treasury: mainly government payment office; provision of advances to departments and agencies, constrained budget execution + arrears, no active cash management; very partial TSA;
- Multiple roles Central bank:
  - Monetary policy
  - Government’s banker (cashier, variety of transaction accounts, payment processing, lender (of last resort))
  - Fiscal agent: cash and debt management
  - Inter-Bank Settlement
- Commercial Banks: provide banking services to government departments and agencies; hold substantial government liquidity

Consequences of traditional approach for CB and Banks

- **Excess government liquidity**: costly to government and beneficial for banking sector and CB (often implicit subsidy, because balances not remunerated))
- **Government cash flows cause considerable volatility in money market and to bank liquidity.** Can disturb monetary policy and liquidity management banks.
- CB implementation of cash and debt management can interfere with monetary policy goals and operations
- Mopping up excess liquidity in banking system can be costly to central bank
- **Central bank and banks remuneration not linked to actual activities for government**
- CB lending to government increases high-powered money >>> potentially inflationary

Modern institutional framework – clear separation of roles

- **Central Bank focuses on monetary policy** and limited banking services, inter-bank settlement, and does not lend to government (or only very short-term)
- **Treasury becomes a real treasury!!,** pools all government liquidity, facilitates unrestricted execution of the budget and performs active cash and debt management on financial markets without recourse to central bank
- **Banking sector provides banking services** to departments and agencies on a **transparently** costed manner, through competitively tendered minimum standard service agreements >>> extent depends on degree of centralization of government payment system

Main requirements for Modern Treasury Management (1)

1. A **comprehensive** Treasury Single Account (TSA) for direct pooling of all government liquidity, held preferably at the central bank >>> Immediate transfer of all government revenues to TSA, including of so-called “own-revenues” of line ministries and agencies
2. **A government direct payments system**, centralized through a Treasury-managed TSA, or decentralized by ministries and agencies through zero-balanced bank accounts connected to the TSA
3. A linked Treasury-managed integrated financial management information system (**IFMIS**), allowing management, monitoring, control and reporting of budget execution and account balances
4. In case of indirect payment system, commercial banks need the capacity to perform **sweeping** operations with the central bank, and provide electronic payments services
5. A **cash flow forecasting** system (requires an IFMIS, an intelligence network, and in-house data analysis and forecasting capacity).

Requirements for Modern Treasury Management(2)

7. **Treasury capacities** (systems, staffing) **and organizational structure** need to be substantially enhanced,
8. **Financial markets** need a certain level of development and liquidity to offer required financial instruments
9. **Active cash management**: use of appropriate short-term financial instruments, both at the liability and at the asset side, to ensure availability of cash and minimize borrowing cost
10. **Targeting** of a remunerated, low an stable TSA balance
11. **New coordination structures** (for payment system, cash forecasting, and importantly for needs (with debt management, Central Bank, other parts of government)
12. **A well-sequenced implementation plan** needs to be developed

Before one starts:

- Central bank must agree to change in roles and responsibilities
- Various models and approaches possible – link to existing national structures

Impact of TSA on CB + Banks

- **Initially:** shift of implicit subsidy from Banks to CB, tightening of monetary conditions
- Central Bank benefits twice: liquidity holdings + money creation

>>> opportunity to negotiate remuneration on TSA balance

>>> reason in some countries to implement TSA gradually (especially state banks are often vulnerable)

- Requires modernization payment (and accounting) systems:

>>> two models: centralized or decentralized payment system

- CB and Banks will want to negotiate service contracts for payment services and zero-balancing

>>>opportunity to provide market-based remuneration to CB and banking sector

TSA and Payment Processing Combinations

	Central Bank responsible for banking operations	**Commercial banks responsible for banking operations**
Treasury responsible for payment processing	• France • USA • Many developing countries post-reform	• USA
Spending Units responsible for payment processing	Australia (in part)	• UK • Australia (in part) • New Zealand

Impact of Active Cash Management on CB + Banks

- **Initially**: reduction of TSA balance leads to lower profitability for CB, and monetary easing

>>> hurts CB profitability twice, end of implicit subsidy CB and monetary policy needs to be tightened

- **Long-term**: Low and Stable TSA balances lead to government cash flows no longer disturbing money market conditions/monetary policy

>>> provides much more stable environment for CB monetary policy and banks' funding requirements

New Relationship Treasury - Banks

- Depends very much on chosen payment system
- Under centralized payments, banks usually still used for revenue collection – requires service agreement
- In decentralized (or mixed) payment system also service agreement for payment services:
  - Need for zero-balancing
  - Need for remuneration of actual banking services provided – transaction basis
  - Price determination through competitive tender
  - Treasury to set minimum service standards
  - Line ministries can negotiate special needs
- Banks often main counterpart on financial markets

>>> requires coordination of issuance and product standards, market facilities, jointly with CB

New relationship Treasury – CB under modern treasury management

Less interdependence, clearer remuneration CB, still some banking and fiscal agent roles CB

>>>increased need for policy and operational coordination, and information exchange

- Policy: (1) monetary policy (2) debt and cash management, (3) financial market development
- Operations: (1) open-market operations, (2) debt and cash management operations, (3) exceptional payment and receipts flows
- Information exchange: (1) cash flow forecasts, (2) flows over the TSA (3) money and capital market developments

Framework for Treasury-CB

- Legal basis, memorandum of understanding, service level agreement – from general to more specific

- Coordination at various levels
  - Minister of Finance/Governor
  - Senior ministry and central bank officials
  - Standing committees
    - Debt Management
    - Treasury Cash Flow
  - Technical working groups
  - Operational managers and staff

- NB: issues outside the Treasury realm also require coordination (macrofiscal policy, economic forecasting, etc.)

Content of Service Level Agreement

- Types and Regularity of Communications
- Auction timetable and any changes to it
- Transaction performance (direct payment, settlement)
- Details of information flows
- Remuneration basis banking services
- Possibly: maximum amount and maturity CB borrowing to government
- Exchange of risk management information
- Coordination of business continuity planning
- Agreement on regular review of the agreement

TSA at CB or large State-owned bank?

- Both enable cash pooling
- With active cash management both would limit impact on money markets/monetary policy
- State-owned bank may be more able to provide banking services (larger network)

However:

- Additional layer in coordination and information exchange Treasury – CB
- Treasury Management influenced by State-owned Bank profitability and other public sector task
- Higher credit risk
- Often in-transparent remuneration; no competition from commercial banks

Treasury bills or central bank bills?

- Important question in some countries
- Helpful for market development if only one instrument
  - Different maturities will help
- Arrangements can be made for using Treasury bills for both public debt and monetary management
  - Coordination necessary to provide adequate stock for CB
  - Can require “blocked” account of government
  - Mechanism to inform market on T-bill purchase CB
  - Sharing of cost often a difficult issue

Thank You!