Bank of Israel
Monetary Committee Secretariat

**Summary of the Monetary Committee discussions
on October 1 and 10, November 12, December 23, 2013 and January 7, 2014
on management of the foreign exchange reserves**

Decision on changes in investment policy guidelines for foreign exchange reserves

Following the end of the consultation process with the Minister of Finance, it was decided to make changes to the investment policy guidelines that the Monetary Committee requested due to (1) the definition of the risk profile of the foreign exchange reserves and (2) the integration of the foreign exchange purchases which are intended to reduce the impact of natural gas production on the exchange rate, in the foreign exchange reserves investment portfolio.

Background

The Committee decided, subject to consultation with the Minister of Finance, to change the foreign exchange reserves investment policy guidelines. The Committee's decisions were:

- To add a formal definition of the foreign exchange reserves' risk profile to the guidelines.
- To update the investment rules detailed in the guidelines in accordance with the profile defined.
- To take into account the risk profile of foreign exchange purchases which are intended to reduce the effect of natural gas production on the exchange rate ("Dutch disease"). The risk profile of these purchases is different than that of the investment of the rest of the reserves, as their investment horizon is longer.
- To make changes in the wording of the guidelines which do not have an investment-related impact.

Appendix 1 presents the changes in the investment rules after they were revised in accordance with the risk profile defined.

The proposed changes in the guidelines were submitted to the Minister of Finance on November 18, 2013, for consultation, as required by Section 40(b) of the Bank of Israel Law, 5770-2010.

With the end of the consultation process with the Ministry of Finance, the revised guidelines came into effect on January 7, 2014.

Participants:

Members of the Monetary Committee
Dr. Karnit Flug, Governor of the Bank of Israel and Chairperson
Prof. Alex Cukierman
Prof. Reuben Gronau
Prof. Rafi Melnick

Prof. Nathan Sussman[1], Director of the Research Department (except for the discussion on January 7, 2014)
Mr. Barry Topf[2], Senior Advisor to the Governor on Monetary Policy (participated in the discussions on October 1 and 10, 2013)

Other participants

Mr. Andrew Abir, Director of the Market Operations Department
Mr. Eddy Azoulay, Chief of Staff to the Governor (except for the discussion on January 7, 2014)
Mr. Tal Biber, Head of Markets Division in Market Operations Department
Mr. Mickey Blank, Deputy Head of Dealing Unit in Market Operations Department
Ms. Francoise Ben-Zur, Head of Finance Division in Market Operations Department
Ms. Guenia De Mayo, Head of Risk Management Unit in Market Operations Department
Mr. Roee Levy, Economist in Risk Management Unit in Market Operations Department
Mr. Ilan Socianu, Assistant to Secretary of the Monetary Committee and the Supervisory Council
Mr. Yoav Soffer, Acting Spokesperson of the Bank of Israel (except for the discussion on January 7, 2014)
Ms. Esti Schwartz, Secretary of the Monetary Committee and the Supervisory Council
Ms. Tida Shamir, General Counsel (participated in the discussion on January 7, 2014)

[1] Prof. Sussman began to serve as a Monetary Committee member on November 1, 2013.
[2] Mr. Barry Topf ceased to serve as a Monetary Committee member on November 1, 2013.

APPENDICES

Appendix 1: Changes in investment rules

Section in original version	Section in revised version	Rule that was changed/added	Original	Change
	4	Formal definition of risk profile		The risk profile will be established such that given the 5 percent of the worst outcomes, the average loss will not be greater than 400 basis points over a 1-year horizon.
4(a)2	5(a)2	The maximum percentage of the reserves permitted to be invested in mortgage-backed securities (MBS)	5%	6% (includes ABS[3])
4(a)6	5(a)6	The maximum percentage of the reserves permitted to be invested in equities	6%	12%
4(d)3	5(c)3	The maximum amount that may be invested in currency positions for short and medium terms	The amount approved by the Committee	Up to 2%
4(d)1	5(d)1	Investment in currencies of countries with credit rating group of BBB	-	Only with specific approval of the Monetary Committee
4(d)2	5(d)2	Investment in bonds and CDs issued by, or guaranteed by a government, with major credit rating category of BBB	-	Only with specific approval of the Monetary Committee, limited to 1% of the reserves
4(d)3	5(d)3	Maximum percentage of reserves permitted to invest in PSE[4] bonds	10%	15%
4(d)3	5(d)3	Investment in PSE bonds rated below AA–	-	Limited to 1% of the reserves
	5(d)4	Investment in corporate bonds with major credit rating category of at least BBB	-	Limited to 6% of the reserves
4(d)4	5(d)5	The maximum percentage of the reserves permitted to be invested in bonds and deposits of international financial institutions	10%	15%
4(d)4	5(d)5	Activity with banks and brokers with major credit rating category of at least BBB	-	Limited to only DVP[5] activities
	5(e)	Minimum percentage to be invested in government bonds		45%

[3] Asset-backed security.
[4] Public sector entity.
[5] Delivery versus payment.

Appendix 2

Bank of Israel
Monetary Committee Secretariat

January 7, 2014

Foreign Exchange Reserves: Investment Policy Guidelines[6]
In effect from January 7, 2014

In accordance with Section 40(b) of the Bank of Israel Law, 5770-2010, the Monetary Committee is to establish the guidelines for the investment policy of the foreign exchange reserves.

1. **Basic guidelines derived from the goals of holding the reserves**

   The investment policy of the reserves portfolio is based on the main goal of achieving the Bank of Israel's objectives and proper fulfillment of its functions as they are detailed in the Bank of Israel Law. Subject to that, the investment policy is also based on the following goals:

   a) **Maintaining the purchasing power of the reserves:** This principle is interpreted as preserving the value of the reserves in terms of measurement currency chosen by the Bank—the numeraire (see 3 below).
   b) **Managing the reserves with a high level of liquidity:** A large part of the reserves are to be invested in assets that can be liquidated rapidly at short notice and without negatively impacting their value. The precise level of liquidity is to be increased to the extent that the actual level of reserves relative to the desired level is low (5(e) below).
   c) **Achieving an appropriate return on the reserves portfolio,** at an acceptable level of risk, to the extent that it does not negatively impact the achievement of the previous goals (see 4 below).

2. **The division of work between the Monetary Committee, the Foreign Currency Committee, and the Markets Operations Department**

In implementing Section 40(b) of the Bank of Israel Law, the Committee made a distinction between establishing the guidelines and periodic monitoring, and setting the detailed instructions for the day to day management of the portfolio.

The Monetary Committee will set the guidelines, in consultation with the Minister of Finance as established by law, will update the guidelines to the extent necessary, and will monitor the implementation of the investment policy by the Markets Operations Department.

The Foreign Currency Committee Committee—an internal Bank of Israel committee headed by the Governor—will translate the guidelines into the detailed foreign exchange reserves investment policy.

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[6] The characteristics of the reserves portfolio are reported to the public in an annual report published on the Bank of Israel website.

The Market Operations Department will implement the investment policy, within the framework of degrees of freedom which will be set periodically by the Monetary Committee or the Foreign Currency Committee, and will report to the Monetary Committee and the Foreign Currency Committee on a quarterly basis on the implementation of the policy: developments in international markets and their impact on the management of the reserves, the investment decisions reached by the Department, the portfolio's rate of return, and the financial and other risks to which the portfolio is exposed.

The Market Operations Department will advise the Monetary Committee and the Foreign Currency Committee on fulfilling their functions, through position papers and suggestions for discussion in the Committees.

The Monetary Committee will approve and update periodically the division of authorities regarding the investment policy of the foreign exchange reserves.

3. The measurement currency for the holding rate of return on the foreign exchange reserves and the principles for its determination

The measurement currency for the holding rate of return on the reserves—hereinafter, the numeraire—is a basket of currencies and its composition allocation[7] is decided by the Monetary Committee. The allocation of the numeraire is set according to principles which reflect the goals of holding the reserves.
The principles according to which the composition of the numeraire is set are:

a) The currency composition of actual imports, and of imports expected in an emergency situation
b) The composition of the short and medium term external debt
c) Assessments regarding the liquidity of the various currencies in which investment is possible.

The composition of the numeraire is also examined from the perspective of the currency composition of foreign exchange reserves portfolios of all central banks of countries that are IMF members, as reported by the IMF.

The composition of the numeraire will be set at the end of each year by the Monetary Committee, on the basis of the Market Operations Department’s recommendation, in accordance with changes in domestic and global market conditions. If there are significant changes in one or more of principles (a)–(c), the composition of the numeraire will be brought to discussion by the Monetary Committee.

The reserves portfolio holding rate of return is measured in terms of the numeraire, so that the currency basket which makes up the numeraire is seen by the reserves portfolio managers as a risk-free currency composition.

4. The risk profile

[7] The numeraire is defined in terms of units of currency (i.e., X dollars, Y euro, and Z pound sterling). The ratio between the currency units (in the above example, X:Y:Z) is determined by the currency composition of the portfolio (in the above example, % of dollars in the portfolio, % euro, and % pound sterling), which is set by the Committee and the exchange rates of the numeraire currencies at the time of the decision.

The risk profile determines the maximum level of risk that the Monetary Committee is willing to accept in order to achieve the goals of holding the reserves. In establishing the risk profile, scenario analysis and a range of analytical tools to measure risk, such as VaR, CVaR, and others should be used. The risk profile is to be set by the Committee on a periodic basis in accordance with the changing conditions in the global capital markets.

The risk profile will be set so that given the worst 5 percent of outcomes, the average loss will not be greater than 400 basis points over a 1-year horizon.

5. The rules for managing the financial risks of the reserves

The rules for managing the financial risks to which the reserves are exposed, and their asset allocation, are to be set in accordance with the goals of the investment policy of the reserves (Section 1 above) and subject to the risk profile set by the Monetary Committee (Section 4). The asset allocation of the foreign exchange reserves will be approved at least once a year by the Monetary Committee.

a) *The types of assets approved for use in managing the reserves are:*
   1. Bonds (including bonds with fixed interest, with variable interest, and CPI-indexed bonds)
   2. Mortgage-backed securities (MBS) and asset-backed securities (ABS), a maximum of 6% of total reserves
   3. Tradable Certificates of Deposit (CDs)
   4. Fixed term deposits
   5. Commercial Paper (CP)
   6. Equities, a maximum of 12% of total reserves
   7. Derivatives whose underlying asset is permitted for investment.

b) *Management against a benchmark*
   Control over most features of the financial risk of the reserves is anchored in their management against a system of benchmarks. The rules for managing the financial risks of the reserves generate the currency allocation of the benchmarks, the features of their price risk (such as duration) in each currency, and the asset types included in it. The investment returns of the portfolio managers are measured against these benchmarks.

c) *Currency risk:*
   The currency exposure of the reserves is set by:

1) The composition of the numeraire.
2) Strategic currency positions relative to the composition of the numeraire: The extent of the strategic currency positions is limited to 10 percent of total reserves. The composition and amounts of the positions will be set by the Monetary Committee.
3) Short and medium term currency positions relative to the composition of the numeraire: Their amount is limited to 2 percent of the total reserves. The composition and amounts of the positions will be set by the Market Operations Department.

d) *Credit risk:*
   In order to limit the credit risk inherent in day-to-day management of the reserves portfolio, the Monetary Committee set the following rules:

1. Investment is permitted in the currency of countries for which their major credit rating category is at least A. Investment in countries for which their credit rating group is BBB requires the specific authorization of the Monetary Committee.
2. Investment in bonds and commercial paper issued by governments, or with government guarantees, is permitted if their major rating category is at least BBB. Investment in the BBB major rating category is limited to 1 percent of total reserves. Investment in such assets, if their major credit rating category is BBB, requires the specific authorization of the Monetary Committee.
3. Investment in bonds of public sector entities (PSE) is limited to a maximum of 15 percent of total reserves, and only in bonds those whose major credit rating category is at least A. Investment in such assets, if their major credit rating category group is below AA, is limited to 1 percent of total reserves.
4. Investment in corporate bonds is limited to 6 percent of total reserves, and only in bonds whose major credit rating category is at least BBB.
5. Investment in bonds and deposits of international financial institutions is limited to 15 percent of the reserves.
6. The exposure of the reserves to the international banking system should not be greater than 10 percent of total reserves, and that is only to banks whose major credit rating category is at least A. Activity with banks and brokers whose major credit rating category is BBB is limited to DVP[8] (delivery versus payment) alone.

[8] DVP activity is when the payment and the asset are transferred between the sides at the same time and thus the credit risk in such activity is essentially zero.

e) Liquidity risk:

In order to provide an immediate response to the financial problems which arise during emergencies, a large portion of the reserves should be invested in assets that can be liquidated in large amounts at short notice and without negatively impacting their realization value.

The assets in which the reserves are invested are classified into 3 levels of liquidity:

1. Assets that can be realized within a week without negatively impacting their realization value.
2. Assets that can be realized within a month without negatively impacting their realization value.
3. Assets that can be realized within six months without negatively impacting their realization value.

There is a minimum level of investment in the two highest liquidity levels, and there is a maximum threshold for the third level. Classification into the various liquidity levels can change due to changes in market conditions. In order to meet the liquidity demands, the Committee established that at least 45 percent of the total reserves are to be invested in government bonds.

f) Active management and compliance rules:

The reserves portfolio is actively managed within the framework of limited and well defined degrees of freedom, as long as the investment policy adheres to the guidelines.

6. The nonfinancial risks inherent in managing the reserves

In determining the investment policy for the reserves, there must be taken into account the exposure of the Bank and of the portfolio to the various nonfinancial risks inherent in investing the reserves—reputation risk, legal risk, political risk, operational risk, and so forth.

7. Measuring returns and reporting them

The reserves are managed with transparency. The Market Operations Department shall report periodically to the Monetary Committee (see 2 above) on the amount of the reserves and changes in them, the currency composition, changes in currency positions, the asset allocation, portfolio duration, country exposure, credit risk, liquidity risk, and the return on the portfolio and its various components. The report should include an analysis of the current developments in the financial markets and their effect on the management of the reserves.