Bank of Israel
Monetary Committee Secretariat

September 24th, 2012

Summary of Monetary Committee discussions on February 7th and 21st, March 6 th, 13th, and 26th, April 17th, and September 12th, 2012 regarding the principles for determining the desirable level of foreign exchange reserves and the guidelines for their investment policy

Decisions

1. The committee discussed the existing principles by which the Governor determines the desirable level of foreign exchange reserves, and found that they should be left unchanged (see Appendix I).
2. Following consultations with the Minister of Finance, as set forth in Section 40(b) of the Bank of Israel Law, 5770-2010, guidelines have been set out for the foreign currency investment policy, as appears in Appendix II of this document.
3. The appendix to the guidelines, regarding the division of authorities between the Monetary Committee, the Foreign Currency Committee and the Market Operations Department is not a component of the guidelines.
4. In general, during consultations with the Minister of Finance as part of outlining the guidelines, we must strive for the Committee's position to be sent to the Minister at least one month before a final decision is made, unless circumstances dictate a shorter preparation time.
5. The Committee's decision of August 14th, 2012, regarding a change in the composition of assets included in each of the three liquidity components of the foreign exchange reserves will be implemented only after holding consultation with the Minister of Finance (see the Summary of Discussions of the Monetary Committee from August 14th, 2012, Section 4).

Background

The Bank of Israel Law, 5770–2010, section 40, states, "(a) The Committee, with the approval of the Minister of Finance, may revise the principles by which the Governor shall determine the desired level of Foreign Currency reserves over the long term ". The Committee discussed the existing principles and found that they should be left unchanged.

Section 40(b) of the Bank of Israel Law, 5770–2010, states, "The Committee, in consultation with the Minister of Finance, shall establish guidelines for the investment policy of the Foreign Currency reserves." Accordingly, the guidelines as formulated by the Monetary Committee were sent for consultations with the Minister of Finance on March 11th, 2012. As background to the guidelines document that was sent to the Minister of Finance for consultations, the Committee attached the principles by which the Governor decides upon the desirable level of reserves.

On March 25th, 2012, the Minister of Finance's response was received, asking for clarifications before reaching a final position, primarily concerning the principles for determining the desirable level (for which there is no requirement of consultation).

On April 22nd, 2012, the Committee sent the additional clarifications. The Minister of Finance did not send a response to the clarifications. Following the end of the consultation process with the Minister of Finance, as set forth in Section 40(b) of the Bank of Israel Law, 5770-2010, the Committee completed outlining the guidelines for the foreign exchange reserves investment policy.

Main points of the discussion:

1. **Reasons for holding reserves—**The Committee members discussed the main reasons for holding the reserves and the great importance of an appropriate level of reserves. (See more information in the attached paper.)

2. **Determining the appropriate level of reserves—**The Committee members agreed that it is proper to use the eclectic approach adopted by the Bank in calculating the appropriate level of reserves in Israel, which is based on international standards adjusted to the specific environment in which the Israeli economy operates. In times of national emergency, Israel is liable to need the reserves both in order to finance imports (according to the import months method, while taking into account the import of goods and services connected to the emergency situation), and in order to deal with potential needs on the part of the capital account, such as debt payments to foreign residents and so forth.

3. **The range of the desirable reserves level—**It was agreed that the Bank would take actions to change the reserves level only when the deviation from the range is significant and sustained, and only if these actions conform to achieving the Bank's objectives as set forth in the Bank of Israel Law—including price stability, support of other objectives of economic policy and supporting the stability of the financial system. Therefore, there is likely to be a situation where foreign exchange reserves may deviate from the desired level for extended periods of time.

4. **Cost-Benefit—**The Committee members asked to add that, in determining the reserves levels, the cost of holding the reserves is taken into account. It is relatively easy to measure the accounting costs of the Bank of Israel's activity in the foreign exchange market, and this is registered in the Bank's general ledger and constitutes a part of the profit and loss line in the Bank's balance sheet. However, there was agreement in the discussion that the measure of the benefits is complex, since it is hard to quantify and price their contribution to the economy, since *inter alia* their contributions would likely be critical during emergency situations whose character and severity are hard to know. (This is somewhat similar to the difficulty in quantifying the benefit of holding inventory in the military's emergency warehouses.) The fact that the likelihood of encountering crises is lower in countries that hold an appropriate level of reserves has been documented in the literature. In addition, when an economy does encounter a crisis, holding a proper level of reserves is expected to make it easier for it to deal with the crisis and to minimize its damage. A quantitative analysis of the benefit of reserves must therefore include the effect of holding them on the probability of encountering crises of different kinds and moderating the expected damages from the crisis as a result of the reserves existing at an appropriate level. Finally, measuring the cost of holding foreign currency reserves is problematic due to the fact that the measurement of the cost in shekel terms ignores the basic fact that the reserves are meant to serve as sources for financing imports or repaying debts in foreign currency during emergency times. Therefore, the test of their ability to fulfill their aim is in maintaining their value in foreign currency terms and not in terms of their purchasing power in shekels. There was agreement in the discussion that in light of the difficulties of a precise quantitative cost-benefit analysis of holding the reserves, in order to determine the appropriate reserves level, the Bank of Israel must continue basing itself on international standards adjusted to the specific environment in which the Israeli economy operates.

5. **Liquidity**—in the discussion on the guidelines, the Committee members emphasized the importance of maintaining a high level of liquidity in order to enable the realization of some of the foreign exchange reserves rapidly and without high costs. The investment of the reserves in liquid assets and in "deep" markets, such as the United States, enables the rapid realization of the reserves without concern of paying a high premium in case of realization.

6. **Conservatism in managing the reserves**—Committee members emphasized that due to the central role of the reserves in the economy, it is important to manage the reserves very conservatively, to allow maintaining the purchasing power of the reserves. Therefore, the aim of achieving an appropriate return does not stand on its own, but is subordinate to the principle of not allowing the achievement of the Bank's other objectives or of holding reserves to be harmed. Conservative management is expressed in the investment rules that are intended to minimize the possible risks to which the reserves are exposed. (See more information in the attached paper.)

7. **The investment policy guidelines—when outlining the investment policy guidelines**, the Monetary Committee wanted to use the guidelines set forth at the Bank of Israel in recent decades as a basis, combined with the necessary changes from the new Law. The Committee emphasized that these guidelines are appropriate as long as the reserves level is within the desired range set forth according to the principles of determining the desirable level of reserves.

8. **Authority and framework for managing the reserves**—The establishment of the Committee based on the new Law required defining the division of authorities between the existing and new entities related to determining the investment policy and management of the reserves: the Monetary Committee, the Foreign Currency Committee (an internal committee chaired by the Governor), and the Market Operations Department. It was agreed in principle that the Monetary Committee would outline in the guidelines the goals of holding the reserves and the risk profile required to meet these goals. Therefore, in the area of risk management, the Committee will determine the methods for defining the level of risk in the reserves portfolio, while the Foreign Currency Committee would translate this profile into investment rules that the Department would implement. (See more information in Appendix I of the attached paper.)

9. **Clarifications sent to the Minister of Finance pursuant to his request, regarding the principles for determining the desirable reserves level. (The consultative obligation did not apply to these principles.)**

9.1 The Committee presented assessments regarding reducing the likelihood of a crisis as a result of increasing foreign exchange reserves, which was created via the purchases made by the Bank of Israel since March 2008.

9.2 The Committee presented estimations regarding lowering the State of Israel's cost of raising capital as a result of increasing foreign currency reserves.

9.3 The Committee clarified that in light of the difficulties of conducting a precise quantitative cost-benefit analysis of holding reserves, the Bank of Israel bases its determination of the desirable reserves level on international standards adjusted to the specific environment in which the Israeli economy operates.

9.4 The Bank of Israel clarified that the Bank will take actions to change the level of reserves only if these actions conform to achieving the Bank's objectives as set forth in the Bank of Israel Law – including price stability, support of the other objectives of economic policy and support of financial stability.

10. **Clarifications sent to the Minister of Finance pursuant to his request, regarding the guidelines for the investment policy for foreign currency reserves. (The consultative obligation applies to outlining the guidelines.)**
It was clarified that the Bank of Israel's guidelines are to a great extent similar to those customary at other central banks in advanced economy countries.

Participants in the discussions:

Members of the Monetary Committee
Prof. Stanley Fischer, Governor of the Bank of Israel, Chairperson
Prof. Alex Cukierman
Dr. Karnit Flug, Deputy Governor of the Bank of Israel
Prof. Reuben Gronau
Prof. Rafi Melnick
Mr. Barry Topf, Senior Advisor to the Governor on Monetary Policy Issues

Other participants
Andrew Abir, Director of the Market Operations Department
Eddy Azoulay, Chief of Staff to the Governor
Tsila Billet, Assistant to Secretary of the Monetary Committee
Francoise Ben-Zur, Head of Finance Division in Market Operations Department
Irit Mendelson, Head of the Markets Division, Market Operations Department when some of the meetings were held. Currently, Director of the Accounting, Payment and Settlement Systems Department
Esti Schwartz, Secretary of the Monetary Committee
Tida Shamir, General Counsel

Appendix I. Principles for Determining the Desired Level of Foreign Exchange Reserves

1. **The appropriate level of foreign exchange reserves as an indicator of the economic strength of the country**

Countries hold foreign exchange reserves for three main purposes:
A. To enable the central bank to intervene in the foreign exchange market in circumstances in which (1) the exchange rate deviates from the range that is consistent with the economy's fundamental equilibrium; or (2) the foreign exchange market is not functioning adequately (market failure);
B. To enable the central bank to operate in the foreign exchange market in order to moderate the effect of large capital flows from either foreign or local residents, which are liable to undermine the stability of the financial markets, and thus harm the stability of the economy as a whole (a specific case of A);
C. To allow for the provision of sufficient foreign currency to the economy in an emergency situation (such as a war or a strong earthquake). In such circumstances, there will be a need to increase imports rapidly and by a significant amount in order to deal with the emergency, while exports may also be adversely affected and therefore this source of foreign currency will also be reduced. Under such circumstances, the government and the private sector will find it difficult to raise foreign currency abroad and the foreign exchange reserves will be left as the country's main source for financing in foreign currency.

Therefore, holding an appropriate level of foreign exchange reserves is considered by local and foreign financial institutions, companies, households and rating agencies as a main indicator of a country's economic resilience. The larger a country's foreign exchange reserves are, the greater the ability of policy makers to deal with unavoidable economic and political pressures. Furthermore, large foreign exchange reserves tend to reduce the rates of interest paid both by the government and by the private sector for financing from abroad. In short, in the eyes of the financial markets and of individuals, foreign exchange reserves at an appropriate level make an important contribution to the confidence in a country's ability to deal with economic, financial and political shocks to the economy.

2. **There are various approaches to the calculation of the appropriate level of foreign exchange reserves:**
    a. *Relative to import months*: For most of the post-World War II period, the appropriate level of foreign exchange reserves was measured in terms of "import months"—the number of months of imports that the reserves would be able to finance. This approach dominated as long as international capital flows were limited, and the main source of difficulties in foreign exchange was the current account of the balance of payments.
    b. *Relative to capital flows*: During the 1990s, it became clear that many financial crises were caused by large-scale capital flows, that is, disruptions in the capital account, rather than by disruptions in the current account of the balance of payments. At the end of the 1990s, wide use was made of the Greenspan-Guidotti rule, according to which a country's foreign exchange reserves should be at least as much as the country's foreign currency liabilities (of both the public and private sectors) during the coming twelve-month period, thus allowing a country to deal with a complete cutoff from sources of foreign currency for a period of one year. The 100 percent rule (according to which the reserves must be equal to the full amount of foreign currency liabilities for one year) was based on an empirical study—how

countries survived the financial crises of the 1990s and early 2000s: it was found that countries which operated according to the 100 percent rule were prone to fewer foreign currency attacks, and were better able to deal with them.

During the global crisis which began in 2007 it became clear that countries which held foreign exchange reserves exceeding 100 percent were better able to deal with the crisis. The main examples are Brazil, Russia, and South Korea. Each of those countries held foreign exchange reserves that exceeded 100 percent of their foreign exchange liabilities, and they used them effectively to stabilize the exchange rate and/or to maintain financial stability. It is currently recognized that foreign exchange reserves of between 100 percent and 200 percent of an economy's foreign currency liabilities are more effective than a reserves level which meets the Greenspan-Guidotti rule precisely.

c. *Relative to potential uses in the future (the eclectic approach)*: In calculating the appropriate level of foreign exchange reserves for Israel, the Bank of Israel adopted the eclectic approach, which is based on the potential uses of the reserves in an emergency. Clearly, in a time of national emergency, Israel will likely require reserves, both to finance imports (according to the import months approach, including imports of goods and services related to the emergency situation) as well as to deal with capital flows – payments of existing debts to foreign residents, with potential capital flows.

Based on the range of factors listed above and in accordance with the current conditions in Israel's economy, the Governor set the desired level of reserves at a range of $65–90 billion.

Additionally, in setting the level of foreign exchange reserves, the cost of holding the reserves[1] was taken into account. However, in terms of a risk-reward analysis of holding the reserves, it is difficult to measure quantitatively the advantages and benefits of holding them. The contribution of the reserves to the economy cannot be quantified and priced, among other reasons because their contribution may be critical in emergency situations whose nature and severity are difficult to predict.

[1] The accounting cost of the Bank of Israel's activity is recorded in the Bank's general ledger. At the same time, the Bank's accounts do not include the expected profit (in terms of stability of the economy) derived from the expected use of the reserves in various situations in the future, nor that derived from market assessments that larger reserves contribute to the economy, as described above.

3. Israel's actual level of foreign exchange reserves

Implementing the eclectic approach, which takes into account both the need to import goods and services as well as the potential capital flows related to a crisis situation, must take into account Israel's unique geopolitical situation, which requires a higher level of reserves relative to economic variables which are generally taken into account when calculating the appropriate level of foreign exchange reserves.

In 2011, the average level of Israel's foreign exchange reserves was 139 percent of the economy's short term external debt, and was 8.8 months of imports (Table 1).

Table 1 – The Level of the Reserves* Relative to Various Aggregates, 1999–2011

	Average level of reserves ($ million)	Reserves to Capita ($)	Imports (months)	Gross external debt	Short-term external debt	Unindexed local-currency assets (M2)	Gross domestic product
				Reserves as percent of aggregate			
1999	21,687	3,493	5.4	34	78	55	20
2000	22,277	3,498	4.6	33	74	46	18
2001	23,715	3,644	5.5	35	80	43	19
2002	24,328	3,669	5.8	34	77	48	22
2003	24,447	3,623	5.6	33	81	47	21
2004	26,530	3,862	5.3	34	84	48	21
2005	27,451	3,927	5.1	35	84	47	20
2006	28,137	3,954	4.8	32	76	45	19
2007	29,179	4,028	4.1	32	73	38	17
2008	32,924	4,442	4.1	37	82	34	16
2009	51,981	6,883	8.4	56	123	50	27
2010	64,939	8,439	8.8	61	119	57	30
2011	76,052	9,735	8.8	70	139	58	32

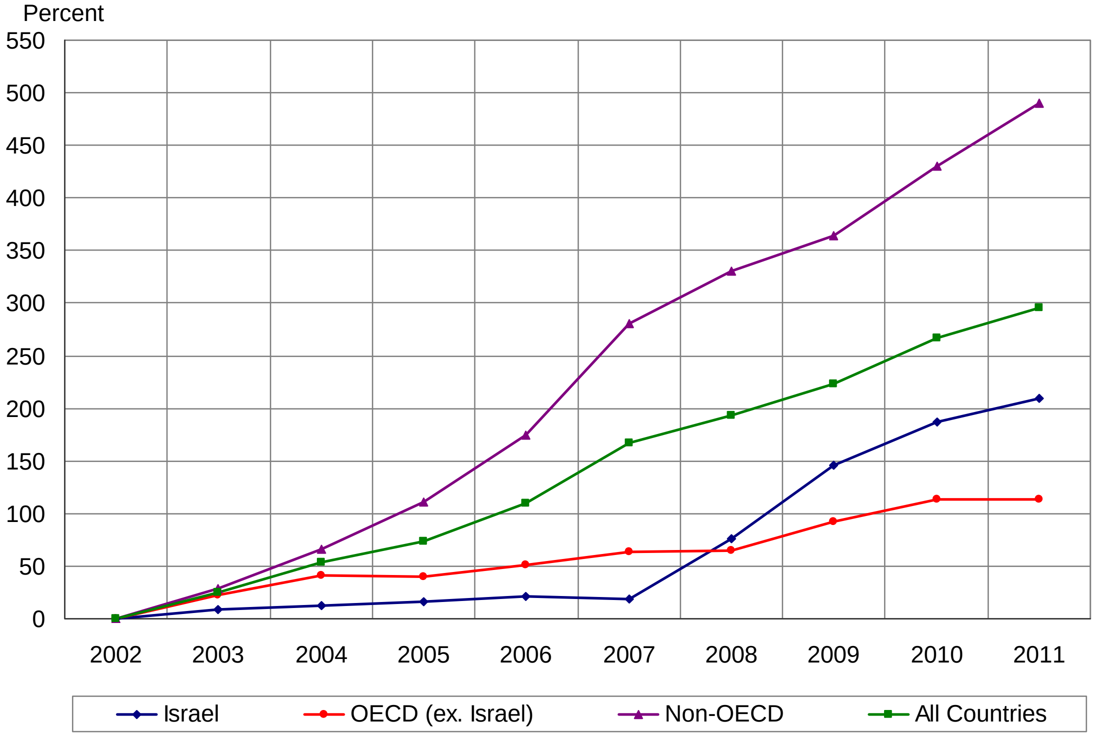
SOURCE: Bank of Israel, The Central Bureau of Statistics, and reports from the banks.

* The reserves include SDRs and the balance of Israe's Reserve Tranche in the IMF.
** External debt and imports data are updated till the third quarter of 2011 (import data is the sum of the last 4 quarters)

An international comparison of Israel's foreign exchange reserves

During the past decade, Israel's foreign exchange reserves increased by 210 percent (Figure 1); nearly all the growth occurred in the past 4 years. This rate is higher than the rate of growth of foreign exchange reserves of advanced countries (110 percent), and lower than the rate of growth of foreign exchange reserves of developing countries (296 percent) and of global reserves (490 percent).

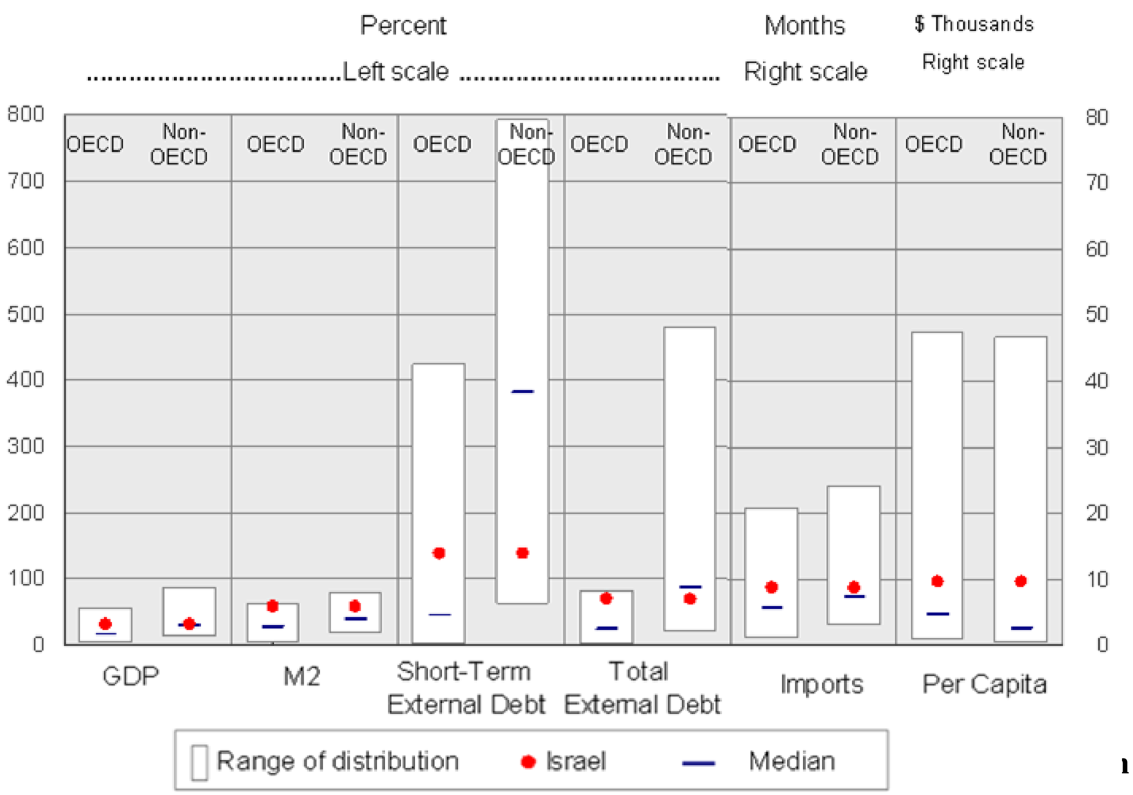
Figure 1 – Changes in the Foreign Exchange Reserves of Various Groups of Countries and of Israel, 2002–11[2]



Israel's level of reserves, relative to most aggregates (Figure 2), is above the median of both advanced and developing countries. However, relative to most aggregates, the level in Israel is not in the upper level of the distribution range. It should be noted that the ratio of Israel's reserves to its short term external debt, at 137 percent, is notably lower than the median for advanced countries (380 percent) but higher than the median for developing countries (45 percent).

[2] The countries in the OECD group are: Australia, Canada, Chile, the Czech Republic, Denmark, Hungary, Iceland, Korea, Mexico, New Zealand, Norway, Poland, Sweden, Switzerland, and the United Kingdom. The countries in the non-OECD group are: Bulgaria, Brazil, China, India, Latvia, Lithuania, Malaysia, Romania, Russia, Singapore, South Africa, Taiwan, Thailand, and the United Arab Emirates.

Figure 2 – The Level of Reserves at the End of 2011 Relative to Various Aggregates, Israel Compared to Other Countries



It is important to note that, as explained in Section 53 of the Bank of Israel Law, the intervention of the Bank of Israel in the foreign exchange market, in order to fulfill its functions and attain its objectives, may lead to a deviation in the actual level of the reserves from their desirable level. Government and banking system activity can also lead to such a deviation. In general, the Bank will act to change the level of the reserves only when the deviation is significant and prolonged, and only if such action is in line with attaining the Bank's objectives as established in the Bank of Israel Law, which include maintaining price stability, supporting other economic policy goals, and supporting the stability of the financial system. Thus, the foreign currency reserves could deviate from the desired level for extended periods of time.

Appendix II. Foreign Exchange Reserves: Investment Policy Guidelines[3]

In delineating the investment policy guidelines of the foreign exchange reserves in accordance with Section 40(b) of the Bank of Israel Law, 5770-2010, the Monetary Committee based its work on the guidelines established at the Bank of Israel over the past decades, together with changes required by the new law. These guidelines are appropriate as long as the level of the foreign exchange reserves is within the desirable range which was set in accordance with the principles detailed in Appendix I.

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 principles:

   a) **Maintaining the purchasing power of the reserves, or in other words,** the extent to which the Bank can use them when needed. Currently, this principle is interpreted as preserving the value of the reserves in terms of the neutral currency composition chosen by the Bank – the numeraire. (See 3 below).
   b) **Managing the reserves with a high level of liquidity.** That is, investing an adequate part of the reserves in assets which can be liquidated in large amounts at short notice and without impacting their realization value. The precise level of liquidity required is affected by several factors, including the actual level of reserves relative to the desired range (4(f) 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 allocation of responsibilities 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 detailed instructions for managing the portfolio and its day to day management. This distinction led to the following division of functions:

The functions of the Monetary Committee are:

a. To approve and update the guidelines presented in this document, in consultation with the Minister of Finance, as established in the new law.
b. To approve and update the division of authorities regarding the investment policy of the foreign exchange reserves between the Committee, the Foreign Currency Committee, and the Markets Operations Department. The Monetary Committee is authorized to delegate its authority to the Foreign Currency Committee and the Markets Operations Department.
c. To track the implementation of the investment policy by the Department.

[3] The characteristics of the reserves portfolio, which are derived from the guidelines, are reported to the public in the annual report, which also details the returns on the investment of the foreign exchange reserves. The annual report will be published on the Bank of Israel website on March 31, 2012.

The function of the Foreign Currency Committee—an internal Bank of Israel committee headed by the Governor—is to translate the guidelines into the foreign exchange reserves investment policy.
The functions of the Markets Operations Department are:

a. To implement the investment policy, within the degrees of freedom granted by the Monetary Committee or the Foreign Currency Committee.
b. To report to the Monetary Committee and the Foreign Currency Committee on a quarterly basis on the implementation of the policy, including the portfolio's rate of return and the investment decisions reached by the Market Operations Department, as well as on current developments in international markets and their impact on the management of the reserves.
c. To advise the Foreign Currency Committee and the Monetary Committee on fulfilling their functions, as listed in the previous section; this through, among other things, position papers and suggestions for discussion in the Committees.

3. The neutral currency composition of the reserves and the principles for its allocation

The neutral currency composition—hereinafter, the numeraire—is a basket of currencies and the principles for its composition allocation are decided by the Monetary Committee, as described below. The numeraire serves as an anchor for managing the currency risk of the reserves. The reserves portfolio holding rate of return is measured in terms of the numeraire, so that the reserves portfolio managers see it as a risk-free currency composition.
The allocation of the numeraire is set according to principles which reflect the goals of holding the reserves. This allocation will be examined at least once a year, and the Department will update it according to these principles, if needed. Currently, 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. The currency composition of all foreign exchange reserves portfolios of central banks of IMF member countries, as reported by the IMF
d. Assessments regarding the liquidity of the various currencies in which investment is possible.

The emphasis placed on the various factors listed above is likely to change from year to year, in accordance with what occurs in the economy and in global markets.

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

The investment policy of the reserves defines general rules for managing their financial risks, including the general rules for constructing a benchmark for the reserves and compliance rules in various areas, as explained below. The existence of the rules is not a goal in and of itself, but is a means to achieving the goals defined in section 1 of the guidelines. The risk/reward profile by which the reserves portfolio is invested should be in line with those goals. The risk/reward profile is derived from:

a) The general rules defined in the guidelines
b) The conditions in global financial markets and the global economy
c) The size of the reserves, specifically the actual level of reserves in relation to the desirable range

d) The features and probabilities of various scenarios, the realization of one or more of which would require selling a sizable part of the reserves.

The general rules and the primary risks in managing the reserves are:

a) *Management against a benchmark*

Control over most features of the financial risk to which the reserves portfolio is exposed is anchored in its management against a benchmark. The rules for managing the financial risks of the reserves generate the currency allocation of the benchmark, the features of its price risk (such as duration) in each currency, and the asset types included in it from the need to invest the reserves precisely in accordance with the benchmark; this is so that the benchmark will be, from the perspective of reserves portfolio managers, a risk-free portfolio.

b) *Currency risk:*

The currency exposure of the reserves will be set by:

1) The composition of the numeraire
2) Strategic currency position: Following the debt crises in the US and Europe, and in light of expectations regarding a transfer of economic activities to countries in Asia, the reserves were diversified, beginning in 2010, among currencies of developing countries, in addition to those which comprise the numeraire. The extent of the strategic currency positions is limited to 10 percent.
3) Short and medium term (up to three months) currency positions which are managed within a smaller deviation framework, which has been authorized by the Monetary Committee.

c) *Price risk:*

The level of price risk in each currency portfolio, measured by the duration of the portfolio, is set by the shortfall approach. Under this approach, a minimum future rate of return on the holding is set for a specific planning horizon. Since there is no certainty regarding the future holding period rate of return for the portfolio, the minimum level must also have a certain confidence level. The current parameters of the method are:

1. Planning horizon – one year
2. Minimum rate of return acceptable for that planning horizon: 0 percent
3. Probability that the actual holding period rate of return will be higher that the minimum return set: 99 percent

d) *Credit risk:*

Credit risk inherent in current management of the reserves portfolio is controlled by a system of rules and quotas. In order to maintain the purchasing power of the reserves:

1. Investment is permitted in the currency of a country with a credit rating of at least A.
2. Investment in bonds and commercial papers issued by governments, or with government guarantees, is permitted if their rating is at least A.
3. A maximum of 10 percent of the investment in bonds of public sector entities (PSE), only in those whose credit rating is at least AA+.
4. Investment in bonds and deposits of international financial institutions is limited to 10 percent of the reserves.
5. The exposure of the reserves to the international banking system should not be greater than 10 percent of total reserves, and that is only with banks whose credit rating is at least A.

e) Liquidity risk:
As stated, an appropriate portion of the reserves should be invested in assets that can be liquidated at large amounts with short notice and without harming their realization value. In practice, the following thresholds were set:

1. A minimum for investing in assets that can be realized **within a week** without harming their realization value—including government bonds of the US, Germany, France and the Netherlands.
2. A minimum for investing in assets that can be realized **within a month** without harming their realization value—including, in addition to those assets that can be realized within a week, deposits, CDs and Reverse Repos with a maturity of within a month, CP, inflation linked assets, Eurobonds longer than one year (bonds sold in financial markets outside the country in whose currency they are denominated), all both in euros and in dollars.
3. A maximum for investment in less liquid assets: external managers, deposits, CDs and Reverse Repos with a maturity of more than three months, and GNMA mortgage-backed securities.

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.

Given the risk management rules, the types of assets approved for use in managing the reserves are:

1. Bonds (including bonds with fixed interest, with variable interest, CPI-indexed bonds and mortgage-backed securities)
2. Tradable Certificates of Deposit (CDs)
3. Fixed term deposits
4. Commercial Paper (CP)
5. Equities
6. Derivatives whose underlying asset is permitted for investment.

In addition, special limitations are in place:

1. At the very most, 3 percent of the reserves portfolio will be invested in equities.
2. At the very most, 5 percent of the reserves portfolio will be invested in GNMA mortgage backed securities (MBS).

5. The non-financial 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 non-financial risks inherent in investing the reserves—reputation risk, legal risk, political risk, operational risk, and so forth.

6. Measuring returns and reporting them

The reserves are managed with transparency and accountability, insofar as this conforms to the proper and professional management of the portfolio, and is not liable to harm the fulfillment of the Bank's roles or achieving its goals. The Department's report to the Committee (2. above) includes returns for the relevant periods.