Bank of Israel
Monetary Committee Secretariat

Summary of the monetary discussions held at the Bank of Israel regarding management of the foreign exchange reserves

Integrating High Yield bonds into the reserves portfolio

The discussion was held on June 9, 2021.

Background:

In recent years, the Bank of Israel has invested in bonds issued by companies with a credit rating of at least BBB-. Recently, (in 2021), the Monetary Committee approved new investment guidelines for managing the foreign exchange reserves. The new version of the guidelines gives greater weight to achieving return and allows the taking of bigger investment risks relative to the past. The new guidelines also allow investment in High Yield (HY) corporate bonds, at a share of up to 5 percent of the foreign exchange reserves portfolio. Bonds of a company with a credit rating below BBB- are defined as HY bonds.

Currently the Bank of Israel foreign exchange reserves portfolio includes mainly bonds issued by countries, as well as equities. The expected return as well as the expected risks in investment in HY bonds in the US and Europe are lower than those of investment in equities, but are higher than in other assets in the foreign exchange reserves portfolio. The COVID-19 crisis, which caused sharp fluctuations in financial markets in 2020 provided an additional opportunity to examine the features characterizing HY bonds, and supports the conclusion above.

HY bonds in the US and Europe are an asset that yields a risk premium of 3–4 percent, on average, relative to bonds with a similar duration issued by countries. This premium is higher than the risk premium yielded by Investment Grade (IG) bonds, which hovers around 1 percent, but it is generally lower than the premium on equities. Investment in HY bonds involves ongoing credit losses as a result of credit failures, in contrast to investment in IG bonds in which the risk of credit failure is very low.[1] Losses resulting from a credit failure in HY bonds are a typical feature of the investment in this asset, even during strong economic periods.

Integrating HY bonds into the foreign exchange reserves portfolio, given the other limitations and constraints in investing the reserves, is assessed to be optimal and therefore their integration makes it possible to reduce the risk in the portfolio, and/or to increase the expected return of the portfolio

[1] In an IG portfolio managed at the Bank of Israel since 2014, there have not been any credit failures to date.

for a given level of risk. Several central banks have already integrated HY bonds into their reserves portfolios.[2]

Discussion:

The advantages and risks in integrating HY bonds into the reserves portfolio were presented comprehensively by the Markets Department. The data presented included the distribution of credit ratings of HY bonds, the failure probability by rating, and the return of HY assets by rating—in the US and in Europe, as well as examples of companies with debt rated HY. Also presented were data on losses in HY bonds in the 3 major crises of the current century.

The Markets Department assessed that HY bonds have the potential to contribute markedly to the reserves portfolio return over time, while diversifying the sources of the expected return on the portfolio and the reduction of dependence on the equity return, particularly in conditions of mediocre economic growth. In times of crisis, the losses in the asset are expected to be lower than those in the equity portfolio. HY bonds are less sensitive than equities to monetary and fiscal shocks.[3]

As the Bank of Israel to date has not invested in HY bonds, the Markets Department recommended to the Monetary Committee a framework for gradually integrating HY bonds at a low share, which will increase over the years 2021–22. The Department recommended that the investment be carried out via several external managers specializing in these assets that will be specifically chosen. Investment in this manner will allow the diversification of risks and will entrench a process of learning and accumulation of experience.

A discussion was held on the Department's recommendations.

Monetary Committee decisions:

- To authorize the Markets Department to invest up to 1 percent of the reserves portfolio in 2021 in HY assets in Europe and the US, while maintaining a risk level in CVaR terms that was approved for this year.

- To authorize the Markets Department to invest up to 2 percent of the reserves portfolio in 2022 in HY assets in Europe and the US, while maintaining a risk level in CVaR terms that would be approved for 2022.

- To carry out the strategic investment via external management.

- The benchmark for the investment will be a single broad benchmark for each portfolio (dollar and euro). The benchmark will be one of the benchmark indices accepted in the market and that is in line with the Bank of Israel's investment horizon.

[2] According to an HSBC survey for 2020, which includes 74 central banks, about 5 percent invest in HY bonds.

[3] The Bank of Israel already holds equities of companies with bonds rated HY in accordance with their weight in the broad equity indices in which it invests, but to date the Bank of Israel has not invested actively in bonds of those companies.

The decision was reached unanimously.

Participants:

Members of the Monetary Committee
Prof. Amir Yaron, Governor of the Bank of Israel and Chairperson
Mr. Andrew Abir, Deputy Governor of the Bank of Israel
Prof. Reuben Gronau
Prof. Moshe Hazan
Prof. Zvi Hercowitz

Other participants
Mr. Nadav Eshel, Research Department
Mr. Tal Biber, Head of Markets Division in Markets Department
Mr. Mickey Blank, Head of Dealing Unit, Markets Department
Ms. Francoise Ben-Zur, Head of Financial Division in Markets Department
Dr. Golan Benita, Chief of Staff to the Governor
Ms. Guenia De Mayo, Head of Financial Risk Management Unit, Markets Department
Mr. Oren Hadjes, Markets Department
Mr. Mark Yohai, Head of Strategic Management Unit, Markets Department
Mr. Dor Lev, Markets Department
Mr. Arad May, Secretariat of the Monetary Committee and the Supervisory Council
Ms. Michal Sinai Livyatan, Legal Division
Dr. Amit Friedman, Advisor to the Markets Department Director
Mr. Ran Tzion, Markets Department
Mr. Tali Kemel, Markets Department
Dr. Sigal Ribon, Head of Monetary Division in the Research Department
Ms. Jeanina Tirosh, Markets Department