Bank of Israel
Monetary Committee Secretariat

Report of the Monetary Committee discussion held at the Bank of Israel regarding management of the foreign exchange reserves

Currency benchmark for managing the reserves

The discussions were held on August 10, and October 13 and 27.

Background:
On April 7, 2021, the Monetary Committee decided to make changes in the foreign exchange reserves investment policy guidelines. Among other things, the Monetary Committee decided (Section 1 of the new investment guidelines) that, in addition to the main goal of achieving the objectives of the Bank of Israel and the appropriate fulfilling of its functions as they are detailed in the Bank of Israel Law, 5770-2010, the investment policy goals would include :

a) Achieving a return in shekel terms that, in the long term, will cover at least the financing cost of holding the reserves[1];
b) Maximizing the holding rate of return in the medium term, in terms of the currency benchmark and within the framework of the risk profile, subject to attaining the goal of managing the reserves with a high level of liquidity.

Regarding the currency benchmark, the Monetary Committee decided (Section 3 of the new investment policy guidelines) that the currency benchmark will be set by the Committee in accordance with the following principles:

(a) Diversification: The currency diversification of the currency benchmark contributes to reducing exchange rate risk vis-à-vis the shekel in the Bank's balance sheet and encourages investment diversification;
(b) Stability: The principle of stability is important both for asset allocation as well as for currency allocation. Given that the reserves are held for the long term, frequent or sharp changes in the currency weights in the benchmark currency, which will lead as well to changes in the weight of the assets in those currencies, are liable to lead to a loss in the long term. Therefore, the stability of the composition of the currency benchmark should be maintained and frequent or sharp changes in it should be avoided;
(c) The currency benchmark shall only include reserve currencies: Due to the importance of the goals of liquidity and appropriate return, the currency benchmark will be made up of currencies that are recognized around the world as reserve currencies;
(d) The currencies that will be included in the currency benchmark will be those of countries in which there is a range of asset markets, with high liquidity;

[1] The financing cost of holding the reserves is the gap between the cost of raising the capital in shekels required for holding the reserves and the return of the foreign exchange reserves in terms of the currency benchmark with the addition of the gain or loss from the currency exposure vis-à-vis the shekel.

(e) In order to achieve a return that covers, in the long term, the financing cost of holding the reserves, in choosing the currency benchmark composition the Committee will take into account the volatility of the reserves' long-term return in shekel terms.

According to the guidelines, the composition of the currency benchmark shall be examined by the Monetary Committee based on the recommendation of the Markets Department, in accordance with changes in global markets, at the end of each year or if there are material changes in said circumstances.

Against the background of the new guidelines, the Markets Department recommended expanding the currency benchmark to additional currencies in order to comply with the principles set out by the Monetary Committee.

The Markets Department presented a new methodology for determining the currency benchmark, which will replace the uses approach that was used until now, with the goal being to reflect in the currency composition the principles of diversification and stability, the global principles (reserve currencies and depth of the markets) and the domestic principles (financing cost of the reserves and minimizing the volatility vis-à-vis the shekel).

The Markets Department presented the said methodology and recommended a composition for the new currency benchmark that will include a broader number of currencies.

The expansion of the currency benchmark to additional currencies will enable the Bank to increase the return in shekel terms, while reducing volatility and tail risk due to the expansion of the currency diversification.

Discussion:
In the discussion, the Markets Department presented the methodology for establishing the new benchmark, and the rationale on which it is based.

The Committee members discussed the methodology and the extent of allocation wanted for the various currencies, while taking into account the unique characteristics of the financial markets in those countries, including the depth of the markets and their liquidity, the extent to which they are developed and the financial sophistication of the markets, the credit rating of their economies and additional considerations.

Monetary Committee decisions:
The Committee decided to approve the methodology presented by the Markets Department and the currency benchmark used to manage the reserves so that it would include the following reserve currencies: USD (61 percent), EUR (20 percent), GBP (5 percent), JPY (5 percent), AUD (3.5 percent), CAD (3.5 percent), and CNY (2 percent).

The Committee decided to examine the results and the methodology in 3 years, and to update the weights in accordance with developments.

The decisions were reached unanimously.

Participants:

Members of the Monetary Committee

Prof. Amir Yaron, Governor of the Bank of Israel and Monetary Committee Chairperson
Mr. Andrew Abir, Deputy Governor of the Bank of Israel
Prof. Naomi Feldman (at the Committee meetings on October 13 and 27)
Prof. Reuben Gronau (at the Committee meeting on August 10)
Prof. Moshe Hazan
Prof. Zvi Hercowitz
Prof. Michel Strawczynski

Other participants

Mr. Tal Biber, Head of Markets Division in Markets Department
Mr. Mickey Blank, Markets Department
Dr. Golan Benita, Chief of Staff to the Governor
Ms. Francoise Ben-Zur, Head of the Financial Division in Markets Department
Ms. Guenia De Mayo, Markets Department (in the Committee meetings on October 13 and 27)
Mr. Oren Hadjes, Markets Department (in the Committee meeting on October 27)
Mr. Daniel Hofbauer, Markets Department (in the Committee meetings on October 13 and 27)
Mr. Mark Yohai, Markets Department (in the Committee meetings on October 13 and 27)
Mr. Roee Levy, Markets Department
Mr. Arad May, Secretariat of the Monetary Committee and the Supervisory Council
Mr. Ori Marilus, Markets Department (in the Committee meeting on October 13)
Ms. Michal Sinai Livyatan, Legal Division
Dr. Amit Friedman, Advisor to Director of the Markets Department
Ms. Esti Schwartz, Secretary of the Monetary Committee and the Supervisory Council (in the Committee meetings on October 13 and 27)