Bank of Israel
Monetary Committee Secretariat

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

Asset Allocation in the Monetary Committee Benchmark—2021 recommendation

The discussion was held on January 20, 2021.

Background:
The investment management framework of the foreign exchange reserves portfolio is based on two benchmarks that fill different roles: **the basic benchmark and the Monetary Committee (MC) benchmark**. A benchmark is a theoretical, investable portfolio that includes a wide variety of assets, constructed according to known and fixed rules. The use of benchmarks is intended to measure the performance of the investment decisions made by the Monetary Committee and of those made by the Markets Department, in accordance with the division of authority between them.

The basic benchmark represents a conservative composition of investable assets, which meets the first two goals of the investment policy for the reserves: maintaining the purchasing power of the reserves and managing them at a high level of liquidity and low level of risk. To achieve its goals, the basic benchmark is comprised of government bonds in the currency-benchmark currencies with a short duration.

The basic benchmark provides a basis for measurement of the performance of the Committee's decisions. Due to its conservative nature, the basic benchmark represents a risk-free investable portfolio, and thus the excess return of the MC benchmark above the return of the basic benchmark represents the MC benchmark's risk premium.

The Committee's benchmark is a theoretical, investable portfolio which reflects the strategic asset allocation that the Committee has selected for the reserves portfolio. The asset allocation in the benchmark is set with the aim of achieving a maximum return for the portfolio, subject to the risk profile established by the Monetary Committee, while also fulfilling the first two goals of the investment policy of the reserves. The main aims of this benchmark are: (**1**) to translate the Monetary Committee's preferences and risk profile into a strategic allocation of assets in the reserves portfolio, subject to the guidelines and based on an assessment of the expected macroeconomic and financial environment; and (**2**) to outline a framework for management of the reserves portfolio. The selection of the MC Benchmark establishes the main characteristics of the reserves portfolio, including its currency composition, asset composition, and the target duration of the benchmark in each currency. The Markets Department manages the portfolio within the degrees of freedom it has been granted by the Monetary Committee, while also staying within the risk profile. Therefore, **the MC benchmark provides a basis for evaluating the performance of the managers of the actual portfolio.**

The process of choosing the recommended MC benchmark for 2021 began with an assessment of the factors expected to affect the macroeconomic environment. Based on that assessment, the Department constructed three scenarios of the macroeconomic environment: baseline, optimistic, and pessimistic. The construction of the **baseline scenario** was based on:

1. An analysis of the **current state** of the global economy
2. Identification of the **main factors** that are expected to drive the global economy, and assessment of the direction in which they will move and the degree of influence they will have in the most likely case.

Constructing the alternative scenarios was based on the following principles:

1. The scenarios are derived from the main risks (to the upside/downside) inherent in the baseline scenario
2. The realization of these risks would be expected to have a marked impact on the risk and return of the portfolio.

The Department then assessed the financial conditions expected under the three scenarios (changes in yield curves and in credit spreads, corporate profitability, etc.) based on internal models, investment houses' strategic reviews and its own assessments. Using this input, the Department derived its forecast for the returns on various assets under each scenario.

Given the Department's forecast of asset returns, and given their risk and the correlations between them, the Department examined various asset compositions that would maximize the portfolio's return at the desired risk level. The recommended composition of the benchmark portfolio was chosen based on analysis of the results, including sensitivity analyses, examining stress scenarios, and judgment. This composition meets the goals of the investment policy and complies with the risk profile set by the Committee.

The Monetary Committee examines the allocation at least once a year, as well as at any time it sees fit to do so, in accordance with market developments.

Discussion:

The Markets Departments presented the macroeconomic and financial forecast, and the forecast for returns on the assets in the MC benchmark.

Following is the recommendation of the Markets Department for the asset allocation in the benchmark in 2021, within the framework of the new guidelines, which will go into effect after consultation with the Ministry of Finance, in accordance with the Bank of Israel Law:

- 76 percent in government bonds in dollar, euro and pound Sterling, with a duration of 2.3 years in the US and 1.5 years in Europe.
- **18 percent in an equities benchmark.**
- 6 percent in investment grade corporate bonds, of which 4 percent shall be in the US market and 2 percent in the European market (unchanged from the current benchmark).

Until the new guidelines go into effect, the MC benchmark allocation shall remain as it was approved in 2020:

- 76 percent in government bonds in the dollar, euro and pound sterling currencies, with an average duration of 2.3 years in the US and 1.5 years in Europe, and an additional 3 percent in government bonds in currencies of countries approved by the Committee.
- 15 percent in the equities benchmark.

- 6 percent in investment grade corporate bonds, of which 4 percent shall be in the US market and 2 percent in the European market.

In addition, the Markets Department made the following recommendations to the Committee:

- As the Department will begin a consultation process with the Ministry of Finance regarding a change in the guidelines, the changes in the MC benchmark and as a result the changes in the investment of the foreign exchange reserves shall be made at the end of the process with the entry into force of the new guidelines, and subject to them.
- Likewise, the Department requested the Committee's approval for a passive breach from the maximum risk of CVaR 475 basis points in the portfolio for the period until the new guidelines go into effect. During this period, the Department will not increase the share of risk assets in the portfolio. The Department will submit a report on each passive breach as noted within the framework of the ongoing reporting on passive breaches to the Monetary Committee.

The Department's recommendations were discussed.

Decision of the Monetary Committee:

The Committee unanimously approved the recommendations of the Markets Department.

Participants in the discussion:

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. Zvi Hercowitz
Prof. Moshe Hazan
Prof. Michel Strawczynski

Other participants in the discussion:
Tal Biber, Head of the Markets Division in the Markets Department
Mickey Blank, Head of Dealing Unit, Markets Department
Francoise Ben-Zur, Head of the Financial Division, Markets Department
Dr. Golan Benita, Chief of Staff to the Governor
Guenia De Mayo, Head of the Risk Management Unit, Markets Department
Oren Hadjes, Markets Department
Mark Yohai, Head of the Strategic Management Unit, Markets Department
Dor Lev, Markets Department
Elias Leghziel, Markets Department
Roee Levy, Markets Department
Arad May, Secretariat of the Monetary Committee and Supervisory Council
Ori Marilus, Markets Department

Michal Sinai Livyatan, Legal Division
Jenny Seri, Markets Department
Dr. Amit Friedman, Advisor to the Director of the Market Operations Department
Ran Tzion, Markets Department
Idan Sneer, Markets Department