Bank of Israel
Monetary Committee Secretariat

March 12, 2013

Summary of the Monetary Committee discussions and decisions of December 18, 2012, January 1 and 28, 2013, and February 5 and 26, 2013 on management of the foreign exchange reserves

I. Monetary Committee decisions on increasing the equities allocation in the reserves portfolio:

1. To increase the portion of the reserves portfolio that is permitted for investment in equities from 3 percent to 6 percent.
2. To increase the actual investment in equities up to 5.5 percent during 2013. The additional investment is to be made in equity markets in the US and Europe, and similar to investments thus far, it shall be made through external managers, under passive management.

II. Monetary Committee decisions on the guidelines for the investment policy for the foreign exchange reserves:

1. Following the completion of the consultative process with the Minister of Finance, the following amendments have been inserted into the guidelines for the investment policy:
   - Section 4(e): Liquidity risk—Elimination of the list of assets in each of the liquidity components and the addition of the following explanation: "The assets in which the reserves are invested are classified into three liquidity levels: Assets which can be realized within one week; within one month; or within half a year, without negatively impacting their value. A minimum level has been set for investment in the two higher liquidity levels, and a maximum has been set for the third level. The classification into the various liquidity levels is subject to change due to changes in market conditions."
   - Section 4—Types of assets approved for investment—Section 8: Increasing the permitted share of investment in equities from 3 percent to 6 percent of the reserves portfolio.
   - Section 4—Types of assets approved for investment—Section 9: Investment in mortgage-backed securities (MBS) will not be restricted to GNMA. The 5 percent limitation on investment in these assets remains unchanged.

III. Monetary Committee decisions on the quarterly reporting to the Ministry of Finance:

1. To approve the quarterly report to the Ministry of Finance (third quarter 2012) on management of the reserves.

I. Increasing the equities allocation in the foreign exchange reserves

Background

At the beginning of 2012, the Market Operations Department began a pilot in which it invested 3 percent of the reserves portfolio in equities. The decision to invest in equities originated mainly from changes in the interest rate environment and in bond yields, which were near-zero in recent years, and in the size of the reserves. In addition, the Bank of Israel Law, which came into force in 2010, permits investment in equities, which was prohibited under the old law. In the current global financial environment, over-concentration in bonds may constitute a high risk. Diversification into additional types of assets, including equities, may improve the risk/return profile of the reserves portfolio.

The main points raised in the discussions:

1. **The yield environment and other considerations upon which the decision was based:** Currently, 97 percent of the reserves are invested in bonds, and the main risk to the portfolio is interest-rate risk, while the yield environment globally is near-zero. In case of increased yields, there will be a strong negative holding rate of return in the reserves portfolio due to declines in bond prices. In this environment, a portfolio without equities is expected to generate very low, and even negative, yields. Adding equities increases the diversification of the portfolio and improves expected performance under a wide range of future scenarios. Another factor behind the recommendation to increase the equities allocation in the portfolio is the level of the reserves, which makes it possible to slightly increase the additional yield while maintaining the liquidity targets and the value of the reserves, while adding little risk. The Department's assessment is that according to its main scenario, it is possible to obtain some additional yield from investment in equities.
2. **On the risk side:** The Market Operations Department presented work based on various models, according to which the distributions of projected yields among portfolios of various compositions were calculated, regarding a number of scenarios concerning market developments. The assessment is that if the investment in equities is increased to 6 percent, then even if the economic recovery does not take place, the added risk is relatively low.

The decision to increase investment in equities was approved unanimously. The Committee members were in agreement with the Market Operations Department concerning the assessment that the current situation is unique, and have not been observed in recent decades in the global economy. Therefore, when a recovery from the crisis begins and there is a return to growth, two parallel developments can be expected: Returns on equity holdings will increase, and bond prices will decline. This will negatively impact performance in the reserves portfolio, since the portfolio is mostly in bonds. Under these conditions, the Committee views investment in equities as a desirable investment.

II. The guidelines for the investment policy of the foreign exchange reserves portfolio

1. The Committee decided, subject to holding consultations with the Minister of Finance, to amend the guidelines for the investment policy for the reserves, in accordance with the decisions it reached during the year. The amendments relate to the portion of investment that is permitted in equities, to the specification of the liquidity components, and to the type of mortgage-backed assets that it is permitted to hold.
2. The proposed amendments were sent to the Minister of Finance for the purpose of holding consultations, as required by law, on February 6, 2013. The Committee asked for the Ministry of Finance's response by February 24, 2013.
3. No response was received from the Ministry of Finance by the stated date. As such, the Committee viewed the consultative process as having been completed.

III. Reports on management of the reserves

1. Report to the Monetary Committee on the management of the reserves (to the end of November 2012)

In accordance with the decision of the Monetary Committee, representatives of the Market Operations Department reported to the Committee on the management of the reserves as of the end of November 2012. The levels of the reserves, yields in the reserves portfolio and the main exposures of the portfolio to currency, market and credit risks were presented.

2. Quarterly report to the Minister of Finance on the management of the reserves (third quarter 2012)

In accordance with Section 40(c) of the Bank of Israel Law, and in accordance with the memorandum of understanding between the Bank of Israel and the Minister of Finance, representatives of the Market Operations Department presented the quarterly report that must be presented to the Minister of Finance regarding the management of the reserves.

The Committee members approved the report.

Participants:

Members of the Monetary Committee
Prof. Stanley Fischer, Governor of the Bank of Israel and 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 Market Operations Department
Tal Biber, Head of Markets Division in Market Operations Department
Tsila Billet, Assistant to Secretary of Monetary Committee and Supervisory Council
Francoise Ben-Zur, Head of Financial Division in Market Operations Department
Mickey Blank, Trading Room
Guenia De Mayo, Head of Risk Management Unit in Market Operations Department
Daniel Hofbauer, Trading Room
David Hoffman, Economist in the Market Operations Department
Roee Levy, Economist in Risk Management Unit in Market Operations Department
Esti Schwartz, Secretary of the Monetary Committee and the Supervisory Council
Hagit Waknin, Economist in the Market Operations Department