



**Bank of Israel**  
Monetary Committee Secretariat

## **Summary of the Monetary Committee discussion held at the Bank of Israel regarding management of the foreign exchange reserves**

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The discussions were held on April 11, 2018, January 16, 2019, and January 30, 2019

### **Asset Allocation in the Monetary Committee Benchmark—2019 recommendation**

The Monetary Committee approved the recommendation of the Market Operations Department for 2019 concerning the allocation of assets in the Committee's benchmark.

The approved composition of the benchmark is:

- 77% in government bonds, with an average duration of 2.3 years in the US and 1.5 years in Europe (of which, 1.2% in government bonds and currencies of countries approved by the Committee).
- 15% in the equities benchmark.
- 8% in investment grade corporate bonds, of which 5.3% shall be in the US market and 2.7% in the European market.

This is in contrast to the composition of the Committee's benchmark for 2018, which was:

- 81.5% in government bonds, with an average duration of 1.5 years in the US and in Europe.
- 12.5% in the equities benchmark.
- 6% in investment grade corporate bonds, of which 4.5% shall be in the US market and 1.5% in the European market.

The changes in the Committee's benchmark, and the resulting changes in the foreign exchange reserves portfolio, shall be made gradually, in accordance with market conditions and at the discretion of the Market Operations Department.

### **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 Market Operations 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 these goals, the basic benchmark

is comprised of government bonds with a currency composition identical to the composition of the numeraire<sup>1</sup> with a short target duration.<sup>2</sup> **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 allocation that the Committee has selected. 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 Market Operations Department manages the portfolio within the degrees of freedom it has been granted by the Monetary Committee, while also staying within the risk profile. **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 2019 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. Realization of the main risks (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 tests, and judgment.

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<sup>1</sup> US, UK, Germany, France and Netherlands government bonds.

<sup>2</sup> A duration of 6 months.

**The strategic allocation for 2019 was made under the new version of the guidelines<sup>3</sup>**, which emphasizes the importance of achieving the target of maintaining the purchasing power of the reserves in the medium term. The weight of equities and corporate bonds in the MC benchmark was increased with a long-term view and with the aim of **increasing the probability of achieving the target of maintaining the purchasing power of the reserves in the medium term.** This was in view of the low and even negative real yields expected on investment in government bonds in most advanced economies in the medium term.

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.

### **Decision of the Monetary Committee:**

The Committee approved the recommendations of the Market Operations Department.

### **Participants in the discussion:**

#### **Members of the Monetary Committee**

Prof. Amir Yaron, Governor of the Bank of Israel, and Chairperson<sup>4</sup> (except for the discussion that took place on April 11, 2018)

Dr. Karnit Flug, outgoing Governor of the Bank of Israel who served as Chairperson<sup>5</sup> (in the discussion that took place on April 11, 2018)

Dr. Nadine Baudot-Trajtenberg, Deputy Governor of the Bank of Israel

Mr. Andrew Abir, Director of the Market Operations Department

Prof. Reuben Gronau

Prof. Zvi Hercowitz

Prof. Moshe Hazan

#### **Other participants in the discussion:**

Mr. Eddy Azoulay, Chief of Staff to the Governor (except for the discussions that took place on April 11, 2018 and on January 30, 2019)

Yossi Isler, Senior Economist, Market Operations Department (except for the discussion that took place on April 11, 2018)

Barak Ettinger, Market Operations Department (except for the discussion that took place on April 11, 2018)

Tal Biber, Head of the Markets Division, Market Operations Department

Mickey Blank, Head of Dealing Unit, Market Operations Department

Francoise Ben-Zur, Head of the Financial Division, Market Operations Department

Dr. Golan Benita, Head of the Strategic Management Unit, Market Operations Department

Nitzan Gad Shinnar, Market Operations Department (in the discussion that took place on April 11, 2018)

Guenia De Mayo, Head of the Risk Management Unit, Market Operations Department

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<sup>3</sup> The new version went into effect on January 23, 2019.

<sup>4</sup> Prof. Amir Yaron began his term as Governor of the Bank of Israel and Chairperson of the Monetary Committee on December 24, 2018.

<sup>5</sup> Dr. Karnit Flug ended her term as Governor of the Bank of Israel and Chairperson of the Monetary Committee on November 12, 2018.

Hanoch Danenberg, Head of the Surveillance and Analysis Unit, Market Operations Department (except for the discussion that took place on April 11, 2018)  
David Hoffman, Economist, Market Operations Department (except for the discussion that took place on April 11, 2018)  
Amir Veler, Economist, Market Operations Department (in the discussion that took place on January 30, 2019)  
Hagit Waknin, Market Operations Department (except for the discussion that took place on April 11, 2018)  
Mark Yohai, Senior Economist, Market Operations Department  
Ketty Cohen, Market Operations Department (except for the discussion that took place on January 16, 2019)  
Dor Lev, Economist, Market Operations Department  
Roev Levy, Economist in the Risk Management Unit, Market Operations Department  
Mark Nulman, Senior Economist, Market Operations Department (in the discussion that took place on April 11, 2018)  
Prof. Michel Strawczynski, Director of the Bank of Israel Research Department  
Michal Sinai Livyatan, Legal Department (in the discussion that took place on January 30, 2019)  
Hanan Pinkas, Market Operations Department (in the discussion that took place on January 30, 2019)  
Dr. Amit Friedman, Advisor to the Director of the Market Operations Department (except for the discussion that took place on April 11, 2018)  
Ran Tzion, Market Operations Department (except for the discussion that took place on April 11, 2018)  
Esti Schwartz, Secretary of the Monetary Committee and the Supervisory Council