Bank of Israel
Monetary Committee Secretariat

August 28, 2012

Summary of Monetary Committee discussion on August 14, 2012 regarding the management of the foreign exchange reserves

First part: Matters submitted for the approval of the Committee

1. Numeraire distribution update

Background

The numeraire is the neutral currency composition of the reserves, and serves as an anchor for the management of their currency risk. The composition of the numeraire is examined annually in accordance with the guidelines drafted by the Monetary Committee. The numeraire distribution is examined through an assessment of the liquidity of the currencies in which the reserves can be invested, according to their potential use in a crisis situation and in accordance with the global distribution of the reserves. This is in order to maintain the purchasing power of the reserves in terms of their potential uses.

In December 2011, as the result of a change in the currency position management framework, the composition of the numeraire was changed.[1] In July 2012, the Market Operations Department adjusted the currency composition of the potential uses of the reserves, including imports and short-term foreign-currency government debt servicing. The Department examined the composition of these updated potential uses through an assessment of the liquidity of the currencies in which the reserves can be invested, according to their potential use in a crisis situation and in accordance with the global distribution of the reserves. Also examined were various scenarios for potential uses in an emergency or in a crisis situation.

As result of this examination, the Market Operations Department submitted for the Monetary Committee's approval a proposal to update the currency distribution of the numeraire whereby the weightings of the dollar, the euro and the British pound in it will be 65 percent, 32 percent and 3 percent, respectively, (instead of the present weightings of 62 percent, 33 percent and 5 percent).

Decision of the Monetary Committee

The recommendation was passed by a majority of three votes. One Committee member abstained and one member objected to the recommendation.

The opinion of those in favor of the recommendation was that there is an advantage in examining the numeraire every year on the basis of the parameters that have been determined: the composition of imports, the need for intervention in an emergency, the composition of the short-term debt, and the currency composition of the foreign exchange reserves of the world's central banks. The

[1] This change was made without examining the currency composition of the potential uses of the reserves, which were last examined back in 2009.

determination of the desired distribution of the numeraire is known to be highly important, because of the need to maintain the purchasing power of the reserves in terms of potential uses, as the Bank of Israel would likely have to supply liquidity in an emergency and at times of crisis, in accordance with the currency distribution of these uses.

The opinion of the person objecting to the recommendation was that the numeraire is a unit of measurement that is intended to measure the rate of return on the investment of the foreign exchange reserves portfolio in terms of a neutral currency basket. In order to fulfill this function, the composition of the numeraire was determined on the basis of the various goals which determine the currency composition of the foreign exchange reserves portfolio held by the Bank of Israel, and the unit of measurement should as far as possible be left unchanged over time. The numeraire composition was last determined at the end of December 2011, and the data presented to the Committee do not show a change in the composition of the goals which would necessitate a change in the composition of the numeraire.

The Governor asked that the composition of uses be re-examined while adopting a larger number of scenarios and taking into account the effect not only on the weightings of the uses components, but also on each and every component.

The decision was passed on August 14, 2012, and went into effect at the beginning of September.

2. Proposal for changing the composition of the strategic currency position

Background

Under the policy of diversifying the reserves and their investment in countries with good economic data, the Market Operations Department submitted for the Monetary Committee's approval a recommendation to add an additional currency to the composition of the strategic position without changing its overall scale (9 percent). The Department believes that diversification of the reserves into an additional currency, whose volatility is lower, without changing the scale of the position will have the effect of reducing the risk in the portfolio.

Decision of the Monetary Committee

The Committee approved the proposal by a majority of four votes, with one member abstaining. The recommendation will be applied at a timing that suits market conditions.

The decision was passed on August 24, 2012.

3. Proposal to update the country quota principles

Background

Under the guidelines drafted by the Committee, it is permitted to invest in a country whose debt rating is not less than A–. Exposure of the reserves to sovereign risk is therefore restricted to a narrow list of countries whose risk is low, relative to that of other countries.

The motivation behind the proposal for updating country quotas is the continuing difficulty in investing the reserves. This difficulty results mainly from increased sovereign risk worldwide, which has led to a reduction in country allocations and a narrowing of the list of countries conforming to the criteria for the allocation of quotas. The proposal submitted to the Committee included a request to add to the parameters determining the country quotas (rating and GDP), a parameter expressing the depth and liquidity of countries' government debt market. The proposed allocation method makes it possible to add to the present list of countries a number of other countries, and thereby to increase the opportunities for diversification. All this is without changing the rating threshold permitted for investment in a country.

The Department asked to change the allocation of the quotas for international financial institutions in accordance with the criteria determined for Public Sector Entities (PSE's).

Decision of the Monetary Committee

The Committee unanimously approved the criteria for selecting countries whose currencies are permitted for investment and for determining their quotas, and the criteria for determining the quotas for international financial institutions.

The decision was passed on August 14, 2012.

4. Recommendation for changing the assets included in the composition of the liquidity components in the compliance guidelines for 2012

Background

The assets in which the reserves are invested are classified into three liquidity levels: assets that can be realized within a week, a month, or six months without detracting from their value. A minimum level has been determined for the two highest liquidity levels, and a maximum threshold has been determined for the third level. Due to changes in market conditions, which led to changes in the level of liquidity of some of the assets in the portfolio, the Market Operations Department recommended that the liquidity classification of those assets be changed. It was recommended that a number of assets that were in the component defined "realizable within a month" should be reclassified as assets "realizable within a week", and that other assets be added to the "realizable within a month" component.

Decision of the Monetary Committee

The Committee unanimously approved the change in the composition of the assets included in each of the three liquidity components. As a result of this decision, the details of the composition of the assets in the liquidity components will have to be changed in the guidelines.

The decision was passed on August 14, 2012.

5. Quarterly report to the Minster of Finance on the management of the reserves (second quarter of 2012)

Background

In accordance with Section 40(c) of the Bank of Israel Law and the Memorandum of Understanding between the Bank of Israel and the Minister of Finance, Market Operations Department representatives presented the Committee with the quarterly report on the management of the reserves which has to be submitted to the Minister of Finance.

Decision of the Monetary Committee

The Committee approved the report after the Department added a comment defining the liquidity levels.

The decision was passed on August 14, 2012.

Second Part: Matters reported to the Committee

1. **Quarterly report to the Monetary Committee on the management of the reserves (second quarter of 2012)**

Pursuant to the decision of the Monetary Committee, the Market Operations Department reported to the Committee on the management of the reserves for the second quarter of 2012. The level of the reserves, the holding period rates of return on the reserves portfolio, and the portfolio's main currency, price, and credit risk exposures were presented. Also presented was the effect of a number of extreme case scenarios on the expected return on the reserves.

2. **Update of bank and broker quota allocations**

The Market Operations Department reported to the Committee on the annual update of the quota allocations to banks and brokers, which the Foreign Currency Committee approved on 2.7.2012.

3. **Update of PSE issuers and issuers with government guarantee**

The Market Operations Department reported to the Committee on the update of PSE (Public Sector Entity) issuers and issuers with a government guarantee, the principles for investing in them and the allocation of the quotas which the Foreign Currency Committee approved on 2.7.2012.

4. **Report on the update of compliance guidelines for 2012**

The Market Operations Department reported to the Committee on the update of the compliance guidelines within the framework of the periodic examination for 2012. The update was also reported to the Foreign-Currency Committee on 2.7.2012.

Participants in the discussion:

Members of the Monetary Committee
Prof. Stanley Fischer, Governor of the Bank of Israel, Chairperson
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 in the discussion:
Andrew Abir, Director of Market Operations Department
Tsila Billet, Assistant to Secretary of the Monetary Committee and the Supervisory Council
Mickey Blank, Economist in Dealing Unit in Market Operations Department
Francoise Ben-Zur, Head of Finance Division in Market Operations Department
Guenia De Mayo, Head of Risk Management Unit in Market Operations Department
Daniel Hofbauer, Economist in Dealing Unit in Market Operations Department
Hagit Waknin, Economist in Risk Management Unit in Market Operations Department
Mark Yohai, Economist in Risk Management Unit in Market Operations Department
Roee Levy, Economist in Risk Management Unit in Market Operations Department
Yossi Saadon, Bank of Israel Spokesperson
Ruth Porat, Senior Auditor in Risk Management Unit in Market Operations Department
Esti Schwartz, Secretary of the Monetary Committee and the Supervisory Council
Nitzan Shinar, Economist in Risk Management Unit in Market Operations Department