



State Comptroller of Israel | Annual Report 72a – Part Two | 2021

Bank of Israel

Foreign Currency Balances Management by the Bank of Israel – Extended Follow-up Audit

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Background

In October 2012, the State Comptroller published a report on the subject "Management of Foreign Currency Reserves – Bank of Israel" (the previous report)¹. The report dealt with a variety of issues related to the management of foreign currency reserves (foreign currency reserves or the reserves) held and managed by the Bank of Israel. In view of the inherent importance in holding the reserves, which serve, among others, to contend with economic, financial and political crisis, and due to the changes that occurred in the level of the reserves and their management from the date of publishing the previous report, the State Comptroller's Office performed a follow up audit on the rectification of the deficiencies raised in the previous report as well as several additional issues.

1 The State Comptroller, **Annual Report 63a** (2012), "Management of Foreign Currency Reserves – Bank of Israel"



Key figures

**USD 110
billion**

The desired maximum level of foreign currency reserves as ratified by the Bank of Israel Governor in June 2020.

**USD 185.1
billion**

The level of foreign currency reserves actually held by the Bank of Israel as of February 2021 (68% over the desired maximum level).

**NIS 555.2
billion**

The Bank of Israel liabilities in local currency as of end December 2020.

**NIS 70.3
billion**

The Bank of Israel deficit as of end December 2020.

**USD 7.5
billion**

The extent of using reserves during the Covid-19 pandemic to contract swap transactions for repayment at local banks.

58%

The growth rate in foreign currency reserves levels for 2013 to 2020 due to purchase of foreign currency by the Bank of Israel.

1.94%

The rate of surplus yield from actively managing reserves relative to the basis indicator for 2013 to 2020.

36%

The rate of risk assets in the reserves portfolio for 2020. The composition – 15% shares, 7% corporate bonds and 14% spread assets².

Audit actions







From October 2020 to February 2021, the State Comptroller's Office examined the actions taken by the Bank of Israel to rectify fundamental deficiencies raised in the previous report, the changes that occurred in the reserve levels, their management, and the use thereof in times of crisis in general and the Covid-19 pandemic in particular. The audit focused on the Markets Division at the Bank of Israel. Various decisions by the Monetary Committee were also examined.

- ² Assets carrying higher yield for redemption than that of government bonds with a similar repayment period, due to differences in exposure to credit risk, liquidity, operating factors etc. The yield margin of an asset is the difference between its yield for redemption and the yield for redemption of similar government bonds.




Key findings


-  **The desired level of foreign currency reserves in international comparison** – the level of reserves at the Bank of Israel (which is 46% of the product as of February 2021) is higher than the desired level according to all customary estimating approaches (which stand at an average of 15% to 22% of the product), and higher than the average level of reserves at comparative countries on all customary indexes. It should be noted that the average level of reserves at comparative countries is also higher than the desired level and indicates a tendency of holding onto a high reserves level.
-  **The level of foreign currency reserves at the Bank of Israel** – as of February 2021 the total foreign currency reserves held by the Bank of Israel were estimated at USD 185.1 billion, whereas the desired level is USD 70 to USD 110 billion. Therefore there is a fundamental deviation of the actual reserves level from the upper bar of the desired level set by the Bank of Israel Governor (on a scale of 68% as of the end of February 2021). This deviation indicate the holding of surplus reserves and may impose risk on the Bank of Israel reputation.
-  **The accumulated deficit in the Bank's capital** – holding a foreign currency reserves portfolio of NIS 557 billion created over the years liabilities totaling NIS 555 billion, most of which are attributed to the accumulation of reserves, and reduced the Bank capital to an accrued capital deficit of NIS 70 billion as of December 2020. The audit found that other than the Bank of Israel, two additional central banks of the nine comprising the comparative group to the State of Israel (Czech Republic and Thailand) have negative capital³. Although the transfer of gains is not an objective or duty of the Bank listed by law, the continued deficit in the Bank capital since 1999 (when it transferred NIS 9 billion to the government following a profit registered in 1998) has prevented the transfer of profits to the government, which may have assisted in financing the government expenses.
-  **The use of reserves to achieve monetary policy goals** – it is evident that the foreign currency purchases are compatible to the fluctuations in the NIS to USD exchange rate. However, the purchase of reserves over recent years did not lead to upholding the inflation goal, particularly for most of the period since June 2014, but contributed to devaluation in the NIS value. It should be noted that in light of the deflationary pressures the economy has been contending with over recent years it is possible that without the intervention of the Bank of Israel on the foreign currency


³ From the financial statements for 2018–2020 published by the central banks. It should be noted that the accounting standards according to which the banks financial statements were drawn up are not uniform.





market the NIS revaluation and the deviation from the inflation goal may have been even higher.

 **Updating the "Procedure for performing financial transactions and investments by the Bank employees to prevent conflict of interest"** – the procedure was last updated on 18.8.15, despite increasing the risk profile and expanding the types of assets in which the reserves portfolio is invested over recent years.

 **A survey of risks at the Bank of Israel** – although according to the markets Division report it is regularly acting to update the various risks, it was found that no risks survey was carried out at the Bank of Israel since August 2013. Despite the substantial changes that have occurred in the reserves level, in their management, in types of assets managed, in the bank systems and in the engagements that the Markets Division performs with external portfolio managers.

 **Evaluating the quality of active management** – the comparison between the yields of active management⁴ and the basic indicator, presented to the public in the annual report published by the Bank of Israel, does not allow an optimal evaluation of the quality of the reserves portfolio management. This is because the basic indicator represents a risk free portfolio and as such is with lower yield expectancy than the assets approved for investment as determined by an assets allocation process. In addition, the use of the Information Ration (IR) index alone (which examines the surplus yield of the portfolio relative to its standard deviation), to examine the yield adjusted to risk, does not provide an optimal picture and is not informative when the portfolio yield is negative, as occurred in 2018.

 **Presenting Portfolio management – internally and externally** – over the years, following the increase in portfolio extent and expansion of the investment to riskier assets designed to maximize yields, the use of external management was extended. As of the audit completion date, nine external managers were managing assets comprising 21% of the portfolio, constituting USD 39 billion, of which: shares forming 15% of the portfolio, MBS (mortgage-backed securities)⁵ in the USA forming 2% of the portfolio and corporate bonds on the European and USA markets forming 2% of the reserves on each market. At the same time, the Bank of Israel annual statement does not present the assets managed by external management separately.

 **The use of reserves during the Covid-19 pandemic** – the audit did not find indications during the Covid-19 pandemic, and particularly in March 2020, the Bank of Israel was examining sale of foreign currency, at a time that the USD exchange rate reached a peak of NIS 3.862 per USD 1. It should be noted that during 2020 the reserves

⁴ Active management refers according to the Bank of Israel definition to decisions to invest in assets and in countries that are not included in the basic indicator.

⁵ A security with a future flow backed by a fund and interest payments on a mortgage collection.

level at the Bank of Israel increased relatively to all countries comparable to the State of Israel in both billions of USD and in change rates (a difference of USD 29.8 billion from the average change in comparable countries and a difference of 24.5% in the average change rate in these countries).



Rectifying deficiencies raised in the previous audit – most of the deficiencies noted in the previous report, including the lack of procedures regulating the activity, including formulating guidelines for investment, differentiating between rules of compliance, the investment, numeraire calculation procedure⁶ and a data and cyber security procedure – were including rectified, alongside handling the portfolio risks in general extreme cases (as detailed in the follow up audit findings table).

Activity of the Markets Division at the Bank of Israel – given that the continued and substantial deviation in the foreign currency reserves from the desired level, the State Comptroller's Office commends the markets Division work to update the investment goals, composition of the currency indicator, method of measuring the reserves holding yield and updating the risk profile of the portfolio.

Key recommendations







It is recommended that the Bank of Israel continue to examine the desired reserves level in a timely manner and the extent of deviation thereof, and present reasons for accumulating surplus reserves and the costs inherent therein. Moreover, it is recommended to continue examining extension of the deviation from the desired reserves level, and if necessary to take action for its resolution.



It is recommended that in view of the deviation from the desired level of reserves, the Bank of Israel examine the need for change in the principles according to which the governor will determine the desired level of long-term foreign currency reserves, with approval of the Minister of Finance. It is also recommended that as financial advisor to the government, the governor continue to advise the government about formulating export incentive policies for the Ministry of Finance, as an alternative to purchasing reserves. These actions should be taken alongside continued examination of the use of other monetary tools to support achievement of the monetary policy objectives, paying attention to the cost created by deviating from the desired level of reserves and the risks entailed therein and the effectiveness of purchasing foreign currency to fulfill inflationary goals.

⁶ A currency basket determined by the monetary committee derived from possible uses of reserves in times of need and from investment goals that reflect the holding objectives.



-  It is recommended that alongside the Bank of Israel's activity on the foreign currency market (paying attention to the Bank of Israel research findings of 2017 detailed in the report concerning the effectiveness of the bank's intervention on the exchange rate for supporting exports) the Ministry of Finance examine the use of fiscal tools to promote export according to government policy.
-  It is recommended to prepare a contingency plan, for examination by the Monetary Committee, to realize surplus reserves effectively in suitable circumstances to reach the desired level and reduce the risk imposed on the Bank of Israel's reputation.
-  It is recommended that the Bank of Israel perform an updated risks survey, particularly concerning the Markets Division activities, which will suit the frequent changes in the reserves portfolio. These changes may cause direct monetary damage and even generate realization of risks. It is further recommended to ensure that a comprehensive risks survey is conducted at least once every four years as determined by the Policy Document of 2013.
-  In order to increase transparency in the portfolio management in view of the increasing exposure to fluctuating assets, it is recommended to present to the public, as part of the annual report, the external management performance, which has inherently greater risks in terms of yield adjusted to risk, and particularly for assets managed also internally. In addition, it is recommended to examine presentation of the portfolio yields relating to additional indicators used by the Bank of Israel in managing the portfolio, including the committee indicator⁷ and the tactical indicator⁸, and examine the possibility of using additional indexes to estimate the yield adjusted to risk and its consistency over time. Adding indexes will assist in receiving a broader and more reliable picture, as done by the division in 2015 and 2016.

7 Reflecting the strategic component of the assets in the portfolio, as chosen by the Monetary Committee.

8 Added to the strategic component of the assets in the portfolio and including the exposures of the markets division at strategic level within the degrees of freedom it was awarded.





Key findings of the follow up audit

Audit Chapter	The deficiency in the previous audit	The degree of deficiency rectification as raised in the follow-up audit			
		Not rectified	slightly rectified	considerably rectified	Fully rectified
Change in Principles for Setting the Proper Level of Foreign Currency Reserves	Principles for setting the proper level were established, but no decision was made as to which changes in principles require the approval of the Finance Minister, as required by law.				
Regulation of Investment Activity	The guidelines for investment policy, methods of risk management, principles for measurement of returns, and levels of flexibility in investment are scattered throughout various systems and documents and not gathered in a single updatable document.				
Directive for Calculation of 'Numeraire'	Even though there have been changes in the procedures for setting the 'numeraire', the Market Division's Directive for its calculation was last updated only in October 2006, and therefore is in effect irrelevant.				

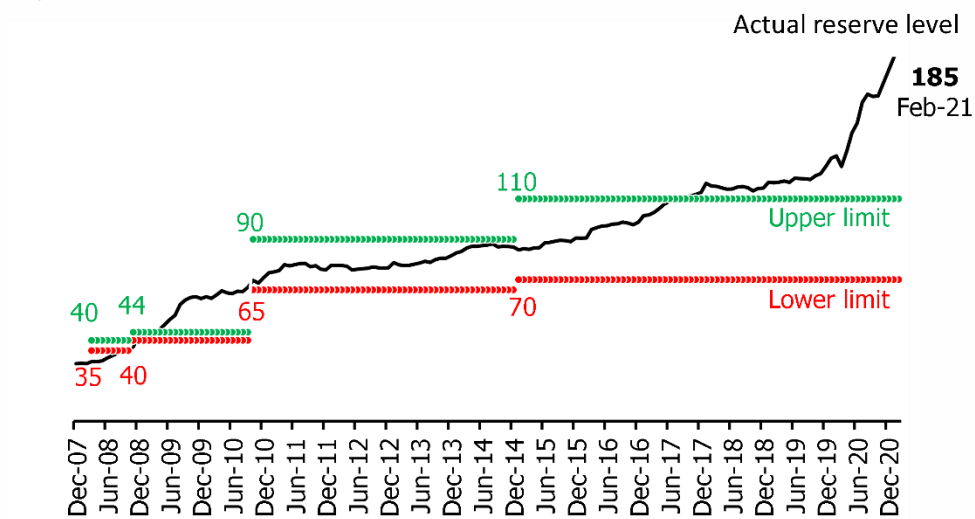


Audit Chapter	The deficiency in the previous audit	The degree of deficiency rectification as raised in the follow-up audit			
		Not rectified	slightly rectified	considerably rectified	Fully rectified
Risk Profile for Reserves Portfolio	No tool was found which could aid the Market Division in analyzing the overall risk to the reserves portfolio in times of extreme circumstances.				
Distinction Between Rules for Investment and Rules for Compliance	No clear distinction was made between the rules for investment and the rules for compliance, and there was no regulation setting the jurisdiction for approval of action reports and the method for dealing with deviations from the rules.				
Procedure for Cyber and Information Protection	There was no procedure set in place for categorization of sensitive documents, which would regulate the methods of documentation, protection, distribution, persons permitted to view said documents, and methods to update and track the various copies existent of said documents.				

Audit Chapter	The deficiency in the previous audit	The degree of deficiency rectification as raised in the follow-up audit			
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Oversight of Connecting Transactions	The commercial system of the Bank does not support the procedure for connecting transactions, which requires connecting two investment managers in transactions over a specific sum.				
Procedure for Receipt of Bids	The Division does not perform total oversight regarding the procedure for receipt of bids by employees in the transactions room, and therefore there is no oversight regarding the operational risk of an employee not receiving a number of bids or not choosing the best one.				



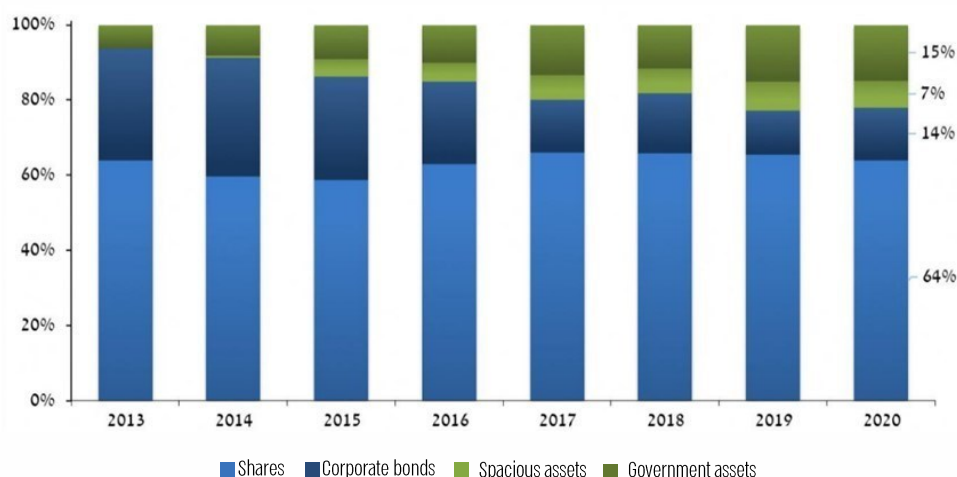
Actual reserve level compared to desired level as determined by the Bank of Israel governors, December 2007 to February 2021, in billions of dollars



Bank of Israel data processed by the State Comptroller's Office.



Composition of the reserve portfolio according to assets, 2013 to 2020, in percentage



The source: Bank of Israel.

Summary

The follow up audit on the subject of managing foreign currency reserves at the Bank of Israel indicated that over the past decade, following the implementation of the Bank of Israel Law 2010, the activity of the Bank of Israel on the foreign currency market have been regularized. Inasmuch, the need for change in the principles on which the desired level of long-term foreign currency reserves is frequently examined, as are the guidelines for investment policy therein. In addition, most of the deficiencies found in the previous report published in October 2012 have been rectified, including the lack of procedures to regular the Bank of Israel activity and to handle risks in the reserves portfolio in general and in radical events in particular. At the same time, a significant increase over the past decade in the rate of foreign currency reserves held by the Bank of Israel (in light of global financial developments), caused, in February 2021, a deviation of USD 75 billion from the top echelon of the desired rate set by the governor, increased the investment risks and created extensive liabilities in the bank reserve to the scope of NIS 555 billion, most of which are related to accrued reserves, alongside reduced bank capital to an accumulated capital deficit of approximately NIS 70 billion, as of December 2020. In order to return to the desired investment rate in the foreign currency reserves and to reduce the foreseen risk to the bank's reputation, a contingency plan



should be prepared to be examined by the monetary committee, to realize surplus reserves effectively in suitable circumstances.