NATIONAL BANK OF THE REPUBLIC OF MACEDONIA

Pursuant to Article 47 paragraph 1 items 3 and 18, and in conformity with Article 7 paragraph 1 item 4, Articles 24 and 41 of the Law on the National Bank of the Republic of Macedonia (Official Gazette of the Republic of Macedonia No. 158/10, 123/12, 43/14 and 153/15), the National Bank of the Republic of Macedonia Council adopted the following

Foreign Reserves Management and Investment POLICY[1]
(Unofficial revised text)

I. GENERAL PROVISIONS

1. The National Bank of the Republic of North Macedonia (hereinafter referred to as: the National Bank) shall manage and invest the foreign reserves of the Republic of North Macedonia (hereinafter: foreign reserves).

2. Foreign reserves play a key role in ensuring the country's ability to cover any foreign exchange net imbalances in the balance of payments and to maintain confidence in the country's monetary and exchange rate policies.

When managing and investing the foreign reserves, the adequate level of foreign reserves determined by the National Bank shall be taken into account, considering all possible sources and uses of foreign reserves, as well as the assessment of macroeconomic vulnerability to external shocks.

The National Bank shall manage and invest the foreign reserves to meet the following objectives:

- Support and maintain confidence in the Denar exchange rate policy, including interventions on the domestic foreign exchange market, and maintain orderly conditions in domestic financial markets;
- Provide confidence to markets that the Republic of North Macedonia can service its external obligations in a timely and orderly manner;
- Provide foreign exchange for operational needs;
- Invest efficiently the balances in excess of the foreseeable liquidity, intervention and precautionary needs;
- Provide a buffer to absorb balance of payments shocks during times of crisis.

II. FOREIGN RESERVES MANAGEMENT AND INVESTMENT OBJECTIVES

3. This policy sets out the institutional framework necessary for the effective and efficient realization of the foreign reserves management and investment objectives. These objectives are: safety, liquidity and profitability, in the same order of priority.

[1] Revised text of the Policy (Official Gazette of the Republic of Macedonia No. 223/15), the Policy on Amending the Foreign Reserves Management and Investment Policy (Official Gazette of the Republic of Macedonia No. 141/2016), the Policy on Amending the Foreign Reserves Management and Investment Policy (Official Gazette of the Republic of North Macedonia No. 132/22) and the Policy on Amending the Foreign Reserves Management and Investment Policy (Official Gazette of the Republic of North Macedonia No. 211/24).

- Safety of foreign reserves, i.e. capital preservation is the foremost investment objective. In this regard, the objective is attained through mitigating the credit, interest rate, currency and operational risks;
- The liquidity of foreign reserves should seek to ensure the availability of adequate funds for timely payment of planned and contingent liabilities of the foreign reserves. In order to ensure sufficient liquidity, foreign reserves are predominantly invested in instruments traded in an active secondary market;
- Profitability, i.e. return of investments, subject to the capital preservation and liquidity constraints, the objective is to achieve a competitive market rate of return on the foreign reserves, in accordance with the investment objectives and established risk constraints.

3-a. When managing foreign reserves, one can take into account also the National Bank's efforts related to the contribution to a green sustainable economy, increased awareness of climate changes and social responsibility, without compromising the principles of safety, liquidity and profitability.

III. FOREIGN RESERVES STRUCTURE

Foreign Reserves Tranching

4. In order to meet multiple objectives, the foreign reserves are segregated operationally in individual portfolios (tranches), depending on the liquidity requirements and investment horizon.

The structure and relative size of each tranche is based on an assessment of liquidity needs over different time horizons, taking into account the adequate level of foreign reserves. When the level of foreign reserves exceeds the scheduled repayment of external government debt and potential liquidity needs, a portion of the reserves can be invested over a longer investment horizon, with an objective to enhance returns.

To optimize foreign reserves management, while taking into account the varying liquidity requirements over different time horizons, each tranche is characterized by a distinct objective, eligible asset classes, risk tolerance and investment horizon. Tranches designed to meet short-term liquidity needs would be invested in short duration highly liquid assets. For tranches with a longer investment horizon, the National Bank would invest in relatively higher risk/return investment strategies, consistent with the principles of diversification of portfolio investments.

Depending on the scheduled repayment of external government debt and potential liquidity needs, while taking account of the level of foreign reserves adequacy, the foreign reserves are allocated into three tranches:

- *The Working Capital Tranche (operational portfolio)*, is funded to meet operational, short-term liquidity obligations and potential interventions. This portfolio has a one month investment horizon and is consequently invested in the most liquid and low risk instruments. Prior to the beginning of each month, the size of the working capital is determined by estimating the level of liquidity needs for the month, including the scheduled repayment of external government debt and potential interventions in the foreign exchange market. If necessary, the size of the working capital can be adjusted during the month;
- *The Liquidity Tranche*, which consists of funds that will replenish the Working Capital tranche (operational portfolio) as and when necessary and which receives excess cash from the Working Capital tranche (operational portfolio). The objective of this portfolio is to meet all contractual and potential draw-

downs over the next 12 months. This portfolio is invested in liquid financial instruments, with a capital preservation objective over a one-year horizon; and
- The Investment Tranche, which may have an investment horizon of more than one year and which is managed in order to enhance the return on foreign reserves, as well as to cover longer term contingent liabilities consistent with the country's macroeconomic and financial stability. This portfolio is deployed in higher risk financial instruments in search of higher investment returns, consistent with the risk tolerance stated by this Policy. Within the investment portfolio, a portion of the securities may be classified as securities held to maturity. The highest permitted amount and maturity of these securities are determined in the Foreign Reserves Management and Investment Guidelines, taking into consideration the level of the foreign reserves relative to the adequate level of foreign reserves assessed in the National Bank.

Without disrupting the function of any of the portfolios, the financial instruments within their framework can be managed according to three business models in order to provide cash inflows and manage financial risks. Depending on the business model, the financial instruments can be held for collection of the contractual cash flows, i.e. for maintaining a certain interest yield; for active and frequent trading to make gains from the changes in the market value of the instruments; or for collection of the contractual cash flows with a possibility of making gains from the changes in the market value of the instruments.

The criteria for determining the size of the portfolios, the eligible asset classes, the maximum maturity, the classification of the financial assets according to the selected business models, as well as the benchmarks are determined in the Foreign Reserves Management and Investment Guidelines. The size of liquidity and investment portfolio is periodically reviewed on the basis of forecasted liquidity needs, the expected foreign exchange needs.

Gold, as an unique portfolio, is aimed at ensuring safety and liquidity of the foreign reserves through diversification of investments, given that gold is an important asset in times of global, economic or political instability. The size and eligible instruments for investing gold are set in the Foreign Reserves Management and Investment Guidelines.

Target foreign reserves currency composition

5. Foreign reserves are invested only in freely convertible currencies of countries with deep and liquid capital markets.

The target foreign reserves currency composition is consistent with the currency composition of:
- interventions in the domestic foreign exchange market;
- external obligations of the country;
- foreign trade of the Republic of North Macedonia;
- other liquidity needs.

The target currency composition is determined, on the foreign reserves excluding the gold.

The target foreign reserves currency composition and the approved deviation bands around the target currency composition, for risk diversification and return enhancement purposes shall be determined in the Foreign Reserves Management and Investment Guidelines.

Strategic Asset Allocation and Investment Benchmarks

6. The strategic asset allocation of the foreign reserves and corresponding investment benchmarks will be established in the Foreign Reserves Management and Investment Guidelines. The strategic asset allocation of the investment portfolios is consistent with the objective for maximizing long-term annual expected return subject to low probability of decrease in their value over the investment horizon.

IV. ELIGIBLE ASSET CLASSES

7. The National Bank is authorized to purchase and sell the following financial instruments and enter into the following transactions:

Gold - the National Bank is authorized to hold a portion of foreign reserves in gold. The gold may be stored both in the National Bank vault and abroad. The National Bank may enter into transactions in domestic and international markets, place secured and unsecured deposits with banks and financial institutions, as well as refine gold that does not meet market standards in gold bullion.

Government securities denominated in domestic and/or foreign currency, government guaranteed securities and securities issued by international financial institutions and multilateral development banks - purchase and sale of debt securities issued or guaranteed by governments or government entities, including regional and local governments and public sector agencies or international financial institutions and multilateral development banks.

Banks' and financial institutions' instruments - placing deposits and purchase and sale of covered bonds, certificates of deposits, commercial papers and other money market instruments, issued or unconditionally guaranteed by banks and other financial institutions approved in the Foreign Reserves Management and Investment Guidelines.

Derivatives transactions - purchase and sale of derivatives with underlying instruments explicitly authorized in the Foreign Reserves Management and Investment Policy.

Repurchase and reverse repurchase agreements and securities lending - lending cash and eligible securities against collateral, where the securities are eligible instruments as determined in the Foreign Reserves Management and Investment Policy and Foreign Reserves Management and Investment Guidelines.

Foreign exchange - purchase and sale of foreign exchange and cash.

Corporate bonds - purchase and sale of debt securities issued by foreign financial and non-financial companies.

Stakes of investment funds - purchase and sale of stakes of investment funds that are registered abroad and with underlying instruments explicitly authorized in the Foreign Reserves Management and Investment Policy.

8. The lists of eligible countries, issuers and counterparties, investment funds management companies, as well as quantitative exposure limits are specified in the Foreign Reserves Management and Investment Guidelines.

9. In order to strengthen the institutional capacity in the management and investment of the foreign reserves, on proposal of the Investment Committee, the Executive Board may mandate external financial institutions to manage and invest part of the foreign reserves.

10. In order to ensure effective liquidity management and investment transactions, the National Bank can engage in offset borrowings from commercial banks and other financial institutions in which the National Bank has investments in order to reduce or eliminate the credit exposure to commercial banks or other financial institutions for a period equal to the remaining term of such investments.

11. The Financial Market Operations Department concludes and enters into transactions to meet the objectives of the Foreign Reserves Management and Investment Policy.

The Payment Systems Department, in coordination with the Financial Market Operations Department, opens and operates accounts with eligible central banks, commercial banks and other financial institutions.

V. CREDIT RISK AND EXPOSURE LIMITS

12. Exposure to credit risk is monitored and controlled by specification of minimum long-term rating levels for the issuers / financial institutions / financial instruments of at least BBB-/Baa3 or equivalent, according to internationally recognized rating agencies, at the moment of investing the foreign reserves. In addition, the credit risk is monitored through appropriate market indicators. Stricter exposure limits or additional restrictions can be determined in the Foreign Reserves Management and Investment Guidelines.

The credit rating of central banks matches the credit rating of the country. The Bank for International Settlements (BIS) and the International Monetary Fund are exempt from the credit rating requirements.

The exposure limit to individual commercial bank shall not exceed 10% of the total market value of the foreign reserves;

13. The Financial Market Operations Department shall regularly monitor the issuers / financial institutions / financial instruments in which foreign reserves are invested to determine the compliance with the criteria set out in the Foreign Reserves Management and Investment Policy and the Foreign Reserves Management and Investment Guidelines and shall inform the Investment Committee in case of new developments which are deemed to have a significant impact on the financial standing and the risk profile of the investments. The Investment Committee shall submit a proposal to the Executive Board on any changes in the criteria and the quantitative exposure limits.

If the credit ratings fall below the minimum threshold rating, the Financial Market Operations Department informs the Investment Committee. Under these conditions, new placements or investments in those instruments are not permitted, and the Investment Committee shall submit a proposal to the Executive Board to hold or to terminate the existing placements or investments under favorable market conditions.

VI. MARKET RISKS, EXPOSURE LIMITS AND RISK TOLERANCE PARAMETERS

14. Foreign reserves are exposed to interest rate risk, credit spread risk and currency risk. Interest rate risk relates to the risk that the market value of the reserves will decrease because of adverse movements in interest rates. Credit spread risk relates to the risk that the market value of the reserves will decrease because of a widening of credit spreads relative to risk-free government securities either because of a general deterioration in credit conditions or a specific deterioration in the creditworthiness of a specific issuer. Exposure to interest rate risk and credit spread risk should ensure the maximization of the expected return, subject to limiting the probability of reducing the market value of foreign reserves up to 1% at a confidence level of 95% during the investment horizon of one year.

The risk tolerance is specified in the Foreign Reserves Management and Investment Guidelines by setting benchmarks, target modified duration, deviations from the target modified duration and risk budget for active management by the portfolio managers in order to generate reasonably higher rate of return relative to the benchmarks. The risk budget is expressed as an acceptable potential drawdown, relative to the benchmarks and translated as limits on the undertaken positions. Risk budget will be distributed among internal and external portfolio managers.

Currency risk is the risk of decrease of the value of the foreign reserves relative to the target currency composition due to a deviation from the target currency allocation and adverse shift in the exchange rates. Currency risk exposure is not expected to exceed the level of revaluation reserves for exchange rate differentials.

Gold exposure to price and currency risk is covered by the revaluation reserves for gold.

VII. OPERATIONAL RISK

15. Internal operational risks in the foreign reserves management and investment process will be controlled by:

- Establishing an appropriate segregation of duties between Departments and Units involved in the foreign reserves management and investment process, covering procedures as follows: executing transactions, monitoring compliance with exposure limits and regulatory requirements, performance measurement, reporting, settlement and accounting;
- Delegation of specific and clearly defined responsibilities and accountabilities to each Department and Unit;
- Adherence to the ethics code, governing staff conduct in the management and investment of foreign reserves;
- Ensuring adequate information technology in order to support foreign reserves management and investment operations.

VIII. DIVISION OF RESPONSIBILITIES

16. The National Bank Council shall be responsible for monitoring the compliance of foreign reserves management and investment with the Law on the National Bank and the Foreign Reserves Management and Investment Policy.

17. The Executive Board of the National Bank adopts the Foreign Reserves Management and Investment Guidelines.

The Executive Board of the National Bank adopts Decision on establishing the Investment Committee.

The Investment Committee is responsible for monitoring the implementation of the Foreign Reserves Management and Investment Guidelines, as well as monitoring and oversight of all foreign reserves management and investment processes.

18. The Internal Audit Department shall monitor the compliance with internal procedures, roles and responsibilities in the foreign reserves management and investment process with the Foreign Reserves Management and Investment Policy and Foreign Reserves Management and Investment Guidelines and reports directly to the National Bank Council.

The Financial Market Operations Department is responsible for maintaining the organizational structure and effective internal controls, which ensures the management and investment of foreign reserves to comply with the Foreign Reserves Management and Investment Policy and Foreign Reserves Management and Investment Guidelines.

The Payment Systems Department shall be responsible for maintaining the organizational structure and effective internal controls that ensure timely and effective realization of all back-office operations related to the management and investment of foreign reserves.

IX. MANAGEMENT REPORTING

19. The Financial Market Operations Department shall report monthly to the Investment Committee on the foreign reserves portfolio composition, risk profile, market conditions and total return to date, as well as certain operational risks and corrective actions. Once the Investment Committee reviews the monthly report, it shall submit it to the Executive Board.

The Financial Market Operations Department through the Investment Committee shall provide quarterly reports to the National Bank Council on the management and investment of foreign reserves. The report contains a review of the current allocation of foreign reserves, including currency composition, instruments, modified duration and credit exposure. The report also includes the performance or the total return and the return from active management of portfolios.

The Financial Market Operations Department through the Investment Committee shall provide an annual report to the National Bank Council on the management and investment of foreign reserves. The report contains a review of the current allocation of foreign reserves, including currency composition, instruments, modified duration and credit exposure. The report also includes the performance or the total return and the return from active management of portfolios. This annual report is part of the Annual Report of the National Bank.

The Internal Audit Department, on an annual basis, shall provide a report on the compliance of internal processes and procedures with the Foreign Reserves Management and Investment Policy and Foreign Reserves Management and Investment Guidelines.

X. TRANSITIONAL AND CLOSING PROVISIONS

20. Once this Policy enters into force, it shall supersede the Policy on Managing the Foreign Reserves of the Republic of Macedonia (Official Gazette of the Republic of Macedonia No. 126/11 and 26/14).

21. This Policy shall enter into force on the eighth day after the date of its publication in the Official Gazette of the Republic of Macedonia, and shall apply from 1 January 2016.

P. No.

Governor
and Chairperson
of the National Bank of the Republic of Macedonia Council