LIQUIDITY RISK MANAGEMENT

Introduction
1. (a) In recent years the importance of cautious liquidity risk management has risen and it has been given great attention throughout the world. An increase in competition over raising deposits, changes in depositors’ preferences, the increase in off-balance sheet operations and improvements in the technological sphere have affected the banking corporations’ sources structure and the mode of managing their liquidity risk. These developments led the International Supervision of Banking Committee (the Basel Committee) to publish principles for the proper banking management of liquidity and supervision of this aspect.

(b) A liquidity problem in a single banking corporation may have implications on the entire banking system and vice versa. For this reason, an analysis of liquidity requirements cannot be limited to the individual banking corporation, but it must examine how the liquidity requirements can develop in various scenarios, including those in which the liquidity distress is more extensive than that of the bank itself.

(c) The regulation relates to the liquidity position in shekels, in foreign currency in general and the principal currencies in which the banking corporation operates.

(d) This regulation prescribes principles for the management, monitoring and control of the liquidity, that require developing infrastructures for managing the liquidity and inter alia determining a policy, infrastructure, information, reports, control and more.

Definitions
2. “Liquidity” - The bank’s ability to finance an increase in assets and to meet the repayment of liabilities as they come due;

“Liquidity risk” - The risk to the banking corporation’s profits and capital deriving from an inability to supply its liquidity requirements;
“Liquid assets” - Assets that can be converted into cash quickly, simply and at a reasonable cost or that can be paid when the management anticipates a need for additional liquidity, such as: cash, Treasury deposits for repayment up to one month, deposits with the Bank of Israel other than against the liquidity requirement for repayment up to one month, marketable government bonds and deposits with banks for repayment up to one month and other marketable government bonds in an amount of 25% of the average monthly turnover in government bonds on the Stock Exchange in the three preceding months;

“The liquidity mismatch” - A mismatch between the repayment flow of the assets and that of the liabilities in any period of time.

Managerial Infrastructure

3. (a) A banking corporation shall determine an overall liquidity management policy that shall be established in writing (hereinafter referred to as “the policy document”), which shall at least include:

   (1) Procedures that define the hierarchy of the managerial responsibility and the authorities;

   (2) Quantitative targets relating to the various liquidity management aspects, such as: composition of the assets and liabilities, use of financial instruments, the liquidity and ability to realise assets; furthermore, regard must be had to possible implications of other risks on the liquidity, including credit risks, market risks and operational risks;

   (3) Restrictions as to the liquidity mismatch, as detailed in section 10 below;

   (4) The set-up for dealing with deviations from the policy and the restrictions that were determined.

(b) The banking corporation shall revise the policy document in accordance with developments in the economy and in the banking corporation.

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Information System

4. A banking corporation shall maintain an adequate information system for monitoring, measuring, controlling and reporting of the liquidity position that shall be characterised as follows:

(a) It shall provide it with the ability to calculate the overall liquidity position and in each of the principal currencies in which it operates, on a daily basis for assets and liabilities the payment date whereof is within a number of days and for longer periods of time;

(b) It shall include information as to the liquidity position as compared with the restrictions that were determined and warn of trends in the development of the liquidity;

(c) It shall include information as to the liabilities structure in general and the large depositors in particular.

Board of Directors

5. A banking corporation’s board of directors shall discuss and resolve on the following matters and also take the actions set forth below:

(a) It shall approve the policy document;

(b) It shall ascertain that management has efficient tools for controlling the liquidity risk;

(c) It shall receive periodic reports, at least once a quarter, of the banking corporation’s liquidity position and the trends in the development of the liquidity, within the context of the exposures document as provided in section 4 of Proper Conduct of Banking Business Directive No. 339 (Risk Management). It shall receive more frequent reports in cases of a material exposure and an immediate report in special cases.

The Risk Control Unit

6. The risk control unit shall act in respect of the liquidity risk as set forth in section 10(b) of Proper Conduct of Banking Business Directive No. 339 (Risk Management).
Internal Audit


A Banking Group

8. (a) The board of directors of a banking corporation that controls other banking corporations shall discuss the banking group’s liquidity management policy in its entirety, including the group’s deployment for a liquidity crisis, and it shall examine the existence of an adequate information system. Furthermore, it shall ensure that restrictions are determined in the controlling banking corporation, with reference to the banking group and taking into account the results of such discussions and examinations.

(b) The internal auditor of a banking corporation that controls other banking corporations shall also ascertain the propriety of the overall liquidity management process in the banking group as an entirety.

Management, Measurement and Control of the Liquidity Position

9. A banking corporation shall maintain a mechanism for the on-going measurement and control of the liquidity position on a daily basis, non-consolidated, including overseas branches that shall *inter alia* include:

(a) **Estimation of the liquidity position**, that shall be performed by calculating the liquidity mismatch according to repayment periods and the ratio of the liquid assets to liabilities for a repayment period of up to one month;

(b) **The sources management** - a banking corporation’s management shall hold a periodic discussion with regard to the financing sources and the raising requirements and shall make decisions as to the composition, characteristics and diversification of the sources, with the object of diversifying the liabilities; regard must *inter alia* be had to the banking corporation’s difficulties in raising sources that are affected by changes in the market attitude towards it, changes in its rating, development of income and profitability and the like; the banking
corporation shall from time to time examine the assumptions that it used in the liquidity management;

(c) **Deployment for a liquidity crisis** - determining a plan for dealing with a liquidity crisis, which shall include a definition of the process of contending with the crisis, sources to cover the liquidity mismatch and the managerial team that shall be responsible for handling a liquidity crisis;

(d) **Scenarios** - an examination of the cash flows in various scenarios, both scenarios relating to the banking corporation and those relating to the entire banking system, and having regard to past experience; a banking corporation that controls other banking corporations shall also examine scenarios in connection with the group as an entirety; restrictions as set forth in section 10 shall be put in place in accordance with the liquidity position in such scenarios.

**Restrictions**

10. Restrictions shall *inter alia* be defined in the policy document in respect of:

(1) The liquidity mismatch - the mismatch according to repayment periods - one day, up to one week, up to one month, up to three months, up to six months, up to one year, in excess of one year;

(2) The ratio of the liquid assets to the liabilities for a repayment period of up to one month, provided that it shall not be less than 1;

for the purpose of calculating this ratio:

(a) Only assets for which there is a market, even in times of stress, should be included;

(b) For such purpose, liquid assets include anticipated receipts from repayments of up to one month of housing loans (as defined in "residential mortgage loans" in section 231 of Proper Conduct of Banking Business Directive No. 204 (Measurement and Capital Adequacy – IRB approaches to credit risk)) that were not classified as being in arrears within the meaning thereof in Proper Conduct of Banking Business Directive No. 314 (Dealing With Problem Debts);
(3) Restrictions on the sources structure that shall *inter alia* refer to concentration of the depositors, type of depositors and repayment period.

**Internal Model**

11. (a) A banking corporation that manages the liquidity risk with a well based internal model shall define the ratio mentioned in section 10(2) having regard to assets that are added to the liquid assets while reconciling the liabilities for a repayment period of up to one month as follows:

   (1) Assets that, according to the model, represent a reliable source for a cash receipt shall be added to the balance of the liquid assets;

   (2) The balance of the liabilities for a repayment period of up to one month shall be increased or decreased, as the case may be, by the level of repayments predicted by the model;

(b) A banking corporation that does not manage the liquidity risk with an internal model, shall do so in accordance with the provisions of section 10(2).

**Criteria for Determining the Liquidity Restrictions**

12. In determining the liquidity restrictions, a banking corporation shall at least take into account the following criteria:

   (a) The banking corporation’s goodwill and rating;

   (b) The degree of reliance on the trading book and the extent of its diversification, the size of the market and volatility of the prices;

   (c) The quality of the personnel managing this risk and the quality of the managerial reports set-up;

   (d) The diversification of the deposits and the rate of deposits of households;

   (e) The degree of certainty and availability of unutilised credit lines;

   (f) The effect of flows that are not taken in the liquidity calculation (operating expenses and the like);

   (g) The degree of the parent company’s willingness (that shall be established in a binding document) and ability to supply liquidity in the event of need.
Management of Liquidity in Foreign Currency

13. A banking corporation shall maintain a system for the measurement, control and monitor, as set forth in section 9, of the overall liquidity position in foreign currency and the principal currencies in which the banking corporation operates. An assessment of the required foreign currency liquidity must be made and restrictions on the foreign currency amount must be determined.

Report to the Banking Supervision Department

14. A banking corporation shall immediately report to the Banking Supervision Department any material deviation from the restrictions or where another material liquidity problem arises.

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