

Management of Credit Risk Derived from Trading Activity of Customers in Derivatives and Securities

Introduction

1. (A) Credit risk derived from trading activity of customers in derivatives and securities results from a banking corporation's financing of or exposure to the activity of customers. It has special characteristics in comparison with ordinary credit risk, because it changes over the life of the transaction according to the market conditions. In addition, the risk created can be two-sided, because the market value of the transaction can be positive or negative for each of the parties.
- (B) The requirements in this directive add to the requirements in the existing Proper Conduct of Banking Business Directives pertaining to risk management, credit risk management, and counterparty credit risk management.
- (C) The purpose of the directive is to emphasize and tighten the requirements for management of the risk assumed derived from trading activity of customers in derivatives and securities, while focusing on activity vis-a-vis customers engaging in speculative activity as defined below. It also adds a requirement for obtaining margin in respect of activity in over-the-counter derivatives (hereafter – "OTC derivatives").

Definitions

2.

"Customer engaging in speculative activity"

A customer of the banking corporation who has significant trading activity in derivatives and securities with potential for high leverage and/or exposure to high volatility.

This group also includes customers with non-financial activity, unless the banking corporation can produce clear

documentation showing that the customer's activity in derivatives and securities was designed to hedge against financial risks in the non-financial activity. The existence of marginal activity not conducted for such hedging purposes shall not prevent the classification of the activity as a whole as designated for hedging purposes.

The definition of significant activity shall be determined by the board of directors of the banking corporation, anchored in the banking corporation's policy, and applied consistently.

"Supervised customer"

One of the entities listed below or a comparable prudentially supervised entity in an advanced economy:

- (A) A banking corporation as defined in the Banking (Licensing) Law, 5741–1981;
- (B) Provident funds as defined in the Supervision of Financial Services (Provident Funds) Law, 5765–2005;
- (C) Insurers as defined in the Supervision of Financial Services (Insurance) Law, 5741–1981;
- (D) Mutual funds as defined in the Joint Investment Trust Law, 5754–1994;
- (E) Corporations whose sole business is issuing exchange traded funds (ETFs) as the term is defined in the Tel Aviv

Stock Exchange (TASE) Rules and Regulations, provided that the ETFs issued by the corporations are listed on the TASE.

"Derivatives securities"

and

- (A) Marketable derivatives and OTC derivatives, including long settlement transactions;
- (B) Securities financing transactions (SFTs), including margin lending transactions.

As these terms are used in Appendix C of Proper Conduct of Banking Business Directive No. 203.

"Trading activity on the capital market"

Trading activity in derivatives and securities.

Application

3. This directive applies to a banking corporation as defined in the Banking (Licensing) Law, 5741–1981. The requirements in the directive apply to all trading activity by customers on the capital market taking place through the banking corporation, including activity by supervised customers.

Principles for Management of Credit Risk Derived from Trading Activity of Customers on the Capital Market

Corporate governance

4. (A) The board of directors shall determine a risk appetite and risk tolerance and shall approve the overall framework for managing the risk. In implementing this, the banking corporation shall be entitled to adapt the principles contained in this directive to the materiality of the customer's activity.

(B) The senior management shall formulate and implement a comprehensive framework for measuring and managing the risk. This framework shall be consistent with the risk appetite and risk tolerance determined by the board of directors and shall facilitate regular monitoring, reporting, and control of the exposure to risk. The framework shall set, among other things, restrictions on exposure, both at the level of the individual exposure to a customer and at the level of concentration of exposures.

(C) Senior management shall verify that those engaging in this activity (in business lines and risk management) have the appropriate expertise, knowledge, and experience commensurate with the level of sophistication and complexity of the activity.

(D) The board of directors and senior management shall receive reports on the exposure to risk at a frequency consistent with the materiality of the exposure and complexity of the transactions. These reports shall include, among other things, results of concentration analysis and stress tests to facilitate understanding of the potential exposures and losses under extreme market conditions. Senior management shall discuss these reports at least once a quarter, with the frequency of the reports increasing as needed, for example if a material change occurs in the exposures to risk.

(E) Management of the risk derived from this trading activity shall be an integral part of the banking corporation's overall risk management process and shall comply with the requirements of Proper Conduct of Banking Business Directive No. 310 ("Risk Management"). This must include the following:

- (1) Separation in risk management between the first line of defense (the business line) and the second line of defense (an independent risk management function).

(2) Proper separation between the party responsible for business (the trading function) and the party responsible for valuation of the transactions.

(3) Proper separation between the customer's manager in the business division and the party responsible for routine control of trading exposures in cases in which the customer engages in both non-financial business and trading activity on the capital market.

(F) The internal audit shall include the subject in its scope of activity as required according to Proper Conduct of Banking Business Directive No. 307 ("Internal Audit Function") and as stated in Paragraph 777(X) in Proper Conduct of Banking Business Directive No. 211 ("Capital Adequacy Assessment").

Measuring Risks

5. (A) Due to the complexity of the exposures to risk, especially exposures resulting from activity in OTC derivatives, a banking corporation shall use a range of measuring methods in order to achieve a comprehensive understanding of this risk and how it changes in different surroundings. The measuring methods shall be consistent with the portfolio's size, complexity, liquidity, and risk profile.

(B) The banking corporation shall have the ability to measure its exposures at various levels of schema (for example, at the level of a legal entity and a group of related legal entities, line of business, sector, family of products, and the entire portfolio).

(C) A banking corporation with significant exposure to this risk shall utilize stress tests. Senior management shall periodically, at least once a quarter, assess the stress test results in order to detect potential for increased risk, and shall take appropriate steps for reducing it. Stress tests shall address, among other things, all trading and different forms of trading, for example OTC derivatives.

Risk management and control

6. (A) The banking corporation shall have an effective system of limits for managing the risk.

(1) Approval of the limits shall be through an escalation mechanism according to the volume of exposure and its level of risk.

(2) Monitoring of the exposure shall be conducted through computerized system independent of the business lines and shall take place at least daily.

(3) The corporation's policy shall also include an escalation mechanism in reporting and handling irregularities.

(B) A banking corporation shall set a policy and rules for effective management of customers in distress, including close-out.

(C) A banking corporation shall formulate and implement a suitable policy of collateral that shall be reviewed periodically. The collateral policy shall also comply with the requirements in Sections 8 and 9 below.

Special Specifications for Activity vis-a-vis Customers Engaging in Speculative Activity

7. (A) The board of directors shall discuss and decide whether it has risk tolerance for customers engaging in speculative activity. Insofar as the answer is positive, the risk appetite and tolerance shall be defined at the level of an individual customer and at the level of all the customers engaging in speculative activity.

(B) Mapping of customers as customers engaging in speculative activity shall be updated at least once a year (or when a significant change occurs in the customer's activity). The risk management function shall review the mapping of the customers at least once a year.

(C) The array of limits shall include specific limits for customers engaging in speculative activity.

(D) The line of business responsible for trading and capital market shall closely monitor the activity. Among other things, tracking of exposure shall also be conducted on an intra-day basis, and authority for reducing the exposure shall be defined. It should be verified that the banking corporation's aggregate exposure to that customer is being tracked.

Obtaining Margin from Customers

8. (A) A banking corporation shall require margin from every customer in respect of his activity in OTC derivatives (and when the customer also engages in activity in securities, in respect of his trading activity on the capital market), as set forth below:

(1) Variation margin

- a. A banking corporation shall calculate on a daily basis the full amount required in order to cover the current exposure created as a result of changes in the market value of the transaction (mark to market) after it is carried out and shall require supplementing of margin as necessary within one business day of the calculation date (hereafter – "variation margin").
- b. A banking corporation shall ask for the variation margin to be delivered to it within one business day of the delivery of the requirement to the customer for supplementing the margin.
- c. The stipulated dates for delivering the margin supplementing requirement and obtaining the margin, including the minimum sums for transferal, shall be anchored in the agreements for activity in OTC derivatives.

(2) Initial margin

- a. A banking corporation shall require the providing of margin on the date on which the transaction is carried out for the purpose of covering the future exposure liable to materialize as a result of potential future changes in the market value of the transaction (mark to market) during close-out and while replacing the position (hereafter – "initial margin").
 - b. A banking corporation shall obtain the initial margin at the beginning of the transaction and thereafter regularly and consistently on the basis of changes in the potential future exposure measured, such as when transactions are added to the portfolio or subtracted from it.
- (B) Transferal of the variable and initial margin shall be subject to a minimum sum for transferal from each customer that shall not exceed NIS 2,000,000.
- (C) Supplementing margin – increasing the customer's line of credit instead of receiving additional margin shall be considered an unacceptable practice inconsistent with proper conduct of banking.

- (D) A banking corporation shall anchor in agreements with the customer a clause stating that failure to supplement margin by him on the required date constitutes grounds for requiring immediate closure of the position.

9. Qualitative requirements regarding collateral

- (A) Definition of eligible collateral – in order to ensure that the assets received as collateral can be realized within a reasonable time span and in a volume that can provide sufficient protection for the banking corporation against losses if necessary, the assets should be extremely liquid and be capable, after applying an appropriate haircut, of maintaining their value at a time of financial stress.
- (B) Valuation of the collateral – the collateral should be calibrated diligently in order to reflect the risks to which they are exposed under both ordinary market conditions and conditions of stress, and appropriate haircut should be applied.
- (C) Substitution of collateral – the conditions should be defined under which the customer will be allowed to convert or substitute the collateral originally provided by him by alternative collateral before the end of the derivatives contract.
- (D) Collateral risk management – the banking corporation's policy shall include means for managing collateral risk – over-concentration, volatility, liquidity, wrong-way risk, and so forth.

Operational and Legal Risks

10. A banking corporation shall carefully manage the legal and operational risk stemming from trading activity of customers in derivatives and securities. In particular, for OTC activity, the banking corporation shall act according to the following principles (the corporation may adjust its implementation of the principle to the type of customer):
- (A) Trading relationship documentation – a policy and procedures shall be set for documenting in advance and in writing the substantive terms (obligations and rights) applying between the parties at the time of conducting transactions.
- (B) Trade confirmation – a policy and procedures shall be set for confirming the material terms in each transaction with the customer as soon as possible after execution of the

transaction. The material terms shall include terms necessary for enhancing the legal certainty of the transaction, including the transaction date, the settlement date, the underlying asset, the relevant law, the type of currency, and the par value.

- (C) Valuating the transaction – an understanding shall be reached with the counterparty on determining the value of each transaction from the execution of the transaction to its termination for the purpose of exchanging margins, with proper documentation of the valuation process.
- (D) Reconciliation – a policy and procedures shall set the performance of a periodic process in which the parties shall verify that the material terms and valuation for each of the transactions in the portfolio are identically recorded by both parties.
- (E) Dispute resolution – a consensual mechanism with the party to the transaction shall be stipulated and documented. The mechanism shall define how disputes involving material terms or valuations are to be settled during the life of the transaction as early as possible.

Effective Date and Transitional Provisions

- 11. (A) A banking corporation shall implement the requirements in this directive no later than July 1, 2018 (hereafter – "the effective date").
- (B) Requirements applying at the level of an individual transaction or transactions (for example, the margin requirement) shall apply to new transactions (including renewed transactions) no later than the effective date.
- (C) At this stage, the margin requirements set forth in Paragraphs 8 and 9 above shall not apply to a supervised customer, a central bank, or any other customer that does not engage in speculative activity. Requirements for these entities shall be determined by the Banking Supervision Department at a later date.
- (D) Regardless of the provisions of Paragraph 8(B), until further notice, a banking corporation shall be entitled to set a minimum transfer sum that shall not exceed NIS 5,000,000.

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Updates

Circular No. 6	Version	Details	Date
2544	1	Original circular	October 23, 2017

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