



Jerusalem
October 23, 2017
Circular no. 2544-06

Attn:
The banking corporations

Re: Management of Credit Risk Derived from Trading Activity of Customers in Derivatives and Securities
(Proper Conduct of Banking Business Directive No. 330)

Introduction

1. Among other things, the 2007–09 global financial crisis exposed weaknesses of banks worldwide in management of the risk derived from trading in derivatives and securities, both in activity by the banks on their own behalf and in activity on behalf of their customers. The banking system in Israel also experienced failures in the past in management of the risk derived from this activity. In order to ensure that the lessons were learned and that additional cases will not occur, this directive establishes requirements for managing this risk, with an emphasis on activity vis-a-vis customers engaging in speculative activity.
2. The Banking Supervision Department intends to publish a directive implementing the Basel committee's guidance pertaining to OTC derivatives¹, activity which constitutes part of trading activity in the capital market.
3. After consultation with the Advisory Committee on matters pertaining to banking business and with the approval of the Governor of the Bank of Israel, I have issued this directive.

Main points of the Directive

4. The following definitions have been established (**Section 2**):
(A) "Customer engaging in speculative activity"

Explanation

Specifications have been established in the directive for activity vis-a-vis customers engaging in speculative activity, who are customers with significant volumes of high-risk trading activity in derivatives and securities. The definition of "significant activity" shall be established by the banking corporation's board of directors, documented, and implemented consistently.

¹ Basel Committee standards:
Securities requirements: Margin requirements for non-centrally cleared derivatives, BCBS/IOSCO – March 2015;
Qualitative requirements: Risk mitigation standards for non-centrally cleared OTC derivatives, IOSCO – January 2015.

- (B) "Supervised customer"
- (C) "Derivatives and securities"
- (D) "Trading activity on the capital market"

5. Principles have been established for management of the risk derived from financing trading activity of customers in the capital market:
- (A) A banking corporation shall manage activity in the framework of accepted and well-defined corporate governance (**Section 4**).
 - (B) A banking corporation shall employ a method for measuring the risks derived from this activity commensurate with the volume and complexity of that activity, while utilizing stress tests in order to detect potential for increased risk (**Section 5**).
 - (C) A banking corporation shall manage the risks derived from this activity under an effective array of limits, closely monitor the exposure, and take effective action to reduce the exposure stemming from it, through the use of margin, among other things (**Section 6**).

Explanation

Financing trading activity of customers on the capital market exposes the banking corporation to a range of risks, and it must therefore manage and monitor those risks closely and appropriately.

6. A banking corporation operating vis-a-vis customers engaging in speculative activity shall employ more stringent risk management measures, including imposing limits at the level of the individual customer and the level of all customers, daily and intraday monitoring of the exposure, and defining authority for reducing exposure. Mapping the customers engaging in speculative activity shall be conducted at least once a year and shall be subject to review by the risk management function.

(Section 7)

Explanation

A banking corporation operating vis-a-vis customers engaging in speculative activity is exposed to higher risk by the nature of these customers' activity and is therefore required to apply more rigorous risk management.

7. A banking corporation shall require margin from customers active in OTC derivatives for securing the existing exposure (variation margin) and the potential exposure (initial margin) in respect of this activity (**Section 8**).
- The collateral shall consist of extremely liquid assets, shall be measured after appropriate haircut are utilized, the possibility of substituting them by other collateral shall be defined in advance, and the risks resulting from them shall be properly managed (**Section 9**).

Explanation

Customers' activity in OTC derivatives (and if a customer also has activity in securities, in respect of all of the customer's trading activity on the capital market) shall be accompanied by providing liquid collateral in order to reduce the banking corporation's exposure to losses. These requirements are becoming the accepted practice in various countries.

8. A banking corporation shall properly manage the legal and operational risks derived from trading activity of customers on the capital market. In particular, it

shall act according to the principles contained in the directive concerning activity of customers in OTC derivatives and securities (**Section 10**).

Explanation

Trading activity of customers exposes the banking corporation to financial risks, but also to legal and operational risks, and these should therefore be managed. For OTC derivatives and securities, it is especially important to carefully comply with arrangements. The directive therefore adopts international standards that have been formulated in this matter. A banking corporation can adjust implementation of these principles to the type of customer.

Cancellation of Proper Conduct of Banking Business Directive No. 335

9. Proper Conduct of Banking Business Directive No. 335 (Futures Transactions) shall be canceled on the effective date (July 1, 2018).

Revised file

10. Update pages for the Proper Conduct of Banking Business Directive file are attached. Following are the provisions of the update:

Insert page	Remove page
(10/17) [1] 330-1-7	

Respectfully,

Dr. Hedva Ber

Supervisor of Banks