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## **Directive 16—Collateral in a Controlled Payment System and a Designated Controlled Payment System**

### **1. Introduction**

In accordance with Section 8 of the Payment Systems Law, 5768-2008 (hereinafter: “the Payment Systems Law”), an operator of a controlled payment system shall formulate rules that will ensure the stability, efficiency, and sound functioning of the system.

In accordance with Principle 5 of the Principles for Financial Market Infrastructures (PFMI), published in 2012 by the Committee on Payment and Settlement Systems of the BIS (CPSS) and the International Organization of Securities Commissions (IOSCO), a financial-service infrastructure (FMI) that requires collateral to manage its or its participants’ credit exposure should accept collateral with low credit, liquidity, and market risks. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.

Collateralizing credit exposures protects an FMI and, where relevant, its participants against potential losses in the event of a participant default. Besides mitigating an FMI’s credit risk, collateral can provide participants with incentives to manage the risks they pose to the FMI or other participants. An FMI should apply prudent haircuts to the value of the collateral to achieve a high degree of confidence that the liquidation value of the collateral will be greater than or equal to the obligation that the collateral secures in extreme but plausible market conditions.<sup>1</sup> Additionally, an FMI should have the capacity to use the collateral promptly when needed.

This Directive regulates the requirement of controlled payment systems and designated controlled payment systems to back credit exposures with collateral that they may use at

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<sup>1</sup> The risk-management methods of some FMIs may integrate the management of risk from participant positions with the risk from fluctuations in the value of collateral provided by participants.



once and to apply prudent haircuts to its value, in consideration, inter alia, of extreme but plausible market conditions.

## 2. Definitions

“Payment system” “controlled system”, “designated controlled system,” “payment-system operator”-	As defined in the Payment Systems Law;
“Payment-system operator” or “system operator”-	Operator of a controlled payment system or a designated controlled payment system;
“Payment Systems Oversight” or “Oversight”-	The oversight unit for payment systems at the Payment and Settlement Systems Division of the Bank of Israel;
“Participant in a payment system”-	One who is defined as a participant under the system rules;
“System rules”-	The rules by which the payment system operates.
“wrong-way risk”-	the risk that an exposure to a counterparty is highly likely to increase when the creditworthiness of the counterparty is deteriorating;



“Credit risk”-

the risk that a counterparty, be it a participant or an other, will be unable to meet its financial obligations in full when they fall due or at any future time;

“Liquidity risk”-

the risk that a counterparty, be it a participant or another entity, will not have sufficient funds on hand to cover its financial obligations in the expected form and time, although it may be able to do so in the future.

“Market risk”-

the risk of a loss due to changes in market prices;

“Collateral”-

a third-party asset or obligation that is used by its giver to secure an obligation made by a collateral taker;

“Procyclicality”-

changes in risk-management requirements or practices that correlate positively with business-cycle or credit-cycle fluctuations and may cause or aggravate financial instability;

“Cross-border collateral”-

Collateral typified by at least one of the following indicators of foreignness: par currency,



“Re-use of collateral”-

jurisdiction of asset location,  
jurisdiction of collateral giver;  
Successive use by a payment  
system of collateral provided  
by participants in the payment  
system in the ordinary course  
of business;

“Haircut”-

a risk-control measure applied  
to underlying assets, in which  
the value of said assets is  
calculated as the market value  
of the assets net of a certain  
percent (the “haircut”).  
Collateral takers use haircuts  
to protect themselves against  
losses from a decline in market  
value of a security in the event  
that they need to liquidate said  
collateral.

“Creditworthiness”-

the ability to repay credit when  
due.

### **3. Incidence**

- 3.1 This Directive shall apply to the operator of every payment system that the Governor has declared a controlled payment system or a designated controlled payment system.



- 3.2 The Bank of Israel may, as circumstances shall indicate, absolve or exempt a payment-system operator from the incidence of certain sections of this Directive and may rescind said exemption.

#### **4. Acceptable collateral**

- 4.1 A system operator who demands collateral for the management of a credit exposure shall aspire to receive collateral assets that pose low levels of credit risk, liquidity risk, and market risk.
- 4.2 The system operator should be confident of the value of the collateral at time of liquidation and in his or her ability to use said collateral quickly, especially under extreme market conditions.
- 4.3 The system operator shall establish conservative haircuts and limits.
- 4.4 The system operator shall not define guarantees as acceptable collateral. In rare cases, subject to approval from Oversight, guarantees that are given by the Bank of Israel or are fully collateralized, and that may be liquidated the same day, may serve as acceptable collateral.
- 4.5 The system operator shall regularly align system requirements in respect of acceptable collateral with changes in the risks associated with said collateral.
- 4.6 The system operator shall act in consideration of possible delays in access to collateral. Furthermore, where necessary, he or she shall make appropriate arrangements with liquidity providers for the purpose of liquidating collateral.
- 4.7 The system operator shall not define a debt or an equity of participants or companies related to them as acceptable collateral.<sup>2</sup>

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<sup>2</sup> Collateralized bonds issued by a participant or a company closely related to it may be accepted as collateral provided the underlying collateral of said bonds is separated by the issuer from its assets and may be considered acceptable collateral within the framework of this principle.



- 4.8 The system operator shall mitigate the realization of misdirection risk by limiting collateral that is likely to lose value in the event of default by the collateral-giving participant.
- 4.9 The system operator shall measure and monitor the correlation of the participant's creditworthiness with the collateral provided and shall take measures to mitigate risks identified, e.g., by establishing more conservative haircuts.
- 4.10 A system operator who uses assets held as collateral to secure lines of liquidity in cases of participant default shall bear in mind, when determining acceptable collateral, what lenders that offer lines of liquidity will find acceptable as collateral.

## **5. Collateral valuation**

- 5.1 The system operator shall have in place prudent collateral valuation procedures and shall establish haircuts that will be reviewed regularly and will take account of extreme market conditions.
- 5.2 The system operator shall revalue the system's collateral, taking extreme market conditions into account, at least once per day.
- 5.3 The haircuts established shall:
  - 5.3.1 reflect the possibility of a decrease in asset value and liquidity during the interval between the last revaluation and the time at which the system can reasonably assume that the asset can be liquidated;
  - 5.3.2 include assumptions as to collateral value in the course of extreme market conditions;
  - 5.3.3 reflect regular extreme stress tests that take extreme price volatility and changes in market liquidity of the asset into account.
- 5.4 The system operator shall use discretion in valuating assets in accordance with predetermined and transparent methods in the event that market prices are not fair representations of the true value of the assets or in the event that market prices do not exist.



- 5.5 Procedures for collateral haircut and worthiness of acceptable system collateral shall be validated independently at least once a year.<sup>3</sup>

## **6. Procyclical management**

- 6.1 The system operator shall make appropriate reference to procyclicality in the system's collateral arrangements.
- 6.2 The system operator shall establish stable and conservative haircuts and shall adjust them such as to include periods of extreme market conditions, and this, in order to mitigate the need for procyclical adjustments.

## **7. Avoidance of collateral concentration**

- 7.1 The system operator shall avoid concentrated holding of assets that may impair the system's ability to liquidate said assets quickly without creating a meaningful adverse effect on prices.
- 7.2 The system operator shall avoid high concentration of holdings by setting limits to concentration or imposing concentration fees:
- 7.2.1 Concentration limits restrict participants' ability to provide certain collateral assets beyond a threshold that the system operator shall establish at the level of the individual participant and at the level of participants in the aggregate.
- 7.2.2 Concentration fees penalize participants<sup>4</sup> for holding certain assets beyond the threshold (quantity or in percent) that the system operator has established.

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<sup>3</sup> Validation of system haircut procedures should be carried out by staff that has adequate expertise and is independent of the staff that created and applied said procedures. Said staff may be internal but a review by an independent external player should be required in some cases.

<sup>4</sup> The penalty on account of concentration fees may find expression in various ways, including a money fine, high haircuts for excess assets, and so on.



- 7.3 Additionally, the system operator shall set concentration limits and concentration fees such that participants may not cover a large share of their collateral requirements by means of the riskiest assets that have been defined as acceptable.
- 7.4 The system operator shall periodically review the concentration limits and fees in order to determine whether they are adequate.

## **8. Cross-border collateral**

- 8.1 A system operator who accepts cross-border collateral shall identify and mitigate risks associated with its use and shall ascertain that he or she has the ability to use them when needed.
- 8.2 The system operator shall ascertain consistently that the system is adequately protected, in the legal and operational senses, to ensure its ability to use cross-border collateral when necessary.
- 8.3 The system operator shall identify and deal with meaningful liquidity effects.
- 8.4 The system operator shall estimate the exchange-rate risk that comes about when collateral is denominated in a currency other than the exposure currency and shall set haircuts in response to this additional risk at a high level of confidence.
- 8.5 The system operator shall ensure that the system is able to cope with the operational challenges that stem from cross-border activity.

## **9. Collateral-management systems**

- 9.1 The system operator shall use a collateral-management system that is well planned and operationally flexible.
- 9.2 The collateral-management system shall:
  - 9.2.1 support changes necessitated by the outcome of the monitoring and regular management of collateral.





- 9.2.2 Track the extent of collateral use (cash and other) and its rights to collateral given to it by participants.
- 9.2.3 apply functions for handling of deposits, withdrawals, swaps, and liquidations of collateral at the requisite time.
- 9.3 The system operator shall allocate adequate resources for the collateral-management system such as to ensure an appropriate level of operational performance, efficiency, and effectiveness.
- 9.4 The system operator shall ensure that the risk-management function is adequately staffed to ensure smooth activity, including at times of extreme market events.

## **10. Monitoring of collateral**

- 10.1 The system operator shall monitor all activities associated with collateral management and shall report them to senior management where necessary.<sup>5</sup>

## **11. Re-use of collateral**

- 11.1 The system operator shall establish clear and transparent rules for re-use of collateral and, in particular, shall know clearly when the system will re-use participants' collateral and the process of collateral restitution to participants.
- 11.2 The system operator shall not rely on re-use of collateral as a way to improve or maintain profitability. He or she, however, may invest any cash collateral obtained from participants for said participants' benefit.

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<sup>5</sup> Said reportage shall include information about re-use of collateral and the terms of said re-use, including the instrument, credit quality, and term to maturity. Said reportage shall also include monitoring of concentration of certain types of assets used as collateral.



## **12. Information reported and frequency of reportage**

- 12.1 When this Directive goes into effect and by March 1 of each year, the system operator shall forward the following documents to Oversight:
- 12.1.1 a list of acceptable collateral assets in the system including their use, whether cross-border collateral is being used, and the haircuts established;
  - 12.1.2 restrictions established, including those relating to concentration or concentration fees;
  - 12.1.3 the revaluation method for assets that are revalued not at market prices;
  - 12.1.4 description of the collateral-management system used;
  - 12.1.5 The rules established by the system operator in regard to re-use of collateral.

## **13 Forwarding information to the Bank of Israel**

- 13.1 A payment-system operator shall forward the information under this Directive by means of secured communication (the Kasefet application). Said application shall be used after prior coordination with Oversight. Oversight may allow the information to be forwarded in other ways.
- 13.2 The information under this Directive shall be forwarded by the system operator to the contact persons whom Oversight shall appoint for this purpose.
- 13.3 A payment-system operator who forwards information under this Directive shall ascertain by telephone that the contact persons specified in Subsection 13.2 received the information.
- 13.4 A payment-system operator who sits within a Bank of Israel structure and makes use of Bank of Israel systems shall forward the information under this Directive by means of the internal electronic-mail system of the Bank of Israel.
- 13.5 Information under this Directive shall be presented to Oversight in digital form.
- 13.6 Reportage shall be carried out in accordance with the deadlines established in this Directive. Insofar as a payment-system operator believes that a given report will not be



presented by the specified deadline, he or she shall present Oversight, by electronic mail, with a written request to revise the deadline for the presentation of the report. Said request shall include, *inter alia*, the actions taken up to said request for revision, the reasons for requesting the revision of the reporting deadline, and the requested target date for the presentation of the report in question. A reporting deadline for which revision is not approved by Oversight shall be presented by the deadline established for said report.

### **11. Promulgation and update of Directive**

<b>Date of promulgation</b>	<b>Essence of update</b>
December 22, 2019	Promulgation of directive

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