



Directive 7—Rules and Procedures for Management of Participant Default in a Controlled Payment System and a Designated Controlled Payment System

1. Introduction

In accordance with Section 8 of the Payment Systems Law, 5668-2008 (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, including in relation to the continued participation in the system of a participant against whom liquidation proceedings are under way.

In accordance with Principle 13 of the Principles for Financial Market Infrastructures (PFMI),¹ a financial service infrastructure should have “effective and clearly defined rules and procedures to manage a participant default. These rules and procedures should be designed to ensure that the FMI can take timely action to contain losses and liquidity pressures and continue to meet its obligations.”

In accordance with Principle 2 of the PFMI, concerning corporate governance, the Board of Directors and the rest of corporate governance shall support the implementation of detailed and effective rules and procedures concerning participant default.

This Directive specifies the rules and procedures that an operator of a controlled payment system and a designated controlled payment system shall apply in managing a participant failure.

¹ The principles were published in 2012 by the Committee on Payment and Settlement Systems of the BIS (CPMI) and the International Organization of Securities Commissions (IOSCO).



2. Definitions

“Payment system” “controlled system,” “designated controlled system,” “payment-system operator”- “Payment-system operator”-	As defined in the Payment Systems Law; 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;
“Operational default”-	Occurs when a participant is unable to meet its obligations due to an operational problem;
“Financial default”-	Occurs when a participant is unable to meet its obligations due to the realization of a liquidity or credit risk;
“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;
“Credit risk”-	The risk that a counterparty, be it a participant or another entity, will be



unable to meet its financial obligations in full when they fall due or at any future time.

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. Rules and procedures

A payment-system operator shall establish clear rules and procedures that will allow the payment system to continue meeting its obligations to non-defaulting participants in the event of a participant default. Said rules and procedures shall include, at the very least, reference to the following:

- 4.1 definition of the circumstances under which an event shall be declared a participant default—be it an operational default or a financial default.
- 4.2 differentiation, to the extent necessary, among types of participant-default situations in the payment system.
- 4.3 a method of identifying a participant default—automatically or with discretion.
 - 4.3.1 Insofar as identification is automatic, the rules and procedures shall include the circumstances under which a participant-default situation must be declared.



4.3.2 Insofar as identification is not automatic, the rules and procedures shall relate to the levels of authority to declare an event a participant failure and the main considerations in applying discretion.

4.4 the actions that the payment-system operator may take when an event is declared a participant failure for the purpose of its containment.

4.5 definition of controls and mechanisms within the payment system that may be invoked to contain the impact of the failure.

4.6 possible revisions of routine processes of the payment system to ensure the continued sound activity of the payment system.

4.7 defining the responsibilities of all parties involved and/or affected by the participant failure, including non-defaulting participants.

5. Default scenarios of participants that rely on other participant's services to operate in the system

5.1 A system operator shall examine the manner in which, and the extent to which, the payment system will be affected by these participants' malfunctions and defaults.

5.2 The system operator shall ensure that the payment-system rules and procedures are clear in regard to the status of these participants' payment orders at every stage of the process carried out by the payment system, including cases of default, be it of the participant on whose services they rely or of the participant who relies on it.

6. Use of financial resources

A payment-system operator shall establish rules and procedures that will allow it to act to contain liquidity pressures before, during, and after declaration of a participant failure. Said rules and procedures shall:



- 6.1 allow the immediate use of the financial resources² that the payment system holds for the purpose of containing liquidity pressures originating in default;
- 6.2 establish the sequence in which the different kinds of resources³ shall be used;
- 6.3 establish explicitly the pathway to replenishing these resources toward an appropriate and predetermined time horizon after the default situation ends; in particular, the rules and procedures shall specify participants' commitment to replenishing the financial resources that are used in the course of the default.

7. Mandatory deployment by system operator

The payment system shall deploy appropriately to apply its rules and procedures in default situations. Said deployment shall include procedures relating to the following matters, *inter alia*:

- 7.1 ascertaining that the payment system has the ability to apply its rules and procedures at the necessary time, including staff that is adequately sized, trained, and instructed, to detect, monitor, and deal with the default.
- 7.2 the way of documenting the default, receiving the information needed for control of the default, and management of communication and decision-making for management and containment of the default.

8. Due diligence in main aspects of rules and procedures

8.1 A payment system shall apply due diligence toward its participants in regard to the main aspects of its rules and procedures in case of default. Said diligence shall include, at the very least, reference to the following:

- 8.1.1 the circumstances under which actions may be taken;

² The system operator shall ensure that the realization of collateral provided be neither precluded nor delayed nor cancelled in accordance with any law or in accordance with the system rules.

³ To incentivize participants to manage risks, particularly credit and liquidity risks, prudently, the system operator shall first utilize assets provided by the participant who has defaulted.



- 8.1.2 who is authorized to take said actions;
 - 8.1.3 the extent of the actions that may be taken, including the handling of funds and other assets;
 - 8.1.4 mechanisms for dealing with an obligation of the payment system to non-defaulting participants;
 - 8.1.5 mechanisms that will help to deal with the obligations of a participant in default to its customers wherever direct relations with participants' customers exist.
- 8.2 The system operator shall ensure that the participants' customers and the public at large have appropriate access to key points in the rules and procedures concerning participant default and shall help them to understand said rules and procedures to the extent necessary—provided that said disclosure do no harm to the stability, efficiency, and sound functioning of the system.

9. Periodic checks and reviews of default rules and procedures

- 9.1 A check and review of participant default rules and procedures shall:
- 9.1.1 take place at least once per year or in the aftermath of material revisions of rules and procedures;
 - 9.1.2 ascertain the practicality and effectiveness of the rules and procedures relating to participant default;
 - 9.1.3 include all relevant parties that are likely to be involved in default rules and procedures (e.g., Board of Directors committees, participants, linked payment systems, relevant authorities, and linked service providers);
 - 9.1.4 include simulations that will check the application of treatment in a situation of participant default;
 - 9.1.5 verify the existence of a supportive legal infrastructure that will allow the measures warranted to deal with the default to be applied and enforced.
- 9.2 The system operator shall present the outcomes of said checks and reviews to the Board of Directors of the payment system and its risk committee.



10. Information reported and frequency of reportage

- 10.1 A payment-system operator shall present Oversight with the rules and procedures relating to participant default at the time this Directive goes into effect.
- 10.2 The payment-system operator shall present Oversight with the rules and procedures relating to participant default after any material revision, in a clean copy and a “Track Changes” copy, a month before said revision goes into effect. Insofar as the system needs adjustments due to said revisions, said report shall include the requisite adjustments and relevant schedules for their implementation.
- 10.3 The payment-system operator shall present Oversight with the checks and surveys laid down in Section 9 above by March 1 of each year.

11. Forwarding information to the Bank of Israel

- 11.1 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.
- 11.2 The information to be presented under this Directive shall be forwarded by the system operator to the contact persons whom Oversight shall appoint for this purpose.
- 11.3 A system operator who forwards information under this Directive shall ascertain receipt of the information by the contact persons referenced in Subsection 11.2 by telephone from the contact person, confirming receipt of the information.
- 11.4 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.
- 11.5 The information to be presented under this Directive shall be forwarded in digital form.
- 11.6 Reportage shall be carried out in accordance with the deadlines established in this Directive. Insofar as the 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 postpone the deadline for the presentation of the report. Said request shall include, *inter alia*, the actions taken up to said request for postponement, the reasons for requesting the postponement, and the requested target date for the presentation of the report in question. A report presentation for which postponement is not approved by Oversight shall be presented by the deadline established for said report.

12. Promulgation and update of Directive

Date of promulgation	Essence of update
April 25, 2018	Promulgation of directive

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