



Directive 14—Custody and Investment Risks 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 16 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) should safeguard its own and its participants’ assets and minimize the risk of loss on and delay in access to these assets. An FMI’s investments should be in instruments with minimal credit, market, and liquidity risks.

This Directive regulates the requirement of controlled payment systems and designated controlled payment systems to manage risks associated with custody and investment of the assets of the system and of its participants.



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.
“Custody risk”-	The risk of losses on assets held in custodianship in the event that the entity defaults, is negligent, is fraudulent, fails in its management, or keeps improper records;
“Investment risk”-	the risk of losses originating in investment of FMI’s or participants’ assets, such as collateral;



“Liquidity risk”-

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

“Market risk”-

The risk of a loss due to change in market prices.

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. Custody risk

The system operator shall manage the custody risk that pertains to assets (e.g., cash and securities) of the system and of those provided by participants in order to secure their obligations to the system. Said risk management shall be carried out by use of various tools, including:



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- 4.1 contracting with entities that participate in settlement via the Zahav (RTGS) system and apply accepted accounting practices, custody procedures, and internal controls that fully protect assets of the system and assets provided to the system by participants, such as collateral;
 - 4.2 ascertaining that assets held in custody are protected from claims by the entity that holds them;
 - 4.3 ascertaining that the entity operates on a sound legal basis that supports its activities, including segregation of its assets from those held by it for others;
 - 4.4 ascertaining that said entity should have a strong financial position to be able to sustain losses from operational problems or non-custodial activities;
 - 4.5 ascertaining the enforceability of the interests and ownership rights in the assets;
 - 4.6 ascertaining timely availability and access to assets of the system and those provided to it by participants, even if these assets are held in another time zone or jurisdiction and even in cases of participant default.
 - 4.7 The system operator shall evaluate and understand its exposures to its custodial entities, taking into account the full scope of its relationships with each entity, and shall understand the exposures of the system to said entities, giving consideration to the totality of relations with each. When performing this examination, the system operator shall ensure that each entity's total exposure to risk does not deviate from the comprehensive risk-management framework¹ that the system has established.
 - 4.8 The system operator shall consider, where possible, the use of several custodial entities in order to diversify the risk exposure that originates in reliance on one entity.
 - 4.9 The system operator shall monitor the concentration of risk exposures among custodial entities and shall track their financial condition on a regular basis.

¹ For elaboration, see Directive 6.



5. Investment strategy

- 5.1 The system operator shall sketch and establish a strategy for the investment of the system's assets and, where relevant, those of participants.
- 5.2 The investment strategy established in accordance with Section 5.1 above should be consistent with the general risk-management framework.
- 5.3 The system operator shall provide system participants with full disclosure of the investment strategy established.
- 5.4 When making investment decisions, the system operator shall act to strike a balance between the profit motive and the financial stability of the system and liquidity-risk management.
- 5.5 The system operator shall make investments that allow for quick liquidation with little, if any, adverse price effect.
- 5.6 The system operator shall invest only in companies/countries that are highly rated by the rating companies.
- 5.7 The system operator shall review the payment system's exposure to credit risk in each company/state in which the system is invested in its instruments, including additional relations² with the same entity that create additional exposures.
- 5.8 The system operator shall refrain from investing participants' assets in securities of the participants themselves or of companies related to them.
- 5.9 The system operator shall ensure that the investment of system resources that may also be used to cover losses and liquidity pressures resulting from a participant default will not compromise the system's ability to use these resources where necessary.

² For example, an entity that is also a participant or an affiliate of a participant.



6. Information reported and frequency of reportage

- 6.1 When this Directive goes into effect and by March 1 of each year, the system operator shall report the following to Oversight:
- 6.1.1 the system's investment strategy / investment policy;
 - 6.1.2 the composition of the investment portfolio and the rating of the investments;
 - 6.1.3 the names of the custodian entities and the assets kept by them (with reference, in this context, to the system's own assets and those provided to it by its participants);
 - 6.1.4 the total risk exposure for each custodian entity.

7. Forwarding information to the Bank of Israel

- 7.1 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.
- 7.2 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.
- 7.3 A system operator who forwards information under this Directive shall ascertain by telephone that the contact persons specified in Subsection 7.2 received the information.
- 7.4 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.
- 7.5 Reportage to Oversight shall be presented in digital form.
- 7.6 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, and the requested target date for the presentation of the report in question. A report presentation for which revision is not approved by Oversight shall be presented by the deadline established for said report.

8. Promulgation and update of Directive

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

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