Bank of Israel
Banking Supervision Department
Policy and Regulation Division

September 28, 2014
Circular Number C-06-2431

To:
The banking corporations and credit card companies

Issue: Liquidity Coverage Ratio
(Proper Conduct of Banking Business Directive 221)

Introduction

1. Due to the lessons learned from the global financial crisis, in December 2010 the Basel Committee on Banking Supervision issued a publication named Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems (hereinafter, "Basel III"). One of the central reforms of Basel III is the development of a minimum standard of liquidity, called the Liquidity Coverage Ratio. The objective of the Liquidity Coverage Ratio is to improve the short term resilience of the liquidity risk profile of banking corporations. It does this by ensuring that banking corporations hold an adequate stock of unencumbered High Quality Liquid Assets (HQLA), which can be converted easily and immediately in private markets into cash in order to meet the liquidity needs for a 30 calendar day liquidity stress scenario. The standard defines a specific framework for calculating the LCR, with the goal of establishing international uniformity.

2. This directive adopts the Basel III recommendations regarding the Liquidity Coverage Ratio in the banking system in Israel. It was formulated, among other things, after conducting a quantitative impact study (QIS) to estimate the effect on the banking system in Israel. The directive reflects the position of the Supervisor of Banks on each of the issues in which the Supervisor has discretion.

3. Following consultations with the Advisory Committee on Banking Business, and with the approval of the Governor, I have decided to set this Directive as follows.

General comments

4. The directive establishes a minimum liquidity level for banking corporations. Similar to the practice regarding the capital adequacy standard, the Supervisor may demand higher minimum liquidity levels from a specific banking corporation, if the Supervisor is of the view that the Liquidity Coverage Ratio does not adequately represent the liquidity risk faced by the corporation.
5. At this time, the directive does not cover the other minimum standard set in Basel III—the net stable funding ratio (NSFR)—which is intended to promote the banking system's resilience over a longer time horizon. This standard is expected to be implemented in the future after Basel Committee work on it is completed and according to the Committee's timeframe.

6. The Basel Committee's recommendations to supervisors regarding monitoring tools for liquidity risk (Chapter 2 of the Basel III document) will be reflected separately in Reporting to Banking Supervision directives. Banking corporations are expected to use these and other monitoring tools to manage liquidity risk.

7. Proper Conduct of Banking Business Directive no. 342 regarding liquidity risk management (hereinafter, Directive 342) will continue to be in force in addition to this directive, and the qualitative and quantitative requirements in it are to be followed. The directive will be updated after the end of the transition period for implementing the Liquidity Coverage Ratio.
   A banking corporation that is interested in advancing the date of implementing the 100 percent Liquidity Coverage Ratio, while foregoing the transition period, may contact the Banking Supervision Department regarding the implementation of the quantitative requirements in Directive 342.

8. The section numbers in the directive are in line with the numbering in the original Basel III document, except for the Introduction, Application, and Implementation Date sections. Likewise, there was a change in numbering of the Annexes (Annexes 2 and 3, which are not relevant in Israel, were cancelled).

The main points of the Directive

9. **Scope of Application (Section 5 in the directive)**
   (a) This directive shall be implemented by a banking corporation, excluding a joint services company.

(b) A banking corporation that heads a banking group shall implement the directive on a solo and consolidated basis.
(c) Other banking corporations shall implement the directive on only a consolidated basis.
(d) A branch of a foreign bank shall meet the requirements in Annex 3.

Explanation
This directive is to be implemented by all banking corporations. Banking groups shall implement the directive on both a solo and consolidated basis. This approach integrates the Basel Committee guidelines for monitoring the Liquidity Coverage Ratio on a consolidated basis with the importance ascribed by the Banking Supervision Department to monitoring and tracking liquidity risk on a solo basis, in light of the characteristics of banking groups in Israel. Other banking corporations are to implement the directive on a consolidated basis, an approach that is in line with the Basel Committee guidelines.

At this time, credit card companies are not required to follow this directive, and shall continue to meet the requirements of Directive 342. At a later point, these companies will be required to meet a quantitative regulatory model that will be in line with their activity characteristics. To remove any doubt, credit card activity will be taken into account by a banking group when calculating the Liquidity Coverage Ratio on a consolidated basis.

A branch of a foreign bank whose activity is not greater than the threshold set, will not be required to meet the Liquidity Coverage Ratio, but rather a simple liquidity ratio, as defined in Annex 3, and subject to receiving a comfort letter from the parent company.

10. **The objective of the Liquidity Coverage Ratio and use of HQLA**
(a) The Liquidity Coverage Ratio looks out over a 30 calendar day liquidity stress scenario, and is intended to ensure that a banking corporation has a stock of unencumbered High Quality Liquid Assets to meet the banking corporation's liquidity needs for that period. With that, a banking corporation should also ensure it has an adequate amount of High Quality Liquid Assets to meet its liquidity needs within this period. **(Section 16 of the directive)**
(b) The directive requires that, absent a situation of financial stress, the Liquidity Coverage Ratio be no lower than 100 percent (subject to the transition provisions). With that, during a time of financial stress a banking corporation

may decline to below the 100 percent level. A decline below the required ratio shall be accompanied by an immediate report to the Supervisor and by the submission of a recovery plan if necessary. It should be clarified that during the transition period only a decline below the obligatory ratio at that time (60 percent beginning April 1, 2015, and 80 percent beginning from January 1, 2016) will require a report to the Supervisor. **(Sections 17 and 18 in the directive).**

11. **Definition of the Liquidity Coverage Ratio**

I. Stock of HQLA

(a) The section contains the tests according to which HQLA will be defined. In order for an asset to be qualified for consideration as HQLA, it must be included in one of the HQLA categories (Sections 49–54c in the directive), and must meet the characteristics of HQLA listed in sections 24–27 of the directive and meet the operational requirements listed in sections 28–40 of the directive.

(b) Level 1 assets can be included in the stock of HQLA without limitation. Level 2B assets and total Level 2 assets are to be included in the stock of HQLA in accordance with limitations set in the directive (15 percent and 40 percent, respectively), calculated after required haircuts and after taking into account the unwind of short term securities financing transactions and collateral swaps that mature within 30 days, that involve an exchange of HQLA **(Sections 46–48 of the directive).**

(c) Level 1 assets are not subject to a haircut under the LCR, except for Israeli government securities, which may be included as Level 1 assets after applying the Bank of Israel haircut rates for makam and government bonds that serve as collateral for credit. The haircut rates do not need to be applied if the banking corporation's total position is not greater than 20 percent of the stock exchange trading volume (as defined in the directive) of that bond type. Bank of Israel reserves shall not include required reserve amounts, except for required reserves in respect of deposits with a run-off rate in the LCR of 100 percent. **(Sections 49–50 of the directive).**

Explanation

The requirement that Israeli government securities be included in the calculation after applying the Bank of Israel haircut rates for *makam* and government bonds that serve as collateral for credit is based on the Israeli

government bond market's characteristics. The required reserve at the Bank of Israel is not included in the stock of HQLA because Bank of Israel policy does not allow it to be withdrawn in times of stress; however, there is no need to offset the required reserve in respect of deposits for which in any case HQLA worth the full value need to be held.

(d) Level 2A assets include marketable securities representing claims on or guaranteed by sovereigns, central banks, PSEs or multilateral development banks that are assigned a 20 percent risk weight, as well as corporate debt securities that meet the conditions listed in the directive, including a minimum rating. Assets are to be included in the stock of HQLA after applying a 15 percent haircut. **(Section 52 of the directive)**.

Explanation

Corporate debt securities are valid for inclusion in HQLA only if, in addition to meeting all other conditions and requirements, they have been rated at the required minimum ranking (long term credit rating of AA- and higher, or a short term credit rating of equivalent quality). This rating is to be the rating of a recognized international credit rating agency, so long as in Israel there is no recognized external credit rating agency.

(e) Level 2B assets include corporate debt instruments meeting the conditions set in the directive, that are rated between A- and A+ by a recognized external credit rating agency or corporate debt instruments traded on the Tel Aviv Stock Exchange that are rated AA- or higher by a local credit rating agency. The debt instruments will be included after applying a haircut of 50 percent. Likewise, Level 2B assets may include the undrawn value of a contractual committed liquidity facility (CLF) provided by the Bank of Israel, so long as the Bank of Israel provides a liquidity facility that meets the conditions in the directive **(Sections 53, 54, and 54a of the directive)**.

Explanation

The directive allows banking corporations to include Level 2B assets in HQLA in order to diversify the stock of HQLA in Israeli shekels. Corporate debt instruments traded on the Tel Aviv Stock Exchange with a high local ranking (AA- and above) may be included in Level 2B assets. Likewise, to the extent that the Bank of Israel will provide a contractual committed liquidity facility to banking corporations that meets the conditions set in Section 54a of the directive, and subject to individual approval by the Supervisor of Banks, a banking corporation will be able to consider such a facility as a Level 2B asset.

(f) A banking corporation that is a controlled subsidiary of a banking corporation is able to include in its stock of HQLA a liquidity facility that the controlling banking corporation commits to provide it in a stress scenario, subject to the conditions set in the directive (**Section 54c of the directive**).

Explanation

The directive permits special treatment of a liquidity facility between a controlled banking corporation and a controlling banking corporation, subject to, among other things, this line not being the main HQLA of the banking subsidiary.

II. Cash outflow

(g) Retail deposits and small-business deposits that are eligible for treatment as retail deposits are divided into two main categories: stable and less stable.

(1) A stable retail deposit is a deposit in Israel (in Israeli shekels or foreign currency) whose overall amount, on a customer basis, is not more than NIS 0.5 million or a retail deposit in another country insured by a deposit insurance, as defined in the directive. In addition, the deposit is to meet one of the conditions listed in the bullets in Section 75 of the directive. A stable demand deposit or with a remaining term to maturity of 30 days and less is to be included in the LCR with a run-off rate of 5 percent, unless the deposit is in a country that implements a run-off rate of 3 percent on stable deposits and the deposit meets the conditions set in that country for this issue.

(2) A less stable retail deposit is a deposit that does not meet the conditions of a stable retail deposit. A less stable demand deposit or with a remaining term to maturity of 30 days or less is to be included in the LCR with a run-off rate that varies from 10–20 percent, in accordance with the size of the deposit (on a customer basis).

(3) A retail deposit with a remaining term to maturity of greater than 30 days is to be included in the LCR with a run-off rate of 3 percent.

(4) The treatment of retail deposits in legal entities of the banking group abroad shall be carried out as per the guidelines in sections 169 and 170 of the directive.

(Sections 73–84 and 89–92 of the directive).

Explanation

The distinction between stable retail deposits and less stable retail deposits and the differences within the category of less stable retail deposits reflect the assumption that deposits of retail customers' and of small businesses with different characteristics will respond differently in the stress scenario at the basis of this directive. For simplicity, a main test was chosen for depositor conduct, and it is the test of size of deposit, even if it is known that it is not the only test. The cash outflow is expected to also include withdrawals from retail deposits with a remaining term to maturity of greater than 30 days, at a rate of 3 percent. The requirement comes due to the concern that a banking corporation will permit its customers to withdraw these deposits as well, for example, for reputation reasons.

(h) Wholesale deposits deposited with a banking corporation for certain reasons may be defined as deposits for operational needs and receive a run-off rate of 25 percent. The directive lists the reasons and conditions under which deposits may be considered as deposits for operational needs. Such recognition also involves advance approval from the Supervisor for such treatment. **(Sections 93–104 in the directive).**

(i) Uninsured wholesale funding from nonfinancial corporations, sovereigns, central banks, multilateral development banks, and PSEs will receive a run-off rate of 40 percent (or 20 percent if fully covered by deposit insurance or equivalent public guarantees). Likewise, a trust whose beneficiary is an individual as defined in the directive is to be treated in this category (a run-off rate of 40 percent). **(Sections 107–108 of the directive).**

(j) Uninsured wholesale funding from other customers, including banking corporations, securities firms, insurance firms, trusts (except for trusts whose beneficiary is an individual as defined in the directive) and maturing debt instruments issued by the banking corporation, will receive a run-off rate of 100 percent. **(Sections 109–110 of the directive).**

(k) Short-term secured funding transactions (whose maturity date is in the next 30 days) are to be treated according to the counterparty to the transaction, to the extent it is a domestic central bank, domestic sovereign, domestic PSE and multilateral development bank or by the asset guaranteeing the transaction. **(Sections 112–115 of the directive).**

(l) Additional requirements

(1) The LCR is to include cash outflows in respect of the following: derivatives transactions, potential changes in market valuation of derivatives transactions, addition collateral that the banking corporation may be required to post for reasons listed in the directive, and the possibility that HQLA received by the banking corporation as collateral will be substituted with assets that are not HQLA. (**Sections 116–123 of the directive**).

(2) The LCR is to include cash outflows in respect of withdrawals from credit and liquidity facilities. The run-off rate is set according to the counterparty. (**Sections 126–131 of the directive**).

(3) The LCR is to include cash outflows in respect of contractual obligations to extend funds within the LCR period that were not expressed elsewhere. (**Sections132–133 of the directive**).

(4) The LCR is to include cash outflows in respect of contingent funding obligations:

- Contingent funding obligations stemming from trade finance instruments, at a run-off rate of 5 percent.
- Guarantees and letters of credit that are not related to trade financing, at a rate of 10 percent, except for performance guarantees for which a 3 percent run-off rate is to be assumed, and guarantees to back investment by homebuyers (according to the Sale (Apartments) (Securing of apartment buyers' investments) Law, 5735-1974, for which a run-off rate of 0 percent is to be assumed.
- Covering customers' short positions by other customers' collateral, a 50 percent run-off factor.
- Potential liquidity withdrawals by joint ventures or by minority interests investments in entities that the banking corporation does not consolidate in its financial reports, the full expected withdrawal.
- Non-contractual obligation to repurchase debt of the banking corporation or to support products to which the banking corporation is related or sponsors, based on the banking corporation's estimation.

(Sections 134–140 of the directive)

Explanation

The cash outflow is to take into account off-balance sheet obligations, potential change in collateral requirements and in market valuations of derivatives, as well as the banking corporation's contingent obligations. The directive includes guidelines with respect to the manner of calculating the cash flows in respect of the various sections.

Credit and liquidity facilities are to be reflected in cash outflows whether they are committed or not. This approach is in line with the approach taken in the capital adequacy standard, as the legal and commercial conditions in Israel do not justify recognizing credit and liquidity facilities that can be cancelled unconditionally.

III. Cash inflows

(m) Cash inflows are capped at 75 percent of total cash outflows. **(Section 144 of the directive)**

(n) Cash inflows will include only:

(1) Cash flows in respect of short term secured lending (maturing in the next 30 days), including margin loans. Cash inflows are to be calculated by the asset securing the transaction, and with the stipulation that the collateral has not been re-used. **(Sections 145–146 of the directive.)**

(2) Cash inflows in respect of exposures contractually due within the next 30 days, fully performing, and that the banking corporation has no reason to expect to default within the next 30 days. Cash inflows are determined by their counterparty. This category may include cash inflows in respect of on-call credit redemption, at an amount not greater than 20 percent of the balance of such credit. **(Sections 150–154 of the directive).**

(3) Cash inflows in respect of securities maturing in the 30-day LCR calculation period and that were not included in the stock of HQLA, at a rate of 100 percent. **(Section 155 of the directive).**

(4) Cash inflows in respect of derivatives. **(Sections 158–159 of the directive).**

Explanation

The directive establishes how to calculate the cash inflows and the cap for such flows. As part of this, the directive allows recognition of on-call credit redemption (as defined in Reporting to Banking Supervision Directive no. 821) up to 20 percent of its balance. The rate is determined on the basis of the assumption that the banking system will be able, in a combined scenario, to call on only a small portion of the credit.

12. **Issues in application of LCR**

(a) The Liquidity Coverage Ratio is to be in ongoing use, on a daily basis, of a banking corporation. The Liquidity Coverage Ratio is to be reported to senior management at least once per month, and to the board of directors at least quarterly. In stress scenarios it is expected that the frequency of reporting will be increased to weekly or even daily. In addition, in special situations (not necessarily stress scenarios) immediate reports should be submitted to these functions. **(Section 162 of the directive.)**

(b) Calculation of the Liquidity Coverage Ratio on a consolidated basis will generally be made according to rules adopted in Israel, except for treatment of retail and small business deposits, regarding which the treatment adopted will usually be that of the host country in which the corporation's branch or subsidiary operates. **(Section 168–170 of the directive.)**

(c) A banking group operating in various countries is not to recognize in the calculation of the Liquidity Coverage Ratio on a consolidated basis liquidity surpluses, if there is a reasonable doubt related to the availability of such surpluses. **(Sections 171–172 of the directive.)**

(d) The Liquidity Coverage Ratio will be determined and be reported in all currencies, combined, and in foreign exchange separately. In addition, banking corporations are expected to estimate the liquidity needs in each one of the significant currencies and to hold HQLA that are in line with the distribution of their liquidity needs in each one of the significant currencies. **(Sections 42 and 173 of the directive.)**

Explanation

In accordance with the principle set in Directive 342, and in light of the characteristics of the Israeli economy, a banking corporation is to maintain an

overall Liquidity Coverage Ratio of not less than 100 percent and a Liquidity Coverage Ratio in foreign currency alone of not less than 100 percent.

Date of implementation

13. The provisions of this circular begin on April 1, 2015.

Transition provisions

14. In accordance with Section 6 of the directive, the minimum requirement for the Liquidity Coverage Ratio will be 60 percent on April 1, 2015, and will increase to 80 percent on January 1, 2016, and to 100 percent on January 1, 2017.

    Explanation

    The period of time until implementation of the requirement to maintain a Liquidity Coverage Ratio of 100 percent is intended to allow banking corporations to prepare for implementation without negatively impacting their operations. With that, in light of the results of the QIS, the transition period set by the Basel Committee was shortened.

    It is expected that a banking corporation that already meets a Liquidity Coverage Ratio of 100 percent on the implementation date of the directive, will not fall below such ratio over the course of the transition period.

15. Notwithstanding the provisions of Section 50(b) of the directive, required reserve in respect of foreign currency derivatives that is deposited at the Bank of Israel may be recognized as Level 1 HQLA until December 31, 2015. Extension of such easing will be examined in accordance with developments in this area.

16. For banking corporations that implement the Liquidity Coverage Ratio on a solo basis and on a consolidated basis, the requirement set in Section 162 for daily monitoring of the Liquidity Coverage Ratio on a consolidated basis will go into effect on January 1, 2017; from the start date until December 31, 2016, said banking corporation is to monitor the solo LCR on a daily basis and the consolidated LCR on a monthly basis.

17. A foreign bank that is not prepared for implementation of Annex 3 at the implementation date, may contact the Supervisor to coordinate the date and/or manner of implementation for said foreign bank.

File update

18. The updated pages of the Proper Conduct of Banking Business file are attached. The following are the update instructions:

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(9/14) [1] 221-1-47	

Sincerely,

David Zaken
Supervisor of Banks