Bank of Israel
Banking Supervision Department

Jerusalem
December 22, 2009
09LM0670
SRP127.doc

Attn:
Banking corporations
Credit card companies
To:
Chairman of the Board of Directors
Chief Executive Officer

Re: Chief Risk Officer and Risk Management Function

1. Appropriate risk management culture, wide ranging and cross-organizational, is a central component of an effective risk management system at banking corporations, and another pillar in assuring their long term stability. Strong risk management requires first and foremost a deep understanding and recognition of the risks inherent in the bank's activities.
2. In order to strengthen the ability to understand the risks and ensure their careful management, there is a need for an independent risk management function, headed by a Chief Risk Officer, as stated in the attached document. The establishment of this function is critical to, among other things, strengthening the connection between the risk profile, risk management systems, and capital adequacy of the banking corporation, as required by the second pillar of Basel II and the related guidelines.[1]
3. This document defines the principles for establishing the Chief Risk Officer role and risk management function at banking corporations, and details the standing, the post, and responsibilities involved. The principles of the document are consistent with the guidelines of the Basel Committee and the Committee of European Banking Supervisors (CEBS), as detailed in section 3 of the attached document.
4. I request that you arrange for implementation of the attached guidelines, and send the planned structure of the risk management function to me for approval by March 31, 2010.

Sincerely,

Rony Hizkiyahu
Supervisor of Banks

Copy:
Mr. Tsuriel Tamam, Basel II project manager

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[1] Letter from Supervisor of Banks, dated December 13, 2007, on the subject of principles of the supervisory review process (173-S).

Risk Officer and Risk Management Function

Introduction

1. Risk taking is an inseparable part of the banking business. The developments in the international and Israeli money and capital markets show the implications of globalization and financial innovation on the potential exposure to risks, in the fields of activity in which banking corporations operate.

2. In order to strengthen the ability to understand the risks inherent in the activities of the banking corporation and to ensure the careful, proper, and complete management of the range of risks, the banking corporations are to confirm that every individual or organization in the banking corporation is aware of their responsibility in the identification, monitoring, mitigating, and reporting of risks found in their area of responsibility; and in addition, to firmly establish a comprehensive and independent risk management function.

3. These guidelines set the founding principles for the existence of a risk management function which is independent, effective, and with a clear formal standing in the banking corporation, headed by a Chief Risk Officer. These guidelines are consistent with Basel principles for strengthening a corporate governance regime[2], with Basel principles for an internal control framework[3], with complementary guidelines that the Basel Committee published in July 2009[4], as well as with the draft recommendations of the Committee of European Banking Supervisors (CEBS) from April 2009.

4. The risk management function is to be suitable for the size of the banking corporation, the characteristics of its business activities, and its complexity.

5. It should be noted that the term "risk management function" refers to a team of workers who perform tasks in the area of risk management oversight, which is professionally subordinated to the Chief Risk Officer. There is no intention, in using this term, to commit the banking corporation to a specific type of organizational structure.

Responsibilities of the Board of Directors and senior management

6. Within the framework of its responsibility to set the banking corporation's risk appetite, the Board of Directors is to understand the ability and limitations of the banking corporation to bear risk. In line with these abilities and the risk appetite that will be set, the Board of Directors will set the banking corporation's strategy and goals.

7. In order to establish a deep understanding of the range of existing and future risks in the activities of the banking corporation and group, the establishment

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[2] Enhancing corporate governance for banking organizations, February 2006.
[3] Framework for internal control systems in banking organizations, September 1998.
[4] *BCBS Enhancements to the Basel II Framework, July 2009.*

of an independent function with wide risk overlook is required. This will provide the board and management all the relevant information for suitable oversight of the banking corporation's risk profile and guidance of its activities.

8. In light of the above, the Board of Directors and senior management of the banking corporation will arrange to set up an appropriate risk management function, and will establish its authorities, responsibilities, and resources.

9. The banking corporation's board will approve the appointment and termination of employment of the Chief Risk Officer, in line with the recommendation of the CEO.

10. The board and senior management of the banking corporation will define the type, extent, and frequency of the required information to fulfill their responsibilities as required.

Chief Risk Officer

11. The Chief Risk Officer will head the risk management function. He will be a member of senior management and will report directly to the CEO. The Supervisor of Banks can exempt specific banking corporations and credit card companies that are subsidiaries from the requirement that their Chief Risk Officer be a member of senior management.

12. The Chief Risk Officer will have a level of expertise and skills that are appropriate to the risk profile of the banking corporation.

13. The Chief Risk Officer will be responsible for coordinating the activities of all units connected to the risk management framework and for a cross-organizational perspective of all the risks implicit in the activities of the banking corporation and the group.

14. The Chief Risk Officer will be independent and will not make any business decisions that involve risk-taking. As part of the senior management and its committees, he will express a professional opinion from the perspective of risk management.

15. The Chief Risk Officer will challenge the decision making processes in the banking corporation in the context of risk policy and risk strategy decided upon by the board of directors and the senior management.

16. The Chief Risk Officer will be invited to meetings of the senior management and also to meetings of the management committees that are relevant to his function.

17. The Supervisor of Banks will receive prior notification of the appointment of a Chief Risk Officer and also when that individual leaves the position. When the Chief Risk Office leaves the position, the notification will include the reasons for the leave.

The roles of the risk management function

18. The risk management function will ensure that risks implicit in the activities of the banking corporation and the group are fully understood and he will provide independent oversight of the manner in which they are managed.

19. The risk management function will be actively involved in the following activities already from an early stage:
   (a) The banking corporation's strategic planning and the setting of its objectives.
   (b) Deciding on risk management policy and practices.
   (c) The process of capital planning and management.
   (d) Identification and analysis of risks implicit in new activity (such as a new product or market) and non-conventional transactions.

20. The risk management function is responsible for ensuring, among other things, that the following processes are effective:
   (a) Identification of existing and emerging risks.
   (b) Establishing limits for risk capacity to be approved by the senior management and the board of directors.
   (c) Creating risk control and management mechanisms and the identification of weaknesses in control.
   (d) Monitoring of positions with respect to the approved risk limits.
   (e) Reporting on the results of risk monitoring to the senior management and the board of directors.

21. The risk management function will approve the development and validation of systems for measuring and evaluating risk.

22. The responsibility of the risk management function to identify, measure, evaluate, monitor and report on risk does not detract from the responsibility and authority of the board of directors, the senior management or risk-taking employees in each of the business lines to manage risks.

Independence of the risk management function

23. The risk management function will be independent and the following principles, at the very least, will apply to it:

(a) Status

The roles of the risk management function will be formally and clearly defined and will provide it with independence and an appropriate status. The status of the risk management function will be based on the following components, among others:
   (1) The definition of its scope of responsibility and authority in the execution of its duties.
   (2) The manner in which the risk management function will be organized, such that the principle of independence is maintained and professionally that it will be subordinated to the Chief Risk Officer.

(3) The right of access, according to its discretion, to the records of the banking corporation, to information and to its employees.
(4) The right to freely report its findings directly to the senior management, the board of directors or to one of its committees.
(5) The obligation to monitor the manner in which management deals with issues it has identified and the recommendations it has made in the matter.
(6) The banking corporation's employees will be informed of the risk management function's authority.

(b) Separation of roles and prevention of conflicts of interest
(1) The risk management function will be organized in a manner that will preserve its separation from the risk-taking units that it oversees.
(2) The workers in the risk management function will avoid a situation that will or is likely to create conflicts of interest between their responsibility in the area of risk management and other roles that they fulfill.
(3) Security measures will be adopted to ensure the independence of the risk management function's decision making, including in cases of cooperation between the risk management function and the senior management and/or the staff in the business units.
(4) The compensation of the workers in the risk management function will not be linked to the performance of a business line over which they oversees. The linkage of compensation to the results of the banking corporation as a whole can in general be viewed as not violating this clause.

(c) Resources
The risk management function will have the resources, skills and collective abilities that are appropriate to the banking corporation's risk profile, in order to effectively fulfill its duties. In this context:
(1) The resources allocated to the risk management function will be sufficient and appropriate for it to carry out its duties.
(2) The workers in the risk management function will have a level of professional skills (such as education, experience, current knowledge, etc.) that will allow them to carry out their duties.
(3) The level of professional skills among the workers of the risk management function will be maintained through appropriate programs for professional development and the maintenance of professional ability.
(4) The risk management function will use appropriate information management systems, which will allow it to properly fulfill its duties.

Reporting arrangements

24. The reporting to the senior management and the board of directors with regard to risk management will be regular, clear and up to date. The frequency and structure of report will be set in accordance with what is considered appropriate for the type of risk and in accordance with the requirements of the board of directors and management.

25. Without detracting from what is stated in clause 24 above, the minimal reporting arrangements will be defined as follows:

(a) At least once annually, the risk management function will report to the senior management and the board of directors on the effectiveness of the risk management processes in the banking corporation and the group.
(b) At least once quarterly, the risk management function will report to the senior management and the board of directors on the exposures of the banking corporation and the group with respect to limits, issues that have been identified, recommendations for action and the follow-up of the handling of problems that have been identified.
(c) Events will be defined that require immediate reporting to the board of directors and the senior management, including issues that need to be brought to the attention of internal audit and/or the Supervisor of Banks.

26. The workers of the risk management function will have a mechanism for directly reporting to the Chief Risk Officer, regardless of the manner in which the banking corporation chooses to organize its risk management framework.

27. Guidelines will be set to ensure that corporations controlled by the banking corporation will provide the banking corporation with the information required to maintain ongoing oversight and control of risk management on the level of the group.

The connection with internal auditing

28. The appropriateness and effectiveness of the risk management function's work will be subject to periodic audits by internal auditing.

29. The banking corporation's internal auditor will provide the Chief Risk Officer with audit results that are relevant to the banking corporation's risk management.