



July 10, 2014

**Circular Number C-06-2425**

To:

The banking corporations

**Issue: A banking corporation's business with related parties**

(Proper Conduct of Banking Business Directives 312 and 301)

### **Introduction**

1. Directive 312 "A banking corporation's business with related parties" (hereinafter—"the Directive") is intended to minimize the risks derived from balance-sheet and off-balance-sheet transactions carried out by a banking corporation with related parties and to prevent the negative exploitation of the banking corporation and activities through conflicts of interest. The Directive restricts the volume of related parties' indebtedness to the banking corporation and requires that transactions between the banking corporation and related parties be executed according to business considerations and under terms that do not deviate from market conditions.
2. As part of adjustments to the Proper Conduct of Banking Business Directives to changes in the Banking (Licensing) Law, 5741–1981 (hereinafter—"the Law"), the Banking Ordinance, 1941<sup>1</sup> (hereinafter—"the Ordinance") and guidelines in this field in the US and Europe, the need arose to revise the Proper Conduct of Banking Business Directives dealing with the issue of a banking corporation's business with related parties.
3. Following consultations with the Advisory Committee on Banking Business, and with the approval of the Governor, I have decided to issue a revised Directive as detailed below.

**The following is a list of the material amendments made to the Directive as per new section numbers:**

### **Definitions**

4. The following changes were incorporated into Section 3(c):
  - 4.1 The determining benchmark in defining a related party was lowered from 10 percent of holdings of the means of control in a banking corporation or a banking

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<sup>1</sup> The legislation was amended, *inter alia*, at the recommendation of the Marani Committee from August 2004 ("Marani Amendment") and an amendment to the "Marani Amendment" from March 2012.



corporation controlled by a banking corporation to 5 percent. For practical reasons, a 60-day temporary deviation from the 5 percent holdings rate, which is unintentional, will not require classification as a “related party” for the purposes of this Directive.

4.2 For a bank with no core holding, the definition of a related party was expanded to include anyone nominating (on his own or as a member of a group of holders) a candidate to serve as a Director and his relatives. The classification as a related party shall be valid as long as the Director proposed by him serves in the position.

### **Explanation**

The amendment was adjusted to changes made in the Law and in the Ordinance. Section 34 of the Law set out the need to obtain a permit from the Governor for holding 5 percent of the means of control, and Section 11d of the Ordinance set out the people that may nominate candidates to serve as directors of banking corporations without a core holding.

5. In Section 3(d), the words “Director or senior officer” were replaced by the term “Officer”, and the word “Spouse” was replaced by the word “relative” of the officer.  
In addition, the banking corporations in which officers and their relatives are to be considered as related parties were listed.

### **Explanation**

The amendment is intended to adjust the Directive to the definitions in the Companies Law and in the Banking (Licensing) Law, and to guidelines from the supervisory authorities in Europe and the United States. The definitions of officer and relative were expanded.

In addition, in the final portion of this Section, relief was provided such that officers in corporations that are not part of the chain of control or holdings of the means of control in a banking corporation would not be included in the definition of related party.

6. A new Section 3(g) was added: “A party that holds 10 percent or more of any type of means of control in a corporation controlled by the banking corporation, and his/her relative.”

### **Explanation**



The definition of a related party was expanded to include anyone holding any kind of means of control of a corporation controlled by the banking corporation in view of experience accumulated in the market in transactions of this kind.

7. In the final portion of Section 3, the definition of capital was changed to “Tier 1 capital after regulatory adjustments and deductions as defined in Proper Conduct of Banking Business Directive number 202.”

#### **Explanation**

The measure of indebtedness of related parties in relation to Tier 1 capital and not to the capital base is in line with the new Basel directives relating to restrictions, and is intended to minimize the banking corporation’s exposure to related parties in general, and to an individual related party in particular.

#### **Policy and Procedures**

8. A new chapter was added dealing with policy and procedures.  
At the beginning of Section 3a(a), a sentence was added: “The Board of Directors shall set out policies and processes for the approval of transactions with related parties, as well as procedures for monitoring and control.” In addition, a new Section 3a(b) was added, setting out that “The Board of Directors shall establish guidelines for cases in which an officer has a personal conflict of interest concerning a transaction of the kind noted in Section 56(c) of Proper Conduct of Banking Business Directive 301.”

#### **Explanation**

The requirement that was added is intended to adjust the requirements of the Directive to proper corporate governance practices, including the existence of an adequate internal control framework. The Section is intended to adopt the principles concerning setting out guidelines to prevent personal conflicts of interest as presented in Proper Conduct of Banking Business Directive number 301.

#### **Transactions with related parties**

9. In Section 4(a), following the words “A banking corporation shall not enter into a transaction with a related party on terms that are preferential”, the words “to those accepted in similar transactions it enters into with others” are added, and the words “to those it provides to others in similar transactions” are deleted.



### **Explanation**

The change in the first part of the Section is intended to clarify the requirement and to prevent hypothetical situations in which credit to a related party is approved on terms that deviate from the corporation's credit policy on the basis of the fact that only one exceptional transaction was carried out with another borrower.

### **Restriction on the indebtedness of related parties**

10. In Sections 5(b)(1) to 5(b)(4), the restrictions on the indebtedness of a holder that does not constitute a component of a controlling group were expanded to 5 percent of capital, and a quantitative restriction on the indebtedness of officers in the banking corporation, of up to NIS 1 million, excluding housing loans, was added.

### **Explanation**

The expansion of the restrictions of indebtedness on related parties is intended to minimize the bank's exposure to risk, particularly in view of the large increase in the volume of the banks' capital in recent years, and is in line with the restrictions anchored in the directives of other regulators abroad.

The quantitative restriction that was added for an officer of the banking corporation, his relatives and corporations under his control is common practice in other authorities abroad.

### **Approval of transactions with related parties by the Board of Directors**

11. In Section 7(a)(1) the amounts of indebtedness that require approval of the Audit Committee or the Committee for Transactions with Related Parties were updated.

### **Explanation**

The last amendment to the Directive was made in 1998. Since then, banks' capital has increased by more than fourfold. The Directive prior to the change enabled transactions to be conducted with related parties at amounts higher than those intended by the Supervisor without requiring any supervision.

12. In Section 7(a)(2), a minimum transaction amount was set for an individual related party and for an officer of the banking corporation, that requires approval of the Audit Committee or the Committee for Transactions with Related Parties.

### **Explanation**



The objective of the amendment is to set a minimum benchmark for transactions that require the approval of the Audit Committee or the Committee for Transactions with Related Parties.

13. At the end of Section 7(4), the words “regarding deposits and account management terms, specific approval is not required if the terms were set out as per the long-term facility agreement” were added.

#### **Explanation**

As part of the commitment to approve passive transactions as well, relief was given such that the Audit Committee or the Committee for Transactions with Related Parties may approve a long-term facility agreement instead of individual transactions.

#### **Personal conflict of interests**

14. Section 7a was added, regarding the behavior expected of an officer in a personal conflict of interest.

#### **Explanation**

Proper Conduct of Banking Business Directive 301 “Board of Directors” sets out the rules of behavior that directors must adopt in a situation of a personal conflict of interests, and the aim of this section is to apply those rules on other officers as well.

#### **General**

15. Section 10 was added, enabling the Supervisor to expand on or detract from the definition of a related party and/or to instruct that indebtedness be deducted from regulatory capital.

#### **Explanation**

The Directive prior to the amendment defined related parties by way of a comprehensive closed list and with precise criteria without granting the Supervisor any consideration. The change is intended to give the Supervisor flexibility in making decisions (more lenient or stricter) in view of the existence of certain circumstances.

#### **Deviation due to classification as a related party**



16. A new Section 11 was added, setting out required adjustments to indebtedness regarding someone who has become a related party. The adjustments will be made in a gradual manner over the period of two years.

**Amendment to Proper Conduct of Banking Business Directive number 301 “Board of Directors”**

17. Sub-Sections 36(f)(1) and 36(f)(2) are repealed in order to prevent duplication with Section 7 of Directive 312, which includes specific guidelines on this matter.

**Applicability**

18. The changes are applicable as of January 1, 2015.
19. Notwithstanding the foregoing, the following shall apply regarding the definition of capital:  
Tier 1 capital as stated in the definition of capital, with the addition of Tier 2 capital as published in the financial statements as of December 31, 2014. This addition will be reduced by equal parts over 16 quarters, reaching zero on December 31, 2018.

**File update**

20. Updated pages for the Proper Conduct of Banking Business file are attached. Update instructions are as follows:

<b>Remove page</b>	301-21 [20] (5/14)
<b>Insert page</b>	301-21 [20] (5/14)*
<b>Remove page</b>	301-22 [20] (5/14)
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Sincerely,

**David Zaken**  
Supervisor of Banks