Israel Securities Authority

Directive to Mutual Fund Managers and Trustees regarding Custody Risk and Credit Risk (temporary directive)

General

The world is currently experiencing an event with macroeconomic implications due to the spread of the Corona virus in many countries. The State of Israel is taking significant and unprecedented steps as a result of this event in an attempt to stop the spread of the virus, as in other countries.

Recent weeks have been characterized by sharp declines in the prices of securities in many of the leading stock exchanges around the world, including the Tel Aviv Stock Exchange, accompanied by an increase in volatility in the prices of commodities and various risk assets. The mutual funds industry is experiencing exceptionally large volumes of redemptions, on a scale that has not been seen in the past, even in previous crises. In addition, and in line with the market trends, the value of fund's assets has fallen.

As a result of this unusual situation, the Israel Securities Authority (hereinafter: the ISA) is wishes to adapt its regulatory and supervisory activity in order to protect the interests of the investors in Israel and at the same time to allow for the orderly and uninterrupted operations of the bodies supervised by it. Therefore, the ISA is hereby announcing a temporary amendment of the Directive to Fund Managers and Trustees regarding Custody Risk and Credit Risk (hereafter: the Directive), which came into effect on May 14, 2017, by means of a temporary directive, as will be explained below.

Explanation

The goal of the Directive, beyond the aspects of custody of the fund's assets, is to limit the maximal credit risk of a fund with respect to a particular financial institution and to establish various requirements of disclosure for this regard.

Section 7 of the Directive establishes the maximal credit risk exposure to a financial institution via holding by the fund or activity in the fund in a list of assets that appears in the Directive and which creates exposure to that institution. The exposure limit is derived from the degree of risk that characterizes that institution, according to the parameters specified in the supplement to the Directive, which differentiates between two risk groups. Thus, the maximal exposure of a fund to a bank in the second risk group will not exceed 25 percent of the value of the fund's assets and in the case of a bank in the first risk group the limit is 33 percent. The exposure of the fund to a bank includes: cash and deposits with the bank (with respect to cash and deposits there is also a limit in the regulations of 25 percent of the value of the fund's assets); credit differences that have not yet been settled as a result of activity in derivatives, i.e. MTM (apart from a case of daily settlement of differences); the value of the bank's promissory notes that are held by the fund; and also foreign securities that were borrowed through the bank.

A deviation from the limits set down in the Directive constitutes an immediate violation. Therefore, in normal times, the fund manager manages these exposures for all the assets by maintaining margins of error. However, during this period, which is characterized by sharpe declines in the markets and exceptionally large redemptions, the fund managers have been passively caught in situations where these limits are exceeded. Thus, for example, in order to comply with the limit on cash and deposits at a particular bank the fund managers must transfer money from one bank to another, each day, in large amounts and with high frequency. Even when the fund manager manages to carry out the transfer on the same trading day, as required, the sharp volatility on foreign stock exchanges in the value of assets held by the fund sometimes leads to a situation in which even after the transfer, the limit on the rate of exposure to a bank exceeds the rate established by the Directive. Furthermore, both the banks and the fund managers are working in small teams due to the instructions of the Ministry of Health and therefore there is also operational difficulty both for the fund manager to make transfer requests and for the bank to handle the high volume of transfers. This difficulty has even led to errors in some of the transfers. Under the present circumstances, the high exposure to a bank, together with the exposure to that bank by way of other assets that are listed in the Directive, are on a daily basis causing immediate passively deviations by the fund from what is established in the Directive, which cannot be immediately rectified.

In view of this situation, the ISA has decided to amend the Directive such that a deviation from the limits specified in Section 7 of the Directive will not be considered a violation if it is rectified within two price calculation days from the time it was created. Thus, the fund manger will be given time to rectify the deviation in a way that will not harm the unit holders. This amendment will be valid from its publication on the ISA site until May 31, 2020, if there is no other announcement by the ISA on this matter.

It is worth emphasizing that despite the temporary amendment, fund managers are required to continue their vigilance and prudence with respect to the risk implicit in the activity of the funds under their management and to make every effort to fulfil the instructions of the law and to minimize to whatever extent possible these deviations from the limits set down in the law.

The amendment

During the period from the publication of this Directive until the May 31, 2020 (8th of Sivan 5780), the following will be added to Section 7 of the Directive to Fund Managers and Trustees regarding Custody Risk and Credit Risk:

"5. Notwithstanding what is stated in this Section, if total exposure of a fund to a particular bank exceeds the rates set down in subsection (a), this will not be viewed as a violation of this directive if it is rectified by the end of the second price calculation day from the end of the price calculation day on which the deviation was created; the fund manager will record this deviation in the fund's deviation diary."