TEL AVIV STOCK EXCHANGE

OTC Derivatives central clearing - Global trends and implications for Israel

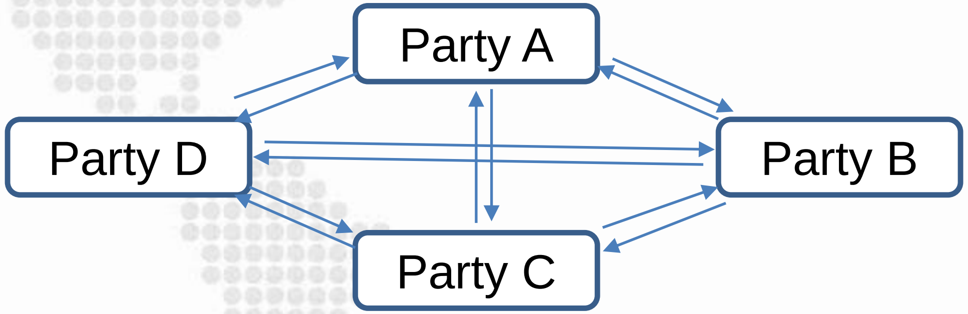
June 2016

Historical review – G-20 decision on central clearing enforcement of OTC derivatives

- In 2009, G-20 leaders agreed to implement a revolutionary reform in the OTC derivatives market, under which the main following principles shall be applied:
  - ✓ **All standard OTC derivatives will be mandatorily forced to go through central clearing by a central counterparty, and also be traded on bourses or electronic trading platforms until the end of 2012**
  - ✓ OTC derivatives out of the scope of the new reform shall consume higher regulatory capital requirements, collateral and risk mitigation processes
  - ✓ All OTC derivatives shall be reported to trade repositories that will be responsible to gather the information for the supervision of the regulator
- Although all G-20 countries have initiated the process of the above reform legislation, the most influential and progressive reforms in the world are “Dodd-Frank” in the USA and “EMIR” in the European union
- As of today, all reforms are still under different implementation processes
- Mandatory clearing is being executed in many currencies around the world, the Israeli Shekel is not among them

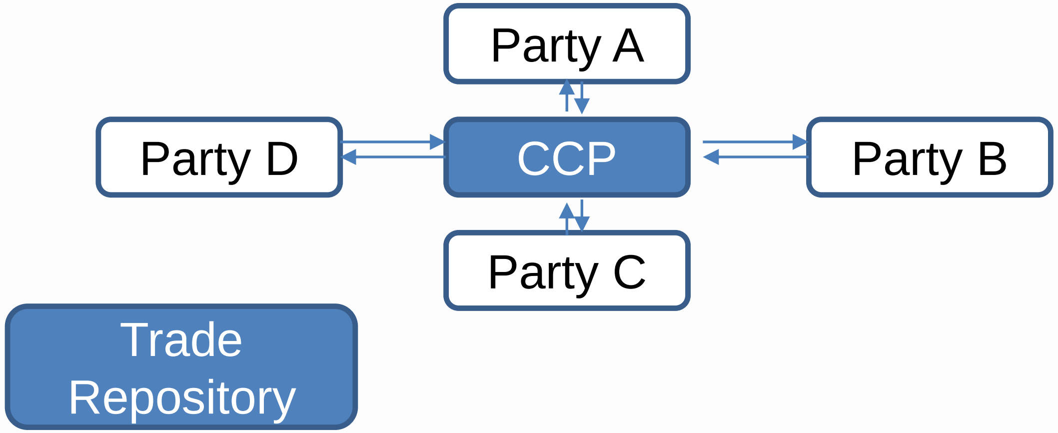
Central clearing of OTC derivatives – before and after the reforms

Before the reforms



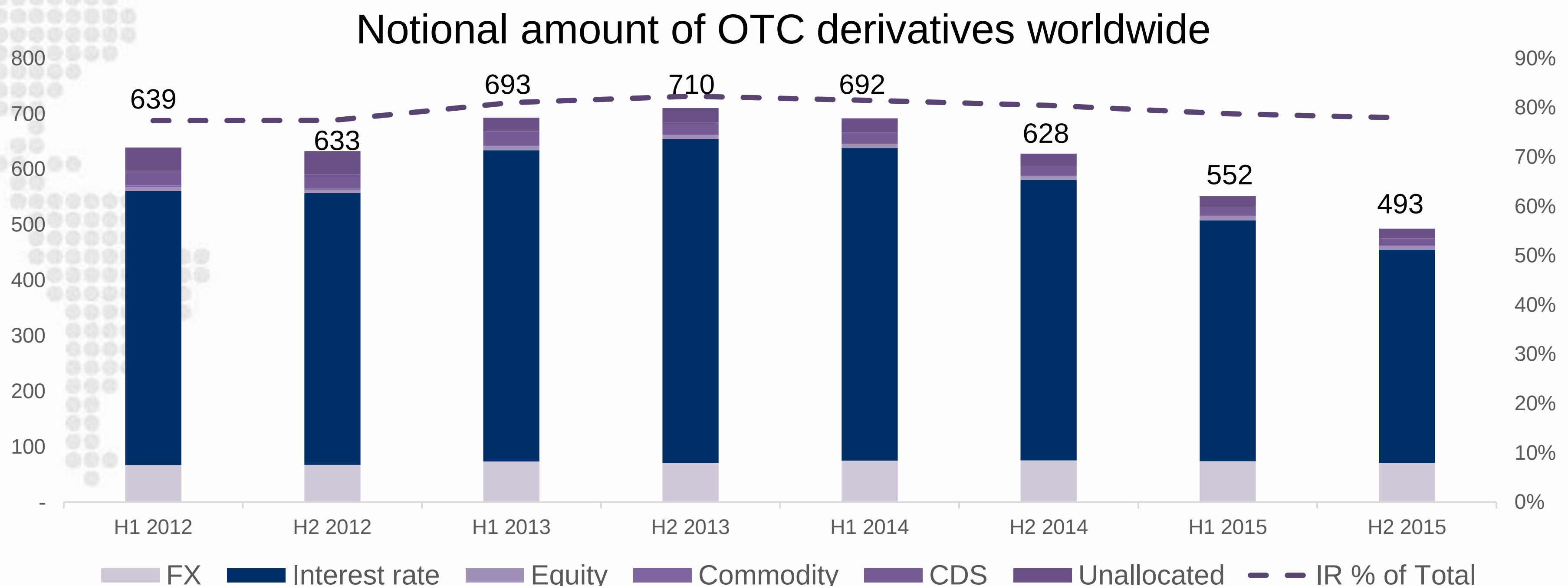
- Most derivatives transactions were bilateral
- No access for regulators to the information regarding the exposure of financial institutions to these instruments
- Large amounts of exposure to several counterparties around the world, making it difficult to manage the risks stem from each counterparty
- Making compression of transactions was almost impossible

After the reforms



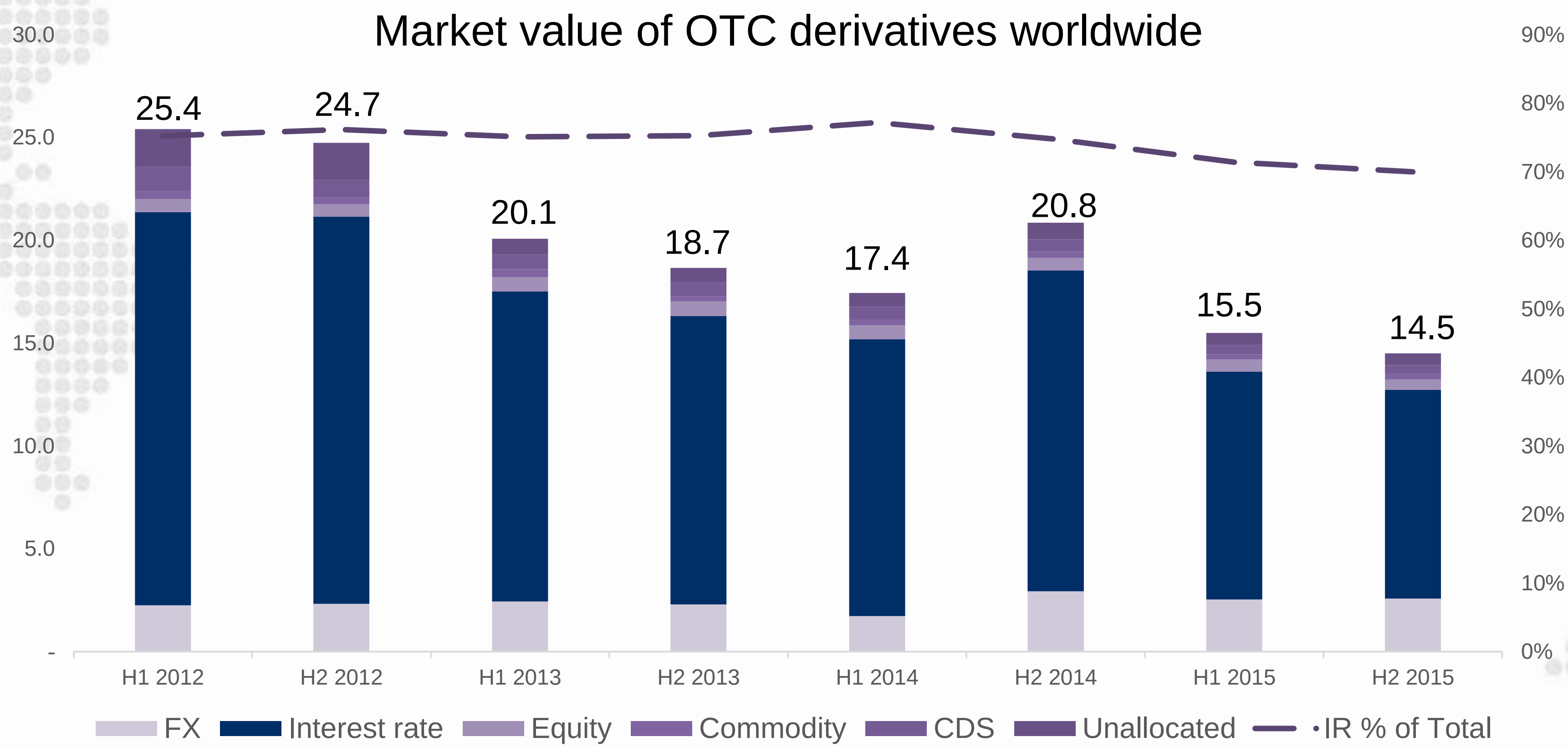
- Several segments of derivatives were chosen to be mandatorily centrally cleared
- In these segments, all parties must take the transaction to a central counterparty
- Exposure of market participants is concentrated in few CCPs making it easier to manage the exposure level and the risks
- As reforms expand, more and more derivatives segments will enter into clearing obligation, or will be voluntarily cleared in order to enjoy the benefits of central clearing:
  - ✓ Lower capital requirements
  - ✓ Concentrated exposure to a strong institution
  - ✓ Efficient risk management, etc.
- In addition to the above, all derivatives are being reported to TRs

OTC derivatives – getting into the numbers (USD Trillions)



- notional amounts of OTC derivatives have declined significantly since 2012, mainly because of compression processes performed efficiently due to central clearing
- Interest rate derivatives (77%-80% of notional value) and CDSs, that constitute more than 83% of total notional amount on average, **are regarded as most standardized derivatives (due to their characteristics) and are mandatorily centrally cleared in all jurisdictions implementing a derivatives reform**
- 95% of potentially cleared interest rate derivatives (excluding exotic IR derivatives – insignificant share) are already centrally cleared, 34% of CDSs are also centrally cleared
- FX derivatives are not under central clearing due to operational complexity and a developed trading market of these instruments

OTC derivatives – getting into the numbers, cont. (USD Trillions)



- Market value of OTC derivatives have declined respectively to the decline in notional amounts
- IR derivatives constitute 74% of total market value of derivatives
- Among IR derivatives, Interest Rate Swaps are 75% of this segment as of 2015 EOY

Tel Aviv Stock Exchange

Derivatives reforms around the world

- Although the most progressive reforms are in the USA and Europe (in which central clearing is already under enforcement), other countries are also making progress toward central clearing:

OTC derivatives activity in Israel

- Currently, there is no mandatory clearing obligation for ILS OTC derivatives in Israel or anywhere in the world, and there is no reform in this issue under process in Israel
- Furthermore, there is no central clearing solution of ILS OTC derivatives neither in Israel nor in any clearing house in the world.
- The ILS OTC derivatives market is mostly dominated by interest rate and FX derivatives. Interest rate derivatives are approximately 60% of the OTC market.
- During 2014 and the first half of 2015, the daily average volume of OTC ILS interest rate derivatives was approximately NIS 5 billion (about USD 1.3 billon). This amount is expected to rise in case of interest rates rising.
- Local Israeli banks, as well as leading foreign banks and other market participants operating in the Israeli market, are highly interested in central clearing, due to the following reasons:
  - ✓ Regulatory capital benefits.
  - ✓ Leverage ratio benefits.
  - ✓ Margin costs savings, especially in light of the new OTC derivatives margin requirements.
  - ✓ Decreasing volumes and liquidity in the OTC derivatives market.
  - ✓ Operational difficulties due to multiple counterparties in declining market.