

September 30, 2021

Circular Number C-06-2674

Attn:

Banking Corporations

Re: Management of Workout and Collection Processes Involving Substantial Troubled Credits

(Proper Conduct of Banking Business Directive no. 314A)

Introduction

1. Against the background of numerous large-scale debt settlements in recent years and the lessons to be learned from them, I find it correct to anchor the management of workout and collection processes involving substantial troubled credits in a Proper Conduct of Banking Business Directive. In Principle 16 of Proper Conduct of Banking Business Directive 311, “Credit Risk Management” (hereinafter: Directive 311), banking corporations are instructed to “have systems and processes in place for early remedial action on deteriorating credits, managing problem credits, workout, and similar situations.” This Directive expands and elaborates on the Banking Supervision Department’s guidelines for the management of substantial troubled credit and for the full range of relevant aspects at all stages of the lifetime of this credit: guidelines for the underwriting stage that will be helpful in assuring appropriate treatment of defaults, guidelines pertaining to early detection of deterioration of debts even before they become problematic, and guidelines on ways of dealing with workout and collection arrangements.
2. In the Directive, it is stated that the optimal way of dealing with substantial troubled credit is by removing their treatment from the business function responsible for their underwriting and regular management and assigning them to a specialized dedicated function. Handling by means of an independent and appropriately resourced dedicated expert entity will help the collection process succeed and mitigate losses to the bank.
3. The promulgation of this Directive, concerning the management of workout and collection processes involving substantial troubled credit, reflects the importance that the Banking Supervision Department attributes to the appropriate treatment of sizable credit failures in order to maximize collection efforts and minimize the loss to the bank, and in order to keep the process fair and mitigate the potential of a “halo effect.” Unlike consumer credit, which is usually managed in a standard manner on the basis of structured modules, large business credit is differentiated in its characteristics and therefore requires individualized and special handling. Proper Conduct of Banking Business Directive 450, issued in 2017 to deal with proceedings for the collection of debts from households and small businesses, was intended to enhance fairness and transparency in bank–customer relations. This separate Directive is concerned with collecting substantial business debts and therefore supplements the principle of dealing with credit failures by including borrowers of all kinds.

4. After consulting with the Advisory Committee on Banking Business Affairs and with the approval of the Governor, I have established this Directive.

Main provisions of the Directive

Incidence (Section 3)

5. This Directive applies to banking corporations that manage substantial debts as defined in the Directive, with the exception of debts that are handled by the debt collection function set forth in Proper Conduct of Banking Business Directive no. 450 on “Debt Collection Proceedings.”

Corporate governance

6. A banking corporation shall have in place corporate governance that takes into account the possibility of failure events and the need to manage workout and collection processes in substantial amounts. Among other things, the corporation needs to establish a policy and to specify the responsibilities and powers of the Board of Directors and management in managing workouts and collecting substantial troubled debts for which a decision to launch collection proceedings has been made. Within this generality, banking corporations must set targets for the mitigation of substantial troubled debts in the medium term, determine the appropriate organizational structure, establish reporting and cooperation mechanisms, and assure the presence of adequate controls (Sections 5, 6). Banking corporations shall also establish a “dedicated function” to handle the settlement of substantial troubled debts and shall determine its status, independence, powers, and resources (Section 7).

Explanatory notes

Appropriate corporate governance is crucial for the effective management of workouts, the collection of substantial troubled debts, and supervision of those who manage these processes. Determining the powers, responsibilities, and processes is a *sine qua non* for the sound and effective management of credit risk and, in particular, of workouts and processes of substantial troubled debts for which a decision to launch collection proceedings has been made. The dedicated function that a banking corporation must establish already exists, in effect, at most banks and is sometimes called a special credit-management function. The Directive allows banking corporations to subordinate this function to the manager of the business division—in which case, however, compensatory controls are needed to mitigate the potential of a conflict of interests.

Involvement of the risk officer

7. A banking corporation must integrate the risk officer into the early stages of the process. The risk officer shall participate in the forum that discusses and makes a decision on assigning a debt to the dedicated function (Section 11). He or she shall also offer an independent written opinion both before the assignment of a debt to the dedicated function is discussed (Section 13) and when the workout includes forgiveness of all or part of a sizable debt or when additional credit to a troubled borrower is needed (Section 18).

Explanatory notes

To deal with credit failures, the involvement of independent professionals who were not involved in underwriting the credit is needed. For this reason, and to reinforce the independence of the dedicated function, a banking corporation must involve the risk officer in various ways: as a member of the forum that decides on assigning credit to the dedicated function and in tendering an independent opinion on the need to make this decision, or when the workout includes forgiveness of some or all of the credit in a substantial amount, or when the extension of additional credit is taken up for discussion.

Compulsory Measures before Debt becomes Troubled (Chapter C)

Early detection of substantial troubled debt by the business functions

8. A banking corporation shall have in place and document a systematic follow-up process for early detection of deterioration of a borrower's credit quality and for assessment of borrower's conduct and the extent of his or her cooperation with the bank. For this purpose, the corporation shall specify qualitative indicators in addition to its quantitative measures and criteria (Section 9(b)) and shall specify indicators that will encourage business functions to detect substantial troubled debt at an early stage (Section 9(d)).

Explanatory notes

Experience shows that a borrower's conduct and extent of cooperation affect the prospects of collection. Therefore, sole reliance on quantitative indicators to detect problems may be inadequate and may result in belated discovery of problems whenever a substantial amount of debt is at stake. Therefore, a banking corporation must broaden the detection process and formulate qualitative criteria and metrics for this purpose.

Experience also indicates that the business functions, due to their close relations with borrowers, assign debts to collection proceedings at a lag, resulting in suboptimal collection. To correct this, a banking corporation should also include measures and targets that will incentivize the timely assignment of debt for treatment.

Risk mitigation measures

9. A banking corporation must take preemptive measures to mitigate risk wherever there is concern about loss of cooperation with a debtor in default. It must, *inter alia*, make sure already at the underwriting stage that the processes it invokes will help to preserve the value of collateral and allow action to be taken in cases where the borrower does not cooperate (Section 8). The corporation must also perform a business and legal review of the completeness of documents and collateral and should evaluate weaknesses in the borrower's file at an early stage, when the borrower is still cooperating and before the debt is handed on to the dedicated function (Section 10).

Explanatory notes

The extent of borrower cooperation may have a material effect on the possibility of correcting weaknesses in the file and carrying out successful debt-collection actions. A banking corporation

must take preemptive measures to minimize risk in cases where the potential of failure and lack of borrower cooperation exists.

Decision on Assigning a Debt to the Dedicated Function (Chapter D)

10. A banking corporation must carry out and document a systematic proceeding for the assignment of a debt to the dedicated function. Within this construct, it must create an anchor for the activity of the forum both in terms of its working process and in guidelines for the considerations that should inform its decision-making. These considerations shall include the borrower’s financial condition, the extent of his or her cooperation, initial scenarios that the banking corporation shall carry out, and minimum criteria for the assignment of a credit to the dedicated function (Sections 11, 12).

Explanatory notes

A decision on assigning a credit to the dedicated function is immensely important for the collection process and for the bank’s continued conduct vis-à-vis the borrower; therefore, a systematic process for making such decisions is needed. A banking corporation must examine a wide range of parameters and scenarios before making the decision. This, it should be emphasized, is not meant to imply that every debt placed on the watch list and taken up for discussion must be assigned to the dedicated function or to other collection processes. This, however, must be examined on the basis of the parameters that the banking corporation has established.

Implementation of Workout and Collection by the Dedicated Function (Chapter E)

11. A banking corporation shall examine several alternatives before it chooses the appropriate strategy vis-à-vis the borrower: a going-concern solution involving rehabilitation or collection of the debt (in cooperation with the borrower or in legal proceedings). Alongside the economic considerations in making the decision, the corporation shall give some weight to additional considerations such as reputation, fairness, and extent of borrower cooperation (Sections 15, 16).

Explanatory notes

The main consideration in choosing the best alternative should be economic, i.e., the alternative that maximizes collection. A banking corporation, however, must also take account of reputational and fairness considerations as well as public and environmental ones. The expectation is that the narrower the gap among the alternatives that maximize collection in accordance with economic considerations, the more weight the additional considerations will be given.

12. When the chosen strategy includes liquidation of assets, a banking corporation shall formulate a systematic and detailed liquidation plan and ensure its tracking (Section 17).

Explanatory note

Liquidation measures are liable to encounter implementational difficulties and delays for various reasons. A banking corporation needs to monitor the plan it has chosen, ensure its

implementation, and establish a compensatory mechanism and a modus operandi for any serious deviation from the plan.

13. A banking corporation shall have in place a procedure for learning from credit failures, specifying special conditions for the activation of a learning process, the identity of the player who will carry out the process, and chains of reportage and decision-making in the aftermath of the process. Lessons from standard failures shall be reported to management and the Board of Directors or to a board committee (Section 19).

Beginning date

14. The Directive established in accordance with this circular shall apply to banking corporations from April 1, 2022, onward.

File update

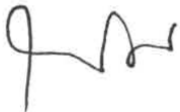
15. Update pages for the Proper Conduct of Banking Business Directives file are attached. The following are the update instructions:

Remove page

Insert page

314A-1-10 (9/21) [1]

Respectfully,



Yair Avidan
Supervisor of Banks