Banking Supervision Department
October 11, 2020
8.284.6648

To:
The Banking Corporations and Acquirers
Attn: Chief Executive Officer

To:
Ms. Eileen Toledano—Chair of the Liaison Committee of the Institute of Certified Public Accountants in Israel with the Supervisor of Banks and Committee members

Re: Coronavirus Event—Supervisory Emphases for Additional Changes in Loan Terms

Dear Madam/Sir:

General

The coronavirus event has a significant negative impact on individuals, businesses, banking corporations and on the economy overall. In response to these effects, the state provides various types of assistance to businesses and borrowers. In addition, the banking system has offered borrowers to adjust the terms of the loans, including in accordance with the outline for deferring payments initiated by the Banking Supervision Department.

The Banking Supervision Department has acted to encourage banking corporations to act prudently to stabilize borrowers who may have difficulty meeting contractual payment terms due to the coronavirus event. In particular, the Banking Supervision Department stated that it considers changes in the loan terms (hereinafter, loan accommodations)[1] as positive actions, which may reduce the negative effects caused by the coronavirus event) to borrowers.

While some borrowers may be able to repay the contractual payments at the end of the loan accommodation period, other borrowers may not be able to meet their obligations due to the continuing financial challenges. The Banking Supervision Department is aware of the fact that some banking corporations may experience difficulties in assessing credit risk, due to the uncertainty level, limited access to the borrower's financial data, breaches of financial covenants due to the coronavirus event, and difficulties in analyzing the impact of state assistance programs related to the coronavirus event.

The Banking Supervision Department encourages banking corporations to consider options for prudent changes in the terms of loans based on an understanding of the borrower's credit risk, consistent with relevant laws, regulations and directives, and which can ease the affected borrowers' cash flow pressures, improve their ability to service the debt, and aid in the ability of the banking corporations to collect the debts. Such arrangements may reduce the long-term impact of borrowers' financial challenges by avoiding arrears or other adverse results. However, careless practices can adversely

[1] For the purpose of this letter, "loan accommodations" include any agreement to defer one or more payments, to make a partial payment, to forbear amounts in arrears, to change a loan or contract, or to provide assistance or other relief to a borrower experiencing financial challenges. "Loans" include revolving credit products and end-open credit. "Options for additional changes" are options that a banking corporation may allow the borrower, subsequent to the initial change made, which may include further change, agreement to pay any amounts that were deferred as part of the initial change, or an agreement for loan accommodations in order to improve the long-term sustainability and repayment ability of the loan.

affect borrowers and expose the banking corporation to an increase in credit risk, compliance risk, operational risk, and other risks, as well as create risks to the banking corporation's capital.

Risk management principles

The following principles include prudent practices for banking corporations in order to stabilize borrowers in a safe and sound manner when loans are nearing the end of the first loan accommodation periods due to the coronavirus event. These principles are based on the guidelines of the supervisory authorities of the banks in the United States dated August 3, 2020[2], adapted to circumstances existing in Israel[3].

Prudent risk management practices

Prudent risk management practices include identifying, measuring and following up the credit risks of loans that have undergone loan accommodations. A banking corporation must understand the loan agreements and accurately monitor the change in terms (such as changes in payments, changes in the interest rate and modified amortization terms. Ongoing monitoring and assessment of changes in loan terms usually enables banking corporations to identify any deterioration in credit in a timely manner, including potential exposures to a loss.

Proper credit risk management includes the proper implementation of classifications and risk ratings, and appropriate decision making regarding the cessation of interest accrual on loans affected by the coronavirus event. In general, following a loan accommodation, the banking corporation must reassess the classification and credit rating of the loan based on the borrower's current level of debt, current financial condition, repayment capacity, and his collateral. A reasonable change in terms does not necessarily result in a loan's negative risk classification solely because of a decrease in the security value, provided the borrower is able to pay in accordance with the adjusted terms.

Management information and reporting systems should present to management the scope of loans with accommodations, the types of initial changes and any other changes made, the dates on which the accommodation periods will end, and the credit risk in segments[4] with higher potential risk in the credit portfolio.

[2] Joint Statement on Additional Loan Accommodations Related to COVID-19, FFIEC, 3.8.2020.
[3] Adjustments were made mainly with respect to comprehensive plans for the deferral of payments, and were made consistently with the following sources:
1) Guidelines of the Supervisory Authorities of the Banks in the United States dated April 7, 2020:
"Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Revised)"
2) Guidelines published by the European Banking Authority (EBA) on April 2, 2020, as updated and clarified by August 7, 2020: "Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis".
3) Guidelines of the Prudential Regulation Authority in England (the PRA):
"COVID -19: IFRS 9 and capital requirements - Further guidance on initial and further payment deferrals", June 4, 2020
"COVID -19: IFRS 9 and capital requirements - Guidance as COVID-19 specific payment deferrals come to an end", August 26, 2020.
[4] Segments in this regard may include product types, characteristics of payments after the changes are made (such as balloon payments, nature and duration of the period of changes in payments, and duration of the extended repayment period), or borrower characteristics (such as unemployed borrowers, underemployed borrowers or on unpaid leave, borrowers included in a watch list, or characteristics based on credit classification or rating, payment history and arrears position, indications of repayment capacity in relation to the debt, area of activity, distinction between businesses that work fully or partially), which may affect credit performance.

Well-structured and sustainable accommodations

For a borrower who continues to experience financial challenges after initial loan accommodations, it may be prudent for the banking corporation to examine options for further changes in order to reduce adverse effects on the borrower following the coronavirus event and thereby reduce losses to the borrower and to the banking corporation. Options for changes that are well constructed and implemented consistently, accompanied by careful risk management practices, can minimize losses to the banking corporation, while assisting borrowers to return to making payments in a structured, achievable, and sustainable way in amounts in accordance with the contract over a reasonable period of time. The effectiveness of the accommodations improves when they are based on a comprehensive overview of how the difficulties affected the borrower's financial condition and his current and future performance.

When a banking corporation is considering whether to offer the borrower options for further changes, it should generally evaluate each loan based on the underlying risk characteristics that affect the collectability of the specific credit. Both in commercial loans and in loans to private individuals, the aforesaid usually includes an assessment of the borrower's financial position and repayment ability and an assessment of whether the current conditions have affected the value of his collateral or the strength of the guarantees, if any. Regarding a commercial loan, the aforesaid also includes an assessment by the banking corporation of the actual cash flows and of the projected cash flows from the borrower's business. The coronavirus event can have long-term negative effects on the borrower's future profits and therefore management may need to rely significantly more on predictive financial information when making underwriting decisions, both for commercial loans and for loans to individuals, recognizing that supporting documentation may be limited, and forecast cash flows may be uncertain.

Reporting to the public

Banking corporations must apply the Reporting to the Public Directives of the Supervisor of Banks and its guidelines (our directives) in relation to all loans in which modifications have been made to debt terms, in accordance with the meaning of this term in our directives, including further modifications in debt terms made with borrowers who may continue to experience financial difficulties at the end of the initial modification period. This includes the holding of an adequate allowance for credit losses. Banking corporations must apply the principles set out in our directives, including principles set out in our letter dated April 21, 2020 regarding the Coronavirus Event – Supervisory Emphases regarding the Handling of Debt and Reporting to the Public. A proper credit loss allowance methodology takes into account all available and relevant information for assessing cash flow collection capacity, including changes resulting from the coronavirus event in the borrower's financial condition, collateral value, credit practices, and economic conditions. Borrowers facing financial difficulties are identified as they approach the end of the period of modification in terms, usually characterized by greater credit risk. According to our directives, for the purpose of estimating credit losses, loans must be grouped into a separate credit portfolio, where they have similar risk characteristics, unless they are assessed on an individual basis.[5]

A banking corporation may have difficulty accurately determining the collectability of certain loans affected by the coronavirus event, and may require additional time to determine the impact of the coronavirus event on the long-term ability of certain borrowers to make payments and to assess the collateral value. According to our directives, management must take into account the impact of the coronavirus event in the process of estimating the credit loss allowance and examine whether the

[5] See Section 29B. and Appendix J to the provisions for Reporting to the Public Directives regarding an allowance for credit losses assessed on a group basis.

change in the credit loss estimate is made in accordance with our directives as more information becomes available.[6]

- Regarding the implementation of our directives and our letter dated April 21, 2020 for the purpose of accounting treatment of loan accommodations, it is clarified that a further modification of loans should be examined cumulatively in order to determine whether the additional change constitutes a restructuring of problem debt. For this purpose, a banking corporation will act in accordance with our letter dated April 21, 2020. For example, if the cumulative loan modifications are all related to the coronavirus event, and present cumulative short-term changes (for example, a cumulative 6 months or less), and the borrower is not in arrears in relation to the contractual terms (arrears of less than 30 days in relation to all contractual payments) as of the date of the subsequent change, management can continue to assume that the borrower is not in financial difficulties at the time of the change for the decision regarding whether to classify the debt as a debt restructuring of a problem debt, and the subsequent loan accommodation will not be considered a debt restructuring of a problem debt.
- For all other subsequent loan accommodations[7], a banking corporation must adequately evaluate subsequent modifications in accordance with the Reporting to the Public Directives and its internal accounting policies in order to determine whether these modifications constitute reorganizations of problem debts in accordance with the Reporting to the Public Directives (see Section 30A on the issue of a problematic debt in restructuring).

The date of payment in a loan is determined by the date specified in the loan agreement. Therefore, the arrears situation reported to the public should be determined in accordance with the adjusted contractual terms of the loan.

Regarding the interest accrual status, a banking corporation must continue to act in accordance with the Reporting to the Public Directives and its internal accounting policy, in order to determine whether a loan whose terms have been modified should be reported in the public reports as an asset that does not accrue interest income.

<u>Comprehensive plan for the deferral of payments</u>

The deferral of payments of a loan that was given until December 31, 2020 as part of a comprehensive plan for the deferral of payments[8], regarding a loan that is not in arrears of 30 days or more at the time of the deferral of payments, will not require the classification of the loan as a debt in the restructuring of a problem debt.

For example, consistent with our letter dated April 21, 2020, when in accordance with the extended outline published by the Supervisor of Banks on July 13, 2020, further deferred payments were

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[6] A banking corporation should increase the qualitative adjustments included in its credit loss allowances for information not yet included in the loss estimation process, among other things, to take into account the uncertainty in the measurement and the limited supporting documentation and existing information regarding the condition of its borrowers. As time passes and additional information becomes available, the banking corporation must integrate the additional information into the credit rating and classification processes and in the process of determining the allowances for credit losses and documenting them.

[7] See below in this letter a separate reference to the deferral of payments made under a comprehensive plan.

[8] For the purposes of this letter, a comprehensive plan for the deferral of payments is a program implemented at the initiative of the Bank of Israel or the state, which includes all of the following characteristics: (1) The plan was implemented in response to the coronavirus event (2) The plan is implemented throughout the banking system (3) The plan refers to a pre-determined large group of borrowers and enables each borrower in the group to defer payments in full or in part, in a similarly pre-defined manner (4) The borrower's option to defer payments under the plan is not affected by the banking corporation's assessment of the borrower's credit quality (5) The plan defers contractual payments for a pre-determined limited period, and does not change other conditions in the debts, such as the interest rate (7) The plan for the deferral of the payments does not apply to new loans given subsequent to implementation of the plan.

provided for housing loans that are not in arrears, due to the coronavirus event, generally the deferral does not require classification of the housing loan as a debt in the restructuring of a problem debt, even when the cumulative deferral exceeds six months.

However, as stated in the previous paragraphs, even in these circumstances the banking corporation must ensure that in its reports to the public, it adequately identifies and classifies the loans according to their inherent risks. Furthermore, although the deferral of loan payments does not require classification as a restructuring of a problem debt, it can reasonably be assumed that in some of the loans there has been a deterioration in the quality of the credit and it is necessary to examine their appropriate classification in the public reports in accordance with the existing principles.

For practical reasons, with respect to relatively small debts, a banking corporation may perform the examination for a group of debts with similar risk characteristics and is not required to perform the examination for each individual loan. These characteristics may include, for example, the duration of the cumulative deferral granted in relation to the original period of credit, as well as indications existing in the banking corporation that are relevant to the borrower's repayment capability and collateral value.

Internal control systems

Cautious risk management practices at the end of periods of the initial loan accommodation and of subsequent modifications include credit control functions, operational risk management, compliance risk management, and an internal audit appropriate to the size, complexity, and risk in the banking corporation's operations. These internal control functions typically include focused examinations of the appropriateness of the process applied to manage each stage of the modifications in the debt terms. Careful examination by the internal control functions usually verifies the following issues:

- The modification in terms is carried out in accordance with the appropriate powers.
- The servicing systems accurately sum up the balances, calculate the required payments, and process the billing requirements for the full range of potential repayment terms that exist, when the modification periods end.
- The staff, including the collection and problem credit team, are skilled and can deal effectively with the expected workload.
- Communication with the borrowers and guarantors, and the legal documentation, are clear, accurate and executed on time, and in accordance with the contractual terms, policy guidelines, and legal requirements, regulations and directives.
- The risk rating assessments and credit classification are performed on time and are properly supported and documented.

Sincerely,

Or Sofer
Deputy Supervisor of Banks

CC:
Yair Avidan—Supervisor of Banks
Ido Galil—Head of the Financial Reporting Unit