Bank of Israel
Supervisor of Banks

Jerusalem
March 28, 2018
18LM2755
188S6838

To: **The banking corporations and credit card companies**
Attn: CEO

Re: Adoption of US banks' generally accepted accounting principles updates - Current expected credit losses and additional directives

General

1. As part of the process of banking corporations and credit card companies in Israel (hereinafter, banking corporations) to fully adopt generally accepted accounting principles (GAAP) used by US banks, banking corporations should prepare to implement updates to these principles that were published in recent years, with the objective of improving the quality of financial reporting and strengthening the public's confidence in the banks' financial statements, as detailed below.

1.1. **Current Expected Credit Losses (CECL)**

This change was carried out in the US as part of the process of learning from the global financial crisis. The objective is to improve the quality of banks' financial statements, by earlier recognition of allowance for credit losses, in a manner that strengthens anti-cyclicality of the allowance, supports a more rapid response by banks to a deterioration in borrowers' credit quality, and strengthens the connection between the manner in which credit risks are managed and the manner in which these risks are reflected in the financial statements.

See Section 4 below regarding the preparation required for implementing the new directive.

1.2. **Financial instruments, including derivative instruments and hedging activities, and the accounting treatment for leases**

These updates lead to, among other things, risk management activities by banks via derivative instruments being better reflected in the financial statements, the level of leverage created by long-term lease agreements being better reflected in the financial statements and more simplified accounting treatment for financial instruments.

For further details regarding the updates, and the main expected effects of their implementation on banking corporations' financial statements, see the attached Appendix.

2. We intend to revise in the near future the Reporting to the Public Directives in line with the above.

Effective date

3. The initial implementation of the said updates will be in accordance with the dates noted below:

3.1. Update of the accounting treatment for allowances for credit losses—beginning January 1, 2021, and onward.

3.2. Update of the accounting treatment for leases—beginning January 1, 2020, and onward.

3.3. Update of the accounting treatment for financial instruments, including derivative instruments and hedging activities —beginning January 1, 2019, and onward.

The initial implementation will be in accordance with the transitional provisions established in the US accepted accounting principles. Disclosure of the expected implementation of the updates shall be included in accordance with generally accepted accounting principles.

In this regard, it is clarified that a quantitative disclosure of the expected impact of the revised accounting treatment of leases shall be included no later than the financial statement for the second quarter of 2019.

The CECL project

4. The banking corporations should prepare for the implementation of the new US accounting principles regarding the allowance for current expected credit losses. Following are additional clarifications in this regard:

4.1. In June 2016, new accounting principles were published in the US regarding expected credit losses.

4.2. In the US, it was emphasized that the principles are intended to be appropriate for banking corporations of various sizes and at different levels of complexity, and therefore a large extent of judgment and practical implementation is allowed. . Our intention is to adopt this approach. In addition, in order to ease the implementation by banking corporations in Israel, and similar to the approach of the US supervisory authorities, we intend to allow further improvement in the measurement methods, even after the initial implementation.

4.3. We intend to publish soon a translation of the new accounting principles on the Bank of Israel website.

4.4. As part of their preparation to implement the accounting principles, banking corporations are required to:

4.4.1. Each banking corporation should appoint a person (one person or more), at the level of member of management, to be responsible for the CECL project. Care should be taken to integrate all the relevant functions into the project, including the functions responsible for financial reporting, for originating and managing credit risk, IT, and internal audit.

4.4.2. The management of each banking corporation should report at the end of each quarter to the banking corporation's board of directors, or to a Board committee that will be authorized for such issue (hereinafter, the Committee), about the status and progress of the preparation by the banking corporation to implement the new principles. The report should be submitted to the Board (or to the Committee) within two months from the end of the quarter. The first report will be as of June 30, 2018. A copy of the report to the Board (or to the Committee) shall be sent to the Banking Supervision Department parallel with being sent to the Board (or to the Committee).

4.4.3. The management of each banking corporation should prepare an initial list of issues regarding which the banking corporation requests to receive clarifications, alongside detailed recommendations that the banking corporation suggests. These lists should be sent by each banking group no later than June 30, 2018. Moreover, based on the subjects that will be raised, we will decide on the establishment of joint working teams for promoting specific issues.

4.5. Please send the information required in this section, as well as any other future helpful or required information regarding this topic to Mr. Alon Emanuel, Head of the Financial Reporting Area and the coordinator of the project at the Bank of Israel, via email: alon.emanuel@boi.org.il.

Sincerely,

Dr. Hedva Ber
Supervisor of Banks

Appendix

1. Update to the accounting treatment for allowance for credit losses

1.1. In June 2016, new guidance was published amending US generally accepted accounting principles (GAAP) regarding the accounting treatment of credit losses.[1] Banking supervisory authorities occasionally publish clarifications within the framework of guidelines and questions and answers that refer to the manner of implementation of the new guidance (the most recent update was in September 2017).[2] In addition, the Basel Committee on Banking Supervision published guidelines on this issue, including reference to decisions that each supervisory authority is to make with regard to the manner of initial implementation of the new guidance for the purpose of calculating minimum capital ratios.[3]

1.2. The objective of the new guidance is to improve the quality of the banks' financial statements, by , by early recognition of allowance for credit losses, in a way that strengthens the anti-cyclicality of the allowance for credit losses, which supports a more rapid response by banks to a deterioration in borrowers' credit quality, and that strengthens the connection between the management of the credit risks and the way such risks are reflected in the financial statements, based on existing methods and processes.

1.3. Below is a summary of the main changes expected in the accounting treatment in banking corporations' financial statements due to the implementation of such guidance:

1.3.1. The allowance for credit losses shall be calculated based on the expected loss over the lifetime of the credit, as opposed to estimating the loss that was already incurred but has not yet been identified.

1.3.2. The estimate of the allowance for credit losses is to make significant use of forward-looking information that will reflect reasonable forecasts regarding future economic occurrences.

1.3.3. The disclosure regarding the impact of the credit origination date on the credit quality in the credit portfolio will be expanded.

1.3.4. The method of recording declines in value of debt securities in the available for sale portfolio will change.

1.3.5. The new guidance for calculating the allowance for credit losses shall apply to financial assets measured at amortized cost basis (including housing loans), debt securities held to maturity, and certain off-balance sheet credit exposures. Thus, the complexity of the accounting treatment will be reduced as a result of the decrease in the number of methods for measuring a decline in value of financial instruments.

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[1] FASB- ASU 2016-13, "Financial Instruments—Credit Losses".

[2] FED, FDIC, NCUA, OCC—"Frequently Asked Questions on the New Accounting Standard on Financial Instruments—Credit Losses", September 2017.

[3] BIS—"Regulatory Treatment of Accounting Provisions—Interim Approach and Transitional Arrangements", March 2017.

1.4. In general, the new guidance will be implemented by recording the cumulative effect of implementing this guidance in retained earnings on the date of initial implementation.

1.5. At this stage, material changes are not expected in the US in the guidance for classification and write-offs of loans.

2. Updates to the accounting treatment for financial instruments, including derivative instruments and hedging

2.1. **Update to the accounting treatment for financial instruments:**

2.1.1. In January 2016, new guidance was published amending US generally accepted accounting principles (GAAP) regarding recognition and measurement of financial instruments.[4]

2.1.2. The main objective of the new guidance is to simplify the model for reporting financial instruments and to provide users of the reports more usable information for making decisions.

2.1.3. Below are the main changes expected in the accounting treatment in banking corporations' financial statements due to the implementation of this guidance:

2.1.3.1. Trading equity securities in the available for sale portfolio shall be measured at fair value through profit and loss statement, , instead of the current measurement that generally requires banks to record unrealized holding gains and losses , in other comprehensive income (OCI).

2.1.3.2. The changes in the fair value of the financial liabilities measured under the fair value option, caused by a change in instrument-specific credit risk, shall be recognized in other comprehensive income (OCI), and not in the profit and loss statement .

2.1.3.3. There will be a revision in the way of presenting financial instruments on the balance sheet.

2.1.4. On the date of initial implementation, unrealized gains and losses in respect of available for sale equity securities recorded in OCI shall be reclassified as retained earnings.

2.2. **Update to the accounting treatment of derivative instruments and hedging activities:**

2.2.1. In August 2017, new guidance was published amending the US generally accepted accounting principles (GAAP) regarding derivative instruments and hedging activities.[5]

2.2.2. The objective of the new guidance is to improve the financial reporting of hedging relationships, in a way that will better reflect the economic results of the banking corporation's risk management activities through changes in the

[4] FASB, ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities".
[5] FASB, ASU 2017-12, "Derivatives and Hedging".

designation, measurement, and presentation of the hedging results. An additional objective is to simplify the implementation of hedgeaccounting.

2.2.3. Following are the main changes expected in the accounting treatment in banking corporations' financial statements due to the implementation of the guidance:

2.2.3.1. The guidance expands the banking corporations' ability to hedge certain risk components, and align the effects of hedging instruments and the hedged items in the financial statements.

2.2.3.2. The amendments in this update ease and simplify the implementation of hedge accounting guidance, particularly by easing the requirements of effectiveness assessment and documentation of the hedging relationship.

2.2.3.3. The amendments in this update modify the disclosure requirements on banking corporations' activities in derivative instruments.

3. Update to the accounting treatment of leases

3.1. In February 2016, revised accounting guidance was published amending the US generally accepted accounting principles (GAAP) regarding leases.[6] In addition, the banking supervisory authorities in the US and the Basel Committee clarified the manner in which assets, which are recorded in the balance sheet as a result of the implementation of the new guidance, will be treated for the purpose of calculating capital ratios.[7]

3.2. The main objective of the new guidance is to reflect in the financial reports of banking corporations the level of leverage created by long term lease agreements.

3.3. Below is a summary of the main changes excepted in the banking corporations' accounting treatment due to the implementation of this guidance:

3.3.1. Banking corporations that lease assets for a period exceeding 12 months shall recognize them in the balance sheet, even if the lease is classified as an operating lease.

3.3.2. In operating lease transactions, record in the balance sheet the asset that reflects the banking corporation's right to use the leased asset, and against it record a liability to pay for the lease.

3.3.3. In some cases, transactions in which the banking corporation sells an asset and leases it back, will be accounted for as sale transactions, subject to certain provisions that are specified in the new guidance.

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[6] FASB – ASU 2016-02, "Leases".
[7] BIS – "Frequently Asked Questions on Changes to Lease Accounting", April 2017.
FDIC – "Supplemental Instructions, Call Report Materials", March 2017.