

Management of Workout and Collection Processes Involving Substantial Troubled Credits

Chapter A: General Remarks

Introduction

1. 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.” Early detection of a deteriorating credit before it is classified as troubled is crucial for possible action by a banking corporation and for the chance of thwarting further deterioration. Belated detection and inadequate treatment of troubled credit and large workouts may also expose a banking corporation to significant reputational risks in addition to credit risks.
2. To apply this principle, this Directive presents banking corporations with the Banking Supervision Department’s guidelines for the management of substantial troubled credit and the totality of relevant aspects at all stages of the lifetime of such credit, from underwriting to workout and collection. For this purpose, banking corporations shall, *inter alia*:
 - (a) have in place a strategy and targets for the treatment of substantial troubled credit, and monitor and control their implementation;
 - (b) establish policies and procedures for collection and workout of substantial troubled credit in accordance with the principles set forth in this Directive;
 - (c) define the powers, status, independence, resources, and working processes of its dedicated function that specializes in workout;
 - (d) have in place a systematic process for the detection of substantial troubled credit by its business functions, including qualitative indicators that will help assess borrowers’ comportment and extent of cooperation;
 - (e) take risk-mitigation measures before troubled credit is assigned to the dedicated function, at a stage when the borrower is still cooperating;
 - (f) have in place a systematic process relating to the decision to assign credits to the dedicated function for treatment, taking into account borrower’s solvency and level of collateral and the effect of assigning the debt on the extent of borrower’s cooperation;
 - (g) determine the roles, involvement, responsibilities, and powers of the risk-management function in all processes included in this Directive;
 - (h) have in place a systematic process of review of alternatives for the appropriate treatment of substantial troubled credit, taking into account economic considerations in favor of maximizing collection along with additional considerations as the case may be;
 - (i) have in place a process and control for liquidation in order to ensure that they are carried out as planned;
 - (j) have in place a procedure for learning from failure events at all stages of the process: underwriting, detection, workout, and collection.

Incidence

3. This Directive shall apply to the following corporations as defined in the Banking (Licensing) Law, 5741-1981 (hereinafter: “the Law” and “banking corporation,” respectively) that manage substantial credit as defined in this Directive:
- (1) a banking corporation as defined in Section 1 of the Law;
 - (2) an acquirer as defined in Section 36i of the Law.

Definitions

4. **“Dedicated function”**—a dedicated entity at a banking corporation that specializes in settling troubled credit as specified in this Directive.
- “Substantial debt”**—indebtedness as defined in Directive 313, with the exception of an investment in equities, if any:
- (a) indebtedness in excess of NIS 50 million; or
 - (b) indebtedness that meets quantitative or qualitative parameters that the banking corporation has set for this purpose, even if smaller than the sum specified in Subsection (a) *supra*.
- “Substantial troubled debt”**—a substantial debt that is classified as a “troubled credit risk” as defined in Section 1 of the Reporting to the Public Directives concerning “Presentation and Publication of Annual Financial Report” or a substantial debt with negative indications that amplify the risk of its becoming a troubled credit risk (e.g., a substantial debt included on a watch list or assigned to workout), with the exception of debts being treated by a “debt collection function” as set forth in Proper Conduct of Banking Business Directive 450, “Debt Collection Proceedings.”

Chapter B: Corporate Governance in Managing Troubled Credit

Board of Directors

5. As part of its comprehensive responsibility, the Board of Directors shall relate to processes associated with workout and collection of substantial troubled debt in the following respects at least:
- (a) having in place a strategy for effective management and important milestones in its implementation;
 - (b) setting attainable targets, at least in the medium term, for the mitigation of substantial troubled debt for which collection processes have been decided upon. In setting said targets, targets related to maximizing collection, expected economic developments, market expectations, risk appetite, reputational aspects, and the regulatory and legal framework shall be taken into account;
 - (c) approving a policy that comports with the strategic targets set;
 - (d) approving an appropriate organizational structure and powers and responsibilities derived from it, including powers related to the approval of workouts;
 - (e) periodically discussing and auditing all activities of the banking corporation in this field, in accordance with Section 8d of Directive 314.

Senior management

6. Senior management is directly responsible for dealing with workout and collection of substantial troubled debt, for which collection processes have been decided upon, and for the activity of the dedicated function. Within this framework, management shall, *inter alia*:
- (a) assimilate into policy, and establish in procedures, the strategy that the Board of Directors has determined on the basis of this Directive;
 - (b) establish in procedures appropriate working processes, including those of the dedicated function, and ensure that said function has adequate resources;
 - (c) establish a format for regular reporting to the management and the Board of Directors that presents complete and relevant information, on a high level of quality, about the extent of substantial troubled debt, progress in attaining mitigation targets established, credit assigned to the dedicated function, information needed for the approval of workouts as stated in this Directive, and all other relevant information;
 - (d) integrate the relevant components of the problem credit management strategy into the Internal Capital Adequacy Assessment Process (ICAAP) as required by Directive 211, including quantitative and qualitative measurement of the development of troubled credit under extreme conditions and its impact on capital planning;
 - (e) ensure adequate internal auditing of the management of workout and collection of troubled credit.

Dedicated workout function for treatment of troubled credit

7. As stated in Section 84 of Directive 311, a banking corporation that manages substantial credit exposures shall establish a function devoted primarily to troubled credit workout. Said function shall be segregated from the business functions that originate said credit and handle it on an ongoing basis. This notwithstanding, if total exposure to substantial troubled credit is not significant, a banking corporation may have in place a different organizational structure, provided the principles set forth in this Directive are upheld.

Qualifications

- (a) The function shall be headed by an executive whose experience and qualifications correspond to the types of accepted solutions that the bank proposes to apply in handling troubled credit in one or more of the following fields: familiarity with the legal environment, experience in credit and finance management, familiarity with the accounting environment, or other relevant business experience;
- (b) The staff of said function shall have economic or legal training or expertise and experience in dealing with troubled credit and debt collection; these qualifications shall enable them to carry out thorough analyses, including analysis of quantified alternatives for the continued management of said credit.
- (c) Insofar as the staff of the function believes that legal assistance is needed, e.g., in complex situations, it should be ascertained that said assistance shall be provided by a party that had not been involved in underwriting the credit.

Status and independence

- (d) The staff of the function shall be independent and shall avoid conflicts of interest with the staff of the business units that had participated in underwriting and managing credit that is now assigned to the staff of the function for its treatment.
- (e) The manager of the function shall report directly to a senior executive who is authorized to make decisions, such as the manager of the business division or the CEO of the bank.
- (f) In cases where the function is subordinate to the manager of the business division that is also responsible for underwriting credit, the banking corporation shall ensure adequate internal controls to mitigate potential conflicts of interest, e.g., a reporting mechanism in cases where decisions are made in contravention of the view of the risk-management function and as specified in Section 13 below.

Resources

- (g) The resources of the function shall be commensurate with the extent of its activity, the level of risk, and the complexity of the cases assigned to it for treatment.

Working procedure

The working processes of the workout function shall be anchored in a systematic working procedure that shall include, *inter alia*, a timeframe, responsibilities, and reference to the following processes:

- (h) processes of preparing for workout (e.g., extent of information needed, sources and integration of the information, risk assessment and forecasts, considerations allowing waiver of debt, and guidelines for appropriate quantitative calculations);
- (i) the internal working processes of the banking corporation, including those pertaining to cases that require rapid decisions;
- (j) processes that assure the retention and integrity of crucial documents and of collateral and its revaluation;
- (k) rules for the formulation of a business plan vis-à-vis the borrower, including analysis of strengths, weaknesses, opportunities, and threats (SWOT) as well as rules for documentation and tracking.

Chapter C: Compulsory Measures before Debt becomes Troubled

Appropriate underwriting processes

8. A banking corporation shall ensure the ability of its underwriting processes to help it act vis-à-vis a borrower in default even in cases where the borrower does not cooperate.

Within this framework, the banking corporation shall consider, in accordance with the substantiality and complexity of the credit, inserting practices into its underwriting and management processes in matters such as maintaining the effectiveness of personal guarantees and personal wealth statements that will be helping in auditing and detecting assets (e.g., via compulsory up-to-date reportage on any substantial change in assets), preventing denying of indebtedness by borrowers, tracking of changes in borrowers' total leveraging, and setting appropriate financial conditions at the underwriting stage in a way that will allow it to act in the event of deterioration or default.

Early detection of substantial troubled debt by the business functions

9. In accordance with Principle 9 in Directive 311 and Section 16 in Directive 314, a banking corporation shall have in place a process that includes criteria for early detection of deterioration in credit quality at a stage when remedial action remains possible. The banking corporation shall act, to the extent possible, to integrate evidence based on analysis and digital information incidental to the use of advanced analytical methods (ML, BI, AI, etc.).

Within this process, the business functions shall be responsible for:

- (a) detecting information about the deterioration of substantial debt in view of the aforementioned criteria.
- (b) periodic systematic and documented gathering of qualitative evidence that is helpful in assessing, at the earliest possible stage, the borrower's conduct and the extent of his or her cooperation with the bank.
- (c) discussing and making decisions on the need to assign such debt to the workout function, as specified in Chapter D.
- (d) setting metrics and targets (KPIs) in order to measure substantial troubled debt and encourage the business functions to detect it at an early stage.

Risk-mitigating measures preceding assignment of debt to the workout function

10. A banking corporation shall take preemptive measures to mitigate risk wherever there is concern about loss of cooperation with a debtor in default. Said activities shall be carried out incidental to underwriting and shall be reviewed periodically as long as the substantial debt exists. Within this generality, a business and legal review shall be conducted to verify the completeness of the documents and to assess collateral and weaknesses in the borrower's file in view of potential lack of cooperation at time of default (hereinafter: "the Review").

The Review shall be performed in accordance with the following rules at the very least:

- (a) The Review of substantial troubled debts shall take place at the time the decision to place said debts on the watch list is made and before they are assigned to the dedicated function.
- (b) The Review shall be performed by someone who had not been involved in underwriting the debt.
- (c) A banking corporation shall discuss and document the outcomes of the Review and shall make decisions on actions to be taken vis-à-vis the borrower. Said actions shall be taken at the earliest possible stage and, at the very least, at stages where decisions are needed, in order to mitigate risks originating in the weaknesses while the borrower is still cooperating.

Chapter D: Decision on Assigning a Debt to the Dedicated Function

11. A banking corporation shall hold a discussion of substantial debts with negative indicators that the business functions or other entities have detected and shall make and document a decision on whether to assign them to the dedicated function or not, including the reasons for said decision (hereinafter: "the Decision"). For this purpose, the banking corporation shall determine:

- (a) the appropriate forum in which to discuss and make the Decision, assuring the participation in said forum of representatives of relevant business functions, the dedicated function, and the risk-management function. Said discussion may take place in the course of discussions of watch lists that exist for deciding on credit loss provisioning and troubled debt classification

in accordance with Section 56(c) of Directive 311 and the Reporting to the Public Directives, or in any other forum that the banking corporation may choose.

- (b) the frequency and timing of the discussion and the Decision.

Considerations in making the Decision

12. In making the Decision, a banking corporation shall:

- (a) establish guidelines for considerations in deciding to assign a substantial troubled debt to the dedicated function, including:
- (1) financial capacity—quantitative parameters relating to the borrower’s financial situation and, in particular, his or her ability to make regular repayments on account of the debt and the coverage rate and liquidity of his or her collateral;
 - (2) the extent of the customer’s cooperation and the likelihood that assigning the debt will affect it;
 - (3) additional qualitative aspects and criteria.

A banking corporation shall also examine the implications of the borrower’s membership in a borrower group for these considerations.

- (b) examine initial scenarios that will be helpful in making the Decision;
- (c) establish minimum criteria by which, when present, a substantial debt should be assigned to the dedicated function (e.g., in cases of impaired or inferior debts and debts of borrowers in the midst of liquidation, receivership, creditors’ settlement, or stay of proceedings). The background material for the discussion shall include documentation on meeting the criteria set forth;
- (d) debts for which it is decided against assignment to the dedicated function even though they meet the minimum criteria established under Subsection (c); these debts shall be reported periodically to management or to the Board of Directors or to a board committee, including a detailed presentation of the reasons for the decisions made.

Involvement of the Chief Risk Officer in the Decision

13. Given the importance of assigning a borrower who has a substantial troubled debt to the dedicated function for successful collection, the Chief Risk Officer or someone acting on his or her behalf shall be involved in the decision on assignment to the function, at least in cases where the business function is disinclined to recommend said assignment. Accordingly, the forum referenced in Section 11(a) shall relate, in making the Decision, to a written opinion from the Chief Risk Officer or his or her representative on the matter. Said opinion shall include an independent analysis of the considerations for assigning the debt to the dedicated function and, as the case may be, shall challenge the business function’s judgment.

A banking corporation shall have in place a procedure for treatment in cases of disagreement between the business function and the risk-management function in regard to the Decision, resembling the mechanism established in Section 44 of Directive 311.

Stewarding process

14. Wherever credit meets the criteria for assignment to the dedicated function as set forth in Section 12(c) *supra* but the Decision is not to assign it solely because said assignment may impair maximum collection, the credit may be handled by the business function on condition that ongoing reporting to a forum to which the dedicated function belongs takes place.

Chapter E: Implementation of Workout and Collection by the Dedicated Function

Examining the appropriate way of handling the borrower

15. Before deciding on the appropriate way to deal with a borrower on account of substantial troubled credit that has been assigned to it, the dedicated function shall review several different alternatives:

- (a) recovery and rehabilitation of the business (a going-concern solution)—such as deferral of repayment, rescheduling of repayment (recycling), and an operational recovery plan;
- (b) divestment proceedings—
 - (1) with the borrower’s cooperation, such as a workout that includes a forgiveness program, a liquidation plan, etc.;
 - (2) without the borrower’s cooperation—unilateral or legal proceedings such as exercising the right of offset, unilaterally liquidating collateral (with court involvement), an insolvency proceeding, seizure, sale of debt to a third party, etc.

16. In deciding on the appropriate alternative, the following considerations shall be borne in mind:

- (a) economic considerations in favor of maximum collection—a quantitative test shall be carried out for each of the alternatives proposed in Section 15 (going concern as against collection proceedings).

First, the alternatives shall be quantified on the basis of economic data only, e.g., analyzing the borrower’s solvency; evaluating the collateral encumbered for the debt; estimating expected payback from guarantors, if any; additional sources of payback (by current owner or by bringing in a partner who will inject capital); the likelihood of the borrower’s recovery, the duration of the process, etc.

Said review of alternatives shall include documentation of the assumptions and methodology that underlie the review, the calculation process, and the outcome of the alternative chosen.

- (b) Additional considerations—a banking corporation shall also give some weight to additional considerations such as reputation, public and environmental considerations (e.g., in the event of layoffs), etc.

These considerations shall be additional to the economic considerations in favor of maximum collection as specified in Subsection (a).

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.

- (c) Borrower cooperation—the banking corporation shall take into account the extent of borrower cooperation in choosing the alternative. For this purpose, it shall bear in mind, *inter alia*, the effectiveness of the risk-mitigating measures taken as specified in Section 10(c) *supra*.

The less cooperative the borrower is, the more likely it is the bank will prefer to adopt a collection proceeding alternative as set forth in Section 15(b) and, as the case may be, to initiate court proceedings.

The banking corporation shall retain full and detailed documentation of the considerations invoked in choosing among the alternative ways of handling the borrower.

Tracking a liquidation plan in the course of workout

17. Wherever the chosen alternative includes liquidation, a banking corporation shall:
- (a) draw up a systematic and detailed liquidation plan including an approximate schedule, determined, as far as possible, in coordination with the borrower;
 - (b) track the targets against the performance of a plan involving liquidation of substantial assets, including documentation and reporting to management or the Board of Directors, or to a board committee, any meaningful delay in liquidation and the reasons therefor;
 - (c) set up a compensatory mechanism and a modus operandi for cases in which a major deviation from the plan occurs, to the extent possible.

Forgiveness or approval of additional credit to a borrower who has substantial troubled credit

18. Whenever workout includes forgiveness of all or some debt in a substantial amount, or when further lending on a substantial scale to the holder of troubled credit as part of a workout is taken up for discussion, an independent opinion from the Chief Risk Officer, in accordance with the provisions of Section 44 in Directive 311, must be obtained. For the purposes of this Section, a “substantial amount” is NIS 25 million or more.

Learning from major default events

19. To mitigate the risk of recurrence of default events, a banking corporation shall have in place a procedure for learning from credit failures. Said procedure shall lay down the following, *inter alia*:
- (a) threshold conditions (qualitative and quantitative) for carrying out a learning process in the following cases at the very least:
 - (1) underwriting failure;
 - (2) failure in determining when credit becomes troubled;
 - (3) collection failure.
 - (b) the function that will carry out the learning process;
 - (c) the function that will receive reports and make decisions pursuant to the lessons learned. In any event, lessons from substantial failures shall be reported to management and the Board of Directors or to a board committee.

Updates

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