International bank Risks report - first quarter of 2019

This report includes additional information to the Bank's financial statements and is compiled in conformity with directives of the Supervisor of Banks, which include disclosure requirements of Basel Pillar 3 and additional disclosure requirements of the Financial Stability Board (FSB).

**Risks Report**

This risks report includes additional information to the condensed consolidated financial statements of Bank International Ltd. and its subsidiaries as of March 31, 2019.

The condensed financial statements and additional information to the condensed financial statements, including the Report of the Board of Directors and Management, this Risks Report and other supervisory disclosures have been approved for publication by the Bank’s Board of Directors at its meeting held on May 20, 2019.

The Risks Report and other supervisory disclosures are compiled in conformity with directives of the Supervisor of Banks, which include disclosure requirements of Basel Pillar 3, disclosure requirements published by the Financial Stability Board (FSB) and other disclosure requirements of the Financial Stability Board (FSB).

Pursuant to the Public Reporting Regulations of the Supervisor of Banks, the quarterly format of the risks report is limited and focused on qualitative and quantitative disclosures whose quarterly analysis and presentation are material for readers of the report.

If needed, this report should be read in conjunction with the 2018 Risks Report.

The disclosure in this report is designated to allow users to evaluate significant information included with regard to implementation of the framework for capital measurement and adequacy and to implementation of provisions of "Basel III: A global regulatory framework for more resilient banks and banking systems".

All of these reports are also available on the Bank’s website.

www.mizrahi-tefahot.co.il >> about the bank >> investor relations >> financial statements.

As directed by the Supervisor of Banks, additional information with regard to risks is provided in the Report of the Board of Directors and Management in the financial statements as of March 31, 2019, in the following chapters:

* Chapter "Overview, targets and strategy" / major risks
* Chapter "Explanation and analysis of results and business standing" / Key and emerging risks
* Chapter "Risks Overview"

In conformity with the Equal Rights to Handicapped Persons Regulations (Service Accessibility Adaptations), 2013, the website also provides accessible reports.

 Doron Melzers, Chief risk officer

**Bank approach to risk management (OVA)**

The Bank complies with directives concerning risk management and control, as stipulated by the Supervisor of Banks, and in particular with Proper Conduct of Banking Business Directive310 "Risks Management", which is based on the Basel Committee recommendations and which specifies the principles for risks management and control in the Israeli banking system and stipulates the standards required of the banks for creating their risks management and control framework in line with regulatory requirements, the Bank's risk profile and its business targets.

All policy documents for risk management and control at the Bank are based on these basic principles.

The risks management and control framework at the Bank, as recommended by the Basel Committee, specifies three pillars:

Pillar 1 – minimum capital – minimum capital allocation requirements with respect to credit risk, market risk and operational risk calculated by standard models.

Pillar 2 – Supervision and control process over capital adequacy, the Internal Capital Adequacy Assessment Process (ICAAP) conducted by the Bank, as well as the Supervisory Review and Evaluation Process (SREP).

Pillar 3 – "market discipline" – reporting and disclosure to the regulating authority and to the public.

Efficient, comprehensive risks management is a key foundation for ensuring the Bank's stability over time.

Risks management and control processes at the Bank and at the Group are designed to identify, manage, quantify and mitigate all risks associated with Bank operations and to support achievement of the Bank's business objectives.

The Bank is exposed to a succession of risks which may potentially impact its financial results and its image.

The Bank exposed to financial risks, such as: credit risks and market and interest risks, as well as non-financial risks, such as: compliance risks, operating, legal, reputation risk and other risks.

Risks management at the Group is conducted from a comprehensive viewpoint of Bank operations in Israel and at overseas affiliates and in conformity with regulatory requirements, so as to support achievement of the Group's strategic objectives, while assuming risks in an informed manner and maintaining a risk level in line with the overall risk appetite specified by the Bank’s Board of Directors.

The risk appetite defines, at the highest level, the overall risk level which the Bank wishes to and can assume.

The risk appetite defines where the Bank would like to be in terms of reward (proceeds/benefit) vs. risk (cost from a forward-looking viewpoint).

Risk appetite is defined in qualitative and quantitative terms and is based on the risk strategy and on basic principles of the Bank's business and strategic plan and on the required liquidity and capital for achieving the strategic objectives.

Risk tolerance is a specific determination of risk levels for all risks to which the Bank is exposed.

Risk levels are determined by a range of qualitative and quantitative benchmarks, in support of achieving the business goals, while keeping the Bank within the overall limits of the specified risk appetite and subject to strict regulatory restrictions.

These risk restrictions, on aggregate, reflect the overall risk level which the Bank is willing to assume.

For further information [click here](https://minutehack.com/opinions/banks-new-approach-to-risk-management).

General mapping of risk factors and their impact

Below is a mapping of risk factors, their potential impact on the Bank Group and executives appointed Risk Owners for each risk factor:

| **Risk factor** | **Risk factor impact**  | **Risk Owner** |
| --- | --- | --- |
| Overall effect of credit risks | Low-medium | Manager, Business Division |
| Risk from quality of borrowers and collateral | Low-medium | Manager, Business Division |
| Risk from industry concentration  | Low-medium | Manager, Business Division |
| Risk from concentration of borrowers/ borrower groups | Low | Manager, Business Division |
| Risk with respect to mortgage portfolio | Low | Manager, Business Division |
| Overall effect of market risk | Low-medium | Manager, Financial Division |
| Interest risk | Medium | Manager, Financial Division |
| Inflation risk | Low-medium | Manager, Financial Division |
| Exchange rate risk | Low | Manager, Financial Division |
| Share price risk | Low | Manager, Financial Division |
| Liquidity risk | Low-medium | Manager, Financial Division |
| Overall effect of operational risk | Medium | Manager, Risks Control Division |
| Cyber and information security | Medium  | Manager, Risks Control Division |

The impact of the various risks factors in the table above have been determined based on management assessment, as provided from time to time.

These assessments are based on monitoring of various quantitative risk benchmarks specified by the Bank, includes the expected direction of their development and are based on qualitative assessment of risks management and the effectiveness of control circles, in line with the Bank's ICAAP process and its results , led by the Bank's Risk Managers.

In the first quarter of 2019, the Bank's risk profile is low, similar to the risk profile at the end of 2018.

Risks with a risk level other than Low typically arise from inherent risk in Bank operations, and are in line with the specified risk appetite principles.

The potential loss due to unexpected events, relative to the Bank's capital and profit, is low; Bank profitability is stable, i.e. profit volatility is low and the capital cushion available to the Bank is satisfactory under stress scenarios as well.

The Bank conducts processes for risk identification and measurement, base on a range of methodologies to assess risk levels and exposure to various risks, in the normal course of business and under stress scenarios.

The Bank applies quantitative measurement methods (models, benchmarks / indicators, scenarios and sensitivity analysis, inter alia) and qualitative measurement methods (expert assessments and surveys).

Summary of Bank policy on major risks and developments in the first quarter of 2019

**Forward-Looking Information – Strategic plan**

In 2018, the Bank Board of Directors has not declared any dividends with respect to earnings in the second, third and fourth quarters of 2018, following developments in the investigation by the US DOJ, including the signing of a DPA agreement, dated March 12, 2019, with the US DOJ to conclude the investigation into the Bank Group's business with its US clients.

For more information see Note 26.C.12 to the 2018 financial statements.

The Bank’s Board of Directors, upon approving the signing of the agreement by the Bank, estimated that the Bank can achieve the outline for the five-year strategic plan for 2017-2021.

The Board of Directors further estimated at that time that in 2019, the Bank could resume acting in conformity with its policy of distributing dividends, subject to terms and conditions prescribed in the strategic plan, including compliance with statutory requirements and limits stipulated by the Supervisor of Banks.

**Credit risk**

Business loans are managed using a range of risk benchmarks and its risk level is low-medium.

The Bank has the business. legal and operating infrastructure for flexible management of credit risk by selling and/or sharing risk.

In the first quarter of 2019, there were no deviations from risk limits, and the Bank is acting and constantly reviewing the risk profile and limits, in line with the scope of operations and risk.

Housing loans carry a significant weight out of total credit risk of the Bank; however, the overall risk level in the mortgage portfolio is low.

This area typically has a widely diversified borrower base from different economic sectors with relatively low LTV ratios and extensive geographic diversification of pledged properties.

The Bank also uses various risk mitigators, including property insurance and life insurance.

In the first quarter of this year, key risk benchmarks remained stable: In particular: LTV ratio (original LTV ratio in the portfolio: 52.5%), repayment ratio, rate of obligo in default; rate of arrears for new loans (up to one year since origination).

Furthermore, the rate of arrears for new loans (up to one year since origination) has been low in recent years.

Credit risk in the capital market is the risk of the borrower failing to meet their obligations towards the Bank, including the obligation to cover losses due to capital market activity conducted through the Bank.

The scope of business and risk level at the Bank in this area are low.

Loans in the micro and small business segment are a key growth engine and a component of the Bank's strategic plan.

This segment is highly diversified in terms of clients in various economic sectors, mostly in small industry, trade, business and financial services.

Financing in the micro and small business segment is mostly provided for short terms, for current operations and for financing of working capital, covering gaps in cash flow, financing trade receivables, inventory and import activities.

Such financing is provided against appropriate collateral, such as checks for collateral / checks receivable, invoices, pledging of contracts and current liens.

The risk level in the credit portfolio for small and micro-businesses is constantly monitored, including use of custom credit rating models and monitoring of high-risk economic sectors.

In the first quarter of 2019, the Bank continued development of computer-based processes for credit applications and a model to determine differential interest authorizations.

Loans to the individual client segment are highly diversified – by number of clients and by geographic location.

Most clients in this segment are salaried employees with an individual account or joint household account.

A recession in non-banking operations is a major risk factor for household activity and higher unemployment may increase the number of clients who face difficulties.

As from the second half of 2018, clients of the Retail Division are rated using advanced custom models.

These models quantify the probability of default (PD) and the loss given default (LGD) for small businesses and individual clients of the Retail Division.

Current management at the Retail Division is primarily based on the MADHOM system (for client management, rating and pricing).

In the first quarter of 2019, the Bank continued to deploy, implement and use advanced models under development for optimal analysis and management of retail credit.

The credit risk profile of individual clients, in view of the risk appetite determined based also on the internal model, shows a risk level which is not high and stable over time.

**Market and interest risk in the bank portfolio**

Activity in the negotiable portfolio (portfolios managed by the trading room) is low, with most of the Bank's financial activity and risk associated with the banking portfolio.

The Bank's banking portfolio mostly includes long-term uses (mortgages), against which the Bank raises resources which may be short-term.

The portfolio structure exposes the Bank EV to erosion in case of rising interest rates.

In 2018, the Bank conducted an extensive review of the risk estimation methodology, in line with common practice for application of Basel guidelines.

Consequently, Bank policy, including measurement methods and the resulting risk limits, was significantly revised downwards in the first quarter of 2019, so as to more reliably reflect the interest exposure, including dynamic effects of behavioral options inherent in the mortgage portfolio and in deposits, which are dependent on interest.

In the first quarter of this year, the overall risk level remained Low-Medium (the interest risk level remained Medium).

Risk benchmark values were calculated in conformity with the revision to the methodology in the policy and were in line with limits imposed by management and by the Board of Directors.

In the normal course of business, risk values (such as VaR) ranged at relatively low risk levels and risk values under stress scenarios, which reflect extreme concurrent increase in interest rates, are lower than the current risk appetite specified.

**Liquidity risk**

In the first quarter of 2019, the Bank maintained appropriate liquidity by investing excess liquidity in liquid assets of very high quality.

The average (consolidated) liquidity coverage ratio for the first quarter of 2019 was 120%.

In this quarter, there were no exceptions from the risk appetite limits and concentration benchmarks, and there were no material unusual events.

Note that in March 2019, the Bank raised its state of alert to Elevated Alert, due to tensions around Gaza and in the South.

In practice, no events and/or indications were observed which would indicate realization of a liquidity event.

In early April 2019, after return to normal conditions, the Bank decided to return to the normal course of business.
The following chart includes probability of risk:

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**Operational risk**

In the first quarter of this year, operational risk remained Medium.

There were no material operational events, and the risk level reflects the potential damage that may be caused by materialization of operational risks.

Activity continued to improve monitoring, management and control of operational risks, with emphasis on upgrading the IT system for management of risks surveys and further activity to identify, analyze and enhance awareness of the various operational risks.

**Business continuity**

The Bank applies Proper Conduct of Banking Business Directive 355 concerning "Management of business continuity".

In the first quarter of 2019, the Bank continued to operate in conformity with the work plan.

A periodic questionnaire was launched to review the integrity and currency of the branch emergency file, emergency procedures were revised and branch operation using power generators was exercised.

Concurrently, the list of services under Business Impact Analysis (BIA) were reviewed and planning of the major annual drill were started.

**Information security and cyber security**

In the first quarter of 2019, the risk level remained Medium.

In this quarter, a small number of fraud attempts against clients were identified (through fishing attacks), which resulted in stealing their account credentials in order to conduct unauthorized transactions in their accounts.

Most of these attempts to conduct unauthorized transactions were identified and blocked by the defense systems applied by the Bank to protect its client accounts.

Concurrently, towards the end of this quarter the Bank reinforced the defense mechanisms applied in Bank systems, in order to further limit the ability to defraus clients and to conduct un-authorized transactions in client accounts.

**Compliance risk**

Compliance risk remained unchanged at Low-Medium. The Bank believes the risk is trending downwards due, inter alia, to continued addressing of risks rated high and to further enhancement of controls and training and further streamlining of work processes in this area and measures taken to improve interfaces between units.

This is in view of further increased regulatory activity reflected, inter alia, in new directives being issued frequently, which the Bank is preparing for.

Key and emerging risks

Bank business exposes it to various financial and non-financial risks, which may impact the Bank's business results and reputation.

In the risk identification and mapping process, the Bank reviews all of its risk exposures.

Top risks, existing (or new) risks which may materialize over the coming 12 months which potentially may materially impact the Bank's financial results and stability (such as: credit, interest and liquidity risks).

The Bank also identifies emerging risks, which may materialize over the longer term and subject to uncertainty with regard to their nature and impact on the Bank.

Of these risks, one may note the following: information security and cyber risk, IT risk and reputation risk.

As noted, the risks mapping is regularly reviewed to ensure that it encompasses all business operations at the Bank, market conditions and regulatory requirements.

The Bank continues to upgrade the framework for handling "emerging" risks, such as compliance and regulatory risk, AML risk and cross-border risk – while allocating the required resources for addressing these risks.

Note that the Bank has zero appetite for non-compliance with applicable regulatory directives of the Bank of Israel.

Bank operations with regard to these risks are primarily qualitative actions designed to create the required framework for addressing these emerging risks.

**Credit risk**

This chapter discusses credit risk, in conformity with disclosure requirements of the Basel Committee and the FSB; the chapter structure and topic order (adjusted for the nature of Bank operations) are also in conformity with these requirements.

The chapter "Counter party credit risk" below includes qualitative and quantitative disclosures about the capital requirement with respect to this risk and adjustment to capital requirements with respect to credit risk (CVA).

Credit risk is the risk that a borrower or counter-party of the Bank would not fulfill its obligations towards the Bank.

Credit risk is a material risk to Bank operations.

This risk is affected by multiple factors: Business risk due to client activities, concentration risk due to over-exposure to a borrower / borrower group and to economic sectors, geographic concentration risk, risk due to exogenous changes which mostly involve changes to the borrower's macro-economic environment, overseas credit risks and operational risks which, should they materialize, would have implications for credit risks. . All credit risks does not refer to tax issues including VAT.

Moreover, such risk is interrelated to multiple other risks, such as market and interest risk, liquidity risk, compliance risks and other risks.

Credit is at the core of banking operations and therefore, credit risk is the major risk addressed by the banking system.

Accordingly, the lion's share of capital allocated in Tier I is with respect to credit risk.

For more information about credit risk, see chapter "Credit risk" in the 2018 Risks Report, available on the Bank website.

**Market risk**

Market risk – This is the risk of loss from on– and off-balance sheet positions, arising from change in fair value of financial instruments, due to change in market risk factors (interest rates, exchange rates, inflation, prices of equities and commodities).

The Bank has no exposure to commodities and its exposure to equities is not material, so that Bank exposure to such risk is primarily due to basis risk – the risk exists when the Bank's assets and liabilities are denominated in different currencies or are in different linkage segments – and from interest rate risk, which the risk to Bank profit and to Bank capital, primarily due to fluctuations in interest rates, fluctuations of various curves used by the Bank in its business operations or from the fact that a change in interest rates may result in a change in composition of the Bank's assets and liabilities due to exercise of options for early repayment due to change in market interest rates.

Changes in interest rates impact Bank profits (change in revenues) and the value of Bank assets (change in fair value).

For more information about market risk, see chapter "Market risk" in the 2018 Risks Report, available on the Bank website.

**Liquidity risk**

Liquidity risk – risk resulting from uncertainty as to the availability of sources and the ability to realize assets within a specified period of time and at a reasonable price.

Liquidity risk is a material and unique, due to the need to respond to it in the shortest possible time.

Risk materialization may cause the Bank to incur significant loss and may even result in collapse of the Bank.

For more information about liquidity risk, see chapter "Liquidity risk" in the 2018 Risks Report, available on the Bank website.

**Key factors that impact the results of liquidity coverage ratio**

The major factors affecting the liquidity coverage ratio results are composition of Bank sources and uses.

High-Quality Liquid Assets ("HQLA") are Level 1 assets, which are typically highly negotiable and associated with low risk. These include cash, current accounts and deposits with central banks, debentures of sovereigns with a 0% risk weighting and debentures of the State of Israel.

Cash outflows primarily consist of unsecured wholesale financing – deposits which corporations and financial institutions deposited with the Bank, as well as outflows with respect to exposure to derivatives.

Cash inflows primarily consist of credit receipts and inflows with respect to exposure to derivatives.

The ratio is primarily cyclical and may be forecast based on internal estimates by the Bank.

The key factor which affects evolution of this ratio over time is growth in Bank business, both in raising and management of source composition and increase in uses.

There is some volatility between days of the month, due to current activity of clients and interchangeability between NIS and foreign currency, primarily due to activity in NIS / foreign currency derivatives.