Examples of Issues that Arose in Examinations Conducted by the Banking Supervision Department Regarding “Real Estate Underwriting and Credit Classification”

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General

This document contains examples that describe various cases that arose in credit risk examinations carried out in recent years. They were carried out with regard to credit extended through the banking system to borrowers in the construction and real estate industry.

- Part A: Issues 1a–5a: related to credit **classification** processes
- Part B: Issues 1b–6b: related to credit **underwriting** processes

The examples are presented to illustrate and show the analysis process of the Banking Supervision Department's examination teams when they refer to various specific issues related to underwriting and classification of credit extended to this industry, with the goal of strengthening the transparency and supervisory consistency.

The Supervisor of Banks will consider continuing anchoring the principles that arise from the individual cases, through a Proper Conduct of Banking Business Directive or a FAQ file.

We emphasize that decisions related to underwriting and classifying business credit should take into account all the relevant facts and circumstances for each case on its own, and discretion should be used in line with the principles and rules established in Proper Conduct of Banking Business Directives and Reporting to the Public Directives by the Supervisor of Banks. Therefore, care should be taken when coming to implement what arises from the examples in credit decisions reached in real life.

Part A
Issues related to classification of credit to borrowers in the construction and real estate industry

- Issue 1a: Classifying credit in a construction loan project
- Issue 2a: Relying on surplus funds from other projects as a source of repayment in a construction loan project with difficulties.
- Issue 3a: Financing a residential project in a construction-loan format in stages or for the project overall.
- Issue 4a: Financing a stock of unsold homes in a completed project.
- Issue 5a: Significant extension of the financing period for purchasing land.

Issue 1a:
Classifying credit in a construction loan project

- A developing-contracting company (the developer) has credit at the bank that was extended in the format of financing a residential construction loan project.
- The project has a prolonged, unplanned, gap between the low rate of sales (20 percent) and the advanced engineering execution rate (80 percent), which indicates difficulty in repaying the credit from the sales of homes at the time the project is completed.
- In addition, a calculation of the exposure for the project by the bank, which examined the expected revenue vs. the expected expenses and liabilities for the project, indicated surplus funds of NIS 30 million before applying safety coefficients, and a deficit of NIS 130 million after safety coefficients were applied in line with the bank's policy (70 percent on expected revenue from the stock of unsold homes; 90 percent on revenue to be received from homes sold, and 110 percent on expenditures required to complete the project.)
- The developer is not injecting additional actual capital into the project account in order to repay the credit.
- In this case is it required to criticize the debt in respect of the project?

Issue 1a: Reference by Banking Supervision Department examiners
Classifying credit in a construction loan project

- In general, the primary source for repayment of credit for a construction loan project format is the expected flows from selling the homes in the project.
- Under the circumstances of the example, as it refers to a construction loan project, and in view of the difficulties expected in repaying the debt on time, reflected in a low rate of sales that leads to an expected deficit after the application of safety coefficients, the Banking Supervision Department examiners will check whether it is necessary to classify the project as criticized, including as non-accruing.
- In their reference to the expected deficit after applying safety coefficients, the Banking Supervision Department examiners will take into account, among other things, the level of caution of the applied safety coefficients and how they are in line with the uncertainty regarding timing and the amount of the expected cash flows from the project.
- When a bank requests to take into account the robustness of the developer in determining the appropriate classification of the debt, the Banking Supervision Department examiners will ask to see that the developer supports the project's account, for example via additional capital injected, and that it shows a reliable financial ability and commitment to continue supporting the project in a manner that will ensure that the debt is returned in accordance with the original terms.

Issue 2a: Relying on surplus funds from other projects as a source of repayment in a construction loan project with difficulties

- Under the circumstances of issue 1a, the contracting company has additional credit extended in the format of financing a construction loan project for the goal of building 4 additional residential projects.
- While the project detailed in Issue 1 is facing difficulties, in the 4 additional projects—owned by the same company—being financed by the bank, surplus funds are expected.
- The bank intends to rely on the expected surplus funds in the additional projects as a source of repaying the credit in order to determine the classification of the said project.

Can the bank rely on the expected surplus funds in a borrower's additional projects with the bank as a source of repaying the credit in order to determine the classification of the project which is facing difficulties?

Issue 2a: Reference by Banking Supervision Department examiners
Relying on surplus funds from other projects as a source of repayment in a construction loan project with difficulties

- In the circumstances of the example, in examining the appropriateness of the bank's intention to rely on surplus funds from other projects, the Banking Supervision Department examiners will check if:
  - The other projects are also managed at the bank, so that the withdrawal of the surplus funds that serve as a repayment source is under its control, and the bank has a clear legal right that allows it to use those surplus funds for repayment of the project.
  - The bank has a cautious policy for relying on those surplus funds.
  - For the most part, banks tend to determine in their credit policy that surplus funds from another project may be relied on after achieving significant progress in the other project, in terms of execution rate and in the rate of sales, and subject to that in accordance with the calculation of exposure in the project there is a surplus in the project's account, after generally accepted coefficients.
- For reliance on the robustness of the developer in general, beyond the said surplus funds, see the reference to Issue 1a.

Issue 3a: Financing a residential project in a format of construction loans in stages or for the project overall

- The bank approved extending credit to a developing-contracting company to finance a residential project in a construction loan format in 2 stages, given the following circumstances:
- Beginning of stage A financing –

  Capital - 20 percent of stage A costs

  Rate of advance sales – 25 percent of stage A
- Switch to stage B financing – Rate of advance sales – 50 percent of Stage A
- In actuality, the developer invested the required capital, but the rate of advance sales was lower than expected and was consistently at 20 percent of all the homes in the two stages of the project combined. This rate of sales complies with the bank's credit policy to finance a residential construction loan project in overall management (not in stages). Accordingly, the developer contacted the bank to request to open all the credit facilities for financing as an overall project, without switching between stages.
- In this case, is it required to criticize the debt in respect of the project?

Issue 3a: Reference by Banking Supervision Department examiners
Financing a residential project in a format of construction loans in stages or for the project overall

- In general, credit policy usually defines clearly the various terms and criteria for cases in which a residential project can be financed in a construction loan format for a project overall or as a project in stages (such as availability of land, building permits, engineering complexity, various risk characteristics in each stage, etc.).
- In general, throughout the life of a project, it is expected not to switch from managing in stages to overall project management, or vice versa. When such a switch is made, Banking Supervision Department examiners will check if it derives from difficulties that arose in the project and therefore it does not comply with the original terms that were approved, and that an attempt has not been made to align the state of the project in actuality with other criteria established in the credit policy.
- In terms of handling the project in which difficulties arose, see the reference to Issue 1a.

Issue 4a: Financing a stock of unsold homes in a completed project

- The bank granted credit to a developing-contracting company to finance a residential project in a format of construction loan.
- The developer has a small stock of unsold homes that are left, and it requested to extend the credit for several additional months in order to sell the remaining stock.

In such a case, is it required to criticize the debt in respect of the project?

Issue 4a: Reference by Banking Supervision Department examiners
Financing a stock of unsold homes in a completed project

- In general, in financing a construction loan project, the expectation is that after completing the project, the developer will repay the credit in the project account.
- A high percentage of homes unsold for a prolonged period is likely to indicate difficulties in marketing the project (for example, as a result of overpricing the homes in the planning stage, a decline in the market value of the homes, or deficiencies in construction), and in general, given a lack of another available source of repayment, requires criticizing the debt (see the reference to Issue 1a).
- However, in general, the Banking Supervision Department examiners will not require a bank to criticize the credit when the bank grants credit at the end of the project against a small stock of homes unsold for short bridging periods (of several months), to the extent that the repayment of the credit on the new contractual date seems secured (for example, the developer works actively to sell the homes, and the rate between the credit balance and value of the stock of homes (LTV) is not high).
- To the extent that the developer does not sell the stock in this time, and does not repay the credit, in the absence of another available source of repayment, usually it will be required to criticize the debt.

Issue 5a: Significant extension of the financing period for purchasing land

- A developing-contracting company received credit from the bank to purchase land designated for construction of a residential project. The financing period was 3 years. During the financing period, as long as actual construction had not begun, the borrower was not required to repay the principal of the credit, but just to make the periodic interest payments. In accordance with the financing agreement, the borrower is required to repay the principal of the credit by the end of the financing period at the latest.
- At the end of the financing period, a building permit had not yet been received and no significant process was made in the construction licensing processes. As such, the developer asked the bank to extend the financing period by another 3 years.
- In this case, is it required to classify the credit for purchasing the land as criticized?

Issue 5a: Reference by Banking Supervision Department examiners
Significant extension of the financing period for purchasing land

- In general, banking corporations tend to define, in their credit policy, a maximum reasonable period for repaying credit for purchasing land. Most of the time, as the land does not generate revenue until the construction on it begins, it is usually financed for relatively short bridging periods.
- Generally, financing land for long periods, without another primary source of repayment for the credit, exposes the bank to volatility in the value of the land and serves as speculative financing (against only a security) in which the bank does not have any control over the source of the repayment.
- In general, in cases in which there isn't another primary source of repayment, and the borrower asks to extend the original financing period for the land for a significantly longer period, Banking Supervision Department examiners will check if there has been any significant real progress in the construction licensing process, or if it can be seen clearly and backed by documentation that the onset of construction on the land is expected to begin within a reasonable period of time. Otherwise, in general, the bank will have to criticize the credit (to the extent it was not already identified as criticized) and to examine the need to classify the credit as non-accruing debt.

Part B
Issues related to credit underwriting processes to borrowers in the construction and real estate industry

- Issue 1b: Extending credit outside of the construction loan accounts of the real estate developer.
- Issue 2b: Weighting purchase tax in calculating the loan to value ratio.
- Issue 3b: Validating the value of the lands purchased in an Israel Land Authority tender.
- Issue 4b: Financing against land revaluation.
- Issue 5b: Risks deriving from the environmental impact of financing lands.
- Issue 6b: Change in terms of credit secured by income-generating real estate.

Issue 1b: Extending credit outside of the construction loan accounts of the real estate developer

- A developing-contracting company has credits at a bank that was extended to it in the format of construction loan project for the goal of financing the construction of 5 residential projects, some of which began recently.
- The company applied to the bank for receiving a revolving credit facility for a period of 2 years, outside of the construction loan accounts managed at the bank. The company does not have another significant primary source for repayment, and therefore the repayment of the credit is based mainly on the surpluses funds resulting from the project's sales.
- The bank approved the request.

Will the Banking Supervision Department examiners require the rectification of deficiencies in credit risk management from a bank that did not take into account the credit extended outside the construction loan accounts when calculating the exposure of the projects?

Issue 1b: Reference by Banking Supervision Department examiners
Extending credit outside of the construction loan accounts of the real estate developer

- In general, credit to a real estate developer, which is based mainly with the primary source of repayment being selling homes in construction projects he owns, should be granted in an appropriate structure of construction loan and under tight supervision.
- Under the circumstances in the example, the bank decided to grant the developer a revolving credit facility for a period of 2 years, without another significant repayment source other than the projects being managed, even though some of them began only recently. In such a case, the Banking Supervision Department examiners will verify that:
  - The surplus funds that serve the bank as a repayment source are sufficient and reliable. In this regard, in general, the reliance on projects that recently began does not seem appropriate in this regard. For additional reference regarding the reliance on surplus funds from other projects as a repayment source for a construction loan project with difficulties, see Issue 2a.
  - The credit is identified and handled at the bank in accordance with its essence. In the circumstances of the example, unless it was granted with another specific defined goal, generally its essence will be providing capital for projects. In such a case, it should be identified as credit for a capital transaction.
  - Furthermore, it will be checked that the credit is taken into account in calculating the absorption capacity and in calculating the exposure of all the projects for which it serves as capital completion.
  - The bank defined the characteristics of the customers to which it extended such credit and the underwriting conditions that enable it to sufficiently control the repayment of the credit (such as features of the developer, maximum period, financial covenants, limits on the sum, appropriate pricing, etc.) as well as conducts enhanced monitoring of the credit, in view of the inherent weaknesses in it.

Issue 2b: Weighting purchase tax in calculating the loan to value ratio

- A banking corporation extended credit to a developing-contracting company to purchase land that is designated for building a residential project in a high-demand area.
- The cost of the land is NIS 100 million. In addition, the borrower is required to pay purchase tax of 6 percent of the cost of the land (an additional NIS 6 million).
- In the credit application, the borrower asked for financing totaling NIS 80 million (which is about 75 percent of the cost of the land plus purchase tax: 106*75%=79.5).
- Can the purchase tax be added on to the cost of the land for calculating the loan to value ratio?

Issue 2b: Reference by Banking Supervision Department examiners
Weighting purchase tax in calculating the loan to value ratio

- In general, rules for calculating the LTV without taxes (such as purchase tax that is paid by the borrower and won't be returned if the land is sold) should be established in the credit policy.
- Including the purchase tax that was paid by the borrower when calculating the LTV is liable to cause a downward bias of the LTV compared to the actual LTV, and thus to adversely impact the process of risk monitoring, as well as in the manner of reporting to the board of directors and the Banking Supervision Department.

Issue 3b: Validating the value of the lands purchased in an Israel Land Authority tender

- A developer company contacted the bank to request NIS 350 million in financing for land purchased in an Israel Land Administration tender.
- The financing amount was determined as the amount of the maximum LTV that the bank is prepared to finance in accordance with its policy.
- The developer company won the tender after submitting the highest proposal—NIS 500 million.
- Only two proposals were submitted for the tender.

Will the Banking Supervision Department examiners require rectification of deficiencies in a bank's credit risk management that is based exclusively on the winning price in the tender in order to establish the maximum amount of financing for the land?

Would the reference have changed if there were 10 submissions for the tender, though the second proposal in the tender was lower by 20 percent than the winning proposal (that is, NIS 400 million)?

Issue 3b: Reference by Banking Supervision Department examiners
Validating the value of the lands purchased in an Israel Land Authority tender

- In general, when financing land, it is expected of the bank to examine the reasonableness of the price paid in respect of the land. The importance and depth of the examination are larger the more uncertainty there is regarding the value of the land, and the larger the LTV is.
- Under the example's circumstances, it appears that there is uncertainty regarding the value of the land (additional cases of uncertainty can include cases in which the company won an Israel Land Authority tender, but only a few applicants made submissions, or if there was a wide gap in the tender between the winning tender and the other ones).
- In such cases, Banking Supervision Department examiners will check that the bank validated the value of the land, for example by the assessment of an assessor carried out according to accepted standards (such as Standard 19 of the Land Assessors Council on "Minimum details required for assessing land designated for offering land rights as a security for a loan"), or via the bank's assessor. The validation is to be documented and it should be presented when making decisions on extending credit.

Issue 4b: Financing against land revaluation

- A robust and longstanding developer company received credit from the bank to purchase land, which is designated for construction of a residential project, against the value of the land of NIS 100 million.
- Against the background of an environment of anomalous and rapid increases in land prices, and in view of land purchases at prices that incorporate expectations for price increases, after about a half-year from the purchase date, the developer sold half the land at a price that appears higher than the price in which market transactions regularly take place, which implies a land value of NIS 180 million.
- The developer applies for additional credit (to free up capital) for additional projects at the bank relying on the up to date high value of the land, which the developer claims has to be established according to the price at which the developer sold the land.

Will the Banking Supervision Department examiners require rectification of deficiencies in credit risk management from the bank that decided to approve the credit application?

Issue 4b: Reference by Banking Supervision Department examiners Financing against land revaluation

- In the circumstances of the example, and in view of the rapid and significant growth within a very short period of time in the value reflected for the land, based on a sale at a price that appears higher than the price at which transactions are regularly carried out in the market, it is expected that the banking corporation will examine the reasonableness of the price paid in respect of the land. The importance and depth of the examination are larger the more uncertainty there is regarding the value of the land, and the larger the LTV is.
- In view of the lack of certainty existing in the circumstances of this example regarding the reasonability of the land price, the banking corporation is expected to validate the land value, for example by an assessor’s assessment carried out according to accepted standards (such as Standard 19 of the Land Assessors Council on “Minimum details required for assessing land designated for offering land rights as a security for a loan”), or via the bank’s assessor.
- As the increase in value in the example does not derive from enhancing the building rights on the land, Banking Supervision Department examiners will check if the valuation on which the bank relies reflects stringent safety coefficients, does not incorporate expectations for price increases, and that the credit structure is cautious.

Issue 5b: Risks deriving from the environmental impact of financing lands

- A developer company in the commercial income-generating real estate area applied for credit from the bank to purchase land with the goal of establishing a commercial center. In the credit application, it was noted that the land served in the past as a gasoline station.

Will the Banking Supervision Department examiners require rectification of deficiencies in the environmental risk management process within the framework of managing the bank's credit risk?

Issue 5b: Reference by Banking Supervision Department examiners
Risks deriving from the environmental impact of financing lands

- Banking corporations examine the risks deriving from the environmental impact when extending credit based on the environmental risk management policy it has established, among other things in line with the industry of the borrower’s activity and the characteristics of the borrower and the transaction.
- When there is an indication of an environmental problem in land for which the financing was extended, such as concern of land or underground water sources contamination, it is expected of the bank to rely on the opinion of the expert consultant for environmental quality issues regarding the risks deriving from the environmental impact in respect of the previous uses of the land.

Issue 6b: Change in credit terms secured by income-generating real estate

- A robust company in the income-generating real estate area has credit at a bank, which was extended for 25 years in order to purchase a mall, with an LTV of 70 percent. The credit was extended in line with bank's credit policy, which allows extending credit for a maximum period of 25 years for the goal of purchasing income-generating commercial real estate, at an LTV of 70 percent.
- After 7 years, 28 percent of the credit was repaid. The company applied to the bank with a request to receive an additional loan for which the repayment source is that same mall, at a scope that reflects a return to an LTV of 70 percent, and to restructure the credit balance, including the additional loan, for a new period of 25 years from that date (a total of 32 years from the original date)
- The additional loan is for an undefined purpose (all-purpose loan)

Will the Banking Supervision Department examiners require rectification of deficiencies in the credit risk management process by the bank that will approve the extending of said credit?

Issue 6b: Reference by Banking Supervision Department examiners Change in credit terms secured by income-generating real estate

In general, long-term credit will be extended for defined activity that is expected to generate flows over a long time. As such, to the extent that credit is extended for a long time with no defined goal (all-purpose), Banking Supervision Department examiners will require to verify that the bank carried out a deep and cautious examination that refers to how this credit will be used, the financial state of the borrower, and the risk level of the credit.

In addition, in the circumstances of the example, Banking Supervision Department examiners will check:

- Did the changes in credit derive from financial difficulties of the borrower, and serve as a troubled debt restructuring?
- Did the bank carry out a full renewed underwriting for the credit (including the additional loan) in accordance with the credit policy of the bank, including checking the economic lifespan of the mall and its ability to serve as a reliable and sufficient source of repayment for the credit?
- Does the bank's credit policy establish cautious rules for extending credit for an undefined purpose (all-purpose), in accordance with its characteristics?

The said rules shall generally refer to aspects such as: exposure limitations (for an individual transaction and out of the total portfolio), characteristics of the customers to whom the credit will be extended, the maximum repayment period for extending the credit, extending it on an eroding payment track, and in a manner that will enable the bank to reduce the exposure should there be an unexpected deterioration in the borrower's situation, the appropriate credit structure, and the requirement to monitor tightly the state of the borrower.