Bank of Israel

Banking Supervision Department
Onsite Examination Division
August 19, 2021
4.149.14480

To: The banking corporations
Attn: Chair of the board of directors
Bank CEO

Re: Increase in credit risk to the construction and real estate industry

Dear Sir or Madam:

1. In the first half of the year, there was a marked increase in the balance of business credit in general, and in the balance of credit to the construction and real estate industry in particular.
   Financial statements published for the first half of 2021 indicate that the increase in the first half of 2021 of overall risk in the business portfolio of the five large banking groups was about NIS 66 billion, a growth rate of approximately 8 percent over that period. More than half the increase (about 54 percent) derives from a rise in total credit risk to the construction and real estate industry, a growth rate of approximately 12 percent over that period.
2. Examinations that we carried out and discussions that we held with the banking system regarding developments in credit to the construction and real estate industry indicate that in view of the enhanced competition over new credit (within the banking system and vis-à-vis nonbank entities), the rise in the balance of credit to this industry comes with an increase in risk appetite and in easings in underwriting standards, and with that a rise in the level of risk and a decline in credit spreads of new transactions.
3. The rise in credit risk is reflected in an increased risk appetite in credit policy documents as well as in a high scope of deviations from the credit policy. These are particularly in parameters such as a reduced share of capital, absorption capacity that is lower than in the past, extending "mezzanine loans" instead of equity, the possibility to release surplus funds in an early stage, advance rental rates that are lower than in the past, and more.
4. The continuation of the trend is liable to lead to the taking of excess risks that are not in line with the standards expected for credit underwriting by banking corporations and to a deterioration in the bank credit portfolio quality.
5. In view of the above, you are required to enhance the processes of monitoring and controlling the development of risks, particularly in new credit transactions, as detailed below:
   5.1. Enhanced monitoring and reporting processes: To monitor, at least at a quarterly frequency, the new credit transactions that were extended during the quarter, as detailed below:

5.1.1. To monitor the new credit, extended at a heightened risk, to the construction and real-estate industry. To that end, the bank shall determine criteria for underwriting credit that it defines as "at heightened risk" in the various segments (see Appendix for examples of parameters for underwriting that reflect heightened risk).

5.1.2. To monitor the prices of the credit and the spreads of the new credit that were extended during the quarter and from this, the prices of credit and spreads of new credit that was extended at heightened risk.

5.1.3. The results of the monitoring of the new credit extended during the quarter as detailed in Sections 5.1.1–5.1.2 shall be brought to a quarterly discussion in the Risk Management Committee together with the bank's quarterly risk document (which monitors the overall portfolio balance).

5.2. Examining the need for limitations: In line with the result of the monitoring as detailed above, the bank shall examine the need to set limitations on the component it defines as being at heightened risk.

6. In addition, in line with the requirements of the Reporting to the Public Directives, when calculating the collective allowance for credit losses, account should be taken of the rapid growth of the credit portfolio and easings in underwriting terms. You are hereby required to verify that the required adjustments in the calculation of the allowance are made.

7. We request that you send us for perusal, by October 15, 2021, the background material that was presented to the Risk Management Committee and the minutes of the discussion that was held on each of the issues detailed in Sections 5.1–5.2, regarding the credit that was extended in the second quarter of 2021. In addition, we request of you, after the publication of the 2021:Q3 report, to send us details regarding the manner of the collective allowance adjustment as noted in Section 6 above.

Sincerely,

Vered Yefet
Head of the Credit Risk Examination Unit
On behalf of the Supervisor of Banks

cc: Mr. Yair Avidan, Supervisor of Banks
Mr. Or Sofer, Head of the Onsite Examination Division and Deputy Supervisor of Banks
Mr. Ido Galil, Head of the Financial Reporting Unit
The Head of the Corporate Division
Chief Risk Officer
Internal Auditor
Chief Accountant

Appendix: Examples of parameters that reflect credit underwriting at heightened risk in the construction and real-estate industry

Segment	Example of parameter that reflects heightened risk	Comments
Land	LTV>80 percent	
Financing of closed projects	Capital<10 percent Absorption capability<30 percent Projects with a completion rate higher than the rate of sales>20 percent	Do not include mezzanine loans as part of capital
Financing stock of unsold homes in a completed project	LTV>60 percent The financing period exceeds 1 year from the project completion Share of unsold homes out of total homes in the project>10 percent	
Income-yielding assets under construction	LTV>85 percent Share of rentals from the outset<40 percent	
Income-yielding assets generating income	LTV>75 percent	
Mezzanine loans	Scope of exposure	
Ongoing activity of the company	Scope of unsecured credit	