Bank of Israel

Banking Supervision Department

Jerusalem, March 25, 2010
10LM0715
REG09092H

To: **Banks and credit-card companies - attn. Chief Executive Officer**

Re: <u>Buying Groups</u>

<u>Introduction</u>

1. During a long time, owner construction by means of buying groups was a fringe factor in housing credit activity. For this purpose, a buying group is a group of people that are organized for the purpose of buying land and building a residential project. Said organization may be accomplished in various ways, including the formation of a registered society.
2. Buying group activity has become much more widespread recently, so much so as to figure very importantly in housing starts.
3. The main reason for increase is a combination of cost cutting and significant tax advantages. The effect of these factors has accelerated due to an upturn in public awareness of this activity and the incentive of "organizers" in this field. Macroeconomic factors specific to the construction industry, such as the supervisory limit on industry financing, the dearth of land available for building, and concern about the construction companies' financial resilience, also contributed to the increase.

<u>Risks in activity</u>

4. Notwithstanding the advantages relative to buying a dwelling from a contractor, credit taken by a buying group carries risks beyond those associated with the issuance of "standard" housing credit, for both the members of the group and the bank that finances this activity. The contents of this section are all the more valid due to the exceptional increase in the extent of this activity, as noted above, the entry into this domain of organizers even though the groups' fitness to do business has not yet been proved, and inexperience in large-scale defaults at times of falling housing prices.

5. These risks have generated concern about material impairment of credit quality and bank reputation due to the potential eventuation of one risk factor or a combination of several risk factors:

5.1 cessation of payments by some group members due to financial difficulties or other considerations, resulting in impairment of project cash flow;

5.2 disputes and disagreements within the group, leading to significant delays;

5.3 possible uncertainties about the tax status of the transaction, especially with the tax authorities looking into the appropriateness of the tax benefits;

5.4 an unexpected increase in costs due to lack of experience among some representatives and organizers, among other factors;

5.5 risk to the bank's reputation in the case of project failure occasioned by purchasers' misunderstanding of the role of the bank, which they perceive as the issuer of a construction loan. This risk may be aggravated by the absence of the bank guarantee that a contractor conventionally provides buyers in order to assure the buyers' investment in such a case.

<u>**Classification of credit issued to buying group**</u>

6. Given the uniqueness of these transactions, I believe it correct to explain our stance on the classification of this credit for limitation of obligation, industry classification, and capital adequacy purposes:

6.1 <u>During and up to completion of construction</u>:

6.1.1 Credit (on and off the balance sheet) issued to a buying group that intends to build ten or more dwellings shall be classified as the obligation of a real estate corporation (the buying group shall be classified as a "corporation" even if it is not officially incorporated). If there is a material relationship among different buying groups, the total credit to these groups shall be classified under a "Group of Borrowers".

6.1.2 Accordingly, said credit shall be weighted at 100 percent for capital-adequacy purposes. (The contents of this Section relate to Proper Conduct of Banking Business - Directive 311, and to Temporary Directive - Framework for Capital Measurement and Capital Standards).

6.2 <u>At end of construction and after keys are handed to buyers</u>:

Absent unusual circumstances, credit to group members shall be classified as "Housing Loan" and shall be treated in accordance with the various Directives.

7. The bank shall establish procedures for the treatment of credit for buying-group projects. Within this framework, parameters shall be set for the examination of the credit risk, with reference both to single borrower solvency and the risks attending to the project.

   In addition to the accepted parameters for the examination of borrower solvency in housing loans, parameters specific to or typical of credit to buying groups shall be taken into account. For example:

   7.1 Repayment capacity in respect of loans issued with a grace period shall be examined in reference to “full” repayment (principal and interest).

   7.2 Possible implications of additional costs on account of inflation and delays in project performance on repayment capacity.

Effect

8. The contents of this letter shall be applied with all possible celerity and no later than the financial statements as of June 30, 2010.

Transitional provisions

9. A bank that, as a result of applying the provisions of this letter, overshoots the concentration limits on industry indebtedness in the construction and real-estate industry (Proper Conduct of Banking Business - Directive 315) shall apply the Supervisor of Banks for transitional instructions relating to said exceptional indebtedness.

Respectfully,

Rony Hizkiyahu
Supervisor of Banks