Chapter 1
Summary of Developments

The global economy continued to expand in 2010, at a rate of about 5 percent, and world trade increased by 12 percent, with the emerging market economies growing faster than the advanced economies. The positive trends in the global financial system that had started in 2009 also continued; these were reflected in further increases in stock market prices and issues of corporate bonds. Despite the recovery trends, the government debt crises in several European countries became more severe in the second quarter of 2010. The adoption of austerity plans by most of those countries and the undertaking by the EU and international institutions to provide monetary aid to some of them calmed the financial markets. Nevertheless, as the year went by concern increased again over the ability of the problem countries to meet their debts, and in 2011 the problem of government debt still hangs over the European and US economies.

Israel's economy enjoyed continued growth in economic activity in 2010, due to the steep increase in global and domestic demand, and GDP grew by 4.7 percent. The main developments in Israel's economy in 2010 were the increase in GDP and employment, the drop in the unemployment rate, the rise in firms' profitability, a marked increase in the prices of financial assets and houses, and the appreciation of the shekel. In 2010 the Bank of Israel continued to increase the interest rate gradually, from 1 percent at the beginning of the year to 2 percent at year-end.

Against the background of the stabilization of the global financial system and the positive forecasts regarding the expansion of domestic real economic activity, the positive trends in Israel's banking system persisted in 2010. The banks became more robust, among other things as a result of the continued strengthening of their capital structure and the return to high profitability. Despite the firmer entrenchment of the strength of the banking system following the crisis, the banks' exposure to housing credit increased considerably, and required regulatory involvement to moderate this development.

The following is a summary of the main developments in the banking system in 2010:

- **Credit risk:** Credit risk in the banking system declined in 2010, reflected in improvements in most indices of the quality of the credit portfolio. This was mainly due to the improved situation of borrowers in light of the positive growth figures, the expansion of exports and the continued improvement in the labor market. Despite the positive developments in the quality of credit, the banks' exposure to balance-sheet housing credit increased considerably (by 16 percent), alongside the undesirable developments in the housing market, and concurrently the banks' exposure to the construction and real estate industry also increased. These, together with the exposure of the banks to other leveraged credit—credit to purchase means of control—and the concentration of the bank credit portfolio by size of borrower, show that credit risk in the banking system remained high. Against this background the Supervisor of Banks introduced several measures in the area of housing credit, and took action to reduce the concentration in the bank credit portfolio.

- **Housing credit:** The low yields in interest-bearing investment channels and the low interest rate in the mortgage market boosted the demand for houses for sale. This trend, together with the house supply constraint, led to the continued rapid increase in house prices. The developments in the housing market greatly increased banks' mortgage activity: outstanding balance-sheet housing credit increased by 16 percent in 2010, and new loans granted for the purchase of residential property jumped by 37 percent. About half of the mortgages taken by the public in 2010 were unindexed, at floating interest rates, with the rate of interest directly linked to the Bank of Israel interest rate. The Banking Supervision Department introduced a range of measures since mid-2009 to reduce the risk in the mortgage portfolio, improve the banks' portfolio risk management process, and to increase transparency vis-à-vis the public.
- **Exposure abroad:** Uncertainty regarding the debt crisis and large budget deficits in several European countries, including Portugal, Ireland, Greece and Spain, led the Israeli banks to reduce their exposure to those countries, and at the end of December 2010 it stood at 0.1 percent from total assets. At the same time the banks continued to conduct a cautious policy of investment in the securities portfolio, reducing their investments in bonds of foreign financial institutions, and purchasing Israeli government bonds.
- **Liquidity:** In 2010 the banks continued to maintain the relatively high level of liquidity that they had reached in 2009. The banks' main sources of finance are deposits of the public, not interbank and financial markets, so that compared with banks in other countries the liquidity risk of Israel's banking system is relatively low.

  Following the global financial crisis, the Basel Committee on Banking Supervision formulated principles emphasizing the importance of establishing a proper framework for managing liquidity risk, and published guidelines for international standards for measuring and monitoring liquidity risk (Basel III). For the first time these include two quantitative supervisory criteria. The Banking Supervision Department intends to adopt these guidelines, adapting them to the domestic environment.
- **Capital adequacy:** The capital adequacy ratio increased by 0.6 percentage points in 2010, and reached an unprecedented 14.2 percent, close to the average level in the OECD countries. All the banking corporations met the core (T1) capital target of 7.5 percent. The positive development in capital adequacy derived from growth in core capital resulting from an increase in banks' profits, and an increase in Tier 2 capital by means of funding via hybrid capital instruments and subordinated notes. These trends enabled the banks to pay dividends in 2010. Nevertheless, it is expected that the growing worldwide trend regarding the strengthening of the regulatory capital

Table 1.1
Principal banking system indices, five largest banking groups, December 2001 to December 2010

Year	Average yield spread between bonds of the banks and government bonds	Ratio of credit to GDP	Ratio of annual expense on the loan-loss provision to total credit to the public, multiplied by 100	Share of non-performing loans in total credit to the public (percent)	Capital adequacy (percent)	Ratio of shareholders equity[a] to total assets (percent)	ROE (percent)
2001	**0.8**	**0.99**	**0.85**	**1.7**	**9.38**	**5.11**	**5.8**
2002	**0.8**	**1.03**	**2.50**	**2.5**	**9.90**	**5.10**	**2.8**
2003	0.7	0.99	1.12	2.6	10.32	5.51	8.4
2004	0.8	0.94	0.90	2.5	10.73	5.71	13.2
2005	0.7	0.92	0.69	2.3	10.68	5.60	13.9
2006	0.6	0.89	0.52	2.0	10.83	6.04	17.3
2007	1.1	0.92	0.28	1.4	10.96	6.25	15.6
2008	**1.9**	**0.97**	**0.72**	**1.5**	**11.16**	**5.87**	**0.3**
2009	**1.7**	**0.90**	**0.75**	**1.4**	**13.69**[b]	**6.43**	**8.8**
					13.611[c]		
2010	1.7	0.91	0.41	1.2	14.23	6.81	9.7

[a] Including minority interest.

[b] Calculated in accordance with the Basel I principles.

[c] Calculated in accordance with Basel II principles.

SOURCE: Published financial statements and Bank of Israel Information and Statistics Division data.

framework and the supervisory activity to tighten the accounting rules will reduce the banks' ability to pay dividends in the future.

- **Profit and profitability:** The banking system presented fair financial results in 2010, and in many aspects the positive trend of the boom years prior to the crisis continued. Total net income of the five major banking groups increased sharply to about NIS 6.6 billion and the return on equity reached 9.7 percent, similar to the average level in the last ten years. The increase in net income in 2010 derived mainly from the expansion of banking activities, due to the positive trend in real economic activity and the increase in the Bank of Israel interest rate. These led to an increase in net interest income, a decline in loan loss provisions and the collection of debts written off in previous years. At the same time, in 2010 an increase in operating expenses was evident, resulting mainly from salaries and related expenses.

The Banking Supervision Department carries out on a regular basis sensitivity analyses and scenario tests to identify main risk areas and incipient threats and to check the resilience of the banking system and of individual banks. This is against the background of the widespread acceptance of the status and importance of stress tests in the reality of the economic situation in the wake of the crisis, and familiarization with and adaptation of international standards. Stress tests performed in 2010 showed that the banking system maintained its resilience, and that the banks' average capital adequacy ratio remained above the minimum required to meet the realization of an extreme scenario.