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Introduction by the Supervisor of Banks

Israel's banking system is in the midst of a digital revolution, and has undergone tremendous changes in recent years, which are expected to benefit mainly households and small businesses. The many changes also affect the banks' employees and managements, and are expected to continue in the coming years. The changes reflect increased supply of the financial products and services offered to households, a change in how they are consumed—transitioning to remote consumption via the Internet, cellular applications and ATMs, alongside a reduction in the number of bank branches and in the number of customer visits to the branches—and in a decline in the number of bank employees. This is all a result of the banking technology revolution that we are seeing in all areas of our lives, including an increase in the power of the consumer and a change in consumer demands, widespread legislation in banking areas, and initiatives by the Banking Supervision Department that are intended to improve the state of households and small businesses while ensuring a sustainable business model for the banks that maintains the stability of the banking system.

An analysis of the banks' results for 2016 shows that in parallel with the many changes, the banks have continued to strengthen their stability, while increasing their capital and liquidity, reducing concentration in the credit portfolio, and increasing dividend payments. The banks' profitability remains at an average of 8–9 percent, against the background of very low credit losses and an increase in total assets, and despite the low interest rate environment and increased capital.

In 2016 and the first half of 2017, we have seen initial evidence in the field of the results of reforms enabled and advanced by the Banking Supervision Department, which are intended to promote the entry of technology and innovation in banking, improve the banks' efficiency, and increase competition in the banking and payments areas.

- **In the area of technology—the banks are offering more technological tools and new services for customer use,** such as cellular applications that enable customers to execute almost all banking activity remotely and with greater convenience; more sophisticated ATMs through which customers can execute a greater number of transactions; personal warnings that the banks send to customers to assist them in informed financial activity; centralized cash management information for businesses covering all their accounts; and more. We have seen that the public consumes more than 50 percent of banking services from outside the branches, through various direct means, and this rate is increasing. As a result of changes in banking product consumption habits, the number of bank branches was reduced by 23 in 2016. Most of the banks merged branches that were close to each other, mainly in the main cities, and opened branches in the periphery. Our assessment is that the public's transition to consuming banking services outside the branch will continue and expand in the coming years, and that the decline in the number and size of bank branches will continue, similar to the trend in Europe and in the US.

However, technology will not necessarily replace the personal connection between the bank and the customer, but will rather help in creating a different personal connection, more in line with the customer's needs, and not necessarily involving a face-to-face meeting. In order to help customers who are having difficulty due to the closure of branches, chiefly senior citizens, the Banking

Supervision Department has worked to set principles for a correct decision-making process and for maintaining a proper level of service in cases where branches are closed and the number of tellers at branches is reduced. Furthermore, in order to ensure the implementation of these principles, the Banking Supervision Department is examining each request to close a branch on a case-by-case basis, in keeping with its legal authority.

- **Alongside the promotion of technology, the Banking Supervision Department acted in the past year to strengthen the management of risks derived from technology, and involved the banks in the establishment of a banking cyber center that began operation at the beginning of 2017.** This is a joint project of the National Cyber Defense Authority, the Ministry of Finance, all of the banks, and the Banking Supervision Department. The center, which is similar in format to the Financial Services – Information Sharing and Analysis Center (FS-ISAC) that operates in the US, is intended to assist the banks in dealing with cyber attacks that take place on an on-going basis and with nation-wide attacks that may be significant. We view the banking cyber center as an essential additional line of defense that exploits the advantages of synergy in transferring information between the banks in order to protect the entire system, and harnesses the abilities of experienced experts on the national level to protect depositors as well.
- **In the area of efficiency, the banks presented significant plans to reduce their work forces and expenses, and have already begun implementing them, in accordance with the Banking Supervision Department’s requirements.** In 2016, 1,940 employees left the banks, and this trend is expected to continue in 2017 and in the coming years. The departure of many employees from the banking system is being managed such that it respects them and their contributions over the years, through a voluntary retirement program. With that, the departure of employees is not easy for some of them, or for the banks, since it requires the banks to adapt their work processes to the reduced work force and to fill in the knowledge that is lost with the retirement of experienced skilled employees. The reduction of the work force is a result of the banks’ need to adapt themselves to digital banking, where some activities no longer require the assistance of a teller. It is also derived from the Banking Supervision Department’s requirement that the banks streamline and reach the efficiency levels customary in banks around the world. The Banking Supervision Department will continue requiring the banks to take a variety of additional measures to reach better efficiency ratios and to pass the savings from the streamlining on to customers through improved tools and service and lowering the cost of banking services, alongside the distribution of dividends to bank shareholders, most of whom are from the broad public.
- **In the areas of promoting competition, the Banking Supervision Department issued a license for a new merchant acquirer in 2017, which is expected to provide services to small and medium businesses, and to compete with the three credit card companies currently operating in the field.** The entry of this acquirer to the market was made possible due to the significant reduction in requirements and entry barriers adopted by the Banking Supervision Department—mainly the lower capital requirement (to the standard common around the world) and leniencies in the process of issuing the license.

In addition, the Banking Supervision Department worked with the Ministry of Finance, as part of the Committee to Advance Cooperation, to advance the separation of two credit card companies from the large banks while working to ensure their ability to develop during the transition period until they are sold by the banks, so that they will be able to become significant players in a variety of financial areas, and even become digital banks if they choose that strategy. The two large banks are preparing to sell the credit card companies in accordance with the requirements of the law. At the same time, the Banking Supervision Department has been acting to remove entry barriers to banking, in order to encourage the establishment of a new—digital—bank.

- **In the area of maintaining fairness and increasing transparency, the Banking Supervision Department issued guidelines concerning the collection of debts from households and small businesses.** These guidelines ensure, among other things, an increase in “soft collection” proceedings and the involvement of the banking corporation in all stages of collection. However, the Banking Supervision Department emphasizes that debt must be repaid, whether the debtor is a large corporation or a household. The Banking Supervision Department also adopted various measures in the area of bank fees. Among those was the inclusion of senior citizens and those with disabilities to the low-cost tracks service; providing guidelines for customer-executed transactions; and regulation of fees for withdrawals from remote ATMs.

Alongside the promotion of these banking reforms, the Banking Supervision Department attributes great importance to the banks’ support of economic growth. This support is reflected in providing credit to large corporations and small and medium businesses, alongside the credit provided to households. After a number of years in which the banks dealt with the challenge of increasing capital and liquidity, and in which the bank credit to GDP ratio continued to decline, all of the banks reached their regulator capital targets and liquidity targets at the end of 2016, and can therefore now more easily increase credit to all sectors. Therefore, large corporations that in recent years had to deal with some reduction in the supply of bank credit, can now receive a new response from the banks, while ensuring proper underwriting procedures and the implementation of conclusions drawn from the failure of large and leveraged borrowers.

In the past two years, many legislative initiatives in banking and finance were promoted, and additional initiatives are currently being advanced. These come in addition to many measures adopted by the Banking Supervision Department to increase competition and efficiency in the banking system and the payments field. It is very important to me **that we now focus on implementing all the changes generated by the new legislation, and avoid the advancement of new legislative initiatives. These changes are complex, and we must direct their implementation so that they will fully benefit the public. The creation of regulatory certainty is also necessary so that investors will consider entering the industry, purchasing the credit card companies and even establishing new financial entities.** It is important to understand that implementing these laws and regulations and harvesting their fruits will be gradual and will last for a few years.

Beyond the challenge of implementing these laws and technological changes in banking, one of the main challenges to the economy in the financial realm in the coming years will be to ensure that

the promotion of competition and the increase in the number of credit providers will not lead to a flood of credit to households such that it will have a negative impact on some borrowers. There is already no lack of credit to households, after this credit increased very rapidly in recent years. In 2016, the number of private customers having difficulty repaying their debts increased, and the banks' credit losses in the area of retail credit increased to the relatively high level of 0.85 percent of credit. The entry of mass financing platforms, institutional investors, and designated nonbank credit providers into the retail credit field, alongside increased effort on the part of credit card companies to expand their activities against the background of separating two of them from the large banks, may lead to an oversupply of credit to households, where the current leverage of households is still reasonable by international comparison. Therefore, **it is important that households also remain alert, not be tempted to take out exaggerated amounts of credit that could make it difficult for them and lead to complications in the future, and that they take advantage of the increasing alternatives, mainly to lower the interest they are paying on credit.**

A handwritten signature in black ink that reads "Hedva Ber." The signature is written in a cursive style with a large initial 'H'.

Dr. Hedva Ber
Supervisor of Banks

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CHAPTER 1

DEVELOPMENTS IN THE BANKING SYSTEM

In 2016, the Israeli banking system continued to navigate domestic and global challenges while maintaining resilience and stability, supported by a growth rate higher than in the previous four years, low unemployment, growing private consumption, and a low interest rate environment. The increasing stability of the system was reflected in continued capital accrual and improvement of capital composition, the maintenance of adequate profitability, and a continued decline in concentration of the credit portfolio as exposure to large borrowers continued to decline and the liquidity risk profile improved. The system's resilience was also reflected in the results of a stress test that the Banking Supervision Department conducted during the year.

Consumer credit risk, operational risks, and risks derived from a change in the business environment escalated. The latter include regulatory uncertainty amid rapid legislative changes, growing consumer power among customers, and an increase in risks originating in the rapid development of banking technologies, all of which challenge the banks' business model. To mitigate the technological risks and create tools that will help deal with cyber attacks, the Banking Supervision Department, in conjunction with the National Cyber Authority, the Ministry of Finance, and the banks, acted to set up a Banking Cyber Center.¹

Risks due to cross-border activity and activity with foreign customers have also been escalating around the world in recent years as countries take more aggressive enforcement actions against financial institutions in regard to compliance. In the reviewed year, however, the banks' exposure to these risks continued to decline because, among other reasons, they assimilated tools for the detection of activities and customers that may expose them to compliance-related investigations and fines, and downscaled their activity vis-à-vis foreign countries and nonresident customers.

The banks continued to take measures to improve operational efficiency, enhance their production function, and optimize their management of inputs in view of the ongoing erosion of structural profit sources and supervisory instructions to have in place multi-year efficiency programs. Concurrently, they assimilated digital and innovative banking into the customer interfaces, which was reflected in the improvement and expansion of direct service channels.²

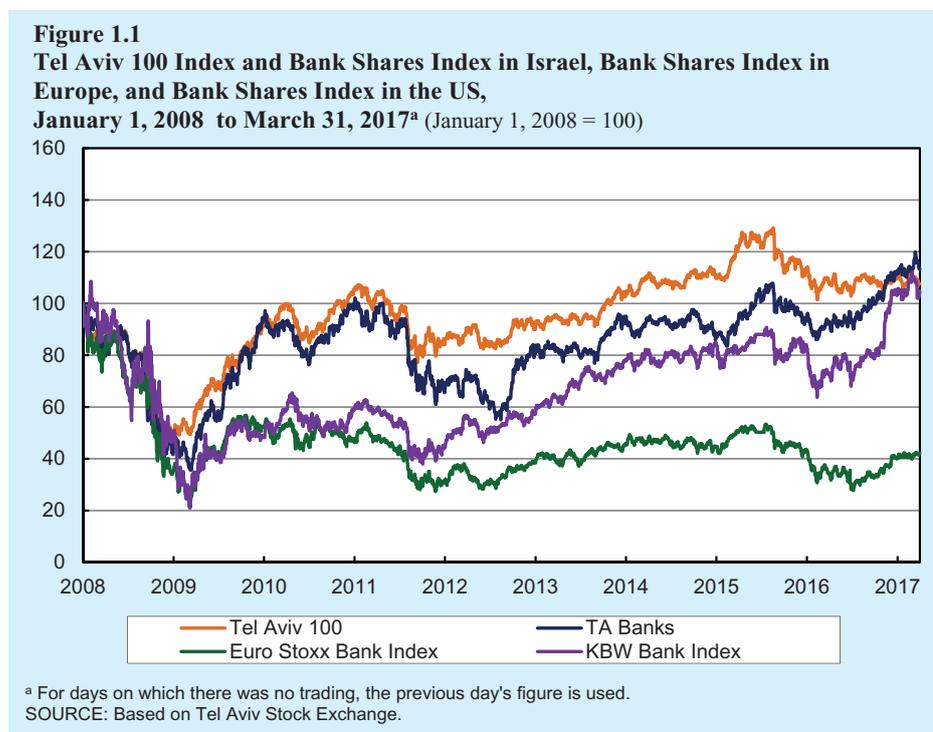
The reinforcement of capital, the attainment of regulatory capital targets, and the resilience of the banking system, as reflected in additional activity indicators, allowed the banks to pay larger dividends to shareholders, most of whom belong to the public.

¹ The center was established at the beginning of 2017 as part of the Cyber Emergency Response Team (CERT). Its main purposes are inter-agency sharing of information and intelligence about cyber alerts and events and helping to deal with cyber events that strike banking corporations.

² Websites, mobile applications, self service banking machines, and telephone call centers that include both human and automated digital response.

The Israeli banking system remains resilient, stable, and ready to navigate new challenges.

A manifestation of the improvement may be found in the increase of about 18 percent recorded in the index of bank shares during 2016, even as the Tel Aviv 100 index lost about 2.5 percent (Figure 1.1).



1. BUSINESS RESULTS

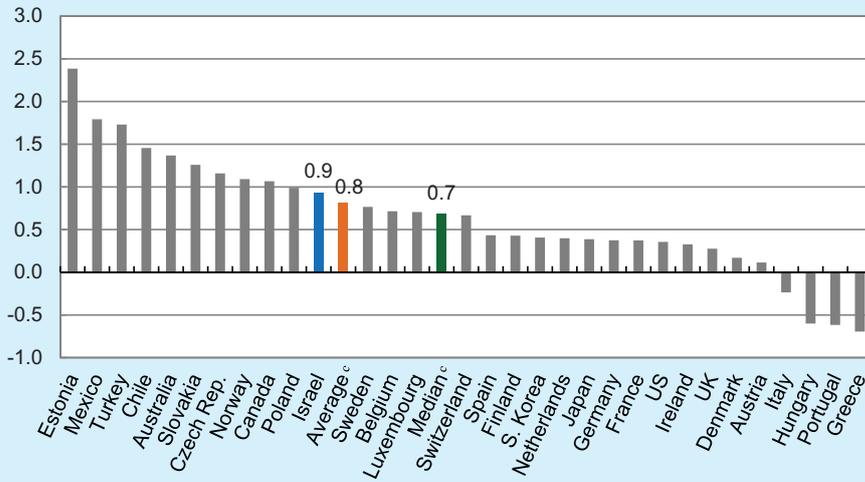
The profitability of the five large banking groups declined slightly relative to 2015 but remained similar to the OECD average.

Profitability among the five large banking groups declined slightly relative to 2015 but continued to approximate the OECD average (Figure 1.2). Return on equity was about 8.3 percent (compared with about 9.1 percent in 2015 but approximating the average in recent years—Figure 1.3)—an adequate level, particularly in view of the low domestic interest rate environment and an increase in the banks' capital ratios. Net earnings developed differently among the banking groups, declining at the two largest groups (foremost the Hapoalim group, which posted a decline of about 15 percent) and growing significantly among the three medium-sized groups (Table 1.3). Net earnings among all groups were adversely affected by the cut in the corporate tax rate, which reduced the banks' balance of deferred taxes.^{3,4}

³ The effect of the corporate tax changes on the five large groups' net earnings was about NIS 787 million in 2016. Net of this effect, the banking system's return on equity was about 9.1 percent, largely unchanged from 2015.

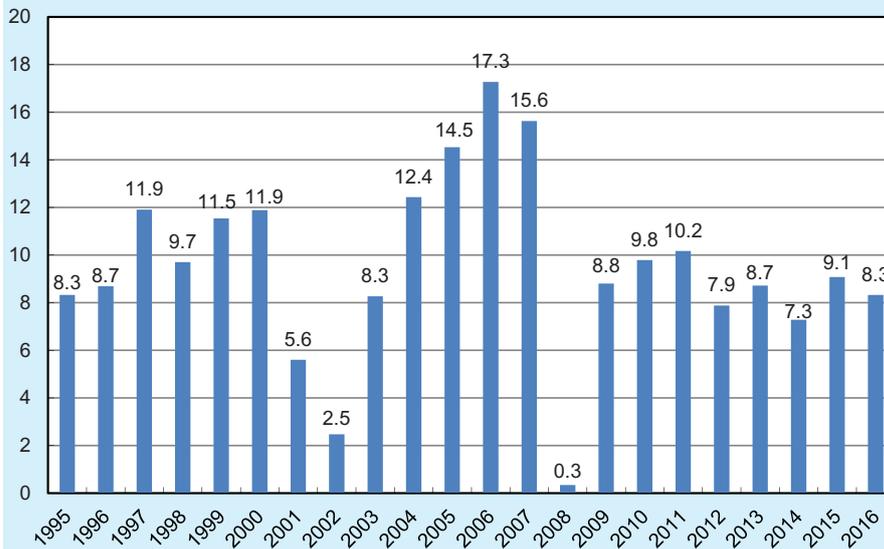
⁴ The Knesset approved two changes in corporate tax in 2016. On January 4, it passed Amendment 216 to the Income Tax Ordinance to lower the corporate tax rate by 1.5 percentage points from 2016 onward, setting it at 25 percent (among other provisions). On December 22, it passed the Economic Efficiency Law, 5777-2016, which lowered the corporate tax rate from 25 percent to 23 percent in two phases—the first, to 24 percent, took effect in January 2017, affecting tax expenditure in the last quarter of the year.

Figure 1.2
International Comparison of the Return on Assets (ROA), Before Tax, in the OECD Countries^a, 3-year average^b (percent)



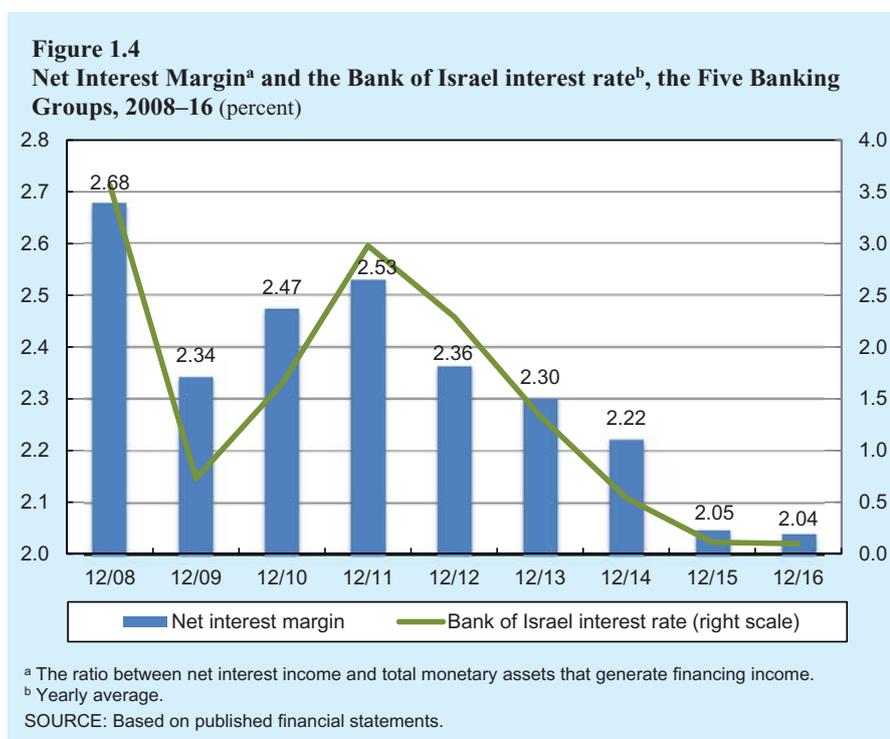
^a Iceland and Greece were excluded due to lack of data. The figure for Slovenia was omitted as an outlier.
^b The figure for Israel is the average from 2014 to 2016; The figures for the other countries are the averages for 2013 to 2015.
^c The average and median figures do not include countries where the return was negative.
 SOURCE: Foreign countries—International Monetary Fund; Israel—based on published financial statements.

Figure 1.3
Return on Equity (ROE) After Tax, of Five Banking Groups, 1995–2016 (percent)



SOURCE: Based on published financial statements.

The low interest rate environment domestically and globally continued to erode the banks' basic profit sources in 2016 and to pose a challenge to the banking system. The situation was manifested in the continuation of the low financial spread⁵ (about 2 percent) and the overall interest rate gap⁶ (about 3 percent—Figures 1.4 and 1.5).



Notwithstanding the low interest rate environment, net interest income increased (by about 6 percent) for the first time in several years due to an increase in the volume of bank credit issued to the domestic public (Table 1.4) in all activity segments other than large business, primarily households and small business. (For elaboration, see Section 4.1—The Credit Portfolio and Credit Risk.) Conversely, the comfortable macroeconomic environment and the low interest rate environment mitigated the banks' expenses. The result was reflected in low loan loss provisions and collection of business debts previously written off. Provisions on account of the consumer credit portfolio, however, increased. (For elaboration, see *ibid.*)

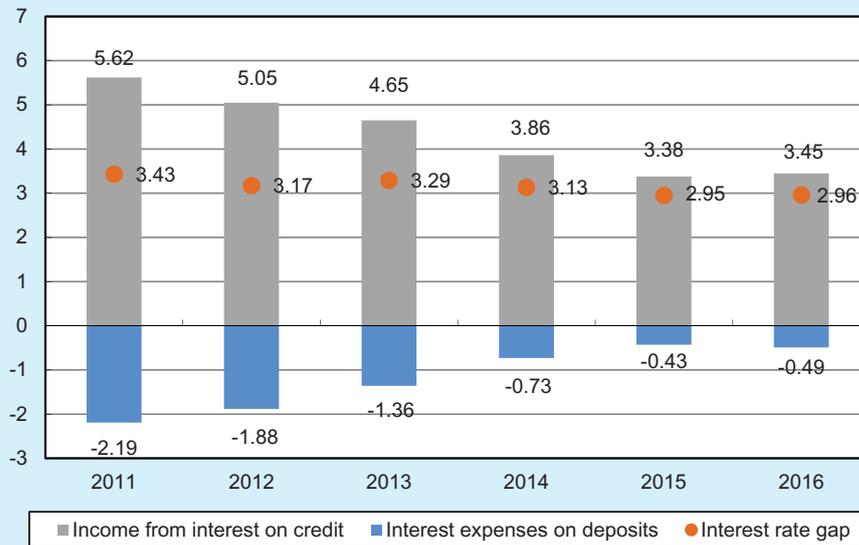
The ratio of banks' fee income to activity has been falling in recent years (Figure 1.6). This is a result, among other things, of regulatory and supervisory measures that the Banking Supervision Department has taken in regard to fees in order to enhance transparency, improve customers' ability to comparison-shop, and,

The ratio of banks' fee revenue to activity has been declining in recent years.

⁵ The ratio of net interest income to total financial assets that yield lending income.

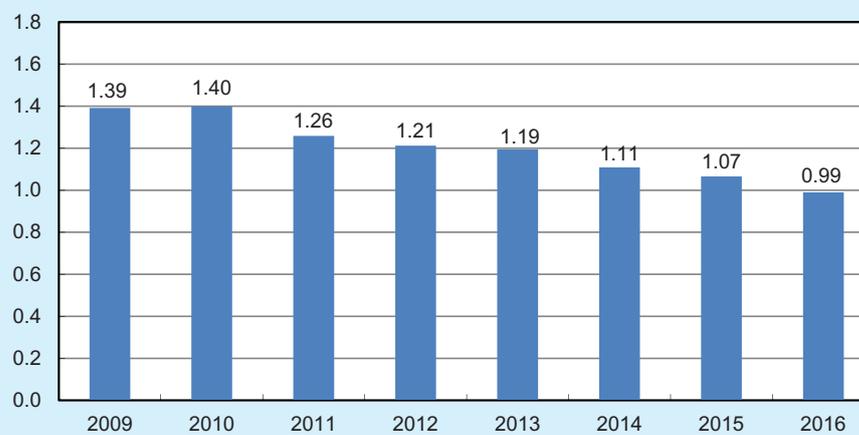
⁶ The difference between the rate of interest income on credit to the public and the rate of interest expenditure on the public's deposits.

Figure 1.5
Income from Interest on Credit to the Public, Interest Expenses on the Public's Deposits, and the Interest Rate Gap, the Five Banking Groups, 2011–2016
 (percent)



SOURCE: Based on published financial statements.

Figure 1.6
Fees Income Relative to Total Assets, the Five Banking Groups, 2009–16^a
 (percent)



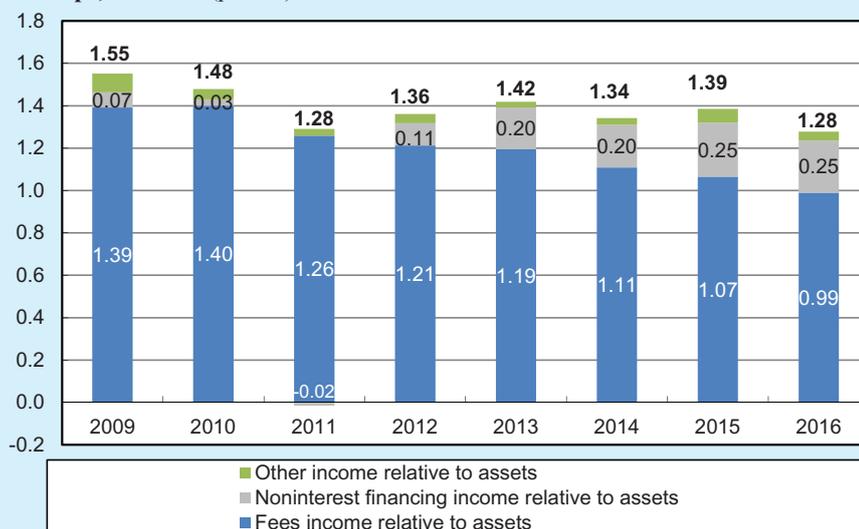
^a The sharp decline in 2014 is derived from the accounting reclassification of income from credit activity due to a Supervisor of Banks directive.

SOURCE: Based on published financial statements.

thereby, stimulate competition in the banking system.⁷ The decline has been reflected in the steady contraction of income from account management and securities activity fees, partly offset by an increase in credit card fee income—mainly due to an increase in the volume of activity. Fee income continued to trend downward in the reviewed year, particularly in income from capital market activity and also from account management fees (Table 1.6). The decline in income on account of capital market activity stems from a decline in activity, which induced decreases in fee income on account of buying, selling, and redeeming securities and managing securities deposits.

Countering the downward trend in banks' fee income, **the share of noninterest financing income has been growing significantly in recent years**, largely due to increased income from selling bonds and shares from the portfolio available for sale (Figure 1.7). In 2016, several banks earned sizable income of this kind from the sale of VisaEurope, Ltd., to Visa, Inc.⁸ Operating expenses increased due to a provision

Figure 1.7
Composition of Noninterest Income Relative to Total Assets, the Five Banking Groups, 2009–16^a (percent)



^a The sharp decline in 2014 is derived from the accounting reclassification of income from credit activity due to a Supervisor of Banks directive.

SOURCE: Based on published financial statements.

⁷ The regulatory measures include the “Banking ID Card,” the tracks service, lowering the minimum current account management fee, broadening the definition of small businesses entitled to inclusion in the retail fee schedule, disclosure of the cost of securities services for customers, and an amendment to the Banking Order concerning early repayment of housing loans.

⁸ The profit derived from the acquisition of VisaEurope, Ltd. by Visa, Inc. was about NIS 378 million for the Leumi group (pretax), about NIS 109 million for the Hapoalim group (pretax), about NIS 178 million for the Discount group (after tax), and about NIS 68 million for the First International group (after tax).

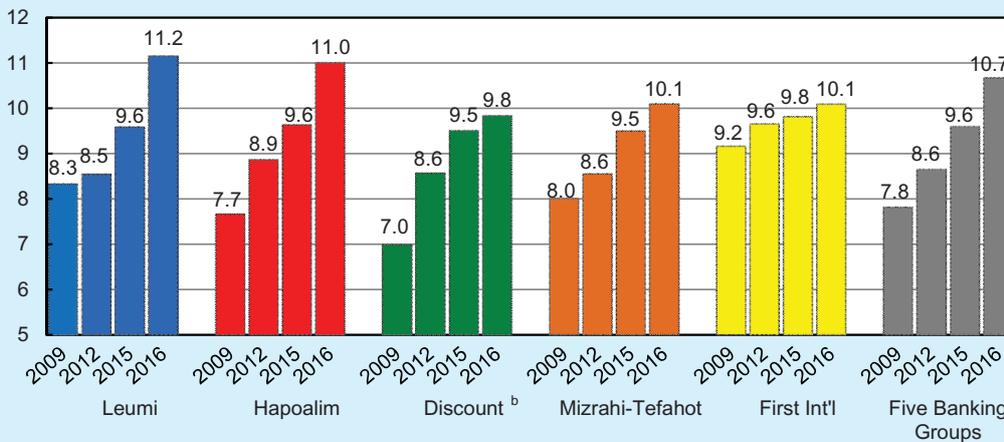
by Bank Hapoalim for an investigation by American authorities⁹, whereas wage and related expenditures remained largely unchanged relative to 2015. (See elaboration in Chapter 2, Section 2—Banking System Operating Efficiency, Branches and Personnel.

2. CAPITAL ADEQUACY AND LEVERAGE

In 2016, the banks made further progress toward their capital targets and increased their capital ratios. The five large groups posted a 10.7 percent Common Equity Tier 1 capital ratio, up 1.1 percentage points from the previous year, and all banks met their regulatory targets (9 percent for small and medium-sized banks, 10 percent for the two largest banks, and they all have capital buffers for housing loans—Figure 1.8, Table 1.7). Increasing the Common Equity Tier 1 capital ratio was accompanied by the banks’ continued support of growth in lending to micro/small businesses and households amid a slowdown in the growth rate of business credit, chiefly at the two largest banks, which had to attain higher capital targets, and as efficiency programs were implemented. The leverage ratio rose to 6.6 percent in view of the increase in capital, and all banks surpassed the threshold requirements that the Banking Supervision Department established on the basis of the Basel III principles (Table 1.8).

The banks have continued to reinforce their capital, and they all currently meet their regulatory capital targets—allowing them to pay larger dividends to shareholders.

Figure 1.8
Common Equity Tier 1 Capital Ratios^a, the Five Banking Groups,
December 2009 to December 2016 (percent)



^a Data for 2009 and 2012 are in Basel II terms (Core Tier 1 capital ratio). Data from 2015 onwards are in Basel III terms (Common Equity Tier 1 capital ratio) in accordance with the transition directives.
^b The Core Tier 1 capital ratio of the Discount Group in Basel II terms does not include the deduction in respect of the Group's investment in the First International Group.
 SOURCE: Based on published financial statements and reports to the Banking Supervision Department.

⁹ In 2016, Bank Hapoalim adjusted its provision for its exposure to American investigation by about NIS 528 million.

Common Equity Tier 1 capital increased due to the banks' accrued profits. Concurrently, the banks acted to cut back on credit risk assets. Some did so by continuing to reduce lending to large businesses, obtaining reinsurance abroad for their portfolios of homebuyers' guarantees under the Sales Law, selling mortgage portfolios, and entering into syndication transactions with institutional entities. There was a marked increase in the Common Equity Tier 1 capital ratios of the two largest banks, Leumi and Hapoalim—which, as stated, have to meet stricter regulatory capital requirements than the rest of the system. The banks began to implement multi-year efficiency programs and the Banking Supervision Department relaxed capital stringencies, to an estimated average of 0.2 percentage points, in order to remove material obstacles to this activity.

Following the attainment of the regulatory capital targets, the Banking Supervision Department revised the dividend policy and principles for distribution, which enabled most of the banks to increase the dividends they distributed to shareholders, or to declare an increase in dividends in the coming year. Most shareholders of Israeli banks are among the broad public, which holds shares directly or through pension and provident savings.

In 2016, several banks issued Contingent Convertible (CoCo) securities, which qualify as Tier 2 capital under the Basel principles, while following the transitional directives and lowering their balances of supplemental Tier 1 and Tier 2 capital instruments that no longer qualify as supervisory capital.

3. MAIN DEVELOPMENTS IN BALANCE-SHEET AND OFF-BALANCE-SHEET ACTIVITY

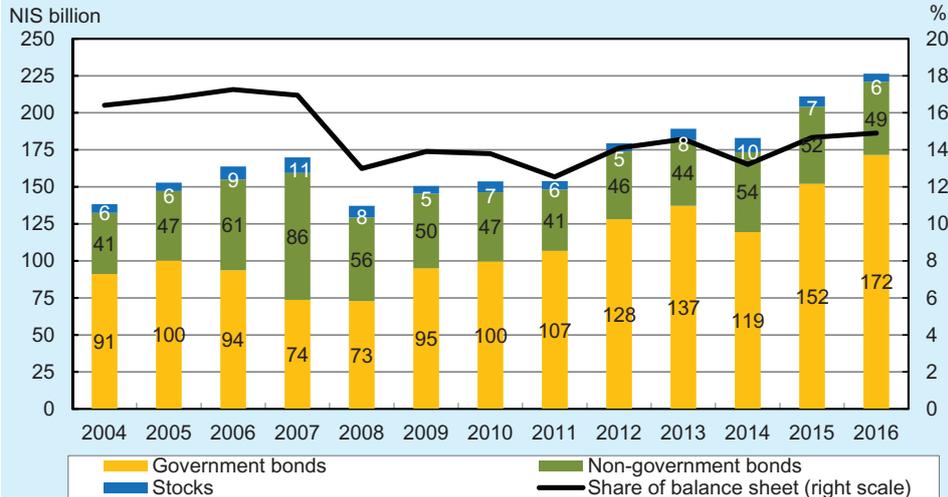
The increase in sources was translated into a mild increase in the credit portfolio and, mainly, an increase in the volume of liquid assets.

The total aggregate balance sheet of Israel's banking corporations was about NIS 1,529 billion, up about 5 percent (Table 1.9). Each bank's balance sheet evolved differently due to differences in the intensity of regulatory and economic effects on them during the year. In 2016 as in previous years, the balance-sheet increase was made possible due to upward trends in equity and deposits from the public. The latter was partly a result of migration of assets from the capital market to the banks, despite low interest rates in general and deposit interest rates in particular. The change was typified by declines in the public's holdings of *makam* and direct holdings of government bonds despite the low interest rate environment, reflecting stagnation in the domestic capital market (a slump in the Tel Aviv 25 index and mild increases in the government bond market) and a decline in the worthwhileness of *makam* (in the low interest rate environment) due to their buying and selling fees. This increase on the liabilities side was channeled to a mild increase in the credit portfolio (about 3 percent—Table 1.9) and, foremost, an increase in the volume of liquid assets, particularly cash and deposits with the Bank of Israel.

The main factors of the increase in the credit portfolio¹⁰ were an increase in private consumption, which generated demand for consumer credit on the part of individuals (against the background of low unemployment and low interest rates) and the continuation of developments in the domestic housing market that contributed to continued growth in the housing credit portfolio.¹¹

Liquid assets on the balance sheet and their share in total assets appear to have been affected by measures taken by several banks (Leumi, Hapoalim, and Mizrahi-Tefahot) to converge toward the new regulatory threshold for the liquidity coverage ratio.¹² The composition of the securities portfolio reinforces this assessment: Here too, the volume and proportion of liquid assets increased, chiefly domestic government bonds (Table 1.10, Figure 1.9) and foreign sovereign instruments that qualify as Level 1 assets for the calculation of liquidity coverage ratios. (See elaboration in Section 4.3—Liquidity Risk.)

Figure 1.9
The Total Securities Portfolio^a of the Israeli Banking System^b—Size and Composition, 2004–16



^a Excluding consolidated companies.

^b Including the five banking groups (Leumi, Hapoalim, Discount, First International, and Mizrahi-Tefahot), as well as Union Bank, Bank of Jerusalem, and Dexia Bank.

SOURCE: Based on published financial statements.

¹⁰ Apart from its growth, the credit portfolio has shown changes in composition in recent years: a larger share of consumer credit and a decline in that of business lending. See elaboration in Section 4.1—“The Credit Portfolio and Credit Risk.”

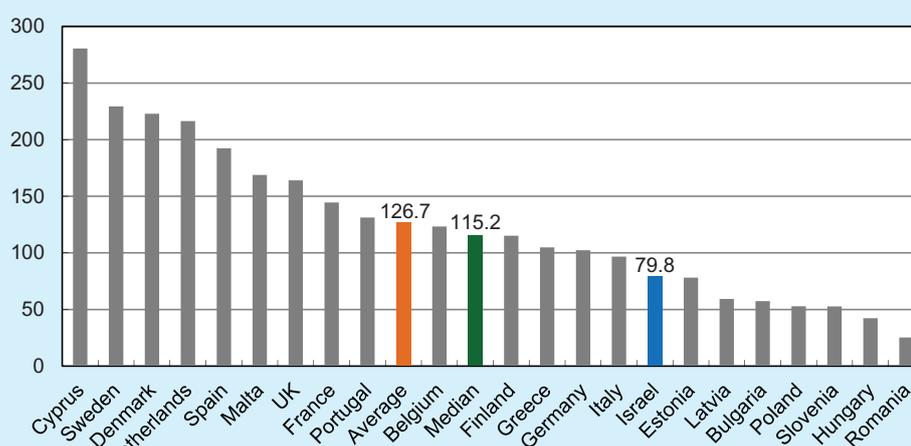
¹¹ In recent years, the Banking Supervision Department has taken a series of measures to reduce borrowers’ and banks’ exposure to adverse developments in the housing market and the construction and real estate industry, restraining the growth rate of housing credit somewhat.

¹² In January 2017, the third and final installment in raising the regulatory benchmark of the liquidity coverage ratio (Proper Conduct of Banking Business Directive no. 221) went into effect, raising the ratio from 80 percent in 2016 to 100 percent.

In off-balance-sheet activity, total guarantees and commitments to provide credit were about NIS 479 billion, down about 10 percent from 2015 despite continued increases in the portfolios of housing credit and homebuyers' guarantees (about 11 percent—Table 1.11). This is probably due to legislation to enhance competition in the banking system and the Proper Conduct of Banking Business directives concerning capital ratios that went into effect. These factors were reflected in the contraction of unused credit card facilities (by about 6 percent—Table 1.11), total unused credit facilities (by about 30 percent), and commitments to provide credit (by about 11 percent). The latter improved capital ratios by mitigating the two largest banks' off-balance-sheet exposure to credit risk.

Banking corporations' total activity in derivatives (notional values) was NIS 2,272 billion, down about 4 percent (Table 1.12), solely due to declines in the volume of interest rate contracts (of about 16 percent) and other contracts (of about 17 percent).

Figure 1.10
Total Banking System Credit^a Relative to GDP, Israel^b and EU Countries^c, 2015
(percent)



^a Total credit is calculated on a consolidated basis and includes all of the banking groups and all of the independent banks operating in the domestic economy, as well as subsidiary companies and banking branches controlled by foreign corporations and active in the domestic economy.

^b The figure for Israel is as of December 2016.

^c In Luxembourg (does not appear) the ratio is 0.495. Austria, the Czech Republic and Lithuania are excluded from the comparison due to a lack of data.

SOURCE: European countries—European Central Bank (ECB) and Eurostat; Israel—published financial statements and Central Bureau of Statistics.

Changes in the business environment, the growth of digital banking, and rapid legislative changes are presenting the Israeli banking system with new challenges.

4. RISKS

The banking system is exposed to a plethora of risks including credit risk, market risk, liquidity risk, and operational risk. Over the years, much attention has been devoted to these risks in analyzing the banks' stability and resilience. In recent years, changes in the business environment have given rise to the development and strengthening of additional risks originating in technological development, accelerated regulatory

and legislative moves in Israel and abroad, and changes in global banking and in consumers' preferences and behavior. (See elaboration in Chapter 2, "Main Changes in the Banking System.") The unique characteristics of these risks make it hard to detect them fully and, in particular, to quantify and estimate the damage they may cause. The risks posed by the new business environment present the banks with a serious challenge and necessitate adjustments in risk management and tools by both banks and policymakers.

The new and growing risks include:

- **Business model risk.** Structural changes in the competitive and technological environment, including the entry of new nonbank players, the development of innovative financial products and services, the ability to collect and share copious information easily, and technological developments that change customer behavior, coupled with intensive public and political involvement, are burdening the banks and forcing them adjust their business model to current realities. An additional factor is the low interest rate environment, which challenges banks around the world, including Israel, to maintain adequate profitability.
- **Regulatory risk.** In recent years there have been multiple legislative initiatives in the fields of banking and finance. The profusion of measures in a short period of time, along with their complexity, create hardships for the system in deploying to assimilate them, place banks and customers at risk by changing the business environment, and may even impair the banks' ability to attain the new targets that the legislation and regulations set forth. The resulting regulatory uncertainty has implications for the entry of new players in the market, product development, and the creation of new banking interfaces, among other things.
- **Technology risk.** Technological progress and the growth of digital banking in Israel, like elsewhere around the world, offer opportunities but also present structural risks—including leakage of customer and bank information due to cyber attacks; embezzlement and fraud; business continuity risks; and outsourcing risks (those flowing from reliance on third party technologies and infrastructure).
- **Conduct risk.** Banking systems around the world are at risk from conduct toward customers that is unethical, yet does not violate the law. This escalating risk presents banks with a major challenge in maintaining business conduct that meets stringent standards of fairness, integrity, and transparency.
- **Cross-border activity risk.** The escalation of supervisory enforcement operations in various countries against financial institutions concerning customer noncompliance, customer tax evasion, money laundering, and financial crime are forcing banks to be proactive, for example by assimilating innovative tools to detect activities and customers that may expose them to investigations and fines in areas of compliance and demanding more support documentation.

The Banking Supervision Department is promoting optimum management that will minimize these risks and develop the banks' ability to cope with risks that come to pass. Its steps in this direction include regulation and enforcement, removal of barriers, subscription to accepted international standards, and adjustment of supervisory capabilities. Among its actions in response to the new and growing risks, the Department has instructed banking corporations to draft multi-year efficiency plans so that they will adjust their business models to the new banking world; placed emphasis on regulation and advancement in technological matters; established a "banking cyber center," in conjunction with the top experts in this field in Israel; taking a stringent approach toward the management of risks originating in cross-border activity; focusing on implementing a policy that aims to enhance competition, fairness, and transparency vis-à-vis customers; and adjusting the Department's structure and capabilities by establishing a new division in the area of technology and innovation. (For elaboration, see Chapter 3—"Activities of the Banking Supervision Department.")

4.1 *The Credit Portfolio and Credit Risk*

Developments in the activity segments¹³

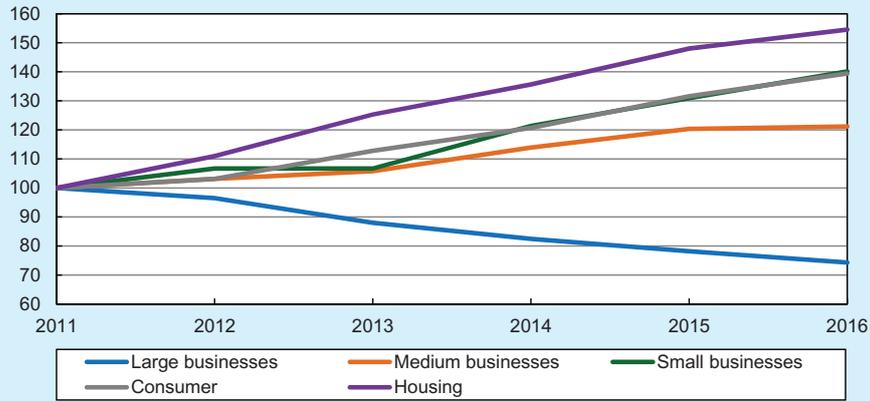
Lending to households and micro and small businesses is continuing to grow, while credit to large businesses is contracting.

The banks' balance-sheet credit portfolio increased by 3 percent, to NIS 935 billion at the end of the year, with continued redirection of credit from large businesses to households, and micro and small businesses (Table 1.13, Figures 1.11 and 1.13). The increase occurred at the medium-sized banks, while lending by large banks, which have to meet higher regulatory capital requirements, did not increase (Figure 1.12).

In recent years, the banks have increased credit to household and small and micro business customers and reduced credit to large business borrowers. This is a consequence of several factors, including (1) the banks' efforts to attain regulatory capital targets by lowering the share of credit to large business borrowers, which has a 100 percent weight in the capital requirements, and increasing the share of retail and small business credit, which carry lower risk weights; (2) restrictions and guidelines by the Banking Supervision Department to mitigate borrower concentration in the bank credit portfolio; and (3) the availability of nonbank sources of credit for large businesses, particularly institutional entities and the capital market. As a result of these and other processes, the share of household credit has grown in recent years to about half of the banks' credit portfolio (Figure 1.14) and credit to micro and small businesses has reached 43 percent of the business credit portfolio (Figure 1.15).

¹³ The analysis in this section parses developments by the following activity segments: households including consumer and housing credit; micro business (businesses with less than NIS 10 million in annual turnover), small business (NIS 10 million–NIS 50 million), medium businesses (NIS 50 million–NIS 250 million), and large business (more than NIS 250 million).

Figure 1.11
Estimated Development of Credit^{a,b} in the Various Activity Segments, the Five Banking Groups, 2011–16 (Index: December 31, 2011=100)

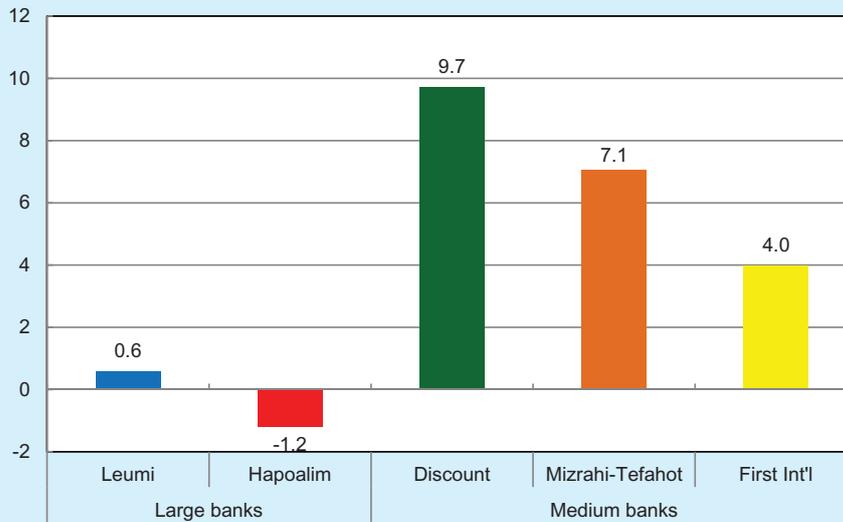


^a The development of credit between 2011 and 2015 is calculated on the basis of activity segment definitions by each of the banking groups. The rate of change in 2016 is calculated on the basis of the regulatory activity segment definition.

^b In the first quarter of 2013, the Discount Group reclassified credit to the various activity segments, and in the fourth quarter of 2014, the First International Group reclassified credit to the activity segments. During 2016, the Leumi Group reclassified customers to the regulatory activity segments. As such, the data were standardized.

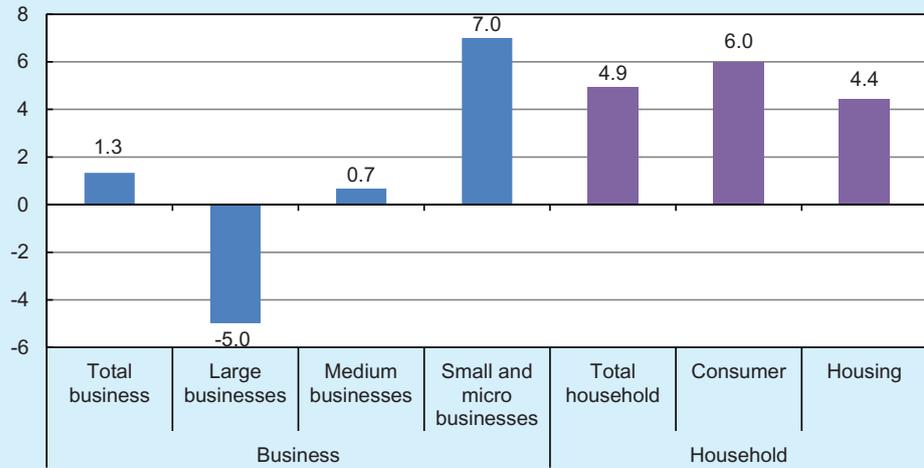
SOURCE: Based on published financial statements and reports to the Banking Supervision Department.

Figure 1.12
Change in Credit to the Public in 2016, the Five Banking Groups (percent)



SOURCE: Based on published financial statements

Figure 1.13
Change in Outstanding Credit in the Various Activity Segments^{a,b}, the Five Banking Groups, December 2016 compared with December 2015 (percent)

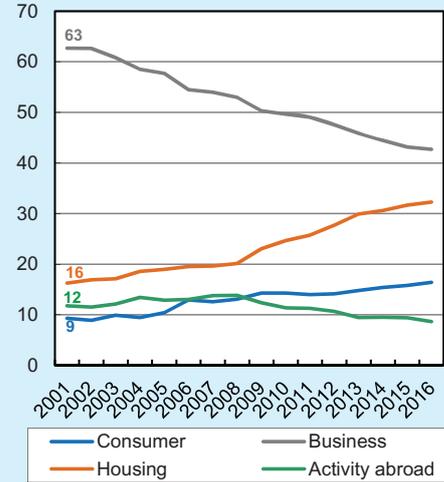


^a During 2016, the Leumi Group reclassified customers to the activity segments. As a result, customers from the small business segment, with a credit balance totaling NIS 13 billion, were sorted into the large business and medium business segments—NIS 12 billion to the large business segment, and NIS 1 billion to the medium business segment. The rate of increase in credit by activity segment was estimated taking these changes into account. As such, the rates of change in the business segments in this figure are not consistent with the balance of outstanding credit in Table 1.14.

^b The classification of the regulatory activity segments is different from the sector classification.

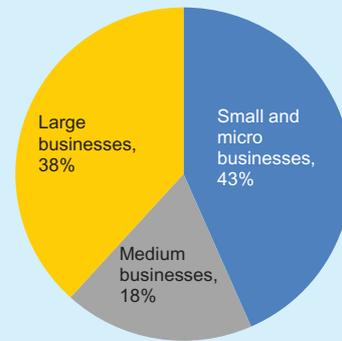
SOURCE: Based on published financial statements.

Figure 1.14
Distribution of Balance-Sheet Credit by Sector, the Five Banking Groups, 2001–16 (percent)



SOURCE: Published financial statements and reports to the Banking Supervision Department.

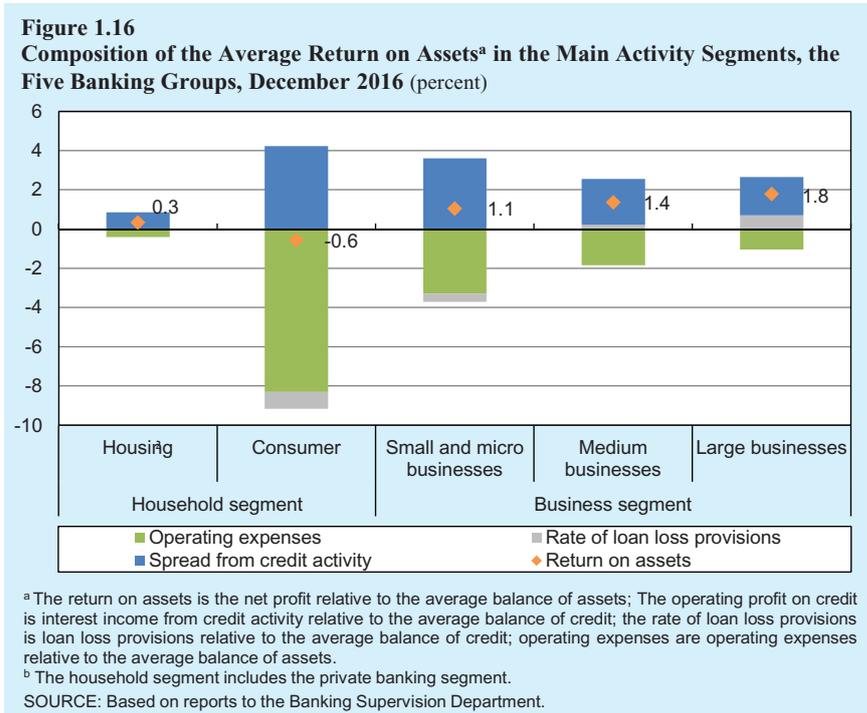
Figure 1.15
Distribution of Business Credit by Activity Segment, the Five Banking Groups, December 2016



^a The micro business segment—businesses with a turnover of less than NIS 10 million; the small business segment—businesses with a turnover of between NIS 10 million and NIS 50 million; the medium business segment—businesses with a turnover of between NIS 50 million and NIS 250 million; the large business segment—businesses with a turnover of more than NIS 250 million.

SOURCE: Based on reports to the Banking Supervision Department.

The lending margin relative to the average balance of credit is higher in the household and small business segments, but the banks' return relative to assets in recent years has been higher in the business segments than in the household segment (Figure 1.16). From the banks' point of view, these differences may be attributed both to the macroeconomic environment and to differences in the characteristics of activity in the respective segments, including high operating costs in the household segment and the extent of competitiveness. The effect of **the macroeconomic environment** is reflected in the fact that performance in the business segments has thus far been highly exposed to macroeconomic developments and to the domestic business cycles. Thus, in times of economic expansion, these segments generate strong returns and low credit losses relative to the consumer segment, which is less sensitive to macroeconomic developments.

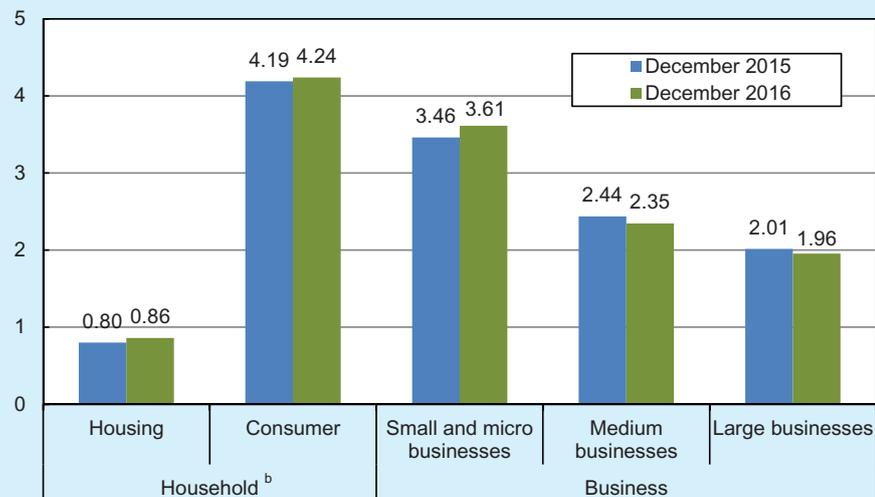


Operating costs have a major effect on the differences in returns among segments. They are much higher in the consumer and micro- and small-business segments than in the medium- and large-business segments due to the need for an extensive network of branches, including sizable physical and human infrastructure. Activity vis-à-vis medium and large businesses, in contrast, is concentrated in a small number of central locations where more business is done at less cost. This illustrates the importance of the efficiency process that the banking system is currently conducting—one that includes, among other things, broader use of digital banking.

The extent of competition also affects returns in the various activity segments. Here too, it is conventional to distinguish among the business segments—particularly between large businesses and the rest. Large businesses’ ample access to alternative nonbanking sources of credit—such as domestic and foreign capital markets, institutional credit, and borrowing from foreign banks—has been stimulating competition in this segment. The housing loan segment is also typified by brisk competition due to the characteristics of the product and consumers’ behavior. Competition in the consumer and micro- and small-business segments is expected to increase in the next few years as policy measures and reforms intended to eliminate entry barriers to banking and allow new players to enter the credit market are now being advanced.

The aforementioned differences in the characteristics of segmental activity also explain discrepancies in the lending margin. In 2016, for example, the margin in consumer lending was about 4.2 percent whereas in the business segment it was about 2.7 percent. Even within the business segment there is high variance in the margin, with the margin correlating with the extent of a company’s activity: the more activity, the narrower the margin (Figure 1.17, Table 1.14)—a consequence of variance in operating costs, risk, and extent of competition.

Figure 1.17
The Spread from Credit Activity Relative to the Average Balance of Credit in the Various Activity Segments^a, the Five Banking Groups, December 2016 compared with December 2015 (percent)



^a The figures relate to activity in Israel and do not include the financial management segment, others, and adjustments.

^b The household segment includes the private banking segment.

SOURCE: Based on published financial statements.

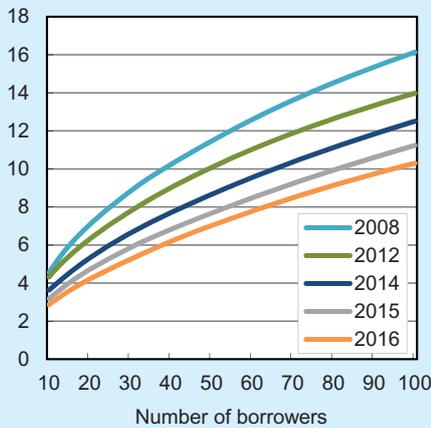
Credit risk

The indicators of banking credit portfolio quality continued to improve, resulting in higher quality than among banks in most developed countries, and portfolio concentration by borrower size continued to decline (Figure 1.18). However, the implicit risk in the consumer credit portfolio increased. The banks' exposure to this credit, as well as to housing credit and credit to the construction and real estate industry, and the correlations between these types of lending, remain the principal risk in the banking system's credit portfolio.

In recent years, the banks have considerably reduced their exposure to large and leveraged borrower groups and implemented more conservative risk management processes. This is due, among other things, to lessons that the Banking Supervision Department and the banking system learned from several large credit loss events due to the failure of large borrower groups. The Department used a variety of tools in the learning process, including setting limits, issuing regulatory directives, conducting multiple examinations of exposure to specific large borrowers, and implementing decisions made by various economic committees.¹⁴

The improvement in credit portfolio quality indicators is due to an improvement in the quality of the business portfolio brought on by the low interest rate environment, economic growth, and the decline in unemployment to a near full employment environment—which makes borrowers' debts easier to pay back. Similar to previous years, the share of credit losses in the banking portfolio was virtually zero in 2016, thanks to smaller provisions and collection of debts previously written off. The share of problematic debt in the banking portfolio continued to decline and the coverage ratio¹⁵ continued to rise, attesting to an improvement in the banking system's ability to absorb expected losses (Table 1.16). In contrast, and despite the aforementioned

Figure 1.18
Credit Risk of the 100 Largest Borrowers^a As A Share of Total Credit Risk, the Five Banking Groups, 2008, 2012, 2014, 2015 and 2016 (percent)



^a The large borrowers do not include banking corporations.

SOURCE: Based on published financial statements and reports to the Banking Supervision Department.

Indicators of banking credit portfolio quality continued to improve and credit concentration by borrower size continued to fall.

The risk in consumer credit increased. Exposure to housing credit and to credit to the construction and real estate industry remains the main risk in the banking system's credit portfolio in view of the volume of such credit.

¹⁴ For elaboration, see the Banking Supervision Department press release of February 19, 2017 concerning credit to large borrowers—lessons from credit failures, Banking Supervision Department actions, and the state of affairs today.

¹⁵ The ratio of loan loss allowances to the sum of impaired credit and nonimpaired credit that is ninety days or more past due.

state of the economy, the implicit risk in the consumer credit portfolio increased, as reflected, for example, in rising rates of write-offs and an increase in credit loss provisions, the latter coming to 0.8 percent of the consumer credit portfolio. (For elaboration, see Box 1.1—“Retail Consumer Credit.”)

Credit to the construction and real estate industry

Lending to the construction and real estate industry accounted for NIS 116 billion, 29 percent of the business credit portfolio. Credit to the construction industry¹⁶—roughly half of credit for construction and real estate—expanded during the year by 3 percent in view of growth in the industry’s output. In contrast, credit to the real estate industry¹⁷ contracted by 2 percent against the background of the industry’s growing reliance in recent years on nonbanking sources of finance, including bonds and shares.

In September 2016, the Banking Supervision Department changed the way it measures the limit of indebtedness to the construction and real estate industry (Proper Conduct of Banking Business Directive no. 315) in acknowledgement of risky sales made by banks. Thus, credit risk originating in Sales Law guarantees for which the banks took out coverage from foreign insurers is classified mainly under the financial services industry rather than the construction and real estate industry. The decision was made after the banks purchased reinsurance abroad in order to protect themselves from the credit risks derived from Sales Law guarantees, and because these policies qualify in the calculation of capital adequacy under the Basel III rules. This change in the method of measuring the indebtedness limit in the construction and real estate industry allows the banks to increase the supply of credit to this industry.

There has been a marked improvement in the quality of the banks’ construction and real estate credit portfolio in recent years: The share of problematic loans has declined considerably and the loss rates in this portfolio have been near-zero if not negative (Table 1.15). However, in view of the banks’ acute exposure to this industry and the continued increase in home prices in recent years, lending to this industry carries major risks.

Housing credit

The housing loan market is showing signs of slowing but the housing loan portfolio remains a focal point of risk to borrowers and to the banking system due to its size.

The housing loan market has recently been showing signs of slowing, as reflected in a moderation of the growth rate of housing credit, a decline in new mortgages, and an increase in the interest charged on them (Figure 1 in Box 1.1; Figure 1.19;

¹⁶ Largely for construction work (development work on construction sites; construction of whole buildings or parts thereof; related work (carpentry, metalwork, installation of waterworks, electricity, air conditioning, and other systems; final touches; building renovations and repairs; and construction, assembly, and installation of prefabricated structures) and civil engineering works (earthworks, paving, and infrastructure; other engineering works; leasing of construction equipment or demolition in conjunction with an operator).

¹⁷ Mainly trade and brokerage in immobiliers; leasing, management, and maintenance, collection of rent, and related activities.

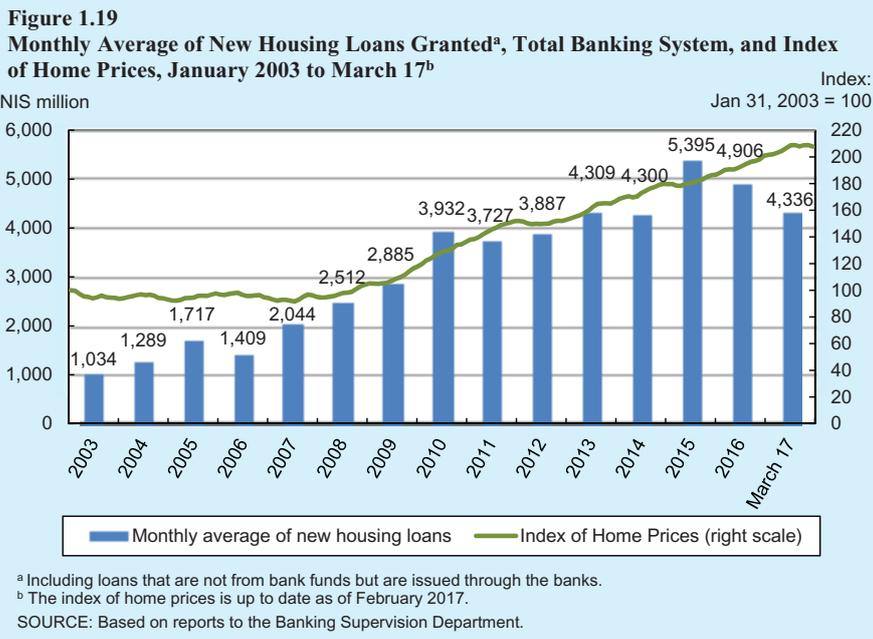


Figure 1.20). Several of the risk characteristics of housing loans improved due to measures taken by the Banking Supervision Department in recent years, which were reflected in a slight decline in the housing credit loss rate in a stress test conducted during the year. (For elaboration, see Box 1.2—Stress Test.) However, the housing loan portfolio remains a focal point of risk in view of the large share of housing credit in the banks’ credit portfolio (32 percent), the increase in the size of the average housing loan, the lengthening term to repayment, and the continued increase in home prices (4.7 percent in the past twelve months).

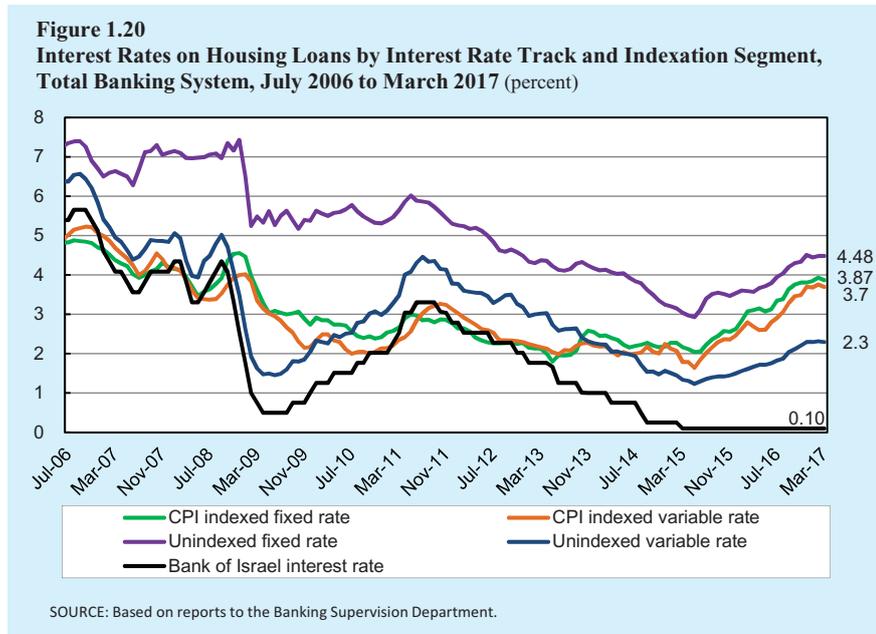
Developments in the housing market in recent years expose borrowers and the banking system to the possibility of harm as a result of changes that may take place in the economic environment. Shocks such as a major blow to borrowers’ income due to an upturn in unemployment, a sharp increase in interest rates, and a significant and rapid decline in home prices may make it harder for borrowers to pay back their mortgages and may harm the banks as well. In recent years, the Banking Supervision Department has taken a series of measures to mitigate these risks and price them more appropriately. The interest rate on mortgages is affected by the cost to the banks of raising sources, the extent of competition in the housing loan market, and borrower and loan risk. The banks’ internalization of the implicit risks in housing credit, with guidance by the Banking Supervision Department, was one of the main factors in the increase in interest rates that has occurred in the past two years—a development that

Housing loan interest rates have risen, mainly because the banks have internalized the risks inherent in housing credit.

has a dampening effect on the increases in mortgage demand and in home prices¹⁸ (Figure 1.20).

To support the ability of persons eligible for Buyer's Price projects to take part in the program, the Supervisor of Banks ruled that the size of housing loans for participants would be determined on the basis of the market value of the dwelling (as established by an adjuster) and not by the actual purchase price—provided the buyer's down payment is NIS 100,000 or more and the dwelling's value does not exceed NIS 1.8 million.

Banks and institutional entities recently signed NIS 6 billion worth of agreements to regulate the banks' sales of housing loans to these institutions and to establish syndicate lending relations for housing purposes. These transactions allow the banks to free up capital for additional domestic lending, make it possible to admit new players to the credit supplier market, give institutional players strong returns relative to risk, and help them diversify savers' investment portfolios. Given the novelty of this activity and the ongoing lessons derived from the global financial crisis, a draft directive regulating these relations has been sent to the banks.



¹⁸ For elaboration, see the semiannual overview of the banking system for 2016.

Box 1.1: Retail Consumer Credit¹

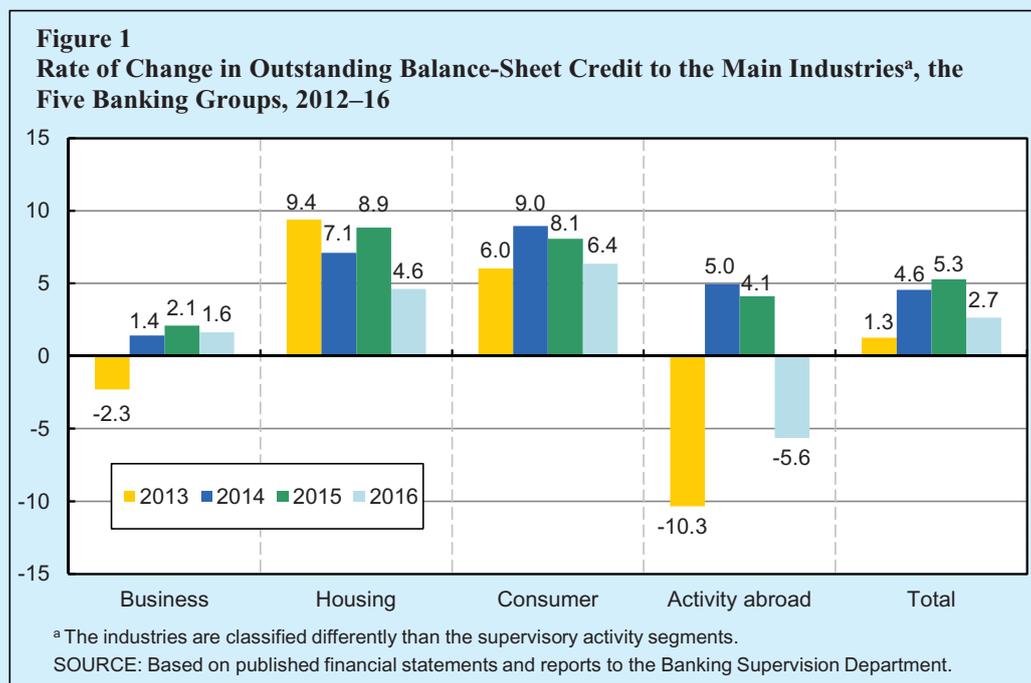
- Although banks are the main source of household credit, the number of nonbank players and the volume of credit they provide to the public have been growing in recent years.
- Consumer lending by banks, including that for which credit-card companies are responsible, has grown by 25 percent in cumulative terms in the past three years—outpacing the increase of business credit and housing credit—and by 45 percent in the past six years. Consumer credit now adds up to NIS 153 billion, 16 percent of the banks' credit portfolio.
- The risk inherent in the consumer credit portfolio has been growing due to the rapid increase in this credit and longer terms to repayment in recent years. The upturn in risk is reflected in growth of credit losses, which are also affected by legislative and regulatory changes in the consumer field. Consumer credit, however, is scattered over numerous borrowers and accounts for a small share of the banks' credit portfolio. Israel's ratio of household debt to GDP has not gone up significantly in recent years and is low by international comparison.
- Various banking and finance reforms, foremost the Enhancement of Competition Law and the Supervision of Financial Services Law, are expected to increase the sources for and supply of consumer credit. They may also, however, lead households to become overleveraged. Therefore, it is important to apply adequate supervision and uniform standards to nonbank providers of consumer credit, particularly where fairness and transparency are concerned.
- Additional legislation and reforms in recent years concern debt collection and bankruptcy proceedings. They are meant to alleviate the burden on borrowers who encounter repayment difficulties and allow them to rehabilitate themselves. The legislative changes have reduced the banks' ability to collect debts from customers who have run into difficulty, which may lead to an impairment of borrowers' payment ethics and aggravating the banks' risk. In response, the banks may toughen their underwriting rules and raise interest rates. It is therefore important for the legislation to strike a balance between the desire to rehabilitate debtors and the enforcement of repayment obligations.
- The Banking Supervision Department is promoting measures intended to increase customers' bargaining power, enhance transparency, and strengthen competition in the retail credit market. It is important for consumers to understand their overall financial situation vis-à-vis their banks and any other potential creditor, make sure that they do not over-borrow, familiarize themselves with the financial products that they intend to consume, and comparison-shop among credit providers.

a. Growth of consumer credit in recent years

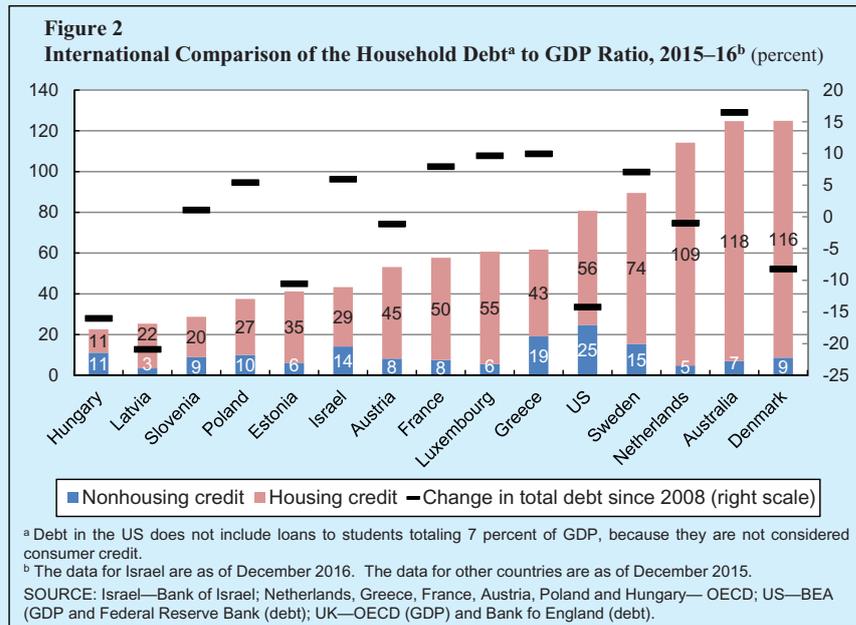
The banking system is the main source of household credit, the extent of which has increased sharply in recent years. At the same time, the number of nonbank players has been growing and the volume of their lending to the public has been rising rapidly. The increase in consumer credit is affected by the

¹ This analysis of bank credit includes lending for which credit-card companies are responsible and relates to the five banking groups.

expansion of private consumption, changes in the public's tastes, the low interest rate environment, and the low unemployment rate. On the supply side, several developments are having an effect: regulatory capital requirements that, under the Basel III principles, give banks an advantage in offering retail credit, mitigation of borrower concentration in the business portfolio, and the existence of nonbank credit alternatives for the large business segment. These factors have caused the banks to intensify their activity in the household sector and reduce their lending to large-business borrowers. Household credit is typified by wide dispersion and relatively weak correlations among borrowers; accordingly, the banks' exposure to risk in this segment is relatively low. In the past three years, consumer credit has been growing at an average rate of 8 percent per year, to NIS 153 billion at the end of 2016, accounting for 16 percent of the banks' credit portfolio (Figure 1). Despite the sharp increase in consumer lending, the ratio of household debt to GDP has gone up only mildly in recent years and is lower than in other advanced economies. The ratio of nonhousing household debt to GDP, however, is not low in comparison with other countries (Figure 2).² Changes in the public's tastes, particularly the desire of households to improve their standard of living, are reflected (as shown in examinations by the Banking Supervision Department) in the growing share of consumer loans for current consumption and for refinancing old loans and, in recent years, in more borrowing for the purchase of motor vehicles. Secured lending by banks and credit card companies for the latter purpose totaled about NIS 12 billion as of December 2016. Although this is only 8 percent of consumer credit, the full extent of auto loans is presumably greater because the banking system can also provide such loans without liens. Car loans typically charge lower interest than other consumer credit largely because, unlike most other consumer credit, it is backed by collateral. Households do not rely solely on the banking system to finance their car purchases. In recent years a nonbank credit market for this purpose has developed in



² For elaboration, see the Bank of Israel Financial Stability Report, June 2016.



Israel. This credit is usually typified by underwriting proceedings based on collateral quality and is given at higher interest rates than those applying to bank credit, in which underwriting is based on customer risk and prior familiarity with the customer.

The Banking Supervision Department has been keeping an eye on the growth of the consumer credit portfolio. Thus, in 2015 it sent the banks’ managements a circular about their marketing of retail loans (for nonhousing purposes), instructing them to have policies, procedures, and processes in place concerning initiated outreach to retail customers, and to make sure that such outreach for the purpose of providing loans is regularized and detailed. The Department also instructed the banks’ managements and boards of directors to conduct a special test of the suitability of their credit and other retail products for customers’ needs and to assimilate an organizational culture of responsible lending based both on customers’ wellbeing and needs and on their repayment ability. As an adjunct to this, the Department instructed the managements and boards of directors to fine-tune the definition of their banks’ risk appetite in respect of retail credit.

b. Increase in retail credit portfolio risk

In the past two years, the Banking Supervision Department has taken a variety of steps to examine and limit risk in the consumer credit portfolio. In January 2015, it issued a directive meant to ensure adequate conservatism in credit risk allowances.³ In 2015–2016, it examined the banks in order to review their processes of underwriting consumer credit and their follow-up and control of the development of risk in this portfolio. The examinations were based, among other things, on random and representative

³ The directive sets the minimum rate of qualitative adjustments included within the group credit loss allowance for non-problematic consumer credit at 0.75 percent.

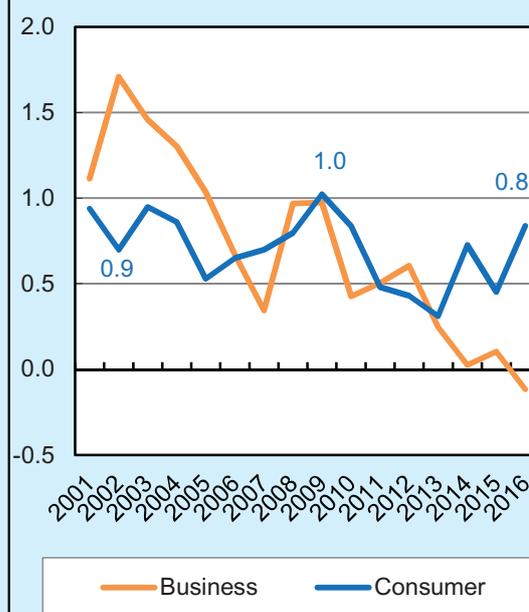
sample checks, analysis of data received from the banks at the Department's demand, and analysis of the banks' regular reports. The need for these examinations became clear after studies abroad found a positive relation between rapid growth of credit and an increase in credit risk: At times of credit growth, underwriting standards are relaxed and loans executed at these times are typified by higher failure rates.

The Department's examinations showed that consumer credit portfolio risk has indeed increased, as shown by the extension of the term to repayment and an increase in debt size. For example, some 60 percent of new loans in 2015 were issued for terms of five years or more and new loans taken out for terms of six and seven years trended upward. Until recently, the term to repayment of consumer credit rarely exceeded five years. The examinations also found that the increase in portfolio risk is also reflected in the large share of new loans for current consumption and refinancing of old loans. In comparison with the business segment, the consumer credit portfolio is typified by a high share of loans that are unsecured and with lengthy terms to repayment. In recent years, more and more customers are finding it difficult to repay their debts, as manifest in an increase in the share of write-offs and the level of loan loss provisions on account of the consumer portfolio (Figures 3–4). The increase in consumer credit risk may result in an upturn in interest rates from the 5.7 percent average on loans given in 2016.

In recent years, the banks have been making more use of “soft” collection proceedings vis-à-vis consumer customers in order to offer borrowers in financial difficulties easier repayment terms. Due to these measures, there has been a marked increase in the rate of settlements for consumer debtors to the point that it even exceeds that the rate in the business segment.⁴ In early 2017, the Banking Supervision Department made debt collection even easier and improved disclosure and fairness vis-à-vis customers by issuing a directive on debt-collection procedures (Proper Conduct of Banking Business Directive no. 450). The point of departure is that debts must be repaid and that a bank is entitled to initiate legal proceedings for this purpose but should exhaust various remedies before doing so.

In the past few years, legislation and reforms relating to debt collection and bankruptcy proceedings have made it easier for borrowers experiencing difficulties to pay back their debts and rehabilitate themselves. Additional legislative measures in this respect are currently being promoted, including the Legislative

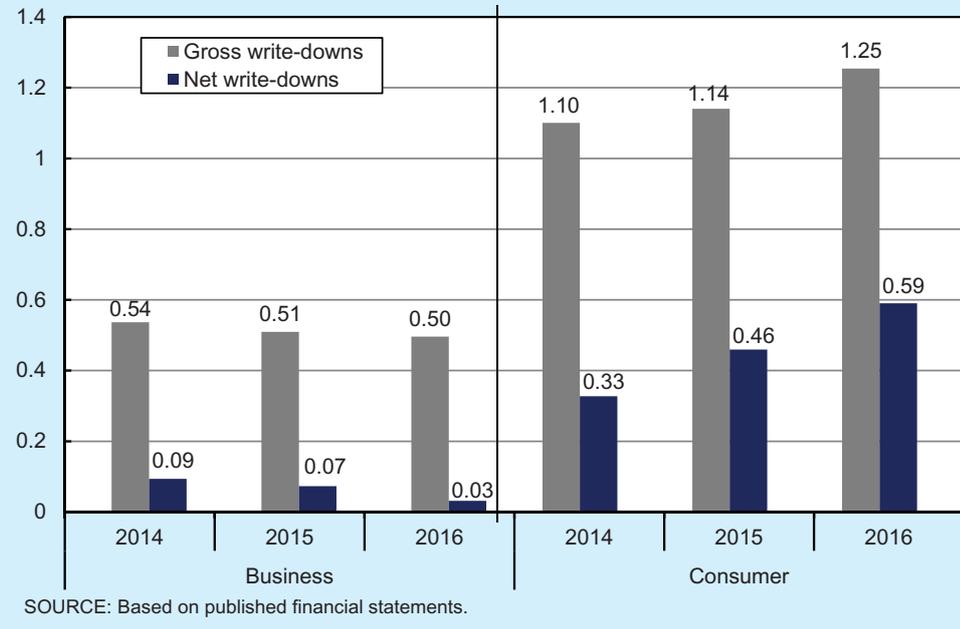
Figure 3
Loan Loss Provisions as a Share of Balance-Sheet Credit to the Sector, the Five Banking Groups, 2001–16 (percent)



SOURCE: Based on published financial statements.

⁴ For elaboration, see the Banking Supervision Department press release of February 19, 2017, on credit to large borrowers—lessons from credit failures, Banking Supervision Department actions, and the current state of affairs.

Figure 4
Gross Write-downs and Net Write-Downs as a Share of Total Credit in the Consumer Segment (Excluding Housing) and in the Business Segment, the Five Banking Groups, 2014–16 (percent)



Memorandum on Insolvency and Economic Rehabilitation, 5775–2015, and the proposed Execution and Collections (Amendment—Cancellation of Late Payment Interest for Paying Debtor) Law, 5775–2015. (For elaboration, see Box 2.1—“Legislative Initiatives in the Banking Activity Environment and the Importance of Establishing Regulatory Certainty”. The legislative changes have reduced the banks’ ability to collect from debtors who encounter repayment difficulty. Banks face increased risk in this regard because the measures may motivate customers to opt for bankruptcy proceedings in order to avoid repaying their debts—forcing banks to toughen their underwriting rules and raise lending rates. It is therefore important for the legislation to strike a balance between the desire to rehabilitate debtors and facilitate repayment, and the need to enforce their duty to repay the debt.

c. Development of the credit suppliers market

Various legislative changes and reforms that aim to increase competition in the provision of banking services have been advanced in recent years. These processes, along with developments in FinTech, are expected to broaden the market of nonbank credit providers, enhance access to credit, and increase the supply of domestic consumer credit. They may also, however, cause borrowers to over-leverage themselves. There is little information currently available about nonbank credit to households; it is important to gather it systematically and monitor the development of this credit, its price, its inherent risks to the economy and to borrowers, and lenders’ conduct toward borrowers. It is therefore important to impose adequate supervision

and uniform standards on this market, particularly where fairness and transparency are concerned, and to do so promptly.

The enactment of the Increased Competition in the Banking System Law requires Bank Hapoalim and Bank Leumi to divest themselves of their holdings in credit card companies (Isracard Group and Leumicard) within the next few years. This measure, which includes placing the divested entities' activity under the supervision of the Banking Supervision Department, is expected to expand the supply of credit to the economy, particularly in the retail segment. The cost of credit to the customer, in turn, is affected by a wide range of factors including the cost of raising the sources, borrower and loan risk characteristics, related operating costs, and the extent of competition in the credit market. Thus, it is hard to estimate how the measure will affect the interest that credit card companies will charge their customers.

d. Measures by the Banking Supervision Department to bolster customers' standing vis-à-vis banks

In recent years, the Banking Supervision Department has been advancing consumer-related measures to narrow the information gap between retail borrowers and banks, bolster consumers' bargaining power, and enhance competition in the retail credit market. These steps are accompanied by the encouragement of wider use of digital banking, which facilitates comparison shopping and better access to financial services, promotes competition in the retail credit market, and lowers costs to the customer.

The measures taken include the following: unveiling a “banking ID card”— a report to the customer that allows him or her to understand his or her financial situation with the bank and compare the terms of his or her account management with other banks' offers; requiring banks to advise customers of the differentials between deposit interest and overdraft interest; prohibiting banks from approaching indebted customers with an offer to place money in a deposit; and issuing a Reporting to the Public Directive that instructs banks to expand the disclosure that they provide in their annual and quarterly statements in regard to (nonhousing) loans to private individuals, so that users of these reports may better understand the banks' exposure to this activity. As part of the implementation of the Credit Providers Law, 5776–2016, the Bank of Israel is coordinating the establishment of a central database for sharing credit data. Its purpose is to stimulate competition in the retail credit market, make such credit more accessible, reduce discrimination in lending, and create an anonymous information base that the Bank may use to examine developments in the credit market.

These measures notwithstanding, it is important for consumers to understand their overall financial situation—vis-à-vis banks and vis-à-vis nonbank entities from which they have borrowed, understand the financial products that they intend to consume, comparison shop among credit providers, and borrow in accordance with their ability. To strengthen the retail segment and assure informed financial consumerism, financial education is needed. Such education would enable households to use the tools that they are offered—particularly in view of the measures being advanced that will expand the number of financial entities that offer credit and financial products to the public, and in view of the increasing technological ease of using financial services.

4.2 Exposure to foreign countries and financial institutions

There was an increase in global political uncertainty in 2016, along with continued worsening of conditions in the European banking system, due to poor bank profitability in view of the low interest rate environment and a standstill in credit growth, high proportions of problematic debt in several banking systems, and steep fines imposed on banks by American authorities for compliance violations.

The balance-sheet exposure of the Israeli banking system to foreign financial institutions remained small, at NIS 49 billion in December 2016, 3 percent of total assets (Table 1.18). As in previous years, most of this exposure centered on foreign financial institutions that had credit ratings of A- or higher (92 percent—Table 1.18). About half of the banks' exposure to foreign countries is derived from exposure to the US, while another one-fourth is to countries in Europe (Table 1.19).

4.3 Liquidity risk

The liquidity risk profile of Israel's banks continued to improve during the reviewed period, as shown by the adequate liquidity level of the system at large—reflected in the LCR (liquidity coverage ratio)¹⁹—the high quality and large scale of liquid assets, and the stable composition of sources.

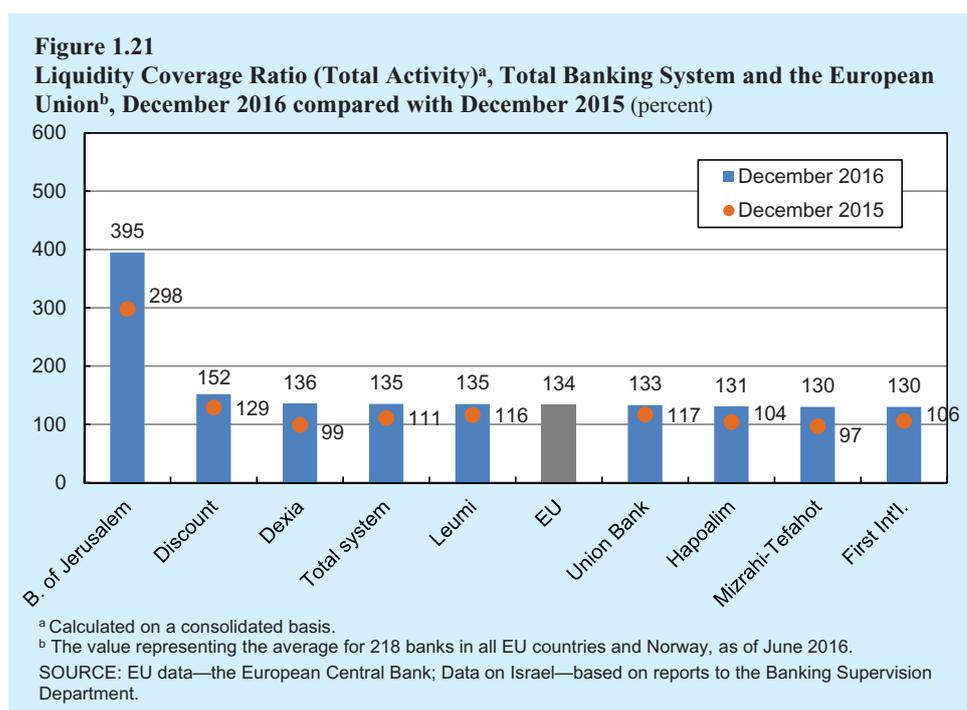
The upward trend in liquidity is a direct result of regulatory measures by the Banking Supervision Department in recent years to strengthen the banks' resilience and ability to absorb diverse shocks. In this respect, the most conspicuous step relating to liquidity is the adoption and phased-in implementation of the Basel III guidelines regarding the LCR. Implementation began in April 2015 (Proper Conduct of Banking Business Directive no. 221) and the last phase, requiring the banks to maintain an LCR of at least 100 percent, went into effect in January 2017.

The aggregate LCR (comprising activity in domestic and foreign currency)²⁰ was about 135 percent in December 2016 (compared with 111 percent a year earlier) and its value at each bank in the system exceeded 100 percent, the aforementioned threshold requirement (Figure 1.21). The improvement in system liquidity and LCR over the years was achieved mainly due to the accumulation of liquid assets and a cumulative

The liquidity risk profile of Israel's banks continued to improve in 2016.

¹⁹ The LCR, developed by the Basel Committee to enhance the short-term resilience of banking corporations' liquidity profiles, indicates the quantity of HQLA (High Quality Liquid Assets) that corporations should hold in order to withstand a significant stress scenario that lasts thirty calendar days. The LCR is composed of two elements. The first, on the numerator side, is the inventory of HQLA (High Quality Liquid Assets), which is comprised of two levels of assets. Level 1 includes high quality assets that may be held in unlimited amounts, and Level 2 is composed of assets that are limited to a maximum aggregate holding of 40 percent of the HQLA inventory. (This level is divided into two sublevels: 2A and 2B. At the latter level, the share of assets that may be held is limited to 15 percent.) The second element, on the denominator side, is the total net cash outflow, i.e., the expected total cash outflow less the expected total cash inflow in the stress scenario. The expected total cash outflow is calculated by multiplying the balances of different categories or types of balance-sheet and off-balance-sheet liabilities by their expected runoff or drawdown rates. The total expected cash inflow is calculated by multiplying outstanding contractual receivables by the rates at which they are expected to be received in the scenario, up to a cumulative 75 percent of the predicted total cash outflow.

²⁰ Calculated on a consolidated basis and on end-of-period balances.



increase in their share in total assets (to about 25 percent), exceeding the growth of net outflow as a share of total liabilities. Examination of these two components over time reflects this, and shows a cumulative increase of about 30 percent in liquid assets as a share of total assets, compared with a more moderate increase in net outflow as a share of total liabilities (about 11 percent—Figure 1.22).

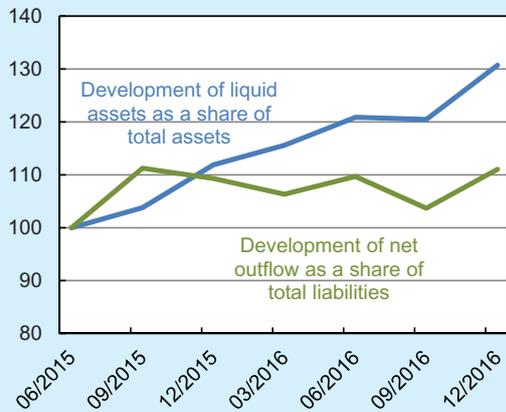
The LCR improvement in 2016 brought Israel's banks up to the European average²¹ (Figure 1.21). In addition, the Israeli banks' liquid assets²² are of high quality—an advantage reflected in their composition, which is characterized by a high proportion of Level 1 assets, particularly cash and deposits with the central bank (Figure 1.23).

The Israeli banks' sources of funding are stable and rely primarily on retail core deposits (private individuals and small businesses—about 58 percent) and less on wholesale financial funding (22 percent) and wholesale nonfinancial funding (20 percent).

²¹ Regulatory changes carried out by the authorities in Europe in regard to the Basel III recommendations are having a positive effect on the LCR of small banks and a negative impact on that of large banks in Europe. The average LCR of all banks after the inclusion of the changes is similar to the average value obtained net of the effects of these changes.

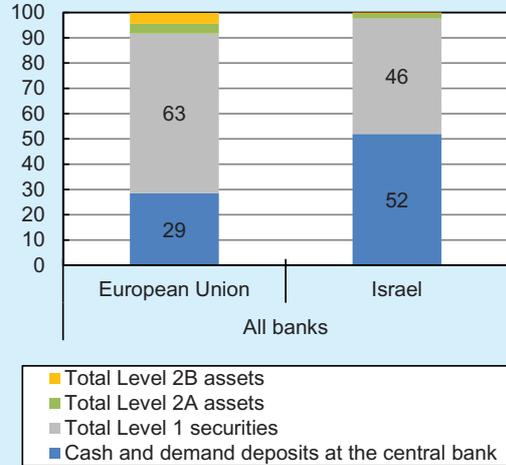
²² As defined for the purpose of calculating the LCR; see note 19.

Figure 1.22
High-Quality Liquid Assets (HQLA)^a as a Share of Total Assets, and Net Outflow as a Share of Total Liabilities, Total Banking System, June 2015 to December 2016
 (Index: June 30, 2015=100)



^a As defined in Proper Conduct of Banking Business Directive 221.
 SOURCE: Based on reports to the Banking Supervision Department.

Figure 1.23
Composition of the Stock of High-Quality Liquid Assets of Banks in Israel and the European Union, Total Banking System, December 2016^a (percent)



^a European Union values—December 2015 averages.
 SOURCE: European Union data—EBA; Israel data—based on reports to the Banking Supervision Department.

4.4 Market risk

Exposure to interest rate risk²³ was basically unchanged in the reviewed year. The banking groups, with the exception of Leumi, were exposed to an interest rate increase much as they were in past years. The potential erosion of net fair value of capital²⁴ in those four banking groups as a result of a 1 percentage-point increase in the interest rate ranged from 0.5 percent to 10.3 percent of fair value at year's end²⁵ (Figure 1.25). Bank Leumi, unlike the other banks in the system, is exposed to a decrease in the interest rate in its CPI-indexed activity segment because interest has a material effect on its liabilities on account of employees' entitlements.

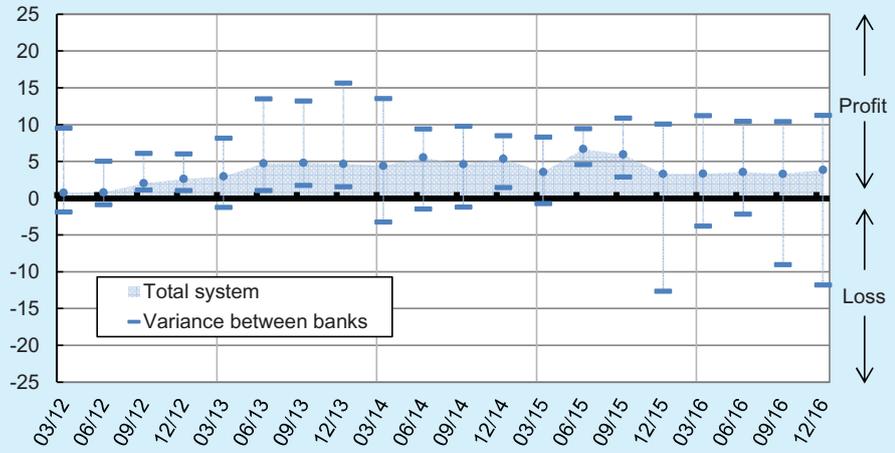
Exposure to indexation-based risk declined slightly in 2016, largely because several banks reported a decline in their net position in the CPI-indexed segment.

²³ It is worth emphasizing that the risk resulting from changes in the interest rate is also measured in other ways, including impairment of earnings or equity, in which the risk is not necessarily reflected in impairment of the fair value of the banks' capital. In this chapter, only the potential erosion of the fair value of the bank's capital, to the exclusion of the additional approaches.

²⁴ The net fair value of a bank's capital is equal to the difference between the fair value of financial assets and that of financial and other liabilities in all indexation segments, plus the effect of derivative financial instruments.

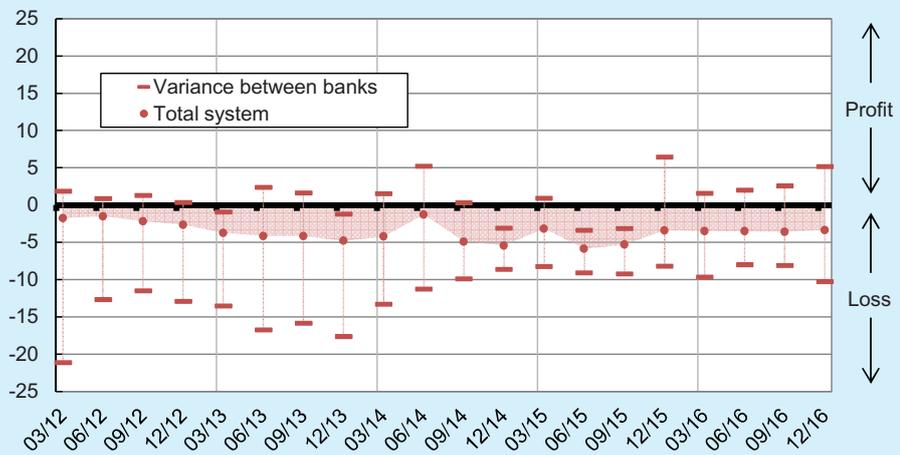
²⁵ The calculation is derived from the banking groups' board of directors reports. These reports show how parallel hypothetical changes in interest rates affect the net fair value of the financial instruments of the bank and its consolidated firms.

Figure 1.24
Rate of Change in the Net Fair Value of Capital of the Five Banking Groups as a Result of a Decline of One Percentage Point in the Interest Rate, Total Indexation Segments, 2012–16 (percent)



SOURCE: Published financial statements and reports to the Banking Supervision Department.

Figure 1.25
Rate of Change in the Net Fair Value of Capital of the Five Banking Groups as a Result of an Increase of One Percentage Point in the Interest Rate, Total Indexation Segments, 2012–16 (percent)



SOURCE: Published financial statements and reports to the Banking Supervision Department.

The potential loss as a result of a maximum change in exchange and inflation rates²⁶ was NIS 278 million, 0.3 percent of the five groups' total capital (Table 1.21). The groups' exposure varied widely, with the potential loss ranging from 0.2 percent of bank capital to 1.7 percent.

In CPI-indexed activity, most of the large banking groups posted surpluses of assets over liabilities in 2016, much as in recent years, and were therefore exposed to an unexpected decline in the CPI. In foreign currency activity, the exchange rate exposure of most of the large groups was similar to its level from the previous year.

Box 1.2: Macroeconomic stress test of the banking system on the basis of a uniform scenario, 2016–2017

- The results of the Banking Supervision Department's stress test this year indicate that in the event of a severe domestic macroeconomic scenario in concurrence with a significant shock in Europe that reflects increased uncertainty about the survival of the European Union, the Israeli banking system will remain stable but will absorb large and protracted credit losses.
- Although the banks' capital ratios are likely to decline in this scenario, those of all banks are expected to exceed the threshold that the Banking Supervision Department has set (a Common Equity Tier 1 capital adequacy ratio of 6.5 percent). The results reflect the significant strengthening of capital in recent years and supervisory measures that induced greater conservatism in risk management, including reduction of the banks' exposure to large and leveraged borrower groups and an improvement in the characteristics of the housing portfolio.
- In the stress scenario, the banks sustain sizable credit losses: about one-third in the business portfolio (excluding construction and real estate), another third in construction and real estate and housing, and about 20 percent in consumer credit.

a. General remarks

It is general practice worldwide to evaluate the risks facing the banking system by means of, among other things, analysis of the impact of an extreme event, based on a uniform scenario that the supervisory authority presents to the entire banking system. The test is conducted system-wide in order to estimate the effect of a severe scenario on the banks' profitability, capital, and stability. The goal is to make sure that even in a very severe scenario, the banks will remain stable even if they have to absorb considerable losses. In Israel, each banking corporation estimates the test results by applying a method of its own, and the Banking Supervision Department tests each bank in a consistent and uniform manner. This process contributes to a better understanding of focal points of risk that the banking system and the individual bank face, constitutes an auxiliary tool for estimating system resilience and assuring capital adequacy, and deals with banks' resilience on a case-by-case basis as necessary. It is worth emphasizing that the test is not a forecast. It is based on numerous models and assumptions, and its outcomes are therefore a rough estimate of possible losses.

²⁶ The maximum change in inflation and the exchange rate is determined on the basis of the monthly changes that occurred, respectively, in inflation expectations and the nominal NIS-USD exchange rate over the past seven years, assuming normal distribution and 99 percent significance.

The results of the test conducted in 2016¹ indicate that in the event of a severe domestic macroeconomic scenario with a concurrent significant shock in Europe that reflects increased uncertainty about the survival of the European Union, **the banking system will remain stable but will absorb large and protracted credit losses.** Capital ratios are likely to fall but those of all banks are expected to exceed the minimum (6.5 percent Common Equity Tier 1 capital adequacy ratio) required by the Banking Supervision Department. These outcomes reflect a direct blow to the system on account of credit risk, market risk, and, to a limited extent, operational risks. They do not take into account additional effects such as a decline in liquidity—a development that may harm the banks' reputation and customer confidence and lead to negative feedback. It is important to note, however, that the results are as severe as they are because they do not take into account actions that the banks' managements will take in response to the crisis. The Banking Supervision Department insisted on this methodology in order to make the results for all banks comparable.

The following are details of the characteristics of the scenario and the test results. The results should be viewed as indications of the banks' level of risk and as an additional measure for estimating it.

b. The scenarios

The test conducted in 2016 was based on two scenarios—a base scenario and a stress scenario. The stress scenario is very severe. It should again be emphasized that the stress scenario is not a forecast but a hypothetical situation meant to test the banking corporations' resilience in an alternative macroeconomic environment. The scenarios cover a time frame of thirteen quarters starting on September 30, 2016.

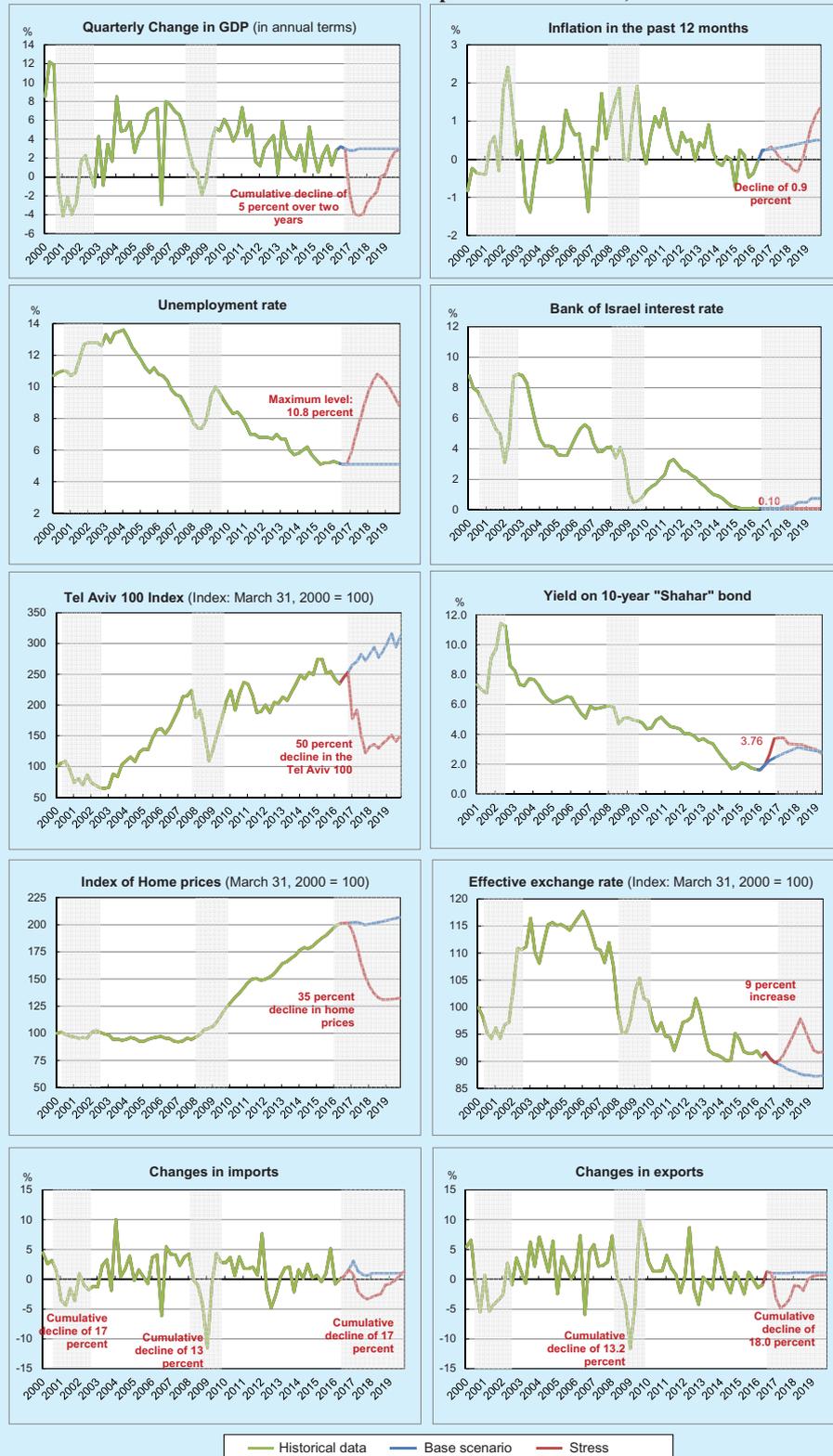
The base scenario reflects the expected path of the economy and is based on the Bank of Israel's macroeconomic forecasts, international financial institutions' forecasts of global developments, and additional assessments of economic developments—all of which were as of the date on which the scenarios were created.

The stress scenario is a shock originating in Europe that reflects increased uncertainty about the survival of the European Union and coincides with a shock to the domestic housing market that causes prices to plummet. The two shocks affect the Israeli economy adversely in both its real and its financial aspects. They cause domestic economic activity to decline steeply, reflected in a sharp decline in exports and investment and a sharp increase in unemployment. As economic activity loses momentum, the Consumer Price Index declines and the Bank of Israel interest rate remains at its current low level. The increasing credit risk, however, is reflected in higher lending interest rates. The weakening of the domestic economy and the flight to safety are manifested in depreciation of the shekel against main currencies other than the euro. As real activity slumps, the shocks leave their effects on the prices of financial assets. The Tel Aviv 100 index loses half of its value, cumulatively, by the end of 2018, and corporate spreads widen in all rating classes due to concern about large credit losses among firms, a transition to assets that are perceived as relatively safe, and liquidity difficulties among investors.

Figure 1 shows the development of main macroeconomic variables in both scenarios.

¹ The following banking corporations took part in the stress test: Leumi, Hapoalim, Israel Discount, Mizrahi-Tefahot, First International, Union, and Bank of Jerusalem.

Figure 1
Historical Macroeconomic Data and Development of Scenarios, 2000–19^a



^a The shaded areas denote crisis periods.

SOURCE: Historical data—Based on Central Bureau of Statistics and Tel Aviv Stock Exchange; Base and Stress scenarios—Bank of Israel.

c. Assumptions

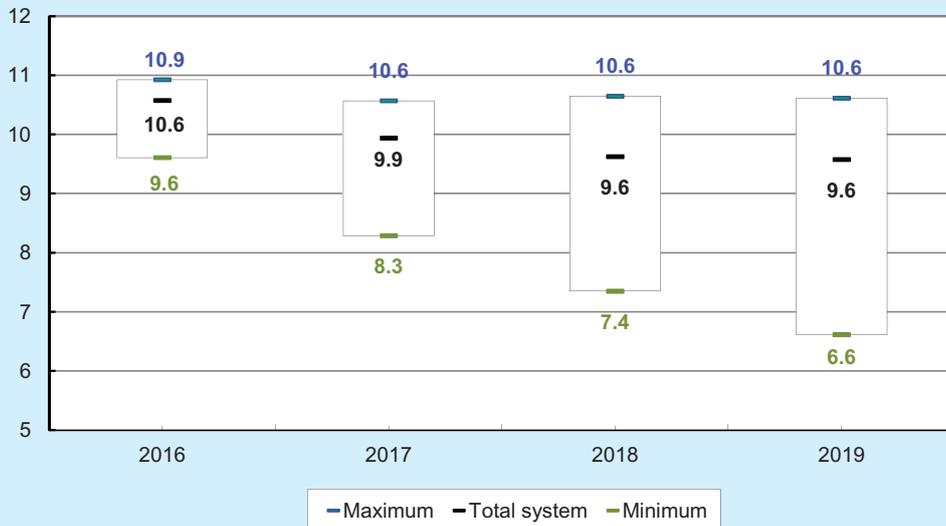
The Banking Supervision Department conducted the uniform stress test on the basis of various assumptions that were meant to facilitate comparison among banks and isolate the effects of the scenario itself from possible reactions. In the course of the scenario, for example, the balance and composition of assets do not change, no additional capital is raised, and, as stated, responses by banks' managements to the evolution of the crisis are not taken into account. The test results reflect the direct effect of this scenario on capital, profitability, and the credit and securities portfolios. The test does not examine the possibility of a decline in the banks' liquidity and related indirect effects, such as lowering of banks' ratings and a negative impact on investor confidence.

d. Findings

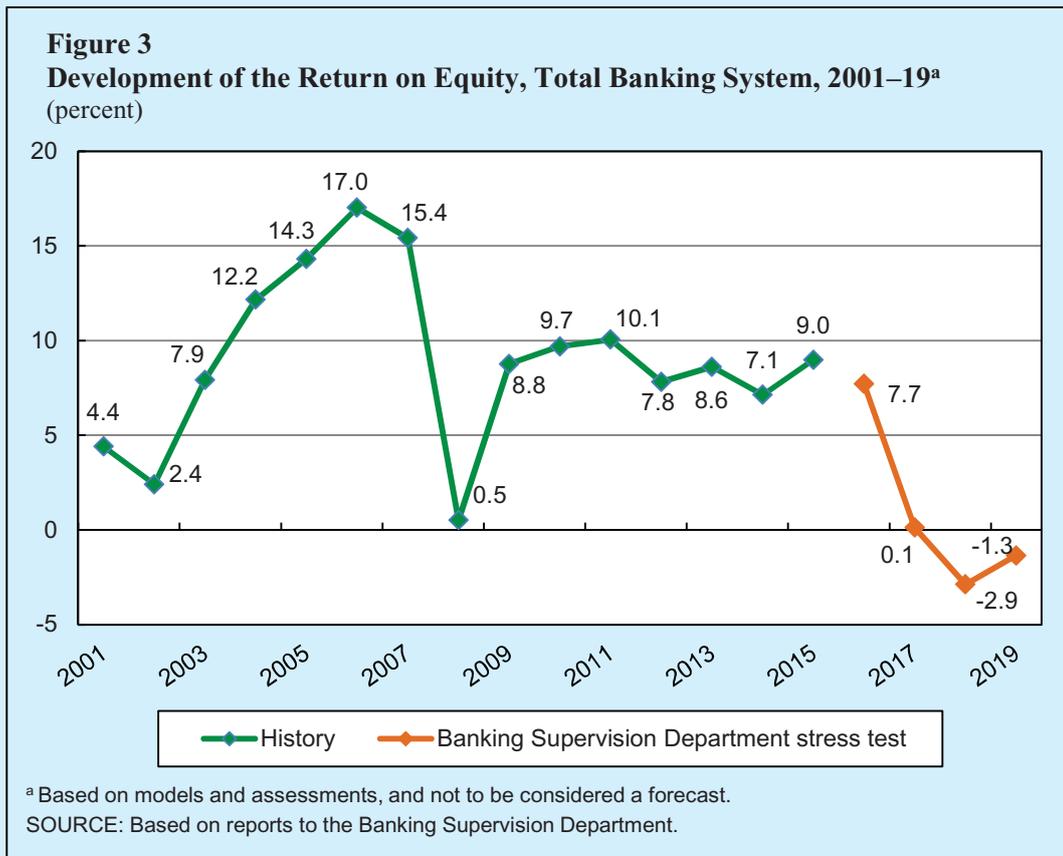
The simultaneous occurrence of a shock originating in Europe and a domestic macroeconomic crisis—including a shock to the housing market, causing prices to plunge—is likely to have a significant effect on the banking system but is unlikely to put stability at risk. The ensuing recession will make it difficult for mortgage, household, and business borrowers to honor their obligations, causing the banks to record large credit losses.

The extent of the direct blow to the banking system, under the aforementioned assumptions, indicates that the system will have enough capital to maintain resilience in the stress scenario and that the banks' capital ratios will not fall below the mandatory minimum. This reflects the major reinforcement of capital

Figure 2
Development of the Tier 1 Capital Ratio, Total Banking System, 2016–19^a (percent)



^a Based on models and assessments, and not to be considered a forecast.
SOURCE: Based on reports to the Banking Supervision Department.

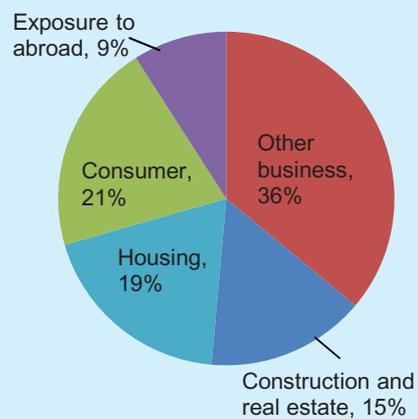


in recent years alongside supervisory measures that led to more conservative risk management, such as the significant decline in the banks' exposure to large and leveraged borrower groups and improvement in the characteristics of the housing portfolio. Nevertheless, the banking system will sustain a serious and long-lasting impact: about NIS 6.6 billion in cumulative losses (pre-tax), zero return on equity in 2017, and negative ROE in 2018 (-2.9 percent) and 2019 (-1.3 percent). The impairment to the banking system's Common Equity Tier 1 capital ratio is reflected in a decline from 10.4 in September 2016 (when the scenario begins) to 9.6 at the end of 2019 (when it ends). The damage caused under this scenario varies widely among the banks. The capital ratio of the bank that sustains the most serious impact will bottom out at 6.6 percent. The most significant damage to the banks' profitability in the scenario described above is derived from credit losses. During the three years of the scenario, the banks will record NIS 35 billion (pre-tax) in credit losses—about 1.2 percent per year on average.

About one-third of the total credit losses will come from the business credit portfolio (excluding construction and real estate). Another third will originate in the construction and real estate industry and housing credit, due to the sharp decline in housing prices assumed by the scenario and the serious impact to the labor market. The strong correlation between these segments will aggravate industry concentration risk and may magnify the loss due to feedback effects. The increase in the risk inherent in

the consumer credit portfolio in recent years (see elaboration in Box 1.1, “Retail Consumer Credit”), typified by a large proportion of unsecured loans alongside the serious impact of the scenario on the labor market, are reflected in credit losses on account of the consumer segment, adding up to about 20 percent of total losses in the banking credit portfolio with high variance among banks.

Figure 4
Expected Credit Losses During the Stress Scenario, Total Banking System, 2017–19^a (percent)



^a Based on models and assessments, and not to be considered a forecast.

SOURCE: Based on reports to the Banking Supervision Department.

Table 1.1
Principle banking system indices, December 2001 to December 2015

	Ratio of market value to book value ^a (MV/BV)	Average yield spread between bonds of the banks and government bonds ^b (percentage points)	Ratio of credit to GDP ^{c,d} (percent)	Rate of change in balance-sheet credit to the public ^{c,d} (percent)	Annual loan loss provision to total credit to the public ^{d,e} (percent)	Liquidity coverage ratio ^{c,f} (percent)	Ratio of credit ^{e,g} to deposits (percent)	Common Equity Tier 1 capital ratio ^{e,h} (percent)	Equity to total balance-sheet assets ^e (percent)	Leverage ratio ^{c,i} (percent)	ROE ^e (percent)
2001	0.91	0.7	109.4	-	0.84		0.81		4.9		5.6
2002	0.56	0.8	104.7	-1.1	1.32		0.83		4.9		2.5
2003	0.85	0.7	103.0	-1.7	1.12		0.82		5.3		8.3
2004	1.06	0.7	98.6	0.1	0.92		0.80		5.5		12.4
2005	1.45	0.7	99.7	6.7	0.69		0.82		5.4		14.5
2006	1.33	0.6	94.7	2.0	0.52		0.80		5.9		17.3
2007	1.21	0.9	94.7	7.7	0.28		0.85		6.1		15.6
2008	0.56	2.0	98.9	10.4	0.72		0.90		5.7		0.3
2009	1.11	1.6	93.0	-1.4	0.75		0.86	7.9	6.3		8.8
2010	1.06	1.0	92.7	7.2	0.41		0.91	8.2	6.7		9.8
2011	0.69	1.3	89.7	3.7	0.39		0.89	8.0	6.2		10.2
2012	0.78	1.0	86.3	2.1	0.41		0.87	8.7	6.6		7.9
2013	0.84	0.9	81.8	1.1	0.25		0.87	9.3	6.9		8.7
January 2014								9.1			
2014	0.72	0.9	81.8	4.3	0.15		0.85	9.2	6.7		7.3
September 2015										6.4	10.2
2015	0.74	0.9	81.6	5.2	0.12	100.7	0.84	9.6	6.9	6.4	9.1
2016	0.83	0.7	79.8	2.7	0.10	137.8	0.81	10.7	7.0	6.6	8.3

^a In calculating the MV/BV ratio, the book value (BV) of the five major banks is calculated with a delay of one quarter after the market value (MV). As of December 2014, the book value includes the effect of employee rights and software expenses.

^b Average for December of that year.

^c Measured in relation to the entire banking system.

^d Until December 2010—net credit to the public; from December 2011—gross credit to the public.

^e Measured in relation to the five banking groups.

^f Calculated on a bank basis, and based on end-of-period balances, and taken from reports to the Banking Supervision Department.

^g Calculated in relation to net credit.

^h Until December 31, 2013, the banking corporations presented the Core Tier 1 capital ratio, in accordance with Basel II principles. From January 1, 2014, they present the

ⁱ Calculated as the ratio between Tier 1 capital and total exposures, in accordance with Basel III principles.

^j Calculated in accordance with Basel II principles.

^k Calculated in accordance with Basel III principles in accordance with the transition directives.

SOURCE: Banking Supervision Department based on Central Bureau of Statistics, Tel Aviv Stock Exchange, Bank of Israel, published financial statements, and reports to the Banking Supervision Department.

Table 1.2
Banking system structure, December 2016^a

Bank	Balance-sheet data					Direct holdings				Size data	
	Share of total banking system assets (Percent)	Share of total bank credit (Percent)	Total assets	Credit to the public (NIS million)	Total deposits	Equity	Holdings by parties at interest ^b (Percent)	Institutional holdings ^c (Percent)	Public holdings	Number of branches ^d	Number of employee posts ^e
Leumi ^f	28.3	27.1	438,603	265,450	346,854	31,714	5.9	0.0	94.1	234	12,257
Hapoalim	29.0	28.2	448,105	276,084	338,502	34,225	20.1	0.0	79.9	264	11,893
Discount	14.2	14.6	219,577	142,904	172,318	14,936	0.0	5.7	94.3	208	8,842
Mizrahi-Tefahot	14.9	17.6	230,455	172,779	178,252	13,324	44.3	0.0	55.7	187	6,103
First International	8.3	8.0	127,907	78,175	105,817	7,604	48.3	0.0	51.7	166	4,680
Total for the five banking groups	94.6	95.5	1,464,647	935,392	1,141,743	101,803				1,059	43,775
Union Bank of Israel	2.6	2.4	40,988	23,937	32,756	2,342	74.8	0.5	24.8	36	1,309
Bank of Jerusalem	0.9	1.0	14,202	9,893	10,868	808	86.6	0.0	13.4	24	623
Dexia Israel Bank	0.6	0.7	9,487	6,414	5,178	932	65.4	0.0	34.7	1	45
Total for the independent banks	4.2	4.1	64,677	40,243	48,803	4,082				61	1,977
Total of foreign bank branches^g	1.2	0.4	18,432	4,050	16,445					6	
Total for banking system	100	100	1,547,756	979,686	1,206,990	105,885				1,126	45,752

^a Financial data for the five banking groups is presented on a consolidated basis, and the numbers of branches and of employee posts include all banks belonging to the group.

^b A "party at interest" is defined as someone holding five percent or more of the issued share capital of a corporation or of voting rights in the corporation. In addition, the reporting on holdings of parties at interest includes the

^c Institutional holdings of more than 5 percent of the issued share capital of a corporation or of voting rights in the corporation. Institutions are as defined in Regulation 33(i) of the Securities (Periodic and Immediate Reporting)

^d The number of branches includes activities abroad, performance units and extensions of parent branches.

^e On a monthly average basis.

^f Bank Leumi is the only banking corporation in the system where there is still a government holding (about 6 percent of the bank's capital).

^g The balance-sheet data for Barclay's Bank are not included in the calculation of aggregate values due to the characteristics of its activity.

SOURCE: Based on published financial statements, reports to the Banking Supervision Department, and reports to the Stock Exchange.

Table 1.3
Main items in consolidated profit and loss statements of the five banking groups, 2014–16
(NIS million, at current prices)

	Leumi			Hapoalim			Discount			
	2014	2015	2016	2014	2015	2016	2014	2015	2016	% change in 2016 compared with 2015
Interest income	10,012	8,784	9,552	10,673	9,837	10,200	5,736	5,267	5,671	7.7
Interest expenses	2,649	1,666	2,026	2,905	1,952	2,007	1,518	1,042	1,102	5.8
Net interest income	7,363	7,118	7,526	7,768	7,885	8,193	4,218	4,225	4,569	8.1
Loan loss provisions	472	199	-125	425	475	269	164	187	469	150.8
Net interest income after loan loss provisions	6,891	6,919	7,651	7,343	7,410	7,924	4,054	4,038	4,100	1.5
Noninterest income	5,141	6,297	5,408	6,254	6,477	6,528	3,153	3,053	3,439	12.6
<i>of which: Noninterest financing income</i>	795	1,610	1,282	916	1,044	1,152	549	363	754	107.7
<i>of which: Stocks^a</i>	485	1,298	478	136	94	329	63	-52	444	-953.8
<i>Bonds^b</i>	628	248	273	343	520	204	307	239	138	-42.3
Activity in derivative instruments ^c	1,893	-260	-213	1,933	588	555	854	-341	-291	-14.7
Exchange rate differentials	-2,252	310	700	-1,496	-161	-29	-675	504	449	-10.9
<i>Fees</i>	4,167	4,092	3,967	5,207	5,287	5,216	2,586	2,611	2,585	-1.0
Total operating and other expenses	9,371	8,836	8,580	9,183	8,790	9,490	6,414	5,725	5,814	1.6
<i>of which: salaries and related expenses</i>	5,253	5,544	5,422	5,343	4,934	4,783	4,086	3,396	3,416	0.6
Pre-tax profit	2,661	4,380	4,479	4,414	5,097	4,962	793	1,366	1,725	26.3
Income tax provision	1,278	1,691	1,717	1,713	2,097	2,358	271	568	753	32.6
After tax profit	1,383	2,689	2,762	2,701	3,000	2,604	522	798	972	21.8
Net income attributed to shareholders	1,413	2,835	2,791	2,713	3,082	2,628	505	750	905	20.7
Total pre-tax ROE (percent)	10.24	15.87	14.94	14.81	15.89	14.58	6.60	10.56	12.58	
Total after-tax ROE (percent)	5.44	10.27	9.31	9.10	9.61	7.72	4.20	5.80	6.60	
Total ROA (percent)	0.37	0.70	0.65	0.69	0.73	0.60	0.25	0.36	0.43	

Table 1.3 (cont'd.)
Main items in consolidated profit and loss statements of the five banking groups, 2014–16

	Mizrahi-Tefahot				First International				Total for all groups			
	2014	2015	2016	% change in 2016 compared with 2015	2014	2015	2016	% change in 2016 compared with 2015	2014	2015	2016	% change in 2016 compared with 2015
Interest income	5,347	4,906	5,311	8.3	2,664	2,260	2,526	11.8	34,432	31,054	33,260	7.1
Interest expenses	1,972	1,372	1,533	11.7	563	307	357	16.3	9,607	6,339	7,025	10.8
Net interest income	3,375	3,534	3,778	6.9	2,101	1,953	2,169	11.1	24,825	24,715	26,235	6.2
Loan loss provisions	173	211	200	-5.2	89	18	80	344.4	1,323	1,090	893	-18.1
Net interest income after loan loss provisions	3,202	3,323	3,578	7.7	2,012	1,935	2,089	8.0	23,502	23,625	25,342	7.3
Noninterest income	1,612	1,858	1,862	0.2	1,667	1,541	1,480	-4.0	17,827	19,226	18,717	-2.6
<i>of which:</i> Noninterest financing income	173	358	295	-17.6	230	149	115	-22.8	2,663	3,524	3,598	2.1
<i>of which:</i> Stocks ^a	11	7	6	-14.3	60	22	25	13.6	755	1,369	1,282	-6.4
<i>of which:</i> Bonds ^b	114	180	72	-60.0	197	84	41	-51.2	1,589	1,271	728	-42.7
Activity in derivative instruments ^c	1,614	34	-192	-664.7	870	-33	-193	484.8	7,177	-9	-334	-
Exchange rate differentials	-1,566	136	364	167.6	-897	76	242	218.4	-6,886	865	1,726	-
<i>of which:</i> Fees	1,395	1,426	1,433	0.5	1,375	1,378	1,300	-5.7	14,730	14,794	14,501	-2.0
Total operating and other expenses	3,039	3,226	3,299	2.3	2,912	2,710	2,683	-1.0	30,919	29,287	29,866	2.0
<i>of which:</i> salaries and related expenses	1,866	1,944	2,071	6.5	1,780	1,629	1,656	1.7	18,328	17,447	17,348	-0.6
Pre-tax profit	1,775	1,955	2,141	9.5	767	766	886	15.7	10,410	13,564	14,193	4.6
Income tax provision	657	761	833	9.5	328	326	398	22.1	4,247	5,443	6,059	11.3
After tax profit	1,118	1,194	1,308	9.5	439	440	488	10.9	6,163	8,121	8,134	0.2
Net income attributed to shareholders	1,092	1,134	1,266	11.6	455	446	521	16.8	6,178	8,247	8,111	-1.6
Total pre-tax ROE (percent)	17.23	17.24	17.25		11.46	11.16	12.24		12.28	14.94	14.57	
Total after-tax ROE (percent)	10.60	10.00	10.20		6.80	6.50	7.20		7.29	9.08	8.33	
Total ROA (percent)	0.58	0.56	0.58		0.40	0.37	0.41		0.48	0.61	0.57	

^a Includes the profits/losses from investments in shares available for sale, profits from the sales of shares of affiliated companies, dividends and profits/losses from adjustments to fair value of tradable shares.

^b Includes the profits/losses from investments in bonds held to maturity and available for sale and income/expenses realized and not yet realized from adjustments to fair value of tradable bonds.

^c Includes derivative instruments not intended for hedging purposes (ALM instruments) and other derivative instruments.

SOURCE: Based on published financial statements.

Table 1.4
The effect of quantity^a and price^b on interest income and expenses, Israel and abroad
the five banking groups, 2016 compared with 2015 (NIS million)

	2016				2015				
	Quantity effect		Price effect		Quantity effect		Price effect		
	Assets side	Liabilities side	Net	Assets side	Liabilities side	Net	Assets side	Liabilities side	
Credit to the public / deposits of the public in Israel	1,424	160	1,264	551	325	226	1,975	485	1,490
Credit to the public / deposits of the public abroad	-3	13	-16	111	64	47	108	77	31
Total credit to the public / deposits of the public	1,421	173	1,248	662	389	273	2,083	562	1,521
Other interest-bearing assets / liabilities in Israel	259	86	173	-145	87	-232	114	173	-59
Other interest-bearing assets / liabilities abroad	-112	-45	-67	121	-4	125	9	-49	58
Total other interest-bearing assets / liabilities	147	41	106	-24	83	-107	123	124	-1
Total interest income / expenses	1,568	214	1,354	638	472	166	2,206	686	1,520
	Quantity effect		Price effect		Quantity effect		Price effect		
	Assets side	Liabilities side	Net	Assets side	Liabilities side	Net	Assets side	Liabilities side	Contribution to net interest income
Credit to the public / deposits of the public in Israel	1,356	-27	1,383	-3,799	-2,180	-1,619	-2,443	-2,207	-236
Credit to the public / deposits of the public abroad	217	22	195	-99	-15	-84	118	7	111
Total credit to the public / deposits of the public	1,573	-5	1,578	-3,898	-2,195	-1,703	-2,325	-2,200	-125
Other interest-bearing assets / liabilities in Israel	213	7	206	-1,172	-1,029	-143	-959	-1,022	63
Other interest-bearing assets / liabilities abroad	22	-3	25	-116	-43	-73	-94	-46	-48
Total other interest-bearing assets / liabilities	235	4	231	-1,288	-1,072	-216	-1,053	-1,068	15
Total interest income / expenses	1,808	-1	1,809	-5,186	-3,267	-1,919	-3,378	-3,268	-110

^a The quantity effect is calculated as the change in the balance-sheet balance (current year versus previous year) multiplied by the price during the current period, divided by 1000.

^b The price effect is calculated as the change in price (current year versus previous year) multiplied by the balance-sheet balance for the same period in the previous year, divided by 1000.

SOURCE: Banking Supervision Department based on published financial statements.

Table 1.6
Fees and other income, and operating expenses, the five banking groups, 2014 to 2016

	Amounts			Distribution			Changes compared with previous year	
	2014	2015	2016	2014	2015	2016	2015	2016
	(NIS million, at current prices)			(Percent)				
1. Fees and other income								
Income from banking services								
Account management fees	2,949	2,838	2,737	19.4	18.1	18.1	-3.8	-3.6
Credit cards	3,808	3,928	4,157	25.1	25.0	27.5	3.2	5.8
Credit services and contracts	570	605	633	3.8	3.9	4.2	6.1	4.6
Foreign trade activity and special services	392	387	387	2.6	2.5	2.6	-1.3	0.0
Other fees ^a	1,534	1,600	1,561	10.1	10.2	10.3	4.3	-2.4
Total income from services	9,253	9,358	9,475	61.0	59.6	62.7	1.1	1.3
Income from capital market activity								
From securities activity	2,894	2,742	2,394	19.1	17.5	15.8	-5.3	-12.7
Financial products ^b distribution fees	893	916	845	5.9	5.8	5.6	2.6	-7.8
Management, operational and trust fees for institutional investors	232	230	216	1.5	1.5	1.4	-0.9	-6.1
Total income from capital market activity	4,019	3,888	3,455	26.5	24.8	22.9	-3.3	-11.1
Fees from financing transactions	1,458	1,548	1,571	9.6	9.9	10.4	6.2	1.5
Other income^c	434	908	618	2.9	5.8	4.1	109.2	-31.9
Total fees and other income	15,164	15,702	15,119	100.0	100.0	100.0	3.5	-3.7
2. Operating expenses								
Salaries and related expenses ^d	18,328	17,447	17,348	59.3	59.6	58.1	-4.8	-0.6
<i>Of which:</i> Salaries	11,042	11,509	11,140	35.7	39.3	37.3	4.2	-3.2
Maintenance and depreciation of premises and equipment	5,490	5,511	5,396	17.8	18.8	18.1	0.4	-2.1
Amortization and write-down of intangible assets and goodwill	209	143	116	0.7	0.5	0.4	-31.6	-18.9
Other expenses	6,892	6,186	7,006	22.3	21.1	23.5	-10.2	13.3
<i>Of which:</i> Marketing and advertising	914	921	1,016	3.0	3.1	3.4	0.8	10.3
Computer expenses	816	884	948	2.6	3.0	3.2	8.3	7.2
Communications	630	653	627	2.0	2.2	2.1	3.7	-4.0
Insurance	115	106	264	0.4	0.4	0.9	-7.8	149.1
Office expenses	302	287	276	1.0	1.0	0.9	-5.0	-3.8
Professional services	798	961	1,034	2.6	3.3	3.5	20.4	7.6
Total operating expenses	30,919	29,287	29,866	100.0	100.0	100.0	-5.3	2.0

^a Includes mainly margin and collection fees on credit from the Finance Ministry, conversion and other differentials.

^b As part of the Bachar Reform, the banks began to charge a "distribution fee". The ceiling on the distribution fee with respect to mutual funds amounts to 0.25 percent of assets in funds that invest mainly in low risk short-term investments, 0.80 percent of assets in equity funds, and 0.40 percent of assets in other funds. The ceiling with respect to provident funds and pension funds amounts to 0.25 percent of the assets in a fund.

^c Includes profit from the realization of assets received in respect of the discharge of credit, management fees from related companies and other income.

^d Includes payroll tax, severance pay, benefits, pension and national insurance

SOURCE: Based on published financial statements.

Table 1.7
Distribution of capital and capital ratios at the five banking groups^a, December 2015 and December 2016

	Leumi		Hapoalim		Discount		Mizrahi-Tefahot		First International		The five groups	
	Dec 2015	Dec 2016	Dec 2015	Dec 2016	Dec 2015	Dec 2016	Dec 2015	Dec 2016	Dec 2015	Dec 2016	Dec 2015	Dec 2016
Equity ^b	29,107	31,714	33,219	34,225	13,634	14,936	12,415	13,324	7,337	7,604	95,712	101,803
Common Equity Tier 1 capital ^c	29,001	32,586	33,246	35,045	13,549	15,036	12,299	13,318	7,349	7,684	95,444	103,669
Tier 1 capital ^c	29,001	32,586	34,955	36,510	14,796	16,104	12,299	13,318	7,349	7,684	98,400	106,202
Tier 2 capital ^c	12,593	11,850	14,593	11,609	5,610	5,020	4,916	4,888	2,580	2,819	40,292	36,186
Total capital base	41,594	44,436	49,548	48,119	20,406	21,124	17,215	18,206	9,929	10,503	138,692	142,388
Total balance sheet	416,499	438,603	431,638	448,105	205,260	219,577	209,158	230,455	125,476	127,907	1,388,031	1,464,647
Credit risk	277,034	266,534	317,891	290,139	127,695	138,335	120,793	122,605	67,766	69,262	911,179	886,875
Market risks	5,167	4,788	4,562	4,866	2,435	2,483	950	1,184	995	748	14,109	14,069
Operational risk	20,432	20,843	22,671	23,374	12,330	12,072	7,743	8,113	6,141	6,168	69,317	70,570
Total risk-weighted assets	302,633	292,165	345,124	318,379	142,460	152,890	129,486	131,902	74,902	76,178	994,605	971,514
	(Percent)											
Common Equity Tier 1 capital ratio	9.6	11.2	9.6	11.0	9.5	9.8	9.5	10.1	9.8	10.1	9.6	10.7
Tier 1 capital ratio	9.6	11.2	10.1	11.5	10.4	10.5	9.5	10.1	9.8	10.1	9.9	10.9
Tier 2 capital ratio	4.2	4.1	4.2	3.6	3.9	3.3	3.8	3.7	3.4	3.7	4.1	3.7
Total capital adequacy ratio	13.7	15.2	14.4	15.1	14.3	13.8	13.3	13.8	13.3	13.8	13.9	14.7

^a The banking corporations allocate capital in accordance with Basel III rules, as per the transition directives.

^b Including minority interest in accordance with the group's balance sheet.

^c After deductions.

SOURCE: Based on published financial statements and reports to the Banking Supervision Department.

Table 1.8
Main capital indices of the five banking groups, December 2009 to December 2016

(percent)							
	Year	Leumi	Hapoalim	Discount	Mizrahi- Tefahot	First International	Five Groups
Common Equity Tier 1 capital ratio ^a	2011	8.07	7.90	8.07	7.77	8.48	8.01
	2012	8.55	8.87	8.57	8.55	9.65	8.74
	2013	9.32	9.30	9.30	9.01	9.92	9.32
	01/01/2014 ^b	9.09	9.08	8.92	8.73	9.98	9.08
	2014	9.09	8.92	9.08	8.73	9.98	9.08
	2015	9.58	9.63	9.51	9.50	9.81	9.60
	2016	11.15	11.01	9.83	10.10	10.09	10.67
The ratio between credit risk assets and total exposure to credit ^c	2009 ^d	64.17	67.88	60.56	67.15	54.44	64.12
	2009 ^e	67.01	69.16	63.89	59.59	55.50	65.22
	2010	68.30	68.62	67.17	58.66	61.00	66.39
	2011	67.67	67.33	60.45	58.26	60.02	64.59
	2012	65.67	64.83	61.27	58.03	57.69	63.05
	2013	64.56	64.98	59.09	56.12	55.66	61.91
	2014 ^b	66.36	67.72	60.07	55.82	56.21	63.44
	2015	62.98	65.64	59.77	54.86	53.73	61.38
2016	57.34	58.97	60.24	50.72	53.06	56.89	
Leverage ratio ^f	30/06/2015	6.54	7.16	6.60	5.24	5.47	6.45
	2015	6.27	7.10	6.55	5.32	5.43	6.36
	2016	6.77	7.25	6.60	5.27	5.52	6.55
Equity to total balance-sheet assets	2011	6.46	6.76	5.44	5.36	5.93	6.19
	2012	6.71	7.19	6.04	5.70	6.41	6.59
	2013	7.07	7.65	6.25	5.75	6.33	6.86
	2014	6.58	7.65	6.27	5.69	5.98	6.68
	2015	6.99	7.70	6.64	5.94	5.85	6.90
	2016	7.23	7.64	6.80	5.78	5.94	6.95
Impaired loans and unimpaired loans 90 or more days past due, net, to total equity	2012	18.15	20.41	33.22	18.70	9.05	20.48
	2013	11.32	17.54	17.94	10.26	6.35	13.87
	2014	6.67	9.78	9.49	3.88	2.43	7.49
	2015	4.10	5.36	9.56	3.46	2.37	5.10
	2016	3.53	2.14	8.30	1.51	-0.46	3.20

^a Until December 31, 2013, the banking corporations presented the Core Tier 1 capital ratio, in accordance with Basel II principles. From January 1, 2014, they present the Common Equity Tier 1 capital ratio, in accordance with Basel III principles.

^b As of this date, the ratio is calculated in accordance with Basel III rules in accordance with the transition directives.

^c Calculated as the ratio between credit risk assets and the value of exposure after conversion to credit.

^d The ratio is calculated in accordance with Basel I rules.

^e As of this date, the ratio is calculated in accordance with Basel II rules.

^f Calculated as the ratio between Common Equity Tier 1 capital and Total exposures, in accordance with the Basel III rule.

SOURCE: Based on published financial statements and reports to the Banking Supervision Department.

Table 1.9
Balance sheet of the total Israeli banking system^a, 2014–16

	In current prices			Rate of change during 2015	Rate of change during 2016	Distribution		
	2014	2015	2016			2014	2015	2016
	(NIS million)			(Percent)		(Percent)		
Assets								
Cash and deposits at banks	218,731	226,145	263,974	3.4	16.7	15.7	15.6	17.3
<i>Of which:</i>								
Cash ^b	183,643	206,158	243,540	12.3	18.1	84.0	91.2	92.3
Deposits at commercial banks	35,088	19,987	20,434	-43.0	2.2	16.0	8.8	7.7
Securities	183,537	212,286	227,381	15.7	7.1	13.2	14.6	14.9
<i>Of which:</i>								
Securities provided as collateral to lenders	18,226	19,400	17,221	6.4	-11.2	9.9	9.1	7.6
At fair value	147,569	171,589	186,428	16.3	8.6	80.4	80.8	82.0
Securities borrowed or bought under reverse repurchase agreements	3,708	2,879	3,058	-22.4	6.2	0.3	0.2	0.2
Credit to the public	903,498	950,058	975,635	5.2	2.7	64.9	65.4	63.8
Allowance for credit losses	12,930	12,792	12,574	-1.1	-1.7	0.9	0.9	0.8
Net credit to the public	890,568	937,266	963,061	5.2	2.8	63.9	64.5	63.0
<i>Of which:</i>								
Unindexed local currency	563,821	622,559	669,176	10.4	7.5	63.3	66.4	69.5
Local currency indexed to the CPI	194,492	185,454	174,734	-4.6	-5.8	21.8	19.8	18.1
Foreign-currency indexed and denominated	130,901	127,806	117,720	-2.4	-7.9	14.7	13.6	12.2
<i>Of which:</i> In dollars	99,240	97,570	93,466	-1.7	-4.2	75.8	76.3	79.4
Nonmonetary items	1,353	1,448	1,432	7.0	-1.1	0.2	0.2	0.1
Credit to governments	4,887	4,517	4,925	-7.6	9.0	0.4	0.3	0.3
Investments in subsidiary and affiliated companies	2,941	1,685	1,759	-42.7	4.4	0.2	0.1	0.1
Premises and equipment	12,269	11,991	12,011	-2.3	0.2	0.9	0.8	0.8
Intangible assets	616	520	508	-15.5	-2.4	0.0	0.0	0.0
Assets in respect of derivative instruments	46,910	32,860	31,262	-30.0	-4.9	3.4	2.3	2.0
Other assets	28,724	22,074	21,385	-23.2	-3.1	2.1	1.5	1.4
Total assets	1,392,891	1,452,224	1,529,324	4.3	5.3	100	100	100
Liabilities and equity								
Deposits of the public	1,049,237	1,122,280	1,190,546	7.0	6.1	75.3	77.3	77.8
<i>Of which:</i>								
Unindexed local currency	628,747	713,887	786,137	13.5	10.1	59.9	63.6	66.0
CPI-indexed local currency	85,686	74,191	64,552	-13.4	-13.0	8.2	6.6	5.4
Foreign-currency indexed and denominated	333,323	332,526	338,083	-0.2	1.7	31.8	29.6	28.4
<i>Of which:</i> In dollars	260,321	264,925	270,817	1.8	2.2	78.1	79.7	80.1
Deposits from banks	17,938	16,357	15,926	-8.8	-2.6	1.3	1.1	1.0
Deposits from governments	2,411	1,981	2,169	-17.8	9.5	0.2	0.1	0.1
Securities lent or sold under repurchase agreements	6,070	5,241	5,156	-13.6	-1.6	0.4	0.4	0.3
Bonds and subordinated notes	100,714	102,491	105,542	1.8	3.0	7.2	7.1	6.9
Liabilities in respect of derivative instruments	47,175	34,160	32,296	-27.6	-5.5	3.4	2.4	2.1
Other liabilities	76,785	69,926	71,804	-8.9	2.7	5.5	4.8	4.7
<i>Of which:</i> Allowance for credit losses in respect of off-balance-sheet credit instruments	1,441	1,495	1,521	3.8	1.7	1.9	2.1	2.1
Total liabilities	1,300,329	1,352,437	1,423,439	4.0	5.2	93.4	93.1	93.1
Minority interest	1,733	1,705	1,862	-1.6	9.2	0.1	0.1	0.1
Shareholders equity	90,829	98,082	104,023	8.0	6.1	6.5	6.8	6.8
Total equity	92,562	99,787	105,885	7.8	6.1	6.6	6.9	6.9
Total liabilities and equity	1,392,891	1,452,224	1,529,324	4.3	5.3	100	100	100

^a On a consolidated basis. Includes the five banking groups (Leumi, Hapoalim, Discount, First International and Mizrahi-Tefahot), and the three independent banks (Union Bank, Bank of

^b Including deposits at the Bank of Israel.

SOURCE: Banking Supervision Department based on published financial statements.

Table 1.11
Transactions in off-balance-sheet financial instruments where the par value
reflects credit risk, total banking system^a, 2015 and 2016

	End of year balance		Rate of change (percent)	Distribution	
	2014	2015		2014	2015
	(NIS million)			(percent)	
Documentary credit	4,804	4,071	-15.3	0.9	0.9
Credit guarantees	18,260	18,511	1.4	3.4	3.9
Guarantees for home purchases	60,668	67,449	11.2	11.4	14.1
Other guarantees and liabilities	63,884	62,572	-2.1	12.0	13.1
Unutilized credit card facilities	104,056	97,982	-5.8	19.5	20.5
Unutilized credit facilities to the public	127,503	89,205	-30.0	23.9	18.6
Irrevocable commitments to provide credit that has not	103,702	92,537	-10.8	19.5	19.3
Commitments to issue guarantees	49,693	46,333	-6.8	9.3	9.7
Total	532,569	478,659	-10.1	100	100

^a The five banking groups, Union Bank, Bank of Jerusalem and Dexia Israel Bank.

SOURCE: Banking Supervision Department based on published financial statements.

Table 1.12
Distribution of the balance of derivative instruments,
Israeli banking system^a, 2016 compared with 2015

	(NIS million) ^b						
	By type of instrument			By type of transaction			
	2015	2016	Rate of change compared with 2015	2015	2016	Rate of change compared with 2015	
Interest rate contracts	1,126,800	1,089,988	-3.3	Hedging derivatives ^d	24,726	27,338	10.6
Exchange rate contracts	881,050	885,348	0.5	ALM derivatives ^{d,e}	2,019,381	1,984,753	-1.7
Other contracts ^e	357,603	296,226	-17.2	Other derivatives ^f	321,346	259,472	-19.3
Total	2,365,453	2,271,563	-4.0	Total	2,365,453	2,271,563	-4.0

^a Includes the five banking groups and the independent banks (Union, Jerusalem and Dexia).

^b In notional amounts, at current prices.

^c Contracts in respect of shares, commodity contracts and other contracts.

^d Excluding credit derivatives.

^e Derivatives constituting part of the bank's assets and liabilities, which were not designated for hedging purposes.

^f Including credit derivatives and currency swaps.

SOURCE: Banking Supervision Department based on published financial statements.

Table 1.13
Outstanding credit to the public, by principal industries^a, the five banking groups, 2015 and 2016

	Total balance of credit risk ^b				Balance-sheet credit ^c (debits)				
	Balance		Distribution of credit to the public		Balance		Distribution of credit to the public		Change in credit (percent)
	2015	2016	2015	2016	2015	2016	2015	2016	
Borrower activity in Israel	1,220,479	1,230,083	88.2	89.1	825,683	854,670	90.6	91.4	3.5
Business sector	659,617	654,909	47.6	47.5	393,002	399,433	43.1	42.7	1.6
Agriculture	7,645	7,772	0.6	0.6	5,838	6,044	0.6	0.6	3.5
Manufacturing	97,618	88,776	7.1	6.4	55,740	51,104	6.1	5.5	-8.3
Mining and quarrying	5,666	5,543	0.4	0.4	3,737	3,405	0.4	0.4	-8.9
Construction and real estate	226,387	227,462	16.4	16.5	115,110	115,990	12.6	12.4	0.8
<i>Of which: construction</i>	<i>156,312</i>	<i>159,666</i>	<i>11.3</i>	<i>11.6</i>	<i>54,969</i>	<i>56,864</i>	<i>6.0</i>	<i>6.1</i>	<i>3.4</i>
<i>real estate</i>	<i>70,075</i>	<i>67,796</i>	<i>5.1</i>	<i>4.9</i>	<i>60,141</i>	<i>59,126</i>	<i>6.6</i>	<i>6.3</i>	<i>-1.7</i>
Electricity and water	22,165	19,869	1.6	1.4	12,275	10,858	1.3	1.2	-11.5
Commerce	99,640	104,325	7.2	7.6	77,010	80,525	8.5	8.6	4.6
Tourism	17,235	17,292	1.2	1.3	14,990	14,946	1.6	1.6	-0.3
Transport and storage	22,621	24,910	1.6	1.8	18,048	19,860	2.0	2.1	10.0
Communications and computer services	19,562	18,205	1.4	1.3	11,839	11,788	1.3	1.3	-0.4
Financial services	87,635	82,718	6.3	6.0	39,978	42,364	4.4	4.5	6.0
Other business services	31,713	34,544	2.3	2.5	21,589	24,192	2.4	2.6	12.1
Public and community services	21,730	23,493	1.6	1.7	16,848	18,357	1.8	2.0	9.0
Private individuals	560,862	575,174	40.5	41.7	432,681	455,237	47.5	48.7	5.2
<i>Of which: housing loans</i>	<i>304,500</i>	<i>314,715</i>	<i>22.0</i>	<i>22.8</i>	<i>288,526</i>	<i>301,892</i>	<i>31.7</i>	<i>32.3</i>	<i>4.6</i>
<i>nonhousing loans</i>	<i>256,362</i>	<i>260,459</i>	<i>18.5</i>	<i>18.9</i>	<i>144,155</i>	<i>153,345</i>	<i>15.8</i>	<i>16.4</i>	<i>6.4</i>
Borrowers' activity abroad	163,949	150,063	11.8	10.9	85,549	80,722	9.4	8.6	-5.6
Total	1,384,428	1,380,146	100.0	100.0	911,232	935,392	100.0	100.0	2.7

^a The industries are classified differently than the supervisory activity segments.

^b Includes balance-sheet and non-balance-sheet credit risk.

^c Includes credit to the public, excludes bonds and securities borrowed or purchased under reverse repurchase agreements.

SOURCE: Banking Supervision Department based on published financial statements.

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Table 1.14
Supervisory Activity Segments^{a,b} - Balance-Sheet Balances and Performance Indices, the Five Banking Groups, Activity in Israel, 2016 and 2015

	Household ^c				Business ^d				Total activity in Israel ^e
	Housing	Credit cards	Other consumer	Total household	Small and micro	Medium	Large businesses	Total business	
					businesses	businesses			
December 2016									
(NIS million)									
Outstanding credit to the end of the reporting period	298,134	39,079	113,307	450,520	175,261	73,999	154,514	403,774	867,368
Outstanding impaired debt and debt more than 90 days past due	2,659	54	1,353	4,066	3,233	1,355	4,509	9,098	14,212
Balance of deposits to the end of the reporting period	---	87	524,559	524,646	137,573	75,329	143,804	356,706	1,052,378
Balance of risk assets to the end of the reporting period	183,465	34,007	108,873	326,345	189,408	88,810	177,642	455,860	887,830
Net profit	1,008	534	-1,462	80	1,756	976	2,984	5,716	8,211
(percent)									
Return on assets (net profit divided by the average balance of assets)	0.35	1.42	-1.13	0.02	1.05	1.36	1.80	1.41	0.63
Financial gap (net interest income divided by the average balance of assets and liabilities)	1.74	3.56	2.16	2.09	4.08	2.45	2.16	2.98	1.90
Credit activity divided by the average balance of credit	0.86	2.06	4.94	2.00	3.61	2.35	1.96	2.70	2.91
Deposit activity divided by the average of deposits	---	---	0.27	0.27	0.20	0.17	0.12	0.16	-0.07
Average cost (operational expenses divided by average balance of assets and liabilities)	0.81	9.75	3.63	3.07	3.61	1.80	1.08	2.22	2.14
Operating loss divided by the average balance of assets and liabilities	0.60	-1.63	2.48	1.74	1.70	0.45	-0.17	0.69	0.73
Operating efficiency ratio (operating costs divided by total gross income)	41.76	65.25	109.86	89.60	60.22	47.41	31.58	49.19	64.88
Loan loss provisions divided by the average balance of assets and liabilities	0.02	0.94	0.34	0.27	0.45	-0.21	-0.74	-0.16	0.05
Loan loss provisions divided by the credit balance to the end of the period	0.01	0.52	0.96	0.29	0.39	-0.21	-0.76	-0.16	0.07
Net profit divided by the average balance of assets and liabilities	0.69	2.44	-0.45	0.02	1.15	1.33	1.88	1.49	0.65
December 2015									
(NIS million)									
Outstanding credit to the end of the reporting period	285,564	36,192	107,584	429,340	175,937	72,507	149,981	398,425	839,384
Outstanding impaired debt and debt more than 90 days past due	2,885	18	1,216	4,119	3,859	1,858	5,907	11,624	15,833
Balance of deposits to the end of the reporting period	---	82	490,358	490,440	130,717	63,550	127,386	321,653	980,550
Balance of risk assets to the end of the reporting period	170,234	32,241	108,730	311,205	184,603	92,848	208,090	485,541	905,823
Net profit	831	401	-1,091	141	1,817	968	2,066	4,851	7,870
(percent)									
Return on assets (net profit divided by the average balance of assets)	0.30	1.12	-0.95	0.03	1.08	1.37	1.33	1.23	0.65
Financial gap (net interest income divided by the average balance of assets and liabilities)	1.63	3.27	2.17	2.05	3.96	2.62	2.22	3.02	1.89
Credit activity divided by the average balance of credit	0.80	1.86	4.99	1.94	3.46	2.44	2.01	2.71	2.87
Deposit activity divided by the average of deposits	---	2.35	0.25	0.26	0.18	0.13	0.09	0.13	-0.09
Average cost (operational expenses divided by average balance of assets and liabilities)	0.86	10.03	3.89	3.24	3.66	1.89	1.05	2.29	2.22
Operating loss divided by the average balance of assets and liabilities	0.64	-1.03	2.53	1.79	1.65	0.41	-0.09	0.73	0.72
Operating efficiency ratio (operating costs divided by total gross income)	46.67	70.00	110.20	92.62	61.29	46.17	31.27	50.04	65.53
Loan loss provisions divided by the average balance of assets and liabilities	0.02	0.64	0.20	0.17	0.31	-0.16	-0.03	0.09	0.09
Loan loss provisions divided by the credit balance to the end of the period	0.01	0.36	0.55	0.17	0.27	-0.15	-0.02	0.08	0.12
Net profit divided by the average balance of assets and liabilities	0.61	1.99	-0.37	0.03	1.20	1.44	1.43	1.33	0.67

^a Beginning with the financial statement for the first quarter of 2016, there is a requirement of disclosure to supervisor activity segments according to the new rules adapted to the new uniform and comparable definitions set out by the Banking Supervision Department, which are mainly based on the classification of customers by the volume of their activity. There are also additional requirements for separate disclosure of the institutional investors segment and the financial management segment, and additional requirements for disclosures of balance-sheet balances to the end of the reporting period (credit and deposits) and balances of impaired credit and nonimpaired credit 90 days past due. The implementation of the Directive had no material effect on the banks' financial statements, other than the manner of presentation and disclosure.

^b Supervisory activity segments are classified differently than the classification of industries.

^c The household segment is presented together with private banking due to the latter's small share of total credit to households.

^d Micro business - Volume of activity totaling less than NIS 10 million; Small business - Volume of activity totaling between NIS 10 million and NIS 50 million; Medium business - Volume of activity totaling between NIS 50 and NIS 250 million; Large business - Volume of activity totaling over NIS 250 million.

^e Including institutional entities, the financial management segment, and the "others" segment.

SOURCE: Based on published financial statements and reports to the Banking Supervision Department.

Table 1.15
Credit quality indices, by principle industry, the five banking groups, 2015 and 2016

	(percent)									
	Impaired loans to total balance-sheet credit to the industry		Loan loss provisions to total balance-sheet credit to the industry		Net write-offs to total balance-sheet credit to the industry		Allowance for credit losses to total balance-sheet credit to the industry		Coverage ratio: Allowance for credit losses to impaired loans to the industry	
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016
Borrowers' activity in Israel										
Business Sector	1.6	1.4	0.13	0.10	0.12	0.11	1.53	1.47	94.2	105.8
Agriculture	3.2	2.7	0.10	-0.12	0.04	-0.01	2.19	2.05	69.1	76.0
Manufacturing	1.7	2.1	0.33	0.33	-0.19	0.07	1.66	1.84	99.0	86.0
Mining and quarrying	3.5	3.0	2.71	2.74	-0.26	-0.43	2.71	2.74	78.4	90.1
Construction and real estate	0.0	4.6	0.37	2.58	0.00	-0.09	0.37	2.58		
<i>Of which: Construction</i>	3.3	2.9	-0.24	-0.74	-0.22	-0.37	2.38	2.02	71.24	70.21
Real estate	3.1	3.0	-0.19	-0.32	-0.27	-0.27	2.44	2.35	78.8	78.2
Electricity and water	3.6	2.7	-0.30	-1.15	-0.18	-0.47	2.33	1.69	65.3	61.8
Commerce	0.1	2.5	-0.01	0.12	-0.01	0.06	0.81	1.19	909.1	46.7
Tourism	3.6	1.9	1.07	0.81	0.55	0.72	2.85	2.70	79.4	138.8
Transportation and storage	4.0	3.5	0.27	-0.16	0.26	-0.16	1.02	1.07	25.8	30.7
Communications and computer services	3.1	1.5	-0.10	-0.11	-0.08	-0.12	0.91	0.85	29.7	57.9
Financial services	14.4	11.2	1.50	0.21	0.37	0.91	4.45	3.82	31.0	34.2
Other business services	1.7	3.2	-0.67	-0.41	-0.01	-0.32	1.71	1.56	100.4	49.1
Public and community services	0.9	0.9	0.41	0.74	0.35	0.41	1.40	1.57	162.0	177.6
Private individuals	0.6	0.5	-0.17	0.17	0.04	0.08	0.72	0.77	124.7	153.3
<i>Of which: Housing loans</i>	0.2	0.2	0.16	0.28	0.18	0.22	0.94	0.96		
Nonhousing loans	0.0	0.0	0.01	0.00	0.05	0.03	0.62	0.57		
Borrowers' activity abroad	0.7	0.7	0.45	0.84	0.46	0.60	1.57	1.72		
	1.96	1.84	0.00	0.09	0.25	0.23	0.25	0.23		

SOURCE: Banking Supervision Department based on published financial statements.

Table 1.16
Indices of credit portfolio quality of the five banking groups, 2010 to 2015
 (percent)

	Year	Leumi	Hapoalim	Discount	Mizrahi Tefahot	First International	Five groups
Loan loss provision to total balance-sheet credit to the public	2011	0.30	0.48	0.65	0.28	0.14	0.39
	2012	0.50	0.39	0.61	0.21	0.20	0.41
	2013	0.11	0.34	0.49	0.21	0.14	0.25
	2014	0.18	0.16	0.13	0.12	0.13	0.15
	2015	0.08	0.17	0.15	0.13	0.02	0.12
	2016	-0.05	0.10	0.33	0.12	0.10	0.10
Net write-offs to total balance-sheet credit to the public	2012	0.47	0.38	0.51	0.26	0.24	0.39
	2013	0.21	0.38	0.42	0.40	0.13	0.32
	2014	0.12	0.06	0.24	0.10	0.05	0.11
	2015	0.20	0.08	0.12	0.09	0.14	0.13
	2016	0.00	0.20	0.27	0.09	0.09	0.12
Allowance for credit losses to total balance-sheet credit to the public	2011	1.62	1.64	1.67	1.35	1.33	1.57
	2012	1.68	1.61	1.74	1.22	1.22	1.56
	2013	1.59	1.54	1.81	0.94	1.19	1.46
	2014	1.55	1.56	1.68	0.90	1.25	1.44
	2015	1.38	1.56	1.59	0.87	1.12	1.36
	2016	1.33	1.49	1.50	0.83	1.08	1.29
Problematic loans to total balance-sheet credit to the public	2013	4.42	6.05	5.73	1.99	3.50	4.62
	2014	3.96	4.46	4.84	1.38	3.45	3.75
	2015	3.14	3.43	3.54	1.38	2.39	2.91
	2016	2.90	2.77	3.55	1.44	2.29	2.64
Impaired loans and non-impaired loans 90 days or more past due to total balance-sheet credit to the public	2011	3.26	3.74	5.19	2.57	2.02	3.49
	2012	3.54	3.79	5.11	2.55	2.11	3.57
	2013	2.81	3.54	3.71	1.70	1.83	2.89
	2014	2.23	2.70	2.69	1.20	1.50	2.20
	2015	1.83	2.19	2.60	1.14	1.36	1.89
	2016	1.75	1.76	2.37	0.95	1.04	1.64
Allowance for credit losses to impaired loans and non-impaired loans more than 90 days past due	2011	49.5	43.7	32.1	52.6	66.1	44.9
	2012	47.3	42.5	34.1	47.9	57.7	43.6
	2013	56.4	43.6	48.7	55.4	65.0	50.5
	2014	69.6	57.8	62.4	75.4	83.7	65.2
	2015	75.5	71.3	61.1	76.5	82.6	71.7
	2016	76.0	84.9	63.4	87.7	104.3	78.8

SOURCE: Banking Supervision Department based on published financial statements.

Table 1.17
Indices of concentration of the portfolio of credit to the public^a of the five banking groups, 2010–2016

	Year	Leumi	Hapoalim	Discount	Mizrabi-Tefahot	First International	The five groups
Concentration by principal industries							
Herfindahl-Hirschman Index (HH) of the concentration of the aggregate credit portfolio excluding credit to individuals ^{b,c}	2010	0.09	0.08	0.09	0.04	0.07	0.08
	2011	0.09	0.08	0.08	0.04	0.06	0.07
	2012	0.09	0.08	0.08	0.04	0.05	0.07
	2013	0.08	0.07	0.07	0.03	0.06	0.07
	2014	0.08	0.08	0.07	0.03	0.06	0.07
	2015	0.08	0.07	0.07	0.03	0.05	0.06
	2016	0.07	0.07	0.07	0.02	0.05	0.06
Herfindahl-Hirschman Index (HH) of business credit portfolio concentration ^{d,e}	2010	0.20	0.18	0.17	0.20	0.18	0.18
	2011	0.21	0.17	0.17	0.19	0.17	0.18
	2012	0.21	0.17	0.17	0.21	0.17	0.18
	2013	0.20	0.17	0.17	0.23	0.18	0.18
	2014	0.21	0.17	0.18	0.24	0.18	0.19
	2015	0.22	0.17	0.17	0.23	0.18	0.19
	2016	0.21	0.17	0.18	0.23	0.18	0.19
Credit to individuals as a share of total credit ^f (percent)	2010	30.5	30.9	28.9	54.7	37.2	34.2
	2011	31.5	30.8	29.2	57.0	41.1	35.2
	2012	33.0	32.0	29.7	59.0	42.9	36.7
	2013	35.4	32.6	32.3	60.9	42.8	38.5
	2014	36.5	32.3	32.5	61.6	43.1	38.9
	2015	37.9	33.5	33.6	64.4	45.0	40.5
	2016	38.2	34.5	35.0	65.5	46.1	41.7
Credit for borrowers' activity abroad as a share of total credit portfolio (percent)	2010	17.3	11.5	21.9	2.4	3.9	13.0
	2011	15.6	11.0	26.8	1.9	3.0	13.0
	2012	15.9	10.6	25.2	2.7	2.3	12.6
	2013	15.3	10.2	22.2	2.9	1.8	11.7
	2014	15.0	11.0	23.2	2.4	1.9	11.9
	2015	15.0	11.2	22.4	2.5	2.1	11.8
	2016	15.0	8.9	20.9	2.4	1.2	10.9
Concentration by borrower size							
Gini Index ^g of credit diversification by	2010	0.91	0.91	0.91	0.81	0.85	0.90
	2011	0.90	0.92	0.91	0.81	0.85	0.90
	2012	0.90	0.92	0.92	0.81	0.85	0.90
	2013	0.88	0.92	0.91	0.81	0.85	0.90
	2014	0.87	0.92	0.90	0.80	0.84	0.90
	2015	0.89	0.91	0.90	0.79	0.84	0.89
	2016	0.88	0.91	0.90	0.79	0.84	0.89
Credit granted to borrowers whose indebtedness exceeds NIS 40 million as a share of total credit (percent)	2010	42.0	49.0	43.2	26.1	33.3	41.6
	2011	41.8	48.9	44.5	24.6	29.3	41.2
	2012	40.1	47.7	43.4	23.1	27.9	39.6
	2013	38.0	46.6	39.7	22.7	28.2	38.0
	2014	36.6	46.4	38.8	21.0	27.3	37.1
	2015	35.2	44.7	38.6	19.4	27.6	35.8
	2016	33.7	41.7	37.9	18.4	27.4	33.8
Credit granted to borrowers whose outstanding indebtedness exceeds 5% of the group's equity ^h as a share of the group's total credit (percent)	2010	5.5	8.2	7.9	7.6	10.4	
	2011	5.6	8.4	13.0	5.2	9.1	
	2012	5.2	7.8	10.9	4.3	7.5	
	2013	5.7	6.6	9.3	3.9	7.1	
	2014	3.8	5.9	8.6	3.1	4.8	
	2015	1.8	3.8	7.9	2.1	5.7	
	2016	1.0	2.5	7.6	1.6	5.2	

^a On a balance-sheet and off-balance-sheet basis.

^b This index is the sum of the squares of the weights of credit in a specific industry (excluding credit granted to individuals) in total credit to the public (including credit granted to individuals). The index increases with an increase in concentration.

^c The weighting of the principal industries in this index includes the borrowers' activity both in Israel and abroad.

^d This index is the sum of the squares of the weights of credit in a specific industry (excluding credit granted to individuals) in total credit to the public (excluding credit granted to private individuals).

^e The weighting of the principal industries in this index includes the borrowers' activity in Israel only.

^f Refers only to credit issued in Israel.

^g The Gini Index expresses inequality in the distribution of credit by borrowers. The index increases with an increase in inequality.

^h Plus minority interest.

SOURCE: Banking Supervision Department based on published financial statements.

Table 1.18
Current credit exposure to foreign financial institutions^{a,b}, the five banking groups, 2016
 (NIS million)

Credit rating ^c	Leumi			Hapoalim			Discount			Mizrahi-Tefahot			First International			Five groups, total		
	Total credit risk	Balance sheet	of which: credit risk	Total credit risk	Balance sheet	of which: credit risk	Total credit risk	Balance sheet	of which: credit risk	Total credit risk	Balance sheet	of which: credit risk	Total credit risk	Balance sheet	of which: credit risk	Total credit risk	Balance sheet	of which: credit risk
AAA to AA-	17,846	15,338	5,651	3,824	2,904	597	2,295	2,904	2,904	597	1,045	945	41,863	25,435	25,435			
A+ to A-	1,997	1,985	12,404	3,484	3,227	628	6,053	3,227	3,227	628	1,175	1,161	28,832	19,405	19,405			
BBB+ to BBB-	966	571	1,883	288	288	25	25	288	288	25	219	205	3,551	2,972	2,972			
BB+ to B-	31	4	42	34	22	0	18	22	22	0	64	64	226	132	132			
Below B-	18	18	-	0	0	0	-	0	0	0	0	0	18	18	18			
Unrated	347	347	129	144	58	1	1	58	58	1	63	55	703	590	590			
Total credit exposure to foreign financial institutions	21,205	18,263	35,256	7,774	6,499	1,251	8,392	6,499	6,499	1,251	2,566	2,430	75,193	48,552	48,552			
Balance of problematic debts	0	0	0	93	93	0	0	93	93	0	0	0	93	93	93			
Exposure as a share of assets (%)	0	4	4	0	3	1	0	0	3	1	0	2	0	3	3			
Exposure as a share of equity (%)	67	58	103	52	44	9	63	44	44	9	34	32	74	48	48			

^a Foreign financial institutions are: investment banks, broker/dealers, insurance companies, institutions and entities controlled by those institutions. Credit exposure does not include exposure to financial institutions that have clear and full government guarantees, and does not include investments in asset backed securities.

^b Balance sheet credit risk: deposits in banks, credit to the public, fixed income investments, securities borrowed or bought in reverse repurchase agreements, and other assets in respect of instruments. Off balance-sheet credit risk: primarily guarantees and commitments to grant credit, including third-party indebtedness guarantees.

^c External credit rating is based on ratings assigned by the Fitch, S&P, and Moody's credit rating agencies.

SOURCE: Banking Supervision Department based on published financial statements.

Table 1.19
Exposure to foreign countries, the five banking groups, December 2015
 (NIS million)

	Balance sheet exposure abroad		Net balance sheet exposure of		Total balance sheet exposure to equity (%)	Total balance sheet exposure to assets (%)	Total off-balance-sheet exposure ^d
	To governments ^a	To banks	To others	overseas offices ^b of the banking corporation to local residents ^c			
US	21,529	7,733	14,323	39,510	81.6	5.7	25,518
UK	379	9,657	7,785	5,746	23.1	1.6	10,418
Germany	250	2,623	987	0	3.8	0.3	4,086
France	922	2,985	2,290	0	6.1	0.4	6,349
Switzerland	0	1,443	933	6,833	9.0	0.6	4,237
Belgium	-	-	-	0	-	-	-
Turkey	-	-	-	-	-	-	-
Netherlands	0	-	-	0	-	-	-
Italy	78	1	20	0	0.1	0.0	3
Spain	-	4	3	0	0.0	0.0	31
Portugal	0	0	2	0	0.0	0.0	-
Ireland	0	-	14	0	0.0	0.0	1
Greece	0	0	0	0	0	0	1
Other countries	5,438	16,672	17,019	1,711	40.1	2.8	16,658
Total exposure to foreign countries	28,596	41,118	43,376	53,800	163.9	11.4	67,302
<i>Of which:</i> Total exposure to LDCs ^e	547	1,679	2,707	1,435	6.3	0.4	3,536
Exposures to Portugal, Ireland, Greece, Italy, and Spain, which were not included above.	0	221	530	0	1.1	0.1	1,406
Total exposure to Europe	1,629	16,713	12,034	12,579	42	3	25,126
<i>Of which:</i> Total exposure to Portugal, Ireland, Greece, Italy, and Spain	78	226	569	0	1	0	1,442

^a Governments, official bodies, and central banks.

^b The banking corporation's offices in a foreign country.

^c Net balance sheet exposure after deduction of local liabilities.

^d Credit risk in off-balance-sheet financial instruments, as calculated for the borrower indebtedness limit.

^e Less developed countries – the countries classified by the World Bank as having low or medium revenue.

SOURCE: Banking Supervision Department based on published financial statements

Table 1.20
Exposure to changes in interest rates, the five banking groups, December 2015 and December 2016

	(NIS million)											
	Leumi		Hapoalim		Discount		Mizrahi-Tefahot		First International		Total system	
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016
Unindexed segment												
Net position in segment ^a	20,805	22,971	20,085	24,668	5,232	4,128	-348	5,322	5,519	3,541	51,293	60,630
The change in the fair value of the net position in the segment as a result of an interest rate change ^b												
1 percentage point increase	-842	-397	-810	-881	-245	-273	-242	-301	-324	-339	-2,463	-2,191
1 percentage point decrease	838	289	895	971	446	587	260	348	390	379	2,829	2,574
The change in the fair value of the net position in the segment as a percentage of the net fair value of the bank's total equity												
Interest rate increase	-8.5	-3.4	-3.1	-3.2	-2.4	-2.5	-2.8	-3.4	-5.9	-7.7	-4.1	-3.4
Interest rate decrease	8.5	2.5	3.4	3.5	4.4	5.3	3.0	3.9	7.1	8.6	4.7	4.0
CPI-indexed segment												
Net position in segment ^a	-8,832	-8,955	6,507	3,697	2,228	3,812	9,109	3,324	27	771	9,039	2,649
The change in the fair value of the net position in the segment as a result of an interest rate change ^b												
1 percentage point increase	1,746	1,592	-68	-10	-142	-239	79	709	-70	-66	1,545	1,986
1 percentage point decrease	-2,229	-2,095	51	27	190	296	-104	-114	90	76	-2,002	-1,810
The change in the fair value of the net position in the segment as a percentage of the net fair value of the bank's total equity												
Interest rate increase	17.6	13.5	-0.3	0.0	-1.4	-2.2	0.9	8.0	-1.3	-1.5	2.6	3.1
Interest rate decrease	-22.5	-17.8	0.2	0.1	1.9	2.7	-1.2	-1.3	1.6	1.7	-3.3	-2.8
Foreign currency segment^c												
Net position in segment ^a	-2,056	-2,239	-569	-756	2,613	3,079	-77	215	-21	107	-110	406
The change in the fair value of the net position in the segment as a result of an interest rate change ^b												
1 percentage point increase	-265	-582	-300	-398	-435	-451	-76	-448	-58	-48	-1,134	-1,927
1 percentage point decrease	136	415	532	409	326	357	85	451	77	43	1,156	1,675
The change in the fair value of the net position in the segment as a percentage of the net fair value of the bank's total equity												
Interest rate increase	-2.7	-4.9	-1.2	-1.4	-4.3	-4.1	-0.9	-5.1	-1.0	-1.1	-1.9	-3.0
Interest rate decrease	1.4	3.5	2.0	1.5	3.2	3.2	1.0	5.1	1.4	1.0	1.9	2.6
Total												
Total fair value of bank's total equity ^d	9,917	11,777	26,023	27,609	10,073	11,019	8,684	8,861	5,525	4,419	60,222	63,685
The change in the fair value of the bank's total equity as a result of an interest rate change ^b												
1 percentage point increase	639	613	-1,178	-1,289	-822	-963	-239	-40	-452	-453	-2,052	-2,132
1 percentage point decrease	-1,255	-1,391	1,478	1,407	962	1,240	241	685	557	498	1,983	2,439
The change in the fair value of the bank's total equity as a percentage of the net fair value of the bank's total equity												
Interest rate increase	6.4	5.2	-4.5	-4.7	-8.2	-8.7	-2.8	-0.5	-8.2	-10.3	-3.4	-3.3
Interest rate decrease	-12.7	-11.8	5.7	5.1	9.6	11.3	2.8	7.7	10.1	11.3	3.3	3.8

^a The difference between the fair value of assets and the fair value of liabilities, including the effect of futures transactions in each indexing segment

^b Based on published financial statements - directors report: "The effect of potential changes in interest rates on the net fair value of financial instrument"

^c Including the foreign-currency-indexed segment

^d The total of net positions in the three indexing segments

SOURCE: Banking Supervision Department based on published financial statement

Table 1.21
Exposure to changes in the CPI and the exchange rate, the five banking groups, December 2015 and December 2016

	Leumi		Hapoalim		Discount		Mizrahi-Tehnot		First International		Total system	
	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016	2015	2016
Unindexed segment												
Total assets (excluding futures transactions and options)	270,159	291,150	281,512	304,559	126,463	140,573	134,423	159,317	92,050	97,910	904,607	993,509
Total liabilities (excluding futures transactions and options)	219,518	239,055	247,782	260,287	111,717	125,354	121,141	135,767	77,439	83,617	777,597	844,080
Effect of futures transactions and options	-25,208	-24,142	-13,910	-20,919	-11,063	-12,222	-12,558	-16,812	-9,321	-9,350	-72,060	-83,445
Total position in the segment ^f	25,433	27,953	19,820	23,353	3,683	2,997	724	6,738	5,290	4,943	54,950	65,984
The bank's total equity^{b,c,e}	22,424	25,488	27,022	28,202	9,846	11,302	10,764	11,664	5,477	5,835	75,533	82,491
CPI-indexed segment												
Total assets (excluding futures transactions and options)	51,672	48,573	51,782	47,099	19,257	20,211	52,733	50,352	13,241	12,594	188,685	178,829
Total liabilities (excluding futures transactions and options)	50,997	47,588	41,391	40,438	13,969	12,116	36,800	39,883	12,539	11,541	155,696	151,566
Effect of futures transactions and options	-1,308	-1,469	-2,106	-626	-2,047	-3,076	-5,911	-5,590	-505	-239	-11,877	-11,000
Total position in the segment ^f	-633	-484	8,285	6,035	3,241	5,019	10,022	4,879	197	814	21,112	16,263
Maximum change in the CPI ^f (percent)	0.9	0.7	0.9	0.7	0.9	0.7	0.9	0.7	0.9	0.7	0.9	0.7
Loss as a result of the maximum change in the CPI												
CPI increase	6	3	-	-	-	-	-	-	-	-	6	3
CPI decline	-	-	74	40	29	34	89	33	2	5	194	112
Foreign currency segment^d												
Total assets (excluding futures transactions and options)	85,592	89,768	91,289	88,346	55,338	54,371	20,174	18,971	16,165	13,958	268,558	265,414
Total liabilities (excluding futures transactions and options)	114,880	117,081	108,388	111,077	65,526	66,383	38,624	41,326	26,001	23,469	353,419	359,336
Effect of futures transactions and options	26,912	25,332	16,016	21,545	13,110	15,298	18,468	22,402	9,826	9,589	84,332	94,166
Total position in the segment ^f	-2,376	-1,981	-1,083	-1,186	2,922	3,286	18	47	-10	78	-529	244
Maximum change in the exchange rate ^f (percent)	5.3	4.8	5.3	4.8	5.3	4.8	5.3	4.8	5.3	4.8	5.3	4.8
Loss as a result of the maximum change in the exchange rate ^f												
Weakening of the shekel (depreciation)	125	96	57	57	-	-	-	-	1	-	183	154
Strengthening of the shekel (appreciation)	-	-	-	-	154	159	1	2	-	4	155	165
Total maximum loss to the bank's total equity as a result of indexation base risk^h	131	99	131	98	183	193	90	35	2	9	377	278
As a percentage of the bank's total equity	0.6	0.4	0.5	0.3	1.9	1.7	0.8	0.3	0.0	0.2	0.5	0.3

^a The total position in the segment as the difference between assets and liabilities in the segment, including the effect of futures transactions.

^b The difference between assets and liabilities in all segments includes the effect of futures transactions (excluding nonmonetary items), per the Note to the published financial statements "Assets and liabilities by indexation segment".

^c The bank's total equity is attributed (by definition) entirely to the unindexed segment, with the result that the nominal exposure to indexation bases occurs in the indexed segment and in the foreign currency segment.

^d The maximum change in the CPI derived from monthly changes in inflation expectations during the past 7 years, assuming a normal distribution and a significance level of 99 percent.

^e Including foreign-currency indexed. The calculation of the banking corporations' exposure to foreign currency in this survey is based on the positions obtained from the Note to the financial statements entitled "Assets and Liabilities by currency and by term to repayment". The positions presented do not take into account taxation effects, while the banking corporations may take them into account when managing the exposure.

^f The maximum change in the nominal shekel-dollar exchange rate, which is derived from monthly changes in the exchange rate over the past 7 years, assuming a normal distribution and a significance level of 99 percent.

^g The change that will occur in the bank's position as the result of a maximum change in the shekel-dollar exchange rate.

^h The total maximum loss as a result of indexation base risk is obtained by simple addition of the maximum losses as a result of risks in the indexed segment and the foreign currency segment, assuming that the maximum change will occur in the direction that causes the bank the maximum loss.

SOURCE: Banking Supervision Department based on published financial statements and Central Bureau of Statistics data.

CHAPTER 2

MAIN CHANGES IN THE BANKING SYSTEM

Banking systems in advanced economies have undergone far-reaching changes in the aftermath of the global financial crisis. Various factors set these developments in motion: changes in the technological environment and in consumers' preferences, the entry of competitors from outside the industry, new financial regulation, and, in most Western countries, a challenging macroeconomic reality.

These factors affect Israel and its banking system as well. Even though Israel's banks proved resilient to the global crisis, the ensuing changes in the business environment are presenting them with major challenges. Globalization processes, technological changes, and new developments in banking activity worldwide, along with domestic processes such as changes in social thinking, legislation, and regulation, have changed the face of the business environment in which Israel's banks operate.

There are three main processes underlying the changes in Israel's banking business environment:

- a. **A challenging macroeconomic reality, typified by long-term low interest rates,** is reducing the banks' income even as their activity is affected by low unemployment and surging private consumption. These developments have eroded the banks' structural profit sources and their ability to generate interest income from their assets, forcing them to rethink their main activity segments and adapt their activity models. They must do this in order to remain competitive and relevant in an era in which new players are already operating, and will be operating, on the basis of different activity models typified by no physical infrastructure, no banking license, and a low cost structure. The banks are also seeking sources of income in additional ways and, with the Banking Supervision Department's assistance, have begun to implement meaningful and comprehensive efficiency programs.
- b. **The increase in consumer and public awareness since the social protests of 2011, the Banking Supervision Department's emphasis on amplifying customers' power as consumers, and the implementation of structural changes to increase competition in banking and financial services** have made banking more transparent and fair. These processes have been accompanied by significant regulatory and legislative changes that are aimed at enhancing competition in the delivery of banking services, but that also carry risks. These moves, including the future divestiture of two credit card companies by the two largest banks, will require the banks to adjust their activity and to become more attentive to the public's wishes.
- c. **Technological developments in financial communication and innovation** are abetting changes in the public's financial service consumption habits and

The banking systems in advanced economies, including Israel, have been undergoing far-reaching changes in recent years.

There are three main processes underlying the changes: a challenging macroeconomic reality, increased consumer and public awareness, and technological developments.

The changes in the business environment necessitate a good understanding of the new reality, adaptation of the business model, and understanding and monitoring the challenges and risks that the new environment portends.

have led to the adoption and assimilation of technologies meant to improve the banks' internal processes and develop new self-service channels. By assimilating advanced technological means, banks can progress and respond to the public's changing requirements by aligning their communication channels with consumers' preferences and managing their production factors more efficiently.

These changes in the business environment pose a challenge to the Israeli banking system and policymakers. They necessitate a good understanding of the new reality, reexamination of banking business models, and understanding and monitoring the challenges and risks that the new environment portends—along with continued responsible, controlled, and prudent conduct to maintain the stability of the banking system and to protect the good of the public.

This chapter reviews the main changes in the activity of Israel's banking system in 2016 and onward. Part 1 discusses the advancement of competition in retail banking, Part 2 concerns operational efficiency in the use of bank branches and personnel, and Part 3 deals with digitization and innovation.

1. PROMOTING COMPETITION IN RETAIL BANKING

The measures meant to enhance banking competitiveness are complex and long-term processes, the results of which will be seen gradually over the next few years.

The changes in Israel's socioeconomic-business-technological environment are catalyzing significant changes in the banking industry and, in turn, an increase in competitive pressure. In recent years we have seen changes in the technological environment that are making it easier for new players to enter various areas of banking, as well as changes in the way the public consumes banking services. In view of these external changes, increasing competition in banking activities has been defined as an objective to which many players in the economy subscribe: policymakers and regulators (Bank of Israel, Ministry of Finance, Antitrust Authority, and additional government entities), service providers (banks and existing and new nonbank entities) and, of course, consumers. This objective has been translated into a broad set of initiatives meant to invigorate competition, with implementation beginning in 2016 and continuing in 2017. It should be borne in mind, however, that restructuring the market and stimulating competition are complex and long-term processes, the results of which will be seen gradually only in the next few years.

Competition in retail banking and payments has been evolving only in recent years. In contrast, competition in business lending expanded greatly even earlier and is vigorous today, as institutional players became active in lending to large firms and those firms are able to raise sources on the capital market. Due to these alternatives to bank credit, some 50 percent of business credit is no longer provided by banks.

For the past two years, the Banking Supervision Department has been promoting competition in the retail and small business field with an emphasis on supply-side structural reforms, particularly lowering entry barriers and

restructuring the market to increase the number of competitors in the financial-banking market and expose existing players to competitive pressure. In previous years, the Department emphasized stepping up competition by influencing the public's demand for banking services through measures that would increase the banking consumer's power.

The main measures taken in the reviewed year to promote competition on the **supply side**, some of which were implemented as part of the recommendations of the Strum Committee (on increasing competition and mitigating concentration in the domestic banking market), were: lowering capital requirements for new merchant acquirers and banks; lowering technological barriers, while amending the Banking (Licensing) Law, allowing one bank to host another for its technological systems, and encouraging the establishment of a joint computer center that would serve several banks; lowering expectations that banks will open new branches and expanding the public's opportunities to use remote banking services, including the issue of a Proper Conduct of Banking Business Directive on "E-banking"; revising the Bank of Israel's licensing procedures to give prospective licensees greater certainty about receiving licenses and helping candidates for opening a new bank or merchant acquirer; and advancing the policy of encouraging greater efficiency in the banking system, which is likely to lower costs and prices and allow banks to price their services more competitively. The idea behind all these moves is to allow a new bank or merchant acquirer to join the industry—which has already happened in 2017 (a new merchant acquirer)—and to enable the credit card companies that the banks will spin off to become significant players in the market of credit and other financial products for the public.

On the demand side, the Banking Supervision Department is focusing its efforts on improving the transparency of information to customers about the range and cost of banking products and services that they consume, enhancing customers' financial awareness, and creating more convenient tools for comparison shopping among banks. The Department began to take these measures as part of the implementation of the recommendations of the Interministerial Team to Examine How to Increase Competitiveness in the Banking System (Zaken Committee) and is continuing to implement them in its ongoing work. Concurrently, the Bank of Israel has been making additional moves to bring down barriers, foremost the development of a central credit register that will facilitate the risk-adjusted and more accurate pricing of credit.

The banks have also been analyzing the changes in the business environment. Realizing that their business model has to be revised and adjusted to the changing environment, they have been making large and comprehensive changes in their activities. Their actions are expected to afford them greater flexibility in their business activity and bolster their competitive resilience against other banks and nonbank entities that are entering various areas of banking business, as well as new players that are likely to come into being. The banks' diverse actions in this context are manifest in

The Banking Supervision Department has been working to increase competition in banking by lowering entry barriers to new competitors and increasing consumers' power.

The banks have been adjusting their business model to the changing environment by adopting new technologies, expanding their basket of products and services, and implementing efficiency programs.

expanding and focusing their “basket” of products and services offered to customers, and revising their cost structure.

It is noteworthy that the banks are focusing their products and services on the retail and small business activity segments. This is reflected in offering customers high value; tailoring financial solutions to the needs of each segment and, at times, specific individuals; developing digital means that are adjusted to customers’ tastes and requirements without detriment to population groups that have low digital literacy; strong attention to information security and defense against cyber attacks in order to keep customer information confidential; and effective handling of consumers’ complaints about banks’ conduct. In addition, the banks are acting to improve the availability and quality of their services, help customers in states of personal or financial failure or hardship, and provide the public (foremost retail consumers of all ages, and small businesses) with more extensive financial knowledge, which helps them to improve their economic conduct and even their economic situation. They are also offering products that allow customers to manage their finances more effectively, they are becoming more involved in the community, and more.

Among the more prominent changes the banks are making to their cost structures, the banks are assimilating meaningful efficiency plans and revising processes in order to cut expenses, adapting staff to a new working environment, and promoting technological improvements that reduce costs for the bank itself and for the customer, among other measures. (See elaboration in Box 2.2—“Efficiency Programs in the Banking System.”)

While some pro-competition measures have already being taken and others are expected to follow, it should be borne in mind that this is a complex and lengthy process that will show its results gradually over the next few years. It is predicated on eliminating barriers, which is complex and continuous, changes in the technological and business environment, and changes in the public’s tastes and consumers’ conduct. Competition-stimulating measures include regulatory and policy changes, adoption of new technologies by banks and nonbank entities, “educating the market,” continued enhancement of consumers’ financial awareness, and encouraging them to be more active in their consumption of financial services. There is no doubt that those who share this goal must continue implementing the process while constantly examining its progress and the implications of the changes made.

It is important to measure, over time, the outcomes of all the measures that have been carried out and their contribution to the enhancement of competition and improvement of customers’ situation. It should not be forgotten, however, that the development of competition is not measured by one single indicator, but is composed of diverse elements such as the number of players in the market, the level of access and quality of financial services, tailoring the products to the public’s needs and tastes, the extent of the competitive threat, and the price and substitutability of the products offered. The Bank of Israel is acting to construct systematic measures of all of these parameters and to publish them.

Box 2.1**Legislative Initiatives in the Banking Activity Environment and the Importance of Establishing Regulatory Certainty**

- The financial system is a complex mechanism that plays a central role in the stability of the economy and in individuals' lives. Due to its centrality and its acute sensitivity to shocks, governmental authorities must display responsibility and strong involvement in its supervision and regulation in order to protect the public good.
- Many legislative initiatives in the fields of banking and finance have been put forward in recent years. In addition, the Banking Supervision Department has spearheaded many regulatory changes meant to stimulate competition, enhance banking customers' power, and bolster the banks' stability, as part of the lessons of the global financial crisis.
- The regulatory changes in banking, as a whole, are beginning to pay off. To attain their outcomes in full, however, many assimilative processes are needed.
- In addition to the regulatory changes, the banking system is being challenged by its undertaking to implement far-reaching efficiency programs and adjust to an environment that is changing under the influence of technological developments and the entry of new rivals.
- Many major changes in the "rules of the game," will create risks, may make the goals of legislation harder to attain, and may even incur high costs that may be rolled over to consumers unless financial service entities are given a chance to assimilate them.
- Regulatory uncertainty may also deter new investors and players from entering the market. The International Monetary Fund addressed the situation in Israel in this context and noted the risk of over-regulation.
- It is the Banking Supervision Department's position that to assure the public interest after the uninterrupted series of legislative and regulatory changes in the past two years, the Department should now be given time to implement the legislation as it exists today and that the banking and financial system should be allowed to assimilate its implications and settle into the new equilibrium that the regulatory changes were meant to attain.

The financial system is a complex one that figures centrally in the stability of the economy and in people's lives. Due to its centrality and its acute sensitivity to shocks, governmental authorities must display responsibility and strong involvement in its supervision and regulation in order to protect the public good. Therefore, financial systems in Israel and around the world are subject to tough legislation and regulation that aim to maintain the stability of financial institutions and the financial system, preserve the fairness and efficiency of the markets, and protect consumers and investors.

In recent years, we have witnessed, and have been partners in, widespread legislation that seeks to enhance competition in the banking system and give retail customers—households and small businesses—more power. The aftermath of the 2011 social protests was typified by regulatory activism, multiple private and governmental legislative initiatives, and a significant increase in the involvement of parliamentary committees in banking and finance matters. During these years, for example, several

interministerial committees drafted recommendations that evolved into meaningful reforms in the industry—including the Zaken Committee on enhancing competitiveness in the banking industry, which issued its recommendations in 2013; the Brees task force on the regulation of extra-institutional financial activity, the recommendations of which were cited in a legislative memorandum issued in August 2015; and the Strum committee on increasing competition and reducing concentration in the domestic banking market, which published its recommendations in 2016. The recommendations of these panels were applied, and are being applied, in intensive legislative and regulatory actions. Concurrently, additional legislation concerning the banking field is being advanced. This is all in addition to the many additional regulatory changes spearheaded by the Banking Supervision Department. The Department's moves are derived from the need to reconcile directives in Israel with regulatory changes abroad, changes in risk environments, and its own goals—promoting competition, efficiency, technology and innovation, and maintaining fairness in the banking system.

To assimilate these multiple changes, the banking system needs to invest massive managerial and organizational resources in overhauling computer systems, revising legal contractual arrangements, and so on. Accordingly, the outcomes of the widespread legislation and regulation are not immediate but will be felt gradually. Even though the many changes are based on professional considerations, cautiously implemented, and meant to benefit the banking system's customers, their cumulative effect will be assessable only after they are fully implemented. Only then will it be possible to determine whether they met their goals or came with undesired implications.

The many requirements imposed on the banking system should be implemented in tandem with a profound and equally important change that the system is being asked to carry out—improving its efficiency and adjusting its business model to the evolving technological world. A thorough and substantial efficiency drive is needed so that Israel's banks may operate at levels of efficiency that resemble those in the Western world and, thus be able to present the public with competitive offers, even as the technological revolution is transforming the face of banking and opening competition to nonbank entities.

The immensity of the legislative and regulatory changes, coupled with their simultaneity, are changing the “rules of the game” for the banks' activities and increasing risks and uncertainty in the industry. Furthermore, many of the changes are imposing a regulatory burden on the supervised entities and subjecting them to adjustment costs that may be passed on to consumers.

It is important to bear in mind that so many changes, made so quickly and without enough time given to assimilate them, may also deter new players from entering the market, which would actually reduce competition.

The regulatory burden issue is neither exclusive to Israel nor typical solely of the financial system. Recently, the government defined mitigation of the excessive regulatory burden as a central objective, and international financial institutions (BIS, IMF) are also ascribing more and more importance to the regulatory burden on supervised corporations. The international standard that has been determined is that the regulator should address the question of regulatory burden whenever it issues an instruction and should test the benefit of the instruction to financial stability and the public against the costs of its implementation. In its 2016 review of the Banking Supervision Department's activity, the IMF's economists also called attention to the risk of over-regulation and political influence on regulators in Israel:

“Further strengthening the financial stability framework while reducing regulatory uncertainty is needed to fully realize the benefits of greater competition. [...] It is important to safeguard the operational independence of each financial regulator from political pressures, including to ensure that potential new entrants are not deterred by uncertainty about future regulatory arrangement.”

It is the Banking Supervision Department’s position that after the series of legislative and regulatory changes in the past few years, new legislation should be avoided as much as possible in order to give the Department time to implement the new legislation and to allow the banking and financial system to assimilate its implications and settle into the new equilibrium that the regulatory changes were meant to attain. Furthermore, the Department believes that in order to bring new entrants into the system (whether through the acquisition of credit card companies or by establishing a new bank), investors should be given a horizon of regulatory certainty and stability.

It deserves clarification and emphasis that, none of this means to imply that Department’s powers or those of the legislature to require the banking system to make additional important and urgent changes, if such become necessary, should be cut back. Additional regulation, however, should be undertaken only after all the implications of the changes underway are understood, with proper balance maintained between the benefit of an additional legislative change and the uncertainty and burden attending to it.

Below is a list of main legislative measures advanced over the past two years—statutes and bills—that pertain directly to the banking system or have a major influence on the banks’ activity and competitive environment and are in various stages of legislation or have been passed into law. During the relevant period, the Banking Supervision Department also addressed itself regularly to dozens of additional private member’s bills on a wide range of topics, which are not included in this list.

Statutes

1. **Enhancement of Competition and Narrowing of Concentration in the Israeli Banking Market Law (Legislative Amendments), 5777–2017.** The law is meant to increase competition in the financial system and ease the entry of new players into the market. An important element in the law is the demand that the two largest banks divest themselves of the credit card companies that they own and that all banks reduce their stake in Shva. The law was published in *Reshumot* on January 31, 2017.
2. **Supervision of Financial Services (Regulated Financial Services) Law, 5776–2016.** The statute regulates the activities of financial service providers that were not previously subject to specific financial supervision, or that were subject to supervision in respect of the prohibition of money laundering and terror financing only. Its purpose is to enable the establishment of nonbank financial entities that will enhance competition in the banking system and to regulate the activities of existing entities that have operated without supervision thus far. The law was published in *Reshumot* on August 1, 2016, and amended several times since then.
3. **Securities Law (Amendment 63), 5777–2017** (also known as the “Restructuring of the Stock Exchange Law”). The statute requires the banks to make major reductions in their stakes in the Tel Aviv Stock Exchange, among other measures.

4. **Remuneration of Officers in Financial Service Corporations (Special Authorization and Non-Recognition of Aberrant Remuneration Expenditure for Tax Purposes) Law, 5766–2016.** The statute limits the wages of financial corporations' senior officers and staff. The law was published in *Reshumot* on April 12, 2016.
5. **Compulsory Caveat in Advertising and Marketing Loans Law (Legislative Amendments), 5777–2017.** The statute requires banks and other lenders to include, in their advertising and telephone marketing of loans, a warning to the public that explains the risk attending to default. The law was published in *Reshumot* on March 1, 2017.
6. **Economic Program Law (Legislative Amendments for Implementation of Economic Policy in Fiscal Years 2015 and 2016), 5776–2015, and, within its framework, the Banking (Licensing) Law (Amendment 21).** The amendment allows financial entities to raise sources and issue credit even if they are not defined as banks and are not supervised by the Bank of Israel. Thus, it allows such entities to issue liability certificates that require a prospectus and to extend credit even if they are not banking corporations, provided the proceeds of the issue of certificates does not exceed NIS 2.5 billion or another sum up to a maximum of NIS 5 billion if the Minister of Finance so determines subject to additional terms. The law was published in *Reshumot* on November 30, 2015.
7. **Economic Program Law (Legislative Amendments for Implementation of Economic Policy in Fiscal Years 2017 and 2018), 5777–2016.** Within the framework of this statute, a number of amendments were made to the Supervision of Financial Services (Regulated Financial Services) Law in matters such as the licensing of deposit and credit unions and issuers. The law was published in *Reshumot* on December 29, 2016.
8. **Banking (Licensing) Law (Amendment—Closure of Branches), 5775–2015.** The amendment, implemented in 2016, requires banking corporations to advise the Supervisor of Banks of their intention to close a branch at least sixty days before said closure, allows the Supervisor of Banks to object to this, and allows the banking corporation to present its claims. Pursuant to the legislation, the Banking Supervision Department issued a Proper Conduct of Banking Business Directive that regulates the closure of bank branches, the downscaling of teller services, and the changeover to direct-channel service in a way that responds to various customers' needs. The law was published in *Reshumot* on August 16, 2016.
9. **Amendment of Income Tax Ordinance (no. 227) Law, 5776–2016, and Income Tax Regulations (Implementation of FATCA Agreement), 5776–2016.** The legislation is meant to implement an agreement concluded between the governments of Israel and the United States (FATCA—Foreign Account Tax Compliance Act) concerning the sharing with the US Internal Revenue Service of information in the possession of financial institutions in Israel regarding American citizens' accounts. The legislation lays the groundwork for the implementation of agreements concerning automatic information-sharing between Israel and additional countries in accordance with the OECD-developed CRS standard. It requires banks to make extensive preparations and meet many requirements for monitoring customer activity. The law was published in *Reshumot* on July 14, 2016.
10. **Prohibition of Money Laundering Law (Amendment 14), 5776–2016.** The statute defines grave tax offenses as source offenses and expands the requirements of banks relating to offenses originating in tax evasion. The law was published in *Reshumot* on April 7, 2016.
11. **Electronic Check Settlement Law, 5776–2016.** The statute allows banks to switch from physical settlement of checks to electronic settlement and required them to make major preparations. The law was published in *Reshumot* on the February 10, 2016.

12. **Credit Data Law, 5776–2016.** The statute creates a comprehensive arrangement for the sharing of credit data, including provisions for the collection of such data from information sources designated in the law, keeping said data in a central database to be run by the Bank of Israel, and sharing credit data with credit bureaus for processing and forwarding to credit providers, while maintaining customers' interests and privacy. The law was published in *Reshumot* on April 12, 2016.
13. **Protection of Privacy (Information Security) Regulations, 5777–2017.** These regulations will be extended to the banks, and will establish principles pertaining to management and use of information in databases, in addition to those set forth by the Banking Supervision Department concerning information security.

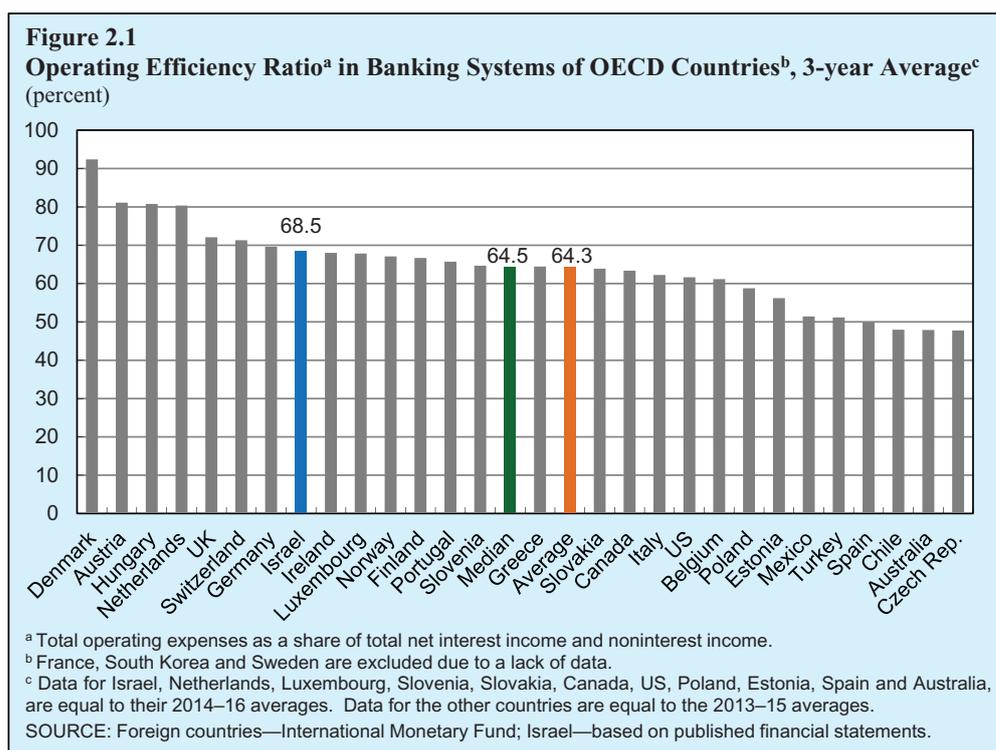
Examples of bills in the legislative pipeline

14. **Regulation of Nonbank Loans Bill (Amendment 3), 5775–2015** (renamed “Fair Credit Bill”). The bill sets a maximum interest rate on loans issued by any creditor countrywide.
15. **Insolvency and Economic Rehabilitation Bill, 5775–2015.** The bill proposes a comprehensive insolvency reform and seeks to fully regulate all personal and corporate insolvency law.
16. **Supervision of Financial Services (Regulated Financial Services) Bill (Amendment 4) (Operation of A Credit Intermediaries System), 5777–2017.** The bill regulates the activities of P2P credit intermediary systems.
17. **Banking (Service to the Customer) Bill (Amendment—Reporting on Exploitation of Elderly or Defenseless Persons), 5775–2015.** The bill is meant to minimize the economic exploitation of elderly and defenseless persons by establishing the expectation that bank clerks will detect such cases.
18. **Supervision of Financial Services (Insurance) Bill (Amendment—Housing Loan Insurance in Event of Unemployment), 5777–2016.** The bill offers a solution to cases in which a mortgage borrower loses his or her source of livelihood and encounters repayment difficulties. It will affect the banks' lending considerations.
19. **Supervision of Financial Services (Regulated Financial Services) Bill (Amendment) (Interest-Free Deposit and Credit Services), 5777–2016.** The bill regulates the activities of individuals, nonprofit organizations and public welfare corporations in reference to issuing interest-free loans and accepting interest-free deposits. The banking system is required to provide these financial service entities with an infrastructure for their activity.
20. **Banking (Service to the Customer) Bill (Amendment—Material Provider of Discounting Services), 5776–2016.** The bill seeks to add the presumption that refusal to allow contracting between a discounting service provider and a supplier due to credit or a loan that the supplier took from a merchant acquirer shall be deemed unreasonable. It also proposes to establish rules concerning the fee that a merchant acquirer may charge for settlement services.
21. **Bill of Pledges, 5775–2015.** The bill replaces the arrangements set forth in the Pledges Law and the Companies Ordinance with a new arrangement.
22. **Legislative Memorandum: War on Terrorism (Declaration of Foreign Organizations and Activists) (Amendment 2), 5777–2017.** The memorandum allows financial entities to take immediate action to freeze property and financial activities in the accounts of foreign organizations and activists that have been declared terror organizations or terror activists.

2. BANKING SYSTEM OPERATING EFFICIENCY, BRANCHES, AND PERSONNEL

The efficiency of Israel's banking system, measured via conventional efficiency ratios, is low compared with other advanced economies.

The efficiency of Israel's banking system, measured via conventional efficiency ratios, is low compared with other advanced economies (Figure 2.1). The operating efficiency ratio¹ of the five large banking groups was 66.4 percent at the end of 2016, slightly below the average in recent years (Table 2.1), while average cost² was 2.09 percent, further to the continued improvement in this indicator in recent years. The banks' efficiency ratios vary as a function of each bank's activity, size, staff characteristics, labor accords, and extent of technological progress, among other factors. Improving the operating efficiency of the Israeli banks and bringing them in line with the norm among similar banks in other advanced economies is one of the Banking Supervision Department's primary objectives. (See elaboration in Box 2.2—"Streamlining the Banking System.") For several years, the banks' efforts to adjust to changing market conditions and become more competitive and profitable have been manifested in initiatives to improve their production function and operational efficiency. However, it must be remembered that these processes are lengthy and complex, have an effect on staff and customers, and, in their initial stage, are quite costly.



¹ The ratio of total operating and other expenses to total net interest income and noninterest income (cost to income ratio).

² The ratio of total operating and other expenses to the average asset balance (average cost ratio).

Table 2.1
Cost per Output Unit^a and Efficiency Ratio^b of the Banking Groups in Israel, 2012–16
 (percent)

Year	Leumi	Hapoalim	Discount	Mizrahi - Tefahot	First International	The five groups	Union	Bank of Jerusalem	Dexia	Total banking system
2012	2.46	2.43	2.89	1.78	2.72	2.46	2.06	2.14	0.53	2.43
2013	2.35	2.39	2.96	1.73	2.64	2.40	2.09	2.27	0.58	2.38
2014	2.43	2.33	3.15	1.61	2.55	2.40	2.09	2.56	0.51	2.38
2015	2.17	2.09	2.78	1.58	2.23	2.16	2.05	25.80	0.62	2.15
2016	2.01	2.16	2.74	1.50	2.12	2.09	2.46	2.72	0.59	2.10
2012	74.9	65.2	75.5	58.2	74.1	69.9	78.7	73.9	36.2	70.0
2013	68.9	66.2	78.1	59.5	74.3	69.1	80.1	80.5	37.3	69.3
2014	74.9	65.5	87.0	60.9	77.3	72.5	87.9	75.8	32.2	72.7
2015	65.9	61.2	78.7	59.8	77.6	66.7	87.6	76.7	40.5	67.1
2016	66.3	64.5	72.6	58.5	73.5	66.4	95.4	75.7	40.4	67.1

^a The ratio between total operating and other expenses and the average balance of assets (average cost).

^b The ratio between total operating and other expenses and the total maximum net income and noninterest income (cost to income).

SOURCE: Based on published financial statements.

The entry of technological tools into the banking industry is allowing the banks to adapt to the new reality.

A decade of technological revolution in the financial services industry and the entry of technological tools into the banking industry³ require the banks to adapt to the new reality by revising their business models and managing their production factors and processes more efficiently. The combination of technological developments and changing consumer preferences is allowing the banks to make products and services available to customers by remote access, and thereby to cut back on their costly branch systems. In the near term, these processes force the banks to invest huge sums, but in the future they are likely to help them cut their expenses.

Trends in the number of the bank branches

The number of bank branches in Israel continued to trend downward in 2016—part of a general tendency among banking systems in many advanced economies.

The number of bank branches in Israel continued to trend downward in the reviewed year (particularly in the major cities)—part of a global tendency among banking systems that began in the immediate aftermath of the global financial crisis but started in Israel several years later. The main reasons for the decline are the banks' adoption of new technologies, changes in consumer habits and preferences regarding banking services, increased competition in retail banking activity from nonbank service providers, banking regulation that encourages competition and operational efficiency, and the erosive effect of the macroeconomic environment on the banks' structural sources of earnings. (For elaboration, see Box 2.3—"Deployment of Bank Branches in Israel and Abroad—Current Trends and Challenges.")

In 2016, there were 1,110 bank branches in Israel, a net decline of 2 percent (23 branches), approximating the decrease in 2015 (Figure 2.2). Similar to previous years, much of the decline took place in central and very central localities (usually by merging the activities of nearby branches), while there was no substantial change in localities ranked as peripheral⁴ and medium-peripheral (Figure 2.3). Although the number of branches in Arab localities continued to grow, the countrywide total continued to decline due to the stronger ongoing downward trend in Jewish and mixed-population localities (Figure 2.4).

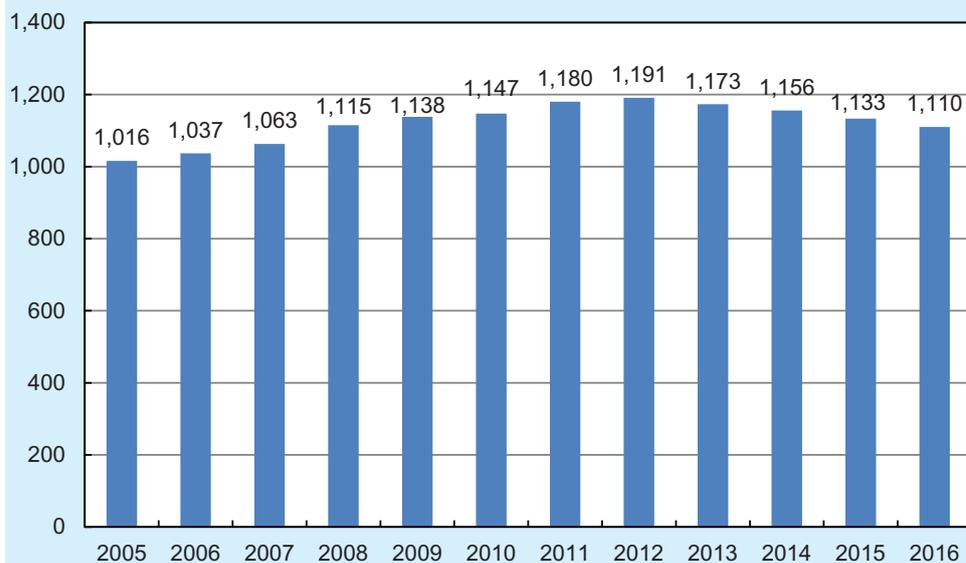
The Banking Supervision Department is acting to ensure that this downsizing of the number of bank branches does not impair the good or well-being of consumers. Against the background of an amendment to the Banking (Licensing) Law that requires banks to obtain permission from the Supervisor of Banks to close any branch⁵, the Department issued Proper Conduct of Banking Business Directive no. 400, which regulates the matter. According to the directive, a bank that wishes to close a branch must offer its customers suitable alternative ways of accessing the full

³ See elaboration in Box 1.1 of Israel's Banking System—Annual Survey 2015: "Technological innovation in financial services: Fintech companies and digitalized banking."

⁴ Peripheralities is calculated by taking into account two identically weighted indices: "the proximity of the municipal authority to the boundary of Tel Aviv District" and "potential access" (which weights the proximity of a municipal authority to other municipal authorities countrywide and their population size). The peripherality of municipal authorities in Israel is based on measurements by the Central Bureau of Statistics in 2008 on the basis of 2004 data.

⁵ Banking (Licensing) Bill (Amendment 22) (Closure of Branches), 5776–2016.

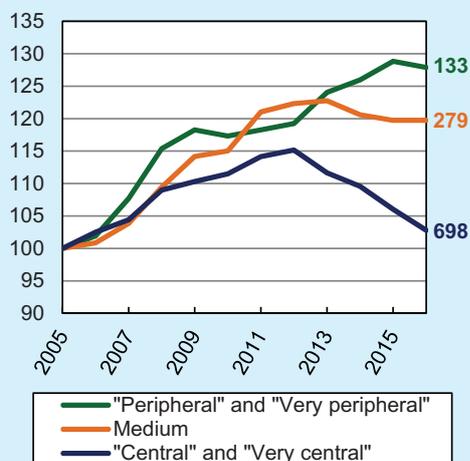
Figure 2.2
Number of Branches^a, Total Banking System, 2005—16



^a Operating in Israel.

SOURCE: Based on reports to the Banking Supervision Department.

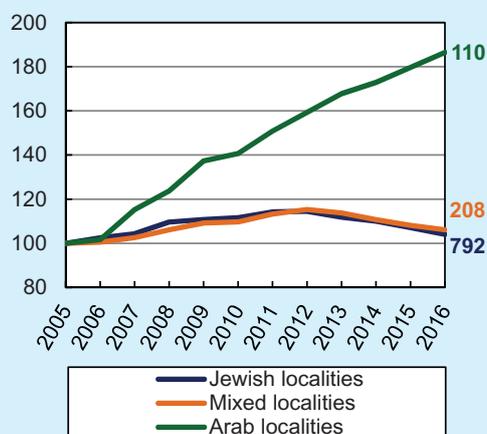
Figure 2.3
Development of Number of Branches, by Periphery Extent^a, Total Banking System, 2005—16 (Index: 12/05=100)



^a Periphery level of local authorities in Israel as measured by the Central Bureau of Statistics in 2008, based on data from 2004.

SOURCE: Based on CBS and reports to the Banking Supervision Department.

Figure 2.4
Development of Number of Branches by Population Segment^a, Total Banking System, 2005—16 (Index: 12/05=100)



^a Mixed localities: Those where the Arab population exceeds 10% of residents: Haifa, Jerusalem, Lod, Maalot-Tarshiha, Nazereth Ilit, Acco, and Ramle.

SOURCE: Based on reports to the Banking Supervision Department.

range of banking services—referral to a nearby branch, leaving automatic machines in the vicinity of the closed branch, opening a mobile or partial service branch, giving instruction and support in switching to direct banking channels, and so on.

In view of these changes in the world of financial services, the Banking Supervision Department's instructions, and the banks' efficiency programs for coming years, most of the banks are likely to continue streamlining their branch systems in coming years as well. The efficiency drive will include changes in the number and structure of branches in order to make them more economical, more technological, and better able to provide focused responses to individual customers' specific needs. (For elaboration, see Box 2.3, "Deployment of Bank Branches in Israel and Abroad—Current Trends and Challenges.")

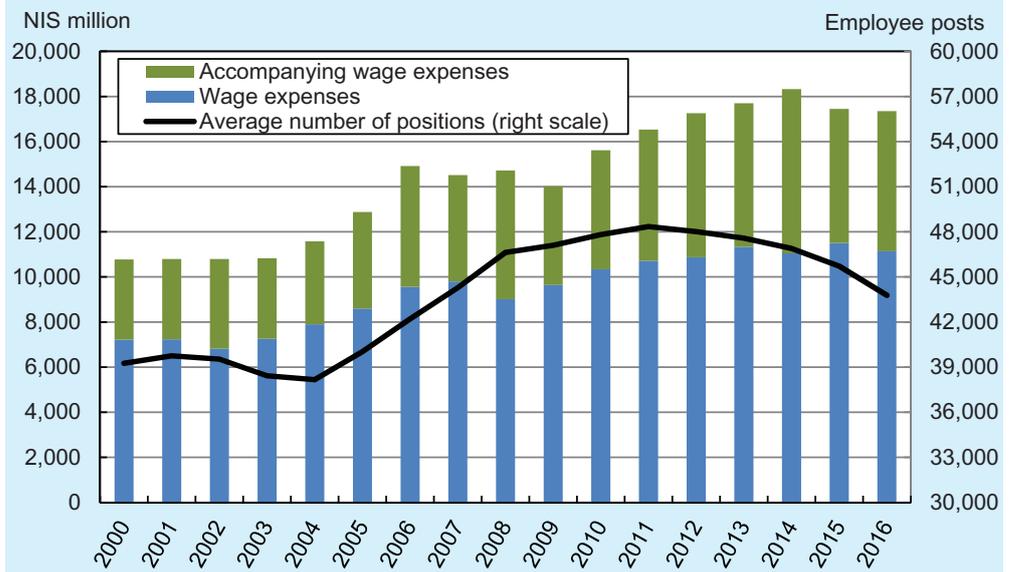
Most of the banks are likely to continue streamlining their branch systems in coming years as well.

Personnel and payroll developments

Many of the banking system's efficiency measures in recent years have been carried out by adapting human resources and branch deployment to changing realities. This process, as stated, is likely to continue in coming years as the banks implement their efficiency plans and in accordance with the Banking Supervision Department's demands. The cutback in personnel is being implemented by means of programs that encourage voluntary retirement in return for a package of benefits.

Many of the banking system's efficiency measures in recent years have been carried out by adapting human resources and branch deployment to changing realities.

Figure 2.5
Average Number of Employee Posts, and Wage and Accompanying Expenses in Respect of Employees^a, the Five Banking Groups, 2000–16



^a Accompanying expenses include severance, benefits, advanced training fund, pension, vacation, National Insurance and payroll taxes, other peripheral expenses, voluntary retirement expenses, and employee options benefits.

SOURCE: Based on published financial statements.

Table 2.2
Number of employee posts and expenses by annual salary levels,
the five banking groups, 2015 and 2016^a

	2015		2016		Annual change in number of employee posts (percent)	Annual change in salary expenses (percent)
	Number of employee posts	Salaries and related expenses (NIS million)	Number of employee posts	Salaries and related expenses (NIS million)		
Active employees at offices in Israel - yearly salary levels (NIS thousand)						
Up to 60	83	2	74	2	-10.8	-16.6
60 to 120	6,013	566	5,251	494	-12.7	-12.7
120 to 240	15,074	2,848	15,532	2,895	3.0	1.7
240 to 360	12,054	3,406	11,735	3,449	-2.6	1.3
360 to 600	7,903	3,478	7,808	3,667	-1.2	5.4
600 to 1,000	1,792	1,273	1,850	1,324	3.3	4.0
Above 1,000	347	523	300	453	-13.4	-13.3
Total wage and related components attributed to active employees at offices in Israel	43,266	12,095	42,550	12,284	-1.7	1.6
<i>of which</i> : expenses for external employees, yearly salary levels (NIS thousand)						
Up to 120	1,984	600	2,183	709	10.0	18.3
Above 120	683	68	616	63	-9.8	-7.9
Wage and related components not attributed to active employees at offices in Israel	1,301	531	1,567	647	20.4	21.7
Bank employees at offices abroad		3,804		4,112		
Salary expenses capitalized to assets	2,874	1,792	2,178	1,376	-24.2	-23.2
Total	-847	-340	-953	-424	12.6	24.6
	45,293	17,351	43,775	17,348	-3.4	-0.0

^a In the report on the number of employee posts and expenses by annual salary levels, no comparative data are obtained. Thus, the data presented for 2015 are not revised. Total employee posts to the end of 2015 were 45,714. Total salaries and related expenses were NIS 17,447 million.

SOURCE: Based on published financial statements and reports to the Banking Supervision Department.

The banks' voluntary retirement process was launched in 2016, and led to a decline of more than 1,900 in the average number of employee posts systemwide.

The banks' voluntary retirement process, based on the efficiency programs that they presented to the Banking Supervision Department, was launched in 2016, and led to a decline of 4.2 percent⁶ (about 1,939 posts) in the average number of employee posts systemwide, further to the trend in recent years (Figure 2.5). Concurrently, wage and related expenditure⁷ edged downward (by about 0.6 percent) as wage expenditure fell by close to 3 percent while related outlays actually increased by about 4.5 percent. Employee posts and wage expenditure declined both at low income levels and at the highest staff and executive level (more than NIS 1,000,000). The decrease in wage expenditure at these levels, however, was offset by an increase in spending in medium wage brackets (Table 2.2). Posts and wage expenditure on staff at foreign offices showed a particularly prominent decline due to a decrease in the offices' activity. Total average wage expenditure per employee post in the banking system increased by 4 percent.

Influenced by public controversy surrounding the wages of senior banking officers, the Knesset passed the Remuneration of Officers in Financial Service Corporations Law.⁸ This statute, meant to cap the wages of senior officers in the financial services industry⁹, went into effect in October 2016. As result, there was a wave of resignations among dozens of staff in the banking system, including senior officers. In the long term, it is important to ensure that the law, which establishes structural discrimination between the financial services sector (of which the banking industry is a part) and the nonfinancial sector in regard to remuneration of senior personnel, will not impair the quality of personnel in the banking industry relative to that in other industries.

⁶ The number of posts includes those at foreign subsidiaries and consolidated firms and conversion of overtime cost and budgets for external personnel as are required for ongoing staff adjustments and performance of projects.

⁷ Related expenditure includes severance pay, reimbursements, advanced training fund, pension, vacation, National Insurance contributions and payroll tax, other related expenses, voluntary retirement expenses, and benefits on account of allocation of options to staff.

⁸ Remuneration of Officers in Financial Service Corporations (Special Authorization and Non-Allowance of Expenditure for Tax Purposes on Exceptional Remuneration Expenditure) Law, 5766–2016, passed on April 12, 2016.

⁹ According to the law, remuneration of an officer exceeding NIS 2,500,000 per year requires a series of authorizations by the corporation's organs. In any case, no remuneration shall be approved that exceeds thirty-five times the lowest remuneration at the corporation. Any portion of wage that exceeds NIS 2,500,000 per year is not allowed to the employer as a recognized expense.

Box 2.2**Efficiency programs in the Banking System**

- **The Banking Supervision Department set advancing efficiency in the banking system as an objective for 2016 and subsequent years.**
- **The Department instructed the banks to draw up multi-year efficiency plans and worked to eliminate barriers to their implementation.**
- **The efficiency plans that the banks presented to the Department include the streamlining of internal processes and adjustments in personnel, profit centers, and real estate assets—including through the use of advanced technologies.**
- **As a result of these plans, 12 percent of bank employees (5,300 persons) are expected to retire and the number of branches is expected to drop by 20–25 percent by 2020. In 2016, the number of employee posts contracted by 4 percent (1,940).**
- **The Department’s goal is to ensure that the improvements in bank efficiency will be passed on to consumers in the form of narrower interest margins, innovations and improvements in banking services, and an increase in dividends to the banks’ shareholders—most of whom belong to the Israeli public at large (which holds the shares via its pension and provident funds).**

The Banking Supervision Department defined improving the efficiency of the banking system as an objective for 2016 and subsequent years. It sees the improvement of operational efficiency as a vital necessity for the assurance of the banking corporations’ long-term stability, competitiveness, and profitability. Accordingly, the Department instructed the banks to draw up significant multi-year efficiency plans and ensure that their efficiency and cost-cutting moves do not impair essential controls and adequate risk management, the aim of which is to maintain the stability of the banking system, and that they will not be attained at the expense of customer service. One of the factors that make this process possible is technological development, including the integration of digital means into banking activity. The Banking Supervision Department believes that this kind of streamlining, assuming that additional conditions are met, may lower costs and reduce the prices of service to the public.

The Department’s demand for long-term efficiency improvements

In a letter circulated in January 2016, the Supervisor of Banks instructed the banking corporations to draw up comprehensive multi-year efficiency plans (hereinafter: the “plans” or “plan”) and present them to the Banking Supervision Department for approval by year’s end. Concurrently, the Department gave the banks various dispensations in order to remove material obstacles to implementing the plans. One important dispensation was to allow the banks to spread out the costs of the plans over five years in a straight line for capital adequacy and leverage ratio calculation purposes. The Supervisor expected the plans to include specific measures that the banks would take during those five years as well as longer-term efficiency principles. The Department insisted that the plans set interim objectives, at an annual frequency at least, and prescribe methods that

the board of directors would use to monitor and supervise the attainment of the objectives and, where necessary, adjust the plans. The attainment of objectives and other updates are also to be reported to the Banking Supervision Department in periodic reports on the implementation of the plans. In response to the Supervisor's demand, each bank presented an efficiency program for 2016–2020. At the beginning of 2017, the Department even encouraged the banks, by giving them a dispensation on regulatory capital, to explore the possibility of spending less on real estate and on maintaining staff and management units in ways that would include reexamining the units' geographical locations.

The banks' efficiency plans focus on five main levels: (a) optimal management of personnel and payroll in ways that include introducing voluntary retirement schemes and signing new wage agreements that leave much less on “autopilot” and increase the performance-dependent share of remuneration; (b) cutting back on real estate and making processes more efficient—including by merging organizational units and revising the spread and size of branches and other real property; (c) focusing on key activities—downsizing foreign and other activities by means of outsourcing, among other measures; (d) assimilating advanced technologies for autonomous use and effective management of internal processes; (e) financial education for the public—showing customers how to switch to direct banking and developing and adopting digital media for customers' use.

An analysis of data from the banks' efficiency programs in regard to optimal personnel management shows that some 5,300 employees in the banking system, 12 percent of the system's workforce, are expected to retire by 2020—2,100 by natural attrition and the others via early retirement. Concurrently, 750 new employees are expected to be hired.

The efficiency programs are being carried out in accordance with existing labor agreements and enjoy the consent of the workers' committees, within the framework of voluntary retirement plans and guidelines from the Supervisor of Banks, in a responsible manner in which the employees and their rights are respected.

As changes in the banks' workforce are made, the deployment of bank branches is expected to change as well. By 2020, the number of branches is expected to contract by 20–25 percent relative to the situation at the end of 2015, as digital tools are developed that will allow customers to transition to direct banking, among other measures. The banking system's efficiency is expected to improve and its operating efficiency ratios are expected to resemble those typical of similar banks in other developed countries.

At the beginning of 2017, the Banking Supervision Department gave the banks extra time to formulate their efficiency plans so that they could assess the adequacy of the plans they had already presented and extend their efficiency processes to the domain of real property. In the next few years, the Department expects the banks to continue implementing the efficiency plans that have been set, extend them to their subsidiaries, and expand them to deal with additional inefficiencies.

Box 2.3**Deployment of Bank Branches in Israel and Abroad—Current Trends and Challenges**

- For several decades, until just recently, the number of retail bank branches in Israel and abroad grew steadily. Retail branches served the banks as main venues for the delivery of banking goods and services and for face-to-face encounters with customers.
- Since the global financial crisis, it has been the trend among many banks in the advanced economies to downscale their branch systems in view of macroeconomic and regulatory changes, technological innovations, and changes in consumer preferences toward consuming services at a distance.
- In Israel, as in most advanced economies, the total number of branches has begun to contract, chiefly in the large cities. The trend in Israel, however, began several years later and has been progressing more slowly.
- Although Israel has relatively few branches, access to teller services is strong—even exceeding the average in the Eurozone—because branches in Israel are larger than the Eurozone norm and numerous relative to the country’s size.
- To prevent the net closure of branches from impairing consumers’ access to banking services, the Banking Supervision Department is acting to regulate the downsizing in a way that will make it less burdensome on the population. Its measures in this respect include encouraging the banks to assimilate new technologies, enhancing the public’s awareness and financial education, and instructing the banks to provide banking services in the format of partial-service branches.

Retail bank branches have always been main venues for the distribution of banking goods and services. They have served as a physical meeting place for banks and their customers, where customers can obtain financial advice, manage their accounts, withdraw and deposit funds, take loans, manage savings, and partake of additional financial services in accordance with their needs and preferences. Banks consider their branches instruments for strengthening relations with customers, places where they gather information about customers’ financial strength, magnets for raising sources, and marketing tools. This traditional role of the bank branch has been undergoing major changes in the past decade, accompanied by a decrease in the number of retail branches in most Western countries. The entrance of new technologies and players into the industry, a change in consumers’ preferences, and a decline in the importance of the branch as a place where sources are raised are changing the face of the financial services industry and mitigating the need for the bank branch in its familiar structure. This presents banks, consumers, and regulators with the difficult challenge of having to make adjustments and regulate the process of change that is sweeping the industry.

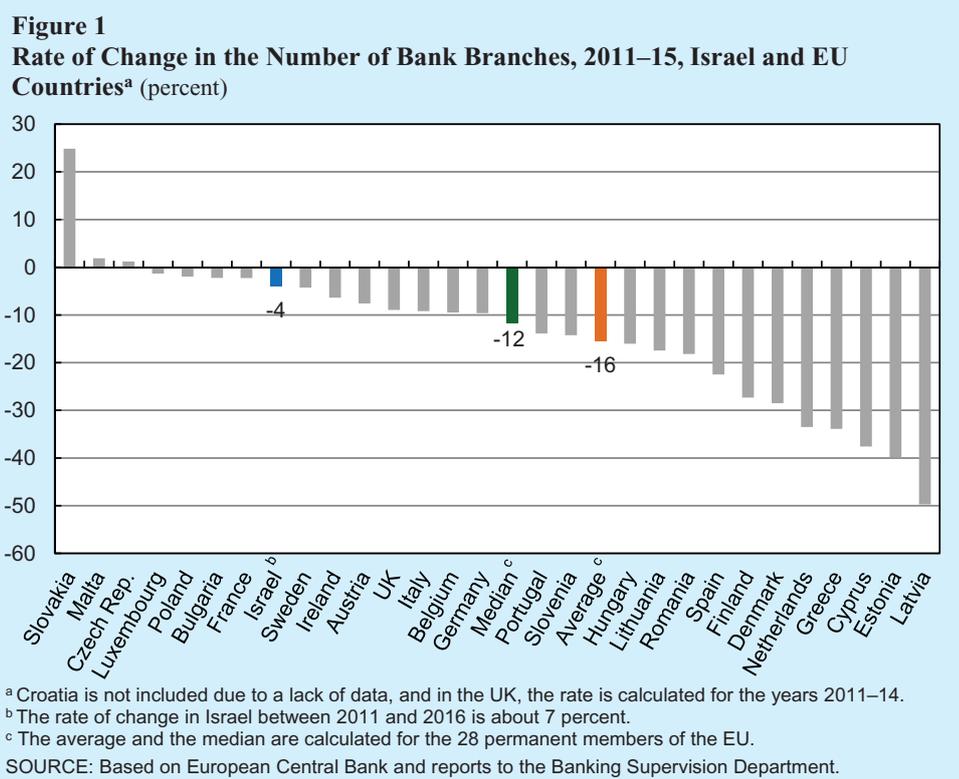
The use of retail branches, although entailing much physical and human capital and imposing high operating costs on the bank, expanded steadily for decades for lack of good alternatives. In the 1980s and 1990s, in an attempt to contend with the steep costs, enhance customer access to banking services, and exploit available technologies, banks began to make direct channels available to customers for autonomous use. The best known among them are automatic teller machines for cash withdrawals (which

later expanded to financial information machines and now allow customers to perform many additional bank transactions) and call centers where customers could seek advice, obtain information, and carry out transactions. In the late 1990s, when the Internet came into private use, the banks broadened their direct channels and established online interfaces for their customers. These channels, however, were limited in their ability to offer a good alternative to the bank branch, and they developed as complementary adjuncts alongside the continued upward trend in the number of retail branches.

The turning point in the branch deployment policies of many banks worldwide, setting the number of branches on a downward path, occurred in the aftermath of the global financial crisis. This period was (and remains) difficult and challenging for banks because it is fraught with many macroeconomic, regulatory, technological, and consumer developments. The simultaneity and speed of these developments forced the banks to reevaluate their operating models and shift the focus to the expenditure side, including having fewer branches and reconfiguring those that remained. The adverse effect of the macroeconomic environment was felt in credit losses and a low interest rate environment that undermined the validity of the existing profit models and challenged their ability to adapt to the new reality and continue to generate sustainable revenues. Regulatory developments focused on attempts to increase competition in retail segments by eliminating entry barriers to new players from within and outside the industry and removing obstacles to the transition of customers from one banking service provider to another. Consumer developments were typified by changes in financial services consumption habits and were derived from general technological developments in communications, mainly the strong presence of the Internet and the wide distribution of smart mobile devices. Further on the technological side were the entrance of nonbank high-tech ventures with different business models, and of technological developments at the banks, such as credit rating and statistical analysis systems (which allowed banks to manage and deliver services by remote control) and mobile apps and advanced and friendly online interfaces that let customers carry out a wide range of transactions on their own.

In Israel, as in most of the advanced economies, the total number of branches has been declining, but the process began years after it did elsewhere and has been progressing more slowly. In 2011–2015, the number of bank branches in Israel declined modestly by 4 percent (47), compared with a sharper, 16 percent, decrease in the European Union countries (Figure 1). The disparity may have something to do with the resilience of Israel's economy and banks to the global financial crisis, which moderated the loan loss provisions and the decline in net earnings that afflicted many banks in the EU countries. Despite this resilience, the spread of the trend to the domestic banking system was only a matter of time due to Israeli banks' exposure to other factors that affected global banking, and due to their exposure to domestic factors that were mainly legislative and regulatory. In particular, these included the approaching implementation of the Strum Committee recommendations on increasing competition in common banking and financial services¹ and the current policies of the Banking Supervision Department and the Bank of Israel on consumerism, technology, and operational efficiency. These are expected to amplify the global challenges that the Israeli banks face and further impair revenues and profits, against

¹ In June 2015, the Minister of Finance and the Governor of the Bank of Israel issued the letter of appointment for the committee, instructing it to recommend necessary measures to increase competition and mitigate concentration in common banking and financial services.

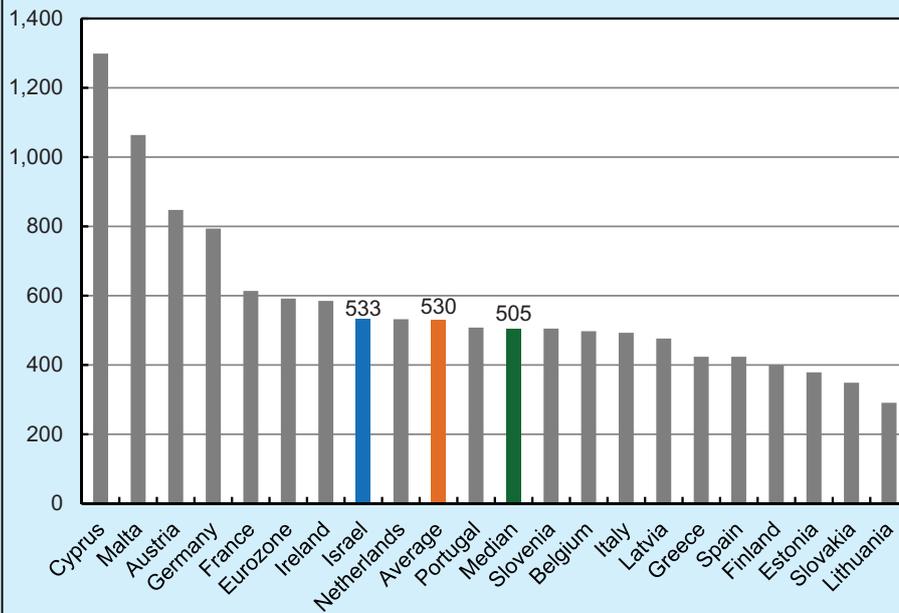


the background of the banks' divestiture of credit card companies, growing competition over the prices of financial products and services, and the expected short-term increase in operating expenses due to the efficiency measures. To contend with the current and future challenges, the Israeli banks are acting to reduce operating expenses by developing digital alternatives to physical banking services, reconfiguring some branches (including replacing expensive teller stations with ATMs), and reducing the number of branches. At some banks, these measures have been advanced as part of a broader efficiency drive that includes merging subsidiaries.

The downward trend in the number of branches is attracting much interest in Israel and abroad. However, it is also evoking some concern about that the difficulties of certain population groups in dealing with the change. From the banks' perspective, the decrease is unavoidable. (In Israel, it is also influenced by the Banking Supervision Department's instructions concerning efficiency plans.) It is accompanied by a series of complementary measures and adaptations, such as adopting new technologies, cutting costs, and adjusting activity models to the changing needs of customers (and of the banks themselves) and the changing nature of the financial services industry. From the perspective of the public and the Banking Supervision Department, it is imperative to make sure that the decrease in the number of branches does not impair the current high level of access to banking services, particularly

among elderly populations or those that do not use digital means.² Currently, Israeli residents do have good access to physical banking services via tellers, resembling and even exceeding the Eurozone average (Figure 2). This level is attained despite the small number of branches relative to population size, due to the structure of the deployment and the high volume of activity at each branch. This structure is not unique to Israel (it exists, for example, in the Netherlands), and its evolution over the years traces to the extent of innovativeness of the banks and the public and to Israel's physical and demographic indicators—including high population density, small territorial size, large proportion of urban dwellers, strong digitization and innovation among Israeli banks, and the Israeli public's consumption habits and adoption of new technologies. In the Netherlands, for example, much as in Israel, the small number of branches per resident is influenced by population density and the high degree of innovativeness of the banks. In Estonia, the small number of branches per capita is derived, among other factors, from the habits of customers, who tend to consume banking services online. In Malta, in contrast, where population density is very high, the branch-to-resident ratio remains high because consumers prefer to

Figure 2
Number of Banking Employee Posts^a per 100,000 Residents, Israel and Eurozone Countries, 2015



^a Calculated on the basis of yearly averages.
 SOURCE: Foreign countries—European Central Bank; Israel—Based on published financial statements.

² In this context, the Banking Supervision Department expects the banks to give customers a way to maintain a direct human connection with the bank and to continue providing customers with banking services even in the digital era, in which customers typically rarely visit the branch.

access banking services physically.³

Restrictive intervention by regulators or legislators in market behavior and their prevention of the banks from adjusting their business models, making changes and streamlining their branch system, may cause the banks to incur onerous expenses and suffer from low profitability in the long term, which would preclude them from adjusting to changes in their industry and render them uncompetitive, unable to lower prices to customers, and irrelevant in the market. To tackle this challenge, the Banking Supervision Department has been acting on four parallel planes: (1) removing barriers to improvements in efficiency and adoption of new technologies that would allow the banks to cut their costs, streamline their internal work processes, and enhance customers' access to services; (2) regular monitoring of the long-term trend toward fewer branches overall and by different cross-sections of the population, to prevent the financial exclusion of various population groups; (3) financial education to enhance the public's awareness, knowledge, and understanding of basic financial matters, including introducing the public to advanced digital tools; (4) regulating the closure of branches by amending the Banking (Licensing) Law to authorize the Supervisor of Banks to approve any request to close a branch⁴ and by publishing Proper Conduct of Banking Business Directive no. 400, which requires banks to provide adequate alternatives whenever they close a branch—referring customers to a nearby branch, leaving automatic banking machines in the vicinity of the discontinued branch, opening a mobile branch or a partial-service branch, offering assistance, training, and support in switching to direct-service channels, and so on.

³ Deutsche Bank (2013), "Bank Branches in Europe—Trends and Driving Forces."

⁴ Banking (Licensing) Bill (Amendment 22) (Closure of Branches), 5776–2016.

3. DIGITIZATION AND INNOVATION

The powerful impact of technological progress on our lives in recent years—generally and in the financial services industry in particular—is motivating the banking system to assimilate far-reaching technological and business changes in order to adapt to the new world and meet customers' expectations. Technological innovation has changed the ways in which banks do business and interact with their customers, suppliers, and partners. Today, banks deliver advanced services “anytime, anywhere” by means of websites, cellular and tablet apps, call centers, and self-service stations. While technological development allows them to improve operational efficiency and improve banking products, it also exposes the banks to operational risks that include technological and cyber risks, which make it necessary to strengthen risk management and prepare for situations in which the risks become real.

Technological progress in recent years, particularly in the possibility of remote interface with the banking system and the change in methods and processes of identification, requires banks to deploy appropriately to manage the attendant risks. With this in mind, the Banking Supervision Department instructed the banks to implement a series of new and comprehensive controls in order to minimize risks stemming from e-banking, an area of endeavor that is expected to

The banks' adoption of new technologies allows them to expand their basket of products and services and improve service to the customer, but also exposes them to new risks.

continue expanding to greater numbers of customers and a broader range of channels and services. The controls include advanced monitoring devices, innovative tools for the detection of irregularities (unusual activity), security for end-point units on customers' premises, training for customers, and participation in building the National Banking Cyber Center. (For elaboration, see Box 2.4, "Establishment of the Israel Banking Cyber Center.")

The banks in Israel, like their counterparts abroad, are taking strategic action to assimilate enterprising and innovative banking for customers, as reflected (among other things) in improving and expanding their direct¹⁰ and digital¹¹ service channels. These innovative processes mesh well with the importance that both banks and customers ascribe to the improvement of service. Among these measures, the banks have developed advanced UI (user interface) and UX (user experience) capabilities, with which they enrich the content and range of transactions that can be carried out via direct means: opening an account online, depositing checks and withdrawing cash by means of mobile devices, retrieval of credit card PIN number, and chatting and email correspondence with bank personnel.¹² One of the most significant areas of development among the technological changes is the improvement of customer identification on direct channels via the use of advanced and simple ID measures (nonrecurrent password, biometric technology, etc.) that maintain a high level of information security, because the ID process is a material obstacle to direct channel activity. The banks are also acting to automate processes that have been partly or fully manual by employing advanced and secure technologies, streamlining processes, familiarizing themselves with the needs of the different types of customers, and adjusting to these needs. The new initiatives have developed in part due to stronger cooperation between the banks and the Fintech community¹³ in Israel and abroad. Concurrently, the banks are looking into, and advancing, appropriate solutions for business customers as well.

The Banking Supervision Department is guiding and encouraging the banks in their efforts to innovate and enhance the efficiency of their customer service channels. In July 2016, the Department published Proper Conduct of Banking Business Directive no. 367 ("E-Banking"), which relaxes barriers and allows banks and credit card companies to offer additional services that customers may obtain through direct, including digital, channels, while advancing adequate controls. Advancing the use of direct channels allows banks to cut operating costs, supports efficiency measures, and lowers the cost of banking services to the consumer.

¹⁰ Websites, mobile applications, automated banking machines, and call centers that include human and automatic response.

¹¹ Websites and mobile applications.

¹² High-quality solutions for email correspondence have been worked out, subject to the restrictions set forth in Proper Conduct of Banking Business Directive no. 367 ("E-Banking") and with assurance of stringent information security.

¹³ Startup firms in the field of financial services.

The Banking Supervision Department welcomes the innovation and efficiency processes but demands stringent application of adequate controls and maintenance of access to banking services for the entire population.

Concurrently, the Department is acting to assure the accessibility of the full range of banking services to the entire population, including senior citizens and persons with disabilities, in a manner tailored to them. Relating to the closure of bank branches and cutbacks in teller services, the Department issued a directive requiring banks to manage the process with strict attention to appropriate responses to customers, including senior citizens, who have difficulty adjusting to the new technological media. In the directive, the banks are instructed to stringently maintain the availability and convenience of banking services for a wide range of customer types and needs, and to provide human assistance and guidance for those who find the direct means hard to use. Notably, the banks are making telephone banking services accessible to the entire population, including senior citizens. Advanced direct channels, foremost digital ones, have brought about a substantial improvement in the accessibility of service for additional groups as well. Thus, for instance, websites, self-service stations, and apps have been made more accessible for the visually and hearing impaired, the banks' websites are translated into several languages and the elderly are able to obtain information, correspond with bank personnel, and even carry out banking transactions online from home, comfortably, with no need to visit the branch.

The direct channels, particularly the digital ones, have enhanced the availability and scope of information for customers (Figure 2.6). **The mobile app channel is becoming an essential element in customer activity vis-à-vis the bank, both in obtaining service and as a means of identification.** The evolving world of Big Data may soon provide private and business customers with tools for the analysis of their financial activity—including calculators, personal forecasts of the customer's financial situation, and alerts in all matters related to financial activity. It is evident that customers of the banking system who are accustomed to using advanced technological media in other areas of life (shopping, culture, transportation) easily identify and quickly adopt advanced technological services and developments.

Bank customers' direct channel activity¹⁴

In 2016, the Banking Supervision Department began to gather and analyze data from the banks on customers' direct channel activity, including digital activity¹⁵, in ways that include segmentation by age groups. This information will help the Department to plan its steps in advancing technology and innovation in the banking system—particularly for the purposes of eliminating barriers, incentivizing the system in accordance with customers' habits, and responding appropriately to the needs of various population groups. As this area of activity is advanced, the possibility of obtaining service in the traditional manner from a teller at the branch will be preserved at the requisite level.

The banks' customers are embracing the technological changes, and in 2016, they performed 50 percent of all banking transactions via direct channels.

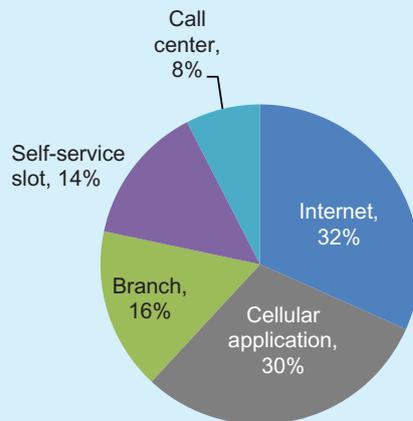
¹⁴ Websites, mobile applications, automatic self-service stations, and call centers that incorporate human and automatic digital response.

¹⁵ Websites and mobile applications.

The data show that, during the reviewed year, customers performed 50 percent of all banking transactions via direct channels¹⁶, and that this rate increases from quarter to quarter (Figure 2.7).

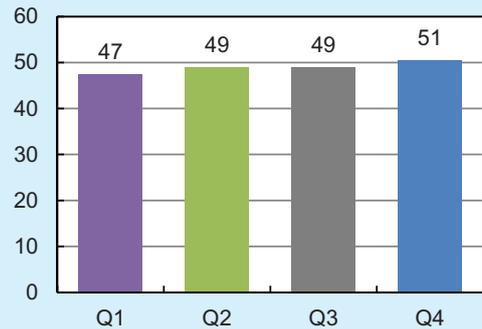
The Banking Supervision Department examined the banking transactions customers commonly execute through direct channels, and found most of them to be more convenient for customers due to availability, immediacy, autonomy, customer control, clear visual display, and accessibility. Such transactions included transfers of funds, payments, buying and selling securities, ordering checkbooks, and depositing checks (Figure 2.8). Customers were less likely to execute transactions such as making and cashing in deposits and taking and repaying loans through direct channels. It stands to reason, however, that as progress is attained in technological tools (calculators, information aggregation services, etc.) that will make it possible, among other things, to offer value tailored to the customer, the share of such transactions carried out through direct channels will grow steadily.

Figure 2.6
Percentage of Enquiries Identified in Each Channel as a Share of Total Identified Enquiries on All Channels, Total Banking System, 2016^a



^a The figures relate to the last three quarters of 2016.
SOURCE: Based on reports to the Banking Supervision Department.

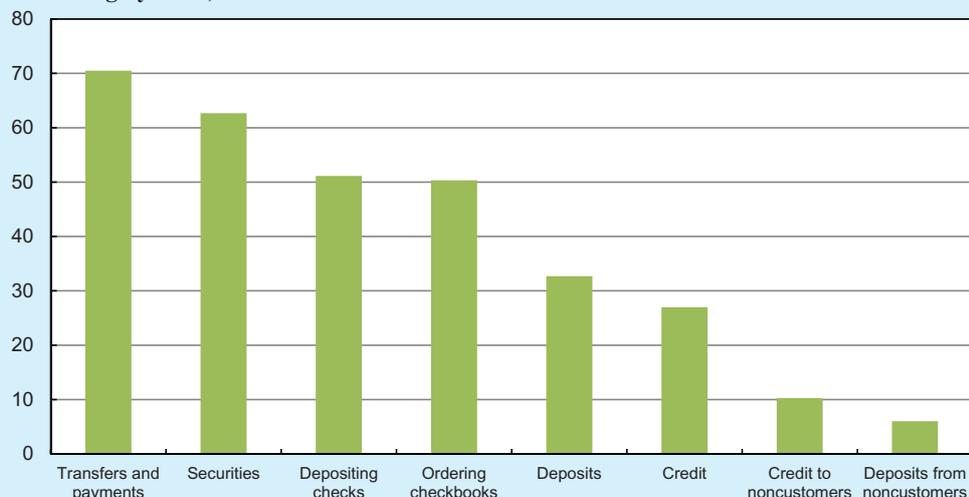
Figure 2.7
Percentage of Customer-Executed^a Transactions^b by Quarter, Total Banking System^c, 2016



^a Customer-executed transactions include those executed via the Internet, cellular applications, automated self-service machines, and call centers including both human and automated response.
^b Calculated according to data on a selected sample of customer-executed transactions: transfers and payments, ordering checks, depositing checks, credit and deposits, and securities.
^c The figures include Hapoalim, Leumi, Discount, Mizrahi-Tefahot, First International and Bank of Jerusalem.
SOURCE: Based on reports to the Banking Supervision Department.

¹⁶ The figure is based on a basket of common banking transactions.

Figure 2.8
Percentage of Customer-Executed Transactions^a, by Type of Transactions, the Israeli Banking System^b, 2016



^a Customer-executed transactions include those executed via the Internet, cellular applications, automated self-service machines, and call centers including both human and automated response.

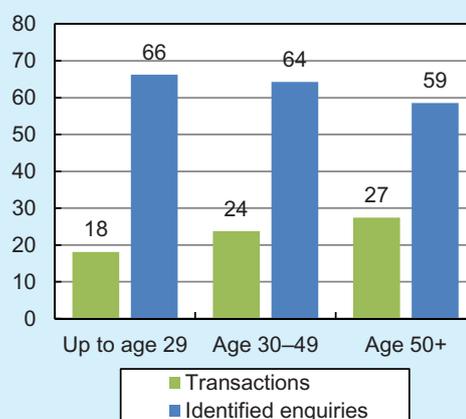
^b The figures include the following banks: Hapoalim, Leumi, Discount, Mizrahi-Tefahot, First International and Bank of Jerusalem.

SOURCE: Based on reports to the Banking Supervision Department.

An examination of direct channel activity by age group (Figure 2.9) found that the number of transactions performed via digital means increases with the age of customers. In terms of the distribution of identified visits¹⁷ to direct channels during the year, digital channels have a solid lead over visits to branches, call centers, and self-service stations (Figure 2.6).

The data on global trends in direct banking indicate rapid growth of the use of apps to obtain information and carry out banking transactions at the expense of other channels. The trend has evidently reached Israel as well, in view of the wide distribution of advanced mobile devices among the population.

Figure 2.9
Digital Channel^a Identified Enquiries as a Share of Total Identified Enquiries, and Digital Channel Transactions as a Share of Total Transactions, Total Banking System, 2016^b (percent)



^a Digital channels: websites and cellular applications.

^b The figures relate to the last three quarters of 2016.

SOURCE: Based on reports to the Banking Supervision Department.

¹⁷ Number of visits to direct channels after the customer has identified him/herself.

Box 2.4**Establishment of the Israel Banking Cyber Center**

- **In 2016, the Banking Supervision Department, in conjunction with the National Cyber Authority and the Ministry of Finance, spearheaded the establishment of a Banking Cyber Center as part of the National Cyber Center.**
- **The Department's goal is to bolster the defense against cyber attacks that may impair banks and their customers and to ensure that if and when a major cyber incident occurs, the banks will be prepared to handle it with the help of state-level experts in the field.**

In February 2015, the government decided (Resolution 2444) to establish a national CERT (Cyber Emergency Response Team) to contend with cyber threats and to strengthen Israel's resilience in the face of cyber threats. The roles of the CERT, as defined in the government resolution, are to centralize and share relevant information with all entities in the economy, to help deal with cyber threats, and to serve as a central interface between defense agencies and those in the civilian economy. The CERT was established in Beersheva in September 2016 by the National Cyber Authority. **As part of the CERT, with the encouragement of the Banking Supervision Department and in conjunction with the Ministry of Finance and all the banks, a Banking Cyber Center (hereinafter: the Center) became operative (in an initial mode) in January 2017.**

The Banking Supervision Department considers the establishment of the Center a flagship project of the utmost importance. Its express purpose—sharing cyber defense information and capabilities among banks and between them and state-level experts in the field—creates a synergy that significantly bolsters the ability to protect the public's deposits and the banks' stability against ongoing attacks and large cyber incidents, insofar as they occur.

The main goals of the Center resemble those of the national-level CERT except that they focus on the banking sector. One of these goals is information and intelligence sharing on cyber alerts and incidents among the entities that make up the financial services sector generally and the banking sector in particular. Another goal is helping to deal with cyber incidents that affect banking corporations. The activities of CERT and the Banking Cyber Center entail massive resource allocations, particularly professional human resources specializing in the cyber field. All banking corporations and credit card companies (hereinafter: banking corporations) are members of the Center.

A prime goal of the Center, as stated, is **to assist in sharing information and intelligence**—a main element in coping with cyber threats and events—among banking corporations. Information-sharing in the banking industry is essential because the banking system is a target for attack by well-financed adversaries and potential assailants such as terrorist organizations, crime organizations, and even states. The goals of a cyber attack by these adversaries are diverse—**theft of money, theft of confidential customer information for trafficking purposes or to damage the banking corporation's reputation, impairment of the national financial system by dealing a devastating blow to a corporation (such as attacking payment systems or compromising customer data), and so on.** The methods of such attacks are growing in complexity and sophistication. Cyber incidents around the world are increasingly moving into financial service sectors, some causing grievous harm to organizations and their customers. Today it is clear that cyber attacks

cannot be totally prevented. When a wealthy and patient adversary targets an organization for a focused attack, the attack is likely to succeed. Accordingly, to mitigate the potential damage, it is of paramount importance to detect the incident as soon as possible after its occurrence.

By sharing information via the Banking Cyber Center, all members of the Center will be apprised of indications of an attack, attempted attacks, and alerts at banking corporations and other financial entities. By receiving this information, each member can determine whether it is prepared to deal with an incident of similar characteristics or whether it must take certain actions to achieve such preparedness.

The information shared via the Banking Cyber Center will flow in two directions. The first is top-down, from the Center to the banking corporations. The Center will share information that it receives from various sources: intelligence agencies, research institutes, CERTs abroad, and so on—on a case-by-case basis, after the information is processed and analyzed by experts and analysts with the help of various tools. The other direction is bottom-up, as banking corporations voluntarily pass on details (indicators such as IP addresses) about alerts, attacks, and even “noise” (unsuccessful attack attempts). The Cyber Center will examine and analyze these details, determine whether the attack is relevant only to the reporting corporation or also to other banking corporations and/or entities, and share the information with all relevant players without revealing the reporting corporation’s identity. It is important to emphasize that in no case will a banking corporation forward classified information (business information, customer data, etc.) to the Center.

In addition to information-sharing, the Cyber Center is expected to provide the banking system with defensive services by means of specific cyber tools that will augment each banking corporation’s own defensive and security measures. The Center and additional entities at the Cyber Authority are also expected to help banking corporations deal with major cyber incidents as necessary and in coordination with the Banking Supervision Department. By means of these (and other) activities, the Banking Cyber Center is expected to provide banking corporations with an additional layer of defense in dealing with cyber incidents.

The Banking Supervision Department is therefore acting to get the Center up and running and assure its success, and to actively encourage banking corporations on an on-going basis to share information through it. The idea behind the Department’s efforts is to make sure not only that the project will take shape but also that the banking corporations will derive genuine value from it. For this purpose, the Department initiated and set up joint task forces that will formulate principles for information-sharing and management of serious cyber incidents.

One of the most important objectives is to create trust between the banking corporations and the Center in the following respects:

- Maintaining confidentiality: ensuring that confidential information—for example, the name of a bank that sustains a cyber attack—will not be leaked.
- Making a genuine contribution to the banks’ strength via effective information-sharing about attempted attacks and cyber alerts.
- Reciprocity: avoiding a situation in which banking corporations refrain from sharing information in their possession and merely benefit from information shared by others.

- The Banking Supervision Department demanded that the Center be activated gradually. In the first stage, only information-sharing activity should take place, it being assumed that this would also have the effect of enhancing trust.

In summation, the Banking Supervision Department believes that the Banking Cyber Center will make the banking system better prepared to contend with cyber threats, which are becoming a significant risk in this technological world, and will thereby enhance the system's resilience.

CHAPTER 3

ACTIVITIES OF THE BANKING SUPERVISION DEPARTMENT

1. THE VISION AND STRATEGIC TARGETS OF THE BANKING SUPERVISION DEPARTMENT

The overarching goal of the Banking Supervision Department is to protect the public good by maintaining the stability and resilience of the banking system in order to secure the financial assets that the public deposits with the system; maintaining fairness in relations between banks and their customers; promoting competition; and ensuring the banking system's support of commercial and personal economic activity. These functions are intertwined with each other and crucial for maintaining the public's trust in the banking system and enabling economic growth.

In 2015 the Department reviewed its strategic targets and developed its vision for the following years: to be a professional and proactive supervisory authority for the benefit of the public and the economy. In 2016, the Department continued taking measures to pursue these objectives.

The Department's key strategic objective is to maintain the stability of the banking corporations, and to ensure their cautious behavior in order to protect the public's funds. The Department has two additional strategic objectives. The first is to encourage competition in banking services—with emphasis on retail credit, small business lending, and settlement and payments—through the advancement of structural changes accomplished by lowering entrance barriers to the banking industry. The second is to maintain fairness, a crucial trait for preserving the public's trust in the banking system.

In choosing these strategic objectives, the Department reviewed major changes in the economic, technological, and social environment that make it necessary to rethink the structure of the system, the identity and number of players in it, and the players' business models.

To help attain the aforementioned strategic targets, the Banking Supervision Department adopted several supportive objectives: promoting greater operating efficiency among the banks, encouraging banks to embrace innovation and technology by removing regulatory barriers relating to them—inter alia in order to facilitate the delivery of high-quality banking services that deliver high added value to customers—and balancing the regulatory burden.

To attain the strategic target in terms of stability, the Department is taking measures to ensure that the banks have sufficient capital and liquidity, adjust their business model to the changing competitive technological environment, and update their risk management activity to tackle new as well as existing risks.

The main objectives of the Banking Supervision Department are maintaining stability, promoting competition, and maintaining fairness in the banking system. To support these objectives, the Department encourages innovation, technology, and greater efficiency in the banking system.

To support the strategic objective of increasing competition, the Department has taken a leading role in making significant changes in the structure of the banking system, foremost guiding the divestiture of credit card companies by the two largest banks; lowering entry barriers to the banking and payments industry; promoting the sharing of digital infrastructures—a significant measure that is meant to make it easier for new players to enter the industry; lowering capital requirements for new players; and creating a “lenient level of supervision” for new and small players.

To attain the strategic objective in terms of fairness and the public's trust, the Department is taking measures to enhance the public's financial awareness with the focus on various target groups (seniors, adolescents); make banking information more accessible to consumers; improve public disclosure; guide efficiency processes; and close bank branches without compromising customers' interests.

The Department's main activities in 2016 are reviewed below.

2. MAIN ACTIVITIES IN SUPPORT OF STABILITY

To continue enhancing the system's stability, the Department:

- Continued to strengthen the banking system's capital adequacy and liquidity by reviewing banks' capital adequacy and ability to absorb major losses in stress scenarios.
- Carried out a comprehensive annual assessment of the banks' risk profile, presenting the findings to the banks and issuing the banks with various demands for implementation.
- Took measures to strengthen the banks' corporate governance—to enhance the effectiveness and efficiency of the board of directors and strengthen its ability to control management's activity—by revising the Proper Conduct of Banking Business directive that defines the board's duties and *modus operandi*.
- Acted to set up a Banking Cyber Center in conjunction with the relevant national players. The center will help to protect the financial system against cyber threats and encourage information-sharing among the relevant elements in the system—a matter of great importance in a world where banking is becoming ever more technological.
- Announced a policy of allowing banking corporations to distribute dividends to shareholders. This measure aligns Israeli banking with international standards, makes the banks more attractive to investors, and is expected to improve the tradability of the banks' equities.
- Raised the maximum stake of institutional players in banks from 5 percent to 7.5 percent. This measure is expected to make banks' equities more tradable and allow the public at large, which keeps funds with institutional investors, to increase its stake in these equities, something done thus far via derivatives and not directly.

- Updated Proper Conduct of Banking Business Directive no. 411, which concerns anti-money laundering and countering the financing of terrorism (AML/CFT). The update, carried out in accordance with revisions of international standards, gives the banks more efficient tools to manage compliance and anti-money laundering risks that have developed in recent years and are reflected in major events that banks worldwide have been experiencing.
- Allowed the sale of housing loan portfolios to institutional entities in order to diversify risk to the financial system while continuing to respond to demand for housing loans.
- Continued to monitor the development of risks in the housing loan and consumer credit portfolios in view of the continued growth of household credit, by conducting examinations and taking other risk-mitigating actions. The Department devoted special attention to the implicit risk in nonhousing consumer credit, how it is managed, and disclosure to the public about it, due to the perceptible increase in this credit in recent years.
- Continued monitoring (including audits) of the development of risks in the business credit portfolio and the assimilation of key risk-management directives. In this context, the Department instructed the banks to correct weaknesses and deficiencies that were found and emphasized the need for examining the overall adequacy of credit loss allowances.
- Took further steps to improve the quality and usefulness of the banking corporations' public financial statements. In this context, the banking corporations were instructed, among other things, to emphasize more material matters and evolving risks and to cut back on less important information. Consequently, the statements became about 25 percent shorter on average (and those of large banks contracted even more). Concurrently, the gradual adoption of US Generally Accepted Accounting Principles continued and is now near completion.

3. PROMOTION OF COMPETITION AND EFFICIENCY

To support increased competitive pressure and competition in coming years, the Department promoted the implementation of the following structural changes:

- Passage of an “enhancement of competitiveness law.” The Bank of Israel participated in this legislative act on the basis of its aspiration to increase competition in the financial system while maintaining its stability.
- Measures to bring new competitors into the banking system, including support of the spinoff of two credit card companies and the establishment of credit unions, as well as lowering significant entry barriers to the banking and payment systems. In so doing, the Department made a policy change, backing legislation that would allow one bank to host another on its systems

and promoting the establishment of a joint computer center that would serve several banks and financial service providers—all with the understanding that computer infrastructure creates a significant entry barrier to new and small players in the banking market.

- Promoting competition in settlement activity by relaxing requirements for, and supervision of, potential and existing merchant acquirers. This activity paid off in April 2017 with the licensing of a new merchant acquirer. Among other measures, the Department facilitated the entrance of new merchant acquirers by introducing a new path to obtaining a settlement license; lowered capital requirements for new merchant acquirers to the accepted level abroad according to the PSD (Payment System Directive) approach; promoted the use of debit cards; and removed technological barriers to connectivity with the payment card system.
- Encouraged innovation and technology in banking through a new Proper Conduct of Banking Business directive on “E-Banking”. This directive removes barriers that were identified in advancing banking through direct channels, without the need for branches, and lays the groundwork for the establishment of a digital bank with no branches.
- Instructed the banks to become more efficient and guided their efficiency processes by giving them capital dispensations in order to make enable meaningful streamlining measures. The banks presented the Department with multi-year efficiency programs that included far-reaching processes that, once implemented, are expected to narrow their efficiency gap vis-à-vis banks abroad. Improved efficiency will stimulate competition and lower prices to the consumer on the basis of a sustainable business model. Enhanced efficiency is now becoming more important as the technological revolution among banks around the world will reduce the need for human resources in some areas of banking.
- Acclimated the public to the “Banking ID Card”—a document that itemizes all of a customer’s assets and liabilities in a bank, including income and expenses in respect of assets, liabilities and ongoing activities, as well as total interest and banking fee expenses. The first report of this kind was sent to bank customers in February 2016 and it is expected to help them to engage the banks in dialogue and entertain competing offers.
- Authorized the use of a mobile bank branch and a partial-operation branch, allowing service to be delivered in areas and locations where a full-service branch cannot be maintained.

4. ENHANCING FAIRNESS

To continue enhancing fairness in relations between banking corporations and their customers and to strengthen the customer's position vis-à-vis these corporations, the Department—

- Represented the Bank of Israel's position before Knesset committees and ministerial committees on matters related to banking consumerism, submitted professional opinions on numerous bills, and participated in handling class-action suits.
- Introduced a built-in discount on all customer-executed transactions relative to the rate for the same services at the teller's desk. The purpose is to encourage customers to switch to more efficient and cost-effective direct banking. The change will go into effect during 2017.
- Determined that bank customers will pay a direct-transaction fee when they withdraw funds by bank card from ATMs of the bank where they keep their account, irrespective of how close they are to the branch. This is part the adjustment to the closure of bank branches.
- Instructed the banks to automatically enroll senior citizens and persons with disabilities in their basic fee tracks, thereby making banking activity less costly for them.
- Issued a directive relating to the process of closing branches and downsizing teller services in order to help customers to adjust to the change. The trend of closing branches and cutting back on teller services originates in the banks' efficiency drive and the transition to direct channels in the delivery of banking services. The Department does not oppose the process because it means better service, better availability of service (24/7), and lower cost of service for most customers. The directive is intended to ensure that when a bank decides to close a branch or reduce teller services, it will be mindful of all considerations including the potential impact of the change on its customers—particularly those who may find the changeover burdensome, such as the elderly and persons with disabilities.
- Spearheaded the Har ha-Kesef 2 project, in which inactive deposits and accounts of deceased persons are tracked down. The purpose is to help customers locate deposits where there has been no instruction from their owners for a long time and to help heirs locate the accounts of deceased persons.
- Initiated activities to enhance the public's financial awareness by (among other things) holding an open day at 100 bank branches countrywide, where customers of all banks received information about proper financial conduct.
- Issued a directive on fairness in debt collection. The directive sets guidelines and defines processes that will improve disclosure and fairness in collecting debts from customers who violate loan repayment terms. The directive expresses the expectation that banks will try to exhaust various remedies

before launching legal proceedings.

- Continued to enhance responsiveness to public enquiries and strengthen the position of ombudsmen. It should be emphasized that the Public Enquiries Unit remains the address for problems that banks fail to address to customers' satisfaction.
- Provided information, authorizations, and individualized legal and technical clarifications to tens of thousands of customers whose accounts were restricted.
- Required the banking corporations to develop text message services that alert customers to an increase in the risk of account restriction due to bounced checks (after five such incidents) and actual restriction.

Box 3.1

Measures to Advance Competition in the Israeli Banking and Payments Systems

- The Banking Supervision Department is committed to increasing competition in banking while maintaining stability, and is taking various initiatives in pursuit of this goal, including promoting structural changes in the market.
- The technological revolution is a central factor in creating competitive pressure in the financial services industry.
- The increase in competition is expected to manifest itself gradually in the coming years in the form of improved service, innovativeness in services and products to benefit customers, and a growing range of alternatives for customers.

In recent years, the Bank of Israel set itself the goal of enhancing competition and has been encouraging various initiatives to this end. This process, being implemented in conjunction with policymakers, regulators, and various (present and future) players, includes many measures that have already been put into place, and many others that are in various stages of implementation. It should be borne in mind, however, that increasing competition is a complex and lengthy process that will deliver results gradually over coming years. This is because it requires the removal of various barriers, changes in the technological and business environment, changes in the public's tastes and behavior, and educating the market for the new competitive environment. To allow the many simultaneous measures to attain their goal, a high level of certainty about the regulatory environment, particularly for the players (foremost new ones), is also needed. The success of the process will not be measured by one metric only but by a range of indicators.

Competition in retail banking services and in payments is being advanced on two parallel tracks: on the supply side, namely financial service providers, and on the demand side—the consumer public that is interested in a broader array of financial services and products. In our estimation, these measures will increase the supply of credit for households and businesses but their effect on prices is not yet clear.

Below are the main measures to advance competition:

1. Vis-à-vis financial service providers (supply side):

1.1 Admitting new competitors

- Creating independent credit card companies as competitors of banks and nonbank entities. The newly enacted Increasing Competition and Reducing Concentration in the Banking System Law requires the two largest banks to divest themselves of the credit card companies that they own and lays down rules of conduct to protect the newly weaned credit card companies and to regulate this part of the industry permanently. This is because these companies are mature financial service providers that have adequate capital, risk management capabilities, a significant database, and corporate governance. As such, they can construct a business model that will offer a range of financial services and compete with banks for household and small business custom. The Banking Supervision Department is closely monitoring the divestiture process.
- Introducing new merchant acquirers. In late 2015, the Banking Supervision Department issued dispensations for the establishment of a new merchant acquirer, and has been closely stewarding applicants toward merchant acquirer licensing and easing the process significantly. This measure has already paid off: In April 2017 the Bank of Israel licensed Tranzila, Ltd., which is expected to begin operations over the coming year as the fourth acquirer in the payment card market. (For elaboration, see Section 1.2 below.)
- Additional financial service providers. Measures have been taken to bring in additional players—including credit unions and payment service providers—that are not supervised by the Bank of Israel, and to establish a supervisory framework for them. (For elaboration, see Section 1.2 below.) This is expected to increase credit supply for households and small businesses and may therefore lead to an increase in customer leveraging and expose the new providers to acute attendant risk. Accordingly, these changes should be made gradually, under supervision and guidance, over the next few years.
- An advanced payments market. Action has been taken to promote the assimilation of the EMV technology standard in the payments market, allowing new players to enter and making the payments market more technologically advanced.

1.2 Lowering entry barriers

Several serious entry barriers to the banking market have been detected and the Banking Supervision Department is acting to remove them so that new competitors may break into the market and compete with those already there. Some of the barriers have already been eliminated, while others are in the process of being removed. Examples follow:

- Introducing a more lenient licensing path for merchant acquirers. This more lenient process, introduced by the Department in late 2015, allows license applicants to obtain a limited license quickly and thus to be certain about their ability to obtain licensing from the very beginning of the process. The stages of the procedure include reviewing the honesty and integrity of the applicant and the officers of the company or the bank and

vetting the applicability of the applicant's business plan. Conditions for applicants for a permit relating to control and ownership of means of control in a merchant acquirer were also adjusted, and specific regulatory dispensations were given to help new merchant acquirers gain stable footing in the market. Thanks to these measures, a new merchant acquirer was licensed in early April 2017 and is poised to enter the market.

- Introducing a path to reduce minimum capital requirements for new banks and merchant acquirers. The Banking Supervision Department reduced the minimum capital that a new bank must have from NIS 400 million to NIS 50 million provided certain conditions, determined jointly by the Bank of Israel and the Ministry of Finance, are met. This accords with the customary practice under the European payment system directive (PSD), and is an outgrowth of the view that a merchant acquirer that does not hold public funds poses relatively low systemic risk.
- Establishing a more lenient level of supervision for small new banks and merchant acquirers. Since the risk level of small new banks and merchant acquirers is lower, and they have less of an effect on the stability of the financial system than do large and medium-size banks, the regulatory standard that they have to meet can be lower than that of providers whose stability is critical to the financial services system.
- Advancing the formation of a joint computer center in order to remove the barrier of having each new bank establish its own computer system. The purpose of this measure, being implemented in conjunction with the Ministry of Finance, is to bring down the costs of establishing computer systems for new and small banks and for credit unions, given the considerable economies of scale that exist in computer services.
- Eliminating barriers to connection by a new merchant acquirer to the credit card switch. The existing switch poses an entrance barrier to new acquirers. To correct this, changes had to be introduced in the switch and in local processes—including assimilation of the EMV standard (by which new acquirers can connect to the switch directly) and establishing rules for hosting a new acquirer on an existing acquirer's infrastructure.

1.3 Promoting greater efficiency in the banking system and digital activity

- Requiring banks to draw up meaningful efficiency plans. This will lead to lower costs of production of banking services and, in turn, reduce costs to the customer. The Department's demand for efficiency measures was accompanied by dispensations in capital requirements for banks that adopt efficiency plans. (For elaboration, see Chapter 2, Section 2—"Banking System Operating Efficiency, Branches, and Personnel.")
- Leniencies for banks and credit card companies in digital activity (activity conducted outside the branches). Dispensations for opening a new account online or online contracting by a business with a merchant acquirer (Directive 418), broadening the range of services that a customer may obtain online, and more.
- Establishing a new Innovation and Technology Division at the Banking Supervision Department. The goal is to advance the banking system toward advanced technological

standards and to provide guidance in their implementation, coupled with proper risk management.

1.4 Another measure advanced by the Bank of Israel to encourage competition

- Creating a Central Credit Register. Under the Credit Data Law, 5776–2016), the Bank of Israel assumed responsibility for spearheading the establishment of a central database for sharing credit data. The purpose of the law is to create a comprehensive arrangement for the sharing of such data, including provisions on gathering credit data from the information sources set forth in the law, storing them in a central database to be operated by the Bank of Israel, and sharing credit data from the database with credit bureaus for processing and transfer to credit providers among others—all without compromising on customers’ interests and privacy. The establishment of the database is meant to increase competition in the retail credit market, make credit more accessible, and create a database of anonymous information that the Bank of Israel may use to examine developments in the credit market. The database is expected to become operative in the fourth quarter of 2018.

2. Vis-à-vis recipients of financial services (demand side)

- Transparency of information for the customer. The Banking Supervision Department has developed, and is working to develop, tools that will give customers easy access to banking information that is relevant to them. Thus, in 2016, a customer “Banking ID Card” was introduced, showing customers the totality of their financial information with every bank in an easily comprehensible manner. The Department also launched a search engine for inactive deposits and accounts of deceased persons in the banking system (Project Har ha-Kesef 2). The Department is currently working on the profile of a technological mechanism to gather all of the customer’s banking information, including data on the customer’s activity at all banks and credit card companies with which the customer does business.
- Enhancing the public’s financial awareness. In 2016, the Department, in conjunction with the banking system, held a Financial Awareness Week in order to provide bank customers with greater access to basic knowledge about financial conduct and information.
- Lowering obstacles to switching banks or merchant acquirers. To allow customers to switch banks and companies to change merchant acquirers more easily, the Department eased the rules for opening bank and settlement accounts online, letting small businesses and retail customers switch service providers easily, anytime, and anywhere.
- Increasing the supply of banking products. The Department acted to encourage the use of debit cards, which may be used, among other things, as a credit card substitute for customers who are not interested in using credit or cannot do so (restricted customers, minors, and so on).

- Greater transparency and lower prices for banking products. Various regulatory measures were taken in 2016 to simplify the banks' rate schedules and make them more transparent to customers, bring down the prices of products and of all digital services, and add specific population groups to reduced-rate tracks that are suitable for them, among other steps.

3. Competition in payment and charge card activity

The Banking Supervision Department also placed emphasis on increasing competition in this field both in order to increase the benefit to cardholders and businesses from payment card business and as part of the increased competition in banking services generally and the issue of credit particularly. Increased competition in this area of activity is coupled with the Bank of Israel's efforts to promote competition in this part of the industry. In this context, several measures described at length above deserve mention:

- Guiding the banks' divestiture of two credit card companies and supporting the infant industry protections that these companies will receive.
- Creating a lenient path to the licensing of merchant acquirers and close support of license applicants upon submission of application and through the vetting process.
- Establishing a less stringent level of supervision for merchant acquirers and much more lenient capital adequacy requirements for small providers (Directive 472).
- Eliminating barriers to connection with the payment card switch, as part of the promotion of advanced payment methods (EMV) and the issuance of rules for hosted merchant acquirers.
- Increasing the supply of products and accessibility of payment cards to customers.
- Increasing the transparency of information for customers and businesses.

Box 3.2

Handling of public enquiries and complaints

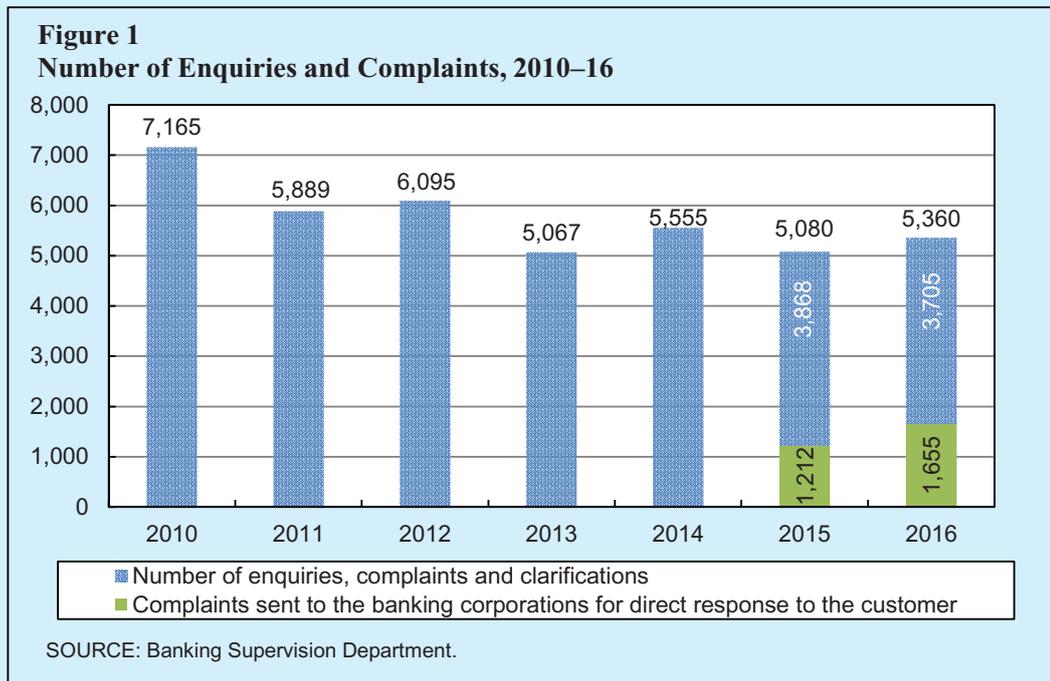
- **In the reviewed year, the Public Enquiries Unit dealt with more than 20,000 enquiries received by telephone and in writing, resulting in interventions that included refunds of money to bank customers.**
- **Most enquiries concerned means of payment, current accounts, and quality of service.**
- **The Unit gave focused treatment to enquiries that concerned response to disempowered population groups, response to customers due to closure of branches and cutbacks in teller services, opening non-overdraft current accounts, and locating lost accounts.**

The Public Enquiries Unit of the Banking Supervision Department manages the handling of public enquiries referred to the Department concerning the dealings of banking corporations (banks and credit card companies). The Unit also serves as a conduit for information from the public to relevant people in the Department and at the Bank of Israel. On the basis of this information (among other things), the Department detects across-the-board deficiencies in the consumer domain—at banking corporations and in the banking system at large—deals with them, regulates consumer-related matters, conducts examinations, and disseminates information.

1. Handling of public enquiries and complaints by the Banking Supervision Department

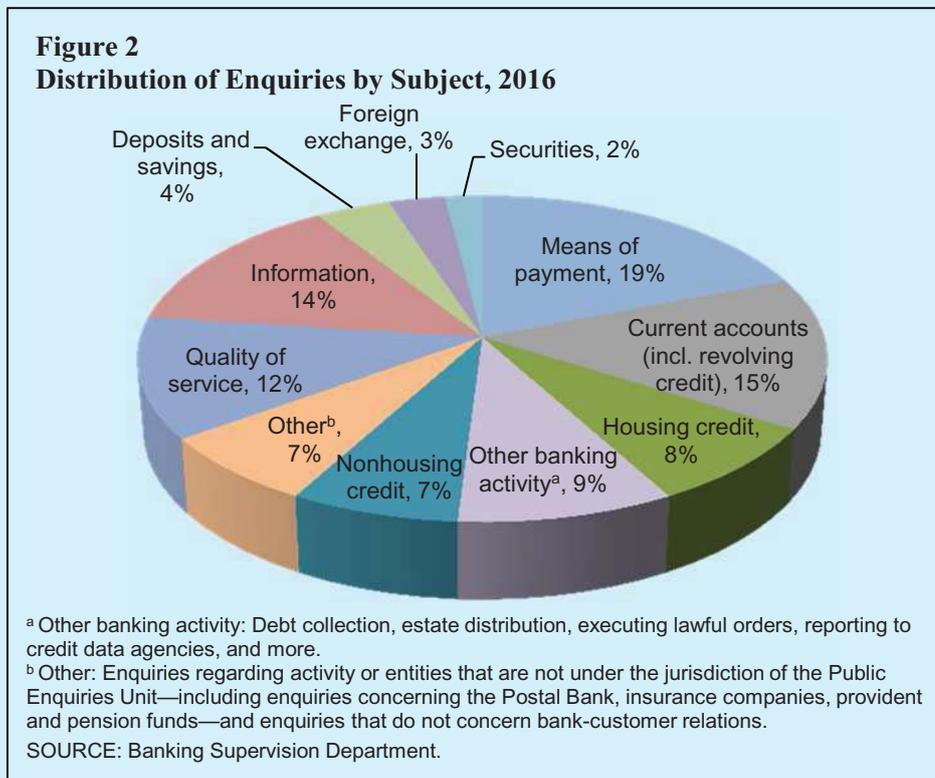
In 2016, the Unit received 5,164 written enquiries, requests, and complaints and dealt with 5,360. Among the total enquiries, 3,558 were classified as complaints and concerned disputes between customers and banking corporations. Most complaints come with a demand for financial compensation or other action by the banking corporation. In addition, 1,542 written enquiries were handled, in the course of which information was given about the policies and directives of the Banking Supervision Department, banking legislation, consumer rights, and the activity of the Department and of the Unit. The Unit also handled 260 requests for assistance from banking corporations. As a result of the Unit’s activity, some bank customers received cash refunds.

	2013	2014	2015	2016
Enquiries received by telephone	21,450	20,346	17,963	~18,000
Written enquiries and complaints handled	5,067	5,555	5,080	5,360
Enquiries referred to banking corporations under Proper Conduct of Banking Business Directive 308A	N/A	N/A	1,212	1,655



2. Topics of complaints

Most enquiries and complaints received in 2016 concerned means of payment (particularly checks and credit cards), bank credit (consumer and housing), matters related to opening and managing current accounts, requests for information, and the quality of banking corporations' service.



3. Focal topics of activity

Several main topics lay at the focus of the Public Enquiries Unit's activity in 2016. They reflected important banking and consumer issues that emanated from information submitted by the public. They yielded a mirror image of processes under way in the banking and public environment that affect customers and the way they do business with the banking system.

- **Responding to needs of disempowered population groups**

The Banking Supervision Department considers it very important to help all banking system customers. As such, it promotes a social policy of caring for weak and special needs population groups. As part of this social policy, the Public Enquiries Unit devotes special attention to the needs of population groups that suffer from financial hardships, those with special needs such as the elderly and persons with disabilities, and customers who lack knowledge and experience in financial consumerism—teenagers, non-Hebrew-speakers, and so on. These customers are given individualized responses commensurate with the needs expressed in each case.

In dealing with enquiries, the Unit emphasizes three principles—the fastest possible response, tailoring the response to the customer and his or her special needs as the case may be, and finding a solution in cooperation with the bank where the enquirer keeps his or her account.

- **Protecting customers following the closure of branches and cutbacks in teller services**

The Unit received complaints from customers concerning the closure of branches and cutbacks in teller services due to the inconvenience that these changes caused some customers in certain cases. The Unit responded by providing information, explaining the considerations and the rationale behind these processes, giving specific information, and guiding customers toward solutions—referral to a branch close to the one that was closed, enhancing awareness of available technological solutions, advising on the possibility of switching banks, and so on. In exceptional cases where customers encountered a problem due to special needs, or had difficulties in transitioning from traditional banking to direct banking, adequate solutions were sought in conjunction with the bank.

- **Opening current accounts and providing customers with basic means of payment**

The Banking Supervision Department considers it immensely important to enable anyone who so requests to open and manage a non-overdraft bank account for the management of their financial activity.

According to Proper Conduct of Banking Business Directive no. 422—“Opening and managing a current account with no credit facility”—banking corporations must allow everyone to open and manage a non-overdraft current account unless there is reasonable cause to withhold this service.

Most complaints that were received and dealt with in this matter concerned refusal by a bank to open an account for customers who were mired in economic difficulties. Additional complaints pertained to a bank’s refusal to provide customers with basic means of payment with which they could manage their accounts.

To help customers in these matters, the Unit has a fast track for enquiries on this topic and makes enquiries of its own to prevent recurrence. Sometimes, representatives of the Unit escort customers to the bank when they apply to open an account in order to test the bank’s conduct in implementing the Directive.

- **Requests to locate accounts**

In September 2016, the Bank of Israel, in conjunction with the Ministry of Finance, launched a web site called Money Mountain 2, which allows bank customers to locate accounts and deposits owned by individuals who have not issued instructions concerning them for a long time, and helps heirs to track down accounts of deceased persons.

In 2016, hundreds of customers who submitted enquiries in such matters received responses, and the Public Enquiries Unit is available to the public for queries and requests in locating accounts by means of the aforementioned site.

Box 3.3**Treatment of restricted accounts**

- The number of restricted customers increased slightly in 2016 due to an increase in restrictions by nonbank entities.
- The Banking Supervision Department is acting to improve the state of restricted customers and lower their number in several ways: sending text message warnings, establishing a personal website for restricted customers and accounts, cooperating with the Enforcement and Collections Agency to ease restrictions on small debtors, and providing training and information to the public on the topic of restriction.
- In the reviewed year, there were 799,574 visits to the Restricted Accounts Section of the Bank of Israel website.

1. Number of restricted customers and accounts

In 2016, there were nearly 270,000 restricted customers and around 460,000 restricted accounts. The moderate increase in the number of restricted customers and accounts is mainly a result of an increase in the number of special restrictions imposed by nonbank entities (the Enforcement and Collections Agency, the Official Receiver, the Center for Collection and Fines, and the rabbinical courts)—236,000 restrictions by these entities, compared with 33,000 restrictions due to anomalous checking activity. As one may see, the large majority of restricted customers were restricted not by the banks but by other agencies that are empowered by law to restrict customer accounts. The Banking Supervision Department has made it its goal to reduce the number of restricted customers. Its activity for this purpose, and to help restricted customers rehabilitate themselves, takes place at four levels:

- **Alerts to customers in the event of returned checks:** The Department requires banking corporations to warn customers by means of text messages both when customers are at risk of account restriction (five returned checks in the previous twelve months) and when the restriction is invoked (so that the customer can act as quickly as possible to track down errors in counting checks, erroneous reportage by the restricting entity, failure to relate to payment of debt, and so on, and can settle matters with no unnecessary delays). This requirement will go into effect in the second to third quarters of 2017.
- **Establishment of a personal ID website for restricted customers and accounts:** The site will provide customers with personal and focused information including the identity of the entity that restricted them, the reasons for the restriction, a map of the restricted accounts and the reason for the restriction of each, the customer's rights and obligations, how to appeal a bank restriction, common Q&A, references to relevant directives and statutes, a detailed guide to restrictions, issuing an automatic certification of status document, and more. The site is expected to become operative in the course of 2017.
- **Cooperation with the Executions and Collections Agency** to reduce the number of restrictions on small debtors.
- **Information and training activity in regard to restrictions.**

2. Handling enquiries related to restrictions and appeals of restrictions

During the reviewed year, the Banking Supervision Department handled some 4,500 written enquiries (submitted by fax, online form, e-mail, and conventional mail) and around 20,000 telephone enquiries. The enquiries pertained to a range of problems and questions raised by customers with restricted accounts, general information about rights and obligations of customers with restricted accounts, and the certification of customer status for presentation to a third party. The Department also regularly monitors banking corporations' implementation of court orders, reviewing appeal files on a case-by-case basis in order to prevent violations of law. In 2016, the Restricted Accounts Section closed 830 appeal files concerning account restrictions.

An interactive voice response (IVR) system and a website are also available to the public. In the reviewed year, there were 799,574 visits to the relevant pages.

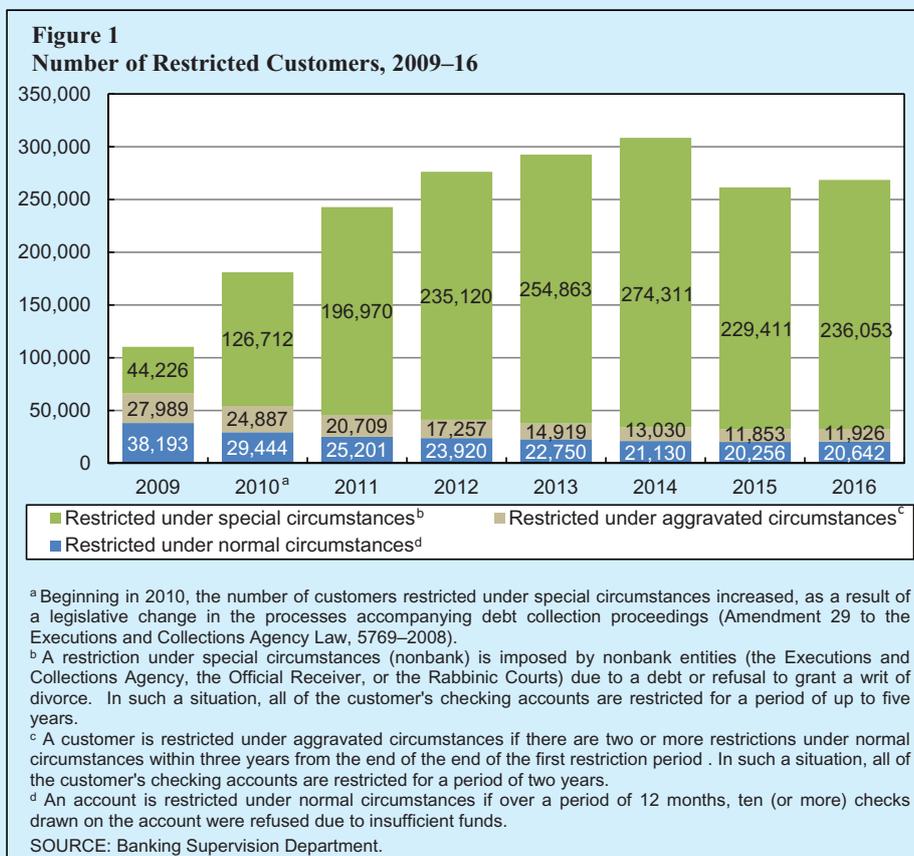
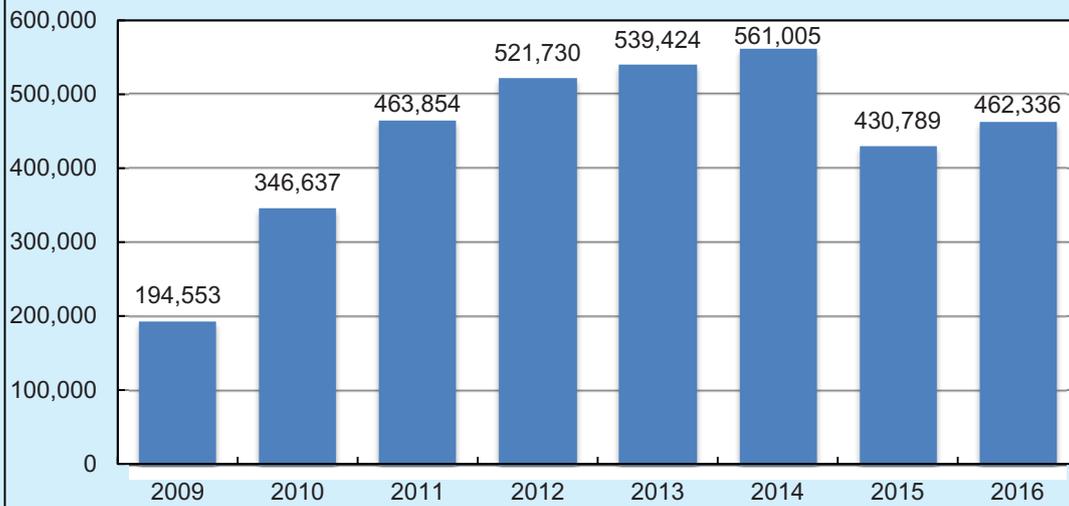


Figure 2
Number of Restricted Accounts^a, 2009–16



^a Beginning in 2010, the number of customers restricted under special circumstances increased, as a result of a legislative change in the processes accompanying debt collection proceedings (Amendment 29 to the Executions and Collections Agency Law, 5769–2008).

SOURCE: Banking Supervision Department.

Appendix: Directives Issued in 2016^{1,2}

- January 3 **Publication of Supervisor’s letter on “Debits by Authorization”—clarifications**
 Proper Conduct of Banking Business Directive no. 439 regulates the process of transferring debits by authorization when a customer changes banks. The guidance letter was sent to the banking corporations following inquiries on the topic after an amendment to the directive went into effect (on October 11, 2015).
- January 26 **Publication of letter about management of risks inherent in the activation of a voluntary disclosure program in Israel**
 Pursuant to the publication of a procedure for voluntary disclosure of unreported and untaxed income, the Israel Tax Authority allowed taxpayers to report their income, attaching a statement to the effect that it does not originate in illegal activity, and to receive certification of such from the Authority. Since customers may abuse the provision to transfer funds of criminal origin, various requirements are established in the letter, including a requirement to update policies and procedures that the banking corporation must adopt in this regard.
- February 3 **Amendment to Proper Conduct of Banking Business Directive no. 432—“Transferring Activity and Closing Customer’s Account”**
 According to the directive, banking corporations must provide an up-to-date periodic report to customers requesting information on the possibility or the advisability of switching their activity out of their account. The amendment relates to circumstances under which the request for information is presented close to the date of update of the report. The amendment went into effect on February 28, 2016.
 Amendment to Proper Conduct of Banking Business Directive no. 425—“Annual Reports to Customers of the Banking Corporations”
 The amendment was necessary due to various issues that arose in the course of implementation of the Directive. The amendment went into effect on February 28, 2016.
- March 20 **Publication of letter of clarification on the implementation of Proper Conduct of Banking Business Directive no. 454—“Early Repayment of a Non-Housing Loan”**
 Following enquiries submitted before the update to the directive was to go into effect (on April 1, 2016), a letter of clarification was sent to the banking corporations.
- March 21 **Adjustment of Reporting to the Public Directives on reporting by banking corporations and credit card companies in Israel to the US Generally Accepted Accounting Practices.**
 Due to the importance of the accounting treatment of foreign currency issues, accounting policy, revision of accounting estimates, and errors and events after the balance sheet date, it was decided to adjust the accounting treatment of these issues to the U S Generally Accepted Accounting Practices.

¹ The full and binding wording of the description of regulatory actions appears on the Bank of Israel web site.

² New directives and important amendments to existing directives appear against a blue background.

May 1

Publication of Proper Conduct of Banking Business Directive no. 472—“Merchant Acquirers and Acquiring Payment Card Transactions”

- In response to the growing use of payment cards, and to encourage competition in merchant acquirer services and retail credit, Proper Conduct of Banking Business Directive no. 472 was published, setting forth the main rules for settlement of payment card transactions. The main provisions of the directive are as follows:
 - Setting minimum equity that a merchant acquirer must have, distinguishing between acquirers with insignificant volumes of credit activity and the others.
 - Establishing a mechanism for separation of funds in the settlement process in order to protect funds received from issuer against the merchant acquirer's creditors until they are forwarded to businesses.
 - A requirement to set out policies and procedures for underwriting businesses and monitoring their risk levels.
 - Allowing a merchant acquirer to lease EMV-compliant terminals to businesses with which it concludes settlement agreements—subject to terms set forth in the directive.

Amendment to Proper Conduct of Banking Business Directive no. 329—“Limitations on Issuing Housing Loans”

Proper Conduct of Banking Business Directive no. 329 was updated to support the ability of eligible participants in reduced-price homebuying projects such as the “Target Price” or “Buyer's Price” programs. The amendment establishes rules for calculating the value of properties on which reduced-rate loans are given so that homebuyers may put up less equity of their own when they participate in such projects.

May 22

Reporting to the Public Directives concerning the reorganization of problematic debt

Adjusting the accounting treatment to the FASB codification concerning reorganization of problematic debt, including authorization to terminate the classification of a debt as a problematic debt under reorganization when a supplemental reorganization is carried out in regard to it and when certain conditions specified in the directive are present.

June 16

Permits for stakeholding in banks for entities that manage customers' funds—policy update

The letter updates the Bank of Israel's policy on permits for holders of controlling interest in entities that manage customers' funds and, among other things, allows such parties to hold up to 7.5 percent of means of control in a banking corporation.

- July 11 **Amendment to Proper Conduct of Banking Business Directive no. 403—“Non-Banking Benefits to Customers”**
 The directive sets forth rules under which banking corporations may provide nonbank benefits to customers. The amendment broadens the ability of banking corporations to give customers such benefits due to customers’ ongoing conduct in their account. The amendment went into effect the day it was published.
- Amendment to Proper Conduct of Banking Business Directive no. 454—“Early Repayment of a Nonhousing Loan”**
 The directive defines the way payments may be collected from borrowers in the event of early repayment of nonhousing loans. The amendment incorporates clarifications that were sent to the banking corporations in the letter of March 20, 2016, and addresses additional issues that came up. The amendment went into effect the day it was published.
- Supervisory letter extending the deadline for implementing Section 6a(d) of Proper Conduct of Banking Business Directive no. 439—“Debits by Authorization”**
 Banking corporations were given an extension to January 1, 2017, for the use of existing forms to create an authorization of direct debit. From then on, they will have to include in such an application all details set forth in Addendum A of the directive.
- July 19 **Amendment to the Banking Rules (Service to the Customer) (Fees), 5768–2008**
- Banking corporations are required, at their initiative, to enroll senior citizens and persons with disabilities in their basic track service (where participating in it is advantageous to them) and to advise them of this.
 - The fee for changing the repayment date on a housing loan is reduced from NIS 125 to the price of one teller-executed transaction.
 - Banking corporations shall provide customers, once at no fee, a copy of legal notices sent to them electronically in the six months preceding the closure of an account.
 - Producing a document such as “letter of recommendation” is included among the services of “producing reports at customer request—reports involving the gathering of information.”
- Supervisory order concerning standard report service at customer request**
 A supervisory order was issued setting a maximum fee for producing standard reports at the customer’s request. The order went into effect on August 1, 2016.
- July 21 **Publication of Proper Conduct of Banking Business Directive no. 367, “E-Banking”**
 With banking corporations’ customers making increasing use of e-banking services, a new directive was published that eliminates barriers to the continued development of e-banking and allows flexibility in accordance with changing technology. The directive went into effect on January 1, 2017.

- July 25 **Amendment to Proper Conduct of Banking Business Directive no. 420—“Sending Notices via Means of Communication”**
 The amendment allows customers of banking corporations to receive information via telecommunication channels that was customarily obtained at the branch only. It also allows banking corporations to offer a service through which alerts are sent via telecommunication channels to help customers in the informed management of their accounts. and the amendment also requires banking corporations to send text message alerts to the customer’s mobile telephone if five checks have been refused due to insufficient funds and if the account has been restricted. The purpose is to help customers avoid having their accounts restricted and to help them know promptly about restrictions imposed on their account. The amendment to the directive went into effect gradually—part on the day it was published, part on April 1, 2017, and part on July 1, 2017.
- August 7 **Circular on types of accounts and conditions that, when present, obviate the need for the customer to sign an agreement**
 The purpose of the circular is to promote the changeover to digital banking. In accordance with the circular, a customer, instead of signing certain banking agreements, may certify on the website, or via the banking corporation’s mobile application, that he or she was given the requisite opportunity to study the agreement. According to the circular, it is also possible to conclude an e-banking agreement and a telephone-instruction agreement by means of a recorded phone conversation or digital telephone response.
- August 21 **Adding pension consulting services to the fee schedule**
 Pension consulting services were added to the full fee schedule in the First Addendum to the rules concerning fees. The measure allows banks to charge customers who choose to receive advice a fee for this service.
- September 12 **Publication of a Proper Conduct of Banking Business directive on locating inactive deposits and accounts of deceased persons**
 To help bank customers find inactive deposits and accounts of deceased persons, a project has been set up that allows owners of inactive deposits and heirs of deceased bank customers to receive information about such deposits and accounts. The directive regulates various aspects of the project. It went into effect the day it was published.
- September 27 **Improving access of banking services to persons with disabilities—business continuity**
 Pursuant to the applicability of the Equality of Rights for Persons with Disabilities Law, 5758–1998, a circular was published in which banking corporations are asked to make reference to the way banking services are made accessible and to how customers with disabilities can reach a protected space, as part of the comprehensive management of business continuity as specified in the circular.

September 29 **Update of Proper Conduct of Banking Business Directive no. 301A—“Remuneration Policy in a Banking Corporation”**

Following the passage of the Remuneration for Officers of Financial Service Corporations (Special Authorization and Non-Deductibility of Aberrant Remuneration) Law, 5776–2016, and due to its expected implications for the level and composition of remuneration at banking corporations, Proper Conduct of Banking Business Directive no. 301A “Remuneration Policy at a Banking Corporation” was amended. The main changes are as follows:

- The “Key Employees” group was downsized, as specified in the directive.
- The definition of “fixed remuneration” was revised so that shares blocked for use at the time they are granted may be recognized within this definition.
- In regard to the variable component, pre-determined criteria may include a discretionary element that shall not exceed three monthly salaries per year.
- The requirement of a minimum holding or maturation period for capital instruments given as non-deferred variable compensation is abolished.
- The upper bound of the variable compensation exempt from the deferral requirement is raised.

Update of Proper Conduct of Banking Business Directive no. 315—“Supplementary Provision for Doubtful Debts”

In view of the banking corporations’ recent purchases of credit protection against exposures stemming from bank guarantees to homebuyers under the Sales (Dwellings) (Assurance of Homebuyers’ Investments) Law, 5735–1974, and recognition of the eligibility of these guarantees for credit risk mitigation as set forth in Directive 203, it became necessary to amend Proper Conduct of Banking Business Directive no. 315 in regard to the impact of shifting risk to an insurer on the industry’s indebtedness.

Update of Proper Conduct of Banking Business Directive no. 312—“Banking Corporation Business with Related Parties”

Following the publication of a Supervisor’s letter on June 16, 2016, concerning “Permits for stakeholding in banks for entities that manage customers’ funds—policy update,” Proper Conduct of Banking Business Directive no. 312 was updated and any person who has more than a 5 percent stake in any kind of means of control in a banking corporation, or in a banking corporation that controls a banking corporation, is exempt from the definition of a “related party” if the permit is issued subject to the terms sets forth in the letter.

Update of Proper Conduct of Banking Business Directive no. 351—“Fraud and Embezzlement by Employees and Officeholders”

To enhance clarity and standardize practice in the banking system, Proper Conduct of Banking Business Directive no. 351 was amended to include, among the examples of “material events,” an event reported to “another authority” such as the police, the Israel Securities Authority, and other supervisory and enforcement authorities.

- October 13 **Alignment of Reporting to the Public directives concerning reporting by banking corporations and credit card companies in Israel with US Generally Accepted Accounting Principles**
 Given the importance of the accounting treatment of noncurrent assets held for sale, terminated activities, fixed property and real estate for investment, earnings per share, cash-flow reporting, interim-period reporting and additional matters, it was decided to align the accounting treatment of these matters with the Generally Accepted Accounting Principles for American banks. It also became necessary to include clarifications on reporting on income tax according to the US rules, due to implementation issues that arose in the joint task force that included representatives of the Banking Supervision Department, the banking corporations, and external auditors.
- Amendment of Proper Conduct of Banking Business Directive no. 304a, “The External Auditor—Performing Audits and Reviews in Accordance with Certain US Standards”**
 Following the publication of additional auditing standards by the Public Company Accounting Oversight Board in the US, it became necessary to update Directive 304a.
- October 30 **Update of Proper Conduct of Banking Business Directive no. 411—Management of AML/CFT Risks**
 Due to the application of the AML/CFT regime to holders of trading platform licenses, an appendix was added to the directive stating that the provisions of the Prohibition of Money Laundering Order relating to recording a beneficiary in an account shall not apply to trust accounts managed by a company that holds a trading platform license under Section 44M of the Securities Law, for its customers.
- November 23 **Update of Proper Conduct of Banking Business Directive no. 411—Management of AML/CFT Risks**
 With the introduction of universal long-term savings for children, it was determined that the National Insurance Institute will deposit the sum of NIS 50 per month in an account in the name of each child. As a result, an appendix was added to the directive: “Arrangement Established by the Supervisor of Banks under Section 7A of the Order”, requiring banking corporations to record the identifying particulars that have been set out for opening a bank account.
- Letter concerning preparedness for management of compliance risks in view of determination that tax offenses are source offenses**
 With banking corporations increasingly at risk of exploitation for tax evasion purposes, the Prohibition of Money Laundering Law has been amended and several grave tax offenses (source offenses) were added to the list of offenses in the First Addendum to the law. As a result of the amendment, banking corporations are required to consider necessary changes in policy, risk assessment, and procedures, with reference, *inter alia*, to patterns of action that appear on the list of red flags in the appendix to the letter.

November 28 **Capital requirements for central counterparty exposure**
 Proper Conduct of Banking Business Directive no. 203, sets out that from January 2017 onward, the banking corporations will have to meet the Basel Committee’s updated capital requirements for central counterparty exposure. According to the directive, the total exposure to customers who are active on the stock exchange should be calculated using the current exposure approach and not the scenarios approach that has been employed thus far. Since the current exposure approach is expected to significantly reduce stock exchange trading volumes, continued calculation of exposure using the scenarios approach is allowed until the new approach, set forth by the Basel Committee, is applied. The Department intends to adopt this approach within several years.

Directives in the Year to Date (2017)

January 9 **Publication of Proper Conduct of Banking Business Directive on closing bank branches and downsizing teller services**
 The directive regulates the closure of bank branches, the downsizing of teller services, and the changeover to direct banking services in a manner that meets various customers’ needs. The directive went into effect on the day it was published, with the exception of Sections 19 and 20, which went into effect sixty days after publication.

February 1 **Publication of Proper Conduct of Banking Business Directive on debt collection proceedings**
 The directive specifies compulsory measures to enhance fairness and transparency in collecting debts from customers who fail to meet loan terms and do not meet regular payment deadlines. The directive will go into effect a year after its publication.

March 6 **Cancellation of circular concerning advertising—financial guidance of construction**
 Following legislative changes and updates of Proper Conduct of Banking Business directives on the topic, this circular is no longer relevant and has therefore been cancelled.

Amendment to Proper Conduct of Banking Business Directive concerning business days of banking corporation offices

The directive sets rules for banking corporations in cases of temporary closure of a branch and changes in business days. The amendment was made due to the regulation of branch closure by means of the Banking (Licensing) Law (Amendment no. 22), 5776–2016 and the Proper Conduct of Banking Business directive on closing bank branches and downsizing teller services.

Amendment to the Proper Conduct of Banking Business directive on E-Banking

To allow banks to open and manage long-term savings accounts for children as set forth in the National Insurance Law and its regulations concerning long-term savings for children, the Proper Conduct of Banking Business directive on E-Banking needed adjustments. An adjustment in this directive relating to inactive deposits was also necessary.

Amendment to the circular regarding types of accounts and conditions for which customers need not sign an agreement

To allow banks to open and manage long-term savings accounts for children as set forth in the National Insurance Law and its regulations concerning long-term savings for children, the circular needed certain adjustments.

Amendment to Proper Conduct of Banking Business Directive no. 411—Management of AML/CFT Risks

The directive was amended in accordance with the recommendations of the FATF for effective implementation of the Money Laundering and Financing of Terrorism Prohibition, and in accordance with the Basel Committee guidelines intended to be consistent with those recommendations. The following are the main points of the amendments:

- Expanding the list of roles of the corporate governance function and adapting them to the compliance risk management set out in Directive 308.
- Listing the factors upon which the banking corporation must rely when conducting the risk assessment, and the data that must be gathered from internal and external parties in order to formulate the risk assessment.
- In order to reduce risks, a requirement was introduced to take risk factors into account by customer, country, territory and product, services and distribution channels when setting the “Know Your Customer” policy and procedures.
- Including account management for domestic public officials and senior officers in international organizations as part of risk activity.
- Listing the requirements for formulating group policy for banking corporations that manage international activity through subsidiary companies or branches outside of Israel.

April 9

Amendment to Proper Conduct of Banking Business Directive no. 355 “Business Continuity Management”

The directive was amended to clarify aspects concerning cases of significant operational interruptions, including the importance of maintaining the proper functioning of the payment and settlement systems, and continued supply of banking services to the public. The following are the main points of the amendments:

- Redefining essential processes and services
- Including strikes as a factor that may create a “significant operational interruption”
- Updating the requirements relating to critical sites.
- Updating the policy for opening branches during emergencies

Drafts Published in the Year to Date (2017)

January 23

Draft Proper Conduct of Banking Business directive on telephone response

The directive is meant to regulate a banking corporation’s duty to a professional telephone response service to its customers and to limit waiting time for a human response when a customer contacts a call center. The directive imposes on banking corporations the main conventional requirements in this matter under consumer protection laws, *mutatis mutandis* for the banking system.

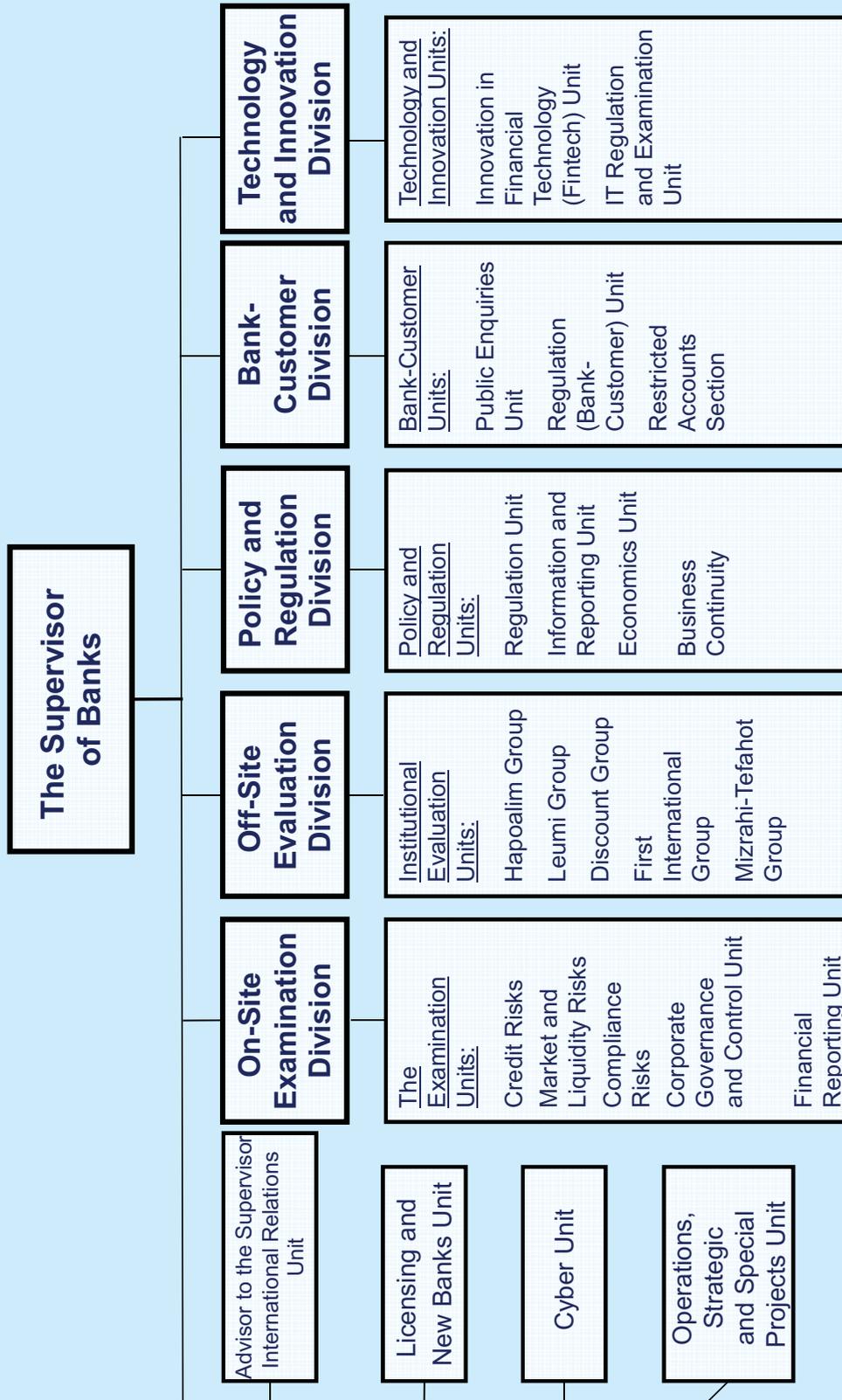
January 25

Draft amendment to the Banking Rules (Service to the Customer) (Fees), 5768–2008

The amendment envisages changes that are expected to go into effect in the course of 2017 in respect to fees:

- Banks will be required to charge less for direct channel service than what they charge for the same service by a teller.
- Every customer will be able to withdraw funds by means of his or her bank card at any ATM of his or her bank, irrespective of his or her distance from the branch, at the cost of a direct transaction.
- Banks will have to show information about the cost of cash withdrawal on the screen of automatic banking machines, commensurate with different types of machines and customers.
- A bank may charge a noncustomer (one who does not have an account with it) a higher fee for a teller-executed transaction than it charges its regular customers.

The Banking Supervision Department



* Includes responsibility for promoting a framework for the operation of credit unions and for the development of a supervised information infrastructure.