



BANK OF ISRAEL
Office of the Spokesperson and Economic Information

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Press Release

Remarks by the Supervisor of Banks at the Globes Israel Business Conference

Opening remarks

- This conference presents a real challenge to us all—to attempt to present the complete picture of the economy heading into 2012 and beyond. As has already been said, the complete picture is complicated, and it is also very dynamic, changing rapidly—and every change requires a new assessment of the situation. Essentially, we are looking at a movie, not a still picture. Despite assessments of the situation, and the scenarios examined, reality continues to surprise us—events follow one another rapidly, or perhaps we are in a long event which continues to evolve, rising a notch with each stage.
- In my remarks I will concentrate on those parts of the picture which are connected to the banking system and are a focus of our surveillance and activity as the supervision of banks.

I will begin with the general macroeconomic situation:

The general macroeconomic situation reflected in the situation of the banks

- **The banks' activities and financial results present a mirror image of the economy and the firms which operate in it.** Profitability of the banks declines in times of recession and slowdown, while in times of prosperity, profitability increases. That is, over the long term there is a high correlation between business activity and bank results.
- The Israeli economy is an open economy—in terms of both real and financial activity—and thus it is affected not only by domestic developments but also by the global environment, and banks are also affected by these developments.
- There is clear evidence of this, and one does not need to go too many years back—we saw a near zero (0.35 percent) return on capital in the banking system only three years ago, during the great financial crisis,, and of less than 3 percent in 2002. In the same period we saw upsides in bank profits during years of expansion.

The global environment and its impact on the banks:

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- **On the real side, there has been moderation in the rate of global economic growth. In other words, a slowdown, and in some countries there are even forecasts of recession. With that, at this time, the greatest problem is focused in Europe**—the continent's large countries are expected to show very little growth and the threat of the breakup of the eurozone remains in the air.
- In addition to a decline in real activity in the eurozone, on the financial side, too, there is a sovereign debt crisis of eurozone countries, especially countries on the periphery (Portugal, Italy, Ireland, Greece and Spain, or as they are abbreviated, PIIGS). The sovereign debt crisis has a negative impact not only on growth, due to the need to take austerity measures to reduce government debts, but also on the financial status of European banks, for whom a significant part of their nostro account assets are bonds issued by European governments. By the way, these are assets that were considered not risky and served as reserve holdings. Those same banks are also exposed to each other—through inter-bank activities including deposits, loans, and derivatives—which increases the risks in the financial systems.

The situation in the eurozone has direct and indirect consequences on the banking system in Israel, deriving from the real as well the financial situation there.

- Banks are directly exposed to the eurozone, primarily through their activities with European financial institutions, although the exposure to peripheral countries is relatively low.
- Banks are also indirectly exposed to the eurozone through the impact of the recession in the eurozone on the repayment ability of Israeli companies that were granted credit from banks for activities abroad, or activities with abroad: about 26 percent of Israel's goods exports, and 23 percent of services exports, head to the EU. While activities can be redirected toward other, emerging, markets—and it appears that Israeli exporters are trying to do just that—it is nonetheless not a simple process, and therefore in the short term there is an increase in risk from this direction.

The effects of the range of negative financial and real developments in the eurozone can already be seen in steps taken by the banks in a number of areas:

- Reducing direct exposure to eurozone sovereign debt and financial institutions, and a shift of the exposure to the stronger countries in the eurozone;
- Increasing liquid reserves in foreign currency—in effect, the banks in Europe and throughout the world are keeping foreign currency reserves close to home and are increasing reserves;
- Strengthening collaterals from borrowers who are exposed to the crisis in Europe.

All these steps are taken with constant and close surveillance, at the senior management level, through the use of stress tests, with the focus changing as events warrant.

We believe that these procedures need to continue in light of the continuing uncertainty.

The system is also exposed to risk from developments and the characteristics of the local economy.

- **In the real sector, certain economic indicators point to a slowdown in economic activity and in demand—primarily, moderation in two main growth engines of the economy: exports and private consumption.** In the final quarter of 2011 we have seen a significant decline in exports, of about 17 percent, and likewise, more moderate growth of private consumption than in the past—an increase of only 0.9 percent.
- According to the Bank of Israel Research Department forecast, the economy is expected to continue and grow in 2012, but at a slower pace than we have experienced in the past two years, and the forecasts are liable to be revised downward, in light of more current figures.
- The slowdown in domestic activity has a number of effects on the banks:
 - An increase in provision for credit losses
 - A decrease in recovery of problem loans which had been created in the past
 - A decrease in interest income due to a decline in use of credit
 - A decrease in operating income in light of a decline in demand for banking services (such as, capital markets activities and foreign trade activities)

The strength of these effects depends on the state of the economy as well as the mix of various banking activities.

The banking system is exposed to risks stemming from credit portfolio concentration—borrower concentration and industry concentration.

- **Concentration of credit to large borrowers presents a focus of risk to the banking system.** Banks' credit to the business sector is concentrated, deriving from the structure of the Israeli companies.
- **We see the risk of credit to large borrowers as a systemic risk, as the largest borrowers from banks are generally also the largest borrowers outside the banking system.** A credit failure in one of these markets has an effect on the other, for example by reducing the value of collateral, creating credit repayment difficulty in the other market, and so forth. Stiffening credit demands in one market, as well, is liable to have an impact on credit risk in the other market. The background to this is not only the size of the borrowing companies, but also their total leverage.

The responsibility to guarantee that this leverage does not rise above a reasonable level is not only that of company managers', but, primarily, of the financial entities—banks and non-banks, within the framework of their responsibility to manage other peoples' money.

- In that connection, I note the importance of the non-bank credit market to the business sector. This market grew markedly in recent years, and today it provides about half of business credit (47 percent). Therefore, it is critical that this market operate soundly and allow debt recycling, since the banking system will not be able to carry business credit double what it is already providing in the short and medium term.

Industry concentration

- When speaking of industry concentration in the banks' credit portfolio, we refer to credit to the construction and real estate sector, which represents 17 percent of total credit. Looking over the long term, the real estate industry is cyclical. In recent

years it has seen prosperity, but in the last few months there are signs of a change in trend, meaning the risk level rose.

- Essentially, we are discussing risk which is inherent in granting credit. However, in this case, concentration adds another dimension of risk—it is not one or two borrowers, but a significant share of the credit portfolio. The regulatory limitations in this area were intended to prevent a situation in which a crisis in a specific industry is liable to snowball into problems for the entire banking system, similar to limitations which were intended to prevent a major impact of a failure by one large borrower at the bank.

The bottom line is that the risk level has risen. So what do we do?

I will focus on two steps that the banks are taking already and that they will take in the near future, intended to enable them to deal more effectively with the risks and with the changes in the economic situation: the first is strengthening the risk management system, and the second is improving capital adequacy and capital planning.

Strengthening the risk management system and ensuring appropriate underwriting procedures in the banks

- In the last year we published several draft directives describing the overall approach to risk management, the purpose of which is to improve the ability of the banking system to exercise effective control over the level of risk. This approach incorporates three lines of defense:
 1. The first is in the banks' lines of business themselves, with their responsibility for identifying and managing the risks inherent in their products and in the activity for which they are responsible.
 2. The second lies in the independent risk management function in the banks' areas of business, the function responsible for the system of total risk management, including the formulation of a risk policy.
 3. The third is internal audit that examines the propriety and efficiency of processes, and reveals control weaknesses.
- **With regard to underwriting procedures, we consider that the adoption of this approach will necessitate changes in some bank management procedures,** and will ensure improved underwriting, based on rigorous analysis of customers' repayment ability, and taking into consideration the extent of the borrowers' leverage. This would also ensure that the problem of concentration is dealt with.

Improving banks' capital adequacy and capital planning

- The regulatory trends throughout the world regarding capital adequacy and accumulation of Tier 1 capital in banks abroad, and not just in Europe, show clearly that the level of capital and its quality need to be increased. Capital accumulation abroad does not derive from internal sources alone, i.e., from profit, but from the injection of external capital via issues, including the dilution of shareholders.
- Regulatory authorities abroad recently started to publish their intentions regarding banks' capital targets, and it seems that concerning the amount of capital and the timetable they are stricter than those in Basel III.

The European Banking Authority (EBA) requires the major European banks to present plans ensuring a Tier 1 capital of 9 percent as soon as in June 2012, after deducting the fall in value resulting from the investments in government bonds. In the UK, the Financial Services Authority announced its intention of demanding 10 percent Tier 1 capital, and in Sweden the Tier 1 capital ratio is to rise gradually to 10 percent and then to 12 percent.

- In Israel we have still not set a framework for increasing capital. The framework that will be established will take into account not only world trends, but also banks' ability to create capital without harming their ability to support economic activity.

The banking system is not an island and needs to be attentive to public sentiment.

- The social protest brought into focus issues which in the past were not top priorities, and it is now clear that the voice of the public cannot be ignored.
- In banking sectors, the system made a significant leap in terms of transparency to the public, through the implementation of the bank fees reform, which dealt with common fees for households. There is also consistent improvement in dealing with public enquiries. However, there is still room to examine where the level of competition can be improved, something that will be reflected both in the level of prices and the level of banking services. **From this perspective, we will closely scrutinize the Trajtenberg Committee recommendations—the section dealing with cost of living—with the aim of fixing and improving where necessary, taking into account as well consumer considerations and stability considerations**, both of which are intended to protect the whole of the general public, including taxpayers, depositors, and customers.
- **The level of competition is not necessarily connected to the structure of the banking system, that is, to concentration in the system. We find proof of this in the mortgage sector.** We see high competition in this area, despite talking about the same players as in other areas. As such, there is room to examine ways to strengthen customers' bargaining power, to simplify banking products, and to create conditions that will allow other entities to operate in market niches where the price is higher than a price which can be considered competitive.

Besides these risks, we are in a geopolitical environment that demands special vigilance from the system, in order to be able to provide services in various scenarios, and to recover quickly in the case of threatening scenarios, including terror and war.

In closing, it is important to continue and ensure a stable banking system, even in an environment of high uncertainty. The banking **system** is exposed to local and foreign risks, and therefore, needs to take care in its operation, in order to be able to continue and provide strong leverage for support of economic activity.