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Letter of the Supervisor of Banks submitted with the 2011 Survey of Israel's Banking System

Risks increased in the banking system's operating environment in 2011. To a large extent, this was the effect of negative developments in the global financial system, against the background of the debt crisis in Europe and the continued slowdown in global growth. The risk in the banks' operating environment also increased due to local factors—including sharp declines in share prices; increased risk spreads; a decline in the ability to roll over debts in the nonbank market, primarily at large business groups and at real estate companies; and increased geopolitical concerns in the region.

Despite these developments, Israel's economy grew by 4.7 percent this year, a rapid pace compared to other advanced economies, and the banking system continued to present reasonable profitability and improved capital adequacy and to maintain its stability and resilience. With that, during the course of the year, the quarterly rate of growth moderated, and declined from 5.1 percent in the first quarter to 3.1 percent in the final quarter. This trend continued in the first quarter of 2012 as well, and had a negative impact on banking operations.

In order to ensure the banking system's continued resilience to severe shocks, and to strengthen the system's ability to fulfill its obligations to depositors, the Banking Supervision Department continued to take steps to strengthen the capital adequacy of banks in Israel. These steps were taken as part of the preparations for adopting the Basel III framework—which is primarily a redefinition of capital components, an increased core capital ratio, strengthening liquidity requirements, and reducing leverage—in Israel. The Basel III guidelines are intended to deal with weaknesses which arose during the 2008–09 financial crisis. These weaknesses led to the collapse of banks and large financial institutions in other countries, and furthermore, induced damage to capital markets and economies around the world.

Within the framework of the implementation of Basel III in Israel, we set in March 2012 guidelines which require all banking corporations to increase, by January 1, 2015, their minimum core capital ratio to 9 percent. The two largest banks, Bank Leumi and Bank Hapoalim, are required to increase their core capital ratio by another percentage point, to 10 percent, by January 1, 2017. This measure strengthens banks' resilience, which is required for the continued proper functioning of Israel's economy and for the safety of the public's deposits. Achieving the capital targets should be a gradual process, in order to ensure the continued provision of bank credit, which is crucial to the economy's growth.

Along with strengthening capital adequacy, we continued to move to implement international standards of risk management and corporate governance. As such, we acted to advance regulation regarding firm-wide risk management, and we established directives for dealing with specific risks. Likewise, we published, for the first time, a directive dealing with the internal audit function.

With regard to the system's risk profile, the risk of borrower concentration in the bank credit portfolio continues to be a focus of risk, and should the risks transpire they are liable to have a marked effect on the banking corporations' capital. We therefore acted during the year to reduce this risk by making stricter the limits on a borrower's, or group of borrowers', indebtedness. Likewise, in order to reduce the risks deriving from the housing market, we established a guideline according to which the variable rate component of a housing loan shall not exceed one-third of the total loan. This limit reduces both the macroprudential risk deriving from developments in the housing market as well as the risk that borrowers will find it harder to repay mortgage debts should interest rates increase.

In light of the importance of preparing the banking system in advance to provide banking services in various situations which are liable to cause severe disruptions in its operations, we regulated, in a

comprehensive directive, the issue of business continuity. Likewise, in light of continued attempts to attack the Internet sites and information systems of various Israeli institutions, we established a framework to deal with the risk involved in an attack on the information technology systems of the banks in Israel.

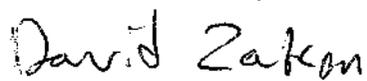
In 2011, we continued to work for the improvement of disclosure and measurement in banks' financial reports. Among other things, the banks began, for the first time, to implement the directive on "The Measurement and Disclosure of Impaired Debts, Credit Risk, and Allowance for Credit Losses". This is a central directive, the implementation of which required a long period of intensive preparation, both by the Banking Supervision Department and by the banking corporations. The implementation of the directive improves the ability to confirm that the allowance for credit losses accurately reflects all the expected losses in the credit portfolio, even if they have not yet been identified. In addition, it improves the banks' ability to monitor and manage credit risks, and it increases the ability to compare banking corporations in Israel with other banks around the world.

During the course of the year, changes with long-term ramifications were advanced in Israel. These were intended to create a robust infrastructure of a decentralized holding structure in banks in Israel. Within this framework, amendments to banking laws were completed, including guidelines on the mechanism of appointing directors at a bank that does not have a controlling core, regulations which define who has the right to appoint directors at such a bank, and efforts to increase the transparency and "market discipline" in the process of choosing directors at banks—whether they have a controlling core or not. At the same time, we published documents of principles which cover the financial and other requirements that the Bank of Israel demands from someone who wishes to acquire control at a bank, as well as the method of decentralization of the controlling core at the bank. These documents were presented to the public for comment. Likewise, in February 2012, the Committee on Increasing Competition in the Economy published its recommendations, the goals of which are to reduce the concentration and conflicts of interest in the economy. The Committee's recommendations are expected to have an effect on banks in Israel. For example, the recommendation regarding separation between holding real corporations and financial ones may lead to changes in the composition of control at some of the banks.

Following on the recommendations of the Committee for Economic and Social Change, the Minister of Finance and the Governor of the Bank of Israel appointed, in December 2011, an interministerial team which I am heading. The team is examining various methods to increase the competition in the banking industry, and in particular to bolster the negotiating power of customers, to simplify the banking product, and to improve and to increase the sophistication of the service provided by granters of credit, primarily to households and small businesses. The team felt that it was best to emphasize increased competition in those sectors through, among other things, reducing information gaps and removing barriers to transfer.

In conclusion, banks in Israel and world wide face considerable challenges, and not-insignificant risks continue to weigh on the domestic and global environment, and have an effect on the banks' financial results. The resilience of the banking system in Israel stood us in good stead during the 2008–09 global crisis—a crisis which exacted a heavy price in other economies around the world, including bank collapses, losses for depositors, and increased government deficits to prevent bank failures, with negative impact on economic growth. It is important that decision makers at banks, the Banking Supervision Department, and other institutions that influence the banking industry keep the lessons of the last financial crisis in mind. It is no less important that banks be attentive to the public's feelings, and take steps to increase the quality and competitiveness of banking services. In light of the gap between the operating efficiency of banking

corporations in Israel and the efficiency of the banking systems in other OECD countries, there is a need for significant improvements in efficiency. Improved operating efficiency will allow the banking corporations to offer financial services and products to their customers at lower prices than are common today, without negatively impacting their stability and quality of products and services that they provide to the public in Israel.

A handwritten signature in black ink that reads "David Zaken". The signature is written in a cursive, slightly slanted style.

David Zaken
Supervisor of Banks

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