Chapter 3
Financial Results

In 1999 the banking system was characterized by a continued rise in profit and return on equity (ROE): the total profit of the five major banking groups increased from NIS 3.1 billion to NIS 3.6 billion, reflecting the growth of ROE from 9.9 percent in 1998 to 11.2 percent in 1999—above the long-term average of the last decade. In the last three years the five major banking groups appear to have shifted again to a higher ROE plateau, even adjusting for nonrecurring profits, as occurred chiefly in 1996 and 1997 due to sales of excess nonfinancial holdings (Table 3.1). The ROE achieved by the five major banking groups in recent years is not exceptional in global terms, as is indicated by comparing their performance and operating indices with those of banking systems elsewhere. The risk-weighted assets ratio in Israel, on the other hand, is lower than in the peer-group countries (Table 3.2).

Profitability in 1999 was affected to a great extent by the expansion of the financial activity of all segments, leading to an increase in net interest income alongside a decline in specific loan-loss provision and its share in credit to the public. Concurrently, operating ratios improved in 1999 (Table 3.3), as the rise in non-interest income—from both commissions and from the capital market—exceeded that in operating expenses. There were no significant changes in the other components of the banks' income and expenditure compared with 1998.

1. THE PROFITABILITY OF THE BANKING GROUPS: MAIN RESULTS[1]

The financial results for 1999 indicate the continued growth in profits of the five major banking groups: total profit (including net income and minority interests) rose from NIS 3,062 million in 1998 to NIS 3,580 million in 1999, reflecting an increase in the average

[1] This chapter focuses on the income and profitability of the five major banking groups, although the extended analysis of margins, operating expenses, and non-interest income encompasses all the commercial banks. Data are based on the banks' published annual financial statements and returns to the Supervisor of Banks.

Table 3.1
Indicators of Profitability, the Five Major Banking Groups, 1994–99

(NIS million, December 1999 prices)

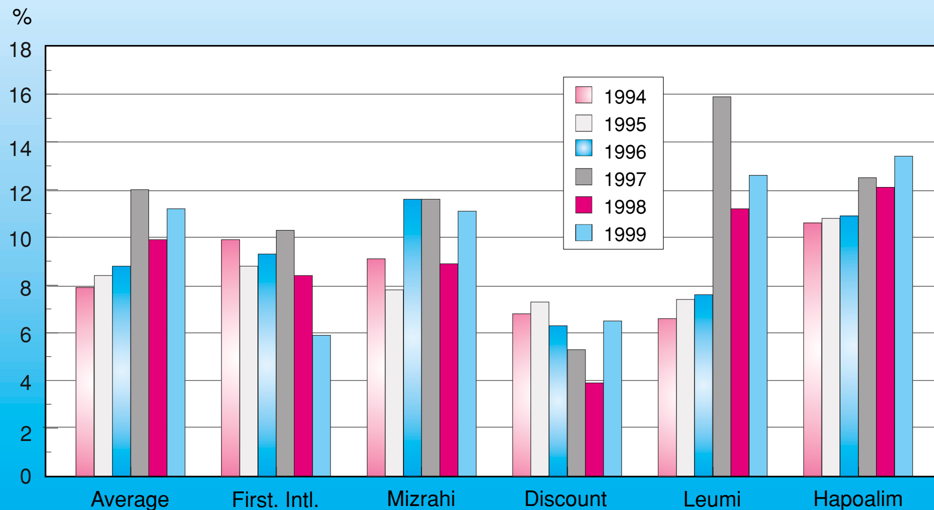
	1994	1995	1996	1997	1998	1999
End-of-year capital[a]	25,718	27,066	28,569	30,968	32,005	33,558
Adjusted capital[b]	24,406	25,718	27,066	28,569	31,001	32,040
Loan-loss provision	1,931	3,092	2,693	2,392	2,220	2,066
Ordinary pre-tax profit	3,512	3,645	3,959	4,919	4,516	6,093
Tax provision	1,918	1,855	2,189	2,366	1,913	3,043
Extraordinary after-tax profit	107	47	168	451	18	157
Share in profits of unconsolidated subsidiaries	279	368	406	395	354	358
Translation adjustments	–48	–42	49	30	87	15
Total net income[c]	**1,934**	**2,162**	**2,393**	**3,429**	**3,062**	**3,580**
Percent						
Ordinary pre-tax profitability[d]	14.4	14.2	14.6	17.2	14.6	19.0
Return on equity (ROE)[e]	7.9	8.4	8.8	12.0	9.9	11.2
Return on assets (ROA)	0.4	0.5	0.5	0.7	0.5	0.6
Loan-loss provision/credit to public	0.8	1.2	0.9	0.8	0.6	0.5

[a] Including minority interests.
[b] Capital at beginning of year *plus* issues weighted according to date of issue.
[c] Including the share of minority shareholders in consolidated profits.
[d] Ordinary pre-tax profit *divided by* adjusted capital.
[e] Total net income *divided by* adjusted capital.
SOURCE: Published financial statements.

return on equity (ROE) from 9.9 percent to 11.2 percent (Table 3.1). The ROE achieved by the banking groups in the last few years is noteworthy for several reasons: a. The economic slowdown in Israel for the third consecutive year was not evident in the performance of the banking system, although other industries experienced fluctuations and a decline in profits, due in part to macroeconomic developments (see Chapter 1). b. The performance of Israel's banking system is in line with that of the banking systems of advanced economies; Table 3.2 gives an international comparison of performance, operating, and risk indices for banking systems in twenty different countries,[2] showing

[2] The international comparison included the ten major banking groups in each country whose principal activity is commercial banking, assuming that these reflect to a great extent the performance of the entire banking system in that country. In Israel we included the five major banking groups, and in the US the 100 major groups, and the entire sample encompasses some 300 banks. Note that the data for Israel's banking system are adjusted for the effect of inflation, while in the peer group the reports are on a nominal basis. The database is drawn from *Bankstat* and *The World Factbook*, 1999.

Figure 3.1
Return on Equity, by Banking Groups, 1994–99



SOURCE: Published financial statements.

that the net interest margins on total assets and ROE in Israel's banking system do not differ from the average in the peer group.[3]

As in previous years, there is considerable variance in the ROE of different banking groups, and two distinct levels may be discerned in 1999: the higher level is evident in the Hapoalim (13.4 percent), Leumi (12.6 percent), and Mizrahi (11.1 percent) groups, while the lower level is evident among the Discount (6.5 percent) and First International (5.9 percent) groups.[4] In the Hapoalim and Leumi groups ROE has risen consistently since 1994, except for a decline in 1998 (due to an exceptional figure in 1997, when there were large profits arising from the sale of excess nonfinancial holdings, Figure 3.1). While there was no uniform trend in the other three groups, ROE has declined in

[3] Israel's peer group included countries which are similar to it as regards the size of GDP and the banking system. Countries which meet these criteria but differ significantly from Israel as regards their conditions and the nature of banking activity (e.g., highly non-concentrated banking systems or where most activities are off-shore) were not included in the peer group.

[4] Note that the calculation of ROE in this chapter is defined as total profit (net profit plus the share of minority shareholders and translation adjustments imputed to capital), divided by beginning-of-year capital, which includes minority shareholders' rights. This calculation varies from that of net ROE, as the denominator is different in each case, so that, for example, the net ROE of First International was 7.4 percent in 1999.

Table 3.2
Indicators of the Performance of Various Banking Systems,[a] 1998

	Performance indices (%)			General indices ($ million)		Operating indices (%)			Risk indices (%)	
	Financial margin on total assets[a]	ROE	ROA	GDP	Per capita GDP	Total income/ operating expenses	Operating expenses/ total assets (AC)	Non-interest income/ operating expenses	Loan-loss provision/ total credit	Capital adequacy
Australia	2.53	12.51	0.94	393,900	21,200	1.51	2.62	54.76	0.28	11.28
Belgium	1.44	11.13	0.42	236,000	23,400	1.26	1.95	63.09	0.54	11.17
Canada	1.87	9.64	0.47	688,300	22,400	1.14	2.14	53.30	0.40	10.88
Denmark	1.94	9.92	0.59	124,400	23,300	1.51	1.55	40.97	0.52	11.87
Finland	1.74	6.83	0.45	103,600	20,100	1.44	2.26	51.75	0.52	12.41
France	1.12	4.93	0.16	1,320,000	22,600	1.18	1.69	63.25	0.93	11.80
Germany	1.03	6.24	0.19	1,813,000	22,100	1.24	1.22	56.83	0.81	–
Greece	2.31	–	0.86	143,000	13,400	1.40	3.33	70.74	1.26	–
Ireland	1.99	14.89	0.69	67,100	18,600	1.63	1.95	60.76	–	–
Italy	2.17	7.68	0.58	1,181,000	20,800	1.21	3.48	59.12	1.20	10.78
Luxembourg	0.69	12.99	0.61	13,900	32,700	1.71	1.05	89.26	0.76	–
Netherlands	1.69	10.84	0.49	348,600	22,200	1.41	1.58	62.52	0.64	11.84
Norway	2.56	12.66	0.78	109,000	24,700	1.35	2.59	50.04	0.28	11.12
Portugal	2.54	13.69	0.71	144,800	14,600	1.19	3.94	70.56	1.52	10.72
South Africa	2.88	14.71	–	290,600	6,800	1.48	3.97	67.96	1.06	–
Spain	2.05	13.69	0.93	645,600	16,500	1.37	2.55	53.91	0.38	11.63
Sweden	1.25	15.93	0.66	175,000	19,700	1.50	1.89	60.46	0.48	14.68
Switzerland	1.14	6.71	0.50	191,800	26,400	1.40	1.61	90.33	0.35	–
UK	2.06	19.39	0.96	1,252,000	21,200	1.48	2.51	62.59	0.51	13.44
US	3.40	15.54	1.34	8,511,000	31,500	1.48	3.61	55.21	0.65	11.78
Average	1.92	11.57	0.65	887,630	21,210	1.39	2.37	61.87	0.69	11.80
Peer-group average[c]	2.18	11.98	0.64	152,313	18,113	1.41	2.69	59.48	0.81	11.46
Israel 1998	2.23	9.90	0.49	96,397	16,600	1.48	2.46	57.21	0.61	9.20
Israel 1999	2.23	11.17	0.55	98,517	16,100	1.56	2.30	58.83	0.50	9.43

[a] For each country we included the ten major banking groups, except for the US and Israel, for which the 100 and five major banking groups respectively, were included.

[b] The financial margin on total assets was calculated as total net interest income *less* financing costs, *divided by* total assets.

[c] Israel's peer group included eight countries that resemble it in size of GDP and banking system characteristics: Belgium, Denmark, Finland, Greece, Ireland, Norway, Portugal, and South Africa.

SOURCE: *The World Factbook*, 1999, and data provided by Bankstat.

First International for the second year in succession, *inter alia* due to the expense of obtaining market penetration for Alpha Card.

Several factors explain most of the rise in the banking groups' ROE in 1999:

1. The expansion of activity in all the intermediation segments and steep NIS 1.4 billion increase in the net interest income of the five major banking groups (Table 3.3); the banks' reports of their net interest income come from two sources: a. balance-sheet activity, representing the various intermediation segments (unindexed, indexed, domestic transactions in foreign currency, and transactions abroad in foreign currency); b. off-balance-sheet activity, representing profits from derivatives which are not classified as hedging instruments, i.e., intermediation at the bank's responsibility in derivatives, and transactions undertaken by the bank in order to close positions on indexation bases and neutralize exposure to market risk. Since these transactions are undertaken in the framework of managing the bank's balance sheets, they should be regarded as an integral part of income and expenditure due to balance-sheet activity. Notwithstanding, in the reports received from the commercial banks for 1999 the financial derivatives were not attributed to a specific segment in accordance with the underlying asset,[5] but were ascribed to the item listing income from derivatives. Hence, in the following analysis we present margins by intermediation segment and ignore the contribution to them of the derivatives—even though profits from derivatives offset or complement the results deriving from currency or interest-rate shifts in the various segments.

Net interest income from balance-sheet activity contracted slightly, due to the decline in the net interest margin on balance-sheet uses (from 2.3 percent in 1998 to 2.1 percent in 1999). The main reasons for this decline were increased competition for the public's money, and a change in the mix of banks' sources and uses, consisting primarily of a rise in the share of more expensive sources, especially in the unindexed local-currency segment, as well as in that of the less-profitable uses at the expense of other uses. Thus, for example, deposits in the Bank of Israel (in the unindexed segment) rose; while the return in this category is lower than it is for the other uses, it is also riskless and accounted for about a third of uses in the segment. In the framework of the management of balance-sheet activity, the banks accrued surplus unindexed sources which financed uses in other indexation segments; this activity also affected net interest margins in the various indexation segments, but the banks acted in the derivatives market to close these positions, and these activities generated profits. The total net interest margin, taking the contribution of derivatives into account, yields a slight rise in this margin—from 2.0 percent in 1998 to 2.1 percent in 1999.

2. A rise in the contribution of non-interest income, especially from fees and commissions. The greater use of banking services, alongside the rally on the secondary capital market and real increase in some fees and commissions contributed to the NIS 566 million rise in non-interest income in the five major banking groups (Table 3.3).

[5] The ascription is not trivial as it is necessary to meet other essential conditions. In 2000 the banks are supposed to ascribe profits from derivatives to the various indexation segments.

Table 3.3
Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 1998–99

(NIS million, December 1999 prices)

	Leumi		Hapoalim		Discount		Mizrahi		First Intl.		Total		Contri-bution	Rate of change
	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999	to profit	(%)
Net interest income before loan-loss provision	4,362	4,490	3,957	4,730	2,384	2,758	1,064	1,170	989	1,040	12,756	14,188	1,432	11.2
Loan-loss provision	721	535	573	742	643	558	190	145	93	86	2,220	2,066	154	–6.9
Net interest income after loan-loss provision	3,641	3,955	3,384	3,988	1,741	2,200	874	1,025	896	954	10,536	12,122	1,586	15.1
Total non-interest income[a]	2,731	2,928	2,854	3,039	1,129	1,196	752	769	583	683	8,049	8,615	566	7.0
of which Fee income	2,309	2,361	2,304	2,421	921	953	643	60	509	584	6,686	6,979	293	4.4
Total operating expenses	4,704	4,826	4,478	4,528	2,685	2,855	1,161	1,206	1,041	1,229	14,069	14,644	–575	4.1
of which Salaries and related expenses	2,945	3,054	2,717	2,655	1,804	1,974	709	764	598	674	8,773	9,121	–348	4.0
Ordinary pre-tax income	1,668	2,057	1,760	2,499	185	541	465	588	438	408	4,516	6,093	1,577	34.9
Tax provision	644	998	764	1,251	57	266	229	278	219	250	1,913	3,043	–1,130	59.1
Ordinary after-tax income[b]	1,024	1,059	996	1,248	128	275	236	310	219	158	2,603	3,050	447	17.2
Other income[c]	–37	231	195	167	57	49	–31	–44	14	42	198	445	247	124.7
Net income	987	1,290	1,191	1,415	185	324	205	266	233	200	2,801	3,495	694	24.8
Total income[d]	1,096	1,307	1,325	1,481	200	345	222	287	219	160	3,062	3,580	518	16.9
Equity[e]	9,832	10,399	10,942	11,056	5,139	5,276	2,489	2,592	2,599	2,717	31,001	32,040	1,039	3.4
Ordinary ROE, net (%)	10.4	10.2	9.1	11.3	2.5	5.2	9.5	12.0	8.4	5.8	8.4	9.5		
Total ROE (%)	11.1	12.6	12.1	13.4	3.9	6.5	8.9	11.1	8.4	5.9	9.9	11.2		
Total ROA (%)	0.6	0.7	0.7	0.7	0.2	0.3	0.4	0.5	0.4	0.3	0.5	0.6		
Loan-loss provision/ total credit	0.64	0.42	0.47	0.54	1.14	0.89	0.47	0.32	0.27	0.22	0.61	0.50		
Risk-based capital ratio	9.5	9.8	8.7	9.1	8.8	9.1	9.4	9.4	10.9	10.2	9.2	9.4		

[a] Including profit/loss from sale of shares, *less* customers' share of profits.
[b] After deduction of goodwill in United Mizrahi Bank.
[c] Other includes the group's share in the profits of its subsidiaries, minority interests, income from the sale of assets and investments, and net income from extraordinary activities, including divestment of excess and other holdings.
[d] Total income is defined as net income *plus* the share of minority interests and translation adjustments imputed to equity.
[e] Equity and minority interests at beginning of year *plus* issues at time of issue.
SOURCE: Published financial statements.

3. Current loan-loss provision fell in 1999, contributing to the NIS 154 million increase in banks' profits (Table 3.3). Specific provisions for each industry except for that of households, which includes mortgage credit, declined. The reason for the decline is not clear, as credit risk actually rose, as expressed in the increase in credit and in its share in business-sector product, as well as in the greater concentration of the credit portfolio and increase in problem credit (less credit to agriculture). Thus, the level of banks' risk may not yet be reflected in the level of loan-loss provision. Nevertheless, there may have been some improvement in credit to certain industries, such as agriculture, in which there were substantial charge-offs in the past, leaving the credit portfolio 'clean' and in a better condition.

4. The disparity between the 'known' and 'in-lieu' Consumer Price Indices had a positive effect on the profits of the five major banking groups in 1999, amounting to NIS 60 million, compared with a negative effect of NIS 80 million in 1998. The differences between the indices was expressed chiefly in the increase in net interest income reported by the CPI-indexed segment and the increase in tax provision against these profits. This effect on banks' profits is random and dependent on shifts in inflation, so that in the long run it can be expected to decline along with the variance of inflation during the year.[6]

Several factors operated to reduce profits in 1999, however:

1. The contribution of subsidiaries to banks' profits declined, and amounted to NIS 1.5 billion in 1999, compared with NIS 1.8 billion in 1998 (Table 4.1). In the present analysis we examine the banks' profits from a different viewpoint, viewing a banking group as an investor with a diversified portfolio that includes financial and mortgage activity, overseas offices, and nonfinancial companies. The decline in the contribution of profits of subsidiaries to banks' profits is the result of the fall in the profits of banks' subsidiaries abroad, from NIS 180 million in 1998 to NIS 119 million in 1999. The contribution of the profits of subsidiaries abroad to the group's profits, as recorded in Israel after accounting adjustments and translation into NIS, fell from about NIS 878 million to only NIS 204 million, due to the non-recurrence of the subsidiaries' exceptional profits in 1998 (which stemmed *inter alia* from the sale of subsidiaries and tax rebates arising from previous losses) as well as to the real appreciation of the NIS against foreign currencies, especially the Swiss franc. The return on investment in the main subsidiaries continued to be positive for all kinds of holdings, however, averaging 8.5 percent, compared with 11 percent in 1998. The positive contribution of the mortgage banks stands out among the various subsidiaries, and the return on investment in them has been high and steady in the last few years (11.5 percent in 1999 and an average of 13.2 percent in 1993–99). The performance of the mortgage banks in the context of the economic slowdown in general, and in the real estate industry in particular, and the increased competition in the mortgage industry is noteworthy. The activity and performance of all subsidiaries—both consolidated and unconsolidated—and their contribution to the profit of the banks at the head of each group, are described in detail in Chapter 4.

[6] See Box 3.1 in last year's edition of this publication.

2. The rise in operating costs, from NIS 14 billion in 1998 to NIS 14.6 billion in 1999, also detracted from banks' profits. Increased operating costs, especially direct wage costs, alongside the 1.2 percent decline in the number of employees, led to a 4.8 percent increase in the average wage per employee post in banks (compared with 2.2 percent in the economy in general), and this amounted to NIS 162,000 in 1999. This year, too, as was the case in 1998, the banks allocated funds for severance pay, in the framework of programs to encourage early retirement of employees, although no substantial improvement is yet evident in the 1999 figures.

2. CONTRIBUTION OF MAIN COMPONENTS TO NET INCOME

a. Net interest income

The net interest income of all the commercial banks was up by NIS 1.7 billion in 1999 over 1998, and amounted to NIS 12.4 billion—a 16 percent increase Table 3.4). Note that the overall net interest margin, which takes income from derivatives into account, rose slightly, from 2.0 percent in 1998 to 2.1 percent in 1999. Because of the difficulty of ascribing derivatives to the various indexation segments, the following analysis of margins by indexation segment ignores derivatives income, even though the distinction between income on transactions in them and income from balance-sheet activity is not clear-cut.

Net interest income comprises two main items: income from transactions in the various indexation segments, i.e., from balance-sheet activity, and income from off-balance-sheet activity. Net interest income from balance-sheet activity declined in 1999 (by some NIS 200 million), due to the fall in its net interest margin from 2.3 percent in 1998 to 2.1 percent in 1999, alongside the marked expansion of activity (by about 11 percent). On the other hand, income from off-balance-sheet activity, representing income from derivatives, complementing or offsetting net interest income from balance-sheet activity, contributed NIS 351 million to net interest income, compared with a negative contribution of NIS 1.7 billion in 1998 (see below and Table 3.5).

(i) The unindexed local-currency segment

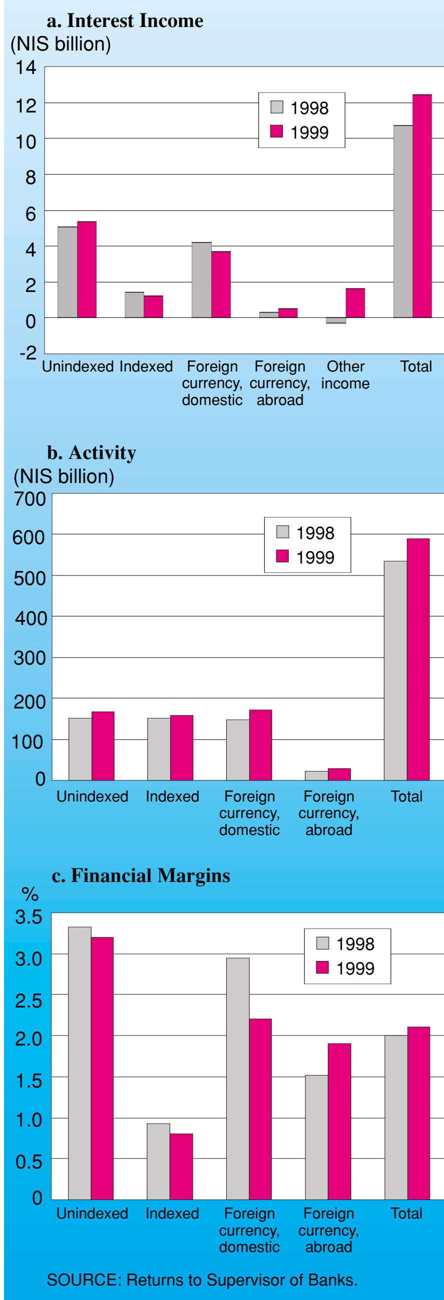
Net interest income from unindexed local-currency activity rose by NIS 300 million in 1999 (from NIS 5,055 million in 1998 to NIS 5,358 million), due to the marked (10 percent) expansion of unindexed local-currency activity, alongside stability in the net interest margin of the segment.

The stability of the net interest margin is the result of several opposing factors:

1. The slowing of inflation in 1999 and the Bank of Israel's monetary policy led to a rise in the real interest rate in this segment and slight decline in its interest-rate spread (see Chapter 2).

2. Changes in the mix of sources and uses served to reduce the net interest margin:

Figure 3.2
Intermediation Segments; Interest Income, Activity, and Margins, 1998–99



SOURCE: Returns to Supervisor of Banks.

On the sources side: Interest-rate spreads on deposits acted to increase the public's time deposits (by 20 percent), because of the relatively high real interest on these deposits relative to alternative investment channels and stability in the other deposits of the public (e.g., SRO deposits). Because of the larger share of the more expensive deposits, the interest on sources increased faster than that on uses, so that the net interest margin declined.

On the uses side, there were two main changes: Since 1997 the Bank of Israel has used the auction on the interest rate on banks' unindexed local-currency deposits deposited at it for periods of between one week and three months in order to absorb surplus liquidity and sterilize the effect of foreign-exchange conversions on the monetary base. These deposits grew in 1999, their average balance standing at NIS 50 billion, i.e., about one third of all banks' uses in the unindexed local-currency segment. The return on them is lower than the average on the balance of uses (because of their low risk), and hence moderated the rise in real interest on uses. There was also a marked (20 percent) increase in the balance of term credit, especially on-call credit, and this also served to moderate the rise in real interest on uses, as the return on term credit is lower than that on other credit in the segment.

The share of the unindexed local-currency segment in total uses continued to rise, in line with its development in recent years, and reached 28.5 percent, against the backdrop of the decline in the inflation rate and inflationary uncertainty. Consequently, despite the persistent fall in the net interest margin in this segment

Table 3.4
Estimated Financial Margins of all Commercial Banks, and Income from Them, by Uses, 1998 and 1999

(NIS million, December 1999 prices)

	Average balance		Share of total uses (%)		Financial margin (%)		Net interest income		Contribution of profit to net interest income (%)	
	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999
Unindexed	152,029	168,153	28.4	28.5	3.3	3.2	5,055	5,358	47.1	43.1
CPI-indexed	152,595	159,535	28.5	27.1	0.9	0.8	1,418	1,225	13.2	9.9
Nondirected	133,201	144,553	24.9	24.5	1.0	0.8	1,339	1,199	12.5	9.6
Directed[a]	19,394	14,982	3.6	2.5	0.4	0.2	79	26	0.7	0.2
Foreign-currency activities in Israel	147,087	171,128	27.5	29.0	2.8	2.2	4,192	3,690	39.1	29.7
of which Indexed	14,296	14,861	2.7	2.5	4.0	3.0	567	445	5.3	3.6
Denominated	132,791	156,267	24.8	26.5	2.7	2.1	3,625	3,245	33.8	26.1
Foreign-currency activities abroad	22,909	27,718	4.3	4.7	1.5	1.9	347	536	3.2	4.3
Total balance-sheet uses	**474,620**	**526,534**	**88.6**	**89.4**	**2.3**	**2.1**	**11,012**	**10,809**	**102.7**	**87.0**
Derivatives[b]							–1,748	351	–16.8	2.4
Commissions on financing transactions[c]	61,170	62,590	11.4	10.6	1.1	1.1	697	665	6.5	5.4
Total uses	535,790	589,124	100.0	100.0	1.8	2.0	9,961	11,826	92.4	94.8
Other net interest income[d]							762	599	7.6	5.2
Total net interest income	**535,790**	**589,124**	**100.0**	**100.0**	**2.0**	**2.1**	**10,723**	**12,425**	**100.0**	**100.0**

[a] Credit to the government, the public, and others, from earmarked deposits, does not include credit from earmarked deposits at the responsibility of the depositor, repayment of which is contingent on collection.

[b] Excluding hedging, as expenditure on this is included in the relevant segments above (see Table 3.5).

[c] See Table 3.6.

[d] Including profit/loss on bonds, reduction of loan-loss provision, repayment of debts, and receipt of early repayment fees.

SOURCE: Returns to Supervisor of Banks.

since the reform package of 1985, net interest income in it has not contracted in the last few years, and amounted to NIS 5.4 billion in 1999—some 43 percent of net interest income Figure 3.2 and Table 3.4).

(ii) The CPI-indexed segment

Net interest income in the CPI-indexed segment fell by about 14 percent, and amounted to NIS 1.2 billion. This decline derived from a slight drop in the net interest margin—from 0.9 percent to 0.8 percent—and a 4.5 percent rise in the extent of indexed uses. As has been the case in the last few years, the share of earmarked uses in total uses has continued to decline, as has their contribution to the banks' net interest income.

The interest rates in this segment are derived from the public's demand for indexed credit and the yield on bonds. An increase in the government's borrowing requirement and the continued redemptions from provident funds led to a rise in the yields on bonds, affecting both the cost of credit and yields on savings schemes, as well as a slight increase in the interest-rate spread in the segment. The widening of the spread derived from the combination of increased demand for indexed local-currency credit and decline in the supply of indexed deposits, due to the slowing of the inflation rate and the high real interest in the unindexed local-currency channel. Despite the rise in the interest-rate spread, the net interest margin in this segment fell for the following reasons:

1. A marked shortage of indexed sources, expressed in surplus uses in the segment, which amounted to NIS 15 billion (about one tenth of the segment). This surplus was financed from unindexed sources, which were expensive in 1999 relative to both indexed sources and uses. Note, however, that in order to offset the exposure to inflation risk described above, the banks used derivatives to close this position, thereby generating net interest income, recorded as income from other derivatives and not ascribed to this segment.

2. A change in the mix of uses and sources. On the uses side, the shortage of long-term sources in mortgage banks served to increase the share in total uses of commercial banks' deposits in mortgage banks, i.e., to increase the share of less profitable uses. On the sources side, the share of deferred liabilities—which are more expensive than the other sources in the segment—rose. In 1998 and 1999 the five major banks issued deferred liabilities in order to expand their tier-2 capital, thereby enabling a rise in the components of risk and the distribution of dividends without deviating from the regulations regarding the minimum capital ratio. As stated, the cost of deferred liabilities is relatively high, and this increases the average cost of obtaining indexed sources, serving to reduce the net interest margin in the segment.

(iii) The segment denominated in and indexed to foreign currency (domestic activity)

Net interest income in this segment declined by some 12 percent in 1999, and amounted to NIS 3.7 billion (Table 3.4). The decline in income in this segment derived from the decline in the net interest margin (from 2.8 percent to 2.2 percent), which was partly offset by the greater extent of activity (16 percent). In recent years both the net interest margin and net interest income in this segment have been characterized by wide

fluctuations, as they are influenced by many factors, some of them external to the bank. One such is the development of the exchange rate of the NIS against the various currencies; while in 1999 there was local-currency appreciation against the dollar of only 0.2 percent (monthly average), this development had a considerable effect on the segment, because the difference between the highest average monthly rate (in September) and the lowest (in March) was as great as 5.9 percent. Developments vis-à-vis the other currencies were similar—the fluctuations in their exchange rates during the course of the year affected income in this segment.

The dollar interest-rate spread in this segment did not change, as dollar interest rate on sources and uses declined at the same rate—and similar to the Libor interest rate. Nonetheless, as stated, the net interest margin declined in NIS terms, for a variety of reasons: a. Surplus uses in the segment rose in 1999 and were financed by unindexed sources, which were more expensive than the average cost of foreign-currency sources; b. Surplus uses, which characterized the segment, and the real appreciation of the NIS against the other currencies, also reduced the margin in the segment in real NIS terms; c. Part of the profit/loss on activity in foreign currency is not recorded in this segment and appears as income from derivatives, as described below.

(iv) Income from derivatives

Income from derivatives which, as stated, complements or offsets income from balance-sheet activity, amounted to NIS 351 million in 1999, compared with losses of NIS 1.7 billion in 1998 due to large financing expenses on currency options (Table 3.5).

Derivatives are used for hedging against exposure resulting from investment in subsidiaries abroad and of domestic activity, i.e., to hedge against currency or interest-rate risk, especially in the foreign-currency segment. If income/expenditure due to derivatives (as well as commissions on financing transactions and other income from net

Table 3.5
Income from Derivatives, All Commercial Banks, 1998–99

(NIS million, December 1999 prices)

	1998			1999		
	Fees from intermed-iation transactions	Net interest income *or* expenses from other transactions	Total	Fees from intermed-iation transactions	Net interest income *or* expenses from other transactions	Total
Interest contracts	15	58	73	3	230	233
Currency contracts	78	–1,991	–1,913	46	–39	6
Shares contracts	91	1	92	111	2	112
Total	**184**	**–1,932**	**–1,748**	**159**	**192**	**351**

SOURCE: Returns to Supervisor of Banks.

Table 3.6
Income from Fees on Financing Transactions, All Commercial Banks, 1998–99

(NIS million, December 1999 prices)

	1998		1999	
	Average annual balance	Income	Average annual balance	Income
Acceptances	1,728	60	990	39
Documentary credits	3,727	103	3,462	100
Credit guarantees	12,632	75	15,767	70
Home-buyers' guarantees	18,022	97	15,448	103
Guarantees and other liabilities	25,061	362	26,923	353
Total fees on financing transactions	**61,170**	**697**	**62,590**	**665**

SOURCE: Returns to Supervisor of Banks.

financing operations) were ascribed to balance-sheet activity in 1998 and 1999 the overall net interest margin would even have risen slightly in 1999—from 2.0 percent to 2.1 percent (Table 3.4).

(v) Income from commissions on financing transactions and other net interest income
Most net interest income is from acceptances, credit guarantees, guarantees to home-buyers, and documentary credit. There was no significant change in the extent of this activity and commissions on it in 1999, so that the income from it—NIS 665 million—was similar to the amount in 1998 (Table 3.6). Other net interest income includes profit (loss) from the sale of bonds held to maturity or available for sale, as well as from the collection of problem debts, provision for interest on doubtful debts, and commissions on the early repayment of credit. This category of income fell by NIS 163 million in 1999, and amounted to NIS 600 million.

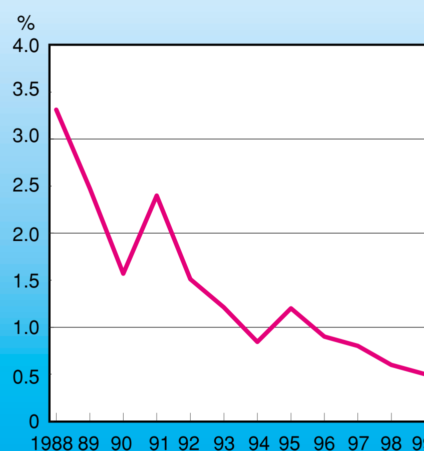
b. Loan-loss provision

Since 1988 there has been a continual decline in the annual loan-loss provision for credit to the public at the banking group's responsibility. In 1988 this reached a peak (an average of 3.3 percent), because of extensive provision against problem credit extended to the agricultural sector and single borrowers.[7] In 1999 loan-loss provision declined by about

[7] In April 1999 the real-estate agreement reached with certain *kibbutzim* was amended, because of the difficulty in assessing the value of their land. In the wake of the amendment, additional *kibbutzim* joined the debt-restructuring arrangement between their umbrella-organization, the government, and the banks.

7 percent to NIS 2,066 million, accounting for only 0.5 percent of credit to the public at the groups' responsibility (Figure 3.3). An international comparison (Table 3.2) shows that the rate of loan-loss provision is lower in Israel than the average in the peer group (0.8 percent).

Figure 3.3
Ratio of Loan-Loss Provision to Credit to the Public, 1988–99



SOURCE: Published financial statements.

With the exception of the Hapoalim group, which recorded a rise in loan-loss provision of NIS 170 million in 1999, the loan-loss provision of the major banking groups declined. This stemmed entirely from the NIS 202 million reduction in the specific provision, and was partly offset by the increase in the additional provision, which has fluctuated widely in recent years. The specific provision fell both in absolute terms and as a proportion of outstanding credit to each industry, because of the steep rise in outstanding credit. As regards the by-industry distribution of these provisions, the only industry in which there was a marked increase was households, credit to which includes mortgages. Loan-loss provision for households rose by some 9 percent in 1999, accounting for over one quarter of total specific provisions. This increase is explained by the economic slowdown, expressed in liquidity constraints affecting a wide variety of entities defined as households. On the other hand, although the rate of GDP growth was relatively slow for the third year in succession, and the extent of problem credit (excluding credit to agriculture) is growing, specific loan-loss provision for doubtful debts to all industries, especially manufacturing and real estate, declined in 1999. The level and share of loan-loss provision in 1999 may not yet reflect the current level of banks' credit risk.

In 1999, too, there were significant variations in the rates of change of loan-loss provision, ranging from a 26 percent drop in the Leumi group to a 30 percent rise in the Hapoalim group (Table 3.3).

c. Non-interest income

The non-interest and other income of all the commercial banks rose by 7 percent in 1999, and amounted to NIS 6.7 billion, due to the increase in income from fees and commissions (up by NIS 233 million) and other income (up by NIS 190 million, Table 3.7).

The growth of non-interest income is explained largely by the expansion of banking activity, the surge in the capital market, and the updating of commissions, which increased the price of several banking services in real terms. Prominent among the categories in which non-interest income rose were severance pay funds, credit and contracts, and

deposit management. The sole area of activity in which non-interest income fell in 1999 was in services regarding credit cards, income on which amounted to NIS 250 million (down by 19 percent).[8] The credit card market was not static, and in 1999 and 2000 some of these companies changed hands and the rates private consumers were charged rose (see Chapter 6).

Income from fees and commissions arising from the public's capital-market activity includes income from securities transactions, custody fees, and underwriting and distribution of securities. This income rose by 4 percent on average, as a result of the public's capital-market activity, expressed in turnover, share offerings, and the level of prices in the market, indicated by the various yields. The surge in the capital market, as reflected in the various indicators given in Table 3.8, evinces considerable interest in and involvement of customers in the capital market—both in expectation of emergence from the economic recession (despite the high real interest rates in the alternative markets) and under the influence of the surge in world stock markets, in view of the growing globalization of capital flows. This was evident in the increase in share issues by Israeli firms in stock markets abroad in 1999, mainly by software and communications companies, while offerings in the domestic stock market contracted.

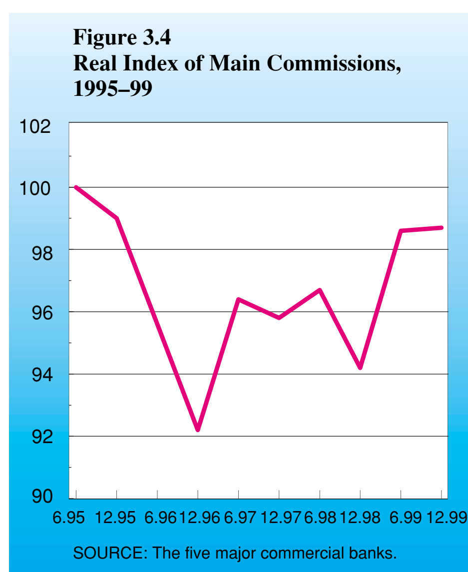


Figure 3.4
Real Index of Main Commissions, 1995–99

SOURCE: The five major commercial banks.

Two factors led to the rise in income from fees and commissions not associated with the capital market in 1999: As stated, the main one is the quantity effect, derived from the expansion of the public's activity vis-à-vis the banks, while the second is the price effect, as indicated by the index of fees and commissions. This index reflects the average fees private customers and small businesses (not all customers[9]) are charged for the thirteen most common bank services. Data from the five major banks indicate that the index of main fees and commissions rose by an annual average of

[8] These categories involve only the banks, and do not include the income of the credit card companies themselves. The income from credit cards of the five major banking groups, which includes the income of the credit card companies, was NIS 1,314 million in 1999, compared with NIS 1,353 million and NIS 1,331 million in 1998 and 1997 respectively.

[9] The fees included in the index are: a personal check, registering a transaction in an account, managing an overdraft account, paying a bill at the counter, depositing a postdated check, returning a check to the drawer due to lack of coverage, returning a check to the depositor, purchase/sale of securities, securities custody fees, foreign currency exchange, the current withdrawal of information, and annual debiting for the use of information retrieval cards.

Table 3.7

Non-Interest Income and Operating Expenses, All Commercial Banks, 1997–99

	Amount (NIS million)[a]			Distribution (%)			Year-on-year change (%)	
	1997	1998	1999	1997	1998	1999	1998	1999
1. Non-interest income								
Fees and commissions from:								
Ledger fees	947	995	1,089	15.0	16.0	16.4	5.1	9.4
Payment services	1,832	1,816	1,822	29.0	29.2	27.4	–0.8	0.3
Credit cards	352	310	250	5.6	5.0	3.8	–11.9	–19.3
Credit services and contracts	315	305	433	5.0	4.9	6.5	–3.0	42.1
Computerized services	236	241	245	3.7	3.9	3.7	2.0	1.8
Foreign trade and special services[b]	297	294	319	4.7	4.7	4.8	–1.0	8.4
Securities services[c]	413	429	442	6.6	6.9	6.7	3.7	3.2
Custody fees	197	199	217	3.1	3.2	3.3	0.8	9.1
Underwriting and distribution of securities	74	85	83	1.2	1.4	1.3	14.9	–1.7
Other commissions[d]	210	193	199	3.3	3.1	3.0	–8.3	3.2
Total fees and commissions income	**4,873**	**4,867**	**5,100**	**77.2**	**78.2**	**76.7**	**–0.1**	**4.8**
Other income from:								
Provident and mutual fund fees	872	900	920	13.8	14.5	13.8	3.3	2.3
Related companies management fees	200	177	160	3.2	2.8	2.4	–11.2	–9.5
Profits from severance pay funds	97	11	179	1.5	0.2	2.7	–89.1	1,595.2
Other	167	198	215	2.6	3.2	3.2	18.3	9.0
Total	**1,335**	**1,285**	**1,475**	**21.1**	**20.6**	**22.2**	**–3.7**	**14.8**
Income from sale of shares	103	75	75	1.6	1.2	1.1	–27.3	–0.8
Total non-interest income	**6,311**	**6,227**	**6,650**	**100.0**	**100.0**	**100.0**	**–1.3**	**6.8**

Table 3.7 (continued)

	Amount (NIS million)			Distribution (%)			Year-on-year change (%)	
	1997	1998	1999	1997	1998	1999	1998	1999
2. Operating expenses								
Salaries and related expenses[e]	8,109	8,128	8,393	66.1	65.4	65.4	0.2	3.3
Amortization and deductions	710	772	764	5.8	6.2	5.9	8.7	–1.1
Maintenance of buildings and equipment	1,355	1,396	1,481	11.1	11.2	11.5	3.0	6.1
Other expenses	2,088	2,125	2,204	17.0	17.1	17.2	1.7	3.8
Marketing and advertising	260	277	271	2.1	2.2	2.1	6.8	–2.1
Computer expenses	384	440	445	3.1	3.5	3.5	14.6	1.3
Communications	342	360	371	2.8	2.9	2.9	5.2	2.9
Insurance and office services	233	227	241	1.9	1.8	1.9	–2.3	6.0
Professional services	242	248	235	2.0	2.0	1.8	2.4	–5.2
Other	628	572	641	5.1	4.6	5.0	–8.9	12.0
Total operating expenses	**12,262**	**12,421**	**12,843**	**100.0**	**100.0**	**100.0**	**1.3**	**3.4**
Operating coverage ratio[f]	**51.5**	**50.1**	**51.8**					

[a] NIS million; December 1999 prices.
[b] Including cross rates between selling and buying.
[c] Including income from financial instruments.
[d] Including margin and collection fees on credit from the Treasury, and other margins and fees.
[e] Including payroll taxes, severance pay, benefits, pensions, and national insurance.
[f] Ratio of total non-interest income to total operating expenses.
SOURCE: Returns to Supervisor of Banks and published financial statements.

Table 3.8
Indicators of the Development of the Capital Market, 1990–99

(NIS billion, December 1999 prices)

	Total amount raised by shares and traded securities[a]	Total turnover[b]	Market value[c]	Real yield[c] (%) General share-price index	Real yield[c] (%) Bonds
1990	2.4	67.2	43.6	–1.5	–5.8
1991	3.7	96.5	64.0	37.1	–0.4
1992	8.7	135.1	146.8	75.2	7.3
1993	14.9	211.9	244.3	26.7	–2.0
1994	8.3	173.4	139.0	–47.0	–4.6
1995	3.0	121.6	149.2	5.4	1.1
1996	5.7	118.8	137.3	–10.5	2.3
1997	13.1	131.5	180.4	26.4	5.1
1998	11.9[d]	175.0	172.3	–5.1	0.5
1999	17.0[d]	193.4	271.5	62.3	5.0

[a] Including capital raised from direct offerings and warrants exercized by companies going public in Israel and abroad and registered on the TASE.
[b] Including stock-exchange transactions, offsets, and off-the-floor transactions.
[c] End-period data.
[d] Of which NIS 3.2 billion and NIS 13.1 billion was raised abroad in 1998 and 1999 respectively.
SOURCE: Tel Aviv Stock Exchange and Bank of Israel.

3.3 percent in real terms in 1999, in the context of the low inflation rate during the year (Figure 3.4). The level of the index at the end of 1999 was similar to that at the end of 1995—when the Bank of Israel began to publish it in order to increase the public's awareness of interbank differences in these rates, thereby contributing to increased competition. In the past the banks froze the fees for their services, serving to bring the real index down, and some banks even refunded customers a part of the fees they had paid.[10] This did not occur in 1999, explaining part of the rise in non-interest income.

A considerable contribution was made to the increase in banks' non-interest income in 1999 by income from other fees and commissions, especially from severance pay funds and management fees on provident and mutual funds (Table 3.7). Profit from severance pay funds amounted to NIS 180 million, compared with only NIS 10 million in 1998—explained by the rise in yields on shares and bonds, held by the funds to cover severance-pay commitments, beyond the rise required by the reserve for severance pay.

[10] Sharing profits with customers was introduced by First International and Poalei Agudat Israel banks, contingent on attainment of ROE of more than 8 percent. First International did not attain this level of ROE in 1999, and hence did not share profits with its customers.

Income from provident funds accounted for 14 percent of non-interest and other income in 1999, and stood at NIS 920 million for all the commercial banks (Table 3.7). This income could fall if the recommendations of the inter-ministerial committee on the banks' control of the provident funds and the proposed Provident Fund Law are accepted (see Box. 3.1).

Box 3.1
The Banks' Holdings in the Provident Funds

The inter-ministerial committee on the banks' control of the provident funds focused on two main problems: 1. Reducing the conflict of interest between the fund and the entity controlling and managing it; 2. Minimizing concentration—thus enhancing competition in financial markets by increasing the number of entities managing provident funds and acting on their behalf. In July 1999 the assets of the funds (provident, severance pay, and advanced study) managed directly by all the banks amounted to NIS 103.5 billion, i.e., 73 percent of all provident funds' assets. The three largest banks manage (directly) some 60 percent of all provident funds' assets. It is the opinion of the committee that this high level of concentration affects the service provided to members and the commissions charged. The committee's principal recommendation is that banks and other entities active in the capital market should be prohibited from controlling or being a party at interest in companies that manage provident funds whose total managed assets exceed 10 percent of the funds' total assets. Implementation of this recommendation will reduce banks' income from provident fund management fees, which amounted to NIS 766 million in 1999. In 1999 this income averaged 4.5 percent of total bank income (net interest and non-interest), and ranged from 0.1 percent to 19.6 percent among the various banks. The implementation of the recommendations will have a varying effect on banks' profits, mainly on those of the three largest banks, where control will be restricted to 10 percent of the funds' assets. Obviously, the reduction of profits can impact on other banks belonging to those banking groups, and predominantly banks in which income from provident fund management accounts for a large share of income.

d. Operating and other expenses

The operating and other expenses of all the commercial banks rose by 3.4 percent in 1999, compared with an increase of 1.3 percent in 1998, and amounted to NIS 12,843 million (Table 3.7). The major component of these expenses was salaries and related

expenses, which rose by a similar rate so that as a share of total expenses they remained unchanged (about 65 percent). There are several reasons for the rise in expenditure on employees: 1. Wage agreements were reached for 1999, determining nominal wage increments that because of the low inflation rate turned out to be high in real terms; 2. Programs to encourage early retirement were introduced by the banks as part of the drive to increase efficiency; 3. There was greater provision for pensions, because of the updating of obligations on the basis of fresh mortality tables and new agreements in some banks regarding pension plans, which led to the updating of the pension reserves; 4. Grants and bonuses were paid in accordance with improved performance.

Alongside the rise in employee-associated expenses, the number of posts was down by 440 (–1.2 percent) from 1998, so that the wage per employee post rose steeply, from NIS 150,000 to NIS 162,000 (Table 3.9). This increase is also explained by the change in the mix of employees in banks, with a decline in those at the lowest wage levels and a rise in those earning medium and high wages. This reflects the banks' policy of the last few years of improving the quality of their personnel by replacing low-paid, unskilled employees with more costly graduates with professional qualifications. This process

Table 3.9
Banks' Expenditure on Employees,[a] 1995–99

(NIS, December 1999 prices)

		Salaries		Related expenses[c]		Salaries and related expenses	
	Average no. of posts[b]	Total (million)	Per post ('000)	Total (million)	Per post ('000)	Total (million)	Per post ('000)
1995	34,925	4,998	143	2,380	68	7,378	211
1996	35,400	5,164	146	2,675	76	7,839	221
1997	35,595	5,374	151	2,735	77	8,110	228
1998[d]	35,259	5,436	154	2,692	76	8,128	231
1999	34,823	5,625	162	2,769	80	8,393	241
Year-on-year change (*percent*)							
1995	2.8	–1.7	–4.2	14.8	11.5	3.6	0.8
1996	1.4	3.3	1.9	12.4	10.9	6.2	4.8
1997	0.6	4.1	3.5	2.3	1.7	3.5	2.9
1998	–0.9	1.1	2.1	–1.6	–0.6	0.2	1.2
1999	–1.2	3.5	4.8	2.8	4.1	3.3	4.6

[a] Including companies which are owned by the banks and supply them with computer services.

[b] 12-month average; this number includes established employees, trainees, pensioners, temporary and part-time workers (weighted by share of a post). This also includes overtime: 165 overtime hours are calculated as a post.

[c] Including national insurance, pension, vacation, and compensation expenses, and expenses due to changes in discounting rates or methods of calculating grants and pensions.

[d] Data for 1998 have been reclassified.

SOURCE: Published financial statements and returns to Supervisor of Banks.

derives from advances in information technology and the complexity of modern financial services. The wage per employee post in the banks rose by 4.8 percent, a striking rate in view of the 2.2 percent wage hike in the economy in general, and 0.4 percent decline in the public sector. Note, too, that in the banking sector the wage per employee post is higher than in the economy as a whole.

As stated, in 1999 the number of employee posts in banks declined, chiefly as a result of programs encouraging early retirement adopted by some of the major banks. Such programs, which have been implemented for several years, involve high nonrecurring costs associated with salary-related expenses, and these rose by 2.8 percent in 1999.[11] This year, too, the annual cost per employee post varied among the five major banks, ranging from NIS 214,000 to NIS 262,000.

Expenses on amortization and deductions remained stable, while the cost of maintaining buildings and equipment rose by 6 percent. The increase was due to banks' investments in recent years in purchasing buildings, adapting branches to the needs of the public, and introducing improvements in branches and communications systems, both hardware and software. Part of the investment in equipment derived from banks' efforts to prepare for on-line banking and communications via the Internet, fax, fixed and mobile phones-an area of investment which is expected to continue expanding in the coming years. Since 1997 the five major banking groups have invested a cumulative $ 100 million in Y2K-associated activities.

Other expenses, most of which are connected with computers, communications, advertising, and insurance, amounted to NIS 2.2 billion in 1999—up by 3.8 percent over 1998 (Table 3.7).

e. Operating indices and efficiency[12]

Indices of banks' operating characteristics include: 1. Average expenditure per unit of output; 2. Output per employee; 3. Coverage ratio of operating expenses to non-interest income; 4. Income efficiency ratio.

1. *Average expenditure per unit of output*; a comparison of operating expenses per shekel of output among banks of a similar size shows their differences in operating efficiency. Because of the difficulty of defining banking efficiency and the increased share of off-balance-sheet activity in total banking activity in recent years, we chose a bank's value added as an index of output. The value added of the banking industry is calculated on the basis of the sum of the components of its generating income—ordinary net income before tax, salaries and related expenses, amortization and deductions, and maintenance of buildings and equipment. The ratio of operating costs per shekel of value added in the seven largest banks (Table 3.10) rose steadily (from 0.85 to 0.95) in 1992-95,

[11] Another component of the rise in salary-related expenses is the enlargement of the pension reserve.

[12] This section refers to unconsolidated data of the commercial banks.

Table 3.10
Ratio of Operating Expenses to Value Added,[a] 1992–99

	1992	1993	1994	1995	1996	1997	1998	1999	Average
Leumi	0.72	0.78	0.91	0.97	0.87	0.85	0.91	0.78	0.85
Hapoalim	0.97	0.86	0.91	0.91	0.89	0.81	0.86	0.78	0.87
Discount	0.94	0.92	1.00	0.97	0.99	1.20	1.51	1.13	1.08
Mizrahi	0.99	0.91	1.00	1.22	1.00	0.96	0.97	0.88	0.99
First International	0.74	0.73	0.79	0.83	0.82	0.80	0.85	0.78	0.79
Union	0.97	0.95	1.03	1.03	1.03	1.05	1.05	1.12	1.03
Mercantile Discount	0.79	0.84	0.89	0.94	1.04	1.15	1.11	1.06	0.98
Yahav	0.81	0.88	0.79	0.85	0.96	1.03	1.10	1.08	0.94
Maritime	2.29	0.85	1.03	1.41	1.97	1.63	1.44	1.29	1.49
Otsar Hahayal	0.84	0.85	0.92	0.91	0.94	0.92	1.02	1.02	0.93
American Israel	0.96	0.95	1.20	1.42	1.60	1.07	1.01	–	1.03
General	0.67	0.68	0.91	0.94	1.02	0.94	0.89	1.07	0.89
Continental	0.74	0.77	0.71	0.70	0.81	0.71	0.78	0.70	0.74
Massad	1.20	1.22	1.03	1.04	0.95	1.04	1.06	1.00	1.07
Seven largest									
Average	0.85	0.84	0.93	0.95	0.91	0.90	0.97	0.85	0.90
Standard deviation	0.12	0.08	0.08	0.12	0.09	0.16	0.23	0.17	0.13
Coefficient of variation	0.14	0.09	0.09	0.13	0.10	0.18	0.24	0.20	0.15
Next seven									
Average	0.88	0.88	0.95	1.00	1.06	0.99	1.02	1.02	0.97
Standard deviation	0.56	0.17	0.16	0.28	0.43	0.28	0.21	0.19	0.29
Coefficient of variation	0.64	0.19	0.17	0.28	0.41	0.29	0.20	0.19	0.30
Total									
Average	0.85	0.84	0.93	0.96	0.92	0.91	0.98	0.86	0.90
Standard deviation	0.41	0.13	0.12	0.21	0.32	0.23	0.21	0.18	0.23
Coefficient of variation	0.48	0.15	0.13	0.22	0.35	0.25	0.21	0.21	0.25

[a] Value added is defined as net income from ordinary before-tax activities *plus* costs—salaries and related expenses, amortization and deductions, and maintenance of buildings and equipment.

SOURCE: Returns to Supervisor of Banks and published financial statements.

and has been declining since then (with the exception of 1998), and this intensified in 1999. The decline in operating expenses per shekel of value added in 1999 encompassed most of the ordinary banking corporations (except for Union and Investec Clali banks), and indicates increasing efficiency. The variance between the medium-sized banks in this respect was found to be greater than that between the seven largest banks. The average ratio of operating costs per shekel of value added in the large banks was similar in 1999, despite its decline, to its level at the beginning of the period (1992), and in the small banks the ratio was even higher than it was in 1992. Because of economies of scale, the average ratio of operating costs to value added in the seven largest banks is lower than in the seven next largest (Table 3.10).

It is not clear how interbank differences in economies of scale will develop in the next few years. On the one hand, the penetration of virtual banking, including banking via the Internet, could radically alter banking in the future, obliterating large banks' economies of scale and concentration; their dominance of the household-sector market could disappear as a result of technological advances in the area of telecommunications, and the availability of personal computers will make it possible to offer an ever-increasing range of banking services without requiring the customer to be physically present in the branch. This will contribute to greater competition in the retail market, which in the past was based on a wide network of branches belonging to the large banks. Independence of such a network will enable the smaller banks to compete in this sector. Note, on the other hand, that activity over a large geographical area and in a wide variety of spheres requires constant investment in a complex system of communications and information technology. The ability to invest in infrastructures of this kind may be restricted primarily to the large banks, so that their economies of scale may persist and even grow. The persistence of the process and the extent to which economies of scale exist will be determined to a great extent by the ability of the banks, both large and small, to adapt to the new situation.

2. *Output per employee*; this index of employee productivity is used by bank managements in determining bonuses. The banks have bonus programs that differ with regard to the criteria used for assessing performance, as determined by the management. These programs are based mainly on the following: a. an overall bonus for all employees, in accordance with the individual's salary level and the bank's results; b. a unit bonus, per branch or unit, in accordance with its financial results; c. a personal bonus, to employees who are considered to have made a special contribution to the bank. As it is not possible here to go into the details of an individual bank's bonus system, we will present a long-term view of the development of value added per employee post (Table 3.11), representing an estimate of output per employee, compared with cost per employee post, representing the average remuneration per employee. We do this for two periods,[13] 1992–95 and 1996–99 (Figure 3.5). It was found that in the large banks, with the exception of Discount, cost per post rose in line with the increase in value added per post, while in

[13] The calculation was based on a long-term average, in order to minimize nonrecurring and random deviations affecting specific years

Table 3.11
Value Added per Post,[a] 1992–99

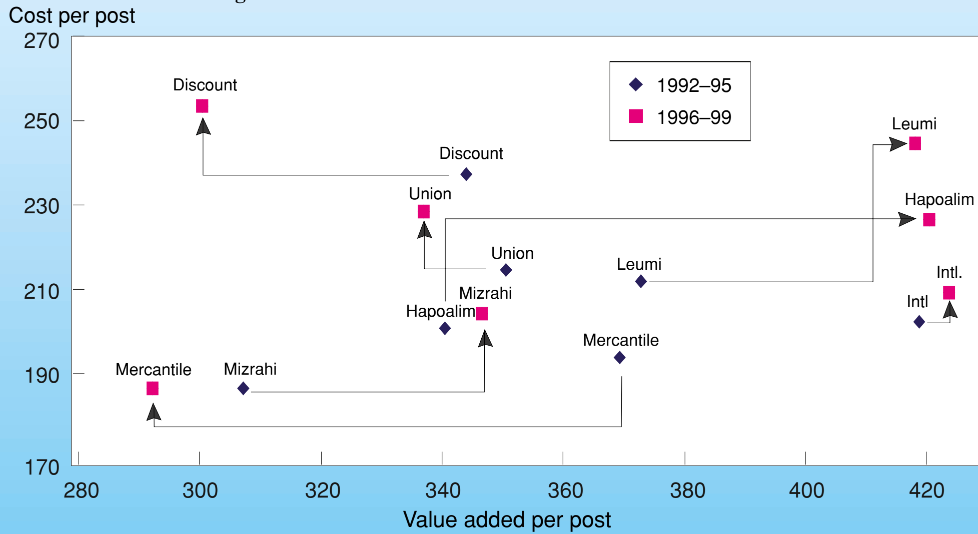
	1992	1993	1994	1995	1996	1997	1998	1999	Average
Leumi	429	399	343	320	395	410	386	481	395
Hapoalim	307	361	338	356	371	420	419	472	380
Discount	338	344	337	357	341	309	227	324	322
Mizrahi	322	341	312	254	331	328	340	388	327
First International	440	448	396	391	402	418	409	465	421
Union	353	369	342	339	323	330	345	350	344
Mercantile Discount	400	391	368	318	274	273	299	323	331
Yahav	438	402	396	419	347	340	284	322	369
Maritime	149	514	525	335	219	295	331	405	347
Otsar Hahayal	373	369	348	375	341	362	339	374	360
American Israel	362	383	313	245	203	323	353	–	273
General	631	610	422	384	351	388	444	411	455
Continental	485	475	494	494	427	522	573	608	510
Massad	304	309	371	393	392	379	381	441	371
Average									
Seven largest	365	375	342	338	366	381	361	431	370
Next seven	394	407	373	362	322	361	354	386	370
Total	367	377	344	339	365	380	360	428	370
Standard deviation	109	60	64	64	66	65	82	82	74
Coefficient of variation	0.30	0.16	0.19	0.19	0.18	0.17	0.23	0.19	0.20

[a] Value added is defined as net income from ordinary before-tax activities *plus* salaries and related expenses, amortization and deductions, and maintenance of buildings and equipment costs.

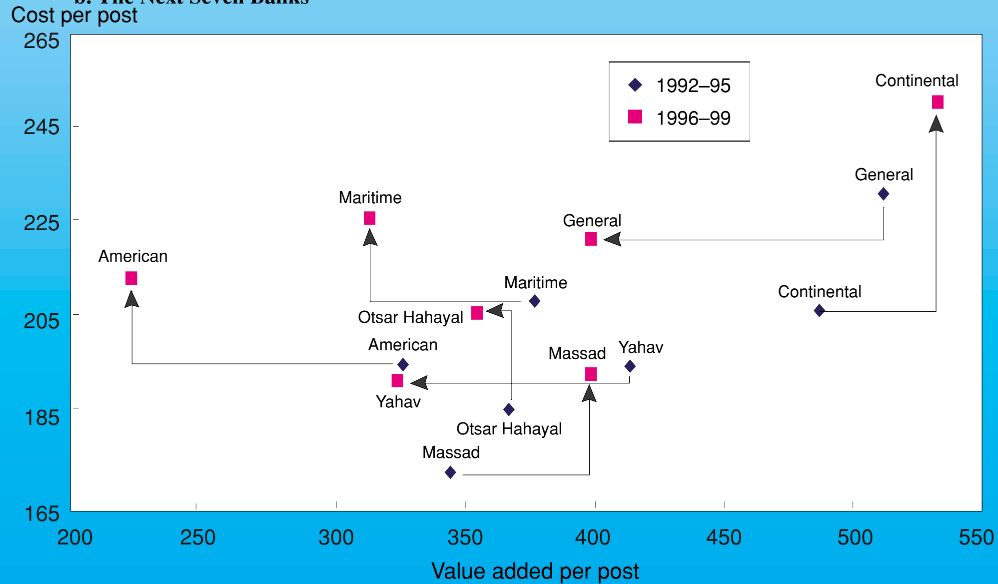
SOURCE: Returns to Supervisor of Banks and published financial statements.

Figure 3.5
Cost per Employee Post Vis-á-Vis Value Added per Employee Post, 1996–99 Compared with 1992–95
(NIS thousand, December 1999 prices)

a. The Seven Largest Banks



b. The Next Seven Banks



SOURCE: Returns to Supervisor of Banks and published financial statements.

Discount the reverse occurred. No general trend emerged for banks that did not belong to the five major groups; in some of them (Continental, Massad, Investec Clali, Yahav, and Mercantile Discount) the trend of cost per post was identical with that of value added per post, while in others (Union, American, Maritime, and Otsar Hahayal) the trends were opposed.

3. *Operating coverage ratio*[14]; the developments described above regarding non-interest income and operating expenses led to a rise in the average operating coverage ratio in the banking system as a whole, from 50.1 percent in 1998 to 51.8 percent in 1999 (Table 3.7). A long-term view shows that the coverage ratio rose constantly between 1988 and 1993. In 1993, due to the surge in the stock market and large non-interest income associated with the capital market, this ratio reached its peak. In 1994-96 the ratio declined, since when it has edged up (Figure 3.6). In spite of the differences in the banks' operating

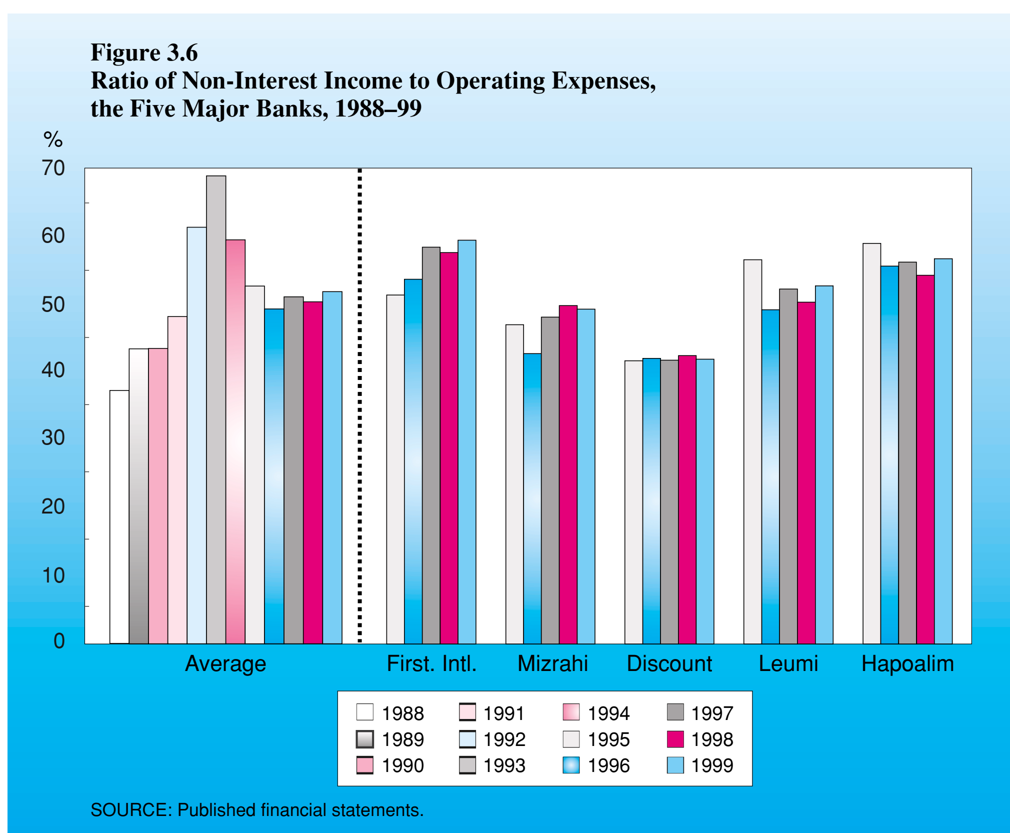


Figure 3.6
Ratio of Non-Interest Income to Operating Expenses, the Five Major Banks, 1988–99

SOURCE: Published financial statements.

[14] The operating coverage ratio is calculated as the ratio of total non-interest and other income to total operating and other expenses, and is generally known as 'the coverage ratio.'

Table 3.12
Coverage and Efficiency Ratios, the Seven Largest Banks, 1998–99

	1998			1999		
	IR[a]	CR[b]	ER[c]	IR[a]	CR[b]	ER[c]
Hapoalim	0.92	0.54	1.47	1.09	0.57	1.66
Leumi	0.91	0.50	1.41	1.01	0.53	1.53
Discount	0.66	0.42	1.09	0.84	0.42	1.26
Mizrahi	0.83	0.49	1.31	0.88	0.48	1.36
First International	0.88	0.58	1.46	0.95	0.59	1.54
Mercantile	0.84	0.43	1.27	0.85	0.45	1.30
Union	0.91	0.39	1.29	0.81	0.39	1.20

[a] The interest ratio (IR) is calculated as the ratio of net interest income before loan-loss provision to total operating and other expenses.

[b] The coverage ratio (CR) is calculated as the ratio of non-interest and other income to total operating and other expenses.

[c] The efficiency ratio (ER) is calculated as the ratio of total net and non-interest income to total operating expenses.

SOURCE: Published financial statements.

characteristics, the trend with respect to the operating coverage ratio has been similar for all of them. The operating coverage ratio in Israel is similar to the average in the peer group countries[15] (Table 3.2).

4. *Income efficiency ratio*; a bank's operating expenses derive from its ongoing operation, in respect of which it receives net interest and non-interest income; consequently, it is customary to examine the efficiency ratio, defined as the ratio of total net interest and non-interest income to total expenses. This ratio indicates a bank's efficiency, with a high ratio indicating that it utilizes its factors of production to increase its profitability. In 1999 this ratio rose in most of the large banks (Table 3.12), primarily due to the significant increase in their net interest income. There are marked differences between the banks, however, with the ratio ranging from 1.2 percent in Union bank to 1.7 percent in Hapoalim. An international comparison (Table 3.2) shows that in Israel's banking system this ratio is slightly above the average (in the peer group countries), because the ratio of net interest to total income is slightly higher than is customary elsewhere.[16]

[15] Comparative data refer to banking groups in various countries, and hence for Israel's banking system we calculated the data on a group basis, so that they differ slightly from those that refer to individual banks, as reported in Table 3.7.

[16] As stated in the preceding note, the international comparison is calculated on a group basis, so that the data for Israel in the table differ from those in Table 3.12, where they are given for individual banks.

f. Other factors affecting banks' profitability in 1999

1. Nonrecurring activities and effects were evident in 1999, chiefly in the two largest banking groups, being expressed in extraordinary income that affected profitability. Extraordinary income was NIS 158 million in the Leumi group (constituting 1.5 percentage points of the bank's ROE) in 1999, compared with NIS 26 million in 1998. This income is explained by the implementation of Banking (Licensing) (Amendment no. 11) Law, 5756-1996 which requires banks to divest themselves of excess holdings of nonfinancial companies. Accordingly, in December 1999 Leumi bank reduced its holdings in the Migdal Insurance Company from 24.91 percent to 20 percent, by exercising all its sales options. The proceeds of the sale were NIS 240 million, representing after-tax profit of NIS 151 million. Extraordinary profit in the Hapoalim group was NIS 23 million due to income of NIS 50 million from the sale of shares in Koor, and NIS 17 million from the sale of shares in Poalim Investments, partly offsetting losses from the sale of shares in Ampal and the sale of buildings.

2. Income of NIS 360 million accrued from subsidiaries in 1999. The Leumi group recorded income of NIS 90 million resulting from increased profits from the Migdal Insurance Co. and the Africa-Israel Investment Co. The Hapoalim group recorded income of NIS 193 million (down by NIS 40 million from 1998), due largely to the Koor (NIS 128 million) and Klal Insurance (NIS 35 million) companies. The decline in income in the Hapoalim group was the result of sales of its holdings in the Klal Israel, Poalim Investments, and Ampal companies. The Discount group registered profits of NIS 53 million, because of the contribution of First International Bank to its income in 1999, compared with NIS 62 million in 1998 (see Chapter 4).

3. The banks' income and expenses items were also affected to some extent in 1999 by the disparity between the rates at which the 'known and 'in-lieu' consumer price indices rose. This increased net interest income before tax by NIS 100 million-most of it in the indexed local-currency segment-and the tax provision by NIS 45 million. In 1999 the disparity between the indices increased the banking groups' income by NIS 56 million, whereas in 1998 it reduced it by NIS 82 million.

g. Tax provision

The provision for tax on the ordinary before-tax income of the five major banking groups was NIS 3,043 million in 1999, compared with NIS 1,913 million in 1998—a 59 percent rise (Table 3.3). There are two reasons for this growth: the increase in before-tax income, accounting for 35 percent of the rise in the tax provision, and the increase in expenses not recognized for tax purposes and taxable income, explaining another 24 percent of the rise. Although the statutory tax rate has not changed in the last three years (remaining at 45.3 percent), the effective tax rate on before-tax income has risen by about 7 percentage points to stand at 49.9 percent (Table 3.13). The higher effective tax rate, relative to both its level in 1998 and to the statutory rate, is the result of several factors: 1. The income of

Table 3.13
The Transition from a Statutory Tax Rate to Provision for Tax on Income in Profit and Loss Statement of the Major Banking Groups, 1999

	Total tax (NIS million)	Tax rate on ordinary pre-tax profit (%)
Statutory tax rate	2,760	45.30
Tax on adjustment of financial assets (net)	26	0.43
Income from subsidiaries abroad	86	1.41
General and additional loan-loss provision	–11	–0.18
Tax-exempt and tax-restricted income	–19	–0.31
Amortization, differentials, and capital gains	23	0.38
Other expenses	72	1.18
Payroll tax	88	1.44
Tax for previous years	51	0.84
Erosion of advance payments on tax	21	0.34
Income from subsidiaries in Israel	–53	–0.87
Other		
Actual tax	**3,043**	**49.94**

SOURCE: Published annual reports.

consolidated subsidiaries abroad—the tax provision for which was up by NIS 86 million over 1998 due to real negative exchange-rate differentials on investments abroad[17] stemming from real local-currency appreciation against the foreign currencies, and the Swiss franc in particular, which eroded the value of investments in those countries. These differentials are not part of the taxable income base. 2. Final tax-assessments were issued for some of the subsidiaries, as a result of which additional retroactive taxes were paid. 3. Increased tax provision, due to the difference between the 'known' and 'in-lieu' consumer price indices, leading to a rise in net interest income and tax on it. 4. Expenses included in the financial statements but not recognized for tax purposes, as well as a rise in the payroll tax paid by corporations, as a substitute for the VAT paid by ordinary firms. 5. The erosion of advance tax payments in line with the moderate increase in inflation in 1999.

3. RETURN ON EQUITY AND THE POLICY OF DIVIDEND DISTRIBUTION

Alongside the rise in the banking groups' profits in recent years, there has also been a significant increase in the dividends paid to shareholders, as well as in their share in net income and/or paid-up capital. In 1999 some NIS 2 billion was paid out as dividends

[17] In 1998 the reverse was the case—positive exchange-rate differentials which are not recognized as taxable income.

(compared with NIS 1.5 billion in 1998), constituting 57.1 percent of net income,[18] and in Hapoalim this amounted to over 80 percent of net income. In recent years dividends have accounted for an increasing share of net income.[19] This rise is explained by bank-owners' desire to recoup their investment and by the internalization of the commonly-accepted practice of distributing dividends to shareholders. In some banks the board of directors has adopted a long-term policy of distributing dividends at a pre-set level, provided Regulation no. 331 of Proper Conduct of Banking Business is upheld. The regulation prohibits the distribution of a dividend greater than the annual net income, and also requires the board of directors to assess the bank's liquidity and decide whether it enables a dividend to be distributed; at all events, a dividend may not be distributed if the bank's non-financial assets exceed its equity. The distribution of dividends must meet additional stability requirements, including the minimum capital ratio, according to which a bank's equity may not constitute less than 9 percent of its risk-weighted assets. Section 23a of the Banking (Licensing) Law, 5741–1981 restricts the share of equity a banking corporation may invest in nonfinancial corporations, and prohibits the distribution of dividends from the capital reserve or from differentials originating from the translation of the financial statements of autonomous units abroad.

At the end of 1999 the equity of the five banking groups, which constitutes one of the components used in calculating ROE, was NIS 33.6 billion, compared with NIS 32 billion in 1998. Most of the increase stemmed from net income (NIS 3.5 billion), which was offset in part by the distribution of dividends (NIS 2 billion). The ROE of the five major banking groups was 11.2 percent in 1999, ranging from 5.9 percent in First International to 13.4 percent in Hapoalim (Table 3.3). It is advisable to examine the differences in ROE between banking groups, taking the risk level of each group into account, i.e., in accordance with the risk-adjusted return on equity (RAROC). When this is done, we find that the differences between the groups are smaller, and that their ranking by RAROC in 1999 does not differ from that calculated on the basis of ROE.

[18] This is the dividend offered; the final amount depends on being approved at each bank's annual general meeting.

[19] In 1995-99 dividends accounted for 30, 36, 36, 56, and 57 percent respectively of net income.