

CHAPTER 1

SUMMARY OF DEVELOPMENTS

The growth rate of the **global economy** slowed in 2011, with advanced economies growing at a relatively slow rate of 1.6 percent as developing economies continued growing, at a relatively fast pace of 6.2 percent. The first quarter of the year was characterized by continuing recovery from the crisis, and some central banks raised their interest rates during this period. In contrast, during the second half of the year, the financial situation in Europe deteriorated, leading to sharp downward revisions in forecasts of worldwide growth. Significant yield differentials developed in the bond markets between countries perceived as risky, and those such as Germany, Japan and the US which were perceived as safe havens where long term interest rates were at historical lows. Share prices fell in many countries, following an uptrend during 2009 and 2010, and volatility was high.

Israel's economy grew at a relatively rapid rate of 4.7 percent, with a large increase in investment and a decline in unemployment. However, the rate of growth moderated during the second half of the year, with a slowdown in the growth of private consumption and exports, and a reduction in the rate of inflation. Monetary policy during the year reacted to changes in inflation and in the economic environment. Thus, at the beginning of the year, the interest rate was raised to 3.25 percent but as concerns of a crisis in Europe grew, the process of raising interest rates came to a halt, and starting in October the Bank of Israel began to reduce the interest rate. The exchange rate of the shekel depreciated this year, following a prolonged trend of appreciation, against the background of a deterioration in the current account and reduced activity of foreign residents in the shekel market. As a result, the Bank of Israel reduced its purchases of foreign currency this year and eventually ended them completely. The local capital market also showed negative results, following a positive trend during the previous two years; and share prices fell, as in foreign stock markets. The risk premium in the business sector increased, which was reflected in the spreads on corporate bonds of all ratings and in all industries.

Against the background of the deterioration in the global economic situation, the risk level of the banking system in Israel rose to some extent this year. Nonetheless, the banking system is healthy and stable, as is evident from the various stress tests carried out by Banking Supervision Department.

- **The credit portfolio and credit risk:** The credit risk of the banking system rose in 2011 due to the increased risk of companies. This occurred against a background of falling prices in the capital market and a slowdown in local economic activity during the second half of the year. Nonetheless, the level of risk of companies is lower than it was during the crisis in 2008. The concentration of borrowers in the credit portfolio remained high and was evident in the results of stress tests carried out by Banking Supervision Department. As a result, the Banking Supervision Department took steps to reduce the potential risk of concentration in the banks' credit portfolio by tightening the restrictions that apply to a borrower's indebtedness and by applying those restrictions to borrower banks as well. Total outstanding credit grew by only three percent this year and its rate of increase slowed during the second half of the year.
- **Housing loans:** Total outstanding housing loans increased by nine percent in 2011 to about NIS 215 billion in gross terms, although its trend during the year was not uniform. During the first half of the year, the rapid growth that characterized previous years continued, while during the second

half of the year the rate of growth in new mortgages granted slowed significantly, though their level remained high. The slower growth in new mortgages was due to a drop in demand for homes, against the background of continuing regulatory intervention.

- **The construction and real estate industry:** This year the exposure of the banks to the construction and real estate industry increased by five percent. The high exposure of the banks to this industry was reflected in the fact that most of them were near the industry indebtedness limit of 20 percent. In addition, the level of risk of companies in the industry rose, which was reflected in a high rate of provisions. Additional evidence of the industry's high level of risk could be found in the high yields on the industry's corporate bonds. In recent years, these companies have significantly increased their leverage by raising capital in the capital market and the bonds of some of the companies were trading at yields of more than 12 percent.
- **Country risk:** As a result of the debt crisis in Europe, the banks' risk as a result of exposure to foreign countries increased. While there is virtually no direct exposure to high-risk European countries, there is some exposure to foreign financial institutions, though it does not endanger the stability of the banking system. This year, the banks continued to work towards reducing their foreign exposure, by reducing their investment in the bonds of foreign financial institutions and their exposure to borrowers who operate primarily abroad.
- **Liquidity risk:** In 2011, the banks continued to maintain a relatively high level of liquidity, which even increased, compared with the previous year. Most of the banks increased their total liquid assets this year, against the background of continuing economic and financial uncertainty worldwide, and also as part of the preparations for implementing the Basel III guidelines regarding capital requirements and liquidity risk. The banks' main sources of funds are deposits from the public rather than interbank and financial markets and therefore their liquidity risk is low compared with other countries.
- **Capital adequacy:** The core tier 1 capital ratio remained basically unchanged this year at 7.9 percent, which is low in comparison with European countries. The Banking Supervision Department and the banking system are preparing for the implementation of the Basel III guidelines, which involve the redefinition of capital components, the raising of the common equity tier 1 capital ratio and the strengthening of risk coverage and liquidity requirements. As in a number of other countries, the Supervisor of Banks published revised guidelines for minimum common equity tier 1 capital ratios, in March 2012. According to these guidelines, all banks are required to meet a minimum common equity tier 1 capital ratio of 9 percent by January 1, 2015, and Bank Leumi and Bank Hapoalim will be required to further raise their minimum common equity tier 1 capital ratios by another percentage point, to 10 percent, by January 1, 2017. The common equity tier 1 capital targets were set at higher levels than those required by Basel III and the period for their implementation is shorter. This is expected to strengthen the resilience of the banks and their ability to absorb losses during a crisis. It should be noted that for purposes of measuring capital adequacy Israeli banks use the standard method, according to which credit risk assets are weighted more conservatively than is the case for most leading banks in Europe, which use internal models.
- **Profit and profitability:** The operating results of the five major banking groups were relatively good this year, despite the slowdown in local activity, which occurred primarily during the second half of the year. Total net income totaled about NIS 7 billion and the return on capital reached 10.2 percent, which is similar to its average for the last decade. The profits of the banking groups and their

Table 1.1
Principal banking system indices, five major banking groups,
December 2001 to December 2011

| Year | Ratio of market value to book value (MV/BV) | Average yield gap between bonds of the banks and government bonds | Ratio of credit to GDP ^a (percent) | Rate of change in banks' credit portfolio ^a (percent) | Loan loss provision to total balance sheet credit to the public ^b (percent) | Ratio of liquid assets ^c to liquid liabilities ^d | Ratio of credit to deposits | Total capital ratio (percent) | Core tier 1 capital ratio (percent) | ROE (percent) | Risk adjusted return on capital (RAROC) |
|-------------|---|---|---|--|--|--|-----------------------------|-------------------------------|-------------------------------------|---------------|---|
| 2001 | 0.8 | 0.8 | 98.7 | 16.1 | 0.9 | | 0.81 | 9.4 | | 5.8 | 0.1 |
| 2002 | 0.6 | 0.8 | 103.2 | -3.0 | 1.3 | 0.42 | 0.83 | 9.9 | | 2.8 | -0.2 |
| 2003 | 0.8 | 0.7 | 98.9 | 0.2 | 1.1 | 0.41 | 0.82 | 10.3 | | 8.4 | 0.3 |
| 2004 | 1 | 0.8 | 94.7 | 4.7 | 0.9 | 0.41 | 0.80 | 10.7 | | 13.2 | 0.8 |
| 2005 | 1.4 | 0.7 | 92.2 | 8.5 | 0.7 | 0.42 | 0.82 | 10.7 | | 13.9 | 1.0 |
| 2006 | 1.3 | 0.6 | 89.9 | 7.4 | 0.5 | 0.38 | 0.80 | 10.8 | | 17.3 | 1.0 |
| 2007 | 1.2 | 1.1 | 92.5 | 10.3 | 0.3 | 0.29 | 0.85 | 11.0 | | 15.6 | 0.8 |
| 2008 | 0.6 | 1.9 | 97.0 | 7.8 | 0.7 | 0.27 | 0.90 | 11.2 | | 0.3 | -0.1 |
| 2009 | 1.1 | 1.7 | 90.1 | -5.6 | 0.7 | 0.38 | 0.86 | 13.7^e | 7.9 | 8.8 | 0.4 |
| 2010 | 1.1 | 1.7 | 90.8 | 6.3 | 0.4 | 0.32 | 0.91 | 14.0 | 8.0 | 9.8 | 0.5 |
| 2011 | 0.7 | 1.5 | 90.7 | 2.7 | 0.4 | 0.37 | 0.89 | 14.0 | 7.9 | 10.2 | 0.5 |

^a Measured using net credit.

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

^c Liquid assets include cash as well as deposits at the Bank of Israel and at other banks with up to 3 months to maturity, and government bonds.

^d Liquid liabilities include total deposits with up to 3 months to maturity.

^e Calculated in accordance with the Basel I principles.

^f Calculated in accordance with Basel II principles.

SOURCE: Central Bureau of Statistics, Bank of Israel, published financial statements, reports to the Banking Supervision Department and Banking Supervision Department calculations.

profitability was positively affected this year by changes in the tax laws, which led to a significant one-time drop in tax payments, and by a moderate expansion in banking activity as a result of growth in the local economy. Nonetheless, the deterioration in the financial markets, primarily during the second half of the year, reduced revenues originating from capital markets.

Stress tests carried out this year by Banking Supervision Department included a wide variety of scenarios and types of tests, including for the first time a macroeconomic stress test (whose results were taken into account in an evaluation of the stability of the financial system in Israel carried out by the FSAP delegation).¹ The tests show that the banking system is maintaining its level of resilience and that the average capital adequacy ratio for the system remains above the required minimum in a stress scenario. At the same time, the results identified various focal points of risk in the banks and the need to continue strengthening core capital.

¹ Financial Sector Assessment Program. The evaluation was carried out by the IMF in November 2011. The results of the macroeconomic stress test can be found in "Israel: Technical Note on Stress Test of the Israeli Banking Insurance and Pension Sectors", April 2012.