



**BANK OF ISRAEL
SUPERVISOR OF BANKS
THE ECONOMICS UNIT**

ISRAEL'S BANKING SYSTEM

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Letter of the Supervisor of Banks submitted with the 2010 Survey of Israel's Banking System

In view of the central role of the banking system in financial activity in Israel, the stability and proper functioning of the system for the purpose of supporting economic activity—both real activity and financial activity—are of overwhelming importance. In order to assure the resilience of the system and its ability to supply a high level of banking services in a changing risk environment, in 2010 the Banking Supervision Department focused on activity aimed at strengthening the system's capital base, corporate governance and risk management. These measures were taken *inter alia* as part of the application of the Basel II directives, which went into effect in 2010, and in response to developments in the housing market. At the same time, the Banking Supervision Department maintained activities that are aimed at maintaining fairness in the relationships between the banks and their customers, and at encouraging competition in the banking system. These activities included processing the public's enquiries and complaints, increasing the amount of explanatory activity and consumer information provided to the public, and arrangements for facilitating customers' move from bank to bank.

Overall, 2010 was a good year for the Israeli banking system, which continued to present an improvement in its financial results and capital adequacy. Four years after the onset of the global financial recession, the banking groups' performance during the year with respect to the majority of parameters reverted to the levels typical of the years of prosperity that preceded the recession. This improvement was based on the positive developments in the Israeli economy. GDP rose at a high rate in 2010 and improvement showed in numerous areas, including employment, labor productivity, the financial resilience of business firms and real wages. Against the background of these trends, demand for bank credit and banking services expanded, and the quality and financial resilience of borrowers increased. These developments formed the basis for the growth in the five banking groups' profit and profitability, and the groups presented an average ROE of 9.7 percent and an aggregate net profit of NIS 6.6 billion.

The positive results were accompanied by exposure to risk from the global aspect and in particular, from the local aspect, the worrying developments in the housing market in Israel and in housing loans that were extended by the banking system. These developments, which included an upsurge in apartment prices and in the volume of housing loans, resulted from the low interest rate environment in the economy and from the apartment supply shortage, making it necessary for the Banking Supervision Department to intervene in order to mitigate the potential risks deriving from the housing market. A number of macroprudential measures were therefore taken in 2010 for the purpose of increasing awareness of the risks and increasing the banks' reserves for the coverage of unexpected losses in respect of this credit. In addition, in May 2010 that part of a housing loan which the banks are entitled to extend at floating-rate interest was

restricted to a third of the overall loan granted to a customer. This measure is intended to reduce the risk to borrowers in the event of an interest-rate hike that greatly increases the monthly repayments on their loans, and also therefore to ensure the quality of the housing loans in the banking corporations' portfolios.

The enhancement of capital adequacy was at the forefront of the measures promoted during recent years, and included the adoption of a pattern for increasing the overall capital adequacy ratio to levels of over 12 percent. This activity continued in 2010, and the banking system was directed to adopt a target core capital adequacy ratio of at least 7.5 percent. These measures enhanced the system's ability to absorb unexpected shocks, and brought its capital up to a level and a quality that are accepted in many countries. As part of an examination of the capital adequacy of the banking corporations, a comprehensive extreme-case scenario stress test was conducted for the purpose of testing the banking system's resilience and sensitivity to a variety of risk drivers. Although this test showed that the system had remained resilient and stable, it also emphasized the need for the further strengthening of core capital, risk management and controls in high-risk activity, such as investment in securities and the extension of leveraged credit.

In our processing of credit risk, we continued to assist the banking system in its preparations for the application of the Directive for Reporting to the Public with "The Measurement and Disclosure of Impaired Debts, Credit Risk and Allowance for Credit Losses", which went into effect in January 2011. The directive is intended to strengthen the relationship between changes in the quality of credit and changes in the loan-loss provision, to improve risk management processes, and to enhance the ability to compare different banks in Israel and in particular, to compare Israeli banks with banks abroad. An examination of the initial application of the directive reveals the need for increased loan-loss provisions in order to create more suitable coverage for these losses, including loan losses that have yet to be detected.

Activity aimed at strengthening corporate governance in the banking system continued in 2010, and was centered on a major revamping of the Proper Conduct of Banking Business Regulations concerning the board of directors, in the spirit of the recommendations of the Basel Committee and the changing perception of the term "corporate governance" in recent years. The amended regulation includes clear principles for defining the functions, authorities and composition of the board of directors, its responsibilities and the responsibilities of the senior management with respect to the financial corporation's activities and relationships with its customers.

The Banking Supervision Department endeavored to promote legislative amendments for the purpose of strengthening the corporate governance at the banks, with an emphasis on banks without a controlling core. To that end, mechanisms were prescribed for preventing actual control by a person lacking a control permit from the Governor of the Bank of Israel. The proposed amendments balance rights conferred to shareholders and the need to prevent control of a bank by a person who has not passed an integrity and financial resilience test by the Banking Supervision Department.

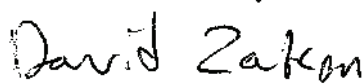
In line with the Banking Supervision Department's responsibility for the proper functioning of the banking system, numerous actions were taken to increase the system's preparedness for a state of emergency. As part of the action taken in this respect, we formulated policy principles for the system's minimal service targets for the purpose of ensuring that essential financial services will be provided to the economy and to the public in a state of emergency. As a supplementary measure, we prescribed temporary relaxations in the Proper Conduct of Banking Business Regulations in order to make it easier for the population to obtain banking services in times of emergency. These measures enhance the banking system's ability to fulfill its designated role as financial intermediary even in periods of stress.

The improvement in the banks' results and the processes which they have adopted in order to strengthen corporate governance and risk management are a good starting point for coping with the numerous and complex challenges facing them. In the area of business activity, the resumption of the competition from the non-bank credit market and the growth in competition in the retail segment and in housing loan activity will make it necessary to strengthen existing profit channels, develop new channels, and improve the banking services provided to the public and the banks' operational efficiency.

In view of these challenges, including exposure to economic and geopolitical risks, during the coming years the banking system will have to continue strengthening its capital adequacy, liquidity and risk management.

In the coming years the banks will have to continue allocating major resources in order to adhere to more extensive and more complex regulation. The Banking Supervision Department has presented itself with the strategic objective of adopting best international practices in the areas of banking and the supervision of the banking system. This is in order to assure the robustness of the system and its status in Israel and abroad. These practices have been extended considerably during recent years in view of the lessons learned globally from the recent financial recession. The main challenges in this respect include the closure of gaps with the best practices in the core areas of banking, while applying the new Basel Committee directives of December 2010, known as Basel III, and enhancing the tools available to the Banking Supervision Department for assisting in the resolution of a troubled bank.

The banking system and the Banking Supervision Department have sound infrastructures that will make it possible to cope successfully with these numerous and complex challenges.

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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