



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

ISRAEL'S BANKING SYSTEM

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Letter of the Supervisor of Banks, Mr. Rony Hizkiyahu, Submitted with the 2007 Survey of Israel's Banking System

In its sixty-first year of independence, Israel has a strong, stable, and profitable banking system. The favorable macroeconomic fundamentals that have cushioned the banks' operations in recent years are clearly reflected in the banks' performance, financial results, and exposure to risks.

Israel's economy continued to develop positively in 2007. The combination of rapid growth of business-sector product and a buoyant domestic capital market was reflected in the achievements of the banking system, which reported improvements in its capital-adequacy ratio, its quality of credit, and its profits.

The shocks experienced by the global and domestic financial markets in late 2007 did not overlook Israel's banking system, mainly due to the banks' holdings of asset-backed securities. Nevertheless, their effect was relatively subdued and did not undermine system stability. The events did, however, suggest that the foreseen global economic slowdown is likely to affect Israel, too.

Even before the crisis erupted, the Banking Supervision Department, as part of its regular supervisory activities, took measures to maintain the stability of the banking system. As part of the process of improving risk management and supervision, I announced, when taking office at the beginning of 2007, that Israel would apply the recommendations of the Basel Committee on Banking Supervision ("Basel II") in both the banking system and in banking supervision by the end of 2009. Once this is done, Israel's banking system will satisfy the most advanced international banking standards and the banks will have upgraded their risk-management systems, internal controls, and corporate governance. The implementation of Basel II includes, among other things, a move to risk-based management, a change in the organizational management approach, and attention to risks not dealt with previously (such as operational risk and liquidity risk). The Banking Supervision Department, for its part, is preparing to adapt its working methods to changes in the risk-management environment and to switch to a risk-based supervision framework. Its preparations involve structural reorganization and the adoption of processes, controls, and rules that satisfy the most advanced international standards.

Complementing my directive regarding the adoption of the Basel II proposals, I informed the banks that they would do well to adhere to an upward capital-adequacy trajectory that would result in a capital ratio of at least 12 percent by the end of 2009. This level of capital adequacy, which has become the norm in advanced economies, will reinforce their ability to meet unexpected changes that will occur if risks come to pass. The banking system undertook to attain this capital target due to their awareness of the importance of capital adequacy specifically in periods of expansion, which are predictably followed by downturns in the business cycle. Due to the combination of these factors, the capital-adequacy ratio of the five major banking groups climbed to

around 11 percent by the end of 2007, the highest level in the last ten years, despite the effects of the financial crisis.

Credit risk fell in 2007, pursuant to the downward trend that started in 2005. The decline originates in the improvement in credit-portfolio quality despite the deterioration in the volume of credit and its concentration. Toward the end of 2007, given the volatility in the financial markets and the increase in the risk premium on corporate bonds, banks' exposure to credit risk and market risk increased. The banking system initially dealt with these changes by widening its capital safety net, mainly Tier 1 capital, and then by adopting the latest methods of risk management. In April 2008, I instructed Bank Hapoalim to double its capital allocation related to its holdings of asset-backed securities, as is used to calculate the risk-weighted capital ratio, due to the high risk attached to these holdings. After incurring heavy losses on these securities, the Hapoalim Group opted, in May 2008, to liquidate its portfolio of such holdings. Consequently, in the middle of 2008 the banking system had a relatively low exposure to the subprime mortgage crisis and was better positioned to cope with the expected slowdown in domestic economic activity.

The net income of the five major banking groups increased in 2007 despite losses on holdings of asset-backed securities. The rise in banking activity and the improved quality of credit enhanced the banks' net interest income and allowed the banks to reduce their loan-loss provisions. System profitability, measured by return on equity, was lower in 2007 than in 2006, but most of the decline traced to strong capital gains in 2006 that derived from the sale of ownership and management interests in provident and mutual funds under the Bachar reform.

Classic banking intermediation activity continued to decline in 2007. The share of banks in total credit and credit substitutes fell, giving way mainly to corporate bond issues, and the share of the public's deposits with banks relative to the other components of its financial assets portfolio slumped. Concurrently, the rapid growth of business-sector product led to a marked rise in domestic demand for credit and sources of finance. Although most of the demand was directed to non-bank entities, demand for bank credit also rose and outstanding credit increased.

In the last few years, amid the downturn in classic banking intermediation, Israel's banking system increased its external involvement abroad by acquiring banks in emerging markets, making deposits with and investments in financial institutions abroad, and moving ahead with other investments. The purpose of this expansion overseas was to diversify sources of income, spread risks, and attain strong returns. However, this course of action also involves various risks. Thus, two foreign banks opened branches in Israel in the last year and a half, joining two other banks that have long had branches here. This increase in cross-border activity entails special efforts and close attention on the part of both the domestic banks and the Banking Supervision Department.

In 2007, pursuant to the tendency in recent years to merge the activities of mortgage banks with those of their parent banks, structural changes continued that will make the system less concentrated and more competitive. Thus, ownership of three banks—

Massad, Yahav, and Otsar Hahayal—was transferred from Bank Hapoalim to medium sized banks. The Banking Supervision Department continues to explore various ways of increasing competition in the banking industry, particularly in the household segment. Practical steps in this direction included attempts to encourage a foreign bank to enter Israel with retail banking services for the public, promoting the establishment of an on-line bank, privatization of the Israel Postal Bank, and encouraging the on-line distribution of mutual funds. Despite these developments, Israel's banking system remains highly concentrated relative to systems in advanced economies and evinces a relatively low level of competition. The answer lies in forging ahead with the development of the non-bank financial market, including a more sophisticated capital market, and systematizing activity in hybrid financial instruments. Such advances must go hand-in-hand with measures that will contend with the risks that inherently pertain to these activities, including systematic supervision of the markets involved.

In addition to the steps taken to encourage competition in the banking system, I promoted legislation to toughen the supervision of banks' fees. The resulting statute, which went into effect on July 1, 2008, empowers the Bank of Israel and the Banking Supervision Department to regulate the prices of bank services in various ways. Pursuant to its new powers, the Department drew up a short, standard, and explicit list of services for which banks may charge a fee. This will improve due disclosure and transparency and enhance customers' ability to compare the prices of services at different banks. The new legislation is also expected to increase competition among banks in the retail banking sector, lower the average price of banking services, and enhance the public's welfare.

In 2007, the Banking Supervision Department also dealt with the collapse of the Heftsiba development and construction company. By gathering information from apartment buyers and banks with alacrity, we were able to obtain a reliable picture of the situation. The Department took immediate steps to deal with the plight of the main victims of the collapse, the apartment buyers, and then explored ways to prevent the recurrence of such an event. Reflecting one of the lessons learned from this case, I issued a Proper Conduct of Banking Business Directive that regulates the way home buyers transfer funds to project-finance accounts and protects their money. These two areas of the Department's responsibility—assuring the stability of the banking system while reviewing its exposure to the company's collapse, and its obligation to home buyers as arising from its role in supervising banks' fair treatment of their customers—dictated the assistance proffered to customers and the rapid and thorough correction of the faults revealed.



Rony Hizkiyahu
Supervisor of Banks

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