

Chapter 2

The Financial Results of the Five Major Banking Groups

The financial results of the five major banking groups this year were good, and constituted, at least up until the fourth quarter of the year, a direct continuation of the prevailing positive trend in the banking system in recent years. Aggregate net profit grew by a negligible 0.8 percent rate this year, and was affected by both the impressive growth rates posted by the three medium-sized groups and the negative growth rates of the two largest groups. The entire growth in net profit this year was due to a rise in profit from ordinary operations, in contrast to 2006, when the increase in net profit was affected by a steep rise in profit from extraordinary operations caused by implementation of the Bachar reform. Profit from financing operations, which grew this year at four of the five largest banking groups, was characterized by high variance, and was due to the positive substitution effect, which overcame the negative price effect in each of the mediation segments. This year, as in the preceding years, the improvement in the quality of the banking portfolio and the ability of borrowers to repay their debt caused a sharp drop (of approximately 41 percent) in loan-loss provisions. This year, the banking groups reported improvement in their operating efficiency. This improvement was due to stability in operating expenses – mostly owing to lower salary expenses – coupled with a rise in non-interest income caused principally by higher income from bank fees.

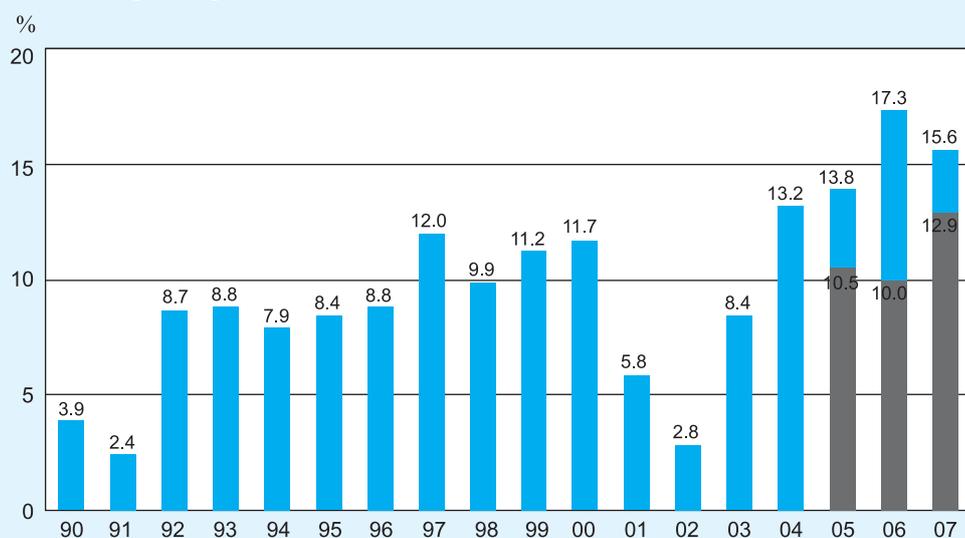
The financial crisis in global markets overshadowed the system's positive results in the first three quarters of the year, and had a negative impact on the development of profit and profitability of the system as a whole in the fourth quarter, principally through the financial results of the Hapoalim Group.

As a result of these developments, the aggregate return on equity of the five largest banking groups declined to 15.6 percent this year, compared with 17.3 percent last year, while the return on equity from ordinary operations grew from 10 percent last year to 12.9 percent this year.

1. PROFIT AND PROFITABILITY OF THE BANKING GROUPS

Following four years in which the banking system posted impressive growth rates in net profit and high levels of profitability, the rate of growth in profit this year was negligible, and the level of profitability, as measured in terms of the return on equity, actually fell. At the same time, the five largest banking groups again had a large aggregate net profit this year – about NIS 9 billion, compared with NIS 8.9 billion in the corresponding period last year, a 0.8 percent increase (Table 2.1). The level of profitability¹ declined from 17.3 percent in 2006 to 15.6 percent this year, but was higher than that of 2005² (Figure 2.1).

Figure 2.1
Return on Equity^a (ROE) and Ordinary After-Tax ROE of the Five Major Banking Groups, 1990-2007



^a The data for 2005-07 have been reclassified in accordance with the new accounting directives sent to the banks by the Banking Supervision Department. For further details, see footnote 1 to the text. The grey areas at the bottom of the columns for 2005-07 represent ordinary after-tax ROE.
SOURCE: Based on published financial reports.

¹ Starting in the first quarter of 2007, the banking corporations were required to calculate their return on equity using the method employed in the US and other countries. The return on equity is calculated as the net profit, minus the dividend per preferred share not listed as an expenditure in the profit and loss statement and declared in the reporting period only, divided by the average equity. The average equity for this purpose is the total capital resources, minus the average balance of external shareholders' rights, minus/plus the average balance of as yet unrealized loss/profit from adjustment to the fair value of marketable bonds and of the loss/profit in respect of bonds available for sale that are included in the equity.

² Due to a change in the method of calculating the return on equity mentioned above (see Footnote 1), comparison of the figures for 2005-07 with those of previous years is problematic.

As mentioned above, net income was high again this year, despite its low rate of growth. Like last year, it was affected by an array of factors, some of which were cyclical and some non-repeating. The positive trend in the Israeli and global economies in recent years continued to have a positive impact on the performance of the banking groups this year, and constituted, at least up until the fourth quarter, a direct continuation of the prevailing positive trend in the banking system in recent years. This trend was reflected in continued growth in profit from ordinary operations, due to higher profit from financing operations, higher income from operating bank fees, and a sharp drop (of approximately 41 percent) in loan-loss provisions, caused mostly by an improvement in the quality of credit and strength of the business and commercial segments. Return on equity from ordinary operations rose from 10 percent in 2006 to 12.9 percent this year (Table 2.1).

Where profit from extraordinary operations is concerned, it emerges that the continuation and completion of the first stage of the Bachar reform³ boosted the banking groups' one-time capital gains derived from the proceeds of the sale of ownership and management rights in the provident and remaining mutual funds again this year, but to a lesser extent than in the preceding year. The entire increase in net profit this year was due to a 45 percent rise in profit on ordinary operations, in contrast to the preceding year, in which the rise in profit was due to an increase in profit on extraordinary operations caused by implementation of the Bachar reform.

The subprime crisis in the American mortgage market⁴ and the subsequent liquidity crisis in many markets around the world in the third and fourth quarters of the year reduced the banking system aggregate profit. This unrest in the financial markets had a negative impact on development of profit and profitability of the Israeli banking system as a whole, mostly through the business results of the Hapoalim Group, which were affected by activity in hybrid financial instruments related to some extent to the crisis. The volume of write-offs by the group this year in its net profit line for activity in hybrid financial instruments totaled NIS 1.2 billion (approximately 45 percent of the Group's net profit in 2007), due to a decline in value of securities of a non-temporary nature. The write-offs of the other groups were negligible, and did not affect their profit trend: Mizrahi-Tefahot, NIS 114 million, amounting to 13 percent of its total profit this year; Leumi, NIS 28 million; and the First International, NIS 10 million. Discount made no write-offs at all (see the box in Chapter 3).

The contribution of the overseas bank branches to profit from ordinary operations this year was a negative NIS 70 million (Table 1.9). Most of the decline was due to the appreciation of the shekel, which caused negative exchange rate differences between it and the foreign currencies in which the branches operate (for a more thorough discussion, see Chapter 1).

³ For the purpose of this analysis, the first stage is the sale of ownership and management rights in the provident and mutual funds and the sale of non-financial holdings, as required by the law of increasing competition and reducing over-concentration and conflicts of interest in the Israeli capital market.

⁴ For more information, see Box 3.1.

Table 2.1
Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 2005–07

	(NIS million, at current prices)									
	Leumi			Hapoalim			Discount			% change from 2007 to 2006
	2005	2006	2007	2005	2006	2007	2005	2006	2007	
Net interest income before loan-loss provision	6,629	6,922	7,648	7,394	7,579	6,933	3,697	3,790	4,225	11.48
Loan-loss provision	1,426	933	407	1,268	986	513	691	570	447	-21.58
Net interest income after loan-loss provision	5,203	5,989	7,241	6,126	6,593	6,420	3,006	3,220	3,778	17.33
Total operating and other income	3,727	3,881	4,222	4,815	5,371	5,250	2,406	2,359	2,572	9.03
of which Fee income	2,819	3,013	3,350	3,763	4,097	4,349	1,863	1,911	2,216	15.96
Total operating and other expenses	6,080	7,267	6,937	7,025	7,632	7,940	4,729	5,020	5,066	0.92
of which Salaries and related expenses	3,627	4,552	4,218	4,222	4,687	4,769	2,967	3,202	3,030	-5.37
Ordinary before-tax income	2,850	2,603	4,526	3,916	4,332	3,730	683	559	1,284	129.70
Tax provision	1,193	1,320	1,722	1,645	1,897	1,458	324	350	566	61.71
Ordinary after-tax income	1,657	1,283	2,804	2,271	2,435	2,272	359	209	718	243.54
Other income ^a	480	2,190	515	699	979	527	177	706	602	-14.73
Net income	2,136	3,534	3,357	2,888	3,559	2,679	458	836	1,265	51.32
Capital for the calculation of ROE^b	15,822	17,582	19,293	15,781	17,314	19,000	6,361	7,145	8,605	20.44
Ordinary ROE, net (%)	13.0	8.3	15.4	14.6	14.4	12.3	-	3.5	9.6	
Total ROE (%)^c	13.5	20.1	17.4	18.3	19.4	14.1	6.8	11.7	14.7	
Total return on assets (ROA)(%)	0.84	1.27	1.16	1.10	1.20	0.95	0.32	0.53	0.78	

(cont'd)

Table 2.1 (Cont'd)
Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 2005–07

	(NIS million, at current prices)											
	Mizrahi-Tefahot			First International			Total					
	2005	2006	2007	% change from 2006 to 2007	2005	2006	2007	% change from 2006 to 2007	2005	2006	2007	% change from 2006 to 2007
Net interest income before loan-loss provision	1,904	1,987	2,026	1.96	1,673	1,831	2,047	11.80	21,297	22,109	22,879	3.48
Loan-loss provision	292	305	228	-25.25	276	219	181	-17.35	3,953	3,013	1,776	-41.06
Net interest income after loan-loss provision	1,612	1,682	1,798	6.90	1,397	1,612	1,866	15.76	17,344	19,096	21,103	10.51
Total operating and other income	1,114	1,215	1,190	-2.06	1,018	1,146	1,425	24.35	13,080	13,972	14,659	4.92
of which Fee income	924	991	1,034	4.34	862	932	1,117	19.85	10,231	10,944	12,066	10.25
Total operating and other expenses	1,839	2,117	1,938	-8.46	1,575	1,867	2,338	25.23	21,248	23,903	24,219	1.32
of which Salaries and related expenses	1,154	1,395	1,169	-16.20	908	1,079	1,330	23.26	12,878	14,915	14,516	-2.68
Ordinary before-tax income	887	780	1,050	34.62	840	891	953	6.96	9,176	9,165	11,543	25.95
Tax provision	371	349	368	5.44	374	387	369	-4.65	3,907	4,303	4,483	4.18
Ordinary after-tax income	516	431	682	58.24	466	504	584	15.87	5,269	4,862	7,060	45.21
Other income ^a	-9	212	226	6.60	6	19	197	936.84	1,353	4,106	2,067	-49.66
Net income	507	643	908	41.21	453	509	744	46.17	6,442	8,881	8,953	0.81
Capital for the calculation of ROE^c	4,371	4,946	5,279	6.73	3,905	4,426	5,096	15.13	46,241	51,414	57,274	11.40
Ordinary ROE, net (%)	11.7	8.6	12.9	-	11.4	11.5			10.5	10.0	12.9	
Total ROE (%)^c	11.6	13.0	17.2		11.6	11.5	14.6		13.8	17.3	15.6	
Total return on assets (ROA) (%)	0.61	0.74	1.00		0.66	0.70	0.86		0.79	1.01	0.98	

^a In 2003 includes erosion and adjustments of income and expenses that were included in before-tax income as reported in statements adjusted for inflation according to the December 2003 CPI (NIS 370 million).

^b Capital for the calculation of ROE includes all capital funds *minus* the average balance of external shareholders' rights and *minus/plus* the average balance of as yet unrealized losses/profits from the adjustment to fair value of portfolio bonds and from losses/profits on bonds available for sale.

^c Calculated as the ratio of net income to capital for the calculation of ROE (see note b above).

SOURCE: Based on published financial statements.

The distribution of profit during the year and the development of profit in the various activity segments highlights the effect of the crisis in the financial markets on the groups' profits in the fourth quarter of the year, particularly those of the Hapoalim Group. Only Discount and Leumi reported an increase in profit from financial operations in the fourth quarter of the year; the other banking groups reported a fall in this profit of 22.6 percent, compared with the corresponding period last year. Accordingly, aggregate profit from ordinary operations was down 37.4 percent during this period.

As we assessed in the review by the Supervisor of Banks for 2006, the Israeli banking groups are expected to face challenges in the coming years: they will have to deal with the consequences of the Bachar reform, the Supervision of Bank Fees Law (2007), an expected slowing of growth in the Israeli and global economies, and upheaval in the financial markets. In the short term, the expected drop in operating and other income as a result of the implementation of the Supervision of Bank Fees Law, the completion of the first stage of the Bachar reform, and a possible reduction in profit from financing operations caused by upheaval in the financial markets and slower growth will force the banking groups to develop alternative income channels and to continue their streamlining in order to overcome the problem of exhaustion of their existing resources and to continue achieving high levels of profit and profitability.

a. Net interest income before loan-loss provision

The aggregate net interest income of the five major banking groups grew by a modest 3.5 percent this year, reaching NIS 22.9 billion (Table 2.2), and it rose in four of the five major banking groups this year. In contrast to last year, the variance in the rate of increase was high. Other than the Hapoalim Group, which posted an 8.5 percent drop in net interest income, the groups reported increases ranging from 2 percent for the Mizrahi-Tefahot Group to 11.8 percent for the First International Group.

The rise this year was due to a 7.6 percent increase in net income from classic financial intermediary activity and a 3 percent rise in income from activity in options and other derivative financial instruments, significantly offset by a 27.9 percent drop in the other interest income (see Table 2.2).

An analysis of net income from classic financial intermediary activity by indexation segment, including the effect of derivatives, shows that the substitution effect this year derived from the volume of activity was 13 percent. This was greater than the negative price effect, measured as the overall interest rate spread (1.42 percent, compared with 1.50 percent last year, see Table 2.3). Interest income from unindexed shekel activity grew 5.2 percent this year (Table 2.2). Even though its weight in the balance sheet total was 35 percent, its contribution to profit was higher (about 49 percent), because the interest rate spread in it was higher than in the other indexation segments (Table 2.3 and Figure 2.2).

Continuing the trend in recent years, unindexed banking activity surged 27.6 percent this year, for two main reasons: (a) a rise in aggregate demand for credit – resulting

from expansion in economic activity in Israel and increased income of households, and (b) a shortage of unindexed credit substitutes, which caused a steep rise of the assets in the segment outstripping the increases in the other indexation segments (Table 2.3). The interest rate spread declined from 2.62 percent in the preceding year to 2.14 percent this year (Table 2.3), because interest rates in the segment depend on the monetary interest rate set by the Bank of Israel, which declined by 1 percent this year. This positive correlation between the two variables is consistent with the results of empirical studies,⁵ which stress the trend towards a long-term positive correlation, and show that sometimes there is even a negative correlation between them in the short term (Figure 2.3).

Profit in the CPI-index segment rose by a steep 26 percent this year, and its contribution to total interest income amounted to 13.1 percent. An assessment of the changes in profit in the segment shows that this year's increase was due entirely to income effect, as reflected in the expansion of indexed activity. This resulted from the rise in aggregate demand for credit for purposes of financing the activity and needs of business and retail entities in the economy, and from the increasing uncertainty regarding inflation and rising inflation expectations during the second half of the year⁶ (Figure 1.8). The effect of this substitution, as reflected in the narrowing of the interest rate spread by 0.11 percent, slightly offset the income effect. The interest rate spread in the segment dropped from 0.91 percent last year to 0.80 percent this year (Table 2.3), and was affected by a decline in yield rates in the market for government bonds,⁷ which serve as a substitute for activity in the segment. The contribution of the foreign

⁵ For a more thorough discussion, see:

a. "Analysis of the Interest Rate Spread in the Unindexed Shekel Sector of the Banking System in Israel," D. Ruthenberg, D. Geva, and T. Samet, July 1984-May 1987; "Issues in Banking 7," March 1988.

b. "Financial Spread, Interest Rate Spread, Integrating Activity in Derivatives, and the Importance of the 'Monetary Penalty'," D. Ruthenberg, Study, Bank of Israel Banking Supervision Department – Research Unit.

The model developed relies on the following interest spread equation, where M is the interest rate spread, S is the interest on a monetary loan, ρ is the liquidity obligation on the deposit, θ is the elasticity of the supply of deposits, and η is the elasticity of demand for credit.

$$M = R_L - R_D = \left[\frac{1}{1 + \frac{1}{\eta}} - \frac{(1 - \rho)}{1 + \frac{1}{\theta}} \right] \bullet S = \left[\frac{\eta}{1 + \eta} - \frac{\theta(1 - \rho)}{1 + \theta} \right] \bullet S = h[s, \rho, \eta, \theta]$$

Since a business (banking) firm will always operate in a sector in which $\eta < 1$, it follows that

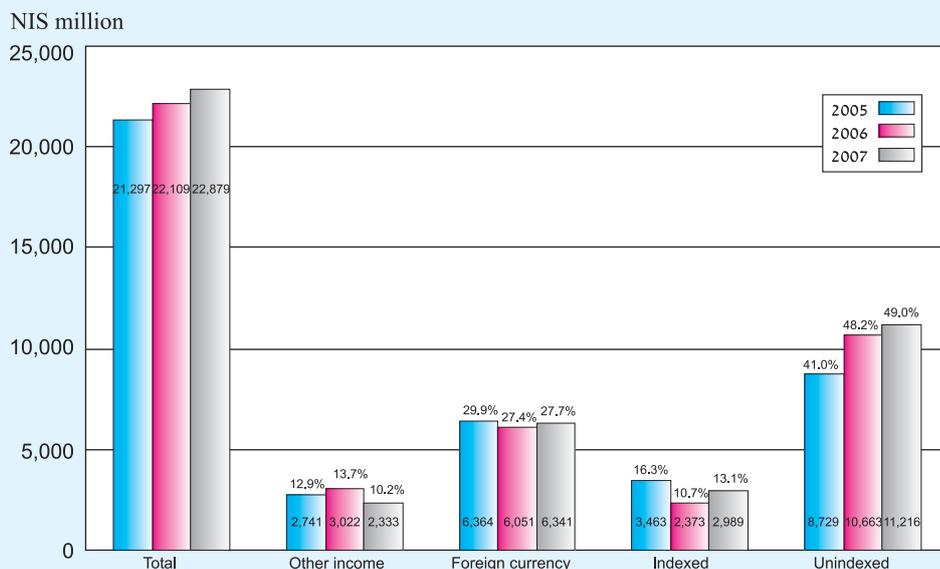
$$\frac{\partial M}{\partial S} = \left[\frac{\eta}{1 + \eta} - \frac{\theta(1 - \rho)}{1 + \theta} \right] > 0$$

⁶ The average balance of assets in the sector grew in the second half of the year, after falling during the first half.

⁷ Yields on linked government bonds declined in the first half of the year as a result of reduced inflation expectations. In the third quarter of the year, they rose sharply, and again fell in the fourth quarter, owing to increased anxiety about a slowing of global growth and a drop in inflation expectations.

Figure 2.2
The Contribution of the Various Indexation Segments to Profit,
2005-07

(at current prices)



The numbers above the columns show the share (in percent) of the segment in total net interest income, and the numbers within the columns show profits.

SOURCE: Based on published financial statements.

currency segment (both domestic and overseas activity) to total interest income grew only slightly this year, reaching 27.7 percent, up from 27.4 percent last year. As in the other indexation segments, the increase in profits in the segment was due to the income effect, partially offset by the substitution effect. The nominal interest rates in the segment, which serves as an alternative to overseas financial activity, remained almost unchanged this year, because the dollar LIBOR rate⁸ remained at the same level in the first 10 months of the year.⁹ In contrast, real interest rates fell sharply this year, as a result of the steep 9 percent shekel appreciation against the dollar (Table A.1.5).

An examination of the development of interest rate spreads over time shows a strong trend towards a narrowing of the differences between weighted interest rate spreads in the various intermediary segments. The deregulation of foreign currency in the mid-1980s,

⁸ The LIBOR is the interest rate relative to the pricing of the interest rate in the foreign currency sector, just as the Bank of Israel interest rate is the interest rate relative to the pricing of the interest rates in the unindexed shekel sector.

⁹ In October-December, the LIBOR fell by a cumulative 0.5 percent, compared with the end of 2006. This change, however, affected only the yield rates in the fourth quarter of the year, which dropped by the same amount.

Table 2.2**Breakdown of Profits from Financial Activities before Loan-Loss Provision, by Type of Indexation, The Five Major Banking Groups, 2006–07**

			(NIS million)	
	2006 (at current prices)	2007	Change relative to 2006 (NIS)	(percent)
Net income^a by type of indexation (including derivatives)				
Local currency, unindexed	10,663	11,216	553	5.2
Local currency, CPI-indexed	2,373	2,989	616	26.0
Foreign currency - domestic activity	6,051	6,341	290	4.8
1. Total income from indexation segments	19,087	20,546	1,459	7.6
Other financial income				
Commissions on transactions	810	824	14	1.7
Other net financial income	1,712	994	-718	-41.9
<i>of which: Interest income on problem debts previously not recorded</i>	1,095	1,393	298	27.2
<i>of which: Profits from the sale and valuation of bonds^b</i>	230	-1,043	-1,273	-553.5
2. Total other financial income	2,522	1,818	-704	-27.9
3. Options and other derivatives	500	515	15	3.0
Profit from financial activities before loan-loss provision (1+2+3)	22,109	22,879	770	3.5

^a Net income from assets *minus* expenses on liabilities.

^b Including profits/losses from the valuation and sale of tradable bonds and the sale of bonds available for sale and bonds held until maturity.

SOURCE: Published financial statements.

which exposed the Israeli banks to competition from international entities, and reduced the involvement of the government and the Bank of Israel in the money and capital markets, caused a narrowing of interest rate spreads in all the intermediary segments, particularly in the unindexed local currency segment, in which the banks benefit from greater freedom of action in determining financial intermediary terms (Figure 2.4).

Total other financial income, composed of fees on financing business and net other financial income,¹⁰ plunged 27.9 percent to NIS 1.8 billion this year, compared with NIS 2.5 billion in the corresponding period last year. Commissions on transactions, mostly for off-balance sheet activity,¹¹ rose by a minimal 1.7 percent this year, principally because of a rise in income from guarantees for apartment buyers (this was apparently the beginning of the recovery in the real estate industry) and income from other guarantees. The improvement in economic conditions, which caused an improvement

¹⁰ Net other interest income includes previously unreported interest on problem debt and profits on the sale and revaluation of marketable bonds and the sale of bonds available for sale and bonds held until maturity.

¹¹ This income consists mostly of income from guarantees for credit and apartment purchasers, documentary credits, acceptances, and other guarantees.

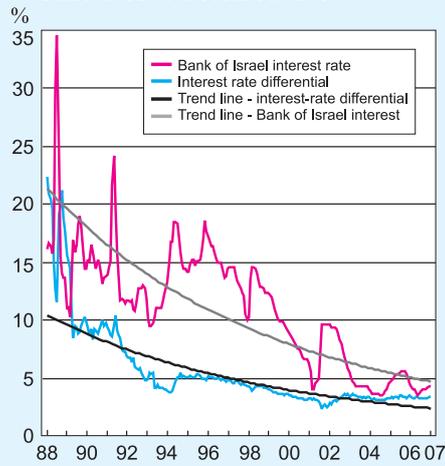
in the borrowers' solvency, led to a rise in income from not previously listed collection of problem debt (27.2 percent, Table 2.2). The subprime crisis in the US mortgage market and the resulting liquidity crisis caused losses from the sale and revaluation of bonds of the five major groups for the first time since 2002. The fall in value of securities in which the banking groups invested some of their asset portfolios, especially in the Hapoalim Group, led to large losses in this item: NIS 1.2 billion in the Hapoalim Group and NIS 90 million in the Mizrahi-Tefahot Group. The Leumi Group showed a slight drop in profits, while the Discount Group and the First International Group even posted increases in profits in this item.

Another factor that contributed to net interest income this year was profit from activity in options and other derivative instruments not defined as hedges or assets and liabilities management (ALM). This profit rose by a moderate 3 percent this year (Table 2.2).

b. Loan-loss provision

The growth in the Israeli economy, which began in late 2003, led to improvement in recent years in the quality of the banking portfolio, and in the ability of borrowers to repay their debt. The consistent strength of the Israeli economy has reduced the risk of upheavals, and the materializing of the credit risks has lessened. As a result, the amount of provision listed in the profit and loss statements of the five largest bank groups plunged 41 percent, following a 19 percent average annual drop in 2003–06 (Table 2.4).

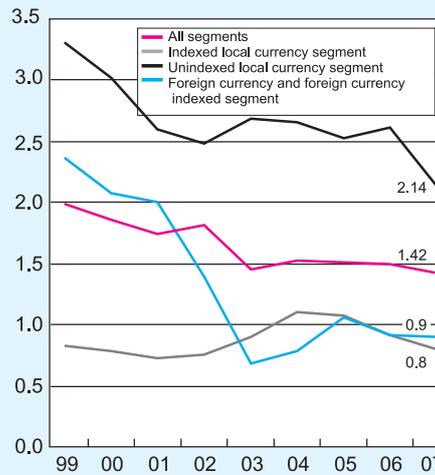
Figure 2.3
Bank of Israel Interest Rate and the Interest Rate Differential^a in the Unindexed Local Currency Segment, June 1988 to December 2007



^a Between time credit and self-renewing overnight deposits.

SOURCE: Based on bank reports on costs and tariffs.

Figure 2.4
Weighted Interest Rate Differential in the Different Indexation Segments, 1999-2007



SOURCE: Published financial statements.

Table 2.4

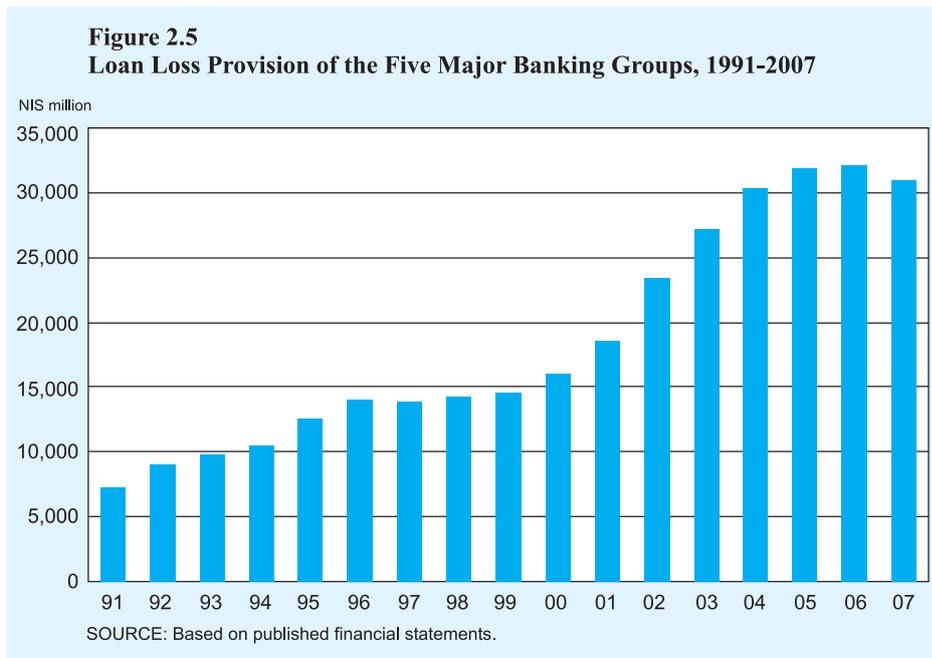
Components of the Loan-Loss Provision for the Five Major Banking Groups, 2005–07

	2005			2006			2007		
	The specific provision	The general and additional provision	Total	The specific provision	The general and additional provision	Total	The specific provision	The general and additional provision	Total
Beginning-of-year balance of the provision	26,948	3,386	30,334	28,531	3,389	31,920	28,839	3,241	32,080
Additions to the provision during the accounting year	5,773	129	5,902	5,144	113	5,257	4,274	48	4,322
Reduction of the provision	-1,730	-131	-1,861	-1,875	-261	-2,136	-2,146	-303	-2,449
Collection of debts written off in previous years	-88	0	-88	-108	0	-108	-97	0	-97
Amount entered in the profit and loss statement	3,955	-2	3,953	3,161	-148	3,013	2,031	-255	1,776
Debts written off	-2,378	0	-2,378	-2,853	0	-2,853	-2,868	0	-2,868
End-of-year balance of provision	28,525	3,384	31,909	28,839	3,241	32,080	28,002	2,986	30,988

SOURCE: Published financial statements.

The steep decline in the loan-loss provision during the year encompassed all the banking groups¹² and, together with collection of bad debts for the first time since 1997, led to a fall in the balance of the provision for the end of the year (Figure 2.5). Both elements of the provision improved again this year. The specific provision¹³ was partially offset by the general¹⁴ provision and the additional provision,¹⁵ so that the total provision listed in the profit and loss statement amounted to NIS 1.776 billion (Figure 2.6).

The improvement in the repayment ability of borrowers and the quality of guarantees in recent years has enabled the banking corporations to obtain a regular flow of loan payments and to collect debts in arrears or under special supervision, as reflected in



¹² The decrease stood out at the two largest banking groups.

¹³ The specific provision is calculated according to an evaluation of specific borrowers, relying on the bank's internal assessment. This assessment is based on several considerations: the debtor's repayment capability, the sector in which he operates, the economic environment, past experience, etc.

¹⁴ The general provision was used in the Israeli banking system up until 1991. It was determined as a proportion of total debts. According to directives by the Supervisor of Banks in 1992, the banks made an additional loan-loss provision in place of the general provision. At the same time, the banks were required to continue making the general provision at the proportion of total debts determined for December 31, 1991.

¹⁵ The additional provision reflects the structural risks inherent in the credit portfolio, and replaces the previously used general provision. The additional provision is calculated as a proportion of undue indebtedness, as determined in the directives of the Supervisor of Banks, and defined according to eight risk factors: financial information about the borrower, indebtedness of related parties, concentration of indebtedness by a single borrower or a group of borrowers, industry sector concentration of indebtedness, problem debts, indebtedness of less developed countries, concentration by extent of arrears, and high leverage buyout financing.

the “current provisions” and “reduction of provisions”¹⁶ items (Table 2.4).

The subprime mortgage crisis in the US led to the beginning of a slowdown in economic activity in many countries, which is liable to also affect the Israeli economy and end the boom in the business cycle.

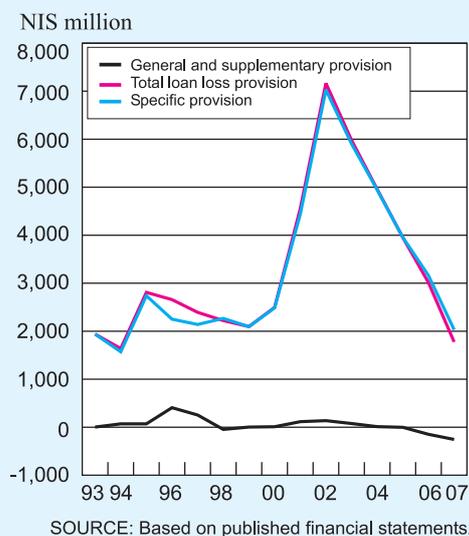
c. Non-interest and other income

The rise in the operating and other income of all five banking groups continued in 2007 with a 5 percent increase (NIS 700 million). The growth rate was more moderate than in previous years (6 percent in 2006 and 12 percent in 2005). Two different forces, economic and regulatory, affected the banks’ income in opposite directions. The positive trend in the global economy, domestic economic activity, and the domestic capital markets led to expansion in the uses of GDP, with a steep increase in gross domestic investment and stronger demand for bank and non-bank credit in the economy.¹⁷ On the other hand, intervention by the authorities in the structure of the financial system, based on the implementation through legislation of the Bachar Committee recommendations, caused a sharp decline in income from management fees for provident and mutual funds (Table 2.5).

There was significant variance this year in the growth rate of total operating and other income of the banking groups. At one end of the scale was the First International, whose income in this category grew 24 percent. In the middle were Leumi and Discount whose income in this category rose by 9 percent each. At the bottom of the scale were Hapoalim and Mizrahi-Tefahot, whose income in this category actually fell 2 percent for each group (Table 2.1).

Non-interest income from banking services grew 7 percent to NIS 9.1 billion this year, compared with 4.7 percent growth to NIS 8.5 billion in 2006 (Table 2.5). Most of the increase (NIS 350 million) was due to a 14 percent surge in credit card activity.¹⁸

Figure 2.6
Developments in Components of Loan Loss Provision in the Five Major Banking Groups, 1993-2007



¹⁶ Some of the reduction in provisions was due to special provisions made during 2006 for housing loans as a result of implementing Bank of Israel guidelines (for a list and more thorough discussion, see the review for 2006, p. 73).

¹⁷ For a more thorough discussion, see Chapter 1 of this survey.

¹⁸ For a more thorough discussion of the banks’ credit card activity, see Section 6b of Chapter 1.

Table 2.5
Non-Interest Income and Operating Expenses of the Five Major Banking Groups, 2005–07

	Amount			Distribution			Year-on-year change	
	2005	2006	2007	2005	2006	2007	2006	2007
1. Non-interest income								
Income from banking services	(NIS million, at current prices)			(percent)			(percent)	
Ledger fees	1,433	1,188	1,220	10.9	8.5	8.3	-17.1	2.7
Payment services	2,100	2,311	2,529	15.9	16.5	17.3	10.0	9.4
Credit cards	2,222	2,505	2,846	16.9	17.9	19.4	12.7	13.6
Credit services and contracts	864	1,064	1,155	6.6	7.6	7.9	23.1	8.6
Computerized services, data and approvals	204	214	212	1.5	1.5	1.4	4.9	-0.9
Foreign trade and special services	419	446	429	3.2	3.2	2.9	6.4	-3.8
Other commissions ^a	925	820	754	7.0	5.9	5.1	-11.4	-8.0
Total income from banking services	8,167	8,548	9,145	62.0	61.2	62.4	4.7	7.0
Income from activity in the capital market								
From activity in securities ^b	2,154	2,396	2,921	16.4	17.1	19.9	11.2	21.9
Provident and mutual funds management fees	2,136	1,897	846	16.2	13.6	5.8	-11.2	-55.4
Provident fund fees	946	1,116	603	7.2	8.0	4.1	18.0	-46.0
Mutual fund fees	1,190	781	243	9.0	5.6	1.7	-34.4	-68.9
Provident and mutual funds distribution fees ^c	-	126	276		0.9	1.9		119.0
Total income from activity in the capital market	4,290	4,419	4,043	32.6	31.6	27.6	3.0	-8.5
Other income								
Profit from compensation funds	372	104	167	2.8	0.7	1.1	-72.0	60.6
Profit from the sale of shares ^d	131	674	976	1.0	4.8	6.7	414.5	44.8
Others ^e	210	227	328	1.6	1.6	2.2	8.1	44.5
Total other income	713	1,005	1,471	5.4	7.2	10.0	41.0	46.4
Total operating fees^f	10,321	10,944	12,066	73.9	78.3	82.3	6.0	10.3
Total non-interest income	13,170	13,972	14,659	100.0	100.0	100.0	6.1	4.9

(cont'd)

Table 2.5 (Cont'd)
Non-Interest Income and Operating Expenses of the Five Major Banking Groups, 2005–07

	Amount			Distribution			Year-on-year change	
	2005	2006	2007	2005	2006	2007	2006	2007
	2. Operating expenses							
Salaries and related expenses ^a	12,878	14,915	14,516	60.6	62.4	59.9	15.8	-2.7
<i>of which: Wages</i>	8,595	9,561	9,814	40.5	40.0	40.5	11.2	2.6
Maintenance of buildings	3,656	3,854	4,231	17.2	16.1	17.5	5.4	9.8
Other expenses	4,714	5,134	5,472	22.2	21.5	22.6	8.9	6.6
Marketing and advertising	660	810	883	3.1	3.4	3.6	22.7	9.0
Computer expenses	773	848	865	3.6	3.5	3.6	9.7	2.0
Communications	529	599	611	2.5	2.5	2.5	13.2	2.0
Insurance	169	152	118	0.8	0.6	0.5	-10.1	-22.4
Office	293	323	343	1.4	1.4	1.4	10.2	6.2
Professional services	617	778	771	2.9	3.3	3.2	26.1	-0.9
Total operating expenses	21,248	23,903	24,219	100.0	100.0	100.0	12.5	1.3
Coverage ratio^b (percent)	62	58	61					

^a Including primarily collection spreads and commissions on credit from the Ministry of Finance, handling fees for inheritances and estates, rental of safes, etc.

^b Including income from the activity of customers in securities, from financial instruments, custody fees, underwriting and distribution of securities.

^c Following the "Bachar reform" the banks started charging fees for distributing provident funds and mutual funds.

^d Including income from the sale of shares available for sale, from the adjustment of the fair value of tradable shares and dividends from tradable shares available for sale.

^e Including profit from the sale of assets that were received to pay off debts and rental of buildings that are not in use by the bank, dividends not from subsidiaries or affiliated companies, etc.

^f Including total income from banking services and activity in securities.

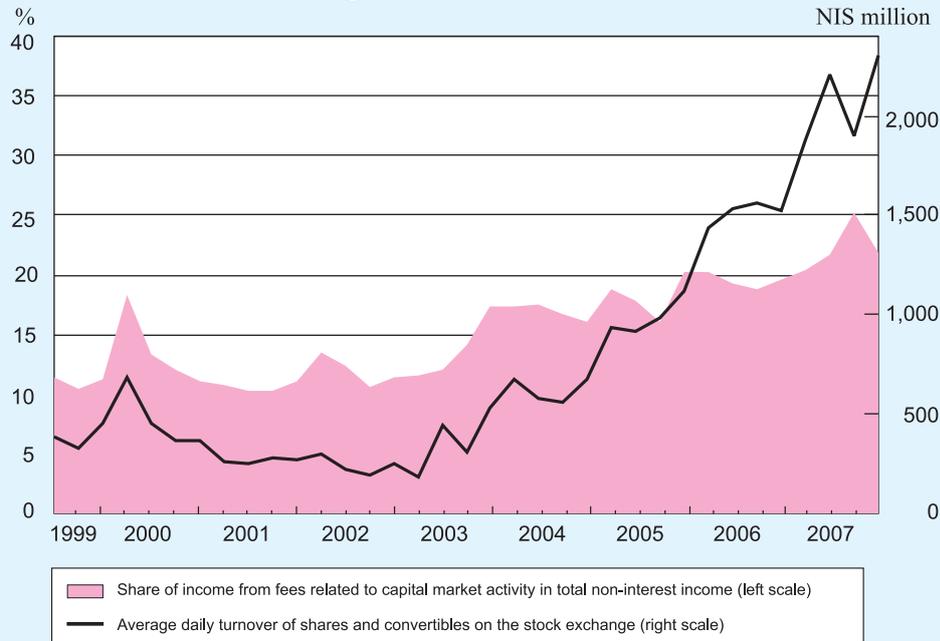
^g Including payroll tax, compensation, benefits, pension and National Insurance.

^h The ratio of non-interest and other income to operating and other expenses.

SOURCE: Reports to the Supervisors of the Banks.

A small 2.7 percent rise (NIS 32 million) in the account management charges item was posted this year. It is believed that the banks' income in 2008 will be affected by the initial implementation of the Supervision of Bank Fees Law, which grants the Supervisor of Banks the authority to control bank fees.¹⁹

Figure 2.7
Share of Income from Capital Market Activity of the Five Major Banks in Total Non-Interest Income, and the Average Daily Turnover in Shares on the Tel Aviv Stock Exchange, June 1999 to December 2007



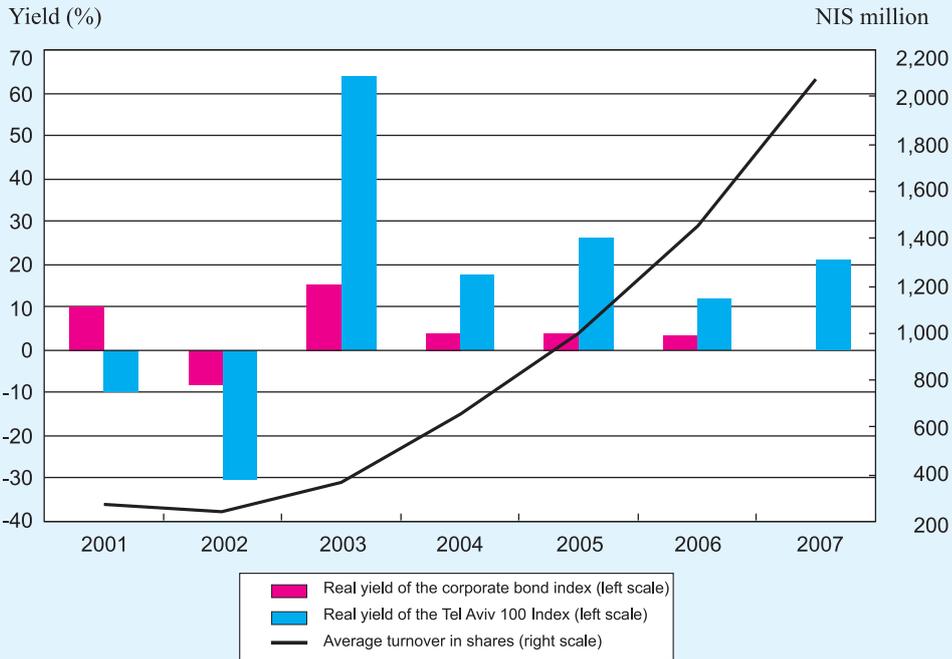
The correlation coefficient between the share of income from capital market activity in non-interest income and the average daily turnover on the stock exchange is 0.203.

SOURCE: Reports to the Supervisor of Banks and the Tel Aviv Stock Exchange.

The bank groups' income from capital market activity was down 8.5 percent (NIS 400 million) in 2007. On the one hand, the capital market boom as reflected in trading turnovers and the various yield indices had a positive impact on total income from activity in securities, which climbed by an impressive 22 percent (NIS 525 million) (Figure 2.7 and Figure 2.8). On the other hand, implementation of the "Bechar reform" had a negative impact on the groups' income. Collection of management fees from provident and mutual funds plummeted 55 percent (NIS 1.05 billion). Nevertheless, this was partially offset by the new "income from fees on distribution of mutual and

¹⁹ For a more thorough discussion of this question, see Chapter 4 of this review.

Figure 2.8
Real Annual Yield of the Tel Aviv 100 Index, the Corporate Bond Price Index
and Average Daily Turnover in Securities, 2001-07



SOURCE: Based on data from the Tel Aviv Stock Exchange

provident funds” item, which totaled NIS 276 million in 2007, NIS 150 million more than in 2006.

d. Operating and other expenses

The rapid expansion of operating and other expenses of the five largest banking groups halted in 2007 with a rise of only 1.3 percent, compared with 12 percent increases in each of the two preceding years (Table 2.5). Salary and related expenses, which account for 60 percent of total operating expenses in the system, dipped 3 percent this year, compared with rises of 16 percent in 2006 and 11 percent in 2005. The increase in miscellaneous expenses was also more moderate – 6.6 percent, compared with 8.9 percent in 2006 and 18 percent in 2005. Only the maintenance expenses and depreciation of buildings and equipment component grew this year at a higher rate than in the two preceding years. Aggregate operating and other expenses totaled NIS 24.2 billion this year, compared with NIS 23.9 billion in 2006 (Table 2.5).

The decline in operating expenses involving employees this year resulted from a combination of two factors. The first was a large drop in the rate of increase of direct salary expenses, which grew 2.6 percent, compared with increases of 11.2 percent in 2006 and 8.8 percent in 2005. The second factor was a 12 percent decrease in other salary expenses.²⁰ The difference over the last decade between the high variance of other salary expenses and the lower variance of direct salary expenses led us to examine the trends in the change in each of these with respect to business cycles, as measured by the rate of change in GDP. It emerged that there was a strong positive correlation (77 percent) between direct salary expenses and business cycles, and a weaker correlation (47 percent) between other (related) salary expenses and business cycles (Figure 2.9).

The high positive correlation between direct salary expenses and business cycles is explained, among other things, by the dependence of direct salary on an array of factors related to the performance of the bank and the economy, such as profitability grants, automatic salary upgrades (derived from work agreements between the bank and the workers' representatives), and cost-of-living increments dictated by law. This link weakened somewhat in 2007.

On the other hand, the lower correlation between other expenses and business cycles and the high variance of the former are explained by the multiplicity of expenditure elements and the dependence of some of them on various management decisions²¹ that are not necessarily cyclical or linked to economic performance.

Figure 2.9
Rate of Change of Direct and Other Salary Expenses of the Five Major Banking Groups and Rate of Change in GDP, 1995-2007



SOURCE: Based on published financial statements and data from the Central Bureau of Statistics.

²⁰ This includes a benefit for employees for an issue, compensation, remuneration, pension, advanced training and vacation fund, National Insurance fees, employers' tax and payroll tax, supplements for the reserve for related expenses in respect of changes in salary during the financial year, overseas salary and related expenses, voluntary retirement expenses, and other related expenses.

²¹ These items are expenses related to voluntary retirement and benefits for employees in a stock issue.

Two key factors affected the relatively moderate rise in direct salary this year. The first was the first decrease since 2002 in average salary per employee post (2.2 percent, Table 2.6). The other factor was a drop in the proportion of employees in the banking system receiving high salaries from 18.9 percent to 16.6 percent (Figure 2.10). The steep fall in other salary expenses this year in comparison with 2006 was due mainly to an absence of the undue expenses incurred in the preceding year.²²

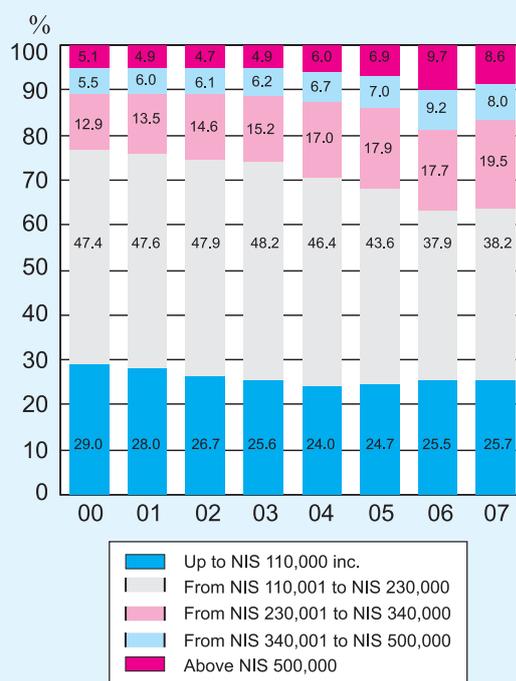
The rise in the average number of jobs²³ continued this year at the same rate as in the two preceding years, 5 percent, amounting to 2,000 jobs (Table 2.6). This followed three years of decline caused by implementation of the programs for the encouragement of voluntary early retirement and layoffs dictated by the group's streamlining policy.

As part of this streamlining policy, the banks continued to improve the quality of their manpower this year by increasing the proportion of employees with higher education, as shown by the change in the composition of employees at the three largest banking groups (Figure 2.11).

Despite the above-mentioned decrease in salary costs, these are still high, compared with the other financial segments. This gap stood at 10 percent at the end of 2007, and at 30 percent, in comparison with the economy as a whole (Figure 2.12).

In an attempt to examine the salary expenses of the Israeli banking system from an international perspective, in comparison with other banking systems around the world, we calculated the ratio of salary expenses to total added value, which is used in professional literature as an accepted measure of the system's output. The analysis shows that while the weight of the added value of the banking system in GDP in Israel

Figure 2.10
Distribution of Employees by Salary
in the Commercial Banks, 2000-07
(annual salary, NIS thousand)



SOURCE: Reports to the Supervisor of Banks.

²² For a more thorough discussion of this subject, see Chapter 2 of the Supervisor of Banks' survey for 2006.

²³ The average number of jobs includes jobs at overseas subsidiaries and consolidated companies, a translation of the cost of overtime, and external manpower budgets required to adjust regular manpower and assimilate projects.

Table 2.6
Salaries and Related Expenses of the Five Major Banking Groups, 1998-2007
 (reported amounts,^a at current prices)

	Average number of posts ^b	Salaries		Related expenses ^c		Salaries and related expenses	
		Total	Per post	Total	Per post	Total	Per post
		(NIS million)	(NIS thousand)	(NIS million)	(NIS thousand)	(NIS million)	(NIS thousand)
1998	38,230	6,341	166	2,955	77	9,296	243
1999	38,248	6,607	173	3,063	80	9,669	253
2000	39,251	7,220	184	3,557	91	10,777	275
2001	39,753	7,231	182	3,560	90	10,791	271
2002	39,531	6,819	172	3,976	101	10,795	273
2003	38,427	7,260	189	3,566	93	10,826	282
2004	38,170	7,898	207	3,681	96	11,579	303
2005	40,029	8,595	215	4,283	107	12,878	322
2006	42,200	9,561	227	5,354	127	14,915	353
2007	44,281	9,814	222	4,702	106	14,516	328
Change from previous year (percent)							
1999	0.05	4.2	4.1	3.6	3.6	4.0	4.0
2000	2.6	9.3	6.5	16.1	13.2	11.5	8.6
2001	1.3	0.1	-1.1	0.1	-1.2	0.1	-1.1
2002	-0.6	-5.7	-5.2	11.7	12.3	0.0	0.6
2003	-2.8	6.5	9.5	-10.3	-7.7	0.3	3.2
2004	-0.7	8.8	9.5	3.2	3.9	7.0	7.7
2005	4.9	8.8	3.8	16.4	11.0	11.2	6.1
2006	5.4	11.2	5.5	25.0	18.6	15.8	9.9
2007	4.9	2.6	-2.2	-12.2	-16.3	-2.7	-7.2

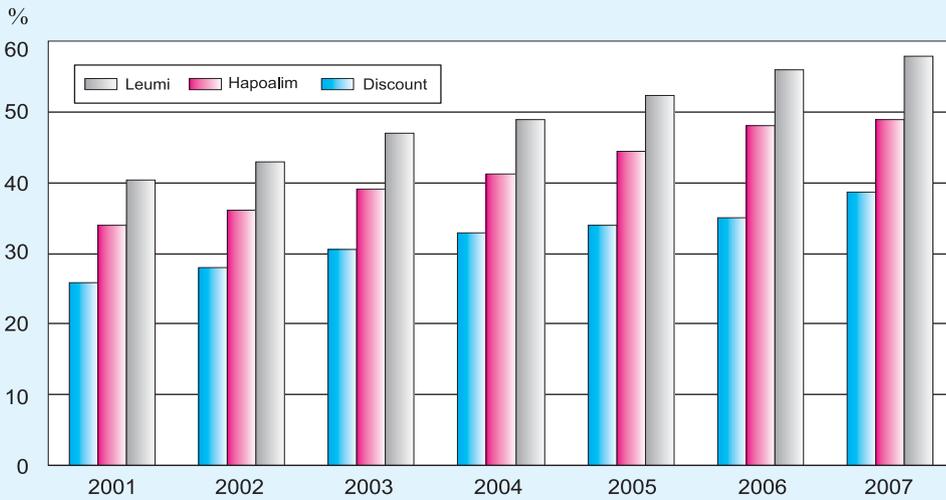
^a Up to 2002, the amounts are adjusted for inflation according to the December 2003 index.

^b The number of posts includes those in subsidiaries abroad and in the consolidated companies, translation of the cost of overtime and the budgets for outside workers required to adjust for changes in the regular manpower and to assimilate projects.

^c Includes mainly severance pay, benefits, advanced study fund, pension, annual leave, National Insurance and payroll tax, other related expenses, voluntary retirement expenses, and distribution of options to staff.

Source: Published financial statements and reports to the Supervisor of the Banks.

Figure 2.11
Proportion of Employees with Higher Education in the Three Major Banking Groups, 2001-07

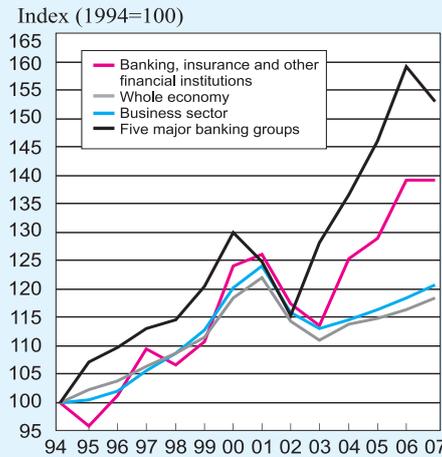


SOURCE: Published financial statements.

is similar to accepted levels around the world (Figure 1.6 in Chapter 1), the ratio of salary expenses to total added value in Israel (about 45 percent) is significantly higher than the global average of 31 percent and the average of the control group for Israel (29 percent, Figure 2.13).

An examination of the development of the cost per job, compared with output per job,²⁴ shows a difference between the various banking groups. In three of them (Leumi, Mizrahi-Tefahot, and Discount), the rise in output per job in 2007, compared with last year, was accompanied by a decrease in salary costs per employee (Figure 2.14).

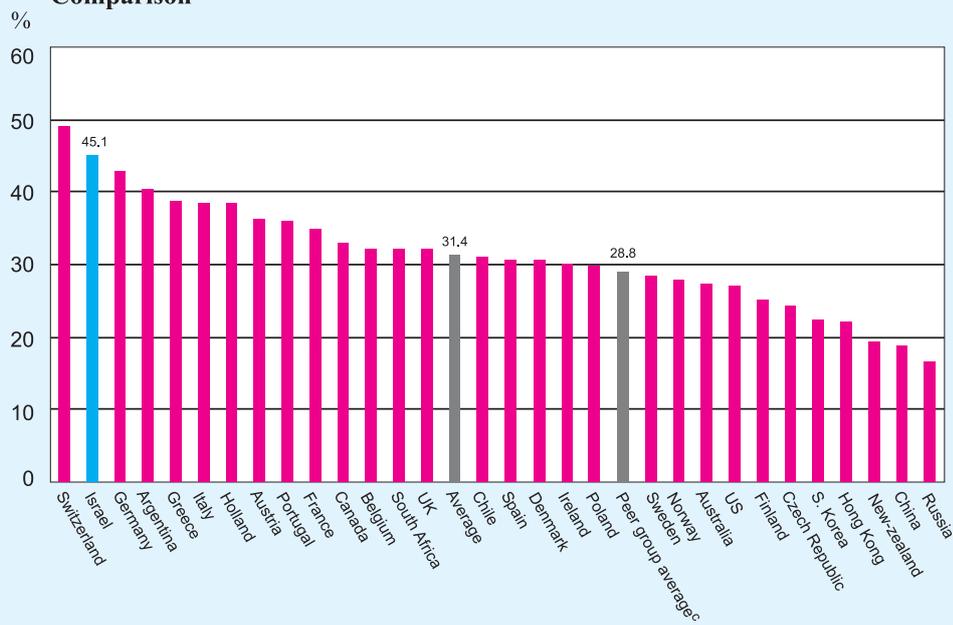
Figure 2.12
Index of Real Wage per Employee Post in Banking, Insurance and Other Financial Institutions vis-a-vis the Business Sector and the Whole Economy, 1994-2007



SOURCE: Based on Central Bureau of Statistics data.

²⁴ Output per job is calculated as the group's total on-balance sheet assets plus the value equivalent of off-balance sheet assets, divided by the number of job.

Figure 2.13
Salary Expenses as a Proportion of Value Added^a in 2006, an International Comparison^b



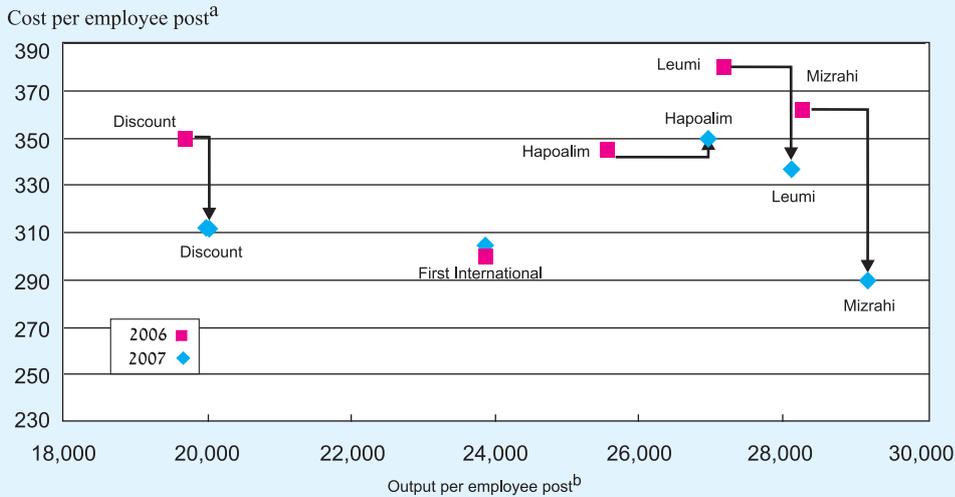
^a Value added is the sum of net ordinary before-tax income, salaries and related expenses, maintenance and depreciation on buildings and equipment, and general and other expenses.

^b In each country the optimal number of banking groups was chosen, as a function of the structure and size of the banking sector.

^c Israel's peer group here consists of 10 countries with similar features in terms of GDP, GDP per capita and size of banking sector: Belgium, the Czech Republic, Finland, Greece, Ireland, New Zealand, Norway, Portugal, South Africa, and South Korea.

SOURCE: Based on data from Bankscope.

Figure 2.14
Cost^a and Output^b per Employee Post in the Five Major
Banking Groups, 2007 compared with 2006
 (NIS thousand at current prices)



^a Salaries and related expenses divided by number of employee posts including those in subsidiaries abroad; includes a translation of the cost of overtime and a budget for staff from manpower companies.

^b Total balance-sheet assets of the banking group plus credit equivalent value of off-balance-sheet assets.

SOURCE: Based on published financial statements.

e. Operating and operating efficiency measures

The performance and business results of the banks are influenced to a great extent by their operating efficiency. In order to identify the differences in the banks' operating characteristics, we used four accepted measures: the operating coverage ratio;²⁵ the operating efficiency ratio;²⁶ increasing, decreasing, or constant returns to scale, as reflected in the development of operating expenses per unit of output²⁷ (average output); and the efficiency of the banks, given their size, or X-efficiency.²⁸

Following two years of decline, the operating coverage ratio of the five largest banking groups rose from 0.58 in 2006 to 0.61 this year (Table 2.7). The trend in this

²⁵ Calculated as the ratio of total operating and other income to total operating and other expenses.

²⁶ Calculated as the ratio of total operating and other income *plus* profit from financing operations to total operating and other expenses.

²⁷ Calculated as total operating and other expenses per output, where output is calculated as total on-balance sheet assets *plus* the value equivalent of off-balance sheet assets.

²⁸ Calculated as the average minimum expenditure *divided by* the average maximum expenditure in each group size (AC_{\min}/AC_{\max}). One *minus* this ratio in each group therefore reflects the potential maximum saving in production expenses for each group.

ratio differed in each of the groups: the ratio fell in the Hapoalim Group, remained unchanged in the First International Group, and improved in the other banking groups.

Table 2.7
Coverage and Efficiency Ratios of the Five Major Banks, 2006 and 2007

Bank	2006		2007	
	Coverage ratio ^a	Efficiency ratio ^b	Coverage ratio ^a	Efficiency ratio ^b
Hapoalim	0.68	1.70	0.66	1.53
Leumi	0.53	1.49	0.61	1.71
Discount	0.47	1.22	0.51	1.34
Mizrahi-Tefahot	0.57	1.51	0.61	1.66
First International	0.61	1.59	0.61	1.49
Average of the five major banks	0.58	1.51	0.61	1.55

^a Calculated as the ratio of non-interest and other income to overheads.

^b Calculated as the ratio of non-interest income and net interest revenue to operating expenses. It is sometimes presented as the ratio of operating expenses to non-interest income and profit from financial activity.

SOURCE: Based on published financial reports.

The decline in the ratio in the Hapoalim Group this year is explained by an increase in operating expenses, coupled with a 2.3 percent decline in operating and other income, mostly owing to a drop in income from management fees for provident and mutual funds as a result of implementation of the Bachar reform and the discontinuation of consolidation of Bank Otsar Hahayal in the group's financial statements. In contrast to the preceding year, variance in the value of the ratio was low this year, and as in the previous five years, the Discount Group had the lowest ratio of all five groups (0.51, Table 2.7), despite an increase this year.

The aggregate average efficiency ratio also rose this year to 1.55, compared with 1.51 last year. Like the coverage ratio, the trend in this ratio was mixed: the Hapoalim and the First International groups posted declines, while the other groups reported increases. The rise in the aggregate ratio this year is explained by an increase in net interest income and in non-interest income, which outstripped the increase in operating expenses.

In addition to these two efficiency measures, we present two other measures of operating efficiency: (1) efficiency derived from changes in the size of the banks, as reflected in economies of scale in production, and (2) efficiency derived from a reduction in the bank's operating expenses without a change in its size (output), i.e., X-efficiency. The latter is reflected in the bank management's ability to reduce the expenses of production factors without changing the bank's output, i.e. it reflects the quality of the bank's management.

Differences in operating efficiency can be identified by comparing operating expenses per NIS 1 of output among banks of similar size. We therefore divided the banks into

three groups, by size: large banks, i.e., whose output exceeds NIS 150 billion, medium-sized banks, with output of NIS 40–150 billion, and small banks, with output of up to NIS 40 billion. We chose total assets as a measure of banking output, including the balances of on-balance sheet assets and the credit value equivalent of off-balance sheet assets. Analysis shows that economies of scale prevailed in the Israeli banking system over the past decade, reflected in a decline in average expenses in the transition from the group of small banks to the groups of medium-sized and large banks.

Table 2.8
Ratio of Overheads to Unit of Output^a, and X-Efficiency by Banking Group (by Size), 1996-2007

	Small banks (up to NIS 40 billion) ^b	Medium-sized banks (NIS 40-150 billion) ^c	Large banks (more than NIS 150 billion) ^d
	Average expenses		
1996-2006	0.0262	0.0211	0.0172
2007	0.0239	0.0199	0.0167
	Maximum X-Efficiency ^e (maximum saving)		
1996-2006	0.13 (0.87)	0.66 (0.34)	0.91 (0.09)
2007	0.38 (0.62)	0.68 (0.32)	0.98 (0.02)

^a Defined as total operating expenses as share of output. Output is calculated as total balance sheet assets and equivalent value of off-balance-sheet assets.

^b This group includes banks that were active during all or part of the period 1996–2007, so as not to affect the quality of the indices. The banks included are: Union, Otsar Hahayal, Yahav, Arab Israel, Massad, Poalei Agudat Israel, Industrial Development (up to 2002), Jerusalem (from 1997), Investec (Israel), Maritime (up to 2002), Euro-Trade, and Trade (up to 2001).

^c This group includes Discount, Mizrahi-Tefahot and First International.

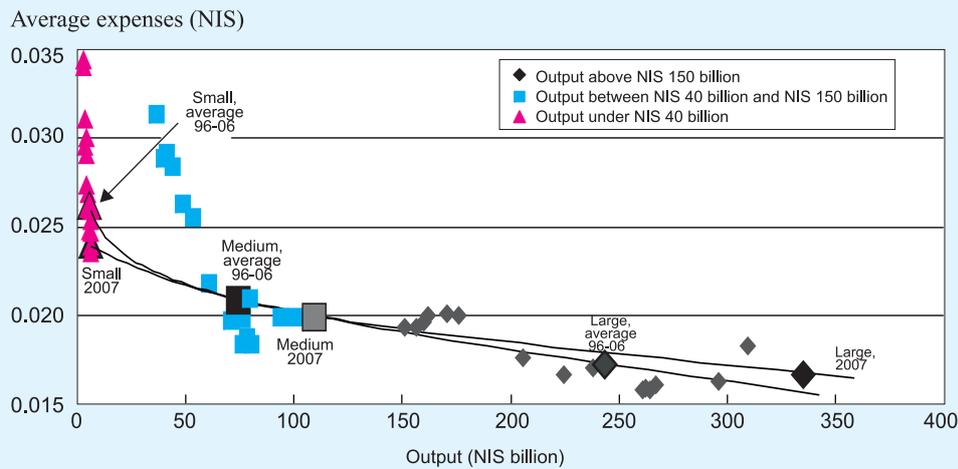
^d This group includes Hapoalim and Leumi.

^e Calculated as the minimum average expenses *divided by* the maximum average expenses for that group of banks (by size) (AC_{\min}/AC_{\max}), and therefore 1 *minus* this ratio, in each group, reflects the maximum potential saving in production expenses for that group.

SOURCE: Reports to the Supervisor of Banks.

An examination of the figures for 1996-2007 shows that in the transition from the group of small banks to the medium-sized ones, economies of scale are greater than in the transition from the group of medium-sized banks to the group of large banks (Figure 2.15, Table 2.8). These figures indicate the great potential in streamlining for the small banks, and the difficulty for these banks in adapting the allocation of the various production factors to changes in the technological environment. At the same time, the technological developments, particularly the introduction of direct banking and Internet banking services, greatly reduces the economies of scale previously enjoyed by large and medium-sized banks – advantages that stemmed from widespread deployment of a network of branches – because the new services make the small banks accessible to the entire population.

Figure 2.15
Operating Expenses per Unit of Output^a in the Banking System,^b
by Size of Bank, 1996-2007



^a Output: The book balance of balance-sheet assets and the equivalent balance-sheet value of non-balance-sheet assets.

^b Bank Hapoalim, Leumi Bank, Discount Bank, Mizrahi Bank, First International Bank of Israel, Union Bank, Mercantile Discount Bank, Bank Otsar Ha-hayal, Bank Yahav for Government Employees, Arab Israel Bank, Bank Massad, Bank Poalei Agudat Israel, Continental Bank, Industrial Development Bank (up to 2002), Bank of Jerusalem (from 1997), Bank Investec Israel, Maritime Bank (up to 2002), Eurotrade Bank, Trade Bank (up to 2001), National Credit and Savings Bank, Netanya, Cooperative Association Ltd. (up to 2004), World Investment Bank (up to 2003), and Bank Polska Kasa Opieki Tel Aviv (Bank Pekao) Ltd. (up to 2003).

SOURCE: Based on published financial statements.

An analysis of X-efficiency (Table 2.8) shows that the potential improvement in operating efficiency is very great in the small banks, and low in the medium-sized and large banks. This potential improvement indicates that in the group of small banks, the bank in which the average operating expenses were highest in 2007 should save up to 62 percent of its expenses in order to equal the most efficient bank in the same size group. The maximum potential saving was 32 percent in the group of medium-sized banks, and 2 percent in the group of large banks (Table 2.8).

A comparison of maximum potential saving in 2007 with the average for 1996-2006 shows that the improvement was greatest in the group of small banks, probably because of the process of closing and acquisition of many small banks whose operating efficiency was low. Nevertheless, the gap in this group is still wide, and is due to large differences between the banks making up the group: some are independent, while others are owned by a large banking group. The banks in the other size groups are few, and resemble each other.

2. ANALYSIS OF PERFORMANCE BY ACTIVITY SEGMENT, THE LARGEST THREE BANKING GROUPS

In the early 2000s, a process of change began in the organizational structure of some of the large banking groups. As part of this process, banking activity segments were allocated to independent profit centers used by the bank management in analyzing their financial results, and in their consequent decision making. According to directives from the Bank of Israel,²⁹ an activity segment must fulfill three conditions: it must deal in business activities expected to generate income and bear expenses, the result of its operations must be evaluated regularly by management and the board of directors for purposes of decision-making about the allocation of resources to the segments and the assessment of its performance, and separate financial information about it must be available. In July 2005, the Supervisor of Banks clearly defined which activity segment reporting is required: the business segment, the commercial segment, small businesses, private banking, households, financial management, and other. The division into activity segments is based on the types of products and services or the types of customers.³⁰ Because of the changes instituted this year by the Mizrahi-Tefahot Group as part of the organizational change in its activity segments and its inability to present comparative data for 2006, it was not possible to include this group in the analysis, which covers mainly the development of the results of activity in comparison with previous years. We have therefore chosen to also omit the First International Group from the analysis, and to concentrate on the three largest banking groups.³¹

Continuation of economic growth in Israel, powered by expansion in domestic and global demand, combined with a fall in the unemployment rate and prosperity in the domestic capital market, were clearly evident in the performances of the five activity segments. The loan-loss provision, which is affected by the repayment capability of the borrowers, fell this year in all activity segments, except for private banking, in which a negligible increase was posted as a result of expansion in its activity. As in the preceding year, the steepest decline in loan-loss provision this year was in the business segment, and was due principally to expansion in domestic and global demand for the segment's products, which led to expansion in the volume of activity of local commercial companies and improvement in their repayment ability.

An examination of the distribution of loan-loss provisions in the various activity segments highlights this improvement in the solvency of business segment customers:

²⁹ Directives on Reporting to the Public (9) (12/01), Annual Financial Statements, Section 79 (Principal Activity Sectors).

³⁰ The banking groups are entitled to define their activity segments according to the character, extent, and activity characteristics of their customers. This right creates a difference in definitions, and complicates the analysis. At the same time, in the presented analysis, we focus on five main activity segments for which disclosure is required: the business segment, the commercial segment, small businesses, private banking, and the household segment.

³¹ The three largest banking groups are the Bank Leumi Group, the Bank Hapoalim Group, and the Israel Discount Bank Group.

the rate of provision in the segment this year was 5 percent, compared with 62 percent in 2004 (Table 2.9). This year, for the first time, the total provision listed in the profit and loss statement for customers in the segment was less than the provision for customers in the household segment, who are considered safer customers. The ratio of the loan-loss provision to the average balance of assets in the household segment this year was 10 times greater than in the business segment (0.4 percent, compared with 0.04 percent, Table 2.9).

Total net profit, despite a decline this year in the household and private banking segments, does not indicate the financial results of these segments, mostly because it was affected this year by a decrease in the extraordinary profits posted in the previous year as a result of the inclusion of non-recurring profits on the sale of ownership and management rights in the mutual and provident funds, and the attribution of these profits to each segment according to its proportion of total income – the results of implementation of the Bachar reform. Analysis of profit on ordinary operations shows that the private banking and business segments were the only ones to post a decrease in this item this year. The decrease in the private banking segment was due to a rise in its operating expenses and a slight increase in the loan-loss provision. The decrease in the business segment was due to a loss posted for a decline in the value of asset-backed securities (NIS 1.2 billion) in the Hapoalim Group in the activity item in this segment as a result of the subprime crisis in the US mortgage market and the resulting financial crisis.

In recent years, the Bank of Israel and the Knesset have taken a number of regulatory and legislative measures to bolster competition in the domestic credit market and diminish the oligopolistic power of the commercial banks. These measures were aimed at reducing concentration in the Israeli banking system (as explained in Chapter 1) and encouraging competition among the banks and between the banks and non-banking entities. In business credit, the reforms implemented in recent years³² in the Israeli capital market fostered the development of competition between the commercial banks and institutional entities and the capital market for customers in the business segment and encouraged the creation of non-banking credit available to those customers. In retail credit, Proper Banking Management Directive No. 432³³ concerning transferring activity and closing an account, which was designed to boost mobility of customers in the household segment; the Supervision of Bank Fees Law,³⁴ which will contribute to greater transparency in the cost of banking services for retail customers; and many other attempts aimed at bolstering competition within the segment, such as promoting

³² Relaxing the rules for investment institutions (2002), tax reform (2003), pension reform (2003), the law for increasing competition and reducing concentration and conflicts of interest (2005), the underwriting reform (2005), and reform in the government bonds market (2005). For a more thorough discussion of this subject, see the activity chapter in this review.

³³ Proper Banking Management Directive, July 2005.

³⁴ The Supervision of Bank Fees Law is expected to go into effect on July 1, 2008. For a more thorough discussion, see Chapter 4 of this review.

Table 2.9
Performance Indicators in the Five Major Banking Groups,^a by Sector, 2006–07

	2006					2007				
	Households	Private banking sector	Small businesses	Business sector	Commercial sector	Households	Private banking sector	Small businesses	Business sector	Commercial sector
Components of profit	Distribution (%)									
Average balance of assets	26	7	10	41	17	27	7	10	39	17
Net interest income before loan-loss provision	33	12	14	27	14	35	12	16	21	16
Total non-interest and interest income	39	15	13	21	12	40	15	14	17	13
Loan-loss provision	24	1	20	35	20	34	2	28	5	30
Non-interest and other income	49	20	12	10	7	48	20	13	11	8
Operating expenses	49	17	13	11	10	48	17	14	10	10
Ordinary before-tax profit	18	16	10	44	12	23	13	12	36	16
Net profit	35	19	8	28	10	33	12	11	30	14
	Ratios (%)									
Loan-loss provision to total assets	0.5	0.1	1.1	0.4	0.6	0.4	0.1	0.8	0.04	0.5
Profit from financial activity to total assets	4.5	6.2	5.0	2.3	3.0	4.5	5.7	5.3	1.8	3.1
Total income ^c to total assets	8.6	12.5	7.8	2.9	3.9	8.3	11.7	8.2	2.4	4.1
Operating expenses to total assets	7.1	9.3	5.3	1.0	2.3	6.6	8.8	5.4	1.0	2.1
Return on equity	1.7	3.5	1.0	0.9	0.7	1.5	2.0	1.4	0.9	1.0
	Ratios									
Coverage ratio ^d	0.57	0.68	0.53	0.55	0.39	0.58	0.68	0.54	0.65	0.46
Efficiency ratio ^e	1.20	1.35	1.48	2.97	1.70	1.26	1.33	1.53	2.50	1.93
Return per unit of risk ^f	3.65	43.04	0.95	2.02	1.21	3.92	23.53	1.61	22.51	1.88

^a Each banking group defines the sectors of its activity using its discretion and in accordance with the characteristics and extent of its customers' activities. In general, the household sector consists of private customers with low to medium financial wealth; the private banking sector consists of wealthy private customers; the small business sector consists of commercial customers with a low level of business activity; the commercial sector consists of businesses with a high level of activity; the business sector consists of companies with high sales turnover and indebtedness.

^b Not including the financial management sector, others, and adjustments.

^c Total income is defined as the sum of non-interest and other income plus net interest income before loan-loss provision.

^d Calculated as the ratio between total non-interest and other income to total operating and other expenses.

^e Calculated as the ratio between total non-interest and other income and profit from financial activity to total operating and other expenses.

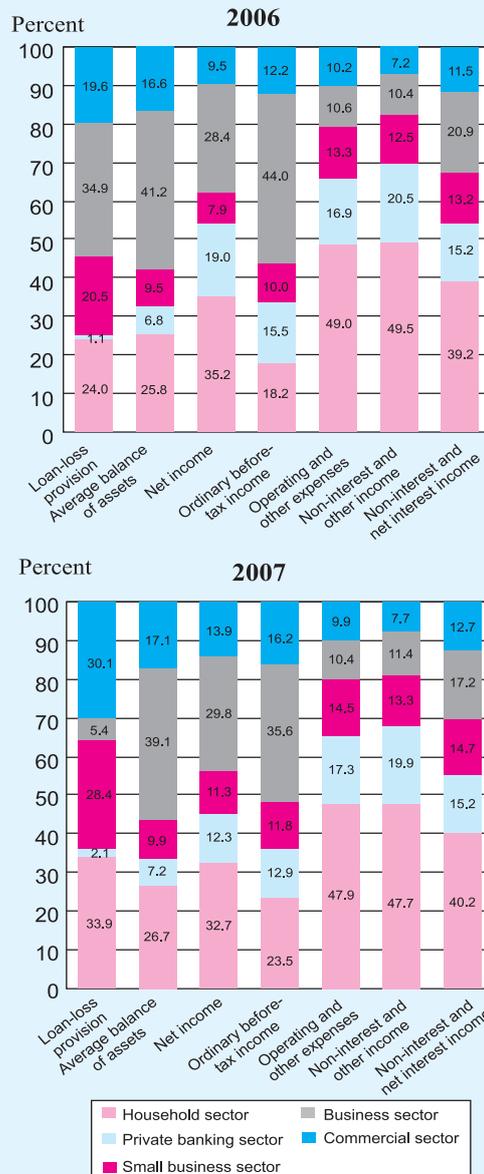
^f Calculated as the ratio of before-tax profit plus provisions to the total loan-loss provision.

SOURCE: Based on published financial statements.

the entry of additional banks into the system, inducing a foreign bank to work with retail customers, operation of an Internet bank, and privatizing the Postal Bank. As mentioned above, these measures were designed to augment competition within the banking system and between it and the non-banking market, thereby leading to the development of a sophisticated credit market in retail credit as well, and the reduction in the commercial banks' ability to exercise market power against these customers.

As in previous years, differences stood out this year in the level of the banks' exposure to competition for customers in the various segments, and in the degree of their ability to exercise market power against customers. These differences were reflected this year in the distribution of non-interest and interest income among the segments (Figure 2.16). A comparison between the activity segments highlights a slight decline in the large contribution of the household segment to total income (approximately 40 percent), compared with the small and stable contribution of the business segment (17 percent, Figure 2.16). It appears that this difference is due mainly to the ability of customers in the business segment to obtain financing from non-banking entities, combined with the absence of adequate substitutes for banking credit for households. The gap between the low level of competition in the household segment and the relatively high level in the business segment is translated by the banks into an increase in the large and stable contribution by households to the banks' profits.

Figure 2.16
Contribution of Different Areas of Activity^a to Selected Items in the Financial Statements of the Three Major Banking Groups^b



^a Not including financial management sector, others and adjustments.

^b Hapoalim, Leumi and Discount.

SOURCE: Published financial statements.

In evaluating the operating efficiency of the groups in allocating their resources among the activity segments and in exploiting the resources at their disposal in each one of those segments, there is a very noticeable difference between the high operating cost in the retail segments (households, private banking, and small businesses) and the lower operating cost in the wholesale segments (the business and commercial segments), as reflected in the weight of each segment in total operating and other expenses. The gap between the high operating cost in the household segment, which accounts for 48 percent of total operating and other expenses, and the low operating cost in the business segment is explained by the need to maintain and operate a widespread network of branches for customers in the retail segment, including many human and physical resources, compared with the limited number of commercial centers required for business segment customers (about 10 percent of total operating and other expenses).

An analysis of the operating coverage ratios³⁵ shows a clear increase in the operating efficiency of the business segment, compared with the other activity segments, which remained at the level of the preceding year. An examination of the operating efficiency ratio³⁶ shows a clear decline in the business segment. As noted above, this decline was affected by the inclusion of losses in respect of the decrease in value of securities for this segment in the Hapoalim Group. The other segments posted a degree of improvement in their operating efficiency ratios, mostly due to a rise in profit on financing operations. A comparison of operating ratios this year to those of 2005 shows a clear drop in the operating coverage ratios of the retail segments and an increase in the operating efficiency of the business segment. Also noticeable is the fluctuation in the efficiency ratios in the business segment (Table 2.9).

In order to evaluate the performance of segments with respect to profits and the risk incurred in the activity of each segment, we calculated the ratio of net profit to the loan-loss provision. This ratio is used as an approximation for the risk adjusted return on capital (RAROC). An examination of the results shows improvement in each of the segments (except for the private banking segment, which posted a decline, although the level of this measure in it is still high), with a steep rise in the ratio in the business segment, which was affected this year by the reduction in loan-loss provisions. In addition, it can be seen that the performance of the retail segment this year was not better than that of the wholesale segment (Table 2.9).

³⁵ Calculated as the ratio of total operating and other income to total operating and other expenses.

³⁶ Calculated as the ratio of total non-interest income plus profit on financing operations to total operating expenses.

3. AN ANALYSIS OF THE BANKS' PERFORMANCE AS MEASURED BY THE MARKET VALUE TO BOOK VALUE RATIO (MV/BV)

The MV/BV ratio³⁷ reflects the premium that the market is willing to pay on the book value of the bank's share capital and it is used as an effective and accepted measure of the market's assessment of a bank's future performance. The MV/BV ratio is defined as the ratio of the market value of a bank's share capital, which reflects the capacity of the capital to generate income, to its book value, which reflects the original cost of raising the capital. When this ratio is greater than 1, it means that investors underestimate the economic value of the share capital. It therefore follows that its latent future potential (as reflected in a high return and/or a low risk) is high, and vice versa.

In Figure 2.17, we calculated the MV/BV ratio for the seven largest commercial banks in Israel. In addition to the five largest, this also includes Union Bank and the Bank of Jerusalem, but the following analysis relates solely to the five largest banks (Figure 2.17).

2007 featured a decline in this ratio, and a slight increase in its degree of dispersal.³⁸ The average value³⁹ of the ratio at the end of the year was 1.21, lower than at the end of 2006 (1.33), but higher than 1, and higher than the average for the five previous years (1.05, Figure 2.17).

In 2007, two forces affected the ratio. Some of these forces were internal forces specific to the banking system, and some were systematic and external. Among the internal factors, the rise in profitability and fall in risk stood out this year. Among the systematic factors, the continued positive trends in the Israeli economy and ongoing prosperity in the domestic capital market were prominent. Despite the positive background conditions, the MV/BV ratio continued to decline this year, which we attribute to a response on the part of investors to new developments and the continuation of others that negatively influence the banks' profits through their business results and performance. Beyond the negative short-term effect of the Bachar reform and the Supervision of Bank Fees Law on the non-interest income of the commercial banks, there was another negative influence this year – the subprime crisis in the American mortgage market, and its effect on global capital markets. This crisis had a negative impact on the value of the Israeli bank shares in the present, mainly because investors feared the exposure of the banks to risks incurred in their activity with hybrid financial instruments. This exacerbated

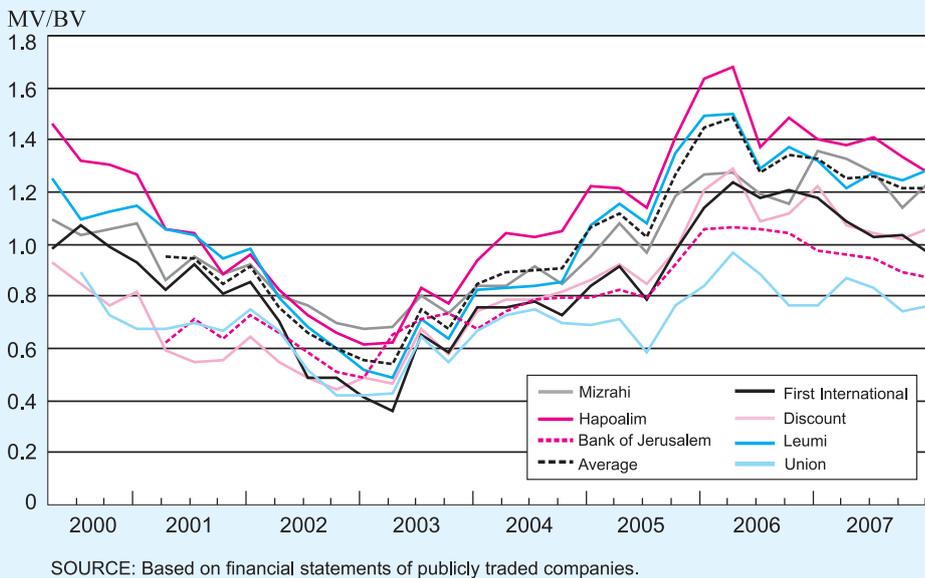
³⁷ The market value to book value ratio is defined as $(MV/BV)_i$, where MV_i is the market value of the shares and options of bank i in period t . The market value of any company is defined as the value of its shares and options listed for trading (excluding convertible bonds). The market value also includes shares not listed for trading, to which is assigned the market value of the shares that are listed for trading. BV_i is the balance sheet value of the equity, including paid in share capital, reserves, and surplus capital, of bank i in period $t - 1$.

³⁸ The degree of dispersal of the ratio was calculated as the average standard deviation of the four quarters of the year at the five largest banks only. The degree of dispersal this year was 0.021, compared with an average value of 0.019 during the past five years.

³⁹ The average displayed is the average weighted by the equity of the five largest commercial banks only.

their anxiety that the banks would fail to meet their own future profitability targets. Offsetting all these negative factors this years was the positive effect of the growth trend in the Israeli economy and the boom in the capital market.

Figure 2.17
Ratio of Market Value to Book Value (MV/BV) of the Five Major Banks
and Two Independent Banks, March 1993 to December 2007



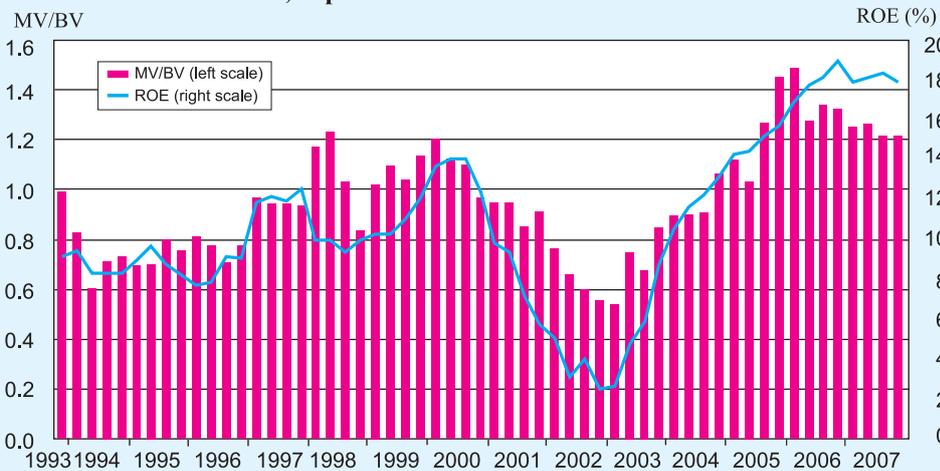
The value of the ratio fell at each of the five largest banks at rates varying from 2 percent at Leumi to 19 percent at the First International. The across-the-board decline of the ratio this year reinforced our previous assessment that investors are taking into account an expected blow to the banks' business results caused by their need to deal with common future challenges, such as the Bachar reform, the Supervision of Bank Fees Law, and the consequences of the subprime crisis. At the same time, increased dispersal and variance in the rates of decline highlight the differing degree of exposure that investors attribute to these challenges for each bank.

Where the connection between the MV/BV ratio of the five largest banks and their return on equity is concerned, it seems that in contrast to the preceding year, in which there was a trend towards a negative connection between the two variables,⁴⁰ the trend towards a positive connection between them resumed this year. This trend, as reflected in the decline of the MV/BV ratio and the return on equity at the five largest commercial

⁴⁰ For a more thorough discussion, see the chapter on the business results in the Supervisor of Banks' review for 2006.

banks, matches the results of empirical studies,⁴¹ which report a significant positive link between the value of the MV/BV ratio and the return on equity (and a negative link to the banking risk,⁴² Figure 2.18).

Figure 2.18
Return on Equity (ROE)^a and the MV/BV Ratio of the Five Major Commercial Banks, September 1993 to December 2007



^a The annual return on equity was calculated as the average of the past four quarters.

SOURCE: Based on financial statements of publicly traded companies.

In 2009, the Israeli banks are expected to implement the new guidelines of the Basel II agreement. We expect this to lead to more focused and accurate risk management, and increased transparency and proper disclosure. This will give the market a signal of improvement in the banks' decision-making and risk management, and increased market discipline as an additional supervisory mechanism, in addition to the institutional one. We expect this process to lead to more accurate estimates of the market value and the MV/BV ratio, and to strengthening of the connection between it and the return on equity.

⁴¹ For a more thorough discussion, see "The Market to Book Ratio of the Bank Shares in Israel," David Ruthenberg and Shaul Pearl, Bank of Israel Banking Supervision Department, Research Unit, Bank of Israel, Essays for Discussion, 2nd Edition, June 2004.

⁴² This link rests on the MV/BV equation, formulated as follows: $MV/BV = (ROE - g)/(k - g)$, where ROE is the return on equity, g is the bank's growth rate, and k is the bank's risk. For a more thorough discussion, see the essay by Ruthenberg and Pearl mentioned in the preceding footnote.

