

Chapter 2

The Financial Results of the Five Major Banking Groups

The five major banking groups reported good financial results in 2006, as expressed by the various components of their profit and the return on equity (ROE), with some of the elements continuing the positive trend of the last few years. These results, against the backdrop of the general economic recovery from the deep recession that prevailed in Israel in 2001 and 2002, stemmed from two factors which had a positive effect on the banking groups' profit and ROE in 2006: (a) a one-off factor—the implementation of the legislation designed to increase competition and reduce concentration and conflicts of interest in Israel's capital market (the Bachar reform), which led to the sale of the ownership and management rights of the provident and mutual funds, and brought the banking groups handsome profits; and (b) a cyclical factor—the upsurge in the economy and the capital market, expressed this year primarily in the financial results and performance of the business sector. As far as the financial results of the banking system are concerned, net income grew by a steep 38 percent in 2006 and ROE was 19.5 percent—a record figure. If the financial results are adjusted for the one-off effect of the Bachar reform, it transpires that ordinary after-tax profit declined by about 7.7 percent in 2006, compared with a 20 percent increase in 2005, while ROE fell to 14.4 percent this year from 15.4 percent in 2005.

Loan-loss provision, expressing the banks' stance vis-à-vis credit risk, declined by a sharp 24 percent in 2006, largely due to provision for the business sector influenced by the economic boom evident in Israel and globally this year. Net interest income this year was affected primarily by the expansion of the banking groups' activity rather than by the interest-rate spread, which remained similar to that of 2005. The banking groups' non-interest income, derived mainly from their income from fees and commissions, rose by a moderate 7 percent, while operating expenses rose by a steep 12.5 percent (largely because of an increase in salary expenses); an examination of performance by activity segment clearly shows the robust nature of the retail activity segments (households, private customers, and small businesses).

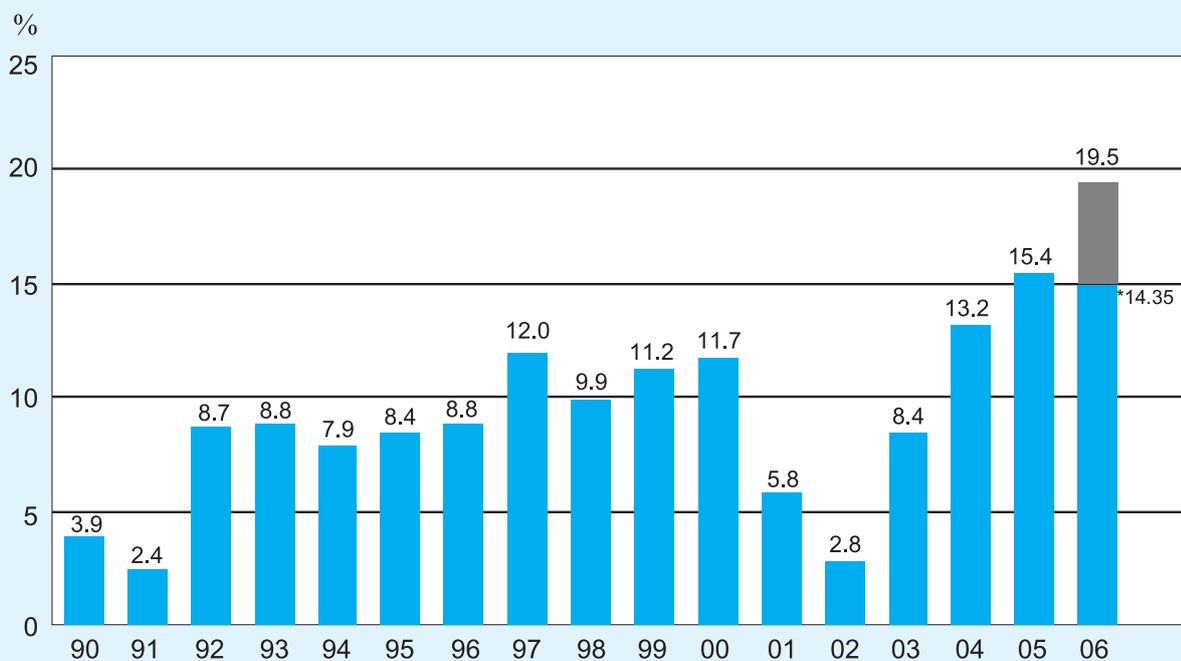
1. THE PROFIT AND PROFITABILITY OF THE BANKING GROUPS

The upward trend in profit and profitability (ROE) evident in the banking system in the last three years continued in 2006, leading to particularly high levels of both.

The net income of the five major banking groups grew by about 38 percent this year and amounted to NIS 8.9 billion, a steeper rise than in 2005 (when it was 25 percent, Table 2.1). The growth of income in 2006 encompassed all the major banking groups and was affected primarily by factors of a one-off nature rather than by factors associated with the business cycle.

ROE,¹ which rose in each of the banking groups except First International,² reached an all-time high in 2006—an annual average rate of 19.5 percent—compared with 15.4 percent in 2005 and an average of about 10.8 percent in the last ten years (Figure 2.1).

Figure 2.1
After-Tax Return on Equity (ROE), the Five Major Banking Groups,
1990 to 2006



* Return on equity excluding income from the sale of provident and mutual funds following the Bachar reforms.
SOURCE: Based on published financial reports.

¹ As of 2007:Q1 the banking corporations will be required to calculate ROE according to the method customary in the US and other countries, i.e., as net income adjusted for the dividend for preference shares not recorded as expenditure in the profit and loss statement and declared in the reporting period only divided by average equity. In this respect average equity is the total of all equity minus the average balance of external shareholders' rights minus/plus the average balance of losses/gains not yet realized from the adjustment of trading bonds at fair value, as well as the losses/gains from bonds available for sale included in equity.

² In the First International banking group ROE dipped from 12.7 percent in 2005 to 12.5 percent in 2006.

ROE this year was positively correlated with the size of the banking group: the ROE of the two largest banking groups, Hapoalim and Leumi, exceeded 22 percent, while that of the medium-sized groups, Discount, Mizrahi-Tefahot, and First International, was around 13 percent (Table 2.1).

The increase in net income led to a rise in the equity³ of the five major banking groups, so that their total equity at the end of the year stood at NIS 53.5 billion—a 12 percent rise from its value at the beginning of the year.

The high level of profits and profitability in 2006 was influenced to a great extent by non-recurring capital gains⁴ from the sale of ownership and management rights in provident and mutual funds in the wake of the implementation of the Law for Increasing Competition and Reducing Concentration and Conflicts of Interest in the Israeli Capital Market, 5765–2005 (The “Bachar” Law).⁵ Adjusting for this one-off income, which amounted to about NIS 2.4 billion this year, ordinary after-tax profit, which reflects profit from ongoing activity, dipped by 7.7 percent in 2006 compared with a 20 percent increase in 2005. This decline, despite the sharp drop in loan-loss provision (24 percent), stemmed inter alia from a steep increase in operating expenses (primarily salary expenses) compared with a more moderate rise in non-interest income (Table 2.1). ROE adjusted for the one-off capital gains obtained through the implementation of the Bachar reform declined in 2006 in all the major banking groups with the exception of the Bank Hapoalim group, and averaged 14.4 percent (Figure 2.1).

The effect on the banks’ profit and profitability of the Second Lebanon War, which broke out in July, can be seen from the comparison of the third quarter of 2006 with the third quarter of 2005. Total ordinary after-tax profit plummeted by about 20.5 percent in this period, largely because of the contraction of economic activity in the north of the country (which accounts for approximately 20 percent of Israel’s total economic activity), as expressed in a steep drop (about 11 percent) in non-interest income in the banking groups in 2006:QIII.

It appears that in the next few years the Israeli banking groups will have to contend with the repercussions of the Bachar reform. The expected decline in operating expenses resulting from the sale of financial assets, alongside the expected entry of insurance firms and other financial entities into classic banking activity,⁶ will oblige the banking groups to develop alternative income channels in order to continue attaining high levels of profit and profitability.

³ The equity includes: paid-up share capital, acceptances on account of shares (only when there is an irrevocable obligation to buy and allocate the shares), perpetual liabilities, funds, profit including other, surpluses, and dividends proposed or declared after the balance-sheet date.

⁴ In the First International Banking group capital gains from the sale of provident and mutual funds are expected to be recorded in the financial statements for 2007.

⁵ For details see the Annual Surveys of Israel’s Banking System for 2004 and 2005.

⁶ Primarily extending credit and capital market activity.

Table 2.1
Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 2004–06

	(NIS million, at current prices)											
	Leumi			Hapoalim			Discount					
	2004	2005	2006	% change from 2005 to 2006	2004	2005	2006	% change from 2005 to 2006	2004	2005	2006	% change from 2005 to 2006
Net interest income before loan-loss provision	6,359	6,628	6,922	4.44	7,071	7,609	7,788	2.35	3,473	3,697	3,790	2.52
Loan-loss provision	1,514	1,426	933	-34.57	1,768	1,268	986	-22.24	880	691	570	-17.51
Net interest income after loan-loss provision	4,845	5,202	5,989	15.13	5,303	6,341	6,802	7.27	2,593	3,006	3,220	7.12
Total operating and other income	3,403	3,718	3,871	4.12	4,215	4,600	5,162	12.22	2,231	2,406	2,359	-1.95
of which Fee income	2,718	2,810	3,003	6.87	3,217	3,548	3,888	9.58	1,776	1,863	1,911	2.58
Total operating and other expenses	5,488	6,070	7,257	19.56	6,388	7,025	7,632	8.64	4,028	4,729	5,020	6.15
of which Salaries and related expenses	3,248	3,627	4,552	25.50	3,858	4,222	4,687	11.01	2,564	2,966	3,201	7.92
Ordinary before-tax income ^a	2,760	2,850	2,603	-8.67	3,140	3,916	4,332	10.62	796	683	559	-18.16
Tax provision	1,244	1,193	1,320	10.65	1,361	1,645	1,897	15.32	342	324	350	8.02
Ordinary after-tax income	1,516	1,657	1,283	-22.57	1,779	2,271	2,435	7.22	454	359	209	-41.78
Other income ^b	388	480	2,190	356.25	379	699	979	40.06	158	177	709	300.56
Shareholders' net income	1,864	2,136	3,534	65.45	2,107	2,888	3,359	16.31	556	458	836	82.53
Total income for calculation of return on equity ^c	1,904	2,137	3,473	62.52	2,158	2,970	3,414	14.95	612	536	918	71.27
Capital for the calculation of ROE^d	13,293	14,149	15,081	6.58	13,892	14,510	15,352	5.80	5,955	6,386	6,718	5.20
Ordinary ROE, net (%)	11.4	11.7	8.5		12.8	15.7	15.9		7.6	5.6	3.1	
Total ROE (%)^e	14.3	15.1	23.0		15.5	20.5	22.2		10.3	8.4	13.7	
Total return on assets (ROA)(%)	0.77	0.84	1.27		0.83	1.13	1.25		0.44	0.37	0.59	

(cont'd)

Table 2.1 (Cont'd)
Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 2004–06

	(NIS million, at current prices)											
	Mizrahi-Tefahot			First International			Total					
	2004	2005	2006	% change from 2005 to 2006	2004	2005	2006	% change from 2005 to 2006	2004	2005	2006	% change from 2005 to 2006
Net interest income before loan-loss provision	1,652	1,904	1,987	4.36	1,432	1,673	1,831	9.44	19,987	21,511	22,318	3.75
Loan-loss provision	359	292	305	4.45	437	276	219	-20.65	4,958	3,953	3,013	-23.78
Net interest income after loan-loss provision	1,293	1,612	1,682	4.34	995	1,397	1,612	15.39	15,029	17,558	19,305	9.95
Total operating and other income	1,036	1,114	1,215	9.07	832	1,018	1,146	12.57	11,717	12,856	13,753	6.98
<i>of which</i> Fee income	874	924	991	7.25	718	862	940	9.05	9,303	10,007	10,733	7.25
Total operating and other expenses	1,679	1,839	2,117	15.12	1,362	1,575	1,867	18.54	18,945	21,238	23,893	12.50
<i>of which</i> Salaries and related expenses	1,089	1,154	1,395	20.88	820	906	1,076	18.76	11,579	12,875	14,911	15.81
Ordinary before-tax income ^a	650	887	780	-12.06	465	840	891	6.07	7,811	9,176	9,165	-0.12
Tax provision	255	371	349	-5.93	211	374	387	3.48	3,413	3,907	4,303	10.14
Ordinary after-tax income	395	516	431	-16.47	254	466	504	8.15	4,398	5,269	4,862	-7.72
Other income ^b	10	-9	212	1455.6	-2	6	19	216.7	933	1,353	4,109	203.70
Shareholders' net income	386	507	643	26.82	242	453	509	12.36	5,155	6,442	8,881	37.86
Total income for calculation of return on equity ^c	405	507	643	26.82	252	472	523	10.81	5,331	6,622	8,971	35.47
Capital for the calculation of ROE^d	3,778	4,133	4,631	12.05	3,497	3,714	4,181	12.57	40,414	42,892	45,963	7.16
Ordinary ROE, net (%)	10.5	12.5	9.3		7.3	12.5	12.1		10.9	12.3	10.6	
Total ROE (%)^e	10.7	12.3	13.9		7.2	12.7	12.5		13.2	15.4	19.5	
Total return on assets (ROA)(%)	0.51	0.61	0.74		0.39	0.69	0.73		0.68	0.81	1.04	

^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 Includes the group's share in the profits of companies included on an equity basis, net income from extraordinary activities, and the cumulative effect of a change in the method of accounting and also translation adjustments from the report on the change in equity for companies included on an equity basis.

^c Total income is defined as net income plus the share of minority interests and translation adjustments imputed to equity.

^d Equity and minority interests at beginning of year plus issues according to time of issue minus dividends paid, according to time paid.

^e Calculated as profit to the end of the year divided by equity at the end of the previous year.

SOURCE: Based on published financial statements.

2. THE DEVELOPMENT OF INCOME AND EXPENDITURE

a. Net interest income before loan-loss provision

Net interest income before loan-loss provision rose in all the five major banking groups in 2006 and amounted to NIS 22.3 billion, up by NIS 800 million over the equivalent period in 2005 (about 3.8 percent). The increase in this income this year derived from the rise in net income from classic financial intermediation activity, including derivatives (2.9 percent), as well as from the huge rise in income from activity in options and other

Table 2.2
Breakdown of Profits from Financial Activities before Loan-Loss Provision, by Type of Indexation, The Five Major Banking Groups, 2005–06

	2005	2006	Change relative to 2005	Change relative to 2005
	(NIS million, at current prices)		(percent)	
Net Income^a by type of indexation (including derivatives)				
Local currency, unindexed	8,729	10,663	1,934	22.2
Local currency, CPI-indexed	3,463	2,373	-1,090	-31.5
Foreign currency - domestic activity	6,364	6,063	-301	-4.7
1. Total income from indexation derivatives	18,556	19,099	543	2.9
Other financial income				
Commissions on transactions	770	810	40	5.2
Other net financial income	1,980	1,925	-55	-2.8
<i>of which</i> Interest income on problem debts previously not recorded	1,002	1,095	93	9.3
<i>of which</i> Profits from the sale and valuation of bonds ^b	287	230	-57	-19.9
2. Total other financial income	2,750	2,735	-15	-0.5
3. Options and other derivatives	205	484	279	136.1
Profit from financial activities before loan-loss provision (1+2+3)	21,511	22,318	807	3.8

^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.

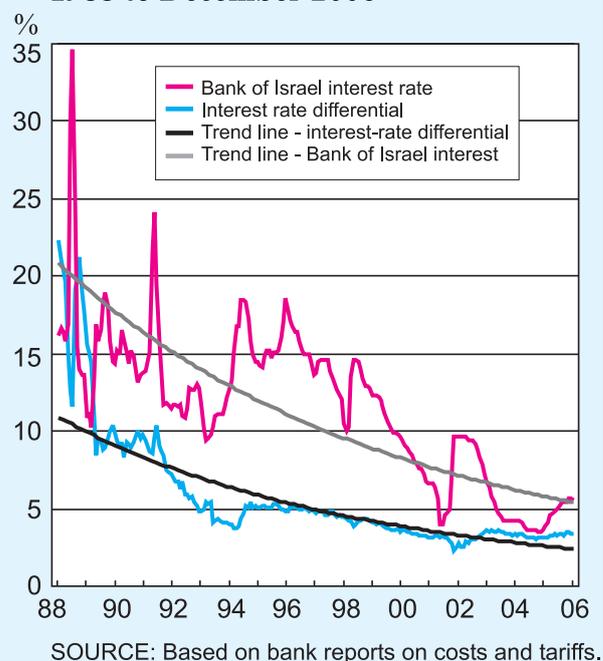
SOURCE: Published financial statements.

derivative instruments (about 136 percent), slightly offset by the decline in other net interest income items (0.5 percent, Table 2.2).

An examination of the development of net interest income from classic banking activity by indexation segment in the five major banking groups shows that the increase in net interest income was influenced mainly by the rise in the volume of activity in 2006 (the quantity effect), rather than by the overall interest-rate spread (the price effect), which remained at a similar level to that of 2005 (1.52 percentage points in 2006 compared with 1.51 percent in 2005, Table 2.3). The main contribution to the increase in income in this category in 2006 stemmed from activity in the unindexed local-currency segment, which even compensated for the 5 percent decline in the income of the foreign-currency segment⁷ and the 32 percent drop in that of the indexed local-currency segment (Table 2.2). Activity in derivatives contributed to the increase in income in 2006, and its share in total net interest income was 17 percent, compared with 1 percent in 2005.

The increase in the income of the unindexed segment, where most interest rates are short-term, was affected to a great extent by the hike in the Bank of Israel's key interest rate, which rose by a cumulative one percentage point in the first ten months of 2006.⁸ This interest-rate hike was reflected in an increase in effective rates of return,⁹ both nominal and real, on assets and liabilities in the unindexed local-currency segment, as well as in the expansion of the simple spread between the annual average rates of return on unindexed liabilities (deposits) and unindexed assets from 3 percentage points in 2005 to 3.3 percentage points in 2006 (Table 1.4). The widening of the simple spread, together with the rise in the extent of economic activity, led to an increase in net interest income and financing costs, as well as to the expansion of the overall interest-rate spread in this segment, from 2.52 percent in 2005 to 2.63 percent in 2006 (Table 2.3). The positive correlation found this year between the key interest rate and the interest-rate spread in the unindexed local-currency segment is consistent with the results of other

Figure 2.2
Bank of Israel Interest Rate Compared to the Interest Rate Differential (Time Credit less SRO) in the Unindexed Shekel Sector, June 1988 to December 2006



⁷ Including domestic and foreign activity.

⁸ The rise in the Bank of Israel's key interest rate in the first ten months of the year was from a monthly rate of 4.5 percent in January to 5.5 percent in October; in the last two months of 2006 the interest rate declined by a cumulative 0.5 percentage points.

⁹ Both nominal and real interest rose by about 1 percentage point.

studies carried out in the past.¹⁰ These studies attach importance to the positive long-term correlation between the two variables, showing that, despite the positive trend, there is sometimes a negative correlation between them in the short term (Figure 2.2).

Interest rates in the CPI-indexed local-currency segment, which are derived from the public's demand for indexed credit as well as from the development of yields in the government bond market,¹¹ that constitutes a substitute for activity in the segment, rose in 2006 in the wake of the increase in returns on bonds in the first half of the year.¹² Profits in the CPI-indexed local-currency segment declined this year, and their share of total profit fell to about 10.6 percent, (Figure 2.3). This was due to the contraction of demand for indexed credit, mainly as a result of the low inflation environment, and the narrowing of the differential between nominal and real effective rates of return between medium- and long-term savings schemes on the one hand, and indexed credit on the other, from 2.8 percent in 2005 to 2.4 percent in 2006 (Table 1.4, Chapter 1). These two factors led to the decline in the rate of income from the segment's assets and to a fall in the rate of expenditure on its liabilities, so that the overall interest-rate spread dipped from 1.07 percentage points in 2005 to 0.91 percentage points in 2006 (Table 2.3).

Interest rates in local-currency terms in the foreign-currency segment declined in 2006 despite the rise in the dollar LIBOR interest rate¹³ (by about 0.5 percentage points), following the 7 percent appreciation of the shekel against the dollar this year (see Chapter 3). Like interest rates, the demand for foreign-currency-indexed and denominated credit

¹⁰ For further elucidation of this subject, see: D. Ruthenberg, D. Geva and Z. Samet, 'An Analysis of the Interest-Rate Spread in the Unindexed Local-Currency Segment of Israel's Banking System, July 1984–May 1987,' *Banking Review* 7, March 1988; D. Ruthenberg, 'Net Interest Margin, Interest-Rate Spread, Activity in Derivatives, and the Importance of the 'Monetary Fine', ' research study, Research Unit, Banking Supervision Department. The model that was developed is based on the following interest-rate spread equation:

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

where M = the interest-rate spread, S = the monetary loan rate, ρ = the deposit's reserve requirement, θ = elasticity of supply of deposits, η = elasticity of demand for credit.

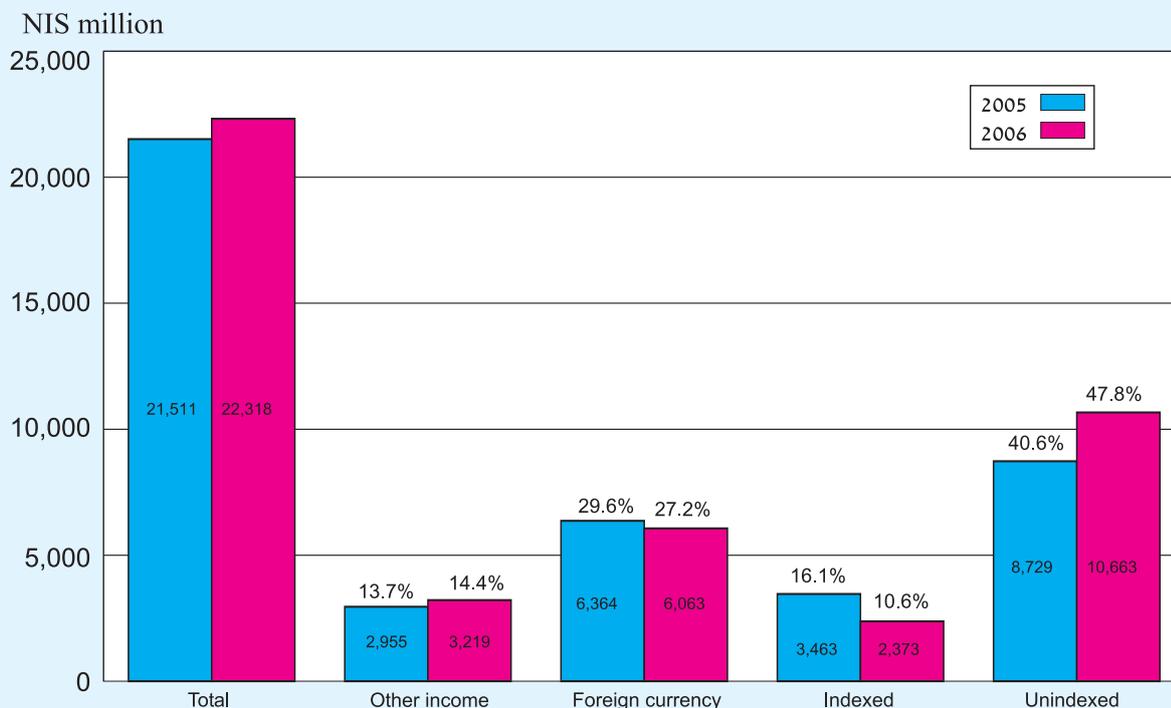
Since a (banking) firm will always operate in the area where $\eta < -1$, then $\frac{\partial M}{\partial S} = \left[\frac{\eta}{1+\eta} - \frac{\theta(1-\rho)}{1+\theta} \right] > 0$.

¹¹ This development is affected by the government's borrowing requirement and by the public's demand for CPI-indexed credit to finance investments.

¹² This rise, despite the decline in government borrowing (supply side), stemmed from the steeper decline in the extent of medium- and long-term savings schemes (demand side), in the context of low inflation rates. In the second half of 2006 rates of return on government bonds fell primarily because of the continued contraction of supply and the introduction of the 'market-maker' bond market reform in September.

¹³ The LIBOR interest rate serves as a point of reference for pricing interest in the foreign-currency segment, just as the Bank of Israel's key interest rate constitutes the yardstick for pricing interest in the unindexed local-currency segment.

Figure 2.3
The Contribution of the Various Indexation Segments to Profit of the
Five Major Banking Groups, 2005 and 2006
 (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.

also contracted this year (in favor of unindexed local-currency credit), as a result of the negative nominal interest-rate differentials between interest rates abroad and the Bank of Israel's key interest rate. These two factors led to a steep drop in the segment's net interest income and financing costs in 2006 as well as to the contraction of the overall interest-rate spread, which was 0.91 percentage points this year, compared with 1.06 percentage points in 2005 (Table 2.3). As a result, the segment's profit declined by 5 percent in 2006 and it constituted about 27 percent of total profit (Figure 2.3).

Another factor contributing to the increase in net interest income in 2006 was the sharp rise in options and other derivatives not defined as hedging instruments or asset liability management (ALM) (a rise of about 136 percent, Table 2.2)

The other interest income category, which consists mainly of income from interest on loans that were registered in the past as problem loans and gains/losses from the sale of bonds and from adjustments relating to trading bonds, was about 0.5 percent less in 2006 than in 2005, offsetting some of the increase in income in the other interest income items. The decline stemmed this year from the fall (of about 20 percent) in income from

the sale and revaluation of bonds.¹⁴ This decline (in spite of the increase in holdings of securities available for sale) was a result of the rise in the domestic interest rate, which caused exercise prices and the fair value of bond portfolios in banks to fall. The interest-income component on problem debts not recorded in the past grew by 9 percent in 2006 (Table 2.2), due mainly to an improvement in the repayment ability of borrowers in the business sector.

b. Loan-loss provision

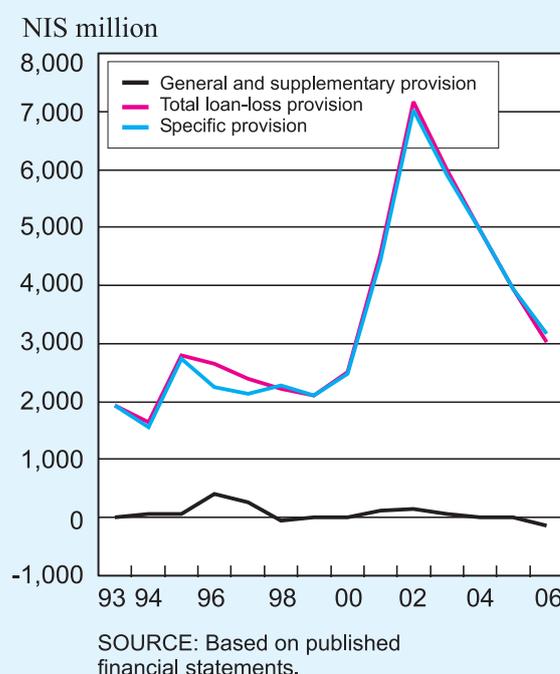
This section presents a general review of loan-loss provision. For further elucidation of this subject, see Chapter 3.

Israel's economic growth during 2006, together with the positive global economic developments which had a far-reaching effect on the Israeli economy in general and the business sector in particular, evinced themselves this year in the ongoing improvement in Israeli borrowers' repayment ability. This improvement was expressed in the continued downward trend in the annual loan-loss provision of the five major banking groups, which amounted to about NIS 3 billion in 2006, compared with about NIS 4 billion in 2005, down by some 24 percent (Table 2.4).

Since 2003 there has been a trend decline in the development over time of the loan-loss provision and its components—both specific loan-loss provision, which is determined by bank managements in accordance with borrowers' repayment ability and the nature of their collateral, and the general and supplementary loan-loss provisions, which are determined in accordance with the Supervisor of Banks' directives regarding the risk and size of the credit portfolio. The general and supplementary loan-loss provision was negative this year because of the collection of debts against which loan-loss provision was made in the past (Figure 2.4; for further elucidation, see Chapter 3).

The decline in loan-loss provision in the five major banking groups in 2006 stemmed primarily from the improvement in the repayment ability of business borrowers in the context of economic growth in Israel and worldwide, and it occurred in spite of the

Figure 2.4
Developments in Components of Loan-Loss Provisions in the Five Major Banking Groups, 1993-2006



¹⁴ Including profits/losses from the sale and revaluation of trading bonds as well as from the sale of bonds available for sale and bonds held to maturity.

increase in the provision made in other activity segments (for a fuller discussion, see Section 3 below, Analysis of Performance by Activity Segment).

Table 2.4**Components of the Loan-Loss Provision for the Five Major Banking Groups, 2004–06**

(NIS million, at current prices)

	2004			2005			2006		
	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	24,037	3,374	27,411	26,948	3,386	30,334	28,531	3,389	31,920
Additions to the provision during the accounting year	6,517	100	6,617	5,773	129	5,902	5,138	113	5,251
Reduction of the provision	-1,521	-88	-1,609	-1,730	-131	-1,861	-1,870	-261	-2,131
Collection of debts written off in previous years	-50	0	-50	-88	0	-88	-107	0	-107
Amount entered in the profit and loss statement	4,946	12	4,958	3,955	-2	3,953	3,161	-148	3,013
Debts written off	-2,004	0	-2,004	-2,378	0	-2,378	-3,016	0	-3,016
Erosion and adjustment of balances	69	0	69	4	0	4	0	0	0
End-of-year balance of provision	26,979	3,386	30,365	28,525	3,384	31,909	28,676	3,241	31,917

SOURCE: Published financial statements.

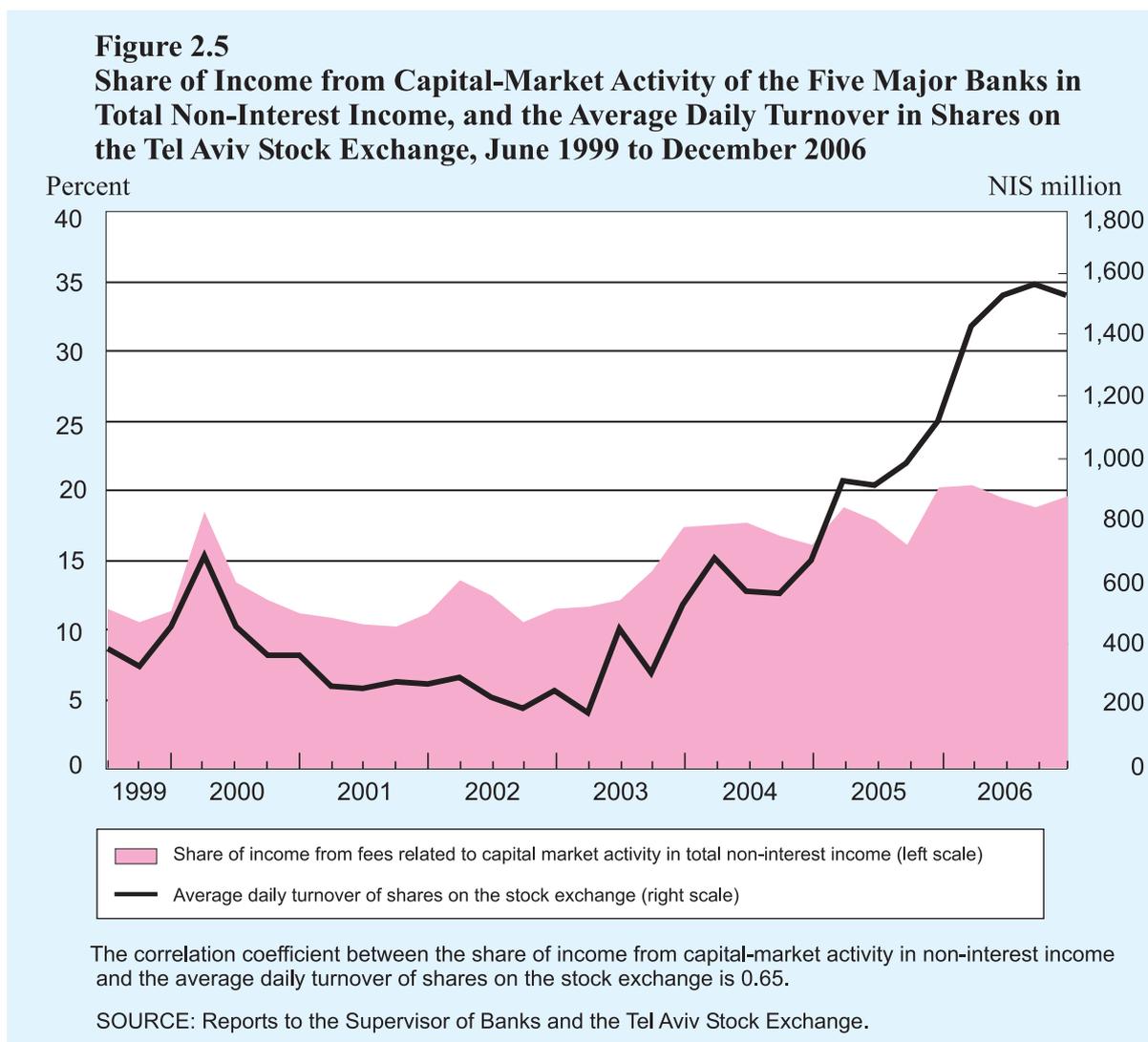
c. Non-interest income

The relatively rapid growth rate evident in Israel's economy in the last two years persisted in 2006, accompanied by an increase in the extent of economic activity and demand for the financial and other services which contribute to the banking groups' non-interest income. Total non-interest and other income rose by NIS 900 million in 2006 and amounted to some NIS 13.7 billion, up by 7 percent (Table 2.5). The increase, which varied considerably from group to group, encompassed all the major banking groups this year with the exception of the Discount Banking group, which recorded a 2 percent decline.¹⁵

Non-interest income associated with capital market activity grew by a modest 2.5 percent in 2006, and constituted 32 percent of total non-interest and other income (Table 2.5). This increase was influenced in 2006 by two factors which operated in opposing directions: the surge in the capital market and the implementation of the Bachar reform.

¹⁵ Mainly because of the contraction in income from management fees on mutual funds following the sale of Ilanot Discount to the Clal Financing Betuha group in 2006:QII and the sharp fall in the profits of the severance pay funds.

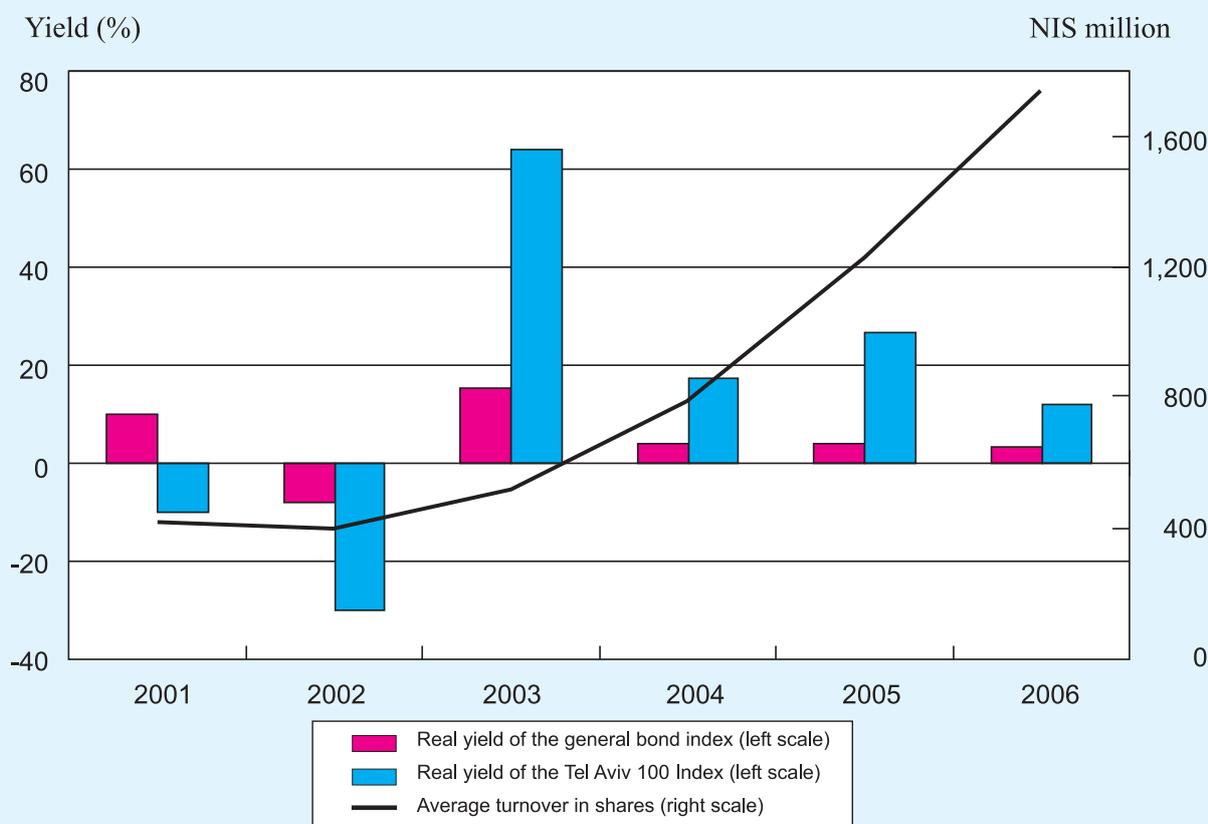
The surge in the capital market, as reflected in the volume of turnover and the various yield indices (Figures 2.5 and 2.6), had a positive effect on total income from activity in securities (up by 10.6 percent), mainly as a result of the increased demand for the different services associated with the capital market by customers in the various activity segments.



The process of implementing the Bachar reform and absorbing it into the system, which began in 2006:QII, had a negative effect on the income of the banking groups and was evident in two opposing categories: (a) the extent of income from fees for administering mutual funds, which plummeted by 34 percent in 2006 in the wake of the transfer of ownership and management rights to the purchasing groups;¹⁶ and (b) the new category, ‘Income from mutual and provident fund distribution fees,’ which generated

¹⁶ The mutual funds were transferred to the purchasing groups at various dates. For further details, see “The Effect of the Bachar Commission Reform on the Financial Results of the Banking System,” in Bank of Israel, *Israel’s Banking System*, 2005, pp 44–47.

Figure 2.6
Real Annual Yield of the Tel Aviv 100 Index, the General Bond Price Index
and Average Daily Turnover in Shares, 2001-06



SOURCE: Based on data from the Tel Aviv Stock Exchange

income from the distribution of mutual funds (about NIS 120 million) and partly offset the decline in income from management fees of mutual funds. The effect of the Bachar reform on income from management fees of provident funds, which rose by 18 percent in 2006, has not yet become evident (Table 2.5) because most of the sales transactions regarding which there is an agreement in principle have not yet gone through.¹⁷

The non-interest income related to the various ordinary banking services grew by 6.3 percent in 2006 and constituted 61 percent of total non-interest and other income. The most prominent items this year were: handling credit and drawing up contracts, which grew by 23 percent, mainly as a result of the implementation of Directive 325 of the Proper Conduct of Banking Business (December 2005) regarding the management of credit lines in current accounts; income from credit cards (about 13.1 percent), which rose largely in the wake of the expansion of economic activity and the number of credit

¹⁷ The only purchase transaction which has gone through this year within the major banking groups was between the Bank Leumi group and the Harel company in December 2006. This transaction generated one-off capital gains for the group of NIS 575 million.

cards issued (as described in detail in Chapter 4), and income from services to the payments system (about 11.3 percent, Table 2.5). Income from account management fees plummeted by some 17 percent in 2006 due to the implementation of the ‘package deal’ for households¹⁸ and the increase in competition between the banks¹⁹ as well as between banks and nonbanking institutions²⁰ for customers in the retail segment.

The rest of the income items rose slightly in 2006 as a result of the general expansion of economic activity and the adjustment of fees intended to minimize the reduction of non-interest income in the account management fees item as a result of the ‘package deal.’

Other income, which accounts for 7.3 percent of total non-interest and other income, soared by 41 percent this year, in the context of the increase in profits from investment in shares (up by a massive 400 percent), and despite the drop in income from severance pay funds (Table 2.5). The decline in income from severance pay funds in 2006 stemmed from the contraction of the gap between the increase in returns on shares and bonds held by the funds to cover severance pay obligations and the required increase in these reserves.

d. Operating and other expenses

Total operating and other expenses of the five major banking groups rose by a steep 12.5 percent in 2006 and amounted to NIS 23.9 billion (Table 2.5). As was the case in last few years, most of the increase in this item this year stemmed from the growth in the salaries and related expenses item, which soared by 15.8 percent, accounting for 62.4 percent of total expenditure, compared with 60.6 percent in 2005. In line with these expenses, other expenditure items also rose in 2006: expenditure on maintenance and depreciation of buildings and equipment grew by 5.6 percent, while other expenditure items rose by 8.8 percent, increasing their shares in total operating and other expenses to 16.2 and 21.4 percent respectively (Table 2.5).

The steep increase in staff-related expenses in 2006, which has also been in evidence in the last three years, followed three years of stability (2001–03) and derived from the sharp increase in both direct expenditure on salaries (10.5 percent) and other salary-

¹⁸ On 1.12.2005 the agreement reached between the banks and the Knesset Finance Committee, in cooperation with the Supervisor of Banks and the Director-General of the Anti-Trust Authority, known as ‘the package deal,’ went into effect. The agreement was based on three arrangements concerning fees and commissions: two arrangements regarding management fees in current accounts and an arrangement regarding the fees incurred in moving from one bank to another.

¹⁹ Directive 432 of the Proper Conduct of Banking Business (July 2005) regarding the transfer of a customer’s activity and the closing of a bank account was introduced to facilitate the switch from one bank to another, and thus to increase interbank competition.

²⁰ Primarily on the part of credit card firms and insurance companies, as well as of other financial entities.

Table 2.5
Non-Interest Income and Operating Expenses of the Five Major Banking Groups, 2004–06

	Amount		Distribution		Year-on-year change			
	2004	2005	2004	2005	2005	2006		
	(NIS million, at current prices)						(percent)	
1. Non-interest income								
Income from banking services								
Ledger fees	1,483	1,470	1,221	12.7	11.4	8.9	-0.9	-16.9
Payment services	1,901	1,931	2,150	16.2	15.0	15.6	1.6	11.3
Credit cards	1,930	2,138	2,418	16.5	16.6	17.6	10.8	13.1
Credit services and contracts	793	867	1,068	6.8	6.7	7.8	9.3	23.2
Computerized services, data and approvals	216	197	208	1.8	1.5	1.5	-8.8	5.6
Foreign trade and special services	383	419	446	3.3	3.3	3.2	9.4	6.4
Other commissions ^a	845	848	858	7.2	6.6	6.2	0.4	1.2
Total income from banking services	7,551	7,870	8,369	64.4	61.2	60.9	4.2	6.3
Income from activity in the capital market								
From activity in securities ^b	1,752	2,137	2,364	15.0	16.6	17.2	22.0	10.6
Provident and mutual funds management fees	1,814	2,136	1,895	15.5	16.6	13.8	17.8	-11.3
Provident fund fees	875	946	1,114	7.5	7.4	8.1	8.1	17.8
Mutual fund fees	939	1,190	781	8.0	9.3	5.7	26.7	-34.4
Provident and mutual funds distribution fees ^c	-	-	120			0.9		
Total income from activity in the capital market	3,566	4,273	4,379	30.4	33.2	31.8	19.8	2.5
Other income								
Profit from compensation funds	138	372	104	1.2	2.9	0.8	169.6	-72.0
Profit from the sale of shares ^d	273	131	674	2.3	1.0	4.9	-52.0	414.5
Others ^e	189	210	227	1.6	1.6	1.7	11.1	8.1
Total other income	600	713	1,005	5.1	5.5	7.3	18.8	41.0
Total operating fees^f	9,303	10,007	10,733	67.6	72.8	78.0	7.6	7.3

(cont'd)

Table 2.5 (Cont'd)
Non-Interest Income and Operating Expenses of the Five Major Banking Groups, 2004–06

	Amount			Distribution			Year-on-year change	
	2004	2005	2006	2004	2005	2006	2005	2006
	(NIS million, at current prices)			(percent)			(percent)	
2. Operating expenses								
Salaries and related expenses ^g	11,579	12,875	14,911	61.1	60.6	62.4	11.2	15.8
<i>of which:</i> Salaries	7,898	8,753	9,671	41.7	41.2	40.5	10.8	10.5
Maintenance of buildings	3,371	3,656	3,862	17.8	17.2	16.2	8.5	5.6
Other expenses	3,995	4,707	5,120	21.1	22.2	21.4	17.8	8.8
Marketing and advertising	596	660	810	3.1	3.1	3.4	10.7	22.7
Computer expenses	532	680	743	2.8	3.2	3.1	27.8	9.3
Communications	480	529	578	2.5	2.5	2.4	10.2	9.3
Insurance	199	169	152	1.1	0.8	0.6	-15.1	-10.1
Office	263	293	323	1.4	1.4	1.4	11.4	10.2
Professional services	592	710	883	3.1	3.3	3.7	19.9	24.4
Total operating expenses	18,945	21,238	23,893	100.0	100.0	100.0	12.1	12.5

^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.

SOURCE: Reports to the Supervisors of the Banks.

related expenses²¹ (27.1 percent). The difference between the high variance of other salary expenses and the lower variance of direct salary expenses in the last decade led us to examine the trends of change in each of these categories in relation to the business cycle.²² We found a strong positive correlation between direct salary expenses and the business cycle (approximately 77 percent), but a weaker positive correlation between the salary-related expenses and the business cycle (about 47 percent, Figure 2.7).

The high positive correlation between direct salary expenses and the business cycle is not surprising and is explained inter alia by the dependence of direct salaries on the various factors connected with the performance of a bank and the economy in general, such as profitability bonuses, automatic salary updates (derived from the labor agreements between the banks and the workers' representatives), and the Cost of Living Allowance paid by law.

On the other hand, the low correlation between other salary expenses and the business cycle, as well as their high variance, is explained by the multiplicity of expenditure items and the dependence of some of them²³ on various management decisions, which are not necessarily cyclical or connected with the performance of the economy in general.

The main factors which led to the rise in direct salaries in 2006 were: (a) One-off profitability bonuses, deriving from the banking groups' high profits; (b) large salary increases, stemming from the inflation rate, which was significantly below that on which wage agreements were based in the past; and (c) the rise in the share of high salaried workers in the bank's workforce. The growth of other salary expenses this year was due primarily to the increase in the benefits issued to employees²⁴ as well as to the rise in

Figure 2.7
Rate of Change of Direct and Other Salary Expenses of the Five Major Banking Groups Compared to Rate Of Change in GDP, 1995-2006



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

²¹ Such as share options issued to employees, severance pay, benefits, pensions, advanced study and vacation funds, national insurance, employers tax, payroll tax, topping up reserves against expenses arising from salary changes during the balance-sheet year, salaries and related expenses abroad, early retirement payments and other associated expenses.

²² We chose the rate of change of GDP as an index of the business cycle in Israel.

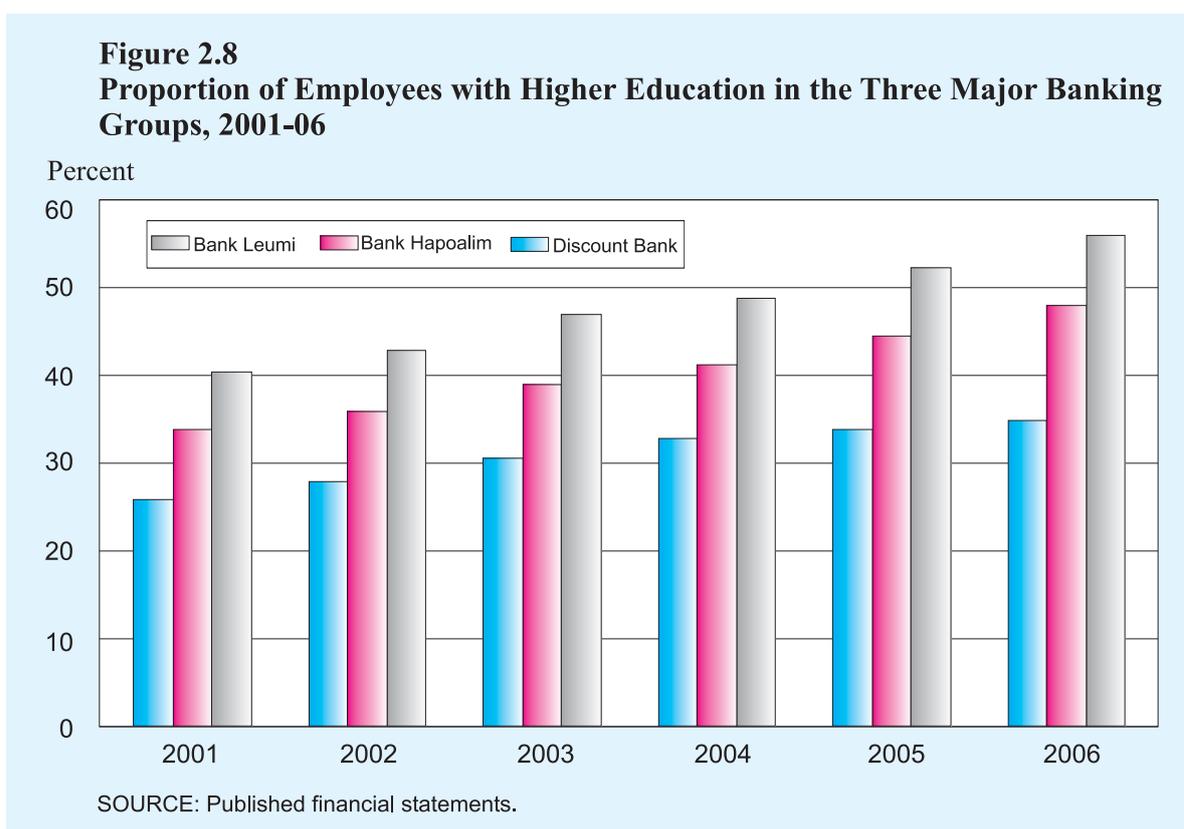
²³ Such as voluntary early retirement and share options granted to employees.

²⁴ Mostly in the Bank Leumi group (about NIS 437 million) because of the purchase of 2.85 percent of the bank's share capital by its employees in the wake of the agreements regarding the privatization of the bank and the purchase of share options.

early retirement incentives²⁵ as part of the restructuring processes which the banking groups have undergone, the increase in the pension provision item, payments into the severance pay and advanced study funds, and the topping up of reserves intended for severance pay.

Alongside the increase in total salary expenses in 2006, there was a 4.6 percent rise in the average number of employee posts²⁶ (1,834 posts) over 2005, as well as in wage costs per post, from NIS 217,000 a year in 2005 to NIS 230,000 in 2006 (up by 5.7 percent, Table 2.6). This increase in the average number of posts in the last two years followed three years in which it fell as a result of the implementation of the program intended to encourage early retirement and voluntary resignations, in the wake of the restructuring policy which the banking groups adopted.

As part of the restructuring policy, the banks continued to improve the quality of their workforce in 2006 by increasing the proportion of employees with university degrees and reducing the share of lower-grade employees, as is indicated by the change in the employee mix in the three largest banking groups (Figure 2.8)



²⁵ Mainly in the Bank Leumi and Mizrahi-Tefahot group, which grew by 64 and 470 percent respectively.

²⁶ The average number of posts, including those in foreign subsidiaries and consolidated subsidiaries, the translation of the cost of overtime work, and outside workforce budgets required in order to regulate the workforce and assimilate projects.

Table 2.6
Salaries and Related Expenses of the Five Major Banking Groups, 1998-2006 (at current prices)^a

	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	40,303	8,753	217	4,122	102	12,875	319
2006	42,137	9,671	230	5,240	124	14,911	354
Change from Previous Year (percent)							
1999	0.0	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	5.6	10.8	5.0	12.0	6.1	11.2	5.3
2006	4.6	10.5	5.7	27.1	21.6	15.8	10.8

^a Up until 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.

This qualitative change in the employee mix was reflected in the shift in their numerical distribution by salary level in 2006—an increase in the share of employees with high salary levels²⁷ (from 31.8 percent in 2005 to about 36.6 percent in 2006) and a decline in the share of employees earning medium- and low-level salaries²⁸ (from 43.6 percent in 2005 to 37.9 percent in 2006, Figure 2.9).

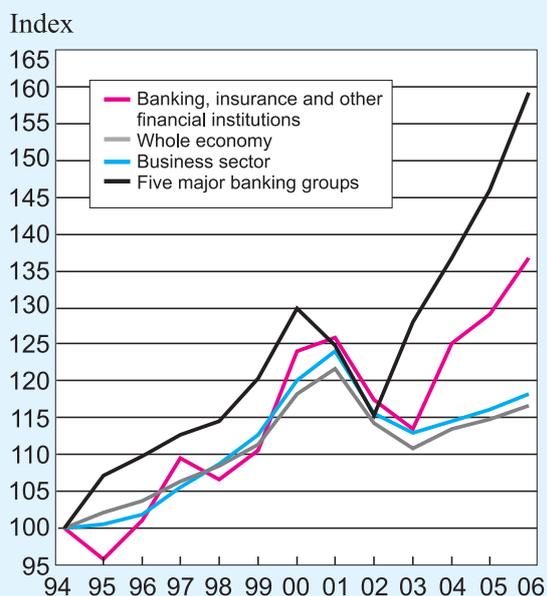
²⁷ A high salary level is defined here as direct annual salary costs per post of NIS 231,000 or more.

²⁸ A medium to low salary level is defined here as direct annual salary costs per post of between NIS 111,000 and NIS 231,000.

The high salary costs in the five major banking groups are exceptional in comparison to other financial segments as well as to the business sector and the economy as a whole. While the index of real salary per employee post in the economy as a whole rose by approximately 1.6 percent in 2006, in the financial sector (including banking) it went up by 5.9 percent, and in the five major banking groups by a steep 8.9 percent (Figure 2.10).

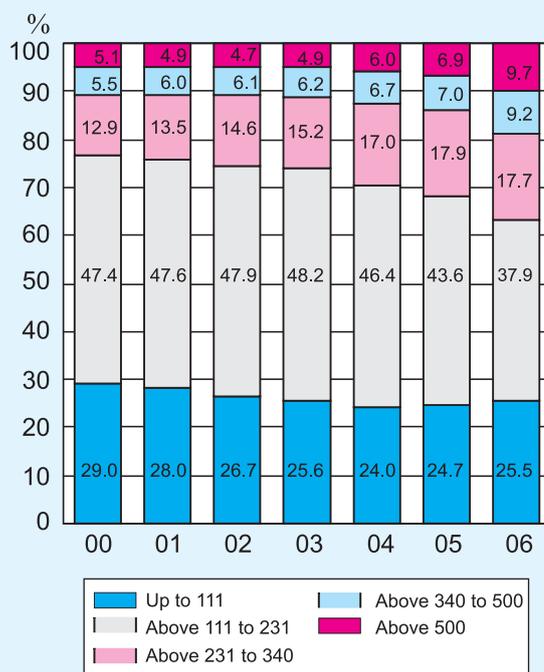
In an attempt to examine salary expenses in Israel's banking system from an international perspective, we calculated the share of salary expenses in total value added,²⁹ which is used in the literature as an index of the system's

Figure 2.10
Index of Real Wage per Employee Post in Banking, Insurance and Other Financial Institutions vis-à-vis the Business Sector and the Whole Economy, 1994-2006 (1994=100)



SOURCE: Based on Central Bureau of Statistics data.

Figure 2.9
Distribution of Employees by Salary in the Commercial Banks, 2000-06
 (annual salary, NIS thousand)



SOURCE: Reports to the Supervisor of Banks.

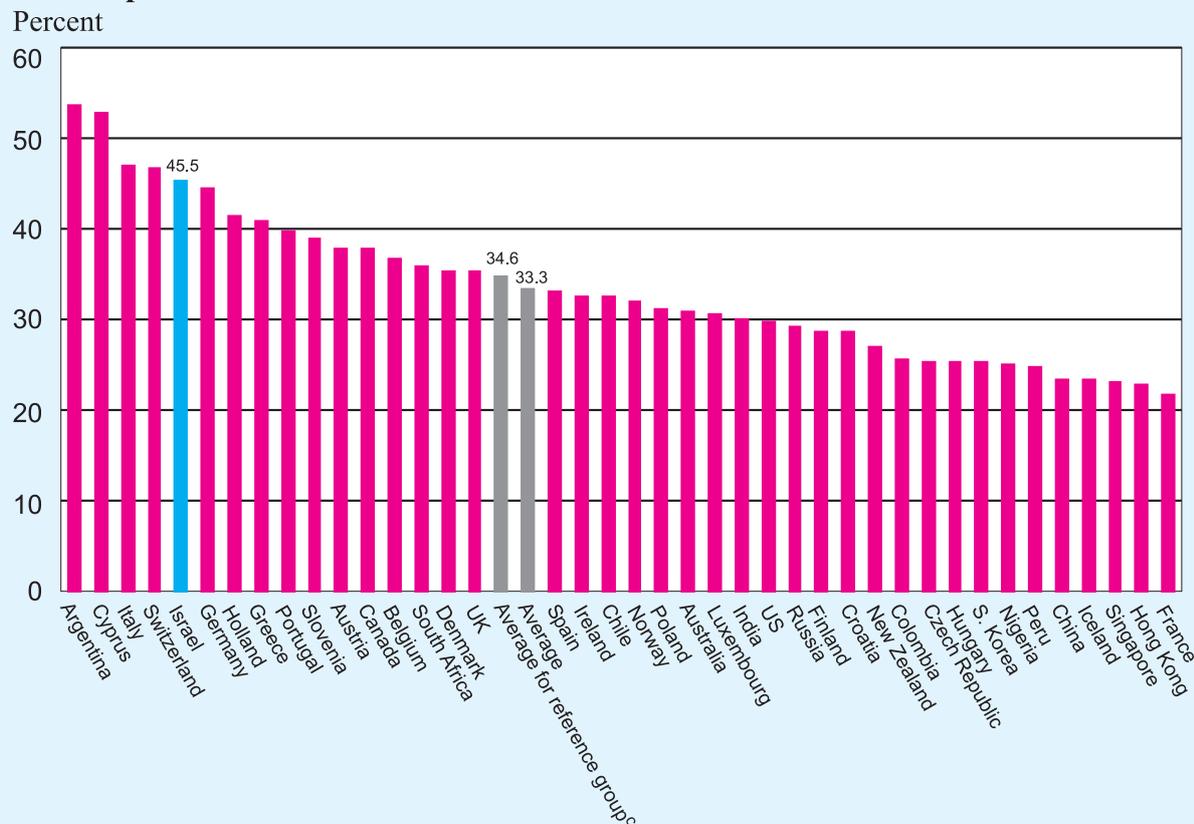
or a bank's output. Our analysis shows that while the share of the banking system's value added in GDP is similar in Israel to that in the rest of the world (Figure 1.6, Chapter 1), the share of salary costs in total value added in Israel (about 53 percent in 2006 and 45.5 percent in 2005) is significantly above the average in the rest of the world (about 33.3 percent), and in Israel's peer group (an average of approximately 34.6 percent, Figure 2.11).

With regard to the development of expenses per post vis-à-vis output per post,³⁰ in each of the five major banking groups this ratio was higher in 2006 than the average ratio in the years 2000–05.

²⁹ Value added includes before-tax net income plus direct and related salary expenses and depreciation of buildings and equipment.

³⁰ Output per post is calculated as the banking group's total balance-sheet assets plus the value of the off-balance-sheet assets divided by the average number of posts.

Figure 2.11
Salary expenses as a Proportion of Value Added^a in 2005, 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 reference group here, consists of 12 countries with similar features in terms of GDP, GDP per capita and size of banking sector: Belgium, Cyprus, the Czech Republic, Finland, Greece, Ireland, New Zealand, Norway, Portugal, Slovenia, South Africa, and South Korea.

SOURCE: Based on data from Bankscope.

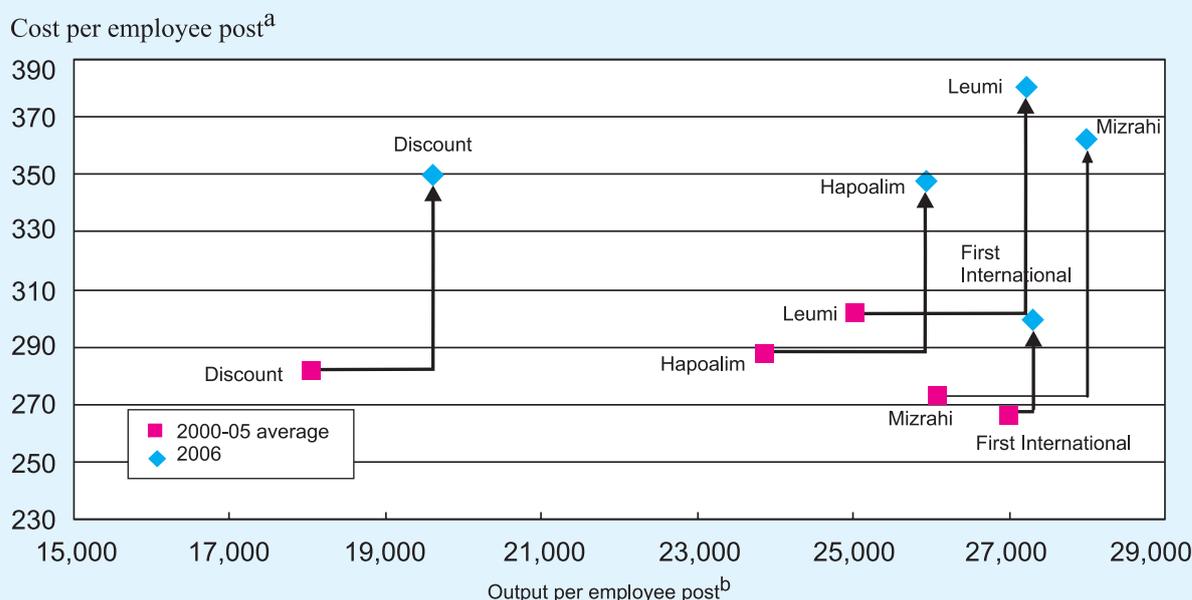
e. Operating indices and operating efficiency

The banks' operating efficiency, which is derived from their performance and the level of their operating expenses and non-interest income, is measured here by means of four different indices customarily used in the literature: the operating coverage ratio,³¹ the efficiency ratio,³² the returns to scale, as expressed in the development of operating

³¹ Calculated as the ratio between total non-interest and other income and total operating and other expenses.

³² Calculated as the ratio between total non-interest and other income plus net interest income and total operating and other expenses.

Figure 2.12
Cost^a and Output^b per Employee Post in the Five Major Banking Groups, 2006 compared to the 2000-2005 average
 (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.

expenses per output unit³³ (average expenses) and the bank's X-efficiency.³⁴ An examination of the first two efficiency ratios yields the same result—a decline in the operating efficiency of the five major banking groups: the average coverage ratio dipped from 0.61 in 2005 to 0.58 this year, and the efficiency ratio fell markedly—from 1.62 in 2005 to 1.51 in 2006.

In order to examine the operating efficiency of the banks while allowing for differences in their size, we calculated the operating expenses per unit of output in three reference groups: large, medium, and small banks.³⁵ The analysis yielded two main findings: (1) economies of scale have existed in Israel's banking system since the mid-1990s; (2) the existence of economies of scale has remained stable over time, and 2006 was characterized by a slight rise in average expenses in the group of large banks in comparison with the 1995–2005 average (Table 2.8, Figure 2.13).

³³ Calculated as total operating and other expenses relative to output, where output is calculated as total balance-sheet assets plus the value of off-balance-sheet items.

³⁴ The effectiveness with which a given set of inputs are used to produce outputs, calculated as minimum average expenses divided by maximum average expenses in each size group (ACmin/ACmax). Hence, one less this ratio, in each size group, reflects the maximum potential savings in that group's production costs.

³⁵ Large banks defined here as those with output greater than NIS 150 billion; medium banks—whose output is between NIS 40 billion and NIS 150 billion; small banks—banks whose output is less than NIS 40 billion. For further details about the banks included in each group, see Table 2.8.

Table 2.7
Coverage and Efficiency Ratios of the Five Major Banking Groups, 2005 and 2006

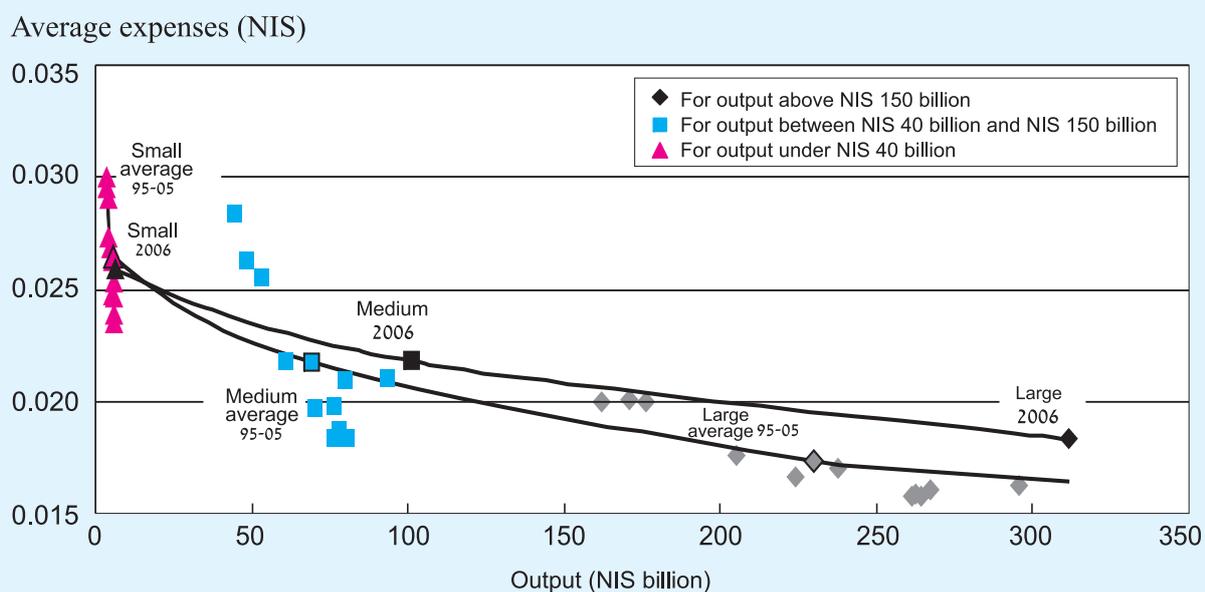
Bank	2005		2006	
	Coverage ratio ^a	Efficiency ratio ^b	Coverage ratio ^a	Efficiency ratio ^b
Hapoalim	0.65	1.74	0.68	1.70
Leumi	0.61	1.70	0.53	1.49
Discount	0.51	1.29	0.47	1.22
Mizrahi-Tefahot	0.61	1.64	0.57	1.51
First International	0.65	1.71	0.61	1.59
Average of the five major banks	0.61	1.62	0.58	1.51

^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 which is known as the efficiency ratio. 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.

Figure 2.13
Operating Expenses per Unit of Output^a in the Banking System^b, 1995-2006



^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, and Trade Bank (up to 2001).

SOURCE: Based on published financial statements.

The last index we used to analyze operating efficiency was the X-efficiency index, which examines the ability of bank managements to reduce expenditure on factor inputs without affecting output. Our analysis shows that there is considerable potential for improvement in the group of small banks and little such potential in the group of large banks, as is reflected in the maximum potential saving (Table 2.8). The large gaps within the group of small banks derive primarily from the considerable difference between its constituent banks—small independent banks and banks which belong to banking groups—vis-à-vis small differences in the small, more homogeneous group of large banks.

Table 2.8
Ratio of Overheads to Unit of Output^a, and X-Efficiency by Banking Group (by Size), 1995-2006

	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		
1995-2005	0.027	0.022	0.017
2006	0.026	0.022	0.018
	Maximum X-Efficiency ^e (maximum saving)		
1995-2005	0.30 (0.70)	0.67 (0.33)	0.90 (0.10)
2006	0.33 (0.67)	0.73 (0.27)	0.90 (0.10)

^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 It should be taken into account that this group of banks underwent structural changes during the period, such as mergers and acquisitions or closures of certain banks, which influenced the average over time. The banks included in this group are Union, Otsar Hahayal, Yahav, Arab Israel, Massad, Poalei Agudat Israel and Continental.

^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 (by size) of banks (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.

3. ANALYSIS OF PERFORMANCE BY ACTIVITY SEGMENT

In the early 2000s a process of change began in the organizational structure of some of the major banking groups. Within that framework banking activity segments were allocated to independent profit centers which are used by bank managements in analyzing financial

results and making decisions. In accordance with the Bank of Israel's requirements,³⁶ an activity segment must meet three conditions: it must engage in financial activities from which it is possible to gain income and bear expenses; the results of its activities must be examined regularly by the management and board of directors in order to make decisions regarding the allocation of resources to the segment and assess its performance; it must have separate financial information. In July 2005 the Supervisor of Banks clearly defined for which activity segments reporting is required—the business segment, the commercial segment, small businesses, private banking, households, and other financial management. The division into activity segments is based either on products and services or on customers.

The activity segments are defined by each banking group in accordance with the nature, extent, and characteristics of its customers' activity; this creates differences in definitions, which makes the analysis more difficult. Nevertheless, the analysis below focuses on the five main activity segments for which reporting is required: the business segment, the commercial segment, the small businesses segment, the private banking segment, and the household segment.

Economic growth and the expansion of business activity were clearly evident in 2006 in the improvement in the performance of the business segment and its financial results. As regards loan-loss provision, which serves as an index of credit quality and customers' repayment ability in these segments, the business segment was the only one in which annual loan-loss provision declined; it rose in all the others.

The sharp decline in loan-loss provision in the business segment stemmed from two factors in 2006: a rise in global demand for the segment's products, leading to an increase in business activity and product, as well as the slight improvement in the construction industry, after several years of decline and stagnation.³⁷ In view of the continued positive trend in the principal industries in which most of the customers of the commercial and small business segments operate, we would have expected a decline in total loan-loss provision regarding activity in these segments too; this rose, however, mainly because of the increase in the extent of activity, expressed in the rise in the average balance of assets. In spite of the increase in total loan-loss provision in these segments, the ratio between it and the average asset balance remained virtually unchanged in 2006 (0.6 percent and 1.1 percent respectively). The increase in loan-loss provision in the household segment (including housing loans), stemmed primarily from the implementation of the clarification circular appended to Directive 314 of the Proper Conduct of Banking Business Regulations³⁸ regarding the calculation of loan-loss provision regarding housing credit; the circular was sent to the banks by

³⁶ The directives on the public reports—Annual financial statements, section 79 (Principal Activity Segments).

³⁷ The rise in the product of the construction industry reflects an increase in the extent of renovations, due in part to work arising from the Second Lebanon War. The industry's other spheres of activity, including the construction of new housing units, did not grow.

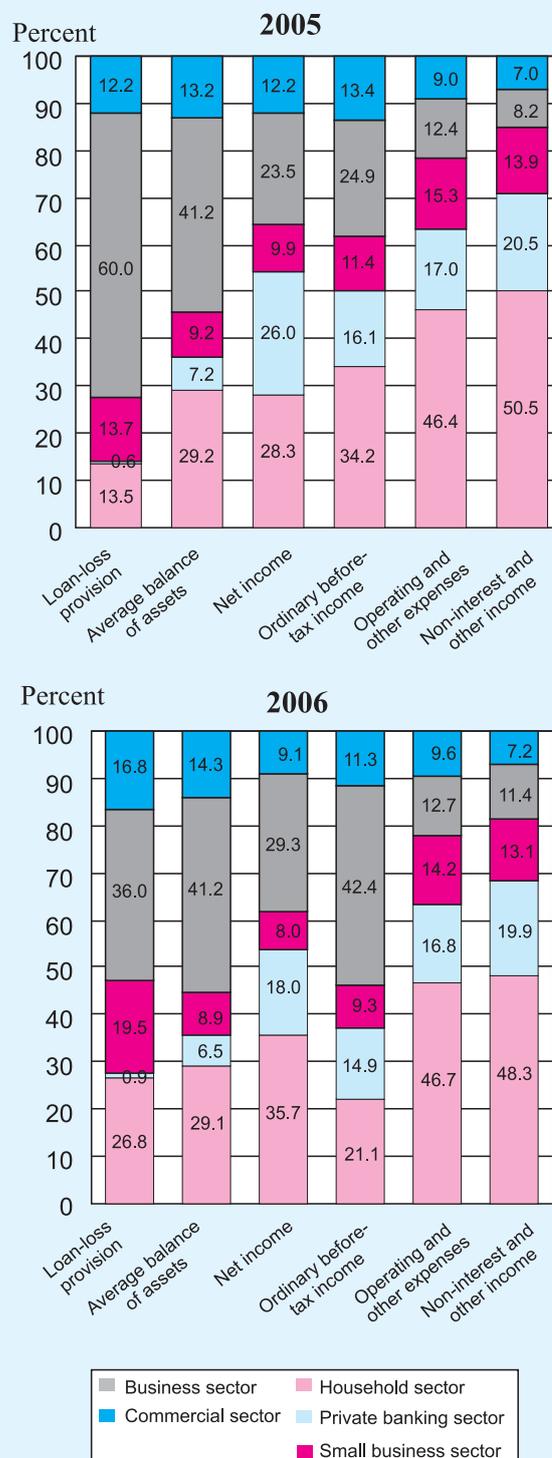
³⁸ Proper Conduct of Banking Business [7] (5/98), "Dealing with Problem Loans."

the Supervisor of Banks in January 2006 (for further details, see Chapter 3). These developments led to a change in the distribution of loan-loss provision this year, the most prominent shift being the decline in the share of provision made for the business sector, which constituted 36 percent of total loan-loss provision, compared with 60 percent in 2005, and the rise in the share of provision made for customers in the household segment, which accounted for 27 percent of total provision in 2006, compared with 14 percent in 2005 (Figure 2.14)

The banks' different levels of exposure to the competitive threat in the various customer segments, and their ability to utilize market power in this regard, were expressed in the distribution of net interest and non-interest income in 2006 (Figure 2.14). A comparison of activity segments shows that the contribution of the household segment to operating income was considerable (about 48 percent), while that of the business sector was low (about 11 percent). This difference apparently stems largely from the ability of business sector customers to borrow from non-banking entities—an option which is not adequately available to households. The gap between the low level of competition in the household segment and the relatively high level in the business segment is used by the banks to increase further the large contribution of the household segment to their profits. The various reforms implemented in the last few years³⁹ in Israel's capital market

³⁹ The easing of restrictions on investment by insurance companies (2003); the pension reform (2003); the legislation intended to reduce conflicts of interest (2005); the underwriting reform (2005); the legislation to reform the government bond market (2005). For further details, see Chapter 4.

Figure 2.14
Contribution of Different Areas of Activity^a to Selected Items in the Financial Statements of the Five Major Banking Groups



^a Not including financial management sector, others and adjustments.
 SOURCE: Published financial statements.

supported the development of competition for business credit, stimulating the creation of readily available non-banking credit for business segment customers. The implementation of Directive 432 of the Proper Conduct of Banking Business (July 2005) regarding the transfer of activity and the closing of customer accounts, as well as other measures introduced by the Bank of Israel in the sphere of fees, were intended to facilitate the interbank mobility of household segment customers, thereby contributing to greater competition in this segment too.

An examination of operating and related expenses shows that there is a marked difference between the high operating costs in the retail segments (households, private banking, and small businesses) and the relative low operating costs in the wholesale segments (business and commercial), as reflected in the share of each segment in total operating and other expenses. The high operating cost of the household segment, which accounts for 47 percent of total operating and other expenses, is explained by the need to maintain and operate an extensive array of branches, including wide-ranging human and physical resources, compared with the relatively low cost of operating the business segment (approximately 13 percent of total operating and other expenses), due to the limited number of business centers.

Although net income in each activity segment was substantially higher than in 2005, it is biased and does not reflect the true contribution of the customers of the various segments to the banking groups' profits. The high growth rates of net income in each activity segment derived from the inclusion of one-off income from the sale of the ownership and management rights in mutual and provident funds, and the fact that this was ascribed to each segment in accordance with its share in total income, as a result of the implementation of the Bachar reform. Adjusting for this non-recurring income, and examining ordinary before-tax profit, shows that only the business segment demonstrated a handsome 89 percent increase in net income, while net income in the private banking segment rose by only 2 percent. Net income declined in the remaining segments, primarily as a result of the increase in loan-loss provision as well as in the differential between the growth rates of non-interest and other income on the one hand and operating expenses on the other. Ordinary before-tax profit dipped in 2006 despite the rise in net interest income in all activity segments which was due mainly to the expansion of activity in the area of banking and finance.

The various activity segments are distinguished from one another by their operating efficiency, as is indicated by the calculation of the coverage ratio and the efficiency ratio. In 2006 there was a deterioration in the coverage ratio in all the activity segments except for the business segment as a result of the sharp rise in operating expenses, alongside a moderate increase in non-interest income (in the small businesses segment there was even a negative growth rate). The efficiency ratio also deteriorated in 2006, and this applied to all the activity segments. The decline in the ratio this year despite the increase in both net interest and non-interest income was due to the steeper increase in operating expenses and reflects the decline in the banks' efficiency in utilizing the resources available to them in each activity segment. In spite of these changes, the

retail activity segments, whose operating costs and non-interest income are high, were also characterized by a lower efficiency ratio this year than the other activity segments (Table 2.9).

In order to examine the performance of the activity segments in relation to the net income and risks involved in the activity of each one of them, we calculated the ratio between net income and loan-loss provision. This ratio constitutes a proxy for the Risk Adjusted Return on Capital measure (RAROC). An examination of the results shows that the performance of the retail segment (private banking, households, and small businesses), with a ratio of about 8.9, was better than that of the wholesale segment (business and commercial segments, Table 2.9), with a ratio of about 1.9.⁴⁰

4. ANALYSIS OF THE BANKS' PERFORMANCE BY MARKET TO BOOK RATIO

The market value to book value (MV/BV) ratio⁴¹ reflects the premium the market is prepared to pay for the book value of the bank's shares and constitutes an efficient index of the market's assessment of the bank's future performance. When the ratio is higher than 1, the higher the ratio, the greater the bank's future potential, as perceived by investors; the opposite applies if the ratio is lower than 1, as investors regard the book value as an over-estimation of the value of the bank's share capital, and hence the future potential it reflects is low.

The average MV/BV ratio of the five major commercial banks dipped from 1.5 at the end of 2005 to 1.2 in 2006 (Figure 2.15). This decline is the result of the considerable improvement in the book value of the banks' share capital, mainly due to the one-off capital gains resulting from the Bachar reform vis-à-vis the more moderate improvement in their market value.

In our view, the decline in the MV/BV ratio in 2006 reflects the market's doubts regarding the large banks' ability to repeat their impressive performance of the last few years. The decline in the ratio this year in all the major banks (Figure 2.15), despite the differences in their characteristics and financial results, indicates that investors expect the banks' performance to deteriorate as a result of their need to contend with common future challenges, ranging from the expected fall in non-interest income as a result of the implementation of the Bachar reform to attempts to introduce legislation aimed at restricting their ability to increase fees of commissions.

⁴⁰ These values were obtained after weighting the return per risk unit by the average balance of the assets in each activity segment.

⁴¹ Defined as $(MV/BV)_i$, where MV_i is the market value of shares and options of bank i in period t . The market value of a company is defined as the market value of its shares and options registered for trading (excluding convertible bonds). The market value includes shares not registered for trading, which are included at the same price as the shares that are registered for trading. BV_i is the balance sheet value of the equity, including the paid-up share capital, reserves and surpluses of bank i in period t .

Table 2.9

Performance Indicators in the Five Major Banking Groups,^a by Sector, 2005–06

	2005					2006				
	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	29	7	9	41	13	29	6	9	41	14
Net interest income before loan-loss provision	32	11	14	30	13	33	12	14	29	13
Loan-loss provision	14	1	14	60	12	27	1	20	36	17
Non-interest and other income	50	20	14	8	7	48	20	13	11	7
Operating expenses	46	17	15	12	9	47	17	14	13	10
Ordinary before-tax profit	34	16	11	25	13	22	15	9	42	11
Net profit	28	26	10	24	12	36	18	8	29	9
	Ratios (%)									
Loan-loss provision to total assets	0.3	0.1	1.0	1.0	0.6	0.5	0.1	1.1	0.4	0.6
Profit from financial activity to total assets	3.7	5.2	5.2	2.4	3.2	4.0	6.5	5.4	2.5	3.1
Total income ^e to total assets	7.3	11.0	8.3	2.8	4.3	7.4	12.8	8.4	3.0	4.2
Operating expenses to total assets	5.4	7.9	5.6	1.0	2.3	5.9	9.5	5.8	1.1	2.5
Return on equity	0.8	3.1	0.9	0.5	0.8	1.5	3.4	1.1	0.9	0.8
	Ratios									
Coverage ratio ^d	0.66	0.74	0.56	0.40	0.47	0.58	0.66	0.51	0.50	0.42
Efficiency ratio ^e	1.36	1.39	1.48	2.80	1.88	1.26	1.35	1.44	2.67	1.70
Return per unit of risk ^f	2.59	52.22	0.90	0.48	1.24	3.22	48.46	0.99	1.97	1.31

^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.

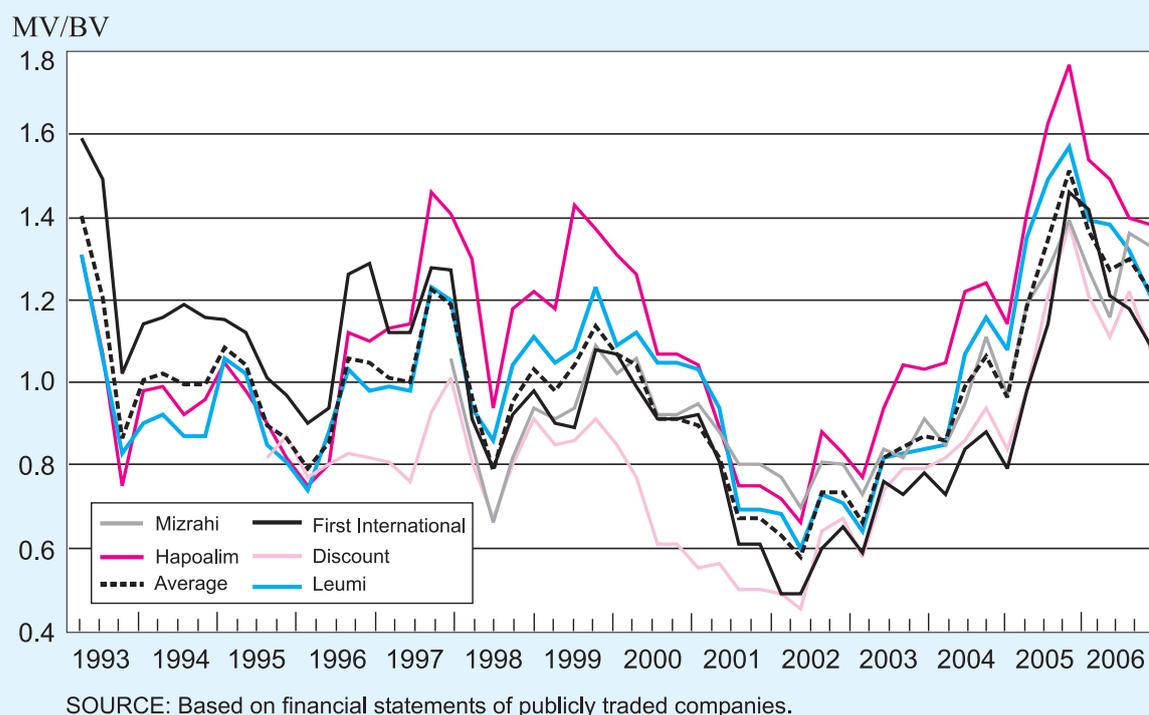
^e Calculated as the ratio between total non-interest and other income and profit from financial activity to total operating and other expenses.

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

SOURCE: Based on published financial statements.

The decline in the MV/BV ratio in 2006 was the first drop in four years. Nonetheless, it is still higher than 1 and above the average for this period (1.08). The decline in the ratio is particularly prominent this year in the context of the rise in the ROE of the five major commercial banks. This increase contradicts the results of empirical studies in the literature,⁴² which show a significant and positive correlation between the MV/BV

Figure 2.15
Ratio of Market Value to Book Value (MV/BV) of the Five Major Banks,
March 1993 to December 2006



ratio and ROE (and a negative correlation with bank risk).⁴³ In our view, the decline in the ratio expresses the fact that investors have taken into account the one-off effects of the Bachar reform on the banks' profits and profitability. Indeed, when we adjust for these profits, the contradiction is resolved, and the positive correlation between the two variables persists (Figure 2.16).

⁴² See D. Ruthenberg and S. Pearl, "Market to Book Ratio of Bank Shares in Israel," Bank of Israel, Banking Supervision Department, Banking Research Unit, Discussion Papers, second version, June 2004.

⁴³ This correlation is based on the MV/BV equation formulated as follows: $MV/BV = \frac{ROE - g}{k - g}$

where:

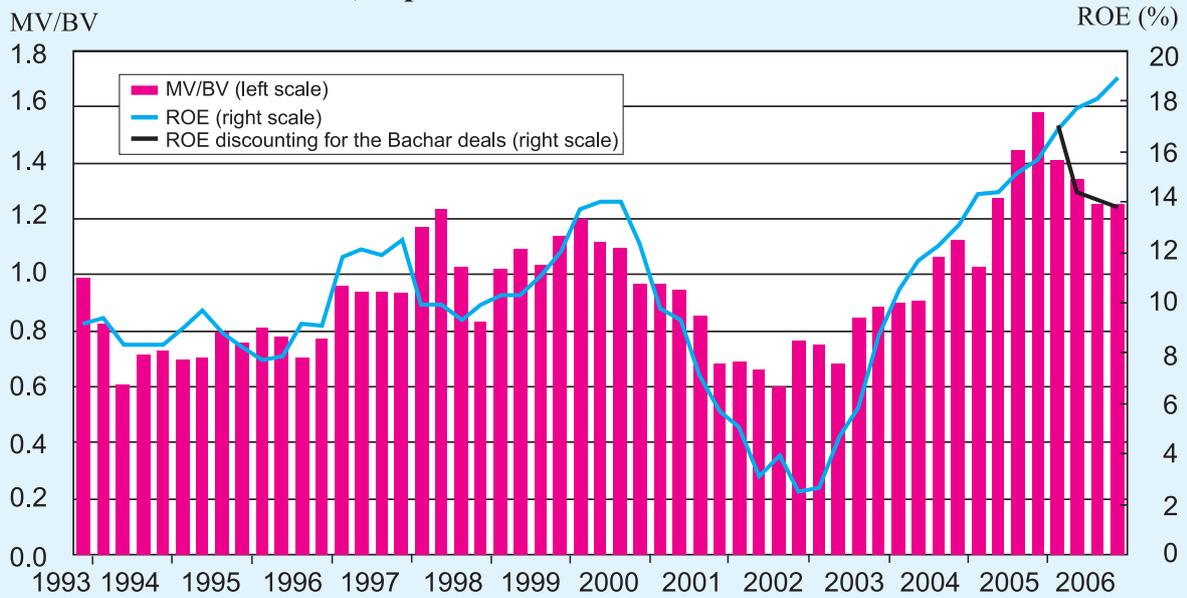
ROE = return on equity

g = the bank's growth rate

k = the bank's risk

For further elucidation, see the article by Ruthenberg and Perl referred to in footnote 42 above.

Figure 2.16
Return on Equity (ROE)^a and the MV/BV Ratio of the Five Major Commercial Banks, September 1993 to December 2006



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

SOURCE: Based on the financial statements of companies listed on the Stock Exchange.