

The banks in Israel are preparing for the adoption of the new capital targets and the implementation of the Basel III guidelines. These preparations are strengthening the banks' core Tier 1 capital and contributing to the resilience and stability of the banking system as a whole. The strengthening of the core Tier 1 capital in the Israeli banking system and in banking systems around the world is reflected in the improvement in the leverage ratio that has taken place in recent years⁴⁷ (Figure 1.20).

Box 1.1: A macroeconomic stress test of the banking system, based on a uniform scenario

The Banking Supervision Department conducts stress tests of the banking system, on both regular and ad-hoc bases, for specific as well as systemic needs. Stress testing is an important tool used by the Banking Supervision Department to evaluate the stability of the banking corporations and to identify both specific and systemic risks. Stress tests are also used to assist in evaluating capital adequacy.

A macroeconomic stress test based on a uniform scenario was carried out by the Banking Supervision Department for the first time in 2012. Each of the five major banking groups conducted the test in accordance with detailed guidelines sent to it, and was required to report to the Banking Supervision Department on the methodologies used to conduct the tests, and on their results. At the same time, the Banking Supervision Department conducted the test on each of the banking groups using a consistent and uniform methodology. This process, through which the regulatory authority and the banks conduct a macroeconomic stress test in parallel, is among the recommendations of the Basel Committee, and the international standard is to uphold it. In some countries, these tests are included in the regulatory authority's SREP processes and the banks' ICAAP processes, and they assist in the evaluation of capital adequacy.¹

Throughout the test there was professional collaboration between the Banking Supervision Department and the banks, enabling the Department to evaluate the banks' ability to conduct a macroeconomic stress test—including basing the test on optimal databases, constructing models, and understanding the focal points of risk and the effects of the main macro variables on a bank's profitability and stability.

The test was based on three scenarios—a base scenario and two stress scenarios:

1. The base scenario: This scenario is based on the quarterly projections of the Bank of Israel's Research Department and of other entities around the world regarding expected global developments.

2. Scenario 1: A moderate local security scenario: This scenario reflects the possible ramifications of a moderate security incident in Israel. The scenario is characterized by an increase in the State of Israel's risk premium and in a capital outflow that leads to a significant depreciation

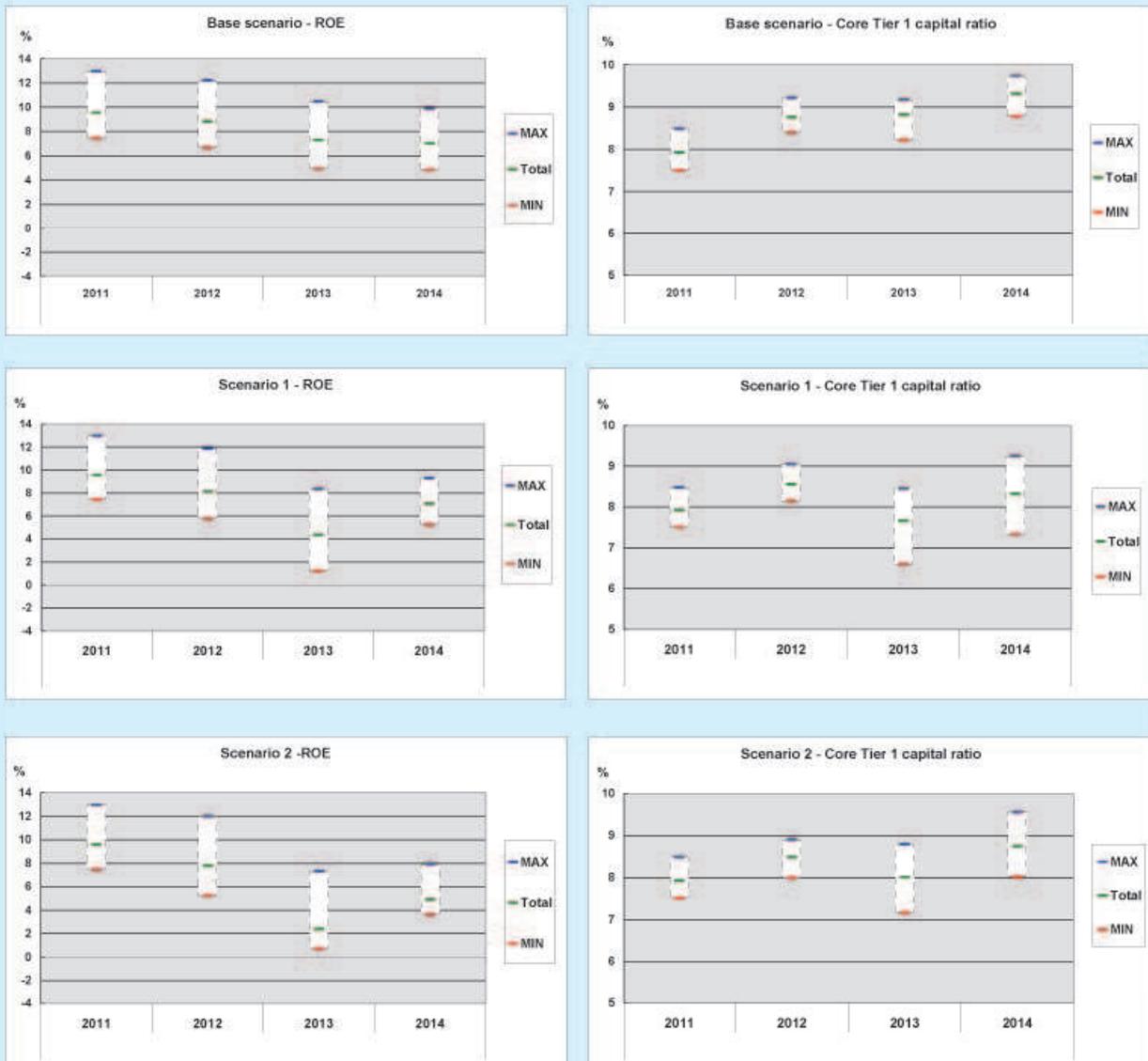
¹ It should be emphasized that this test does not replace the stress tests currently carried out by the banks as part of the ICAAP, but comes in addition to them.

⁴⁷ The ratio of equity to total assets.

of the shekel. This in turn leads to high inflation and an increase in the Bank of Israel interest rate. But the negative impact on GDP and the increase in unemployment are moderate.

3. Scenario 2: Global stress scenario: The assumption in this scenario is that there is a deterioration in the macro variables due to a severe global crisis. The crisis is of a similar dimension to the 2008 crisis, but has a more serious effect on the economic situation in Israel. The deterioration is reflected in a contraction of GDP for four quarters (the contraction in 2008 lasted for just two quarters) and in low growth rates thereafter.

Figure 1
Results of macroeconomic balance sheet stress test



SOURCE: Based on reports to the Banking Supervision Department.

These scenarios were constructed by the Bank of Israel's Research Department. For each one, the Research Department formulated forecasts for the macroeconomic variables. These forecasts are partially based on the Dynamic Stochastic General Equilibrium (DSGE) model, which is used in the formulation of the Bank of Israel's monetary policy decisions. The starting point was based on data from the financial reports for December 2011, and the forecast covers the period to the end of 2014.

The stress test was carried out using a top-down approach², and was based on Banking Supervision Department data and on the methodologies developed in the Department. These include satellite models connecting the macroeconomic variables and the credit risk and profitability variables of the banks; a methodology to determine dividend distribution policy; and a methodology to determine the change in value of government bonds and bonds of foreign financial institutions.

The results indicate that the global scenario and the moderate local scenario have significant effects on the banking system, but these effects do not constitute a threat to the system's stability. The banking system will still show a positive return on equity, although profitability will decline significantly—to just 2 percent in 2013 under the global scenario. Under that scenario, the core Tier 1 capital ratio of the banking system will decline to 8.0 percent in 2013. For the purpose of stress tests, the generally accepted minimum core Tier 1 capital ratio worldwide is 5.0 percent (Figure 1).

The macroeconomic models do not fully capture all of the potential risk factors, such as the effect of feedback and contagion on markets and institutions, the risk of borrower group concentration, the risk of industry concentration, leveraged credit, and more. The Banking Supervision Department therefore integrated other methodologies that capture additional risk factors, which significantly increased the negative impact on the banking groups resulting in an overall loss. However, in all banking groups, the core Tier 1 capital ratio remained above 6 percent.

Among the factors that contributed to the banking system's resilience in the stress scenarios were the strong data at the starting point of the scenarios, including capital levels and profitability.

² When the stress test is carried out top-down, the regulatory authority defines the stress scenario, estimates its effect on the individual bank's portfolio or on the aggregate portfolio of all the banks, and analyzes its effect on the banking system.

11. FINANCIAL RESULTS

a. Profits and profitability of the banking groups

The net profit of the five major banking groups totaled about NIS 6 billion in 2012, a decline of 15 percent compared with 2011. At the same time, profit before taxes grew by 6 percent (Table 1.16).

The net profit of the five major banking groups reflects a return on equity of 7.9 percent, which is lower than in 2011 (10.2 percent) and the long-term average (9.9 percent) (Figure 1.21). This low return was affected mainly by the sharp decline in the return on equity for the Bank Leumi group, to only 3.8 percent. The return was also affected by the increase in capital as part of the banking groups' preparations to meet the new capital targets.