

Chapter 2

The Financial Results of the Five Major Banking Groups

As part of the world banking system and the global economy, Israel's banking system is affected by developments and trends that are typical of both. After 2008, in which the country's banking groups had to cope with the implications of the world financial crisis on their assets and financial results, the situation in both respects improved perceptibly in 2009: the domestic banking system posted improved profit and profitability, the latter parameter climbing to 8.8 percent as against 0.35 percent in 2008.

The banking groups' financial results in 2009, while good in themselves, were largely affected by non-recurrent developments that impacted the various components of their income. Unlike the development of financial results in the pre-crisis years—when the banking groups posted solid improvements that were backed by the expansion of banking activity and favorable macroeconomic conditions—most of the change in 2009 originated in “profit corrections” derived largely from developments in domestic and global capital markets.

Various factors affected the groups' profits and profitability in 2009; most were exogenous to the system and acted mainly on interest and operating income. Notable among them were the expansionary monetary policy (reflected in a low and stable interest environment), which negatively affected profit from financial activities in 2009, and positive developments in the domestic and global capital markets, which positively affected profit from financial activities and operating income—mostly, as stated, via non-recurrent “corrections” of profit lines that had been adversely affected by the previous year's crisis, including profit from the sale and revaluation of bonds, realization of shares, and management of workers' severance-pay funds

The mixed trend in the domestic economy, coupled with the economic slowdown in the second half of 2008, was reflected this year in the development of loan-loss provisions. These were typified in the review year by a mixed trend and strong variance among the banking groups, mirroring the effect of these developments on the assessment of implicit risk in the groups' credit portfolios. Notwithstanding the strong variance, however, the level of provisions approximated that in 2008.

Among the various activity segments, the financial-management segment (which includes investment portfolios) improved considerably in what appears to be to a correction of the retreat of this area of activity in 2008. Earnings in this activity segment were affected in 2009 by developments in the domestic

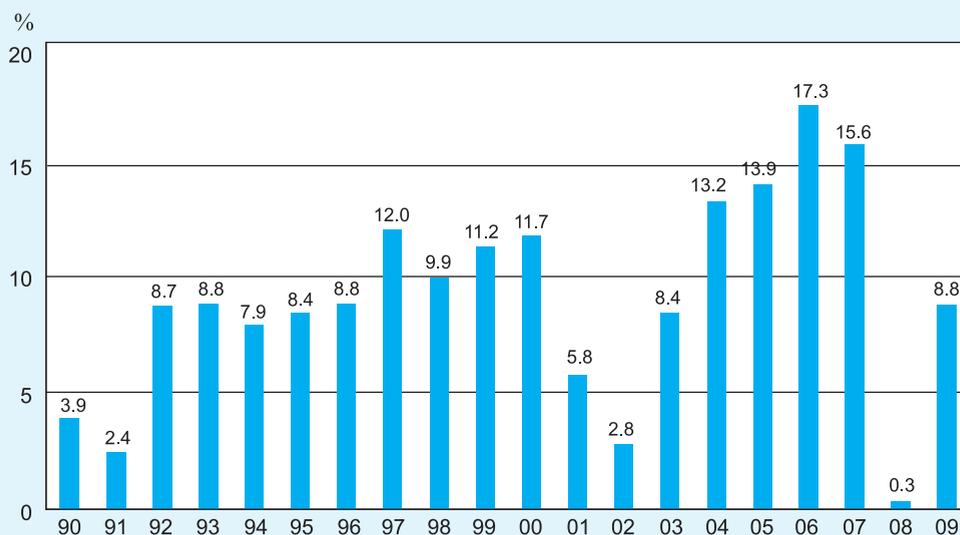
and global capital markets, the banking groups' conservative policies (in which the groups chose to sell off much of their risky holdings), and strict supervision. The business-related segments also contributed more to profit in the review year whereas the retail segments contributed less, even though activity in these segments expanded.

The improvement in the groups' business results may also be seen in the auspicious behavior of the average MV/BV ratios of the five large commercial banks, which rose in the review year and crossed the "1" threshold.

1. PROFITS AND PROFITABILITY OF THE BANKING GROUPS

The five large banking groups' total net profit increased steeply during 2009 and ended at NIS 5.4 billion as against NIS 205 million in 2008 (Table 2.1). Return on equity also improved and reached a rate of 8.8 percent in 2009 as against 0.35 percent in 2008 (Figure 2.1). Despite the steep increase, however, ROE failed to meet the previous decade average (10 percent) and resembled that of 2003 (8.4 percent)—the year in which the domestic economy began to climb out of the 2001–2002 recession.

Figure 2.1
Return on Equity After-Tax (ROE) of the Five Major Banking Groups, 1990-2009



SOURCE: Based on published financial reports.

The rapid transition from zero profit in late 2008 to strong profit a year later, although affected for better or worse by different factors, rested mainly on the strong foundations of the Israeli economy and the banking groups' activity, which yielded auspicious financial results. From the macroeconomic perspective, the mixed trend in activity took a turn for the better in real and financial domains from in the second quarter onward, reflecting the domestic economic recovery and the onset of the exit from the recession of late 2008 and early 2009. Unlike other developed economies, in which the recovery process began only in the third quarter of the year and originated mainly in government-initiated intervention measures, the Israeli economy began to climb out of its recession in the second quarter, made little use of government-initiated measures to stimulate activity, and rebounded largely through the use of monetary tools. These positive developments, mirrored in changes of trend in real indicators and capital-market indices, led to an upturn in demand for various kinds of banking services including retail borrowing (largely for housing), activity in securities, an improvement in gains on investments in securities, and an increase in operating income (chiefly income affected indirectly by the capital market). Two factors dampened the banking groups' profits: the high level of loan-loss provisions and the adverse and immediate effect of the low-interest environment on the total interest spread and the groups' profit from financial activities.

From the microeconomic perspective, two indicators of the banking groups' activity helped them weather the crisis in 2008 and contributed to their rapid rebound to profitability in 2009: (a) the provision of a wide range of financial services and products, a pattern of activity based on the idea of "universal banking"; this allowed the Israeli banks to widen the range of financial services to customers over the years. Apart from helping to spread the risks, this broad range of areas of activity contributed to the increase in profitability and, more important, helped to establish complementary channels of revenue and diversify sources of profit. Notable among the groups' services are activity in credit cards, capital markets (including activity in securities, distribution of financial products, and operating and trust services for institutional entities), and activity in mortgage lending. In 2008, for example, the groups' credit-card activity compensated for some of the falloff in profit from other areas of activity, whereas in 2009 stronger profits in banking and financial activity and in mortgage lending compensated for the decrease in profit from other revenue centers. (b) The groups' specialization in serving different kinds of customers—the distinction among five segments of banking activity,¹ which constitute autonomous profit centers—and in the management of their assets, their risks, and the analysis of their business results, has contributed over the years to the creation of a somewhat balanced and stable income flow. In 2008, for example, the decrease in profit of the business segments was offset by the positive contribution of the retail segments, whereas in 2009 the tables turned, the business segments partly offsetting the decrease in retail profit (especially from households)—which traced,

¹ The five segments of banking activity are the five "classic" ones: business, commercial, small-business, private banking, and households.

Table 2.1
Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 2007–09

	Leumi		% change from 2009 to 2008		Hapoalim		% change from 2009 to 2008		Discount		% change from 2009 to 2008	
	2007	2008	2009	2008	2007	2008	2009	2008	2007	2008	2009	2008
Net interest income before loan-loss provision	7,648	6,380	7,023	10.08	6,933	3,256	6,718	106.33	4,225	4,127	4,757	15.27
Loan-loss provision	407	2,145	1,517	-29.28	513	1,520	2,017	32.70	447	780	998	27.95
Net interest income after loan-loss provision	7,241	4,235	5,506	30.01	6,420	1,736	4,701	170.79	3,778	3,347	3,759	12.31
Total operating and other income	4,222	2,800	4,563	62.96	5,250	4,655	5,251	12.80	2,651	2,573	3,091	20.13
of which: Fee income	3,593	3,538	3,511	-0.76	4,880	4,654	4,633	-0.45	2,474	2,495	2,625	5.21
Total operating and other expenses	6,937	7,003	6,937	-0.94	7,940	8,147	7,647	-6.14	5,145	5,348	5,486	2.58
of which Salaries and related expenses	4,218	4,118	4,052	-1.60	4,769	4,762	4,062	-14.70	3,030	3,106	3,175	2.22
Ordinary before-tax income	4,526	32	3,132	-	3,730	-1,756	2,305	-	1,284	572	1,364	138.46
Tax provision	1,722	421	1,191	182.90	1,458	-397	996	-	566	169	507	200.00
Ordinary after-tax income	2,984	-158	1,986	-	2,328	-1,469	1,288	-	707	255	943	269.80
Extraordinary after-tax income	373	250	28	-88.80	351	574	28	-95.12	558	-10	-20	-
Net income	3,357	92	2,014	-	2,679	-895	1,316	-	1,265	245	923	276.73
Average equity ^a	19,293	20,000	19,745	-1.28	19,000	18,724	19,642	4.90	8,605	9,074	9,418	3.79
Ordinary ROE, net (%)	15.47	-0.79	10.06	-	12.25	-7.85	6.56	-	8.22	2.81	10.01	-
Total ROE (%)	17.40	0.46	10.20	-	14.10	-4.78	6.70	-	14.70	2.70	9.80	-
Total return on assets (ROA)(%)	1.14	0.03	0.64	-	0.92	-0.29	0.43	-	0.77	0.14	0.50	-

(cont'd)

Table 2.1 (Cont'd)
Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 2007–09

	(NIS million, at current prices)													
	Mizrahi-Tefahot			First International			Total			% change from 2009 to 2008				
	2007	2008	2009	2007	2008	2009	2007	2008	2009	2007	2008			
Net interest income before loan-loss provision	2,026	2,289	2,385	2,047	1,857	2,164	22,879	17,909	23,047	16.53	22,879	17,909	23,047	28.69
Loan-loss provision	228	395	375	181	238	268	1,776	5,078	5,175	12.61	1,776	5,078	5,175	1.91
Net interest income after loan-loss provision	1,798	1,894	2,010	1,866	1,619	1,896	21,103	12,831	17,872	17.11	21,103	12,831	17,872	39.29
Total operating and other income	1,190	1,229	1,464	1,425	1,357	1,762	14,738	12,614	16,131	29.85	14,738	12,614	16,131	27.88
of which Fee income	1,108	1,161	1,307	1,261	1,320	1,419	13,316	13,168	13,495	7.50	13,316	13,168	13,495	2.48
Total operating and other expenses	1,938	2,153	2,640	2,338	2,635	2,741	24,298	25,286	25,451	4.02	24,298	25,286	25,451	0.65
of which: Salaries and related expenses	1,169	1,273	1,630	1,330	1,461	1,468	14,516	14,720	14,387	0.48	14,516	14,720	14,387	-2.26
Ordinary before-tax income	1,050	970	834	953	341	917	11,543	159	8,552	168.91	11,543	159	8,552	-
Tax provision	368	356	286	369	213	371	4,483	762	3,351	74.18	4,483	762	3,351	339.76
Ordinary after-tax income	681	601	532	587	161	566	7,287	-610	5,315	-11.48	7,287	-610	5,315	-
Extraordinary after-tax income	227	1	-2	157	0	2	1,666	815	36	-	1,666	815	36	-95.58
Net income	908	602	530	744	161	568	8,953	205	5,351	-11.96	8,953	205	5,351	-
Average equity^a	5,279	5,788	6,235	5,096	5,552	5,856	57,273	59,138	60,896	7.72	57,273	59,138	60,896	2.97
Ordinary ROE, net (%)	12.90	10.38	8.53	11.52	2.90	9.67	12.7	-1.0	8.7	5.48	12.7	-1.0	8.7	8.7
Total ROE (%)	17.20	10.40	8.50	14.60	2.90	9.70	15.6	0.3	8.8	9.70	15.6	0.3	8.8	8.8
Total return on assets (ROA)(%)	0.98	0.57	0.45	0.83	0.17	0.56	1.10	0.03	0.69	0.56	1.10	0.03	0.69	0.69

^a Average equity is used to calculate ROE and it includes total equity minus the average balance of minority shareholders' rights plus/minus the average balance of unrealized loss/profit on the adjustment of tradable bonds to their fair value and loss/profit on bonds available for sale included in equity.
 SOURCE: Based on published financial statements.

among other things, to the low-interest environment that prevailed during the year (discussed at greater length below in this chapter).

A study of the relation between the macroeconomic activity environment and the development of profit and profitability in the past decade lends some support to the procyclical hypothesis that draws a correlation between banks' performance and business results with macroeconomic business cycles. Thus, the banking institutions' profitability improved considerably in years of surging economic activity (2004–2007) and decreased steeply in years of major slowdown (2001–2002). As for 2008 and 2009, even though GDP increased in 2008 on annual reckoning, the banking groups' profits slipped badly, mainly due to the worsening of the global financial crisis and its impact on the groups' assets and, to a lesser extent, the effects of developments in domestic economic activity. The picture changed in 2009: despite the mild rate of increase in GDP (0.7 percent), the groups' profit and profitability took an abrupt upward turn.

Four of the five large banking groups reported an increase in their net profit in 2009. (Only Bank Mizrahi-Tefahot posted a decrease, at 12 percent.) Profit was affected in 2009 by positive developments in domestic and global capital markets, the Bank of Israel's expansionary monetary policy, and the mixed trend that typified real developments in the domestic economy. Net profit was positive in all four quarters of the year, in contrast to 2008, when most groups other than Bank Mizrahi-Tefahot showed negative profit in the fourth quarter and the Bank Hapoalim group also posted negative profit in the first quarter.

As for the contribution of the various income and expenditure components to profit, the positive effect of the rebound of net interest income stood out in the review year (up 28.7 percent), returning to its typical pre-crisis level (0.73 percent higher than in December 2007) after, in 2008, the groups' investments in mortgage-backed bonds and foreign financial institutions' assets and securities induced a steep 27.7 percent contraction of profit. Importantly, however, the main factors behind the upturn in the groups' profit from financial activities in 2009 were positive developments in the capital markets, which offset the falloff in profit from classic activity that was abetted by the low-interest environment. Another contributor to the increase in net profit in 2009 was operating and other income, which rose by 27.9 percent relative to 2008 (and by 9.45 percent relative to December 2007) despite a relatively mild increase in income from operating fees (2.48 percent). Operating and other income was affected in 2009 mainly by favorable trends in the capital markets and the sale of holdings in "Hot" and "Bezeq" by the two largest groups, which yielded profits for the groups from securities investments and management of workers' severance-pay funds (Table 2.5).

The income and expenditure components that dampened net profit in 2009 were the loan-loss provisions (1.9 percent up from 2008) and the contraction of profit from extraordinary operations to zero after four years of strong performance, occasioned by the application of the Bachar reform and the process of sale of small banks by large banks to medium ones.

2. DEVELOPMENTS IN INCOME AND EXPENSES

a. Net interest income before loan-loss provisions

After slumping due to economic developments in 2008, the groups' interest income rebounded strongly in 2009 to its pre-crisis level (up 0.7 percent relative to December 2007). Each of the five large banking groups reported increases in net interest income and the aggregate came to NIS 23 billion—up NIS 5.1 billion (28.7 percent). However, even though all banking groups reported increases in net interest income, this parameter was affected mainly by developments at the Bank Hapoalim group, a consequence of strong revenues on activity in the capital markets in 2009 due to stiff losses in 2008 on account of the sale and revaluation of bonds. The bullish behavior of the capital markets had a decisive upward effect on the development of net interest income in 2009, surpassing the income-dampening effects of the Bank of Israel's expansionary monetary policy.

Table 2.2**Breakdown of Profits from Financial Activities before Loan-Loss Provision, by Type of Indexation, The Five Major Banking Groups, 2007–09**

	(NIS million)				
	2007	2008	2009	Change relative to 2008	
	(at current prices)			(NIS)	(percent)
Net income^a by type of indexation (including derivatives)					
Local currency, unindexed	11,213	13,011	12,106	-905	-7.0
Local currency, CPI-indexed	2,992	2,871	121	-2,750	-95.8
Foreign currency - domestic activity	6,341	5,633	6,379	746	13.2
1. Total income from indexation derivatives	20,546	21,515	18,606	-2,909	-13.5
Other financial income					
Commissions on transactions	824	920	992	72	7.8
Other net financial income	994	-3,819	2,890	6,709	-
<i>of which:</i> Interest income on problem debts previously not recorded	1,402	1,388	994	-394	-28.4
<i>of which:</i> Profits from the sale and valuation of bonds ^b	-1,043	-5,804	1,241	7,045	-
2. Total other financial income	1,818	-2,899	3,882	6,781	-
3. Options and other derivatives	515	-707	559	1,266	-
Profit from financial activities before loan-loss provision (1+2+3)	22,879	17,909	23,047	5,138	29

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

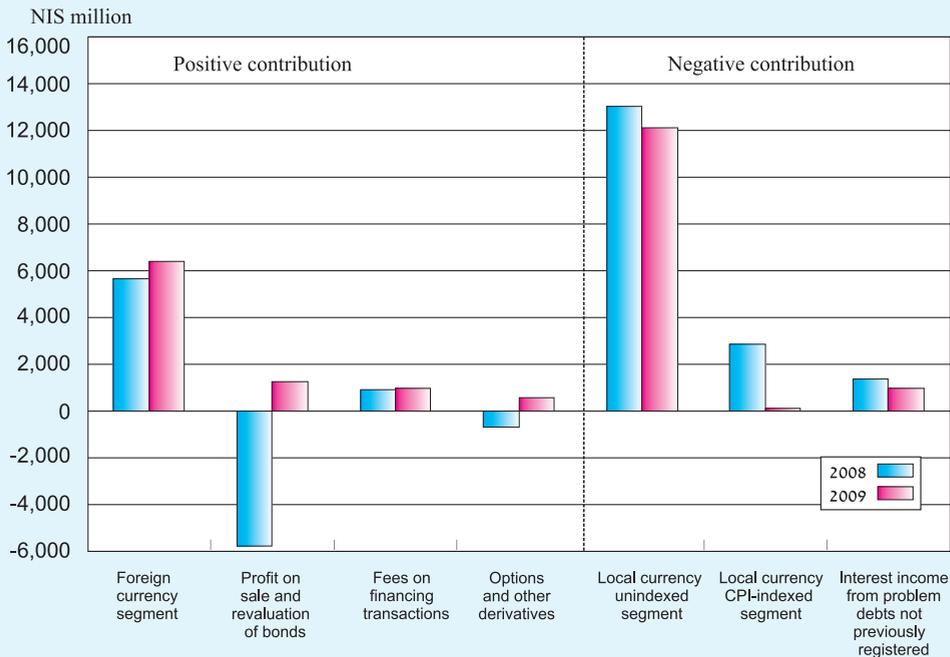
^b Including profits/losses from the valuation and sale of tradable bonds and the sale of bonds available for sale and bonds held until maturity.

SOURCE: Published financial statements.

Two main factors affected net interest income in the review year, both exogenous to the banking system and both somewhat cyclical: (a) the positive developments in the capital markets and (b) the immediate impact of expansionary monetary policies in Israel and abroad. The two factors affected net interest income in contrasting directions and were coupled by the milder effect of macroeconomic developments, as described below.

Developments in the various components of net interest income were characterized by a mixed trend in 2009, unlike 2008. Total other interest income, affected in 2008 by developments at the two largest banking groups (foremost Bank Hapoalim) and constituting the main reason for the downturn in net interest income, increased considerably in 2009 and came to NIS 3.9 billion (Table 2.2, Figure 2.2). In contrast, income derived from classic financing activity made a negative contribution in 2009, losing ground at four of the five large groups. Total income from options and other derivatives not defined as hedging activity or ALM were positive in 2009 at NIS 559 million as against a negative NIS 707 million in 2008.

Figure 2.2
Changes in the Components of Interest Income and their Contribution to Total Interest Income, the Five Major Banking Groups, 2008 and 2009 (at current prices)



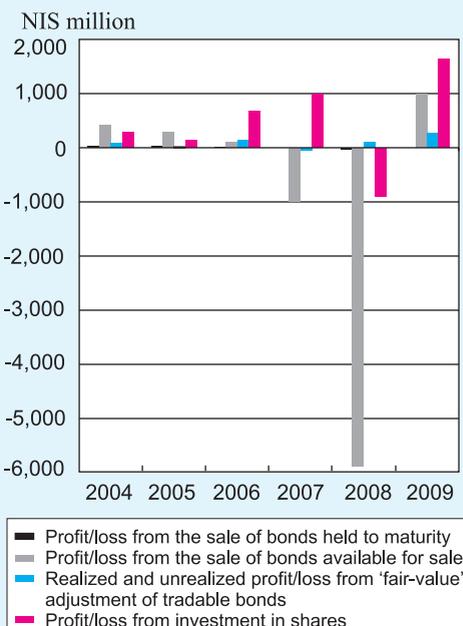
SOURCE: Based on published financial statements.

Total other interest income increased considerably in 2009, as stated, making a positive contribution to profit from financial activities. This component of income, which includes profit from the sale and revaluation of bonds, was affected in the past two years by the groups' investment policies in previous years. These policies, which were meant to create alternative and complementary ways of raising income as against classic financing activity, led during these years to the expansion of the groups' portfolio investments in corporate bonds (foremost of foreign financial entities) and mortgage-backed bonds. Even though some of these investments do not increase the banks' exposure to risk, some are made at the conscious price of increasing exposure relative to classic activity for the purpose of attaining a higher return. An example of the eventuation of the riskiness of such investments was observed in 2008 as the groups posted serious losses on account of the sale and revaluation of bonds held by them. In 2009, in contrast, this component of income, favorably affected by positive developments in bond prices in domestic and foreign capital markets, contributed to the increase in total other interest income. Thus, total profit from sale and revaluation of bonds climbed perceptibly in 2009 (NIS 7 billion) and contributed NIS 1.2 billion to profit from financial activities—of which, NIS 976 million on account of the sale of bonds available for sale and NIS 265 million in profit from the sale and revaluation of tradable bonds—as against an NIS 5.8 billion loss in the year-earlier period (Figure 2.3).

Interest income on problem debts previously not recorded decreased by 28.4 percent in 2009, making a negative contribution to net interest income while remaining strong at roughly NIS 1 billion. The change in this component of income in 2009 was chiefly a reflection of its high level in 2008 but was also affected by the auspicious domestic macroeconomic conditions in the pre-crisis years. The contribution of income from transactions² fees was positive in 2009, due to an upturn in income gained from loans' and homebuyers' guarantees, among other things.

Total interest income from classic financing activity (including activity in

Figure 2.3
Profit/Loss Deriving from Changes in Bonds Prices on the Capital Market and from Investments in Shares, the Five Major Banking Groups, 2004–09



SOURCE: Published financial statements.

² Composed of receipts, documentary credit, loan guarantees, home purchasers' guarantees, and other guarantees and undertakings.

derivatives) fell in 2009 for the first time after more than a decade of steady growth, offsetting some of the increase in the other components of profit from financial activities. This net income, derived from the level (quantity) of activity and interest spreads (price) in the various indexation segments, decreased in 2009 at four of the five large banking groups—mainly due to negative developments at the two largest groups, which accounted for most (90 percent) of the decrease in income on this account. Net income on this line contracted by NIS 2.9 billion in 2009 and came to NIS 18.6 billion, down 13.5 percent (Table 2.2).

As for the contribution to net interest income of each of the three indexation segments, interest income on account of CPI-indexed local-currency activity contracted steeply and conspicuously in 2009 (by 96 percent), against the background of an increase in income from the foreign-currency segment (13 percent) and strong income from nonindexed local-currency activity, even though this component decreased by 7 percent in 2009 relative to 2008 (Table 2.2).

During the year, the development of CPI-indexed local-currency activity, which is affected to short terms by the Bank of Israel rate and to medium terms by yields in the market of CPI-indexed government bonds (which are surrogates for CPI-indexed bank credit), reflected the negative effect of price and showed hardly any evidence of the effect of quantity, which was typified by stability in the average balance of CPI-indexed assets. The interest spread in CPI-indexed local-currency activity narrowed in 2009 under the influence of two complementary monetary tools that the Bank of Israel wielded: (a) lowering the monetary rate in the first months of the year and keeping it low afterwards, and (b) purchasing government bonds.³ After the interest tool exhausted itself without having a material effect on longer-term interest rates, the Bank of Israel purchased government bonds in the secondary market in an attempt to enhance the efficiency of the monetary policy that had come about—which aimed, among other things, to lower the cost of borrowing, ease borrowing terms for the business sector, and improve the business sector's payback ability. An examination by the Bank of Israel showed that the government-bond purchases had a 0.3–0.4 percentage-point downward effect on yields. Although these measures did reduce the cost of raising capital for the banking groups, they lowered returns on income-producing CPI-indexed assets even more. The negative interest spread, unquestionably an aberrant development in 2009, was influenced not only by the foregoing but also by accounting discrepancies between the calculation of the value of derivative instruments, which is based on fair value, and the value of the underlying assets, which is measured on an accrual basis. The total interest spread in this segment contracted to –0.15 percent in 2009 (Table 2.3) as against +0.75 percent (0.33 percent net of the effect of derivatives in 2009)

Profits on unindexed local-currency activity were NIS 12.1 billion in 2009, down by a modest 7 percent relative to 2008. The decline originated in the adverse effects of price, the narrowing of the interest spread outweighing the favorable effect of quantity.

³ The Bank of Israel purchased government bonds as a monetary tool in February–August, in sums ranging from NIS 100 million per day in February to NIS 200 million per day from then until August.

Unindexed local-currency activity, most of which is short-term, was strongly affected in 2009 by the development of the monetary lending rate. The rate fell steeply in January and gradually in the next few months—from 1.75 percent in January to 0.5 percent in April—and was left at this level until September, when it was raised gradually to 1 percent in December. The positive relation between the monetary rate and the rate paid on unindexed local-currency activity was described at great length in previous years' surveys of the Supervisor of Banks. Here we only note that various empirical studies have studied this effect (see elaboration in the survey of the Supervisor of Banks for 2008) and found that in the short term it may also be characterized by a negative relation. In 2009 as in 2008, there was a weak relation between the total interest spread in this area of activity—which contracted to 1.63 percent (Table 2.3) (2.46 percent net of the effect of derivatives) as against 1.96 percent in 2008—and the monetary rate. Here again, as in 2008, this traces to the increase in the risk premium that was occasioned by economic developments in the second half of 2008 and the first few months of 2009. The effect of quantity, in turn, was positive in 2009 as a direct continuation of the upward trend of unindexed balance-sheet activity in recent years.

In contrast to the two local currency segments, the contribution to net interest income of the foreign currency indexed or denominated segment was positive in 2009 at NIS 6.4 billion, up 13.2 percent. This was due to the effect of quantity, reflected in an increase in the average balance of segment assets (14.8 percent), and the effect of price, manifested in the widening of the total interest spread in this segment from 0.80 percent to 0.84 percent (2.36 percent net of the effect of derivatives) (Table 2.3). The increase in segment assets is attributable, on the balance-sheet side, to increases in foreign-currency deposits with the Bank of Israel (at the expense of deposits with foreign banks) and foreign-currency-indexed and -denominated credit and, on the off-balance-sheet side, to an upturn in activity in embedded derivatives and ALM, offset by less activity in hedging assets. This happened despite the low-interest environment abroad and the gradual lowering of the three-month USD LIBOR rate during the year (from 1.43 percent in January 2009 to 0.26 percent in December) left the banking groups with little discretion in setting the interest spread. The spread widened this year and was also affected, as in the two other indexation segments, by accounting discrepancies between the value of derivatives (measured on the basis of fair value) and that of underlying assets (measured on an accrual basis).

These changes in the development of income from activity in the various indexation segments were reflected in 2009 in each segment's share of net interest income on account of this activity. The main change in 2009 was the proportional contraction of the CPI-indexed local-currency segment from 13.3 percent in 2008 to less than 1 percent (0.65 percent) in 2009. The contributions to profit of the unindexed local-currency segment and the foreign-currency segment increased in 2009 to 65 percent and 34.3 percent, respectively.

Another component that contributed positively to profit from financial activities in 2009 was the banking groups' activity in options and derivative financial instruments not

defined as hedging instruments or ALM. Income on this account increased significantly, to NIS 559 million in 2009 as against a loss of NIS 707 million in 2008 (Table 2.2). In the review year, as in the previous year, the distribution of profits on this line displayed strong variance and was affected mainly by positive developments at the two largest groups. This component was powered in 2009 by auspicious developments in the domestic and foreign financial markets.

b. Loan-loss provisions

The five large banking groups' annual loan-loss provision increased slightly in 2009 and remained relatively stable at NIS 5.2 billion (Table 2.4), 0.75 percent of total credit to the public (Table 3.2). The level of provisions varied severely among the groups, largely due to the mixed trend in domestic economic developments.

Each group's provisions are determined on the basis of an estimate of the risk and are derived from an assessment of developments in variables of influence that may affect future payback, e.g., borrowers' solvency and the quality of their collateral. Once the directive "Measurement and disclosure of impaired loans and debt securities, credit risk and the allowance for credit losses" goes into effect (in January 2011) the banks should be better able to monitor credit risks and a stronger connection between risks and the loan-loss provision should be established. (For elaboration, see Box 3.1.)

The specific loan-loss provision and the general and supplementary provision moved in different directions in 2009 for the first time in ten years (Figure 2.4). While the specific-provision component, based on the bank's internal estimates of its borrowers' payback ability, deteriorated slightly, the general- and supplementary-provision component, which responds to credit-portfolio risks that cannot be identified or cannot be estimated as of the balance-sheet date, improved somewhat (Table 2.4). Although the cumulative specific provision increased during the year, it declined slightly in the last quarter, attesting to a positive change of trend in the banking groups' estimates of their borrowers' payback ability during the year. The increase in the other provisions, in turn, may reflect the uncertainty that is typical of economic activity.

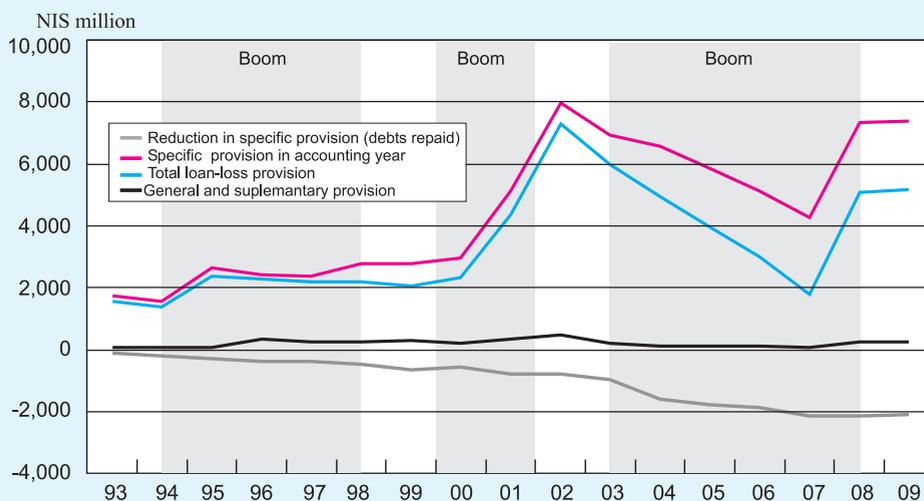
At the system level, the loan-loss provision was affected in 2009 mainly by developments at the three largest banking groups (Leumi, Hapoalim, and Discount). The Bank Leumi group posted a decrease in provisions in 2009 (against the background of large provisions in 2008); the other groups showed increases. All three groups were affected by domestic economic developments and the composition of their credit portfolios. However, while the effect at the Bank Leumi group reflected the improvement trend in the second half of the year and the high level of provisions in 2008, the impact of the crisis, which seeped into the fourth quarter of the year, was evident in the condition of borrowers at the Hapoalim and Discount groups. Thus, economic developments led the Discount group to actively increase its specific loan-loss provision, mainly due to a downturn in borrowers' payback ability, and in the Bank Hapoalim group to a reduction in two components: "Reduction of the Provision" and "Collection of Debts Written Off in Previous Years."

Table 2.4
Components of the Loan-Loss Provision for the Five Major Banking Groups, 2007-09
 (NIS million, at current prices)

	2007			2008			2009		
	The specific provision	The general and supplementary provision	Total	The specific provision	The general and supplementary provision	Total	The specific provision	The general and supplementary provision	Total
Beginning-of-year balance of the provision	28,813	3,249	32,062	27,971	2,999	30,970	29,857	3,075	32,932
Additions to the provision during the accounting year	4,269	53	4,322	7,224	243	7,567	7,361	236	7,597
Reduction of the provision	-2,146	-303	-2,449	-2,120	-167	-2,287	-2,073	-251	-2,324
Collection of debts written off in previous years	-97	0	-97	-202	0	-202	-98	0	-98
Amount entered in the profit and loss statement	2,026	-250	1,776	5,002	76	5,078	5,190	-15	5,175
Debts written off	-2,868	0	-2,868	-3,116	0	-3,116	-2,895	0	-2,895
End-of-year balance of provision	27,971	2,999	30,970	29,857	3,075	32,932	32,152	3,060	35,212

SOURCE: Published financial statements.

Figure 2.4
Developments in Components of Loan-Loss Provision in the Five Major Banking Groups, 1993-2009



SOURCE: Based on published financial statements.

The main background for the net increase in aggregate provisions in 2009 was an upturn in provisions on account of retail activity segments, especially those relating to small businesses and households, whereas provisions in the business segments (corporate and commercial) were slightly smaller. For elaboration, see “Performance Analysis by Activity Sectors—the Five Large Banking Groups,” below in this chapter.

c. Operating and other incomes

Total operating and other income of the five large banking groups increased at a vigorous 27.9 percent pace in 2009, at NIS 16.1 billion as against NIS 12.6 billion in 2008 and NIS 14.7 billion in 2007 (Table 2.5). The upturn encompassed all five groups and was evident particularly in Bank Hapoalim.

The banking groups’ operating and other income was affected in 2009, as every year, by two main factors: (a) domestic economic developments, which influence operating income from banking services through the mechanism of demand for fee-generating services, and (b) developments in the capital markets, which affect operating income directly via the extent of customer activity in the capital market and indirectly via the level of activity in the capital market.

In March 2009, the Supervisor of Banks published a circular titled “Disclosure of Operating Fees in the Financial Statements of Banking Corporations,” which revised the format of reporting on operating fees. It became necessary to issue this circular

Table 2.5
Non-Interest Income and Operating Expenses of the Five Major Banking Groups, 2007–09

	Amount			Distribution			Year-on-year change	
	2007	2008	2009	2007	2008	2009	2008	2009
1. Non-interest income								
Income from banking services		(NIS million, at current prices)			(percent)		(percent)	
Ledger fees	2,904	2,997	3,098	19.7	23.8	19.2	3.2	3.4
Credit cards	2,965	3,334	3,478	20.1	26.4	21.6	12.4	4.3
Credit services and contracts	1,126	1,116	965	7.6	8.8	6.0	-0.9	-13.5
Foreign trade and special services	417	383	359	2.8	3.0	2.2	-8.2	-6.3
Other commissions ^a	1,606	1,630	1,543	10.9	12.9	9.6	1.5	-5.3
Total income from banking services (1)	9,018	9,460	9,443	61.2	75.0	58.5	4.9	-0.2
Income from activity in the capital market								
From activity in securities (2)	2,759	2,715	3,142	18.7	21.5	19.5	-1.6	15.7
Provident and mutual funds distribution fees ^b (3)	767	599	589	5.2	4.7	3.7	-21.9	-1.7
Institutional investors management and operation fees (4)	772	394	321	5.2	3.1	2.0	-49.0	-18.5
Profit/loss from the sale of shares	976	-908	1,633	6.6	-7.2	10.1	-	-
Profit from compensation funds	167	-	683	1.1	0.0	4.2	-100.0	-
Total income from activity in the capital markets	5,441	2,800	6,368	36.9	22.2	39.5	-	-
Total other income ^c	279	354	320	1.9	2.8	2.0	26.9	-9.6
Total operating fees ^d (1+2+3+4)	13,316	13,168	13,495	90.4	104.4	83.7	-1.1	2.5
Total non-interest income	14,738	12,614	16,131	100.0	100.0	100.0	-14.4	27.9

(cont'd)

Table 2.5 (Cont'd)
Non-Interest Income and Operating Expenses of the Five Major Banking Groups, 2007–09

	Amount			Distribution			Year-on-year change	
	2007	2008	2009	2007	2008	2009	2008	2009
2. Operating expenses	(NIS million, at current prices)			(percent)			(percent)	
Salaries and related expenses ^a	14,516	14,720	14,387	59.7	58.2	56.5	1.4	-2.3
of which: Wages	9,798	9,015	9,634	40.3	35.7	37.9	-8.0	6.9
Maintenance of buildings	4,233	4,613	5,041	17.4	18.2	19.8	9.0	9.3
Other expenses	5,549	5,953	6,023	22.8	23.5	23.7	7.3	1.2
Marketing and advertising	881	878	744	3.6	3.5	2.9	-0.3	-15.3
Computer expenses	865	977	977	3.6	3.9	3.8	12.9	0.0
Communications	620	646	651	2.6	2.6	2.6	4.2	0.8
Insurance	120	114	139	0.5	0.5	0.5	-5.0	21.9
Office	348	355	341	1.4	1.4	1.3	2.0	-3.9
Professional services	771	815	778	3.2	3.2	3.1	5.7	-4.5
Total operating expenses	24,298	25,286	25,451	100.0	100.0	100.0	4.1	0.7
Coverage ratio (percent) ^f	60.7	49.9	63.4					

^a Including primarily collection spreads and commissions on credit from the Ministry of Finance, conversion differences and others.

^b As part of the Bachar reform, banks have started charging fees for distributing provident and mutual funds. The maximum fees relating to mutual funds are: 0.25 percent of the balance of assets for funds that invest mainly in short-term low-risk investments, 0.80 percent of the balance of funds that invest in shares, and 0.40 percent for other funds. Regarding provident funds (and pension funds) the maximum fee is 0.25 percent of the balance of the funds' assets.

^c 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.

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

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

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

SOURCE: Reports to the Supervisors of the Banks.

when the “Fees Law” went into effect in the second half of 2008. The classification of fees under the new statute is based on a new rate code and the principle of aggregating fees that are derived from essentially similar activities, as is the practice in the U.S. and many other countries.

Total income from banking services decreased in 2009 by a negligible 0.2 percent and came to NIS 9.4 billion, as in 2008. The development of this component of income showed strong variance and a mixed trend in the review year: the two largest banking groups posted decreases—1.4 percent at the Bank Hapoalim group and 4.2 percent at the Bank Leumi group—whereas the three medium-sized groups reported increases ranging from 2.8 percent at the Discount group to 24.3 percent at the First International group. Two main factors explain the mixed trend: (a) changes of ownership in 2008 in the banking system, the Bank Hapoalim group selling Massad Bank and Yahav Bank to medium-sized banking groups—First International and Mizrahi-Tefahot, respectively. Consequently, the Hapoalim group reported a decrease in income on this account in 2009 and Mizrahi-Tefahot and First International posted increases; (b) differences among the groups in the composition of income from banking services and the extent to which these components were affected by developments during the year. Total income from banking services—in effect, total operating-fee income not derived from the capital market—generated 58.5 percent of total operating and other income in the review year, affected favorably by upturns in income from credit-card activity (4.3 percent, mainly due to the expansion of activity) and from ledger fees (3.4 percent—Table 2.5) and affected adversely by real developments in the first few months of the year that dampened income from foreign-trade and special-services transactions (6.3 percent), a consequence of the contraction of Israel’s foreign-trade activity, and by the reform in bank fees, which reduced income from credit services and contracts (13.5 percent).

The banking groups’ operating income from capital-market activity falls into two categories: (a) income from operating fees derived from direct customer activity in the capital markets, including fees on customer activity in securities and, in 2009 for the first time (pursuant to the publication of the circular on “Disclosure of Operating Fees in the Financial Statements of Banking Corporations”), distribution fees for financial products and management fees, operation fees, and trust fees charged to institutional entities; and (b) income derived from indirect market activity—profit/losses from investment in shares held by the groups and earnings on workers’ severance-pay funds, derived from the management of workers’ compensation and pension reserves, which are affected by developments in prices in the capital market. Total income from operating fees derived from direct activity in the capital market increased from NIS 3.7 billion in 2008 to NIS 4.1 billion in 2009, up 9.3 percent. This component of income was favorably affected in 2009 by activity in securities—largely due to an increase in the public’s activity in the capital market, under the influence of auspicious market developments and the low-interest environment—and was adversely affected by activity in the distribution of financial products and management and operating services for institutional entities. Total income derived from indirect activity in the capital market

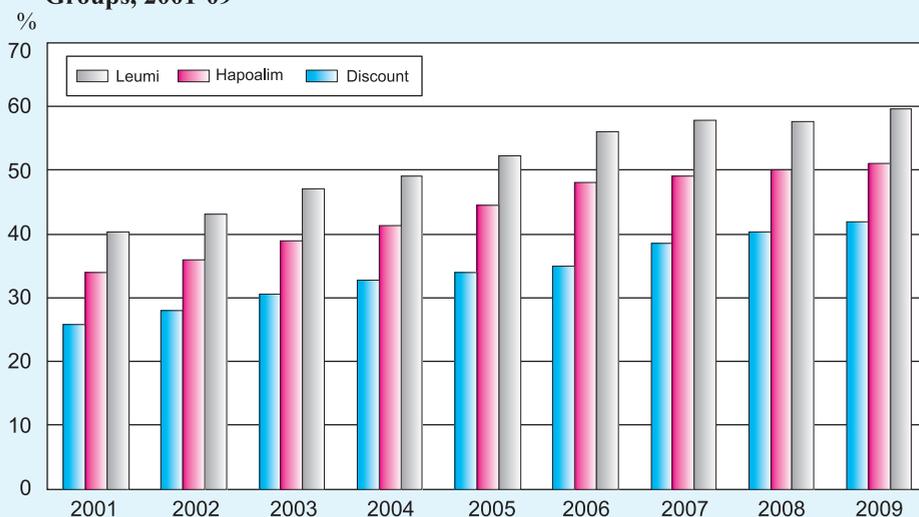
increased significantly, from a loss of NIS 908 million in 2008 to a positive NIS 2.3 billion in 2009 (Table 2.5). The development of this component of income, which was the main factor behind the upturn in total operating and other income in 2009, originated in the effect of bull conditions in the capital market on profit from investments in shares and workers' severance-pay funds. These positive developments were conspicuous in 2009 at the two largest banking groups, especially Leumi, chiefly due to the heavy losses posted on this line in 2008 and the positive contribution to income derived from the sale of shares in Hot and Bezeq.

d. Operating and other expenses

The five large banking groups' operating and other expenses were NIS 25.5 billion in 2009 as against NIS 25.3 billion in 2008, up 0.7 percent (Table 2.5). Total payroll expenses (salaries and related) decreased by 2.3 percent and accounted for 56.5 percent of total operating expenses of the banking system as against 58.2 percent in 2008. Other operating expenses (excluding payroll) were NIS 11.1 billion in 2009 as against NIS 10.6 billion in 2008—up 5 percent, mainly due to expenses related to maintenance and depreciation of buildings and equipment, which grew by 9 percent in 2009 and came to NIS 5 billion.

The decrease in salary expenses relative to 2008 traces mainly to losses on severance-pay funds in 2008. Direct salary expenses increased by 6.9 percent over 2008, a down year in this respect (Table 2.5). Notably, direct salary expenses correlate positively and

Figure 2.5
Proportion of Employees with Higher Education in the Three Major Banking Groups, 2001-09



SOURCE: Published financial statements.

strongly with domestic business cycles; the main explanation for this is the dependency of direct salaries on the bank's performance, e.g., the awarding of grants and bonuses derived from profitability. This relation, coupled with the improvement in the banks' performance in 2009, explains the increase in salary per post (Table 2.6).

Reward incentives that had become standard practice in the financial system were one of the main factors behind the eruption and acceleration of the global financial crisis.

Table 2.6
Salaries and Related Expenses of the Five Major Banking Groups, 1998-2009
(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	7,732	203	3,677	96	11,409	299
2005	40,029	8,753	219	4,122	103	12,875	322
2006	42,200	9,561	227	5,354	127	14,915	353
2007	44,286	9,815	222	4,701	106	14,516	328
2008	46,628	9,015	193	5,705	122	14,720	316
2009	47,260	9,634	204	4,753	101	14,387	304
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	6.5	7.4	3.1	3.4	5.4	6.1
2005	4.9	13.2	7.9	12.1	7.3	12.8	7.7
2006	5.4	9.2	3.7	29.9	23.3	15.8	9.6
2007	4.9	2.7	-2.2	-12.2	-16.5	-2.7	-7.1
2008	5.3	-8.2	-13.1	21.4	15.1	1.4	-3.7
2009	1.4	6.9	5.7	-16.7	-17.2	-2.3	-3.8

^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.

Often it was found that such incentives encouraged staff to take risks that deviated from the bank's risk policy and substantially raised the bank's risk profile. Consequently, regulation relating to remuneration policy gathered momentum; currently, the global trend is leaning in the direction of a tougher approach toward regulatory requirements in this respect. At the end of 2009, Israel's banks were also instructed to adopt a suitable remuneration policy based on several principles: incentives must correspond to the bank's profitability and long-term goals; they must not encourage risk-taking beyond the bank's risk preferences; and the payment of incentive rewards must be based on risk-adjusted profit and cost of capital.

Unlike direct salary expenses per post, related salary expenses per post vary widely among the large banking groups, the average ranging in 2009 from NIS 83,000 to NIS 136,000. The reason for the variance is that these expenses are also affected by specific components such as voluntary-retirement programs that banks introduced as part of their efficiency processes and outlays for compensation, benefits, and pensions. The quality of the banks' personnel continued to improve in 2009, as evidenced by a growing proportion of graduates at the expense of the others (Figure 2.5).

e. Operating indicators and operating efficiency

Operating efficiency is an important topic in the banking literature. From the business aspect, a bank's management tries to obtain as much information as possible about the factors that may affect the level of production expenses and the sensitivity of the totality of these expenses to changes in each of their components—information that may help management to improve its decision-making processes. From the public aspect, an understanding of the production function enables the regulator to plan long-term policy on the desired structure of the banking system and, in this way, to influence the extent of competition in the industry.

The analysis that follows uses four conventional indicators to assess the efficiency of Israel's banks. The first two indicators are the operational coverage ratio⁴ and the operating efficiency ratio,⁵ which make it possible to assess a bank's ability to cover its operating expenses by non-interest income and by its non-interest income and net interest income together. The other two indicators examined are increasing, decreasing, or constant returns to scale as reflected by the development of operating expenses per unit of output⁶ (average expense) and the banks' efficiency given their size, or X-efficiency.⁷

⁴ The ratio of total operating and other incomes plus profit from financial activities []to total operating and other expenses.

⁵ The ratio of total operating and other incomes to total operating and other expenses.

⁶ Calculated as total operating and other expenses relative to output, where output is calculated as total balance-sheet assets plus the value equivalent of off-balance-sheet assets.

⁷ Calculated as the average minimum expenditure divided by the average maximum expenditure in each group size (AC_{min}/AC_{max}). 1 *minus* this ratio in each group therefore reflects the potential maximum saving in production expenses for each group.

These indicators are based on the economic theory that defines return to scale as the extent of change in the bank's average cost as a function of change in the volume of its output.⁸

The positive developments in banks' profits in 2009 derived largely from the steep increase in interest income and operating and other incomes over 2008. These led to an improvement in the operational coverage ratio and the efficiency ratio after contractions in 2008, restoring these indicators to their pre-crisis levels.

In 2009, the five banking groups' **operational coverage ratio** climbed to 0.63 (Table 2.4). The upward movement of this ratio originates in a combination of steep increase in the five groups' total operating income and relative stability in operating expenses. The development of the ratio of the past two years was strongly affected by changes in the two largest groups' operating income, which, as stated, lowered the ratio in 2008 and raised it at the end of 2009.

The efficiency ratio showed a similar trend but was more volatile in the past two years, under the influence of developments in net interest income (other interest income in particular) since the crisis began (Table 2.7). The five large banking groups' **average efficiency ratio** came to 1.54 in December 2009, resembling its level on the eve of the crisis and the average in the past decade. The acute volatility of the efficiency ratio in the past two years traces to the heavy losses that the banks posted in 2008 on account of the sale and revaluation of bonds and the profit that they earned in 2009 from favorable developments in the capital markets and bond prices.

All the banking groups reported an improvement in both indicators with the exception of Bank Mizrahi Tefahot, which showed an increase in operating expenses in 2009.

To analyze efficiency that is derived from changes in banks' size, we calculated operating expenses per shekel of output in accordance with the banks' different size groups. For this purpose, we divided the banks into three size groups (peer groups): large banks—banks with an output exceeding NIS 150 billion; medium-sized banks—with an output of between NIS 40 billion–NIS 150 billion; and small banks—with an output of up to NIS 40 billion. As an indicator of banking output, we selected total assets, which include balances of balance-sheet assets and the credit value equivalent of off-balance-sheet assets.

The banks' **average expense per unit of output**, by size groups, has not changed significantly in recent years. However, there are evident differences among the three groups: small banks have the highest average expense per unit of output and large banks have the smallest (Table 2.8). Thus, scale advantages do exist in Israel's banking system but essentially peter out at the level of activity of medium-sized banks.

Similarly, the differences in average expenses among the small banks in the system, as manifested in the X-efficiency index, are greater than the differences among the media banks, where as the differences among the large banks are smaller. Indeed, the large banks have less potential for savings, at only 0.04, as against 0.30 in the group

⁸ Return to scale is graphically described as the slope of the average-cost curve: a negative slope indicates scale advantages and a positive slope denotes scale disadvantages.

Table 2.7
Coverage and Efficiency Ratios of the Five Major Banks, 2007-09

Bank	2007		2008		2009	
	Coverage ratio ^a	Efficiency ratio ^b	Coverage ratio ^a	Efficiency ratio ^b	Coverage ratio ^a	Efficiency ratio ^b
Leumi	0.61	1.71	0.40	1.31	0.66	1.67
Hapoalim	0.66	1.53	0.57	0.97	0.69	1.57
Discount	0.52	1.34	0.48	1.25	0.56	1.43
Mizrahi-Tefahot	0.61	1.66	0.57	1.63	0.55	1.46
First International	0.61	1.49	0.52	1.22	0.64	1.43
Average of the five major banks	0.61	1.55	0.50	1.21	0.63	1.54

^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.

of medium-sized banks and 0.62 among small banks (Table 2.8). The big discrepancies among the small banks originate, among other factors, in the severe heterogeneity of this group—the fact that it is composed of independent banks and banks affiliated with banking groups—in contrast to the other size groups, which are typified by a small number of similar banks.

Table 2.8
Ratio of Overheads to Unit of Output^a, and X-Efficiency by Banking Group (by Size), 1997-2009

	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			
1997 - 2008	0.0256	0.0205	0.0169
2009	0.0243	0.0184	0.0152
Maximum X-Efficiency ^e (maximum saving)			
1997 - 2008	0.39 (0.61)	0.69 (0.31)	0.94 (0.06)
2009	0.38 (0.62)	0.70 (0.30)	0.96 (0.04)

^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 1997–2008, so as not to affect the quality of the indices. The banks included are: Union, Mercantile Discount, Otsar Hahayal, Yahav, Arab Israel, Massad, Poalei Agudat Israel, Continental, 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.

3. ANALYSIS OF PERFORMANCE BY ACTIVITY SEGMENT OF THE FIVE MAJOR 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,⁹ an activity segment must fulfill three conditions: it must deal

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

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 specialization that the Israeli banking groups acquired in the delivery of diverse financial products and services to different types of customers has helped over the years to create a balance in the groups' income flow. This stood out in particular in the past two years, when the weighting of changes among the various profit centers came into sight.

The stabilization of the global and domestic financial system stabilized toward the end of the fourth quarter of 2009, coupled with the mixed trend in the domestic real economy, had different effects on different activity segments at two levels: the development of profit in the financial-management segment and in the retail and business segments.

The development of the financial-activity segment¹⁰ as a central and important part of the banking groups' activity originates in various reforms that the Israeli financial system underwent in the past decade,¹¹ foremost the Bachar reform.¹² Before these reforms, the banking groups benefited from a large market share, market power, and stable income; therefore, they had no incentive to develop and invest in hybrid financial instruments. The upturn in competition between the banking and the non-banking systems (largely in the corporate segment) together with the compulsory sale of provident and mutual funds, and expectations regarding the application of the "Bank Fees Law" prompted the groups to seek alternatives and complementary sources of income to those derived from classic activity. The measures taken included the expansion of the groups' activity in foreign markets—by acquiring local banks and expanding their activity in foreign branches—and stepping up their activities in portfolio investment via the financial-management segment. Indeed, the financial-management segment made a conspicuously positive contribution to the groups' total profit from financial activities. Profit on this account was affected mainly by the heavy losses that were ascribed to the financial-management segment in 2008 and by two developments in the review year: (a) positive developments in the domestic and foreign capital markets, which pushed

¹⁰ The financial-activity segment, although defined somewhat differently by different banks, usually concerns the management of the groups' own ("nostro") portfolios, which include investments in foreign securities and hybrid financial instruments, business-room activity, and management of market and liquidity risks (including activity in derivatives).

¹¹ Easing the investment rules for institutional investors (2002), tax reform (2003), pension reform (2003), legislation enhancing competition and alleviating concentration and conflicts of interest (2005); and reform of the government-bond market (2005).

¹² See chapter, "The Financial Results of the Five Major Banking Groups," in the 2005 Survey of the Supervisor of Banks.

up the value of the groups' investment portfolios; (b) the groups' wise decision to lower their exposure to risk and sell some risk assets that they had held in their investment portfolios before the crisis. Consequently, total profit from financial activities in this segment was NIS 1.7 billion in 2009 as against a loss of NIS 4.1 billion in 2008 and a profit of NIS 2.5 billion in 2007.

The contribution of the classic activity segments to profit from financial activities showed a mixed trend. The main factors that affected these segments included the mixed trend in the real economy, accompanied by recovery in the domestic capital market, and the expansionary monetary policy, manifested in a low-interest environment. Both factors had powerful but contrasting effects on profits in the classic segments, as described below.

Although loan-loss provisions were largely stable relative to their end-2008 level, there was a perceptible difference in the development and distribution of the provisions among the classic activity segments. In 2008, the increase in provisions encompassed all segments of activity and especially the business ones; in 2009, notwithstanding the mixed trend among the groups, the total provision on account of business segments decreased slightly although the downturn was offset by an increase on account of retail activity.

To sterilize the effects of the change in provisions that derived from changes in the extent of each segment's activity, we calculated the share of loan-loss provisions in the total average balance of assets in each segment. The results show that most activity segments held their provision ratios stable—with the exception of the small-business segment, in which the ratio climbed to 1.4 as against 1.1 in 2008, and the corporate segment, in which it slipped to 0.9 as against 1.0 percent a year earlier. The increase in the small-business segment traced to a larger provision on account of customer activity, in view of the economic slowdown in the first few months of the year and the contraction of lending in the past two years under lending policies at the banking groups that focused on lowering the risk exposure of their credit portfolios. As for the corporate segment, the ratio decreased for two reasons: smaller provisions and an upturn in activity, which occurred despite a decline in lending to segment customers as part of the groups' policy to reduce their exposure to risk and the recovery of issuing in the domestic capital market.

Net of developments in the financial-management segment, examination of the contribution of classic activity segments to net profit underscores the reversal in the contribution to profit of the business segments (corporate and commercial) and the retail segments (households, private banking, and small business). Thus, the business segments' contribution climbed from 32.5 percent in 2008 to 65 percent in the review year and that of the retail segments slumped from 68 percent to 35 percent in the respective years (Table 2.9, Figure 2.6). The decline in the retail segments' contribution to profit and the decrease in these segments' total net profit in 2009 trace to the Bank of Israel's expansionary monetary policy in the review year. This policy, reflected in a low-interest environment, crimped the development of profit from financial activities in

all three retail segments by narrowing the interest spread. Furthermore, the economic slowdown in the first few months of the year, accompanied by escalating unemployment and uncertainty about the pace of the domestic economic recovery, prompted the groups to raise their risk assessments and increase their provisions accordingly. Another factor that was adverse to net profits in these segments was the high level of profit from extraordinary activities that was ascribed to the household segment in 2008. Notably, net profit in the retail segments decreased in 2009 even though lending to households increased (foremost for housing) and profit in the business segments improved in 2009 despite less corporate lending and the low-interest environment; this was mainly due to an increase in risk premium for loans to corporate borrowers and the steep upturn in this segment's operating and other income.

Seemingly, the household segment made a conspicuously paltry contribution to the banking groups' net profit in 2009. However, Excluding non-recurrent effects and developments, e.g., the imputation of earnings from the sale of shares in Bezeq and Hot to the operating income of the corporate segment in 2009—and when the distribution of net interest income is examined, it becomes evident that in 2009, as before, the household segment made a strong contribution to the groups' profit (31 percent), exceeding its contribution to total net profit (15 percent). When the household segment's long-term contribution to net interest income is examined and compared with the corresponding contribution of the corporate segment, it is found that this contribution has been rather stable whereas that of the corporate segment is typified by severe variance. Two different factors influence this finding: (a) the great exposure of the corporate segment to business cycles as against the mild exposure of the household segment; (b) the lack of adequate bank-credit substitutes for households, allowing the banking groups to apply market power to households and benefit from a steady contribution of households to their profits—although this effect was weaker in 2009 than in previous years due to the low-interest environment and the groups' narrow latitude in setting interest spreads.

In recent years, the Bank of Israel and the Knesset have taken several regulatory and legislative measures to step up competition in the domestic credit markets and mitigate the commercial banks' oligopolistic power—mainly by reducing concentration in the domestic banking system (described at length in Chapter 1) and encouraging competition among banks and between them and nonbanking entities. On the corporate-borrowing side, reforms in the domestic capital market in recent years¹³ support the development of competition for segment customers between the commercial banks, on the one hand, and institutional entities and the capital markets, on the other hand, by promoting the availability of non-banking credit to corporate customers. In retail

¹³ Easing of investment rules for institutional investors (2002), tax reform (2003), pension reform (2003), legislation enhancing competition and alleviating concentration and conflicts of interest (2005), underwriting reform (2005), and reform of the government-bond market (2005). For an expanded discussion, see the chapter on activity in this Survey.

Figure 2.6
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.

Table 2.9
Performance Indicators in the Five Major Banking Groups,^{a,b} by Sector, 2007–09

	2007					2008					2009																			
	Private banking sector		Business sector		Commercial sector		Private banking sector		Business sector		Commercial sector		Private banking sector		Business sector		Commercial sector													
	Households	Small businesses	Small businesses	Business sector	Commercial sector	Households	Small businesses	Small businesses	Business sector	Commercial sector	Households	Small businesses	Small businesses	Business sector	Commercial sector	Households	Small businesses	Small businesses	Business sector	Commercial sector										
Components of profit	Distribution (%)																													
Average balance of assets	30	6	9	39	17	31	6	8	39	16	32	6	8	40	14	35	11	14	23	16	35	10	14	26	15	31	9	13	31	16
Net interest income before loan-loss provision	39	14	14	20	13	40	13	14	21	13	36	12	13	27	12	39	14	14	20	13	40	13	14	21	13	36	12	13	27	12
Total non-interest and interest income	32	2	28	13	25	17	1	12	51	18	20	2	15	48	16	32	2	28	13	25	17	1	12	51	18	20	2	15	48	16
Loan-loss provision	46	19	13	15	8	48	18	14	11	9	44	16	12	21	7	46	19	13	15	8	48	18	14	11	9	44	16	12	21	7
Non-interest and other income	47	16	14	12	11	46	16	13	13	13	48	16	13	13	11	47	16	14	12	11	46	16	13	13	13	48	16	13	13	11
Operating expenses	24	12	10	40	14	36	10	17	24	13	15	9	12	53	12	24	12	10	40	14	36	10	17	24	13	15	9	12	53	12
Ordinary before-tax profit	33	12	10	33	12	40	12	16	21	11	15	8	12	54	11	33	12	10	33	12	40	12	16	21	11	15	8	12	54	11
Net profit	Ratios (%)																													
Loan-loss provision to total assets	0.3	0.1	0.9	0.1	0.4	0.4	0.2	1.1	1.0	0.8	0.4	0.2	1.1	1.0	0.8	0.3	0.1	0.9	0.1	0.4	0.4	0.2	1.1	1.0	0.8	0.4	0.2	1.1	1.0	0.8
Profit from financial activity to total assets	3.9	6.0	5.4	2.0	3.2	3.7	5.4	5.5	2.2	3.1	2.9	4.8	5.2	2.3	3.3	3.9	6.0	5.4	2.0	3.2	3.7	5.4	5.5	2.2	3.1	2.9	4.8	5.2	2.3	3.3
Total income ^c to total assets	7.0	12.1	8.3	2.7	4.2	6.4	10.9	8.4	2.7	4.1	5.5	10.5	8.2	3.4	4.3	7.0	12.1	8.3	2.7	4.2	6.4	10.9	8.4	2.7	4.1	5.5	10.5	8.2	3.4	4.3
Operating expenses to total assets	5.4	8.9	5.7	1.0	2.4	4.8	8.9	5.1	1.1	2.4	4.6	8.5	5.1	1.0	2.5	5.4	8.9	5.7	1.0	2.4	4.8	8.9	5.1	1.1	2.4	4.6	8.5	5.1	1.0	2.5
Return on equity	1.3	2.4	1.3	1.0	0.9	1.0	1.5	1.4	0.4	0.5	0.3	1.0	1.1	0.9	0.6	1.3	2.4	1.3	1.0	0.9	1.0	1.5	1.4	0.4	0.5	0.3	1.0	1.1	0.9	0.6
Coverage ratio ^d	Ratios																													
Efficiency ratio ^e	0.57	0.68	0.52	0.75	0.40	0.57	0.62	0.57	0.49	0.41	0.58	0.67	0.59	1.02	0.41	0.57	0.68	0.52	0.75	0.40	0.57	0.62	0.57	0.49	0.41	0.58	0.67	0.59	1.02	0.41
Return per unit of risk ^f	1.29	1.35	1.47	2.63	1.73	1.34	1.22	1.63	2.54	1.70	1.21	1.23	1.61	3.33	1.71	1.29	1.35	1.47	2.63	1.73	1.34	1.22	1.63	2.54	1.70	1.21	1.23	1.61	3.33	1.71
	4.19	27.91	1.43	10.86	1.99	2.39	8.31	1.31	0.42	0.65	0.71	4.62	0.79	1.08	0.67	4.19	27.91	1.43	10.86	1.99	2.39	8.31	1.31	0.42	0.65	0.71	4.62	0.79	1.08	0.67

^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.

lending, Proper Banking Management Directive 432,¹⁴ relating to the transfer of activity and closing of accounts, aims to improve household customers' ability to switch banks. The "Fees Law" enhances transparency in regard to the cost of banking services for retail customers. Many additional attempts to improve competitiveness in the banking industry have been made, e.g., encouraging more banks to join the system, bringing in a foreign bank to do business with retail customers, activating an online bank, and privatizing the Postal Bank. All these measures, along with the appointment of the Ariav Committee¹⁵ for the development and enhancement of competition in the domestic banking system and capital market, were meant, as stated, to improve competitiveness within the banking system and between it and the non-banking market, to create an efficient credit market in retail lending as well, and to limit the commercial banks' ability to apply market power.

The household segment is much costlier to run than the other activity segments. This high cost (47.6 percent; Figure 2.6), reflected in the share of this segment in total operating and other costs, is a consequence of the expenses that the banking groups incur for the maintenance and operation of a wide array of branches for their retail customers, including large quantities of human and physical resources. In contrast, expenses on account of corporate-segment activity are relatively low (12.9 percent) due to the relative small number of business centers.

In terms of the long-term operating efficiency of the various activity segments—a parameter derived from each segment's levels of profit and income—there is a considerable difference between the stability of efficiency in the retail segments and the volatility in the efficiency of the business segments. Given the high sensitivity of business activity to domestic business cycles relative to that of retail activity, the business segments' operating-efficiency ratios are more volatile across business cycles than those of the retail segments—higher during economic upturns and lower at times of slowdown. In the retail segment, in contrast, financial results are less affected by business cycles and, therefore, the segment's efficiency ratio is less volatile. Thus, the coverage ratio of the household segment was 0.58 in 2009 as against 0.57 in 2008, whereas the corresponding figures in the corporate segment were 1.02 and 0.49, respectively (Table 2.9, Figure 2.6).

¹⁴ Proper Banking Management Directives, July 2005.

¹⁵ In November 2007, the Governor of the Bank of Israel and the Minister of Finance appointed the Director General of the Ministry of Finance, Yarom Ariav, as chair of a committee on the development and enhancement of competition in the Israeli banking system and capital market. The committee was instructed to examine the development of the domestic capital market and to recommend necessary measures to develop the market further and make it more attractive to foreign capital, so that it may become a significant player on the global scene and a more competitive and efficient market.

4. ANALYSIS OF THE BANKS' PERFORMANCE AS MEASURED BY THE MARKET VALUE TO BOOK VALUE RATIO (MV/BV)¹⁶

The analysis that follows reflects a complementary approach to that based on information available in the financial statements. It is based on the market-value-to-book-value (MV/BV) ratio, an indicator of the estimation of banks' performance as reflected in investors' assessments. This indicator, based on information from the markets, elicits an estimate of banks' performance and resilience.

The MV/BV ratio, expressing the premium that the market is willing to pay over the book value of a bank's share capital, is an effective and accepted indicator of the market's assessment of the future performance of a bank. 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 smaller than 1, it means that investors are skeptical about the bank's ability to intelligently manage losses that its exposure to risks may cause. In other words, investors believe that the book value of the bank's share capital exceeds its economic value, i.e., its latent potential (reflected in high yield and/or low risk) is poor.

After the first quarter of 2006, when the average MV/BV ratio of the five large commercial banks attained record levels, the ratio showed a clear downward trend amid volatility. The trend stopped in the first quarter of 2009; the ratio leveled off at that time and took a perceptible upward turn during the review year.

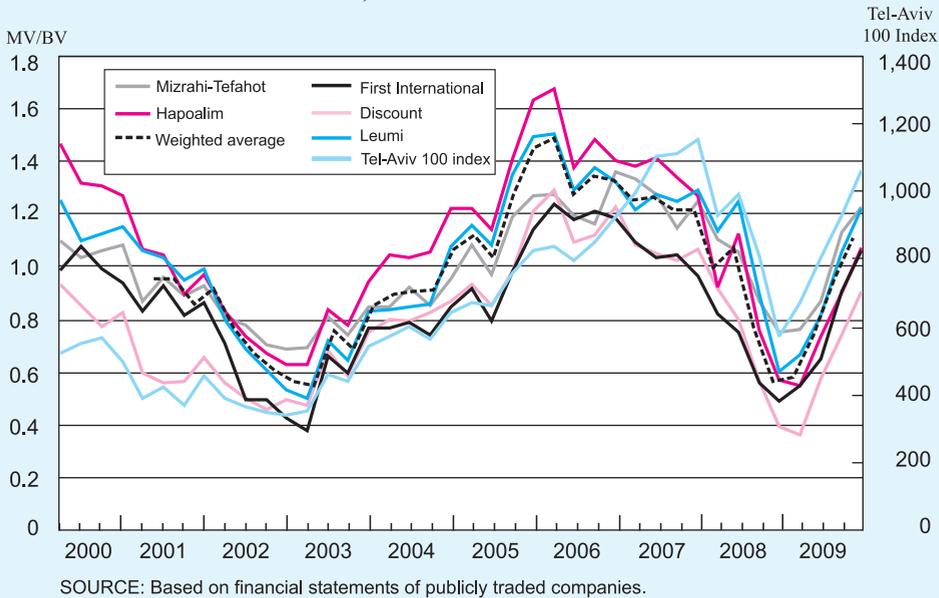
The average MV/BV ratio of the five large commercial banks increased in 2009, crossing the threshold of unity, and ending the year at 1.09 as against 0.56 in 2008—up 96 percent. The 2009 level resembled that of the autumn of 2008, preceding the worsening of the global financial crisis, but fell short of the all-time record that was set in late 2005 and early 2006 (Figure 2.7).

Various factors have affected the MV/BV indicator over the years—some internal and specific to the banking system and others system-wide and derived from developments in the macroeconomy and the domestic and foreign capital markets. In 2007, for example, investors' doubts about the banks' ability to regain previous years' high levels of profit and profitability outweighed the favorable effect of the growth trend and the bull market; consequently, in 2008 the totality of the factors pushed the ratio down to its lowest level since the early-2003 trough.

In 2009, as stated, the downward trend in previous years reversed direction and the average ratio climbed to 1.09. Some of the factors that affected the ratio favorably in 2009 were systemic; others were internal. The system-level factors included the positive

¹⁶ 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). Market value also includes shares not listed for trading, to which the market value of shares listed for trading is assigned. BV_i is the balance-sheet value of the equity, including paid up share capital, reserves, and surplus capital, of bank i in period $t-1$.

Figure 2.7
Ratio of Market Value to Book Value (MV/BV) of the Five Major Banks
and the Tel Aviv 100 Index, March 2000 to December 2009

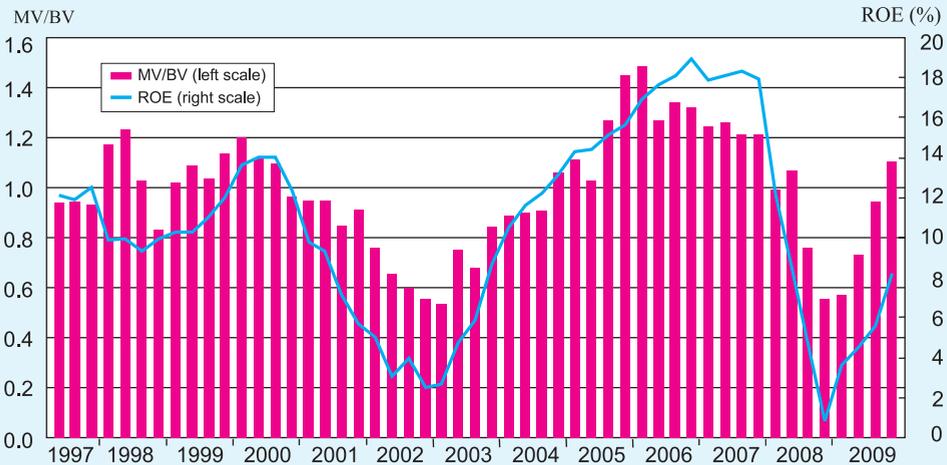


climate in the domestic financial markets due to the resilience of the domestic financial system and, foremost, the banking system, to the global crisis; the positive atmosphere in the global capital markets due to various countries' intervention measures and rescue programs—a factor that also projected onto the domestic capital markets—the low-interest environment in Israel and abroad, which brought investors back to the capital markets and pushed prices up; and the buoyancy of the Israeli economy and its unexpectedly early return to a trend of growth. All these factors helped to boost optimism among investors and improved their assessment of the future performance of Israeli banks. Notable among the internal factors that affected the ratio were the banks' return to a trajectory of profitability and gradual improvement in their financial statements during the review year and an improvement in the banks' resilience as manifested in the various risk indices, including a change for the better in the composition of their assets, a decline in risks originating in the capital market, and an improved capital ratio.

As for the change in the ratio at each of the five large commercial banks, each bank improved its ratio and four banks surpassed 1. Only Israel Discount Bank had a ratio lower than 1, even though it posted the steepest increase relative to 2008 (130 percent).

The dispersion of the ratio,¹⁷ reflecting the difference between investors’ subjective assessments of each bank’s performance separately, decreased to 0.020 in 2009 as against 0.027 in 2008. In our estimation, two factors explain the decline: (a) none of the banks surveyed went back to distributing dividends in 2009 and (b) the market believed that the effect of the system-level factors of influence, to which each bank in the system is exposed, outweighed the differences in their characteristics, risk exposure, and financial results. This argument is supported by the strong correlation that was found between the MV/BV ratio and the Tel Aviv 100 index in the past three years (0.96), as against a weaker correlation in the previous decade (0.69; Figure 2.7). Figure 2.8, which contrasts the commercial banks’ MV/BV ratio with their profitability (ROE) between March 1998 and December 2009, aptly demonstrates the positive relation between the variables—a relation described at length in the professional literature¹⁸ based on finance theory.¹⁹

Figure 2.8
Return on Equity (ROE)^a and the MV/BV Ratio of the Five Major Commercial Banks, March 1997 to December 2009



^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.

¹⁷ Calculated as the average Standard Deviation of the four quarters of the year for the five large banks.

¹⁸ For expanded discussion, see Yoram Landskroner, David Ruthenberg, and Shaul Pearl, “Market-to-Book Value Ratio in Banking—The Israeli Case,” Banking Supervision Department, Research Unit, Bank of Israel, June 2006.

¹⁹ This relations is based on the MV/BV relation, formulated as follows: $MV/BV = \frac{ROE - g}{k - g}$

where:

ROE—Return on Equity

g—the banks’ growth rate;

k—the bank’s risk.

For expanded discussion on the subject, see Landskroner, Ruthenberg, and Pearl, n. 19 above.

