*Chapter 3*

# *Financial Results*

The banking system experienced an even more difficult year in 2002 than in 2001; total profit of the five major banking groups declined from NIS 2.3 billion in 2001 to NIS 1.1 billion in 2002. This reflects a fall in return on equity from 5.8 percent to 2.8 percent—the lowest level of profitability recorded in the last decade. However, profitability varied widely among the five major banks—from a positive return of 8.6 percent at United Mizrahi Bank to a negative return of–1.4 percent at the First International Bank. The low levels of profitability of the five major banking groups in 2002 and their wide variance are explained primarily by the loan-loss provision, which reached an unprecedented level of NIS 7.3 billion in 2002 compared to NIS 4.6 billion in 2001—in itself a high level. The exceptional size of the loan-loss provision was due to the worsening recession in Israel that followed the escalation of security incidents, and the continued worldwide economic slowdown, particularly in the high-tech industries, which eroded the solvency of many businesses. It may also have revealed deficiencies in credit management by the banks in previous years.

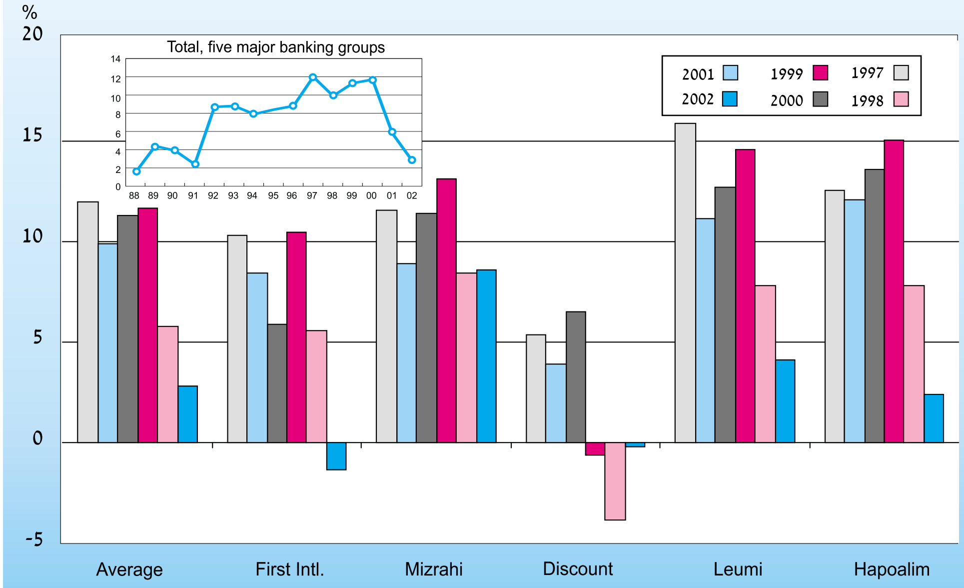
The differential effect of the loan-loss provision on the profitability of the five major banking groups stemmed mainly from differences between them in the amount of credit extended to business enterprises, in particular to those operating in industries worst affected by recent economic developments (e.g., communications and computer services, manufacturing, construction and real estate, financial services, and hotels and catering). On the other hand, the loan-loss provision for retail customers was low, enabling the banks to achieve profitability, albeit at a low level, even in this difficult year.

The recession also left its mark on the banks' interest and non-interest income, both of which remained relatively stable. The banks also succeeded in halting the rise in operating expenses and even reduced them, thus improving operating efficiency. This meager improvement, however, did not offset the adverse effect of the steep rise in the loan-loss provision.

## 1. PROFIT AND PROFITABILITY OF THE BANKING GROUPS

The deepening recession resulting from negative developments in Israel and abroad exerted a powerful adverse effect on the financial results of the banks; the annual financial statements of most of the banking groups were the worst in the last decade.[1] Total profit of the five major banking groups—Bank Hapoalim, Bank Leumi, Bank Discount, Bank Mizrahi and the First International Bank—was approximately NIS 1,130 million in 2002, a reduction of 50 percent from the level in 2001 (Table 3.1). Results were particularly poor in the last quarter of the year, when the five major banking groups showed a total loss of NIS 190 million—their first combined quarterly loss since 1988. The return on equity (ROE) was 2.8 percent this year, down from 5.8 percent in 2001—low profitability compared to the long-term average of the last decade, 8.7 percent. Although 2002 was another difficult year from the standpoint of average profitability of the banking system, profitability varied considerably among the banking groups. Mizrahi showed an ROE of 8.6 percent at the end of 2002, Leumi, 4.1 percent and Hapoalim, 2.4 percent, whereas Discount and the First International recorded negative returns, –0.2 percent and –1.4 percent respectively (Figure 3.1).

**Figure 3.1**
**Return on Equity, by Banking Groups, 1988–2002**




SOURCE: Published financial statements.

[1] The discussion in this chapter focuses on the profits and the profitability of the five major banking groups, although the extended analysis of the operating income and expenditures and of the indices of operation and efficiency covers all the commercial banks. This year, data on two branches of foreign banks (Citibank and HSBC) are included as well.

**Table 3.1**
**Adjusted Capital and its Profitability, the Five Major Banking Groups, 1998–2002**

(NIS million, December 2002 prices)

| | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|
| 1. End-of-year capital[a] | 34,561 | 36,146 | 38,885 | 40,686 | 40,489 |
| 2. Beginning-of-year capital[b] | 33,476 | 34,156 | 35,433 | 38,631 | 40,667 |
| 3. Ordinary before-tax income | 4,877 | 6,576 | 6,532 | 4,711 | 2,344 |
| 4. Tax provision | 2,066 | 3,285 | 3,118 | 2,324 | 1,049 |
| 5. Extraordinary net income[c] | 19 | 172 | 347 | –13 | –72 |
| 6. Share in profits of unconsolidated subsidiaries | 382 | 387 | 407 | –191 | –100 |
| 7. Translation adjustments | 94 | 16 | –30 | 70 | 7 |
| **8. Total profit[d] (3)–(4)+(5)+(6)+(7)** | 3,306 | 3,866 | 4,138 | 2,253 | 1,130 |
| *Percent* | | | | | |
| 9. Ordinary before-tax profitability (2)/(3) | 14.6 | 19.3 | 18.4 | 12.2 | 5.8 |
| 10. Return on equity (ROE)(8)/(2) | 9.9 | 11.3 | 11.7 | 5.8 | 2.8 |
| 11. Return on assets (ROA) | 0.5 | 0.6 | 0.6 | 0.3 | 0.1 |

[a] Including minority interests.

[b] Capital at beginning of year *plus* issues weighted according to date of issue, *minus* dividends calculated according to dates of payment.

[c] Including deduction of goodwill in United Mizrahi Bank.

[d] Including the share of minority shareholders in consolidated income.

SOURCE: Published financial statements.

ROE is derived from total profit and capital. The capital of the five banking groups (capital of the banks including minority interests) was approximately NIS 40.5 billion at the end of 2002, as against NIS 40.7 billion at end-2001. The relative stability of equity in contrast to its upward trend in recent years was affected mainly by accounting adjustments made to show securities available for sale at fair value[2] and by the annual losses of certain banking corporations. As recommended by the Supervisor of the Banks the banking groups again did not distribute dividends in 2002. The recommendation was made due to the deteriorating economic situation, some increase in uncertainty in the banking system and the sharp decline in banking profits.[3] This was in addition to the non-distribution of dividends in accordance with the Supervisor's instructions prohibiting distribution under certain conditions detailed therein.[4]

[2] For amplification see Box 3.2.

[3] Despite this, Bank Hapoalim distributed its shares in Koor Industries as a dividend in kind, totaling NIS 190 million.

[4] Apart from limitations on dividend distribution detailed in the Companies' Law, additional restrictions are imposed on a banking corporation (Regulation 331 in "Proper conduct of banking business")—including a prohibition on dividend distribution from capital funds or from differentials originating from the translation of financial reports of autonomous units abroad, a prohibition on dividend distribution if a suspicion exists that doing so will prevent the corporation from meeting its anticipated liabilities, and a prohibition on dividend distribution if the profits of the banking corporation are not appropriate for distribution (for example, when accumulated surplus balances, according to the latest financial reports, are not positive).

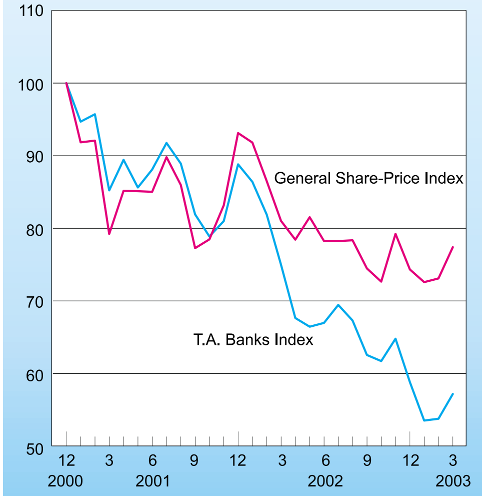
The marked decline in banking profits in recent years was due principally to the high level of the loan-loss provision, in particular against debts in the business sector. The loan-loss provision totaled NIS 7.3 billion this year, compared to NIS 4.6 billion in 2001, a steep rise of 57 percent (Table 3.2). The significant increase in the extent of the loan-loss provision stemmed, in part, from the continuing recession caused by two negative shocks—the escalation of security incidents that directly and indirectly affected many principal industries, such as construction and tourism, and the slackening rate of economic growth worldwide, manifested in falling demand for high-tech products, which led the growth of Israel's exports in the last few years. The global slowdown had an adverse effect on the high-tech industries, particularly communications, computer services and other advanced-technology industries. The increase in the loan-loss provision may also have brought to light wrong decisions in previous years regarding credit.

External conditions also affected the non-interest and interest income of the five major banking groups. Although this income remained relatively stable (increasing by NIS 41 million), it is reasonable to expect that, were it not for the recession, some growth would have taken place. The five major banking groups apparently began stabilizing their operating expenses which have been relatively high in recent years (achieving a reduction of 1.3 percent), thus improving their operating efficiency somewhat. This improvement, however, did not offset the large increase in the loan-loss provision, which was the main factor in the decline of the banks' performance.

The fall in the banking system's profitability, together with deepening recession and the apprehensions regarding possible further increase in the loan-loss provision, raised the level of concern in the markets. This was expressed in a sharp drop in bank share prices on the stock exchange, while the banks' market values were markedly lower than their book value. Thus, the Bank Shares Index[5] fell in 2002 by 34 percent, compared to a drop of 20 percent in the General Share Price Index (Figure 3.2).

These events in the banking system became one of the variables determining the state of the economy, and in particular its

**Figure 3.2**
**Tel-Aviv Banks Index and General Share-Price Index, December 2000–March 2003** (December 2000=100)




SOURCE: Tel Aviv Stock Exchange.

[5] The Tel Aviv Bank Shares Index, published by the stock exchange since June 1, 2000, includes the stocks of the five commercial banks with the highest market value of all those included in the Tel Aviv 100 Index.

**Table 3.2**
**Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 2001 and 2002**

(NIS million, December 2002 prices)

| | Leumi | | Hapoalim | | Discount | | Mizrahi | | First Intl. | | Total | | Contri- bution to profit | Rate of change (%) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2001 | 2002 | 2001 | 2002 | 2001 | 2002 | 2001 | 2002 | 2001 | 2002 | 2001 | 2002 | | |
| Net interest income before loan-loss provision | 5,568 | 5,182 | 6,059 | 6,442 | 2,914 | 2,947 | 1,350 | 1,448 | 1,328 | 1,243 | 17,219 | 17,262 | 43 | 0.2 |
| Loan-loss provision | 1,579 | 1,944 | 1,279 | 3,267 | 1,003 | 894 | 313 | 315 | 462 | 864 | 4,636 | 7,284 | –2,648 | 57.1 |
| Net interest income after loan-loss provision | 3,989 | 3,238 | 4,780 | 3,175 | 1,911 | 2,053 | 1,037 | 1,133 | 866 | 379 | 12,583 | 9,978 | –2,605 | –20.7 |
| Total non-interest income[a] | 2,878 | 2,950 | 3,510 | 3,583 | 1,944 | 1,789 | 866 | 854 | 709 | 729 | 9,907 | 9,905 | –2 | 0.0 |
| *of which* Fee income | 2,304 | 2,478 | 2,912 | 2,952 | 1,538 | 1,528 | 778 | 798 | 613 | 649 | 8,145 | 8,405 | 260 | 3.2 |
| Total operating expenses | 5,416 | 5,352 | 5,927 | 5,944 | 3,904 | 3,681 | 1,354 | 1,375 | 1,178 | 1,187 | 17,779 | 17,539 | 240 | –1.3 |
| *of which* Salaries and related expenses | 3,411 | 3,542 | 3,549 | 3,645 | 2,450 | 2,225 | 876 | 877 | 712 | 719 | 10,998 | 11,008 | -10 | 0.1 |
| Ordinary before-tax income | 1,451 | 836 | 2,363 | 814 | –49 | 161 | 549 | 612 | 397 | –79 | 4,711 | 2,344 | –2,367 | –50.2 |
| Tax provision | 541 | 267 | 1,062 | 301 | 251 | 211 | 265 | 304 | 205 | –34 | 2,324 | 1,049 | 1,275 | –54.9 |
| Ordinary after-tax income[b] | 910 | 569 | 1,301 | 513 | –300 | –50 | 283 | 308 | 192 | –45 | 2,386 | 1,295 | –1,091 | –45.7 |
| Other income[c] | 27 | –139 | –341 | –156 | 28 | 11 | –36 | –35 | –16 | –21 | –338 | –340 | -2 | 0.6 |
| Net income | 937 | 430 | 960 | 357 | –272 | –39 | 247 | 273 | 176 | –66 | 2,048 | 955 | –1,093 | –53.4 |
| Total income[d] | 978 | 561 | 1,049 | 329 | –236 | –14 | 275 | 303 | 187 | –49 | 2,253 | 1,130 | –1,123 | –49.8 |
| Equity[e] | 12,480 | 13,676 | 13,414 | 13,776 | 6,113 | 6,126 | 3,259 | 3,534 | 3,364 | 3,556 | 38,631 | 40,667 | 2,036 | 5.3 |
| Ordinary ROE, net (%) | 7.3 | 4.2 | 9.7 | 3.7 | –4.9 | -0.8 | 8.7 | 8.7 | 5.7 | –1.3 | 6.2 | 3.2 | | |
| **Total ROE (%)** | **7.8** | **4.1** | **7.8** | **2.4** | **–3.9** | **–0.2** | **8.4** | **8.6** | **5.6** | **–1.4** | **5.8** | **2.8** | | |
| Total return on assets (ROA)(%) | 0.42 | 0.22 | 0.44 | 0.13 | –0.18 | –0.01 | 0.37 | 0.38 | 0.27 | –0.07 | 0.30 | 0.14 | | |
| Loan-loss provision/ total credit | 0.93 | 1.11 | 0.68 | 1.70 | 1.33 | 1.18 | 0.53 | 0.52 | 0.91 | 1.75 | 0.85 | 1.32 | | |
| Risk-based capital ratio | 9.74 | 10.32 | 9.10 | 9.95 | 9.26 | 9.33 | 9.11 | 9.46 | 9.74 | 9.81 | 9.38 | 9.91 | | |

[a] Including profit/loss from sale of shares.
[b] After deduction of goodwill in United Mizrahi Bank of NIS 1 million in 2001.
[c] Includes the group's share in the profits of its subsidiaries, minority interests, income from the sale of assets and investments, and net income from extraordinary activities.
[d] Total income is defined as net income *plus* the share of minority interests and translation adjustments imputed to equity.
[e] Equity and minority interests at beginning of year *plus* issues at time of issue *minus* dividends paid, according to time paid.
SOURCE: Published financial statements.

## Table 3.3
## Indicators of the Performance of Various Banking Systems,[a] 2001

| | Performance indices (%) | | | General indices | | Operating indices (%) | | | Risk indices (%) | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Financial margin on total assets[b] | Return on equity | Return on assets | GDP ($ billion) | Per capita GDP ($ 000s) | Total income/ operating expenses | Operating expenses/ total assets | Non-interest income/ operating expenses | Loan-loss provision/ total credit | Capital adequacy | Tier 1 capital ratio |
| Austria | 1.5 | 10.6 | 0.4 | 217.4 | 26.4 | 151.2 | 1.6 | 55.6 | 0.7 | 11.9 | 7.3 |
| Australia | 2.1 | 14.0 | 0.9 | 491.8 | 24.6 | 177.3 | 2.3 | 86.7 | 0.4 | 10.6 | 7.9 |
| Belgium | 1.5 | | 0.7 | 262.5 | 26.2 | 137.4 | 1.8 | 55.9 | 0.2 | 12.0 | 7.7 |
| Canada | 1.9 | 14.0 | 0.7 | 843.2 | 26.5 | 144.0 | 2.9 | 84.5 | 0.7 | 12.2 | 9.0 |
| Denmark | 1.4 | 13.9 | 0.5 | 155.4 | 28.5 | 169.5 | 1.2 | 40.2 | 0.3 | 10.3 | 7.4 |
| Finland | 1.9 | 11.2 | 0.6 | 126.8 | 24.0 | 148.9 | 1.9 | 47.4 | | 12.0 | 8.1 |
| France | 0.5 | 13.0 | 0.5 | 1,420.0 | 24.1 | 143.0 | 1.5 | | 0.6 | 10.6 | 7.7 |
| Germany | 0.8 | 2.3 | 0.1 | 2,086.8 | 25.2 | 157.4 | 1.4 | 60.4 | 0.6 | 11.0 | 6.7 |
| Greece | 2.7 | 9.8 | 0.8 | 184.7 | 17.5 | 154.7 | 2.7 | 54.6 | 0.8 | 12.5 | 8.8 |
| Ireland | 1.9 | 14.1 | 0.8 | 124.4 | 27.2 | 175.6 | 1.8 | 69.0 | 0.3 | 10.8 | 7.1 |
| Italy | 2.2 | 9.8 | 0.5 | 1,429.7 | 24.5 | 153.7 | 2.3 | 60.2 | 1.0 | 9.4 | 6.1 |
| Netherlands | 1.5 | 11.7 | 0.5 | 436.2 | 27.4 | 130.7 | 2.0 | 54.7 | 0.3 | 11.0 | 8.4 |
| Norway | 2.3 | 12.0 | 0.8 | 133.7 | 29.3 | 143.7 | 2.7 | 59.2 | 0.4 | 11.0 | 7.8 |
| Portugal | 2.2 | 18.3 | 0.9 | 181.9 | 17.7 | 177.8 | 1.9 | 59.5 | 0.5 | 9.5 | 7.0 |
| South Africa | 1.8 | 7.4 | 0.6 | 488.3 | 10.9 | 181.5 | 2.2 | 99.1 | 0.8 | | |
| Spain | 2.8 | 13.5 | 1.0 | 828.4 | 19.9 | 168.1 | 2.4 | 55.1 | 0.8 | 11.3 | 8.2 |
| Sweden | 1.4 | | 0.9 | 215.0 | 23.8 | 176.5 | 1.5 | 58.1 | | 12.2 | 8.8 |
| Switzerland | 0.8 | 6.9 | 0.3 | 203.2 | 31.0 | 120.4 | 2.7 | 88.7 | 0.4 | 16.9 | 11.7 |
| UK | 1.8 | 16.2 | 0.9 | 1,420.3 | 24.3 | 177.3 | 1.9 | 79.9 | 0.5 | 12.1 | 7.4 |
| US | 1.6 | 12.2 | 0.8 | 9,792.5 | 34.3 | 142.6 | 3.4 | 95.6 | 0.9 | 13.1 | 9.5 |
| **Average** | **1.7** | **11.7** | **0.7** | **1,052.1** | **24.7** | **156.6** | **2.1** | **66.5** | **0.6** | **11.6** | **8.0** |
| **Reference group average[b]** | **2.0** | **12.4** | **0.7** | **207.2** | **22.7** | **161.1** | **2.0** | **60.6** | **0.4** | **11.2** | **7.7** |
| **Israel 2001** | **2.3** | **5.8** | **0.3** | **125.9** | **19.6** | **152.6** | **2.2** | **55.7** | **0.9** | **9.4** | **6.4** |
| **Israel 2002** | **2.3** | **2.8** | **0.1** | **106.7** | **16.1** | **154.9** | **2.2** | **56.5** | **1.3** | **9.9** | **6.6** |

[a] For each country we included the ten major banking groups, except for the US, for which the 100 banking groups were included, and Israel and Finland, for which the five major banking groups were included.

[b] Israel's reference group included eight countries that resemble it in size of GDP and banking system characteristics: Belgium, Denmark, Finland, Greece, Ireland, Norway, Portugal, and South Africa.

SOURCE: Based on data provided by *Bankscope* and the World Bank website.

financial stability. In the course of 2002, the international rating companies Moody's, Fitch-IBCA and Standard and Poor's lowered the credit rating of most Israeli banks, a change reflecting the assessment by international agencies of the condition of the domestic banking system and the Israeli economy in general relative to similar banking systems throughout the world (for a fuller discussion see Appendix 5.1).

A comparison with the banking systems of advanced countries with respect to indices of performance, operation and risk shows the low level of profitability in Israeli banks, in both ROE and return on assets (ROA) (Table 3.3). Of note as well is the high exposure to credit risk, as shown in the high ratio of loan-loss provision to total credit. The negative implications of this high exposure increase because of the capital adequacy ratios, which are much lower than in the countries surveyed.[6] As the level of capital adequacy of Israeli banks was not high enough in the period of prosperity, they may be forced to continue to maintain low rates of growth of risk-weighted assets, especially of credit, a development expected to delay the improvement of profitability in the future. Such an improvement also depends on learning the lessons of the generous credit policy of previous years and on the timing and pace of economic recovery globally and in Israel.

## 2. DEVELOPMENTS IN INCOME AND EXPENDITURE

### a. Net interest income

The upward trend of net interest income (NII) of the five major banking groups evident since 1999 was halted in 2002. NII before loan-loss provision rose reviewed by NIS 43 million in 2002 to NIS 17.3 billion (Table 3.4). The increase was only 0.3 percent (compared to 5.1 percent in 2001) and there was significant variation between the groups—from a rise of 7.2 percent at Mizrahi to a decline of 6.9 percent at Leumi. NII in 2002 was affected by the moderate (1.6 percent) increase in financial activity as measured by the volume of assets earning interest income (quantity effect) and the stability of the overall interest margin (price effect) that came to 2.3 percent—slightly higher than the norm abroad, but similar to its level in 2000 and 2001. The stability of the interest margin derived mainly from the decline in the contribution to banks' NII of domestic-activity segments, that offset the growing contribution of foreign-currency operations abroad. (An extended discussion of net interest margins by indexation segments appears in Chapter 2).

[6] This international comparison included the ten major banking groups in each country, whose principal activity is commercial banking, assuming that they reflect to a great extent the performance of the entire banking system in each country. For Israel and for Finland, the five major banking groups were included, and for the US, the 100 major banking groups. It should be noted that Israel's banking system data are still adjusted for inflationary effects, while in the reference group of countries the data are on a nominal basis. The data base was taken from the Bank Scope database.

**Table 3.4**
**Income from Financing Operations Before Loan-Loss Provision, and Estimated Net Interest Margins of the Five Major Banking Groups, 2001 and 2002**

(NIS million, December 2002 prices)

| | Amount | | Distribution (%) | |
|---|---|---|---|---|
| | 2001 | 2002 | 2001 | 2002 |
| Credit to the public | 42,884 | 28,568 | 70.4 | 75.8 |
| Bonds | 9,026 | 5,274 | 14.8 | 14.0 |
| Bank deposits | 4,573 | 3,532 | 7.5 | 9.4 |
| Other assets | 4,417 | 332 | 7.3 | 0.9 |
| **Total income on assets** | **60,900** | **37,706** | **100.0** | **100.0** |
| Deposits of the public | –42,593 | –19,306 | 90.2 | 83.2 |
| Other liabilities | –4,606 | –3,909 | 9.8 | 16.8 |
| **Total expenses on liabilities** | **–47,199** | **–23,215** | **100.0** | **100.0** |
| **Total income on assets and liabilities** | **13,701** | **14,491** | 90.0 | 92.8 |
| Income on hedging derivatives and ALM | 1,529 | 1,126 | 10.0 | 7.2 |
| **Total income on activity in the indexation segments** | **15,230** | **15,617** | **100.0** | **100.0** |
| Income from other financial derivatives | 69 | –74 | 3.5 | –4.5 |
| Commissions on financing transactions | 823 | 781 | 41.4 | 47.5 |
| Other financing income, net | 1,097 | 938 | 55.2 | 57.0 |
| **Total other income** | **1,989** | **1,645** | **100.0** | **100.0** |
| **Total income from financing operations before loan-loss provision** | **17,219** | **17,262** | | |
| **Total net interest margins** | **2.3** | **2.3** | | |

SOURCE: Published financial statements.

The reduction in the rate of expansion of financial activity stems from the continuing and deepening economic slump. Furthermore, analyzing financial assets by indexation segment shows that most of the growth was concentrated in the foreign-currency sector (nominal and indexed). The 5.4 percent rise in foreign-currency-denominated assets sprang from the real devaluation of the NIS against leading world currencies, as well as from a small increase (in dollar terms) of activity in this sector. In contrast, local-currency assets remained relatively stable (declining by 0.6 percent), partially due to Israel’s high level of inflation.

The five major banking groups derive their NII from three main sources: operations in the various indexation segments, i.e., balance-sheet operations; off-balance-sheet operations; and other interest income.

NII from balance-sheet operations rose by 2.5 percent in 2002, as a consequence of some increase in banking activity and from changes in the mix of various other services—a rise in the share of credit to the public, the most profitable service, at the expense of investment in bonds that were less profitable this year due to falling prices in the bond market. There was also a noticeable decline in interest income on and financing costs of balance-sheet operations. This was due to the decline in real interest rates, particularly in the first half of the year, following the lowering of interest rates at the end of 2001, and from the sharp rise in the inflation rate. In the framework of the management of assets and liabilities in balance-sheet operations, the banks also transact business in the financial derivatives market (called ALM—Asset Liability Management) to close balance-sheet positions in the various indexation segments. Income from these instruments totaled NIS 1.1 billion in 2002, down from NIS 1.5 billion in 2001, a decline that partially offset the increases in profits from interest on balance-sheet operations. The expansion of non-performing loans, due to borrowers' difficulties that affected their solvency, also contributed to reducing profits.

NII was adversely affected by the drop in financing fees and commissions that totaled NIS 781 million in 2002, down from NIS 823 million in 2001 (a 5 percent reduction). These fees include mainly interest income from off-balance-sheet operations, in particular fees for various types of guarantees—for granting credit, for home acquisitions, and other guarantees and fees from foreign-trade activities.

Other interest income (net) includes profit (loss) from the sale of bonds held to maturity or available for sale, from adjustments of bonds for trade at fair value, from collection of doubtful debts already provided for, from reduction of the provision for interest on doubtful debts and from fees on early repayment of credit. Income from these sources declined in 2002 by 14.5 percent to NIS 938 million. Most of the decline stemmed from losses which the five banking groups recorded in their nostro portfolios (Box 3.1), following bond-market fluctuations during the year that led to a fall in bond prices. Significant losses of NIS 357 million were incurred from the adjustments of bond prices in the trading book to fair value.

**Box 3.1**
**The Nostro Portfolio**

In the last few years, the banking groups in Israel increased their use of securities (bonds and shares), acting as intermediaries for their customers and also as buyers and sellers on their own account—subject to the limitations imposed on them by the Supervisor of the Banks. As intermediaries, the banks bring buyers and sellers together and charge commissions—as a certain percentage of the value of transactions, or as a margin between the buying and the selling price, etc. The banks' investment in securities for their own account serves to vary their sources of income and to increase their profits through the utilization of market opportunities for arbitrage operations. The banks' investments in securities are classified into three groups:

**Table 3.5**
**The Securities Portfolios of the Five Major Banking Groups, 2002**

(NIS million, December 2002 prices)

| | Hapoalim | | Leumi | | Discount | |
|---|---|---|---|---|---|---|
| | Fair value | Distribution | Fair value | Distribution | Fair value | Distribution |
| **Bonds held to maturity** | | | | | | |
| Government bonds | 2,092 | 7.8 | 3,041 | 8.3 | 12 | 0.0 |
| Other bonds | 531 | 2.0 | 85 | 0.2 | 32 | 0.1 |
| **Total bonds** | **2,623** | **9.8** | **3,126** | **8.5** | **44** | **0.1** |
| **Securities available for sale** | | | | | | |
| Government bonds | 9,847 | 36.9 | 15,868 | 43.1 | 29,148 | 78.0 |
| Other bonds | 10,901 | 40.8 | 12,729 | 34.5 | 7,338 | 19.6 |
| Total bonds | 20,748 | 77.7 | 28,597 | 77.6 | 36,486 | 97.6 |
| Total shares | 261 | 1.0 | 837 | 2.3 | 546 | 1.5 |
| **Total securities** | **21,009** | **78.7** | **29,434** | **79.9** | **37,032** | **99.0** |
| **Trading securities** | | | | | | |
| Government bonds | 3,012 | 11.3 | 3,259 | 8.8 | 144 | 0.4 |
| Other bonds | 36 | 0.1 | 857 | 2.3 | 165 | 0.4 |
| Total bonds | 3,048 | 11.4 | 4,116 | 11.2 | 309 | 0.8 |
| Total shares | 15 | 0.1 | 176 | 0.5 | 5 | 0.0 |
| **Total trading securities** | 3,063 | 11.5 | 4,292 | 11.6 | 314 | 0.8 |
| **Total government bonds** | **14,951** | **56.0** | **22,168** | **60.2** | **29,304** | **78.4** |
| **Total other securities** | **11,744** | **44.0** | **14,684** | **39.8** | **8,086** | **21.6** |
| **Total securities** | **26,695** | **100.0** | **36,852** | **100.0** | **37,390** | **100.0** |

**Table 3.5 (continued)**

(NIS million, December 2002 prices)

| | Mizrahi | | First International | | All banking groups | |
|---|---|---|---|---|---|---|
| | Fair value | Distribution | Fair value | Distribution | Fair value | Distribution |
| **Bonds held to maturity** | | | | | | |
| Government bonds | 690 | 17.2 | 0 | 0.0 | 5,835 | 5.3 |
| Other bonds | 549 | 13.7 | 166 | 4.0 | 1,363 | 1.2 |
| **Total bonds** | **1,239** | **30.9** | **166** | **4.0** | **7,198** | **6.6** |
| | | | | | | |
| **Securities available for sale** | | | | | | |
| Government bonds | 1,780 | 44.4 | 2,486 | 60.0 | 59,129 | 54.2 |
| Other bonds | 823 | 20.5 | 1,212 | 29.2 | 33,003 | 30.3 |
| Total bonds | 2,603 | 64.9 | 3,698 | 89.2 | 92,132 | 84.5 |
| Total shares | 124 | 3.1 | 116 | 2.8 | 1,884 | 1.7 |
| **Total securities** | **2,727** | **68.0** | **3,814** | **92.0** | **94,016** | **86.2** |
| | | | | | | |
| **Trading securities** | | | | | | |
| Government bonds | 42 | 1.0 | 154 | 3.7 | 6,611 | 6.1 |
| Other bonds | 1 | 0.0 | 0 | 0.0 | 1,059 | 1.0 |
| Total bonds | 43 | 1.1 | 154 | 3.7 | 7,670 | 7.0 |
| Total shares | 0 | 0.0 | 10 | 0.2 | 206 | 0.2 |
| **Total trading securities** | 43 | 1.1 | 164 | 4.0 | 7,876 | 7.2 |
| | | | | | | |
| **Total government bonds** | **2,512** | **62.7** | **2,640** | **63.7** | **71,575** | **65.6** |
| **Total other securities** | **1,497** | **37.3** | **1,504** | **36.3** | **37,575** | **34.4** |
| **Total securities** | **4,009** | **100.0** | **4,144** | **100.0** | **109,090** | **100.0** |

SOURCE: Published financial statements.

a. *Bonds held to maturity*—bonds that the bank intends to and can hold to maturity. The income is recorded on an accrual basis, meaning that the effect of changes in their rates shows up only at maturity. Banking regulations prohibit the inclusion of bonds in the portfolio of securities held to maturity if they may be expected to be sold because of changes in interest rates, the need to improve liquidity, changes in the return on alternative investments, etc.

b. *Trading securities*—securities held for the purpose of sale in the near future (and thus held for short periods). Trading usually consists of lively buying and selling activity, undertaken to generate profits (short-term changes in price, bid-ask spread, etc.). These securities are listed on the balance sheet at fair value (market value), and the profit (or loss) including unrealized profit (the change in fair value) is recorded on an ongoing basis in the profit and loss statement (under the net interest income item) and is included in the capital base recognized for the calculation of the minimal capital ratio.

c. *Securities available for sale*—securities not classified as bonds held to maturity or as trading securities. Securities available for sale are shown on the balance sheet at fair value, but income from changes in the market value of such a security is entered directly into the capital reserve—which represents a separate item within the framework of the bank's equity, although this item is not included in the calculation of capital adequacy. Only when the bank sells the security is the realized profit or loss transferred to the profit and loss statement, under the net interest income item.

Investments in securities by the five major banking groups increased by 8 percent to NIS 109 billion in 2002, following an increase of 14 percent in 2001. The banks' nostro portfolio consists mainly of government bonds, classified as available for sale (Table 3.5). This classification provides the banks with a certain degree of flexibility in the management of their investments and permits them to sell assets when required. The composition of the securities' portfolio differs among the major banking groups due to variations in their ability and willingness to bear risk.

### b. The loan-loss provision

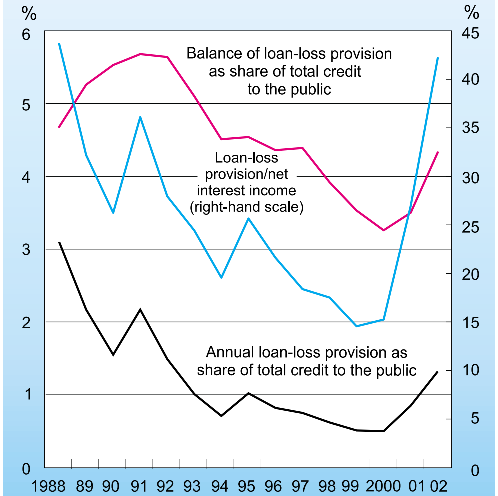
The loan-loss provision has been the principal factor reducing the profit of the five major banking groups during the past two years. The deterioration of the economic situation in Israel and abroad that began in 2001, due to the increasing severity of security incidents, the crisis in the high-tech industries and the declines on the major capital markets, became even more pronounced in 2002. Some credit ratings, both country ratings and the ratings of banks, were lowered, and interest rates rose in most indexation segments, against the background of a tight monetary policy and growing volatility in the exchange rates of the major currencies. These developments adversely affected the activity of many enterprises throughout the economy and, in consequence, credit risk in the banking system. This was reflected in the erosion of solvency and of the value of collateral, as evidenced in 2002 in the continued growth of the provision for doubtful and problem loans. The increase also exposed deficiencies in credit management in prior years.

In 2002, the loan-loss provision of the five banking groups increased by 57 percent, reaching a total of NIS 7.3 billion, following a steep rise of 87 percent in 2001 when the provisions were exceptionally high too. As a consequence of the increase in the loan-loss provision, common to all the banking groups except Discount, the rate of the annual loan-loss provision as a proportion of credit to the public increased by 1.3 percent, against 0.85 percent and 0.50 percent in 2001 and 2000 respectively. The rate differed from bank to bank, from 0.5 percent at Mizrahi to 1.8 percent at the First International, reflecting differences among the banks in their exposure to industries particularly affected by macroeconomic developments—primarily communications and computer services, manufacturing, construction and real estate, financial services, hotels and catering. The loan-loss provision as a percentage of credit to the public deviates to a great extent from the average rate in the reference group (0.4 percent), and indicates the deterioration in the quality of the credit portfolio of Israel's banking system in recent years resulting from the difficult economic climate.

The balance of loan-loss provision of the five major banking groups was NIS 23.9 billion at the end of the year, representing a coverage rate of 4.3 percent of credit to the public. The increase in the size of the loan-loss provision was reflected also in the rise in the share of the annual loan-loss provision in total net interest income before the provision to 42 percent from 27 percent in 2001 (Figure 3.3).

As in previous years, most of the loan-loss provision in 2002 consisted of the specific provision, determined by the banks' managements in accordance with borrowers' anticipated solvency and the quality of their collateral. The additional loan-loss provision, as specified in the regulations of the Supervisor of the Banks and based on the risk characteristics of the bank's total credit portfolio, also increased (Table 3.6). One of the reasons for this increase in the additional provision was the rise in problem debts (14.6 percent), this too due to the effect of the severe recession in Israel's economy (for a fuller discussion see Chapter 5).

**Figure 3.3**
**Loan-Loss Provision in the Banking Groups, 1988–2002**




SOURCE: Published financial statements.

**Table 3.6**
**The Components of Loan-Loss Provision in the Five Major Banking Groups, 2000–2002**

(NIS million, December 2002 prices)

| | 2000 | | | 2001 | | | 2002 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Specific provision | General & additional provision | Total | Specific provision | General & additional provision | Total | Specific provision | General & additional provision | Total |
| **Balance of provision at beginning of year** | **12,615** | **3,069** | **15,684** | **12,984** | **3,078** | **16,062** | **15,728** | **3,194** | **18,922** |
| Provision in accounting year | 3,178 | 220 | 3,398 | 5,449 | 383 | 5,832 | 7,992 | 459 | 8,451 |
| Reduction of provision | –624 | –211 | –835 | –848 | –266 | –1,114 | –790 | –323 | –1,113 |
| Collection of debts written off in previous years | –66 | – | –66 | –82 | – | –82 | –54 | – | –54 |
| **Amount recorded in Profit and Loss Statements** | **2,488** | **9** | **2,497** | **4,519** | **117** | **4,636** | **7,148** | **136** | **7,284** |
| Write-offs | –2,086 | – | –2,086 | –1,638 | – | –1,638 | –1,415 | – | –1,415 |
| Erosion and adjustment of balances | –33 | – | –33 | –137 | – | –137 | –883 | – | –883 |
| **Balance of provision at end of year** | **12,984** | **3,078** | **16,062** | **15,728** | **3,195** | **18,923** | **20,578** | **3,330** | **23,908** |

SOURCE: Published financial statements.

Erosion of the solvency of large business enterprises in most branches of the economy has caused the accelerated growth of the specific provision in the past two years. The erosion was marked in industries particularly affected by the developments throughout the economy—that brought about the transition from accelerated business activity in 2000 to a freeze and even regression in 2001 and 2002—and by the swings in the financial markets. The stiff competition in business banking in Israel's banking system is also relevant in this context. It is possible that some of the banking corporations, in their activities with business customers, took high risks that were realized and necessitated extensive provision for loan-loss. As opposed to this, the loan-loss provision for credit to households was relatively low (despite signs of deterioration in the situation of private households as well).[7]

In the business sector, loan-loss provisions increased in 2002 mainly due to credit to the following industries:[8]

*Communications and computer services*: The worldwide crisis in the communications and high-tech industries was influenced by developments in capital markets throughout the world, and particularly in the Nasdaq, where the majority of shares of companies of the "new economy" are traded. The Nasdaq fell by 32 percent in 2002, after declining 21 percent and 39 percent in 2001 and 2000 respectively. Against this background, a number of customers in the communications and computer services industry found themselves in difficulties, and the value of the collateral against their credit—some of which had been provided for the acquisition of companies—eroded. As a result, this industry featured prominently again this year for its large contribution to the specific loan-loss provision, with a rise of NIS 1.1 billion to a total of NIS 1.9 billion. The provision as a percentage of total credit in this industry increased to 5 percent, the highest rate of all the principal industries.

*Manufacturing*: The continued worldwide economic slump and the sustained recession in domestic activity, against the backdrop of uncertainty caused by the security situation, adversely affected also manufacturing activity. This was felt mainly in the high-tech industries (specifically electrical and electronic machinery and equipment), due to the fall in world demand for these products. Thus Israel's manufacturing exports went down by 3 percent and exports of the high-tech industries by 11 percent (monthly averages), and impaired the industry's solvency. As a result, the loan-loss provision for the manufacturing industry leapt by NIS 924 million to NIS 1.5 billion—most of it (NIS 821 million) for credit extended to the advanced industries.

*Construction and real estate*: Construction activity continued to contract in 2002, for the fifth consecutive year, although at more moderate rates than in earlier years. The ongoing slowdown in this industry was evidenced, inter alia, by the decline in the share of its product in business-sector output and by a reduced number of transactions in

[7] Among these signs were the rise in the unemployment rate and the reduction in the real wage, which, it seems, were not yet fully in evidence in the banks' data.

[8] Data on loan-loss provisions and credit to the public include balance-sheet and off-balance-sheet operations of the banking groups, in Israel and abroad.

apartments (down by 4 percent from a year earlier). The prolonged recession in the industry brought about a reduction in the value of borrowers' collateral and to difficulties among many borrowers and contractors that led to a continuation of the high level of the industry's specific loan-loss provision. This provision increased by 13 percent in 2002, to NIS 1.3 billion, from an average of NIS 790 million in 1997-2001, during which period the provision and its ratio to total credit were already high. However, this industry had less of an effect on credit quality in the banking system in 2002 than other affected industries.

*Financial services*: The domestic and global economic crisis and the security situation in Israel have continued to exert an adverse effect on the Israel's securities market in recent years. The negative developments in this market were manifested in particular by the marked decline (28 percent) in the value of shares and convertible securities, which represent a considerable proportion of collateral held against credit to financial services companies. In the last few years this credit was taken largely for the acquisition of controlling interests, and it includes credit whose source of repayment is the same corporation in which the controlling interest was acquired (non-recourse loans).[9] Decline in the value of collateral explains a large part of the rise in the annual loan-loss provision for this industry from NIS 188 million in 2001 to NIS 416 million this year. At the same time, it is important to note that the quality of credit in this branch, as measured by the ratio of its specific loan-loss provision to total credit, was lower this year than the average ratio for all the principal industries (0.45 percent compared to 0.87 percent respectively).

*Hotels and catering services*: The number of tourists and the number of bed nights in hotels have fallen steeply since the fourth quarter of 2000, to their lowest levels in many years. The crisis in this industry—due to security incidents—has had a negative effect on the companies active in it and on the industries closely allied to it as well, such as transport, business services (travel agents) and commerce (souvenir shops). These negative influences have weakened hotels' cash flow and revenue, which in 2002 stood at only 67 percent of their level in 2000, a peak year for tourism. Due to the industry's impaired solvency, the loan-loss provision increased by NIS 223 million to NIS 499 million. The ratio of loan-loss provision to total credit (2.7 percent) in this industry is the second highest of all industries, and its ratio of problem loans to total credit—a ratio that gives an indication of the extent of future insolvencies—31 percent, is the highest (see Chapter 5 for a more extended discussion).

In view of the huge loan-loss provision, it would be appropriate for banks' managements to examine carefully their credit-allocation policy and to learn lessons from the past. Prudent management of credit-allocation procedures will serve to reduce the loan-loss provision and its ratio to total credit, which will have a positive effect on banks' future profitability and robustness.

[9] With respect to these non-recourse loans, the bank is unable, legally or practically, to collect the loan from the borrower himself. Payment of the debt is based primarily on the capacity of the acquired corporation to distribute consistently high dividends.

### c. Non-interest income

The importance of non-interest income in bank profit has expanded steadily in recent years, in view of the growing trend among banking institutions throughout the world to provide a wide and stable base of fee-earning financial services. This has been achieved in part through off-balance-sheet activity and accelerated penetration into fields which are highly synergetic with the banking field—for example, insurance. It can be assumed that this trend will develop in Israel too when the economy reverts to the path of growth, with the expectation that high growth rates in the economy will (again) accelerate the pace of expansion of financial services and all fee-earning services.

Non-interest and other income of all banking corporations fell in 2002 by NIS 114 million (1.5 percent) to NIS 7.6 billion (Table 3.7). This small reduction was the consequence of several developments. Considerable erosion in the prices of securities and convertible instruments acted to reduce this income, an effect offset by a certain amount of growth in investor activity, especially in the bond market and in Treasury bills, the updating of some fee tariffs and the levying of new fees at some banks.

The level of activity in the capital market has both a primary and a secondary impact on non-interest income. Incomes originating directly in the capital markets are affected at the primary level. Such incomes include commissions on transactions in securities and custody fees which are related to turnover in the market, fees from underwriting and distributing securities, derived mainly from raising capital mobilization, and administrative fees from provident funds and mutual funds, which are determined by the market value of the securities. Items which are affected at a secondary level by the level of activity in the capital market include profits (losses) from investment in securities held by the banks and the profits (losses) sustained by banks that manage the severance pay and pension funds for their staff that result from the rise (fall) in prices on the capital market.

The banks' direct income from capital-market operations remained relatively stable (with a rise of 0.3 percent), affected positively by an upswing in activity in the capital market by the public (principally speculators) following increased volatility, and negatively by the erosion of prices.

Despite the many aspects of uncertainty that had an impact on developments in the financial markets, the markets, particularly the bond market, showed diversified buying and selling activity and marked growth in turnover. Thus, average daily turnover in securities (including bonds and Treasury bills) rose by 33 percent, mainly due to the increase in turnover in all types of bonds. This increase occurred in response to various developments throughout the year, including the rise in the rate of inflation and its variance, depreciation of the NIS against leading currencies and the raising of interest rates by the Bank of Israel. Activity in the financial markets, especially in the bond markets, was also influenced by the tax reform that came into effect at the beginning of 2003.[10]

[10] This effect became apparent mainly at the end of 2002—as the effective date of the tax reform approached—in the transition from unindexed deposits, which were taxable, to Treasury bills and the *Shahar* bond series, that remained tax free (for further discussion see Box 2.2).

**Table 3.7**
**Non-Interest Income and Operating Expenses, All Commercial Banks, 2000–2002**

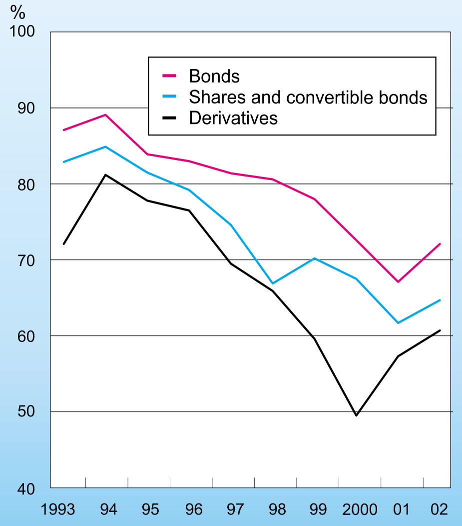
| | Amount (NIS million, Dec. 2002 prices) | | | Distribution (%) | | | Year-on-year change (%) | |
|---|---|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2000 | 2001 | 2002 | 2001 | 2002 |
| **1. Non-interest income** | | | | | | | | |
| Fees and commissions from: | | | | | | | | |
| Ledger fees | 1,224 | 1,257 | 1,285 | 15.5 | 16.4 | 17.0 | 2.7 | 2.2 |
| *of which* In foreign currency | 35 | 32 | 35 | 0.4 | 0.4 | 0.5 | –6.3 | 8.8 |
| Payment services | 2,075 | 1,980 | 2,073 | 26.2 | 25.8 | 27.4 | –4.6 | 4.7 |
| *of which* In foreign currency | 1,193 | 1,096 | 1,156 | 15.1 | 14.3 | 15.3 | –8.2 | 5.5 |
| Credit cards | 322 | 315 | 313 | 4.1 | 4.1 | 4.1 | –2.3 | –0.6 |
| Credit services and contracts | 562 | 612 | 645 | 7.1 | 8.0 | 8.5 | 8.9 | 5.3 |
| Computerized services | 280 | 288 | 270 | 3.5 | 3.8 | 3.6 | 2.9 | –6.4 |
| Foreign trade and special services | 363 | 345 | 354 | 4.6 | 4.5 | 4.7 | –4.9 | 2.8 |
| Securities services[a] | 1,005 | 754 | 842 | 12.7 | 9.8 | 11.1 | –25.0 | 11.7 |
| Underwriting and distribution of securities | 96 | 55 | 51 | 1.2 | 0.7 | 0.7 | –42.3 | –8.5 |
| Other commissions[b] | 207 | 200 | 197 | 2.6 | 2.6 | 2.6 | –3.4 | –1.6 |
| **Total fees and commissions income** | **6,134** | **5,806** | **6,030** | **77.6** | **75.7** | **79.8** | **–5.3** | **3.8** |
| Other income from: | | | | | | | | |
| Provident and mutual fund fees | 1,238 | 1,189 | 1,113 | 15.7 | 15.5 | 14.7 | –3.9 | –6.5 |
| Related companies management fees | 202 | 205 | 201 | 2.5 | 2.7 | 2.7 | 1.7 | –1.8 |
| Profits from severance pay funds | 0 | 153 | 0 | 0.0 | 2.0 | 0.0 | | |
| Other[c] | 249 | 258 | 260 | 3.1 | 3.4 | 3.4 | 3.7 | 1.0 |
| **Total** | **1,688** | **1,806** | **1,575** | **21.3** | **23.5** | **20.8** | **7.0** | **–12.8** |
| Income from sale of shares | 85 | 59 | -47 | 1.1 | 0.8 | –0.6 | –30.7 | |
| **Total non-interest income** | **7,908** | **7,671** | **7,557** | **100.0** | **100.0** | **100.0** | **–3.0** | **–1.5** |

**Table 3.7 (continued)**

| | Amount (NIS million, Dec. 2002 prices) | | | Distribution (%) | | | Year-on-year change (%) | |
|---|---|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2000 | 2001 | 2002 | 2001 | 2002 |
| **2. Operating expenses** | | | | | | | | |
| Salaries and related expenses[d] | 9,983 | 9,816 | 9,745 | 66.5 | 64.8 | 64.8 | –1.7 | –0.7 |
| Depreciation of buildings and equipment[f] | 839 | 961 | 1,064 | 5.6 | 6.3 | 7.1 | 14.5 | 10.7 |
| Maintenance of buildings and equipment | 1,574 | 1,612 | 1,736 | 10.5 | 10.6 | 11.5 | 2.4 | 7.7 |
| Other expenses | 2,612 | 2,751 | 2,492 | 17.4 | 18.2 | 16.6 | 5.3 | –9.4 |
| Marketing and advertising | 327 | 357 | 257 | 2.2 | 2.4 | 1.7 | 9.3 | –27.9 |
| Computer expenses | 482 | 534 | 510 | 3.2 | 3.5 | 3.4 | 10.7 | –4.5 |
| Communications | 399 | 417 | 394 | 2.7 | 2.8 | 2.6 | 4.4 | –5.5 |
| Insurance | 91 | 106 | 164 | 0.6 | 0.7 | 1.1 | 16.2 | 55.4 |
| Office | 159 | 157 | 140 | 1.1 | 1.0 | 0.9 | –0.8 | –10.9 |
| Professional services | 310 | 343 | 355 | 2.1 | 2.3 | 2.4 | 10.6 | 3.5 |
| Other | 844 | 837 | 673 | 5.6 | 5.5 | 4.5 | –0.8 | 19.7 |
| **Total operating expenses** | **15,009** | **15,140** | **15,037** | **100.0** | **100.0** | **100.0** | **0.9** | **–0.7** |
| **Operating coverage ratio**[e] | **52.7** | **50.7** | **50.3** | | | | | |

[a] Including income from derivatives and custody fees.
[b] Mainly margin and collection fees received from the Treasury on credit, income from managing estates, and rent on safe-deposit boxes.
[c] Including profit on realization of assets received in settlement of credit.
[d] Including payroll taxes, severance pay, benefits, pensions, and national insurance.
[e] Ratio of total non-interest and other income to total operating expenses (percent).
SOURCE: Returns to Supervisor of Banks and published financial statements.

Figure 3.4
**Banks' Share in Stock Exchange Turnover, 1993–2002**



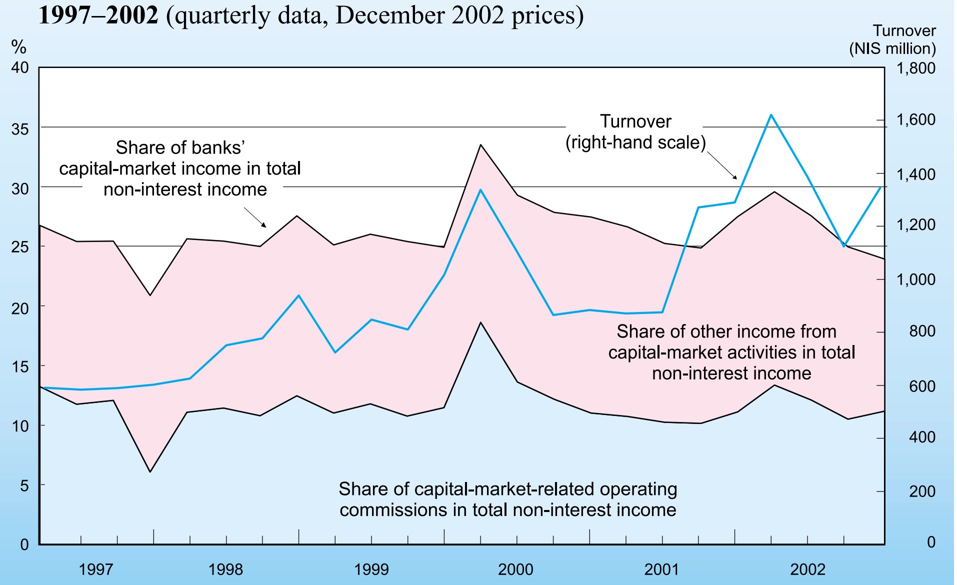

SOURCE: Tel Aviv Stock Exchange.

This growth in the turnover of securities and convertibles and the expansion of public activity in these markets yielded a rise of 11.7 percent in bank income from securities (including custody fees). Another reason for the rise in income from securities was the increase in the proportion of customers doing business with banks which are stock exchange members (principally with the five large banking groups) while business entrusted to other, non-bank stock exchange members declined (Figure 3.4).

Although total capital raised in the securities market (including shares, convertibles and corporate bonds) via direct flotation and the exercise of options expanded in 2002 by 20 percent, bank income from the underwriting and distribution of securities shrank by 8.5 percent, because in 2002 capital was raised mainly through private offerings of securities. This was due to the difficulty in raising capital in 2001–02 in the light of the deep recession in the economy and the problems faced by the business sector. Bank income from these offerings was further reduced because private offerings are less expensive and faster than public offerings, as they are exempt from the need to publish a prospectus and to register with and report to the Securities' Authority. As a result of increasing competition in the industry, some banks—particularly the large banks that manage the majority of mutual funds' assets—offer discounts to their customers for purchasing units in their funds. This practice also contributed to the fall in bank income from the sale of securities.

The decline in prices in most investment channels, especially in the shares market, had an adverse effect on provident fund yields, and this led to a continuation of the trend that began in 1994 of (net) withdrawals from the funds. Asset balances of provident funds were 9 percent lower in December 2002 than in December, 2001, while asset balances of mutual funds went down by 32 percent—in contrast to the rising trend in the past five years—following the negative yields posted by the funds in the course of the year. The low rate of growth of the provident and mutual funds and their decline in value explain a decrease (of 6.5 percent) in bank income from management fees, as income in this component of banking activity is usually collected as a percentage of the value of provident and mutual funds.

**Figure 3.5**
**Share of Commercial Banks' Income from Capital-Market Activity in Total Non-Interest Income, and Average Daily Stock Exchange Turnover in Shares, 1997–2002** (quarterly data, December 2002 prices)




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

Capital-market operations fluctuated sharply during 2002 (Figure 3.5). In the first quarter of the year activity in the market was affected by the steep reduction in interest rates introduced by the Bank of Israel at the end of 2001. Turnover and investment in securities rose, as did the market value of securities listed on the stock exchange. These positive trends brought about a gain of 6 percent at the primary level in the non–interest income of the banks from capital-market activity. During the second and third quarters, turnover and investment fell as stability in the domestic financial markets was undermined and security incidents escalated. This development led to a marked fall in banks' income from the capital market, compared to the first quarter. In the last quarter of the year (in particular in October-November), turnover and investment continued to contract, although at a lower rate, and other indices show reduced activity in the capital market and a corresponding fall in income.

The recession and the decline in prices on the capital market had a secondary effect—losses on investments in trading securities and a dearth of profits from severance pay funds in some of the banks—due to relatively low returns on bonds held by the funds to cover liabilities for severance pay. Thus, non-interest income from these items declined

**Table 3.8**
**Performance Indicators in the Banking Groups, by Sector, 2002**

| | Households | | Business sector | | |
|---|---|---|---|---|---|
| | Total | Mortgages | Total | Construction & real estate | Total |
| **Large banks**[a] | | | | | |
| *Shares (percent of total)* | | | | | |
| Total assets | 42 | 14 | 58 | 10[b] | 100 |
| Loan-loss provision | 17 | 2 | 83 | 15 | 100 |
| Total income[c] | 71 | 5 | 29 | 4 | 100 |
| Operating expenses | 82 | 3 | 18 | 1 | 100 |
| Before-tax profit | 134 | 22 | –34 | –4 | 100 |
| *Ratios* | | | | | |
| Loan-loss provision/total assets | 0.5 | | 1.8 | | 1.3 |
| Total income[c]/total assets | 7.5 | | 2.3 | | 4.5 |
| Operating expenses/total assets | 5.1 | | 0.8 | | 2.6 |
| Before-tax profit per NIS of assets | 1.9 | | –0.3 | | 0.6 |
| **Medium-sized banks**[a] | | | | | |
| *Shares (percent of total)* | | | | | |
| Total assets | 40 | 33 | 60 | 14 | 100 |
| Loan-loss provision | 16 | 11 | 84 | 6 | 100 |
| Total income[c] | 57 | 20 | 43 | 8 | 100 |
| Operating expenses | 57 | 11 | 43 | 5 | 100 |
| Before-tax profit | 139 | 75 | –39 | 27 | 100 |
| *Ratios* | | | | | |
| Loan-loss provision/total assets | 0.4 | | 1.4 | | 1.0 |
| Total income[c]/total assets | 5.2 | | 2.5 | | 3.6 |
| Operating expenses/total assets | 3.0 | | 1.5 | | 2.1 |
| Before-tax profit per NIS of assets | 1.8 | | –0.3 | | 0.5 |
| **Total** | | | | | |
| *Shares (percent of total)* | | | | | |
| Total assets | 42 | 19 | 58 | 13[b] | 100 |
| Loan-loss provision | 16 | 4 | 84 | 13 | 100 |
| Total income[c] | 68 | 8 | 32 | 5 | 100 |
| Operating expenses | 78 | 5 | 22 | 2 | 100 |
| Before-tax profit | 135 | 32 | –35 | 2 | 100 |
| *Ratios* | | | | | |
| Loan-loss provision/total assets | 0.5 | | 1.7 | | 1.2 |
| Total income[c]/total assets | 7.0 | | 2.3 | | 4.3 |
| Operating expenses/total assets | 4.7 | | 1.0 | | 2.5 |
| Before-tax profit per NIS of assets | 1.9 | | –0.3 | | 0.6 |

[a] Large banks: Hapoalim and Leumi. Medium sized banks: Mizrahi and First International.
[b] Not including data relating to Bank Hapoalim, as that bank did not publish the balance of its assets in construction and real estate in its financial statements.
[c] Total non-interest income *plus* profit from financing transactions (before loan-loss provision).
SOURCE: Based on published financial statements.

sharply, by 122 percent, and reduced non-interest income of the commercial banks by a significant NIS 259 million.

Income not connected to the capital market rose this year by 2.5 percent, in part from increased tariffs of charges for banking services and from the levying of new fees and commissions by some banks for services previously provided free of charge or at a sweeping discount.[11] The increase in fees and commissions may have stemmed in part from the low profitability of the banks in the last few years, which motivated them to increase their profits from alternative sources, such as in activity with private customers where profits are high and risks relatively low. And indeed, profitability in this segment enabled the banks to achieve overall profitability, although at a low level, from all its operations even in such a difficult year, as is shown by an analysis of the operations of the major banking groups by their profit centers.[12] The proportion of the retail segment in loan-loss provision is small (16 percent, Table 3.8) relative to its significant contribution to profitability (135 percent). Most of the loan-loss provision (84 percent) was concentrated in the business segment, and for this reason, the contribution of this segment to the profitability of the five banks was negative (-35 percent). For a more extensive discussion see Box 3.2).

**Box 3.2**
**Analysis of Performance, by Area of Activity**

The banking corporations operate in several major areas of activity, each one of which constitutes a profit center—a division utilized by bank managements in analyzing performance and in decision-making. According to Bank of Israel regulations, an area of activity is required to meet three conditions: it must cover activities from which the bank is likely to earn income and on which it will incur expenses; the results of the activity in the area must be examined regularly by the management and the board of directors for the purpose of making decisions concerning the allocation of resources in the area and assessing its performance; and there must be separate financial information regarding the area of activity. The division into areas of activity is based on the types of product and service or on the types of customer.

[11] Thus, for example, discounts were reduced on account management fees for certain groups in the population (young people, students, pensioners) as were charges for document preparation, and check discounting, while certain banks have introduced deposit-management fees.

[12] The annual financial statements provide details on activities and financial results by profit centers for all the major banking groups except Discount. The analysis thus relates only to the data from the other four major banking groups.

The main areas of activity are shown below:

*Business banking*—provision of banking and financial services for large companies which operate in Israel and abroad. The primary field of activity in this area is providing of credit.

*Middle-market banking*—provision of banking and financial services to medium-sized business customers. In this area as well, provision of credit is the main activity, but the extent of credit is more limited.

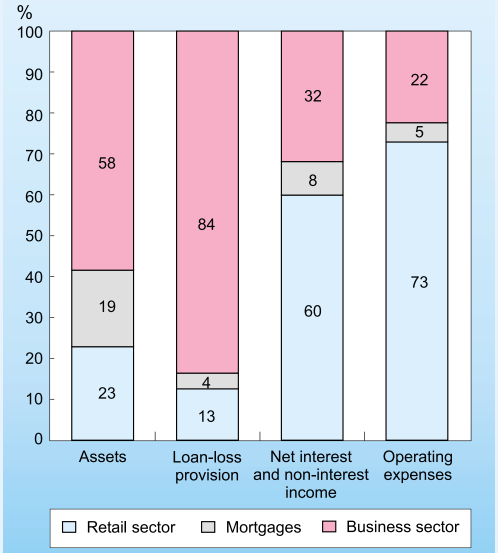
*Retail banking*—provision of comprehensive banking services to a variety of private customers, households and small businesses. This area offers its customers principally investment possibilities (deposits, savings programs) and also various types of credit adapted to the customers' special requirements.

*Private banking*—provision of banking and financial services, both domestic and foreign, to affluent Israeli and nonresident private customers. Among the services available to these customers are traditional types of investment as well as sophisticated financial tools for hedging and diversification. They can also take advantage of credit and expert services in the field of investment banking.

*Construction and real estate*—provision of banking and financial services to building contractors and large projects in the field of construction and real estate—mainly providing business credit for building and residential construction and for the purchase of land and commercial real estate.

*Mortgages*—the provision of loans to private customers for the acquisition of homes and for various other purposes—loans secured by mortgaging apartments.

**Figure 3.6**
**Distribution of Contribution of Different Areas of Activity to Selected Items in Banking Groups' Financial Statements, 2002**




SOURCE: Published financial statements.

*Capital-market operations*[1] —provision of banking and financial services in the field of off-balance-sheet investment, primarily management of mutual

[1] Activity in the capital market and in credit cards is part of the activity of other segments, mainly the retail segment.

funds, provident funds, portfolio management and other investment and underwriting activity.

*Credit cards*—the issuing of credit cards and clearing credit card vouchers for businesses.

*Other activity and adjustments*—includes mainly the income and expenses of a bank which do not derive from its activity vis-a-vis customers (i.e. management of the bank's nostro portfolio, management of risk exposure and adjustments of inter-segment activity).

The banks use different models to measure and manage assets and liabilities and to analyze the results of activity in the profit centers. In order to compare them, it has been necessary to make a number of assumptions.[2] There are marked differences among the various areas of activity of the banks:

The boom in Israel's economy during most of the 1990s, and the processes of privatization, liberalization and de-regulation which typified the decade provided a springboard for the acceleration of banking activity in Israel. This acceleration was based primarily on large business customers.[3] In Israel, most banking competition takes place in this segment of the market—competition between the banks themselves, with the foreign banks that began operating in Israel in the last few years, with financial institutions and with the capital market. In the retail banking segment there is less competition, owing to a lack of alternatives to the banking network in providing credit and accepting deposits. This can be seen in the considerable contribution of households to the interest and non-interest incomes of the banks (68 percent, Figure 3.6)—as compared to the smaller contribution of business customers (32 percent)—which is explained also by the size of the net interest margin and the commissions paid by small customers. The share of operating expenses attributable to the retail banking segment is also particularly high (78 percent)—due to the heavy expenditure on human and physical resources involved in operating the extensive network of branches characteristic of retail activity. As opposed to this, business activity is carried out in a limited number of business centers, and therefore, it accounts for only a small proportion (22 percent) of operating expenses.

Despite the high operating cost involved in activity with households, it has made a large and stable contribution to the profits of the five large banking

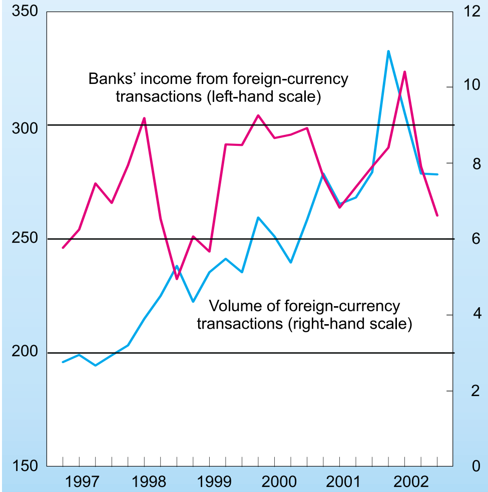
[2] In order to compare the reports of profit centers of different banks with each other, data of the business, commercial and real estate segments were combined and defined as the business segment. Data relating to retail activities, capital-market operations and private (including international) activities were also combined with data on mortgages to create a new segment called the household segment. As information was unavailable regarding the distribution of "other activity and adjustments" among the various segments, this category was ignored in the analysis.

[3] To a certain degree, it was also based on private banking.

groups in the last few years, as has been noted. This was even more notable in 2002 in the light of the losses made by the banks on their activities with business customers. The significant contribution of households to the profitability of the major banks was also influenced by the relatively low level of risk involved in this activity, as seen in the small share of this segment in the loan-loss provision (16 percent in 2002) compared to that of the business segment (84 percent). In providing credit to many relatively small customers with a wide dispersion of small credit units, banks are acting to reduce their credit risk, while the correlation and the dependence between them, with regard to repayment ability, are low. The relatively low level of risk in providing credit to this segment is partially due to the fact that households are "surplus units", capable of putting up financial collateral which generally maintains its value. Businesses, on the other hand, are "deficit units", primarily supplying non-financial collateral whose value at time of realization is not certain.

As a result of the inherent advantages in retail banking activity and the extensive losses in the business segment, several banking corporations have taken energetic steps to attract private customers, setting themselves the objective of increasing the proportion of retail banking in their mix of activity. This trend is expected to intensify in the future, due to the technological developments in communications and the accompanying process of de-regulation, which are intended to increase competition in the banking system and to improve customer welfare.

**Figure 3.7**
**Commercial Banks' Income from Ledger Fees and Payment Services in Foreign Currency,[a] and Average Daily Volume of Foreign-Currency Transactions,[b,c] March 1997–December 2002**




[a] NIS million, December 2002 prices.
[b] The volume of foreign-currency transactions does not include interbank transactions or swaps.
[c] Quarterly dollar data translated into NIS millions, December 2002 prices.

SOURCE: Returns to Supervisor of Banks and Bank of Israel Foreign Currency Department.

In 2002 income from fees and commissions increased. Thus, for example, income from managing credit and from contract preparation rose by 5.3 percent, despite the relatively moderate 2 percent increase in credit; income from ledger fees grew by 2.2 percent, and from payment-system services by 4.7 percent. Most of the increase in income from these sources derived from the rise in non-interest income received from foreign-currency activities—in part as a result of the larger volume of such activities (Figure 3.7) following the steep depreciation of the NIS and the marked rise in related uncertainty.

In view of many complaints received by the Banking Supervision Department in 2002 with regard to operating fees and various banking costs in particular, the Department focused on the services that banks provide to their customers, and introduced requests for fuller disclosure and improvements in information supplied to customers on fees and interest rates, by means of amendments to the Banking (Service to Customers) Law (for a fuller discussion see Chapter 6). Better service and increased transparency should be of great concern to the banks themselves, as they provide a means for improving their reputation, boosting the trust placed in them by the Israeli public and giving them an opportunity to improve their relative standing in the current difficult economic conditions. The increase in transparency and fuller disclosure by the banking institutions can be expected to foster market discipline, which serves as a means for strengthening the stability of Israel's banking system.

**d. Operating expenses**

The operating expenses of the banking corporations stabilized in 2001–02 in an environment of the deep recession in the economy and the decline in bank profitability. This stability derived from steps taken by most of the banking corporations to economize and to improve efficiency in the light of the slowdown in the pace of expansion of banking output in 2002. The relative stability of operating expenses is reflected in the low rates of change in this item in 2002 (-0.7 percent) and in 2001 (+0.9 percent) (Table 3.7), compared to an average of 4 percent in 1994–2000.

There was marked variation between the large banks in the development of operating expenses—from a rise of 2.4 percent in Mizrahi to a steep decline of 11.7 percent in Discount, the latter resulting from measures to promote efficiency introduced by that bank in recent years.

The largest element (65 percent) in operating expenses is payroll and related expenses, and this item fell in 2002 by a modest 0.7 percent (Table 3.7). However, important changes occurred in the composition of labor-related expenses: direct salary expenses dropped by 8 percent, while related expenses rose sharply by 12 percent (Table 3.9). Additionally, the number of posts declined this year by 603 (1.7 percent) compared to 2001. Thus, the salary per employee post decreased by 6.2 percent (from NIS 181,000 per year to NIS 170,000), similar to the rate of decline of the wage per employee post in the entire business sector (6.3 percent), but the cost per post rose by 1 percent (from NIS 279,000 to NIS 282,000).

The drop in the number of posts reflects the marked decline in bank profitability, in a period of deepening recession, and apparently agrees with the assessment of the bank managers that no real improvement in the financial results of the banking system is in sight in the near future. Banking corporations, which in the past refrained from dismissing staff, partially because of the costs involved in doing so and from a desire to avoid

**Table 3.9**
**The Banking System's Expenditure on Employees,[a] 1997–2002**

(December 2002 prices)

| | Average no. of employee posts[b] | Salaries: Total (NIS million) | Salaries: Per post (NIS'000) | Related expenses[c]: Total (NIS million) | Related expenses[c]: Per post (NIS'000) | Salaries and related expenses: Total (NIS million) | Salaries and related expenses: Per post (NIS '000) |
|---|---|---|---|---|---|---|---|
| 1997 | 35,595 | 5,804 | 163 | 2,954 | 83 | 8,758 | 246 |
| 1998 | 35,467 | 5,871 | 166 | 2,908 | 82 | 8,778 | 248 |
| 1999 | 34,823 | 6,074 | 174 | 2,990 | 86 | 9,065 | 260 |
| 2000 | 35,020 | 6,560 | 187 | 3,423 | 98 | 9,983 | 285 |
| 2001 | 35,162 | 6,378 | 181 | 3,439 | 98 | 9,816 | 279 |
| 2002 | 34,559 | 5,880 | 170 | 3,865 | 112 | 9,745 | 282 |
| Year-on-year change (*percent*) | | | | | | | |
| 1998 | –0.4 | 1.1 | 1.5 | –1.6 | –1.2 | 0.2 | 0.6 |
| 1999 | –1.8 | 3.5 | 5.4 | 2.8 | 4.7 | 3.3 | 5.2 |
| 2000 | 0.6 | 8.0 | 7.4 | 14.5 | 13.8 | 10.1 | 9.5 |
| 2001 | 0.4 | –2.8 | –3.2 | 0.5 | 0.0 | –1.7 | –2.1 |
| 2002 | –1.7 | –7.8 | –6.2 | 12.4 | 14.4 | –0.7 | 1.0 |

[a] Including companies which are owned by the banks and supply them with computer services.
[b] 12-month average; this number includes established employees, trainees, pensioners, temporary and part-time workers (weighted by share of a post). This also includes overtime: 165 overtime hours are calculated as a post.
[c] Consisting mainly of national insurance, pension, vacation, compensation, and expenses, and voluntary (early) retirement.
SOURCE: Returns to Supervisor of Banks.

harming labor relations in the bank and the damage this would cause to their reputation—changed their practice, adapting their work forces to the reduced level of profitability expected to continue at least in the near term. The fall in profitability may also have motivated them to plan ahead toward implementation of efficiency measures.

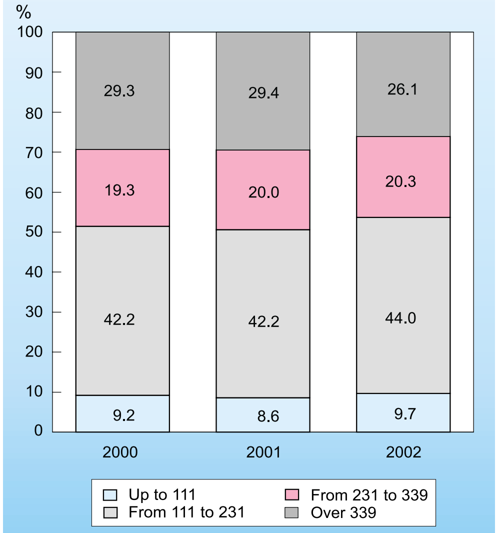
The staffing mix was adjusted to the difficult economic environment in the course of 2002 principally by reducing the number of part-time positions (temporary and tenured), as bank managers tried to improve the utilization of the available manpower. Nevertheless, the number of tenured, full-time staff declined in the fourth quarter of the year at a relatively high rate (6.3 percent)—apparently because of the worsening erosion of profitability in the banking system and the growing need to increase efficiency. It is anticipated that the downward trend in the number of tenured workers will continue and strengthen in 2003. Thus, Hapoalim declared its intention to cut its staff by 10 percent, and similar measures to improve efficiency are to be undertaken by other banking corporations in response to economic developments.

The change in staffing also explains the decline in labor-related expenses. In 2002, the share of the two lowest wage grades (up to NIS 111,000 per year) in total labor cost grew by about one percentage point, while that of the two highest wage grades (more than NIS 339,000 per year) declined by 3.3 percentage points (Figure 3.8). This may be explained by the sharp drop in the number of tenured workers (particularly in the last quarter of the year), in contrast with a moderate decrease (a reversal of a long-term rise) in the number of part-time employees, whose salaries are lower.

The decline in wage costs is due not only to a reduction in the work force and a change in its mix, but also to a reduction in bonuses paid to workers in 2002 because of the disappointing financial results. An additional factor in the fall of wage costs is the surprise regarding inflation[13] and the delay in reaching a cost-of-living agreement that would compensate, even if only in part, for the rise in prices.

As noted above, the decline in direct payroll costs was accompanied by a steep rise in related costs, due primarily to the rise[14] from NIS 467 million in 2001 to NIS 979 million in 2002 of expenses related to voluntary early retirement by employees. The increase in this item was particularly notable in Hapoalim (NIS 477 million) and Leumi (NIS 377 million). In voluntary retirement programs, banks offer early retirement under preferential conditions to certain of their employees, for example from among those with considerable seniority and high salary. These programs were initiated by the banks with the intention of adjusting staffing to their actual needs, improving the bank efficiency and reducing future wage costs. The largest two banks made the decision to introduce this program at the beginning of 2003. Expenses related to the early retirement plan were recorded in the financial statements of 2002 but the change in staffing following its implementation will appear during 2003.

**Figure 3.8**
**Distribution of Wage Levels, the Commercial Banks, 2000–2002**
(by annual wage levels, NIS ’000)




SOURCE: Returns to Supervisor of Banks.

Despite the decline in labor input in the banking system and the reduction in the number of branches, expenses on building maintenance and equipment continued to rise. The increment in 2002 was NIS 124 million (7.7 percent), which points to some potential for efficiency measures in this area as well. It seems, however, that even with the reduced need for customers to visit branches and the increased utilization of direct banking channels (a development discussed fully in Chapter 6), a significant number of private and business customers continued to regard the branch as their principal service location. For this reason, the banks were forced to continue investing heavily in maintenance of buildings and equipment.

Depreciation expenses also rose sharply by 10.7 percent, mostly stemming from increased expenses on the depreciation of computers and programs—partially due to the

[13] In the last quarter of 2001, inflation in 2002 was expected to reach slightly more than one percent. The actual rate of inflation in 2002 was 6.5 percent.

[14] The increase in wage-related costs is explained as well by accounting effects on the calculation of the provision for severance and pension, because of losses in the severance pay funds and benefits.

capitalization of certain costs of in-house development of computer programs for investment in equipment. Other operating expenses declined by 9.4 percent this year and their mix changed. On the one hand, there was a marked drop in marketing expenses (27.9 percent) and in computer expenses (4.5 percent, a reversal of their consistent upward trend in the past). The decline in these expenses apparently stems from banks' growing awareness of the need to focus on and reduce their expenses as necessary. On the other hand, the main increase in expenses was in insurance (55.4 percent), and this was due to higher premiums on banking insurance policies. The premium rose mainly due to the higher cost of insurance throughout the world following the events of September 2001 and disclosure of large-scale accounting frauds in major companies, for example WorldCom and Enron. The realization of operational risk in the Israeli banking system after the embezzlement at Leumi-Switzerland and at the Trade Bank, the large safety-deposit-boxes theft at Discount and incidents of embezzlement at other banking corporations may also have contributed to the rise of these expenses.

**e. Provision for tax**

In view of the reduction in ordinary pre-tax profits, provision for tax was about 55 percent lower this year than in 2001, and totaled NIS 1,049 million. As a result, the effective tax rate this year was 44.8 percent of pre-tax profit, against 49.3 percent in 2001 (Table 3.10). This rate differs from the statutory tax rate applicable to banking corporations, which was raised[15] in 2002 to 45.5 percent, after remaining stable at 45.3 percent for a number of years. The drop this year in the effective, as compared to the formal, tax rate was due mainly to exchange-rate differentials on foreign-currency investments in subsidiaries abroad. This investment is not considered an expense for tax purposes so that positive income from exchange-rate differentials that accrued in the course of the year—following the depreciation of the NIS against the leading currencies—is not included in the tax base. This served to lower the tax provision by 13.1 percentage points, most of it posted by Leumi. The reduction of tax provisions for prior years also had a marked effect on the decline in the effective tax rate. It reduced the tax rate by some 7.6 percentage points and contributed greatly to lowering the provisions in Hapoalim and Discount. These banks were issued final tax assessments for previous years, after which the considerable surplus provisions for tax conservatively recorded in previous years were cancelled.

In contrast, losses and deductions for which no deferred tax was recorded increased indebtedness by 14.7 percentage points (Table 3.10). This was particularly marked in Discount, where receivable deferred taxes for current losses were not recorded for tax purposes because of the small likelihood of implementing the program to improve the financial results in the short term. The profit tax on the payroll tax imposed on the banking

[15] On 15 June 2002 value-added tax was raised from 17 percent to 18 percent, a rate intended to remain in force until 31 December 2003. Following this increase, profits tax and the payroll tax applicable to banking corporations were increased to 18 percent. Thus the statutory tax rate on banking corporations was 45.5 percent in 2002 and is expected to be 45.8 percent in 2003.

**Table 3.10**
**The Transition from a Statutory Tax Rate to Provision for Tax on Income in Profit and Loss Statement of the Major Banking Groups, 2001 and 2002**

(at December 2002 prices)

| | Total tax (NIS million) | | Tax rate on ordinary before-tax profit (%) | |
|---|---|---|---|---|
| | 2001 | 2002 | 2001 | 2002 |
| **Statutory tax** | **2,135** | **1,067** | **45.3** | **45.5** |
| Adjustment differentials on financial assets, net | 7 | –44 | 0.1 | –1.9 |
| Income from subsidiaries abroad | –291 | –306 | –6.2 | –13.1 |
| General and additional loan-loss provision | 18 | 63 | 0.4 | 2.7 |
| Tax-exempt and tax-reduced income | –27 | –48 | –0.6 | –2.0 |
| Depreciation differentials, and adjustment of depreciation and capital gains | 16 | 22 | 0.3 | 0.9 |
| Other expenses not recognized for tax purposes (fines and excess expenses) | 69 | 77 | 1.5 | 3.3 |
| Timing differences for which no deferred tax was recorded | 449 | 344 | 9.5 | 14.7 |
| Payroll tax | 86 | 98 | 1.8 | 4.2 |
| Tax for previous years[a] | –66 | –179 | –1.4 | –7.6 |
| Erosion of tax advances | 8 | 15 | 0.2 | 0.6 |
| Tax on income from subsidiaries in Israel | –23 | –19 | –0.5 | –0.8 |
| Other expenses | –57 | –41 | –1.2 | –1.7 |
| **Provision for taxes on income** | **2,324** | **1,049** | **49.3** | **44.8** |

[a] Including an extra amount for problem debts.

SOURCE: Published financial statements.

corporations—an alternative to the value-added tax on other companies—which is not recognized as an expense for tax payment purposes, helped offset the decline in tax provisions. This factor explains 4.2 percentage points of the effective tax rate.

### f. Other sources of profit

Companies included under an equity method made a negative contribution to the profitability of the five large banking groups in 2001 and 2002. Additionally, non-recurring operations and activities had a marked effect on extraordinary losses. Companies included under an equity method are companies that are not consolidated into the financial reports of the parent bank primarily because its holding in them is relatively small, though it has significant influence on (as opposed to control over) them. This category includes financial companies (banks, insurance companies, portfolio management firms, mutual funds) and non-financial companies (maintenance companies, construction and real estate, communications). The main difference between the major banking groups in this context is the extent of their involvement in non-financial investment, concerning which each bank has its own business strategy (see Chapter 4 for a full discussion).

The share of the five major banks in the net losses of the companies included under an equity method shrank from NIS 191 million in 2001 to NIS 100 million this year. Most of this decline derived from the smaller share of Hapoalim in the current losses of Koor Industries, in which the bank had a 20 percent holding up to its distribution to stockholders of a stock dividend in kind,[16] and in this way reduced its losses due to its investments in companies included under an equity method from NIS 293 million in 2001 to NIS 59 million in 2002. Two other major banking groups also posted losses from their investments in companies included under an equity method. One was Leumi, with a loss of NIS 33 million, against a profit of NIS 55 million in 2001. The decline in the contribution to Leumi's profits of the companies included under an equity method was due largely to the reduction in profits of Migdal Insurance and Financial Holdings and a rise in the losses of the Israel Corporation. The other was Discount, where there was a sharp drop in the contribution to profitability of the companies included under an equity method, due mainly to the transition of the First International to loss status in 2002. The remaining two of the five major banking groups recorded losses from the activities of the companies included under an equity method, but not in significant amounts.

During 2002, profit and profitability in some the five major banking groups were also affected by the extraordinary profits item. These profits, substantial in total, derive from non-recurring activities, different in character from the ordinary operations of the banking corporation; these activities are reflected by substantial income or expenses being recorded. The extraordinary losses of the five banking groups increased from NIS 12 million in 2001 to NIS 72 million in 2002, most incurred by Hapoalim, due to a difference of NIS 131 million between the balance-sheet value of its investment in Koor Industries on 30 September 2002 and the value of the company on the stock exchange on 11 November 2002. In comparison, extraordinary profits of Discount rose by NIS 31 million, mainly capital gains on the sale of real estate.

Extraordinary profits in the banks' financial reports were also influenced this year by the implementation of Standard No. 15 regarding impairment of assets (see Box 3.3 for a fuller discussion). Although the standard is intended to apply to the financial reports of public companies and their subsidiaries beginning in the first quarter of 2003, some of the five large banking groups adopted the standards in part in the last quarter of 2002, at the urging of the Supervisor of Banks. Thus, Hapoalim's loss from extraordinary operations includes an allocation of NIS 19 million for the fall in value of its subsidiary, the Industrial Building Corporation, while profits of Discount include allocations totaling NIS 18 million for the decline in value of its buildings and investments in a company included under an equity method. Sums were set aside as well for the fall in value of two other banking corporations not included among the five major banking groups—NIS 10 million at Union Bank for its investments in Taya Investment Co. and NIS 8 million at the Maritime Bank, for the decline in the value of a building.

[16] On 27 November 2002, all holdings of Hapoalim in the shares of Koor Industries were distributed as a dividend in kind to all the bank's shareholders.

**Box 3.3**
**Impairment of Assets**

In February, 2003 the Israeli Accounting Standards Board published its Accounting Standard No. 15 (hereinafter Standard 15)—Impairment of Assets. This standard, based on International Standard No. 36,[1] determines the accounting treatment and the presentation required in a case of impairment of assets. The standard, which comes into force in the first quarter of 2003, will be employed in the accounting treatment of asset impairment appearing on the balance sheet of the reporting company, including investments in companies included under an equity method, and interbank investments. The standard excludes the majority of financial and other assets (such as inventory, assets deriving from employee benefits, deferred tax assets).

It obliges companies whose assets have declined in value to review the situation on a current basis and obtain assessments of asset value. The standard also specifies that the primary test of asset impairment and the means of measuring it are a comparison of the book value of the asset with the recoverable amount.

The recoverable amount is the higher of two values: the market value of the asset or its utility value, determined by estimating the capitalization of the anticipated cash flow deriving from the use of the asset and its realization at the end of its life.

Standard 15 coincides with the Principle of Conservatism in accounting, by permitting the allocation for impairment of assets—when the value of an asset on the balance sheet is greater than its recoverable amount—and not the reverse, i.e., not the increase in recorded profit due to a rise in value when the value of an asset on the balance sheet is lower than its recoverable value. If changes occur in the estimates that served, on the date of the recognition of the loss from asset impairment, to determine the recoverable amount of the asset, the loss from asset impairment will be canceled.

Implementation of the standard may adversely affect public companies that make provisions for impairment of assets (unless they show assessments of value that will exempt them from the need for such provision). As a result, their financial results may suffer, which may make it difficult for them to meet certain basic financial criteria required to obtain credit from the banking system, and they may even suffer a decline in the value of their collateral held by the banks. Such a development may oblige the banks to classify credit granted to these companies as problem loan, which will have a negative effect on the financial reports of financial and non-financial companies held by the banks and compel them to make provision for asset impairment under this standard.

[1] International Accounting Standard (IAS) 36: Impairment of Assets.

However, the standard is expected to a positive effect on the Israeli capital market by increasing full disclosure, transparency and informational efficiency in the market, all of which are basic conditions for the existence of an efficient capital market.

## 3. OPERATING INDICES AND EFFICIENCY OF THE COMMERCIAL BANKS

One of the central components in evaluating the functioning of the banking system is the extent of its efficiency in utilizing the available factors of production (capital and labor). This efficiency is exhibited in the bank's success in increasing its income and reducing its expenses.

With the decline in profitability of the Israeli banking system, the importance of improving efficiency, as one of the methods of achieving a reasonable and stable level of profitability, grew. In order to analyze the operating characteristics and efficiency of the banks, all commercial banks were divided into three groups by size: large banks,[17] medium-sized banks[18] and small banks.[19] This last group includes banks owned by a banking group, and independent banks. A number of indices serve to indicate the operating and efficiency aspects of the bank, including: (1) operating coverage ratio; (2) income efficiency ratio, calculated as total income (interest and non-interest) to operating expenses; and (3), average expenses per unit of output.

### a. Operating coverage ratio

In 2002, the operating coverage ratio declined by 0.4 percentage point, to 50.3 percent, on average. This decline represents different developments between banks of different size, including a fall in the average rate of coverage in the two largest banks—especially Leumi—and a rise in the medium-sized banks (Table 3.11). This variation is explained by the differences in the operating characteristics of the banks: in the large banks, the decline in the coverage ratio was caused by a reduction in non-interest income, while in the medium-sized banks the rise in the ratio was caused by the decline in operating expenses. The variation between the operating coverage ratio in the group of small banks became even more pronounced in 2002. The operating coverage ratio of the small independent banks fell considerably, while the small banks belonging to the major banking groups succeeded in maintaining their operating coverage ratios at a high level this year too, due to an increase in non-interest income, deriving from the large share of households—that avail themselves of only basic banking services—among their customers.

[17] Hapoalim and Leumi.

[18] Discount, Hamizrahi, First International, Union, and Mercantile Discount.

[19] Otsar Hahayal, Yahav, Arab Israel, Massad, Poalei Agudat Israel, Israel Continental, Industrial Development, Jerusalem (from 1997), Investec (Israel), Maritime, Euro-Trade, Trade (till 2002), Pekao (from 1993), Global Investment, and Kupat Haoved Haleumi.

**Table 3.11**
**Coverage and Efficiency Ratios, 2001–2002**

| | 2001 | | | 2002 | | |
|---|---|---|---|---|---|---|
| | Coverage ratio[a] | Interest ratio[b] | Efficiency ratio[c] | Coverage ratio[a] | Interest ratio[b] | Efficiency ratio[c] |
| Hapoalim | 0.56 | 1.09 | 1.65 | 0.55 | 1.20 | 1.75 |
| Leumi | 0.51 | 1.02 | 1.52 | 0.48 | 0.88 | 1.36 |
| Discount | 0.43 | 0.56 | 0.99 | 0.43 | 0.73 | 1.16 |
| Mizrahi | 0.48 | 0.85 | 1.33 | 0.49 | 0.90 | 1.40 |
| First International | 0.58 | 1.02 | 1.60 | 0.60 | 0.89 | 1.48 |
| Union | 0.36 | 0.98 | 1.33 | 0.46 | 0.98 | 1.44 |
| Mercantile-Discount | 0.43 | 0.83 | 1.27 | 0.51 | 0.96 | 1.46 |
| Seven largest banks | 0.50 | 0.94 | 1.45 | 0.50 | 0.97 | 1.47 |
| Small independent banks[b] | 0.44 | 1.02 | 1.46 | 0.38 | 0.75 | 1.13 |
| Small banks that belong to banking groups | 0.59 | 0.88 | 1.46 | 0.62 | 0.84 | 1.46 |
| Total small banks | 0.54 | 0.93 | 1.46 | 0.54 | 0.81 | 1.34 |

[a] The coverage ratio is calculated as the ratio of non-interest and other income to total operating and other expenses.

[b] The interest ratio is calculated as the ratio of net interest income before loan-loss provision to total operating and other expenses.

[c] The efficiency ratio is calculated as the ratio of total non-interest income and net interest income to total operating expenses. It is sometimes calculated as the ratio of total operating and other expenses to total income.

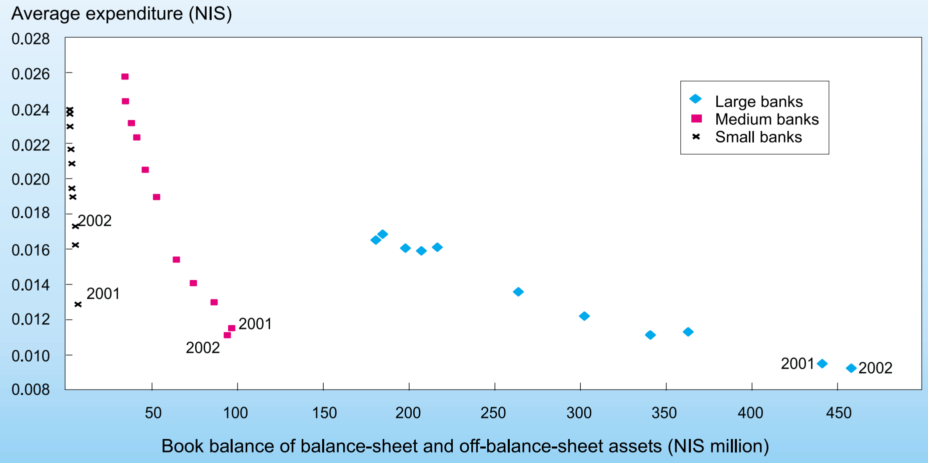
[d] Including for the first time data on the Bank of Jerusalem.

SOURCE: Published financial statements.

### b. Income efficiency ratio

Bank operating expenses stem from current operations, on which they earn non-interest and interest income. Thus, it is important for a bank to analyze its income efficiency ratio, defined as the ratio of total income (interest and non-interest) to total operating expenses. This measure shows the bank's ability to adjust the available factors of production in rational fashion to changes in both the quantities and prices of financial intermediation to bring about a rise in income. A high ratio indicates that the bank is properly utilizing its factors of production. The efficiency ratio of the commercial banks remained stable at 1.45 in 2002, the outcome of developments in operating expenses and non-interest and interest income. This stability overall incorporated wide variation between the banks. A reduction in net interest income led to a fall in the efficiency ratio of Leumi and of the First International, both of which had high efficiency ratios in the past, whereas there was a marked rise in the ratios in Hapoalim and other medium-sized banks (Table 3.11).

**Figure 3.9**
**Average Expenditure per Unit of Output, 1992–2002**




SOURCE: Returns to Supervisor of Banks.

### c. Average operating expenses per unit of output

The policy of improving operating efficiency adopted by the banks in the last decade was expressed in the downward trend in the ratio of operating expenses per unit of output in all the major banking groups (Figure 3.9). The so-called intermediation approach was used as a measure for determining bank output: this defines earning assets as banking output; book balances of balance-sheet and off-balance-sheet assets were selected for this purpose.[20]

Economies of scale featured prominently in Israel's banking system in the last ten years, as evidenced in the average expenses per unit of output (Table 3.12). In addition, the differences in expenses between small banks in the system are larger than those between medium-sized banks, whereas the differences between the large banks are insignificant. Differences between the small banks are derived, inter alia, from the great heterogeneity of this group, composed as it is of independent banks and banks owned by the five major banking groups. The differences in each size group between the bank with the highest average expenses and the bank with the lowest expenses has grown over the last two years, and they indicate the potential for improvement in operating efficiency—potential which is particularly significant in small banks, but important also in medium-sized banks. Improving efficiency without damaging output can be achieved by reducing manpower, lowering wages, closing branches, altering the mix of the factors of production and by other means. A better allocation of the factors of production in Israel's banking system, together with structural changes, may well increase competition within the domestic banking system, and improve the profitability and increase the stability of the banks and the economy. This depends to a great extent on a robust banking system, which will be attained provided the banks are efficient, profitable and expanding.

[20] Unlike in the past, value added was not selected as the measure of output, owing to its extreme sensitivity to negative financial results in ordinary pre-tax profit recorded this year by many of the banking corporations.

**Table 3.12**
**Ratio of Operating Expenses to Unit of Output, by Size of Banks, 1992–2002**

| | Large banks | Medium banks[b] | Small banks[c] |
|---|---|---|---|
| Average 1992–2002 | 0.0135 | 0.0182 | 0.0195 |
| Average 1997–2002 | 0.0112 | 0.0140 | 0.0171 |
| Average 2001–02 | 0.0094 | 0.0113 | 0.0151 |
| Difference between maximum and minimum | | | |
| Average 1992–2002 | 0.0027 | 0.0146 | 0.0815 |
| Average 1997–2002 | 0.0018 | 0.0153 | 0.0914 |
| Average 2001–02 | 0.0020 | 0.0127 | 0.1012 |

[a] Leumi and Hapoalim.

[b] Discount, Mizrahi, First International, Union, and Mercantile Discount.

[c] Otsar Hahayal, Yahav, Arab Israel, Massad, Poalei Agudat Israel, Israel International, Industrial Development, Jerusalem (from 1997), Investec (Israel), Maritime, Euro-Trade, Trade (until 2002), Polska Kasa Opieki (Pekao) (from 1993), Global Investment, and Kupat Haoved Haleumi.

SOURCE: Returns to Supervisor of Banks.