SURVEY OF THE BANKING SYSTEM – FIRST HALF OF 2021

During the first half of 2021, there was a decline in the morbidity rate which led to the lifting of many of the government-imposed restrictions and facilitated a significant increase in economic activity. These trends had a positive effect on businesses and borrowers and led to a decline in the level of economic uncertainty. Due to the economic recovery, the business results of the banking system for the first half of 2021 were significantly better than for 2020, particularly relative to the same period in 2020, during which there was a major slowdown in activity due to morbidity levels. Nonetheless, there is still uncertainty with regard to the duration of the COVID-19 crisis and its future effect on the domestic and global economies, particularly in view of the recurring waves of morbidity (including among those already vaccinated) and the temporary reimposition of certain restrictions.

BUSINESS RESULTS

The net profit[1] of the banking system in the second quarter of 2021 totaled about NIS 5.4 billion—a sharp increase of 236 percent relative to the same period in 2020, when net profit totaled about NIS 1.6 billion (Table 2). **Net profit for the first half of 2021 was about NIS 9.7 billion, compared to NIS 2.4 billion in 2020**—an increase of about 300 percent. **Relative to the net profit for the parallel quarter and the average net profit for the parallel six-month periods during 2017–19—years in which there was no crisis—the increases were 89 percent and 83 percent, respectively. The increases are, for the most part, explained by the income in the loan-loss provision item in view of the economic recovery, and in particular relative to the high level of expenses recorded in this item during the parallel period in 2020, which was a result of the high level of uncertainty. Another factor contributing to the increase in profit is the CPI, which increased by about 1.4 percent during the first half of 2021. The return on equity during the first half of 2021 increased to about 15.6 percent, compared to only about 4.2 percent during the parallel period in 2020. This was the second highest level achieved in the last 26 years.** (The highest level was observed in 2006, and in 2007 the return on equity was identical to the current level; Figure 1.) An examination of the profit and loss items (Figure 2) shows that the increase in interest income, the reduction in loan-loss provisions and the increase in noninterest income contributed to the growth in net profit during the reviewed six-month period. The increase in profit was partially offset by an increase in interest expenses, a rise in operating and other expenses, and a higher provision for taxes that was primarily due to the increase in pretax profit.

Figure 1

Figure 2

The main factors affecting the banking system's business results during the firsts half of 2021 relative to the parallel period in 2020 were as follows:

[1] Net profit attributed to the banks' shareholders.

Net interest income increased by about 13.3 percent during the first half of 2021 relative to the parallel period in 2020, to about NIS 18.4 billion (Table 2). It was primarily affected by the difference between the rise in the CPI during the first half of 2021 (1.4 percent) and the decline of 0.7 percent during the parallel period in 2020. The contribution of the CPI[2] to total net interest income during the first half of the year was about NIS 1 billion, and was the result of the surplus of CPI-indexed interest-bearing assets[3] over CPI-indexed interest-bearing liabilities[4], which totaled NIS 71.5 billion in December 2020 (Figure 3). During the first half of 2021, there was a significant widening of this gap (Figure 3), to about NIS 85.4 billion at the end of the period, such that from a forward-looking perspective the net interest income of the banking system will continue to benefit from an increase in the CPI. If the effect of the CPI is neutralized, then net interest income rose during the first half of 2021 by about 7.1 percent relative to the parallel period in 2020.

Figure 3

With respect to the price and quantity effect on interest income and interest expenses, both quantity and price had a positive effect on net interest income (Table 3), where the quantity effect is somewhat greater than the price effect (explaining about 55 percent of the total contribution to net interest income). Most of the effect on net income during the first half of the year, due to both the quantity effect and the price effect, originated from the portfolio of credit to the public, despite the drop in interest rates that was observed in all of the supervisory activity sectors. (For further details on the interest rates by activity segment sector, see the section on credit.) Nevertheless, the increase in the CPI made a significant contribution to the price effect by way of net interest income (interest income from credit to the public less interest expenses on the public's deposits). If this effect is neutralized, then it appears that the direction of the price effect is reversed, and it contributed to a significant reduction in interest income on credit to the public, in contrast to the parallel period in 2020.

During the reviewed half of the year, the upward trend continued in the interest rate gap between the rate of income from credit to the public and the rate of expenses due to the public's bank deposits. The spread was about 3.3 percent, compared to 2.9 percent in 2020 (Table 4; Figure 4). However, this increase is entirely explained by the effect of the rise in the CPI. If we neutralize the CPI, the aforementioned interest rate gap during the first half of 2021 is about 2.67 percent, reflecting a decline relative to 2020, and the lowest gap during the past seven years. This decline is consistent with the drop in the interest rate on credit with the growth in total interest-bearing assets. (For further details, see the section on credit.) Similarly, the financial spread[5] in the banking system, which reflects the return on interest-bearing assets, rose during the reviewed half of the year to about 2.04 percent,

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[2] All of the analyses of the effect of the CPI in this chapter are estimated on the basis of the end-of-period balances of interest-bearing assets and liabilities that are indexed to the CPI.

[3] The average cumulative balance since the start of the year.

[4] The average cumulative balance since the start of the year.

[5] The ratio between net interest income and total financial assets that produce financing income.

compared to about 2.03 percent at the end of 2020. If the effect of the rise in the CPI is neutralized, the financial spread was about 1.93 percent.

Figure 4

Loan-loss provisions were negative (a reduction in the loan-loss provisions accumulated in the past) during the first half of 2021, and totaled NIS -2.5 billion (Table 2), in contrast an increase about NIS 5.9 billion during the same period in 2020, representing a decline of 142 percent. The reduction in provisions in this item during the first half of 2021 recouped about one-third of the provisions recorded in 2020. The decline is primarily the result of lower group provisions, but also a decline in the individual provisions. This decline is primarily due to the improvement in macroeconomic parameters, and subsequently to a reduction in debt on which payments are deferred, which led to a reduction in the total credit-loss allowance. (For further details, see the section on credit.)

Noninterest income increased to about NIS 9.4 billion during the first half of 2021, a 17.1 percent increase relative to the parallel period in 2020 (Table 2). This increase was primarily the result of the noninterest financial income item, which reflects the profit from investments in equities during the first half of 2021 (Figure 5). About 27 percent of the total increase in this item during the first half of 2021 was the result of the Leumi Group's realized and unrealized profit on real investments. Another contributing factor to the increase in this item is the high volatility in the capital markets during the first quarter of 2020, as a result of the onset of the COVID-19 pandemic, which led to significantly lower noninterest financing income during the first half of 2020.[6] In addition, the banks are continuing to efficiently hedge their activity against exchange rate differences.

Figure 5

Fees income during the first half of 2021 increased by about 5.7 percent relative to the same period in 2020, to about NIS 6.5 billion (Table 2). The increase was primarily due to fees from securities activity[7] and from financing transactions. In addition, there was an increase in credit handling fees and in credit card fees. The increase in fees income during the reviewed half-year was partially offset by the decline in fees from exchange rate differentials as a result of the sharp increase in this item during the same period in 2020, and a decline in account management fees[8] during the reviewed half-year.

Total operating and other expenses increased during the first half of 2021 by about 9.5 percent relative to the same period in 2020, to about NIS 14.8 billion (Table 2). Most of the increase is explained by an increase in salary and related expenses, which rose by about

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[6] The main effect on income in this item originated from Bank Leumi's loss of about NIS 660 million in this item during the first quarter of 2020, which was entirely offset during the second quarter of 2020. Bank Leumi's total noninterest financing income during the first half of 2020 was about NIS 30 million.

[7] Apart from Bank Hapoalim, which showed a small decline during the reviewed half-year relative to the same period in 2020.

[8] The decline in account management fees is partly explained by the accelerated move by customers to online platforms, where fees are lower.

15.7 percent relative to the same period in 2020 due to the resumption of grants and bonuses paid by the banking system to its employees. The increase in this item is due to the sharp rise in rates of return, which directly affect the payment of grants and bonuses, and particularly relative to the same period in 2020 when they were not paid out—as was the case among banks in other countries—due to the poor business results and the high level of uncertainty regarding the development of the crisis.

OPERATIONAL EFFICIENCY

The cost-to-income ratio[9] declined significantly during the first half of the year (54 percent) relative to the same period in 2020 (58 percent). At the same time, average cost per unit of output[10] fell (1.5 percent; Figure 7) relative to the first half of 2020 (1.62 percent; Table 5) as a result of the larger increase in the average quantity of assets than in operational and other expenses. The improvement in the cost-to-income ratio was achieved as a result of a greater increase in income than in expenses: net interest income, noninterest financing income, and other income. Furthermore, the cost per unit of production that is not dependent on income improved in all the banks (even though it is dependent on average total assets, which also grew as a result of the crisis)[11], apart from the case of Bank Mizrahi-Tefahot (as a result of its merger with Union Bank[12]). Bank Leumi presented the best cost-to-income ratio in the system (Figure 6 partly due to its large profit of about NIS 382 million) in the noninterest financing income item as a result of the profit from a subsidiary's realization of real assets. (Even when subtracting out this income, Bank Leumi maintained the lowest ratio – 48 percent.) In the rest of the banks, the improvement in the cost-to-income ratio continued, in contrast to the parallel period in 2020, which was affected by the crash in the markets during the first quarter and the correction in the second. (The exception was Discount Bank, whose expenses on grants grew significantly in the second quarter relative to the previous quarters, and where a one-time expense incurred for a one-time actuarial write-off of about NIS 100 million exceeded the growth in income.)

Figure 6

Figure 7

CAPITAL ADEQUACY AND LEVERAGE

The recovery in the global economy, and particularly in the Israeli economy, contributed to the banks' business results during the first half of 2021, as was reflected in the net profit of about NIS 9.7 billion recorded by the banking system during this period. (For further details, see the chapter on business results.) Due to

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[9] The ratio of total operational and other expenses to total net interest income and noninterest income.
[10] Ratio of total operational and other expenses to the average amount of assets.
[11] It is worth mentioning that the increase in average assets does not necessarily reflect an increase in activity but rather is the result of growth in the public's deposits, a large part of which was converted into cash and deposits at the banks. (For further details, see the section on the balance sheet.)
[12] The merger with Union Bank in the last quarter of 2020 led to a downward bias in the cost-to-income ratio for 2020.

the halt in the distribution of dividends, this profit was fully accumulated within equity capital and thus led to a healthy increase in the banking system's Tier 1 Capital. Thus, the Tier 1 Capital in the system increased by about 13.8 percent in annual terms during the first half of 2021, to about NIS 138.4 billion (Table 12). As a result of this increase in capital, the Tier 1 Capital ratio improved slightly for all of the banks, and was estimated at about 11.3 percent for the total banking system, as opposed to 11.1 percent in December 2020 (Table 12). In this context, the Tier 1 Capital ratio in each of the banks in the system exceeds the minimal capital target set by the Banking Supervision Department, even before the capital leniencies granted as a result of the COVID-19 crisis (as published in the temporary order issued during the crisis, which is expected to remain in place until December 2021[13]). As a result of the healthy capital ratios—which reflect the banks' resilience and their ability to support economic activity—alongside the accelerating exit from the crisis, the Banking Supervision Department decided that there was no reason to prevent the banks from considering the distribution of dividends[14], based on a cautious and conservative policy that takes into account the uncertainty regarding the future of the crisis and its implications. The Banking Supervision Department's revised position states that distributing more than 30 percent of the bank's profit in 2020 and 2021 would not be considered to be cautious capital planning.[15]

Alongside the increase in Tier 1 Equity Capital, the banking system's credit portfolio grew as the economic recovery progressed. As a result the risk assets in the system increased by about 10.2 percent in annual terms during the first half of the year. Most of the increase in risk assets can be explained by greater exposure to corporations and commercial real estate, which carry a high risk weight.[16] This increase in exposure explains about 76.9 percent of the total increase in weighted risk assets, while the increase in exposure to housing loans (which carry an average risk weight of about 53.8 percent) explains roughly another 25.5 percent.[17] Despite the increased exposure to segments with a high risk weight, the average risk weight in the exposure to credit declined slightly. The is due to the significant increase in exposure to sovereigns, which are weighted by a negligible risk weight that fell even further during the first half of the year[18] (0.4 percent compared to 0.6 percent in December 2020).

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[13] See the press release from September 19, 2021, "The Banking Supervision Department acts to extend the validity of the temporary provision through December 31, 2021, and updates its policy regarding dividends" https://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/19-09-2021.aspx

[14] The public holds more than 80 percent of the banks' shares.

[15] See the press release on September 19, 2021, "The Banking Supervision Department acts to extend the validity of the temporary provision through December 31, 2021, and updates its policy regarding dividends" https://www.boi.org.il/en/NewsAndPublications/PressReleases/Pages/19-09-2021.aspx

[16] The average risk weight among corporations is about 93.7 percent and for commercial real estate it is 100.1 percent.

[17] There are factors that negatively affected the growth in risk assets, so that the effect of the aforementioned factors on the growth in exposure totals more than 100 percent.

[18] A principal reason for the decrease in the risk weight of exposure to sovereigns is that Bank Hapoalim has switched to using only one rating agency for purposes of measuring capital adequacy instead of using the lower rating of two rating agencies, as it has done until now (the remaining rating company is Standard and

The total capital ratio eroded slightly during the first half of the year to about 14.3 percent, compared to 14.4 percent in December 2020 (Table 12). This was in spite of the expansion in the capital base, since total risk assets grew at an even faster pace. The explanation for the erosion of the total capital ratio in parallel to the increase in the Tier 1 Capital ratio is the decline in the other components of equity (Additional Tier 1 Capital and Tier 2 Capital), due to the continuing gradual erosion of capital instruments not included in regulatory capital. Nevertheless, it is worth mentioning that the total capital ratios of Discount Bank and Bank Mizrahi-Tefahot increased, thanks to the raising of debt through instruments that can be included in the banks' Tier 2 Capital (CoCo bonds) during the first half of the year.

The leverage ratio for the entire banking system eroded slightly during the first half of 2021, to about 6.16 percent compared to 6.22 percent in December 2020 (Table 13). However, there was a mixed trend among the banks, result from differing rates of increase in total exposure. Thus, while the ratio was eroded for Leumi, Hapoalim, and Discount, due to the sharp increase in total exposure (an increase of about 17.5 percent on average in those three banks, as opposed to an average of 15 percent in 2020—the year of the COVID-19 pandemic—and about 2 percent in 2017 and 2018), there was a moderate increase in total exposure in Mizrahi and First International (although it was still high relative to the precrisis trend). The sharp increase in total exposure is a result of the continuing upward trend in the public's deposits. (For further details on the reasons for the increase in the public's deposits during the COVID-19 crisis, see Box 4.1 in the Survey of the Banking System for 2020.) This translated into increased exposure for the banks, due to both increased provision of credit and the depositing of funds from those deposits with the Bank of Israel (which increases the exposure to sovereigns).

DEVELOPMENT OF THE BALANCE-SHEET

The aggregate balance sheet of the banking system grew at a particularly high rate of 13.0 percent[19] during the first half of 2021, to a total of about NIS 2,058 billion (Table 14) compared to about NIS 1,932 billion at the end of 2020. If the CPI and the exchange rate are neutralized, then the rate of increase in the total balance sheet was about 12.6 percent. **On the sources side, the upward trend in the public's deposits continued**, primarily demand deposits in Israel, which grew at a rate of about 15.3 percent during the first half of 2021. The growth in this item was one of the main components within the growth of the system's liabilities. **On the assets side, the growth in sources was used to expand the portfolio of net credit to the public** by about 11.7 percent, to a total of about NIS 1,199 billion. In addition to the growth in the portfolio of credit to the public, there was an expansion of about 4.2 percent in the banking system's portfolio of securities (Table 15), particularly equities and in some banks also foreign government bonds. **The rest of**

Poors). The switch to one rating company led to a drop in the risk weight used to weight the exposure to sovereigns, which translated into a loosening of about 0.12 percent in the Tier 1 Capital ratio at the time of Bank Hapoalim's switch.

[19] All of the data presented in this section are expressed in annual terms.

the increase on the uses side was in total cash and bank deposits in the banking system's balance sheet (about 28.9 percent), to about NIS 532.7 billion as of the end of the first half of 2021. The banking system's equity grew by about 15.2 percent during the first half of 2021 to about NIS 137.7 billion.

In the banks' off-balance-sheet activity, total guarantees and commitments to provide credit grew during the reviewed period by about 11.8 percent, similar to the trend in 2020, to about NIS 596 billion. This constitutes about 36.9 percent of the banking system's total credit risk, a moderate increase relative to its average weight in past couple of years (about 36.3 percent). The increase in total off-balance-sheet exposure during the first half of 2021 is due to the growth in irrevocable commitments to provide credit that has already been approved but not yet provided and guarantees to home buyers, which explain about 101 percent of the increase. With the increased allocation of credit to the housing and large business segments in recent years (for further details, see the section on credit) for, among other things, the financing of national infrastructure development projects, construction and real estate, and in the context of providing approval in principle of mortgages and as part of Sales Law guarantees, there is a lag between the approval of a commitment to provide credit and its actual provision. Between these two points in time, the credit is classified as off-balance-sheet, such that there is a correlation between the growth in credit to the large business and housing segments and the irrevocable commitments to provide credit. This increase was partly offset by the decrease in credit card facilities approved during the same period, as will be described in detail below.

Total approved credit facilities[20] in the banking system grew by about 6.4 percent during the first half of 2021 to about NIS 103.8 billion (Figure 8). This increase is mostly (about 62 percent) explained by the increase in unutilized credit facilities (which grew by about 5.4 percent during this period), while the rest is explained by the increase in total utilized credit facilities (which grew by about 9.4 percent during this period).

Figure 8

THE CREDIT PORTFOLIO AND CREDIT RISK

The banking system's credit portfolio grew by a high rate in 2021 (about 11.1 percent[21] compared to an average of 4.6 percent during the previous two years; Figure 9). This growth was primarily the result of increases in business credit (which was due mainly to the construction and real estate industries) and in housing credit, which accounted for over 70 percent of the total growth in the portfolio during the year. In addition, during the first half of 2021 and for the first time since 2019, there was an increase in consumer credit (3 percent). Similarly, there was an improvement in the credit quality indices following the recovery in economic activity, which worked to reduce total deferred credit, among other

[20] Total utilized and unutilized credit facilities.
[21] In annual terms.

things. However, the effect of the crisis and the continuing uncertainty regarding further waves that may cause further harm to the economy are still reflected in the credit quality indices, which have not yet returned to their precrisis levels.

Figure 9

Households

Consumer credit

For the first time since 2019, there was growth in consumer credit (3 percent), a trend that characterized most of the banks. The Bank of Jerusalem, Bank Leumi, and First International Bank led the trend (9.9 percent, 6.8 percent, and 6.6 percent, respectively) while Bank Hapoalim experienced a drop of 2 percent in total consumer credit. The growth in consumer credit was accompanied by a drop in the interest rate (an average monthly rate of 4.86 percent during the first half of 2021, compared to an average monthly rate of 5.14 percent during 2020; Figure 10). The decline in the interest rate was apparently the result of lower costs in obtaining bank sources, the economy's recovery from the COVID-19 crisis, and the improvement in the quality of the portfolio. The growth in credit and the drop in the interest rate led to a significant decline in profit from consumer credit activity in most of the banks (apart from Bank Mizrahi, where it was basically unchanged; Table 6).

Figure 10

The improvement in the economic situation led to higher consumer credit indices (Table 7). Thus, income was recorded in the loan-loss provision item, totaling -0.85 percent of total credit, compared to a rate of 1.06 percent during 2020. This income was primarily a result of the decline in the group provision, which was partly due to the fact that **payments on about 99 percent of consumer credit, which had been deferred during the pandemic, had been resumed as of September 2021** (Figure 11).

Figure 11

The total approved credit facilities for individuals (current account credit facilities) remained relatively unchanged at about NS 41.1 billion as of the end of the first half of 2021. For the first time since the beginning of the COVID-19 crisis, there was a significant increase in utilized credit facilities for individuals. They now total about NIS 9.3 billion, a 10.4 percent increase (in annual terms) during the reviewed period, which is primarily explained by accounts attributed to those in the highest income category (Category E).[22] Accordingly, there was a decline in total unutilized credit facilities, to NIS 31.7 billion during this period.

Total approved bank credit card facilities fell by about 20.8 percent, to about NIS 55.4 billion at the end of the first half of 2021. This is the result of a requirement imposed on

[22] The income categories are classified into five groups: A to E, from lowest to highest income. For further details, see Reporting Instructions to the Banking Supervision Department no. 836.

the two largest banks to reduce their total approved credit card facilities as part of the Strum reform, the goal of which is to increase competition in the financial market.

Housing

During the first nine months of 2021, a total of NIS 82.2 billion in credit was provided, up 45 percent from the same period in 2020, and the number of transactions stood at about 93,000, an increase of 26 percent relative to the same period in 2020 (Figures 12 and 13).

Figure 12

Figure 13

Closings during the year were characterized by somewhat higher loan-to-value (LTV) ratios (Figure 14) and the purchase of more expensive assets. These led to an increase in the size of the average loan in 2021 (Figure 16), to about NIS 881 thousand as of September 2021, an increase of 13 percent relative to the average for 2020.

Figure 14

Figure 15

Figure 16

Credit provided for residential housing increased for all purchasing objectives, particularly for **first-time buyers and housing upgraders, who constitute over 80 percent of total credit provided since the beginning of the year (Figure 17).** In this context, there was a drop in the weight of borrowers in the Buyer's Price program, which constituted about 12 percent of the closings and transactions during the year, declines of about 3 percentage points and 7 percentage points, respectively, relative to the average for 2020 (Figure 18).

Figure 17

Figure 18

During the year, there was a moderate increase in investors' share of credit for residential housing, relative to an increase in their share of transactions in the housing market, particularly after the reduction in the purchase tax at the end of July 2020 (Figure 19).[23,24] Starting in August 2020, the gap widened between the share of investors in the housing market and their share of the market for residential housing credit, which stood at an average of about 8 percentage points compared to 3 percentage points prior to the reduction in the purchase tax. This gap is essentially a reflection of purchases made by investors without the need for bank credit.

Figure 19

[23] https://www.gov.il/he/departments/news/sa-29072020-1 (Hebrew)
[24] Survey of the Residential Real Estate Sector for the First Quarter of 2021, August 2021.

In January 2021, the limit on the proportion of a loan that can be indexed to the prime rate was raised from one-third to two-thirds. This measure acted to increase the proportion of the variable unindexed track, most of which is provided in the prime rate track, within total new mortgages by about 8 percentage points, relative to the end of 2020, to 40.6 percent (Figure 20). The increase in the weight of this component supported the downward trend in the interest rate on housing credit, and as of September 2021 the weighted interest rate on mortgages was 2.15 percent, a decline of 27 basis points relative to the same period in 2020. The CPI trend and the expectations of a rise in inflation in coming years moderated the drop in the interest rate in unindexed tracks relative to the CPI-indexed tracks. Thus, the interest rate in the fixed unindexed track remained unchanged relative to December 2020 (3.03 percent). In contrast, the interest rate in the fixed CPI-indexed track (2.31 percent in August 2021) declined by 44 basis points relative to December 2020 (Figure 21).

Figure 20

Figure 21

The low interest rate, in addition to regulatory changes, led to an increase in mortgage refinancing. Thus, total refinancing during the year (both external and internal) grew by about 16 percent relative to 2020 (NIS 16.5 billion during the first nine months of 2021). Furthermore, there was a 48 percent increase in early repayments (about NIS 27.6 billion) relative to September 2020. However, it is worth mentioning that during 2021, refinancing (both internal and external) as a share of total housing credit (17.5 percent) declined relative to 2020 (21 percent), partly due to the refinancing that was a type of alternative track that the system designed for certain customers.

The quality of the housing credit portfolio

The growth in housing credit was accompanied by a slight decline in the quality indices of the housing credit portfolio. During the course of the year, there was an increase in the average LTV ratio to 54 percent, an increase of one-half of a percentage point relative to the end of 2020. This was due to the increase in the proportion of credit provided with a high LTV ratio (a ratio of 60–75 percent), to about 43 percent of total credit provided since the beginning of the year, compared to an average of 40.4 percent during 2020. Furthermore, there was a slight rise in the average term to maturity, to 22.7 years during 2021, compared to 22.4 years during 2020. In addition, there was a slight rise in the payment-to-income (PTI) ratio (an average of 26.5 percent during 2021 compared to an average of 26.3 percent during 2020; Figure 22), which constitutes the main index of a borrower’s ability to absorb a shock to his income and to continue paying his mortgage. **Despite these trends, it is important to emphasize that the housing credit portfolio has a high level of quality, including in comparison to other countries.** (For further details, see the box entitled “An International Comparison of the Housing Credit Market”.)

Figure 22

Nonetheless, in recent years and particularly during the first half of 2021, there has been a clear upward trend in the weight of loans with high LTV ratios (60–75 percent) and high PTI ratios (30–40 percent). Thus, for example, such loans totaled 16.5 percent of total transactions, an increase of 2.5 percentage points relative to the 2020 average, and an increase of 4 percentage points relative to the 2019 average (Figure 23).

Figure 23

During the past year, deferred credit constituted one of the main focal points of risk in the bank credit portfolio, and the majority of credit that remains in deferral is housing credit (about 73 percent of total deferred credit as of September 2021; Figure 24). Nonetheless, **there is a continuing downward trend in total credit on which payments are deferred,** and as of September 2021, deferred credit accounted for only 2.3 percent of total housing credit (including all-purpose housing credit), compared to 9.4 percent at the end of 2020 (Figure 25). In this context, it should be mentioned that the mortgage payment deferral plan allowed partial deferral for longer periods than in other activity segments, due to the large payments on this type of credit, thus explaining the higher deferral rate in housing credit.

Figure 24

Figure 25

The business sector

Growth in business credit during the first two quarters of 2021 was 13.7 percent (Figure 26; Table 8) and was primarily attributable to large businesses (19.3 percent) and medium businesses (15.5 percent). Credit provided to large businesses constituted about 46 percent of total business credit provided during the first six months of 2021, and about 64 percent of total growth. There was growth in the small and micro business segment (6 percent) despite the sharp drop in the activity of State-guaranteed funds during 2021, to the point that the funds' activity appears to have been exhausted. As of July 2021, total credit provided by the State-guaranteed funds[25] was a little over NIS 23 billion, the vast majority of which was provided in 2020.

Figure 26

The spread from credit activity in the business sector was 2.54 percent as of June 2021, a drop of more than 30 basis points relative to 2020. The continuing decline in the spread from credit activity is partly due to the growing competition in the credit market, both within the banking system and from nonbank credit[26], in view of the economy's rapid recovery from the crisis (Figure 10; Table 9).

[25] For further details on the activity and characteristics to the funds, see Chapter 4 of the Bank of Israel Annual Report for 2020.
[26] Financial Stability Report, August 2021, Bank of Israel.

With respect to the quality of business credit, there was a reduction of loan loss provisions in all of the activity segments (Figure 27), after the banks recorded large loan loss provisions in 2020, primarily at the onset of the COVID-19 crisis. With the improvement in macroeconomic indices, the banks reduced their loan loss provisions, which was reflected in this income. Thus, the rate of loan loss provisions among small and micro businesses fell during the second quarter of 2021 to -0.38 percent, compared to 1.18 percent in 2020. In the large businesses segment, the loan loss provisions fell from 0.8 percent in 2020 to -0.77 percent in the second quarter of 2021.

Figure 27

Credit by segment

Credit to the public grew by about 11.1 percent during the first two quarters of the year, a high rate relative to the average for the previous two years (average growth of 4.6 percent during the years 2019–20). **As in recent years, credit to the construction and real estate industries and housing credit led the growth in the portfolio.** Credit to the construction and real estate industries, which grew by about 22 percent during the year (Table 10), continued to lead the growth in commercial credit and constituted about 70 percent of the growth in the commercial portfolio during the year. **A Banking Supervision Department examination of developments in credit to the construction and real estate industries revealed rapid growth accompanied by increased risk appetite and less stringent underwriting terms, an increase in the level of risk, and a narrowing of credit spreads on new transactions. In view of these developments, the Banking Supervision Department required the banks to strengthen their monitoring and control processes for risk management, particularly in the case of new credit transactions.** In this context, credit to the construction and real estate industries and housing credit as a share of total credit to the public continued to grow, to 53.1 percent as of June 2021 (as opposed to 52 percent at the end of 2020; Figure 28). The Banking Supervision Department regularly monitors these developments and is managing the risks brought about by the growth in exposure to these industries, with the goal of maintaining the stability of the banking system and of the economy as a whole.

Figure 28

Credit quality

The bank credit portfolio continued to recover from the effects of the crisis. During the first two quarters of the year, there was a recovery in most of the credit quality indices (Table 11). As the economy returned to normal and the unemployment rate dropped, all of the banks reduced their loan loss provisions (a rate of -0.41 percent in annual terms; Figure 29). During the first half of the year, the banking system recorded income of about NIS 2.5 billion, about one-third of the provisions recorded during 2020 (about NIS 7.8 billion). Income was recorded in both the individual provisions category, which resulted from the reduction in the provisions and the increased volume of collection, and in the group provisions category, which resulted from adjustments in the provision’s rates due to the decrease in deferred credit (Figure 26) and in problematic credit. Nonetheless, the total provision as a share of credit to the public, and the coverage ratio[27], remained high relative to their precrisis levels (1.4 percent and 115.3 percent, respectively, compared to 1.2 percent and 88.3 percent in 2019). This is evidence of the banking system's healthy buffers in provisions, in view of the fact that the economy has not fully recovered and there is still uncertainty with respect to continuing outbreaks that might lead to further impact to the economy.

Figure 29

LIQUIDITY RISK

The Liquidity Coverage Ratio (LCR)[28] of the banks eroded slightly during the second quarter of 2021, but the aggregate value of the ratio remained high relative to precrisis levels, at about 133 percent, compared to 137 percent in December 2020 and 126 percent in December 2019 (Figure 30). The ratio exceeds the minimal requirement established by the Banking Supervision Department (100 percent). The slight erosion of the ratio characterized most of the banks.

Figure 30

The erosion of the ratio occurred despite the rapid growth in the stock of high-quality liquid assets (HQLA; an increase of 18.6 percent in annual terms), in view of the large increase in net outflow (an increase of 26.2 percent in annual terms; Figure 31). The continuing rapid increase in the public's deposits—which began with the onset of the COVID-19 crisis—is the main factor that led to the growing stock of HQLA (due to the increase in cash and bank deposits) and the net outflow. Thus, **the public's deposits grew by about 15 percent in annual terms during the first half of the year** (about NIS 113.4 billion); **wholesale nonfinancial deposits grew by about 24.5 percent in annual terms** (about NIS 45 billion); **and wholesale financial deposits grew by about 30.7 percent in annual terms** (about NIS 50 billion; Figure 32). The deposits in the wholesale segments

[27] The ratio of the total credit loss allowance to impaired credit and unimpaired credit in arrears of 90 days or more.

[28] The LCR, developed by the Basel Committee to enhance the short-term resilience of banking corporations' liquidity profiles, is a measure of the quantity of HQLA (High Quality Liquid Assets) that corporations should hold in order to withstand a significant stress scenario that lasts thirty calendar days. The LCR is composed of two elements. The first, on the numerator side, is the inventory of HQLA (High Quality Liquid Assets), which is comprised of two levels of assets. Level 1 includes high quality assets that may be held in unlimited amounts while Level 2 is composed of assets that are limited to a maximum aggregate holding of 40 percent of the HQLA inventory. (This level is divided into two sublevels: 2A and 2B. At the latter level, the share of assets that may be held is limited to 15 percent.) The second element, on the denominator side, is the total net cash outflow, i.e., the expected total cash outflow less the expected total cash inflow in the stress scenario. The expected total cash outflow is calculated by multiplying the balances of different categories or types of balance-sheet and off-balance-sheet liabilities by their expected runoff or drawdown rates. The total expected cash inflow is calculated by multiplying outstanding contractual receivables by the rates at which they are expected to be received in the scenario, up to a cumulative 75 percent of the predicted total cash outflow.

are weighted as part of the estimation of the ratio by high relative withdrawal coefficients[29], which led to the aforementioned sharp rise in net outflow.

Figure 31

Figure 32

The increase in the public's deposits was used by the banks both to increase net credit to the public (by about NIS 62.3 billion in the first half of the year) and to increase cash and deposits at the Bank of Israel (by about NIS 67.8 billion in the first half of the year). Thus, **the stock of liquid assets grew by about NIS 50.6 billion during the first half of the year,** which is primarily the result of the increase in cash and deposits at the Bank of Israel.

The increase in wholesale financial deposits was the result of growth in institutional investors' assets, which was also manifested in their cash and deposits (Figure 33), partly due to the profits they recorded.

Figure 33

With respect to wholesale nonfinancial deposits, it appears that **growth during the first half of the year (about 68 percent) was due to deposits denominated in foreign currency.** There was an increase of about 53 percent in wholesale nonfinancial deposits denominated in foreign currency during the first half of 2021 (about 50 percent if the effect of the exchange rate is neutralized). The increase may be explained in part by the sharp increase in the volume of capital raised abroad by Israeli companies (Figure 34).

Figure 34

Box: An international comparison of the housing credit market

- **There has been a high level of activity in Israel's housing market in recent months.**
- **This development was reflected in the purchase of more expensive assets at higher LTV rates, leading to an increase in the size of the average loan and a larger proportion of loans provided at high LTV rates (LTV rates of 60–70 percent) and high PTI rates (PTI rates of 30–40 percent).**
- **Despite these trends, and in view of the similar trends abroad, the debt to housing ratio, housing prices, and rents remained low relative to other countries.**
- **An analysis of the macroprudential measures adopted in other countries shows that the measures adopted in Israel were conservative in every possible category and worked to reduce the risk in the housing credit portfolio.**

[29] The withdrawal coefficients for wholesale nonfinancial deposits are usually 40 percent. Those of wholesale financial deposits are 100 percent. For purposes of comparison, retail deposits are weighted with withdrawal coefficients of only 3–5 percent.

There has been a high level of housing market activity in Israel, and in credit provided for residential purposes, in recent months. In August 2021, about NIS 11.8 billion of credit was provided for residential housing, the largest monthly amount of housing credit ever provided in Israel. This was reflected in increases in the number of transactions (Figure 1), the quantity of loans (Figure 2), home prices, and in the size of the average housing loan, which stood at about NIS 881,000 during 2021 (an increase of 13 percent relative to the average for 2020; Figure 3). Nonetheless, there was a significant drop in the number of transactions in the housing market in the second quarter of 2021 (Figure 4).

Figure 1

Figure 2

Figure 3

Figure 4

The increase in housing credit activity was observed for all types of purchases, **particularly among first homebuyers and housing upgraders, who account for more than 80 percent of the credit provided since the beginning of the year (Figure 16 in the section on housing credit).** In the housing market, it appears to be the investors who had a leading role in the growth of transactions in recent months (a total of 2600 homes as of July 2021, which was three times the number from July 2020[30]). However, the "stock" of housing owned by investors remained basically unchanged as a result of an identical level of sales. In this context, **Banking Supervision Department data show that many investors are not using a mortgage to finance the purchase of homes, since their proportion of those taking out a mortgage has not grown at a similar pace to their share of homebuyers.**

The factors explaining the high level of activity in the housing market also include macroprudential measures[31] (not just regulatory ones). On the demand side, the factors include a reduction in the purchase tax on investment homes in July 2020 (which increased investors' activity in the market[32]); the announcement terminating the Buyer's Price program; the decrease in the interest rate on mortgages; a shift in purchasers' preferences as a result of the COVID-19 crisis (larger/more spacious homes); and an increase in household savings during the COVID-19 crisis. (For further details, see the Financial Stability Report.)

According to the Financial Stability Report published by the Bank of Israel in August 2021, factors on the supply side include the drop in building starts relative to previous years. National Accounts data show that investment in residential construction fell by 6.6 percent in 2020. This reflects a decline in both housing completions, which fell at a significant rate,

[30] Survey of the Housing Sector – July 2021, Ministry of Finance, Chief Economist's Unit.
[31] Financial Stability Report, August 2021, Bank of Israel.
[32] Survey of the Housing Sector – June 2021, Ministry of Finance, Chief Economist's Unit.

and housing starts.[33] Furthermore, the long-term rate of construction indicates that the supply of housing will grow at a slower pace than demand, which takes into account population growth. In addition, there is a continuous rise in the construction costs of new housing, particularly the costs of raw materials and transport, as can be seen in the Index of Construction Inputs, which contributes directly to the price of new housing.[34] The index increased by 4.6 percent from December 2020 to August 2021, in contrast to 2019 when the index rose by only 1 percent and 2020, a year in which the index remained unchanged.

The high level of activity in the residential credit market acted to raise the ratio of households' housing debt to GDP in Israel, as occurred in the majority of the OECD countries.[35] Despite its increase during 2020, Israel's ratio remained low relative to the OECD countries (Figure 5–6). Thus, the ratio of housing debt to GDP in Israel stood at 30.1 percent at the end of 2020, an increase of 2.6 percentage points relative to 2019. **The increase in this ratio in Israel was low relative to the OECD countries, which recorded an average increase of 3.8 percentage points in 2020.**

Figure 5

Figure 6

During 2021, the risk of the banking system's housing credit portfolio increased slightly, which included an increase in the weight of loans provided with high LTV rates (60–75 percent; Figure 13 in the section on housing credit) and high PTI ratios (30–40 percent; Figure 21 in the section on housing credit). Nonetheless, it is important to emphasize that the macroprudential measures adopted during the past decade have meant that the **restrictions imposed in Israel are more conservative than in other countries in every possible category** (restrictions on the LTV ratio, the PTI ratio[36], and the term to repayment; Figure 7). This is in addition to the **capital-based measures[37] adopted by the Banking Supervision Department in recent years, which require the banks to set aside more capital against housing credit** (Figure 8), **a measure that contributed to the quality of the housing credit portfolio (which remains high relative to other countries).**

Figure 7

Figure 8

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[33] This may have been the result of difficulties that emerged since the start of the COVID-19 crisis and the restrictions imposed on the population.

[34] Including housing that is part of the Buyer's Price program.

[35] Countries for which the 2020 figure was available to us.

[36] In Israel the PTI ratio is the ratio of the monthly payment to monthly disposable income. **Monthly disposable income** is net monthly income minus fixed costs, which are **expenses due to the borrower's liabilities that have a remaining period of more than 18 months. (For further details, see Appendix B).**

[37] These measures include the adoption of a more stringent approach to the weighting of risk assets (the standard approach) than that of the Basel Committee, and the requirement that the banks allocate capital at a rate of 1 percent of total housing credit.