



**BANK OF ISRAEL  
SUPERVISOR OF BANKS  
THE RESEARCH UNIT**

# **ISRAEL'S BANKING SYSTEM**

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## **Letter of the Supervisor of Banks, Mr. Rony Hizkiyahu, submitted with the 2006 Survey of Israel's Banking System, published by the Bank of Israel**

The global economy had a good year in 2006, and Israel benefited from continued growth in economic activity and in the capital market. This contributed to further improvement in the robustness and performance of Israel's banking system, expressed by the decline in exposure to credit risk and the rise in profitability. The capital adequacy ratio of the largest five banking groups rose slightly in 2006, after remaining steady in 2005.

The reduction in credit risk in all the banks and most of the principal industries resulted from the enhanced quality of the credit portfolio. It was reflected mainly by the decline in loan-loss provisions and in credit classified as problem credit, a trend which continued also in the first quarter of 2007. Despite the improvement in the quality of credit over the last few years, problem credit in Israel remains higher than in the advanced economies.

The net income of the largest five banking groups rose during 2006, despite a fall in ordinary after-tax income. The increase derived from a rise in net income from extraordinary activities, most of which was due to the banks' non-recurring capital gains from the sale of the ownership and management rights of their provident and mutual funds, as part of the Bachar reform.

It should be noted that Israel's excess capital adequacy is low compared with that in the advanced economies. The Banking Supervision Department considers it essential for the banks to improve their capital adequacy beyond the minimum required by the Banking Supervision directives. This should be implemented during periods of economic growth and expansion in the business cycle, and should be deemed a precautionary step intended to provide support in times of recession in economic activity.

Alongside the above developments, there was a decline in the extent of classic banking intermediation, evident in two areas: (1) bank credit to businesses declined, due to the increase in credit substitutes funded by non-bank sources, especially via the issue of corporate bonds. This development might have an adverse impact on the economy and on the banking system in times of crisis. (2) The share of the public's total financial assets managed by the banks declined, as customers switched from bank deposits to the capital markets and to non-bank financial institutions. These two trends had a positive effect on economic welfare by increasing the competitive threat to the banking system; they may, however, jeopardize the future performance of the banking system, which must therefore find alternative sources of income and cut costs. The banks reacted in several ways: they increased credit to individuals, developed and marketed substitute deposit products (structured deposits, for example), expanded their credit card activity, and increased their investments in the capital market in Israel and abroad (mainly in the portfolio of securities available for sale) and their deposits in banks abroad.

In 2006 the trend of merging mortgage banks into the commercial activities of their parent banks continued. In the commercial banking area, following the government's decision of May 1993 to increase competition by requiring the two largest banking

groups to divest themselves of their smaller banks, the restructuring was completed. This did not, however, reduce the high degree of concentration in the banking system to any significant degree and this remained high in comparison with the level in the advanced countries and also in comparison with countries in Israel's peer group. At the same time, the banking system (and in particular the two largest banks) expanded its presence abroad.

The Supervision of Financial Services Law (Pension Consultancy and Pension Marketing), 5765–2005,<sup>1</sup> determines the path banks must follow in advising customers about pensions, following their sale of the pension-related assets they managed. In the context of the Bachar reform, the banks took steps during the year to sell the activity of their provident and advanced study funds, and the mutual funds management companies. The Banking Supervision Department is furthering this process, which is of great importance to the economy and to the public's welfare.

Following intensive efforts on the question of banks' fees by the Banking Supervision Department, the Knesset passed the Increased Supervision of Banking Fees Law on 26 June 2007. For the first time, the Law grants the Supervisor of Banks far-reaching authority over banking fees. Under the Law, a small list of fees will be drawn up, and fair disclosure and public transparency of prices of banking services will be enhanced. The Law is intended to improve public welfare while intensifying competition in retail banking sector.

On 1 July 2006 the directive on the Management of Credit Facilities in Current Accounts came into effect. The Banking Supervision Department established a control room that maintained contact with the banks and monitored progress on this issue in the relevant period, to ensure a smooth transition to the new format of activity. It also set up a telephone call center to handle customers' queries and provide assistance on the implementation of the directive. The public demonstrated maturity, and most customers arranged their credit limits. The data illustrate that the number of returned checks and restricted accounts after the introduction of the directive did not exceed the level prior to its introduction. We consider that reconciliation of the deviations from the credit limits will, in time, lead to an improvement both in consumers' management of their financial transactions and in banks' assessments of customers and customer risks.

At the beginning of 2007 I announced that the recommendations of the Basel Committee on Banking Supervision—International Convergence of Capital Measurement and Capital Standards—published in June 2006 (Basel II) would apply to Israeli banking corporations from December 2009, and every banking corporation should prepare itself to ensure that it will be ready by then. The Banking Supervision Department intends to work towards achieving this aim via a combination of (a) upgrading risk management systems, internal controls and corporate governance of banking corporations, and (b) moving to risk-focused banking supervision. In this context the Supervisor of Banks circulated a draft of the full Basel II Accord in July 2007. To facilitate the implementation of Basel II in Israel, teams were appointed in the Banking Supervision Department to

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<sup>1</sup> Sefer Hahukkim 5765, No. 2024, 10.8.2005, p. 918 (Hebrew).

deal with the following specific topics: a standardized approach to credit risk, market risk and operational risk; an internal rating-based (IRB) model of credit risk; a process for assessing capital adequacy; a process for supervisory review and assessment; a quantitative impact study (QIS); and defining the capital base. The Banking Supervision Department will continue to work in cooperation and consultation with the banking corporations and other entities in order to place Israel in a position among the leading advanced countries in the area of risk management and supervision.



Rony Hizkiyahu  
Supervisor of Banks

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