

Chapter 3

Financial Results

Total profit of the five major banking groups, including net income from extraordinary activities and minority interests, rose by about 7 percent in 2000, to NIS 3.8 billion, reflecting a total return on equity of 11.7 percent, up from 11.3 percent in 1999. The rise was mainly due to increased financial activity, particularly in the unindexed local-currency segment (while the total net interest margin remained stable), which led to a rise in banks' net interest income. Lively trade in securities in Israel and abroad, which increased banks' income from customers' capital-market activities by a significant 40 percent, and a rise in banks extraordinary income arising from the sale of several companies also played a role in improving banks' profitability.

The improvement in banks' profits was partly offset by a rise in salaries and related expenses—particularly those associated with early retirement, part of the streamlining process which some banks are implementing—and by an increase in loan-loss provisions, indicating some deterioration in the quality of credit.

The economic slowdown and the security situation started affecting banks' financial results in the last quarter of 2000, and to a greater extent in the first half of 2001. It would thus appear that the long-term trend of an improvement in banks' profitability will not continue in 2001, and their profit may even decline.

1. THE PROFITABILITY OF THE BANKING GROUPS: MAIN RESULTS¹

The rise in the income and profitability of the banking system which has been evident in the last few years continued in 2000. Total profit of the five major banking groups (including net income and minority interests) rose from NIS 3,580 million in 1999 to NIS 3,833 million in 2000, and reflected a rise in average return on equity (ROE), i.e., profitability, from 11.3 percent to 11.7 percent (Table 3.1). As in previous years, ROE

¹ This chapter focuses on the income and profitability of the five major banking groups, although the extended analysis of margins, operating expenses, and non-interest income encompasses all the commercial banks. Data are based on the banks' published annual financial statements and returns to the Supervisor of Banks.

Table 3.1
Adjusted capital and Profitability of the Five Major Banking Groups,
1995–2000

	(NIS million, December 2000 prices)					
	1995	1996	1997	1998	1999	2000
End-of-year capital ^a	27,066	28,569	30,968	32,005	33,473	36,004
Adjusted capital ^b	25,718	27,066	28,569	31,001	31,630	32,810
Loan-loss provision	3,092	2,693	2,392	2,220	2,066	2,311
Ordinary pre-tax profit	3,645	3,959	4,919	4,516	6,090	6,050
Tax provision	1,855	2,189	2,366	1,913	3,042	2,888
Extraordinary after-tax profit	47	168	451	18	159	321
Share in profits of unconsolidated subsidiaries	368	406	395	354	358	377
Translation adjustments	-42	49	30	87	15	-27
Total profit^c	2,162	2,393	3,429	3,062	3,580	3,833
<i>Percent</i>						
Ordinary pre-tax profitability ^d	14.2	14.6	17.2	14.6	19.3	18.4
Return on equity (ROE) ^e	8.4	8.8	12.0	9.9	11.3	11.7
Return on assets (ROA)	0.4	0.5	0.7	0.5	0.6	0.6
Loan-loss provision/credit to public	1.0	0.9	0.8	0.6	0.5	0.5

^a Including minority interests.

^b Capital at beginning of year *plus* issues weighted according to date of issue.

^c Including the share of minority shareholders in consolidated profits.

^d Ordinary pre-tax profit *divided by* adjusted capital.

^e Total net income *divided by* adjusted capital.

SOURCE: Published financial statements.

showed marked differences between the banking groups: while it rose in four of the five major groups, it was actually negative (-0.6 percent) in the Discount group (Table 3.2). Although the groups' profits rose, their before-tax profits from ordinary activities were stable (at NIS 6,050 million, compared to NIS 6,090 million in 1999), and most of the increase in total profit derived from extraordinary activities and from a reduction in provisions for tax. This is most clearly evident in the Leumi group, and will be discussed below.

The improved performance of most of the major banking groups evident in 2000 did not continue into the first quarter of 2001, when the average ROE in the five major banking groups was only 7.6 percent, with each of the groups showing a decline. In this quarter the effect of the economic slowdown, which was due to several unrelated factors, was particularly marked. These factors included: the security situation and the economic uncertainty regarding the future facing the area, the crisis in the high-tech industries which had led growth in 2000, and the depressed state of the capital markets in Israel and abroad. All these had an adverse effect on bank's profitability: the recession in certain industries lowered the quality of credit granted to them, and customers ran into difficulties in repaying bank loans. Income from the capital market declined, too, and there was a

contraction in net interest margins, which was not entirely offset by the expanded activity.

The performance of Israel's banking industry is generally not very different from that of the banking systems of industrialized countries. Table 3.3 compares indices of the performance, operation, and risks of the banking systems in twenty different countries;² and shows that the ROE in Israel's banking system is not different from the average in its peer group,³ but the net interest margin on total assets in Israel is a little higher than that of the group. The net interest margin in Israel did not change from 1999 to 2000, but in most of the peer group countries it fell due to globalization in general, and a more competitive banking environment in particular (competition from large international banks and international bank mergers). Regarding risk indices, the share of current loan-loss provision in total credit and the rate of capital adequacy in Israel are lower than those in the peer group. The ratio of operating expenses to total assets is lower in Israel than in the peer group (possibly due to the different definitions of "total assets"), whereas there are no significant differences between Israel and the others with regard to the rate of coverage of operating expenses by non-interest income and the efficiency ratio.

The following items explain most of the increase in the banking groups' ROE from 1999 to 2000:

- The expansion of financial activity, mainly in the unindexed local-currency segment, while the total net interest margin remained unchanged (at 2.0 percent). This served to increase net interest income of the five major banking groups by about NIS 1 billion (before provision for loan losses) (Table 3.2). This expansion in activity has been a feature of the banking system in the last few years, and it explains the constant rise in net interest income since 1994 (Figure 1.8).
- An increase in the contribution from non-interest income, which led to a rise of about NIS 900 million in the groups' profits from 1999 to 2000. Most of increase in non-interest income derived from fees and commissions related to capital-market activity; these rose by some 40 percent due to the surge in activity on the primary and secondary capital markets evident from turnover and capital raised, and increased investment in Israel and abroad by Israelis, particularly in the Nasdaq.
- A rise in subsidiaries' contribution to banks' profits from NIS 1.56 billion in 1999 to NIS 1.73 billion in 2000 (Table 4.2). This can be seen from a different analysis of the banking groups' profits which regards the groups as investors spreading their portfolio investments over classical financial activities and other activities—mortgage banks,

² The international comparison included the ten major banking groups in each country whose principal activity is commercial banking, assuming that these reflect to a great extent the performance of the entire banking system in that country. In Israel we included the five major banking groups, and in the US the 100 major groups, and the entire sample encompasses some 300 banks. Note that the data for Israel's banking system are adjusted for the effect of inflation, while in the peer group the reports are on a nominal basis. This difference is not significant, due to the low rates of inflation in the peer group countries and Israel's zero rate of inflation in 2000. The database is drawn from *Bankstat* and *The World Factbook*, 2000.

³ Israel's peer group included countries which are similar to it as regards the size of GDP and the banking system. (see note to Table 3.3). Countries which meet these criteria but differ significantly from Israel as regards their conditions and the nature of banking activity (e.g., highly non-concentrated banking systems or where most activities are off-shore) were not included in the peer group.

Table 3.2
Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 1999–2000
(NIS million, December 2000 prices)

	Leumi		Hapoalim		Discount		Mizrahi		First Intl.		Total		Contri- bution to profit	Rate of change (%)
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000		
Net interest income before loan-loss provision	4,490	4,720	4,730	5,348	2,758	2,626	1,152	1,276	1,040	1,186	14,170	15,156	986	7.0
Loan-loss provision	535	618	742	694	558	698	145	187	86	114	2,066	2,311	-245	11.9
Net interest income after loan-loss provision	3,955	4,102	3,988	4,654	2,200	1,928	1,007	1,089	954	1,072	12,104	12,845	741	6.1
Total non-interest income ^a of which Fee income	2,928	2,680	3,039	3,470	1,193	1,781	787	836	683	730	8,630	9,497	867	10.0
Total operating expenses of which Salaries and related expenses	2,361	2,117	2,421	2,736	955	1,499	678	735	585	647	7,000	7,734	734	10.5
Total operating expenses of which Salaries and related expenses	4,826	5,004	4,528	5,235	2,855	3,553	1,206	1,244	1,229	1,256	14,644	16,292	-1,648	11.3
Ordinary pre-tax income	3,054	3,106	2,655	3,228	1,974	2,295	764	790	674	735	9,121	10,153	-1,032	11.3
Tax provision	2,057	1,778	2,499	2,889	538	156	588	681	408	546	6,090	6,050	-40	-0.7
Ordinary after-tax income ^b	998	713	1,251	1,275	265	276	278	320	250	304	3,042	2,888	154	-5.1
Other income ^c	1,059	1,065	1,248	1,614	273	-120	310	361	158	242	3,048	3,162	114	3.7
Net income	231	540	167	15	51	15	-44	-32	42	72	447	610	163	36.5
Total profit ^d	1,290	1,605	1,415	1,629	324	-105	266	329	200	314	3,495	3,772	277	7.9
Equity ^e	1,307	1,557	1,481	1,658	345	-34	287	355	160	297	3,580	3,833	253	7.1
Ordinary ROE, net (%)	10,256	10,679	10,875	11,014	5,276	5,584	2,517	2,697	2,707	2,837	31,630	32,810	1,180	3.7
Total ROE (%)	10.3	10.0	11.5	14.7	5.2	-2.1	12.3	13.4	5.8	8.5	9.6	9.6		
Total ROA (%)	12.7	14.6	13.6	15.1	6.5	-0.6	11.4	13.2	5.9	10.5	11.3	11.7		
Loan-loss provision/total credit	0.61	0.78	0.66	0.80	0.31	-0.03	0.46	0.52	0.27	0.46	0.56	0.56		
Risk-based capital ratio	0.42	0.43	0.54	0.44	0.89	1.02	0.32	0.36	0.22	0.27	0.50	0.50		
	9.8	9.2	9.1	9.2	9.1	9.3	9.4	9.3	10.2	9.5	9.4	9.2		

^a Including profit/loss from sale of shares, less customers' share of profits.

^b After deduction of goodwill in United Mizrahi Bank.

^c Other 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, including divestment of excess and other holdings.

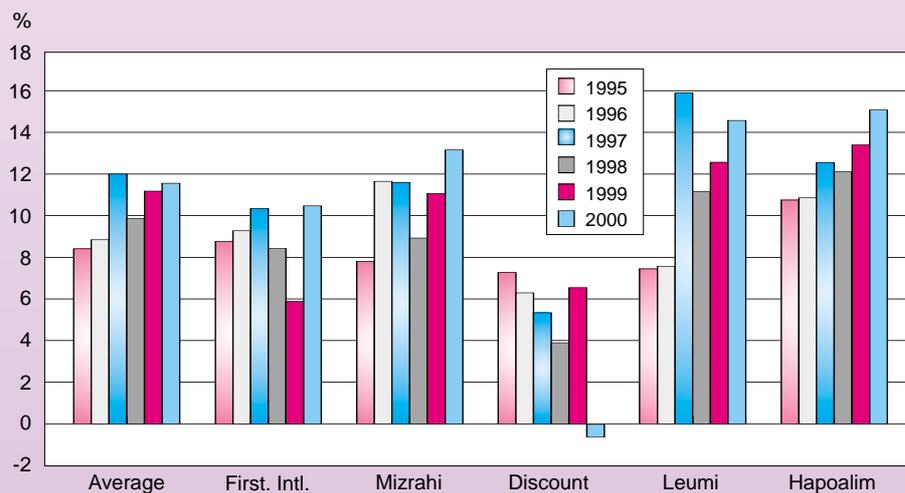
^d Total income is defined as net income plus the share of minority interests and translation adjustments imputed to equity.

^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.

overseas offices, and nonfinancial companies. The rise in subsidiaries' contribution was the result of an increase in the profit of subsidiaries which are investment or holding companies and of mortgage companies: the contribution of investment company and holding company subsidiaries to the net profit of the banking groups rose by NIS 90 million to NIS 370 million, and came mainly from the sale of the operational infrastructure of the First International Bank's "Alpha Card" and from the profit arising from the realization of that investment, and also from profits made by banking groups' subsidiaries which are active in the capital market and which engage in underwriting and investments. The positive contribution made by the mortgage banks came as a surprise in the light of the continued slowdown in the real estate industry and increased competition in mortgages. Mortgage banks' ROE was stable and high over the last few years (11.9 percent in 2000, and an average of 13.0 percent in the years 1993–2000). On the other hand, the contribution of nonfinancial companies and insurance companies to the net profit of the banking groups fell to NIS 180 million from NIS 260 million in 1999. The decline was essentially due to the losses incurred by ECI Telecom Ltd., a subsidiary of Koor, as a result of which the latter contributed only about NIS 57 million to the profit of the Hapoalim group in 2000, down from NIS 128 million in 1999. The contribution of the banking companies abroad to net profit in 2000, about NIS 227 million, was similar to that in 1999, and their ROE was only 4.4 percent (the lowest return on any of the banks' investments, Table 4.2). The activity and performance of all the subsidiaries—both

Figure 3.1
Return on Equity, by Banking Groups, 1995–2000



SOURCE: Published financial statements.

**Table 3.3
Indicators of the Performance of Various Banking Systems,^a 1999**

	Performance indices (%)				General indices			Operating indices (%)			Risk indices (%)	
	Financial margin on total assets ^b		ROA	ROE ^c	GDP (\$ billion)	Per capita GDP (\$ 000s)	Herfindal index (%)	Total income/operating expenses (AC)	Non-interest income/operating expenses	Loan-loss provision/total credit	Capital adequacy	
	margin on total assets ^b	ROE ^c										
Australia	2.3	14.9	0.9	381	20.1	16.4	1.5	3.2	65.5	0.31	10.55	
Belgium	1.3	11.7	0.4	251	24.5	17.0	1.2	2.7	76.6	0.16	12.22	
Canada	1.9	9.5	0.5	591	19.3	15.8	1.3	2.8	63.6	0.48	11.20	
Denmark	1.5	12.6	0.7	170	32.0	17.7	1.4	1.9	63.2	0.23	10.95	
Finland	1.5	11.9	1.0	123	23.8	22.2	1.6	1.6	64.5	n.a.	12.57	
France	1.0	8.7	0.3	1,400	23.5	8.9	1.3	2.0	81.2	0.44	9.85	
Germany	0.7	4.8	0.1	2,100	25.4	5.6	1.2	1.4	74.7	0.47	10.73	
Greece	2.2	n.a.	n.a.	124	11.8	29.1	1.7	3.5	n.a.	1.70	n.a.	
Ireland	2.0	15.6	0.8	71	19.2	20.4	1.7	1.9	63.7	n.a.	n.a.	
Italy	1.6	9.8	0.5	1,100	19.7	7.1	1.2	2.9	64.8	1.01	8.90	
Luxembourg	0.8	10.1	0.3	19	44.6	3.4	1.4	1.6	91.2	0.66	13.16	
Netherlands	1.5	12.7	0.6	384	24.3	20.3	1.2	3.9	84.1	0.24	10.96	
Norway	2.2	16.4	1.1	146	32.9	16.7	1.5	2.3	58.7	n.a.	13.19	
Portugal	2.4	9.6	0.5	106	10.6	10.1	1.1	4.7	70.1	1.48	n.a.	
South Africa	2.8	18.0	1.3	133	3.2	-	1.4	3.7	62.6	1.07	11.30	
Spain	2.5	12.1	0.8	552	14.0	13.4	1.3	3.2	52.1	0.61	12.09	
Sweden	1.2	9.3	0.4	222	25.0	23.7	1.5	1.6	74.4	n.a.	13.30	
Switzerland	0.8	13.8	0.9	273	38.4	19.3	1.3	2.6	101.7	0.57	16.80	
UK	2.0	18.8	0.9	1,300	22.6	7.9	1.5	2.4	69.4	0.53	12.77	
US	2.9	16.7	1.4	8,400	30.6	3.9	1.5	4.1	76.5	0.69	11.89	
Average	1.7	12.5	0.7	892	23.3	14.7	1.4	2.7	71.5	0.67	11.91	
Peer-group average ^d												
1998	2.2	12.0	0.6	152	18.1	16.9	1.4	2.7	59.5	0.81	11.46	
1999	2.0	13.7	0.8	141	19.7	19.0	1.5	2.8	65.6	0.93	12.05	
Israel 1998	2.23	9.9	0.49	96	16.6	21.7	1.5	2.5	57.2	0.61	9.20	
Israel 1999	2.23	11.5	0.55	98	15.9	21.3	1.6	2.3	58.7	0.51	9.43	
Israel 2000	2.20	11.8	0.55	107	16.8	21.8	1.5	2.4	58.3	0.50	9.24	

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

^b The financial margin on total assets was calculated as total net interest income less financing costs, divided by total assets.

^c ROE in all countries, including Israel, is calculated as net profit divided by equity at the beginning of the year. This calculation is different from that in the rest of this chapter, where ROE includes also the share of minority shareholders.

^d Israel's peer 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: *The World Factbook*, 1999, and data provided by *Bankstat*.

consolidated and unconsolidated—and their contribution to the profit of the banks heading the groups, are analyzed in Chapter 4.

- A rise in banks' extraordinary profit, which almost doubled to NIS 348 million. This item accounts for more than 9 percent of the groups' profit, and constitutes about one percentage point of the ROE. Extraordinary profit was most notable in the Leumi group, and contributed 3.1 percentage points to the bank's profit. This profit derived from the sale of shares in Koor Industries and in CAL.

Acting in the opposite direction, however, the following factors tended to lower the profit of the five groups:

- The rise of about NIS 250 million (12 percent) in loan-loss provision, after four years of decline. The rise was due mainly to an increase in the provision for the construction and real estate industry, which was still in the doldrums for the fourth year in succession. Loan-loss provision for the hotels and catering industry also increased as a result of the ill effects of the security events which started towards the end of the year. Credit risk measured by various qualitative and quantitative indices (extent of credit, its share in GDP, and the level of loan-loss provision) show that banks' exposure to credit risk rose. On the other hand, it is noteworthy that loan-loss provision is only 0.5 percent of credit, similar to its level in 1999, and lower than the average for other countries with similar characteristics (0.93 percent, see Table 3.3). This may mean that Israeli banks' level of risk is not yet reflected in the level of loan-loss provision. Further evidence of this is provided by the continued rise (of 12.7 percent) in the loan-loss provision in the first quarter of 2001 from its level in the first quarter of 2000.
- The rise in operating expenses to NIS 16.3 billion in 2000 from NIS 14.6 billion in 1999. The bulk of the increase (about NIS 1 billion) was due to a rise in salaries and related expenses, and in particular expenses connected with early retirement, which totaled NIS 378 million in the commercial banks. These expenses reflect the implementation of early-retirement plans, especially in the three largest banks, intended to streamline the system and to cut their future salaries expenses by replacing highly paid veteran employees with newly recruited staff. Although these plans have been in operation for several years, they have yet to have a visible impact on banks' operating expenses. The number of employee posts did not change in 2000, so that the average wage per employee post in the banking system rose by 7.4 percent, slightly higher than the 6.5 percent increase in the whole economy, although the latter was greatly affected by pay increases in the high-tech industries due to high demand for workers. Interbank differences in the cost per employee post widened in 2000, especially in the small banks.

In 2000 the banking system encountered difficulties with regard to banks' financial results and performance compared with previous years, for two reasons: first, structural changes in the banking system led to the consolidation of certain reports which were unconsolidated in 1999, while reports of other companies were separated as a result of

companies being sold.⁴ Second, changes in the Guidelines for Preparing Reports to the Public require the commercial banks to report to the Banking Supervision Department, for the first time, on the effect of financial derivatives on each of the indexation bases which constitute part of the assets and liabilities management system and which are intended to close balance-sheet positions. Prior to 2000, profits from these derivatives were recorded under a separate item.

2. CONTRIBUTION OF THE MAIN COMPONENTS TO NET INCOME

a. Net interest income

The net interest income of all the commercial banks was 5 percent higher in 2000 than in 1999, and totaled NIS 13 billion (Table 3.4). The rise came from an increase of 9 percent in financial activity, continuing the upward trend evident in previous years, while the overall net interest margin dipped slightly, from 2.1 percent in 1999 to 2.0 percent in 2000.⁵

The year 2000 was the first in which the banks have had to include in their reports on net interest income also the effects of the financial derivatives defined as ALM (Asset-Liability Management, i.e., used to manage assets and liabilities). Hitherto, only the income from hedging activities in the various indexation segments were recorded; from 2000, in addition to hedging activities, banks must allocate their ALM activities according to their economic designation.⁶ As this is the first report compiled according to the new definition and there are no comparative data for 1999, the comparison of net interest margins in 2000 with those in 1999 must be made with caution. Activity in financial derivatives was particularly evident in the foreign-currency and unindexed local-currency segments. This activity closed the surplus sources in the unindexed segment, and also the surplus uses in the foreign-currency segment.⁷

⁴ For example, in the Hapoalim group, data relating to Otsar Hahayal Bank were included in the consolidated report for the first time, but in comparisons with previous years the group did not include its share in the profits of that bank. Consolidating the reports increases the pre-tax profit of the Hapoalim group by NIS 100 million. In Israel Discount Bank, data relating to two subsidiaries—Ilanot Discount Ltd., and Israel Credit Cards Ltd.—were included for the first time. Changes also took place in the credit card area, and Leumi's share in Visa CAL was sold to Israel Discount Bank, and Alpha Card of the First International Bank ceased operating. All the above make comparisons of performance in 2000 with that of earlier years problematic.

⁵ For the purposes of international comparison we adopt the calculation reported in the Bankstat data base, i.e., the margin is calculated for the five major banking groups as the share of net interest income in total assets, unlike the method used herein.

⁶ When the derivative is intended to reduce excess liabilities, the off-balance-sheet amount of the derivative's asset receivable will be deducted from the segment's balance-sheet liabilities. When the derivative is intended to reduce the assets surplus, the off-balance-sheet amount of its liability to pay will be deducted from the segment's balance-sheet assets. The other side of the off-balance-sheet transaction will be added to the total assets or liabilities of the segment and the income from or expenditure on the derivative will be recorded in that segment.

⁷ In the banking groups' reports, ALM transactions were also attributed to the different segments in 1999 too, but only in general terms. Net interest margins in the banking groups, including ALM transactions for 1999 and 2000 were similar to those calculated for the all the banking corporations (Table 3.4A).

(i) *The unindexed local-currency segment*

Net interest income from unindexed local-currency activity rose significantly, by about NIS 530 million, from NIS 5,358 million in 1999 to NIS 5,890 million in 2000, due to the marked expansion of unindexed activity combined with a decline of about 0.4 percentage points in the net interest margin. Unindexed banking activity has been expanding for several years. The expansion in 2000 is explained by the high level of real interest rates in the market, which led to the public's preference for short-term over long-term credit, which is usually indexed, and at the same time encourage investment in unindexed local-currency assets the return on which is higher than that on alternative investment channels. Moreover, the lowering of the inflation environment and particularly of uncertainty regarding inflation tended to direct activity away from the indexed into the unindexed segment. The unindexed segment rose to a third of total uses, and due to its net interest margin, which despite its reduction remained higher than that in other segments, its contribution to the banks' net interest income reached 45 percent (Table 3.4).

The reduction of the average net interest margin on uses in unindexed local-currency activity from 3.2 percent in 1999 to 2.8 percent in 2000 (Table 3.4) was the outcome of the reduction in the interest-rate spread: the average rate of interest on uses went down by about 1.5 percentage points, while that on sources dipped by only 0.8 percentage points (for further details, see Chapter 2). The contraction of the interest-rate spread continues the long-term trend which started in 1985; it is consistent with liberalization of the money and capital markets which removed most of the barriers, and increased the substitutability

Figure 3.2
Contribution of the Different Indexation Segments to Net Income, 1999–2000

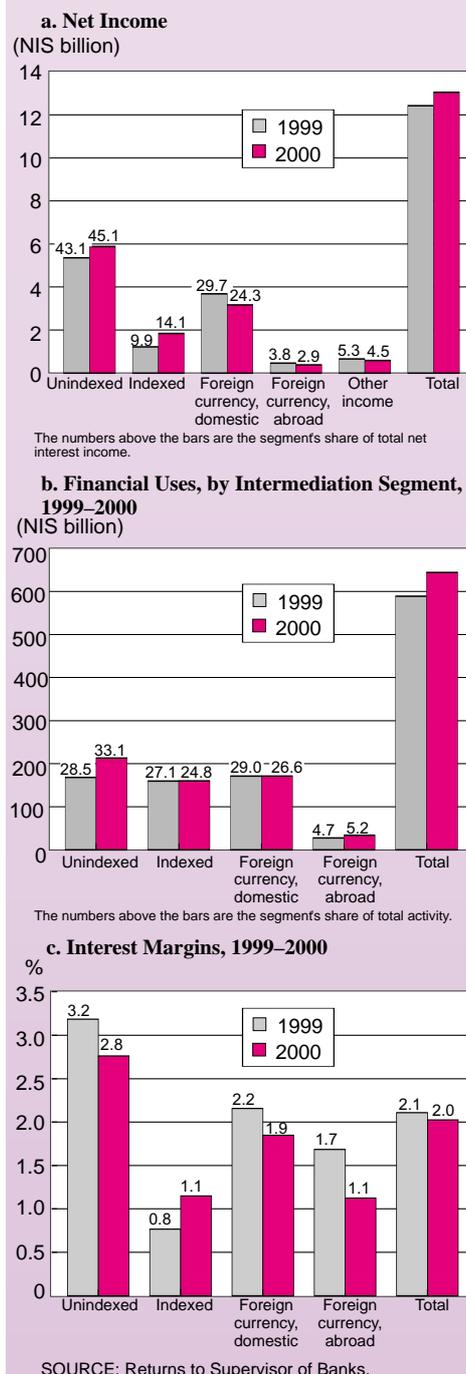


Table 3.4
Estimated Net Interest Margins and Income^a of all Commercial Banks, by Uses, 1999 and 2000
(NIS million, December 2000 prices)

	Average balance		Share of total uses (%)		Net interest margin (%)		Net interest income		Contribution of net interest income to profit (%)	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
Unindexed	168,153	213,253	28.5	33.1	3.2	2.8	5,358	5,890	43.1	45.1
CPI-indexed	159,535	160,107	27.1	24.8	0.8	1.1	1,225	1,839	9.9	14.1
Nondirected	136,758	143,120	23.2	22.2	0.9	1.3	1,199	1,813	9.6	13.9
Directed ^b	22,777	16,987	3.9	2.6	0.1	0.2	26	26	0.2	0.2
Foreign-currency activities										
in Israel	171,128	171,455	29.0	26.6	2.2	1.9	3,690	3,173	29.7	24.3
of which Indexed	14,861	12,527	2.5	1.9	3.0	2.4	445	298	3.6	2.3
Denominated	156,267	158,928	26.5	24.7	2.1	1.8	3,245	2,875	26.1	22.0
Foreign-currency activities abroad	27,718	33,610	4.7	5.2	1.7	1.1	467	378	3.8	2.9
Total balance-sheet uses	526,534	578,425	89.4	89.8	2.1	1.9	10,740	11,280	86.4	86.4
Derivatives ^c							363	516	2.9	4.0
Commissions on financing transactions ^d	62,590	65,972	10.6	10.2	1.1	1.0	665	675	5.4	5.2
Total uses	589,124	644,397	100.0	100.0	2.0	1.9	11,768	12,471	94.7	95.5
Other net interest income ^e							657	583	5.3	4.5
Total net interest income	589,124	644,397	100.0	100.0	2.1	2.0	12,425	13,054	100.0	100.0

^a The rate of income on credit to the public is calculated on credit *minus* total loan-loss provision.

^b Credit to the government, the public, and others, from earmarked deposits; does not include credit from earmarked deposits at the responsibility of the depositor, repayment of which is contingent on collection.

^c Excluding hedging and ALM transactions, as expenditure on this is included in the relevant segments above (see Table 3.5).

^d See Table 3.5.

^e Including profit/loss on bonds, reduction of loan-loss provision, collection of debts, and receipt of early-repayment fees.

SOURCE: Returns to Supervisor of Banks.

Table 3.4A
Estimated Net Interest Margins and Income^a of the Five Major Banking Groups, by Uses, 1999 and 2000
(NIS million, December 2000 prices)

	Average balance		Share of total uses (%)		Net interest margin ^b (%)		Net interest income		Contribution of net interest income to profit (%)	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
Unindexed	164,597	197,012	28.5	31.1	3.5	3.0	5,755	5,944	40.6	39.2
CPI-indexed	202,192	205,887	35.0	32.5	1.3	1.4	2,618	2,899	18.5	19.1
Foreign-currency activities in Israel	139,956	151,676	24.2	24.0	2.4	2.1	3,314	3,140	23.4	20.7
Foreign-currency activities abroad	71,674	78,388	12.4	12.4	1.5	1.5	1,088	1,183	7.7	7.8
Total uses	578,419	632,963	100.0	100.0	2.2	2.1	12,775	13,166	90.2	86.9
Derivatives ^c							-77	605	-0.5	4.0
Commissions on financing transactions ^d	578,419	632,963	100.0	100.0	2.5	2.4	14,182	15,210	10.5	10.0
Other net interest income ^e							-12	-54	-0.1	-0.4
Total net interest income	578,419	632,963	100.0	100.0	2.4	2.4	14,170	15,156	100.0	100.0

^a The rate of income on credit to the public is calculated on credit *minus* total loan-loss provision.

^b At constant prices. In calculating the net interest margins in various segments, hedging and ALM derivatives transactions are taken into account.

^c Excluding hedging and ALM transactions, as activities and income of these are included in the relevant segments above.

^d Including income from acceptances, documentary credits, and various guarantees.

^e Including profit/loss on bonds, reduction of loan-loss provision, collection of debts, and receipt of early-repayment fees.

SOURCE: Published Financial Statements.

between the various activity segments and reduced the differences between their net interest margins.

There were other reasons too for the fall in the net interest margin: first, a change in the composition of credit to the public, with a significant (40 percent) rise in the balance of term credit, in particular of on-call credit; this acted to lower the real rate of interest on uses, as the return on term credit is lower than that on other credit in the segment. Secondly, since 1997 the Bank of Israel has held an auction for the rate of interest on banks' unindexed local-currency deposits for periods of one week to three months, with the purpose of absorbing excess liquidity and sterilizing the effect on the monetary base of foreign-currency conversions. In 2000 these deposits rose, and their average balance reached NIS 55 billion, about a quarter of the banks' total uses in the unindexed local-currency segment. They provide a lower return than the average on other uses (due to their low risk), making the decline in the real interest on uses even steeper.⁸ In the last few years the segment has had surplus sources, which financed other segments of activity. A surplus would have been recorded in 2000, too, were it not for activity in derivatives, but attributing financial derivatives to the different indexation-base segments shows a closing of this position, and even a small surplus of uses (of about NIS 1 billion).

(ii) The CPI-indexed segment

The level of activity in the CPI-indexed segment remained steady, but a rise from 0.8 percent to 1.1 percent in the net interest margin resulted in an increase of 50 percent in net interest income to NIS 1.8 billion. As in the last few years, unrestricted activity rose at the expense of earmarked activity, which contracted by 25 percent (Table 3.4).

Rates of interest in this segment are derived from the public's demand for indexed credit and the return on bonds. As in previous years, withdrawals from provident funds continued, and the return on bonds rose (see Chapter 2 for further details). In the wake of this rise, the return on indexed credit rose too, having a stronger effect on savings schemes' cost of raising money. The reason was that persistent shortage of indexed sources increased interbank competition for them, making them offer investors an attractive return. Despite the rise in the return on indexed savings schemes in 2000, they remained cheaper for the banks than the other sources, particularly unindexed local-currency sources. Changes in rates of interest led to a slight contraction of the marginal interest-rate spread in the indexed segment, but the average spread and the net interest margin in the segment rose, for the following reasons: first, the effect of marginal activity in the indexed segment on the average interest-rate spread is not significant, due to the relatively large share of assets and liabilities whose interest rate was determined in the past for the long term. Secondly, the surplus uses in the segment were financed by financial capital, whose real cost, for purposes of calculating the net interest margin, is zero.⁹ In the last few years

⁸ A rough estimate may be made of the banks' profit on their deposits in the Bank of Israel. The real return on these deposits came to 8.3 percent, while the average cost of raising sources in that segment was 7.9 percent. Thus, assuming an interest-rate spread of 0.4 percent, banks' profit from this source amounted to some NIS 220 million.

⁹ This is a strong assumption, but is necessary for adjusting net interest income from the various segments to the banks' total reported net interest income. If we had adopted a more realistic assumption, that the economic price of active capital is similar to the return on indexed long-term bonds, there would have been no rise in the margin in this sector.

there has been a shortage of indexed sources, which was aggravated in 2000; this can be seen from the surplus of uses over liabilities in the segment, amounting to NIS 20 billion, or 12 percent of all assets (compared with NIS 14 billion and 8.7 percent respectively in 1999). The banks' ALM activities in financial derivatives to close their positions in this segment was very marginal, apparently because the indexed segment was closed by financial capital, so that the position in it does not expose the bank to the risk of inflation. On the other hand, in the other indexation segments there was lively activity in financial derivatives, which reduced the exposure to indexation base risk significantly. Thirdly, the uses mix changed, with the share of credit to the public, the most profitable of the uses, rising, and the less profitable ones, such as credit to the government, falling (by 24 percent), the fall reflecting the continued reduction in government intervention in the field of savings schemes, while government bonds also fell, with the withdrawals of the proceeds of bond issues deposited in the Treasury. Fourthly, the gap between the known and the "in lieu" price indices increased net interest income in 2000 by NIS 105 million, most of which was in the indexed segment. This effect on banks' profits is random, depending on changes in inflation, and it can be expected to disappear in the long run, with the reduction of fluctuations in inflation during the year.¹⁰

(iii) The foreign-currency and foreign-currency-indexed segment (domestic activity)

Net interest income in this segment declined by about 14 percent to NIS 3,173 million, due to the reduction in the net interest margin from 2.2 percent in 1999 to 1.9 percent in 2000 combined with a stable level of activity in NIS terms (Table 3.4). The decline in the net interest margin can be traced back to the contraction of the dollar interest spread in real NIS terms. In the last few years there has been a considerable surplus of uses in the foreign-currency segment, which was financed by unindexed sources and/or capital sources; in 2000 the entire surplus of foreign-currency assets was closed by the opposite position in financial derivatives, and there was actually a surplus of foreign-currency liabilities. The comparison with last year must be treated with caution, however, because in 2000, for the first time balances of financial derivatives and the profits or losses deriving from them were allocated to the different indexation segments and were not recorded in the item "profit from financial derivatives." Nevertheless, the reduction in the net interest margin also emerged from reports of the five banking groups (Table 3.4A) which showed the effect of the contribution of ALM on the different indexation segments. In some banks activity in ALM is also intended to buttress them against the risks incurred in investing in subsidiaries abroad, the value of such investment depending on changes in exchange rates, which also affect the banks' net profit. To neutralize this effect, banks created surplus liabilities in various currencies against their investments overseas, thereby hedging against exchange-rate risks.

In the mix of activity in the foreign-currency segment, a change was evident on the sources side—the share of deposits of the public, which are more expensive than other

¹⁰ For a detailed discussion, see Box 3.1 (p. 76) in the 1998 issue of this Survey.

sources, rose at the expense of deposits of the banks and the government; this acted to raise interest on sources and to reduce the margin. There were no significant changes on the uses side: the main uses—credit to the public and deposits in banks—rose by 10 percent each. The continued increase in demand for foreign-currency credit derives mainly from the widening yield gaps between the various segments in Israel, and between Israel and abroad, against the background of further appreciation of the NIS and the tight monetary policy. The yield gaps, evident since the second half of 1994, led to increased demand by Israelis for foreign-currency credit in preference to credit in NIS, and to the conversion of foreign-currency deposits into unindexed NIS deposits.

The net interest margin and net interest income in this segment have shown high volatility in the last few years, because they are affected by many factors, some of them extraneous to the banks. One such is the change in the exchange rate of the NIS against other currencies: in the course of 2000 the NIS appreciated against the dollar by 2.7 percent, based on monthly averages. This had a marked effect on the segment in the light of the volatility of the exchange rate during the year: the gap between the highest rate (NIS 4.2 to \$1, in May) and the lowest (NIS 3.96, in March) reached 6 percent. The volatility of other currencies also affected profits in this segment.

(iv) The foreign-currency segment (activity abroad)

The profit from overseas branches' activity in foreign currency totaled NIS 380 million in 2000, 20 percent below the 1999 figure. The fall was the outcome of a decline in the net interest margin from 1.7 percent to 1.1 percent, partially offset by an increase in the activity of overseas branches. The decline in the margin was mainly due to an increase in share of deposits of the public at the expense of deposits from banks, which are cheaper, and to exchange-rate differentials between certain currencies, particularly the appreciation of the NIS against other currencies.

(v) Net interest income from other uses

The rise in net interest income (from balance-sheet and off-balance-sheet activities, hedging activities and ALM) by indexation segments, from NIS 10.7 billion to NIS 11.3 billion, was partially offset by the reduction in net interest income from other activities. There are three main sources for this income:

1. Financial derivatives which are not hedging transactions or ALM. Profit from financial derivatives in 2000 amounted to NIS 3,400 million. About NIS 2,910 million of this was allocated to the various indexation segments,¹¹ and about NIS 516 million was income from transactions included in this category which were neither hedging nor ALM. These transactions were classified as "other," as they could not be classified individually against basis assets in the different indexation segments.

¹¹ Divided as follows: the unindexed local-currency segment, NIS 1,891 million; the foreign-currency segment, NIS 1,006 million; and in the indexed segment, a loss of NIS 13 million.

Table 3.5
Income from Fees on Financing Transactions,
All Commercial Banks, 1999–2000

(NIS million, December 2000 prices)

	1999		2000	
	Average annual balance	Income	Average annual balance	Income
Acceptances	990	39	1,076	41
Documentary credits	3,462	100	4,170	101
Credit guarantees	15,767	70	18,544	78
Home-buyers' guarantees	15,448	103	14,859	90
Guarantees and other liabilities	26,923	353	27,323	365
Total fees on financing transactions	62,590	665	65,971	675

SOURCE: Returns to Supervisor of Banks.

2. Profit from fees and commissions on financing transactions: this remained steady in 2000 at NIS 675 million (Table 3.5). It includes income from guarantees for granting credit, from guarantees for housing purchases went down slightly, due to the persistent recession in real estate, but other guarantees increased a little, apparently due to the expansion of Israel's foreign trade in the year under review.
3. Other net income from other financing activities, including profits (or losses) from sales of bonds held to redemption or available for sale, from adjustments of tradable bonds to a fair value, from collection of problem loans for which loan-loss provision has been made in the past, from the reduction in the provision for interest on loan-loss provision, and from commissions on early repayment of credit. Income on the above went down by NIS 74 million to NIS 583 million (Table 3.4).

b. Loan-loss provision

For the first time since 1995, total loan-loss provision recorded in the profit and loss statements of the five major banking groups rose. The provision in the year 2000 rose by 12 percent, or NIS 245 million (Table 3.2; it continued rising at the same rate, in annual terms, in the first quarter of 2001). All the groups showed the same trend, except for Hapoalim, whose loan-loss provision went down by about NIS 50 million; the rise in three smaller groups was most marked—First International (32 percent), Mizrahi (29 percent, and Discount (25 percent). The current loan-loss provision in 2000 consisted entirely of the specific provision, while the share constituted by the general and additional provisions in the total provision was minimal (less than 1 percent).

Loan-loss provision did not develop uniformly throughout the year: in the first two quarters it declined, rising in the third and fourth at a rate higher than those in the equivalent periods in previous years. The upward trend is most evident in the larger groups (except for Hapoalim), as a result of a certain decline in the quality of the credit portfolio attributable to the uncertainty regarding the political and security situation at the end of

the year. The situation adversely affected the rate of growth, particularly in the tourist industry and in real estate. In addition share prices on the Tel Aviv Stock Exchange (TASE) fell, mainly at the end of the year, reflecting the falls on the New York Exchange and the Nasdaq and the decline in activity in the shares of high-tech companies. The most marked rise in loan-loss provision was in that for the construction and real estate industry, where the slowdown in activity continued for the fourth successive year. The share of loan-loss provision in total credit to this industry (including the credit value of off-balance-sheet activity) reached 0.67 percent in the banking system as a whole, and as high as 2 percent in the Discount group.

Loan-loss provision grew in the hotel and catering industry too, as mentioned above. The industry benefited from rapid growth until the third quarter of the year, but the security events which broke out at the end of that quarter hit it hard, and resulted in a surge in loan-loss provision.

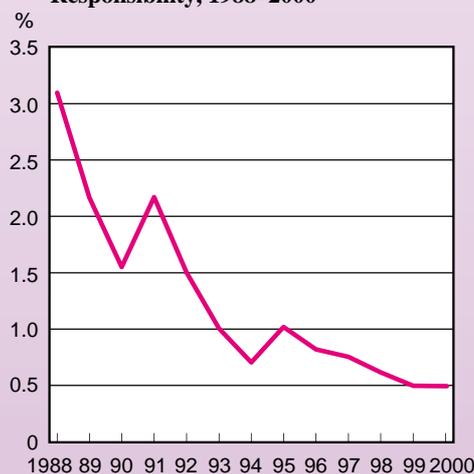
On the other hand, the provision for commerce and households fell with the recovery in activity in 2000, reflected in rates of growth of 5.9 percent in GDP and 7.7 percent in business-sector product.

The size of loan-loss provisions in the next few years will depend on macroeconomic developments, specifically Israel's economic situation, the peace process, and the degree of the banks' success in correctly assessing risks and developments in the real estate market.

In any event, the rise in loan-loss provision in the major banking groups in the last quarter of 2000 and its continued rise in the first quarter of 2001 indicate the path this provision is likely to take in 2001. This applies even more strongly in the light of heavy fall in the rate of growth in high-tech industries—especially in start-ups which had provided the impetus for the favorable rate of growth in 2000—the slowdown suggested by all the economic indicators in 2001, the decline in the capital market, uncertainty regarding the security situation and its implications for many parts of the economy, all these have an adverse effect on the quality of credit, and lead to increased loan-loss provision.

The share of loan-loss provision in total credit differs from bank to bank, and within each bank it varies over time. Thus, for instance, in the last few years loan-loss provision in the Discount group and its share in the group's total credit have increased constantly,

Figure 3.3
Ratio of Loan-Loss Provision to Credit to the Public at the Banks' Responsibility, 1988–2000



SOURCE: Published financial statements.

while in Hapoalim and Leumi they have fallen. The loan-loss provision as a share of credit in 2000 in the five major banking groups were: Discount, 1.0 percent; Hapoalim and Leumi, 0.45 percent; Mizrahi, 0.34 percent; and the First International, 0.26 percent. The average for the five groups was 0.5 percent—lower than the worldwide norm (Table 3.3). In the last few years the average rate of increase of credit reached 12 percent; as loan-loss provision did not increase at the same rate, its share of credit fell. It appears that the provision in 2000 was still low, especially in the light of the deterioration in the economic situation reflected by the data for 2001.

c. Non-interest income

In 2000 the commercial banks' non-interest and other income rose significantly, to NIS 7.3 billion, from NIS 6.7 billion in 1999, a rise of 10 percent (Table 3.6). This was due to a sharp 11 percent rise (NIS 580 million) in income from fees and commissions and a 6 percent rise (about NIS 88 million) in other income. The increase in non-interest income derived from a rise in all the services on which banks earn operating fees and commissions (Table 3.6), and most was due to expanded activity. Most of the rise in non-interest income was in income related to capital-market activity, credit and contracts, credit cards, and services connected with the payments system.

Israeli investors broadened their activity in 2000, both in the domestic capital market and in stock markets abroad, particularly in the Nasdaq.¹² Income from customers' activities in securities (buying/selling fees, custody fees, and other conversion fees) constitutes about 13 percent of total non-interest income. This income from security-related activities surged by 40 percent in 2000 to NIS 931 million, after rising by a more modest 6.1 percent in 1999. The reason for this lies in the accelerated activity in the capital markets, which was reflected mainly in increased turnover and in capital raised.

The General Share-Price Index at the end of 2000 was at the same level as at the end of 1999 (Table 3.7), but it was very volatile during the year: in the first quarter the capital market was in a boom, the index rose by 20 percent, and average daily turnover was 50 percent higher than in the last quarter of 1999. The lively interest in the capital market in the first quarter of 2000 had a marked effect on bank's non-interest income from customers' activity in securities, and this income grew twice as fast (in annual terms) in the quarter as it did in 1999. The share-price index continued to rise in the second and third quarters, but slowly, as did non-interest income. In the last quarter, with the outbreak of the security-related incidents, the continued sharp falls on the Nasdaq, and the expectation that all these would harm the rate of growth, share prices fell steeply on the TASE, and turnover and capital raised also declined. This resulted in a considerable reduction in banks' income from the capital market compared with its average level in the first three quarters of the

¹² The surge in the activity of Israeli investors in foreign securities is most noteworthy: investment abroad in securities by the private nonbanking sector surged from NIS 550 million in 1999 to NIS 6.7 billion in 2000. Concurrently, foreign investment in Israel's capital market also increased, from NIS 10.8 billion in 1999 to NIS 15.5 billion in 2000.

Table 3.6
Non-Interest Income and Operating Expenses, All Commercial Banks, 1998–2000

	Amount (NIS million) ^a			Distribution (%)			Year-on-year change (%)	
	1998	1999	2000	1998	1999	2000	1999	2000
1. Non-interest income								
Fees and commissions from:								
Ledger fees	995	1,089	1,133	16.0	16.4	15.5	9.4	4.1
Payment services	1,816	1,822	1,922	29.2	27.4	26.2	0.3	5.5
Credit cards	310	266	298	5.0	4.0	4.1	-14.2	12.3
Credit services and contracts	305	433	520	4.9	6.5	7.1	42.0	20.0
Computerized services	241	229	259	3.9	3.4	3.5	-4.8	13.0
Foreign trade and special services ^b	294	319	336	4.7	4.8	4.6	8.4	5.1
Securities services ^c	429	449	626	6.9	6.7	8.6	4.6	39.6
Custody fees	199	217	305	3.2	3.3	4.2	9.1	40.5
Underwriting and distribution of securities	85	83	89	1.4	1.3	1.2	-1.7	6.7
Other commissions ^d	193	193	192	3.1	2.9	2.6	0.2	-0.5
Total fees and commissions income	4,867	5,100	5,680	78.2	76.7	77.6	4.8	11.4
Other income from:								
Provident and mutual fund fees	900	936	1,129	14.5	14.1	15.4	4.0	20.6
Related companies management fees	177	145	204	2.8	2.2	2.8	-18.4	41.1
Profits from severance pay funds	11	179	0	0.2	2.7	0.0	-	-
Other	198	215	230	3.2	3.2	3.1	9.0	7.0
Total	1,285	1,475	1,563	20.6	22.2	21.3	14.8	5.9
Income from sale of shares	75	75	79	1.2	1.1	1.1	-0.9	5.7
Total non-interest income	6,227	6,650	7,322	100.0	100.0	100.0	6.8	10.1

Table 3.6 (continued)

	Amount (NIS million) ^a		Distribution (%)		Year-on-year change (%)	
	1998	1999	2000	1998	1999	2000
2. Operating expenses						
Salaries and related expenses ^e	8,128	8,393	9,244	65.4	65.2	66.5
Depreciation of buildings and equipment ^f	734	747	777	5.9	5.8	5.6
Maintenance of buildings and equipment	1,396	1,481	1,458	11.2	11.5	10.5
Other expenses	2,163	2,246	2,419	17.4	17.5	17.4
Marketing and advertising	277	271	302	2.2	2.1	2.2
Computer expenses	440	445	447	3.5	3.5	3.2
Communications	360	371	370	2.9	2.9	2.7
Insurance and office services	227	241	231	1.8	1.9	1.7
Professional services	248	235	287	2.0	1.8	2.1
Other	611	682	782	4.9	5.3	5.6
Total operating expenses	12,422	12,868	13,898	100.0	100.0	100.0
Operating coverage ratio^g	50.1	51.7	52.7			3.6
						8.0

^a NIS million; December 2000 prices.

^b Including cross rates between selling and buying.

^c Mainly margin and collection fees received from the Treasury on credit, and income from managing others' credit portfolios.

^d Including margin and collection fees on credit from the Treasury, and other margins and fees.

^e Including payroll taxes, severance pay, benefits, pensions, and national insurance.

^f From 2000, "deductions" are included under "other".

^g Ratio of total non-interest income to total operating expenses (percent).

SOURCE: Returns to Supervisor of Banks and published financial statements.

year. Capital raised in the domestic primary market totaled NIS 6.3 billion, up from NIS 3.9 billion in 1999, increasing income from underwriting and distributing securities (Table 3.7). The most outstanding event in this context was the issue by Bank Hapoalim, the largest issue in the history of the TASE: the state sold the balance of its share holding in the bank (about 17 percent) to the public and the employees of the bank for NIS 2.4 billion.

As in previous years, the paths followed by different banks' income from activity in securities—from customers' transactions in them, custody fees and distribution—showed marked differences, depending on the degree of the banks' involvement in the capital market: this income rose by between 27 percent in Bank Mizrahi to 49 percent in the First International Bank.

Banks' income from fees and commissions was also materially affected in 2000 by an increase of some NIS 100 million (5.5 percent, Table 3.6) in income from services related to the payments system. Income from this source rose due to the increase in foreign-currency activity, with marked expansion of foreign trade, and stability (-1 percent) in income from local-currency activity. Income from handling credit and drawing up contracts also rose in 2000, against the background of the continued rise in credit granted due among other things to economic growth.

Income from magnetic cards (credit cards, cards for information retrieval or cash withdrawals) rose by 12 percent. The increase was due largely to the 46 percent rise in cards for information retrieval or cash withdrawals, and a 6 percent rise in credit cards, the income from which had fallen in 1998 and 1999. The rise in income from credit cards was mainly due to the continued increase in their usage, estimated at 26 percent in 2000. (For a detailed discussion of credit cards see Box 3.1.) At the same time competition which has been a feature of this market for the last two years was reflected by reductions in charges related to credit cards, both for businesses and for customers and mainly by exemptions from payment for card usage and from premiums for liability cover. Several banks changed this policy in 2000: they stopped granting reductions across the board to all customers and started making them conditional on certain criteria, such as a minimum number of transactions during the month, or minimum total value of transactions in the year, or belonging to a particular group of customers, such as soldiers, youth, etc.

Other income (not from interest or fees and commissions) rose by 6 percent in 2000 to NIS 1.6 billion. The major component of this item is income from ledger fees from provident and mutual funds; this item grew by 21 percent. Most of the increase was due to the rise in the market value of assets portfolio of the mutual funds (Table 3.7).

In 1999 banks' other income included earnings of NIS 180 million from their severance pay funds, but no such profit was made in 2000, due to the negative returns of most provident funds.

The index of fees and commissions of the five major banks edged up in 2000, by 1.4 percent, continuing the trend evident since 1997 of small positive increases in real terms. Since 1997, the fees and commissions index has risen by a cumulative 7.8 percent in real

Table 3.7
Indicators of the Development of the Capital Market, 1990–2000

(NIS billion, December 2000 prices)

	Total capital raised via shares and convertible securities ^a	Total turnover ^b	Market value ^c	Real yield ^c (%)		Market value of mutual funds managed by banks
				General share-price index	Bonds	
1990	2.4	67.2	43.6	-1.5	-5.8	18.0
1991	3.7	96.5	64.0	37.1	-0.4	23.9
1992	8.7	135.1	146.8	75.2	7.3	47.2
1993	14.9	211.9	244.3	26.7	-2.0	52.1
1994	8.3	173.4	139.0	-47.0	-4.6	23.2
1995	3.0	121.6	149.2	5.4	1.1	17.7
1996	5.7	118.8	137.3	-10.5	2.3	13.4
1997	13.1	131.5	180.4	26.4	5.1	19.7
1998	11.9	175.0	172.3	-5.1	0.5	20.4
1999	17.0 ^d	193.4	271.5	62.3	5.0	29.9
2000	23.6 ^d	240.0	269.9	0.3	4.5	39.0

^a Including capital raised from direct offerings of corporate bonds, shares, and convertible securities, and, since 1996, warrants exercised by companies going public in Israel and abroad and registered on the TASE.

^b Including stock-exchange transactions, offsets, and off-the-floor transactions.

^c End-period data.

^d Of which NIS 13.1 billion and NIS 17.3 billion was raised abroad in 1999 and 2000 respectively.

SOURCE: Tel Aviv Stock Exchange and Bank of Israel.

terms, and in the first half of 2001 it rose by another 1.4 percentage points (Figure 3.4).¹³ The index represents the average of thirteen fees and commissions charged mainly to individuals and small businesses by the five major banks. A review of the index over a longer period, from June 1995 to June 2000, shows that in that time it rose by only one percent in real terms, and at the beginning of the period, in 1995–96, there was considerable competition between banks trying to attract customers' money, as a result of which part of the tariff for banking services was frozen and some prices even fell in real terms.

¹³ The method of calculation was changed in 2001, and figures for previous years have been adjusted accordingly to provide the series with continuity.



It is interesting to note that the gap between most expensive bank in 2000 (Hapoalim) and the cheapest (Mizrahi) over the thirteen charges from which the index is calculated expanded to 4.1 percent from 1.4 percent in 1999 (when Leumi and Hapoalim headed the list and the First International was the cheapest).

Box 3.1
The credit-card market

The credit-card market in Israel has been undergoing structural changes since the middle of 1998, when the First International's Alpha Card was launched, ending the duopoly of Isracard (wholly owned by Bank Hapoalim) and Visa CAL (jointly owned by Bank Leumi and Israel Discount Bank). The structural changes, which continued in 2000, led to increased competition in the issue and clearing of credit cards, to reduced fees, and to strategic alliances in the field of customers' clubs and between retail chain stores.

At the beginning of 2000, as a result of Amendment No. 11 to the Banking (Licensing) Law relating to control of an auxiliary corporation, and the requirement imposed by the Director-General of the Anti-Trust Authority, Discount Bank bought Leumi's share in CAL and in Diners Club Israel, according to a company value of NIS 510 million. This deal left Leumi without a credit-card clearing company, and it therefore set up Leumi Card, which in December 2000 began to issue and clear Visa cards for its customers. Leumi Card was able to operate due to the purchase of the operational infrastructure of Alpha Card, controlled by First International Bank. In the years when Alpha Card was in operation it had caused large losses to the First International Bank, totaling some NIS 105 million net, most of which was due to the high cost of penetrating the market. The company did not succeed in reaching the critical number of cards necessary to ensure its survival in the market, and in May 2000 it therefore ceased operating. The First International then purchased 20 percent of the equity of CAL and 9 percent of Diners.

Alpha card and Leumi Card's entry into the market removed the identity between the clearing company and the issuing company, and since then several issuers and several clearing companies operate in the market for the same credit cards. This is the situation currently regarding Visa, and is likely to apply soon to the other cards, and leads to competitors needing bilateral agreements to divide businesses' fees between the issuer and the clearer. The fees, known as interchange fees, are paid by the clearer to the issuer for the latter's expenses (for credit risk, operating expenses, issue expenses, and other indirect expenses). In March 2001, the Director-General of the Anti-Trust Authority instructed that this fee be reduced from about 1.38 percent to 1.25 percent on average. If the businesses' fees are reduced by a similar amount,

and are not passed on to customers, the reduction is likely to lower the issuing companies' income.

Credit-card companies' income derives from membership dues paid by customers, fees received from businesses, and net interest income on credit extended to customers via the issuers. In 2000 non-interest income (fees and membership) of the five major banking groups totaled NIS 1.46 billion, up from NIS 1.31 in 1999, a rise of 11 percent. In addition, the net interest income of the five groups from credit to customers amounted to NIS 275 million, a 9 percent reduction from the NIS 303 million in 1999. This reduction was the result of a significant increase on the interest-free credit which businesses grant their customers, due to increasing competition and the need to deepen their business activity; this credit, too, is financed by the banks. The reduction in the prime interest rate, on which the interest on credit cards is based, may also have contributed to the drop in this income.

d. Operating and other expenses

Commercial banks' operating and other expenses increased by 8 percent from their level of NIS 12.9 billion in 1999 to NIS 13.9 billion in 2000 (Table 3.6). As this increase was a little below that of non-interest and other income (which rose by 11.4 percent), the operating coverage ratio rose by one percentage point from its 1999 level to 52.7 percent. The operating coverage ratio in the five major groups was 58.3 percent, close to the average in Israel's peer group countries. The ratio is higher for banking groups than for individual banks due to the contribution to non-interest income made by companies which engage in capital-market activity.

The rise in operating and other expenses was due to a significant (10.1 percent) increase in payroll and related expenses. Direct salary expenses rose by 8 percent, part of this being payment of bonuses, and related expenses went up by some 14.5 percent (Table 3.8). The other components of operating expenses increased by a moderate 4 percent, so that the share of salary expenses in total operating expenses rose to 66.5 percent, after falling for two years.

The increase in payroll and related expenses was mainly due to a considerable rise in the latter component, related expenses. These consist mainly of provisions for pensions, severance pay, encouragement for early retirement, social security payments, payroll tax, and employers' tax. The main increase occurred in the expenses on early retirement, which rose by 68 percent to NIS 378 million. This was the result of the implementation of early retirement schemes particularly in the three largest groups intended to streamline their systems and reduce future salary costs by replacing veteran, high-cost employees with new recruits.

The change in staffing also explains the upward trend in direct salary costs, reflected in a higher salary per employee-post. In the last few years the banks have been trying to

Table 3.8
Banks' Expenditure on Employees,^a 1995–2000

(NIS, December 2000 prices)

	Average no. of employee posts ^b	Salaries		Related expenses ^c		Salaries and related expenses	
		Total (million)	Per post (‘000)	Total (million)	Per post (‘000)	Total (million)	Per post (‘000)
1995	34,925	4,998	143	2,380	68	7,378	211
1996	35,400	5,164	146	2,675	76	7,839	221
1997	35,595	5,374	151	2,735	77	8,110	228
1998 ^d	35,259	5,436	154	2,692	76	8,128	231
1999	34,823	5,625	162	2,769	80	8,393	241
2000	35,020	6,074	173	3,170	91	9,244	264
Year-on-year change (<i>percent</i>)							
1995	2.8	-1.7	-4.2	14.8	11.5	3.6	0.8
1996	1.4	3.3	1.9	12.4	10.9	6.2	4.8
1997	0.6	4.1	3.5	2.3	1.7	3.5	2.9
1998	-0.9	1.1	2.1	-1.6	-0.6	0.2	1.2
1999	-1.2	3.5	4.8	2.8	4.1	3.3	4.6
2000	0.6	8.0	7.4	14.5	13.8	10.1	9.5

^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 Including national insurance, pension, vacation, and compensation expenses, and expenses due to changes in discounting rates or methods of calculating grants and pensions.

^d Data for 1998 have been reclassified.

SOURCE: Published financial statements and returns to Supervisor of Banks.

improve the quality of their personnel by increasing the number of staff who are graduates¹⁴ and who have high professional qualifications, whose salary costs are relatively high, and cutting the number of junior staff. This move was spawned by two processes taking place in the last few years: technological advances in the computing and communications fields, which affect the number and quality of banks' employees, and the globalization and liberalization in the money and capital markets, which make banking services more complex, and thus raise the level of professionalism, skill, and knowledge required by banks. Data from banks show that total salary and related expenses on the lowest two salary grades (i.e., up to NIS 103,000 per year) went down by 11 percent, while those on the highest two salary grades (above NIS 314,000) rose by 22 percent.

The rate of inflation, which was significantly lower than expected (relative to the inflation target and capital-market expectations) and which was the basis underlying

¹⁴ In Hapoalim, for example, from 1996 to 2000 the number of graduates rose from 24.6 percent of total employees to 30.2 percent, and in Leumi from 26 percent to 36.5 percent.

wage agreements and the determination of wage increments, explains part of rise of salary and related expenses. Moreover, in 2000 bonuses and grants were paid to employees as compensation for their successful performance.

The number of employee posts did not rise in 2000, so that the increase in direct and indirect salary costs was reflected by rises in salary and costs per employee post. The 7.4 percent rise in the average salary per employee post in the banking system was slightly higher than the 6.5 percent increase in that in the economy as a whole, despite the fact that the latter was greatly affected by the rise in high-tech industries due to the high demand for labor in them (Table 3.8).

As in years past, the cost per employee post showed a wide spread, which became even wider in 2000: in the seven largest banks the annual cost per employee post varied between NIS 230,000 in Mizrahi to NIS 280,000 in Leumi and Discount, while the spread among the smaller banks was even more pronounced, from NIS 182,000 in Bank Yahav to NIS 362,000 in the Maritime Bank of Israel.

Depreciation costs rose by 4 percent in 2000, and expenses on building and equipment maintenance edged down, by 1.6 percent, due mainly to a reduction in rent, municipal taxes, and property tax in the two largest banks.

Other expenses increased considerably, by 7.7 percent, due to higher expenses on marketing, advertising, and professional services, with some fall in expenses on office services, insurance, and communications.

e. Operating indices and efficiency

Banks' financial results are affected by their operating efficiency, among other things. Indices of banks' operating characteristics include: 1) average expenditure per unit of output (added value); 2) output per employee; 3) coverage ratio of net interest income (before loan-loss provision) to operating expenses; 4) coverage ratio of non-interest income to operating expenses; and 5) income efficiency ratio—the ratio of total interest and non-interest income to total operating expenses.

1. Average expenditure per unit of output: this measure serves as an approximation of expenses per sheqel of activity, and is calculated as operating expenses per sheqel of added value. Due to the difficulty in defining banking output and the rise in the share of off-balance-sheet activity in the banks' total activity in the last few years, we chose a bank's added value as an output index. The banking industry's added value is calculated as the sum of the components of implied income—net pre-tax profit from regular activities, salaries and related expenses, depreciation, deductions, and building and equipment maintenance. A comparison of operating expenses per sheqel of output between banks of similar size indicates differences in their operating efficiency. This ratio has not followed a consistent path in the seven major banks: in 1999–2000 it was slightly below the average for the period 1992–2000, a result which suggests a trend towards greater efficiency in the banking system (Table 3.9). In 2000, the ratio was at the same level as in 1999 in the seven major banks, except for a slight improvement in the Union Bank

Table 3.9
Ratio of Operating Expenses to Value Added,^a 1992–2000

	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average
Leumi	0.72	0.78	0.91	0.97	0.87	0.85	0.91	0.77	0.79	0.84
Hapoalim	0.97	0.86	0.91	0.91	0.89	0.81	0.86	0.78	0.76	0.86
Discount	0.94	0.92	1.00	0.97	0.99	1.20	1.51	1.13	1.53	1.13
Mizrachi	0.99	0.91	1.00	1.22	1.00	0.96	1.00	0.90	0.87	0.98
First International	0.74	0.73	0.79	0.83	0.82	0.80	0.85	0.78	0.76	0.79
Union	0.97	0.95	1.03	1.03	1.03	1.05	1.05	1.12	0.95	1.02
Mercantile Discount	0.79	0.84	0.89	0.94	1.04	1.15	1.11	1.06	1.08	0.99
Yahav	0.81	0.88	0.79	0.85	0.96	1.03	1.10	1.08	1.04	0.95
Maritime	2.29	0.85	1.03	1.41	1.97	1.63	1.44	1.29	0.83	1.42
Otsar Hahayal	0.84	0.85	0.92	0.91	0.94	0.92	1.02	1.02	1.36	0.97
Arab Israel	0.65	0.77	0.90	0.75	0.64	0.61	0.61	0.56	0.53	0.67
General	0.67	0.68	0.91	0.94	1.02	0.94	0.89	1.07	0.84	0.89
Continental	0.74	0.77	0.71	0.70	0.81	0.71	0.78	0.70	0.74	0.74
Massad	1.20	1.22	1.03	1.04	0.95	1.04	1.06	1.00	1.02	1.06
<i>Seven largest</i>										
Average	0.85	0.84	0.93	0.95	0.91	0.90	0.97	0.85	0.87	0.90
Standard deviation	0.12	0.08	0.08	0.12	0.09	0.16	0.23	0.17	0.28	0.15
Coefficient of variation	0.14	0.09	0.09	0.13	0.10	0.18	0.24	0.20	0.32	0.16
<i>Next seven</i>										
Average	0.83	0.84	0.90	0.90	0.91	0.90	0.94	0.93	0.96	0.90
Standard deviation	0.59	0.17	0.12	0.24	0.43	0.33	0.27	0.25	0.26	0.29
Coefficient of variation	0.71	0.20	0.13	0.26	0.47	0.36	0.28	0.27	0.27	0.33
<i>Total</i>										
Average	0.95	0.86	0.92	0.96	1.00	0.98	1.01	0.95	0.94	0.95
Standard deviation	0.41	0.13	0.10	0.18	0.30	0.25	0.24	0.20	0.26	0.23
Coefficient of variation	0.44	0.15	0.11	0.19	0.30	0.25	0.24	0.21	0.28	0.24

^a Value added is defined as net income from ordinary before-tax activities plus costs—salaries and related expenses, amortization and deductions, and maintenance of buildings and equipment.

SOURCE: Returns to Supervisor of Banks and published financial statements.

and an exceptional observation in Bank Discount. In Bank Discount, which in the last few years has shown relatively high expenses per sheqel of output compared with similar banks, average expenses rose considerably due to before-tax losses and the rise in operating expenses on account of early retirement.

In the seven smaller banks, too, there was no clear trend regarding expenses per unit of output, with marked changes from 1999. The ratio rose significantly in Otsar Hahayal Bank, due the implementation of an early-retirement plan, as a result of which the bank recorded a net loss for the first time. In contrast, expenses per unit of output declined considerably in the Maritime Bank due to a rise in its profit. The differences between the small banks was similar in 2000 to that between the large banks, with the latter having risen slightly due to the exceptional figure for Bank Discount.

2. *Output per employee*: this is defined as added value per employee post, and is a measure for estimating average productivity of the bank's employees; it is used by banks' management as a component in the determination of employee benefits (Table 3.10). In the last few years banks have tended to provide their staff with incentives by offering one-time or annual bonuses and grants in accordance with the bank's overall performance and the employee's individual contribution. Taking a long-term view¹⁵ the question of whether changes in an employee's output match changes in cost per employee post may be analyzed. Figure 3.5 shows changes in added value per post and cost per post for two periods, 1995–97 and 1998–2000. The findings show that in the five major banks except for Discount both added value per post and cost per post rose; in Discount cost per post increased, but added value per post declined considerably. The increase in cost which accompanied the rise in added value in the last few years prevented a fall in the average labor-related expense per sheqel of output in the major banks, whereas in the small banks the average cost actually went up. Banks not in the category of the five major ones did not follow a uniform pattern: in most (Mercantile, Union, Continental, Massad, Investec Clali, Maritime, and Arab Israel), cost per post and added value per post both moved in the same direction, whereas in others (Yahav and Otsar Hahayal) they moved in opposite directions.

3. *Net interest coverage ratio*: this is defined as the ratio of net interest income (before loan-loss provision) to operating expenses, and reflects the share of these expenses that is covered by classic financial activity, mainly by interest receipts. The coverage ratio in the two largest banks is higher than in the others due to the inherent advantage of extending credit to large corporations and to operating large systems (Table 3.11). In the three major banks (Leumi, Hapoalim and Discount) the ratio dropped slightly, apparently due to the high costs of implementing the early-retirement programs. The net interest coverage ratio in the other four large banks rose, mainly due to expanded activity combined with small changes in net interest margins.

¹⁵ The calculation is performed using the average of several years in order to minimize non-recurring and random effects which may occur in particular years.

Table 3.10
Value Added per Employee Post, ^a 1992-2000

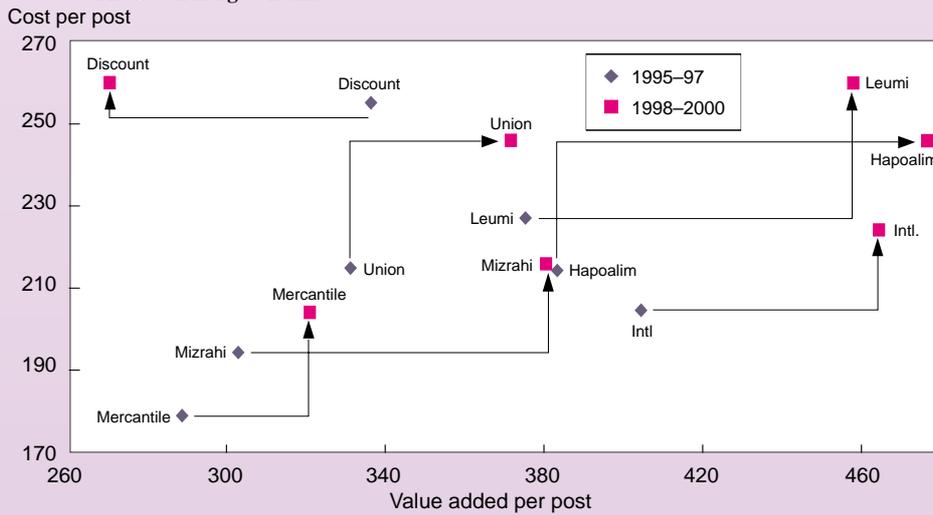
	(NIS '000s, December 2000 prices)									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	Average
Leumi	429	399	343	320	395	410	378	487	508	407
Hapoalim	307	361	339	356	372	420	419	472	537	398
Discount	338	344	337	357	341	309	227	324	258	315
Mizrahi	322	341	312	249	330	328	340	388	412	336
First International	440	448	396	391	402	418	409	465	517	432
Union	353	369	342	339	323	330	345	350	418	352
Mercantile Discount	400	391	368	318	274	273	299	323	340	332
Yahav	438	402	396	419	343	340	284	322	315	362
Maritime	149	514	525	335	219	295	331	405	815	399
Otsar Hahayal	373	369	348	375	339	362	339	374	317	355
Arab Israel	406	353	310	358	423	445	463	509	560	425
General	631	610	432	400	367	388	444	411	526	468
Continental	485	475	494	494	427	522	573	608	641	524
Massad	304	309	371	393	392	379	381	441	372	371
<i>Average</i>										
Seven largest	365	375	343	337	366	381	359	432	455	370
Next seven	405	403	376	389	363	381	372	405	407	387
Total	367	376	344	340	366	381	359	431	452	380
Standard deviation	109	81	65	57	57	67	86	83	150	84
Coefficient of variation	0.30	0.22	0.19	0.17	0.16	0.18	0.24	0.19	0.33	0.22

^a Value added is defined as net income from ordinary before-tax activities *plus* salaries and related expenses, depreciation and deductions, and maintenance costs for buildings and equipment.

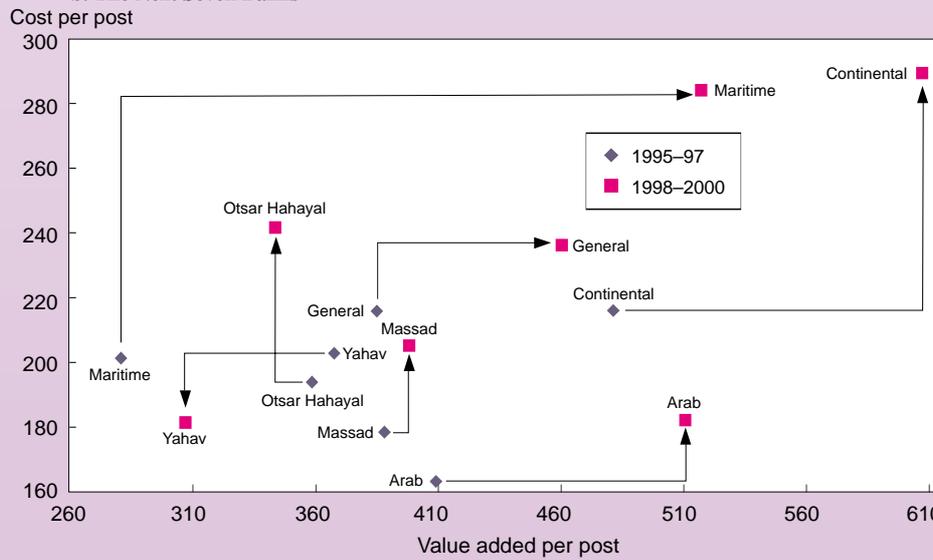
SOURCE: Returns to Supervisor of Banks and published financial statements.

Figure 3.5
Cost per Employee Post vis-à-vis Added Value per Employee Post,
1995–97 and 1998–2000
 (NIS thousand, December 2000 prices)

a. The Seven Largest Banks



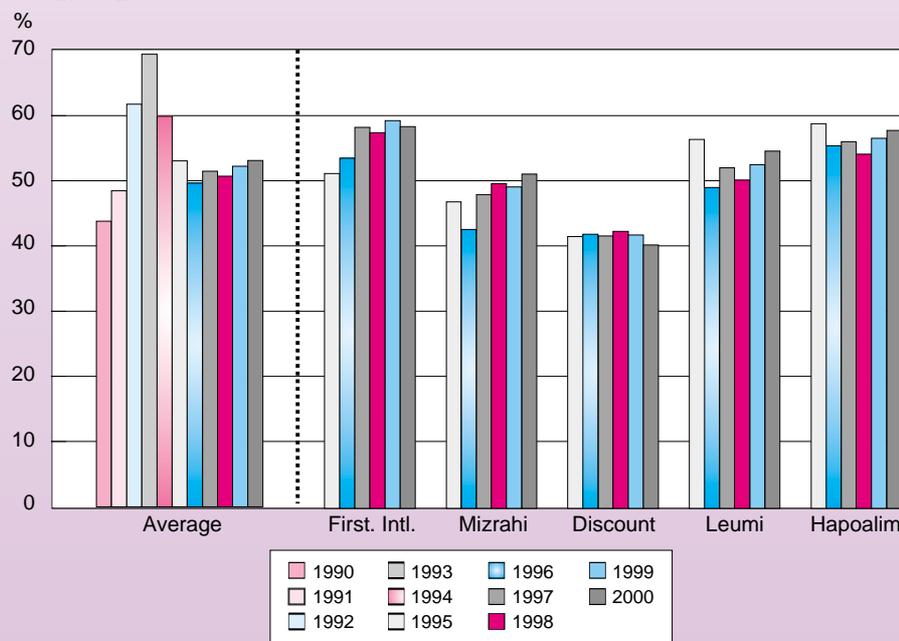
b. The Next Seven Banks



SOURCE: Returns to Supervisor of Banks and published financial statements.

4. *Operating coverage ratio*: this is the ratio of non-interest income to operating expenses. Large differences between the seven major banks were evident in 2000, as in the past, with the ratio varying from 40 percent in Discount Bank and Union Bank to 59

Figure 3.6
Ratio of Non-Interest Income to Operating Expenses, the Five Major Banks,
1990–2000



SOURCE: Published financial statements.

Table 3.11
Coverage and Efficiency Ratios, the Seven Largest Banks, 1999–2000

	1999			2000		
	IR ^a	CR ^b	ER ^c	IR ^a	CR ^b	ER ^c
Hapoalim	1.09	0.57	1.66	1.06	0.58	1.64
Leumi	1.01	0.53	1.53	1.00	0.55	1.55
Discount	0.84	0.42	1.26	0.67	0.40	1.07
Mizrahi	0.86	0.50	1.36	0.91	0.51	1.43
First International	0.95	0.59	1.54	0.99	0.59	1.57
Mercantile	0.85	0.45	1.30	0.85	0.43	1.28
Union	0.81	0.39	1.20	1.01	0.40	1.41

^a The interest ratio (IR) is calculated as the ratio of net interest income before loan-loss provision to total operating and other expenses.

^b The coverage ratio (CR) is calculated as the ratio of non-interest and other income to total operating and other expenses.

^c The efficiency ratio (ER) 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.

SOURCE: Published financial statements.

percent in the First International (Table 3.11 and Figure 3.6). In line with the long-term trend, the ratio rose slightly in 2000 in the large banks, with the exception of Discount Bank. The operating coverage ratio is heavily affected by developments in the capital market and the extent of the banks' activity in it. Thus, in 1993 the ratio peaked at 69 percent, due to the stock-exchange boom and income deriving from the capital market. From 1994 to 1996 it declined steadily, and since then it has been creeping up, closely matching movements of the General Share Price Index. The ratio in the banking system as a whole rose by one percentage point, to 52.7 percent. An international comparison based on data for 1999 relating to the banking groups of other countries shows that the ratio in the five major banking groups in Israel, 58 percent, is lower than that (66 percent) in Israel's peer group countries. It must be noted that the ratio in question relates only to balance-sheet assets, and country differences may derive from the differences in shares of off-balance-sheet activity.

5. *Income efficiency ratio*: in performing its ongoing operations, in on which it receives interest and non-interest income, a bank incurs expenses; one way of examining the bank's efficiency is via the ratio of its total income (interest and non-interest) to its total expenses. A high ratio indicates that the bank utilizes its factors of production intelligently to increase its profit. In 2000 this ratio continued the rise evident in the last few years in most of the large banks (except for Bank Discount and Mercantile Discount, in which it fell steeply, Table 3.11). The average efficiency ratio in Israel's banking system is similar to that in the banking systems of countries in Israel's peer group (Table 3.3).

f. Other factors affecting banks' profitability in 2000

Several nonrecurring activities and occurrences in 2000 resulted in extraordinary profit/loss being recorded in some of the groups. Extraordinary profit in the five major banking groups rose by 43 percent to NIS 321 million, raising its share of net profit to 9 percent. In the Leumi group extraordinary profit increased from NIS 158 million in 1999 to NIS 336 million (about 3 percentage points of the bank's ROE) in 2000. This profit arose from the sale of 5.6 percent of the shares of Koor Industries Ltd., which yielded a profit of NIS 187 million, and from the sale of the bank's holding in CAL, yielding a profit of NIS 147 million. The First International's extraordinary profit totaled NIS 54 million (2 percentage points of ROE), and derived mainly from the sale of the operating infrastructure of Alpha Card and from the transfer of the Alpha Card operation to Visa Cal. In contrast, Hapoalim recorded a loss of NIS 43 million from extraordinary activities, due mainly to provision for deferred taxes and realized losses on sales of buildings. Mizrahi recorded losses from revaluation of real estate to be sold.

In 2000 profit from companies included on an equity basis (unconsolidated subsidiaries and affiliates) amounted to NIS 377 million, a rise of 5 percent. The Leumi group showed a profit of NIS 165 million, arising from the equity profit from the merger with a brokerage company held by Bank Leumi-UK, and from recording, for the first time, the bank's

share of the profit of the Israel Corporation Ltd., with the completion of the purchase of shares entitling the bank to 20 percent of the voting rights in the company. In Mizrahi, too, profit from companies included on an equity basis increased, due to the sale of investments in a venture-capital fund. In Hapoalim, on the other hand, profit from companies included on an equity basis plunged to NIS 105 million, half their previous level. Most of this bank's profit in this category comes from Koor, which had low profits in 2000 because of its share in the losses of ECI Telecom Ltd.

The banks' income and expenses items were also affected to some extent in 2000 by the disparity between the rates at which the 'known' and 'in-lieu' consumer price indices rose. This increased both net pre-tax interest income by NIS 105 million—most of it in the indexed local-currency segment—and the tax provision by NIS 42 million. In 2000 the disparity between the indices increased the banking groups' income by NIS 63 million, not very different from its effect in 1999, when it increased their income by NIS 56 million.

g. Provision for tax

The provision for tax on the ordinary pre-tax income of the five major banking groups was NIS 2,888 million in 2000, a 5 percent decline from the level of NIS 3,042 million in 1999 (Table 3.1). The effective tax rate on pre-tax income was 47.74 percent in 2000, compared with 49.94 percent in 1999. The decline in both the tax provision (Table 3.12) and the effective tax rate was due to:

1. Tax provision for previous years, which contributed a reduction of NIS 80 million in the provision, after rising by NIS 50 million in 1999. The main reason for this was the provision of Bank Leumi in the US, which in 1997 and 1998 had deferred taxes receivable, deriving from the past losses not yet realized for tax purposes. Since in the past only part of these deferred taxes had been entered in the consolidated financial statements, their reduction in the statement of the overseas office in 2000, offsetting profits, resulted in a reduction of NIS 90 million in the provision for tax.
2. Final assessments were issued in 2000 for some of the banks and their subsidiaries, and the reduced provisions derived from these.

The following factors exerted pressure to increase the tax provision compared with that calculated from the historical rate (45.3 percent):

1. Losses and deductions for which no deferred tax had been recorded raised the tax due by about NIS 155 million (1.5 percentage points); this was the case in Discount Bank, which had not entered deferred tax receivable for current losses for tax purposes in 2000, in the light of the low probability that the programs for improving the financial results would be implemented in the foreseeable future.
2. Expenses which are written into the financial statements but are not recognized by the tax authorities, such as negative real differences in exchange rates in investments overseas arising from the appreciation of the NIS against other currencies, which eroded the investments in those countries.

Table 3.12
The Transition from a Statutory Tax Rate to Provision for Tax on
Income in Profit and Loss Statement of the Major Banking Groups, 2000

	Total tax (NIS million)	Tax rate on ordinary pre-tax profit (%)
Statutory tax rate	2,741	45.30
Losses and deductions for which no deferred tax was recorded	154	2.55
Payroll tax	94	1.55
Tax for previous years	-79	-1.31
Adjustment of statutory tax rate to the rates applicable to the income of consolidated companies	-59	-0.98
Tax-exempt and tax-reduced income	-34	-0.56
Depreciation differentials, and adjustment of depreciation and capital gains	19	0.31
Differentials from definitions of assets and liabilities for tax purposes	-12	-0.20
Tax for financial assets adjustment differentials	12	0.20
Income from subsidiaries abroad	11	0.18
Income from subsidiaries in Israel ^a	-13	-0.21
Other expenses ^b	54	0.89
Provision for taxes on income	2,888	47.74

^a Including losses of consolidated subsidiaries.

^b Including expenses not recognized (for tax purposes) and additional amounts to pay for doubtful debts, general and additional loan-loss provision, erosion of tax advances and other differentials.

SOURCE: Published annual reports.

3. A rise in provision for tax arising from the disparity between the 'known' and 'in-lieu' consumer price indices, and for which net interest income, and the relevant tax, rose by NIS 45 million.
4. A rise in payments of profit tax on the payroll tax which is imposed on corporations as an alternative to VAT imposed on regular companies.

3. THE POLICY OF DIVIDEND DISTRIBUTION AND THE RETURN ON EQUITY

a. The policy of dividend distribution

In the last few years, as the profits of the banking groups have risen, so too have the dividends paid to their shareholders, and the rate of dividend to net profit and/or to paid-up capital. This was not the case in 2000: in the three banking groups which distributed a dividend, the dividend rate to net profit was lower than it was in 1999. The total dividend distributed in 2000 was NIS 1.5 billion, down from NIS 2 billion in 1999. This resulted

from a reduction in the rate of dividend to net profit, mainly in Hapoalim (from 80 percent in 1999 to 37 percent in 2000), and from the non-distribution of a dividend by Mizrahi and Discount, which recorded current losses for 2000. Policy and the dividend rate is determined by the board of directors, in accordance with Regulation 331 of the Proper Conduct of Banking Business. Since 2001 the regulation permits distribution of dividend in excess of the balance of surpluses, with certain limitations and with the authorization of the Supervisor of Banks; it also specifies that the board must consider and determine whether the bank's liquidity makes such a distribution possible, and in any event no dividend may be distributed if the bank's nonfinancial assets exceed its equity. The distribution of dividend must satisfy another requirement, i.e., that specified in the Companies Law, 5759–1999, which states that a bank may distribute a dividend from its profit (the balance of its surpluses or surpluses which have accrued in the previous two years, whichever is higher), provided that there is no reason to expect that this would prevent it from meeting its expected liabilities. The Minimum Capital Ratio requirement determines that the share of capital shall not fall below 9 percent of the bank's risk-weighted assets; in addition, Section 23a of the Bank Licensing Law, 5741–1981 limits the share of capital which a banking corporation may invest in nonfinancial corporations, and prohibits the distribution of dividend from capital funds or from differentials arising from the translation of financial statements of autonomous units abroad.

b. Return on equity

The equity of the five major banking groups, used in the calculation of the return on equity (ROE), was NIS 36 billion at the end of 2000, up from NIS 33.5 billion a year earlier. Most of the increase in equity derived from net profit of about NIS 3.8 billion, which was partially offset by the distribution of dividends. ROE of the five major banking groups reached 11.7 percent, with great variation between them: -0.6 percent in Discount; 10.5 percent in the First International; 13.2 percent in Mizrahi; 14.6 percent in Leumi; and 15.1 percent in Hapoalim (Table 3.2). The ROEs of the two largest groups have both risen in the last few years, and seem to show no marked differences between them (Figure 3.1). A closer look at their performances, however, shows significant differences in the sources of their profits: in Hapoalim, gross return on equity (the share of pre-tax profit in equity) rose, which can be explained mainly by the expansion of the bank's activity, the net interest income deriving therefrom, and also by the increase in net non-interest income (after deducting operating expenses). In Leumi, the most notable contribution to profit has been made by extraordinary profit deriving mainly from the sale of excess nonfinancial holdings. In 2000 these profits were swelled by profit from companies included on an equity basis and by a relatively low tax rate (40 percent), which clarify the source of the good level of profitability achieved by the group. Leumi's pre-tax profit declined by NIS 280 million in 2000, i.e., by 14 percent, while its total profit rose by NIS 250 million to NIS 1.6 billion.

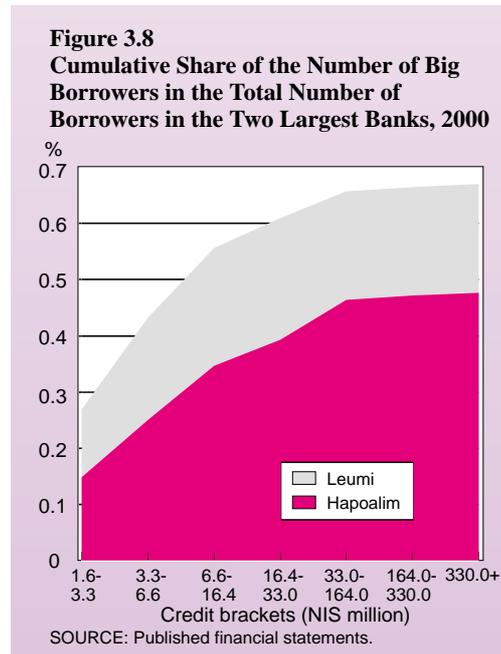
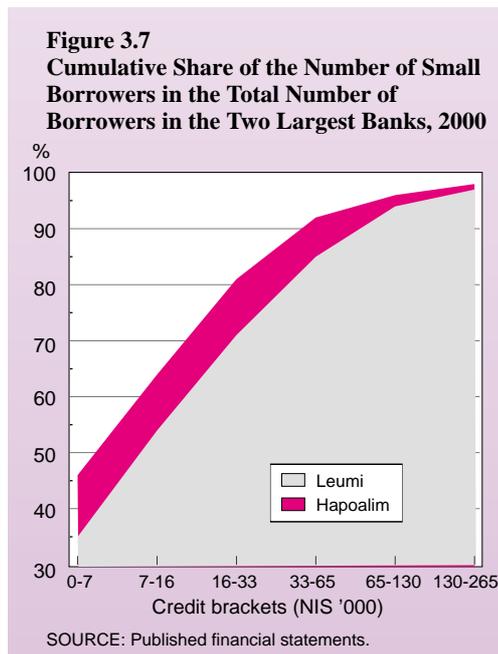
APPENDIX 1

Analysis of the profit centers of the two largest banks ¹⁶

In the last few years some of the large banks have started changing their organizational structures; this has included dividing their areas of banking activity into independent profit centers, each comprising various divisions, and each dealing with different groups of customers. The main divisions are:

- The retail division, which deals with households, small businesses and private banking;
- The commercial division, which deals with medium-sized businesses;
- The business division, which deals with large businesses.

Measurement and reporting by the profit centers help management to determine the bank's business strategy, in particular the allocation of available capital, which enables an assessment to be made of the performance and marginal contribution of each activity (at the customer level). Reports by profit centers also provide a useful tool for deciding on employees' pay differentials. The basic advantage of such reports are that they enable a uniform approach towards analyses of business activity and segmentation of income and expenses across a wide range of characteristics, even down to the level of the individual customer or business.



¹⁶ In banks' financial statements, only the largest two banks detail financial results according to profit centers, and the following analysis is therefore based on them. The development of a similar system in the First International was completed in 2000, but data on its profit centers were not detailed in full in the annual financial statement.

Profit for an individual customer is calculated as follows: for a customer making a deposit in the bank, the profit is the product obtained by multiplying the amount of the deposit by the interest differential (between the price of capital and interest payments on the deposit). For a customer taking credit, profit is calculated as the product of the amount of the credit and the interest differential (between interest received on the credit and the price of capital). Operating expenses and non-interest income is allocated to both types of customer according to cost-accounting methods.

The profit at the division level takes into account the size of the sources and uses in it, and in the event of surplus sources these are transferred to a division where there is a surplus of uses, using “transfer prices.”

These prices are set according to the bank’s economic approach, and reflect marginal costs of raising capital.¹⁷

The rules for measuring and reporting are based on definitions and measurement policies specific to each bank, and to enable a comparison between the banks, certain assumptions had to be made.¹⁸

The analysis of the contribution of the profit centers to the activity and profit of the banks highlights great differences between the centers in each bank and between the banks. The analysis below focuses on the main ones: in Hapoalim the contribution of the retail division makes a major contribution (52 percent) to the bank’s profit, compared with 36 percent in Leumi. This is due to the mix of sources in the former: the share of deposits of the public in its retail division is greater than that in Leumi (87 percent and 68 percent respectively). As a result of a low level of competition for small customers, the return received by depositors is lower than that received by other sources, so that the contribution of this division is larger in Hapoalim than in Leumi. The high share of retail activity in Hapoalim is also seen in the relatively large number of small borrowers (Figure 3.7). Operating the retail division is expensive, because it requires a broad base of branches and high expenses on human and physical resources. On the other hand,

¹⁷ Inter-division transfer prices between for each bank were not available, and they may not reflect market prices.

¹⁸ Leumi reports that it has four main profit centers: banking activity, private activity and investments, commercial activity, and business activity. To enable comparison with Hapoalim, which reported on three profit centers—retail, commercial, and business—the data on banking activity, private activity and investments in Leumi, which deal mainly with households and smaller customers, were combined, and called the retail division. Since no data are available on how the data on the accounting department and head office are allocated to the different divisions, they were ignored for the purposes of this analysis.

Figure 3.9
Effective Cost of Credit in the Unindexed Local-Currency Segment in the Seven Major Banks, 1999 and 2000

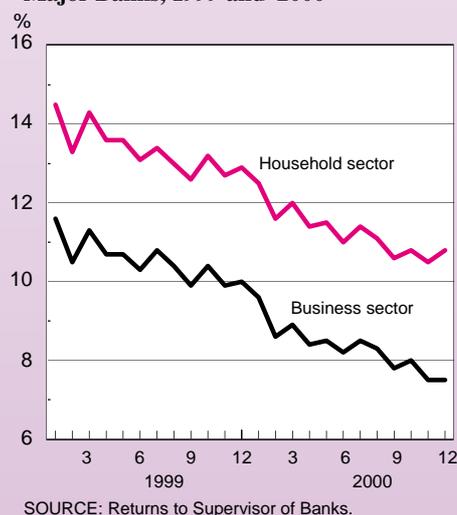


Table 3.13
Performance Indicators of Different Profit Centers of the Two
Largest Banks, 2000

(percent, 2000 data)

	Hapoalim			Leumi		
	Retail division	Commercial division	Business division	Retail division	Commercial division	Business division
Activity mix ^a	53	6	41	48	21	31
Contribution to pre-tax profit	52	8	40	36	26	38
Operating coverage ratio	61	61	78	55	71	118
Pre-tax profit per Sheqel of activity	0.67	0.98	0.65	0.44	0.73	0.73

^a Weighted by the share in total credit and deposits.

SOURCE: Published financial statements.

non-interest and net interest income are high due to the relative shortage of alternative sources for retail credit, and this is reflected in the high fees and rates of interest characteristic of this market segment.

In Leumi, by contrast, the commercial and business divisions make major contributions to profit. Activity in the business sphere is very competitive as there are alternative sources of credit—the capital market, insurance companies, and financial companies abroad. These divisions have higher profitability in Leumi than the corresponding ones in Hapoalim due to the greater number of large customers in the former (Figure 3.8).

The business division does not incur heavy expenses, relatively, so that in both banks the operational coverage ratio is higher than that of the retail division (Table 3.13).

A comparison of net interest income by type of customer (households and business customers) shows that average interest for NIS 1 of credit (in the unindexed local-currency sector) for households' activity is higher than that paid by business customers. This is because of insufficient competition for small customers (Figure 3.9).