CHAPTER 2

CHAPTER 2
SUMMARY OF THE MAIN DEVELOPMENTS IN BALANCE-SHEET AND OFF-BALANCE-SHEET ACTIVITY

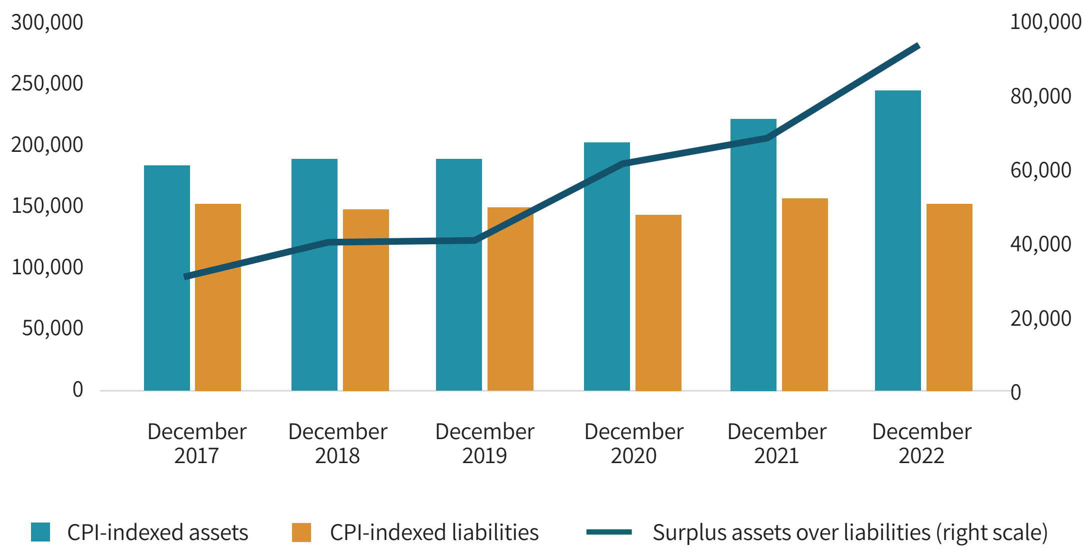
1. BACKGROUND

The aggregate balance sheet of the banking system stood at NIS 2,384 billion at the end of 2022, an increase of about 7.4 percent (Table 3). This growth rate was somewhat more moderate than during the COVID-19 crisis (an average annual rate of growth of about 15.5 percent during the years 2020–21), though it was significantly above the long-term average prior to the pandemic (an average annual rate of growth of 4.2 percent during the period 2009–19).

This growth was primarily due to the increase in total credit to the public, which grew as a result of both the continued trend of positive results and the high inflation environment, which increased the value of total CPI-indexed assets (which constitute about 10 percent of total assets). Thus, the increase in assets, adjusted for inflation, stood at about 6.9 percent. The banks that usually maintain a surplus of CPI-indexed assets over CPI-indexed liabilities, further increased that position, as a result of actual inflation (which had a greater effect due to the original differences in size on the assets side) but also as a result of managements' decisions to increase the size of the position[1], based on the expectation that this trend will continue (Figure 2.1) and will contribute to profitability (for further details, see Chapter 3).

The surplus of CPI-indexed assets over CPI-indexed liabilities continued to grow during the year due to inflation, among other factors.

Figure 2.1 Surplus Assets Over Liabilities, CPI-Indexed, Total Banking System 2017–2022 (NIS billion)



SOURCE: Based on published financial statements.

[1] Managements' decisions are reflected in the pricing of CPI-indexed and unindexed assets and the gap between them, as well as in the decision not to reduce the position that is derived from the demand of borrowers in the market.

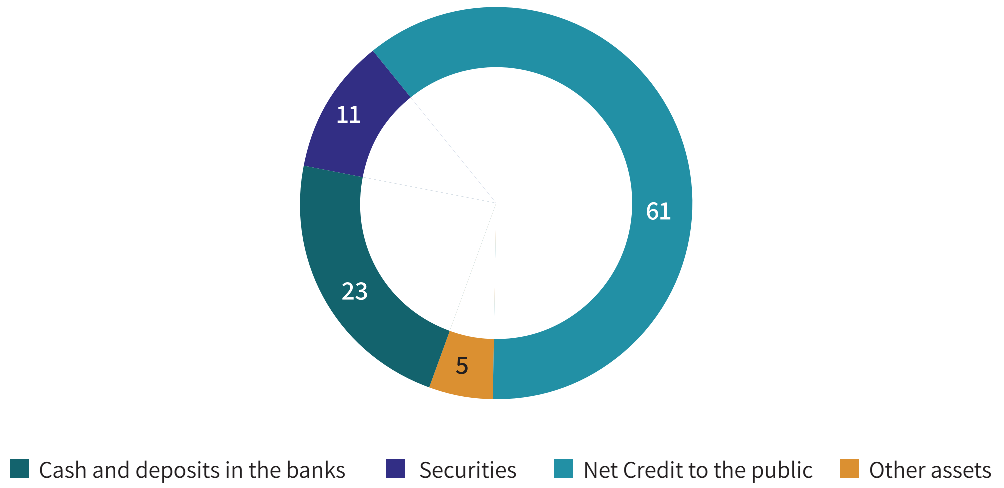
The weakening of the shekel against the dollar during the period being surveyed also had a significant effect on the banks' balance sheets (since about 15 percent of total assets are denominated in foreign currencies, primarily the dollar), such that after adjusting for the depreciation of the shekel, the banks' assets grew by 5.8 percent. The net effect (of the exchange rate and inflation) points to an increase of only 5.3 percent in the banks' balance sheet.

2. MAIN DEVELOPMENTS ON THE ASSETS SIDE OF THE BANKING SYSTEM

Net credit to the public, which constitutes the main component of the banks' assets (Figure 2.2), is the main factor explaining the growth in total assets, which continued during the period being surveyed at the high rate of about 12.3 percent (compared to a rate of about 13.6 percent in 2021, which was a record year; the net effect, after adjusting for the exchange rate and inflation, was that net credit to the public grew by about 10.4 percent). The securities portfolio, which constitutes about 11 percent of the system's total assets (Figure 2.2), recorded an increase of about 14.8 percent, compared to a contraction of about 10.4 percent in total cash and deposits at the Bank of Israel (primarily reserves at the Bank of Israel).

Credit to the public is the main component of total assets in the banking system, while cash and deposits also account for a significant share.

Figure 2.2 Distribution of Total Assets in the Banking System, December 2022



SOURCE: Based on published financial statements.

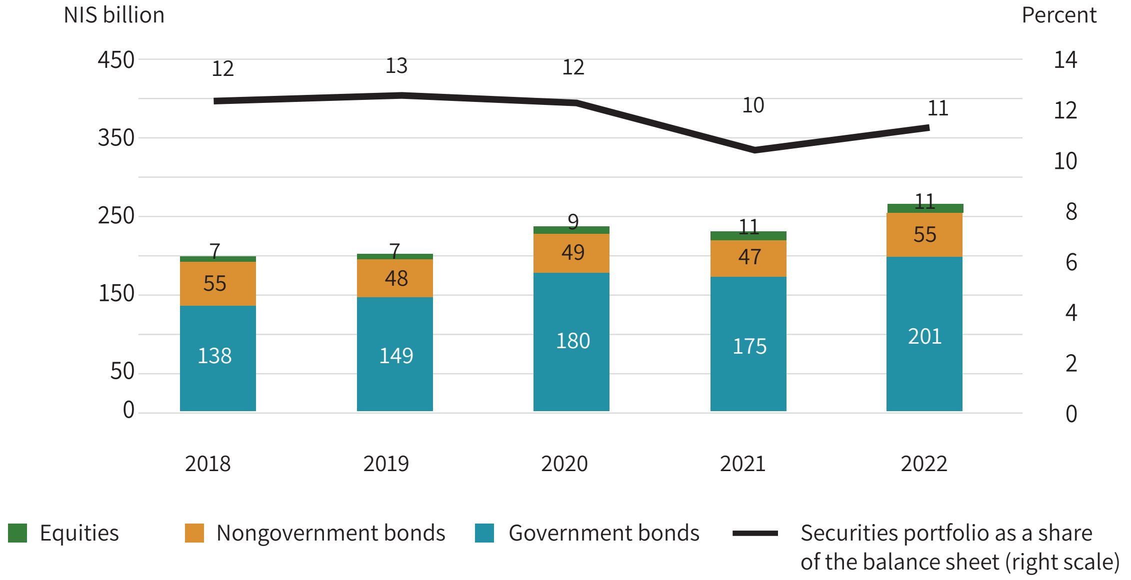
The main part of the growth in the credit portfolio stems from business credit and housing credit, which together account for about 95 percent of the growth in total credit, with consumer credit also contributing to the portfolio's growth (for further details, see Chapter 5.2). During this period, the total allowance for credit loss also grew (by about 12.7 percent); however, the share of the total credit loss allowance within total balance sheet assets remained unchanged relative to the end of 2021, which was in spite of the increase in allowances carried out as a result of the transition of Israeli banks to the CECL method and the deterioration in the macroeconomic environment during the year (for further details, see Chapter 5.2).

The main part of the growth in the securities portfolio was due to an increase in government bonds (the vast majority of which is explained by the increase at one of the large banks), which grew by about 15 percent (Table 4). In addition, there was an increase of about 18 percent in nongovernment bonds (of which a not insignificant portion is explained by the growth of this item at one of the large banks; Figure 2.3). Investments in bonds in the securities portfolio are classified, at the time of purchase, into one of three possible portfolios: the hold to maturity portfolio, the available for sale portfolio, and the trading portfolio. In addition, equities are classified as tradable or nontradable. The type of security determines the way in which its value is presented in the balance sheet (for example: bonds to be held to maturity are presented in the balance sheet according to cost while bonds available for sale are presented according to fair value on the day of the report), as well as the recording of profits or losses due to fair value adjustments (for example: unrealized profits or losses from the adjustment to fair value for bonds that are available for sale are reported as part of other profit while profits and losses from adjustments to fair value in the case of tradable bonds are recorded in the profit and loss statement).

During the course of the year, several banks transferred bonds from the available-for-sale portfolio to the hold to maturity portfolio, with the goal of reducing the exposure of the bank's capital to fluctuations in the markets, given the interest rate and inflation environment in Israel and worldwide that has affected bond yields. Accordingly, the share of the portfolio held to maturity within the total securities portfolio rose to 17 percent by the end of 2022, compared to 10 percent in the previous year, while in contrast the share of the available-for-sale portfolio fell to 72 percent, compared to 79 percent in the previous year (Figure 2.4).

The securities portfolio grew since the beginning of the year, due to the increase in government and nongovernment bonds.

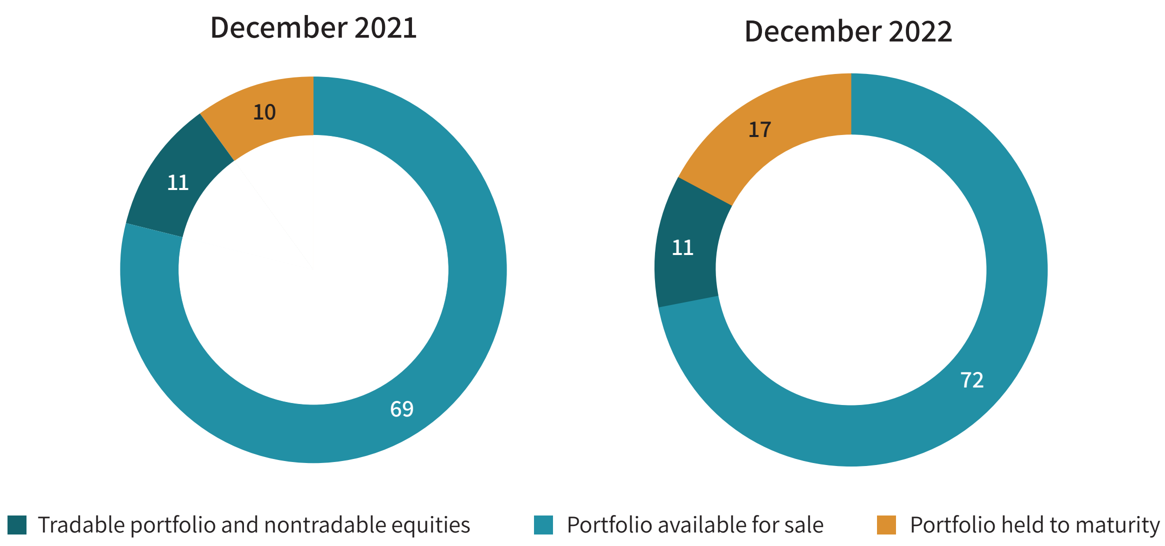
Figure 2.3 Securities Portfolio of the Total Banking System—Size and Composition, December 2018–December 2022



SOURCE: Based on published financial statements.

The available-for-sale portfolio constitutes the main component of the banking system's securities portfolio, with the portfolio held to maturity growing at its expense during 2022.

Figure 2.4 Distribution of the Banking System's Securities Portfolio, Total Banking System, December 2021 and December 2022, percent



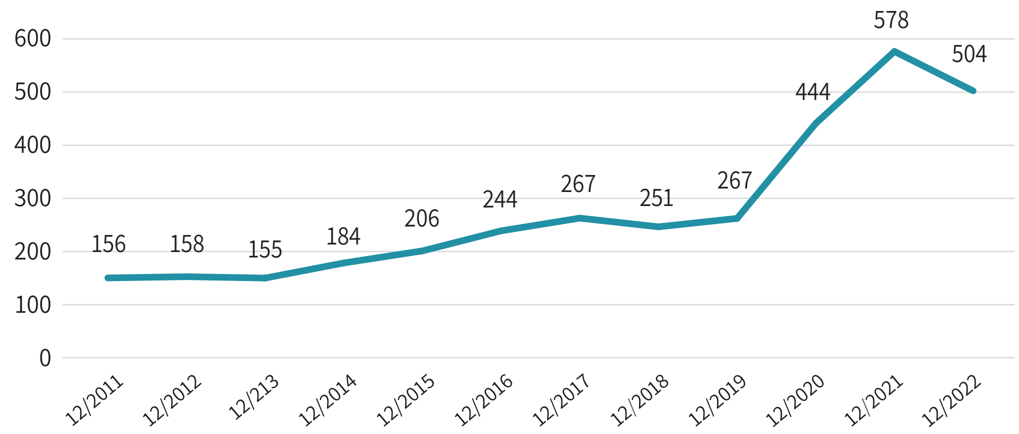
SOURCE: Based on published financial statements.

However, in contrast, there has been a decline of about 12.7 percent in cash and deposits at the Bank of Israel, which followed several years of almost uninterrupted increase (Figure 2.5). This trend in fact accelerated since COVID-19 due to the adoption of expansionary monetary and fiscal policies. The banks' deposits at the Bank of Israel (which constitute the majority of "cash and deposits at the Bank of Israel") are determined by the Bank of Israel's use of periodic monetary tenders of various maturities among the banks. The goal is to absorb surplus liquidity in the economy to support the announced Bank of Israel interest rate. Accordingly, the level of the banks' deposits with the Bank of Israel is determined by changes in the banking system's liquidity situation, which are the result of actions by the government (such as the redemption of government bonds, transfer payments, etc.) and by the Bank of Israel (acquisition of bonds or foreign currency) which inject liquidity, or conversely actions by the government (collection of taxes and issuing of bonds) and by the Bank of Israel (issuing of *Makam*) that absorb liquidity. (*Makam* is a type of bill issued by the Bank of Israel to the public on behalf of the government.)

As part of the absorption of liquidity, the Bank of Israel accelerated the issuing of *Makam* during the last quarter of 2022, in order to meet the high demand for it as a result of the interest rate increases in the economy.[2] Furthermore, and following two years of major fiscal expansion during the COVID-19 pandemic, 2022 can be viewed as a year of contractionary fiscal policy.[3] These two trends therefore bought about a decline in the deposits of the banks at the Bank of Israel, which also had an impact on the item "total cash and deposits with the Bank of Israel" within the banks' balance sheets.

There was a decline this year in total cash and deposits with the Bank of Israel due to the activities of the government and the Bank of Israel to absorb liquidity from the banking system.

Figure 2.5 Volume of Cash and Deposits at the Bank of Israel, Total Banking System, December 2021–December 2022 (NIS billion)



SOURCE: Based on banks' reports to the Banking Supervision Department.

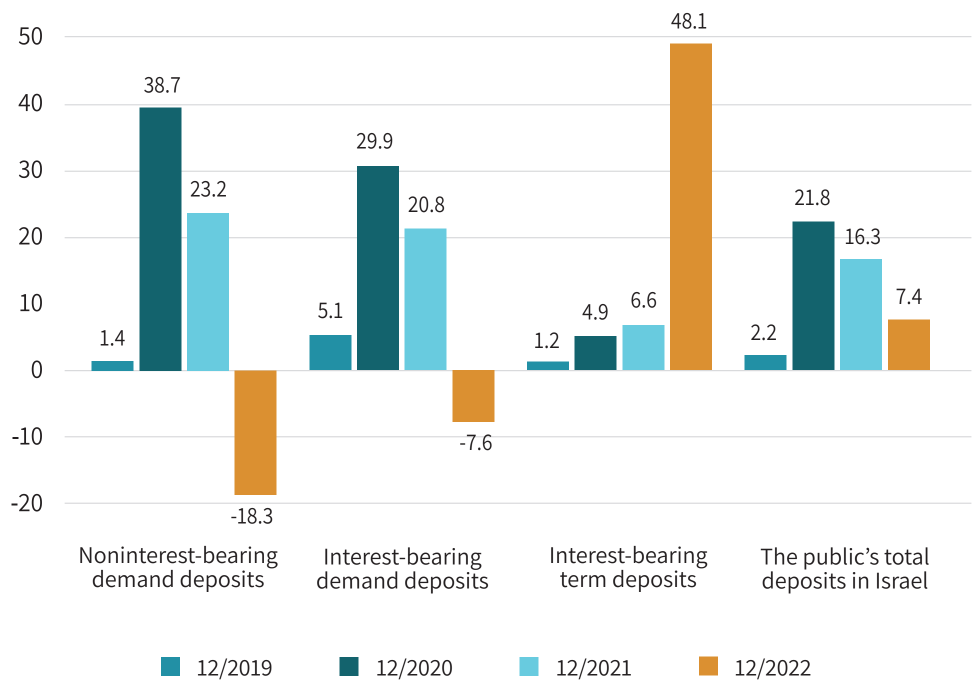
2 For further details, see Chapter 3.2 in the Bank of Israel Annual Report for 2022.
3 For further details, see Chapter 1.2.5 in the Bank of Israel Annual Report for 2022.

3. MAIN DEVELOPMENTS ON THE LIABILITIES AND EQUITY SIDE OF THE BANKING SYSTEM

On the liabilities side, the public's deposits grew by about 6.2 percent during the period being surveyed (Table 3). The public's deposits can be divided into three categories: fixed-term interest-bearing deposits (total of NIS 866 billion), interest-bearing on-demand deposits (totaling NIS 455 billion), and non-interest-bearing deposits (totaling NIS 520 billion). An analysis of the trends in each of the deposit types (Figure 2.6) shows that the growth in the public's deposits can be attributed to fixed-term interest-bearing deposits (which constitute about 47 percent of the public's total deposits), partly due to the shift from on-demand deposits (both interest-bearing and non-interest-bearing) to fixed-term interest-bearing deposits. This can be explained by the increase in the interest rates on these deposits following the hike in the Bank of Israel interest rate. Furthermore, an analysis of the trends according to type of depositor (Figure 2.7) shows that growth occurred among all types depositors, with about 43 percent of the growth explained by the deposits of corporations and others, 39 percent by the deposits of individuals, and 18 percent by institutional investors' deposits.

The growth in the public's deposits was the result of growth in interest-bearing deposits, which is due in part to the shift from on-demand deposits.

Figure 2.6 Rate of Change in the Public's Deposits by Deposit Type, Total Banking System December 2019–December 2022 (percent)



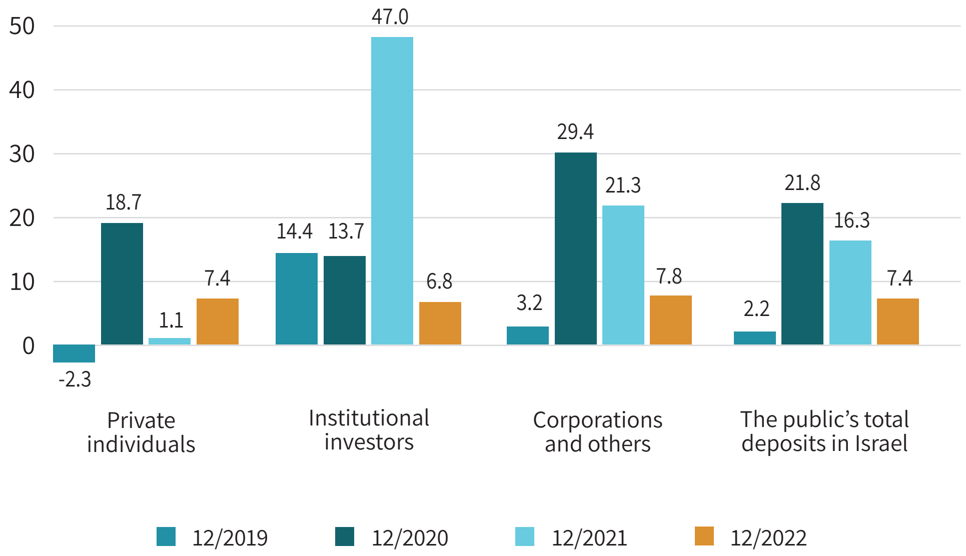
SOURCE: Based on published financial statements.

The large increase in credit provided to the public, alongside the more moderate increase in the public's deposits (against the background of contractionary fiscal policy), led to an increase in the ratio of credit to deposits. This followed an erosion in the ratio over the past two years, particularly since the beginning of the COVID-19 crisis. However, the ratio is still lower than prior to the pandemic (Figure 2.8).

The assets and liabilities related to activity in derivative instruments also grew significantly during 2022, due to the increase in activity in these instruments. This included, among others, interest rate contracts against the background of developments in interest rates in the various markets since the start of interest rate increases by central banks worldwide. Nonetheless, the increase in assets due to derivative instruments exceeded the increase in liabilities due to derivative instruments during 2022, such that the net balance-sheet exposure due to derivative instruments grew this year.

The growth in the public's deposits characterized all types of depositors.

Figure 2.7 Rate of Change in the Public's Deposits by Depositor Type, Total Banking System, December 2019–December 2022 (percent)

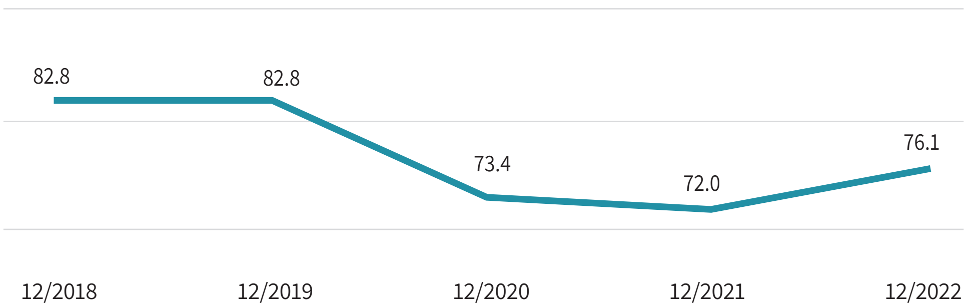


SOURCE: Based on published financial statements.

The total equity of the banking system also grew in 2022, by a rate of 13.1 percent. The accumulation of equity was the result of the high level of profitability among all the banks and the issue of shares to the public (by some of the banks), which was offset to some extent by the distribution of dividends (for further details, see Chapter 4)

There was an increase in the credit-to-deposits ratio against the background of a rapid increase in credit alongside a slowdown in the rate of increase in the public's deposits.

Figure 2.8 Ratio of Credit to the Public's Deposits, and Development of its Components Over Time, Total Banking System, 2016–September 2021 (percent)



SOURCE: Based on published financial statements.

4. MAIN DEVELOPMENTS IN OFF-BALANCE-SHEET ACTIVITY

In off-balance sheet items, total exposure due to transactions in off-balance-sheet financial instruments (whose denominated amount represents credit risk) grew at a rate of 2.5 percent (a low level relative to the years 2020–21, when the average annual rate of growth was 13 percent; Table 5). The main growth in off-balance-sheet liabilities was the result of guarantees to home buyers (Sales Law guarantees) and in other guarantees and liabilities. This occurred despite the not insignificant decline in nonrecourse obligations to provide credit that was approved but not yet provided, as well as overdraft facilities and other demand deposit credit lines that were not utilized (Table 5). Total guarantees to homebuyers grew by about 22.2 percent during the year (following an increase of 43 percent in 2021), which can be attributed to the level of new home purchases. However, note that despite the cumulative rate of increase during the year, there was a decline of 0.6 percent during the fourth quarter, reflecting the slowdown in home sales (for further details, see Chapter 5.2). The slowdown in the housing market can also be seen in the reduction of 13 percent in nonrecourse obligations to provide credit that was approved but not yet provided, which essentially reflects a reduction in total approvals in principle issued by the banks to the public (in contrast to an increase of 31 percent during 2021).

Other guarantees and liabilities grew during the year by about 25 percent (similar to the previous year). There was a reduction of 11.5 percent in overdraft facilities and other demand deposit credit lines that were not utilized, although this trends stems from a contraction in credit lines at a specific large bank in the system, based on its own business considerations. An analysis of this item, after adjusting for this bank, shows an increase of about 2 percent (about NIS 1.3 billion) in credit lines.

THE ECONOMIC STABILIZATION PROGRAM AS A TURNING POINT IN THE BANKING SYSTEM'S BALANCE-SHEET ACTIVITY

During the past 50 years, there have been a number of transformations in the character of the banking system's balance-sheet activity. The most significant of them can be attributed to changes in the extent to which the government and the Bank of Israel intervene in the economy. The turning point in this process was 1985, with the implementation of the Economic Stabilization Program.[4]

The banking system's balance-sheet activity: from the early 1970s to the mid-1980s

During the 1970s (and essentially during the two preceding decades as well), the banks had limited independence in the use of their shekel sources. This was due to the control by the government and other institutions of where credit went;[5] by limiting the quantity of nonearmarked credit (though the imposition of credit ceilings, among other things);[6] and by the high liquidity requirement set by the Bank of Israel.[7] During most of the 1970s, there was an acceleration in inflation, which was one of the main factors behind the expansion of banking system assets. Thus, from time to time the banking system was able to expand its nonearmarked intermediation activity to some extent.

Starting from the early 1980s, the inflation rate—which was already at a level of dozens of percent during the 1970s—continued to rise, reaching more than 100 percent annually (and a peak of 445 percent in 1984). Consequently, in the early 1980s the banking system

4 The goal of the program was to lower the inflation rate, balance the balance of payments, and stabilize the economic situation.

5 Whether by means of credit from earmarked deposits that were provided by deposits of the government, the Jewish Agency and other institutions or from deposits of the provident funds (that were directed primarily to the financing of services and public services) or by means of earmarked credit that was provided as part of the export funds and other financed funds, some of them financed by the banks' participation using their nonearmarked funds and also in the form of ease of liquidity requirements (credit that was provided in Israeli currency or foreign currency and was directed primarily toward industry and agriculture).

6 Credit over which the banks had relative discretion in deciding on terms, such as purpose, price and quantity.

7 In 1972, the liquidity ratio on checking deposits was raised from 67.5 percent to 72 percent and on savings deposits from 20 percent to 23 percent (as a result, the actual liquidity ratio rose from 33.7 percent to 39.8 percent). The liquidity ratio on deposits in saving plans ranged from 75 percent to 85 percent. During the 1970s, there were changes made periodically in the liquidity requirement, depending on the level of inflation and monetary policy measures; however, it remained high and had a major effect on the ability of the banks to expand their activity in nonearmarked financial intermediation.

managed to consistently increase the sources it could use according to its full discretion.[8] This facilitated a rapid increase in nonearmarked credit. The high level of inflation and the resulting uncertainty had a significant effect on the banking system's balance-sheet activity in 1984 (which was also the first year following the "bank shares crisis") and the growth in the banks' balance sheets was halted.

With respect to the trends in foreign currency activity in the banking system, 1971 was a turning point in the volume and character of this activity. Until that year, reparations from Germany constituted the main source for foreign currency deposits. From that year onward, the share of foreign resident deposits remained on an upward trend and similarly, deposits and loans from foreign banks became an increasingly important source of foreign currency for the banking system. Contributing to this trend were both internal and external factors: a period of calm in the security situation; a higher ceiling on the interest rate that can be paid on these deposits;[9] and the decline in the US interest rate.[10]

During the 1970s, the banks' activity in foreign currency further expanded, together with the scope of their activity abroad, which can be attributed to the exhaustion of possibilities in the domestic market and the government's encouragement of this activity (with the goal that the banks would become an additional source of foreign currency for the economy). In 1977, a reform was implemented in foreign currency policy (the "foreign currency liberalization") which led to a major expansion in the number of potential depositors in foreign currency deposits. In parallel, there was an increase in liquid foreign currency assets, primarily due to their high rate of liquidity.[11] However, the Israeli economy's image became tarnished in 1984, which led to a halt in the growth of foreign resident foreign currency deposits and in the deposits of foreign banks.

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8 The banks' nonearmarked sources were dependent at that time on a number of factors: (1) the activity of the banks to attract deposits and capital from the public, which involved a major effort invested by the banks in both marketing, and regulation of the secondary market for their shares held by the public and ensuring a high return on them; (2) the conduct of the public and its preferences with regard to holding financial assets; (3) the government and the Bank of Israel which inject or absorb liquidity, thus determining the amount of money in the hands of the public (and in turn the public's ability to provide liquidity to the banking system), while at the same time determining the quantity of nonearmarked sources by means of regulating the liquidity that remains with the banks from the money deposited by the public with the banks.

9 Up until April 1970, Israeli banks were permitted to pay a maximum interest rate of 7 percent on nonearmarked deposits (without any connection to the size of the deposit or its term). During certain periods, this ceiling was lower than the interest rate prevailing in the euro-dollar market. The regulations were changed in April 1970 and the interest rate ceiling was set according to the size of the deposit: 7.0 percent on a deposit of up to $25,000, which rose by 0.5 percentage points for every increase of $25,000. The ceiling was set at 8.5 percent above $100,000.

10 This led to a flow of dollars out of the US to markets with a higher yield and it may be assumed that some of those dollars made their way to Israeli banks.

11 The liquidity ratio on foreign currency deposits in that period was 100 percent on reparations deposits, 90 percent on a local resident checking account, 80 percent on a local resident fixed-term deposit, and 10 percent on a nonresident deposit.

The Economic Stabilization Program and its effect on the banking system's balance-sheet activity

The Economic Stabilization Program in 1985 had a major impact on the banking system. The program, the implementation of which began in July of that year, led to a decline in inflation from an annual level of 381 percent to only 37 percent during the last five months of the year. This was accomplished by a contractionary budget policy, a restrictive monetary policy (which began already at the beginning of 1984 and included, among other things, a lower liquidity requirement imposed on all intermediation sectors),[12] stabilization of the shekel-dollar exchange rate and a price freeze on goods and services. These processes, together with liberalization measures carried out by the government and the Bank of Israel in the financial and capital markets with the goal of reducing their intervention in that market and the effect of the aforementioned on the public's preferences,[13] as well as actions taken by the banks (among others, marketing efforts and increasing competition among the banks over sources and uses), led to a consistent increase in the share of nonearmarked financial intermediation (Figure 2.9). Thus, a process began during those years to remove longstanding barriers between the various intermediation sectors.

The aforementioned measures and the reduced involvement of the government in setting the conditions for banking activity were accompanied by two additional outcomes during the years following the implementation of the program:

1. An increase in competition (among the banks themselves and between the banks and entities outside the banking system both in Israel and abroad);[14]

2. A reduction in the weight of the banking system within total economic activity.[15]

[12] During that period, there was a shift in the implementation of monetary policy: from intervention by way of the interest rate (on credit provided through credit lines, etc.) to intervention by means of quantities (by way of activity in the open market using *Makam* and monetary tenders).

[13] The increased supply of unindexed shekel deposits (as a result of the drop in inflation and its volatility, the economic recovery and the drop in expected yields on dollar-indexed assets as a result of the maintenance of a stable exchange rate) and the increased demand for unindexed credit (due to causes similar in character to those responsible for the increase in the supply of unindexed shekel deposits), in addition to the entry of relatively small customers (households and small businesses) as recipients of this credit, access to which was limited in the past.

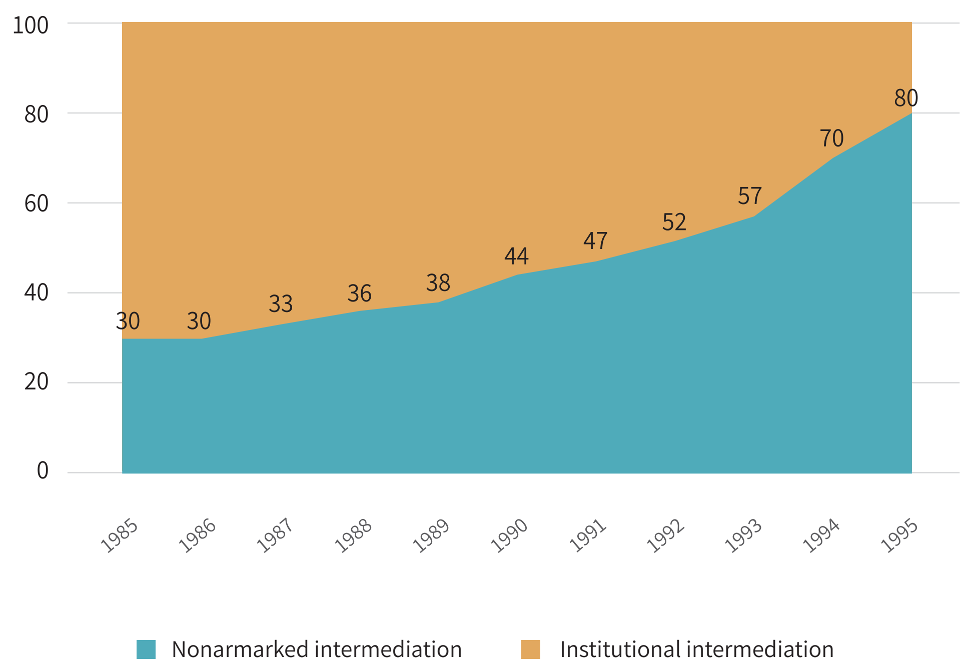
[14] The main indicators of which are the following: (1) the decline in interest rates together with the narrowing of interest rate gaps and spreads in all of the nonearmarked activity segments, primarily due to the higher elasticity in the demand curve for nonearmarked credit; (2) less variation across the banks in the interest rate charged on credit, an indication of, among other things, greater mobility of customers between banks and a reduction in the banks' market power; and (3) accelerated growth in the variety of goods and services, an improvement in their quality and greater expenditure on advertising.

[15] This was a reflected primarily in: (1) a decline in the ratio of the banking system's balance sheet to GDP and (2) a decline in the ratio of the public's assets at the banks to the total portfolio of the public's financial assets.

This turning point in the bank's balance-sheet activity enhanced the activity in the financial and capital markets and in particular the ability of the banks to operate freely as financial intermediaries, in addition to improving the allocation of sources and uses in the economy. Alongside the many advantages from reducing the involvement of the government and the Bank of Israel in the financial markets, the banking system now faced new risks that required it to develop and improve its risk management.

Following the implementation of the Economic Stability Program in 1985, there was a constant increase in the banking system's nonearmarked financial intermediation.

Figure 2.9 Distribution of Nonearmarked and Institutional Financial Intermediation by Total Banking Corporation Assets, 1985–1995 (percent)



SOURCE: Based on banks' reports to the Banking Supervision Department.