

## *Chapter 4*

# *The Main Companies in which the Five Major Banks Have a Holding*

The five major banking groups have many subsidiaries; the extent of their investment in them is massive and the subsidiaries' contribution to the banks' income is substantial. The main areas of activity of the subsidiaries are mortgages, activities abroad, and holdings in nonfinancial companies. Investment in subsidiaries yielded an income of some NIS 1.7 billion in 2000, constituting a return of 8.0 percent, the same as the rate in 1999. This income, which was slightly higher than in 1999, derived primarily from the continued rise in profitability of the mortgage banks, as well as from the increased local-currency contribution of the subsidiaries abroad, even though in dollar terms the profitability of the latter plummeted. By contrast, the contribution of the nonfinancial and insurance companies to the groups' profitability declined.

As in previous years, the mortgage banks were very profitable in 2000, and their net income rose by 11 percent. Nevertheless, the business environment in which the mortgage banks function became more risky because of the economic slowdown, especially in construction.

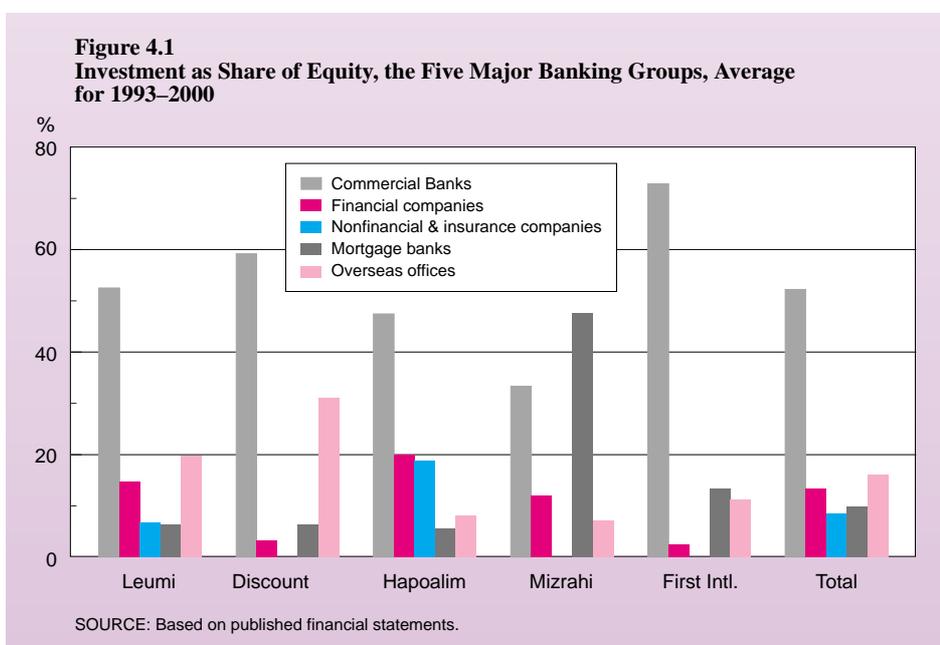
In local-currency terms the income of the overseas offices rose in 2000, (after conversions and accounting adjustments), but investments in subsidiaries abroad were characterized by a relatively low return. In dollar terms, income declined by a substantial 19 percent, because of an event in the Bank Leumi-Switzerland. Deducting the losses due to that incident, the dollar income of the overseas offices rose.

In contrast with the increased contribution to income of the mortgage banks and overseas offices, that of the nonfinancial companies declined in 2000. Most of this derived from Hapoalim Bank's losses on Koor, the result of the losses incurred by ECI Telecom Ltd.

## 1. INTRODUCTION

This chapter focuses on analyzing the main subsidiaries, in Israel and abroad, of the five major banks heading the groups. These companies account for 93 percent of the banks' total investments in subsidiaries.<sup>1</sup>

Most of the investment in subsidiaries in Israel is in commercial banks, mortgage banks, and other specialized banks. The banks also hold companies which operate in areas similar or supplementary to banking intermediation, such as financial leasing, credit card companies, and capital-market companies (Figure 4.3).<sup>2</sup> The banks have additional holdings that are not usually connected with their financial activities, including those in nonfinancial companies (e.g., Koor and The Israel Corporation Ltd.), insurance companies (e.g., Klal Insurance), etc. Most investment in companies held abroad is in financial companies and local commercial banks.



The first part of the chapter examines the contribution of the subsidiaries to the income of the five major banks, by main area of activity. The second part contains an extensive analysis of the performance of the mortgage banks, which are the main source of income of the banking companies that hold them. The third part of the chapter consists of an analysis of the financial activities and results of the overseas offices.

<sup>1</sup> Main subsidiaries are companies which, in the view of the management of a bank, have a substantial effect on its activity and financial results, or in which at least 1 percent of equity is invested, or whose contribution to the bank's net profit or loss from ordinary pre-tax activities is more than 5 percent of its net profit or loss from these activities.

<sup>2</sup> Managing mutual and provident funds, underwriting, and managing investment portfolios.

The *mortgage banks* continued to display a high level of profitability in 2000, as they had in previous years, due largely to an increase in both net interest income and net non-interest income. However, the business environment in which the mortgage banks operate became more risky in 2000 because of the recession; this was expressed in a rise in balances in arrears, ongoing expenditure on loan-loss provision vis-à-vis home-buyers, and in the ratio of both of these to credit.

The contribution of the *subsidiaries abroad* (after adjustments and conversions into NIS) to the income of the banks holding them depends to a great extent on changes in the NIS exchange rate against the dollar and the principal European currencies (Figure 4.11). In 2000 the NIS contribution of the subsidiaries abroad increased, but in dollar terms it declined. This is explained by the extensive provision made by Bank Leumi-Switzerland due to the suspicion that one of its employees acted improperly with regard to customers' accounts. When the figures regarding Bank Leumi-Switzerland are deducted, the subsidiaries' profitability increased as a result of the expansion of banking activity.

## 2. COMPANIES IN WHICH BANKS HAVE A HOLDING: GENERAL<sup>3</sup>

The balance of the investment of the five major banks in subsidiaries amounted to some NIS 23 billion at the end of 2000, up by about NIS 2 billion over 1999. The net income deriving from this investment was NIS 1.7 billion, up by 10 percent over 1999 (Table 4.1). The average return on this investment was 8.0 percent, similar to its rate in 1999. In 2000 this accounted for 64 percent of the equity of the five major banks, but generated only 49 percent of their net income. The main reason for this was the extensive investment in overseas offices, whose income and return were relatively low (Table 4.2).

The range of holdings in nonbank financial companies enables the large banks to engage in universal banking, i.e., classic financial intermediation, which incorporates most financial activities, while utilizing economies of scope: alongside financial intermediation activities, the banks engage in capital-market activities, brokerage, securities custodianship (via the banks), portfolio management, administration of mutual and provident funds, underwriting, and investment banking via subsidiaries. Within the framework of advising large customers, they offer them a wide range of financial tools.<sup>4</sup> In addition, they are penetrating more deeply into the insurance market, which they regard as complementary to commercial banking.<sup>5</sup> In order to diversify their sources of

<sup>3</sup> Accounting practice makes a distinction between consolidated companies and companies included under an equity method (unconsolidated subsidiaries and affiliates). The first category is defined as such because the holding in these companies is less than the minimum required for consolidation in the financial statement, or because it is a financial company.

<sup>4</sup> A consortium, together with foreign banks, for financial and operational leasing, consultancy on the process of underwriting and issuing securities, etc.

<sup>5</sup> To date, the utilization of economies of scope in these areas has been possible for banks only by means of their holdings in insurance companies within the framework of nonfinancial holdings, the permissible rate of holding in which is subject to restrictions. The banks would like to engage in this sphere directly (primarily selling life-insurance policies) via the branches.



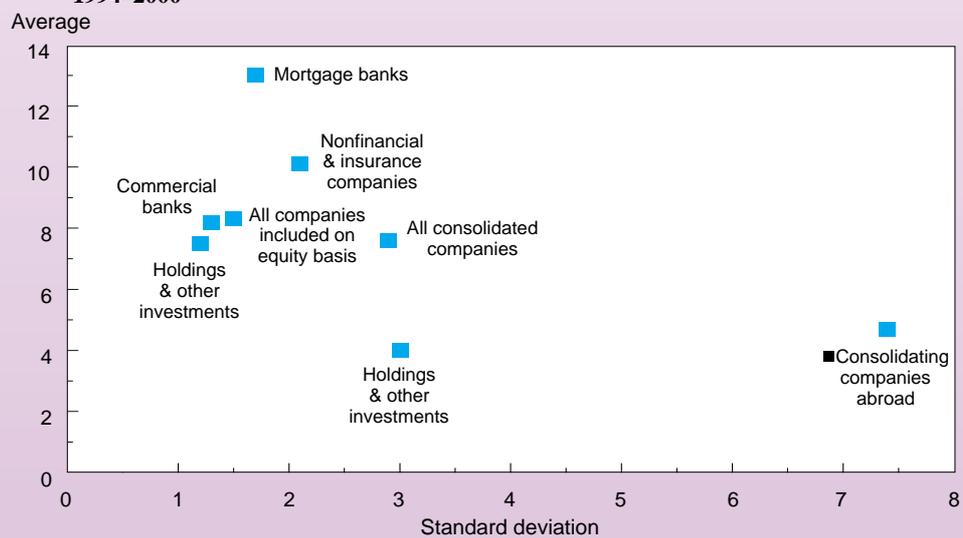
**Table 4.1 (continued)**

	First International				Total			
	NIS million		Percent		NIS million		Percent	
	Book value of investment	Contribution to net income	Yield on investment	Investment/ equity	Book value of investment	Contribution to net income	Yield on investment	Investment/ equity
In commercial banks	87	17	19.5	3.2	2,408	226	9.4	7.5
In mortgage banks	328	40	12.2	12.0	3,696	438	11.9	11.6
In nonfinancial and insurance companies, holdings, investments, and others <sup>c</sup>	-102	62	-60.8	-3.7	7,551	642	8.5	23.6
In banking and financial companies abroad	333	0	0.0	12.2	5,118	264	5.2	16.0
<b>Total in main subsidiaries and affiliates</b>	<b>646</b>	<b>119</b>	<b>18.4</b>	<b>23.6</b>	<b>18,773</b>	<b>1,524</b>	<b>8.1</b>	<b>58.7</b>
Not in main investments <sup>e</sup>	247	-55.0	-	9.0	2,812	156	5.5	8.8
In parent bank (solo) <sup>f</sup>	1,847	250	13.5	67.4	12,647	1,799	14.2	39.5
Balance of equity; total net income <sup>g</sup>	2,740	314	11.5	100.0	31,984	3,479	10.9	107.0

<sup>a</sup> Value of investment at beginning of year. See footnotes to Table 4.1.

SOURCE: Published financial statements.

**Figure 4.2**  
Average Yield vis-a-vis Standard Deviation in Main Companies Held by Banks,  
1994–2000



SOURCE: Based on published financial statements.

income from nonfinancial areas, the banks have invested in large nonfinancial companies, but restrictions have been imposed on such holdings, as regards both the ratio of the investment to equity and its extent.

Below we give a brief analysis of the return on investment in the main subsidiaries, dividing them into consolidated companies and companies included under an equity method (unconsolidated subsidiaries and affiliates).

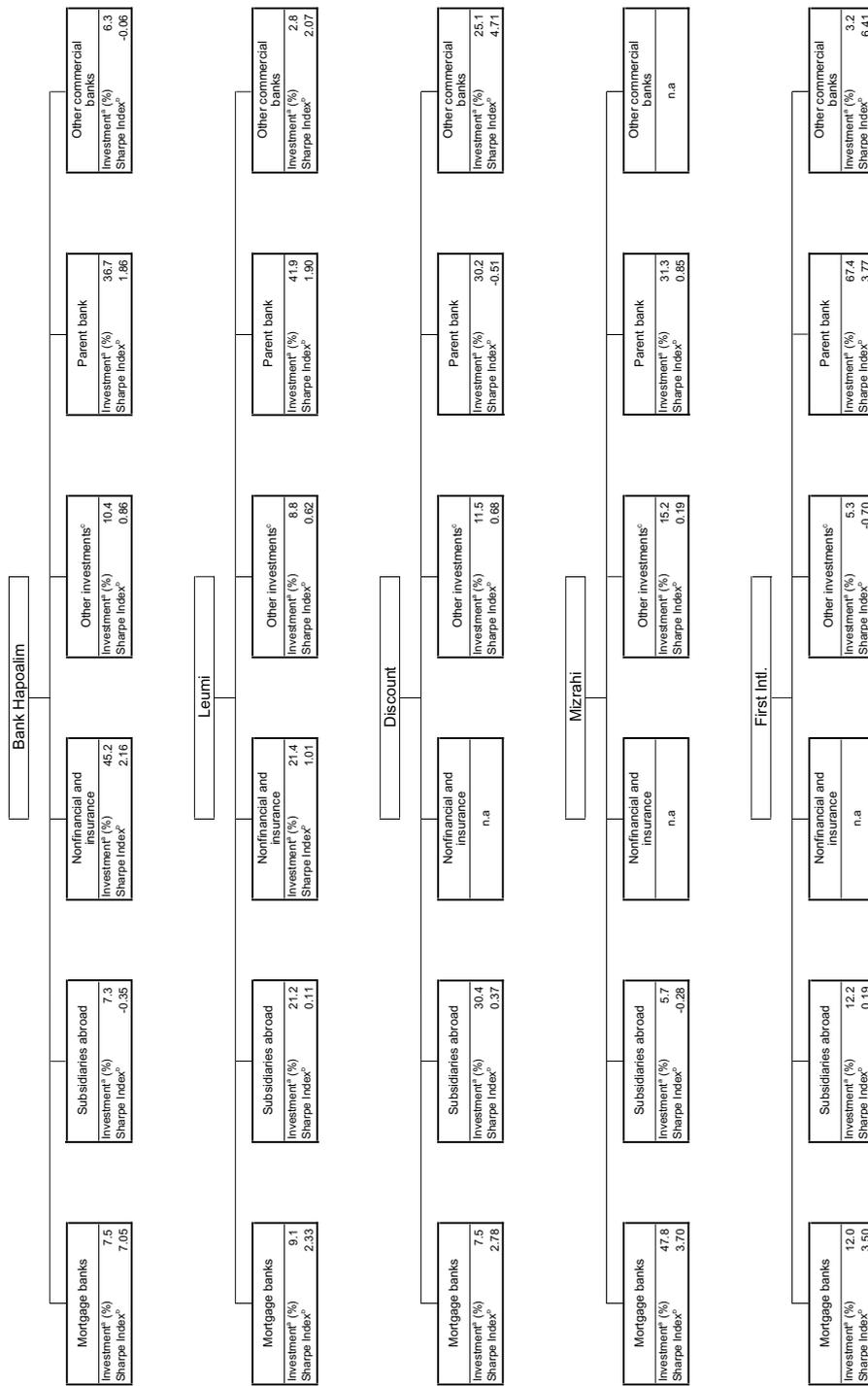
#### **a. Main subsidiary and affiliated companies**

Investment in main consolidated subsidiaries amounted to NIS 16.6 billion in 2000,<sup>6</sup> up by 7 percent over 1999. Net income from these holdings was NIS 1.3 billion—a relatively low return of 8.4 percent, reflecting the banks' consistently low return on their investment in subsidiaries and financial companies abroad (Table 4.2, Figure 4.2). By contrast, investment in subsidiaries in Israel, whether commercial or in the mortgage industry, has yielded consistently high average returns. The high ratio of average return to standard deviation<sup>7</sup> in subsidiaries in Israel indicates a high level of long-term risk-adjusted profitability. In 2000 there was a general improvement in income due to holdings of main consolidated companies in all the spheres of the banking industry. The highest

<sup>6</sup> In the year reviewed the investment in and income from the Tarshish company and Bank Otsar Hahayal are included under investment in main consolidated subsidiaries (Table 4.2).

<sup>7</sup> This relation, which is a pure number independent of criterion, is obtained by dividing the average by the standard deviation. A high ratio denotes a good investment with a low risk level.

**Figure 4.3**  
**Activities of Companies Held by the Five Major Banking Groups, 1993–2000**



<sup>a</sup> Percentage of equity invested.

<sup>b</sup> This index is defined as the surplus risk-adjusted return on a sphere of activity:  $S_i = \frac{R_i - R_f}{\sigma_i}$ , where  $S_i$  is the Sharpe Index of activity  $i$ ,  $R_i$  is the real average return on investment in activity  $i$ ,  $R_f$  is the average real riskless interest rate for the period, and  $\sigma_i$  is the standard deviation of the return in the field of activity  $i$ . This index is best suited for measuring performance in a well-diversified portfolio.

<sup>c</sup> Including 'Holdings, investments, and others' as well as other investments not included in Note 6 of the financial statement.  
 SOURCE: Based on published financial statements.

**Table 4.2**  
**The Return and Investment of the Five Major Banking Groups in Companies Held by Them, 1994–2000**

	Book value		Contribution to net income <sup>a</sup>				Return (%)			Return (%)		
	(NIS mill., end-year)		(NIS mill.)		Composition (%)		1999–2000		1994–2000		Mean/ S.D. <sup>b</sup>	
	1998	1999	2000	1999	2000	1999	2000	1999	2000	Average		Standard deviation
<b>Main consolidated subsidiaries</b>												
Commercial banks	1,469	1,587	1,945	135	157	8.3	8.3	9.2	9.9	8.2	1.3	6.5
Mortgage banks	3,426	3,696	3,995	394	438	17.1	17.1	11.5	11.9	13.0	1.7	7.8
Holdings, investments, and others <sup>c</sup>	5,132	5,147	5,370	281	440	23.0	23.0	5.5	8.5	8.5	2.6	3.2
Subsidiaries and financial companies abroad	5,176	5,118	5,335	204	264	22.8	22.8	3.9	5.2	5.1	7.2	0.7
<b>Total consolidated subsidiaries</b>	<b>15,203</b>	<b>15,548</b>	<b>16,645</b>	<b>1,014</b>	<b>1,299</b>	<b>71.2</b>	<b>71.2</b>	<b>6.7</b>	<b>8.4</b>	<b>7.9</b>	<b>2.7</b>	<b>3.0</b>
<b>Unconsolidated subsidiaries</b>												
Commercial banks	784	821	780	53	69	3.3	3.3	6.8	8.4	8.0	0.7	11.4
Nonfinancial and insurance companies <sup>d</sup>	1,792	1,766	1,708	305	176	7.3	7.3	17.0	10.0	11.2	2.8	3.9
Holdings, investments, and others (including abroad) <sup>e</sup>	655	638	562	19	26	2.4	2.4	2.9	4.1	5.5	4.5	1.2

**Table 4.2 (continued)**

	Book value		Contribution		Return (%)				
	(NIS mill., end-year)		to net income <sup>a</sup>		(1994–2000)				
	1998	2000	1999	2000	1999	2000			
<b>Total unconsolidated subsidiaries (in Israel &amp; abroad)</b>	<b>3,231</b>	<b>3,050</b>	<b>377</b>	<b>271</b>	<b>11.7</b>	<b>8.4</b>	<b>9.3</b>	<b>1.2</b>	<b>8.0</b>
Total main subsidiaries	18,434	18,773	1,391	1,570	7.5	8.4	8.3	1.8	4.5
Other companies <sup>e</sup>	1,176	2,812	166	156	14.1	5.5			
Total subsidiaries	19,610	21,585	1,557	1,726	7.9	8.0	8.5	1.6	5.3
Parent bank (solo) <sup>f</sup>	12,371	12,647	1,812	1,799	14.6	14.2	10.8	2.1	5.1

<sup>a</sup> Only ordinary income is included in income, while dividends and proceeds from the sale of excess holdings are not.

<sup>b</sup> Average yield *divided* by the standard deviation measures the risk-adjusted yield on investment.

<sup>c</sup> Holdings, investments, and others' comprises merchant banks, investment finance banks, and capital market companies (for underwriting and management), as well as credit card and leasing companies.

<sup>d</sup> The yield on investments in these companies is biased downwards because the investment in nonbanking institutions does not require a minimum capital ratio, and hence all the capital invested in them may be used for profitable banking activity, which is not taken into account in the above yield.

<sup>e</sup> Subsidiaries not specified as main in note number 6 of the financial statement.

<sup>f</sup> The investment in the parent bank is derived by deducting investment in subsidiaries, at its balance-sheet value, from total equity, and differs from the definition of equity for the purposes of calculating section 23a in the Banking (Licensing) Law. The contribution to the parent bank's net income is calculated as net ordinary after-tax income, on a bank basis. This constitutes a bank's ordinary after-tax income *less* its net share in the ordinary income of all its subsidiaries.

SOURCE: Published financial statements.

return was yielded by investment in mortgage banks which, despite the slump in the real-estate market, now in its fifth consecutive year, yielded a return of 11.9 percent. The high level of profitability in the mortgage industry caused commercial banks that do not have subsidiaries in the mortgage industry to enter that sphere.<sup>8</sup> The balance of investment in this industry rose from NIS 3.7 billion in 1999 to some NIS 4 billion in 2000. The holding in the small commercial banks also yielded a high return, and the balance of investment in it rose.<sup>9</sup>

The predominant group of investments in bank holdings is that in financial companies, and is dispersed between companies operating in the capital market, credit card companies, mutual funds, and provident funds. The investment in these companies yielded an average return of 7.2 percent in 2000, similar to that in the last decade. Note that some of these companies also contribute indirectly to the banks' income due to the commissions they charge for their activities in the capital market and the income on deposits some of them hold with them.

#### **b. Main companies included on an equity basis**

The balance of investment in main companies included on an equity basis amounted to NIS 3.0 billion in 2000, compared with NIS 3.2 billion in 1999. Some of the decline is technical (see note 3), while the rest derives from the reduction of investment in subsidiaries abroad. Net income from these investments amounted to NIS 277 million in 2000 and the return on them was 8.6 percent, compared with 10.6 percent in 1999. Most of the decline is explained by the crisis in the high-tech industry that emerged in 2000:IV, cutting NIS 250 million from Koor's income.<sup>10</sup> During 2001:I this trend intensified, and Koor recorded an additional loss of about NIS 1 billion, which deducted NIS 111 million from Bank Hapoalim's income.

The high growth rates of the nonfinancial companies and the sales of these excess holdings at high prices yielded large profits; consequently, the nonfinancial companies still constitute an investment target for the banks, and in the next few years these holdings are expected to rise.

<sup>8</sup> The sale of the control core of Carmel Bank aroused interest from several commercial banks; see also note 28 below.

<sup>9</sup> Mainly due to the change in the classification of Bank Otsar Hahayal. At the intermediate stage before it was sold, Bank Hapoalim was allowed to increase its holdings in it to 69 percent for a limited period, as a result of which the financial statements of Otsar Hahayal were combined with the consolidated statements of Bank Hapoalim. Total investment under this rubric amounted to NIS 2 billion in 2000, and yielded a return of 10 percent.

<sup>10</sup> The contribution of Koor holdings to the net income of Bank Hapoalim amounted to NIS 57 million in 2000, compared with NIS 128 million in 1999. The main reason for this was the losses incurred by ECI Telecom Ltd. (a subsidiary of Koor). As a result of the fall in Koor's capital, the Hapoalim group held 21 percent of its capital. Bank Hapoalim's investment in Koor amounted to NIS 871 million at the end of the year.

**Table 4.3**  
**Characteristics of the Housing Industry, 1996–2000**

	1996	1997	1998	1999	2000	Real change (%) 2000
Total area ( <i>mill. sq. m.</i> )	21.2	19.4	17.6	16.7	17.2	3.0
<i>of which</i> Residential	14.3	12.8	12.0	11.5	12.3	7.0
Housing units	106,194	92,702	83,923	76,642	80,989	5.7
<i>of which</i> Government-initiated	39,700	34,050	27,341	20,042	24,166	20.6
Building starts	58,428	52,936	43,911	38,459	46,409	20.7
Total completions	52,548	67,198	53,067	45,423	41,796	-8.0
<i>of which</i> Government-initiated	16,091	22,539	17,612	16,616	10,043	-39.6
Sales of new units	n.a	n.a	14,827	14,240	13,963	-1.9
Sale of land for construction ( <i>units</i> ) <sup>a</sup>	36,570	41,370	31,390	33,544	24,447	-27.1
Total cement sales ( <i>mill. tons</i> )	5.652	5.519	5.087	4.841	4.502	-7.0
Construction investment/GDP (%)	13.4	13.1	11.7	9.9	8.6	-13.1
Construction employment/ total employment (%)	11.1	11.3	10.8	10.0	9.1	-9.0
Change in adjusted housing index <sup>b</sup> (%)	2.7	0.2	-0.7	-3.2		-100.0
No. of real-estate transactions <sup>c</sup>	117,780	96,643	88,674	101,452	95,610	-5.8
Transactions by eligible persons/total transactions (%)	47.0	47.0	47.0	40.0	40.0	0.0
<b>Housing loans taken</b>						
Total by eligible persons	54,962	45,578	41,062	40,241	38,516	-4.3
<i>of which</i> New immigrants	21,365	14,802	9,987	9,772	9,004	-7.9
Young couples	27,015	25,455	26,101	23,619	21,936	-7.1
Total no. of new immigrants	70,919	66,221	56,726	76,766	60,130	-21.7

<sup>a</sup> In terms of housing units; in all frameworks. The data refer to land for construction sold by the Ministry of Construction and Housing, and the Israel Lands Administration, at public auctions and in other frameworks authorized by the Israel Lands Administration.

<sup>b</sup> Change in housing price index adjusted by CPI. As of January 1999 the price index of owner-occupied housing is calculated by a new method, the owner-occupied housing services index, based on the opportunity cost of rent.

<sup>c</sup> Number of real-estate transactions implemented, before property tax.

SOURCE: Ministry of Construction and Housing, *Monthly Information*, March 2001.

### 3. MORTGAGE BANKS

#### a. The activities of the mortgage banks<sup>11</sup>

##### (i) Uses

*Total performance:* the extent of activity (new credit extended) during the year reviewed, financial results, and the risk exposure of the mortgage banks are affected by the level of activity in the construction industry and the real-estate market as well as by the general economic situation. In 2000 the slowdown in construction persisted, as expressed in home-buyers' demand for credit. New credit extended during 2000 was down by 3.2 percent from 1999, amounting to NIS 22.7 billion and affecting most kinds of current activity (Table 4.5). Nevertheless, it is difficult to compare the data with that from 1999 because that year deviated from the downward trend evident in the industry since 1996: changes in legislation that were due to go into effect in 2000 led many consumers to bring transactions forward to 1999.<sup>12</sup>

The level of activity in 2000 was significantly below that of the peak years (1994–96). This year, too, the long-term trend of the decline in the share of directed credit in the total credit extended by the mortgage banks persisted. In distribution by uses, there was a sharp rise in credit to contractors (61 percent), apparently in the context of the increased number of building starts, and developers' and contractors' expectations that demand would revive. The rise in the stock of unsold units may have served to increase the demand for credit. The surge in issues, both on and off the stock market (particularly in the first half of the year), did not include construction companies. The slump in the industry (slower sales of units and a real drop in their prices) makes it more difficult for construction companies to raise capital on the primary market, and hence they depend more on bank finance. On the other hand, the mortgage banks want to supply credit to contractors in order to vary their uses, especially as regards the time-frame and indexation base.<sup>13</sup> Project financing also gives the mortgage banks access to home-purchasers in order to offer additional mortgages.

In 2000 the declining trend in the share of directed credit and the rise in that of nondirected credit, which constitutes 80 percent of credit extended during the year (Table

<sup>11</sup> The analysis encompasses the activity and profitability of the eight mortgage banks and the Bank of Jerusalem, which is a commercial bank but most of its activity is concentrated in the field of mortgages.

<sup>12</sup> The main changes were the imposition of sales tax of 0.8 percent on new units, and changes in purchase tax rates, primarily regarding persons buying a second apartment, nonresidents, and buyers of luxury homes. The change in taxation, despite its implications regarding new units, increased uncertainty in the market and led the public to hasten to implement transactions involving second-hand properties too. Apprehensions regarding possible changes in the land improvement tax worked in the same direction, especially for persons owning more than one apartment. In addition, fears of the repercussions of an inheritance tax and a gift tax led the ownership of apartments to be transferred from parents to children. The Ministry of Construction and Housing estimated that the extent of unrequited transfers rose by about 50 percent in the last few months of 1999.

<sup>13</sup> Most of the credit extended to contractors is unindexed and denominated in foreign currency, which has a larger margin than the indexed segment. The indexed share is extended on average for shorter periods (three and a half years) and its cost is 1.25 times higher than that of credit to home-buyers. Despite the steep rise in credit to contractors, in most banks the share of the indebtedness of the construction industry in total indebtedness of the public was significantly below the level requiring additional loan-loss provision.

4.8), continued. With regard to the part used as credit for housing, it was found that the average loan (for all transactions) was NIS 225,000 in 2000,<sup>14</sup> compared with NIS 93,000 in 1996 (the end of the positive cycle in the industry). This rise might be due to a change in the mix of borrowers: more transactions for the purchase of large apartments to improve living conditions in the center of the country and fewer transactions involving eligible persons, which are characterized by purchases of smaller apartments.

The rising trend in the share of unindexed credit<sup>15</sup> persisted in 2000, too. Nonetheless, its share is still relatively small, and at the end of December current credit extended for the year amounted to 7 percent<sup>16</sup> compared with 4.5 and 4.3 percent in 1999 and 1998 respectively. The mortgage banks want to develop this segment, mainly because of the high margin (relative to the indexed segment, see Table 4.8). Its development is also fostered by the demand side, as wealthier customers seek to diversify their investment portfolios with unindexed loans. Part of the demand derives from the slump in the housing market, creating a need for bridging credit, which is generally short-term. The benefits to customers of these loans as currently offered, in comparison with the indexed alternative, are the absence of indexation of the outstanding amount and of an early repayment fee. On the other hand, the monthly payment is higher (the interest ranges from a level of Prime *less* 0.5 percent to Prime *plus* 1.5 percent). In 2000 credit extended was up by 54 percent over 1999. Several banks offer long-term mortgages indexed to Prime using short-term unindexed sources, and the development of this segment could partly solve the problem of sources in the indexed segment. Despite considerable excess unindexed (short-term) sources in the banking system, and the easy access of the mortgage banks to sources indexed to Prime,<sup>17</sup> there is interest-rate risk in channeling unindexed credit to the long term, because of the short duration on the sources side.

In 2001 one of the mortgage banks began offering long-term unindexed credit at fixed interest,<sup>18</sup> which is an innovation in the mortgage market. The development of the unindexed local-currency segment is made possible by the reduction of local-currency interest in the last two years, the government's borrowing policy—which consists almost entirely of issuing unindexed long-term bonds—and successful issues of unindexed

<sup>14</sup> Over the years it is possible to discern a continuous upward trend in the quality of construction, a development that increases the cost of average apartment. Between 1997 and 2000 the average loan (non-directed credit) rose by a real 33 percent, while apartment prices fell by 4 percent in real terms.

<sup>15</sup> The banks are currently offering two main alternatives regarding unindexed local-currency credit: 1. 'bullet' loans for short terms at prime indexed interest with the option of transferring to any other alternative without incurring an early repayment fee; 2. Prime-indexed mortgages for long terms. The mortgage banks also offer mortgages at variable interest to Libor.

<sup>16</sup> The figures below regarding outstanding unindexed credit are biased downward because not all the mortgage banks report to the Bank of Israel on this area of activity. Regulation no. 877 requires reporting on unindexed activity only if it is substantial, but a regulation is currently being prepared which will make reporting obligatory regarding all mortgage activity, irrespective of how substantial it is.

<sup>17</sup> Most of the mortgage banks are entitled to accept local-currency deposits from the public, but only three banks do so.

<sup>18</sup> The credit is offered for seven years at a fixed rate (8.7 percent). The principal is to be repaid at the end of the period, but the customer is offered the opportunity of repaying it over an additional period of up to 13 years (in a brief procedure that converts the loan into one that is indexed to either the CPI or the dollar). During the additional period the loan is repaid in monthly payments of principal and interest. The sources for this credit came from successful issues (NIS 100 million) of unindexed 7-year bonds at a fixed annual interest rate of 7.75 percent.

**Table 4.4**  
**Principal Data on the Mortgage Banks, 1995–2000**

	1995	1996	1997	1998	1999	2000
Nondirected credit extended during year (NIS million)	16,206	16,960	17,302	15,387	16,742	15,943
of which Housing	13,757	14,931	15,619	13,609	14,602	14,252
At variable interest (percent)	17.8	38.8	37.3	40.8	42.5	28.9
Credit at variable interest		5,404	8,841	10,959	16,224	18,047
Renewed credit at variable interest			3,093	5,067	9,189	13,455
Average loan size incl. directed credit	193,000	193,000	200,000	206,000	218,000	225,000
Average loan size (non-directed credit)			187,764	219,693	248,349	250,252
Average period of non-directed housing credit	13.0	10.5	10.7	10.6	10.4	12.4
Average interest on non-directed housing credit (percent)	5.24	5.45	5.04	5.97	6.33	6.51
No. of housing loans	107,132	113,583	104,250	88,788	90,850	84,150
Value added per employee post <sup>a</sup> (NIS '000s)	559	666	720	630	670	764
<i>Percent</i>						
Return on equity (ROE) <sup>b</sup>	12.6	13.5	13.4	9.4	11.2	11.6
Efficiency ratio <sup>c</sup>	2.28	2.41	2.45	2.35	2.45	2.57
Operating expenses/assets <sup>d</sup>	1.16	1.03	0.97	0.90	0.86	0.79
Marginal interest-rate spread <sup>e</sup>	0.69	0.67	0.57	0.45	0.25	0.03
Margin on active assets	1.16	1.12	1.16	0.98	1.01	1.00
Duration gap <sup>f</sup>		1.5	1.5	1.3	1.2	1.3

**Table 4.4 (continued)**

	1995	1996	1997	1998	1999	2000
Specific loan-loss provision ( <i>percent</i> )	0.19	0.15	0.19	0.25	0.24	0.20
Total accrued home-buyers' arrears ( <i>NIS mill.</i> )	613	672	490	556	658	744
of which Above 180 days	581	620	451	508	608	696
Total arrears/total outstanding credits <sup>e</sup> ( <i>percent</i> )	1.26	1.25	1.19	1.28	1.45	1.48
of which Home-buyers	0.77	0.74	0.77	0.8	0.87	0.91
Contractors and construction companies	3.76	6.43	7.28	11.19	17.65	16.37
Others	5.1	4.32	2.91	2.78	2.85	3.01
Total arrears/end-period capital ( <i>percent</i> )	32.3	32.6	30.8	33.6	37.7	38.1
Weighted equity	2,920	3,366	3,925	4,420	4,620	4,973
Risk-based capital ratio <sup>h</sup>	11.9	12.0	12.0	10.6	10.6	10.2
Tier 2 capital/Tier 1 capital ( <i>max. 50 percent</i> )	24.9	32.7	35.6	40.1	42.2	37.7

<sup>a</sup> Value added per employee post is calculated from ordinary before-tax income *plus* salaries and related expenses, as well as expenses due to amortization and deductions *divided by* the average number of posts.

<sup>b</sup> Ratio of net income to capital at the beginning of the year, *plus* offerings weighted by date of issue.

<sup>c</sup> Ratio of total non-interest income *plus* net interest income before loan-loss provision to operating expenses.

<sup>d</sup> Ratio of total operating expenses to total assets.

<sup>e</sup> The difference between nondirected indexed credit for housing and deposits of the public at banks received during the year.

<sup>f</sup> The weighted gap between the duration of assets and the duration of liabilities in terms of years.

<sup>g</sup> Arrears accrued for more than 3 months (including loan-loss provision) *divided by* the end-year credit balance.

<sup>h</sup> Reclassified.

<sup>i</sup> Approved.

SOURCE: Returns to Supervisor of Banks.

**Table 4.5**  
**Loans Extended and Sources Raised by the Mortgage Banks, 1997-2000**

	Loans extended (NIS million) <sup>a</sup>			Real year-on- year change (%)		Distribution (%)			
	1997	1998	1999	2000	1998	1999	1998	1999	2000
<b>Loans extended</b>									
Total credit extended during the year	24,746	21,553	23,436	22,690	8.7	-3.2	100	100	100
<i>of which</i> To home-buyers	20,834	18,321	19,835	18,904	8.3	-4.7	85	85	83
Directed	5,215	4,712	5,232	4,652	11.0	-11.1	22	22	21
Nondirected	15,619	13,609	14,602	14,252	7.3	-2.4	63	62	63
To contractors and construction companies	1,469	896	856	1,382	-4.5	61.4	4	4	6
Other	2,443	2,337	2,746	2,405	17.5	-12.4	11	12	11
<b>Sources raised</b>									
Total indexed sources raised <sup>b</sup>	16,703	16,672	20,578	19,700	23.4	-4.3	100	100	100
<i>of which</i> Deposits of the public	8,884	8,143	8,354	6,514	2.6	-22.0	49	41	33
Deposits from banks	7,819	8,529	12,224	13,186	43.3	7.9	51	59	67
Difference between non- directed credit and deposits	2,828	170	-2,374	-1,661		-30.0			

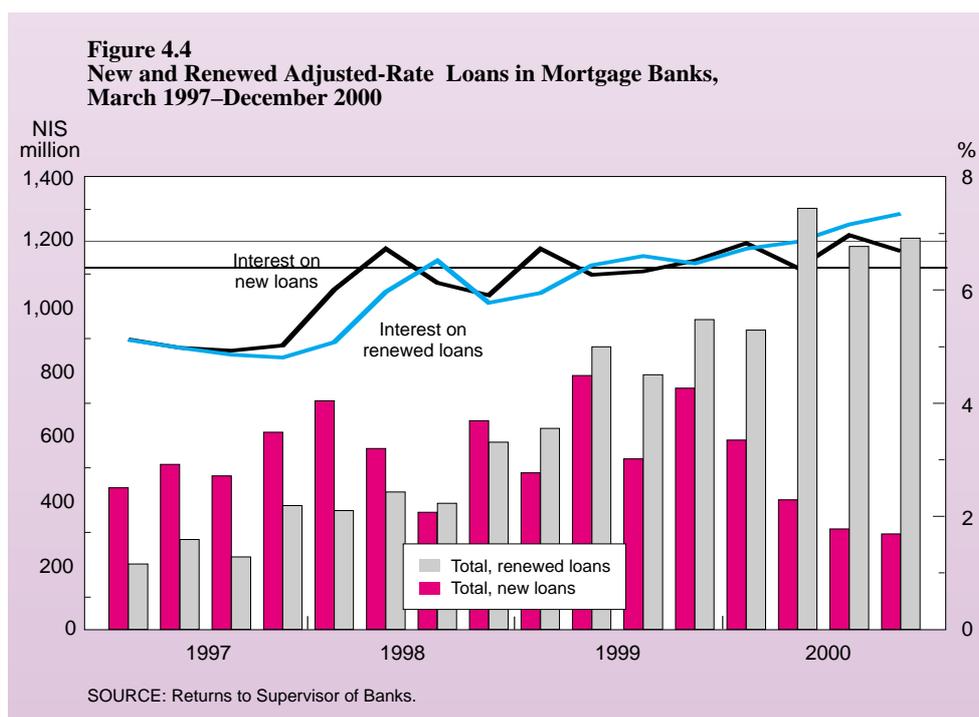
<sup>a</sup> Including directed credit.

<sup>b</sup> Sources raised during the year include savings schemes, but not deposits at the government's responsibility.

SOURCE: Returns to Supervisor of Banks.

corporate bonds; this is because a deep secondary market for unindexed bonds will enable unindexed long-term sources to be raised and unindexed long-term deposits to be priced (as in the indexed market). The number of housing loans fell by 7.4 percent in 2000, continuing the trend apparent since 1995 (with the exception of 1999 which was, as stated, exceptional due to the fact that transactions were brought forward for tax considerations). There was a steeper decline in directed loans taken, and this finding is consistent with the fall in the number of eligible persons taking up loans. The total number of mortgages repaid rose in 2000, and amounted to NIS 18 billion (up by 7 percent over 1999; the share in them of early repayments remained stable—about 22 percent. Early repayment as a share of the total balance was 3.15 percent in 2000, similar to its share in 1999 (3.22 percent). The absence of contraction may be due to the high rate of return on short-term local-currency channels<sup>19</sup> (Table 2.6 and Figure 4.9).

In contrast with the trend of the last few years, when the share of new adjusted-rate loans in total loans extended rose, in 2000 this share fell, to reach only 29 percent (Table 4.3). Part of the explanation for this decline lies in the development of a public debate regarding the updating of interest during the duration of a loan.



<sup>19</sup> Note that the individual's considerations in undertaking early repayment (even in cases where the customer is exempt from paying an early repayment fee) are not necessarily in line with the structure of interest rates on the sources and uses available to the banks. Estimating this flow solely on the basis of a term structure is an over-simplification, and it is reasonable to assume that borrowers have additional considerations.

In 2000 the increase in the share of adjusted-rate loans, which helped the banks to offer credit at a time when the interest rate was rising, was checked. Starting in 1998:I, when a clear rising trend of interest began to emerge, adjusted-rate loans were extended more easily and at a premium no higher than that on fixed-rate loans (Figure 4.4). Nevertheless, in 2000 their price rose relative to that of fixed-rate loans, reaching a spread of 0.4 percent vis-à-vis an average of 0.1 percent in 1997–99, so that for new customers the advantage implicit in adjusted-rate loans narrowed. Note, however, that renewed variable-interest credit was increasing. During the year some NIS 13.5 billion was renewed, compared with NIS 9.3 million and NIS 5.3 million in 1999 and 1998 respectively.<sup>20</sup> One explanation for these growth rates may be the way the mortgage banks have dealt with the rising trend of interest rates in the last three years. Since in recent years, and especially since 1998:I, the general trend of interest has been upwards, customers who had planned to shift to a fixed-interest alternative have deferred doing so, in the expectation that the fixed interest rate will decline. Repaying a variable-interest loan and shifting to one at a higher rate of fixed interest than prevailed at the time the loan was originally taken was perceived by some customers as being unwise, and they refrain from taking that step. The public may also have anticipated that in the next period (when the loan is renewed) the interest-rate trend will change, so that it will be possible to shift to an indexed alternative without paying a penalty. As a result of these developments, there is an upward trend in renewed adjusted-rate loans, while new adjusted-rate loans are declining (Figure 4.5).

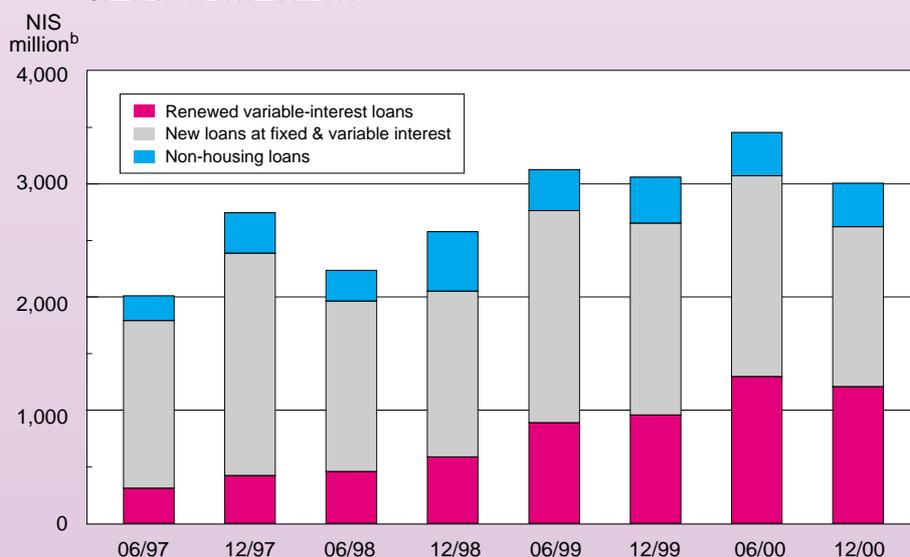
*Outstanding credit:* in mortgage banks this amounted to NIS 99 billion, an increase of 8.5 percent. Credit to home-buyers rose by a similar rate, and amounted to NIS 81 billion. The outstanding credit of contractors and construction companies, which includes off-balance-sheet credit, soared, largely because of the need for ongoing interim finance, the difficulty of raising capital in the stock market, and a slight revival in building starts (the first stage of building is characteristically bank-credit-intensive). In contrast with the past, at present the mortgage banks are far away from the industry exposure limit,<sup>21</sup> and in the context of promising projects the inclination is to make credit available to contractors and construction companies. This outstanding credit grew by 20 percent in 2000, and amounted to NIS 3.5 billion, most of it, as stated, in the unindexed and foreign-currency-indexed segments, and short term.

Outstanding ‘other credit’ (nonresidential, but with a pledge on the asset), which expanded rapidly in the last few years, contracted in 2000, and amounted to NIS 14.2 billion, compared with NIS 14.7 in 1999. The development of this credit expresses a fall in the extent of current loans (new credit), as well as repayment of credit taken in the past. The development of this credit derives from the decline in demand due to the

<sup>20</sup> Since ‘current’ loans eventually become ‘renewed’ loans. Nonetheless, an answer is needed as to why the public does not repay this credit (without incurring a fine) and switch to a fixed-interest alternative.

<sup>21</sup> Total credit at construction risk plus off-balance-sheet liabilities amounted to NIS 10 billion at the end of the year. The construction industry’s indebtedness at the individual bank level ranged from 0.2 to 15.6 percent.

**Figure 4.5**  
**Housing Credit<sup>a</sup> in Mortgage Banks; Total Nondirected Loans,**  
**June 1997–December 2000**



<sup>a</sup> As defined in Proper Conduct of Banking Business Regulation no. 451, for housing and/or housing pledge, in the CPI-indexed segment.  
<sup>b</sup> At December 2000 prices.  
 SOURCE: Returns to Supervisor of Banks.

emergence of unindexed substitutes in the commercial banks (unindexed credit for periods of up to ten years), the rise in the price of credit,<sup>22</sup> and the weakness of the housing market, which reduces the motivation to improve the asset. It is also possible that in the market for other credit the insurance companies have succeeded in infringing on the territory of the mortgage banks—especially since March 1999, when the Ministry of Finance approved secondary legislation permitting them to increase their loan/assets ratio (LTV) to 60 percent. Note that housing loans at this rate that are extended via the mortgage banks are weighted at 100 percent (rather than 50 percent) for the purpose of calculating the capital ratio, which may serve to increase the interest rate on them.

*(ii) Sources*

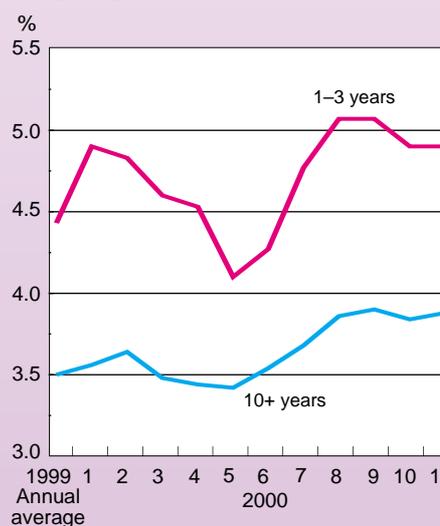
On the sources side, there has been a clear upward trend in recent years in banks' deposits, mainly from related banks, alongside a decline in deposits of the public. The latter constituted 33 percent of total sources raised in 2000, compared with 50 percent and 41 percent in 1998 and 1999 respectively. The decline in the share of deposits of the public

<sup>22</sup> In 1996 the interest on other credit averaged 5.1 percent, compared with 5.04 percent for housing loans; in 2000 these rates were 7.5 and 6.5 percent respectively.

in total deposits is explained by the fall in demand for indexed channels and the preference for unindexed investment channels (see Chapter 2 for a discussion of the public's asset portfolio). Savings schemes as a new source constituted only 10 percent of total deposits at the end of 2000, and the share of long-term, CPI-indexed deposits from institutional investors accounted for 20 percent. A similar trend was evident among commercial corporations: during the year there was net negative accrual of NIS 8 billion in CPI-indexed savings schemes, compared with a negative NIS 1 billion in 1999.<sup>23</sup> Indexed deposits of institutional investors in mortgage banks also declined. These investors, who hold most of the public's long-term assets, also have to contend with the dip in demand for indexed assets (see Box 4.1 below), as expressed in the failure to renew deposits that have reached maturity.<sup>24</sup> The negative accrual in the provident funds has also operated in the same direction, bringing them closer to the ceiling on investment (deposit) in a single entity (5 percent).<sup>25</sup>

In the past, many of the public's savings schemes were renewed at a significantly lower interest rate than the going rate, and a large segment of the public was not aware of this. Today, as a result of the regulations issued by the Bank of Israel and the Ministry of Finance, there is greater transparency of information, and banks are not permitted to invest in follow-on schemes. Consequently, only a small portion of the money is re-invested, and most of it is transferred to unindexed deposits, some of them in mortgage banks. This development in the composition of sources has served to increase the share of banks' deposits in the total liabilities of mortgage banks from 35 percent in 1997 to 41 and 43 percent in 1999 and 2000 respectively (Table 4.5). The shortage of indexed sources is expressed in the cost of raising money (from the public), which

**Figure 4.6**  
Yield to Maturity on Indexed Bonds,  
1999–2000



SOURCE: Monetary Department, Bank of Israel.

<sup>23</sup> Net accrual in approved savings schemes in all the banking corporations was NIS 12 billion in 2000.

<sup>24</sup> The proposals of the Ben Bassat Committee on reforming and taxing the capital market, and especially its implications for long-term sources, led to a steep drop in the opening of new savings schemes by the public. In our view, the committee's recommendations accelerated the diversion of sources from indexed channels to unindexed ones, including redemptions and net negative accrual in provident fund balances. The immediate repercussions of these developments were the higher cost of sources and abbreviation of the period to redemption.

<sup>25</sup> The share of indexed deposits in the provident funds' asset portfolio dipped from 22 percent in 1996 to 19 percent in 2000. In addition, some large provident funds reached the ceiling that prevents them from making further deposits in several banks.

**Table 4.6**  
**Assets and Liabilities of the Mortgage Banks, 1998–2000**

	End-year balances (NIS million) <sup>a</sup>			Real change (%)		Distribution of balances (%)		
	1998	1999	2000	1999	2000	1998	1999	2000
Cash and deposits in banks	257	418	583	62.6	39.5	0.3	0.4	0.6
Loans to government	411	207	5	-49.6	-97.6	0.5	0.2	0.0
Nondirected credit to the public	67,273	74,761	82,461	11.1	10.3	79.3	80.4	81.9
Loans to construction firms and contractors	3,249	2,850	3,406	-12.3	19.5	3.8	3.1	3.4
Other loans and assets	13,636	14,767	14,268	8.3	-3.4	16.1	15.9	14.2
<b>Total assets</b>	<b>84,826</b>	<b>93,003</b>	<b>100,723</b>	<b>9.6</b>	<b>8.3</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Deposits of the public	43,005	44,956	45,787	4.5	1.8	50.7	48.3	45.5
Deposits from banks	31,706	37,634	43,476	18.7	15.5	37.4	40.5	43.2
Government deposits	797	827	1,837	3.8	122.1	0.9	0.9	1.8
Other liabilities	4,677	4,591	4,235	-1.8	-7.8	5.5	4.9	4.2
<b>Total liabilities</b>	<b>80,186</b>	<b>88,009</b>	<b>95,335</b>	<b>9.8</b>	<b>8.3</b>	<b>94.5</b>	<b>94.6</b>	<b>94.7</b>
Equity	4,640	4,994	5,388	7.6	7.9	5.5	5.4	5.3
<b>Total liabilities and equity</b>	<b>84,826</b>	<b>93,003</b>	<b>100,723</b>	<b>9.6</b>	<b>8.3</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>Balance of directed credit</b>	<b>40,201</b>	<b>41,117</b>	<b>41,728</b>	<b>2.3</b>	<b>1.5</b>	<b>47.4</b>	<b>44.2</b>	<b>41.4</b>

<sup>a</sup> At December 2000 prices.

SOURCE: Returns to Supervisor of Banks.

reached an average of 6.5 percent in 2000 for mortgage banks, compared with 4.9 percent in the commercial banks. In those mortgage banks which do not have a framework for raising sources from the public this situation pushed up the price of sources taken from the banks.

*Interest rates:* the gradual reduction of the Bank of Israel's key interest rate, alongside the steep drop in inflation expectations, was expressed *inter alia* in high real interest rates, as well as in the negative slope of the yield to maturity curve for most of the months of the year, indicating that yields to maturity on short-term bonds were significantly higher than long-term ones (Figure 4.6). In general, during the year the yield on bonds rose to very high levels; for short-term bonds this was 6.25 percent, rising to 7.2 percent towards the end of the year.

In 2000 the preference of the public for the unindexed segment intensified, *inter alia* as a result of the sharp decline in inflation and expectations that interest rates—primarily short- and medium-term—would fall. In contrast with the past, these risk-free channels

**Table 4.7**  
**Main Items in the Profit and Loss Statement of the Mortgage Banks,**  
**1998–2000**

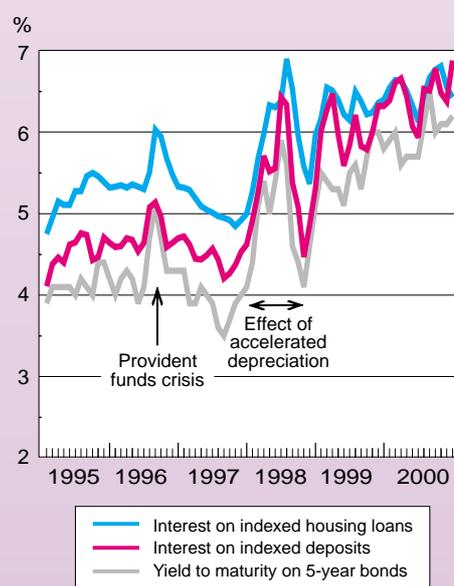
	Average balance (NIS million) <sup>a</sup>			Real change from previous year (%)	
	1998	1999	2000	1999	2000
Net interest income before loan-loss provision	950	1,087	1,142	14.4	5.1
Loan-loss provision	211	219	196	3.8	-10.5
Total non-interest income	845	876	887	3.7	1.3
of which Fee income	815	842	857	3.3	1.8
Total operating expenses	763	800	791	4.8	-1.1
of which Salaries and related expenses	396	442	432	11.6	-2.3
Ordinary before-tax income	821	944	1,042	15.0	10.4
Provision for taxes	404	424	466	5.0	9.9
<b>Net income</b>	<b>414</b>	<b>517</b>	<b>575</b>	<b>24.9</b>	<b>11.2</b>

<sup>a</sup> At December 2000 prices.

SOURCE: Published financial statements.

yielded high returns with considerable liquidity, crowding out the demand for indexed bonds and leading to massive redemptions from savings schemes. The yields on bonds (mainly long-term bonds) affect the level of interest on mortgage banks' sources, because institutional investors demand a liquidity premium that is half a percentage point higher than the yield on bonds. As a result of the situation in the bonds market, the prices of banks' sources soared. The average price on all mortgage banks' sources was 6.48 percent in 2000, compared with 6 percent, 5.5 percent, and 4.5 percent in 1999–97 respectively. (The prices of these uses also rose—although by less than those of sources—due to competition between banks and with other entities.) Thus, the average price of credit at the bank's responsibility has risen from 6.4 percent in 1999 to 6.6 percent in 2000.

**Figure 4.7**  
**Interest on New Fixed-Interest Credit**  
**Extended and on Sources Raised in the**  
**Indexed Segment,<sup>a</sup> in Mortgage Banks,**  
**1995–2000**



<sup>a</sup> Credit includes total indexed, variable-interest, nondirected housing loans; sources include CPI-indexed deposits of the public and banks.  
 SOURCE: Returns to Supervisor of Banks.

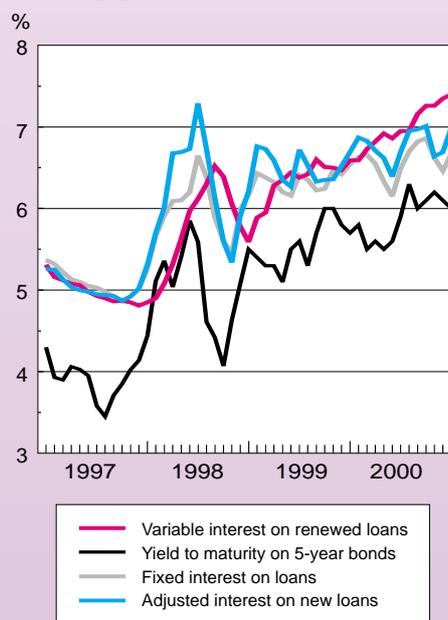
Because of fierce competition in the industry, the banks did not raise the interest on fixed-interest indexed loans to the full extent of the increase in the price of sources. However, the interest on renewed adjusted-rate loans went up in line with the rise in the price of sources (for new loans the average price was 7 percent, compared with 6.4 percent in 1999, similar to the price of adjusted-rate loans that were renewed during the year). This difference between fixed-interest and adjusted-rate loans derives from the large differential between the yields to maturity on short- and long-term bonds: because the price of short-term sources, which finance short-term, adjusted-rate loans, went up (due to the negative slope of their yields) by more than that of fixed-rate loans, the interest on these loans rose.

Towards the end of the period reviewed differentials also emerged between new and renewed fixed-rate loans (Figure 4.8).

The interest-rate spread on new fixed-interest housing loans (which constitute one third of current activity) narrowed slightly in 2000, to stand at 0.22 percent, after 0.24 percent in 1999. This gap does not represent all the activity in new loans, however, as most of it is at variable interest. New loans at variable interest constituted some 15 percent of all loans—including renewed loans—in 2000, and 51 percent of these were renewed during the year (renewed loans below). For the purpose of calculating the average monthly interest rate, the renewed loans are regarded as if they were implemented during the month. Including the renewed loans in the calculation of the interest-rate spread increases the spread, and this is consistent with the rise in the mortgage banks' net interest income (see Chapter 3, financial results).

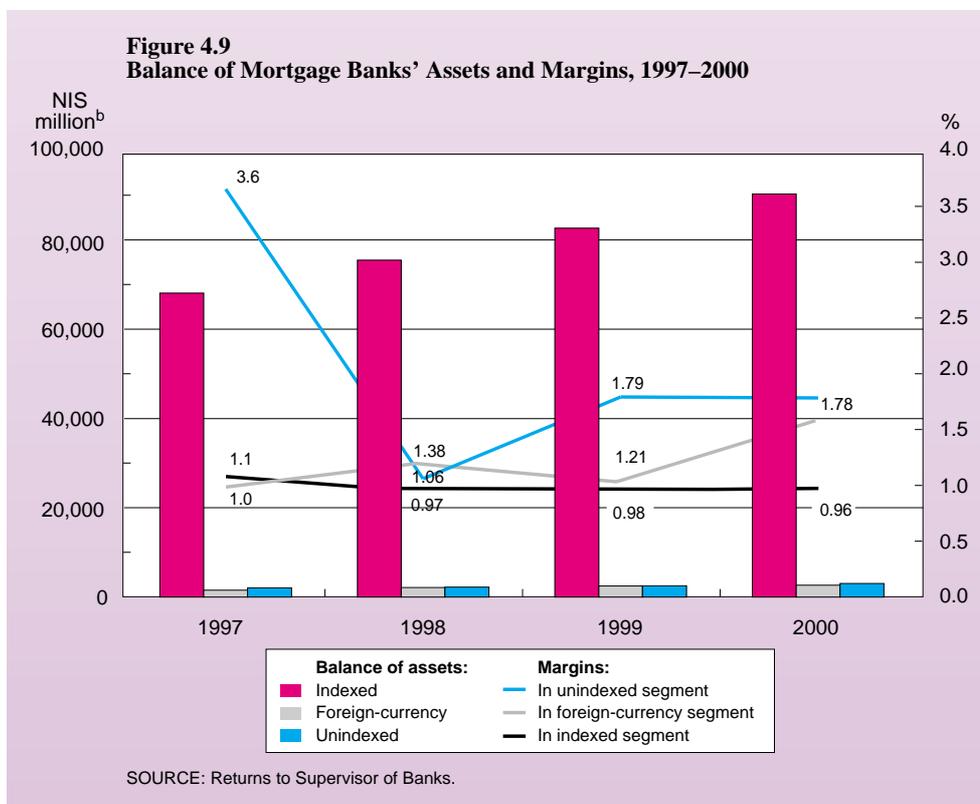
In recent years the commercial banks have begun to direct credit extended to households to long-term channels.<sup>26</sup> The desire to diversify activity, and the decline in inflation expectations may have contributed to this development. In addition, there were several successful issues of unindexed long-term bonds, enabling these banks to offer credit

**Figure 4.8**  
Interest on New and Renewed Credit in Mortgage Banks, 1997–2000



SOURCE: Returns to Supervisor of Banks.

<sup>26</sup> The mortgage banks accounted for 91 percent of outstanding housing credit in the entire banking system, which amounted to NIS 86 billion at the end of 2000, and the rest was divided among the commercial banks as follows: Bank of Jerusalem, 3.5 percent; Union Bank, 1 percent; Mercantile Bank, 1 percent; Leumi Bank, 0.61 percent; Discount Bank, 1 percent; Mizrahi Bank, 0.3 percent.



(including mortgages) at fixed interest for periods of up to seven years (mainly ‘balloon payment’ loans), which are appropriate for households too. The insurance companies have also become more involved in the mortgage market, and since March 1999 they are entitled to finance mortgages of up to 60 percent of the value of the asset. Note that housing loans from mortgage banks where the loan is more than 60 percent of the value of the asset are weighted at 100 percent for the calculation of risk-weighted assets (even if they incorporate a loan to eligible persons). This ‘penalty’ gives the insurance companies an advantage.<sup>27</sup>

#### **b. The financial results of the mortgage banks**

The *mortgage banks’ net income* rose in 2000, to stand at NIS 576 million, a return of 11.2 percent. This increase is due to an improvement in all the components of income: a rise in net interest income, a decline in loan-loss provision, and a slight increase in net non-interest income, constituting a return on equity of 11.6 percent—an 0.4 percent increase over 1999.

<sup>27</sup> The outstanding credit (insured in the mortgage) which appears in the insurance companies’ balance sheets amounted to NIS 3.2 billion at the end of 1999.

**Figure 4.10**  
**Return on Equity in Mortgage Banks, 1990–2000**



SOURCE: Returns to Supervisor of Banks.

Net interest income before loan-loss provision grew by 5.1 percent, in the wake of a rise in average outstanding credit in all segments, and amounted to NIS 1.132 billion. In the indexed segment the expansion of activity contributed additional income of NIS 75 million, despite the slight contraction of the margin from 0.98 percent to 0.96 percent. The expansion of unindexed activity contributed an additional NIS 9 million to income, while the margin remained stable, and activity in the foreign-currency segment contributed NIS 17 million (Table 4.8), largely due to the steep rise in the margin (Figure 4.8). Other net interest income contracted by NIS 23 million in 2000 and amounted to NIS 127 million, mainly as a result of the decline in the provision for interest, in income from collecting problem debts, and in early repayment fees.

Expenditure arising from loan-loss provision fell by 10 percent in 2000, and amounted to NIS 196 million, in contrast with the rising trend of this provision since 1997. Nevertheless, the share of loan-loss provision by mortgage banks, which relates to activity vis-à-vis home-buyers, and the provision derived therefrom, which is calculated on the basis of the extent of arrears (using a formula), soared. As stated, arrears grew for all periods, primarily those of over 15 months, which require ever-increasing provision. Thus, for example, arrears of between 15 and 18 months require provision of 32 percent of the outstanding revalued debt, and for every additional 3 months of arrears provision of another 8 percent has to be made. A rise in the share of arrears, both relative to the outstanding credit to home-buyers and in absolute terms, is largely due to the economic slowdown, which impairs borrowers' ability to repay debts and makes it necessary to

**Table 4.8**  
**Interest-Rate Spreads in the Mortgage Banks, 1997–2000**

(cumulative, end-period data, NIS million, December 2000 prices)

	1997	1998	1999	2000
<b>CPI-indexed segment</b>				
Average assets balance	68,104	75,469	82,628	90,245
Interest income ( <i>NIS mill.</i> )	4,270	3,660	4,571	5,296
Income ( <i>percent</i> )	6.27	4.85	5.53	5.87
Expenditure on sources ( <i>NIS mill.</i> )	3,531	2,931	3,760	4,433
Average spread per unit of credit ( <i>percent</i> )	1.08	0.97	0.98	0.96
<b>Foreign-currency segment</b>				
Balance	1,533	2,112	2,476	2,626
Net income	17.9	29.2	30.0	46.7
Average spread per unit of credit ( <i>percent</i> )	1.17	1.38	1.21	1.78
<b>Unindexed segment</b>				
Balance	2,030	2,216	2,500	3,021
Net income	74.2	23.5	44.8	53.9
Average spread per unit of credit ( <i>percent</i> )	3.65	1.06	1.79	1.78

SOURCE: Returns to Supervisor of Banks.

increase the specific loan-loss provision. Thus, for example, the specific loan-loss provision for housing loans—which is related to the depth of arrears—has risen from NIS 147 million in 1998 to NIS 257 million in 2000.

Since the beginning of the crisis in the construction and real-estate industry the banks have not prepared themselves to charge for arrears; no income from debt-collection has been recorded against loan-loss provision, so that the collection of these loans is in arrears. In 2000 the banks intensified their collection efforts, resulting in a marked rise. Following this improvement, the amount of loan-loss provision imputed to the profit and loss statement declined. During the year these activities led to the cancellation of NIS 145 million of this provision, compared with NIS 44 million and NIS 32 million in 1999 and 1998 respectively.

The operational side of the mortgage banks yielded additional income. Total non-interest income increased by 1.5 percent in 2000, compared with a 1 percent decline in operating expenses (Table 4.9).

Operating fees amounted to NIS 853 million in 2000; the main items—commissions from life insurance and housing transactions—remained unchanged, while fees on collecting credit extended by the Finance Ministry rose slightly (by 0.6 percent). This slight increase is due to the combination of the decline in commissions for channeling new credit contingent on the rate of collection (government credit), as a result of the Finance Ministry's auction for this activity, and the extensive accrual of high-fee credit of this kind. The short-run effect of the reduction of the commissions will continue to be negligible because of this stock.

**Table 4.9**  
**Distribution of Operating Fees, Other Income, and Operating and Other Expenses of Mortgage Banks, 1998–2000**

	NIS million <sup>a</sup>			Year-on-year change (%)		Distribution (%)
	1998	1999	2000	1999	2000	2000
<b>Operating fees</b>						
Life insurance fees	213	222	221	4.3	-0.6	25.2
House insurance fees	143	136	140	-4.6	2.9	16.0
Government credit commissions	311	316	317	1.5	0.5	36.3
Rent commissions	45	47	45	3.9	-3.8	5.2
Credit management and contract preparation fees	52	61	64	17.4	4.6	7.3
Portfolio management fees	1	1	1			0.1
Other	51	59	62	17.0	4.2	7.1
<b>Total fees and commissions</b>	<b>815</b>	<b>842</b>	<b>850</b>	<b>3.3</b>	<b>1.0</b>	<b>97.1</b>
<b>Other income</b>						
Provident fund management fees	10	9	10	-10.0	11.1	1.1
Related companies management fees	1	1	1	0.0	0.0	0.1
Other	19	18	14	-5.6	-23.0	1.6
<b>Total other income</b>	<b>30</b>	<b>28</b>	<b>25</b>	<b>-6.9</b>	<b>-11.3</b>	<b>2.9</b>
<b>Total non-interest income</b>	<b>845</b>	<b>870</b>	<b>875</b>	<b>2.9</b>	<b>0.6</b>	<b>100.0</b>
<b>Operating expenses</b>						
Salaries and related expenses	396	442	432	11.6	-2.3	63.9
Marketing and advertising	37	40	39	9.3	-3.0	5.8
Directors' salaries	5	6	6	23.3	3.2	1.0
Professional services	29	27	22	-8.6	-15.4	3.3
Communications	17	18	18	7.7	-3.1	2.7
Computers	38	37	43	-0.5	16.2	6.4
Business services and insurance	19	20	19	5.1	-3.7	2.8
Other	101	93	95	-7.7	2.0	14.1
<b>Total operating and other expenses</b>	<b>641</b>	<b>684</b>	<b>675</b>	<b>6.6</b>	<b>-1.3</b>	<b>100.0</b>

<sup>a</sup> At December 2000 prices.

SOURCE: Published financial statements.

Income from fees for managing and preparing portfolios has risen by a cumulative 80 percent in the last few years, and amounted to NIS 98 million. The banks, which in the past would absolve many customers (primarily persons eligible for Ministry of Housing benefits) from these fees, now take them from all customers (possibly in order to compensate for the steep drop in fees on Finance Ministry funds). In addition, in recent years the banks have made a point of pricing this fee more precisely, so that the customer

pays for its higher price. Although the competition for mortgages is among the fiercest in the banking industry, it focuses on the level of interest, which is the most important element in the decision-making process, affecting the borrower throughout the duration of the loan. The effect on demand of the other parameters, such as the quality of service and the level of fees—which are essentially non-recurring and low relative to interest costs—is minimal.

Operating and other costs dipped slightly in 2000 and amounted to NIS 791 million. This may be due to measures introduced in some banks to increase operating efficiency,<sup>28</sup> expressed in the closure of branches and encouragement of early retirement by employees. Most of the decline in the operating coverage ratio (ratio of operating expenses to non-interest income) was due to the cost-cutting measures and organizational changes introduced by the independent banks (which act separately, not in the branches of the major banks). Payroll costs, which constitute the largest component of expenses, fell by 2.3 percent in 2000, the total number of employee posts plunged by 7.3 percent, primarily among employees who are more easily shed. In addition, the share of low-salaried employee posts (temporary workers) rose in 2000, while the proportion of tenured employee posts dropped, and the need for overtime—which is more expensive—fell.

As stated, developments in operating expenses and non-interest income attest to an improvement in the mortgage banks' operating efficiency. Operating expenses per dollar assets fell from 0.86 percent in 1999 to 0.78 percent in 2000. Value added per employee post rose by a steep 14 percent, and amounted to NIS 764,000. The efficiency ratio, which also embodies net interest income, reached its highest level for ten years in 2000 and stood at 2.57 (Table 4.4). The ratio of fee income to operating expenses rose in 2000, as did that of total operating expenses to total non-interest income.

### **c. Risks and capital in the mortgage banks**

The economic environment in which the mortgage banks functioned in 2000, and assessments regarding the next few years, appear to indicate a rise in the level of business risk. This is because the recession, and especially the higher unemployment rate, impairs borrowers' repayment ability. The shortage of long-term sources and uncertainty as regards income from insurance transactions may also have an adverse effect on mortgage banks' profitability. The entry of additional entities into the mortgage market, and the possibility that insurance companies will enter the directed credit market will have a similar effect.

The ongoing rise in the share of credit at the bank's responsibility in total loans and total assets increases a bank's quantitative exposure to credit risk. With regard to the quality of credit, several indices point to a rise in the risk level of the mortgage banks: outstanding arrears extended to home-buyers rose by 13 percent to stand at NIS 744 million; most of this increase is attributed to arrears of over 180 days, in which credit risk is particularly high. The ratio of arrears to outstanding credit to home-buyers also

<sup>28</sup> During the last eighteen months 14 branches were closed, and this will affect the operating coverage ratio in the future.

grew, and reached 0.91 in 2000. Although this ratio is low and less than 1 percent of outstanding credit in arrears, it has been rising constantly since 1996, when it was 0.74.

Another ratio that attests to a deterioration in the quality of credit extended to home-buyers is the specific loan-loss provision by depth of arrears relative to outstanding credit to home-buyers. Despite the decline in the provision ascribed to the profit and loss statement in 2000, the share of the provision relating to transactions with home-buyers rose, and amounted to NIS 236 million, compared with NIS 138 million in 1999. The ratio between the specific provision by depth of arrears and outstanding credit (to home-buyers) rose from 0.19 to 0.28. These levels are still low, but the trend indicates a dip in the quality of credit. A further indicator of a decline in the quality of credit to home-buyers is the amount outstanding (*less* provision for interest on arrears and loan losses) in loans in arrears for which loan-loss provision has been made. This balance grew in 2000 and amounted to NIS 2.2 billion, compared with NIS 2.0 billion in 1999. Current expenditure on specific loan-loss provision for transactions with home-buyers, which is calculated, as stated, on the basis of the depth of arrears, rose by a notable 23 percent. There were conflicting trends in the activity of the mortgage banks vis-à-vis contractors, but the share of this outstanding credit in total assets was only 3 percent at the end of the year. The ratio of arrears to outstanding credit extended to contractors declined to 16.3 percent in 2000, compared with 17.7 percent in 1999. The ratio of specific loan-loss provision to credit also improved.

After several years in which adjusted-rate loans increased, their share in total loans declined in 2000 and amounted to 29 percent, compared with 39 percent in 1999. The reduction in the proportion of adjusted-rate credit extended served to increase duration, and the total duration gap rose from 1.2 to 1.3 years.

The rate of exposure of net worth to interest-rate risk (assuming early repayment of 3 percent of the portfolio) was 9.1 percent in 2000, compared with 7 percent in 1999. In mortgage banks the duration of assets is higher than that of liabilities, so that these banks are exposed to the risk of a rise in interest rates. When early repayment of 3 percent of credit is assumed,<sup>29</sup> a different picture emerges for some banks, and some of them are even exposed to a decline in the interest rate. In this respect there is considerable variance between the mortgage banks, their exposure to interest-rate changes varying from 1.2 percent to 27.5 percent.

The risk-based capital ratio in mortgage banks declined in 2000 and stood at 10.2 percent (Table 4.4). Total equity (for calculating the primary, secondary, and tertiary capital ratios) rose by 5.9 percent in 2000, mainly due to an increase in equity (of NIS 400 million), compared with a slight dip in approved secondary capital. This capital amounted to NIS 7.6 billion at the end of 2000, compared with NIS 7.2 billion at the end of 1999.

The balance of weighted assets for the purpose of calculating the capital ratio rose by an average of 11 percent, primarily due to the sharp increase in 100 percent weighted credit (mainly to contractors), compared with a moderate rise in 50 percent weighted

<sup>29</sup> The ratio of the extent of early repayment to the assets in the housing portfolio was 3.22 percent in 1999 and 3.15 percent in 2000.

assets (largely housing credit, in which the ratio of the loan to the value of the asset is less than 50 percent).

The trend of off-balance-sheet activity was the opposite; all the categories of off-balance-sheet balances declined, and on average they fell by 17.4 percent. Risk-weighted assets amounted to NIS 74.3 billion in 2000, compared with NIS 68 billion in 1999.

#### **Box 4.1**

##### **The Background to the Development of Unindexed, Fixed-Rate Mortgages**

In recent years the share of adjusted-rate loans in the indexed segment has risen. These loans enabled the banks to sell credit more successfully, especially at times when the interest rate was shrouded in opaqueness. The range of loans makes it possible to divide the market between the various kinds of consumer, such as between those who are planning early repayment, those who foresee a decline in interest rates in the future, and those who prefer fixed-rate loans so as to reduce uncertainty. In order to bring the adjusted-rate loans to the notice of the public, the banks set the initial interest on them at relatively low rates. These loans partially solved the problem of the mortgage banks' long-term sources in the indexed segment, but exposed them to liquidity risks and also *ex post* to credit risks. The long-term adjusted-rate loans were financed from short-term sources; hence, even when the interest rates were in line with one another in the initial period (reducing interest-rate risk), financing long-term mortgages from short-term sources was likely to cause the bank to lose when the sources were renewed. However, since the indexed segment could contract in the next few years, it is expected that an unindexed, long-term segment which will also provide the mortgage banks with sources will develop. The reduction of local-currency interest in 2000, within a low-inflation environment, brings the market closer to a situation in which unindexed mortgages could constitute a good substitute for adjusted rate ones as far as borrowers are concerned. All this takes place in the context of an increase in the interest on indexed loans in general, and on adjusted-rate loans in particular (Figure 4.8).

After a long period, starting in the mid-1970s, when indexation to the CPI was considered to be an essential way of inoculating against the erosion of the value of money, the indexed segment is now becoming less attractive to investors. The share of indexed channels in the public's asset portfolio has been declining for several years, and today stands at 35 percent, compared with 65 percent in the early 1990s. On the other hand, the share of unindexed assets (including shares) was 55 percent at the end of 2000.

Another factor serving to reduce the demand for indexed assets is the low tradability of indexed bonds; many of these assets are not tradable, and much of the tradable part is held till maturity and does not reach the trading floor. Thus, for example, a total of NIS 90 billion of indexed government capital (bonds) is

registered for trading, while the average daily turnover is only NIS 150 million. By contrast, NIS 40 billion of unindexed government capital (mainly Treasury bills, but also *Shahar and Gilon*) is registered for trading, and the average daily turnover is NIS 150 million.

As inflation stabilized and medium-term unindexed channels became available, money was increasingly diverted from the indexed to the unindexed segment. Savings schemes and provident funds became less popular than they had been in the past, when they constituted a solid investment channel bearing guaranteed high yields, so that the potential sources of mortgage banks declined. The connection between wages and the CPI began to loosen in parts of the labor market.

Macroeconomic conditions, including the slowing of the inflation rate and expectations that interest rates would come down, increased potential demand for long-term unindexed loans. Mortgage-takers include consumers who wish to detach themselves from indexation to the CPI, as some of them do not expect their wages to rise in line with changes in the CPI. On the other hand, taking a long-term, unindexed, fixed-interest loan, even if it is higher than the indexed substitute, could be a good economic decision if the inflation rate rises, as the outstanding debt is eroded in real terms and the monthly payments are fixed. All these factors work to create basic conditions, on both the demand and the supply sides, for the emergence of a market for mortgage credit.

In the wake of the deceleration of inflation and the revival of the market for issues of unindexed bonds from both the public sector (7- and 10-year *Shahar* bonds) and the corporate sector, a long-term unindexed segment has begun to emerge in the capital markets. Its development is a necessary condition for the creation of a parallel market, i.e., unindexed deposits vis-à-vis long-term credit. This is viewed favorably by the mortgage banks, which have begun to raise an increasing share of their sources in other indexed segments, mainly short-term Prime. The deepening and expansion of an unindexed market (by a gradual shift of all capital raised via unindexed bonds to medium and long terms) will increase liquidity and help institutional and other investors to price unindexed long-term deposits in mortgage markets.

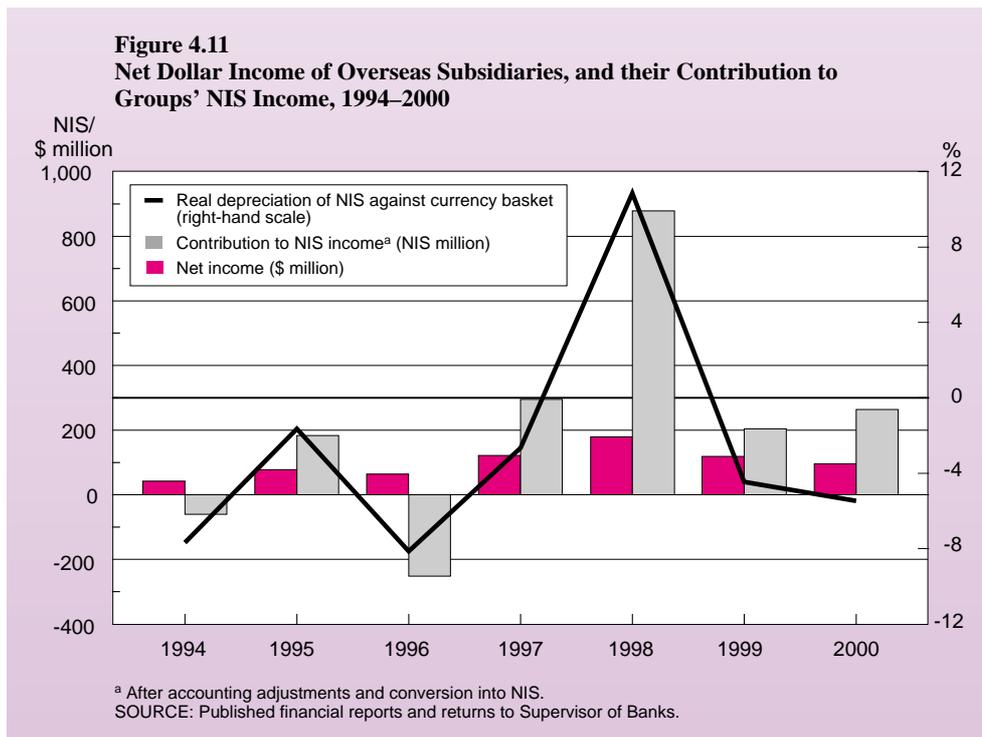
It is possible to discern the first green shoots of the development of an unindexed market for the medium term in 2001. Thus, for example, between January and May 2001 there were 14 auctions for issues of 5- to 10-year *Shahar* bonds, and the amount offered was NIS 8.5 billion, with considerable excess demand (seven times more on average). In addition, the banks have begun for the first time to offer fixed-interest deposits for periods of 3 and 5 years. Another important development has been the issue of a long-term (7-year) unindexed bond, which was also sold successfully to the tax-paying public. In the wake of these issues one of the mortgage banks is offering a fixed-interest 7-year unindexed mortgage for the first time since the 1970s.

## 4. OVERSEAS OFFICES

### a. Introduction

The activity of the overseas offices of Israeli banks is conducted via 79 offices, 17 of them subsidiaries, 22 of them branches and agencies, and 40 of them representative offices,<sup>30</sup> distributed throughout 21 countries: the subsidiaries and branches, in which most of the activity is implemented, are found mainly in the US and western Europe—Switzerland and the UK. The representative offices complete a wider distribution in South America, Germany, Canada, and Australia.

This wide distribution is utilized to deepen and expand private banking activity, as well as to extend financial services to Israeli customers operating abroad, to international elements operating in Israel, and to the Jewish community in the countries in which the overseas offices operate. The overseas offices focus largely on capital-intensive private customers and business firms.



<sup>30</sup> The kinds of offices are distinguished from one another as regards the activities they are permitted to undertake: thus, for example, the representative offices are restricted to establishing contact with customers and transferring information, while the branches are also entitled to implement banking business. The kind of office established in a given country depends on two main factors: the object of the activity in that country and the institutional restrictions in effect there.

The total dollar balance sheet of the overseas offices rose by 15.6 percent, while their net income fell by 18.8 percent and amounted to \$ 149 million, representing a 7.3 percent return on equity.<sup>31</sup> This decline derives mainly from the extensive provision made by Bank Leumi-Switzerland to cover possible future expenses due to activities which, it is alleged, were not authorized.<sup>32</sup> This incident, which came to light in January 2001, points up the importance of the monitoring, control, and supervision of the activity of overseas offices by the parent-company in Israel. Deducting the figures for the Bank Leumi overseas office in Switzerland, the profits of the overseas offices were up by 10.6 percent over 1999, while their ROE rose to 11 percent.

At the end of 2000 the share of the overseas offices in the total local-currency balance sheet of the five major banking groups rose by 0.5 percent, despite the appreciation of the NIS vis-à-vis the dollar and the principal European currencies,<sup>33</sup> and reached 14.4 percent.<sup>34</sup> This ratio is characterized by considerable variance between the banking groups: the lowest ratio, 6.8 percent, was found in the First International Bank, and the highest, 20.5 percent, in the Discount Bank. The increase is explained by the expansion of the international activity of the Israeli banks in the framework of the process of globalization and the deregulation of Israel's money and capital markets, especially as regards investment abroad by residents and in Israel by nonresidents. Another reason for the expansion is expectations of increased competition in Israel's banking system, primarily with the entry into Israel of foreign banks and representative offices.

The performance of the overseas offices is affected by the economic situation and legislative developments in the countries in which they are situated.<sup>35</sup> In 2000 the 'new economy' contracted, and its repercussions were felt by financial markets worldwide. The US capital market was very volatile: in the first half of the year share prices rose, mainly those traded on the Nasdaq, continuing the trend evident in 1999, while in the second half of the year they plunged. During the course of the year the Nasdaq plummeted by 37 percent, and the Dow Jones, which consists mainly of 'old economy' shares, fell by 5 percent. Developments in the US capital markets caused share prices to fall in major stock markets worldwide, including those of the UK and Germany, while the Swiss stock market index rose.

The drop in share prices in the second half of 2000 is explained by the slowing of economic growth in the US and Europe. The slowdown is explained by the rise in the price of crude oil and of interest rates in the wake of these countries' tight monetary policy. The economic changes in the industrial countries were also reflected in the currency markets: the US benefited from capital inflow in 2000 which financed massive investment,

<sup>31</sup> Since some of the activities of the overseas offices are conducted via branches whose equity depends on that of the parent-company, the calculation of their ROE is based solely on data for the subsidiaries.

<sup>32</sup> This incident is currently being investigated by the management of Bank Leumi, as well as by the supervisory authorities in Switzerland and Israel.

<sup>33</sup> During 2000 the NIS appreciated by 2.7 percent against the dollar and by 10.1 percent and 4.9 percent against the pound and the Swiss frank respectively.

<sup>34</sup> Calculated by multiplying the dollar balance sheet by the end-year dollar exchange rate.

<sup>35</sup> Because of the low share (less than 1 percent) of the South American offices in the total assets of the overseas offices, the analysis below focuses on the offices in North America and western Europe.

primarily in the first half of the year, but as a result the US balance-of-payments deficit grew, and the dollar strengthened vis-à-vis the other major currencies.

The developments in the financial markets contributed to shifts in the business environment of the banking system. These were expressed in the continued surge in mergers and acquisitions all over the world, and the increasingly global orientation on the part of investors, aided by advanced technologies, which are becoming more readily available.

As regards legislation and regulation, during the period reviewed there were several developments which could have an effect on both the business environment in which the overseas offices operate and their financial results: in the framework of banking reform in the US a law was introduced in March 2000<sup>36</sup> enabling a BHC (bank holding company) to be defined as an FHC (financial holding company) and to offer customers a wide range of financial services (in the fields of securities, insurance, and financing). Under the new law, the banks themselves are limited primarily to activities in the area of pure banking, while additional activities may be undertaken by means of subsidiaries and affiliates. The process of recognizing a BHC as FHC depends on obtaining approval from the US supervisory authorities and a declaration from the supervisory authorities in the home country (if this concerns a foreign BHC) regarding the quality of its management and its ability to meet the capital adequacy requirements.

On January 1, 2001 new tax regulations (issued by the IRS) went into effect in the US imposing a reporting requirement on all non-American banking corporations whose customers have income from an American source, and the obligation to deduct tax at source from this income (even if the corporation is situated outside the US). These regulations have implications for transactions with customers who invest in the US securities markets via the banking corporations, including Israeli banking corporations that operate in the US. According to the new regulations, any non-American financial intermediary must meet the criteria set by the IRS and be accredited as a qualified intermediary (QI). This status enables it *inter alia* to avoid submitting specific particulars about customers who are not residents of the US and who operate in the American market. The Israeli banks have submitted a request to the IRS to obtain QI status. The request has not yet been granted, but the IRS has given the Israeli banks an interim QI accreditation.

#### **b. The extent of activities in the overseas offices**

The activities of the overseas offices grew in 2000 by a steep 15.6 percent (Table 4.10), similar to their expansion in 1999 (15.8 percent). The rise in the balance sheet of the overseas offices was due mainly to increased investment in securities and credit to the public, on the assets side, and in deposits of the public, on the liabilities side. In spite of the weakening of the European currencies against the dollar and the (relatively) high growth rates in America in 2000, the balance sheet of the western European offices rose more sharply than that of the North American ones.

<sup>36</sup>This law is known as GLBA (Gramm Leach Bliley Act).

**Table 4.10**  
**Assets, Liabilities, and Spreads of the Overseas Offices,<sup>a</sup> 1999–2000**  
(\$ million)

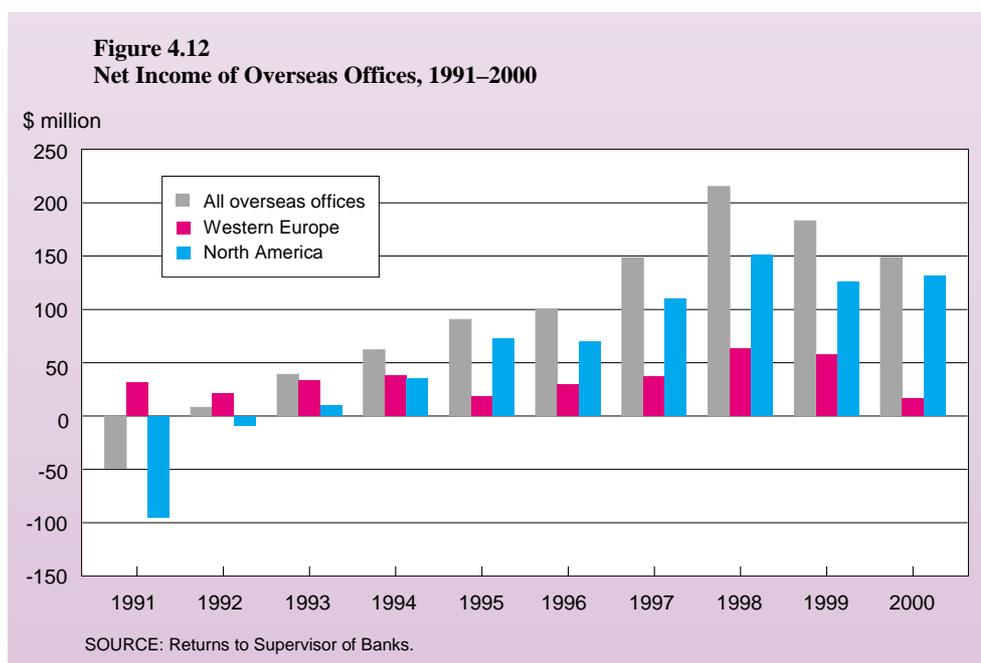
	North America			Western Europe			Total		
	1999	2000	Change (%)	1999	2000	Change (%)	1999	2000	Change (%)
Credit to the public	6,215	6,985	12.4	2,978	3,279	10.1	9,305	10,382	11.6
Cash and bank deposits <i>of which</i> In related banks	3,440	3,379	-1.8	1,624	1,977	21.8	5,115	5,423	6.0
Securities	517	507	-1.9	599	462	-22.8	1,149	1,022	-11.0
<b>Total assets</b>	<b>15,367</b>	<b>17,288</b>	<b>12.5</b>	<b>5,865</b>	<b>7,261</b>	<b>23.8</b>	<b>21,408</b>	<b>24,743</b>	<b>15.6</b>
Deposits of the public	11,458	13,547	18.2	3,060	3,663	19.7	14,657	17,366	18.5
Deposits from banks <i>of which</i> From related banks	2,338	1,898	-18.8	1,729	2,334	34.9	4,092	4,260	4.1
<b>Total liabilities</b>	<b>14,594</b>	<b>16,440</b>	<b>12.6</b>	<b>5,332</b>	<b>6,747</b>	<b>26.5</b>	<b>20,094</b>	<b>23,374</b>	<b>16.3</b>
<b>Equity</b>	<b>773</b>	<b>842</b>	<b>9.0</b>	<b>533</b>	<b>514</b>	<b>-3.6</b>	<b>1,314</b>	<b>1,364</b>	<b>3.8</b>
Interest-rate spreads <sup>b</sup> ( <i>percentage points</i> )									
On: Credit to and deposits of the public	2.77	3.12		1.86	1.36		2.49	2.57	
Net interest margin on total assets and liabilities <sup>c</sup> (incl. off-balance-sheet items)	1.77	1.78		1.60	1.59		1.73	1.73	

<sup>a</sup> Selected items.

<sup>b</sup> On balance at bank's responsibility.

<sup>c</sup> The net interest margin is the ratio of net interest income before loan-loss provision to total financial assets.  
SOURCE: Returns to Supervisor of Banks.

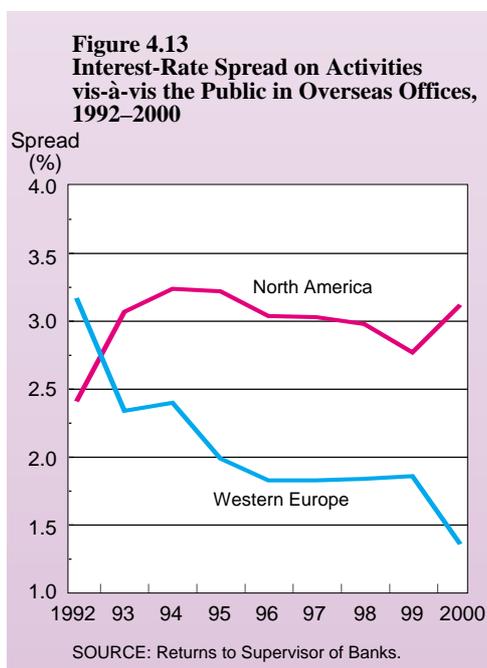
Credit extended to the public by all the overseas offices rose by 11.6 percent in 2000 (Table 4.10); in North America it increased by 12.4 percent, continuing the trend of the last few years of the expansion of transactions vis-à-vis firms and participation in international loan syndicates at the expense of retail banking. This policy is common in most international banks, which concentrate on wholesale banking in their activities abroad. Another factor contributing to the expansion of the credit portfolio is the acceleration of economic activity that characterized the US, especially in the first half of the year.



The growth rates of credit in western Europe were slightly lower, because of the difference in the composition of credit: in the North American offices some 45 percent of credit is extended to manufacturing and commerce, and only 4 percent to individuals. In the western European offices, however, 29 percent of credit is extended to manufacturing and commerce and some 16 percent to individuals. Similarly, the average credit (including off-balance-sheet) extended per borrower in North American offices in 2000 was \$ 1.4 million, compared with \$ 650,000 in western Europe. These differences express the relatively large share of commercial and business banking in the North American offices, compared with the larger share of private banking in the western European ones.

Cash and deposits with banks grew by about 6 percent in all the overseas offices, in the wake of the 21.8 percent rise in the western European offices (Table 4.10). This is a

marked increase compared with the more moderate rise in credit to the public, and derives from the narrowing of interest-rate spreads (between the borrowing and lending rates) on transactions with the public, due to increased competition in private banking, as well as from the notable increase in deposits of the public—some of which were channeled to banks. Interest-rate spreads in the western European offices have been contracting for several years, in contrast with their relatively expansionary trend in the North American ones (Figure 4.13). In addition, in 2000 there was a notable decline in the deposits of the western European offices in related banks and a rise in deposits in other banks, especially foreign ones. The latter category increased by 50 percent because the interest paid by foreign banks in Europe on the deposits of the overseas offices was higher than that paid by the related banks.



The securities portfolio held by the overseas offices continued to expand by a marked 27.5 percent in 2000 (Table 4.10), after a growth rate of 25.2 percent in 1999. During the year the risk that characterizes the portfolio of securities held for investment increased, in the wake of the decline in the share in it of government bonds (which are regarded as a low-risk asset), while the share of the securities of other entities which are not affiliated with or related to the parent-company rose.

The expansion of the more risky activities (credit to the public and the securities portfolio) indicates a trend of increased return alongside greater risk exposure.

The rise in total uses was financed by an increase in the balance of deposits of the public and from banks. Deposits of the public in all the overseas offices grew by 18.5 percent (Table 4.10), as expressed in the greater extent of deposits raised from the business sector vis-à-vis a decline in the share of those raised from households. Because of this development, the size of the average deposit rose from \$ 102,500 in 1999 to about \$ 108,000 in 2000. These developments are explained by strategic changes made in the overseas offices in the last few years, in the framework of which private and commercial banking activity expanded at the expense of expenditure-intensive retail banking.

The trend regarding deposits from banks continued to be mixed in 2000, as expressed in the rise in the balance of deposits in the western European offices and the fall in the balance of those in the North American ones. The latter decline can be explained by the increase in deposits of the public (which are a cheaper supplementary source than those from banks), which rose by an annual average of 18.3 percent in the last three years,

alongside a more moderate increase in this item in the western European offices. The main contribution to the rise in the balance of deposits from banks in western Europe came from banks that are not related to the overseas office, in spite of the dip in interest rates on deposits from related banks and the increased cost of deposits from foreign banks. This development is reflected by a decline in interest-rate spreads (between deposits in banks and deposits from banks) on activities vis-à-vis banks in the same group and the widening of spreads on activities with other banks.

Off-balance-sheet activity and the use of derivatives continued to expand markedly in 2000, especially in the first half of the year. This activity has been rising for several years and reflects *inter alia* the expansion of business and private banking

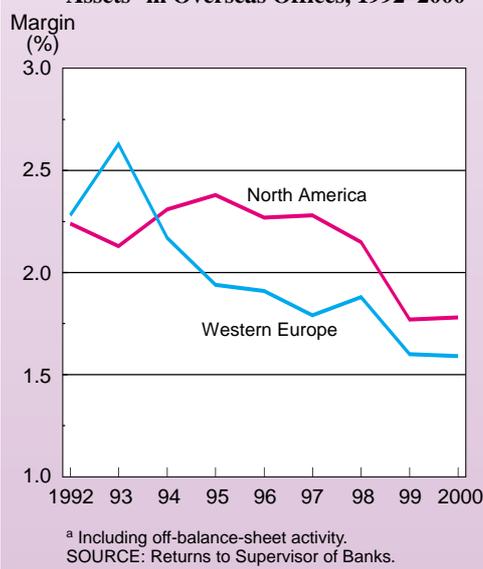
at the expense of traditional retail banking. The balance of collateral and contingent liabilities (off-balance-sheet activities, in which the stated balance represents credit risk) of the overseas offices stood at \$ 7.9 billion at the end of 2000, after rising by 1.7 percent, compared with an increase of 15.7 percent in 1999. The moderation of the demand for collateral and contingent liabilities is consistent with the slowing of economic activity in North America and western Europe in the second half of the year. Total derivatives transactions grew by 35.2 percent in 2000, amounting to \$ 11.3 billion (at face value). The rise in the extent of instruments used for hedging against interest-rate and exchange-rate risks was particularly notable, and arose from the frequent fluctuations in interest and exchange rates in Europe and North America during the year.

The financial spread on total earning assets<sup>37</sup> (including off-balance-sheet assets) of the overseas offices in 2000 remained at the same level as in 1999—1.73 percent (Table 4.10), in contrast with the declining trend of the last few years (Figure 4.14); this spread is considerable lower, however, than the spread that characterizes the peer group (3.69 percent ).<sup>38</sup> The stability of the spread is the result of opposing developments which cancelled one another out: the change in the mix of overseas offices' uses, in the framework of which the share of more profitable uses, including credit to the public and investment in securities, rose at the expense of less profitable ones, such as cash and deposits in

<sup>37</sup> Earning assets are total assets yielding net interest income; they do not include other assets, such as buildings and equipment.

<sup>38</sup> The peer group comprises 313 commercial banks operating in the US; the average extent of their assets was about \$ 3 billion in 2000. Consequently, the comparison is appropriate primarily for the offices in North America (data from FDIC, Quarterly Banking Profile).

**Figure 4.14**  
Net Interest Margin on Total Active Assets<sup>a</sup> in Overseas Offices, 1992–2000



banks, served to widen the spread; on the other hand, the expansion of off-balance-sheet activity (including the use of off-balance-sheet instruments), which in recent years has displayed lower profitability per dollar assets, served to narrow it. The narrow spread, which characterizes this activity of the overseas offices, is explained by the relatively low risk level of their off-balance-sheet activity.

### **c. The financial results of the overseas offices**

The net income of the overseas offices fell from about \$ 183 million in 1999 to some \$ 149 million in 2000, a decline of 19 percent, continuing the 15 percent drop in 1999 (Figure 4.12). In 2000 there were significant differences between the various areas of activity: in the North American offices income rose by 5 percent, whereas in the western European offices it plunged by 70 percent (Table 4.11).

The sharp drop in the western European offices derives from losses of \$ 31.4 million incurred in 2000 by Bank Leumi-Switzerland, due to suspicions that one of its senior employees (the head of the private banking department) undertook unauthorized activities in customers' accounts. In the wake of this incident the bank made (net)<sup>39</sup> provision of about \$ 60.7 million from its income to cover future expenses and expected losses.

The increase in net income in the North American offices was affected positively by the expansion of banking activity. However, income was affected negatively by the increase in loan-loss provision and the growth of operating expenses and provision for taxes. The steep decline in the profitability of the western European offices was due primarily to the sharp rise in other operating expenses as well as to the narrowing of the interest-rate spread on credit. These were offset to a slight extent by the rise in non-interest and other income and the expansion of activity.

Net interest income before loan-loss provision rose by 18 percent in all the overseas offices (Table 4.11), mainly due to the expansion of banking activity both on and off the balance sheet. The financial spread on total earning assets remained stable in 2000, so that the negative effect of price, which had acted in previous years to reduce the overseas offices' net interest income, was averted.

Expenditure on loan-loss provision soared by 166 percent in 2000, and it amounted to 0.25 percent of credit at the bank's cognizance (Table 4.12). The rise in this provision was evident in both regions and resulted from a steep increase in the specific provision, which was partly offset by the reduction of the general provision. The increase in the provision attributed to specific borrowers indicates a deterioration in the quality of the credit portfolio, in the context of the economic slowdown in the US and Europe in the second half of the year. This slowdown is also reflected by expenditure on loan-loss provision over the year: in the second half the expenditure was up by 160 percent over the first half.

<sup>39</sup> Although the provision in Switzerland amounted to \$ 85.6 million, because of the incident the bank released reserves of \$ 24.8 million.

**Table 4.11**  
**Main Items in the Profit and Loss Statements of the Overseas Offices, 1999-2000**

	(\$ million)								
	North America			Western Europe			Total		
	1999	2000	Change (%)	1999	2000	Change (%)	1999	2000	Change (%)
<b>Net interest income before loan-loss provision</b>	<b>310</b>	<b>367</b>	<b>18.6</b>	<b>108</b>	<b>127</b>	<b>17.7</b>	<b>422</b>	<b>499</b>	<b>18.3</b>
Loan-loss provision	8	22	171.8	1	4	154.5	10	26	166.1
Operating fees	37	36	-4.1	56	58	3.7	95	96	0.9
Other income	14	18	31.7	2	28	1618.2	16	46	192.4
<b>Total non-interest and other income</b>	<b>55</b>	<b>58</b>	<b>5.6</b>	<b>59</b>	<b>86</b>	<b>46.3</b>	<b>116</b>	<b>147</b>	<b>26.2</b>
Salaries and related expenses	101	112	11.7	47	50	5.8	151	165	9.7
Other expenses	59	72	22.4	30	116	291.3	91	191	109.0
<b>Total operating and other expenses</b>	<b>187</b>	<b>213</b>	<b>13.7</b>	<b>93</b>	<b>181</b>	<b>95.3</b>	<b>286</b>	<b>400</b>	<b>40.0</b>
Ordinary before-tax income	169	190	12.4	72	28	-61.5	242	219	-9.6
Provision for taxes	44	60	37.1	18	16	-9.6	62	77	24.1
<b>Net income</b>	<b>125</b>	<b>131</b>	<b>4.7</b>	<b>57</b>	<b>17</b>	<b>-70.5</b>	<b>183</b>	<b>149</b>	<b>-18.8</b>

SOURCE: Returns to Supervisor of Banks.

**Table 4.12**  
**Credit Risks in Overseas Offices, 1999–2000**

	(percent)					
	North America		Western Europe		Total	
	1999	2000	1999	2000	1999	2000
<b>Quantity of credit</b>						
Credit to public/total assets	40.4	40.4	50.8	45.2	43.5	42.0
<b>Quality of credit</b>						
Annual loan-loss provision/total credit	0.13	0.31	0.05	0.11	0.11	0.25
Problem debts/total credit	1.90	3.25	2.85	2.06	2.21	2.84
Charge-offs/total credit	0.32	0.05	0.26	0.63	0.29	0.23
<b>Concentration of credit</b>						
Share of credit to single borrowers (\$ 8 mill. or more)	62.2	63.1	43.1	42.6	56.3	57.0
H-Index of by-industry credit concentration	0.164	0.166	0.153	0.141	0.152	0.151

SOURCE: Returns to Supervisor of Banks.

Income from operating fees remained relatively stable in 2000, against the backdrop of the rise in non-interest income in the western European offices and decline in this income in the North American offices (Table 4.11). The differences in the development of non-interest income between the regions derive from the differences between them as regards the kind of activity: the western European offices are characterized by private banking, which is fee-intensive, whereas the North American offices focus on commercial and business banking activity, which produce less fee income. Income from fees and commissions associated with securities transactions rose in both regions in 2000, in the context of the expansion of capital-market activity, while in the North American offices income from payment services and account management fees fell.

Expenditure on salaries and associated expenses rose by some 10 percent in 2000, alongside a 5 percent increase in the number of employee posts (including overtime) and employees. The increase in payroll expenses in 2000 reflects *inter alia* changes in the mix of employees in the overseas offices—a sharp drop in the number of part-time and temporary employees, whose salary costs are lower, and an increase in the number of permanent, full-time employees, whose salaries are higher. One of the possible explanations for this development lies in the policy of improving the quality of personnel in the world banking system, expressed in employing better-qualified individuals and shedding less qualified ones, in view of technological changes requiring more skilled employees. The rise in costs per employee post also derived from the increased need to reward highly-skilled professionals because of the fierce competition for employees in the global financial services industry: in order to keep high-quality employees, smaller

**Table 4.13**  
**Operating and Yield Indices in Overseas Offices, 1999–2000**

	North America		Western Europe		Total	
	1999	2000	1999	2000	1999	2000
Annual wage per employee post (\$'000s)	72	77	81	82	74	78
Financing coverage ratio <sup>a</sup>	1.65	1.72	1.16	0.70	1.47	1.25
<i>of which</i> Excl. Leumi Switzerland			1.23	1.46	1.52	1.64
Operating coverage ratio <sup>b</sup>	0.29	0.27	0.63	0.48	0.41	0.37
<i>of which</i> Excl. Leumi Switzerland			0.44	0.44	0.34	0.32
Efficiency ratio <sup>c</sup>	1.95	2.00	1.79	1.17	1.88	1.61
<i>of which</i> Excl. Leumi Switzerland			1.67	1.90	1.86	1.96
<i>Percent</i>						
Return on assets <sup>d</sup> (ROA)	0.96	0.85	1.08	0.29	0.99	0.69
<i>of which</i> Excl. Leumi Switzerland			0.78	0.93	0.91	0.87
Return on equity <sup>d</sup> (ROE)	9.63	11.24	8.07	1.65	8.92	7.30
<i>of which</i> Excl. Leumi Switzerland			6.10	10.54	8.37	10.95

<sup>a</sup> Ratio of net interest income before loan-loss provision to operating and other expenses.

<sup>b</sup> Ratio of non-interest and other income to operating and other expenses.

<sup>c</sup> Ratio of all non-interest and net interest income to operating and other expenses.

<sup>d</sup> Net income (incl. imputed tax and extraordinary income) *divided by* capital/assets at beginning of year; ROE refers to subsidiaries only.

SOURCE: Returns to Supervisor of Banks.

banks—including Israeli banks operating abroad—have to raise their salaries and improve their working conditions. The average annual wage in the overseas offices was \$ 78,000 in 2000, compared with \$ 74,000 in 1999 (Table 4.13). The average salary per post was higher in the western European offices than in the North American ones; this gap reflects the differences between the regions as regards the cost of living and salaries, on the one hand, and the nature of banking activity, on the other. The western European offices specialize in wholesale and private banking, which require more highly-specialized—and hence more costly—employees.

Tax provision in the North American offices rose by some 37 percent in 2000 (Table 4.11), as a result of the increase in pre-tax income. Due to the effect of the loss incurred by Bank Leumi-Switzerland, the provision was reduced in the western European offices. Adjusting for that event, there was a 32 percent rise, reflecting the increase in net income in the other overseas offices.

The above developments in net interest income, non-interest income, and operating expenses led to a decline in the efficiency ratio,<sup>40</sup> from an average of 188 percent to about 161 percent in all the overseas offices (Table 4.13), below the level in the peer

<sup>40</sup> Calculated as total (non-interest and net interest) income divided by total operating and other expenses.

group (about 179 percent). If the Bank Leumi-Switzerland data are neutralized, the efficiency ratio amounted to 196 percent.

As a result of accrued profit, the equity of the North American offices rose by 9 percent, while due to the losses incurred by the Bank Leumi office in Switzerland, the equity of the western European offices dipped slightly (Table 4.11). The dollar return on equity (ROE) rose to 11.2 percent in the subsidiaries operating in North America—less than in the peer group (14.6 percent) and more than in western Europe (Table 4.13). The dollar return on assets (ROA) declined in all the overseas offices in 2000 to about 0.69 percent, compared with about 1.29 percent in the peer group, the fall in the western European offices being particularly marked. When the Bank Leumi-Switzerland data are neutralized, the ROE of all the banking groups rose to 11 percent, and the ROA of all the overseas offices amounted to 0.87 percent (Table 4.13).<sup>41</sup>

#### **d. Risks in the overseas offices**

During 2000 the risk exposure of the overseas offices rose. This characterized both regions, with the realization of operating risk in Bank Leumi-Switzerland—which had been one of the most profitable overseas offices (until the discovery of the aforesaid incident)—being especially notable.

The various indices of credit risk—its extent, quality, and concentration—indicate a rising trend in risk exposure. The extent of credit grew in both regions, but the share of outstanding credit in total assets declined as a result of the steep rise in the overseas offices' securities portfolio. This portfolio grew in 2000, especially as regards the non-government channels, whose risk exposure is relatively high. Consequently, these developments contributed to the rise in risk associated with overseas offices' assets.

Most of the indices of the quality of credit attest to its deterioration during 2000, so that the rate of loan-loss provision and the share of problem loans in total credit at the bank's cognizance rose in the overseas offices (Table 4.12). On the other hand, the share of charge-offs in total credit declined, although this index was influenced by debts classified in the past as problematic, and does not reflect the quality of the credit extended during the year.

The expansion of business activity in the North American offices caused increased concentration of credit in those offices, compared with a slight dip in the western European offices (Table 4.12); thus, the Herfindahl-Hirschmann index (H-Index), reflecting the by-industry distribution (including individuals), declined from 0.153 to 0.141 in the western European offices, compared with relative stability in the North American ones. The share of credit extended to borrowers with loans of over \$ 8 million, expressing single-borrower concentration, amounted to 57 percent in 2000, a rise of about 0.5 percent. This increase was the outcome of a one percent rise in the share of single borrowers in the North American offices and relative stability in the western European ones.

<sup>41</sup> See note 31.

As stated, the operating risk implicit in the activity of the overseas offices, and especially that deriving from failures in the control and monitoring process, was realized in the Bank Leumi-Switzerland in 2000.

In order to overcome the difficulties imposed by geographical distance and the problems of directly controlling the activities of the overseas offices, as well as to reduce the operating and administrative risks inherent in their activity, the managements of the banks must invest ongoing efforts in improving procedures, methods, and internal monitoring.

In view of the processes of globalization and consolidation that have characterized world banking in the last few years, and as a result of the difficulties encountered by the overseas offices in previous years as well as in 2000, it is incumbent on the overseas offices of Israeli banks to introduce programs for increasing efficiency, as well as to formulate a long-term strategy for their activities. The object of these must be to improve the banks' ability to cope with the challenges confronting them and to uphold the good name of Israel's banking system at a time when information is increasingly available and global financial markets are more accessible.