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Letter of the Supervisor of Banks, Mr. Rony Hizkiyahu, submitted with the 2008 Survey of Israel's Banking System

In 2008 the global banking system faced up to one of the most serious financial crises in modern times. The crisis, which started as a sub-prime mortgage crisis in the US, developed into a worldwide financial crisis with far-reaching implications for financial institutions, including the largest in the world, and for the economies of many countries.

The grave crisis in the credit markets and the severe shortage of liquidity world wide aggravated the global financial crisis in September 2008, and this, as well as its spread into real activity, was evident also in Israel's economic indicators.

Compared with other banking systems, Israel's banking system in this difficult year exhibited resilience to the shocks in the global financial markets, and to their implications on the real economy. The stability of the banking system played a vital role in the maintenance of the robustness of Israel's economy at this time.

Nonetheless, the performance and business results of the five major banking groups were affected by the exposure to foreign financial institutions that were in the center of the crisis, by the fall in the value of assets, and by the impact on some borrowers' repayment ability. Thus, in contrast to the high level of profit and profitability in the last few years, this year the banks reported very low levels.

Capital adequacy

The strength of the banking system and its resilience to the shocks of the crisis may be ascribed to the positive developments in Israel's economy in recent years, the relative conservatism of the banking system's activity, the public's confidence in the system, and the close supervision over it.

Even before the outbreak of the crisis, I advised the banking corporations that it was advisable for them gradually to increase capital adequacy that would result in a capital ratio of at least 12 percent by the end of 2009. The banking system took upon itself to meet that target, initially out of awareness of the importance of a prudential capital policy, and then resulting from the first lessons learned from the world crisis. This capital policy, aimed at bolstering the strength and resilience of the banking corporations to the possibility of the realization of risks and unexpected changes in the business environment, resulted in the banking system showing a capital adequacy ratio of 11.2 percent at the end of 2008, its highest level since 1992, and that despite the effects of the crisis.

That said, the capital adequacy of Israel's banking system is still low compared with that in other advanced economies, which in light of the crisis are also taking steps to improve the capital adequacy of their banking systems. The Banking Supervision will continue to act towards strengthening the banks' capital adequacy, in particular Tier 1 capital, which is a focal component in the maintenance of the stability of the banking system and of the whole economy.

Strengthening the nonbank credit market

The financial crisis resulted in an almost complete halt in capital issuances in Israel's capital market, and thus in the drying up of nonbank credit sources. This highlighted and increased the centrality of the role of the banking system in the economy, and reversed the trend evident in recent years. In 2008 the banks increased total balance-sheet credit to the public by a notable 10 percent. At the same time the effect of the Bank of Israel's monetary policy on the total interest rate spread was apparent: the spread narrowed despite the increase in risks that was expressed in part by the decline in the quality of the bank credit portfolio.

Clearly the banking system alone cannot meet the entire demand for credit. Steps must therefore be taken to strengthen the nonbank credit market, while continuing to preserve the banks' resilience. The combination of these two measures will improve the robustness of Israel's economy at this time of a slowdown in real activity.

The activity of Israel's banking corporations abroad

The upheaval in the global economy stressed the need for tightening regular supervision over the banking corporations and for monitoring developments in them, with constant day-to-day updating of events around the world. The concentrated structure of Israel's banking system, in which each of the five major banking groups accounts for a significant part of the whole, necessitated intense supervisory activity. This encouraged the banking corporations to review the targets they had set themselves in their long-term strategic planning, scrutinize their risk management policies, in particular to adopt a cautious approach to liquidity risk management, and reinforce of their control, management, auditing and checking systems.

This year the Banking Supervision concentrated mainly on examining the banking corporations' activity abroad, and took steps to reduce their exposure to the main risk centers identified. The involvement of Israel's banking system in markets abroad—in the last few years in the form of the purchase of local banks in emerging market countries, deposits and investments in financial institutions abroad and other investments—incurs risks, which increased this year due to the crisis. The Banking Supervision therefore increased the transparency and disclosure required on risk exposures in the banks' financial reports, extended the reporting requirements regarding banks' exposure to foreign financial institutions, and required them to report other exposures directly or indirectly related to the crisis.

Basel II

In parallel with these activities, the Banking Supervision continued to promote the implementation in Israel of the Basel II regime, both in the banking system and in the Banking Supervision, in accordance with the timetable it had set. This was accompanied by the upgrade of the risk management, control and corporate governance systems in the banks, and instilling risk-focused supervision procedures in the Banking Supervision.

As part of this process, on 31 December 2008 I published a Provisional Basel II Directive—A Work Framework for Measuring Capital Adequacy, intended to be implemented by the end of 2009. The Banking Supervision is monitoring the process of implementation closely, with the purpose of upgrading Israel's banking system and aligning it with international standards, which will also facilitate Israel's progress towards accession to the OECD.

Sound corporate governance

The Banking Supervision strives to instill the principles of sound corporate governance in the banking corporations, as part of the adoption of the second pillar of Basel II and the internalization of other generally accepted international standards. It considers the adherence to those principles to be of utmost importance, due to the vital role of the banking corporations in the financial system and the need to protect deposit holders' money. Proper corporate governance in the banks is essential for the public's confidence in the banking system and for the proper functioning of the system and the whole economy.

One of the principles of sound corporate governance is setting a policy of suitable remuneration in the banking corporation. In the context of the adoption of the recommendations of the Financial Stability Forum (FSF) of April 2008, I formulated principles for such a policy, as is the practice in supervisory authorities in other advanced economies. The purpose of these principles is to reduce the risks arising from an inappropriate incentive structure, and to create a link between pay incentives and long-term corporation-wide bank profitability.

The fee reform

Alongside its commitment to preserve the stability of the banking corporations, the Banking Supervision also acts to encourage competition in the banking system. In the context of that activity, the reform in bank fees went into effect in 2008. Its purpose was to create transparency in the prices of bank services, by reducing the number of fees and instituting uniformity in the names of the various fees and commissions and in the mechanisms for their collection. The Banking Supervision frequently publishes a comparison of fees actually paid by the customers of the different banks, and thus contributes to their ability to compare prices of bank services and encourages competition. In a follow-up on the implementation of the reform, the Banking Supervision found that in the first year since its introduction, the average price of bank services for households had in fact declined. The Banking Supervision will continue to monitor prices of banking services, and, with the authority granted by the Knesset, will intervene if necessary.

Regarding consumer protection, the Banking Supervision, in cooperation with the banking system, acted during Operation Cast Lead and eased credit conditions on the current accounts of residents in the area of the hostilities. At that time it also prevented restrictions on the accounts or account holders due to checks without cover.

All the above help to ensure a fair and efficient banking system and provide a firm foundation for public confidence in the banks and in the Banking Supervision.



Rony Hizkiyahu
Supervisor of Banks

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