

Chapter 3

Financial Results

In 2001 the financial results of the banking groups deteriorated significantly, with a sharp fall in profit and in the return on equity (ROE): total profit of the five major banking groups went down from NIS 3.9 billion in 2000 to NIS 2.1 billion, while ROE slumped from 11.7 percent in 2000 to 5.9 percent in 2001, contrary to the upward trend which had prevailed for ten years.

The slowdown in Israel's economy and worldwide in 2001 reduced profitability and affected all its components. The reduction in the banks' profits was due mainly to the large increases (about 86 percent) in loan-loss provisions. These resulted from the continued economic slowdown, the deterioration in the security situation and the worldwide recession, and were especially notable in certain industries (communications and computer services, construction and real estate, and hotels and catering). The recession in the capital market and the reduction in the level of stock exchange turnover in Israel and abroad (in particular the Nasdaq) reduced the banks' non-interest income, and their income from investments in financial and nonfinancial companies was also severely curtailed. On the other hand, the level of operating expenses, which had been rising for several years, was fairly stable.

1. THE PROFITABILITY OF THE BANKING GROUPS: MAIN RESULTS

The profit and profitability of the banking system showed a clear downward trend in 2001. The reduction reflected a deterioration in the security situation, the recession in Israel and the slump in the world economy in 2001, which also revealed mistaken decisions regarding credit in previous years.

The total profit of the five major banking groups¹ (including net income and minority interests) dropped back to about NIS 2.1 billion, reflecting a steep decline in return on equity (ROE) from 11.7 percent in 2000 to 5.9 percent in 2001, far below the averages

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

Table 3.1
**Adjusted Capital and Profitability of the Five Major Banking Groups,
1997–2001**

	(NIS million, December 2001 prices)				
	1997	1998	1999	2000	2001
End-of-year capital ^a	31,401	32,453	33,941	36,513	38,204
Adjusted capital ^b	28,968	31,434	32,072	33,272	35,858
Loan-loss provision	2,426	2,251	2,095	2,345	4,355
Ordinary pre-tax profit	4,987	4,579	6,175	6,134	4,424
Tax provision	2,399	1,940	3,085	2,928	2,183
Extraordinary after-tax profit ^c	457	18	161	326	-12
Share in profits of unconsolidated subsidiaries	400	359	363	382	-178
Translation adjustments	31	88	15	-28	65
Total profit^d	3,476	3,105	3,630	3,886	2,116
<i>Percent</i>					
Ordinary pre-tax profitability ^e	17.2	14.6	19.3	18.4	12.3
Return on equity (ROE) ^f	12.0	9.9	11.3	11.7	5.9
Return on assets (ROA)	0.7	0.5	0.6	0.6	0.3
Loan-loss provision/credit to public	0.8	0.6	0.5	0.5	0.9

^a Including minority interests.

^b Capital at beginning of year *plus* issues weighted according to date of issue, *minus* dividends calculated according to dates of payment.

^c Including deduction of goodwill in Bank Mizrahi.

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

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

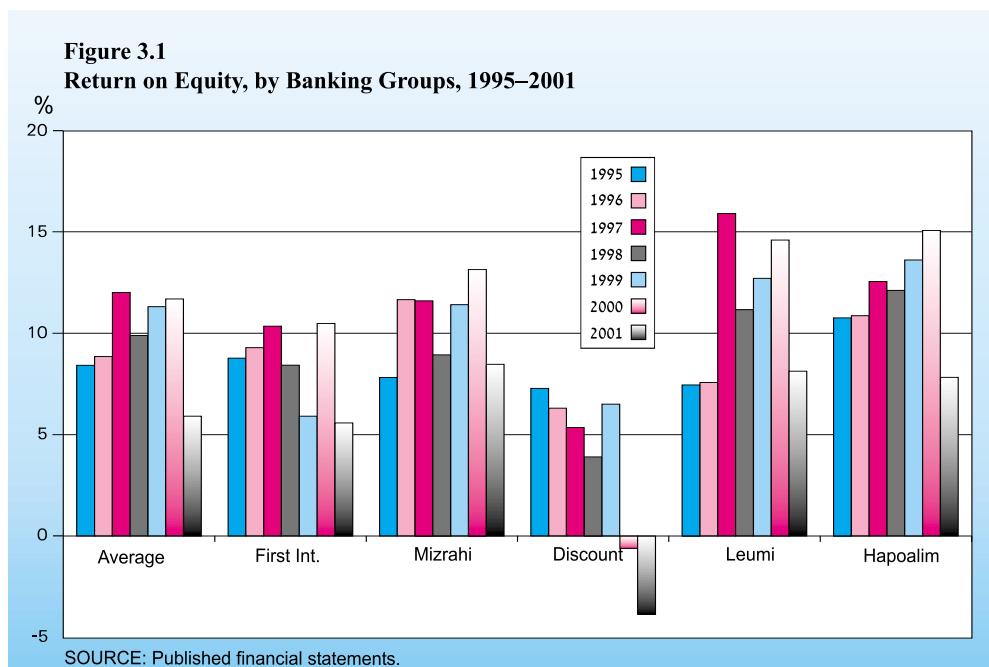
^f Total net income *divided by* adjusted capital.

SOURCE: Published financial statements.

for 1997–2000 (Table 3.1 and Figure 3.1) and the last decade. Once again there was marked variation between the ROEs of the different groups: in Mizrahi it was 8.5 percent; in Leumi, 8.1 percent; in Hapoalim, 7.8 percent; in the First International, 5.6 percent; and in Discount, a negative 3.9 percent (Table 3.2).

The performance of Israel's banking system in 2000, i.e., the return on equity (ROE) and the return on assets (ROA), was similar to those of banking systems of other western countries; in 2001, however, Israel's performance indices deteriorated markedly. In an international comparison of performance, operation and risk indices of twenty banking systems² (Table 3.3), the net interest margin on assets in Israel turned out to be the same

² The international comparison included the ten major banking groups in each country whose principal activity is commercial banking, assuming that these reflect to a great extent the performance of the entire banking system in that country. For Israel and Finland the five major banking groups were included, and in the US the 100 major groups. Note that the data for Israel's banking system are adjusted for the effect of inflation, while in the peer group the reports are on a nominal basis. The data base is drawn from Bank Scope and differs from that used in previous years, hence the data base is also different in 2001.



as that in the peer group.³ Regarding risk indices, the ratio of annual loan-loss provision to total credit in 2000 in Israel was similar to that in the peer group, but in 2001 it rose significantly, indicating a drop in the quality of the portfolio of credit to the public in Israel's banking system due to the difficult economic situation. The credit portfolio is not expected to expand significantly in 2002 as the current low ratio of capital to risk-weighted assets in Israeli banks does not enable risk-weighted assets to increase substantially. The international comparison shows that the ratio of capital (Tier 1 and total) to risk-weighted assets in Israel is lower than the normal in both the peer group and in western countries as a whole. This restricts the ability of Israeli banks to expand their risk-bearing activity and to deal with possible future realization of risks (see Chapter 5 for a full discussion).

There were four main reasons for the reduction in the banking groups' profit from their level in 2000:

1. The first was the 86 percent leap in the current loan-loss provision, after this had followed a downward trend since 1988. The rise amounted to some NIS 2 billion, and was most marked in the communications and computer services, construction and real estate, and manufacturing industries. The increase resulted from the economic difficulties encountered by the businesses active in those fields due to the slump in economic activity in Israel and the worldwide crisis in high-tech industries, and

³ Israel's peer group included countries which are similar to it as regards the size of GDP and the size of the banking system. Countries which meet these criteria but differ significantly from Israel in their conditions and the nature of banking activity were not included in the peer group.

Table 3.2
Main Items in Consolidated Profit and Loss Statements, the Five Major Banking Groups, 2000–2001

	NIS million, December 2001 prices)						Contri- butio n to profit (%)						
	Leumi		Hapoalim		Discount		Mizrahi		First Intl.		Total		
	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001	
Net interest income before loan-loss provision	4,768	5,227	5,423	5,689	2,694	2,736	1,295	1,268	1,203	1,247	15,383	16,167	784
Loan-loss provision	627	1,483	704	1,202	708	942	190	294	116	434	2,345	4,355	-2,010
Net interest income after loan-loss provision	4,141	3,744	4,719	4,487	1,986	1,794	1,105	974	1,087	813	13,038	11,812	-94
Total non-interest income ^a	2,737	2,705	3,519	3,295	1,775	1,827	846	808	740	666	9,617	9,301	-316
of which Fee income	2,165	2,164	2,775	2,735	1,492	1,445	744	726	656	576	7,832	7,646	-186
Total operating expenses of which Salaries and related expenses	5,075	5,087	5,308	5,564	3,603	3,667	1,262	1,265	1,273	1,106	16,521	16,689	-168
Ordinary pretax income	1,803	1,362	2,930	2,218	158	-46	689	517	554	373	6,134	4,424	-1,710
Tax provision	723	508	1,293	997	280	236	324	249	308	193	2,928	2,183	-745
Ordinary after-tax income ^b	1,080	854	1,637	1,221	-122	-282	338	267	246	180	3,179	2,240	-939
Other income ^c	548	26	15	-320	16	27	-5	-35	72	-15	646	-317	-963
Net income	1,628	880	1,652	901	-106	-255	333	232	318	165	3,825	1,923	-1,902
Total profit ^d	1,579	918	1,681	985	-34	-222	359	259	301	176	3,886	2,116	-1,770
Equity ^e	10,829	11,302	11,169	12,596	5,663	5,741	2,735	3,061	2,876	3,159	33,272	35,858	2,586
Ordinary ROE ^f (%)	10.0	7.6	14.7	9.7	-2.2	-4.9	12.4	8.7	8.6	5.7	9.6	6.2	
Total ROE ^f (%)	14.6	8.1	15.1	7.8	-0.6	-3.9	13.1	8.5	10.5	5.6	11.7	5.9	
Total return on assets (%)	0.73	0.39	0.74	0.41	-0.03	-0.17	0.51	0.35	0.46	0.26	0.56	0.28	
Loan-loss provision/ total credit	0.44	0.93	0.45	0.68	1.02	1.33	0.36	0.53	0.27	0.91	0.50	0.85	
Risk-based capital ratio	9.19	9.74	9.18	9.10	9.30	9.26	9.11	9.52	9.74	9.24	9.38	7.8	

^a Including profit/loss from sale of shares.

^b After deduction of goodwill in United Mizrahi Bank of NIS 27 million in 2000 and NIS 1 million in 2001.

^c Includes the group's share in the profits of its subsidiaries, minority interests, income from the sale of assets and investments, and net income from extraordinary activities.

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

^e Equity and minority interests at beginning of year *plus* issues at time of issue *minus* dividends paid, according to time paid.

^f Return on equity (ordinary ROE is ordinary after-tax income *divided by* equity; total ROE is total profit *divided by* equity).

SOURCE: Published financial statements.

Table 3.3
Indicators of the Performance of Various Banking Systems,^a 2000

	Performance indices (%)				General indices				Operating indices (%)				Risk indices (%)		
	Financial margin	Return on total assets ^b	Return on equity ^c	Return on assets ^b	Per capita		Total		Non-interest income/ operating expenses/ total assets		Loan-loss provision/ total credit		Capital adequacy	Tier 1 capital ratio	
					GDP	GDP (\$ billion)	GDP	(\$ 000s)	operating expenses	total assets	total	credit			
Australia	2.2	14.6	1.0	388.3	20.2		1.7	2.4	80.3		0.3	11.3	9.1		
Austria	1.3	11.4	0.4	204.5	25.2	1.6	1.3	55.9		0.5	10.9	6.8			
Belgium	1.2	7.0	0.4	251.6	24.5	1.4	1.6	69.8		0.3	10.8	7.0			
Canada	1.9	13.8	0.7	649.8	21.1	1.5	2.9	84.3		0.5	11.6	8.7			
Denmark	1.2	13.6	0.8	172.2	32.3	1.4	1.2	44.8		0.1	10.3	8.5			
Finland	1.8	1.3	1.3	130.1	25.1	1.7	1.7	65.4			13.4	8.7			
France	0.8	14.7	0.5	1,438.3	24.1	1.4	1.8	101.6		0.5	10.3	7.2			
Germany	0.7	10.7	0.4	2,063.7	25.1	1.3	1.4	80.2		0.3	11.0	6.3			
Greece	2.6	12.6	1.2	126.3	12.0	1.7	2.7	81.7		0.8	12.7	9.9			
Ireland	2.0	11.1	0.7	86.0	22.7	1.8	1.9	68.8			11.6	8.8			
Italy	2.0	15.0	0.9	1,163.2	20.2	1.6	2.3	69.4		0.8	8.5	5.8			
Netherlands	1.6	18.8	1.5	397.5	25.0	1.3	2.3	63.9		0.2	11.8	8.8			
Norway	2.2	11.3	0.7	155.1	34.5	1.6	2.2	56.4		0.3	10.7	7.8			
Portugal	2.1	12.7	0.8	111.3	11.1	1.8	1.9	68.5		0.6	12.2	10.0			
South Africa	2.7	15.9	1.2	129.2	3.0	1.7	3.2	87.2		1.0	13.6	9.9			
Spain	2.4	14.4	1.0	595.3	15.1	1.6	2.3	56.3		0.6	10.7	8.8			
Sweden	1.3	15.1	0.8	240.7	27.1	1.6	1.6	71.2		0.3	14.1	11.6			
Switzerland	0.7	17.1	1.2	273.8	38.1	1.3	2.6	103.8		0.3	16.0	11.4			
UK	1.8	19.2	1.0	1,459.5	24.4	1.9	1.8	78.9		0.4	12.5	7.3			
US	2.9	13.7	1.2	9,601.5	34.1	1.6	3.8	81.7		0.8	12.3	9.5			
Average	1.8	13.8	0.8	981.9	23.3	1.6	2.1	73.5	0.5	11.8	8.6				
Peer-group average^d	2.0	12.0	0.8	145.2	20.7	1.6	2.1	67.8	0.5	11.9	8.8				
Israel 2000	2.4	11.7	0.6	104.1	17.9	1.5	2.4	58.2	0.5	9.2	6.7				
Israel 2001	2.3	5.9	0.3	105.4	17.2	1.5	2.2	55.7	0.9	9.4	6.2				

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

^b For all countries apart from Israel the financial margin on total assets was calculated as total net interest income less financing costs, divided by total assets.

^c Return on Equity in all countries, excluding Israel, is calculated as net profit divided by equity.

^d Israel's peer group included eight countries that resemble it in size of GDP and banking system characteristics: Belgium, Denmark, Finland, Greece, Ireland, Norway, Portugal, and South Africa. Countries which meet the first criterion but whose banking environment and banking services are significantly different from Israel's (such as those whose banking system have a relatively low level of concentration or most of whose banking activity is off-shore) were not included in the peer group.

SOURCE: Based on data provided by Bankscope and the World Bank website.

from the directives issued by the Supervisor of Banks demanding a specific provision due to the above developments. In view of the continued difficult economic situation, it is expected that the extent of loan-loss provisions and their share of total credit will remain high in 2002.

2. The second reason was the decline in the contribution of companies included under the equity method to the banks' profit: in 2001 the banks' investments in these companies resulted in losses of NIS 178 million, in contrast to a NIS 382 million contribution to profit in 2000. This decline was mainly due to the losses incurred by Bank Hapoalim on its investment in Koor Industries and the losses of Bank Leumi on its investment in the Israel Corporation and in Shore Capital.
3. The third reason was the sharp drop in extraordinary profits, which turned from a profit of NIS 353 million in 2000 to a loss of NIS 11 million in 2001. The profits in 2000 came from nonrecurring events such as the sale by Bank Leumi of its holding in Koor Industries and the sale by the First International Bank of its holding in Alpha Card, which were not matched by similar events in 2001.
4. The fourth reason was the fall in banks' non-interest income from their capital market activity (income from customers' activities in securities, from distributing securities, custody fees, and management fees from provident funds and mutual funds). These went down by about NIS 315 million (14 percent), after rising by some 29 percent in 2000. The decline in this income was the outcome of the slump in both the primary and secondary capital markets reflected in the price indices, average turnover, and capital raised. An additional cause of the decline in banks' income from activity on the capital market was the reduction in the proportion of activity carried out via the banks and the rise in that performed via nonbank members of the stock exchange. On the other hand the banks' non-interest income from other banking services remained relatively stable.

2. CONTRIBUTION OF THE MAIN COMPONENTS TO NET INCOME

a. Net interest income

The only element which served to offset some of the sharp decline in the banks' profitability in 2001 was their net interest income (before loan-loss provision). This income, a function of the extent of activity and the interest margins, rose in the five banking groups by NIS 784 million to NIS 16.2 billion, an increase of 5.1 percent. The overall net interest margin remained at the same level as in 2000, at 2.3 percent.⁴ The stability of the margin was the outcome of two opposing developments which offset each other: on the one hand, the reduction in the net interest margin in each intermediation

⁴ The calculations here of the net interest margin are based on the five major banking groups on a consolidated basis, and are therefore slightly different from those quoted in Chapter 2, which are calculated from all the commercial banks on an individual bank basis.

segment in domestic activity acted to reduce the overall margin, particularly that in the unindexed local-currency segment, due to the drop in interest rates and the change in the mix of activity in the various segments. On the other hand, the rise in the margin on foreign-currency activity abroad, and the increase in the share of the unindexed segment, which has a higher margin than the other segments, acted to raise the overall margin (for a discussion of net interest margins by indexation segment see Chapter 2).

Despite the recession in economic activity, the extent of activity in financing operations was 8 percent higher in 2001 than in 2000, continuing the long-term trend. Much of the increase was due to the unindexed local-currency segment, which rose by 20 percent. The foreign-currency segment, where activity abroad rose by 19 percent due essentially to the increase in the differential between the NIS and the dollar interest rates on credit, also contributed to the above increase.

Table 3.4
Profit from Financing Operations Before Loan-Loss Provision, and
Estimated Net Interest Margins of the Five Major Banking Groups,
2000 and 2001

	(NIS million, December 2001 prices)			
	Amount		Distribution	
	2000	2001	2000	2001
(percent)				
Credit (to the public)	28,069	39,286	72.7	69.9
Bonds	3,701	8,475	9.6	15.1
Other assets	6,840	8,475	17.7	15.1
Total profit on assets	38,610	56,236	100.0	100.0
Deposits of the public	-25,559	-38,996	91.5	90.0
Other liabilities	-2,363	-4,334	8.5	10.0
Total expenses on liabilities	-27,922	-43,330	100.0	100.0
Total income on assets and liabilities	10,688	12,906		
Profit on hedging derivatives and ALM	2,710	1,415	57.7	43.4
Profit on other financial derivatives	601	61	12.8	1.9
Commissions on financing transactions	754	774	16.1	23.7
Other financing income, net	630	1,011	13.4	31.0
Total other income	4,695	3,261	100.0	100.0
Total profit from financing operations before loan-loss provision	15,383	16,167		
Total net interest margins	2.3	2.3		

SOURCE: Published financial statements.

The rise in interest income derived mainly from credit to the public, with its contribution rising from NIS 28 billion in 2000 to NIS 39 billion in 2001 (Table 3.4) as credit expanded in all segments, especially in the unindexed local-currency segment. However, as the

contribution of credit to the public to interest income increased, so did financing costs on deposits of the public, which constitute a major source of finance for banking activity. This was the result of the quantity effect on the one hand, reflected mainly in the increase in unindexed deposits, and the price effect on the other, expressed in increased financing expenses, particularly in the foreign-currency segment (on activity in Israel and abroad), due to the depreciation of the NIS against the major world currencies.

In addition, the banks' income on their investments in bonds (in particular those available for sale) doubled as a result of the growth of these uses. The rise of activity in bonds and of their contribution to interest income may have been due to banks' taking market opportunities that arose and to their desire to broaden their sources of income.

The banking groups' interest income from their activity in the various indexation segments totaled NIS 14.3 billion in 2001, up from NIS 13.4 billion in 2000 (Table 3.4). This income includes balance-sheet activity (NIS 12.9 billion, up from NIS 10.7 billion in 2000) and profit from financial derivatives intended to manage assets and liabilities known as ALM (Asset Liability Management), which came to NIS 1.4 billion in 2001, down from NIS 2.7 billion in 2000. The banks also earned income from other financial derivatives,⁵ which in 2001 totaled only NIS 61 million, compared with NIS 601 million in 2000. Other sources of interest income were (a) income from financing fees and commissions, reflecting mainly income from off-balance-sheet activities, including fees and commissions on various types of guarantees and documentary credits. This income amounted to NIS 774 million in 2001, similar to the figure for 2000. (b) Other financing income and expenses—mainly income from the collection of interest on debts previously classified as problem loans, from fees on early repayment of credit, and profit or loss on sales of bonds and from adjustments performed regarding negotiable bonds. Net income from this source totaled NIS 1,011 million in 2001, a rise of 60 percent from its level in 2000.

b. Loan-loss provision

The economic recession in 2001, combined with the security situation and the worldwide crisis in the high-tech industries led to a significant rise in banks' exposure to credit risks (see Chapter 5 for a fuller discussion). The rise in exposure is evident from the marked increase in banks' loan-loss provision, a rise in the balance of problem loans, and a reduction in banks' profitability.

In 2001 the annual loan-loss provision of the five major banking groups totaled NIS 4.4 billion, up from NIS 2.3 billion in 2000, a rise of 86 percent. Most of the rise occurred in the second half of the year, and was the result of the deepening of the economic slowdown, the deterioration in the security situation in Israel and the terrorist attacks of 11 September and their effects on the world economy, particularly on the US and Israel. The communications and computer services industries, construction and real estate, and

⁵ These reflect the effect of activity in derivatives not classified as hedging instruments or ALM, and include commissions on guaranteed intermediation transactions in derivatives.

hotels and catering services were the hardest hit. In the light of these developments, the Supervisor of Banks issued a regulation in September 2001 increasing the loan-loss provision to be made by banks (see Box 3.1).

Box 3.1 **Loan-Loss Provision**

The expense of loan-loss provision affects the value of the assets of banking corporations and their profits. The provision is made when there is a reasonable doubt regarding the collection of a debt, but before the doubt becomes a certainty. The provision is created and written off in two stages: in the first stage a debt is defined as a doubtful debt, and in the second, it is defined as a bad debt. A doubtful debt is one which, after an assessment of the economic situation of the debtor and of the collateral the bank is holding against the debt, the management of the banking corporation decides that there is no reasonable chance that it will be collected. A bad debt is a doubtful debt which, after all efforts have been made to collect it, the management decides has no chance of being collected and so must be written off in the bank's books.

The regulations of the Supervisor of Banks determine that the loan-loss provisions in the banks' financial statements consist of a specific provision, which is the greatest part, a general provision, and an additional provision.

The *specific provision* is calculated from an examination of special customers, according to an internal assessment made by the bank which takes into account several considerations: the debtor's repayment ability, the industry in which he operates, the economic environment, experience, etc.

The other provisions (i.e., the general provision and the additional provision) are intended to cover unexpected and unidentifiable risks, or risks whose magnitude on the balance-sheet date cannot be assessed.

The *general provision*, 1 percent of total indebtedness, was in effect in Israel's banking system until 1991. According to the terms of a regulation issued by the Supervisor of Banks in 1992, instead of the general provision banks now make an additional provision for loan losses; however, they must still maintain the general provision at 1 percent of total indebtedness on 31 December 1991.

The *additional provision* reflects the inherent structural risks in the credit portfolio (and not just its size), and as stated it replaces the general provision which was effective in the past. The additional provision is calculated as a share of exceptional indebtedness as determined in the Supervisor's regulations, defined according to eight risk characteristics: financial information on the borrower, indebtedness of related parties, concentration

by borrower or group of borrowers, problem debts, debts of less developed countries (LDC), concentration by extent of arrears (in the case of housing loans), and extent of involvement in financing purchases of the means of control of corporations.

Against the background of the constant rise in credit risk inherent in banks' activity, and in particular in specific industries that encountered substantial difficulties, and in the wake of the economic developments in Israel in 2001, the Supervisor of Banks issued a regulation regarding a *special loan-loss provision*. According to the regulation, banks had to make a special loan-loss provision in 2001 of not less than 0.15 percent of their risk-weighted assets as at 30 June 2001, 1 percent of the balance of indebtedness under special supervision on that date, and 2.5 percent of the balance of other problem debts on the same date. According to the terms of special regulation, the five major banking groups had to make a provision of about NIS 1,100 million. However, the Supervisor issued a regulation that a banking corporation that had made an exceptional specific loan-loss provision in 2001 (i.e., more than 25 percent greater than its specific provision in 2000) was entitled to ask the Supervisor of Banks for a reduction in its special provision. As a result of the exceptional increase of the specific loan-loss provisions in the five major banking groups, no special provisions were recorded in their published financial statements for 2001.

The exceptional rise in the loan-loss provision in 2001 was reflected in rises in both the additional provision and the specific provision, and was particularly marked in the recent past (Table 3.5).

The specific provision for loan losses was mainly affected by the erosion of the repayment ability of a number of borrowers, against the backdrop of the severe economic slowdown in domestic and foreign markets, the security situation and the difficulties confronting most of the main industries, especially communications, computers, construction and real estate. Moreover, since a banking regulation prevents the banks from recording deferred taxes receivable against the specific provision for loan losses, the banks had an incentive to increase their specific provisions and thereby reduce their tax payments.

The main specific provision and the increase in this category in 2001 in a cross-section by industry occurred in communications and computer services, construction and real estate, and manufacturing (Table 5.6). In communications and computer services the provision increased by about NIS 724 million,⁶ to NIS 750 million, so that the share of the provision for these industries in the total provision surged from 1.1 percent in 2000 to 17.7 percent in 2001. This rise is explained by the worldwide crisis in the

⁶The figures quoted here regarding the specific provision for loan losses include data related to borrowers abroad.

Table 3.5
The Components of Loan-Loss Provision in the Banking Groups, 1999-2001

	(NIS million, December 2001 prices)					
	1999			2000		
	General &	Specific	additional	General &	Specific	additional
Specific provision	additional provision	Total	provision	additional provision	Total	provision
Balance of the provision at the beginning of the year^a	11,612	2,854	14,466	11,849	2,881	14,730
Provion in accounting year	2,838	304	3,142	2,983	208	3,191
Reduction of provision	-676	-302	-978	-585	-199	-784
Collection of debts written off in previous years	-68	-	-68	-62	-	-62
					-77	-77
Amount recorded in Profit and Loss Statements	2,094	2	2,096	2,336	9	2,345
Write-offs	-1,866	-	-1,866	-1,903	-	-1,903
Erosion and adjustment of balances	-129	-	-129	-31	-	-31
Balance of provision at end of year	11,711	2,856	14,567	12,251	2,890	15,141
					14,834	3,001
						17,835

^a The balance at the beginning of 2000 includes a company consolidated for the first time with Bank Hapoalim.

SOURCE: Published financial statements.

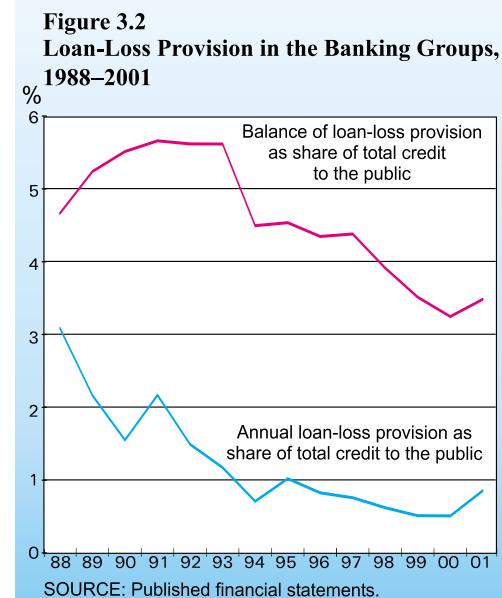
communications industry, especially in the high-tech area, and was also reflected in 2001 by the negative contribution of start-ups to growth, in contrast to their large positive contribution in 2000.⁷

Construction and real estate was another industry for which loan-loss provision increased, as stated. This industry has been facing difficulties for the last five years, expressed in the form of eroding prices and falling demand. As a result of the continuing slowdown in the industry, the specific provision for loan losses in the industry has risen in the last few years, and in 2001 the increase was some NIS 243 million, a rise of about 30 percent from the level in 2000.

The effect of the latest security-related events in Israel and abroad on the hotels and catering services industry was also clearly evident in the decline in the number of visitors to Israel and the number of hotel bed-nights. Despite the low share of credit risk in this industry (about 2 percent), the fall in activity in it has a negative effect both on the companies that operate in the industry, as can be seen from its relatively large contribution to the rise in the specific provision for loan losses (about NIS 131 million, some 7 percent of the increase) and on related industries such as transport, business services and commerce.

The rise in the additional provision, which derived from the increase in the extent of problem debts, also explains part of the rise in the loan-loss provision. Most of the rise of these debts was in non-performing credit and in indebtedness under special supervision, and most of that related to the communications, computer services, construction and real estate industries (see Chapter 5 for a fuller discussion).

The rise in loan-loss provision of the various banks was not uniform, with the most marked being the First International Bank (with a rise of 274 percent) and Bank Leumi (with a rise of 137 percent), due to their exceptional provisions for the problematic industries, mainly the industries mentioned above. The considerable increase in the loan-loss provision significantly raised the ratio of the annual provision to total credit to the public (excluding off-balance-sheet credit), from 0.5 percent in 2000 to 0.85 percent in 2001. This ratio is high when compared to the relatively low ratio in Israel's banking system over the last decade, when credit expanded very rapidly (Figure 3.2). An



⁷ GDP grew by about 6.4 percent in 2000, and without the start-ups it would have been 4.4 percent. In contrast, in 2001 GDP fell by 0.6 percent, whereas excluding the start-ups it would have increased by 0.4 percent.

international comparison shows that whereas in 2000 the ratios of the annual provision to total credit to the public were similar to those in the peer group countries, in 2001 they were higher in Israel, indicating the low quality of credit to the public in Israel's banking system, due to the difficult economic situation (Table 3.3). As in the past, there was great variation between the ratio of loan-loss provision to total credit to the public in the different banking groups, from 0.53 percent in Mizrahi to 1.33 percent in Discount, known for several years for the lower quality of its credit than that in the other banking groups. The rise in the ratio in the First International from 0.27 percent in 2000 to 0.91 percent in 2001 was notable. For the first time since 1996 the share of the balance of the loan-loss provision in total credit rose, from 3.3 percent average in all the banking groups in 2000 to 3.5 percent in 2001 (Figure 3.2), with wide variation between the groups, from 2.1 percent to 5.4 percent.

The macroeconomic developments, reflecting the slowdown in economic activity, the security-related uncertainty and the slump in the capital markets in Israel and worldwide, are expected to continue adversely affecting the activity of companies in different industries, and to increase the level of the loan-loss provisions. Recently, difficulties have been encountered in fully implementing arrangements made in the past with large borrowers and problematic segments^a these difficulties will impair the quality of the banks' credit and will oblige them to maintain a high level of provision for loan losses.

c. Non-interest and other income

Banks' non-interest and other income is affected mainly by the level of economic activity (investment and saving, consumption, foreign trade etc.) that yields an income on the banking services provided for customers, and by activity on the capital market (i.e., customers' activity in securities, underwriting, and distributing securities, managing provident funds and mutual funds, etc.), that yields non-interest income.

In view of the different sources of banks' non-interest income and the different degrees to which they affected income in 2001, as is shown below, a distinction should be drawn between income which derives from charges related to capital market activity and that derived from operating the normal range of banking services.

Against the background of the slump in the capital market, the reduction in the extent of activity in it and the slowdown in economic activity, the commercial banks' non-interest and other income declined by 3 percent to NIS 7.2 billion, after rising rapidly (by 10 percent) in 2000 (Table 3.6).

The non-interest income of the banks from their capital market activity⁸ which accounts for 26 percent of all their non-interest income (Figure 3.3), fell by an average of 14.3 percent after rising by a steep 28.5 percent in 2000. The fall was caused mainly by reduction in the extent of the public's activity in the stock market, which was reflected

⁸ This income divides into income from operational charges (on customers' activities in securities, on custody fees, and from underwriting and distributing securities), and other income (from managing provident funds and mutual funds).

Table 3.6
Non-Interest Income and Operating Expenses, All Commercial Banks, 1999–2001

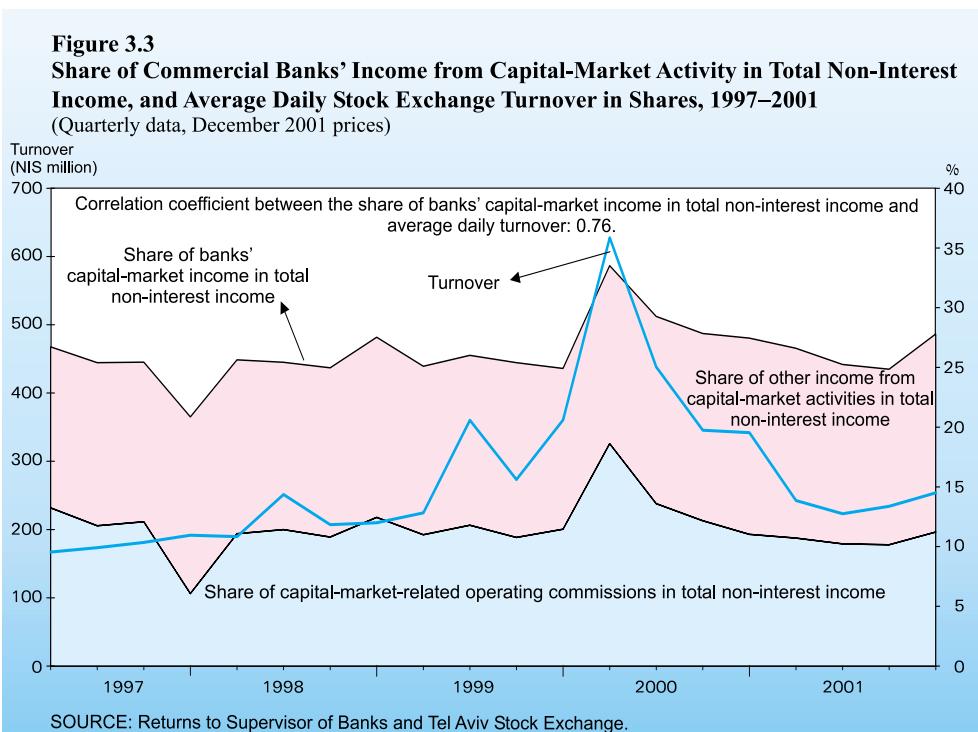
	Amount (NIS million Dec. 2001 prices)			Distribution (%)			Year-on-year change (%)	
	1999	2000	2001	1999	2000	2001	2000	2001
1. Non-interest income								
Fees and commissions from:								
Ledger fees	1,104	1,149	1,180	16.4	15.5	16.4	4.1	2.7
Payment services	1,848	1,949	1,857	27.4	26.2	25.8	5.5	-4.7
Credit cards	270	303	292	4.0	4.1	4.1	12.3	-3.5
Credit services and contracts	440	528	574	6.5	7.1	8.0	20.0	8.9
Computerized services	233	263	274	3.4	3.5	3.8	13.0	4.2
Foreign trade and special services ^a	324	340	324	4.8	4.6	4.5	5.2	-4.9
Securities services ^b	455	635	405	6.7	8.6	5.6	39.6	-36.3
Custody fees	220	309	305	3.3	4.2	4.2	40.5	-1.1
Underwriting and distribution of securities	85	90	52	1.3	1.2	0.7	6.7	-42.3
Other commissions ^c	196	194	188	2.9	2.6	2.6	-0.9	-3.4
Total fees and commissions income	5,172	5,760	5,451	76.7	77.6	75.7	11.4	-5.4
Other income from:								
Provident fees	790	831	806	11.7	11.2	11.2	5.2	-3.1
Mutual fund fees	159	331	315	2.4	4.5	4.4	107.9	-4.8
Related companies								
management fees	147	189	193	2.2	2.5	2.7	28.8	1.7
Profits from severance pay funds	182	0	144	2.7	0.0	2.0	-100.0	
Other ^d	218	234	241	3.2	3.1	3.3	7.2	3.0
Total	1,496	1,585	1,698	22.2	21.3	23.6	6.0	7.1
Income from sale of shares	76	80	55	1.1	1.1	0.8	5.7	-30.7
Total non-interest income	6,744	7,425	7,204	100.0	100.0	100.0	10.1	-3.0

Table 3.6 (continued)

	Amount (NIS million Dec. 2001 prices)			Distribution (%)			Year-on-year change (%)
	1999	2000	2001	1999	2000	2001	
2. Operating expenses							
Salaries and related expenses ^e	8,512	9,374	9,214	65.2	66.5	64.8	10.1
Depreciation of buildings and equipment ^f	758	788	902	5.8	5.6	6.3	4.0
Maintenance of buildings and equipment	1,502	1,478	1,514	11.5	10.5	10.7	-1.6
Other expenses	2,277	2,453	2,581	17.4	17.4	18.2	2.4
Marketing and advertising	275	307	335	2.1	2.2	2.4	5.2
Computer expenses	452	453	501	3.5	3.2	3.5	9.4
Communications	376	375	391	2.9	2.7	2.8	10.6
Insurance and office services	244	234	246	1.9	1.7	1.7	-4.0
Professional services	238	291	321	1.8	2.1	2.3	5.1
Other	692	793	786	5.3	5.6	5.5	10.2
Total operating expenses	13,049	14,094	14,211	100.0	100.0	8.0	-0.8
Operating coverage ratio^g	51.7	52.7	50.7				0.8

^a Including cross rates between selling and buying.^b Including income from financial investments.^c Mainly margin and collection fees received from the Treasury on credit, income from managing estates, and rent on safe-deposit boxes.^d Including profit on realization of assets received in settlement of credit.^e Including payroll taxes, severance pay, benefits, pensions, and national insurance.^f From 2000, "deductions" are included under "other expenses;" the data for 1999 have been adjusted accordingly.^g Ratio of total non-interest income to total operating expenses (percent).

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



by the level of prices on the market, the amount of capital raised, and the turnover. Another element which may account for some of the decline in banks' income from their capital market activity is the reduction over the last few years in the share of activity which customers carry out via the banks and a rise in the share of their activity carried out via other, nonbank members of the stock exchange⁹ (Figure 3.4).

In 2001 share prices fell, following the boom in 1999 which persisted until March 2000. Trade was affected mainly by the deepening recession in the economy, the deterioration in the security situation, and the worldwide collapse of share prices, especially of high-tech shares. Over the year the general share-price index went down by 7 percent, and the Tel Aviv 100 index of leading shares and the MAOF (Tel Aviv 25) index fell by 9 percent. The various indices of yields went hand in hand with a sharp decline in capital raised in the primary market.¹⁰ At the same time the average daily turnover in shares and convertibles thinned out significantly (by about 43 percent), although some recovery was evident at the end of the year.

The developments in the stock market show the lack of interest and involvement by the public in the capital market, as a result of their assessment that the recession in the

⁹ Mainly private brokers.

¹⁰ Capital raised in the domestic primary market (via the issue of shares and rights issues) declined from NIS 5.7 billion in 2000 to NIS 2.8 billion in 2001, and capital raised abroad slumped from \$ 4.4 billion to \$ 1.4 billion.

economy would persist. These developments affected different commercial banks in different ways, according to the extent of their involvement in capital market activity and the width of the range of their sources of non-interest income: the decline in income was less marked in the five major banking groups and more notable in the other commercial banks. This may be because of the concentration in Israel's banking system which obliges the small banks to engage in a reduced range of activities, which includes the capital market. In the large banks the effect of a reduction in one source of income is less pronounced, so that their income declined more slowly. Nevertheless there were significant differences between the changes in their income from their capital market activities: in Hapoalim this income contracted by 6.7 percent, while in Mizrahi, it dropped by 27.3 percent.

Income from fees and commissions on activities unrelated to the capital market, which constitutes 65 percent of banks' total non-interest income,¹¹ remained fairly stable in 2001 (with a dip of 0.8 percent), for two offsetting reasons: (a) a certain reduction in the public's activity with banks—evident from the decline in income from payment-system services—served to reduce this income; the reduction resulted from the sharp fall of 8.4 percent in income from foreign-exchange activity in the light of the recession in Israel and worldwide which led to a contraction of foreign trade (exports shrank by 9.3 percent and imports by 7.2 percent), while income from services in NIS was virtually unchanged (a rise of

Figure 3.4
Banks' Share in Stock Exchange Turnover, 1993–2001

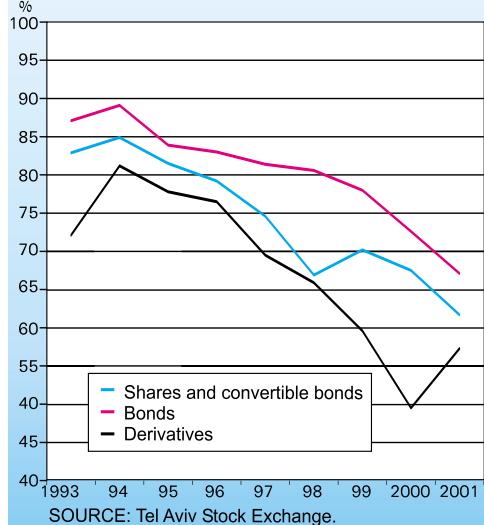
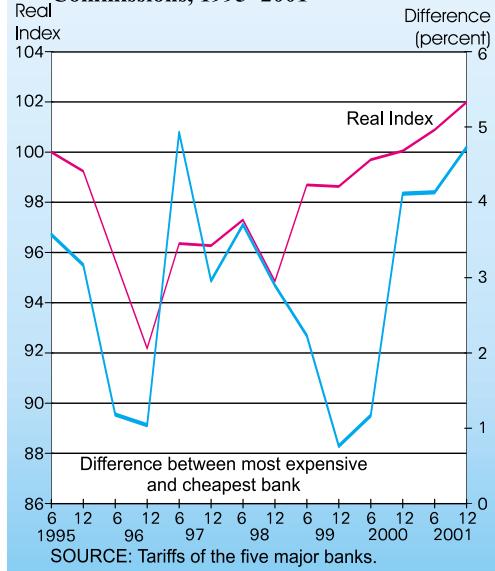


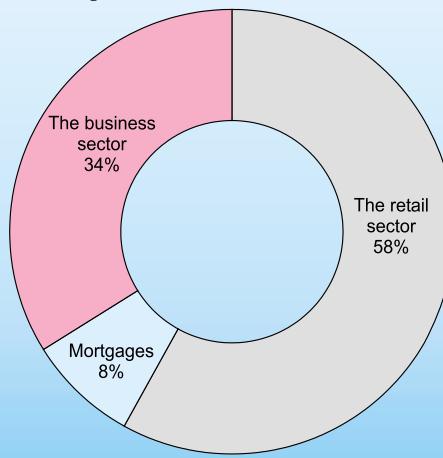
Figure 3.5
Real Index of Tariff of Fees and Commissions, 1995–2001



¹¹ Other non-interest income unrelated to the capital market constitutes about 8 percent of total non-interest income. This includes mainly management fees for related companies and profits from bank staff pension funds.

0.2 percent). The reduction in foreign trade cut the banks' income from foreign-trade-related activity and from services provided in foreign currency by 4.9 percent. (b) The price effect increased non-interest income from activities unrelated to the capital market: the banks updated their tariffs of fees and commissions for various services, which partially explains the 8.9 percent increase in income from handling credit and from drawing up contracts, and the 2.7 percent increase in account-management fees (Table 3.6). The trend of updating charges on services can also be seen from the index of tariff of fees and commissions, which reflects the weighted average fee for the 13 most common services provided for private customers and small businesses, who comprise the majority of banks' customers. A calculation based on data relating to the five major banking groups shows that the index of the tariff of fees and commissions rose by a real 1.9 percent in 2001, continuing its long-term trend. The gap between the indices of the most expensive bank (Hapoalim) and the cheapest bank (Mizrahi) widened in 2001, indicating the increasing differences between charges made for services by the different banks (Figure 3.5). This illustrates that some of the banks take advantage of the relatively low level of competition in the retail banking segment of the market to increase their non-interest income. This finding is consistent with two others which confirm the relatively low level of competition in retail banking: (a) research carried out by the Banking Supervision Department shows that the interest-rate spread related to banks' activities with households is significantly greater than that related to their activities with companies. The spread, defined as the difference between the interest charged on credit and that paid on sources, reached 7.5 percent points at the end of 2001 on activities vis-à-vis households, compared with 3.8 percent on activities with businesses. (b) Viewed from the aspect of the different areas of activity of the banking corporations which reported on the activities of their profit centers (the First International, Mizrahi, Leumi and Hapoalim), it can be seen that the share of households in the profitability of the banking groups far exceeds the share of the business segment. Thus the household segment contributes some 66 percent of the banks' income, while the business segment contributes the balance of 34 percent (Figure 3.6) (see Box 3.2 for a fuller discussion).

Figure 3.6
Contribution of the Different Areas of Activity to the Income of the Banking Groups, 2001



SOURCE: Published financial statements.

Box 3.2

Analysis of performance by area of activity

The banking corporations operate in several areas of activity, with different rates of profitability in each area. The measurement and reporting by area of activity helps external entities (supervisory elements, analysts, etc.) and internal ones to assess the performance of banking corporations. Dividing overall banking activity into separate areas offers additional advantages to management, including the possibility of measuring the extent of activity in a profit center and thus of examining their contribution to the overall profitability of the bank, so that they can allocate resources optimally, and analyze business activity uniformly, simplifying the control of activity and the direction of the bank's branches and business units towards the achievement of management's objectives.

The banking groups¹ divided the sources of their income into several areas of activity, each one of which constitutes a profit center. The report on these areas is based on the banking regulation issued by the Supervisor of Banks on "Reporting on Areas of Activity" published in December 2001. An area of activity is defined as one in which three basic conditions are fulfilled: it covers activities from which the bank is likely to earn income and on which it will incur expenses; the results of activity in the area are examined regularly by management and the board of directors; and there is separate financial information regarding the area of activity.

The main areas of activity are set out below:

Business banking—the provision of financial services for large companies which operate in Israel and abroad.

Commercial banking—the provision of financial services to medium-sized companies.

Retail banking—the provision of total banking services to a variety of private customers, households and small businesses via branches throughout the country and via the existing technological and direct distribution channels.

Private banking—the provision of comprehensive global financial services to private customers, Israelis and nonresidents, who have large financial-asset portfolios.

Mortgages—the provision of housing loans, particularly to households.

Real estate—the provision of financial services to building contractors and financing large projects in construction and real estate.

¹ The annual financial statements of all the banking groups except for Discount contain detailed business results by area of activity; hence the results of the analysis relate only to the other four groups.

Capital-market operations²—activity in provident funds, mutual funds, portfolio management, and investment and underwriting activity in the capital market in Israel and abroad.

Credit cards—the issue of credit cards, and clearing credit-card vouchers for businesses.

Other activity (including adjustments)—income and expenses of a bank which do not derive from its activity vis-à-vis customers (i.e., income from and expenses on the management of active capital, the bank's nostro portfolio, activity vis-à-vis other banks including the central bank, the effect of positions and financial profit centers which the bank uses as market makers, etc.).

As the rules of measuring and reporting are based on specific definitions and measurement policy set by each bank, certain preliminary assumptions had to be made to enable interbank comparisons to be made.³

To take account of the marked differences in the weights of the various banking groups in Israel's banking system,⁴ the banks were divided into two groups based on bank size: medium banks (First International and Mizrahi) and large banks (Leumi and Hapoalim).

An analysis of the financial results of the banking groups by areas of activity shows marked differences in performance between activity areas within banks and also between banks. The main differences are described below.

The household segment is the main focus of profit and income in the various banks, apparently because there is less competition in it than in the other segments. Some 66 percent of banks' interest and non-interest income is derived from the household segment, which itself consists of two sub-segments, retail, which contributed 58 percent of total income in 2001, and mortgages, which contributed 8 percent (Table 3.7).

The contribution of the retail segment both to total income and to ordinary before-tax profit is notably higher in the large banks than in the medium

² Activity in the capital market and in credit cards is part of the activity of the other segments, mainly the retail segment.

³ In order to enable reports of profit centers of different banks to be compared, data of the commercial, business and real estate banking segments were combined and defined as the business segment. In addition, data relating to capital-market, private (including international) and retail activities were also combined into the 'retail' segment. In some analyses data relating to the retail segment and to mortgages were combined into a new segment, called the household segment. As information on the distribution of the data relating to credit cards and capital market activity in Leumi were not available, these were attributed to the retail segment. As data were also unavailable regarding the distribution of 'other activity and adjustments' among the different segments, that category was ignored in the analysis.

⁴ The share of the First International Bank's assets in the total assets of the banking system is 8.5 percent; that of Mizrahi, 9.5 percent; Leumi, 29.6 percent; and Hapoalim, 30.3 percent. Data relating to Discount Bank were not included in the analysis because the report of the profit center in that bank is very incomplete.

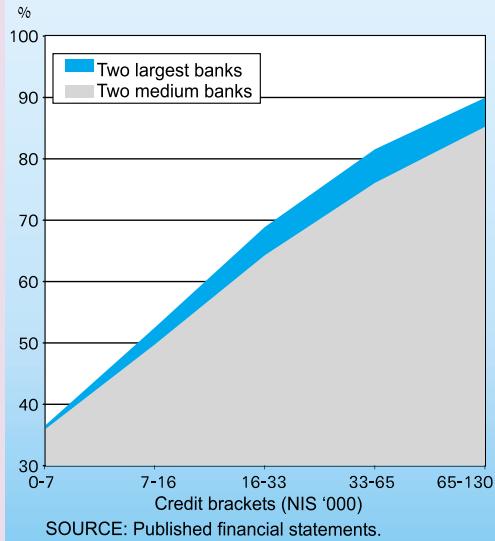
Table 3.7**Performance Indicators by Areas of Activity in the Banking Groups,^a 2001**

	Households	of which:	Business	of which:	Total
		mortgages	sector	construction & real estate	
Large banks					
<i>(Percent)</i>					
Activity mix	36	13	64	11 ^b	100
Contribution to loan-loss provision	26	4	74	13	100
Contribution to total income	69	5	31	4	100
Contribution to before-tax profit	62	14	38	7	100
<i>(Ratios)</i>					
Efficiency ratio	133		302		160
Total income/total assets	7.3		1.8		3.8
Before-tax profit per NIS of assets	1.3		0.5		0.8
Medium-sized banks					
<i>(Percent)</i>					
Activity mix	40	32	60	11	100
Contribution to loan-loss provision	18	12	82	24	100
Contribution to total income	53	20	47	9	100
Contribution to before-tax profit	61	39	39	11	100
<i>(Ratios)</i>					
Efficiency ratio	163		228		189
Total income/total assets	4.8		2.9		3.7
Before-tax profit per NIS of assets	1.5		0.7		1.0
Total					
<i>(Percent)</i>					
Activity mix	37	17	63	11 ^b	100
Contribution to loan-loss provision	25	5	75	16	100
Contribution to total income	66	8	34	5	100
Contribution to before-tax profit	62	21	38	8	100
<i>(Ratios)</i>					
Efficiency ratio	137		277		165
Total income/total assets	6.7		2.0		3.8
Before-tax profit per NIS of assets	1.4		0.5		0.8

^a Medium sized banks: Mizrahi and First International. Large banks: Hapoalim and Leumi.^b Not including data relating to Hapoalim, as that bank did not publish the balance of its assets in construction and real estate in its financial statements.^c The ratio of total non-interest income *plus* net interest income before loan-loss provision to total operating expenses.

SOURCE: Published financial statements.

Figure 3.7
Cumulative Share of the Number of Small Borrowers in the Total Number of Borrowers in the Medium and Large Banks, 2001



ones, apparently due to the relatively high number of small customers and borrowers in the former (Figure 3.7). On the other hand, mortgages make a higher contribution to the profit and income of the medium banks than of the large banks, largely due to Mizrahi's control over 'Tefahot,' Israel's largest mortgage bank.

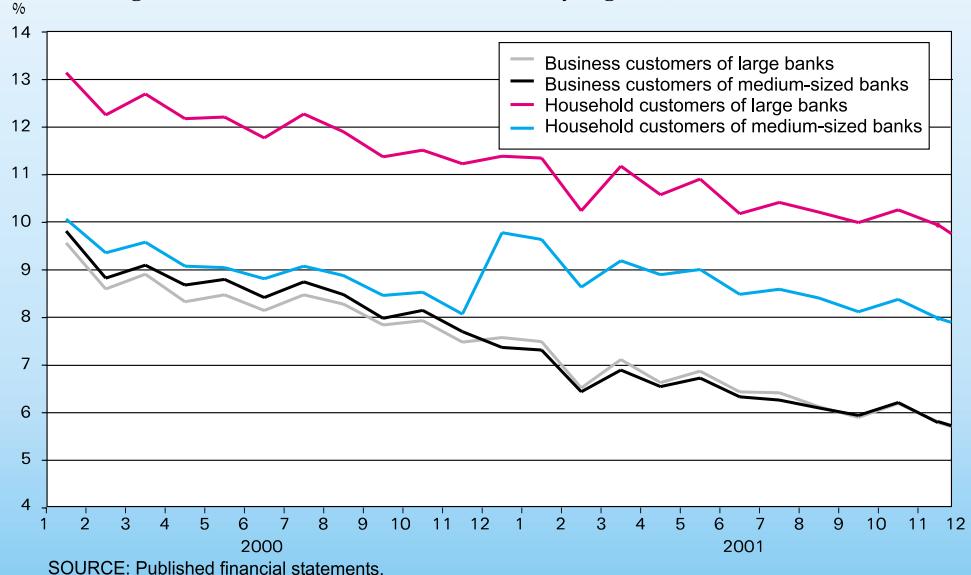
The large profits which banks earn from their activity in the household segment derive from the wide interest margin in the segment (relative to those in the business segment). Thus, the average interest per sheqel of credit to households in the unindexed local-currency segment is considerably higher

than that paid by businesses (Figure 3.8). The interest differentials between the two groups of banks are wider in the household segment than in the business segment. An analysis of before-tax profit per sheqel of assets also shows that banks make 2.8 times as much profit on activity with households as they do on activity in the business segment, with marked differences between the segments in the large banks.

This result can be explained by the increase in competition in Israel's banking system over the last few years, partly due to the entry of foreign banks and representative offices, together with technological progress and deregulation in the financial markets. The competition is most evident in the segment dealing with business customers. In contrast, there is no strong competition for retail customers, due to the absence of alternatives to the banking system as sources of credit or for raising deposits (such as the capital market, provident funds and insurance companies). This is reflected in the wide interest margin in the household segment and the many different bank charges paid by households.

Households account for only a small part of banks' assets, despite their large contribution to the banks' income and profit: most of the banks' assets are concentrated on their activity vis-à-vis business customers (households' assets comprise 37 percent of the banks' total assets, just under half of which,

Figure 3.8
Effective Cost of Credit to Households and to Businesses in the Medium-Sized and Large Banks in the Unindexed Local-Currency Segment, 2000 and 2001



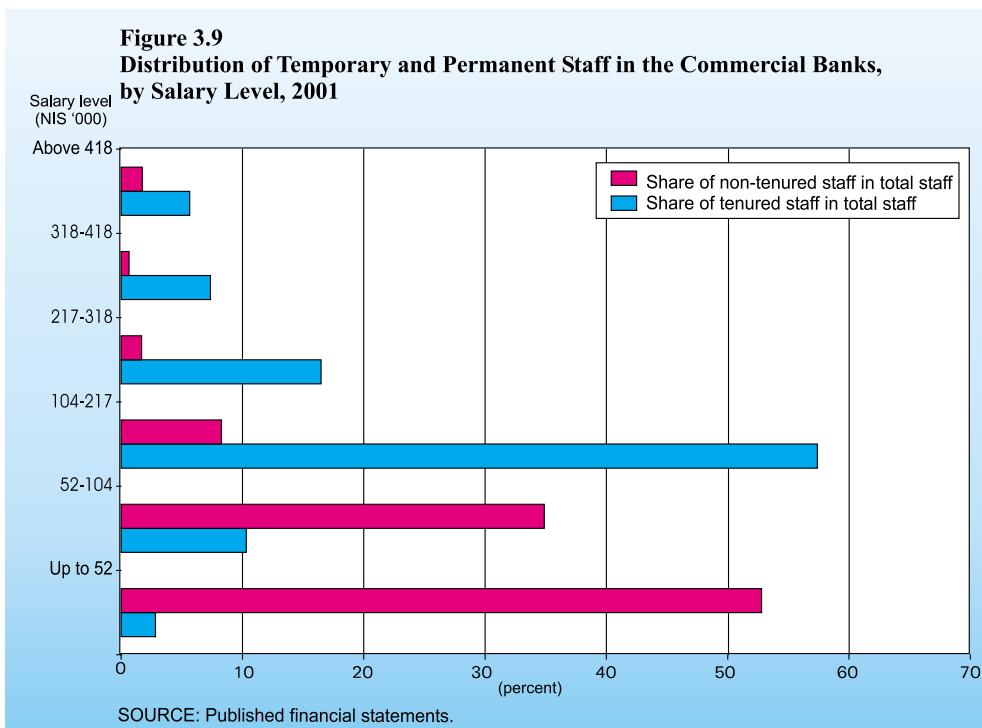
SOURCE: Published financial statements.

i.e., 17 percent of total assets, are mortgages). Moreover, although the banks earn high profits on their activities with households, the risk incurred in this activity is lower than that in the business segment (in other words, credit to households is of better quality than credit to businesses); this is reflected in relatively low contribution of households to the loan-loss provision, with the business segment responsible for a larger contribution, a result obtained in the large and the medium-sized banks (Table 3.7).

d. Operating and other expenses

The banks' operating expenses are affected mainly by the size of banking output and its mix, and the prices of the factors of production (capital and labor). Operating and other expenses showed signs of stability in 2001 after several years of an upward trend, and totaled NIS 14.2 billion, a moderate rise of only 0.8 percent from 2000, when they rose by 8 percent (Table 3.6). At the same time the composition of expenses changed slightly, with labor-related expenses declining by 1.7 percent, after rising by 10.1 percent in 2000, while other operating expenses increased by 5.9 percent. The outcome was that the share of payroll and related expenses in total operating expenses fell to 64.8 percent, with the figure ranging from 60.8 percent in the First International Bank to 69.5 percent in Discount Bank.

The small reduction in labor-related expenses resulted from a 2.8 percent decline in direct salary expenses and stability (a rise of 0.4 percent) in related expenses.



Several opposing forces, tending to offset each other, acted on labor-related expenses. The upward trend in the real wage—which continued because updates of the wage from 1999 to 2001 became real increases as a result of the low inflation level—acted to increase them; expenses on early retirement, which rose by 14.4 percent to NIS 438 million, also acted in the same direction. As part of their efforts to institute cost savings and to become more efficient and to reduce their future labor costs, banks’ continued implementing programs to encourage early retirement among veteran staff members whose salary is relatively high and to replace them with new, lower-paid employees whose professional and academic qualifications are more appropriate to the rising degree of complexity and sophistication of financial services.

Acting in the opposite direction, i.e., tending to reduce labor-related expenses, was the reduction in the bonuses paid to staff, against the background of the erosion of banks’ profitability. The change in the mix of employees working in the banking system explains part of the reduction in payroll and related expenses. The change was expressed in a 1 percent reduction in the number of tenured employees, in contrast to a 6.2 percent rise in the number of non-tenured employees (temporary and hourly workers and pensioners).¹² continuing the long-term rising trend of the number of non-tenured employees in the banking system. An employment policy based on temporary staff affords greater flexibility

¹² These workers are generally employed by manpower agencies; similarly to any other entity employing such workers, banks’ management teams tend to hire and fire them according to changing requirements.

Table 3.8**The Banking System's Expenditure on Employees,^a 1995–2001**

(NIS, December 2001 prices)

Average no. of employee posts ^b	Salaries		Related expenses ^c		Salaries and related expenses	
	Total (NIS million)	Per post ('000)	Total (NIS million)	Per post ('000)	Total (NIS million)	Per post ('000)
1995	34,925	5,068	145	2,413	69	7,482
1996	35,400	5,236	148	2,713	77	7,949
1997	35,595	5,450	153	2,774	78	8,224
1998	35,467	5,512	155	2,730	77	8,243
1999	34,823	5,704	164	2,808	81	8,512
2000	35,020	6,160	176	3,214	92	9,374
2001	35,161	5,988	170	3,226	92	9,214
<i>Year-on-year change (percent)</i>						
1996	1.4	3.3	1.9	12.4	10.9	6.2
1997	0.6	4.1	3.5	2.3	1.7	3.5
1998	-0.4	1.1	1.5	-1.6	-1.2	0.2
1999	-1.8	3.5	5.4	2.8	4.7	3.3
2000	0.6	8.0	7.4	14.5	13.8	10.1
2001	0.4	-2.8	-3.2	0.4	0.0	-1.7
						-2.1

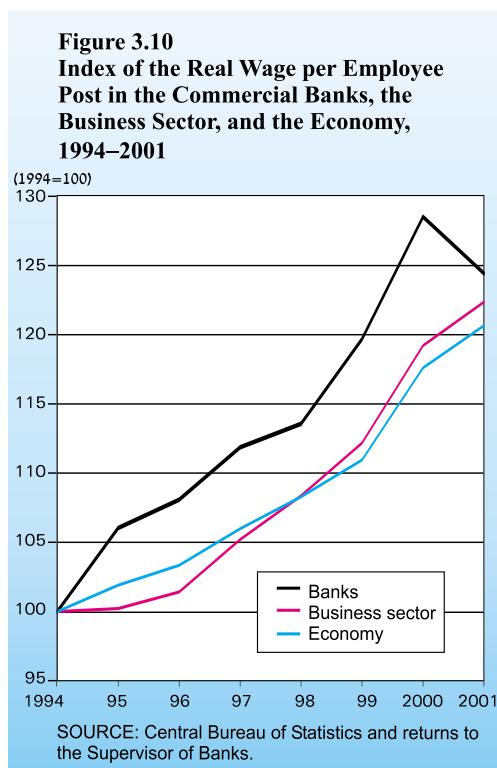
^a Including companies which are owned by the banks and supply them with computer services.^b 12-month average; this number includes established employees, trainees, pensioners, temporary and part-time workers (weighted by share of a post). This also includes overtime: 165 overtime hours are calculated as a post.^c Including national insurance, pension, vacation, compensation, and expenses, and voluntary (early) retirement.

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

to respond to changing public demand for banking services. Apart from this consideration, temporary workers, despite the growth in their number, contribute to the decline in labor-related expenses due to their low salaries (Figure 3.9).

Alongside the decline in salaries and related expenses, the average number of employee posts remained stable in 2001 (a rise of 141 posts, or 0.4 percent). Thus for the first time in a decade the cost per employee post in the commercial banks fell, by 2.1 percent, to NIS 262,000 a year. The reduction was due to a drop in the direct salary cost per employee post, while related expenses per employee post did not change (Table 3.8). Note that the average direct salary cost per employee post in the whole economy rose by 2.5 percent despite the slump in economic activity. It is still higher in banking than in the whole economy, and rose constantly for several years prior to 2001 (Figure 3.10).

As in previous years, there was wide variation between the annual cost per employee post between the large banks, and it ranged from NIS 226,000 in Mizrahi to NIS 282,000 in Leumi. Among the small banks the difference are even more pronounced, with the range extending from NIS 129,000 in Kupat Haoved Haleumi to NIS 334,000 in the Industrial Development Bank.



Among other operating expenses, the rise of 14.4 percent in depreciation and in its share in total operating expenses were notable. In some banks the rise was due to increased depreciation on computers and software arising from the operation of computer programs which had been capitalized in previous years, and to a rise in the rate of depreciation on equipment in several banks. At the same time expenses on building and equipment maintenance also rose by a modest 2.4 percent. Other operating expenses increased by 5.2 percent in 2001, mainly due to a 10.6 percent rise in computer expenses. Expenses of marketing, advertising and professional services also increased.

In the light of the deep recession in the economy and the decline in the level of profitability of the banking system, the effort to cut expenses must be a central feature of the work programs of banks' management in the next few years.

e. Operating indices and efficiency of the commercial banks

The profitability of the banking system is affected inter alia by banks' operating efficiency. In the analysis which follows, the commercial banks are divided into several groups and sub-groups: the seven largest banks, i.e., those whose balance sheets exceed NIS 14 billion, and fourteen small banks. The group of small banks is further divided into two sub-groups, those belonging to banking groups,¹³ and the independent ones.¹⁴ In order to examine the changes in the operating and efficiency indices, a broad cross-section of indices which relate to operating and efficiency aspects of the banks was studied. The indices chosen were: (1) average expenses per unit of output; (2) output per employee; (3) operating coverage ratio; and (4) the ratio of total income (interest and non-interest) to operating expenses, known as the efficiency ratio.

¹³ Otsar Hahayal, Yahav, Massad, and Israel Continental, which are part of the Hapoalim group; Arab Israel, which is part of the Leumi group; and Poalei Agudat Israel, part of the First International.

¹⁴ Industrial Development, Investec (Israel), Maritime, Trade, Euro-Trade, Polska Kasa Opieki (Pekao), Kupat Haoved Haleumi, and Global Investment.

1) Average operating expenses per unit of output

Comparing operating expenses per unit of output of similar sized banks gives an indication of their operating efficiency. The issue of operating efficiency assumed more than normal importance in 2001 due to the sharp decline in banks' profitability.

Owing to the difficulty in defining banking output and the increased share of off-balance-sheet activity in total banking activity in the last few years, value added was chosen as an indicator of output. Value added is defined as ordinary before-tax income, *plus* salaries and related expenses, *plus* depreciation and building and equipment maintenance.¹⁵

The ratio of expenses to value added increased in 2001 in all the seven largest banks, due to the decline in ordinary before-tax profit while expenses remained relatively stable. The rise in the ratio was most marked in Discount Bank, in which it has been rising over the last few years due to losses before tax and the rise in salary-related expenses as a result of the implementation of early retirement programs. A long-term comparison shows that the average expenses/value added ratio in the seven largest banks is slightly lower than that in the smaller banks, because of economies of scale (the result of high fixed costs of operating and management infrastructure). In most of the small banks, and particularly in the independent ones, there was a considerable rise in the expenses/value added ratio in 2001, in contrast to the relative stability in the small banks belonging to banking groups, which have had a relatively low ratio of operating expenses to value added over the last few years, especially in 2001, apparently because they can attribute some of their expenses to their parent bank (Table 3.9)

The extent of the differences between banks' operating efficiency is reflected by the standard deviation of expenses per unit of value added. Among the small independent banks the standard deviation was higher than that among the large banks and the small banks belonging to banking groups, indicating that the former have the potential to improve their efficiency.

The sharp rise in expenses per unit of output which characterized Israel's banking system in 2001 points to the rigidity of the types of activity in which it engages and the banks' difficulty in adjusting the allocation of the factors of production to changes in the macroeconomic and technological environments.

Technological progress obliges the banks to keep investing in complex computer and communications systems and to adapt them to the era of the internet. These infrastructures require heavy financial investments, and are hence available mainly to the large banks. It is thus reasonable to assume that the large banks will derive operating advantages over the small banks, particularly the independent ones. Nevertheless, technological developments, especially those involved in operating direct and online banking services, to great extent reduce the economies of scale which the large banks enjoyed due to the wide spread of their branches, as they make the small banks accessible to the whole population.

¹⁵ According to the value added approach, all banking activity which requires the use of capital and labor, whether on or off the balance sheet, is defined as banking output.

Table 3.9
Ratio of Operating Expenses to Value Added,^a 1992–2001

	Average				Average		Average	
	1992–1996	1997	1998	1999	2000	1997–2000	2001	1992–2001
Hapoalim	0.91	0.81	0.86	0.78	0.76	0.80	0.83	0.86
Leumi	0.85	0.85	0.91	0.78	0.80	0.84	0.99	0.86
Discount	0.96	1.20	1.51	1.13	1.53	1.34	1.98	1.22
Mizrahi	1.02	0.96	1.02	0.93	0.87	0.94	1.03	0.99
First International	0.79	0.80	0.86	0.79	0.76	0.81	0.98	0.81
Union	1.00	1.05	1.05	1.12	0.95	1.04	1.19	1.04
Mercantile Discount	0.90	1.15	1.11	1.06	1.08	1.10	1.22	1.01
Two largest banks	0.87	0.83	0.89	0.78	0.78	0.82	0.90	0.86
Five medium-sized banks	0.93	1.04	1.16	1.00	1.07	1.07	1.33	1.03
<i>Seven largest</i>								
Total	0.90	0.90	0.98	0.86	0.88	0.90	1.03	0.91
Standard deviation	0.08	0.16	0.23	0.16	0.27	0.20	0.38	0.14
Coefficient of variation	0.09	0.18	0.23	0.19	0.31	0.22	0.37	0.15
Industrial Development	0.88	0.97	0.96	0.88	0.82	0.91	2.20	1.02
Investec (Israel)	0.84	0.94	0.89	1.07	0.84	0.94	1.38	0.94
Maritime	1.53	1.63	1.44	1.29	0.83	1.30	0.84	1.37
Trade	1.46	1.28	1.46	1.42	1.45	1.40	2.07	1.50
Euro-Trade	1.61	1.04	1.33	1.65	1.51	1.38	0.99	1.46
Polska Kasa Opieki ^b	1.46	-1.39	5.30	2.75	-0.17	1.62	1.24	1.51
Kupat Haoved Haleumi	1.45	1.51	1.53	1.27	1.23	1.38	1.35	1.41
Global Investment	3.59	4.10	3.20	3.13	7.26	4.42	3.21	3.88
<i>Total small independent banks</i>	1.03	1.24	1.12	1.13	1.22	1.18	1.44	1.13
Standard deviation	0.85	1.49	1.51	0.82	2.30	1.14	0.79	0.93
Coefficient of variation	0.83	1.20	1.34	0.72	1.88	0.97	0.54	0.83
Otsar Hahayal	0.89	0.92	1.02	1.02	1.36	1.08	1.16	0.99
Yahav	0.86	1.03	1.10	1.08	1.04	1.06	1.09	0.96
Arab Israel	0.74	0.61	0.61	0.56	0.53	0.58	0.57	0.66
Poalei Agudat Israel	0.93	0.83	0.81	0.85	0.75	0.81	0.83	0.87
Massad	1.09	1.04	1.06	1.00	1.02	1.03	0.93	1.05
Israel Continental	0.75	0.71	0.78	0.70	0.74	0.73	1.64	0.83
<i>Total small banks belonging to banking groups</i>	0.88	0.87	0.92	0.90	0.97	0.91	0.96	0.90
Standard deviation	0.13	0.17	0.20	0.20	0.29	0.21	0.36	0.14
Coefficient of variation	0.15	0.20	0.21	0.23	0.30	0.23	0.38	0.16
<i>Total small banks</i>								
Total	0.91	0.95	0.96	0.95	1.03	0.97	1.06	0.95
Standard deviation	0.73	1.12	1.25	0.74	1.75	0.94	0.70	0.79
Coefficient of variation	0.81	1.18	1.30	0.78	1.70	0.96	0.66	0.83

^aValue added is defined as net income from ordinary before-tax activities *plus* costs—salaries and related expenses, amortization, and maintenance of buildings and equipment. Data for previous year has been adjusted accordingly.

^b Data for this bank relate to 1993–2001. In 1992 this bank was a foreign corporation, and was therefore not obliged to report to the Supervisor of Banks.

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

Table 3.10
Value Added per Employee Post,^a 1992–2001

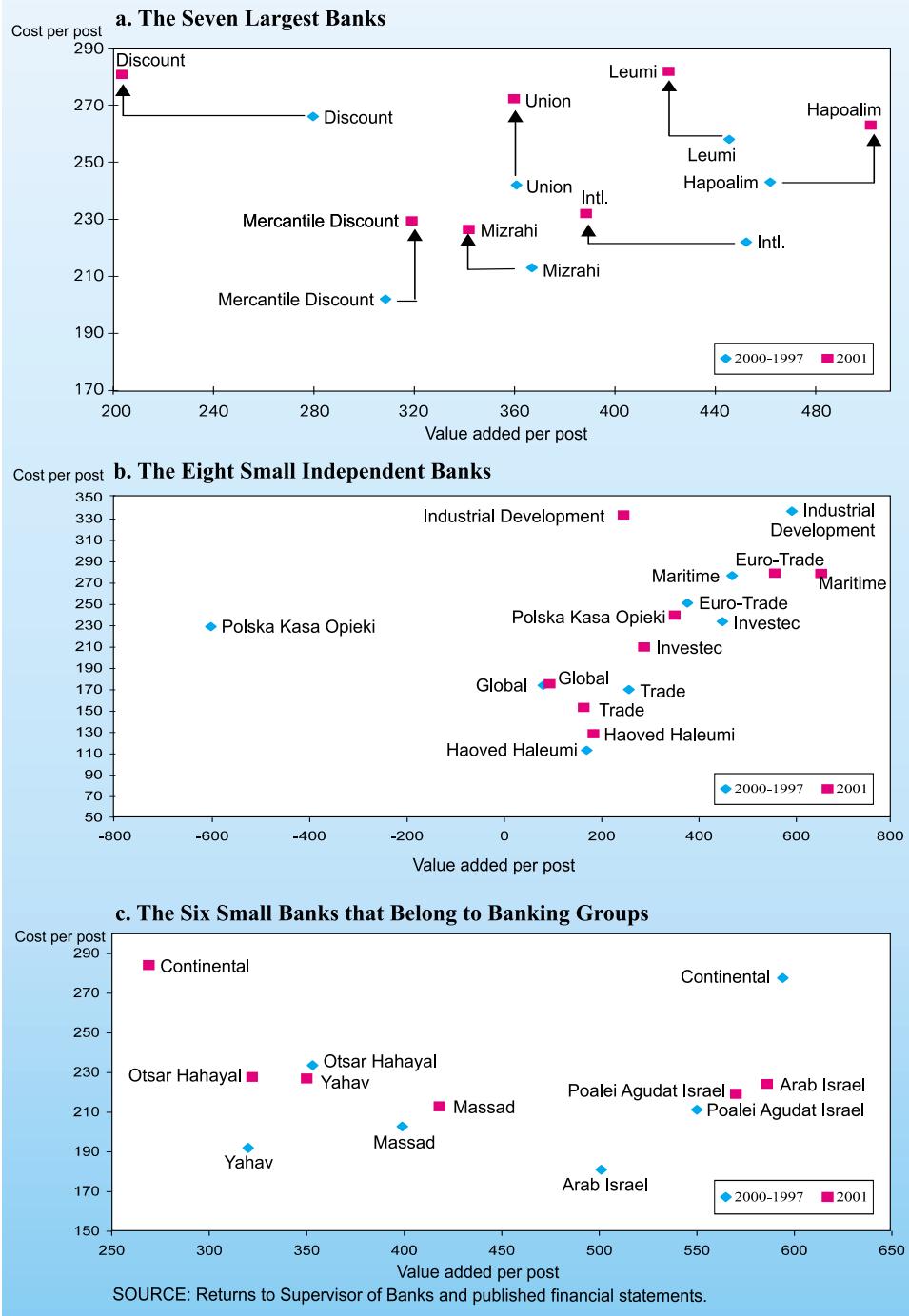
	Average				Average		Average	
	1992–1996	1997	1998	1999	2000	1997–2000	2001	1992–2001
Hapoalim	352	426	425	478	542	468	502	413
Leumi	382	416	383	488	510	449	421	413
Discount	348	313	231	328	262	284	203	308
Mizrahi	315	333	335	384	418	367	342	339
First International	419	419	409	465	524	454	388	430
Union	350	335	350	355	424	366	360	357
Mercantile Discount	355	277	303	328	344	313	319	335
Two largest banks	367	421	404	483	526	459	463	413
Five medium-sized banks	354	335	302	368	365	342	292	343
<i>Seven largest</i>								
Total	362	386	362	435	459	411	392	385
Standard deviation	32	60	67	72	103	73	92	48
Coefficient of variation	0.09	0.16	0.18	0.16	0.22	0.18	0.24	0.12
Industrial Development	559	550	575	593	644	591	245	540
Investec (Israel)	494	394	450	417	533	448	287	455
Maritime	348	300	336	411	826	468	651	426
Trade	231	286	216	260	263	256	163	234
Euro-Trade	104	469	375	320	339	376	556	258
Polska Kasa Opieki ^b	197	–315	80	147	–2,323	–603	350	–141
Kupat Haoved Haleumi	149	148	140	177	210	169	183	160
Global Investment	97	89	98	93	40	80	93	90
<i>Total small independent banks</i>	395	344	385	405	392	381	307	381
Standard deviation	177	272	179	167	998	373	195	213
Coefficient of variation	0.45	0.79	0.47	0.41	2.55	0.98	0.64	0.56
Otsar Hahayal	366	367	344	380	321	353	322	356
Yahav	405	345	288	326	320	320	350	365
Arab Israel	375	452	469	516	568	501	586	447
Poalei Agudat Israel	410	496	514	551	641	550	570	482
Massad	359	384	387	447	378	399	418	381
Israel Continental	482	530	581	616	650	594	269	505
<i>Total small banks belonging to banking groups</i>	382	396	380	419	400	399	395	390
Standard deviation	45	75	110	109	157	112	132	64
Coefficient of variation	0.12	0.19	0.29	0.26	0.39	0.28	0.33	0.16
<i>Total small banks</i>								
Total	386	384	381	416	398	395	374	388
Standard deviation	148	227	166	165	769	306	174	183
Coefficient of variation	0.38	0.59	0.44	0.40	1.93	0.78	0.46	0.47

^a Value added is defined as net income from ordinary before-tax activities *plus* costs—salaries and related expenses, amortization, and maintenance of buildings and equipment. Data for previous year has been adjusted accordingly.

^b Data for this bank relate to 1993–2001. In 1992 this bank was a foreign corporation, and was therefore not obliged to report to the Supervisor of Banks.

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

Figure 3.11
Cost per Employee Post vis-a-vis Added Value per Employee Post, 1997–2000
Average compared with 2001
(NIS thousand, December 2001 prices)



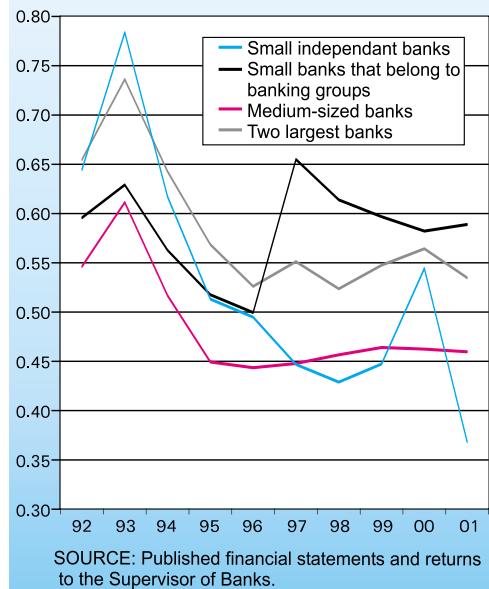
2) Output per employee

Output per employee is measured by the value added per employee post, and it serves as an index of the staff's average productivity. In the last few years banks have emphasized a closer relation between the level of pay and the bank's profitability in general, and the employees' average productivity in particular. It is quite normal to compare output per employee with the cost of employment per employee over time. Table 3.10 and Figure 3.11 show the data for 2001 vis-à-vis the average for 1997–2000. Although a positive long-term correlation between the two ratios would be expected, output per employee declined steeply in 2001 in each of the seven large banks, with no matching fall in the cost per employee post. This indicates the difficulty which the banking system has in adapting its staffing level to changes in the macroeconomic and technological environments. It shows that the banks' efforts to improve their efficiency, for example their early retirement programs, have not yet yielded results as far as productivity and output per employee are concerned. The longer-term (1997–2000 compared to 2001) cross-sectional comparison between the seven large banks highlights the steep decline in the value added per employee post in the First International and Discount, with a relatively modest rise in Hapoalim and Mercantile Discount. As far as the small banks are concerned, no generalizations can be made: in most of them (Maritime, Euro-Trade, Polska Kasa Opieki (Pekao), Kupat Haoved Haleumi, Global Investment, Yahav, Arab Israel, Poalei Agudat Israel and Massad) output per employee rose; in others (Industrial Development, Investec (Israel), Trade, Otsar Hahayal and Israel Continental) it fell. Furthermore, in all the small banks apart from Israel Continental cost per employee post and value added per post moved in the same direction (Figure 3.11).

3) Operating coverage ratio

The average ratio of coverage of operating expenses by non-interest income in the commercial banks went down from 52.7 percent in 2000 to 50.7 percent, as a result of a decline in non-interest income alongside relative stability of operating expenses. An international comparison shows that the ratio is slightly lower in Israel than the norm in comparable western countries (Table 3.3). As in the past, in 2001 there was wide variation around the average among the seven large banks; for example, the coverage ratio in Union Bank was 36 percent, and in the First International Bank, 58 percent. Among the

Figure 3.12
The Operating Coverage Ratio, 1992–2001



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

Table 3.11
Coverage and Efficiency Ratios, 2000–2001

	2000			2001		
	Interest ratio ^a	Coverage ratio ^b	Efficiency ratio ^c	Interest ratio ^a	Coverage ratio ^b	Efficiency ratio ^c
Hapoalim	1.06	0.58	1.64	1.09	0.56	1.65
Leumi	1.00	0.55	1.55	1.02	0.51	1.52
Discount	0.67	0.40	1.07	0.56	0.43	0.99
Mizrahi	0.91	0.51	1.43	0.85	0.48	1.33
First International	0.99	0.59	1.57	1.02	0.58	1.60
Union	1.01	0.40	1.41	0.98	0.36	1.33
Mercantile-Discount	0.85	0.43	1.28	0.83	0.43	1.27
Seven largest banks	0.95	0.52	1.47	0.94	0.50	1.45
Small independent banks	0.96	0.54	1.50	1.16	0.37	1.53
Small banks that belong to banking groups	0.80	0.58	1.38	0.87	0.59	1.46
Total small banks	0.84	0.57	1.41	0.95	0.53	1.48

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

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

^c The efficiency ratio is calculated as the ratio of total non-interest income and net interest income to total operating expenses. It is sometimes calculated as the ratio of total operating and other expenses to total income.

SOURCE: Published financial statements.

small banks, the high ratio in those belonging to a banking group, which have relatively low operating expenses, was quite marked, and was due among other things to the use they made of the parent bank's operating services (Table 3.11 and Figure 3.12). An analysis over the long term shows that in general the coverage ratio rises at times of a boom on the stock exchange, as a result of the large non-interest income related to capital market activity, and falls in a slump. This explains the general downward trend evident since 1993 (Figure 3.12), a trend which was most prominent in the small independent banks, mainly because of the sharp decline in the coverage ratio in Investec (Israel) and the Maritime Bank, which specialize in capital market activity.

4) The efficiency ratio

The ratio of total income (interest and non-interest) to operating expenses reflects a bank's ability to allocate its factors of production (capital and labor) efficiently to its various areas of activity in order to maximize its income (a high ratio indicates highly efficient allocation of factors of production). In 2001 the efficiency ratio of the commercial banks declined somewhat, from 1.47 to 1.45, the outcome of a sharp fall in non-interest

income which was not fully covered for by a rise in interest income. An international comparison shows that the efficiency ratio in Israel is close to the average in the peer group (Table 3.3). Furthermore, the differences between the development of the ratio in the various banks are striking: the ratio in the large banks is generally higher than that in the small banks, mainly due to the higher net interest income in the large banks. The large banks also showed some variation among themselves (Table 3.11): thus, in Discount the ratio came to 0.99, while in Hapoalim it was 1.65. Among small banks, the efficiency ratio has been higher among the independent banks than among those belonging to banking groups in 2000 and 2001, mainly due to the sharp rise of 39 percent in the net interest income of the Industrial Development Bank, before loan-loss provision; the rise was mainly due to the increase in credit in the unindexed segment, the segment with the highest net interest margin. Excluding the data relating to that bank, the efficiency ratio was higher among the small banks owned by banking groups.

f. Other factors affecting banks' profitability in 2001

The banks' profits in the last few years were greatly affected by the financial results of their subsidiaries included under the equity method, and by nonrecurring activities of the banking groups which led to extraordinary profits or losses.

Companies included under the equity method are those in which the bank has invested and the investment is included in the bank's financial statements on the basis of its current balance-sheet value.¹⁶ These companies usually fit into one of two main categories: those that engage in financial activities (banks, insurance companies, and other holding and investment companies), and real companies whose activities are essentially different from those of the first group (see Chapter 4 for a fuller discussion).

In 2001 the financial results of the companies included under the equity method had a substantial effect on the profits of the different banking groups: losses of NIS 178 million were recorded in the five major banking groups due to the results of these companies, compared with profit of NIS 382 million in 2000 (Table 3.2). The greatest fall in the contribution of these companies to the profits of the parent banking groups occurred in the two largest banks: Hapoalim incurred losses of NIS 275 million, mainly because of its holdings in Koor Industries which suffered losses in its subsidiary ECI Telecom as a result of the crisis in high-tech industries; in Leumi, although it made a profit of some NIS 52 million on its holdings in companies included under the equity method, this was NIS 115 million below their contribution in 2000. This reduction was due to losses on the investment in the Israel Corporation, and the sharp decline in the profit of Shore Capital, a subsidiary of Bank Leumi (U.K.). In Discount, too, profits from companies included under the equity method fell, by about NIS 20 million, due mainly to the drop

¹⁶ In this method the cost of the investment is recorded inclusive of the share of the parent company in the profit of the subsidiary, or minus its share of the losses, or taking into account other changes in the equity of the subsidiary since the investment.

in the contribution and the profit of the First International, in which Discount has a 26.5 percent holding. In the other two of the five large banking groups the profit of companies included under the equity method also fell, but less significantly.

Extraordinary profits, which include income and expenses of substantial sums of money deriving from activities or events of a different nature from that of the banking corporation's normal activities. This item includes among other things profit or loss from activities which the bank no longer undertakes, provisions for expected profit or loss on assets which the bank's management has decided to sell (buildings, land etc.).

In 2001 the sharp drop in extraordinary profit had a marked effect on the profit and profitability of some of the banking groups. In 2000 the five major groups recorded extraordinary profit of NIS 353 million, which was 9.2 percent of their net profit for the year, whereas in 2001 this became a loss of NIS 11 million due to nonrecurring activities and effects (Table 3.2), but their contribution to reduced profitability was most prominent in Leumi and the First International. In Leumi extraordinary profit after tax totaled about NIS 1 million, compared with NIS 341 million in 2000. The profit in 2000 derived largely from the sale of its holdings in Koor Industries for NIS 190 million, and in CAL (Cartisei Ashrai LeIsrael—Israel Credit Cards) for NIS 149 million. Extraordinary profit in the First International in 2000 amounted to NIS 54 million, most of which derived from the sale of the operational infrastructure of the Alpha Card to Leumi Card, and from the transfer of the operation of Alpha Card credit cards to Visa CAL, profits which were not repeated in 2001. At the same time Hapoalim recorded losses of NIS 15 million most of which derived from the provision for the decline in value of some of the bank's shares in Koor Industries.¹⁷

As in past years, the difference between the known price index and the index used 'in lieu' again acted to increase the profit of the banking groups. In 2001 the increase was NIS 39 million, compared with NIS 66 million in 2000.

g. Provision for tax

The provision for tax in the five major banking groups was NIS 2,183 million in 2001, down from NIS 2,928 million in 2000, a reduction of 25.4 percent (Table 3.12), due mainly to the drop in before-tax profit. Concomitantly the effective rate of tax on before-tax profit went up from 47.7 percent in 2000 to 49.3 percent in 2001, higher than the statutory tax rate of 45.3 percent¹⁸ applicable to banking corporations. One of the main

¹⁷ Hapoalim has an excess holding (i.e., exceeding 20 percent) in Koor Industries resulting from the purchase by Koor of its own shares. Due to the part which the bank must sell because of its excess holding, a provision for loss of value was recorded, which is attributed to the 'extraordinary losses' item.

¹⁸ The calculation is: $T = \{t_1 + t_2 / (1 + t_1) * (1 - t_1)\} * 100$, where T is the statutory tax rate, t_1 is the corporation tax rate in Israel (36 percent), and t_2 is the VAT rate (17 percent in 2001). The calculation gives the statutory tax rate as 45.3 percent. As part of the economic program in effect since the middle of 2002, VAT was increased by one percentage point, as a result of which the statutory tax rate on banking corporations went up by half a percentage point.

Table 3.12

The Transition from a Statutory Tax Rate to Provision for Tax on Income in Profit and Loss Statement of the Major Banking Groups, 2000 and 2001

	(at December 2001 prices)			
	Total tax (NIS million)		Tax rate on ordinary pre-tax profit (%)	
	2000	2001	2000	2001
Statutory tax	2,780	2,005	45.3	45.3
Tax on income from subsidiaries abroad	8	−272	0.1	−6.1
General provision and additional loan-loss provision	−4	17	−0.1	0.4
Tax-exempt and tax-reduced income	−34	−26	−0.6	−0.6
Depreciation differentials, and adjustment of depreciation and capital gains	19	16	0.3	0.4
Other expenses not recognized for tax purposes (fines and excess expenses)	59	66	1.0	1.5
Timing differences for which no deferred tax was recorded	156	423	2.5	9.6
Payroll tax	95	80	1.5	1.8
Tax for previous years ^a	−80	−64	−1.3	−1.4
Tax on income from subsidiaries in Israel	−76	−70	−1.2	−1.6
Other expenses ^b	5	8	0.1	0.2
Provision for taxes on income	2,928	2,183	47.7	49.3

^a Including an extra amount for problem debts.

^b Including erosion of tax advances and financial assets adjustment differentials, net.

SOURCE: Published financial statements.

causes of the rise in the tax rate was the timing differences for which no deferred taxes were recorded; this raised the effective tax rate by 9.6 percentage points, mostly in Bank Discount, in view of the fact that no improvement in its financial results are expected in the foreseeable future. About 1.8 percentage points of the rise in the effective tax rate was due to the increase in profit tax paid on the payroll tax imposed on banking corporations, which is not recognized as an expense.

On the other hand, the real depreciation of the NIS against the major world currencies led to a rise in the value of the investments in subsidiaries abroad (due to positive exchange-rate differentials which are not part of the basis of income for tax purposes), and thus reduced the provision for tax in 2001 by 6.1 percentage points, in contrast to the effect of the real appreciation against those currencies in 2000. The reduction in the provision for tax was also partly due to income from tax for previous years with the issue of final assessments for some of the banks and their subsidiaries.

Note that the effect of the factors acting to increase tax was far stronger than the effect of those factors leading to a saving of tax payments, hence the increase in the effective tax rate.

Several changes in legislation were introduced in 2001 as a result of the steep reduction in the rates of inflation, and these are likely to affect the financial results of the banking corporations in the future and their provisions for tax:

In October 2001 Accounting Standard No. 12 became effective. This puts an end to the inflation-adjustment of financial statements from 1 January 2003. Until then banks will continue to present their statements adjusted for inflation in accordance with the regulations of the Supervisor of Banks and based on the rules of the Institute of Certified Public Accountants in Israel.

In November 2001 the Knesset passed the Income Tax (Adjustments for Inflation) Law, which empowers the Minister of Finance, authorized by the Knesset Finance Committee, to issue an Order determining that the provisions of the Adjustments for Inflation Law shall not apply in a year when the rise in the Consumer Price Index is less than 3 percent. As the Finance Committee did not authorize the Order, the Adjustments for Inflation Law applied in full in 2001.

3. THE RETURN ON EQUITY

As the result of the sharp reduction in the profits of the banking groups, the average return on equity (ROE) went down to 5.9 percent. This is considerably below the profitability achieved in 2000 and below the levels since 1997, and is close to the level at the beginning of the 1990s.

As in previous years, profitability varies between the banking groups, from a negative 3.9 percent in Discount to 8.5 percent in Mizrahi. ROE is a function of the groups' profit and equity, which includes their capital and the rights of minority shareholders. The equity of the groups reached NIS 38.2 billion at the end of 2001, up from NIS 36.5 billion at the end of 2000 (Table 3.1). The rise in equity was due to the accrual of net profit of the groups (apart from Discount) to their capital during 2001. In the last few years, as the groups' profits rose, so did the dividends they distributed to their shareholders, which served to restrict the growth of their equity. In 2001, due to the decline in profitability, the slowdown in economic activity and the slump in the money and capital markets, the banks decided not to recommend the payment of dividends.

In the light of the continued recession and the uncertainty caused by the security-related situation, the relatively low levels of ROE in Israel's banking system may be expected to persist. Moreover, the potential for the expansion of banking activity (mainly of the credit portfolio) is lower than it was, because the low risk-weighted capital ratio—which in some banks is only marginally above the minimum requirement of 9 percent—prevents the expansion of the risk components unless the capital base rises accordingly.